Understanding the Impact of Bankruptcy on Financial Statements and Taxation

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Published on www.lorman.com - November 2017

According to the National Bankruptcy Center, 2009 saw a record high in bankruptcies, numbering higher than one million. Chapter 7 bankruptcies increased the most at 42%. Although the number of bankruptcies has decreased in every year since then, the trend of less employment and less businesses being started seems to be holding quite steady.

The fact that there are not new businesses stepping up to fill the holes left by businesses that declared bankruptcy seem to indicate that those business owners who files for bankruptcy did not completely understand the implications that their actions would cause to their financial prospects in the future. Contrary to popular belief, simply declaring bankruptcy does not have to mean the end of your business career or your ability to obtain funding for new business ideas.

Bankruptcy as a reorganization strategy only works if the parties considering the technique fully understand the short term and the long term implications that declaring a bankruptcy will have on their financial statements and tax liabilities. Although the full spectrum of the causes and effects of the bankruptcy process are far too complex for a short article to cover, every individual or business owner should know the basics.

Outsourcing the procedural aspects of bankruptcy to a knowledgeable, reputable professional is always recommended, as is seeking the counsel of a specialized tax attorney and accountant before making any decisions that may affect your long term financial records.

- The Difference Between the Two Major Types of Bankruptcies

In order to understand the financial implications of bankruptcy, it is necessary to understand the different types of bankruptcy that are available as a reorganization strategy. The two major types of bankruptcy that are used by individuals and business owners to discharge debts are Chapter 7 bankruptcy and Chapter 13 bankruptcy.

Below is a brief description of the two types and what an individual or a business can expect with regards to taxes and financial statements when using either one as a financial strategy.

One - Chapter 7 Bankruptcy

Chapter 7 bankruptcy is also known as "straight bankruptcy" or a "liquidation bankruptcy." The automatic stay, or legal protection that comes from declaring bankruptcy, means that under Chapter 7 bankruptcy, many tax liabilities as well as most of the debts of the petitioner are no longer legally enforceable.

Although the debts of a bankruptcy petitioner are no longer legally enforceable under Chapter 7 bankruptcy, the court will usually require the liquidation of most of the assets of the company or the individual in order to exercise a good faith effort to pay back as many of the unsecured creditors in the business as possible. After all assets of the company have been liquidated, the court discharges future debts.

All parties who are looking to be paid back must accept the ruling as well as the proceeds that come from a liquidation bankruptcy. The parties that must accept the ruling of the court include the Internal Revenue Service. The major exception to this rule includes any tax liens that were implemented before the filing of the bankruptcy. As long as the tax lien is attached to property that is owned by the business at the time of the bankruptcy, the petitioner will be responsible for that debt no matter the process of liquidation.

-- Eligibility for Chapter 7 Bankruptcy

Not every individual or business is eligible for Chapter 7 bankruptcy. In order for this option for reorganization to apply to an individual or to a business, that individual or business must have an income that is below a "means tested" amount. Also, the non-consumer debts of the individual or the business must exceed the consumer debts of that individual or business.

-- Implications for a Chapter 7 Bankruptcy Proceeding

In order to be eligible for Chapter 7 bankruptcy, a petitioner must file a schedule of liabilities and assets, a schedule of expenses and current income, a financial affairs statement and a schedule of unexpired leases as well as contracts that are under execution. The petitioner must also file relevant tax documents with the court including tax returns that were filed during the most recent tax year as well as any other tax documents that were filed during the filing of the bankruptcy petition.

If a petitioner is an individual with debts that are mostly consumeristic in nature, additional documents must be filed with the court. They must show an indication of undergoing credit assistance planning with a certificate of credit counseling. They must also have a copy of any repayment plan that has been recommended through any credit counseling program. They must submit evidence of employment payment that is received by them up to two months before filing bankruptcy as well as a statement of monthly income after taxes as well as any increase in expenses or income that they expect to incur.

Married couples have additional options when it comes to filing bankruptcy under Chapter 7 procedures. A wife and a husband may choose to file their bankruptcy petitions separately or jointly. An individual filing is usually a strategy that is employed when one partner has many more debts or a much worse credit record than the other.

The many documents that are required for the court to determine eligibility as well as a liquidation plan for a petitioner carry many implications for the financial statements of the individual or the business that is serving as the petitioner. Most of these implications have to do with the inability of the petitioner to redirect any resources to any purpose before the liquidation of assets and the payback of creditors to the extent of the judgment of the court. The automatic stay of Chapter 7 bankruptcy works both ways: Creditors will be unable to directly lay claim to the property of a petitioner; however, the petitioner will be equally as unable to use any property or assets for personal gain that have been deemed under escrow by the bankruptcy court.

If a court finds that a debtor has been fraudulent in reporting any of the above documentation to the court, it may deny the discharge of debt and re-allow creditors to lay a legal claim to the assets of a debtor. It may also directly discharge assets to a creditor to the extent that a debt is owed.

Even in a bankruptcy proceeding, secured creditors retain rights to seize some property of a bankruptcy petitioner. The court may allow reaffirmation of certain properties such as automobiles; however, the details of such an arrangement are strictly between the debtor and the creditor. Reaffirmed debts must also be entered into before a discharge and the debtor must sign a reaffirmation agreement. This document is filed with the court along with the documentation mentioned above.

Other debts that cannot be discharged by a bankruptcy proceeding include child support, alimony claims, certain types of taxes (mostly having to do with property), overpayments for educational benefits, loans guaranteed by government, debts incurred through torts or willful injury by the party bearing the petition as well as debts incurred as a result of a DUI.

Future financial statements and credit reports will show that the petitioner initiated and went through a Chapter 7 bankruptcy proceeding. The normal period for this indication on financial records is seven years. There may also be implications for the credit score of a petitioner, although the exact impact is different depending on which of the major three credit rating agencies is calculating the credit score.

Should a Chapter 7 bankruptcy discharge be found to have been entered into through fraud, the court may immediately revoke the discharge. This will also be noted on financial records and is much worse for a credit score than a successful Chapter 7 bankruptcy proceeding.

If a Chapter 7 bankruptcy proceeding is initiated by creditors instead of by a debtor, the implications for financial statements could be much worse as they will show an induced Chapter 7 proceeding should the court deem it necessary to liquidate the assets of an individual or a company. Having such an action invoked against you is an indication to future investors that an individual may not be able to be trusted with a loan because of a lack of understanding of the debtor process.

Two - Chapter 13 Bankruptcy

Chapter 13 bankruptcy is also known as a deferred payment plan bankruptcy. Instead of liquidating the assets of an individual or a company, the court will force a payment plan upon a debtor that will be administered through a trustee. The petitioner is protected through the court process as all creditors must accept the ruling of the court and the installment plans that the court deems necessary and proper for the petitioner.

Installment schedules in a Chapter 13 bankruptcy proceeding must pay back at least the amount that would have been paid back in a Chapter 7 bankruptcy proceeding. It must also pay off priority and secured creditors within five years of the initial filing. For this reason, Chapter 13 bankruptcy proceedings may be much more favorable to an individual or a business owner who is looking to quickly get back in the financial game. Loans to key investors will be paid off more quickly, giving the debtor a much better chance of obtaining private funding through these sources again in the near future. In short, the more quickly that debts are paid back, the less negative of an implication the bankruptcy proceeding will have on the long term financial statements of a petitioner. The Chapter 13 bankruptcy proceeding allows for a much quicker repayment of some debts as well as a more thorough repayment of unsecured creditors.

-- Eligibility for Chapter 13 Bankruptcy

Many more individuals and businesses will be eligible for a Chapter 13 bankruptcy proceeding than a Chapter 7 proceeding because of the inclusion of a court appointed trustee. In order to be eligible for a Chapter 13 bankruptcy proceeding, a debtor must have documentation showing a schedule of liabilities as well as assets, a schedule of expenses and income, a schedule of leases that are not expired as well as contracts that are under execution and a general statement of financial affairs. In most cases, in order to become eligible for Chapter 13 bankruptcy, a debtor must undergo a credit counseling program and provide documentation of the recommendations of that program to the court.

Chapter 13 bankruptcy offers many different types of advantages to a debtor, especially when compared to Chapter 7 bankruptcy. For instance, a Chapter 13 bankruptcy proceeding may allow an individual to save a piece of real estate from foreclosure by stopping the proceedings. Chapter 13 bankruptcy is also one of the best types of bankruptcy proceedings for curing mortgage payments that are delinquent. Chapter 13 bankruptcy also allows a debtor the ability to reschedule even secured debts as well as stretching them out over a longer period of time for easier payment. Restructuring the payments that are being made by a debtor as well as paying back more of the creditors, including the IRS, will lead to much better implications for financial statements over time.

Any individual or business with a great deal of cosigners may prefer the options of Chapter 13 bankruptcy over other options. Chapter 13 bankruptcy tends to protect cosigners as well as the debtor by limiting the direct contact that a debtor actually has with creditors. The appointed trustee that serves as the consolidation loan distributor will execute all payments to creditors, which tends to reflect well on the financial statements of a debtor.

Chapter 13 bankruptcy has undergone a great deal of change in recent years, making legal counsel throughout the process an absolute rather than a luxury. Depending on the scope of the Chapter 13 bankruptcy proceeding, debtors can save themselves a great deal of trouble and increase their ability to pay back the loans through an extension of the term period as well as the organizational consolidation of the entire loan process.

The Chapter 13 bankruptcy proceeding also has the advantage of certain debt discharges so long as the debtor meets certain criteria. First, a debtor must ensure that all domestic support obligations have been paid. Second, there must be no other discharges that have been received in a prior case for at least two years and at most four for certain types of bankruptcies. Third, the debtor must complete a financial management course that has been approved by the court. All of these requirements for discharge actually help to ensure that the overall negative implications of a Chapter 13 bankruptcy proceeding with respect to financial statements are kept to a minimum.

Another advantage of the Chapter 13 bankruptcy proceeding is the option for a hardship discharge if the debtor cannot pay back his or her debts and meets certain criteria. In most cases, the inability of the debtor to pay back the debts must be outside of the control of the debtor. Also, creditors must have usually received the same amount under the Chapter 13 bankruptcy that they would have received under a Chapter 7 bankruptcy full liquidation proceeding. The court will also make sure that there is no other modification of the payment plan that would allow a debtor to pay back the outstanding debts. Among other things, injury that disallows a debtor from working is grounds for a hardship discharge.

-- Implications of a Chapter 13 Bankruptcy Proceeding

The debts that are discharged in a Chapter 13 bankruptcy are much broader in scope than in most other types of bankruptcies. The only debts that are not able to be discharged include most of the debts on the list of the Chapter 7 bankruptcy proceeding above.

Because payments to creditors from debtors are much more thorough and the discharges are much broader in a Chapter 13 bankruptcy proceeding, the debtor has a much greater chance of less damage being done to his or her long term financial statements and credit score.

Cosigners are protected under a Chapter 13 bankruptcy much more thoroughly than in a Chapter 7 proceeding. This can help a debtor to continue to obtain private funding from outside sources even if his or her personal and business credit record and financial statements show a bankruptcy proceeding currently in progress.

Bankers are also much more likely to view a Chapter 13 bankruptcy proceeding in a positive light as compared to a Chapter 7 bankruptcy proceeding. The general notion of a Chapter 13 bankruptcy is that the debtor is still able to pay back the debts of his or her business or personal responsibilities; he may just need a longer period of time or a bit of help with professional financial planning in order to do it. In some cases, bankers are even willing to lend money to individuals and business owners that are in the middle of a Chapter 13 bankruptcy proceeding. This usually does not happen during any part of a Chapter 7 bankruptcy proceeding.

A Chapter 13 bankruptcy proceeding is a much more organized effort between creditors and debtors. In the Chapter 13 bankruptcy proceeding, the trustee that is appointed by the court is required to hold a meeting of creditors between 21 and 50 days after the filing of the Chapter 13 bankruptcy petition. The creditors are then allowed to ask questions of the debtor, who is placed under oath by the trustee, to better understand the reason for the bankruptcy. Usually during these meetings, creditors will gain a full understanding of the financial affairs of the debtor as well as the terms of the proposed payback plan. Creditors who are better able to understand the process by which they will receive restitution are much more likely to stay any power they have to ruin the credit record and the financial statements of a debtor.

Creditors are also allowed a full three months to file their claims with the bankruptcy estate within the auspices of a Chapter 13 bankruptcy proceeding and to attend the future court hearing of the repayment plan of the debtor.

Chapter 13 bankruptcy proceedings must pay back priority claims in full. Secured claims must be paid back to the extent that they would have been paid back under the auspices of a Chapter 7 bankruptcy proceeding before the court will allow the debtor any discharge under a Chapter 13 bankruptcy. These terms are much better laid out and concrete than a Chapter 7 bankruptcy, which gives additional security to creditors. This additional security will reflect well on the financial statements of a debtor.

Governmental organizations are also more likely to be paid back under the auspices of a Chapter 13 bankruptcy proceeding. Because these are the agencies that have a great deal of power over the financial statements of a debtor, they will have much less of a reason to file any negative reports against the debtor, further allowing a much cleaner financial bill of health for that petitioner. Because governmental organizations receive preference with the three major credit rating agencies, good reports from government will keep items that could cause major damage to a financial report or a credit score off of the permanent records of a petitioner.

-- Consulting the Proper Authorities Before Making any Sudden Moves

No matter which plan a debtor chooses, the proper legal assistance is always required. Although this article goes over the general terms of both Chapter 13 bankruptcy and Chapter 7 bankruptcy proceedings, the particulars of each individual proceeding must be handled by a reputable attorney.

There are also many other types of bankruptcy proceedings which may provide a debtor with even more advantages than the ones mentioned here with respect to the Chapter 13 bankruptcy and Chapter 7 bankruptcy proceedings. Individuals and business owners are encouraged to consult their tax attorneys and accountants to determine the best course of action before making any decision that could affect the long term financial health of a business or an individual.