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Bankruptcy Code Trumps Internal Revenue Code

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Bankrupt taxpayers are subject to the same Internal Revenue Code ("IRC") as other taxpayers. Of course, there are some well-known exceptions. For example, the IRC itself contains several substantive provisions the effect of which depends on whether or not a taxpayer is in bankruptcy.[1] In many aspects of procedure, such as the dischargeability of certain tax liabilities in bankruptcy and the rules regarding the priority of tax claims relative to a debtor's other obligations, bankruptcy law contained outside the IRC has governed and, in some cases, eliminated tax liabilities. Notwithstanding these exceptions, though, it is fair to say that tax lawyers are accustomed to thinking of bankruptcy law as just another area of substantive law—"You tell us how the legal relationships of the parties are affected, we'll tell you the tax consequences."

From a tax lawyer's perspective, then, the substantive tax analysis of a situation generally comes to an end by applying the IRC after all other relevant legal rules have been applied. However, over the last decade or so, commencing with the fabled decision in *Prudential Lines,*[2] we have begun to see instances in which the pattern is inverted—substantive tax rules that, by their terms, make no reference to an exception for bankruptcy cases and that are not aimed at the debt discharge process are set aside in the interests of some broad bankruptcy policy.

Most recently, in *Parker v. Saunders (In re Bakersfield Westar, Inc.),*[3] a Bankruptcy Appellate Panel in the Ninth Circuit (the "BAP") held that an otherwise valid revocation of a corporation's subchapter S election immediately prior to the filing of a bankruptcy petition could be set aside as a voidable transfer under the Bankruptcy Code.

S Election Revoked

Craig and Jodie Saunders were the sole shareholders of Bakersfield Westar (the "Company"), a corporation which they had elected to treat as an S corporation for Federal income tax purposes. As such, Mr. and Mrs. Saunders, rather than the Company, were taxable on the Company's income. On February 1, 1994, the Saunders filed a statement of revocation of the S election with the Internal Revenue Service (the "Service"); following revocation of the S election, the Company, as a "C corporation," was taxable on its own income. Two weeks later, on February 14, 1994, the Saunders filed a voluntary chapter 11 bankruptcy petition. Their bankruptcy trustee filed a voluntary chapter 7 petition on behalf of the Company shortly thereafter.

Two years later, the bankruptcy trustee appointed on behalf of the Company brought a lawsuit against the Saunders and the Service seeking to avoid the earlier revocation of the S election as a fraudulent transfer

under the Bankruptcy Code. The trustee alleged that the Saunders had revoked the S election in order to shift from themselves to the Company the burden of significant capital gains taxes that would arise on the disposition of the Company's assets, and that they did so with the intent to hinder, delay, and defraud creditors. The Saunders and the Service denied the allegations. The Service also contended that the only method to rescind or set aside a revocation of an S election is that provided in the IRC and the Treasury Regulations thereunder.

The trustee moved for summary judgment, claiming that the Company's right to make or revoke a Subchapter S election was "property," and the revocation of that election was a "transfer" within the meaning of the Bankruptcy Code. The trustee alleged that the S corporation status was a valuable property right that allowed the Company to pass its tax liabilities through to its shareholders, and that the revocation was a "transfer" because it caused the Company to dispose of this right. This left the bankruptcy estate of the Company with the obligation to satisfy significant capital gains tax liabilities, an obligation that, had the Company remained an S corporation, would have had to been satisfied by the Saunders. The trustee alleged that the revocation was made with the actual intent to hinder, delay, and defraud creditors, because the Company received no direct or indirect benefit from the revocation, the Company received no consideration for the revocation, Mr. Saunders was an officer of the Company, and the Company was placed into voluntary bankruptcy one month from the date of the revocation.

Bankruptcy Court Ruling

The Saunders opposed the summary judgment motion, arguing that the trustee could not void the revocation, because, under the IRC and Treasury Regulations, only the shareholders of a corporation could elect or revoke a corporation's subchapter S status. They also claimed that they lacked the necessary actual fraudulent intent because they had made the revocation based on the advice of professionals.

The Service argued that the right to make or revoke an S election could not be "property" since it had no present value to any taxpayer, is not defined as property in the Bankruptcy Code, and had never been characterized as property by any other court.

The Bankruptcy Court had ruled in favor of the Saunders and the Service, stating that the Bankruptcy Code refers to transfers *by the debtor*; in this situation, the debtor was wholly passive and had had nothing to do with the revocation of the S election. The action in question was solely in the province of the Company's shareholders.

The trustee appealed the decision of the Bankruptcy Court to the BAP. The BAP found that the right to revoke an S election was in fact "property," as it had value to the bankruptcy estate of the Company (mainly in that, absent the revocation, the capital gains tax liability would not have been an obligation of the Company which reduced the amount of funds available to the other creditors of the Company). The BAP also found that the Company had passed through millions of dollars in taxable *losses* to the Saunders while it was an S corporation, thereby reducing their tax liability, while the revocation of its S status left the Company with capital gains taxes and no *beneficial* tax attributes. Had the revocation not occurred, the Company would have been able to pass through to the Saunders the capital gains tax liability as well.

The BAP also found that the transfer of property that had occurred could be avoided by the bankruptcy trustee. The Saunders argued that they had no knowledge of the capital gains tax liability to which the corporation would be subject and that they relied on the advice of professionals in revoking the S election.

The BAP turned this argument around on them, stating that it was likely that the professionals had informed them of the income tax consequences to both themselves and the Company when they made the revocation and also had made them aware of the fact that there was a strong probability that the Company would soon have to file for bankruptcy, dispose of its assets, and incur substantial capital gains taxes on the disposition. Thus, the Saunders had tried to manipulate the bankruptcy system to achieve their own personal advantage.

IRS Arguments

The BAP then addressed the arguments raised by the Service. The Service argued that the Bankruptcy Code should not be allowed to override the principles of the IRC regarding the revocation of an S election. The courts have always strictly construed the provisions of the IRC that govern S corporation elections and revocations, and generally rejected any effort to expand the scope and application of those rules.[4] The BAP had no difficulty in ignoring the principles of the IRC and determining that the bankruptcy trustee could avoid the revocation. The Service pointed out that the Company itself never had the right to retain or to revoke its S corporation status. Rather, revocation is a right reserved solely to the shareholders of an S corporation. Therefore, the bankruptcy trustee could not succeed to any right of the Company to control its S corporation status. The BAP, however, held that the power of the trustee to "avoid" for bankruptcy purposes is broader than the power to "revoke" for income tax purposes.

The Service also raised the argument that the avoidance of a revocation in a later year could wreak administrative havoc on the tax system. Numerous personal tax returns might have to be adjusted if valid subchapter S elections or revocations are subsequently avoided by a bankruptcy trustee; such "avoidance" could also impact years for which the statute of limitations for income tax adjustments has already expired. The BAP found no merit in this argument, stating that the Service often has to go back to prior years to adjust income tax returns. Therefore, the BAP held that the Bankruptcy Court had been incorrect in holding that the right to make or revoke a subchapter S election was not an interest of the Company in property and in holding that the prepetition revocation was not a transfer.

The Saunders had followed the advice of counsel and the rules set forth in the IRC and the Treasury Regulations, but the BAP chose to ignore all that and avoid the revocation of the S election that they had made. The interesting question is how far the bankruptcy courts will now try to go. If the Saunders had taken an action which rendered the Company *ineligible* to continue to be an S corporation, for example, by transferring some of their stock to an entity not eligible to be an S corporation shareholder, would the BAP still have felt that there had been a voidable transfer by the Company? It would seem much harder for the court to justify such a position in that situation, since the Company would no longer be able to qualify as a subchapter S corporation under the rules set forth in the IRC. Or, suppose that the shareholders of a longstanding C corporation simply refused to make an S election when the corporation began to realize taxable income; could that refusal by the shareholders to relieve the corporation of its tax burden itself be a "transfer"?

The bankruptcy rules are supposed to help troubled debtors restructure and reorganize their financial lives so that they can progress and move on. The IRC respects this and has specific provisions to help alleviate the income tax burden placed on bankrupt taxpayers. Decisions like this one go beyond that, however, and seek to provide bankruptcy policies with precedence over all other areas of law, regardless of those areas' own policies and concerns. We may fairly question whether Congress meant for any one area of the law to have such a (forgive us) unimpeachable priority.

[1] *E.g.*, IRC sections 108(a)(l)(A) (discharge of indebtedness in "title 11 case"), 368(a)(l)(G) (corporate reorganization in "title 11 or similar case").

[2] *In re Prudential Lines, Inc. (Official Comm. of Unsecured Creditors v. PSS S.S. Co.)*, 107 B.R. 832 (Bankr. S.D.N.Y.), *further proceedings*, 114 B.R. 27 (Bankr. S.D.N.Y. 1989), *aff'd*, 119 B.R. 430 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 565 (2d. Cir.), *cert denied*, 502 U.S. 821 (1991). (Note: *In re Prudential Lines, Inc. (Official Committee of Unsecured Creditors v. PSS Steamship Co.)*, 107 Bankr. 832, *further proceedings*, 19 Bankr. Ct. Dec. (CRR) (1945) (Bankr. Ct. S.D.N.Y. 1989).)

[3] 2 A.F.T.R.2d 98-5451 (Bankr. 9th Cir. 1998).

[4] *See*, *e.g.*, *Simons v. U.S.*, 208 F. Supp. 744 (D. Conn. 1962); *Smith v. Commissioner*, T.C. Memo 1988-18; *Pestcoe v. Commissioner*, 40 T.C. 195 (1963).

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