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Debtor Strategies for Avoiding Unfavorable Tax

Consequences from Debtor Collection of Employee Loans

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The treatment of loans to a debtor's former employees can result in unforeseen and unfavorable tax consequences. An unwary trustee or administrator of a plan of reorganization (each, a "Responsible Individual") who employs the wrong approach can expose the estate to unanticipated payroll tax liability. Moreover, if the Responsible Individual fails to reserve sufficient funds for payment of such payroll tax liability, he may be forced to pay such liability out of his own pocket. As a result, it is critical that a Responsible Individual be familiar with the issues and employ the strategies discussed herein.

The Loan Incentive Package

A Responsible Individual's duties under a plan of reorganization often include collection of loans made by the debtor company to its former employees. Frequently, such loans are made as part of a stock incentive program whereby the company loans the employee funds to purchase the company's stock. The loan-purchase approach is often favored by employees over a stock-option approach because, assuming the stock increases in value as expected, the employee will pay capital gains tax rather than ordinary income tax on the gain. When an employee exercises stock options, the employee must pay ordinary income tax on the difference between the exercise price and the market price at a rate of up to 35 percent. See Treas. Reg. §§ 1.83-3(g), 1.61-15(a) (as amended in 2005); I.R.C. § 1(a-d) (2006); Rev. Proc. 2005-70, 2005-47 I.R.B. 979. By contrast, if the stock-loan-purchase approach satisfies certain requirements and the employee holds the stock for a minimum of one year, the employee's profit from the stock is treated as capital gain, which is taxed at a maximum of 15 percent. See 26 I.R.C. § 1001(a) (2006). In an effort to minimize the risk arising under the loan purchase approach from a potential decrease in the value of the stock, the employer may agree that some portion of the indebtedness will be non-recourse and secured solely by a lien on the stock.

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IRS Treatment of Loan Forgiveness

The Internal Revenue Service has taken the position that any portion of a loan from an employer to an employee that is forgiven constitutes compensation on which the employee must pay ordinary income tax and the employer must pay payroll tax. See Treas. Reg. § 1.83-4(c) (1978); Rev. Rul. 2004-37, 2004-1 C.B. 538. The IRS has taken the position that whether the uncollected portion of the loan constitutes “compensation” depends on the circumstances prevailing at the time the loan was extended rather than at the time the indebtedness is compromised. Treas. Reg. § 1.83-4(c) (providing that “[i]f an indebtedness that has been [treated as an amount paid in connection with the performance of services] is subsequently cancelled, forgiven or satisfied for an amount less than the amount of such indebtedness, the amount that is not, in fact, paid shall be includible in the gross income of the service provider.”). Thus, even though, at the time the debt is compromised, the collateral for the non-recourse portion of the debt is worthless and there is no longer an employer-employee relationship, the IRS may contend that the uncollected non-recourse portion constitutes compensation. Based on this rationale, the IRS issued Revenue Ruling 2004-37, ruling that, if an employee and employer, in connection with the performance of services, exchanged a promissory note for restricted stock and the employer subsequently reduced the amount owed on the note, “the reduction of the stated principal amount [will be presumed] a medium for payment of compensation by Employer to Employee.” This position presents a trap for an unwary Responsible Individual of a liquidating debtor who fails to appreciate the unique tax attributes of an employment loan. Indeed, a Responsible Individual pursuing collection of an employment loan may view himself as a collection agent rather than as an employer. Thus, a Responsible Individual may not appreciate the possibility that an uncollected employment loan will be treated as “compensation” to the former employee for tax purposes. Whether the uncollected loan constitutes ordinary debt cancellation or “compensation” is significant, because ordinary debt cancellation does not result in any payroll tax liability, whereas “compensation” generates a payroll tax liability for the debtor-employer.

Potential Personal Liability for a Responsible Individual

The Internal Revenue Code imposes strict liability on employers for the payment of withholding taxes to the IRS. 26 I.R.C. § 3403 (2006). In addition to the employer, “[a]ny person required to collect, truthfully account for and pay over any tax” who willfully failed to do so is personally liable for the amount of the tax evaded. 26 I.R.C. § 6672(a)(2006). See, e.g., *Gephart v. United States*, 818 F.2d 469, 472 (6th Cir. 1987).

Strategies

Avoidance or reduction of the potential payroll tax liability requires the implementation of three interrelated strategies: 1) a litigation strategy for collection of the loan that limits the resulting tax consequences, 2) a procedural strategy for obtaining a determination of what, if any, tax liability exists for the estate and the Responsible Individual and 3) a transactional strategy that enables the Responsible Individual to argue that the uncollected portion of the loan does not constitute “compensation.”

Litigation Strategy

When considering whether to settle a claim, a Responsible Individual must bear in mind the possibility that the estate will incur payroll tax liability for any portion of the loan that goes uncollected. Therefore, a settlement that appears favorable at first glance may be less desirable when the potential tax consequences are taken into account. The only way to foreclose the possibility of payroll tax liability is to collect the loan in full. Otherwise, the estate faces potential payroll tax liability (generally 25 percent) on the portion of the loan that goes uncollected. Thus, if a Responsible Individual were to accept an offer from an employee to repay only 10 percent of a \$5 million loan (\$500,000), the Responsible Individual would expose the estate to potential payroll tax liability of \$1,125 million. Therefore, what might otherwise be viewed as a favorable settlement in other circumstances would subject the Responsible Individual to a potential loss twice as great as the offer itself.

The potential tax liability can be used to justify what otherwise might be viewed as a “hard-line” position. In other words, a Responsible Individual can justify his need to collect the entire loan to avoid subjecting the estate to significant payroll tax liability. Moreover, the Responsible Individual should remind the obligor that he will face cancellation of indebtedness liability for any portion of the loan that goes uncollected. Although this approach is unlikely to induce the obligor to repay the entire loan, it is likely to persuade the obligor to pay a greater portion of the debt than he might otherwise do in the absence of tax liability.

In the event the Responsible Individual is unable to convince the former employee to repay the loan (or a portion thereof that justifies accepting a discounted payoff), the Responsible Individual has a strong incentive to litigate the claim to judgment. By doing so, he can obtain a determination from the court of the actual amount owed and rely upon the “contested liability doctrine.” This doctrine provides that, if the lender “in good faith, dispute[s] the amount of a debt, a subsequent settlement of the dispute [will] be treated as the amount of debt cognizable for tax purposes.” *Zarin v. Comm’r*, 916 F.2d 110, 115 (3d Cir. 1990). While this also applies to a settlement of a disputed claim, litigation to judgment precludes the IRS from contending that the settlement was not in good faith and, thus, falls outside the doctrine.

Courts have interpreted this definition of wages to cover only those transfers of cash, property or other forms of income from employer to employee that are intended to be a payment for services performed during the employment relationship. *In re Thomson McKinnon Sec., Inc.*, Nos. 90 B 10914, 90 B 11805, 1991 Bankr. LEXIS 627 (Bankr. S.D.N.Y. April 26, 1991). In *Thomson*, the court found that employee loans forgiven by a Chapter 11 debtor were not subject to tax withholding requirements unless the debtor’s purpose in forgiving the loans was to compensate its former employees for services performed. *Id.* at *10.

Procedural Strategy

A Chapter 11 debtor may seek resolution of employment tax liability issues by seeking 1) a “private letter ruling” pursuant to Treas. Reg. § 601.201 or 2) a determination, under § 505(a) or (b) of the Bankruptcy Code, of liability resulting from a settlement.

A taxpayer may obtain an advance ruling from the IRS on a prospective transaction through a private letter ruling. Treas. Reg. § 601.201 (as amended in 2002); Rev. Proc. 88-1, 1988-1 C.B. 557. A private letter ruling is “a written statement issued to the taxpayer in which interpretations of the tax laws are made and applied to a specific set of facts.” *United States v. Wahlin*, 384 F.Supp. 43, 46 (W.D. Wis. 1974). Its function is “to advise the taxpayer regarding the tax treatment he can expect from the IRS in the circumstances specified by the ruling.” *Id.* Private letter rulings cover only the taxpayers receiving them and do not constitute precedential authority with respect to third parties. Rev. Proc. 88-1, 1988-1 C.B. 557. Moreover, while a party receiving a negative private letter ruling is not bound by such a ruling, the receipt of a favorable ruling is a defense against future action by the IRS on the same issue. Thus, this approach gives a Responsible Individual “two bites of the apple” in the event of an unfavorable private letter ruling. The disadvantage of this approach is that, in practice, the process of obtaining a private letter ruling may take from three months to two years.

In the event that a private letter ruling is unfavorable or impractical, a Responsible Individual may seek a determination of the estate’s payroll tax liability pursuant to § 505(a) or (b) of the Bankruptcy Code. Prospective relief is potentially available only under § 505(a). Section 505(a) provides, in relevant part:

[T]he court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

Courts have differed as to whether § 505 authorizes a bankruptcy court to make a determination of a debtor’s future tax liability. In *In re Huddleston*, No. 94-50342, 1994 Bankr. LEXIS 1961 (Bankr. W.D. La. December 2, 1994), the court concluded that it had authority under § 505(a) to prospectively determine a debtor’s tax liability where, among other factors, the IRS had filed and twice amended a proof of claim for taxes and a determination was necessary to facilitate the efficient administration of the bankruptcy estate. In reaching its decision, the court considered the following factors: 1) the complexity of the tax issues; 2) the need to administer the bankruptcy case in an efficient manner; 3) judicial economy; 4) the time required for trial and decision; 5) the asset and liability structure of the debtor; and 6) the potential prejudice to the debtor and the taxing authority. *Id.* at *20-21. Other courts have reached the opposite conclusion. See, e.g., *In re UAL Corp., et al.*, No. 336 B.R. 370 (Bankr. N.D. Ill. 2006) (concluding that § 505(a) may not be used prior to confirmation of a reorganization plan to determine tax consequences arising after confirmation of the plan); *Allis-Chalmers Corp. v. Goldberg (In re Hartman Material Handling Systems, Inc.)*, 141 B.R. 802 (Bankr. S.D.N.Y.1992) (holding that § 505 does not grant the court authority to finally determine tax issues before confirmation of a Chapter 11 plan).

Under § 505(b), a Responsible Individual may serve the IRS with the debtor’s tax return along with a request for determination of liability for any unpaid portion of taxes. The IRS then has 60 days to review the return and serve the Responsible Individual with notice of the IRS’s intent to conduct an audit. If the IRS issues a timely audit notice, the IRS then has 180 days to complete its audit and issue a determination of tax liability. If the IRS fails to serve a timely audit notice or fails to issue a timely determination of tax liability, the IRS is precluded from thereafter challenging the amount of the tax liability set forth in the subject tax return. Thus, this process can take as long as 240 days to complete.

Each approach has unique benefits and limitations. Under § 505(a), the Responsible Individual can potentially obtain a determination of the tax consequences of a contemplated settlement *before* entering into such settlement. Moreover, the § 505(a) process is significantly faster than the procedures required under § 505(b). Finally, proceeding under § 505(a) will result in the issuance of an order from the bankruptcy court upon which the Responsible Individual can rely. On the other hand, because the § 505(a) process requires that a motion be filed and served upon the IRS, the 505(a) approach may invite amore vigorous response from the IRS than might attend a 505(b) approach.

Because the 505(b) process is routinely employed by estates in connection with the filing of their final tax returns, it is likely to draw less scrutiny than the formal filing of a motion under § 505(a). On the other hand, the 505(b) process takes significantly more time to complete and does not result in the issuance of an order upon which the Responsible Individual can rely. The lack of issuance of an order is troublesome because § 505(b) specifies that it is a tool available for “the estate, the trustee, the debtor, and any successor to the debtor,” but is silent as to whether its provisions can be utilized by the administrator of a plan of reorganization. Thus, relief pursuant to § 505(b) may not be available to a Responsible Individual post-confirmation.

Transactional Strategy

The transactional strategy involves structuring a sale, or settlement, of the claim for repayment of an employment loan in a fashion that minimizes the likelihood that the IRS could successfully challenge the Responsible Individual’s tax treatment thereof.

Sale of The Claim

As discussed above, in *Thomson McKinnon Sec.*, the court held that the cancellation of a portion of an employment loan constitutes compensation only if the “forgiveness” was intended to be a payment for services performed during the employment relationship. Accordingly, by selling the estate’s claim for repayment of the employment loan to a third party in an arms’-length transaction, the Responsible Individual can recover the sale price for the estate while avoiding the need to compromise the claim. This approach may insulate the estate from any payroll tax liability on account of the claim. Nevertheless, in light of the illiquid nature of the claim, a Responsible Individual may have difficulty finding a buyer willing to pay a sale price high enough to make this approach economically viable.

Treat as Purchase Money Reduction

Frequently, the employee who has executed a note to purchase his employer’s stock will contend that the stock was overvalued at the time of his acquisition thereof and that, as a result, he is entitled to a purchase price reduction (and a corresponding cancellation of indebtedness) that does not result in discharge of indebtedness income.

Section 108(e)(5) of the Internal Revenue Code provides that a purchase-money debt reduction for a solvent taxpayer does not give rise to cancellation of indebtedness income. I.R.C. § 108(e)(5) (2006). Rather, the cancellation of indebtedness is treated as an adjustment to the original sale price. See *Gwinn v. Comm’r*, 3 T.C.M. (CCH) 548 (1944) (holding that an employer’s reduction of its employee’s obligation under a promissory note exchanged for stock in the employer-company was a purchase

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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money debt reduction); *Brantley v. Comm'r*, 70 T.C.M. (CCH)1430 (1995) (IRS acknowledged that cancellation of a \$228,000 note owed by employee to employer in connection with employee's purchase of company stock for \$300,000 did not result in discharge of indebtedness income to employee where company had negative net worth at time of the sale; rather, cancellation treated as purchase price reduction designed to reflect correct value of stock at time of employee's purchase).

Accordingly, a Responsible Individual may settle an employment loan claim by agreeing to a purchase price reduction in exchange for payment by the employee of the fair value of the stock at the time the employment loan was made. If the employee is solvent and the loan reduction is done in conformity with § 108(e)(5), the Responsible Individual can avoid exposing the estate to payroll tax liability. On the other hand, the IRS may take the position that the loan reduction constitutes compensation, rather than cancellation of indebtedness, and thus falls outside the protections of § 108(e)(5). Whether the purchase price reduction constitutes compensation or a cancellation of indebtedness will likely depend on the extent to which the parties can establish that the stock was overvalued at the time of sale and whether there is evidence that the loan reduction is a disguised attempt by the employer to compensate the employee.

Conclusion

It is natural for a Responsible Individual appointed to administer a plan of reorganization to view the treatment of employment loans as a simple collection matter irrespective of the employment context out of which they arose. Such a misstep may result in payroll tax liability that constitutes a claim against the estate of greater priority than the claims of general unsecured creditors and subject the Responsible Individual to personal liability. Accordingly, a Responsible Individual who neglects to consider these issues and employ the correct strategies discussed herein will subject himself or herself to criticism and potential liability.