

## Tax Considerations for Liquidating Trusts

## I. Two Types of Trusts

### A. Debtor Grantor Liquidating Trust

1. This is a trust where assets are transferred to a trust to be liquidated where the Debtor is the settlor, and the proceeds paid to creditors. If the liquidation yields enough to pay all creditors in full and leaves something left over, then the surplus goes to the equity holders.
2. This type of trust is disregarded for tax purposes as the transfer to the trust is not considered a taxable event. The debtor entities file and pay whatever taxes are due under their existing Tax ID numbers unless they are pass through entities in which case the debtor will send K-1s to the owners.
3. There is no gain or loss on the transfer of the assets to the trust since it is a disregarded transaction.

### B. Creditor Grantor Liquidating Trust

1. This is a trust where all assets are deemed transferred to the creditors and then the creditors transfer the assets to the trust for liquidation and pro rata distribution. In the unlikely event that there is a surplus, it goes to the creditors.
2. The transfer to the creditors is considered a taxable event. In the plan, the debtor is required to determine a fair market value of the assets transferred. The gain or loss equals the determined fair market value minus the debtor's tax basis in the assets transferred unless the debt is non-recourse. If the debt is non-recourse, then the basis is the amount of the debt.
3. Thereafter any income earned by the trust or any gain on sale of the assets transferred to the trust is passed to the creditor beneficiaries by sending them K-1s.

## II. Discharge of Debt Income/Cancellation of Debt Income

A. Section 61(a)(12) of the Tax Code provides that the cancellation of debt constitutes income unless an exception under Section 108 applies. Section 108 includes exceptions for debt discharge that occur in bankruptcy or at a time the taxpayer is insolvent.

B. A C Corp is a taxpaying entity which will account for COD income on its Form 1120. Generally COD income is not a problem for a C Corp that is insolvent or bankrupt because the cancellation of debt does not cause **taxable** income, but it does reduce beneficial tax attributes like net operating loss carry forward deductions or basis in assets. If the C-corporation is solvent and not in bankruptcy COD income may be taxable.

C. For a pass through entity like a partnership, S-corporations or an LLC (electing to be a partnership), COD income can cause a major complications for the equity holders.

1. Income (including COD income) is reported to the partner or member on a K-1;
2. The partner or member generally is not in bankruptcy and not insolvent;
3. Therefore, the partner must include the income on its tax return.
4. Assuming the investment is now worthless, the partner may be able to offset the amount invested against the cancellation of debt income.
5. But this depends on the partner or member's basis in the investment.
6. Example:
  - a) *Partner Invests \$1 million in Partnership. The basis is \$1 million.*
  - b) *If the enterprise earns income and distributes it to the partners, the tax basis is increased by the amount of income and then decreased by the amount paid to the partner. So if these amounts are equal, the basis stays the same.*
  - c) *But sometimes, the distributions exceed the income. If this occurs, then the basis decreases. So let's say over the years the partner received distributions of \$500k and there really was no income. The basis is reduced to \$500k. This often occurs in business that have substantial depreciation expense like an apartment complex or office building.*
  - d) *The partnership files for bankruptcy and discharges debt which is allocable to our partner in the amount of \$1 million. Since the discharge of debt income exceeded the basis, the partner has \$500k of taxable income, and no money from the partnership to pay the taxes. This is commonly referred to as "Phantom Income."*

D. In a Debtor Grantor Trust, this cancellation of debt income can be avoided if over time, the creditors are paid in full such that there really is no cancellation of debt. Even if the debt is not ultimately paid in full the timing of the COD income can be delayed until it becomes apparent that the debt will not be paid in full.

E. In a Creditor Grantor Trust, the cancellation of debt income is recognized immediately as the assets are transferred away at a fair value determined in the plan in exchange for release of the liabilities.

NOTE: Even though debtors in liquidating plans don't get discharges, the IRS considers the debt to have been discharged for COD determination purposes once it is obvious the debts will not be paid.