

# Podcast: Straddle-Year Tax Debts in Bankruptcy: Does the King Get Paid First?

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The Internal Revenue Service is often a significant creditor in a bankruptcy proceeding, frequently taking priority over other creditors. In this episode, Tax attorney **Douglas Charnas** (Washington, DC) and Financial Services attorney **Sarah Edwards** (New Orleans) discuss the case of *Affirmative Insurance*, which examined whether federal income tax liability was considered a pre-petition or post-petition debt.

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**Douglas Charnas:** I'm Douglas Charnas, Member in McGlinchey's Washington DC office. I practice tax law. I'm joined by my colleague, Sarah Edwards from our New Orleans office, who practices with our Consumer Financial Services Compliance group, and has advised numerous clients through bankruptcy and restructuring proceedings. Sarah, "the king gets paid first." This was the first thing that I learned in my introductory tax course in law school. Nowhere is that better illustrated than when a taxpayer files for bankruptcy.

**Sarah Edwards:** That certainly is true, Doug. When a business files for bankruptcy, unsecured creditors quickly learn, if they didn't know already, that the king, or should I say the IRS, generally gets paid first. Even secured creditors can be paid behind the IRS in the waterfall of payments to creditors.

**Douglas Charnas:** In the recent case of *United States v. Beskone*, the United States District Court for the District of Delaware overturned a bankruptcy court decision in the case of *In re Affirmative Ins. Holdings Inc.*, in which the bankruptcy court did not give the IRS top priority for income taxes owed by a related group of corporations. The name of the bankruptcy court case is *In re Affirmative Ins. Holdings Inc.*, and I will refer to both the District Court case and the bankruptcy court case as *Affirmative Insurance*. *Affirmative Insurance* involved several related corporations that filed a bankruptcy petition, voluntarily, for proceedings under Chapter 11. (The bankruptcy court later converted the cases to Chapter 7.) Sarah, correct me if I am wrong, but businesses that file for Chapter 11 bankruptcy seek to reorganize their affairs and restructure their debt so they can continue in business after bankruptcy.

**Sarah Edwards:** Generally, yes, that is correct. And unlike a Chapter 7 bankruptcy in which the business's assets are going to be liquidated to satisfy debts owed to a creditor, a business that's entering into Chapter 11 bankruptcy expects to continue operating after it emerges from bankruptcy. So when a business petitions for bankruptcy under either Chapter 11 or Chapter 7, it's got to list all of its debts that it owes. And so these liabilities, once they're listed, are going to be split into two categories. The first is debts that are incurred before the filing of the bankruptcy. Those are called "pre-petition debts." And the second category are debts that are incurred after filing for bankruptcy. Those are called "post-petition debts."

**Douglas Charnas:** So you have pre-petition debts and post petitions debts. So I'm assuming that there must be some significant difference?

**Sarah Edwards:** Yeah, the distinction is going to be very significant. Most of those debts will be pre-petition, and these debts can be modified in bankruptcy. They can even be reduced or eliminated completely, whereas post-petition debts generally are not going to be modified in bankruptcy. The business continues to owe these debts, of course, when it emerges from bankruptcy, and certain expenses that are incurred post-petition in the administration of the bankruptcy (and these are called "administrative expenses") have important payment priority in the bankruptcy case. In most instances, it's going to be clear whether a debt is pre-petition or post-petition, as you might imagine. And the same is true for administrative expenses, but as we saw in *Affirmative Insurance*, that's not always the case.

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**Douglas Charnas:** Well, as I think about this, Sarah, it seems like there is tension between the bankrupt business, on the one hand, and its creditors, on the other hand, when determining whether a debt is pre-petition or post-petition. Am I right in thinking that the business in bankruptcy wants a debt to be classified as pre-petition, so that it can be reduced or eliminated in the bankruptcy proceeding, while the creditor wants it classified as post-petition so that the debt is not reduced in the bankruptcy proceeding?

**Sarah Edwards:** Yes, that's true, and that's actually equally true with expenses. And often there's going to be a fight in the bankruptcy court over whether a debt or expense is pre-petition or post-petition. And this was certainly true in *Affirmative Insurance*. In that case, the group of corporations that filed for Chapter 11, the debtors, filed their bankruptcy petition during the debtor's taxable year. So the taxable year actually straddled the petition date. And during that year, the events that generate a taxable income occurred both pre-petition and post-petition. So the Bankruptcy Court had to decide whether to attribute federal income tax liability to the pre-petition period when the income was generated, or to the post-petition period, when the federal income tax liability was finally determined. And if the tax liability were attributed to the pre-petition period, as we've said before, it could be subject to reduction or elimination, and the federal government would be treated like an unsecured creditor, which could result in a pennies-on-the-dollar payment. However, if the tax liability were attributed to the post-petition period, it would be treated as an administrative expense and subject to top payment priority in bankruptcy.

**Douglas Charnas:** Well, Sarah, as a tax lawyer, I'm familiar with the concept of a straddle. 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 the case of 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 for the pre-closing period falling to the seller, and the financial benefits and burdens of the post-closing period falling to the buyer. In a 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 of the stock, 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 the date when the tax payment occurs.

*The trustee argued that the straddle year in which the debtor filed for bankruptcy should be bifurcated into the pre-petition period and a post-petition period. And income tax should be treated as incurred daily..., and that a single year tax liability should be apportioned between pre-petition and post-petition days, events, and transactions.*

**Sarah Edwards:** That makes sense to me and the trustee and *Affirmative Insurance* actually argued for a similar, equitable approach by bifurcating the straddle year. The trustee argued that the straddle year in which the debtor filed for bankruptcy should be bifurcated into the pre-petition period and a post-petition period. And income tax should be treated as incurred daily based on each day's events and transactions, and that a single year tax liability should be apportioned between pre-petition and post-petition days, events, and transactions. Under this view, the trustee argued, any portion of the tax traceable to events or transactions before the petition date, when no bankruptcy estate yet existed was not (I'm using air quotes here) "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 was not entitled to priority administrative expense status, but rather was only a general unsecured claim, notwithstanding the policy of giving preferential treatment to taxes the Federal Government has not had a reasonable time to assess or collect. The reality was in this case, all the taxable income was traceable to events that occurred during the pre-petition period. So no tax liability was attributable to the post-petition period.

**Douglas Charnas:** Well, this seems equitable to me. While the federal income tax liability was not determined until the end of the taxable year during the post-petition period, the economic burden of the liability was attributable to the pre-petition period, and the federal government should be treated the same as creditors whose debts accrued during the pre-petition period.

**Sarah Edwards:** You might think so, but the United States representing the IRS argued that a corporation's entire annual income tax (air quotes here again) "accrues" on the last day of the taxable year under the Internal Revenue Code. Because a corporation has only a single income tax liability for the taxable year, the entire income tax is incurred by the estate on that single date, which in this case was a post-petition date. As a result, the United States argued the entire income tax is an administrative expense and receives top payment priority.

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**Douglas Charnas:** Well, that's sure sounds to me like the IRS was arguing, in essence, that the king gets paid first. Sarah, before we get to the District Court's decision, I have two questions. First, have other bankruptcy courts address this issue? And then second, is this the first District Court to address the issue?

**Sarah Edwards:** To your first question: Yes, a few bankruptcy courts have addressed this issue, but they're not uniform in their decisions. 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 year tax liabilities should be treated as post-petition administrative expenses that receive top payment priority. But to your second question, the District Court's Affirmative Insurance opinion is the first appellate decision interpreting how to determine priority status of a straddle year tax payment.

**Douglas Charnas:** Well, Sarah, you use the term "appellate decision." Now I think of a District Court as a trial court. Are District Court decisions appellate decisions for bankruptcy court cases?

**Sarah Edwards:** Yes. In the bankruptcy context, the District Court can be a court of appeals. And that's going to be a little different though, if the bankruptcy court is in a jurisdiction that has a separate bankruptcy appellate panel.

**Douglas Charnas:** Okay. So how did the District Court reach its decision?

**Sarah Edwards:** In finding for the United States, the District Court determined that the corporate income tax is incurred for the purposes of the bankruptcy code when it accrues, and the liability is fixed under the Internal Revenue Code. The District Court didn't look into the timing of the events that created the income tax liability. And so the District Court found that the accrual of corporate tax income incurs at a single point in the year, which in this case was post-petition. 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 throughout the taxable year under the Internal Revenue Code. In the case of these other taxes, the portion of the tax that accrues in the pre-petition period of the straddle is bifurcated from the portion that accrues post-petition, and is not treated as an administrative expense.

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**Douglas Charnas:** Oh, I see. So although the United States came out ahead under the facts in Affirmative Insurance, that will not always be the case. The District Court's decision means that the 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 a hundred dollars. And after filing for bankruptcy, it has taxable income of \$110, resulting in net taxable income for the straddle year of \$10. In that case only the tax attributable to \$10 would be treated as an administrative expense.

**Sarah Edwards:** Yep. That's where the District Court's decision takes you.

**Douglas Charnas:** Okay. Then while a corporate income tax liability is determined at the end of the straddle year, the Internal Revenue Code, rather, requires corporations to make four estimated payments of income for a taxable year. The District Court does not address how pre-petition estimated tax payments are treated. Sarah, what are your thoughts on estimated tax payments?

**Sarah Edwards:** Presumably even though these estimated tax payments are paid during the pre-petition period, the District Court's analysis suggests the payments 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 has not been incurred by the estate. And the United States might be required to refund the estimated taxes to the estate. While the court's holding in Affirmative Insurance may be inequitable to creditors other than the United States, it apparently avoids problems that might result from pre-petition estimated income tax payments.

**Douglas Charnas:** Well, do you think the trustee will appeal the District Court's decision to the U S court of appeals for the third circuit?

**Sarah Edwards:** Actually, yes. So the trustee filed to appeal the District Court's decision on September 25, 2020. And I think this is a great case for appeal due to the split of authority on this issue that was already brewing at the bankruptcy court level. So even though the District Court overturned the bankruptcy court's decision in Affirmative Insurance, that bankruptcy court's decision was very well-reasoned. So I think it will be pretty interesting on appeal.

**Douglas Charnas:** Well, I guess for now, then it looks like the king will continue to get paid first.

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