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"Tax Attributes" that Protect from Income Taxes as "Property"

Many small businesses are structured as pass-through entities for federal income tax purposes.[1] Well known examples include partnerships, limited liability companies, and corporations that elect "S Corporation" status under 26 U.S.C. Section 1362.[2]

When a business is failing, its bills exceed available cash. When those bills are not deductible for income tax purposes (such as debt repayment or installment payments for non-depreciable property[3]), the business may incur income tax liabilities without cash available to pay those liabilities. If the business is a pass-through entity and it does not generate adequate cash to pay its tax liabilities, it is the business' owner who may have tax liabilities and no cash to satisfy those tax debts. Many business owners see this danger and seek to avoid those unfunded tax liabilities generated by their business activities; often, the plan is to eliminate the business' pass-through entity status and so leave the tax liabilities with the failing business. That plan is particularly attractive if the business owner has concluded that the business will fail whether or not it is burdened with the tax liabilities.

A common way for business owners to eliminate a business' pass-through status is to destroy a corporation's qualification for S Corporation status. Often this is done by transferring a small ownership interest in the corporation to a prohibited shareholder. See, 26 U.S.C. Section 1361 and related provisions. That fact pattern is exactly what happened before the bankruptcy filing that led to the decision at *In re GYPC, Inc.*, S.D. Ohio Bankr. Case No. 17-31030; *Harker, Trustee v. Cummins et al.*, S.D. Ohio Bankr. Adv. Proc. 19-3046 (Aug. 5, 2020).

In *GYPC*, the trustee brought preference and fraudulent conveyance claims against the company's principals. In part, those claims were based on the idea that GYPC's status as an S Corporation was a "property interest" and that GYPC's loss of S Corporation status was the transfer of property that could be a voidable preference of a fraudulent transfer. Factually, there can be no doubt that GYPC's

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status as an S Corporation protected the company from income tax liability.[4]

Addressing the question of whether S Corporation status is a property interest, the *GYPC* court started by addressing whether state law, tax law or bankruptcy law controlled this question. After acknowledging the general rule that a bankrupt debtor's property interests are determined by state law, the *GYPC* court then said this:

Property of the estate is defined to include "all legal and equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). Property is broadly defined to include various tups of intangible property. Of course, property rights are not expanded by the filing of a bankruptcy, and generally state law defines property rights. *Butner v. United States,* 440 U.S. 48, 56 (1979). In the context of tax law, **the Internal Revenue Code does not create property rights, but "attaches consequences, federally defined, to rights created under state law."** *United States v. Bess,* 357 U.S. 51, 55 (1958). However, once state law establishes an interest – in this case a valid Delaware S corporate entity – "the tax consequences thenceforth are determined by federal law." *Aquilino v. United States,* 363 U.S. 509, 513 (1960). *See also Arrowsmith v. United States (In re Health Diagnostic Lab., Inc.)*, 578 B.R. 563 (Bankr. E.D. Va. 2017) ("State law created 'sufficient interests' in the taxpaying entity by affording it the requisite corporate and shareholder attributes to qualify for S corporation status[.]"). The Supreme Court concluded that federal law determines if a taxpayer has a beneficial interest in property subject to levy. *Drye v. United States,* 528 U.S. 49, 57 (1999). The Bankruptcy Code itself recognizes that the Internal Revenue Code governs whether a bankruptcy estate is separately taxable from the debtor. 11 U.S.C. § 346(a). See *In re Majestic Star Casino, LLC v. Barden Dev't (In re Majestic Star Casino, LLC)*, 716 F.2d 736, 751-52 (3d Cir. 2013) (concluding the Internal Revenue Code, not state law, "governs the characterization of entity tax status as a property interest for purposes of the Bankruptcy Code.")

(emphasis added).

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The *GYPC* court then reviewed prior decisions in other jurisdictions directly addressing whether elimination of a corporation's S Corporation status and the tax liability protection it provided was the transfer of a "property interest" that could be a preference of a fraudulent conveyance. Noting a split of authority, the *GYPC* court said:

The Third Circuit, taking an opposing view from a series of prior decisions, determined that such a transfer is not a recoverable property interest. *Majestic Star Casino*, 716 F.3d at 763 (concluding that a subchapter S corporate status is not a property interest). Another recent decision finding that a change in corporate status is not a property interest is *Arrowsmith v. United States (In re Health Diagnostic Lab., Inc.)*, 578 B.R. 552 (Bankr. E.D. Va. 2017). *See also* Berit Galesi *Shareholders' Rights Regarding Termination of a Debtor Corporation's S Status in a Bankruptcy Setting*, 10 J. Bankr. L. & Prac. (Jan./Feb. 2001) (criticizing the theory that a change in a S Corporation's tax status is a fraudulent transfer). Perhaps the leading case taking the opposite view is *In re Trans-Lines West, Inc.*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996), ... See also *Halverson v. Funaro (In re Funaro, Inc.)*, 263 B.R. 892, 898 (B.A.P. 8th Cir. 2001) (citing *Parker v. Saunders (In re Bakersfield Westar, Inc.)*, 226 B.R. 227, 232-33 (B.A.P. 9th Cir. 1998)) ("[A] corporation's right to use, benefit from, or revoke its Subchapter S status falls within the broad definition of property of the estate.").

Following that discussion, the *GYPC* court then decided to follow the cases holding that an S Corporation status is not a property interest that can be the subject of a potentially voidable transfer by the corporation.

The *GYPC* court agreed with the reasoning of courts that held, because a corporation's shareholders, and not the corporate entity, control the S Corporation election, that status is not a "property" right of the corporation. Specifically, the *GYPC* court said: "[t]he estate lacks the ability to control or dispose of an S corporation status under federal tax law. That right can only be exercised by the election of the shareholders and, thus, lies with the shareholders and not the corporation." Later, the *GYPC* court ruled:

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Outside of bankruptcy, it would never be understood that a corporation could force a Subchapter S corporation to convert to a C corporation. The rights to be a S corporation are strictly defined and inure to the benefit of shareholders that are eligible for such corporate status. Bankruptcy cannot expand property rights and turn over control over Subchapter S corporation status to a trustee in derogation of federal tax law. *Health Diagnostic*, 578 B.R. at 570 ("The Liquidating Trustee cannot use the fraudulent transfer provisions of the Bankruptcy Code to maneuver around the strict requirements of the Tax Code."). For these reasons, the allegation that the conversion of *GYPC* from a Subchapter S corporation to a C corporation is preferential or fraudulent transfer must be dismissed.

Certain "tax attributes" of bankrupt entities are in fact property and can be the subject of a preference or fraudulent conveyance complaint if a transfer was affected. This is particularly important for tax attributes that provide tax benefits. One example is Net Operating Losses (NOLs) that, like S Corporation status, can protect a business from liability for income taxes. Several cases hold that NOLs (and the tax liability protection they provide) are "property" belonging to the business entity that incurred the losses and that a waiver of NOLs can be a fraudulent conveyance. See *Harker v. IRS (In re Citro)*, Case No. 16-32161, Adv. No. 18-3008, doc. 32 (Bankr. S.D. Ohio Aug. 30, 2018) and other cases cited in the *GYPC* decision.

The *GYPC* decision and the complimentary decisions concerning NOLs have the same rationale. The *GYPC* court relied on the NOLs related decisions when it chose between the conflicting prior decisions discussed above concerning S Corporation status: because the entity that incurred NOLs control the use of those losses and the resulting tax benefit, NOLs are property of the entity and, conversely, since a corporation cannot control the S Corporation election, S Corporation status is not property of the entity. See *In re Health Diagnostics Laboratory, Inc.*, 578 B.R. 552, 568-9 (E.D. Bankr. Va. 2017), where the court stated:

. . . [S Corporation status] differs markedly from a corporation's net operating losses ("NOL"). NOLs have several "essential property rights" that are absent in S corporation status. . . . First, a taxpayer

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corporation has the right to exclude others from an NOL, while a corporation cannot exclude others from using S corporation status. Second, the taxpayer [business entity] has much more control over an NOL than over S corporation status. NOLs cannot be revoked or terminated by another party, unlike S corporation status, which can be terminated by shareholder action that causes the corporation to cease to qualify as a small business corporation. . . . Third, an NOL is transferrable to other entities, while S corporation status cannot be transferred. *See, e.g., In re A.H. robins Co.,* 251 B.R. 312, 315, 320-21 (upholding the validity of a confirmation order that transferred NOLs from the debtor to a successor corporation).

With this analysis in mind, it might be possible to predict how bankruptcy courts will determine similar questions concerning other tax attributes that protect debtor businesses from income tax liabilities – for example, historic tax credits. A less than comprehensive search did not uncover any bankruptcy court cases on point, but there are several cases holding that transferrable historic tax credits are property and so transfer of those tax credits is a taxable sale. A representative example is *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (3d Cir. 2011) (tax credits were "property" and their transfer was a "disguised sale" under federal tax law). The court's rationale in that case is very similar to the above-discussed reasoning concerning who controlled the right to use and retain the tax benefits of the tax attribute under consideration. After warning that it was not addressing whether tax credits are property in all situations,[5] the *Virginia Historic Tax Credit Fund 2001 LP* court said:

Accordingly, to determine whether Virginia's historic rehabilitation tax credits are "property" for federal tax purposes, we ask whether they embody "some of the most essential property rights." . . . In particular, the Supreme Court in *Craft* identified the "right to use the property, to receive income produced by it, and to exclude others from it," as fundamental property rights. *Id.* **Similarly, in *Drye*, the Supreme Court placed primary emphasis on the "breadth of the control the taxpayer could exercise over the property"** and whether the right in question was "valuable." (internal marks and quotations omitted). 528 U.S. at 60-61, 120 S.Ct. 474. . . .

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It is clear on these facts that the Funds' tax credits were both "valuable" and imbued with "some of the most essential property rights." . . . Funds' tax credits had pecuniary value is evidenced by the fact that the Funds used the credits to induce investors to contribute money. Additionally, **the Funds could exclude others from utilizing the credits** and were free to keep or pass along the credits to partners as they saw fit.

Id. At 141 (emphases added).

If a bankruptcy court were to adopt the reasoning of *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (3d Cir. 2011), and similar cases, it would mean that a bankruptcy court might invalidate tax credit transfers as preferences of fraudulent conveyances, should the transferor file bankruptcy.

Certain other potentially important legal consequences follow from the conclusion that certain tax attributes are "property." For example, there may be an insurable interest in the property and loss or damage to the property could be actionable in tort. Finally, property can be stolen.

It is always important to know what you own.

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[1] These entities are also labeled as "disregarded."

[2] See IRS Form 2553 titled "Election by a Small Business Corporation."

[3] This dynamic also occurs when accelerated deprecation for tax purposes exhausts the tax deduction benefit of depreciation before the property's installment purchase payments are all paid.

[4] Specifically, the *GYPC* court said: "The Defendants [debtor / taxpayer's principals] may have benefitted from such a conversion because tax liability that would flow to the shareholders as an S corporation instead would be paid by GYPC if it was a C

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corporation. *Gitlitz v. Comm'r*, 531 U.S. 206, 209 (2001)."

[5] The Third Circuit included the following in a footnote: "It bears emphasizing that we are not deciding whether tax credits always constitute 'property' in the abstract. Rather, we are asked to decide only whether the transfer of tax credits acquired by a non-developer partnership to investors in exchange for money constituted 'a transfer of property' for purposes of § 707. *See Charley v. C.I.R.*, 91 F.3d 72, 74 (9th Cir.1996) (finding that even though frequent flyer miles may not be 'gross income' in the abstract, a taxpayer who arranged what was in essence a 'sale' of his miles to his employer was liable for the income received from transferring these miles); *cf. United States v. Griffin*, 324 F.3d 330, 354–55 (5th Cir.2003) (finding that as-of-yet unissued historic development tax credits were not property when they were in a state agency's possession, even though the tax credits took on property attributes after they were distributed to historic developers)."

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