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The 2017 Tax Cuts and Jobs Act: More Trouble for Financially Troubled Businesses

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THE 2017 TAX CUTS AND JOBS ACT: MORE TROUBLE FOR FINANCIALLY TROUBLED BUSINESSES

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CORPORATE TAX CHANGES IN THE TCJA

I. Corporate Tax Rates (I.R.C. sections 11 and 243)

A. Pre-2018 Graduated Rates (generally)

1. Up to $50,000 of taxable income (TI): 15%

2. Over $50,000 up to $75,000 of TI: 25%

3. Over $75,000 up to $10 million of TI: 34%

4. Over $10 million of TI: 35%.

B. Post-2017 rate is a flat 21%

1. Corporations with TI up to about $90,000 got a tax increase!

2. Corporations with TI over about $90,000 got a tax cut.

C. Dividend received deductions are generally reduced to compensate for the tax rate reduction.

II. Net Operating Losses (NOLs) (I.R.C. section 172)

A. Under prior law (for taxable years beginning before 2018), NOLs could be used (subject to limitations, such as I.R.C. section 382) to offset 100% of regular taxable income (see below for treatment under the AMT) and could be carried back two years and carried forward 20 years. Certain "specified liability losses" could be carried back 10 years.

B. Under current law (for taxable years beginning on or after January 1, 2018), NOLs can only offset 80% of taxable income (computed before applying NOLs). Those NOLs cannot be carried back at all (except for certain farming businesses and certain insurance companies), but can be carried forward indefinitely. There is also no carryback for specified liability losses; but there are special rules for certain insurance companies.

C. NOLs generated prior to the effectiveness of current law, are still able to offset taxable income 100%, but are also limited to a 20-year carryforward. There is some dispute as to how the "old" and "new" NOLs interact. The IRS position (and proposed technical corrections in an old House bill) is that the 80% limitation for new NOLs is

based on taxable income after it is reduced by old NOLs. This appears to be the position of an example in the General Explanation of Public Law 115-97 prepared by the staff of the Joint Committee on Taxation (the "Blue Book") at page 181 (although it is noted that it may require a technical correction to get to such interpretation), which conflicts with the literal language of the description of the rule in the Blue Book on page 180.

D. The effective date described in the parts of this discussion of the changes to the NOL rules with respect to indefinite carryovers and the limitations on carrybacks are the position of the Blue Book, which indicates that technical corrections may be necessary to achieve its interpretation. The statute literally provides that those rules apply to taxable years ending after 2017, rather than beginning after 2017. This would be relevant to corporations that do not have a calendar year end for federal tax purposes.

E. No changes to the limitations (and the bankruptcy exceptions) imposed by I.R.C. section 382 on NOLs following an ownership change.

F. The new limitations on the use of NOLs will result in increased tax liabilities for financially troubled companies and will also eliminate the possibility of tax refunds from carrybacks of NOLs that used to provide some financial cushion for companies that begin to have financial setbacks.

III. Alternative Minimum Tax (AMT) (I.R.C. section 53 and 55-59)

A. Prior law (for taxable years beginning before 2018)

1. Tax rate of 20% applied against alternative minimum taxable income (AMTI).

2. There was a $40,000 exemption amount applied against AMTI of up to $150,000. The exemption was phased out by 25% of AMTI in excess of $150,000 (i.e., no exemption once AMTI exceeded $310,000).

3. Corporations with average gross receipts over the prior three years of less than $7.5 million ($5 million for startups) were exempt from the AMT.

4. Various preferences and adjustments were added back to regular taxable income to compute AMTI. Two of the more significant adjustments were:

a) The adjusted current earnings (ACE) adjustment, which added back 75% of a modified book/tax differential computation and

b) A limitation on the use of NOLs (recomputed under the AMT rules) to only offset 90% of AMTI, resulting in an effective 2% tax (10% of AMTI x 20% AMT tax rate) on AMTI for corporations that had NOLs.

5. If a corporation was subject to AMT in any year, the amount of AMT was allowed as an AMT credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeded its tentative minimum tax in the

subsequent year. Corporations were also allowed to claim a limited amount of AMT credits in lieu of bonus depreciation. Any unused AMT credits carried forward indefinitely.

B. New law (for taxable years beginning after 2017)

1. The corporate AMT is repealed (but not the individual AMT).

2. AMT credits carried over from prior years may be used to fully offset regular tax for taxable years beginning after 2017 and before 2022.

3. In addition, for taxable years beginning after 2017 and before 2021, 50% of any remaining AMT credit (after offsetting regular tax for the year) may be claimed as a refund. For the taxable year beginning in 2021, any remaining AMT credit (after offsetting regular tax for the year) may be claimed as a refund.

4. Although the AMT has been repealed, the effective tax on corporations that have NOLs (generated after 2017) has now been increased. Since NOLs can now only be used to offset 80% of taxable income and corporations are subject to a 21% tax rate, such corporations are effectively subject to a 4.2% tax (20% of taxable income x 21% tax rate). Thus the tax on corporations with NOLs has more than doubled under the new law, compared to the old effective 2% AMT tax on corporations with NOLs. Moreover, unlike the old AMT rules, there is no exemption in the new NOL limitation rule for corporations with gross income below a certain threshold.

5. With respect to corporate NOLs generally generated before 2018, they have now become more valuable. They are no longer limited by an AMT system that has been repealed and are not subject to the new 80% of taxable income limitation.

IV. Limitation on deductions of business interest (I.R.C. section 163(j))

A. Applies to corporations (consolidated groups treated as one corporation) with average gross receipts for the 3 preceding tax years in excess of $25 million.

1. Certain real estate businesses and farm businesses can elect out of the limitation.

2. If they do, however, they could lose the ability to take immediate writeoffs of acquired tangible property and lose certain accelerated depreciation benefits.

B. Limitation equals the sum of:

1. Business interest income;

2. 30% of “adjusted taxable income” for the year (not below zero); and

3. Floor plan financing interest (i.e., for car dealerships).

C. For corporations, all interest is considered business interest both for income and deduction purposes.

D. Adjusted taxable income means (for corporations) taxable income computed without regard to:

1. Any item of income, gain, deduction or loss not properly allocable to a trade or business;

2. Interest deductions and income;

3. NOLs;

4. For taxable years beginning after 2017 and before 2022, deductions for depreciation, amortization and depletion.

5. So, for taxable years beginning before 2022, adjusted taxable income is the tax equivalent of EBITDA.

6. For taxable years beginning after 2021, adjusted taxable income is the tax equivalent of EBIT.

E. Any interest disallowed under this provision carries forward indefinitely and becomes interest expense in the following year.

F. *Example*: In 2018, a calendar year corporation had taxable income (excluding interest deductions; there were no NOLs, interest income or floor plan financing interest) of $1 million. It had depreciation and amortization deductions of $500,000. It also had interest expense of $2 million (on $25 million of debt). For the past three years, the corporation had gross income of $75 million, $35 million and $15 million (oldest to most recent).

1. The corporation was subject to the interest limitation rules of I.R.C. section 163(j) for 2018, since its average gross revenues for the past 3 years exceeds $25 million.

2. The corporation had adjusted taxable income of $1.5 million ($1 million of taxable income plus $500,000 of depreciation and amortization deductions).

3. The corporation would be limited to an interest deduction of $450,000 (30% of $1.5 million), leaving it with taxable income of $550,000 ($1 million of taxable income less $450,000 of allowed interest deduction). Its federal tax liability would be $115,500 (21% of $550,000). So, despite the fact that the corporation had negative cash flow (assuming the interest was paid and not just accrued) of about $500,000, it still owes a federal income tax. It also has an

interest expense carryforward of $1,550,000 ($2 million of interest expense less $450,000 of interest deduction).

4. If the taxable year had been 2022, the adjusted taxable income would be $1 million and the amount of allowed interest deduction would be $300,000 (30% of $1 million). The corporation would have taxable income of $700,000 ($1 million less $300,000 interest deduction) and owe federal tax of $147,000. It would have an interest expense carryforward to the next year of $1.7 million ($2 million of interest expense less $300,000 of interest deduction).

G. For purposes of I.R.C. section 382, any carryforward of disallowed business interest expense will be treated as a "pre-change loss" and subject to limitation similar to that of NOLs; and any corporation that has a carryforward of disallowed business interest expense will be a "loss corporation."

H. Oddly, carryforwards of disallowed business interest expense were not added to the list of tax attributes that can be reduced as a result of exclusion of cancellation of indebtedness under I.R.C. section 108(b). This may present opportunities and problems in bankruptcy and insolvency workouts.

IMPLICATION S OF TJCA FOR INDIVIDUAL TAXPAYERS AND DEBTORS

The Bankruptcy Code is the uniform federal law that governs all bankruptcy cases. However, it operates in conjunction with the Internal Revenue Code (IRC) and defers to the IRC for purposes of determining tax consequences associated with the bankruptcy process. Unlike the Bankruptcy Code, the IRC is not primarily concerned with fairness, equity, or a fresh start for the debtor.[1] As such, an individual in Chapter 7 or Chapter 11 bankruptcy generally continues to be subject to generally applicable federal income tax laws despite the bankruptcy and must continue to timely file federal income tax returns and timely pay federal income tax due.[2] In addition, while federal income taxes may be of primary concern, it should also be noted that the debtor generally continues to be subject to state and local tax laws (e.g., sales/use, property tax,

[1] *E.g., In re Olson*, 121 B.R. 346 (Bankr. N.D. Iowa 1990); *In re McGowen,* 95 B.R. 104 (N.D.Iowa 1988); *In re Nevin,* 135 B.R. 652 (Bankr. D. Hawaii 1991). In addition, Congress itself acknowledged this tension between the IRC and bankruptcy laws in connection with the enactment of the Bankruptcy Act of 1978. *See* S. REP. NO. 95-989, at 13-14 (1978) ("A three-way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumulation of taxes for past years; (2) the debtor, whose 'fresh start' should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law has restrained him from collecting.").

[2] *See* IRC §§ 6012, 6151; 11 U.S.C. §346; 28 U.S.C. §960. It should be noted that the IRC contains some statutory provisions that specifically address Chapter 7 and Chapter 11 bankruptcies' however, these provisions generally address specific, narrow tax issues in bankruptcy and are limited in scope. *See e.g.,* IRC §§108, 368(a)(1)(G), 382(l), 1017, 1398, 6658.

franchise tax), as well as other federal tax laws (e.g., payroll, employment) during the bankruptcy process.[3]

The Tax Cuts and Jobs Act ("TJCA" or "Tax Act") is the most comprehensive change to federal tax legislation in decades. While it is important to understand the significant changes instituted under TCJA, our discussion today will narrowly focus on those changes that may have the greatest impact on bankruptcy estates, planning for bankruptcy and insolvent taxpayers.

Before TJCA, there was generally significant differences between the conformity of federal and state tax laws in most states causing a multitude of different tax results. TJCA will cause those differences to be considerably greater. Each state's conformity with specific sections of federal tax laws determines the extent to which the state is impacted by the TJCA. It is now over a year later and the level of conformity by many states is not yet known.

To understand the impact of the new tax laws on individual bankruptcy estates and individuals planning to file for bankruptcy, it is important to first review how individual bankruptcy estates are generally taxed.

Because an individual or entity in bankruptcy is not exempt from the application of general tax laws, tax issues exist in most Chapter 7 and Chapter 11 bankruptcy cases. In this respect, tax issues arising in a Chapter 7 or Chapter 11 bankruptcy case are not limited to the individual debtor, but can also impact third parties who are employed to preserve, administer, protect, or recover assets on behalf of the debtor, or disburse monies or assets to creditors, such as trustees and court-appointed receivers. While the nature and extent of the tax issues involved will depend on the facts and circumstances of each case, one thing is consistent across all bankruptcy cases: the failure to fully understand the application of the tax laws in each case can undermine the success of the bankruptcy procedure, result in unanticipated adverse tax consequences, and can even expose a party to personal liability. As such, all parties involved in a Chapter 7 or Chapter 11 bankruptcy case are well-advised to consult a tax adviser in order to maximize the tax efficiency of the bankruptcy procedure as a whole and to ensure compliance with all applicable tax reporting and payment obligations.

Individual Pre-Petition and Filing Tax Issues

The first set of tax issues arises in connection with the bankruptcy filing itself. A tax professional who understands the tax implications of filing for bankruptcy can add value during the pre-filing period by advising and providing assistance with pre-filing planning matters.

Under bankruptcy law, the filing of a bankruptcy petition by an individual debtor under Chapter 7 or Chapter 11 creates a separate cash-basis bankruptcy estate which consists of property formerly belonging to the debtor.[4] The bankruptcy estate is administered by a trustee or

[3] *See e.g., Holywell Corp. v. Smith,* 503 U.S. 47 (1992); *Raleigh v. Illinois Dept. of Revenue,* 530 U.S. 15 (2000); *California State Board of Equalization v. Sierra Summit, Inc.,* 490 U.S. 844 (1989); *U.S. v. Frontone*, 383 F.3d 656 (7th Cir. 2004).

[4] 11 U.S.C. §541(a).

by a debtor in possession[5] for the benefit of creditors, and it may derive its own income and incur expenditures during the course of the bankruptcy process.[6] Since the estate is a new taxpayer, the bankruptcy estate can select a fiscal or calendar year.

For federal income tax purposes, the creation of a separate bankruptcy estate is a noteworthy event. Most significantly, the bankruptcy estate of an individual is treated as a separate taxable entity which is required to report income and gains realized by the bankruptcy estate from the administration of the estate's assets and liabilities during the bankruptcy case.[7] As such, the bankruptcy estate is required to file federal and state income tax returns reporting income derived and expenses incurred by the estate during the bankruptcy case.[8] In addition, the bankruptcy estate is required to compute and pay any federal and state income tax due with respect to the bankruptcy estate's taxable income.[9] The separate taxability of the bankruptcy estate raises numerous tax considerations for both the debtor and the trustee (or debtor in possession) in a Chapter 7 or Chapter 11 bankruptcy case.

Common Pre-Filing Tax Issues for Bankruptcy Estate

Upon the filing of a voluntary petition for relief under Chapter 7, the U.S. trustee (or the bankruptcy court in Alabama and North Carolina) appoints an impartial case trustee to administer the case and liquidate the debtor's nonexempt assets.[10] Similarly, upon the filing of a voluntary petition for relief under Chapter 11, the debtor automatically assumes an additional identity as a "debtor in possession."[11]

Because the filing of a bankruptcy petition by an individual debtor under Chapter 7 or Chapter 11 creates a separately taxable bankruptcy estate, the trustee or debtor in possession, as the case may be, becomes responsible for computing tax due and filing all required federal and state income tax returns on behalf of the bankruptcy estate during the bankruptcy case.[12] Significantly, the duty to pay federal income tax is tied to the duty to make an income tax

[5] The term "debtor in possession" refers to a debtor that keeps possession and control of its assets while undergoing a reorganization under chapter 11, without the appointment of a case trustee. 11 U.S.C. §§1101, 1107.

[6] 11 U.S.C. §541.

[7] IRC §1398.

[8] IRC §6012(a)(8); 11 U.S.C. §346.

[9] IRC §1398(c).

[10] 11 U.S.C. §§701, 704. *See also* Administrative Office of the United States Courts, *Bankruptcy Basics* at p. 17, available at, http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics (last visited May 19, 2015).

[11] 11 U.S.C. §1101. As noted above, the term "debtor in possession" refers to a debtor that keeps possession and control of its assets while undergoing a reorganization under chapter 11, without the appointment of a case trustee.

[12] IRC §1398(c)(1) (providing that the trustee shall compute tax on behalf of bankruptcy estate); 11 U.S.C. §1107 (providing that the debtor in possession shall generally have same rights and powers and shall perform same functions and duties of trustee).

return.[13] Therefore, the trustee or debtor in possession also becomes liable to pay any federal and state income tax due with respect to the bankruptcy estate's taxable income on behalf of the bankruptcy estate. Failure by the trustee or debtor in possession to timely file income tax returns and pay income tax due exposes the bankruptcy estate to IRS penalties and interest and could potentially expose the trustee or debtor in possession to personal liability. Accordingly, it is imperative that the trustee or debtor in possession fully understand and comply with all applicable tax filing and payment obligations, commencing upon the filing of the bankruptcy petition.

Another pre-filing issue for a trustee relates to pre-petition federal income tax refunds to which the debtor is entitled. When the refund statute has not expired, a Chapter 7 debtor's unreceived pre-petition tax refund becomes property of the bankruptcy estate upon the filing of the bankruptcy petition.[14] As such, the debtor's pre-petition tax refunds are subject to turnover to the trustee. However, in order to obtain turnover of the debtor's tax refund for the benefit of the bankruptcy estate, the trustee must follow and comply with certain procedural requirements.[15] In this regard, invalid or incomplete turnover requests will be denied by the IRS.[16] Accordingly, it is important for the trustee to consult with a tax adviser in order to ensure compliance with all applicable procedural and timing requirements for submitting a request to IRS for turnover of the debtor's pre-petition tax refund.

Common Pre-Filing Tax Issues for the Individual Debtor

In addition to the income tax returns filed by the bankruptcy estate, the individual debtor is required to file individual income tax returns during the bankruptcy case.[17] For this purpose, the debtor is required to report income received, gains and losses recognized, and deductions paid other than income, gains, losses, and deductions which belong to the bankruptcy estate.[18]

One of the most important pre-petition debtor tax considerations which is often overlooked relates to the ability of the individual debtor to make an election to close his or her taxable year as of the day before the date on which the bankruptcy case commences.[19] If this election is made, the debtor's taxable year, which would otherwise be a full year period unaffected by the bankruptcy filing, is divided into two "short" taxable years of less than twelve months, with the first tax year ending on the day before the commencement of the bankruptcy

[13] *See e.g., Holywell Corporation v. Smith,* 503 U.S. 47, 52, (1992) (citing IRC §6151(a), which provides, in relevant part, "[W]hen a return of tax is required . . . the person required to make such return shall . . . pay such tax. . . .").

[14] Internal Revenue Manual (IRM) 5.9.6.2.3(1). Note, however, that the bankruptcy estate's right to the debtor's tax refund is limited to the portion of the refund attributable to pre-petition events.

[15] *See* IRM 5.9.6.2.3(2).

[16] IRM 5.9.6.2.3(4).

[17] IRC §6012(a)(1); IRC §1398(e)(2).

[18] *Id.*

[19] IRC §1398(d)(2).

case, and the second tax year beginning on the commencement date and ending at yearend.[20] Depending on the individual debtor's particular facts and circumstances, this election can result in substantial federal income tax savings to the debtor. Conversely, making the election under the wrong facts and circumstances may be disadvantageous to the debtor. As such, the debtor and his or her bankruptcy counsel should thoroughly understand and consider the potential advantages and disadvantages associated with making an election to close the debtor's tax year.

In order to properly compute individual tax liability during the bankruptcy case and avoid exposure to accuracy-related IRS penalties and interest, it is imperative that the individual debtor gain a full understanding of which current income, loss, deduction, and credit items are properly included on the tax returns filed by the bankruptcy estate and which items are properly included on the debtor's individual tax returns. In addition, the debtor must understand how the creation of a separately taxable bankruptcy estate impacts tax attributes carried forward from prior periods, such as net operating loss (NOL) carryovers, credit carryovers, charitable contribution carryovers, and other tax attributes carried forward from prior tax years. Significantly, tax attribute carryovers of the debtor from tax years ending prior to the commencement of the bankruptcy case can only be used by the bankruptcy estate while the bankruptcy estate is in existence for income tax purposes.[21] Thus, the debtor loses access to its tax attribute carryovers upon the filing of the bankruptcy petition. Depending on the debtor's individual tax situation and the nature and extent of the debtor's tax attribute carryovers, it may be appropriate to consider tax strategies to minimize the reduction or loss of tax attributes upon filing for bankruptcy.

An additional pre-filing consideration for debtors relates to prior year overpayments of tax carried forward from a pre-petition tax year. Significantly, a federal or state tax overpayment carried forward from a pre-petition tax year may become the property of the bankruptcy estate upon the filing of a petition for relief under Chapter 7 or Chapter 11.[22] This means that the prior year overpayment of tax will become available for credit against the bankruptcy estate's tax liability (as opposed to available for credit against the debtor's individual tax liability) upon the filing of the bankruptcy petition. To the extent that a debtor has previously elected to carry forward a prior year overpayment, this may impact the timing of the filing for bankruptcy. Similarly, to the extent that an individual debtor is considering filing for bankruptcy, knowledge of this may impact the decision to request a refund of overpaid taxes (as opposed to electing to apply the overpayment to a subsequent tax year). The debtor and his or her bankruptcy counsel should discuss these types of planning considerations with a tax adviser prior to filing for bankruptcy.

A somewhat related pre-filing consideration for a debtor and his or her counsel relates to pre-petition federal income tax refunds to which the debtor is entitled. As noted above in the discussion of pre-filing tax issues for the bankruptcy estate, an individual debtor's pre-petition tax refunds are subject to turnover to the bankruptcy estate. Significantly, however, the IRS will not honor a trustee refund turnover request which is received after issuance of the refund to the

[20] IRC 1398(d)(2)(A)(i)-(ii).

[21] IRC §1398(i); *Oren L. Benton*, 122 T.C. No. 20 (2004); *Linsenmeyer v. U.S.*, No. 03-1172 (6th Cir. 2003); *Kahle v. Commissioner*, T.C. Memo, 1997-91 (1997).

[22] *Nichols v. Birdsell*, 2007 U.A. App. LEXIS 10919 (9th Cir. 2007).

debtor.[23] This may impact the timing of the filing of the bankruptcy petition for debtors who are entitled to receive a refund of overpaid federal income taxes from IRS. Conversely, the timing of the filing of the bankruptcy petition may also be impacted if the debtor owes taxes from a prior period due to the fact that certain taxes are non-dischargeable in bankruptcy. Non-dischargeable taxes include income and gross receipts taxes which are "assessed" within 240 days of the filing of the bankruptcy petition or which are assessed after the bankruptcy petition is filed.[24] Accordingly, if a debtor owes income taxes from a prior tax period, it may be necessary to review and consider when the tax was "assessed," as this may impact the timing of the filing of the bankruptcy petition in some cases. Significantly, the concept of assessment is a tax term of art. In addition, special rules may apply for purposes of counting the number of days that have elapsed since a prior assessment of tax. Accordingly, debtors and their bankruptcy counsel should consult with a tax adviser to determine when prior period tax was assessed.

Tax Issues during the Bankruptcy Case

While a bankruptcy filing does not relieve the debtor of his or her usual duty to file income tax returns, it can markedly shift the nature, timing, and extent of the debtor's obligations to pay taxes. In addition, the actions and financial activities of the trustee or debtor in possession during the bankruptcy case can create unanticipated adverse tax consequences for both the debtor and the bankruptcy estate.

Common Tax Issues Encountered by the Bankruptcy Estate

Estate income includes amounts paid on after the Petition Date. Thus, Schedule K-1 pass-through from partnerships and S corporations with years ending on or after the Petition Date would be included in the estate's taxable income. Debt relieved, transferred or assumed by the purchaser in a property transfer or settlement is also included in in the estate's income. This income can also be offset by the Debtor's pre-bankruptcy NOLs. For years prior to 12/31/17 can be carried back two years and carried forward twenty years.

Estate tax deductions include expenses that would have otherwise been available to the debtor. Bankruptcy estates can also deduct administrative expenses paid to professionals and others to administrate the estate's assets.

Estate administrative expenses (IRC §1398(h)) are paid out of the property of the bankruptcy estate and can only be utilized by the bankruptcy estate. They cannot be carried back or carried over by the Debtor to pre or post-petition years. In the bankruptcy estate, such expenses can be carried back three years and forward seven years.

In a Chapter 11 case, property acquired by the debtor after the bankruptcy petition date (after-acquired property) becomes the property of the bankruptcy estate.[25] Specifically, Section 1115 of the Bankruptcy Code defines property of the bankruptcy estate to include (1) the debtor's gross earnings from performance of services after the commencement of the bankruptcy case

[23] IRM 5.9.6.2.3(2)(g).

[24] 11 U.S.C. §507(a)(8).

[25] 11 U.S.C. §1115; IRM §5.9.4.1(3)

(post-petition services); and (2) the gross income from property acquired by the debtor after the commencement of the bankruptcy case (post-petition property). As a result, the bankruptcy estate, rather than the individual debtor, is required to include in its taxable income the debtor's gross earnings from post-petition services and gross income generated by the debtor's post-petition property.

This significantly affects how the individual debtor and the debtor's bankruptcy estate are taxed during the Chapter 11 bankruptcy case. In addition, this might potentially affect the debtor's employer and persons filing Forms W-2, 1099, and other information returns that report payments to the debtor. IRS Notice 2006-83 provides guidance for debtors in possession or trustees relative to the tax filing obligations and procedural requirements for ensuring proper reporting of the debtor's income from post-petition services and post-petition property during a Chapter 11 bankruptcy case.

Pursuant to Bankruptcy Code §554, trustees should abandon assets that are burdensome or inconsequential to the bankruptcy estate. Upon abandonment, the asset ceases to be property of the bankruptcy estate. Abandonment of assets by estates is generally seen in instances where the asset exposures an estate to phantom income or gain but the asset does not provide adequate cash flow to pay the resultant tax (e.g., partnership interests or real property with low tax basis and/or mortgage greater than fair market value).

Alternative minimum tax (AMT) considerations: As previously noted, tax attribute carryovers from tax years ending before the commencement of the bankruptcy can be used only by the bankruptcy estate while it is in existence.[26] Therefore, the debtor's tax attribute carryovers from prior tax periods become available to offset the federal income tax liability of the bankruptcy estate during the bankruptcy case. In considering asset transactions, bankruptcy professionals often assume that if there are enough NOLs or other tax attributes to offset taxable income generated by the bankruptcy estate, there will be no federal or state income tax liability for the estate.

However, under the alternative tax NOL rules (Sec. 56(d)(1)), the ability to use NOLs and other tax attributes to offset the estate's taxable income may be limited for AMT purposes. The amount of the NOLs available for AMT purposes (ATNOLs) may differ from the amount of the regular tax NOLs, and generally only 90% of a taxpayer's computed alternative minimum taxable income can be offset with ATNOLs. Thus, even though available regular tax NOLs might exceed the regular taxable income of the bankruptcy estate, the bankruptcy estate may not be able to fully use the estate's ATNOLs, resulting in an AMT liability.

If the bankruptcy estate incurs an AMT liability, the estate may be entitled to a minimum tax credit that it can carry forward to offset regular federal income tax liability in a subsequent tax year when AMT does not apply (Sec. 53(a)). Although the debtor's tax attributes become the property of the bankruptcy estate upon the filing of the petition, any unused tax attributes remaining when the case is closed by the Bankruptcy Court revert back to the debtor in that year (Sec. 1398(i)). Since the trustee is a fiduciary, it is important for him or her to properly track and

[26] (Sec. 1398(g); *Benton*, 122 T.C. 353 (2004); *Linsenmeyer*, No. 03-1172 (6th Cir. 2003); *Kahle*, T.C. Memo. 1997-91 (1997))

carry forward any minimum tax credit generated by the bankruptcy estate to preserve those credits for use by the bankruptcy estate in subsequent tax years or by the debtor after the bankruptcy estate is closed.

Common Tax Issue Encountered by the Debtor

Cancellation of debt is perhaps one of the most common tax issues encountered by debtors during bankruptcy and relates to the cancellation or modification of indebtedness and the attendant tax consequences to the debtor. Generally, a debtor is required to recognize cancellation-of-debt (COD) income to the extent that a debt is discharged for less than the amount owed[27]. While the concept may seem straightforward in theory, its application to a debtor's particular facts is rarely straightforward, especially in a bankruptcy. Another potentially complicating factor in considering COD income relates to situations where a debtor transfers collateralized property to a creditor in exchange for discharge of the debt that the property secures. In this situation, the transaction's tax consequences differ significantly depending on whether the underlying debt is recourse or nonrecourse.

In addition to the threshold challenges associated with identifying a debt discharge event and determining whether a debtor has realized COD income for federal income tax purposes, the general rule requiring recognition of COD income is subject to numerous exceptions, exclusions, and modifications that may provide some relief for the debtor. The most relevant of these are the exclusions of COD income for bankrupt (Sec. 108(a)(1)(A)) and insolvent (Sec. 108(a)(1)(B)) taxpayers.

Tax Cuts and Jobs Act and its Impact on Individual Bankruptcy Estates

The provisions of the TCJA made significant changes to the Internal Revenue Code that may result in an income-deduction mismatching problems, or loss of federal income tax benefits for certain Debtors (and other taxpayers in an Insolvency Case).

TCJA also contains provisions that modify the pre-Tax Act federal income tax income recognition timing rules to require Taxpayers, including Debtors, to accelerate the tax reporting of certain income items, including phantom income items, for federal income tax purposes.[28] The limitation or loss of federal income tax benefits and/or the income recognition acceleration requirement under the Tax Act may result in increased current and future year federal income tax liability to Debtors, and/or the loss of federal income tax refunds by the Debtors for past tax

[27] *Kirby Lumber Co.*, 284 U.S. 1 (1931); Sec. 61(a)(12)

[28] See for example IRC Sections 59A, 67, 118, 162, 163, 165, 172, 367, 381, 382, 451,461, 482, 936, 951, 951A, 956, 957, 958, 965, and 6050X. The provisions of the TCJA accelerate and expand income recognition by certain Debtors including Debtors' that directly or indirectly own or are deemed to own for federal income tax purposes certain foreign subsidiary entities. The provisions of the TCJA generally apply for tax years beginning after December 31, 2017. However, certain tax provisions of the TCJA such as the accelerated income provisions under IRC Section 965 and related tax provisions apply in 2017.

years, which may adversely affect the Debtors' ability in an insolvency case to restructure its debt (debt workout), reorganize its business operations, and/or liquidate its assets.[29]

The provisions of the TCJA made significant changes to the Internal Revenue Code that may exacerbate the income-deduction mismatching problem for certain Debtors (and other taxpayers in an insolvency case). Although the TCJA contains numerous tax provisions that are very favorable to Taxpayers, including to Debtors (and Creditors), the Tax Act also contains provisions that limit and/or prevent such Debtors from claiming certain previously allowed (pre-Tax Act) federal income tax deductions, NOL carrybacks and NOL carryforwards, that allowed Debtors to reduce their current and future year federal income tax liability, and/or obtain federal income tax refunds from overpayments of federal income taxes in prior tax years.

The TCJA removes most Debtors' ability to carryback NOLs to offset such Debtors' federal income tax liability arising in prior tax years, and to obtain federal income tax refunds attributable to such NOL carrybacks, and limits the Debtor's ability to carryforward NOLs to offset their federal income tax liability arising in future tax years. Under the TCJA, for tax years beginning on or before December 31, 2017, Debtors (and other Taxpayers) are allowed to continue under pre-Tax Act rules, to carryforward for 20 years, 100% of their NOLs to reduce the Debtors' federal income tax liability in subsequent tax years. Debtors are also allowed to continue under pre-Tax Act rules, to carryback 100% of their NOLs to reduce the Debtors' federal income tax liability in the Debtors' 2 prior tax years, and obtain a federal income tax refund for any resulting overpayment of tax in such carryback tax years. Debtors that incur a "Specified Liability Loss" within the meaning of IRC §172(f) (generally certain product liability related losses, environmental related losses, and/or workers compensation related losses) are allowed under pre-Tax Act rules to carryback such Loss to the Debtors' 10 prior tax years.[30]

Further, under the TCJA, for tax years beginning on or after January 1, 2018, Debtors' (and other Taxpayers) are only allowed to carryforward 80% (rather than 100%) of their NOLs to offset their federal income tax liability arising in future tax years.[31] The Tax Act also prevents Debtors' from carrying back NOLs generated in such tax years, to offset the Debtors' federal income tax liability arising in prior tax years, and to obtain federal income tax refunds attributable to such tax years. Finally, for NOLs created on or after January 1, 2018, the carryforward is indefinite. However, IRC §1398(h) administrative expense NOLs are not specifically addressed by TCJA and the law did not change IRC §1398(h)'s 3 year carryback and 7 year carryover. Thus, unless there is a change by IRS or Congress, it appears such expenses may still eligible for carryback.

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[29] The reduction of the federal income tax rate combined with the limitations on tax deductions and utilization, corporate tax NOLs under the TCJA may reduce the economic and tax value of the Debtor's NOLs and other tax attributes for federal income tax purposes.

[30] See pre-Tax Act IRC §172. The NOL carryforward and carryback rules are subject to the application of the AMT rules including the AMT 90% limitation rule. The AMT was repealed for corporate taxpayers for tax years beginning on or after January 1, 2018.

[31] The TCJA disallowance of NOL carrybacks does not apply to certain taxpayers that are engaged in the insurance or farming business.

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As a result, the change in the NOL rules exacerbate the income/expense mismatching issue we often see in bankruptcy cases. In the past, individual estates have carried back NOLs to reduce or eliminate income/gains stemming from the sale of assets in the earlier stages of many cases. It is now critical to consider how the estate might mitigate such income in each year it arises as only §1398(h) expenses are allowed to be carried back. Some mismatching may be also be mitigated by the choice of fiscal year, planning an earlier payment of professional fees or other expenses or timing the deductible payment to a settlement fund. Finally, it should be noted that most state tax carryover rules will differ from the federal rules and, as such, should be separately analyzed.

The TCJA also limits the federal income tax deductions for certain previously allowed current business operating losses incurred by individual Debtors. Under the TCJA, for tax years beginning on or before December 31, 2017, individual bankruptcy estates (and other Taxpayers) are allowed to continue, with certain exceptions, to deduct 100% of their business tax losses, and offset such losses against such Debtors' non business income for federal income tax purposes. However, for tax years beginning on or after January 1, 2018, non-corporate Debtors' (and other non-corporate Taxpayers') annual allowable business loss tax deduction is limited to the excess of the Debtors' business deductions for such tax year over the sum of (a) the Debtors' gross income or gain attributable to the Debtors' businesses in such tax year, plus (b) $250,000 ($500,000 in the case of Debtor individuals that file joint tax returns).[32] For an individual estate, the disallowed portion over $250,000 is treated as an NOL carryover. The limitation is also applied after passive losses (IRC §469).

TCJA adds IRC §199A for years beginning after 12/31/2017 and before 1/1/2026. This section provides for a 20% deduction for "qualified business income" This will include many of the trade or business income passed through to an individual from S corporations, partnerships, sole proprietorships including rental activities.

Generally, the deduction is limited to the lesser of 20% of "qualified business income" (QBI) or taxable income and the individual's estate had trade or business income and taxable income less than $157,500. The deduction is fully phased out with taxable income that exceeds $207,500. Estates with income from a "specified service business" (law, accounting, athletics, performing arts, actuarial services, consulting, financial services, health, brokerage and any business the principal asset of which is the reputation/skill of one or more owners/employees) will not qualify for the deduction.

TCJA limits certain itemized deductions for years beginning after 12/31/17 and before 1/1/2026 as follows:

1) State and local taxes are limited to $5,000 annually on Married Filing Separate ("MFS") tax return

2) Interest expense deduction limited on home mortgages ($375,000 of debt MFS),

[32] See IRC §461(l). The limitation on farm losses under this section is suspended through 2025.

3) Interest expense deduction suspended on home equity debt,

4) Personal casualty and theft loss deductions are limited to those taxpayers in federally declared disasters areas (theft and Ponzi loss deductions are therefore suspended)

5) Moving expenses deduction suspended

6) Miscellaneous itemized deductions suspended (unreimbursed employee business expenses, tax preparation fees)

Finally, a Debtor may also incur state or local sales tax and/or state or local income tax liability, even though the Debtor will not incur any corresponding federal income tax liability with respect to the Debtor's activities. This may be attributable to differences between federal, state and local income tax laws or other tax laws such as sales tax laws that do not have a federal tax law equivalent. If the Debtor does business or owns assets in multiple states and cities, the Debtor may be subject to multiple different conflicting state and local tax laws that require complex state income sourcing, apportionments and allocations. The multistate sourcing, apportionment and allocation of the Debtor's Tax Items between states (and cities) may result in the mismatching of the Debtor's income, gains, deductions, and losses, including NOLs, between the states (and cities), resulting in unanticipated state and/or city tax liability to the Debtor.[33]

Conclusion

Understanding and navigating the tax implications associated with common transactions and procedures which occur before and during a Chapter 7 or Chapter 11 bankruptcy case can be complex, requiring an intricate analysis and understanding of the particular facts and circumstances of the bankruptcy case. In this regard, a failure of a debtor or trustee to fully understand the application of tax laws in the context of a Chapter 7 or Chapter 11 bankruptcy case can result in unanticipated adverse tax consequences and can potentially expose a fiduciary, such as a debtor's bankruptcy counsel or the trustee of the bankruptcy estate, to personal liability. The addition of a tax adviser who understands the tax consequences of a Chapter 7 or Chapter 11 bankruptcy to the team of advisers can add tremendous value for debtors, their bankruptcy counsel, and trustees.

BANKRUPTCY, TAXES AND PASSPORTS: THREE WORDS THAT YOU NEVER THOUGHT YOU WOULD SEE IN THE SAME SENTENCE

In December of 2015, Congress enacted the Fixing America's Surface Transportation ("FAST") Act, Pub.L. No. 114-04. In §32101 of the FAST Act, Congress enacted Internal Revenue Code §7345. This section authorizes the Commissioner of Internal Revenue to certify taxpayers who owe a "seriously delinquent tax debt" to the Department of State for the Department to deny, revoke or limit the taxpayer's passport.

A seriously delinquent tax debt is an assessed tax liability that exceeds $50,000 if a) a notice of tax lien has been filed by the IRS pursuant to IRC §6323 and the administrative rights

[33] Many states adopt the provisions of the Internal Revenue Code with modifications.

under §6320 with respect to such filing have been exhausted or have lapsed, or b) a levy is made pursuant to section 6331, subject to statutory exceptions and subject to what the IRS calls "discretionary exceptions."

The statutory exceptions to the definition of a "seriously delinquent tax debt" are a) taxes being paid through an installment agreement, b) taxes being paid through an accepted offer in compromise, c) taxes which are the subject of a pending Collection Due Process hearing under §6330, and d) taxes which are the subject of pending innocent spouse request under §6015.

So what is the connection with bankruptcy? The IRS, in §5.1.12.27.4 (12-20-2017) of the Internal Revenue Manual ("IRM"), takes the position that "IRC § 7345 provides the IRS discretion to exclude categories of tax debt from certification, even if the debt meets the statutory definition of a "seriously delinquent tax debt." These "discretionary exceptions" currently include the following: a) taxes designated as currently not collectible (CNC) due to hardship, b) taxes owed as the result of identity theft, c) **taxes owed by a "taxpayer in bankruptcy,"** d) taxes owed by a dead taxpayer, d) taxes included in a pending Offer in Compromise that meet the criteria described in IRM 5.8.2.3.1, provided that the OIC was not made solely to delay collection, e) taxes included in a pending installment agreement request that meets the criteria in IRM 5.14.1.3(4), provided the request is not made solely to delay collection, f) taxes with a pending adjustment that will full pay the taxes owed, and g) taxes owed by taxpayers in a Disaster Zone.

The Manual states that "[t]hese discretionary exclusion categories are subject to change in the future."

The IRS is required to notify a taxpayer that it has certified a seriously delinquent tax to the State Department by sending a letter to the taxpayer at their last known address. This letter must notify the taxpayer of their right to bring a judicial action in the Tax Court or District Court to challenge the certification. This letter is sent by ordinary mail, and the IRS currently does not send a copy of the letter to the taxpayer's power of attorney.

Once the IRS has certified the debt to the Department of State, the State Department has almost unlimited discretion regarding the denial, revocation or limitation of the taxpayer's passport. See 22 USC §2714a(e), 22 CFR §§51.60, 51.65, and 51.70.

If a tax debt is no longer a "seriously delinquent tax debt" per the statute, the IRS is required to "de-certify" the debt by sending a notice to the State Department. It is unclear whether the IRS is legally required to send a decertification letter where a tax debt is no longer a "seriously delinquent tax debt" because the debt changes status so as to fall within the scope of the "discretionary exclusions" discussed above, such as "taxes owed by a taxpayer in bankruptcy."

Taxpayers can judicially challenge a certification to the State Department that they believe is erroneous in Tax Court or District Court. They can bring a similar judicial challenge based on an erroneous failure to decertify the taxes as a seriously delinquent tax debt.

The IRS did not begin certifying any taxpayers under §7345 to the State Department until the spring of 2018. The State Department holds the certification for 90 days, to give taxpayers a

chance to "work things out" with the IRS. Thus, taxpayers are only now beginning to feel the effect of the certification process.

The procedures used by the Department of State once referral becomes effective remain opaque. There are anecdotal stories involving taxpayers whose accounts were certified last spring but who still have their passports. There are other anecdotal stories of taxpayers whose accounts were certified but who did not lose their passports until they visited a U.S. Consulate abroad to add pages to their passport.

The procedures applicable to actions brought in Court are unclear. It is unclear what evidence may be introduced into the record. The standard of review is unclear. There are far more questions than answers in situations that do not involve bankruptcy. There are even more questions in situations involving bankruptcy. Some of these questions that are unique to bankruptcy are as follows:

1. When is a taxpayer "in bankruptcy" for purposes of this provision?

   The answers, if they exist, will vary from chapter to chapter. In no asset chapter 7 bankruptcy cases, the answer will be relatively straightforward. What about asset chapter 7 cases? Does the answer depend on when the automatic stay is in effect or instead depend on when the case is closed? In Chapter 11 cases and Chapter 13 cases, what is the effect of the confirmation of a plan?

2. Is the phrase "in bankruptcy" too vague to create an enforceable rule? Will courts defer to the IRS's interpretation of this phrase under *Auer v. Robbins*, 519 U.S. 452 (1997)?

3. Given that the "taxpayer is in bankruptcy" exclusion is discretionary on the part of the IRS, does the taxpayer have the right to force the IRS to decertify the debt if the taxpayer is "in bankruptcy"?

   The answer may depend on the line of cases spawned by *Accardi v. Shaughnessy*, 347 U.S. 260 (1954), which addresses the question of when an agency is legally required to comply with its own procedures, particularly those which are adopted for the benefit of the public, even procedures which the agency was not required by statute to adopt.

4. Does the certification of a tax debt under §7345 violate the automatic stay? Does the revocation or denial of a passport based on a certification under §7345 violate the automatic stay?

5. Can the IRS unilaterally eliminate the bankruptcy exception from the definition of "seriously delinquent tax debt?"

6. Does the Bankruptcy Court, as an arm of the District Court, have the authority to hear an action brought by a taxpayer/debtor under §7345?

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Because the enforcement of the statute by IRS started less than one year ago, it is going to be quite some time before we know all of the questions to ask, let alone the answers to the questions.

THE NEW BBA PARTNERSHIP AUDIT PROVISIONS AND BANKRUPTCY: A SHOTGUN WEDDING WITHOUT ANY MARITAL BLISS

Bankruptcy and taxes. Taxes and bankruptcy. These two topics go together like peas and carrots. Except that tax professionals don't like peas, and bankruptcy professionals don't like carrots.

It appears to be a metaphysical certainty that Congress, when it enacted the new BBA partnership audit provisions contained in sections 6221 through 6241 of the Internal Revenue Code in 2015, forgot that it enacted the Bankruptcy Code almost 40 years earlier. These new BBA partnership audit procedures have replaced the so-called TEFRA Partnership audit rules, and are generally effective for tax years starting after December 31, 2017. Thus, we are now entering the very first tax return filing season in which the BBA partnership audit rules apply.

These new partnership audit rules have already been "tweaked" once in 2018 by a Technical Corrections Act. This statutory scheme is in many places completely incompatible with the Bankruptcy Code. Yet, these two statutory schemes must co-exist. Hence the title: A Shotgun Wedding Without Any Marital Bliss.

Bankruptcy practitioners should not even pretend that they will be able to thoroughly understand these new partnership audit rules. Indeed, most tax practitioners will never truly understand these new rules. While the statutory provisions are not lengthy, the regulations consume hundreds of pages. See the recently proposed (August 17, 2018) regulations set forth at https://www.federalregister.gov/documents/2018/08/17/2018-17614/centralized-partnership-audit-regime. These proposed regulations, which take into account changes made by the 2018 Technical Corrections Act, are intended to supersede hundreds of pages of previously issued regulations issued before the passage of the Technical Corrections Act. The "old" regulations superseded by these new proposed regulations include: a) Regulations issued in November of 2017 relating to international issues, b) Regulations issued in December of 2017 relating to procedure and administration, statutes of limitation, penalties, interest, and assessment and collection of taxes, and c) Regulations issued in February of 2018 relating to "tax attributes" and related adjustments.

The latest proposed regulations do **not** supersede certain other previously issued regulations, include a) Regulations issued December 29, 2017, relating to election out of the new partnership rules, available at https://s3.amazonaws.com/public-inspection.federalregister.gov/2017-28398.pdf , and b) Regulations issued August 6, 2018, relating to the Partnership Representative under the new rules and making an election to Apply the new rules, available at https://s3.amazonaws.com/public-inspection.federalregister.gov/2018-17002.pdf.

Rather than attempt to comprehensively explain all of these rules and regulations, an impossible task in a short outline, this outline provides a description of several key aspects of the

new partnership audit rules of interest to bankruptcy practitioners, along with questions as to how each of these key aspects might interact with the Bankruptcy laws.

It is Important For Bankruptcy Practitioners to Know Whether the New Partnership Audit Rules Apply to a Tax Partnership or to a Partner in a Tax Partnership if the Tax Partnership or Partner is Contemplating Filing for Bankruptcy

Where the Tax Partnership is the (Prospective) Debtor

In connection with any anticipated bankruptcy proceeding involving a "tax partnership" (which includes "real" partnerships and LLCs which have elected to be treated as a partnership), a bankruptcy professional representing the "tax partnership" needs to determine whether the new partnership audit rules apply to that entity. If these rules do not apply, breathe a sigh of relief. This means that the tax partnership cannot be held liable for any additional taxes owed as the result of any audit of the partnership's tax return. Any audit of the partnership's tax return will only result in additional taxes owed by the tax partners.

If these rules do apply, then a significant amount of due diligence will apply. First, the bankruptcy professional will need to determine whether there are any ongoing partnership level administrative proceedings with the IRS or partnership level judicial proceedings involving the IRS. If there are ongoing proceedings of any kind, then it is time to bring in a tax professional with appropriate expertise.

Second, the bankruptcy professional will need to review the partnership/LLC agreement, along with any other side agreements that may exist involving the partnership and existing and/or former partners, to the extent the agreements address obligations relating to tax issues. Under the new partnership tax rules, it is possible that, in the event of an IRS audit of the partnership's tax return, taxes could be owed by any one of the following parties:

a) **Taxes could be owed by the partnership itself for the tax year in which the partnership administrative/judicial proceedings involving the IRS are resolved, based on adjustments made to the partnership return(s) for one or more earlier tax years which are being audited**; Yes, you read this correctly -- it is possible that the audit of a partnership's 2019 tax return could result in the partnership itself owing income taxes for the year 2024, even though all of the income, deductions and credits of the partnership shown on the original 2019 partnership return flowed through to the partners;

b) **Taxes could be owed by the persons/entities who/which are tax partners for the year in which the partnership administrative/judicial proceedings involving the IRS are resolved, based on adjustments made to the partnership return(s) for one or more earlier tax years which are being audited**; Once again, you read correctly – it is possible that an audit of the partnership's 2019 tax return could result in taxes being owed by the partners in the partnership during the year 2024; This could happen even if the partners in the partnership in 2024 are not the same partners in the partnership during 2019; or

c) Taxes could be owed by the persons/entities who are tax partners for the tax year in which the income and expenses originally flowed through to the tax partner, for the same tax year which is being audited at the partnership level.

Given the disparity in the possible outcomes, transactional attorneys who draft partnership agreements have been extremely busy over the past 18 months drafting provisions in partnership agreements to deal with the different possible outcomes listed above. Those partnership agreements create contingent obligations for both the partnership and partners that must be dealt with during the course of the bankruptcy case. Understanding the reasons for all of these provisions will require the assistance of a tax professional.

For tax partnerships subject to the new Partnership Audit rules, there will be a continuous need for bankruptcy professionals to monitor whether the IRS has begun an audit of a partnership return. If such an audit has begun, consultation with a tax professional is required. Failure to do so could lead to disaster.

Where the Tax Partner is the (Prospective) Debtor

In connection with any anticipated bankruptcy proceeding involving a partner in a "tax partnership" (which includes "real" partnerships and LLCs which have elected to be treated as a partnership), a bankruptcy professional representing the tax partner needs to determine whether the new partnership audit rules apply to the tax partnership in which the tax partner is a partner. If these rules do not apply, breathe a sigh of relief, for the same reasons discussed in part A above.

If these rules do apply, then a significant amount of due diligence will apply, for the same reasons discussed in Part A above. There may be more contingent obligations at the partner level, given that the identity of partners in a tax partnership can change.

Basic Rules Governing Whether a Partnership is Governed by the New Partnership Audit Provisions

Bankruptcy professionals should seek the advice of tax professionals to determine whether a tax partnership is governed by the new Partnership Audit rules. The relevant Code Section is 6221, which is at this link: https://www.law.cornell.edu/uscode/text/26/6221. There are also detailed regulations, mentioned above. Partnerships with less than 100 qualifying partners may elect out of the new partnership audit rules by filing an election with each year's timely filed annual partnership tax return. Failure to timely file an election out means that the partnership is governed by the new partnership audit rules.

The existence of certain types of partners, such as trusts, prevent the partnership from electing out of the new rules, regardless of the size of the partnership.

All Partnership Audits Must be Handled by a Single Partnership Representative; Partners May Not Participate in Administrative or Judicial Partnership Proceedings, But they Are Bound By the Results in the Partnership Proceeding

The new Partnership audit rules differ significantly from the old TEFRA Partnership audit rules on the question of who may participate in the partnership return audit and in judicial proceedings arising out the partnership return audit. The partnership must be represented at all times by a single partnership representative. That representative need not be a member of the partnership, but they must have a presence within the United States.

Partners are precluded from participating in any partnership audit or in any administrative or judicial proceedings arising out of the partnership audit. And there are no requirements in the Code that the partnership representative give notice to any of the partners regarding what is going on in the partnership audit or any subsequent administrative or judicial proceeding. Such notification requirements must be dealt with in the partnership agreement. This requires that careful attention be paid to the notification requirements in the Partnership Agreement.

Partners are bound by the result in partnership proceeding, even though they may not participate in that proceeding. This statutory requirement could conceivably create a due process issue, where a single partnership representative is required to represent all partners, but two or more partners have adverse interests in the outcome of the issues raised in the partnership proceeding.

There are any number of issues that could arise in bankruptcy filed by the tax partnership or by the partnership representative. Is the partnership representative a professional which/who must be employed by the Court in order to be paid in a partnership bankruptcy proceeding? What happens if the Court denies an application to employ the partnership representative? Will a Trustee in a partnership bankruptcy proceeding have powers regarding a previously named partnership representative that would not be recognized by the IRS or the courts in the absence of a bankruptcy filing?

What happens when a partnership representative files for bankruptcy?

The Possibility That Taxes May Be Owed by the Partnership, And the Possibility That the Year for Which the Partnership Owes Taxes May be the Year In Which the Dispute Regarding the Partnership Tax Return is Resolved, Creates Unique Issues In Bankruptcy

The fact that taxes could end up being owed by the partnership for the year in which there is a conclusion of the dispute regarding the accuracy of the partnership tax return creates some unique issues. For example, suppose that the IRS audits the 2019 tax return of a partnership. In 2025 the partnership files for Chapter 11 bankruptcy, and in 2026 a dispute regarding the accuracy of the 2019 partnership return is resolved, resulting in an assessment of taxes owed by the partnership for the year 2026. Can that claim be characterized as a pre-petition claim for bankruptcy purposes because the liability is based on errors in a pre-petition tax return, even though the claim is a post-petition claim under the Internal Revenue Code? If the claim is a post-petition claim, is it entitled to administrative expense status if the liability is for a tax year in which the bankruptcy estate is in existence?

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The Uncertainty As to Whether Any Additional Taxes Owed Will be Owed by the Partners or by the Partnership Creates Practical Difficulties

Under the new Partnership Audit rules, it is possible that additional taxes resulting from changes made to a partnership tax return will be owed by the partnership; it is also possible that any such taxes will be owed by the partners in the partnership. There will be situations in which it will not be determined for some period of time whether it is the partnership or the partners that owe any additional tax that is owed.

This creates many practical difficulties in applying section 505 of the Bankruptcy Code. When will the Bankruptcy Courts have jurisdiction to determine any tax liabilities that might be owed by the partnership in a partnership bankruptcy? When will the Bankruptcy Courts have jurisdiction to determine any tax liabilities that might be owed by the partners in a partnership bankruptcy? When will the Bankruptcy Courts have jurisdiction to determine any tax liabilities that might be owed by a partner the partner's bankruptcy? When will the application of the prompt audit procedures under section 505(b) bar the IRS from assessing additional taxes against the partnership and/or partners?

These uncertainties, among many other uncertainties, some of which cannot even be identified at the present time, are going to make the confirmation of Chapter 11 plans more time-consuming and difficult. There will be many traps for the unwary.

Statute of Limitations Provisions Applicable in Bankruptcy

The new Partnership Audit provisions, at section 6241(6), contain a special provision regarding the statute of limitations, which provides as follows:

(6) Partnerships in cases under title 11 of United States Code

(A) Suspension of period of limitations on making adjustment, assessment, or collection

The running of any period of limitations provided in this subchapter on making a partnership adjustment (or provided by section 6501 or 6502 on the assessment or collection of any imputed underpayment determined under this subchapter) shall, in a case under title 11 of the United States Code, be suspended during the period during which the Secretary is prohibited by reason of such case from making the adjustment (or assessment or collection) and—

(i) for adjustment or assessment, 60 days thereafter, and

(ii) for collection, 6 months thereafter.

A rule similar to the rule of section 6213(f)(2) shall apply for purposes of section 6232(b).

The practical application of this provision to partnership bankruptcy cases is unclear. Normally, the automatic stay does not prevent an ongoing IRS audit. It also appears that the automatic stay does not bar the filing of a Tax Court petition by a partnership. See Bankruptcy

Code 362(a)(8) (stay prohibits the commencement or continuation of a Tax Court proceeding concerning a corporate tax debtor for a tax debt that may be determined by the Bankruptcy Court and concerning individual debtor for a tax debt for a period ending before the date of the order for relief under the Bankruptcy Code).

The shifting of a potential tax deficiency from the partnership to its partners is done pursuant to what is referred to a "push out" election that must be done within a specified 45 day window. Does the automatic stay in a partnership bankruptcy prohibit the exercise of a push out election to the partners? Probably not, but a partnership debtor in possession may be required to seek permission from the Bankruptcy Court to make such an election. Does the existence of the automatic stay in a partner's bankruptcy prohibit the partnership from exercising the push-out election as to that partner? Possibly.

Is There Any Hope That These Problems Can Be Solved By Means Other Than Endless Litigation in the Bankruptcy Courts and the Tax Court?

There is some hope that the IRS will takes administrative steps to resolve some of the issues discussed above, along with other issues that will arise as the result of the intersection of the Bankruptcy Code and the new Partnership Audit provisions. The 2018 Technical Corrections Act added section 6241(11) to the Internal Revenue Code. This provision permits the IRS to designate certain areas as "special enforcement matters" which are exempt from the application of the new Partnership Audit provisions.

There is no statutory prohibition on the ability of the IRS to designate bankruptcy as an area in which the new Partnership Audit provisions have no application. But the IRS has not yet taken any steps to do so. Given all of the other problems that the IRS faces in implementing these new provisions, it is unlikely that the IRS will consider the extent to which exempt taxpayers in bankruptcy from the application of these new rules any time soon.

The IRS, in Notice 2019-6 (December 20, 2018), available at https://www.irs.gov/pub/ irs-drop/ n-19-06.pdf, indicated that it will be addressing certain other topics under the authority it now has under section 6241(11) to exempt certain areas from the application of the new rules. This gives hope that the IRS will use this section to exempt the application of these provisions in bankruptcy-related situations.

Don't forget that, in Greek mythology, Hope remained in Pandora's Box after that Box was opened and inflicted all of the world's troubles on Earth's population. Certainly one can argue that the enactment of the new BBA Partnership Audit provisions, without properly coordinating those provisions with the Bankruptcy Code, opened up a new Pandora's Box. Congress then gave us all hope by enacting section 6241 in the Technical Corrections Act. We can only hope that the IRS frees hope from that box by exercising its authority under that section to exempt bankruptcy-related situations from the application of those rules.