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Feature

By Mark Dennis

Tax Cuts and Jobs Act: Bankruptcy Estate Tax Considerations

Mark Dennis
Dennis & Company, PC
Greenwood Village, Colo.

Mark Dennis, CPA is president of Dennis & Company, PC in Greenwood Village, Colo.

Tax compliance can be an unwelcome burden for trustees and debtors in possession (DIPs), potentially adding cost, complexity and delay to chapter 7 and 11 estate administration. The Tax Cuts and Jobs Act (TCJA) is the largest tax law overhaul since the Tax Reform Act of 1986, and trustees, debtors and their professionals should be aware of how these changes might affect bankruptcy estates. Although the impact of several of the changes is small and favorable, an important change relating to the treatment of net operating losses (NOLs) will make it more difficult for bankruptcy estates to offset taxable income and tax-deductible expenses, potentially increasing tax liability.

Individual Estate Filing Threshold

Both chapter 7 and 11 individual bankruptcy estates continue to be required to obtain their own separate tax identification numbers. Prior to the TCJA, income tax return filing requirements were governed by § 6012(a)(8) of the Internal Revenue Code (IRC), whenever "*gross income* exceeds the exemption amount plus standard deduction." The TCJA has removed personal exemptions, and the new IRC § 6012(f)(1) modifies the threshold to the new standard deduction only, as defined in IRC § 63. IRC § 63(c)(7) contains new, special rules for taxable years 2018 through 2025, increasing the standard deduction to $12,000 for married-filing-separately individual taxpayers, which is now the statutory filing threshold for individual chapter 7 and 11 bankruptcy estates for the 2018 tax year.

"Gross Income" continues to be defined in IRC § 61(a) as "all income from whatever source derived," including interest, dividends, rents, royalties, business income and *gains* derived from dealings in property. A determination of whether the estate has a gain requires knowledge of the tax basis in the asset and an accounting for the sale, including selling costs. Sales of debtors' primary residences might result in gains that can be excluded pursuant to IRC § 121, theoretically relieving the estate of a filing requirement. However, estates might still be required to file a tax return for these sales if a 1099S is issued to the bankruptcy estate.[1]

Trustees and debtors might still wish to file bankruptcy estate returns even if the $12,000 threshold is not met to, for example, preserve tax attributes for carrying over to subsequent estate tax years, provide debtors with additional support to take deductions on their own tax returns for items of income reported to their Social Security number that the bankruptcy estate has included on its tax return, or simply obtain relief from personal liability via the prompt-determination process.

To illustrate the impact of the higher standard deduction, consider a hypothetical individual bankruptcy estate in receipt of $18,000, which must be recognized as income for tax purposes. Exhibit 1 shows the results before and after the enactment of the TCJA.

1 "Sale of Your Home," IRS (last updated Feb. 1, 2018), *available at* irs.gov/taxtopics/tc701 (last visited Jan. 23, 2019).

Exhibit 1

	2017	2018
Ordinary Income	18,000	18,000
Standard Deduction	(6,350)	(12,000)
Personal Exemption	(4,050)	0
Taxable Income	7,600	6,000
Tax Liability	760	600

Tax Rate Reduction: Individual Estates

Although in the above example the tax rate is the same (10 percent) in both scenarios, the TCJA has lowered marginal tax rates in higher tax brackets, which is a positive development for individual taxpayers, and therefore larger individual chapter 7 and 11 estates. Exhibit 2 shows the old and new tax brackets and rates for married-filing-separately taxpayers.

For example, an individual bankruptcy estate with taxable income of $100,000 had tax liability of $21,442.25 under the old law. However, using the new TCJA rates, the tax liability falls to $18,289.50 for a savings of $3,152.75 (reducing the effective tax rate by 3 percent).

Long-term capital gains of up to $38,600 on individual bankruptcy estates are taxed at 0 percent on federal returns for 2018 (up from $37,950 in 2017). This continues to be an important benefit for individual bankruptcy estates where asset-dispositions are frequently the primary taxable event for the estate, provided that the long-term character of the asset in the hands of the debtor(s) can be verified.[2]

Finally, individuals will be much less likely to be subject to the alternative minimum tax (AMT) due to higher thresholds, and a new IRC § 199A "Qualified Business" deduction will enable qualified individuals with sole proprietorship and/or pass-through business income from s-corporations, partnerships and/or limited liability companies (LLCs) to enjoy a deduction of up to 20 percent of taxable income, further reducing the effective tax rate for these taxpayers.

NOLs

NOLs arise from an excess of business expenses over business income, and they occur either at a corporate level on Form 1120, or on an individual's Form 1040 (from sole proprietorship losses and/or losses from pass-through entities). Any such losses must first pass the at-risk, basis and passive activity limitations before becoming a NOL available to offset other income.

Previously, unless an election was made by the individual or corporation to forego the carryback of a NOL, IRC § 172 specified that the NOL would be carried back two years, then forwarded up to 20 years to offset other income. However, overlaying the NOL provisions of IRC § 172 are the provisions of § 1398(h)(2)(B), which allow individuals' title 11 cases to carry "administrative expense losses" back three years, then forward up to seven years to offset bankruptcy estate income. This carryback provision is particularly useful for bankruptcy estates, where the timing of taxable cash receipts and tax-deductible cash disbursements is dictated by sometimes-lengthy litigation and noticing procedures.

For NOLs arising in tax years *ending after* Dec. 31, 2017 (including fiscal years ending in 2018), the TCJA has modified IRC § 172 to disallow NOL carrybacks for most taxpayers and allow these NOLs to instead be carried forward indefinitely, but on a more limited basis. First, individuals' business losses are now capped at $250,000 per tax year for married-filing-separately taxpayers ($500,000 for married filing jointly), and the excess loss over and above these thresholds must be carried forward. Second, the TCJA has limited the NOL deduction to 80 percent of taxable income for tax years *beginning after* Dec. 31, 2017.[3] The effect of these changes is that NOL carryforward tax attributes will become larger (since less of a large NOL can be utilized in a loss year), however they will no longer fully shield taxable income when carried forward.

Despite these significant changes, IRC § 1398 remains unchanged by the TCJA. Although IRC § 1398(h)(2)(C)'s "Determination of amount carried to each taxable year" refers to the modified TCJA rules in IRC § 172, this discrepancy creates uncertainty and a need for clarification. The current bankruptcy-specific IRS guides and Code sections are still written to allow administrative expense loss carrybacks.

Unintended Consequences?

In the absence of further Internal Revenue Service (IRS) bankruptcy-specific guidance, there might be unintended consequences for IRC § 172-compliant individual bankruptcy estates. Continuing with the hypothetical individual bankruptcy estate, assume that the debtor files a voluntary chapter 7 petition in 2018. The trustee hires counsel who successfully negotiates a settlement agreement with the debtor, and the estate collects the taxable proceeds of $18,000 during 2018. Administrative expenses total $8,000, including the statutory trustee fee of $2,550, legal fees of $5,000 and accounting fees of $450. However, these legitimate administrative expenses do not get paid until *2019*, after the trustee's final report is approved by the bankruptcy court.

2 Please note that taxable capital gains continue to be subject to state tax, and state-level thresholds and rates vary from state to state.

3 The tax-year discrepancy between the NOL carryback and 80 percent limitation rules might be addressed in a future IRS technical correction (Richman, "Net Operating Loss Provision May Need Fix from Congress," 158 *Tax Notes* 587 (Jan. 29, 2018)).

Exhibit 2

Old Brackets	Old Marginal Rates	New Brackets	New Marginal Rates
0-9,325	10%	0-9,525	10%
9,326-37,950	15%	9,526-38,700	12%
37,951-76,550	25%	38,701-82,500	22%
76,551-116,675	28%	82,501-157,500	24%
116,676-208,350	33%	157,501-200,000	32%
208,351-235,350	35%	200,001-300,000	35%
More Than 235,351	39.6%	More Than 300,000	37%

A bankruptcy estate succeeds to the accounting method of the debtor pursuant to IRC § 1398(g)(7), whereas corporations can file taxes on either a cash or accrual basis, and individuals (and hence individual bankruptcy estates) are almost always cash-basis taxpayers. Assuming that the estate files on a calendar-year basis and disregarding administrative expenses, federal tax liability will be $600 on a 2018 tax return, as previously illustrated.

Under the old law, the estate's administrative expenses were available for deduction by creating an ($8,000) administrative expense loss on a 2019 return and carrying it back to 2018 to request a refund of the $600 taxes paid in 2018. Alternatively, in practice (to reduce cost, delay and complexity), an administrative expense deduction could possibly be accelerated on the estate's final 2018 tax return to more accurately offset taxable income with the associated tax-deductible expense.

However, the new discrepancy between IRC §§ 1398 and 172 calls this administrative expense loss carryback and/or acceleration approach into question. If IRC § 172 controls and bankruptcy estates are no longer able to carry back their administrative expense losses, the ability of those estates to effectively offset taxable income and tax-deductible expenses is impaired. It is uniquely difficult for bankruptcy estates to control the timing of their income and expenditures, often due to events beyond their control and at the mercy of the legal process — which makes a strong case for the preservation of their ability to carry back and/or accelerate deductions of legitimate administrative expenses associated with the income realized.

Time Running Out to Request Refunds

Another byproduct of the new IRC § 172 NOL provisions, unrelated to estates' administrative-expense losses, is that time is running out to pursue refunds by carrying back debtors' pre-petition NOLs. It is not unusual for individual debtors to have NOLs on their personal pre-petition tax returns, and bankruptcy estates succeed to them as tax attributes that can be used to shield post-petition estate income. Refunds can also be pursued by amending pre-petition tax returns and requesting refunds of pre-petition taxes paid on pre-petition returns using the NOL carryback provisions in the following circumstances:

1. The NOL must have occurred in a tax year ending Dec. 31, 2017, or earlier;
2. The debtors must not have made an election to forego the carryback; and/or
3. The debtors must have paid non-self-employment income tax in one, or both, of the two tax years preceding the NOL year.

Amended returns and refund requests can be prepared under these circumstances, and taxpayers (including trustees and DIPs) should look for opportunities to do so. Amended returns and refund requests can be prepared on Forms 1040X within three years after the due date, including extensions, for filing the return for the NOL year. From a practical perspective, taxpayers generally have until April 2019 (or later, up to October 2019, if the original return was timely filed under extension) to claim a refund from a NOL arising on a 2015 tax return, which must first be carried back to the 2013 tax year.

These claims represent potentially valuable assets for individual bankruptcy estates, and as time goes by and deadlines sunset, fewer and fewer tax years become available for amendment. Trustees and DIPs should promptly review their files for NOL carryback opportunities for losses that arose during the 2015-17 tax years.

Changes Impacting Nonindividual Estates

The signature component of the TCJA is a reduction of the corporate tax rate from a complex tiered set of rates to a flat rate of 21 percent (including capital gains), and the removal of AMT on corporations, effective for taxable years beginning after Dec. 31, 2017.

No filing requirement changes have been made for domestic corporations, which (unless they are a charitable organization with less than $1,000 of unrelated business taxable income) must file tax returns until they cease business, dissolve and retain no assets (including litigation claims), regardless of the amount of income or loss.[4] Trustees, receivers or assignees of corporations that have not dissolved but retain no assets and have ceased business operations may continue to request an exemption from filing in writing to the local insolvency office, which must respond within 90 days.

Corporations that have made a valid S-election that has been accepted by the IRS must file on Form 1120S, passing items of income, gain and loss through to shareholders. Issues can arise when former officers of S-corporation bankruptcy estates are unsure whether S-elections had been made and/or accepted by the IRS. Verification with the IRS is advisable to avoid late-filing penalties. Such penalties, applicable to both partnerships filing on Form 1065 and S-corporations filing on Form 1120S, have increased from $190 to $200 per partner/shareholder per month (up to a maximum of 12 months per tax year) for the 2018 tax year.

A domestic partnership or multi-member LLC must generally file Form 1065 unless it neither receives income nor incurs any expenditures treated as deductions or credits for federal income tax purposes.[5] Previously, the sale or exchange of 50 percent or more of a partnership's capital and profits within a 12-month period (for example, as part of a chapter 11 reorganization plan) would trigger a "technical termination" of the partnership, whereby two separate tax returns were required for the termination year. However, the TCJA has eliminated the technical termination provision for tax years beginning after Dec. 31, 2017, removing the need to file two separate returns in such tax years. However, an accounting must still be performed to allocate members' distributive share of income and loss for the full tax year, including a complete or partial sale/exchange of membership interests.

Qualified settlement funds (QSFs) are trusts used to administer litigation claims, and one of their benefits is to secure current tax deductions for defendants contributing monies to the trust, even though plaintiffs might not actually receive the funds until much later. QSFs can potentially be established by bankruptcy estates to more closely match taxable income and tax-deductible expense.

4 26 C.F.R. 1.6012-2 (corporations required to make returns of income).
5 2017 IRS Form 1065 Instructions, p. 3.

QSFs must file tax returns on Form 1120SF, and late-filing penalties have increased to the smaller of the tax due, or $210. Amounts transferred to the fund by or on behalf of the transferor are not included in the QSF's income, and likewise payments of claims are not deducted by the QSF. Reportable items include interest, capital gains, other income and administrative expenses.

Conclusion

Many aspects of the TCJA will benefit bankruptcy estates, including the headline-grabbing tax-rate reductions, the simplification of partnership technical terminations, larger NOL carry-forward tax attributes available from pre-petition returns and a higher filing-requirement threshold for individual bankruptcy estates. However, the removal of the NOL carryback provision has complicated the process of matching taxable income and tax-deductible expenses, and created an urgency to assess NOL carryback potential from prior-year losses. Trustees, DIPs and their professionals should carefully consider the changes brought on by the TCJA as they work to maximize tax efficiency and compliance for their asset bankruptcy estates. abi

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