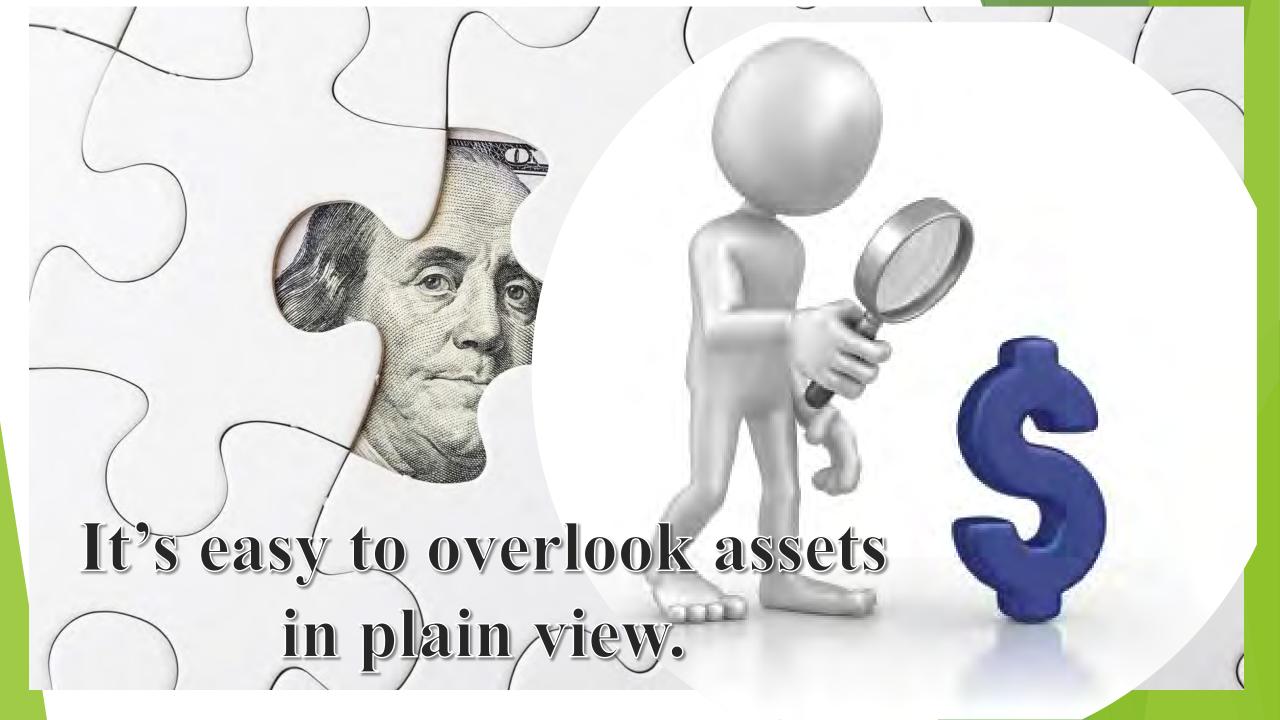
## EVALUATING TAX RETURNS

MISSISSIPPI BANKRUPTCY
CONFERENCE

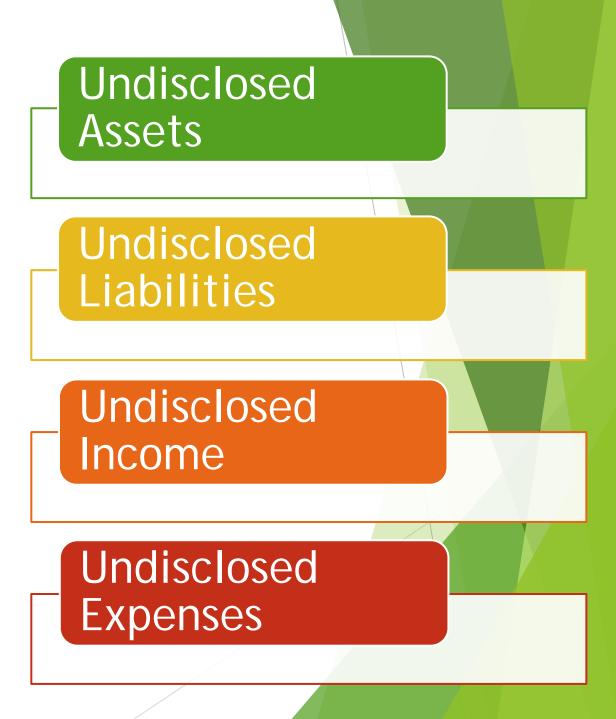
Prepared by: James L. Henley, Jr., Esq., CPA/CFF
Chapter 13 Trustee – Southern District of Mississippi

## Duties of Chapter Trustee

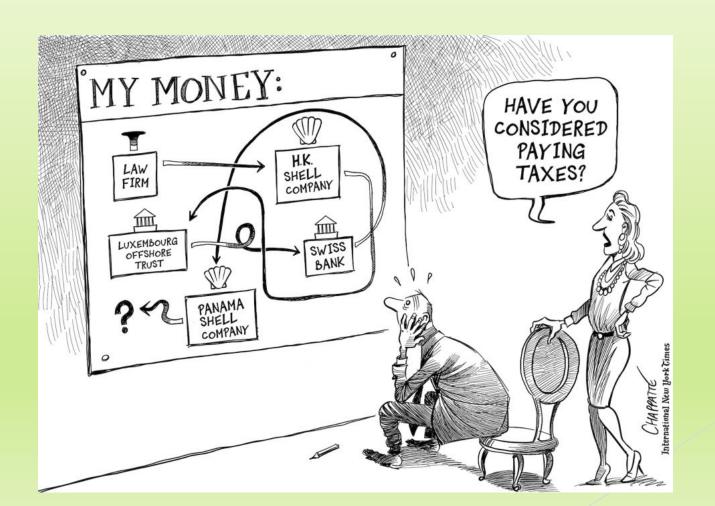
- ▶ Be accountable for all property received during the Chapter 13 bankruptcy case;
- Investigate the financial affairs of the debtor;
- Oppose the discharge of the debtor when necessary;
- ▶ If the debtor is engaged in business:
  - ▶ investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan; and
  - ▶ once the investigation is completed, file a statement of the investigation.



# Purpose of Examination of Returns



Our Debtors probably aren't this sophisticated.





"Honey, I'm making a deposit into our retirement savings."

"Honey, I'm making a deposit into our retirement savings."

# Section 521 Debtor's Duties

- (a) The debtor shall
  - ▶(1) file-
    - (A) a list of creditors; and
    - (B) unless the court orders otherwise-
      - (i) a schedule of assets and liabilities;
      - (ii) a schedule of current income and current expenditures;

Can I spend my tax refund on prepaid VISA gift cards to hide the money from the bankruptcy trustee?



#### Rule 4002. Duties of Debtor

- ▶ (b) INDIVIDUAL DEBTOR'S DUTY TO PROVIDE DOCUMENTATION.
  - ▶ (3) Tax Return. At least 7 days before the first date set for the meeting of creditors under section 341, the debtor shall provide to the trustee a copy of the debtor's federal income tax return for the most recent tax year ending immediately before the commencement of the case and for which a return, or provide a written statement that the documentation does not exist.
  - ▶ (4) Tax Returns Provided to Creditors. If a creditor, at least 14 days before the first date set for the meeting of creditors under section 341, requests a copy of the debtor's tax return that is to be provided to the trustee under subdivision (b)(3), the debtor, at least 7 days before the first date set for the meeting of creditors under section 341, shall provide to the requesting creditor a copy of the return, including any attachments, or a transcript of the tax return, or provide a written statement that the documentation does not exist.

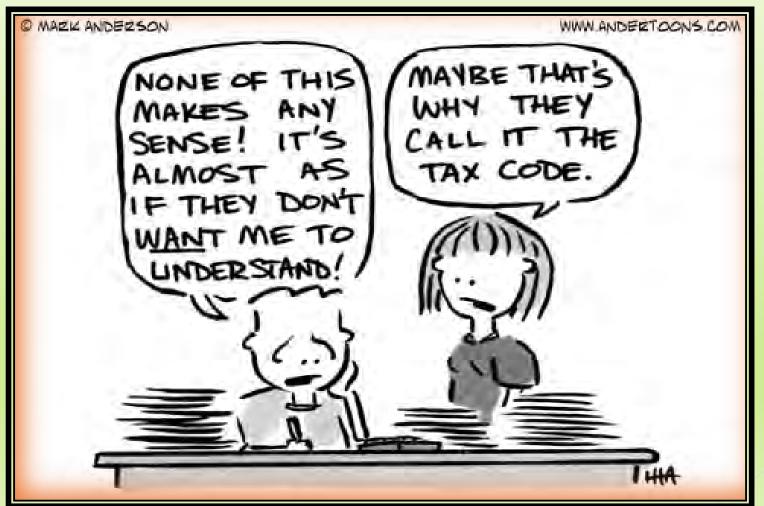
# Section 1325 Section 1325 Confirmation Confirmation of Plan

- (a) Except as provided in subsection
  - (b), the court shall confirm a plan if
  - (9) the debtor has filed all applicable Federal, State, and local tax returns as required by section 1308.

## Section 1308 Prepetition Tax Returns

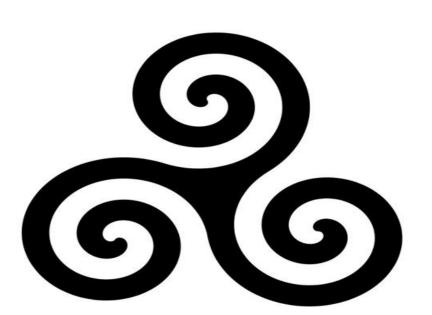
(a) Not later than the day before the date on which the meeting of the creditors is first scheduled to be held under section 341(a), if the debtor was required to file a tax return under applicable non-bankruptcy law, the debtor shall file with appropriate tax authorities all tax returns for all taxable periods ending during the 4-year period ending on the date of the filing of the petition.

### Tax Returns: A Goldmine of Information (If you can understand them!)





### TAX REFUNDS -PAST, PRESENT AND FUTURE





#### MISSISSIPPI EXEMPT PROPERTY

- ▶ § 85-3-1. Property exempt from seizure under execution or attachment.
- ► There shall be exempt from seizure under execution or attachment: . . .
- (\$5,000.00) of earned income tax credit proceeds.
- (\$5,000.00) of federal tax refund proceeds.
- ▶ (k) An amount not to exceed Five Thousand Dollars (\$5,000.00) of state tax refund proceeds.

### In re: Diaz vs. Viegelahn, 19-50982, (5<sup>th</sup> Circuit August 26, 2020)

Court ruled bankruptcy court's local provision requiring debtors to hand over tax refund amounts in excess of \$2000 as invalid because it breached below-median income debtors' substantive rights. Further Court found it violated Section 1325(b)(2), as construed by Hamilton v. Lanning, 560 U.S. 505 (2010). Local rules are intended to govern practice and procedure and should never alter a debtor's substantive rights.



Leaves open the question "is there a difference in the treatment of tax refunds in the initial year for above median income debtors?"

#### Above or Below Median Income

#### Check as directed in lines 17 and 21:

According to the calculations required by this Statement:

- 1. Disposable income is not determined under 11 U.S.C. § 1325(b)(3).
- 2. Disposable income is determined under 11 U.S.C. § 1325(b)(3).
- 3. The commitment period is 3 years.
- 4. The commitment period is 5 years.

#### CARES ACT & TAXES

All payments made to individuals under the CARES Act are not considered in determining a debtor's disposable income for a Chapter 13 plan of reorganization. The exclusion of CARES Act payments provide debtors with additional funds after filing.

#### **Sources: Personal Income Tax Returns**

#### Obtain the parties' personal income tax returns to identify the sources of income:

- 1. Wages, salaries, tips, etc.. (Form W-2)
- 2. Investment income (Schedule B)
- 3. Business Income (Schedule C)
- 4. Capital Gains or Losses (Schedule D)
- 5. Rental real estate, royalties, partnerships, S corporations, trusts, etc. (Schedule E)
- 6. Farm Income or loss (Schedule F)
- 7. Retirement plan distributions

#### **Identify the Sources**

- **Schedule K-1s:** Identifies the distributions (i.e. cash flow).
- **Personal financial statements:** provides a schedule of income producing assets.
- Loan applications: provides sources of income and assets.
- Bank and brokerage accounts: identify unknown deposits or transfers.
- **Public information:** Secretary of State filings, real estate and business records, etc.

#### **Overview of Financial Analysis**

- Financial Analysis is really a "forensic" exercise in which you follow the money to ensure unsecured creditors distributions are maximized.
- Financial Analysis provides an understanding of how debtor(s)' funds were obtained to purchase assets, the location or existence of assets and/or asset changes within the time period immediately preceding the filing.
- Financial Analysis provides any understanding of how debtor(s)' ongoing monthly obligation will be met and an insight into the causes for the filing.

#### **Major Documents for Analysis**

- Schedule A/B: Property (Official Form 106A/B)
- Schedules I & J (Income and Expenses)
  - ► Consistent with other documents? (Tax Returns)
- ▶ 122C-1 Above or below median income determination
  - ▶ Prior 6 months history of income stream
- ► SOFA Statement of Financial Affairs (Official Form 107)
  - ▶ Question 1 Marital Status Potential undisclosed income
  - ▶ Questions 4 & 5 − Sources of Income for past 2 year

### Purpose of Analysis

- 1. Determine Estate vs. Non-estate property (Exempt Schedule C)
- 2. Evaluate whether all income is disclosed
- 3. Assess possible unreported income
- 4. Identify possible hidden assets or undisclosed spending
- 5. Analyze what happened to inflows over time
- 6. Fraud and criminal issues



#### **Examples of Documents**

Business &
Personal Income
Tax Returns

W-2s and K-1s, if applicable

Mortgage Statements Bank Statements

**Deposit Slips** 

Personal Financials

Retirement Account Statements

Cancelled Checks

Credit Cards Statements Gift Tax Returns

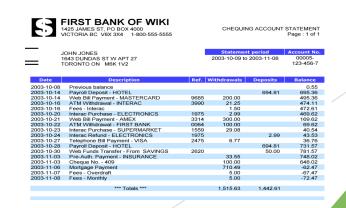
Business Documents

Loan Applications

Loan Statements Contents of Safety Deposit Boxes Public Filings, Secretary of State

Cash
Disbursement
Journals





#### **Section 341 Meeting Exam**

- Interview the Debtor at the 341 hearing
- Build a profile of the parties assets, liabilities, income, and expenses over the period being analyzed.
- Gain an understanding of the information/documentation that is available.
- Compare the information obtained in the interview to the underlying data in the financial analysis.

#### **Sources and Uses Analysis**

Where did the money **come from** and where did it go?

#### Sources

- \* Compensation
- \* Loan proceeds
- \* Business or investment distributions
- \* Gifts

#### <u>Uses</u>

- \* General Living expenses
- \* Asset purchases
- \* Tax payments
- \* Gifts

#### **Identify The Uses**

- **Personal income tax returns:** list tax payments and itemized deductions, including real estate tax, mortgage interest and charitable contributions (Schedule A).
- <u>Credit card statements:</u> details monthly expenses which can be used to illustrate the debtor(s) lifestyle.
- <u>Bank account statements:</u> typically provides a description of electronic withdrawals or transfers including the receiving party and last four digits of account numbers.
- <u>Cancelled check records:</u> identifies where funds were disposed.
- Loan settlement sheets: details the outflows to payoff a loan.

#### Identify the uses

- Real Estate closing statements: details the outflows to purchase a property and the origination of the funds.
- Public real estate records (deeds and tax payments): could identify hidden property
- Schedule K-1s: lists contributions to businesses or investments.
- Gift tax returns: identifies gifts to family or friends.
- Build a lifestyle analysis: depending on the case, it might be necessary to build a lifestyle analysis.

#### **Analyze the Data**

The financial profile built for the subject through the 341 meeting and sources and uses analysis should be used as the starting point to analyze the data.

#### Reconcile the sources to the deposits in the bank accounts.

- Are there accounts that were not previously identified?
- Are there other sources of income that were not reported?
- Track any inconsistencies.

#### Analyze the data

#### Reconcile the uses to the withdrawals from the bank accounts.

- 1. Are there accounts that were not previously identified?
- 2. Are there any significant unidentified outflows?
- 3. Are there transfers to unknown accounts?
- 4. Track inconsistencies.

#### **Analyze the Data**

#### Trace the assets forward from the "event":

- 1. Was the asset disposed?
- 2. How did the asset change over the period analyzed?
- 3. Where is the asset commingled?

Trace the money backwards from the asset (i.e. bank accounts, property, etc.)

- 1. Where did the funds originate?
- 2. What was the source of those funds?

#### **Red Flags**

- Transfers to or from unknown accounts.
- Large unknown deposits or withdraws to or from an unknown source.
- Large assets sales trace the disposition of the funds.
- Transactions with related parties (family, friends, businesses).
- Reconcile all sources of data investigate sources that are inconsistent.
- Prepare a follow-up document request to resolve any red flags.



Undisclosed Liabilities Determined

Unknown Assets Located



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SCHEDULE E Supplemental Income and Loss OM8 No. 1545-0074 (Form 1040) (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.) ► Attach to Form 1040, 1040NR, or Form 1041. Department of the Treasury Internal Revonue Service (\$9) Go to www.irs.gov/ScheduleE for instructions and the latest information. Attachment Name(s) shown on return Sequence No. 13 Your social security number Park I income or Loss From Rental Real Estate and Royalties. Note: If you are in the business of renting personal property, use Schedule C or C-EZ (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40 A Did you make any payments in 2017 that would require you to file Form(s) 1099? (see instructions) X No B If "Yes," did you or will you file required Forms 1099? Yes 1a Physical address of each property (street, city, state, ZIP code) A В C 16 2 For each rental real estate property listed Type of Property Fair Rental Personal Use above, report the number of fair rental and (from list below) QJV Days Days personal use days. Check the QJV box only if you meet the requirements to file as A 45 a qualified joint venture. See instructions. B \*\*\*\*\*\*\*\*\*\*\*\* C Type of Property: 1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental 2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe) income: Properties: A 3 Rents received 3 800 4 Royalties received 4 Expenses: Advertising Auto and travel (see instructions) 6 Cleaning and maintenance 7 Commissions 9 846 Legal and other professional fees. 10 250 Management fees . 11 Mortgage interest paid to banks, etc. (see instructions) 12 2,787 13 14 Repairs 14 1.200 15 Supplies 15 Taxes 16 1,358 17 17 350 Depreciation expense or depletion Other (list) > 19 Total expenses. Add lines 5 through 19 6,841 Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 -6,041 Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions) 22 6,041 23 a Total of all amounts reported on line 3 for all rental properties. 23a 800 b Total of all amounts reported on line 4 for all royalty properties 23b c Total of all amounts reported on line 12 for all properties 23¢ 2,787 d Total of all amounts reported on line 18 for all properties 23d Total of all amounts reported on line 20 for all properties 6,941 24 Income. Add positive amounts shown on line 21. Do not include any losses. 25 Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here. 25 6,041 26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. if Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2. For Pananunck Sadurtion Act Matica con the

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#### SCHEDULE 1 OMB No 1545-0074 Additional Income and Adjustments to Income (Form 1040) Attach to Form 1040. Department of the Treasury Go to www.irs.gov/Form1040 for instructions and the latest information. Attachment Internal Revenue Service Sequence No. 01 Name(s) shown on Form 1040 Your social security number Additional 1-9b Taxable refunds, credits, or offsets of state and local income taxes Income 11 11 Business income or (loss). Attach Schedule C or C-EZ Capital gain or (loss). Attach Schedule D if required. If not required, check here 🕨 🗌 13 Reserved 16b Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17 18 19 19 Other income. List type and amount ▶ Cancelled Debt Income 336. Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and include on Form 1040, line 6. Otherwise, go to line 23 Adjustments 23 Certain business expenses of reservists, performing artists, to Income and fee-basis government officials. Attach Form 2106 . 24 Health savings account deduction, Attach Form 8889 . 25 Moving expenses for members of the Armed Forces. Deductible part of self-employment tax. Attach Schedule SE 27 Self-employed SEP, SIMPLE, and qualified plans 28 Self-employed health insurance deduction . . .

For Paperwork Reduction Act Notice, see your tax return instructions.

Alimony paid b Recipient's SSN ▶

Reserved Add lines 23 through 35

Schedule 1 (Form 1040) 2018

86,902.

336.

-86,566.

31a

#### SCHEDULE C (Form 1040)

**Profit or Loss From Business** OMB No 1545-0074 (Sole Proprietorship) ➤ Go to www.irs.gov/ScheduieC for instructions and the latest information. Department of the Treasury Attachment Internal Revenue Service (93) ➤ Attach to Form 1040, 1640NR, or 1041; partnerships generally must file Form 1065. Sequence No. 09 Name of proprietor Social security number (SSN) B Enter code from instructions Principal business or profession, including product or service (see instructions) ► 7 2 2 3 0 10 lo Business name. If no separate business name, leave blank, D Employer ID number (EIM) (sea instr.) Business address (including suite or room no.) > City, town or post office, state, and ZIP code Accounting method: (1) ☑ Cash (2) ☐ Accrual (3) ☐ Other (specify) ► Did you "materially participate" in the operation of this business during 2018? If "No," see instructions for limit on losses Yes X No If "Yes," did you or will you fire required Forms 1099? . Part I Income Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked . . . . . . . . . . . . . . . . . Subtract line 2 from line 1 Cost of goods sold (from line 42) Gross profit. Subtract line 4 from line 3 Other income, including federal and state gasetine or fuel tax credit or refund (see instructions) . 6 Gross Income. Add lines 5 and 6 Part II Expenses, Enter expenses for business use of your home only on line 30. Advertising . . . . . 18 Office expense (see instructions) 18 19 Pension and profit-sharing plans 19 Car and truck expenses (see instructions). . . . . Rent or lease (see instructions): Commissions and fees a Vehicles, machinery, and equipment 20a Contract labor (see instructions) 11 19.704 b Other business property 20b 37,655. Deptetion 21 Repairs and maintenance. 21 Depreciation and section 179 29,543. 22 Supplies (not included in Part till) 22 expense deduction (not 23 Taxes and licenses 23 Included in Part III) (see instructions). Travel and meals: Employee benefit programs (other than on line 19). . b Deductible meals (see Insurance (other than health) Interest (see instructions): Mongage (paid to banks, etc.) 26 Wages (less employment credits). 26 b Other 27a Other expenses (from line 48) . . . 17 Legal and professional services 17 b Reserved for future use . . . Total expenses before expenses for business use of home. Add lines 8 through 27a . . . . . . . . 86,902. 28 29 Tentative profit or (loss), Subtract line 28 from line 7 -86,902. 29 30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square lootage of: (a) your home: and (b) the part of your home used for business:\_ 30 31 Net profit or (foss). Subtract line 30 from line 29. + If a profit, enter on both Schedule 1 (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3. 31 -86,902. . If a loss, you must go to line 32. 32 If you have a loss, check the box that describes your investment in this activity (see instructions). . If you checked 32a, enter the loss on both Schedule 1 (Form 1040), line 12 (or Form 1040NR, 32a X All investment is at risk. line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see the line 31 instructions). 32h Some investment is not Estates and trusts, enter on Form 1041, line 3. at risk. . If you checked 32b, you must attach Form 6198. Your loss may be limited.

For Paperwork Reduction Act Notice, see the separate instructions.

**絶対なみでは内容は** 

#### "You Won't Believe This"

- Trustee: Have you filed all the tax returns you were required to file for the past four years?
- Debtor: Yes.
- ► Trustee: Have you given me a true and correct copy of the most recent ones?
- Debtor: Yes
- ► Trustee: Did you own any rental property in 2017?
- ▶ Debtor: Excuse me?
- ► Trustee: Did you own any rental property in 2017?
- ▶ Debtor: Did I own any rental property in 2017?
- ► Trustee: Or do you still own any?
- ▶ Debtor: I have a house that I own that I am renting out. Yes.
- **...**

- Trustee: Alright. Well I saw Schedule E on your 2017 return. What type of catering business did you run?
- ▶ Debtor: Umm, trying to cook like at people when they get off from their jobs.
- ► Trustee: What kind of catering business did you run?
- ▶ Debtor: Umm, (pauses for several seconds)
- ► Trustee: It was your business, right?
- ▶ Debtor: Actually, it was me and some others but, (pauses for several seconds) Yes.
- ► Trustee: I'm still waiting on what kind.
- Debtor: You know how you just sale food, you cook and sale food to people you know or to people that's like at a job.
- Trustee: Okay, did they pay you?
- Debtor: Umm, it didn't do too well.
- ► Trustee: But did they pay you?
- ▶ Debtor: Umm (paused for several seconds)
- Trustee: You didn't just cook, give them food and receive no money.
- Debtor: Right.

- ► Trustee: So they paid you for the food, right?
- Debtor: Yeah, uh yes.
- Trustee: So who kept up with the books, you or them?
- Debtor: Them.
- Trustee: But you put it in your tax return.
- Debtor: Yes.
- ► Trustee: Okay. Are you all still in business?
- Debtor: No
- Trustee: Okay, who is them? Do they have a name?
- Debtor: Umm, no. I, I
- ► Trustee: You do realize, and maybe you need to speak with your attorney, that you must answer my questions?
- Debtor: Well yeah, we didn't discuss this before now.
- Trustee: I don't care about that.
- Debtor: I know you don't.
- Trustee: Right.

- ▶ Debtor: So, umm.
- Trustee: Do you want to end this meeting and continue with it later? Or do you want me to do a 2004 exam on him at a later date?
- Attorney: It's whatever, I mean, if you have business partners, we just need to know who they are.
- Trustee: Did you hear your attorney?
- Debtor: Well this is, let's umm, let's, let's, let's clarify something...umm.
- Trustee: This is interesting.
- Debtor: I think we might need to, umm, I might need to, can I talk to my attorney?
- ▶ Trustee: The problem you have is, I'm in the middle of a hearing.
- Debtor: I understand.

- Trustee: So, that's between you and him. He's sitting here, you can talk to him, and you all can decide right now as we sit here.
- Attorney: Debtor?
- ▶ Debtor: The thing is, I figured if there was a problem, we would have already discussed it, and I could have explained it better face to face, but umm.
- Trustee: He may not have known it was a problem until today
- Debtor: Right.
- Attorney: So Debtor, do you want to just try to hold the hearing on another day? Or do you want to answer the question?
- ▶ Debtor: Umm, I can answer the question, but what I'm saying is that I didn't know it was a problem.
- Attorney: I would advise you to answer the question (laugh)
- Debtor: Excuse me?
- ► Trustee: My advice is to just answer the question.

Debtor: Okay, well to be honest with you, umm, I let somebody do my taxes because they said they could get me a big lump sum back. I wasn't sure exactly what they was gone do, and that's what I got back. So...



- ► Trustee: Actually, actually...
- Debtor: I don't know, I don't know, umm. I'm assuming if I was audited, then it would be an issue, so I didn't know that there was an issue today. I just listened to someone who had done something like that before, and that was the outcome.
- ► Trustee: Okay, right. Who was the person who did your taxes?
- ▶ Debtor: Umm, I'll have to get the name from someone else that I know.
- ► Trustee: They didn't sign your tax return, did they?
- ▶ Debtor: No, they put me down. I didn't know they were going to do that either, but they put me down as the umm.
- ► Trustee: Tax preparer?
- ▶ Debtor: Umm, as self-preparer.
- Trustee: Which is what I figured. You will need to get that person's name and get it to your attorney, so they can get it to us. You suing anyone?



"Somehow, I consolidated all my debts into a ten-year sentence!"

## Take Away

- ▶ Debtor's Counsel examine tax returns prior to giving to Trustee
  - \* Business Loss
  - \* Head of Household not separated from spouse
  - \* Non-filed returns
  - \* Factory Preparers I'll get you a large refund
  - \* Schedule C Failure to exempt refunds
- ► Trustee examine tax returns for undisclosed items.
  - ► Undisclosed Assets Schedule C, E
  - ► Undisclosed Income Schedule B (Interest/Dividends)
  - ► Understated Liabilities Taxes (Filing Status)



- Business Name | Business ID | Officer Name | Registered Agent
- Search Criteria
- ► Starting With All Words Any Words Sounds Like Exact Match
- **Business Name:**

#### IT'S ALL ABOUT BUSINESS, Y'ALL!

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