By Risa Lynn Wolf-Smith

Squeezing Juice from a Turnip

Tax Assets and Tax-Allocation Agreements

Risa Lynn Wolf-Smith
Holland & Hart LLP
Denver

Risa Wolf-Smith is a partner and chair of the Bankruptcy and Creditors' Rights Group at Holland & Hart LLP, a regional law firm with offices throughout the Rocky Mountain region.

At first blush, a company with no cash, no unencumbered assets, no operating income and nothing but a history of financial loss may seem like a hopeless prospect for chapter 11, but a savvy bankruptcy professional must not forget about valuable tax assets that may be lurking beneath the surface. If the company is a member of a consolidated corporate group, the intervention of bankruptcy into its financial melee will alter the rights and obligations among the group's members and may actually create cash assets that would not otherwise have existed.

This article explores the body of developing case law that has considered the ownership of tax refunds in the battle among members of consolidated corporate groups.[1] When a bankrupt corporate parent receives a sizeable cash refund on behalf of its consolidated group, does the refund belong to the parent and its bankruptcy estate or to the subsidiary that generated the operating losses that produced the refund? Knowing the answer to this question may transform what would have been a no-asset case into a case with substantial cash dollars, and the educated bankruptcy professional will have magically squeezed luscious juice from a withering turnip.

Applicable Law

When affiliated corporate groups file tax returns on a consolidated basis, the parent company is the sole entity authorized to act on behalf of the group as to all matters relating to tax liability, including the filing of tax returns and the receipt of tax refunds on behalf of the group.[2] Generally, this designation is a procedural device for the convenience of the government in which the parent acts as "agent" for the group.[3] Further, any tax refunds paid to the consolidated group are typically paid to—and received by—the parent company regardless of whether the parent entity, as opposed to its operating subsidiary, actually generated the losses to which the refund may be attributed.[4]

The *Bob Richards* case from the Ninth Circuit was the seminal case on the issue of whether a parent corporation filing consolidated returns on behalf of an affiliated group was entitled to keep tax refunds resulting from its subsidiary's operating losses. It held that "[a]llowing the parent to keep any refunds arising solely from a subsidiary's losses simply because the parent and subsidiary chose a procedural device to facilitate their income tax reporting unjustly enriches the parent."[5] In other words, allowing the parent to retain the refund was deemed to unjustly enrich the parent since the subsidiary's operations created the tax refund. Courts following *Bob Richards* widely agree that absent a clear agreement to the contrary, a tax refund that is attributable to the operations and business losses of a subsidiary in a consolidated group is owned by the subsidiary even though it was received by the parent in its capacity as agent.

However, the existence of a tax-allocation agreement among the members of a consolidated group changes the nature of this agency relationship, and the terms of the agreement may override any presumption regarding ownership of tax refunds or other tax attributes.[6] Thus, courts have held that members of a consolidated group may define their relationship by agreement so that the terms of their agreement govern the ownership of the tax refunds. Disputes among parent companies in bankruptcy and their nonbankrupt subsidiaries regarding the ownership of tax refunds and the interpretation of tax-sharing agreements have produced a robust body of case law.[7] In these cases, disputes over the ownership of tax refunds are resolved by examining the language of the tax-sharing agreements.

Specifically, if the tax-sharing contract creates a debtor/creditor relationship between the bankrupt parent and its subsidiary regarding the obligation of the parent to distribute tax refunds, the tax refunds are property of the parent's bankruptcy estate. Thus, where the agreement calls for "reimbursement," the recording of an intercompany payable, credits or debits as between the parent and subsidiary, or the settling of an account, the parent is not obligated to turn over the refund. Rather, the subsidiary has

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1 This article does not attempt to address the mechanisms used to preserve net operating losses under §§ 382(1)(5) and (6) of the Internal Revenue Code, as ample material can be found on that topic. *See, e.g.*, Kristofer Hess, Joseph Lamport and James L. Bromley, "Protecting Trade Markets and NOLs in Chapter 11," *ABI Journal*, February 2005.

2 *See* U.S. Dept of Treasury Regulation, 26 C.F.R. § 1.1502-77(a).

3 *W. Dealer Mgmt. Inc. v. England (In re Bob Richards Chrysler-Plymouth Corp.)*, 473 F.2d 262, 265 (9th Cir. 1973), *cert. denied*, 412 U.S. 919 (1973).

4 *See* 26 C.F.R. § 1.1502-77(a)(2)(v) ("[A]ny refund is made directly to and in the name of the common parent and discharges any liability of the Government to any member with respect to such refund.").

5 *Bob Richards*, *supra*, 473 F.2d at 265.

6 *Bob Richards*, *supra*, 473 F.2d at 264 ("[W]here there is an explicit agreement or where an agreement can fairly be implied, as a matter of state corporation law the parties are free to adjust among themselves the ultimate tax liability"); *Capital Bancshares Inc. v. FDIC*, 957 F.2d 203, 207 (5th Cir. 1992) (tax refund allocation may result "from an express agreement or an agreement [that] is clearly implied"); *Brandt v. Fleet Capital Corp. (In re TMCI Electronics)*, 279 B.R. 552, 556 (Bankr. N.D. Cal. 2000) (*Bob Richards* is relevant only "in the absence of an express or implied agreement"); *BSD Bancorp Inc. v. FDIC (In re BSD Bancorp Inc.)*, 1995 U.S. Dist. LEXIS 22588 at *13 (S.D. Cal. Feb 28, 1995) (*Bob Richards* "gap-filling rule" can be "expressly or impliedly" overridden).

7 *See* the numerous authorities cited in *Siegel v. FDIC (In re IndyMac Bancorp Inc.)*, 2012 WL 1037481 (Bankr. C.D. Cal. March 29, 2012); *Superintendent of Ins. v. First Cent. Fin. Corp. (In re First Cent. Fin. Corp.)*, 269 B.R. 481, 495-98 (Bankr. E.D.N.Y. 2001), *aff'd*, 377 F.3d 209 (2d Cir. 2004).

a mere unsecured claim against its parent for breach of the tax-sharing contract and its failure to distribute.[8] The parent and its bankruptcy estate are the owners of the cash refunds.

On the other hand, if the language of a tax-sharing agreement creates an agency relationship such that tax refunds are clearly intended to be paid over to the subsidiary that generates them, courts construe such agreements as preserving a trust relationship. In these cases, the parent is viewed as an agent that holds the refunds in trust for its subsidiary. The refunds do not belong to the parent or its bankruptcy estate.[9]

Interestingly, absent clear language to the contrary, the majority of cases that have analyzed the issue of ownership between a parent and its operating subsidiary have decided that the overlap of bankruptcy and tax-allocation agreements creates a mere contractual claim for breach by the subsidiary against the parent.[10] These cases reason that an intervening bankruptcy filing alters any equitable analysis and forces consideration of the debtor's unsecured creditors. Hence, even though a distressed subsidiary may be left with an unsecured contractual claim for breach-of-the-tax-allocation agreement, rather than an ownership interest in the tax refunds received by the bankrupt parent, "the short and conclusive answer is that this is not injustice, it is bankruptcy."[11]

To overcome the conclusion that the bankruptcy estate of a parent corporation is entitled to retain tax refunds received on behalf of a consolidated group, a tax-sharing agreement must be clearly drafted to provide that any refund received by the parent is to be segregated and held in trust for the benefit of the subsidiary. The parent must unambiguously be described as an agent, and its ability to use the tax refunds paid to it must be restricted. Without language delineating that the parent accepts refunds in a trust or agency capacity, it will be difficult to argue that funds received by the parent from the Internal Revenue Service are not property of the parent's bankruptcy estate.[12]

Conclusion

When a member of a consolidated corporate group files for bankruptcy, a sophisticated bankruptcy professional should investigate the potential tax assets that may lie beneath the surface. Armed with the right tax-allocation agreement and an understanding of applicable case law, a battle to wrest control of a valuable tax refund may be worth waging. In many cases, the refund may be the only real asset in sight. To be sure, a substantial body of cases has recently informed this area of the law, and the ability to retain tax refunds for the benefit of a debtor's creditors may be just the trick to squeeze juice out of the proverbial turnip. abi

8 *In re BankUnited Fin. Corp.*, 462 B.R. 885 (Bankr. S.D. Fla. 2011) (where agreement did not require parent to deliver tax refund to its subsidiary but merely required recording of intercompany receivable or payable, refund belonged to parent); *United States v. MCorp Fin. Inc. (In re MCorp Fin. Inc.)*, 170 B.R. 899, 902 (S.D. Tex. 1994) (holding that contract between parent and subsidiary created "ordinary contractual obligations" or "an account, a debtor/creditor relationship, which is the quintessential business of bankruptcy"); *Carlson Inc. v. Commercial Disc. Corp.*, 382 F.2d 903, 905 (10th Cir. 1967) ("The obligation assumed by the [debtor] is nothing more than an obligation to settle an account" and not a trust relationship); *Franklin Sav. Corp. v. Franklin Sav. Assoc.*, 159 B.R. 9, 29 (Bankr. D. Kan. 1993) (where tax-allocation agreement provided for "reimbursements" and "credits" to subsidiary, court held that parent company owned tax refund).

9 *Capital Bancshares Inc. v. FDIC*, 957 F.2d 203, 208 (5th Cir. 1992) (tax refund is property of FDIC as receiver for failed subsidiary bank, not bank's parent company); *Lubin v. FDIC*, 2011 WL 825751 at *5 (N.D. Ga. March 2, 2011) (language does not override presumptive principal/agent relationship and was therefore not property of parent's estate); *BSD Bancorp Inc. v. FDIC (In re BSD Bancorp Inc.)*, 1995 U.S. Dist. LEXIS 22588 (S.D. Cal. Feb. 28, 1995).

10 *See MCORP Financial*, 170 B.R. 899 (S.D. Tex. 1994); *IndyMac*, 2012 WL 1037481 (Bankr. C.D. Cal. 2012), *adopted by* 2012 WL 1951474 (C.D. Cal. 2012); *BankUnited*, 462 B.R. 885 (Bankr. S.D. Fla. 2011); *NetBank*, 459 B.R. 801 (Bankr. M.D. Fla. 2010), *aff'd*, 2012 WL 2383297 (M.D. Fla. 2012); *Team Fin. Inc. v. FDIC (In re Team Fin. Inc.)*, Adv. Proc. No. 09-5084, 2010 WL 1730681 (Bankr. D. Kan. April 27, 2010); *First Cent. Fin.*, 269 B.R. 481 (Bankr. E.D.N.Y 2001), *aff'd*, 377 F.3d 209 (2d Cir. 2004); *Franklin Sav. Corp. v. Franklin Sav. Ass'n (In re Franklin Sav. Corp.)*, 159 B.R. 9 (Bankr. D. Kan. 1993), *aff'd*, 182 B.R. 859 (D. Kan. 1995).

11 *See First Cent. Fin.*, 377 F.3d at 218.

12 *BankUnited*, 462 B.R. at 900; *IndyMac*, 2012 WL 1037481 at *16.