



Don't Be *Bewildered By Bankruptcy*

Learn the basics
to help your
clients make the
right financial
decisions

By Cheri G. David, CPA, CVA

Have you ventured into the attic recently? Time to clear through the cobwebs, blow off the dust and open the mildewed pages of the old college Westlaw book ... bankruptcy is back.

As we forge ahead into the next generation of economic fluctuations, so go our clients' financial lives. Although navigating through tax law to help clients shelter income and save money on taxes is important, the reality of our current economic times is that CPAs will also need to be educated to assist clients through the bankruptcy maze.

"The broken bench"

The oldest written records document and date the concept of bankruptcy as being more than 400 years old. The word "bankruptcy" can be traced back to the ancient Latin root words *bancus* (the tradesman's counter) and *ruptus* (broken). Under old English law, a tradesman who could not repay his debts would have had his bench broken and potentially a shameful public beheading might have followed.

Even the process of redemption and relief from bankruptcy debts can be rooted to Moses communicating the redemption plan to the Israelites. The book of Deuteronomy in the Bible seems to lay out the plan of redemption for the Israelites to happen over a seven-year period. Sound familiar?

Emotional challenges

Shameful public ceremonies in ancient times have been replaced with a more civilized bankruptcy court procedure. Often, the most difficult conversation a CPA can have with a long-term client involves analyzing his or her financial situation and considering consultation with a bankruptcy attorney.

Although relief from debts can offer a “fresh start,” the bankrupt client may be emotionally drawn to continuing to yield to collection calls, funding declining business ventures and foolishly spending.

Be your clients’ trusted advisor. Be honest and factual, and offer help in preparing a healthy financial budget. But be prepared to assist in a bankruptcy proceeding if that becomes necessity.

Bankruptcy considerations

The process of bankruptcy is invasive, can take months or even years to complete, and can be quite emotional. It is not for all clients in declining financial situations.

In fact, The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 modified many provisions to old laws. Some of those changes include the debtor’s completion of credit counseling sessions, means testing, disposable income calculations and budgets based on Internal Revenue Service (IRS) standards. These changes have significantly reduced the ability for many debtors to obtain full discharge of debts through bankruptcy proceedings.

During your conversations with clients, it is important to temper expectations and communicate the possibility of not receiving 100 percent debt relief through filing bankruptcy.

Chapters of bankruptcy

Chapter 7 and Chapter 13 are the most common types of individual bankruptcy cases. In Chapter 7, there is full discharge of debts in exchange for all non-exempt assets. Chapter 13 is the “work-out” plan for wage earners. The debtor is able to keep some of his or her assets in exchange for settling the debts for pennies on the dollar.

In Chapter 13, a payment arrangement is required for the settled debts.

Chapter 12 is specifically for family farms within certain guidelines. Corporations and partnerships file under Chapter 11, a reorganization plan, and full bankruptcy under Chapter 9. Depending upon the type of assets and type of debts (secured or unsecured) involved, the bankruptcy process can be very simple or very complex.

Often, the bankrupt client is concerned about losing a home, cars and personal items, and being forced into the streets. Bankruptcy is designed to provide relief, not destroy a debtor’s ability to continue business activities or put the debtor on the street with no place to live. An automatic stay from collection activity is initiated upon the filing of the bankruptcy petition. In fact, even the IRS is required to stop collection activity. Debtors will have immediate relief from the daily traumatic calls.

Income tax discharge and the taxable bankruptcy estate

Bankruptcy begins with the filing of a petition in U.S. Federal Court. A separate taxable estate is created for individuals filing Chapters 7 and 11, and includes assets owned by the individual prior to the filing date. There is no separate taxable entity created in Chapters 12 and 13. As a taxable estate, the trustee is generally given the responsibility of filing all relevant tax returns (i.e., 1040, 1041 and W-2s). In Chapters 12 and 13, the debtor-in-possession is still required to file timely tax returns and pay estimates.

Be aware that upon filing the bankruptcy petition, any pending refunds could potentially become property of the bankruptcy estate. However, more often the debtor is looking for relief from paying taxes. Under Chapter 7, unsecured income taxes owed for periods longer than three years can be eliminated, if non-fraudulent tax returns were timely filed. This is where many debtors will take advantage of the bankruptcy laws in their favor.

In Chapter 13, the court has discretion to discharge taxes owed to the IRS

without regard to the three-year rule, as long as the debtor satisfies the payment arrangements made within the plan. The IRS may also grant relief from penalties if the debtor follows through on the payment arrangements defined in the Chapter 13 proceeding.

Trust fund/payroll taxes withheld by an employer cannot be discharged, even after three years. The IRS will hold responsible the so-called “responsible” person in charge of the business. In this case, the debtor still must pay back the trust fund portion of the taxes.

Election to end taxable year

The taxable bankruptcy estate begins on the date of filing the petition for Chapters 7 and 13. As such, the debtor may elect to end their taxable year the day before the filing of the petition. A short-year return is filed for the period before the estate began, similar to a decedent’s final tax return. All tax attributes, such as carryforward losses, investment gains, basis in assets, etc., will follow into the estate as if the estate is in the place of the debtor. This election should be well thought-out because once it is made, it cannot be revoked. ▶



SOUND OFF: Bankruptcy and your clients

During the recession, how have your clients fared? Does your firm navigate bankruptcies more often for individuals or companies? What lessons have you learned? Check out Cheri David’s blog post on the VSCPA’s new blog, www.CPACafé.com, and join the conversation!



CPAs should not encourage bankruptcy as a choice, but should assist a client through the process if the client determines it is the best route.

The decision to file bankruptcy

Bankruptcy laws are very complex and are best handled by a competent bankruptcy attorney. Sometimes clients are looking for the quick solution and bankruptcy may not necessary be the “quick” way out. Bankruptcy is intrusive and will have a long-lasting effect on the debtor’s credit history.

Serious heartfelt discussions with your client regarding some of those effects should occur prior to the filing of a petition. Credit reports and background checks have also become an integral part of the business landscape and will be affected for at least seven (sometimes 10) years. Many agencies and occupational license boards will perform credit checks to determine the responsibility of the applicant. Often credit checks are performed prior to renting, leasing, obtaining employment, buying a car and securing any type of credit.

Life after bankruptcy

There is still life after bankruptcy. Remind your clients that there are no debtor’s prisons and tell them the history of bankruptcy stems back hundreds of years. The bankrupt client is not alone in his or her financial struggles. This type of client is often a high-risk taker and/or an aggressive entrepreneur, and has the ability to run a thriving business. Many bankrupt

clients will surpass their financial troubles by making better spending choices, and are able to grow bigger businesses the second time around.

CPAs should not encourage bankruptcy as a choice, but should assist a client through the process if the client determines it is the best route. Believe in your clients, be a good advisor and good friend and help them sort through their situation.

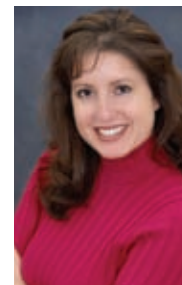
Aiding your clients through their good times, as well as their discouraging financial times, will show your loyalty to them and your belief in their futures, and will secure your opportunity to be there for their future business. □



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