

# For the Tax Advisor

## Tax Issues Preparation

*"Taxes are what we pay for  
civilized society."*

Oliver Wendell Holmes, Jr.  
*Compania de Tabacos v. Collector*  
275 U.S. 87, 100 (1904)

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Tax planning and an understanding of the tax issues, benefits and burdens of a corporate bankruptcy case are essential in prebankruptcy planning for the commercial reorganization case. This area is complex and rapidly changing, and requires competent and thorough analysis.<sup>34</sup>

For purposes of discussion, some of the more prevalent tax issues to be considered are as follows:

## 4.1 The Elusive NOL

A tax advisor must consider preservation of net operating loss (NOL) carry-forwards to reduce postconfirmation income, and the impact of a change in ownership as a result of a reorganization, which may severely limit the postconfirmation use of the NOLs under Internal Revenue Code §382. In a related vein, counsel should analyze the impact of the automatic stay on post-petition stock transfers that may have an impact on the NOL. *See In re Prudential Lines*, 928 F.2d 565 (2d Cir. 1991). To the extent NOLs are available, the post-confirmation company can pay back debt principal out of pre-tax as opposed to after-tax dollars.

## 4.2 Discharge of Indebtedness Income

Bankruptcy tax issues relating to discharge of indebtedness income and Internal Revenue Code §108 must be analyzed. The consequences and analysis with respect to corporations may be different from that applicable to partnerships.

## 4.3 Lurking Personal Liability

“Borrowing” IRS trust fund withholding taxes to keep a business running can subject “responsible officers” to personal liability. This potential personal liability, along with the ability to allocate plan payments to minimize or otherwise protect officers and directors, must be analyzed. *See, e.g.,*

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<sup>34</sup> An excellent, in-depth analysis is found in *Advanced Chapter 11*, Chapter 13. *See also* Sheinfeld, Witt and Hyman, *Collier on Bankruptcy Taxation* (Matthew Bender 1993).

*United States v. Energy Resources Co., Inc.*, 495 U.S. 545, 110 S. Ct. 2139 (1990); *In re Deer Park Ltd.*, 10 F.3d 1478 (9th Cir. 1993). A related issue is the inability to enjoin the IRS from bringing assessment and collection actions against the responsible officers. *See, e.g., In re American Bicycle Ass'n*, 895 F.2d 1277 (9th Cir. 1990). Provisions should ordinarily be made for payment of these types of tax claims so as to keep management focused on the reorganization efforts and to prevent the possibility that personal liability for such taxes may eventually be asserted against the officers and directors. *See, e.g., Begier v. IRS*, 496 U.S. 53 (1990) (providing IRS with preference defense when delinquent withholding taxes are paid within 90 days of bankruptcy filing). The IRS takes the position that the continued prepetition operation of a business with continued use of unencumbered funds to pay for critical raw materials, power, etc., constitutes an impermissible preference of other creditors over the accumulated obligation to the IRS for trust fund taxes—even if the continued operation of the business represents the only feasible avenue for payment of accumulated IRS trust fund taxes and the company remains current on current trust fund taxes. For cases addressing whether there is this impermissible use of unencumbered funds, *see, e.g., Kim v. U.S.*, 111 F.3d 1351 (7th Cir. 1997); *Purcell v. U.S.*, 1 F.3d 932, 938 (9th Cir. 1993); *In re Premo*, 116 B.R. 515 (Bankr. E.D. Mich. 1992). Be sure not to overlook state trust fund taxes, such as sales taxes, which may carry similar consequences for officers and directors of the debtor company.

## 4.4 Open Tax Years/Existing IRS Audit

The IRS may be in the midst of an income tax audit or may file a substantial tax claim. The parties must determine whether there is substantial tax exposure and develop contingency plans for such a tax dispute. Failure to anticipate such circumstances can cause serious delays in plan confirmation. If there are substantial taxes to be paid for the year of the

planned filing (for example, because of significant asset sales undertaken to raise cash), consideration should be given to whether it is practical to delay the filing until after the close of that taxable year in order to forestall an argument that such taxes are administrative claims, as would be the case if they are deemed to have accrued after the filing.

## **4.5 Tax Penalty Claims**

Tax penalty claims cannot be subordinated to the claims of general unsecured creditors absent improper conduct by the government. *See U.S. v. Noland*, 517 U.S. 535, 116 S. Ct. 1524, 134 L.Ed. 2d 748 (1996).