

WEALTH PRESERVATION AND TAX PLANNING ALERT

SPECIAL TAX ELECTION THE IRS WON'T TELL YOU ABOUT

by Nick Jovanovich, Esq.

The filing of bankruptcy under Chapter 7 or Chapter 11 of the Bankruptcy Code by an individual debtor ("debtor") creates a separate taxable estate (referred to as the "bankruptcy estate") which is separate and distinct from the debtor for federal income tax purposes. This bankruptcy estate inherits certain of the debtor's tax attributes (e.g., net operating loss carryovers, capital loss carryovers, etc.). As a result, the bankruptcy estate must file a tax return (Form 1041), which reflects all income that the bankruptcy estate is entitled to receive under the Bankruptcy Code and all income received by the bankruptcy estate after the commencement of the case, and which takes into account the tax attributes that previously belonged to the debtor.

By contrast, the debtor's taxable year is not terminated by the bankruptcy filing. The debtor will generally be required to file one tax return (Form 1040) for the taxable year in which the case commenced. This tax return will reflect all income received by the debtor during the taxable year, excluding any income taxable to the bankruptcy estate and excluding the debtor's tax attributes that pass to the bankruptcy estate. Since this tax liability would not arise until after the commencement of the bankruptcy case, this tax liability would be a "post-petition" liability and, therefore, no portion of this tax liability will be paid from the bankruptcy estate.

It is this passing of tax attributes to the bankruptcy estate and the creation of a "post-petition" liability that may result in adverse tax consequences to the debtor. For example, assume that the debtor has \$100,000 of capital loss carryovers at the beginning of the taxable year in which he files bankruptcy and he incurs \$80,000 of capital gain prior to filing bankruptcy. The debtor's \$100,000 of capital loss carryovers would pass to the bankruptcy estate and

would not be available to offset the debtor's \$80,000 capital gain. As a result, the debtor would be required to pay tax on his entire \$80,000 capital gain. In addition, since the

"Individual Debtors filing bankruptcy under Chapter 7 or Chapter 11 should consider making a special tax election in the year bankruptcy is filed."

debtor's tax liability would be a "post-petition" liability, it would be payable from the debtor's own assets and not from the assets transferred to the bankruptcy estate. The debtor would essentially be using his exempt assets (i.e., assets exempt from claims of unsecured creditors) to pay his tax liability rather than using assets of the bankruptcy estate that he would lose anyway in the bankruptcy process. If the debtor had not filed for bankruptcy, he would have had no taxable gain since his \$100,000 of capital loss carryovers would have fully offset his \$80,000 capital gain. What can the debtor do to avoid this unjust result?

INTERNAL REVENUE CODE SECTION 1398(d)(2) ELECTION TO THE RESCUE

The debtor should consider closing his taxable year, as of the day immediately prior to the commencement of the bankruptcy case. This election would generally result in two separate tax years for the debtor. The first tax year would begin on January 1 and end on the day immediately preceding the commencement of the case ("First Short Tax Year"), and the second tax year would begin on the commencement date and end on December 31 ("Second Short Tax Year"). Accordingly, the debtor would file two separate tax returns for the year in which the bankruptcy case commenced.

There are two primary benefits to the debtor in making this election to create to separate tax years. First, the debtor would be able to use his tax attributes to offset any gain in the First Short Tax Year. For instance, in the previous example of the debtor with a \$100,000 of net capital loss carryovers and \$80,000 of net capital gain, none of this gain would be taxable to the debtor since the \$100,000 of capital loss carryovers would fully offset the \$80,000 of capital gain. Second, since the debtor's tax liability for the First Short Tax Year constitutes a priority claim against the bankruptcy estate, resulting in a "pre-petition" tax liability, the debtor would be using assets of the bankruptcy estate (non-exempt assets that would otherwise go to the debtor's unsecured cred-

itors) to pay for his tax liability for the First Short Tax Year, rather than using his own exempt assets.

PENALTIES AND INTEREST ATTRIBUTABLE TO SHORT TAX YEAR AND AVOIDING IRS COLLECTION ACTION

The tax liability for the First Short Tax Year is a priority claim against the bankruptcy estate. As such, this tax liability should not be paid by the individual debtor but rather should be paid by the bankruptcy estate. The due date for payment of this tax liability is generally April 15th following the commencement of the bankruptcy case. Since it is highly unlikely that the bankruptcy trustee will have made any payment to the IRS on account of this tax liability by such due date, this unpaid tax liability will become a delinquent tax liability of the debtor. Accordingly, the IRS will assess interest and penalties on the unpaid tax liability. In addition, the IRS will in all likelihood attempt to impose a tax lien and exercise collection activities. What can the debtor do?

First of all, the debtor must realize that the ultimate responsibility for the tax liability rests with the debtor, regardless of whether all or any portion of such tax liability, as a priority tax claim, is payable from the assets of the bankruptcy estate. Any shortfall in the tax liability must ultimately be paid by the debtor.

With regard to attempted collection action by the IRS, if the bankruptcy estate has assets with which to pay all or a portion of the tax liability for the First Short Tax Year, there are certain actions which the individual debtor may take in order to "freeze" any attempted collection action by the IRS. These actions may allow the individual debtor to "buy time" until the bankruptcy trustee makes final distributions, including payment to the IRS.

With regard to delinquency penalties imposed by the IRS on the unpaid tax liability for the First Short Tax Year, there are specific actions that the debtor should take in order to eliminate these penalties. In addition, there is a Section in the Internal Revenue Code that specifically prohibits penalties from being added to the tax liability while a case is pending under the Bankruptcy Code if such tax liability is a pre-petition tax liability and the penalties imposed are post-petition. ■



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Nick Jovanovich is an "AV" rated, Board Certified Tax Attorney and former CPA who is a shareholder in the Fort Lauderdale office of Berger Singerman where his practice is concentrated in the areas of general corporate and taxation, bankruptcy tax planning, estate planning and tax controversies involving the IRS and the Florida Department of Revenue. Mr. Jovanovich is an Adjunct Professor at Nova Southeastern University School of Law where he teaches Estate and Gift taxation. He received his undergraduate degree (magna cum laude) and his

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