

Bankruptcy of passthrough and disregarded entities

Commentary from: "Corporate Tax Insights on Checkpoint" by Jack Cummings

The situation of an entity being in bankruptcy, but not being responsible for taxes on its own income (including discharge of indebtedness income), can arise in three ways: (1) partnership in bankruptcy, (2) S corporation in bankruptcy, and (3) tax disregarded entity, such as an LLC, in bankruptcy. Because such a situation is obviously fraught with peril for the entity owners (possibly taxation without representation), it is useful to review the issues.

The most important rules (some of which are not certain) are summarized as follows. Note: Author references below are to the following WG&L Treatises:

[P'SHIP] McKee, Nelson, Whitmeyer - *Federal Taxation of Partnerships & Partners*

[S CORP] Eustice & Kuntz - *Federal Income Taxation S Corporations*

[LLC/DRE] Bishop & Kleinberger - *Limited Liability Companies: Tax & Business Law*

QUESTIONS	P'SHIP	S CORP.	LLC/DRE
Bkcy filing changes tax filing entity or status?	No; §1399	No; Eustice & Kuntz, para. 5.03[4] and 14.02	No; treated like pship; Bishop & Kleinberger, paras. 1.03[1][a], 1.04[4][b][i]
Who must file return?	Trustee "best efforts"; partners must file the return; LTR 8535015	S Corp.	Owner
§108(a) exclusion applies at bankrupt level?	No; §108(d)(6) (applies at partner level)	Yes; §108(d)(7)(A)	No; analogized to partnership; Bishop & Kleinberger, para. 1.04[4][b][ii]
§108(b) attribute reduction occurs where?	Partner level; McKee, Nelson, para. 9.02[2][a][ii][A] and [C]	Suspended loss carryforwards (at shareholder level), then corp. property basis; Eustice & Kuntz, para. 14.04[2]	Owner level; analogized to pship; Bishop & Kleinberger, para. 1.04[4][b][ii]

Owner basis increase for excluded COD income?	Yes, but income is not excluded unless partner is insolvent or in bkcy; usually offsets the income that would result from deemed distribution on liability decrease; McKee, Nelson, para. 9.02[2][a][ii][B]	No; §108(d)(7)(A)	Yes; analogized to pship; Bishop & Kleinberger, para. 1.04[4][b][ii]
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Bankrupt sells property and recourse debt discharged	COD income	COD income	Unclear whether owner recognizes gain as upon nonrecourse debt or COD income as upon recourse debt discharge; Bishop & Kleinberger, para. 2.07[1][i]
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Ability to eliminate passthrough or DRE tax status before filing?	?	Yes, but may be fraudulent transfer; Eustice & Kuntz, para. 14.02	?
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Disregarded LLC in bankruptcy. The single member LLC is a distinct legal entity that exists apart from its member for bankruptcy purposes. (Gilliam v. Speier, 318 BR 712 (2004); 94 AFTR 2d 2004-7281) The *Gilliam* case required estimated taxes paid prior to filing bankruptcy by the bankrupt LLC on behalf of its owner to be turned over to the bankrupt estate. It reasoned that the owner got the benefit of limited liability and no double taxation and so it was not improper to make the owner pay tax on the bankrupt LLC's income. To the same effect L. & L. Holding Co., 101 AFTR 2d 2008-2081 (WD La. 2008) ruled that the owner of a disregarded entity in bankruptcy was liable for its employment taxes. See Bishop & Kleinberger: Limited Liability Companies 2.07.

Conclusion. The voluntary or involuntary bankruptcy of an LLC that is a disregarded entity places the solvent, nonbankrupt, owner in line to pay tax on the LLC's income from before and during bankruptcy, without having access to its cash flow. This is a situation to beware of.

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