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WEALTH PRESERVATION AND TAX PLANNING ALERT

Tax Court Case Involving S Corporations – Debtors and Creditors Beware!

by Sheldon S. Polish, Esq. and Nick Jovanovich, Esq.

Individual debtors who own S corporations and who are considering filing for bankruptcy protection should first consider the impact of a Tax Court decision, *Lawrence Williams v. Commissioner*, which was issued July, 2004. Likewise, creditors who are contemplating accepting a Chapter 11 Plan of Reorganization in which the debtor is allowed to retain certain of his or her non-exempt assets, including S corporation stock, must also pay close attention to this *Williams* case since the failure to do so may result in unanticipated, adverse consequences to the creditors.

In a case of first impression dealing with an individual S corporation shareholder who filed for bankruptcy just prior to the end of the S corporation's tax year, the Tax Court in the *Williams* case held that all of the operating losses sustained by the corporation during the tax year in which the shareholder filed for bankruptcy belonged to the bankruptcy estate and that none of these losses could be deducted by the shareholder on his personal income tax return. The Tax Court noted that S corporation income or loss is determined on the last day of the S corporation's tax year and, therefore, whoever owns the S corporation stock at the end of the corporation's tax year (i.e., December 31) will be allocated all of the income (or loss) of the S corporation for such tax year. In this regard, it is important to note that when an individual debtor files for bankruptcy protection under Chapter 7 or Chapter 11 of the Bankruptcy Code, a separate taxable entity is created for tax purposes (i.e., the bankruptcy estate), and under Section 541 of the Bankruptcy Code all non-exempt assets would pass to the bankruptcy estate as of the date of bankruptcy filing.

> ***"The Williams case has created a potential trap for the S corporation shareholder who is contemplating filing for bankruptcy."***

Prior to the *Williams* case, with regard to the tax year in which the S corporation shareholder filed for bankruptcy, practitioners generally allocated the S corporation income (or loss) for the entire year on a pro-rated basis between the individual shareholder and the bankruptcy estate based on the number of days in the year that the individual shareholder or the bankruptcy estate was the shareholder of record. For example, if the individual shareholder filed for bankruptcy on September 1ST of any year, the S corporation's income (or loss) for such year would be allocated 2/3 to the individual shareholder (8 months) and 1/3 to the bankruptcy estate (4 months) and separate Schedule K-1's would be issued to the individual shareholder and to the bankruptcy estate reflecting their pro-rated share of the S corporation's income (or loss).

Now in light of the *Williams* case, it would *appear* that all of the income (or loss) for the entire year in which the bankruptcy was filed would be allocated to the party who is deemed to be the owner of the S corporation shares as of the last day of such tax year (i.e., December 31ST). In the above example, this would be the bankruptcy estate. Please note the use of the word "*appear*" as it is not clear whether this would be the result if an election to the close the debtor's tax year under Section 1398(d)(2) is in effect (the "Section 1398 election") and the *Williams* case did not involve a situation where a Section 1398 Election was made.

Thus, before an individual S corporation shareholder considers filing for bankruptcy under Chapter 7 or 11 of the Bankruptcy Code, that shareholder needs to assess the tax implications to himself or herself of such action and, in particular, the timing of such bankruptcy filing. For instance, if the individual shareholder of the S corporation is anticipating having large losses from the S corporation to offset his or her other income, he or she must be aware that in light of the *Williams* case, all of those anticipated losses may end up passing to the bankruptcy estate rather than to the individual shareholder. By contrast, if the individual shareholder of the S corporation anticipates having a large amount of income from the S corporation, he or she may be more than willing to allow the bankruptcy estate to be saddled with this income since this tax liability would be payable by the bankruptcy estate from its assets.

Creditors of the bankruptcy estate must also be aware of the tax implications of the *Williams* case to them. For example, assume that the creditors have approved a Chapter 11 Plan of Reorganization in which the debtor, a physician, is allowed to keep his S corporation stock in his or her medical practice. If the medical practice (S corporation) expects to earn a significant amount of income in the year in which the bankruptcy is filed (or in any subsequent year in which the bankruptcy proceeding is still open), the creditors may be quite alarmed to find out that the bankruptcy estate may have a significant income tax liability resulting in assets of the bankruptcy estate, which would otherwise go to repay the creditors, being used to pay the IRS. The creditors could have avoided this adverse result by simply abandoning the S corporation stock back to the individual shareholder (debtor) at the outset, then all of the income tax liability attributable to the S corporation shares would pass to the individual shareholder and not to the bankruptcy estate.

In summary, the *Williams* case has created a potential trap for the unwary S corporation shareholder who is contemplating filing for bankruptcy protection under Chapter 7 or 11 of the Bankruptcy Code, as well as a potential pitfall for the creditors of the bankruptcy estate. Accordingly, it is imperative that these S corporation issues be properly addressed at the outset of the bankruptcy proceeding. ■

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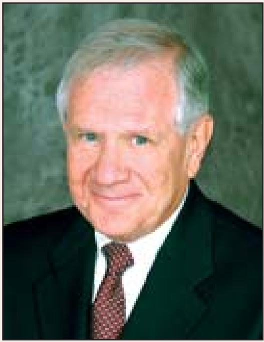

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IN THIS ISSUE...

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