

# Equitable Allocation of Straddle Year Income Tax Liability Does Not Apply in Bankruptcy

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The U.S. District Court for the District of Delaware held that corporate income tax liability attributable to transactions before the filing of a bankruptcy petition are nevertheless administrative expenses because the corporation's taxable year ended after the bankruptcy petition was filed. *United States v. Beskone, (In re Affirmative Ins. Holdings Inc.)*, No. 15-12136-CSS, 2020 WL 4287375, (D. Del. July 27, 2020). Because the income taxes attributable to the entire taxable year were treated as accruing on the last day of the taxable year, the District Court gave them top priority as post-petition bankruptcy administrative expenses.

In "tax speak," a "straddle year" refers to a taxable year that begins before a specific event and ends after that event. For example, when all the stock of a corporation is purchased in the middle of the corporation's taxable year, the taxable year straddles the closing date. Stock purchase agreements generally provide (other than for publicly held entities) that the tax liability attributable to the pre-closing period is the responsibility of the seller, and the tax liability attributable to the post-closing period is the responsibility of the buyer. The rationale is that the seller controls the corporation during the pre-closing period and the buyer controls the corporation during the post-closing period, thus the financial benefits and burdens of the straddle year should be bifurcated with the financial benefits and burdens of the pre-closing period falling to the seller and financial benefits and burdens of the post-closing period falling to the buyer. Pursuant to the typical stock purchase agreement, the fact that under the Internal Revenue Code the corporation's income tax liability accrues and becomes a fixed liability at the end of the taxable year (after the transfer) does not mean that the seller has no financial obligation to pay the amount of taxes that accrued before the closing date. However, if the stock purchase agreement were silent as to who bears the financial burden of the corporate income tax, the buyer would bear the burden because it would own the corporate stock when the tax return is actually filed and/or on the due date for the payment.[1]

This equitable allocation of the liability for income taxes in a straddle year is not available in bankruptcy, at least according to the District Court in *In Re Affirmative Insurance Holdings Inc.* The *Affirmative Insurance* opinion is the first appellate decision interpreting how to determine priority status of straddle year tax payments.[2] Bankruptcy courts are not uniform on this issue. Some bankruptcy courts have found that straddle year tax claims are not entitled to priority as administrative expenses, as did the bankruptcy court in *Affirmative Insurance*, while others have held that straddle tax year liabilities are to be treated as post-petition administrative expenses.[3]

The Trustee in *In Re Affirmative Ins. Holdings Inc.* argued that the straddle year in which the debtor corporation filed for bankruptcy should be bifurcated into a pre-petition period and a post-petition period. Income tax should be treated as incurred daily, based on each day's events and transactions, and that a single yearly tax liability should be apportioned between pre-petition and post-petition days, events, and transactions. Under this view, Trustee argued, any portion of the tax traceable to events or transactions before the petition date, when no bankruptcy estate yet existed, was not "incurred by the estate." Moreover, because the tax period did not end before the filing of the bankruptcy petition, the tax incurred in the pre-petition portion of the straddle year is not entitled to priority status either, but rather is only a general unsecured claim, notwithstanding the policy of giving preferential treatment to taxes the government has not had a reasonable time to assess or collect.

The United States argued that a corporation's entire annual income tax accrues on the last day of the taxable year under the Internal Revenue Code. Because a corporation only has a single income tax liability for the taxable year, the entire income tax is "incurred by the estate" on that date. The last date of the debtor corporation's taxable year in this case was after the bankruptcy petition was filed. Therefore, the entire income tax is an administrative expense.

The District Court was careful to distinguish income taxes from other types of taxes, such as employment tax and excise tax that accrue on the occurrence of specific events during the taxable year under the Internal Revenue Code. In the case of these other taxes that accrue throughout the year, taxes that accrue in the pre-petition period of the straddle year are not administrative expenses.

In finding for the United States, the District Court determined that the corporate income tax is incurred for purposes of the Bankruptcy Code when it accrues and the liability is fixed under the Internal Revenue Code. The court did not look to when the events that created the liability occurred. This means that tax losses from pre-petition events will offset taxable income from post-petition events. For example, assume before filing for bankruptcy a corporate debtor has tax losses of \$100 and after filing for bankruptcy it has taxable income of \$110 resulting in net taxable income for the straddle year of \$10. Only the tax attributable to \$10 would be treated as an administrative expense.

Although corporate income tax liability is determined at the end of the straddle year, the Internal Revenue Code requires corporations to make four estimate payments of income tax during the taxable year. The District Court does not address how pre-petition estimated tax payments are treated. Presumably, even though paid during the pre-petition period, the court's analysis suggests the estimated taxes are an administrative expense that receives top priority. If the estimated taxes paid in the pre-petition period were not administrative expenses, they might constitute a payment to an unsecured creditor for a liability that had not been incurred by the estate and the United States might be required to refund the estimated taxes to the estate. Thus, while the court's holding may be inequitable to creditors other than the United States, it apparently avoids problems that might result from pre-petition estimated income tax payments.

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[1] This assumes the seller paid no estimated taxes.

[2] Bankruptcy court decisions are appealed to a district court, unless the bankruptcy court is in a circuit with a bankruptcy appellate panel.

[3] *Compare, Darr v. United States (In re Telexfree, LLC)*, 615 B.R. 362 (Bankr. D. Mass. 2020) (holding that federal income tax debt that straddled the year in which debtors' Chapter 11 petitions were filed, on account of income that debtors had earned entirely prepetition, was prepetition debt, that was not payable on priority basis as administrative expense) with *In Re Earl Gaudio & Son, Inc.*, No. 13-90942, 2017 WL 377918, (Bankr. C.D. Ill. Jan. 25, 2017), and *In re FR & S Corp.*, No. 08-08659 ESL, 2011 WL 1261329 (Bankr. D.P.R. Mar. 30, 2011) (holding that straddle tax year liabilities are treated as post-petition administrative expenses).

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