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## Electing to Close the Tax Year in Bankruptcy

-by Neil E. Harl\*

The economic downturn in the past couple of years coupled with low commodity prices for milk, hogs and a few other commodities has focused attention on appropriate strategies if the decision is made to file bankruptcy.<sup>1</sup> Among those strategies, and one of the most important, is the decision to elect to close an individual debtor's tax year if the filing is under Chapter 7 liquidation or Chapter 11 reorganization.<sup>2</sup> The election opportunity does not apply to those filing under other chapters of the Bankruptcy Code (Chapters 9, 12 or 13) nor does it apply to partnerships, corporations and other types of entities as debtors regardless of the chapter under which the filing occurs.<sup>3</sup>

### Electing two short years

As a general rule, the bankrupt's tax year does not change when bankruptcy filing occurs.<sup>4</sup> However, a debtor *with assets other than those that will be exempt* may elect to end the debtor's tax year as of the day before the day of filing bankruptcy.<sup>5</sup> This creates two short years for the debtor, one beginning on January 1 (for calendar-year taxpayers) and running through the day before bankruptcy filing; the other beginning the day of bankruptcy filing and running through December 31 (again, for calendar-year taxpayers). Thus, the taxable year may not end on the last day of a month even though the general rule is that a fiscal year must end on the last day of a month.<sup>6</sup>

The decision to divide the bankrupt's tax year is made by election filed by the due date for the return for the first short year.<sup>7</sup> Thus, the election is made by filing an election by the 15<sup>th</sup> day of the fourth full month after the end of the month in which bankruptcy is filed.<sup>8</sup> The election is made with the filing of the return and can be made without the prior approval of the Internal Revenue Service.<sup>9</sup> Once made, the election is irrevocable.<sup>10</sup> The election cannot be made after the tax return has been filed.<sup>11</sup>

To show that the election has been made, "Section 1398 Election" should be printed or typed at the top of the debtor's first short-year return.<sup>12</sup> A similar statement should be attached to Form 4868, Application for Extension of Time." The income tax return filed for the second short year should be marked "Second Short Period Year Return After Sec. 1398 Election."<sup>13</sup>

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The election is voided if the Chapter 7 or Chapter 11 bankruptcy filing is dismissed or is converted to a Chapter 12 or Chapter 13 proceeding.<sup>14</sup> An amended return is to be filed if dismissal or conversion to Chapter 12 or 13 occurs after the filing of the taxpayer's return for the first short year.

A spouse may join in the election to end the taxable year if the debtor and spouse file a joint income tax return for the first short year.<sup>15</sup> They are not bound to file jointly for the second short year, however.

An individual who elects to close the tax year must annualize taxable income for both short years.<sup>16</sup> It is done in the same manner as for a change in accounting period.<sup>17</sup>

#### **So why elect to close the year?**

If the short year is *not* elected, the tax attributes (including the income tax basis, holding period and character of assets of the debtor's property, net operating losses, charitable contribution carryovers, recovery of tax benefit items, capital losses, credit carryovers, method of accounting and other tax attributes) pass to the bankruptcy estate (as a new taxpayer) *as of the beginning of the debtor's tax year*.<sup>18</sup> The statute specifies that the tax attributes are "determined as of the first day of the debtor's taxable year in which the case commences" which, for those not electing to close the tax year, is the beginning of the year (January 1 for most individual taxpayers). Thus, no depreciation may be claimed by the debtor for the period before bankruptcy filing and no use can be made of the other tax attributes, either. Moreover, if the election is not made to close the year, the debtor is responsible for income taxes for the entire year of filing including what would have been the short-year period.<sup>19</sup>

If the short-year election is filed, the tax attributes remain with the debtor until the end of the first short year.<sup>20</sup> Moreover, the debtor's income tax liability for the first short year is treated as a priority claim against the bankruptcy estate.<sup>21</sup> The tax liability can be collected from the estate if there are sufficient assets to pay off the estate's debts, at least down to and including tax liability. If there are not sufficient assets to pay the income taxes, the remaining tax liability is not dischargeable and can be collected from the debtor later.<sup>22</sup> Of course, the income tax owed by the bankrupt for the years ending after the filing is paid by the bankrupt and not by the bankruptcy estate.<sup>23</sup> Thus, closing the bankrupt's tax year can be particularly advantageous if the bankrupt has substantial income in the period before the bankruptcy filing.

#### **To sum up**

In general, the election to close the debtor's taxable year should be made if the debtor projects taxable income for what would be the first short year. If the debtor projects a net operating loss for the year, unused credits or excess deductions for what would be the first short year, it is less advantageous to elect to close the year inasmuch as those tax attributes could be used by the debtor to offset taxable income and tax liability during what would be the second short year. However, even with a projected net operating loss, the debtor may still find it advantageous to close the year if (1) the debtor likely could not use the tax attributes; (2) the items could be used as a carryback by the bankruptcy estate to earlier

years of the debtor or as a carryforward;<sup>24</sup> or (3) the debtor would likely benefit later from the bankruptcy estate's use of the losses, deductions or credits. Thus, carrybacks might reduce the debtor's nondischargeable liability for unpaid taxes.

#### **ENDNOTES**

<sup>1</sup> See generally 13 Harl, *Agricultural Law* Ch. 120 (2010); 5 Harl, *Agricultural Law* Ch. 39 (2010); 2 Harl, *Farm Income Tax Manual* § 9.05 (2010 ed.).

<sup>2</sup> I.R.C. §§ 1398(a), (d)(2).

<sup>3</sup> I.R.C. § 1399.

<sup>4</sup> I.R.C. § 1398(d)(1).

<sup>5</sup> I.R.C. § 1398(d)(2)(A), (C).

<sup>6</sup> I.R.C. § 441(e).

<sup>7</sup> I.R.C. § 1398(d)(2)(E).

<sup>8</sup> Temp. Treas. Reg. § 7a.2(d). *In re Kreidle*, 146 B.R. 464 (Bankr. D. Colo. 1991), *aff'd*, 1991-2 U.S. TaxCas. (CCH) ¶ 50,371 (D. Colo. 1991). (in involuntary bankruptcy, case commenced on entry of order for relief). See also Internal Revenue Service, "Bankruptcy," Pub. 908.

<sup>9</sup> I.R.C. § 1398(d)(2)(A).

<sup>10</sup> I.R.C. § 1398(d)(2)(D).

<sup>11</sup> *Id.*

<sup>12</sup> Temp. Treas. Reg. § 7a.2(d). Ann. 81-96, I.R.B. 1981-20, 13.

<sup>13</sup> Ann. 81-96, I.R.B. 1981-20, 13. See generally Internal Revenue Service, "Bankruptcy," Pub. 908.

<sup>14</sup> See I.R.C. § 1398(b)(1).

<sup>15</sup> I.R.C. § 1398(d)(2)(B).

<sup>16</sup> I.R.C. § 1398(d)(2)(F).

<sup>17</sup> See I.R.C. § 443(a)(1). See T.D. 8996, June 17, 2002 (final regulations on adoptions, changes and retention of annual accounting period).

<sup>18</sup> I.R.C. § 1398(g).

<sup>19</sup> See *In re Mirman*, 1989-1 U.S. Tax Cas. (CCH) ¶ 9297 (E.D. Va. 1989) (debtors individually liable for income taxes for year involuntary bankruptcy filed against them where debtors did not elect to close taxable year as of day before date of bankruptcy filing).

<sup>20</sup> See I.R.C. § 1398(g).

<sup>21</sup> 11 U.S.C. § 507(a)(6). See *In re Allen*, 2007-1 U.S. Tax Cas. (CCH) ¶ 50,294 (D. Mass. 2006) (debtor failed to make election to divide the tax year; no part of the tax liability for year of filing collectible from bankruptcy estate, only from debtor).

<sup>22</sup> See, e.g., *Walsh v. United States*, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,478 (D. Minn. 2002) (discharge of tax debt denied (taxpayer failed to file returns); IRS substitute returns did not constitute required returns).

<sup>23</sup> *Moore v. United States*, 132 B.R. 533 (Bankr. W.D. Pa. 1991).

<sup>24</sup> I.R.C. § 1398(j)(2).