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Southeast Bankruptcy Workshop

Bankruptcy Tax Issues: à la Carte Tax Talk

Jonathan Noble Edel
K&L Gates LLP | Charlotte, N.C.

Hon. Scott M. Grossman
U.S. Bankruptcy Court (S.D. Fla.) | Fort Lauderdale

Virginia Tate
FAI International, Forensic Accounting & Investigations | New Orleans

Damon Yousefy
Alvarez & Marsal | Dallas

CONCURRENT WORKSHOP

2025

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Tax Issues to Consider *Before* Filing for Bankruptcy

- Type of Entity
- Prior Tax Filings
- COD Income
- PPP-EIDL Bankruptcy Concerns
- Trust Funds

Entities & Tax Treatment

- **Sole Proprietor**
- **Partnership**
- **S-Corporation**
- **LLC** (Treated as a Disregarded Entity)
- **LLC** (elected to be taxed as a Corporation or Partnership)
- **C-Corporation**
- **Non-Profit Corporation**

The IRS v. Real World

- The IRS is still "Working" From Home.
- Multiple Complaints filed with US Congressman daily.
- Form 911 – Request for Taxpayer Advocate Assistance filings are not being responded to.
- 80,000 agents have been assigned/reassigned. And…..now they are gone.
- Gap between IRS's business/entity agents and Individual agents grows ever wider. One hand does not and will not work with the other.
- IRS still dealing with COVID errors and corrections.
- Accounting firms are filing F2848 Power of Attorney automatically, slowing the process of POA approval.
- On March 17, 2023, the IRS posted the following notice on their E-News publication:

  "Professional responsibility and the Employee Retention Credit: The IRS warns employers to beware of third parties promoting improper Employee Retention Credit (ERC) claims.
- At the time of this writing, the new tax bill has not been finalized.

Net Operating Loss Preservation

- In general, any amount of CODI excluded from gross income shall "reduce tax attributes of the taxpayer" in the following order under Section 108(b):

- Attribute reduction made after determining the tax due for the taxable year of the discharge (§ 108(b)(4)(A))
  - As a result, gain recognized in the year the debt is discharged can be offset by NOLs before NOLs get reduced by any excluded COD.
- Tax credits are reduced on a 1/3 to 1 basis as Section 108 has not been updated for the updated US federal income tax rate in the TCJA. (§ 108(b)(3)(B))

Note: Section 163(j) carryforwards are not a tax attribute to be reduced under current Section 108.

Net Operating Loss Preservation

- In lieu of applying the general attribute reduction rules, a taxpayer may elect to reduce the basis of depreciable property first (Section 108(b)(5))
  - Reduction cannot exceed aggregate adjusted bases of depreciable property held by taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurred
  - Election can be with respect to a "portion" of the attribute reduction and any remaining excluded CODI must follow typical attribute reduction priority.

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Net Operating Loss Preservation

- A member of a consolidated group to treat stock in a subsidiary as depreciable property to the extent the subsidiary reduces the basis of its depreciable property (Section 1017(b)(3)(D))
- A partner may elect to treat its partnership interest as depreciable property for purposes of these rules (Section 1017(b)(3)(C))
  - Reduction is only to the extent of the partner's share of the partnership's depreciable property
  - Basis reduction creates ordinary income recapture potential on future exit of partnership interest (§ 1017(d))
  - There are various request and consent procedures to follow if corresponding reductions are to be made to partnership property (Treas. Reg. § 1.1017-1(g)(2)(ii))

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Creative Approaches in Tax & Finance

Glimpses into the Individual & Small Business Bankruptcy

- Lies, Damn Lies and…..Financial Statements written for specific purposes require thorough understanding of how and why a particular statement is utilized.
- Previous Tax Strategies Causing Recapture Pain that are often not recognizable to debtor.
- Fraudulent or misstated financial statements take time to sort through, give your financial expert time to get this sorted through.
- Smaller banks have relaxed formal financial statements due to cost and lack of available licensed accountants.
- Real Estate Values and Interest Rates causing pain in loan to value ratios.

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The Intersections of IRS, Legal Transactions & Tax Application

- When it comes to the IRS, every past transaction can be a minefield.
- Audits Hot Topics Include:
  - EVERY transaction will be examined for intersection with personal use, related parties and REAL documentation,
  - Enforcement of 1099 filings and subsequent vendor & customer tax filings are on deck for audit,
  - Physical inspections of real and personal property business use have returned.

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The Intersections of IRS, Legal Transactions & Tax Application

- Get your tax expert on board at the beginning.
- This is going to take some time.
- Tax Professionals are buried in deadlines.
- A restructuring or liquidation has tax implications at every level.
  - Entity
  - Individual
  - Divorce is often concurrent
  - Back tax returns often have to be amended for missing or misstated assets.
  - Financing is tough for the smaller filer.
  - Tracing missing assets takes time.
  - Most small businesses are familial in nature and a restructure may not be possible, but it most likely will be taxable at some level.
  - Potential loss of entity tax elections.

Documenting Tax Planning Positions

- The IRS has been under-resourced and underperforming for years. They are light years behind in technology.
- Many experienced agents have taken early retirement. Newer hires lack authority, experience and understanding of how businesses function.
- Tax court can be an appealing venue for taxpayers, especially those with short term liquidity constraints, because tax is not due and payable until a final judgment has been rendered. However:
  - Interest accrues on any amounts adjudged to be owed.
  - The IRS can assess (and the tax court frequently upholds) substantial penalties for frivolous tax positions or transactions which lack economic substance. These penalties also accrue interest.
- IRS audits and tax court proceedings can advance at a slow pace. It's not unusual for issues to be tried 10 or more years after the tax years in question.
- This makes proper documentation of planning transactions (e.g. structure charts, legal agreements, tax opinions, valuation reports, etc.) extremely important in ensuring these planning activities are of long-term benefit to the taxpayer.

COD Income Considerations

- In general, one has *Cancellation of Debt (COD) Income* when their debt is canceled, forgiven, or discharged ("voided") for less than the amount owed.
- This may create a (tax) deduction or loss to the taxpayer who is owed.
- It creates taxable income to the taxpayer whose debt was voided unless the taxpayer can find a rule of exception, exclusion or deferment.
- Related Party Debt: IRC Section 108(e)(4) indicates who are related parties, such as family members, certain shareholders, partners and beneficiaries, 50% or greater owners, and control group that acquire the borrower's debt.
- There are Exceptions for income type and Exclusions for insolvency , as well as tax attributes to consider.

Small Business Deductions & Tax Incentives that Revert to Taxable or Phantom Income

Phantom Income is the result of transferring assets and/or recapturing depreciation in exchange for forgiveness of debt.

- Differences between Fair Market Value and Net Book Value create phantom income.
- Recapture of depreciation, especially bonus and accelerated (Sec. 179) depreciation can be painful to flow through entity filers.
- Recapture of unused tax credits such as payroll tax credits (ERC) and investment tax credits.
- Examples of COD income include
    - Debt Release or Reduction
    - Write-down of Debt
    - Transfer of property in full or partial satisfaction of indebtedness

Subchapter S Election as Estate Property

- **Issue: Is a corporation's election to be taxed under Subchapter S of the Internal Revenue Code property of the corporation's bankruptcy estate under 11 U.S.C. § 541?**
    - *See* Handout re *In re Majestic Star Casino, LLC*, 716 F.3d 736 (3d Cir. 2013) (No); *In re Vital Pharmaceuticals*, 655 B.R. 374 (Bankr. S.D. Fla. 2023) (Yes; direct appeal pending before 11th Circuit).

Distressed Partnership Tax Issues

- The partnership structure offers certain tax advantages such as pass-through taxation and negotiated allocations of profits interests, which is why it is popular in sectors such as energy.
- The same advantages in good times can be headaches for the partners when the partnership is in distress.
- Even in corporate structures, certain groups (i.e., management) may hold partnership interests.

Distressed Partnership Tax Issues

- Whether CODI is realized and recognized in connection with a partnership debt restructuring is determined at the partnership level
- However, exceptions to CODI recognition and corresponding attribute reductions are applied at the partner level (Section 108(d)(6))
- CODI is ordinary in character.
- CODI for solvent partners is often described as “phantom income” as there is not a corresponding cash distribution, but there is a potential income tax liability.
- CODI is additional adjusted gross income for the year of forgiveness, which may permit some additional amount of interest deductibility under Section 163(j) at the partner level.
- Solvent partners may have suspended losses that offset CODI.
  - See, e.g., losses suspended either under Section 704(d) or Section 469

Distressed Partnership Tax Issues

- If a creditor reduces the debt without foreclosing on the property, the debtor realizes CODI
  - Treas. Reg. § 1.61-12(a); Rev. Rul. 91-31.
- If a partnership transfers a capital interest of a profits interest to a lender in exchange for recourse or nonrecourse debt, the partnership has CODI in an amount equal to if it had satisfied the debt for cash equal to the FMV of the partnership interest (Section 108(e)(8))
  - If certain conditions are met, the FMV of the partnership interest will be deemed equal to the "liquidation value" of the partnership interest (Treas. Reg. § 1.108-8(b)(2)(i)).
  - Any CODI will be included in the distributive shares of taxpayers that were the partners immediately before the discharge
- Where lender takes the collateral in satisfaction of the debt, the results will vary depending on whether the debt is recourse or nonrecourse.
- If property is sold to a third party "in connection with" the lender's discharge of indebtedness, the result for the debtor will be as if the debtor gave the property to the lender in discharge of the debt.
  - See *2925 Briarpark Ltd.*, 163 F.3d 313 (5th Cir. 1999); Treas. Reg. § 1.1274-5(b)(2); *Gershkowitz*, 88 T.C. 984 (1987).
- Significant modifications may result in CODI or repurchase premium depending on the adjusted issue price of the new debt compared to the adjusted issue price of the unmodified debt.

Distressed Partnership Tax Issues

- A taxpayer may exclude CODI if the "discharge occurs in a title 11 case" (Section 108(a)(1)(A)).
- In other words, the taxpayer must be under the jurisdiction of a court in a title 11 case, and the discharge is granted by the court or is pursuant to a plan approved by the court (Section 108(d)(2)).
- Under Section 108(d)(6), the bankruptcy exception is tested at the partner level, so whether the partnership is in bankruptcy is generally irrelevant.
- However, the Tax Court has permitted a general partner to utilize the bankruptcy exclusion to avoid CODI where the general partner was discharged from liability for partnership debts in connection with bankruptcy proceedings relating to the partnership.
  - *Gracia*, 87 T.C.M. (CCH) 1423 (2004); *Price*, 87 T.C.M. (CCH) 1426 (2004); Mirachi, 87 T.C.M. (CCH) 1424 (2004); *Estate of Martinez*, 87 T.C.M. (CCH) 1428 (2004).
  - CODI excluded under bankruptcy exception was in excess of the amount by which such partner was insolvent.
  - IRS has indicated it does not acquiesce in those decisions.
- In 2016, regulations under Section 108 were issued that provide where the commercial debtor is a disregarded entity or grantor trust owned by a partnership the partner must be the 'title 11 debtor' to avail itself of the bankruptcy exception. (Treas. Reg. §1.108-9(a)(2) & (b).
  - In the preamble they also indicated disagreement with Gracia and companion cases.

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Distressed Partnership Tax Issues

- A taxpayer may exclude CODI to the extent of its insolvency (Section 108(a)(3))
- A taxpayer is insolvent to the extent its liabilities exceed the FMV of its assets immediately before the debt discharge (Section 108(d)(3))
- Under Section 108(d)(6), the insolvency exception is tested at the partner level, so the insolvency of partnership is generally irrelevant
- However, how does a partner's share of partnership liabilities affect the insolvency determination?
  - If a nonrecourse liability is being discharged, the excess of the nonrecourse liability over the value of the property will be treated as a liability in measuring insolvency to the extent that the excess is discharged. (Rev. Rul. 92-53)
  - If the nonrecourse debt is not being discharged, treat the debt as a liability only to the extent of the value of the property securing the debt. (Rev. Rul. 92-53)
  - In the partnership context, partnership's discharged excess nonrecourse debt is treated as a liability of the partners for purposes of measuring the partners' insolvency under Section 108(d)(3) based upon how the CODI with respect to that portion of the debt is allocated among the partners under Section 704(b) and the regulations thereunder (Rev. Rul. 2012-14)

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Litigating with the IRS

Dum dum dummmmmm…

- Case Study – Tax Offset Program
  - 26 U.S.C. § 6402
  - *IRS v. Luongo*, 259 F.3d 323 (5th Cir. 2001)

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Litigating with the IRS

- **Any other Claimant…with superpowers**

  - Extended bar date (§ 502(b)(9))
  - Priority Claim Treatment (§ 507(a)(8))
  - Non-Dischargeable (§ 523(a)(1))
    - Payment of Priority Taxes in Full under Ch13 and remain in Ch7
  - Current on Tax Filings (§§ 1325(a)(9) & 1308)
  - Automatic Stay Exceptions (§ 362(b)(2)(F), (b)(9), & (b)(26))
- **Otherwise, they're just like any other creditor**

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Litigating with the IRS – *In re Luongo*

- **Relevant Law:**
  - Tax Intercept Statute (26 U.S.C. § 6402(d)(1)): "Upon receiving notice from any Federal Agency that a named person owes a past-due legally enforceable debt … to such agency, the Secretary shall—(A) reduce the amount of any overpayment payable to such person by the amount of such debt; (B) pay the amount by which such overpayment is reduced under subparagraph (A) to such agency; and (C) notify the person making such overpayment that such overpayment has been reduced by an amount necessary to satisfy such debt."
  - Automatic Stay (11 U.S.C. § 362(b)(26)): Exempting from stay "the setoff under applicable nonbankruptcy law of an income tax refund, by a governmental unit, with respect to a taxable period that ended before the date of the order for relief against an income tax liability for a taxable period that also ended before the date of the order for relief, except that in any case in which the setoff of an income tax refund is not permitted under applicable nonbankruptcy law because of a pending action to determine the amount or legality of a tax liability, the governmental unit may hold the refund pending the resolution of the action, unless the court, on the motion of the trustee and after notice and a hearing, grants the taxing authority adequate protection … for the secured claim of such authority in the setoff under section 506(a)"
  - Setoff (11 U.S.C. § 553): Preserves the rights under nonbankruptcy law to setoff mutual debts that are valid and enforceable that arose before the commencement of the relevant bankruptcy case

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Litigating with the IRS – *In re Luongo*

- **Legal Tensions:**
  - When does a refund become property of the estate?
  - Automatic Stay vs. Setoff Rights
  - Exemption vs. Setoff Rights
  - Mutuality?

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Litigating with the IRS – *In re Luongo*

- **Facts:**
  - Debtor filed for Ch 7 Relief in May 1998
  - Schedules included $3,800 owed to IRS from 1993 tax year
  - August 1998, Debtor filed 1997 tax return, showing overpayment and refund amount of $1,395.94
  - September 1998, bankruptcy court entered discharge, including with respect to the 1993 tax liability
  - November 1998, IRS intercepted 1997 refund to setoff against 1993 liability
  - Debtor reopened case to amend schedules and exempt 1997 tax refund

Litigating with the IRS – *In re Luongo*

- **Legal Issues:**
  - Juxtaposition of Sections 522(c) and 553(a) of Bankruptcy Code
  - Application of automatic stay
  - Pre-BAPCPA, which included 11 U.S.C. § 362(b)(26)
- **Holding**
  - Bankruptcy Court: IRS could not setoff exempt property
  - District Court: IRS setoff right preserved by 553; unaffected by exemption
  - 5th Cir: No stay (case closed); refund never became property of estate

Litigating with the IRS – *In re Luongo*

- **Alternative Approach – *Sexton v. IRS* (*In re Sexton*), 508 B.R. 646 (Bankr. W.D. Va. 2014)**
  - Petition filed in February 2013
  - 2012 tax refund ($4,200) included as exempted asset
  - Debt to DOA for $114,617.42 as deficiency claim after foreclosure sale
  - March 2013, IRS notified debtor of intercepted refund to offset DOA debt
  - Discharge entered and granted in May 2013
  - June 2013, case reopened and AP alleging stay violation initiated

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Litigating with the IRS – *In re Luongo*

- **Alternative Approach – *Sexton***
  - Right to refund vested upon the close of the tax year
  - Stay applied upon filing of petition (§ 362(a)(7))
  - *Luongo*'s reasoning would render § 362(b)(26) superfluous as stay would never apply to IRS offset
  - Section 362(b)(26) only applies to offset against ***income tax liabilities*** (*expressio unius est exclusio alterius*)

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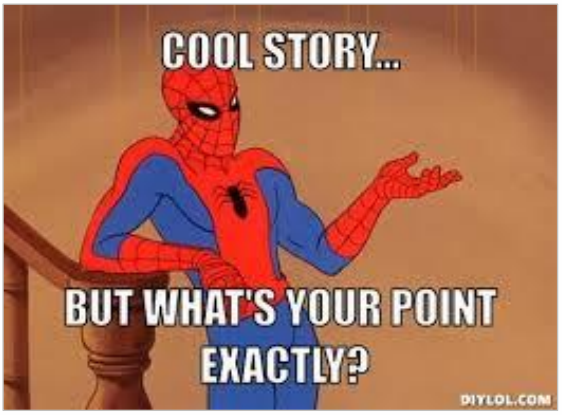
Litigating with the IRS – 4th & 11th Circuits



Litigating with the IRS – 4th & 11th Circuits

- *Wood v. HUD*, 993 F.3d 245 (4th Cir. 2021) (holding bankruptcy estate included tax overpayments; exemption did not trump right to offset by IRS; but § 362(b)(26) did not apply to non-tax liability as excepted from stay)
- *In re Gilland*, 18-bk-00939, 2018 WL 11206273 (Bankr. M.D. Fla. Aug. 9, 2018) (granting relief from stay for Army and Air Force Exchange Service to setoff income tax refund but not credits)
- *In re Mirabilis Ventures, Inc.*, 08-bk-04327, 2011 WL 1167880 (Bankr. M.D. Fla. Mar. 28, 2011) (finding that tax refunds are not property of the estate until the amounts are finally determined by the IRS, but that setoff of non-income tax debts against income tax overpayments were not excepted from the stay)
- *Sissine v. Dep't of Revenue (In re Sissine)*, 432 B.R 870 (Bankr. N.D. Ga. 2010) (holding a debtor's interest in prepetition tax refunds were estate property but not the funds themselves, so the automatic stay did not apply)

Litigating with the IRS – 4th & 11th Circuits

- *Ewing v. USA (In re Ewing)*, 400 B.R. 913 (Bankr. N.D. Ga. 2008) (authorizing setoff of tax liability to tax debts referencing the § 362(b)(26) exception to stay)
- *In re Daniels*, No. 04-10983, 2007 WL 725774 (Bankr. S.D. Ala. Mar. 7, 2007) (allowing setoff of prepetition tax liability against tax overpayment; relief from stay obtained)
- *Henkel v. USA (In re Carpenter)*, 367 B.R. 850 (Bankr. M.D. Fla. 2006) (allowing setoff of prepetition tax liability against tax overpayment; no discussion of stay)
- *Jones v. IRS (In re Jones)*, 359 B.R. 837 (Bankr. M.D. Ga. 2006) (authorizing setoff of tax liability against tax debt over a claimed exemption, following the "emerging view" that an estate has no claim in a refund until offset under intercept statute)
- *In re Pigott*, 330 B.R. 797 (Bankr. S.D. Ala. 2005) (holding that section 553 setoff rights are superior to claimed exemptions, as 553 provides that "this title does not affect any right of a creditor to offset…" including § 522)

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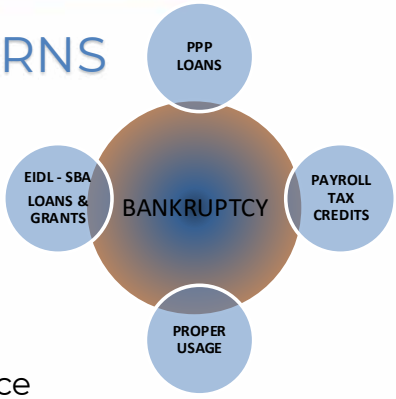
PPP-EIDL BANKRUPTCY CONCERNS



- Owners do NOT guarantee PPP loans
- PPP No Collateral – Non-Recourse Loans
- Cares Act Payroll Retention Tax Credits and Payroll Delayed Deposit programs adversely affect PPP and EIDL loans.
- EIDL Requires Collateral and Physical Presence
  - Lack of Real Estate Collateral requires borrowers to pledge Available Assets

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Trust Funds

Trust fund taxes are Income taxes, Social Security taxes and Medicare taxes employers are required to withhold from the wages of employees as well as certain types of excise taxes.

- Not dischargeable in bankruptcy.
- Is a priority claim.
- The IRS treats failure to pay collected of trust funds as theft.
- Criminal charges imposed in severe cases (intent to defraud).
- Corporate officers are not generally held personally liable, unless:
- IRS IRM 5.17.7 Liability of Third Parties for Unpaid Employment Taxes looks to the responsible party:
  - The person is “responsible” and had the duty to account for, collect, and pay over the trust funds taxes to the government; and
  - The person “willfully” failed to collect or pay over trust fund taxes to the government.

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Renewable Tax Issues

- Renewable tax credits allowed certain industries (i.e., electric cars, solar power, etc.) to grow substantially.
- The current draft of the "Big Beautiful Bill" cuts renewable tax credits through changes in qualification, timing, or outright cancellation.
- Companies in the renewable energy space are expected to experience greater distress as a result of the loss of these credits, which can be sold to third parties under current law.

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Tax Refunds

- **Existing Methodologies**
  - 50/50 Rule
  - Income Rule
  - Withholding Rule (Majority Rule)
  - Separate Filings Rule

Tax Refunds – *In re Pirron*

- ***In re Pirron*, No. 22-08555, 2025 WL 535547 (Bankr. N.D. Ill. Feb. 18, 2025)**
- **Facts**
  - Debtor's employer withheld $15,585 on income of $105,000
    - Proper amount with no liability/refund due
  - Non-debtor spouse made estimated payments of $577,630 from real estate investment income
    - Overpaid by $152,356
  - Refund applied to 2022 taxes
  - Trustee sought turnover of 50% of taxes as Debtor's "share" for creditors

Tax Refunds – *In re Pirron*

- **50/50 Rule**
  - "[P]resumption that each spouse contributed equally to the household, including nonmonetary contribution, and that, thus, the joint tax refund should be apportioned equally between the spouses" *In re McInerney*, 609 B.R. 497, 504 (Bankr. N.D. Ill. 2019)
  - Cases following: *In re Spina*, 416 B.R. 92 (Bankr. E.D.N.Y. 2009); *In re Vongchanh*, Case No. 09-70050, 2009 WL 1852452 (Bankr. N.D. Ill. June 29, 2009); *In re Innis*, 331 B.R. 784 (Bankr. C.D. Ill. 2005)
  - *Pirron* Critique: Arbitrary, lacking basis in legal entitlement, and potentially unfair to creditors or non-debtor spouses

Tax Refunds – *In re Pirron*

- **Income Rule**
  - "[D]ivide[] joint tax refunds proportionally according to the income generated by each spouse." *McInerney*, 609 B.R. at 505.
  - Cases following: *Judson v. Levine (In re Levine)*, 50 B.R. 587 (Bankr. S.D. Fla. 1985); *Lieshout v. Verill (In re Verill)*, 17 B.R. 652 (Bankr. D. Md. 1982); *In re Colbert*, 5 B.R. 646 (Bankr. S.D. Ohio 1980)
  - *Pirron* Critique: Refunds depend on taxes paid versus owed, not just income

Tax Refunds – *In re Pirron*

- **Withholding Rule**
  - "[A]llocated between spouses in proportion to their respective tax withholdings during the relevant tax year." *McInerney*, 609 B.R. at 505.
  - Cases following: *Judson v. Levine (In re Levine)*, 50 B.R. 587 (Bankr. S.D. Fla. 1985); *Lieshout v. Verill (In re Verill)*, 17 B.R. 652 (Bankr. D. Md. 1982); *In re Colbert*, 5 B.R. 646 (Bankr. S.D. Ohio 1980)
  - *Pirron* Critique: Withholding amounts are arbitrary, as employees can claim allowances that will cause excesses or not, while others have no withholdings and estimate taxes quarterly

Tax Refunds – *In re Pirron*

- **Separate Filings Rule**
  - "[T]he refund is apportioned based on a determination of what each spouse's contributions and tax liabilities would have been if the spouses had filed separately." *McInerney*, 609 B.R. at 506.
  - Cases following: *Crowson v. Zubrod (In re Crowson)*, 431 B.R. 484 (10th Cir. BAP 2010); *Lee v. Walro (In re Lee)*, 508 B.R. 399 (S.D. Ind. 2014); *In re Palmer*, 449 B.R. 621 (Bankr. D. Mont. 2011)
  - *Pirron* Critique: Avoided due to complex, hypothetical calculations ignoring joint filing benefits

Tax Refunds – *In re Pirron*

- ***Pirron* Rule**
  - Considered question as one of "legal entitlement"—which spouse would win in litigation over entitlement to refund?
    - If the debtor, then it's estate property; if not, then it's not
  - Question depends on why the refund exists and applicable law
    - May require complex calculations, but not here
  - Here, no evidence Debtor overpaid his taxes; ample evidence that his wife did, so no reason to believe he would prevail in hypothetical litigation

Sovereign Immunity

- **Issue: Does Sovereign Immunity protect the IRS from being sued in Bankruptcy Court to avoid a transfer under state law?**
    - See Handout re *United States v. Miller*, 145 S. Ct. 839 (2025)

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Business Breakout Session – Tax Talk a la Carte

I. Is a corporation's election to be taxed under Subchapter S of the Internal Revenue Code property of the corporation's bankruptcy estate under 11 U.S.C. § 541?

A. No. *In re Majestic Star Casino, LLC*, 716 F.3d 736 (3d Cir. 2013).

B. Yes. *In re Vital Pharmaceuticals*, 655 B.R. 374 (Bankr. S.D. Fla. 2023) (direct appeal pending before 11th Circuit).

Significance of the Issue

If the S-election is not property of the bankruptcy estate, then the shareholders can revoke the election, thus saddling the debtor with tax liabilities that previously had been passed through to the shareholders.

If the S-election is property of the bankruptcy estate, then the shareholders cannot revoke the election without bankruptcy court approval, or, if they did so prepetition, they may be liable to having that election unwound as an avoidable transfer.

General Overview of Legal Framework

Property of the estate includes "all legal or equitable interests of the debtor in property." 11 U.S.C. § 541(a)(1).

But "[p]roperty in which the debtor holds . . . only legal title and not an equitable interest . . . becomes property of the estate under [§ 541(a)(1)] . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." 11 U.S.C. § 541(d).

The Bankruptcy Code itself does not define "property," instead leaving the matter to non-bankruptcy law. *See Butner v. United States*, 440 U.S. 48, 54 (1979) (explaining that, under the former Bankruptcy Act, "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law").

Usually, that is state law. But here, the applicable non-bankruptcy law is federal law. *See Majestic Star*, 716 F.3d at 752 ("[W]e conclude that the I.R.C., rather than state law, governs the characterization of entity tax status as a property interest for purposes of the Bankruptcy Code."); *Vital Pharmaceuticals*, 655 B.R. at 386 ("Because the property interest at issue is Vital's S election, governed by federal statutes, this Court looks to federal law.")

Under 26 U.S.C. § 1362(a) certain corporations, with the consent of each of their shareholders, may elect to be a "Subchapter S corporation."

Under § 1366(a), the corporation's income and other tax attributes are passed through to the corporation's shareholders pro rata and accounted for on the shareholders individual income tax returns.

To be eligible to elect S corporation status, a corporation must be a "small business corporation" as defined by § 1361(b), which means that:

- The corporation must be a domestic corporation.
- The corporation cannot have more than 100 shareholders.
- The shareholders must be U.S. citizens or residents.
- The corporation can only have one class of stock.

Importantly, Internal Revenue Code § 1362 states it is the company that makes the election, with the consent of its shareholders:

> "[A] small business corporation may elect, in accordance with the provisions of this section, to be an S corporation." 26 U.S.C. § 1362(a)(1).
>
> "An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election." 26 U.S.C. § 1362(a)(2).

Treasury Regulation § 1.1362-6 proscribes how the initial election is made:

> "A small business corporation makes an election under section 1362(a) to be an S corporation by filing a completed Form 2553," though the election is not valid unless all shareholders give their consent. Treas. Reg. § 1.1362-6(a)(2).

Internal Revenue Code § 1362 and Treasury Regulation § 1.1362-6 establish a similar scheme for revocation. Under Treasury Regulation § 1.1362-6, "[t]o revoke an election, the corporation files a statement that the corporation revokes the election." § 1.1362-6(a)(3).

The regulation clarifies that the "revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation." *Id.*

In re Majestic Star Casino, LLC, 716 F.3d 736 (3d Cir. 2013)

In *Majestic Star*, the debtor was a qualified subchapter S subsidiary of another company called Barden Development, which itself was an S corporation. After Majestic Star filed for bankruptcy, Barden revoked its own S election, which caused the debtor, to lose its qualified S subsidiary status. The net effect of this is that the debtor would now be subject to taxation.

The debtor then filed an adversary proceeding to undo – or "avoid" – the revocation as an unauthorized post-petition transfer of property of the estate, under Bankruptcy Code §§ 362 and 549. The bankruptcy court granted summary judgment to the debtor, ruling that the debtor's qualified subchapter S subsidiary status was property of its bankruptcy estate.

Barden – the debtor's parent – appealed, and the District Court certified the issue for a direct appeal to the Third Circuit.

The Third Circuit reviewed earlier bankruptcy court decisions holding that the subchapter S election was property of the bankruptcy estate:

- *In re Trans–Lines West, Inc.*, 203 B.R. 653, 662 (Bankr. E.D. Tenn. 1996) ("the Debtor possessed a property interest (i.e., a guaranteed right to use, enjoy and dispose of that interest) in its Subchapter S status....");
- *Halverson v. Funaro (In re Funaro)*, 263 B.R. 892, 898 (8th Cir. BAP 2001) ("[A] corporation's right to use, benefit from, or revoke its Subchapter S status falls within the broad definition of property [under the Code].");
- *Parker v. Saunders (In re Bakersfield Westar, Inc.)*, 226 B.R. 227, 234 (9th Cir. BAP 1998) (concluding that the holding in *Trans–Lines West* "is consistent with the Ninth Circuit's definition of 'property'");
- *Hanrahan v. Walterman (In re Walterman Implement Inc.)*, 2006 WL 1562401, at *4 (Bankr. N.D. Iowa 2006) ("[T]he right to revoke Debtor's Subchapter S election is property . . . as defined in § 541[ ] . . . [and] the revocation of Debtor's subchapter S status is also voidable under § 549 as a postpetition transfer.").

These decisions based their conclusions on cases holding net operating losses to be property. *See Segal v. Rochelle*, 382 U.S. 375, 380 (1966) (net operating losses are "sufficiently rooted in [its] pre-bankruptcy past" such that, when carried back to generate a tax refund, they "should be regarded as 'property' under [the Code]."); *Official Committee of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines, Inc.)*, 928 F.2d 565, 571(2d Cir.1991) (the right to carryforward net operating losses "to offset future income is property of the [subsidiary's] estate within the meaning of § 541.")

The Third Circuit attempted to distinguish NOLs from S corporation status. It reasoned that the value of NOLs is readily determinable, whereas the value of the S corporation election is dependent on it not being revoked, as well as the amount and

timing of future earnings. It also pointed out that NOLs can be monetized in certain transactions permitted under Internal Revenue Code section 382, whereas "the sale of an S-corp will generally result in the termination of its tax-free status" if that sale is to a corporation. Finally, it notes that the S corporation status can be revoked at will, either by the shareholders approving the revocation or a single shareholder selling her shares "to another corporation, or to a nonresident alien, or to a number of new individuals sufficient to increase the total number of shareholders to more than 100," all of which would result in loss of the subchapter S status. Finally, the Third Circuit noted the apparent inequity of income generated during the bankruptcy case going to creditors, while any resulting tax liability being borne by the shareholders. The Third Circuit therefore held that S corporation status is not property of the estate under Bankruptcy Code section 541.

In re Vital Pharmaceuticals, 655 B.R. 374 (Bankr. S.D. Fla. 2023)

After the debtor sold its assets for $370 million, its sole shareholder, John Owoc – who was ousted from control right before the debtor filed for bankruptcy – sought a determination that the debtor's subchapter S election was not property of the estate, such that he could terminate the election and shift any tax liability on the sale to the debtor. Alternatively, he sought stay relief to terminate the election.

The court denied his motion, concluding that the debtor's S election is property of the estate and is therefore protected by the automatic stay. The court also concluded that the shareholder failed to demonstrate "cause" to lift the stay, but that even if he had, stay relief would be futile because the shareholder no longer had the right to revoke the election.

In doing so, the court criticized the Third Circuit's logic in *Majestic Star* as essentially having deduced that because the S election is not an NOL, it is not property. The court also criticized the Third Circuit's distinction as to being able to value NOLs but not the S-election. The court pointed out that just as an NOL can be readily determined, so too can the debtor's tax liability for purposes of the subchapter S election. The court likewise pointed out the fallacy in the Third Circuit's analysis that the ability of the subchapter S election to be revoked at will renders it unlike NOLs and therefore not property. But the court pointed out that NOLs, too, can be lost through shareholders undertaking transactions that effectuate an ownership change under Internal Revenue Code section 382. Finally, the court declined to read into section 541 a limitation for property that cannot be transferred or that could be lost due to a contingency (like a shareholder taking action that would cause loss of the election). Accordingly, the court concluded that an S corporation's "valued right of not having to pay taxes" is a property interest – no less a property interest than that in property that produces income. "In other words, a corporation has a property interest in its right to avoid the tax expense otherwise known as the S election or status," and that property interest is property of the debtor's bankruptcy estate.

The Appeal

The shareholder appealed, and – like in *Majestic Star* – the District Court certified a direct appeal to the Court of Appeals.

Interestingly, while the United States was a party to the bankruptcy case in *Majestic Star* who then appealed to the Third Circuit, the United States was not a party in *Vital*. But it has filed an amicus brief in the Eleventh Circuit. Both the United States and the Liquidating Trustee for Vital argue that the appeal is both constitutionally and equitably moot, because all the debtor's assets were sold, all events establishing tax liability have occurred, and Mr. Owoc's shares were already canceled. Thus, there is no relief the court can afford, and Mr. Owoc could not retroactively revoke the debtor's S corporation status. The United States also argued that the appeal was equitably moot because the debtor's plan was confirmed, no stay pending appeal was sought, the plan was substantially consummated, and the liquidating trustee has distributed nearly $24 million and paid 63% of allowed claims.

But if the court were to reach the merits, the United States argues that the bankruptcy court erred in concluding that the debtor's subchapter S status was property of the estate. The United States urges the Eleventh Circuit to adopt the Third Circuit's analysis in *Majestic Star* and not create a circuit split. The United States also notes that since *Majestic Star*, bankruptcy courts in reported decisions have followed its analysis, including *In re Health Diagnostic Laboratory, Inc.*, 578 B.R. 552 (Bankr. E.D. Va. 2017) (determining that S-corporation status is not "property" based on an analysis of several factors that courts have identified in determining whether something constitutes property).

The Liquidating Trustee also argues that the appeal is moot. But unlike the United States, if not moot, it alternatively argues that the bankruptcy court was correct in holding that the subchapter S election is property of the estate. Mr. Owoc, as the appellant, did not address the mootness argument in his initial brief. But he of course argued that the Bankruptcy Court was wrong to conclude that the subchapter S election was property of the estate.[1]

[1] Mr. Owoc's reply brief is due after the deadline for submission of these materials. It is anticipated he would address the mootness arguments in his reply.

II. Does Sovereign Immunity protect the IRS from being sued in Bankruptcy Court to avoid a transfer under state law?

Yes. In *United States v. Miller*, 145 S. Ct. 839 (2025), the Supreme Court held that the Bankruptcy Code's general waiver of sovereign immunity in section 106(a) does not apply to state law fraudulent transfer claims brought under section 544(b).

In *Miller*, the trustee sought to avoid a pre-petition tax payment made by a debtor on behalf of its shareholders, for which the debtor received no consideration. Because the transfer was made more than 2 years before the petition date, the trustee could not seek to avoid the transfer under section 548. Instead, he had to bring the claim under section 544(b), which permits a trustee to "avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an unsecured claim." In this case, that applicable law was Utah's fraudulent transfer statute.

Although section 106(a) contains a general waiver of sovereign immunity "with respect to" section 544, the Supreme Court held that this sovereign-immunity waiver applies only to the section 544(b) claim itself and not to any underlying state law incorporated into that federal claim. It determined that sovereign immunity waivers are jurisdictional, but that they do not create new substantive rights against the United States. Thus, the Court concluded that section 106(a) is properly understood as a jurisdictional provision that allows courts to hear section 544(b) claims against the United States to the extent such claims are otherwise available under state law. But it does not alter the substantive meaning of section 544(b)'s "applicable law" clause.

In the bankruptcy court below, the United States argued that the trustee could not satisfy section 544(b)'s requirement that a creditor holding an unsecured claim could seek to avoid the transfer, because sovereign immunity would bar such a suit. The bankruptcy court rejected this argument and held that section 106(a) waived sovereign immunity for both the section 544(b) claim and the underlying state law cause of action incorporated therein. Both the District Court and the Tenth Circuit affirmed. The Supreme Court granted certiorari to resolve a circuit split.

The Supreme Court pointed to section 106(a)(5), which states that nothing in the sovereign immunity waiver section is intended to create any substantive claim for relief or cause of action not otherwise existing under the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, or nonbankruptcy law. Section 544(b) requires a trustee to identify an actual creditor capable of voiding the transfer under applicable law. But the trustee here could not satisfy that requirement because outside of the bankruptcy case sovereign immunity would have barred that suit under state law. The Court therefore concluded that section 106(a) does not modify the substantive requirements of section 544(b) and does not abrogate sovereign immunity for state law claims incorporated into section 544(b)'s "applicable law" clause.

Accordingly, it reversed the Tenth Circuit and held that section 106(a)'s abrogation of sovereign immunity does not extend to the underlying state law claims.

Faculty

Jonathan Noble Edel is an associate in K&L Gates LLP's Finance practice in Charlotte, N.C. He has experience representing debtors and creditors in all types of restructuring transactions, including bankruptcies (whether under chapter 7, 11 or 15), assignments for the benefit of creditors, distressed sales and acquisitions, and other out-of-court arrangements. Additionally, Mr. Edel regularly counsels clients on risks and strategies associated with bankruptcy and restructuring matters, including fraudulent conveyance and preference actions, corporate veil and alter ego issues, and fiduciary duty matters. His clients span the spectrum of interested parties in restructuring cases, such as debtors and potential debtors, affiliates of and investors in debtors and potential debtors, secured and unsecured creditors, and defendants in related litigation. Outside of the traditional restructuring sphere, Mr. Edel has also represented clients in complex commercial litigation matters, including in matters before the Delaware Courts of Chancery. He was named to *The Best Lawyers in America*'s "Ones to Watch® in America" for his work in Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law in Charlotte from 2021-25, and in 2022 was selected for the National Conference of Bankruptcy Judges "NextGen" Program. Mr. Edel received his B.S. with honors in 2010 from The Ohio State University and his J.D. in 2013 from the University of Notre Dame Law School.

Hon. Scott M. Grossman is a U.S. Bankruptcy Judge for the Southern District of Florida in Fort Lauderdale, sworn in on Oct. 2, 2019. He previously was a shareholder with a large international law firm in its global restructuring and bankruptcy practice, and he represented distressed companies, debtors, secured and unsecured creditors, official committees, trustees, landlords and purchasers of distressed assets, and worked on bankruptcy cases across various industries, including real estate, hospitality, health care, entertainment, banking, technology, energy and financial fraud. While primarily involved in chapter 11 reorganizations, he also represented clients in out-of-court workouts and restructurings, chapter 7 liquidations, receiverships, assignments for the benefit of creditors and insolvency-related litigation. Judge Grossman was active in local bar activities, including having served as president of the Bankruptcy Bar Association of the Southern District of Florida. When in private practice, he was listed in *Chambers USA*, *The Best Lawyers in America* and *Super Lawyers* magazine, and was a member of the winning teams for the Global M&A Network's Turnaround Atlas Awards for both "Cross Border Special Situation M&A Deal (Small-Mid Markets)" in 2019, as well as "Turnaround of the Year — Small Markets" in 2015. Judge Grossman began his legal career in the Attorney General's Honors Program at the U.S. Department of Justice, where he was a trial attorney in the Tax Division, Civil Trial Southern Section, from 1999-2004. He received his B.S. in 1996 from the University of Florida and his J.D. in 1999 from George Washington University Law School.

Virginia Tate, CFE, CIRA, EA is the president of Tate & Associates, FAI International – Forensic Accounting & Investigations, a division of the EP Global Corporation, in New Orleans. She heads up the firm's Tax, Accounting and Forensic Division, which focuses on litigation support, taxation and financial investigations with clientele throughout the world. Ms. Tate is an ABI member and previously chaired ABI's Commercial Fraud Committee. She also serves on ABI's Litigation and Taxation Committees. Her regular speaking engagements include continuing professional education providers such as the Association of Certified Fraud Examiners, National Business Institute, Association of Insolvency & Restructuring Advisors, ABI, Chambers of Commerce, CPA Societies, televised crime

documentaries and investigation series, as well as exclusive presentations in private industry and nonprofit sectors. Ms. Tate received her B.S. in business administration with a focus on accounting from the University of Washington.

Damon Yousefy is a managing director with Alvarez & Marsal Tax, LLC in Dallas. He specializes in advising clients on tax issues of debt restructurings, bankruptcies, mergers and acquisitions and internal restructurings. Mr. Yousefy has worked with clients across a range of industries, including financial services, technology, mining, oil and gas, consumer products, manufacturing, shipping, automotive and health care. He more than 11 years of experience and has advised clients in 30+ complex debt-restructuring and bankruptcy matters, including the bankruptcy tax modeling and tax structuring for a radio company with $16 billion in debt, a mattress company with $2+ billion in debt and a mining company with $1.5+ billion in debt. Mr. Yousefy also brings M&A experience, specifically in tax due diligence, tax structuring, basis step-up modeling, international tax, legal entity rationalization, internal restructurings, carve-outs, spinoffs, sell-side offerings and joint ventures. He has led engagements such as the $8 billion simultaneous acquisition and structuring of two label companies purchased by a leading private-equity firm; the merger of two nationally known publicly traded beverage companies worth $19 billion; and the sale of a nationally known cosmetics brand to a global conglomerate for approximately $1 billion. Prior to joining A&M, Mr. Yousefy spent more than five years with PricewaterhouseCoopers' Mergers & Acquisitions Tax practice, where he most recently served as director. He began his career in New York in the Transaction Tax practice of Ernst & Young LLP. Mr. Yousefy received his B.B.A. in business *cum laude* from Baylor University, and his M.B.A. in finance and J.D. *cum laude* from Indiana University.