

Financially Distressed S Corporations and their Shareholders: Finding Glitz in a Post-*Gitlitz* World

By Steven W. Swibel

After the *Gitlitz* case was decided by the U.S. Supreme Court in 2001, Congress enacted changes to the Code to address the use of losses by S corporation shareholders, thus raising a myriad of tax planning issues associated with income that a financially distressed S corporation may realize as it struggles with its rehabilitation.

The tax consequences of cancellation of indebtedness (COD) in insolvency and bankruptcy situations are covered generally in Code Sec. 108. Specific rules sometimes provide clarification of the consequences of COD to passthrough entities and their owners. Even with respect to passthrough entities, the rules differ in certain respects depending on the status of the passthrough entity as a partnership or an S corporation. The *Gitlitz* case¹ and subsequent changes in the Code that responded to *Gitlitz* addressed the perceived inappropriate utilization of losses by S corporation shareholders. However, *Gitlitz* and subsequent legislation did little to address some of the practical and difficult choices that an S corporation and its shareholders must confront in an effort to restructure a financially troubled corporation. Such distressed entities must consider a perplexing array of tax planning options that can produce beneficial, unwanted, uncertain and sometimes surprising tax consequences and that have the potential to generate unexpected conflicts between the corporation and its shareholders or among shareholders. While post-

Gitlitz loss utilization remains an important objective, the principal focus of this article is the tax planning issues associated with income that a financially distressed S corporation may realize as it struggles with its rehabilitation.

Cancellation of Indebtedness Income

There are two Code provisions that provide the essential starting point for determining the effect of COD income on a financially distressed S corporation. The first basic rule is that no amount is included in a debtor's gross income by reason of a discharge of indebtedness in a title 11 case, even if the debtor is solvent after the discharge. Code Sec. 108(a)(1)(A). The second basic rule is that, in the case of an insolvent taxpayer, COD income also will be excluded from gross income to the extent the COD income does not render the taxpayer solvent. Code Sec. 108(a)(1)(B). Additional exceptions to COD taxable income recognition may apply, but the additional COD income exclusion provisions generally are not as important in the S corporation context. For example, Code Sec. 108 also excludes

Steven W. Swibel is a Principal at Schwartz Cooper Chartered in Chicago.

COD income from “qualified farm indebtedness.”² or “qualified real property business indebtedness” of a taxpayer other than a C corporation.³ The financially troubled S corporation may also find that the rules applicable to modification of purchase money installment obligations may be helpful.⁴ Moreover, for the S corporation using the cash method of accounting, the rule that excludes COD income if payment of the obligation would have given rise to a deduction by the corporation may be important for avoiding income recognition when the debt of trade creditors is extinguished without payment.⁵ However, the two basic rules referred to above tend to have broader application and generally serve as the cornerstone for avoiding COD income in an S corporation.

The COD rules for passthrough entities differ in significant respects for partnerships and S corporations. In particular, the insolvency exception to COD income applies at the partner level in the case of a partnership. However, in the case of an S corporation, most of the COD rules of Code Sec. 108 are applied at the corporate level.⁶ Thus, if the S corporation is insolvent or the debt is discharged in a title 11 case, COD income is excluded from taxable income without regard to the financial condition of the corporation’s shareholders. In this respect, COD income is often more easily addressed by S corporations than by partnerships, because taxable income can be avoided without testing the solvency of the shareholders. Because COD income is more easily excluded from gross income in the context of a title 11 case, an S corporation seeking a financial rehabilitation and that has enterprise value will often choose a title 11 proceeding rather than rely on an insolvency exception to avoid COD income.

Although COD income may be excluded from gross income under Code Sec. 108, the exclusion comes at a price. That is, the amount of COD income that is excluded under the title 11, insolvency and certain other rules must be applied to reduce certain of the debtor’s tax attributes in the order and manner specified under Code Secs. 108(b) and

1017. In response to *Gitlitz*, amounts excluded from COD income do not increase basis of the shareholder’s stock under Code Sec. 1366(a).⁷ Further, where COD income is excluded, Code Sec. 108(d)(7)(B) provides that any loss or deduction that is disallowed for the tax year of the discharge under Code Sec. 1366(d)(1) is treated as a net operating loss (NOL) for such tax year.⁸

The title 11 COD exclusionary rule specifically requires that the debt be discharged in a title 11 case. Not every title 11 case will result in a continuing enterprise emerging from bankruptcy. In a liquidating bankruptcy, it might be asserted that, as a technical matter, debt is not discharged in some circumstances, so that the title 11 exclusion may not be applicable. This is because unpaid debt is not generally discharged in a liquidating bankruptcy. Where there is no debt discharge, there should be no COD income. This may be beneficial to the extent that the lack of COD income recognition will avoid attribute reduction. In some situations, the S corporation may want to assert that debt should be treated as actually or constructively discharged. In such case, it is suggested that any plan of reorganization specifically provide for discharge and extinguishment of specified debt in order to avoid doubt as to the applicability of Code Sec. 108(a)(1)(A).⁹

COD does not always result in income recognition or basis reduction. For example, if the S corporation uses the cash method of accounting, the cancellation of debt that would have given rise to a deduction if the debt had been paid, does not constitute an item of taxable income and is not an item of COD that requires that the basis of corporate assets be adjusted. Similarly, purchase money debt that is modified by a solvent taxpayer does not create COD income, but the modification will result in an adjustment to the basis of assets that were financed through such acquisition indebtedness.

The financial restructuring of a troubled S corporation frequently results in some COD income, but because of the foregoing rules, COD income is often the least of the S corporation’s concern.

Gitlitz and subsequent legislation did little to address some of the practical and difficult choices that an S corporation and its shareholders must confront in an effort to restructure a financially troubled corporation.

Planning for Other Income Recognized by a Financially Troubled S Corporation

The tax impact of the COD rules on S corporations and resulting consequences to the shareholders that are summarized above are relatively well established. Less attention is often given to the effect of income that is recognized during the financial restructuring of an S corporation. A corporation with enterprise value that is trying to emerge as a successful ongoing concern realizes income not only from COD but also from continuing business operations and the sale or exchange of appreciated assets not in the ordinary course of business. The Code Sec. 108 exceptions to recognizing taxable COD income may shield some income from taxation, but Code Sec. 108 will not help the S corporation or its shareholders avoid or defer recognition of income from continuing business operations or from gain from the sale or disposition of assets.

However, from the perspective of the S corporation and its shareholders, available cash flow tends to be disbursed to creditors, and non-COD income tends to create taxable income and a resulting tax liability without commensurate cash flow, thus impeding the prospects of rehabilitating the corporation. Tax planning for financially distressed S corporations requires careful consideration of COD income and other types of income that will be realized and tax liabilities that arise during the restructuring process.

The typical situation—to the extent a typical situation exists—is frequently complicated by the fact that, if the S corporation is financially troubled, one or more of the shareholders may be facing financial difficulties that stem from the corporation's plight. Accordingly, the S corporation's financial difficulties may cause some shareholders to seek bankruptcy court protection or other restructuring of their financial obligations at the same time as the S corporation engages in such activity. It is in these situations where the corporation and its shareholders are presented with a number of tax planning options.

Should or Can S Corporation Status Be Terminated?

In the case of an S corporation that has commenced a title 11 case, as in the case of a regular C corporation that seeks bankruptcy court protection, no new corporate taxpayer is created. The status of the corporation as an S corporation continues until something else occurs that alters that status. As an initial proposition in any financial restructuring program, the S corporation—and its shareholders—will have to determine whether or not S corporation status can or should be preserved.

One mechanism that can be used to trigger immediate termination of S corporation status is to have a shareholder sell some stock to a nonqualifying shareholder.

If losses are incurred during the restructuring period, the shareholders may want to preserve S corporation status and continue the pass-through of losses. However, if the S corporation is financially troubled, it is likely that the losses have been

suspended in the hands of the shareholders because they lack adequate basis for their stock or debt in the corporation to absorb those losses. Any losses that were not subject to basis limitations may have also been subject to “at risk” and “passive activity” loss limitations. On the other hand, if continuing losses are in the picture, one might question whether or not the business is capable of being financially rehabilitated absent an influx of new capital or a radical change in the corporation. Although a restructured S corporation will presumably become profitable, the corporation may find that the restructuring can be accomplished only by admitting new shareholders. New shareholders may result in a decreased likelihood that suspended losses can be utilized, and the admission of too many new shareholders—or the wrong type or shareholder—will terminate S corporation status. In such cases, the benefits and burdens of retention versus termination of S corporation status must be considered. Even the timing of admission of new shareholders must be carefully considered, particularly for a shareholder that will terminate S corporation status (for example, a corporate creditor accepting stock in exchange for corporate debt).

On the other hand, when taxable income will be generated, the S corporation may want to preserve S corporation status in order to avoid the corporate level tax burden on such income. However, in the

context of a financially troubled S corporation, all or substantially all of the cash flow generated from operations or the sale of assets are very likely to be claimed by creditors of the corporation. While COD income issues may be relatively easy to deal with, taxable income recognized during the financial rehabilitation process is not so easily addressed. Unlike the distressed C corporation, which may have loss carryovers that will shelter taxable income that may be recognized during the restructuring period, the S corporation does not carryover attributes that will shelter income. Prior losses were passed through to the S corporation's shareholders. If the shareholders do not have sufficient attributes to absorb the income of the S corporation without adequate cash flow (something that is unlikely to occur during many financial restructurings), the shareholders may decide that it is their best interest to terminate the S corporation election in order to avoid a tax burden without commensurate cash flow, particularly if the shareholders believe that they have no prospects in retaining substantial equity in a reorganized corporation.

From the corporation's perspective, the corporation will want to preserve S corporation status in order to avoid a tax liability and preserve value of the corporation, if it is believed that the enterprise has more value as an S corporation than as a C corporation. At the entity level, the corporation is not too concerned with COD income. Insolvency or title 11 avoids taxable income, although there may be some reduction of tax attributes. The shareholders of the S corporation have a different perspective. They may be interested in saving their investment and rehabilitating the company, but not at an excessive cost. Faced with the prospect of taxable income without cash flow, the shareholders may want to trap taxable income in the corporation by triggering termination of S corporation status.

Voluntary elections to terminate S corporation status are not effective unless made within first 2-1/2 months of a corporation's tax year, otherwise the election will not be effective until the start of the corporation's next tax year. Such termination elections require shareholder consent, which may be difficult to obtain for a variety of reasons. The tim-

ing of income recognition is not necessarily within the control of shareholders or the corporation, and prompt action may be needed for tax planning purposes. Essentially, voluntary terminations are effective only if made in accordance with Code provisions that impose some rigorous conditions that may limit the ability of the S corporation to terminate S corporation status promptly. Thus, the filing of a voluntary election in these situations is impractical.

One mechanism that can be used to trigger immediate termination of S corporation status is to have a shareholder sell some stock to a non-qualifying shareholder. Such action generally does not require corporation involvement, unless, perhaps, there is a share-

holder agreement in place blocking such a transfer without corporate-level consent.

If the corporation has sought title 11 protection purposes, will the bankruptcy court tolerate any action that terminates S corporation status? If a significant corporate income tax liability is created, this could jeopardize the rehabilitation of the corporation by creating a corporate-level tax liability that will decrease the cash available to pay creditors. The primary concern of an independent court appointed trustee may be to make certain that his or her fees will be paid. A corporate tax liability may impact the ability of the corporation to pay administrative expenses, including trustee fees, in which case the trustee will not want to share available cash with the U.S. Treasury. A trustee can be expected to fight for the preservation of S corporation status in some circumstances.

The situation raises the prospect that the theories and holdings of *Prudential Lines*¹⁰ and its progeny may be extended to prevent an S corporation's shareholders from terminating the S corporation status of the corporation. In *Prudential Lines*, the creditors of the company filed an involuntary chapter 11 case. Prior to the confirmation of the proposed reorganization plan, the parent corporation of Prudential Lines Inc. indicated that it intended to claim a worthless stock deduction for its Prudential Lines stock, an action that could completely eliminate Prudential Lines' net operating losses. The creditors filed an action in the bankruptcy court seeking to enjoin the parent company from taking a worthless stock deduction for

If the S corporation is financially distressed, there is a reasonably good chance that one or more the shareholders of the S corporation may be facing his or her own financial problems.

any year prior to the year of the confirmation of the reorganization plan, arguing that the net operating loss carryover was a valuable corporate asset that was an asset of the bankruptcy estate and that the parent company should not take any action that would impair the value of such asset. The bankruptcy court enjoined the parent company from taking a worthless stock deduction, and the Second Circuit affirmed the bankruptcy court's injunction.

Prudential Lines and related cases have been used to restrict transfers of shares to preserve corporate NOL carryovers. One might think that *Prudential Lines* would have little application to the S corporation status issue. NOLs reside in a C corporation, not an S corporation. To the extent losses have been passed through from an S corporation to its shareholders, the losses are personal to the shareholder to whom the losses were originally allocated and cannot be used or transferred to others. Additionally, the Code expressly confers the ability to make and terminate S corporation elections on the shareholders of the corporation. It would appear that a corporation should not have a right to avoid paying tax on its income. However, perhaps resolution of this issue is not easy, and courts may have different resolutions as to any attempt to terminate an S corporation election in a work-out situation, depending on the facts and circumstances present in each case.

For example, where a shareholder has used prior S corporation losses to offset taxable income from other sources, or where the shareholder has an unutilized NOL carryover or suspended losses that will shelter S corporation income and eliminate substantial adverse cash flow consequences, a court may be inclined to use its equitable powers to prevent the termination of S corporation status.

When shareholders have suspended losses, such situation may be particularly susceptible to forced retention of S corporation status by a bankruptcy court. A bankruptcy court may determine that the sheltering of corporate income at the shareholder level imposes no real burden on the shareholders, but enhances the resources of the S corporation.

In a case where an S corporation that is projected to generate losses for a period of time, a court might determine that the only available new equity inves-

tors are those that would result in the termination of S corporation status or that such new investors are willing to invest only in a C corporation. The court could allow a disqualifying shareholder to invest or possibly take other action that would mandate the termination of S corporation status. This is a more logical extension of *Prudential Lines* than a mandatory retention of S corporation status in order to avoid corporate-level tax liability.

As a general proposition, a corporation does not have the right to avoid taxes. A Code provision that prescribes that S corporation status can be elected and revoked by shareholders should not be construed to create an equitable right in other contexts to avoid corporate-level tax. However, bankruptcy court decisions can produce some inconsistent and bizarre interpretations of federal tax law.

Even where a new shareholder is a permissible shareholder that will not terminate S corporation status, the timing of the event is critical for income allocation purposes.

Of course, such potential issues may never arise where the shareholders have enough confidence regarding the rehabilitation of the S corporation that the continued benefits of S corporation status may be sufficient to preclude any serious consideration of termination of such status. However, where shareholders have not utilized or retain loss carryover benefits, it would seem inequitable to mandate retention of S corporation status on shareholders who have not received substantial economic benefits. There is little equitable justification for a bankruptcy court to force shareholders to absorb income tax liability in order to increase the amount the corporation has available to distribute to creditors. Absent special circumstances, the general rule should be that direct passthrough treatment of income and resulting tax liability should properly be a shareholder option, not a shareholder obligation. There is a dearth of reported cases that have considered this and related issues.¹¹

If the S corporation election is terminated because of the transfer of shares to an ineligible S corporation shareholder, the corporation's tax year consists of an S corporation short year that ends on the day before the first day for which the termination is effective and a C corporation short year for the balance of the corporation's tax year.¹² Generally, each shareholder's pro rata share of any item for any tax year is determined by assigning an equal portion of such item to each day of the tax

year, and then dividing that portion pro rata among the shares outstanding on such day.¹³ However, if an appropriate election is made when a shareholder terminates the shareholder's interest in the corporation, items are allocated as if the tax year consisted of two tax years, the first of which ends on the date of termination.¹⁴ The election requires that all affected shareholders and the corporation agree to the election. It is unlikely that any such election will be made. Someone is apt to be penalized by such an election, so the default rule can be expected to prevail.

The default rule suggests that the timing of the commencement of a case, controlling when COD and other income items generated by sales or exchanges of appreciated assets, and admissions of new shareholders or changes in related ownership of the corporation associated with an influx of new capital require careful advance planning.

Adding a Financially Troubled Shareholder to the Mix

If the S corporation is financially distressed, there is a reasonably good chance that one or more the shareholders of the S corporation may be facing his or her own financial problems. This often occurs because the shareholder may have acted as a guarantor of corporate debt or be liable for debt incurred by the shareholder that the shareholder invested or loaned to the corporation. The shareholder may seek bankruptcy relief concurrently with the corporation. However the situation arises, when a financially troubled shareholder is also in the picture, the issues get more complicated, the tax planning gets more interesting, and resolution of some issues becomes murky.

In connection with the commencement of individual and corporate proceedings, both the shareholder and the bankruptcy estate are confronted with several interesting issues. Although the timing of income recognition and maneuvering to minimize adverse consequences are often not in any taxpayer's control, existing law and regulations—and administrative and judicial interpretation thereof—require advance planning and constant monitoring of events in order to minimize adverse tax consequences and avoid unpleasant surprises.

As indicated above, the filing of a bankruptcy case by an S corporation does not create a new taxpayer; the S corporation continues its existence

and S corporation status is not affected by the mere commencement of the case. However, when an S corporation shareholder who is an individual commences a case under chapter 7 or chapter 11 of title 11, the Code provides certain specific rules for the tax consequences associated with such cases. Upon the commencement of such a proceeding, the bankruptcy estate is a separate taxpayer.¹⁵ The filing of the individual's case does not terminate S corporation status, and the bankruptcy estate is a permissible S corporation shareholder.¹⁶ The individual taxpayer continues as a taxpayer separate and apart from his or her bankruptcy estate.

The individual is given the option to terminate his or her tax year upon the filing of the case.¹⁷ That is, the individual debtor may make an election that allows the debtor to elect to treat the debtor's tax year that includes the commencement of the bankruptcy proceeding as consisting of two tax years, the first of which ends on the day before the title 11 case commences, and the second of which begins on the commencement date.¹⁸ Such election may be made only on or before the due date for filing the return for the tax year for the new short year, and once the election is made, it is irrevocable.¹⁹

If such election is made, Code Sec. 1398(e)(1) provides that the gross income of the estate for each tax year shall include the gross income of the debtor to which the estate is entitled under title 11, but excluding any amount received or accrued by the debtor before the commencement of the title 11 case. The gross income of the debtor does not include any item to the extent that such item is included in the gross income of the debtor's estate by reason of Code Sec. 1398(e)(1).²⁰

Code Sec. 1398(f)(1) provides that a transfer (other than by sale or exchange) of an asset from the debtor to the estate is not be treated as a disposition for purposes of any provision of the Code assigning tax consequences to a disposition, and the estate treated as the debtor would be treated with respect to such asset. Accordingly, the estate succeeds to the debtor's S corporation stock without triggering a taxable disposition. Similarly, upon termination of the individual debtor's bankruptcy estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor is not treated as a disposition for purposes of any provision of the Code assigning tax consequences to a disposition, and the debtor is treated as the estate would be treated with respect to such asset.²¹

Carryover of Tax Attributes

Code Sec. 1398(g) provides that the estate of the individual debtor succeeds to and takes into account certain specified tax attributes of the debtor, determined as of the first day of the debtor's tax year in which the case commences, namely, net operating loss carryovers, capital loss carryovers, charitable contribution carryovers, any amounts to which Code Sec. 111 applies (relating to recovery of tax benefit items), carryovers of any credit, and all other items which, but for the commencement of the case, would be required to be taken into account by the debtor. In the case of any asset acquired (other than by sale or exchange) by the estate from the debtor, the basis, holding period, and character it had in the hands of the debtor continue in the hands of the debtor's estate.

Code Sec. 1398(g)(8) also provides that other tax attributes of the debtor carry over to the debtor's estate to the extent provided in Regulations. Regulations have been adopted which specify that the estate succeeds to the unused passive activity losses and credits of the debtor (determined as of the first day of the debtor's tax year in which the case commences).²² Upon termination of the estate, the debtor succeeds to the same specified tax attributes of the estate.²³

Consistent with Code Sec. 1398, Regulations provide that if the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange) before the termination of the estate, the transfer is not treated as a disposition for purposes of any provision of the Code assigning tax consequences to a disposition.²⁴ The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under Sec. 522 of title 11 and abandonment of estate property to the debtor under Sec. 554(a) of such title. If the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange) before the termination of the estate, the estate must allocate to the transferred interest, part or all of the estate's unused passive activity loss and unused passive activity credit (determined as of the first day of the estate's tax year in which the transfer occurs).²⁵ Regulations also provide that upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's tax year in which the termination occurs, the passive activity loss and passive activity credit disallowed under Code Sec. 469 for the estate's last tax year.²⁶ Similar provi-

sions apply to unused suspended losses under the "at risk" loss limitation rules of Code Sec. 465.²⁷

The coordination of the timing of income recognition, daily pro ration versus alternate income allocation rules, termination or continuation of S corporation status and elections to terminate a debtor's tax year become powerful tax planning tools for the corporation and its shareholders.

The Questionable Status of Suspended S Corporation Losses

The aggregate amount of losses and deductions taken into account by an S corporation shareholder for any tax year may not exceed the sum of the basis of the shareholder's stock and the shareholder's basis for any debt of the corporation to the shareholder.²⁸ Under Code Sec. 1366(d)(2), any loss or deduction that is disallowed is treated as incurred by the corporation in the succeeding tax year with respect to that shareholder. Notwithstanding that the loss is treated as incurred by the corporation in a later year, such loss is not reported on the corporation's return. It is an item tracked and reported only by the shareholder entitled to claim such item.

If for the last tax year of a corporation for which it was an S corporation, a loss or deduction was disallowed because of such basis limitation rules, the suspended loss or deduction is treated as incurred by the shareholder on the last day of any "post-termination transition period."²⁹ The post-termination transaction in the usual context begins on the day after the last day of the corporation's last tax year as an S corporation and ends on the later of (1) the day that is one year after such last day, or (2) the due date for filing the return for such last year as an S corporation (including extensions).

However, the normal basis limitation rules continue to apply. That is, the aggregate amount of losses and deductions taken into account by a shareholder may not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to suspended losses which are being tested as to allowability).³⁰ The shareholder's basis in the stock of the corporation is reduced by any such allowable loss.³¹

The loss is personal to the shareholder to whom it is disallowed and suspended, and cannot be trans-

ferred in any manner. If a shareholder transfers all his stock, the disallowed loss or deduction is permanently lost.

The suspended loss is not an item that is referred to as a tax attribute that carries over to the bankruptcy estate under Code Sec. 1398 or any regulation promulgated under Code Sec. 1398. Suspended losses are not like NOLs or similar carryover items, but are more like a suspended passive activity loss in character.

While it is clear that suspended losses are personal to the shareholder who was allocated losses in the year they arose and are not available to the shareholder's successor in interest, does this apply to the shareholder's bankruptcy estate? No good policy reason exists for not permitting the bankruptcy estate to claim such losses, but allowance would seem to be inconsistent with the IRS approach applicable to passive activity losses. That is, until Reg. §1.1398-1 specifically referred to passive activity loss carryovers as an attribute to which the estate of an individual succeeded, the IRS took the position that suspended passive activity losses were not transferred to an individual's bankruptcy estate.³² This seems to be a situation where regulations should specify that the suspended loss arising from basis limitations should be available to the bankruptcy estate. However, based on prior guidance of the IRS, it would seem that such suspended losses may not be available to the bankruptcy estate until regulations are promulgated that specifically permit the transfer of such losses.

On the other hand, a reasonable reading of Code Sec. 1398(b), which provides that the individual's estate should be treated as the debtor with respect to transferred assets, suggests that an item that is treated as arising after the case has commenced should be an item that can be claimed by the bankruptcy estate, notwithstanding the IRS's previous position on passive activity losses.

The lack of certainty as to the proper treatment of suspended losses may put the individual shareholder bankruptcy estate into a quandary. Will the S corporation income that is passed through be offset? Will there be any net benefit to the estate? Will the estate of the shareholder issue an order or take action to demand that the S corporation election be terminated or that some sale of stock be made to a nonqualifying shareholder? Will the judge in the bankruptcy estate of the corporation issue an order to the trustee/debtor in possession of the shareholder estate to refrain from taking action that would terminate S corporation

status in order to preserve assets to pay the trustee's fees and other administrative expenses? In some situations, a direct conflict of interest between bankruptcy estates will arise. Which bankruptcy judge's orders will prevail? Should boxing gloves be placed on the hands of competing judges? Resolutions by a round of "eenie-meenie-minie-mo" by a comedian acting as a referee might be a refreshing cause for enthusiasm.

Recent Case Adds Another Tax Planning Tool

One might surmise that the general daily proration of income or loss rules, or specialized election income and loss allocation rules, might apply during the year during which an individual S corporation shareholder commences bankruptcy proceeding. *L.G. Williams*,³³ holds otherwise.

Williams involved an individual who filed for bankruptcy on December 3, 1990, at which time he owned all the shares of two S corporations. The individual reported his pro rata share of the S corporation's 1990 loss attributable to the pre-bankruptcy portion of 1990 on his individual return for 1990. The IRS asserted that the individual was not entitled to claim any losses sustained by the S corporation for 1990, and that all such losses had to be allocated to the individual's bankruptcy estate because the estate owned 100 percent of the stock of the S corporations on the last day of the S corporations' tax year.

The Tax Court in *Williams* acknowledged that it was addressing an issue of first impression and agreed with the IRS's position. The court concluded that Code Sec. 1398 had to be considered before applying Code Sec. 1377. Code Sec. 1398(f)(1) provides that a transfer of assets from the debtor to his bankruptcy estate is not a disposition that should trigger tax consequences, and the estate should be treated as if it were the debtor with respect to such asset. Thus, the court concluded that the bankruptcy estate should be treated as if it owned the stock of the two S corporations for the entire year.

The court acknowledged that Code Sec. 1398(e)(1) specifically provides that the estate is entitled to the individual debtor's items of income and loss from the bankruptcy commencement date, while items of income or loss that the individual debtor received or accrued before filing for bankruptcy remain with the individual debtor. Nevertheless, the court concluded that the individual did not receive or accrue any items of loss from the S corporations for 1990 before the

individual filed for bankruptcy because the income or loss of the corporations was not determined until the last day of 1990. The court observed that it had taken a similar position and applied the same rationale in a partnership context,³⁴ even though the court observed that there are distinctions between the tax treatment of S corporations and partnerships in bankruptcy.

It is somewhat surprising that the IRS sought to impose penalties on the individual for his tax return position. Fortunately for the individual, the court found that the individual acted reasonably and in good faith and determined that the individual was not liable for accuracy related penalties under Code Sec. 6662(a).

Applying the court's reasoning, it also would follow that upon termination of the bankruptcy proceeding in a case where the stock reverts to the individual shareholder, the entire taxable income for the year in which the case terminates is the income of the shareholder. If the bankruptcy estate's interests are paramount, a carefully timed taxable sale of the corporation's assets and other income recognition can maximize the estate's cash flow and leave the rehabilitated shareholder with a liability that arises after the close of the bankruptcy case.

Conclusions

Although there are a number of tax planning tools available to the corporation and its shareholders through available elections and careful timing and sequencing of events, the *Williams* case, and the current state of the law and regulations require that any financially distressed S corporation and its shareholders must carefully consider the elections and options available to them in order to chart a carefully orchestrated plan to minimize the overall adverse tax consequences that can flow from the financial restructuring of the corporation's and a shareholder's affairs.

Unfortunately, actions that have an impact on the S corporation and its shareholders are sometimes outside of their control. For example, creditor foreclosures on shareholder stock or creditors receiving corporation stock in exchange for corporation debt create additional problems. If foreclosure creates an impermissible shareholder and, thus, termination of S corporation status, the timing of the foreclosure event becomes important from a tax planning perspective. The question of allocating income among shareholders becomes more interesting.

Even where a new shareholder is a permissible shareholder that will not terminate S corporation status, the timing of the event is critical for income allocation purposes. The default rule is that income is allocated on a pro rata daily basis. If a creditor forecloses on stock or there is a mid-year termination of S corporation status, there is no actual closing of the books. The daily proration rules apply. As indicated above, although there is a mechanism where all shareholders can agree to close the books to produce a more accurate allocation of income among shareholders, these are circumstances in which agreement is unlikely. Someone will be facing an inequitable allocation, and these are not the type of circumstances in which an advance agreement to close the books will be part of the "deal" relating to the transfer of stock. Might this be another area in which a bankruptcy court might invoke *Prudential Lines* to compel shareholders and creditors to make tax elections that will maximize the benefits to the bankruptcy estate.

If the tax problems confronting the bankruptcy estate of the corporation or individual shareholders become onerous, the estate may choose to abandon the S corporation stock well after the case commenced. The tax consequences of such action would be worthy of a separate article.

ENDNOTES

¹ *D.A. Gitlitz*, S Ct, 2001-1 USTC ¶50,147, 531 US 206, 121 S Ct 701. In *Gitlitz*, the shareholders of an S corporation asserted that COD income that was excluded from gross taxable income passed through to the shareholders to increase the basis for their stock. This allowed the shareholders to claim suspended losses that had been previously disallowed because of insufficient basis for their stock. The shareholders observed, that as a technical matter, attribute reduction

attributable to nontaxable COD income did not occur until the subsequent tax year. The government argued that COD income that was excluded as taxable income did not increase stock basis. The Supreme Court agreed with the taxpayers. As a consequence of the *Gitlitz* decision, the Code was amended to provide that, with respect to debt discharges after October 11, 2001, if the COD income is excluded from the S corporation's income because the corporation is in bank-

ruptcy or is insolvent, the shareholders are expressly denied a stock basis increase for excluded COD income. See Section 402 of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147; Mar. 9, 2002).

² Code Sec. 108(a)(1)(C).

³ Code Sec. 108(a)(1)(D).

⁴ Code Sec. 108(e)(5).

⁵ Code Sec. 108(e)(2).

⁶ Code Sec. 108(d)(7).

⁷ Code Sec. 108(d)(7)(A).

ENDNOTES

- ⁸ This provision does not apply to any COD to the extent that the qualified real property debt rules of Code Sec. 108(a)(1)(D) apply to such discharge.
- ⁹ See 11 USC §1141(d)(3) and 11 USC §727(a)(1).
- ¹⁰ *Prudential Lines, Inc.*, CA-2, 92-2 USTC ¶50,491, 928 F2d 565.
- ¹¹ See, e.g., *Forman Enterprises, Inc.*, BC-DC Penn., 2002-2 USTC ¶50,655, 281 BR 600; *Bakersfield Westar, Inc.*, BAP-9, 98-2 USTC ¶50,843, 226 BR 227; *Trans-Lines West, Inc.*, BC-DC Tenn., 97-1 USTC ¶50,252, 203 BR 653. See also *Harbor Furniture Manufacturing, Inc., v. Tuttleton*, Cal. Ct. App., Dkt. No. B192384, 2007 Cal. App. Unpub. LEXIS 3886 (2007) rejecting a minority shareholder's assertion that majority shareholders had a fiduciary duty to minimize the corporation's tax liability and that the majority shareholders should not be allowed to terminate S corporation status.
- ¹² Code Sec. 1362(e)(1).
- ¹³ Code Sec. 1377(a)(1).
- ¹⁴ Code Sec. 1377(a)(2).
- ¹⁵ Code Sec. 1398.
- ¹⁶ Code Secs. 1361(b)(10)(B) and 1362(C)(3).
- ¹⁷ Code Sec. 1398(d)(2).
- ¹⁸ The election is not available if the debtor has no assets other than property that the debtor may treat as exempt property under Sec. 522 of title 11, a situation that will not apply to the situations considered by this article. Code Sec. 1398(d)(2)(C).
- ¹⁹ Code Sec. 1398(d)(2)(E).
- ²⁰ Code Sec. 1398(e)(2).
- ²¹ Code Sec. 1398(f)(2).
- ²² Reg. §1.1398-1(c).
- ²³ Code Sec. 1398(i).
- ²⁴ Reg. §1.1398-1(d)(1).
- ²⁵ See Reg. §§1.469-1(f)(4) and 1.1398-1(d)(2)(i).
- ²⁶ Reg. §1.1398-1(e).
- ²⁷ See Reg. §1.1398-2.
- ²⁸ Code Sec. 1366(d)(1).
- ²⁹ Code Sec. 1366(d)(3)(A).
- ³⁰ Code Sec. 1366(d)(3)(B).
- ³¹ Code Sec. 1366(d)(3)(C).
- ³² In this regard, compare PLR 9304008 with PLR 9611028.
- ³³ *L.G. Williams*, 123 TC 144, Dec. 55,703 (2004).
- ³⁴ *M.H. Gulley*, 79 TCM 2171, Dec. 53,922(M), TC Memo. 2000-190.

This article is reprinted with the publisher's permission from the JOURNAL OF PASSTHROUGH ENTITIES, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF PASSTHROUGH ENTITIES or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com.

All views expressed in the articles and columns are those of the author and not necessarily those of CCH or any other person. All Rights Reserved.