

**ACCOUNTANT'S ROLE IN BANKRUPTCY
AND BANKRUPTCY-RELATED TAX ISSUES**

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OVERVIEW OF BANKRUPTCY

Chapter 7

- Individual or corporate liquidation
- Non-exempt assets are liquidated by Chapter 7 trustee and proceeds distributed to creditors.
- Individual debtor required to continue making payments to secured creditors during bankruptcy proceeding if Debtor retains collateral i.e. house or car.
- Individual debtor receives discharge of debt except for certain tax debts; no discharge for corporations.

Chapter 11

- Individual or corporate reorganization or liquidation
- Absent fraud, Debtor retains control of assets and proposes plan to reorganize or liquidate assets.
- Debtor may sell assets under §363 prior to confirmation.
- Chapter 11 plan must make appropriate provisions for payment of tax debt.
- Debts, including tax debts, discharged in corporate reorganization upon completion of plan.
- Debts are not discharged in corporate liquidation.

Chapter 12

- Available only to family farmer or family fisherman with regular annual income who seeks to reorganize debts
- Similar plan payments as Chapter 13 debtor
- All tax debts “provided for in the plan” and paid pursuant to the plan are discharged upon completion of the plan.

Chapter 13

- Reorganization available only to individual debtors with less than \$336,900 in unsecured and \$1,010,650 in secured debt
- Debtor must pay disposable income (usually ¼ net income) to Chapter 13 trustee who in turn distributes money to creditors over period of 3 to 5 years
- Secured creditors entitled to receive monthly payments equal to value of collateral, together with interest
- House mortgages generally cannot be modified
- At end of plan, remaining unpaid unsecured debt is discharged.

Chapter 15

- Cross-border insolvency
- Company bankruptcy proceedings filed outside of US which impact US creditors or US assets
- May involve reorganization or liquidation

The Accountant's Role in Bankruptcy

Chapter 7 - Accountant for Trustee

Chapter 11

- Debtor-in-Possession
- Operating Trustee, if Trustee appointed
- Creditors' Committee
- Secured creditors
- Examiner
- Operating Trustee
- Expert witness

The Accountant's Engagement, Work and Fees

- Approval by the Bankruptcy Court - usually Chapter 11 reorganization cases
- Applications filed and approved by Court prior to commencement of work i.e. tax returns, tax audits, etc
- All applications should be supported by an engagement letter from the accountant, signed by the client, with specific engagement objectives, tasks and staffing.

- Work must be performed according to GAAP
- Unless previously approved by the Court, billing statements must be submitted to the court for approval prior to payment.
- Some courts allow for monthly payment of billing statements, others require quarterly payment and some permit fixed fees for certain types of work ie. tax returns
- Some courts, such as the Middle District of North Carolina, restrict fees to customary rates of other accountants in the district.

Use of Accountant in Bankruptcy

- Filing of tax returns – Chapter 7 or 11
- Filing of monthly reports in a Chapter 11 case
- Disputes with secured creditors
- Cash collateral litigation.
 - Adequate protection hearings
 - Post-petition financing
- Fraudulent transfer litigation
- Valuation
- Preference litigation
- Solvency versus insolvency
 - New value
 - Ordinary course of business
 - Preference equal to liquidation dividend using present value
- Liquidation analysis
- Reorganization Plan Disputes
- Monthly financial reporting
 - Projections and analysis
 - Sales forecasts and income statement projections
 - Projected balance sheets
 - Forecasting methods

- Financial aspects of the Plan of Reorganization
 - Valuation disputes
 - Feasibility of Plan of Reorganization

The Accountant/Consultant as Expert Witness

- Expert witness is a witness who is qualified to give expert testimony if the Judge finds that to proceed, know or understand the matters about which the witness will testify requires special knowledge, experience, skill and/or training and that the witness has these attributes.
- The purpose of an expert accounting witness is to take something complex and make it incomprehensible!!!
- Bankruptcy attorneys when selecting an expert accounting witness usually select the person rather than the firm.
- If an accountant is subpoenaed, it is likely that a request will be made for production of the following documents:
 - a. Engagement letters.
 - b. Managements letters and drafts.
 - c. Work papers and permanent file financial statements.
 - d. Drafts.
 - e. Published financial statements (both book and tax basis).
 - f. Debtor's business plans and projections given to accountants and bankers.
 - g. Tax work papers.
 - h. Management consulting work papers.
 - i. Correspondence files.
 - j. Time sheets, including detailed description of charges and services rendered.
 - k. Property tax returns and insurance policies.
 - l. Media that is either not in hard copy form when subpoenaed or is on a different basis/alternative analysis

[NOTE: There is no federal client-privilege defense in refusal to produce by the subpoenaed accountant. Reference should be made to available state statutes.]

BASIC TAX ASPECTS OF BANKRUPTCIES

Tax Aspects of Bankruptcy Proceedings Filed by Individuals

- Separate taxable entity created.

- Separate taxable entities are created in Chapter 7 or 11 proceedings
- No separate taxable entity created in Chapter 13 proceeding
- The tax liability of the bankruptcy estate is computed using the rate schedule for a "married individual filing a separate return claiming the standard deduction."
- The bankruptcy estate must file a Form 1041 as a transmittal form, with Form 1040 attached as a schedule
- The return should be filed if gross income is greater than the standard deduction for that tax year
- An S Corporation in which an individual is the shareholder does not lose its status even though a separate taxable entity is created when an individual files Chapter 7 or 11

Income and deductions of the bankruptcy estate

- Gross income of the estate includes gross income to which the estate is entitled under the Bankruptcy Code and all income received or approved by the estate
- Bankruptcy estate excludes income received or accrued by the debtor before the commencement of the case
- Administrative expenses allowed under § 503 of the Bankruptcy Code and any fees or charges are deductible expenses of the estate
- Any administrative expense not used in the current year may be carried back three (3) years and carried forward seven (7) years
- The amount carried to another taxable year may be used only after the exhaustion of a net operating loss
- The estate succeeds to the following income tax attributes of the debtor:
 - Net operating loss carry-overs
 - Charitable contribution carry-overs
 - Any recovery exclusion under IRC § 111 (relating to recovery of bad debts, prior taxes and delinquency amounts)
 - Credit carry-overs
 - Capital loss carry-overs
 - The basis, holding period and character of the asset acquired by the estate from the debtor
 - Other tax attributes to the extent provided in the tax regulations

- Tax attributes fixed as of the first day of the debtor's taxable year in which the bankruptcy case commences
- If the debtor elects to terminate his taxable year under IRC § 1398(d)(2) at the commencement of bankruptcy, the date the petition is filed becomes the first date of the debtor's taxable year in which the case commences and the tax attributes of the debtor will be determined as of the debtor's taxable year ending the day before the date the petition is filed
- If the debtor does not elect to end his taxable year upon filing, the debtor's tax attributes are determined as of the end of the debtor's last taxable year ending prior to the petition date.
- The transfer of assets from the estate to the debtor at the termination of the case (other than by sale or exchange) is not treated as a disposition for the purposes of any provision of the Tax Code assigning tax consequences to a disposition, and the debtor is treated as the estate would be treated with respect to the assets distributed from the estate. See Rev. Rul. 90-25, 1991 C.B. 10.
- Since the estate is a separate taxable entity, a new taxpayer identification number is required
- A federal income tax return (Form 1041 U.S. Fiduciary Income Tax Return) is required if the estate's gross income for the taxable year equals or exceeds the exempt amount plus the standard deduction. IRC § 6012(a)(9).

Income and Deductions of the Debtor

- The transfer of assets from the debtor to the estate at the beginning of the case is not treated as a disposition for the purposes of any provision of the Tax Code; bankruptcy estate is treated as the debtor would be treated with respect to the aspects of the estate
- IRC § 1398 specifically provides that gross income for the debtor does not include any amount to the extent that the income is included in the gross income of the estate under IRC § 108(e)(1).
- Abandonment of property by the estate is not a taxable event; abandonment may have the affect of shifting any gains resulting from foreclosure or sale of the property from the estate to the debtor
- At the conclusion of the bankruptcy case, the assets, including all tax attributes from the estate, are transferred back to the debtor

- Such tax attributes may include NOLs, charitable contribution carry-overs, recovery of tax benefit items, credit carry-overs, capital loss carry-overs, the basis, holding period and character of assets, method of accounting etc

Tax Aspects of Bankruptcy Proceedings Filed by the Corporation

- No separate taxable entity is created even though a separate estate is created by the filing of a corporation for bankruptcy under either Chapter 7 or 11
- Because no separate taxable entity is created, issues regarding the transfer of assets or tax attributes between the entities do not materialize
- Corporate debtor continues to use all of the attributes of the pre-petition corporate entity, as well as the same taxpayer identification number
- Tax returns are filed in the same manner and at the same time as they were prior to the bankruptcy petition

Tax Liability of the Bankruptcy Estate

- To the extent that tax liability of the bankruptcy estate cannot be paid from available assets of the bankruptcy estate, the tax liability does not become a burden to the bankrupt individual. It is the responsibility of the trustee or debtor-in-possession of the bankruptcy estate to see that such taxes are paid.
- Section 554 of the Bankruptcy Code allows a trustee or debtor-in-possession, after notice and hearing, to abandon any property of the estate that is burdensome to the estate or that is of "inconsequential value" to the estate. Thus, an individual holding a "burned out" tax shelter or highly appreciated but equally mortgaged asset may have to deal with the built-in tax burden, even if triggered after the filing of the Chapter 7 proceeding, if the trustee abandons the asset back to the individual.

Determination in Bankruptcy of the Amount of Taxes Incurred During Bankruptcy Proceeding

- Section 505(b) of the Bankruptcy Code provides that a trustee may request a determination of any unpaid liability of the estate for any tax incurred during the administration of the case by submitting a tax return and a request for such determination to the governmental unit charged with responsibility for collection and determination of such tax.
- Section 1146(b) of the Bankruptcy Code also permits the proponent of a Chapter 11 plan of reorganization to "request a determination, limited to questions of law, by a state or local governmental unit charged with the responsibility for collection or

determination of a tax on or measured by income, of the tax effects, under § 346 of this Title and under the law imposing such tax, of the plan."

- Absent fraud or material misrepresentations, the trustee, the debtor and any successor to the debtor are discharged from any liability for such tax:
 - Upon payment of the tax shown on return, if such governmental unit does not notify the trustee that such return has been selected for examination within sixty (60) days after the request, or that unit does not complete such an examination and notify the trustee of any tax due, within 180 days after the request or within such an additional time as the court, for cause, permits.
 - Upon payment of the tax determined by the court, after notice and hearing and after completing by such governmental unit of the examination of return.
 - Upon payment of the tax determined by such governmental unit to be due.

Tax planning review

Tax planning review is necessitated by the inherent gain or loss associated with non-exempt properties the debtor may be holding

If the debtor will experience a gain on disposition of certain properties, either because of forgiveness of the indebtedness income or IRC § 1101 gain and has tax attributes such as NOL carryforwards, then those gains should be triggered, if at all possible, pre-petition

The review process should include a calculation of alternative minimum tax, which may result even if significant NOL carryforwards are present.

Other Methods of Fixing Tax Plans

Pursuant to § 362(a) of the Bankruptcy Code, the filing of a bankruptcy petition automatically stays creditor actions, including claims by the Internal Revenue Service. Upon a showing of cause, the stay be modified to permit the on-going litigation to continue. Tax claim litigation may be better resolved in the bankruptcy court and the debtor may want to consider this option.

Direction of Payment

IRS takes positions that payments by a Chapter 11 debtor are "involuntary" and thus may be applied in any fashion the Internal Revenue Service deems appropriate

Where more than one tax is unpaid and there is a risk that all taxes may not be paid in full from the debtor's estate, the Internal Revenue Service will apply the payment to priority taxes last

Debtors may attempt to "direct" the application of their payments to the Internal Revenue Service, with instruction letters directing the application of the payment and by typing special endorsement language on the back of the check.

Sometimes court authorization is necessary in order to allow the debtor to "direct" its payments.

If the debtor files a Chapter 7 petition, then all payments made to the Internal Revenue Service are deemed to be "involuntary" payments.

CLASSIFICATION OF PRE-PETITION TAX CLAIMS

Secured Tax Claims

- Secured tax claims arise pursuant to statutory authority wherein certain taxes are accorded a lien on the debtor's property
- Section 506(a) of the Bankruptcy Code which limits the amount of the secured creditor's claim "to the extent of the value of such creditor's interest" in the debtor's interest in the property securing the claim, also applies to secured tax claims
- Common secured tax claims arise from unpaid federal taxes, state taxes and county and city property taxes.

Federal Taxes

- Unpaid tax debt shall be a lien "upon all property and rights to the property whether real or personal" belonging to the tax payer
- Lien is not valid until a notice of the lien has been properly filed
- Perfection of a lien on real property requires that Notice of Federal Tax Lien ("FTL") be filed with the Clerk of Court in the county in which the property is located
- Perfection of lien on personal property occurs when both the FTL is filed in the county in which the taxpayer resides and levy has occurred

State Taxes

- State tax liabilities secured by the filing of a certificate of tax liability with the Clerk of Superior Court in county in which the taxpayer resides or has property
- Lien attaches like a judgment lien with respect to the Debtor's real property in which the lien is secured at the time of filing
- Unlike the FTL blanket lien, the state tax lien attaches only upon levy on particular

property.

- N.C.G.S. § 105-242(e) exempts from “levy attachment, and garnishment” the following property:
 - the taxpayers principal residence although levy can occur if the collection of the taxes in jeopardy;
 - tangible personal property that is exempt from federal levy;
 - intangible personal property that is exempt from federal levy; and
 - Ninety percenty (90%) of the taxpayer’s salary or wages per month.

County and City Property Taxes

- Taxes assessed on real estate by a city or county become a lien on the debtor’s real property as of the date the property is listed for such taxes
- Lien trumps all other liens on the property, including any mortgages
- Property taxes assessed on personal property also become a lien on real property as of the listing date; do not become a lien on the personal property until such time as a levy or attachment of the personal property has occurred

Priority Taxes

Priority taxes are a creature of the Bankruptcy Code and are specifically set out in 11 U.S.C. § 507(a)(8). The most common of the priority tax claims are income taxes, trust fund taxes and property taxes.

1. Income Taxes

An income tax is a priority tax if it meets *any* of the following three (3) requirements:

- (i) the tax year which the return was last due, including extensions, three years or less prior to the filing of the bankruptcy;
- (ii) the tax was assessed within 240 days of the filing of the bankruptcy petition. If an offer in compromise is made during the 240 day period, the running of the 240 day period is tolled during the time in which the offer is pending plus an additional 30 days after the offer in compromise is no longer pending;
- (iii) the tax was not assessed before the bankruptcy was filed, but was assessible under applicable law or agreement after the bankruptcy was filed. This rule does not apply to taxes in which the debtor did not file the return, filed the return less than two (2) years before filing the petition, filed a fraudulent return, or willfully attempted to evade the tax.

2. Trust Fund Taxes

26 U.S.C. § 6672 allows the IRS to assess personal liability against any “responsible person” within an organization who willfully fails to pay any taxes which have been collected or withheld from a third party. §507(a)(8)(c) specifies that such trust fund taxes are accorded priority status under the Bankruptcy Code

3. Property Taxes

- A property tax is a priority claim if it was payable without penalty within the year prior to the filing of the bankruptcy pursuant to 11 U.S.C. § 507(a)(8)(b)
- A property tax occurs on the date that the property is to be listed which in North Carolina is January 1
- A property tax assessed for a particular year must be paid by January 5 of the following year to avoid the payment of penalty and interest

4. General Unsecured Taxes

A tax claim that is neither a secured claim nor a priority claim is considered a general unsecured claim and is treated with other similar unsecured claims.

5. Taxes, Interest and Penalties

In bankruptcy cases, interest is treated the same as the underlying tax obligation

With respect to tax penalties, § 726(a)(4) provides that tax penalties which are not in compensation for actual pecuniary loss are included within a group of claims (fines, forfeitures, punitive damages, etc.) that are paid only after all other claims are paid

EFFECT OF BANKRUPTCY ON AN INDIVIDUAL’S LIABILITY FOR TAXES

Chapter 7

The discharge of tax claims for individuals in Chapter 7 (and in Chapter 11) is governed by § 523(a)(1) of the Bankruptcy Code

All taxes of the kind specified in § 507(a)(7) of the Bankruptcy Code, including the following are excepted from discharge:

- an income or gross receipts tax for taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three (3) years before the date of the filing of the petition;

- a tax assessed within 240 days, plus any time, plus thirty (30) days during which an offer in compromise with respect to such tax that was made within 240 days after such assessment was pending, before the date of the filing of the petition;
- a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;
- an employment tax on wage, salary or commission earned from the debtor before the date of the filing of the petition, whether or not actually paid before such date for which a return is last due under applicable law or under any extension, after three (3) years before the date of the filing of the petition;
- a penalty that is compensation for actual pecuniary loss;
- a claim for tax with respect to which a return was not filed or was filed after the date on which such return was last due under applicable law or under any extension, and after two (2) years before the date of the filing of the petition; and
- a tax with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat the tax.

Secured tax liens survive the bankruptcy in the same manner as other non-avoided liens

If property encumbered by a tax lien is liquidated by the Chapter 7 Trustee, the Trustee may “displace” the tax lien to pay certain priority claims under § 724(b)

Priority tax claims under § 507(a)(7) are paid after claims for administrative expenses, but before any distributions to any unsecured creditors to the extent funds are available

In the event such claim remains unpaid, the priority tax claim is not discharged at the conclusion of the case

Unsecured, non-priority tax claims are treated similarly to other general unsecured claims in a Chapter 7 case. If funds are available for distribution, such claims will receive a pro-rata payment with other unsecured claims. If such claims are not paid in full, the claims may nevertheless be discharged unless they fall into one of the exceptions set forth in § 523(a)(1) above.

In Chapter 7 cases where there are insufficient assets to pay either the priority tax claims or the non-dischargeable unsecured claim, the debtor usually enters into a repayment schedule with the IRS to repay the tax debt.

Chapter 12 and 13

- Unless the taxing authority otherwise agrees, the plan must provide either for payment of the present value of the allowed amount of the secured tax claim or surrender of the collateral to the taxing authority
- The latter option is rarely utilized
- When calculating the value of the secured claim under § 506(b), the debtor cannot deduct his or her exemptions.
- Under Chapter 12 and 13 plans, priority payments to a taxing authority must be completed within three (3) to five (5) years from the date of confirmation of the Plan
- With respect to all priority taxes, plans under Chapters 12 and 13 must provide for full payment in deferred cash payments, unless the holder of the claim agrees to a different treatment
- There is no requirement for interest payments, which is why debtors generally file Chapter 13 plans to handle tax claims.
- Bankruptcy attorneys generally consider the following basic rules with regard to handling of pre-petition tax liabilities for individuals:
 - a. There is little advantage between Chapter 7 and 13 with regard to unsecured tax claims. Taxes that are nondischargeable in Chapter 7 must be paid in full in Chapter 13 as a priority debt. The benefit to Chapter 13 is that no interest accrues on the underlying tax obligation during the plan period.
 - b. The one exception to the rule arises when the non-dischargeability of the debt arises solely to the debtor's failure to file a tax return, failure to file a late return within 2 years prior to the filing of the bankruptcy, filed a fraudulent return or attempted to evade the tax. The Chapter 13 debtor can discharge these tax obligations without full payment.
 - c. Another exception arises with respect to penalties related to transactions of events occurring within 3 years of the petition date. These penalties are discharged in Chapter 7 but are considered general, unsecured claims in Chapter 13.
 - d. Secured tax claims "ride through" a Chapter 7 but are paid in full in Chapters 11, 12, 13.
 - d. Chapter 11 offers little advantage to an individual over Chapter 13 other than (i) there is no debt limitation on the debtor for filing and (ii) the debtor has an extra year to pay the tax claim i.e. 6 yrs vs. 5 yrs.

Corporate Debtors Under Chapter 11

- As is the case with secured tax claims for individuals under Chapter 7 or 13, the amount of the secured tax claim is governed by § 506(b) and is limited to the value of the debtor's interest in the property.
- Under Chapter 11, the debtor's plan may provide for deferred tax payments with present value, discounted at market rates, equal to the amount of the priority claim or the value of the secured tax claim.
- These deferred tax payments must be completed within six (6) years from the date of the assessment of the tax.
- If a corporation commences a case under Chapter 11 and attempts to restructure its obligations that effort will usually result in either a G Reorganization or a corporate recapitalization.

G Reorganization

- A G Reorganization is a transfer by a corporation by all or a part of its assets to another corporation in a bankruptcy or similar case, but only if, pursuant to the plan, stock or securities of the transferee are distributed in a transaction that qualifies under IRC §§ 354, 355 or 356.
- The Internal Revenue Service has taken the position that at least one creditor equity holder must participate in order to qualify as a G Reorganization.
- The issuance of a nominal amount of shares to a stockholder for the mere purpose of qualifying is not likely to qualify.
- According to IRC § 354(b), the transferee must acquire "substantially all of the assets of the transferor" and the transferor must distribute (by a plan of reorganization) all stock and securities and other assets received in the transfer.
- The target shareholders must maintain continuity of their interest in the surviving corporation to effectuate a G Reorganization.
- Finally, the transferee must continue the transferor's business or use a significant portion of the assets of the transferor in a business.

Recapitalization

To qualify the transaction or series of transactions as a non-taxable event under IRC § 368(a)(1)(E), the transaction or series of transactions must meet each of the following tests:

- (i) The continuity of interest test.
- (ii) The continuity of business enterprise test.
- (iii) The business purpose test.

Several examples of a recapitalization are set forth in the Regulations

CONCLUSION

CPAs and tax planners should consult with bankruptcy counsel in the event questions arise regarding a possible bankruptcy filing by a client. Care should be given to pre-petition planning to best utilize certain tax attributes and to minimize tax liability.