

Subchapter S Losses: A Trap For the Unwary

Michael S. Fried, Esq. • mfried@hupk.com

The intersection of bankruptcy law and tax law is very complicated and can often result in unexpected consequences for the taxpayer/debtor. A recent United States Tax Court case of first impression, *Williams v. Commissioner*, 123 T.C. No. 8 (2004), illustrates a trap for the unwary Subchapter S corporation business owner facing financial problems and considering bankruptcy. In *Williams*, Lawrence Williams owned all of the shares of an S corporation that was losing a substantial amount of money, and had a significant tax loss for the calendar year. Mr. Williams tried to fund the operation and on-going losses of the corporation with his own money, and found himself in personal financial trouble. As a result, Williams filed for personal bankruptcy on December 3rd of the relevant year. Pursuant to bankruptcy law, at the time of his December 3rd bankruptcy filing, his shares of the S corporation became the property of his bankruptcy estate. Additionally, under federal bankruptcy law, Mr. Williams's bankruptcy estate became a new and separate tax entity. Mr. Williams also continued to be his own personal tax entity.


During the year, the S corporation had a substantial tax loss. The loss had been personally funded by Williams, and Williams expected to use the loss generated by the S corporation through December 3rd to offset his personal tax liabilities for the tax year. Accordingly, the taxpayer reported his pro-rata share of the S corporation's pass-through losses on his personal return. The Internal Revenue Service reviewed the return and denied all Subchapter S losses claimed by the taxpayer for the year of bankruptcy. In *Williams*, the Tax Court agreed with the IRS, and upheld the IRS's position that Mr. Williams's bankruptcy estate, not Mr. Williams, was entitled to claim the losses for the entire year. The Tax Court's decision in *Williams* was consistent with an earlier decision of the Tax Court, *Gulley v. Commissioner*, T.C. Memo. 2000-190, in which it found

that all pass-through partnership losses for the year of an individual partner's bankruptcy belonged to the debtor's bankruptcy estate, not the individual partner/taxpayer.

In *Williams*, the taxpayer argued that Internal Revenue Code Section 1377 allocates each item of a Subchapter S corporation's income or loss on a per share per day ownership basis, and that the transfer of his shares on December 3rd should be treated like any transfer of Subchapter S stock. Accordingly, he argued that he should be entitled to his pro rata share of the losses through December 3rd, and that the bankruptcy estate should only be entitled to losses for its 28 days of ownership. However, Mr. Williams and his advisors failed to consider the possible consequences of Section 1398(f)(1) of the Bankruptcy Code, which states that the transfer of an asset from a debtor to the bankruptcy estate is not a disposition triggering tax consequences.

Relying on its prior holding in *Gulley*, a partnership pass-through case, and Bankruptcy Code Section 1398(f)(1), the Tax Court determined that there was no transfer or disposition of Mr. Williams's Subchapter S shares for tax purposes and that the bankruptcy estate should have been treated "as the debtor would be treated with respect to that asset." Accordingly, the Court ruled that for tax purposes (as opposed to bankruptcy purposes), the bankruptcy estate should have been treated as if it owned the S corporation stock for the entire year, and therefore, was entitled to the Subchapter S losses for the entire year.

While the allocation of Subchapter S or partnership losses may not be common to most individual bankruptcy filings, the rulings in *Williams* and *Gulley* point out a trap for the unwary small business owner in financial trouble. The owner of Subchapter S Corporation stock or a partnership interest must consider the impact and allocation of entity pass-through

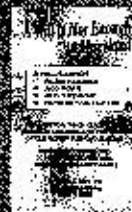
losses before filing a bankruptcy late in a tax year. In *Williams*, if the taxpayer had waited a very short while 29 days, he could have preserved his Subchapter S losses and obtained a substantial reduction of his personal tax liabilities, perhaps even a tax refund. 

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