OUTLINE FOR TAX PRESENTATION

I. Basics on Taxation of Pass Through Entities

A. Partnerships and LLCs do not pay federal income tax

B. Taxable income and certain deductions are passed down to the partners or members on K-1 Forms. As discussed below, this can create big tax problems for the partners.

C. Pass through entities do pay other kinds of taxes such as

1. Payroll tax
2. Sales tax
3. Franchise tax

II. Cancelled Debts, Foreclosures, Repossessions and Abandonments and the Short Year Return Election

A. Generally, the cancellation of debt creates taxable income IRC 61(a)(12).

1. For example, if I loan you $100 and I tell you not to pay me back (i.e. I have discharged you from the debt), you have taxable income of $100

B. But if the debt is discharged in any title 11 case it is excluded from income IRC 108(a)(1)(A).

C. The debt discharge is also not included in income if the taxpayer is insolvent even if the taxpayer does not file for bankruptcy. IRC 108(a)(1)(B)

D. If debt discharge is excluded from income, you must reduce other favorable tax attributes such as net operating loss deductions or reduce basis in assets which will increase your taxes down the road. The basis of the assets is not reduced beyond the amount of liabilities remaining after the discharge. The reductions occur on the first day of the next taxable year after the year of discharge.

After the reductions described above the balance of the discharged debt simply goes away without tax consequence.

III. Phantom Income

A. Pass Through Entities.

1. If the debt of a pass through entity is discharged, the income flows to the partners and members. Solvency is determined at the partner level. So if the pass through entity is insolvent, but the partner is not, the partner will have to include the debt discharge in income. This can be devastating. An analysis should be done at the partner level to determine if there are any passive or suspended losses to absorb the cancellation income.

B. Foreclosures, Repossession and Abandonment

1. Taxable gains and losses are determined by the tax basis in an asset. The following is a dangerous example

   a) *Office building purchased for $1 million with $800,000 of recourse debt and $200,000 of equity.*

   b) *Office building is held for five years and depreciation reduces basis $400,000*

   c) *Loan goes into default and the bank forecloses for the balance the loan say $700,000*

   d) *The borrower has taxable gain of $100,000 or the difference between the loan balance and the basis.*

   e) *The borrower has no money to pay the tax.*

2. Can this be avoided

   a) *Possibly by filing bankruptcy before the foreclosure (Stays the foreclosure and opens possible negotiations with the bank and at a minimum pushes out the foreclosure date))*

   b) *Filing a short year return (Creates Priority tax claim payable from Estate Funds if funds not available individual not discharged from tax)*

   c) *If above transaction would have created a loss, the debtor could carry back or allow Estate to carry back and negotiate a trade for the value of the carry back refund created by the short period election which can only be made by the debtor.*

   d) *review all other assets owned by taxpayer to determine if there are built-in-losses that can be used to offset gain*

   e) review taxpayers passive and suspended loss carryover for availability

IV. Preservation and use of Net Operating Losses in Corporate Cases

A. Assuming the NOL exceeds the debt discharged, the NOL can be used in a few ways.

1. If the entity paid tax in the past, it should be able to carry the loss back and obtain a refund.

2. If the entity did not pay tax in the past, the NOL can be carried forward to offset future income.

B. But this only works if the NOL is not forfeited.

C. The NOL will be forfeited if after confirmation pre-petition shareholders and/or creditors do not own at least 50% of the reorganized debtor. IRC 382(l)(5)

V. Tax Issues in Post-Confirmation Trusts

A. Debtor Grantor trust

1. Transactions that occur in a debtor grantor trust are reported on the tax return of the debtor and are generally of no tax consequence on transfer.

B. Creditor Grantor Trust

1. Assets transferred to this kind of a trust are considered sold at their fair market values at the time of transfer. See Revenue Procedure 94-45 for ruling guidance on the establishment of a Creditor Grantor Liquidating trust. These types of trusts are usually used for the unsecured class.

2. The former creditors are "deemed" to have received the assets of the debtor that are transferred to the trust, in complete satisfaction of their claims and then contributing those assets to a trust which will be entrusted with the liquidation of same and pay out the cash to the now beneficiaries of the trust..

3. Trustee sends a report to each creditor indicating their share of the transactions that have taken place during the year and the trustee files a grantor trust tax return in the appropriate jurisdiction. Tax ID numbers and addresses are required

4. A Disputed Ownership Fund (DOF) or a Qualified Settlement Fund (QSF) (IRC 468B) may be established within the grantor trust as appropriate in some cases.

5. Creditor matrix must be updated for the above each year and can be cumbersome in large cases with a large unsecured creditor group

C. IRC Section 641 Trust

1. This kind of a trust is its own taxable entity and subject to a higher rate of tax than a corporation or and individual. (See GCM 39368 and LTR 8524052 for background guidance)

2. This kind of a trust may be preferred in situations where there are limited funds available for distribution; the creditor matrix is complex or incomplete and there is no expectation of income to be received by the trust.

3. The cost of tax return preparation may be much lower due to the lack of necessary details required for a grantor trust.

VI. Short Year Returns

A. Election under IRC section 1398(d)(2)(A)

1. Irrevocable election is only available to individuals if the estate has assets that are not exempt property
2. If debtor makes the election in the year in which the bankruptcy commences his or her year is treated as two short years with the first year ending on the date before the case commences and the second year beginning on the commencement date and ending on the taxpayer's regular tax year (usually December 31)
3. The election must be made by filing a return for the short year ending on the day before commencement (the first short year) on or before the fifteenth day of the fourth full month following the end of the month that the petition was filed. An election may be made on an extension form but must be signed by the taxpayer. The spouse of such a taxpayer makes the election by filing a joint tax return for that first short taxable year.
4. The taxable income for both short years must be annualized and the debtor must make the other adjustments that are required under IRC section 443