11-12-2004

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Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol15/iss22/1

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Handling S Corporation’s Losses in Shareholder Bankruptcy

-by Neil E. Harl

The fact that a new tax entity may be created on bankruptcy filing has an enormous impact on the income tax consequences for the bankrupt.¹ A recent Tax Court case² has clarified the handling of S corporation losses in bankruptcy where the S corporation shareholder files for bankruptcy and the S corporation generates losses for the year.

New tax entity

In the event an individual files for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (reorganization) a new tax entity is created.³ The new entity is separate from the individual who filed for bankruptcy. A new tax entity is not created for corporate or partnership filers⁴ and is not created for individuals in Chapter 12 or 13 filings.⁵

As a general rule, the bankrupt’s tax year does not change when bankruptcy filing occurs.⁶ However, a debtor with assets other than those that will be exempt may elect to end the debtor’s tax year as of the day before filing for bankruptcy.⁷ This creates two short years for the debtor.

The first short year ends the day before the bankruptcy filing date; the second year begins with the bankruptcy filing date and ends on the bankrupt’s normal year-end date.⁸ If the election is made to close the tax year⁹ the tax attributes (including the property of the debtor and the basis of the debtor’s property) pass to the bankruptcy estate as of the date of the bankruptcy filing.¹⁰ In the event the election is not made to close the bankruptcy year, the tax attributes and property of the debtor pass to the bankruptcy estate as of the beginning of the taxable year of the debtor.¹¹

The closing of the bankrupt’s tax year can be advantageous if the bankrupt has substantial income in the period before bankruptcy filing, because the debtor’s income tax liability for the first short year is a priority claim against the bankruptcy estate.¹²

Complication from S corporation losses

In the 2004 Tax Court case of Williams v. Commissioner,¹³ the sole shareholder of two S corporations, both with operating losses for the year, filed bankruptcy. The initial question was who could claim the operating loss passed through from the S corporations—the bankruptcy estate or the debtor. The sole shareholder (the taxpayer) argued that, since bankruptcy was filed on December 3, approximately 11 months of the losses should be allocated to the taxpayer, applying the S corporation rules which allocate each item of corporate income or loss pro rata on a per share basis per day of ownership.¹⁴ The taxpayer basically argued that bankruptcy does not alter the S corporation rules for allocating income.

¹ Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
and losses to S corporation shareholders. IRS, on the other hand, argued that the bankruptcy estate was entitled to the entire loss even though the bankruptcy estate did not own any stock of either S corporation until the date of bankruptcy filing. Thus, the bankruptcy estate owned all of the stock of both corporations at the corporations’ year end and, therefore, was entitled to claim the entire loss. The taxpayer had not elected to close the year as of the day of bankruptcy filing and to create two short years.

The Tax Court agreed with IRS, pointing out that the bankruptcy estate is entitled to the individual debtor’s items of income or loss from the bankruptcy commencement date while any items of income or loss that the debtor received before filing for bankruptcy would remain with the debtor. Because the income or loss of an S corporation is determined as of the last day of the S corporation’s taxable year, losses of the two S corporations for that year flowed through in their entirety to the bankruptcy estate with none passing to the debtor individually.

In a 2001 Chief Counsel’s Advice letter ruling, the facts were identical to Williams v. Commissioner. Indeed, the facts in the 2001 ruling appear to be that of the 2004 case. The IRS ruled that the debtor could not claim the net operating losses from the two S corporations because the losses passed to the bankruptcy estate. The ruling points out that the net operating losses could then be used to decrease the basis of the stock to the extent of discharge of indebtedness which occurred as part of the bankruptcy case. If any net operating losses remained after the basis reduction, those losses passed to the debtor. After the bankruptcy case closed, the lowered basis for the stock also passed to the debtor.

Loss carryforward after discharge

The Tax Court in Williams v. Commissioner also held that the sole shareholder of the two S corporations was not entitled to carry forward the losses to which the sole shareholder succeeded after the shareholder’s debts were discharged in bankruptcy. Although discharge of indebtedness income realized as a result of bankruptcy discharge is excluded from gross income in the year of discharge, any loss carry forward must be reduced dollar for dollar by the amount of debt discharged. Inasmuch as the amount of the S corporation’s losses was less than the discharged debt, the shareholder had no loss to recognize in the years after discharge.

Footnotes

3. I.R.C. § 1398(a).
5. I.R.C. §§ 1398, 1399.
10. I.R.C. § 1398(g).
11. Id.
12. See In re Mirman, 89-1 U.S. Tax Cas. (CCH) ¶ 9297 (E.D. Va. 1989) (debtors individually liable for income taxes for year involuntary bankruptcy filed against them where debtors did not elect to end taxable year as of date of bankruptcy filing); In re Pratlvadi, 281 B.R. 816 (Bankr. W.D. N.Y. 2002) (taxes for year of bankruptcy filing were post-petition debt where debtors did not elect to bifurcate tax year of bankruptcy filing).
15. Id.
17. I.R.C. § 1398(e)(1).
18. Id.
22. See 5 Harl, supra note 1 at § 39.04[1].
24. Id.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

ANIMALS

HORSES. The defendant operated a horse trail ride which was offered to cruise participants as part of shore leave activities. The plaintiff signed-up for the horse ride and was required to sign a waiver of the defendant’s liability for risks inherent in the trail ride and for negligence by the defendant or its employees. The plaintiff was bitten by one of the horses during the ride and sued for negligence and strict liability. The defendant sought a summary judgment based on the signed waiver of liability. The court examined Hawaii Rev. Stat. § 663-1.54 which governed liability of operators of recreational activities for the public and governed liability waivers. The court held that the statute explicitly prohibits the waiver of liability for negligence and, although the