Intragroup Wars: Abusive Parents, Rebellious Subsidiaries

By Vadim Mahmoudov


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Vadim Mahmoudov is a partner at Debevoise & Plimpton LLP and a member of the Tax Club. He gratefully acknowledges the assistance of Nick S. Kaluk III, Samuel D. Krawiecz, and Adam Namm in preparing this report.

In this report, Mahmoudov examines recent developments in disputes between members of consolidated groups regarding ownership of net operating losses, other tax attributes, and tax refunds. Those disputes were frequent during the last recession, especially in groups that include regulated financial institutions, and they have prompted financial regulators to examine the adequacy of tax sharing agreements.

Table of Contents

In good times, tax sharing agreements (TSAs) and intercompany tax payments between members of a consolidated group are boring topics. They may affect the accounting treatment of deferred tax assets or calculations of stock basis, earnings and profits, and other tax attributes of various members of the group, and they may periodically raise questions of interpretation. But these issues usually do not require the services of a litigator. As long as the group remains one happy family, it is hard to imagine members of the group suing each other over a tax refund.

The happy family can be quickly disrupted, however, if one or more of the members find themselves in financial distress. During the Great Recession, many consolidated groups filed for bankruptcy or saw their regulated members taken into receivership by federal and state regulatory agencies. If the consolidated group has varying creditor and regulatory constituencies at different tiers of the structure, these outside stakeholders often begin fighting over cash flows and tax attributes of the group. In these cases, the docile boxes on the structure chart come alive and begin acting toward each other in a hostile manner — typically at the direction of outside stakeholders who are using the group members as puppets in a proxy war over tax assets.

These disputes create fertile ground for tax advisers and their litigator colleagues to exercise their creativity, due diligence, and — sometimes — vicious brinksmanship. The resulting body of bankruptcy case law and regulatory actions provides valuable insights into the potential pitfalls of intercompany tax sharing arrangements. By examining these train wrecks of the recent past, we can learn what to do and not to do when the next train wreck occurs (or, better yet, before it occurs). This report will focus on recent developments in disputes involving two key tax assets that are often in play during a financial meltdown of a consolidated group: tax attributes and tax refunds.

I. The Ambac Ambush, AKA Who's Your Daddy?

A. Background

Ambac Financial Group Inc. (AFG) was a holding company and a common parent of an affiliated group of companies filing consolidated returns under section 1502. One of its significant subsidiaries

was Ambac Assurance Corp. (Ambac), a Wisconsin-domiciled financial guaranty insurance company. As an insurance company, Ambac was subject to regulation by the Office of the Commissioner of Insurance (OCI) for the state of Wisconsin.

AFG was a public company and had issued significant amounts of debt to third-party lenders. In good times, AFG could rely on dividends from Ambac, which had once enjoyed AAA credit ratings, to service those debt obligations. However, the group took a hit during the 2008 financial crisis.

Starting in 2007, Ambac experienced significant deterioration in its financial condition and stopped originating new business. Faced with mounting obligations to policyholders and credit default swap counterparties, Ambac ended up in rehabilitation proceedings under Wisconsin state law.

In a typical rehabilitation, the state insurance regulator has broad powers to control the affairs of the distressed insurance company. The regulator may fire personnel, replace the board of directors, and otherwise run the show at the insurance company level. One of the first things the regulator usually does is prohibit any payment of dividends to the parent company of the insurer. For AFG, this spelled doom for its ability to repay its debt. On November 8, 2010, AFG initiated a bankruptcy case under chapter 11 of the Bankruptcy Code.

AFG's future looked bleak. Cut off from its key source of revenue — dividends from Ambac — AFG had become a classic insolvent holding company, unable to pay its debt holders and lacking sufficient operating business assets of its own that could generate new revenue. The Ambac insurance business was stranded ''downstairs'' in rehabilitation proceedings tightly controlled by the OCI. Absent a miraculous recovery, there was little likelihood of AFG ever getting a penny out of Ambac again. Or so it seemed.

But that's when the bankruptcy lawyers — and their crafty tax colleagues — parachuted onto the battlefield. When they focused on the structure chart and the financial statements, hoping to find any source of recovery for AFG's angry creditors, they saw a potential gold mine. What followed can be called either highway robbery or brilliant tax planning, depending on which side you might be rooting for.

B. The Tax Angle

As mentioned above, AFG and Ambac were members of a single consolidated group for U.S. federal income tax purposes. As the common parent of the group, AFG generally controlled the filing and preparation of the group's consolidated tax returns and represented it as its agent vis-à-vis the IRS.[1]

Should the commencement of a rehabilitation proceeding by Ambac have terminated the tax consolidation of Ambac with the rest of AFG's group? After all, section 1504(a) requires that AFG maintain ownership of stock in Ambac that possesses at least (1) 80 percent of the total voting power of Ambac's stock and (2) 80 percent of the total value of that stock. But AFG's voting power had become meaningless: The OCI was in control of Ambac's board and decision-making. Further, AFG's economic ownership of the stock of Ambac possibly had zero value in light of Ambac's insolvency.

A large body of IRS rulings confirms that the answer to the above question is no and that the filing of consolidated returns by the group must continue.[2] As Yogi Berra would say, ''It ain't over till it's over.''[3] AFG's ownership of 100 percent of the common stock of Ambac should continue to be respected for tax purposes, even if that stock resembles a lottery ticket given Ambac's dire straits. The seizure of control at the subsidiary level by a regulator (or a court, in some of these rulings) is viewed as temporary. Thus, the shareholder — as long as it retains ownership of the voting stock of the subsidiary — retains the theoretical ability to vote for the subsidiary's directors whenever that seizure should cease to operate.

Accordingly, AFG and Ambac had to soldier on as members of a single consolidated group, whether they liked it or not. This meant that AFG had to continue to remit tax payments to the IRS if Ambac generated taxable income that produced a cash tax liability for the group, regardless of whether Ambac paid anything to AFG.[4] On the flip side, Ambac could be jointly and severally liable to the IRS for any tax liabilities of the entire group incurred

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[1] *See generally* reg. section 1.1502-77(a).

[2] *See, e.g.*, LTR 9246031 (a court-ordered rehabilitation and liquidation of an insurer does not terminate the tax consolidation); LTR 8544018 (an insurer ordered into liquidation continues to be a member of the affiliated group); LTR 9014051 (requiring the continued filing of a consolidated return for a savings and loan subsidiary over which the Federal Savings and Loan Insurance Corp. assumed control); Rev. Rul. 78-119, 1978-1 C.B. 277 (ruling that the temporary seizure of a parent's subsidiary stock and suspension of the parent's voting rights by a court does not affect the parent's ownership for purposes of the 80 percent test).

[3] *See* William D. Araiza et al., ''The Jurisprudence of Yogi Berra,'' 46 *Emory L.J.* 698, 699 (1997) (citing David H. Nathan, *Baseball Quotations* 150 (1993)).

[4] *See* reg. section 1.1502-6(a).

during years in which Ambac was a member of the group, even if the taxable income was not generated by Ambac.[5]

Moreover, as is customary in consolidated groups that include insurance companies (or other regulated entities such as banks or public utilities), members of the group were parties to a TSA that could impose intercompany payment obligations on AFG. Generally, a TSA is required by the subsidiary's regulator — or, often, by other constituencies exposed to the economic fortunes of the subsidiary, such as its creditors or minority shareholders — to ensure that (1) the subsidiary receives adequate compensation for the group's use of its tax attributes and (2) the subsidiary's assets are not depleted by excessive tax payments to the parent for the subsidiary's share of the group's tax liability. Typically, the insurance regulator requires that at a minimum, the insurance subsidiary's tax payments under a TSA not exceed the tax liability it would have owed to the IRS as a stand-alone taxpayer if no consolidated group had existed.[6]

Not surprisingly, the TSA adopted by AFG's group, amended in June 2010 after the group was already in distress, contained similar provisions. AFG, on behalf of itself and its other non-Ambac subsidiaries (AFG Subgroup), was generally obligated to compensate Ambac when AFG Subgroup used Ambac's net operating losses to offset its income, except for some cancellation of indebtedness income. As of March 31, 2011, Ambac had reported NOLs of approximately $7.2 billion for federal income tax purposes.[7] And while it seems doubtful that Ambac would have been able to use all these NOLs to offset its taxable income before they expired,[8] it was quite possible that Ambac would need some of them to shelter projected future income during its runoff period. To make Ambac whole for the loss of these valuable tax attributes, the TSA required AFG to pay notional tax to Ambac to the extent that AFG Subgroup's income soaked up NOLs generated by Ambac and produced tax savings to the group.

But this potential TSA obligation had some wrinkles in it. AFG, after all, was in bankruptcy, with several groups of creditors lined up to fight over its assets. It was far from clear that if AFG used some of Ambac's NOLs and incurred an obligation under the TSA to compensate it, Ambac would be able to obtain a full recovery on its TSA claim in AFG's bankruptcy proceeding. Also, a debtor in bankruptcy (such as AFG) may be able to reject an executory contract to avoid making future payments under it.[9] In sum, AFG might be able to use its bankrupt status to minimize its obligations under the TSA or even avoid them entirely.

More important, AFG's position at the top of the consolidated group gave it immense power over Ambac's NOLs. As agent for the group and the preparer of its tax returns, the common parent generally has the power to decide tax positions to be taken by the group. AFG could also take actions to break consolidation with Ambac — for example, by transferring 21 percent of its Ambac shares to an unaffiliated third party or by abandoning the stock. If applicable requirements were met, AFG could claim a worthless stock deduction under section 165(g) for its stock in Ambac. Finally, AFG could (perhaps at significant cost to itself and its own tax attributes) permit an ownership change within the meaning of section 382 to occur at the AFG level, possibly resulting in a severe limitation on the future use of the group's NOLs.

Those actions could have a disastrous effect on Ambac's ability to shelter its future income with its NOLs, unless Ambac or the OCI could enjoin AFG from taking those actions or force their prompt rescission. A deconsolidation of Ambac or a deduction for its worthless stock was expected to activate the unified loss rule (ULR) of reg. section 1.1502-36 because AFG had a substantial unrecognized loss in the shares of Ambac.

A detailed analysis of the ULR is beyond the scope of this report, but according to AFG's court filings, a deconsolidation event could have allowed AFG to elect under the ULR to reattribute some NOLs from Ambac to AFG.[10] Alternatively, a worthless stock deduction claimed by AFG for its Ambac shares could have resulted, under the ULR, in a reduction of Ambac's NOLs or other tax attributes,[11] while also leaving AFG as the proud owner of a loss carryforward at the AFG level. (Depending on the facts, the worthless stock deduction could have been treated as an ordinary loss under section 165(g)(3).) Either way, those actions could have permitted AFG to, in effect, suck the NOLs out of Ambac — destroying Ambac's tax attribute and

[5] *See id.*

[6] *See, e.g.*, N.Y. Ins. Dep't, Circular Letter No. 33 (Dec. 20, 1979).

[7] *See* Disclosure Statement of Ambac Financial Group Inc., *In re Ambac Financial Group Inc.*, No. 10-15973 (Bankr. S.D.N.Y. July 8, 2011), at 18.

[8] Generally, an NOL can be carried forward for up to 20 years following the year in which it arose. *See* section 172(b)(1)(A)(ii).

[9] *See generally* 11 U.S.C. section 365.

[10] *See* reg. section 1.1502-36(d)(6)(i)(B).

[11] *See generally* reg. section 1.1502-36(d)(2).

obtaining a similar tax attribute at the AFG level that AFG could then use without paying any compensation to Ambac.[12]

C. AFG's Ultimatum: Have We Got a Deal for You

Having identified a potential bargaining chip vis-à-vis Ambac and the OCI, AFG and its creditors decided to press their advantage. After unsuccessful negotiations with the OCI, AFG filed a proposed plan of reorganization with the bankruptcy court spelling out its demands and proposals.[13] Although the plan was complex and involved many other aspects (including ongoing IRS audits of the group), the proposal on tax attributes could be summarized as follows:

- The TSA would be amended, in effect, to reallocate contractually some NOLs generated by Ambac in prior periods to AFG such that AFG would own the economic benefit of those NOLs. This meant that (1) AFG would be able to use those NOLs to offset its own income without paying anything to Ambac; and (2) AFG would also be entitled to charge Ambac to the extent the NOLs were used by Ambac to offset its income, as described below.
- From that point on, Ambac would have to pay AFG for the privilege of using the reallocated NOLs that had formerly ''belonged'' to Ambac. The proposal laid out several pricing options, but each involved (1) some upfront cash payment (ranging between $50 million and $200 million); and (2) periodic payments for any actual use of the reallocated NOLs, based on a percentage of Ambac's notional income tax rate (in some cases, based on a sliding scale that ratcheted up the percentage at higher levels of NOL use).
- In exchange, AFG would graciously agree — to the extent any deconsolidation of Ambac occurred or could have arguably occurred — to make protective elections under the ULR to preserve Ambac's NOLs and other tax attributes.
- If Ambac did not agree to these terms, AFG would reject the existing TSA and pursue a deconsolidation transaction, a worthless stock deduction, or both, and use the ULR to remove the NOLs from Ambac without any compensation.

Obviously, this proposal was far from the typical TSA that an insurance regulator is used to seeing. Instead of being reimbursed by the parent for its NOLs being used, the insurance subsidiary was asked to pay ransom to the parent just to keep them alive. Further, the subsidiary that had generated these NOLs was asked to pay the parent for using them to offset its own income — which, in a customary TSA, is a nonevent that does not require payment to any party.

After several months of negotiations (including a mediation process), the parties cut a deal. The resulting agreement was spelled out in an amended plan of reorganization filed by AFG, which was ultimately confirmed (after several amendments that are irrelevant for these purposes)[14]:

- Ambac would transfer to AFG a cash grant of $30 million. A portion of the cash grant (up to $15 million) could be used as a credit against future payments owing from Ambac to AFG under the amended TSA, described below.
- AFG would make its best efforts to preserve tax attributes for Ambac's potential use, including by avoiding a deconsolidation and, if a deconsolidation event occurred, by making appropriate elections under the ULR to preserve Ambac's tax attributes.
- Some NOLs were ''allocated'' to Ambac, which could use a portion of them free of charge but would have to pay a notional tax rate, based on a sliding scale, to AFG for using the remaining allocated NOLs.
- AFG was allocated a separate amount of Ambac's NOLs, which AFG could use free of charge. To the extent AFG used more than its allocated NOLs (in effect, dipping into the other pool of NOLs that had been reserved for Ambac's use), it would make a payment to Ambac equal to 50 percent of the notional federal income tax liability of AFG Subgroup that would have been owed by AFG if those NOLs had not been available.[15]

In sum, although the upfront payment turned out to be more modest than the amount originally requested, AFG had succeeded in forcing Ambac to pay a cash ransom and to surrender economic ownership of some NOLs, including an agreement to pay for Ambac's future use of those surrendered NOLs. According to more recent news reports, as of December 31, 2015, Ambac had already used up its

[12] *See* Ambac disclosure statement, *supra* note 7, at 49-50.

[13] *See generally id.* at 42-50.

[14] *See* First Amended Disclosure Statement of Ambac Financial Group Inc., *In re Ambac Financial Group Inc.*, No. 10-15973 (Bankr. S.D.N.Y. Sept. 21, 2011), at 41-55. *See also* Ambac Financial Group Inc., Current Report (8-K), Exhibit 1 (Mar. 14, 2012).

[15] *See* Ambac Financial Group Inc., Current Report (8-K), Exhibit 1 (Mar. 14, 2012).

''free'' NOLs and had incurred approximately $71 million of NOL usage payments under the TSA.[16]

D. A Parallel Case: FGIC

While the Ambac ambush was unfolding, a comparable consolidated group went through a similar experience. Fidelity Guaranty Insurance Co. (FGIC Sub) was a New York insurance company that also fell on hard times during the Great Recession. Its holding company parent, FGIC Corp. (FGIC Parent), filed a chapter 11 petition. Although the struggle between the two entities was less publicized than the Ambac case, the court filings reveal the following:

- FGIC Sub agreed to make a contribution of $11 million to FGIC Parent's bankruptcy estate for the benefit of holders of general unsecured claims;[17]
- in exchange for the contribution amount, FGIC Parent would assume an amended and restated TSA, under which FGIC Sub would control some of the tax attributes generated by the members of FGIC Parent's consolidated tax group;[18] and
- the amended TSA contained stringent negative covenants by FGIC Parent prohibiting any action that could impair the group's tax attributes, including deconsolidation or any adverse ULR election.[19]

Putting these pieces together, FGIC Sub's ''contribution'' was paid as part of a quid pro quo for FGIC parents agreeing not to impair its tax attributes.

E. The Takeaway: Obey Your Parents?

One may ask why the insurance regulators, along with other constituents allied with the insurance subsidiary, agreed to the settlements in the Ambac and FGIC cases. At first blush, the outcomes described above were unfavorable to the subsidiary. The parent was able to extract cash payments from the subsidiary by threatening to eviscerate its valuable tax attributes. Was there a way for the subsidiary to simply enjoin the parent from carrying out its threats?

Maybe not. The insurance regulator is not omnipotent. Although it certainly has broad powers over the insurance subsidiary and its potential actions or inactions (for example, distributing cash to the parent), it has far less power over the parent — which, in both cases, was not itself a regulated insurance company. As the OCI had stated in justifying its attempts to negotiate a compromise with AFG:

> OCI's arrangement with [AFG]'s bondholders seeks to protect NOLs against contingencies that are in the control of [AFG] and its creditors. . . . Ambac's ability to actually use the NOLs is limited, and therefore, OCI is exploring negotiation over a portion of the NOLs that it cannot use to the holding company in exchange for greater certainty that the NOLs it might be able to use will not be destroyed due to certain actions of the holding company's creditors in the [AFG] bankruptcy.[20]

However, a regulator may have the power to stop a transaction that is unfair to the insurance subsidiary. For example, N.Y. Ins. Law section 1505 requires that ''transactions within a holding company system to which a controlled insurer is a party'' have fair and equitable terms. Arguably, destroying or reattributing to the parent a subsidiary's NOLs could be viewed as an unfair affiliate transaction with the insurance company or an implicit dividend. If so, to combat alleged violations of section 1505, the New York State Department of Financial Services has broad powers to seek injunctions or to bring civil actions for damages.[21]

But it is far from clear that these powers extend to prohibiting a parent of a consolidated group from claiming a worthless stock deduction (which it is required to do in a timely fashion under the tax law) or exercising ULR elections it is entitled to make under the Treasury regulations, let alone affirmatively requiring that a particular ULR election be made. The parent could note that the existing TSA among the group members has already been approved by the regulator as fair and reasonable, and argue that the affiliate transaction in question was the execution of the TSA. If the existing TSA does not prohibit the parent from reattributing NOLs to itself in the case of a deconsolidation (or better yet, explicitly permits those actions or gives the parent broad discretion to make tax elections), the subsidiary may be hard-pressed to force the parent to amend the TSA or to read into it a prohibition that isn't there.

Further, the parent had an additional advantage in both the Ambac and FGIC cases: It was a debtor

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[16]*See* Ambac Financial Group Inc., Annual Report (10-K) (Dec. 31, 2015), at 46.

[17]Debtor's Motion for Entry of an Order Authorizing the Debtor to Enter Into the Plan Sponsor Agreement With Financial Guaranty Insurance Company, *In re FGIC Corporation*, No. 10-14215 (Bankr. S.D.N.Y. Feb. 3, 2012), at 3.

[18]*Id.* at 4.

[19]*See id.*, Exhibit A, at 7-8.

[20]*See* Tim Zawacki, ''Ambac Shareholders to Be 'in the Money' by $5B or More, Investor Claims,'' *SNL Insurance M&A* (Dec. 21, 2010).

[21]*See* N.Y. Fin. Serv. Law section 309; and N.Y. Ins. Law section 1510.

in a bankruptcy proceeding. Although a regulator could generally attempt to exercise its statutory powers to enjoin a parent from taking actions (or even affirmatively require a parent to take an action, for example, to make a favorable ULR election), the automatic stay generally shelters the parent in a chapter 11 proceeding from lawsuits and other hostile proceedings — except as permitted by the bankruptcy court charged with administering the debtor's case.[22]

Unlike the holding company parent, the insurance subsidiary in each case was in a state court rehabilitation proceeding. Thus, each of the warring parties was subject to the jurisdiction of a separate court, with the bankruptcy court overseeing solely the estate of the bankrupt parent and not necessarily being tasked with preserving the assets of the insurance subsidiary (except to the extent they may affect recoveries of the parent's creditors and shareholders). Because the parent's conduct being supervised by the bankruptcy court is required to be focused on maximizing recoveries for the parent's estate,[23] the insurance subsidiary's pleas for fairness may have fallen on deaf ears in that forum. Whatever was a good economic result for the parent might have been viewed as a proper outcome by the bankruptcy court.

Thus, unless the subsidiary trapped under a bankrupt parent can avail itself of the bankruptcy court's jurisdiction (as in *Prudential Lines*[24] and its progeny, discussed below), it might do no better in the next Ambac ambush case. For insurance companies and banks, filing a bankruptcy case is not an option as a matter of law.[25] One potential tactic for such a subsidiary may be to try forum shopping to win on its home court — for example, in a state court rehabilitation proceeding. In one recent case, a well-represented insurance subsidiary obtained a rehabilitation order in state court enjoining ''any action which might waste the property or assets'' of the subsidiary,[26] before the parent had even filed its bankruptcy petition. Then the bankruptcy court denied the parent's request for a declaratory judgment that it had a right to claim a worthless stock deduction, abandon the stock of the subsidiary, or both. Part of the bankruptcy court's reasoning was that the proposed actions could impair the subsidiary's NOLs and that the state court order prohibited such actions.[27]

Another mitigating tactic may be to negotiate a subsidiary-friendly TSA at the outset, including specific provisions governing deconsolidation and requiring the parent to make subsidiary-friendly ULR elections. But as noted above, a TSA is not bulletproof in light of the parent's ability to reject it after filing for bankruptcy.[28]

Finally, if all else fails, the subsidiary may just have to heed the age-old advice: Obey your parents.

II. The Tables Turned: A Bankrupt Subsidiary

Sometimes the shoe is on the other foot — the subsidiary is a debtor in bankruptcy court, fighting over tax attributes with a solvent parent. In these cases, the subsidiaries have done somewhat better against the parent.

A. *Prudential Lines*: A Subsidiary Rebellion

In the landmark case of *Prudential Lines*,[29] the parent (PSS) planned to do what AFG had threatened to do to Ambac: claim a worthless stock deduction for its bankrupt subsidiary (PLI) before that stock was officially wiped out in the bankruptcy restructuring. PLI, just like Ambac, would have suffered irreparable harm to its NOLs as a result: Section 382(g)(4)(D) would have deemed the subsidiary to undergo an ownership change, likely resulting in a section 382 limitation of zero for PLI's NOLs in the future.

The subsidiary fought back on its home turf — in bankruptcy court. The court enjoined PSS from claiming the deduction, and the Second Circuit affirmed. The rationale for the courts' decisions was that PLI's NOLs constituted property of the estate of the bankrupt subsidiary under section 541 of the Bankruptcy Code. Therefore, the bankruptcy court was empowered to prevent the parent from ''any act to obtain possession of property of the estate . . . or to exercise control over property of the estate.''[30]

Stepping back, it is far from clear that the *Prudential Lines* result is right. Why should a court be able to turn off a tax deduction that is allowed to the parent by the tax code? Indeed, the parent's tax return would be incorrect if it did not contain the

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[22]*See generally* 11 U.S.C. section 362; *but see* 11 U.S.C. section 362(b)(4) (some police and regulatory actions exempted from the automatic stay).

[23]*See* 11 U.S.C. sections 1106-1108; and *In re Brook Valley VII, Joint Venture*, 496 F.3d 892, 900-901 (8th Cir. 2007).

[24]*In re Prudential Lines Inc.*, 928 F.2d 565 (2d Cir. 1991).

[25]*See* 11 U.S.C. section 109(b)(2) and (b)(3) (not eligible to be a debtor under chapter 7); and 11 U.S.C. section 109(d) (not eligible to be a debtor under chapter 11).

[26]*See* Order of Rehabilitation, at 9, *Boron v. Triad Guaranty Insurance Corp.*, No. 12 CH 43895 (Cir. Ct. Cook County Dec. 11, 2012).

[27]*See* Order Denying Debtor's Motion for Summary Judgment on Counts VI and VIII of Its Complaint, *In re Triad Guaranty Inc.*, No. 13-11452 (Bankr. D. Del. June 13, 2014).

[28]*See generally* 11 U.S.C. section 365.

[29]928 F.2d 565.

[30]*Id.* at 573. *See* 11 U.S.C. section 362(a)(3).

deduction, and the IRS may well deny the deduction if the parent attempts to claim it in a later tax year, since the time to do so will have lapsed.

Although *Prudential Lines* remains the gold standard for a successful counterattack to preserve the subsidiary's tax attributes, similar cases have reached mixed results, even while the courts keep nodding to the principle that NOLs are property of the bankruptcy estate. For example, the mere use of a subsidiary's NOLs by other members of the consolidated group to offset the group's income, which occurs by virtue of the normal operation of consolidated group rules, has been repeatedly found unobjectionable.[31]

In several cases in which shareholders of bankrupt subchapter S corporations attempted to revoke the subchapter S election (to shield themselves from taxable income triggered by the bankruptcy restructuring while also potentially sticking the subsidiary with corporate tax liabilities), the subsidiaries had some success in challenging those revocations.[32] But the more recent decision of the Third Circuit in *Majestic Star Casino*[33] casts doubt on these cases and the scope of the *Prudential Lines* doctrine. There, a parent subchapter S corporation sought to revoke a bankrupt subsidiary's qualified subchapter S subsidiary (QSub) election and thereby convert the subsidiary from a disregarded entity into a standalone corporate taxpayer — again with the goal of shielding itself and its shareholders from taxable income triggered at the subsidiary level. The subsidiary predictably argued that its status as a nontaxpayer was its property and that the parent's revocation was an avoidable transfer under section 549 of the Bankruptcy Code. The Third Circuit, mildly questioning the soundness of *Prudential Lines*' reasoning, distinguished QSub status from NOLs and concluded that the QSub election was not property. The court said that even if it were property, it would be property of the parent, not the subsidiary. The Third Circuit noted that subchapter S status can terminate as a result of the nature of the company's shareholders and that it would require ''remarkable restrictions'' to prevent the shareholders from taking any actions that could terminate the election.[34]

B. EFH: Leaving the Parent to Pick Up the Tab?

In the still-pending bankruptcy proceeding of Energy Future Holdings Corp. (EFH), the bankrupt parent found itself in a quandary similar to that of the shareholders of bankrupt subchapter S corporations discussed above. Most of EFH's subsidiaries are limited liability companies treated as disregarded entities for federal income tax purposes. Thus, as a tax matter, the LLCs do not exist and EFH is deemed to directly hold their assets and liabilities.

However, the LLCs very much exist for corporate purposes and have their own stand-alone debt facilities. Some of the LLCs are insolvent, with their secured creditors out of the money. A potential restructuring involving an asset foreclosure (or a credit bid asset purchase, treated similarly for tax purposes) — in which the creditors would take possession of the assets of these LLCs or 100 percent of the equity interests in the LLCs — would be treated as a taxable disposition by EFH of its assets in partial extinguishment of its debt. Because the assets have low tax basis compared with their value, this transaction would trigger billions of dollars of taxable gain for EFH under section 1001, which, unlike cancellation of indebtedness income, could not be sheltered from taxation under section 108. As a result, EFH would be facing a staggering tax bill that it cannot pay, while the secured creditors abscond with the LLCs and their assets. To add insult to EFH's injury, the creditors would likely obtain a full step-up in tax basis of the LLCs' assets as a result of that transaction.[35]

A discussion of what claims or other tools, if any, the IRS or EFH might have against the LLCs or their creditors is largely beyond the scope of this report. (The group had a TSA that generally purported to treat LLCs as corporations.[36]) Suffice it to say that as a general matter, a disregarded entity such as an LLC is still respected as a separate legal entity for nontax purposes and is not considered liable for its parent's obligations, including taxes — absent some veil-piercing or similar argument in favor of ignoring its separate legal existence.[37] Further, nothing in the code makes an LLC directly liable to the IRS for its owner's tax liabilities. In sum, it is far from clear that

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[31]*See, e.g., Nisselson v. Drew Industries Inc. (In re White Metal Rolling and Stamping Corp.)*, 222 B.R. 417 (Bankr. S.D.N.Y. 1998); and *In re Marvel Entertainment Group Inc.*, 273 B.R. 58 (D. Del. 2002).

[32]*See, e.g., Guinn v. Lines (In re Trans-Lines West Inc.)*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996); *Parker v. Saunders (In re Bakersfield Westar Inc.)*, 226 B.R. 227 (Bankr. 9th Cir. 1998); and *Hanrahan v. Walterman (In re Walterman Implement Inc.)*, 2006 WL 1562401 (Bankr. N.D. Iowa 2006).

[33]*Majestic Star Casino LLC v. Barden Development Inc. (In re Majestic Star Casino LLC)*, 716 F.3d 736 (3d Cir. 2013).

[34]*See id.* at 760.

[35]*See* Omnibus Tax Memorandum, at 6-9, 12-15, *In re Energy Future Holdings Corp.*, No. 14-10979 (Bankr. D. Del. Oct. 1, 2014).

[36]*See id.* at 19-20.

[37]*See, e.g.*, ILM 200338012; ILM 200235023; and ILM 199930013.

the LLCs — let alone the creditors — could be tagged with the tax liabilities triggered by a foreclosure. And even if these parties were liable for some or all of these taxes, EFH would also be liable. So EFH was rightfully concerned with the creditors' threat to foreclose on the LLCs in a taxable restructuring.

The standoff between EFH and the creditors of its LLC subsidiaries was, in some ways, the reverse of the Ambac ambush. Instead of the parent threatening to eviscerate the subsidiary's tax attributes by deconsolidating from it, here the subsidiaries' stakeholders in effect threatened the parent with triggering an enormous tax bill by taking away the subsidiaries from the parent. The subsidiaries had little to lose by deconsolidating from EFH, because they were disregarded. They had no tax attributes such as NOLs and arguably would not be liable for taxes caused by their departure. Instead, divorcing EFH in a taxable transaction could have been beneficial to the creditors by creating a new tax attribute — a step-up in asset basis in the hands of the subsidiaries and their new owners.

The parent responded with a threat to check the box on the LLCs under reg. section 301.7701-3. In other words, the parent would elect to convert them into entities treated as corporations for federal income tax purposes, therefore making them jointly and severally liable for the consolidated group's taxes triggered by the potential restructuring. EFH cited *Majestic Star Casino* as arguably permitting that maneuver.[38]

It remains unknown whether the resulting IRS administrative claim against the subsidiary for post-petition taxes under section 503(b)(1)(B) of the Bankruptcy Code would have generated any recovery, as compared with the impaired class of secured creditors, especially if creditors had pursued a foreclosure on the LLCs' assets. (However, the mere presence of an IRS claim could have made it more time-consuming to conclude a bankruptcy proceeding.) It's also unclear why checking the box on the subsidiaries would have made life much better for EFH because — as the parent of the group — it still would have been the first in line to face the resulting tax bill from the IRS. Unlike the shareholders in *Majestic Star Casino*, here the parent could not use the check-the-box election to shield itself from the subsidiaries' tax liabilities: The taxable income from LLC foreclosures would have rippled up the chain and triggered a tax liability for the entire consolidated group. Instead, by converting its subsidiaries into corporations, the parent would merely be expanding the universe of entities potentially liable for the tax bill, without getting off the hook itself. Finally, the very act of checking the box could have triggered tax liabilities to EFH.[39] The final outcome could have resembled the last scene in the movie *Reservoir Dogs*, in which (spoiler alert!) everyone gets shot.

Fortunately for themselves (and frustratingly for legal scholars), the parties appear to have worked out a deal. EFH's recently confirmed plan of reorganization proposes a structure that would avoid a taxable disposition of the LLCs or their assets. Instead, the parties have agreed to pursue a restructuring that attempts to package the assets of some debtor LLCs into newly formed corporations and deliver the stock of those corporations, along with other consideration, to the creditors in a mostly tax-free reorganization under sections 355 and 368(a)(1)(G). Nevertheless, a portion of the asset transfer would be structured as a taxable transaction (sheltered with NOLs at EFH), delivering a partial basis step-up to the spun-off subsidiaries.[40] Thus, EFH would avoid a devastating cash tax bill, while the creditors would receive corporate subsidiaries containing "their" assets with a partial basis step-up.

The lesson of EFH, assuming the current plan of reorganization is consummated, is that bankrupt subsidiaries and their creditors can turn the tables on the parent by threatening to take actions that trigger massive tax liabilities or the reduction of tax attributes detrimental to the parent. For example, the subsidiary can do so by selling assets, or by simply incurring cancellation of indebtedness income that is not completely sheltered by its tax attributes and therefore can reduce NOLs of other group members. This threat seems even more effective when the subsidiary itself is a disregarded entity that may be indifferent to the income tax consequences of its actions.

C. Amputating the Subsidiary

Confronted with a rebellious subsidiary that is threatening to incur tax liabilities and sink the parent's ship, what is a parent to do? One potential remedy, which can also function as a threat — as shown above in the Ambac case — is to deconsolidate from the subsidiary. This may not always be feasible or painless for the parent, especially if the subsidiary is a disregarded entity holding assets with built-in gain (as was the case for EFH) or if the parent has an excess loss account in the subsidiary's stock that would trigger taxable gain to the parent under reg. section 1.1502-19. However, depending

[38] *See* EFH tax memorandum, *supra* note 35, at 20-21.

[39] *See id.* at 21.

[40] *See* Sixth Amended Joint Plan of Reorganization of Energy Future Holdings Corp., *In re Energy Future Holdings Corp.*, No. 14-10979 (Bankr. D. Del. Dec. 7, 2015).

on the facts, divorcing a hostile subsidiary may still be a lifesaving amputation for the rest of the group.

Pegasus Communications Corp. (PCC) faced this scenario when its subsidiaries, headed by Pegasus Satellite Communications Inc. (PSC), filed a bankruptcy petition on June 2, 2004, and consummated some asset sales at the end of the following month. PCC later informed the debtor-subsidiaries that it intended to treat PSC as no longer eligible to join a consolidated group with PCC effective January 1, 2004.[41]

The parent was able to take this route because PSC had a class of preferred stock owned by third parties, which apparently accounted for more than 20 percent of the fair market value of PSC's equity. On July 1, 2003, before the tax year in which PSC's meltdown began, its preferred stock became voting stock because of dividend arrearages. This caused PSC to fail to meet the affiliation test under section 1504(a)(2).[42] Although Notice 2004-37, 2004-1 C.B. 947, possibly allowed PCC in these circumstances to continue treating PSC as a consolidated group member in the absence of specific ''designated events,'' it also allows a consolidated group to take the position that consolidation has ended, effective as of the first day of the tax year (in this case, 2004) for which that position is taken.

Aside from potentially shielding PCC and the rest of its consolidated group from the tax consequences of PSC's bankruptcy, the deconsolidation could have harmed the debtor-subsidiaries' NOLs. Those NOLs amounted to approximately $900 million. Unfortunately, it appeared that the PCC group had undergone an ownership change under section 382, resulting in the imposition of an annual limitation on the NOLs.[43] More ominously, the default rule under the consolidated group regulations regarding section 382 is that the group left behind by the departing subsidiary retains the group's entire section 382 limitation, as well as any of its net unrealized built-in gain within the meaning of section 382(h)(3) and any resulting increases in the section 382 limitation. The departing subsidiary gets none of these NOL-saving section 382 attributes unless the parent elects to apportion some of them to the departing subsidiary.[44] Therefore, absent an election by PCC to do something different, PSC and other departing subsidiaries would have inherited worthless NOLs subject to a section 382 limitation of zero.

Of course, PSC could always make *Prudential Lines* arguments against a forced deconsolidation or in favor of some equitable apportionment of the group's section 382 attributes. Alas, we will never know how the courts would have held because the parties reached a settlement. The final deal, blessed by the bankruptcy court, featured an agreement by both sides to (1) treat PSC as deconsolidated effective January 1, 2004; and (2) apportion specific amounts of the group's section 382 limitation and net unrealized built-in gain to PSC.[45] As in the case of EFH, it seems that neither side was eager to have the courts resolve a complex fight involving many moving tax pieces.

Although this case featured unique facts, the general question ''Is it worth deconsolidating?'' should always be examined by both sides in an intragroup tax dispute. Among the most recent examples is *In re Triad Guaranty Inc.*, in which the bankrupt parent sought permission to abandon the stock of its insurance company subsidiary. So far the parent's attempts have been unsuccessful,[46] but the issue remains pending on appeal. As a policy matter, one may ask why a parent must remain locked into a dysfunctional family. But, by analogy to real families, we don't allow parents to abandon their children willy-nilly, either.

III. 'My Refund!' 'No, *My* Refund!'

A. Background

Another classic battleground between parents and subsidiaries in a distressed consolidated group is a struggle for ownership of tax refunds that are received from a tax authority while one or both of the parties is a debtor in a bankruptcy proceeding. The typical fact pattern involves a bankrupt parent holding company and a subsidiary that may or may not be in bankruptcy (or a receivership proceeding, if it is a bank or an insurance company). The parent, as the agent for the consolidated group, typically receives all IRS refunds.[47]

For the sake of simplicity (the actual facts are often less clear-cut), let's assume that the refund is entirely traceable to the subsidiary: The original tax payment that is being refunded was triggered by taxable income of the subsidiary and was funded by

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[41]*See* Debtors' Motion to Approve Stipulation and Order Pursuant to 11 U.S.C. sections 105(a) and 505(a) and Bankruptcy Rule 9019, at 3-5, *In re Pegasus Satellite Television Inc.*, No. 04-20878 (Bankr. D. Me. Apr. 18, 2005).

[42]*See* Transcript of Hearing on Motion to Approve Stipulation and Motion for Expedited Hearing, at 13-14, *In re Pegasus* (May 4, 2005).

[43]*See id.* at 16-17.

[44]*See* reg. section 1.1502-95(a)(2) and (c).

[45]*See* Stipulation and Order, at 4-7, *In re Pegasus*, No. 04-20878 (Apr. 14, 2005).

[46]*See* Order Denying Debtor's Motion for Summary Judgment on Counts VI and VIII of Its Complaint, *In re Triad Guaranty Inc.*, No. 13-11452 (Bankr. D. Del. June 13, 2014).

[47]*But see* discussion of section 6402(j), *infra* at Section III.C.

that subsidiary, and the loss carryback that is now permitting the group to claim a refund is also attributable to the subsidiary. Assume further that the subsidiary is entitled to a payment (equal to or greater than the amount of the IRS refund) under the TSA as a result of its loss carryback because a TSA typically requires the parent to pay the subsidiary when the subsidiary's losses are used by the group or when the subsidiary could have carried back the loss to obtain a refund on a stand-alone basis. Who should get the IRS refund?

This fact pattern was the subject of frequent litigation during the Great Recession, some of which continues to this day.[48]

The key question, to which the courts have given inconsistent answers, is whether the parent should be viewed as receiving the refund in its capacity as (1) the owner of the refund (the owner theory) or (2) an agent for the subsidiary (the agent theory). The answer usually determines whether the subsidiary can recover the entire refund or, at best, a mere fraction of it.

1. Parent as owner. This theory, which is favorable to the parent and its creditors, means that the cash is part of the parent's bankruptcy estate and thus is subject to the claims of the parent's various creditors. To recover any portion of it, the subsidiary would need to pursue a claim against the parent under the TSA. The problem for the subsidiary is that a TSA claim is typically a general unsecured claim in the bankruptcy waterfall, ranked below the secured creditor and various priority claims.[49] It is common for a general unsecured claim to recover cents on the dollar or sometimes nothing at all. Further, to the extent a confirmed bankruptcy plan of reorganization requires the general unsecured class of creditors to accept a haircut or some form of currency other than cash (for example, the parent's stock), all members of the class are typically subject to the same treatment and can be bound if the class consent threshold is met.[50]

2. Parent as agent. This theory, always argued by the subsidiary and its constituents such as banking or insurance regulators, postulates that the parent does not own the cash received from the IRS — rather, the subsidiary does. The parent is a mere agent for its subsidiaries, collecting cash from the IRS on behalf of the rightful owners. Thus, the cash does not belong in the parent's bankruptcy estate, and there is no need for the subsidiary to struggle with the other creditors for a share of the refund. Instead, the entire refund simply must be turned over to the subsidiary. The agent theory is often framed as an interpretation of the TSA, but failing that, other arguments (for example, constructive trust and similar theories) are often advanced for the basic proposition that it would be unfair to allow the parent to retain the refund.

B. Case Law

The linchpin for most courts' analyses of these conflicting theories is the Ninth Circuit's landmark *Bob Richards* decision.[51] Notably, the subsidiary demanding the refund was in bankruptcy, but the parent was not. The group did not have a TSA in place. Thus, the subsidiary had the home-field advantage — it was a debtor in bankruptcy court. Further, the court was deciding the outcome on a clean slate, not constrained by any contractual arrangement between the parties. Although the subsidiary won, it was the court's reasoning that shaped the landscape for many future cases to come:

> Normally, where 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*. But in the instant case the parties made no agreement concerning the ultimate disposition of the tax refund. *Absent any differing agreement* we feel that a tax refund resulting solely from offsetting the losses of one member of a consolidated filing group against the income of that same member in a prior or subsequent year should inure to the benefit of that member. Allowing 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.[52]

This principle — that in the absence of a TSA, the subsidiary should get the refund that can be traced to its tax attributes — has been upheld in several subsequent cases.[53] But what should be the outcome

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[48]According to some estimates, as of November 2013, there were between 50 and 70 lawsuits pending in U.S. courts on the issue of tax refund ownership. *See* Christopher Brown, "Attorney: Bank Failures in Financial Crisis Highlight Role of Tax-Sharing Agreements," 226 *DTR* G-7 (Nov. 22, 2013).

[49]*See generally* 11 U.S.C. sections 506, 507, 726, and 1129(a)(7).

[50]*See* 11 U.S.C. sections 1126(c) (a class of claims is deemed to accept its treatment in a plan if holders of two-thirds in amount and more than half in number of claims in that class vote in favor); 1129(b)(2)(B) (plan can be imposed on a nonconsenting class of unsecured claims, subject to some conditions).

[51]*See Western Dealer Management Inc. v. England (In re Bob Richards Chrysler-Plymouth Corp.)*, 473 F.2d 262 (9th Cir. 1973).

[52]*Id.* at 264-265 (emphasis added) (citations omitted).

[53]*See, e.g.*, *Capital Bancshares v. FDIC*, 957 F.2d 203 (5th Cir. 1992); and *In re Revco D.S. Inc.*, 111 B.R. 631 (Bankr. N.D. Ohio 1990).

if there is a TSA among the parties? Curiously, as described below, most courts have seized upon the *Bob Richards* holding being limited to situations in which no TSA exists. They have used that as a reason to justify a decision against the subsidiary and in favor of the owner theory when a TSA existed and required payment to the subsidiary, even though *Bob Richards* (1) does not purport to answer any TSA-related question and (2) states a general rule in favor of the subsidiary. Because a TSA is typically supposed to protect a subsidiary from an abusive parent, it is counterintuitive for a subsidiary with a TSA to lose, even though a subsidiary without a TSA would clearly win under *Bob Richards*.[54] Nevertheless, this is the state of the law, although several recent decisions have bucked the trend.

For a while, the key court decision in a case in which a TSA existed was *Franklin Savings*.[55] The subsidiary, a savings and loan association in distress, had been taken over by the Resolution Trust Corp. (RTC), an instrumentality of the United States. The subsidiary incurred losses, resulting in IRS refunds of approximately $10.2 million to the group. The RTC and the subsidiary claimed ownership of the refund. The parent filed a bankruptcy petition and succeeded in having the dispute determined in bankruptcy court. Thus, unlike the facts in *Bob Richards*, here the parent was playing on its home court.

The court acknowledged *Bob Richards* but noted that the holding in that case hinged on the absence of a TSA. The court then focused on the TSA, which used terms such as ''reimbursements'' and ''credits'' to the subsidiary to describe payments owed by the parent:

> These terms are inconsistent with the argument that [the subsidiary] ''owns'' the refunds. ''Reimburse'' means ''to pay back.'' . . . The use of this term is consistent with a ''debt'' or ''receivable,'' rather than ownership. If the parties considered the refund to be property of [the subsidiary], they could have provided for its ''return'' to [the subsidiary]. . . . In short, under the terms of the agreements, [the subsidiary] holds only an unsecured claim, not ownership of the refunds.[56]

The court went on to reject other claims of the subsidiary and RTC that were based on the fiduciary duty and constructive trust doctrines.[57] The court's rationale, and in particular its reliance on language regarding ''reimbursement,'' became the standard for many court decisions across the United States that followed.

In *First Central Financial*,[58] a similar, subsequent case in which both the parent and the subsidiary were in bankruptcy, the owner theory again yielded victory for the parent. Importantly, the court noted that the TSA did not require any segregation of IRS refunds for the benefit of the subsidiary and did not contain any language creating an agency relationship. The TSA did not mention IRS refunds at all, instead focusing on payments owed by the parent to the subsidiary under intercompany tax computations. Based on these facts, the court concluded that the parent (1) owned the IRS refund and (2) separately had a contractual obligation to pay a specified amount to the subsidiary. The court also rejected the subsidiary's arguments invoking reg. section 1.1502-77(a) (which designates the parent as the agent for the group vis-à-vis the IRS), noting that it is well settled that this regulation is purely procedural and does not resolve the question of ownership of the tax refund.[59]

Together, *Franklin Savings* and *First Central Financial* are a blueprint for a successful owner theory argument in favor of the parent in most cases in which a TSA exists, and they have been followed by many courts.[60] A typical TSA does not address IRS refunds directly because actual payments to and from the IRS are usually irrelevant for an intercompany tax sharing scheme. The relevant calculation is that of the subsidiary's stand-alone tax liability or refund, regardless of what happens at the group level vis-à-vis the IRS. Therefore, payments owed under a TSA to a subsidiary would not normally depend on the receipt of an IRS refund or the amount

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[54]*See also* Gordon D. Henderson and Stuart J. Goldring, *Tax Planning for Troubled Corporations*, para. 806.2.4 (2015) (''It seems anomalous that a corporation which had obtained a contract right should be worse off in bankruptcy than one which had done nothing in this regard.'').

[55]*Franklin Savings Corp. v. Franklin Savings Ass'n (In re Franklin Savings Ass'n)*, 159 B.R. 9 (Bankr. D. Kan. 1993), *aff'd*, 182 B.R. 859 (D. Kan. 1995).

[56]*Id.* at 29.

[57]*See id.* at 29-33.

[58]*Superintendent of Ins. for the State of New York v. First Central Financial Corp. (In re First Central Financial Corp.)*, 269 B.R. 481 (E.D.N.Y. 2001), *aff'd*, 377 F.3d 209 (2d Cir. 2004).

[59]*See id.*, 269 B.R. at 489. *Accord In re Bob Richards*, 473 F.2d at 264.

[60]*See, e.g.*, *FDIC v. Siegel (In re IndyMac Bancorp Inc.)*, 554 Fed. App'x 668, 670 (9th Cir. 2014); *Sharp v. FDIC (In re Vineyard National Bancorp)*, 508 B.R. 437 (Bankr. C.D. Cal. 2014); *Giuliano v. FDIC (In re Downey Financial Corp.)*, 499 B.R. 439 (Bankr. D. Del. 2013), *aff'd sub nom.*, 593 Fed. App'x 123 (3d Cir. 2015); and *Imperial Capital Bancorp Inc. v. FDIC (In re Imperial Capital Bancorp Inc.)*, 492 B.R. 25 (S.D. Cal. 2013), *aff'd*, 593 Fed. App'x. 123 (3d Cir. 2015). *But see Cohen v. Un-Ltd. Holdings Inc. (In re Nelco Ltd.)*, 264 B.R. 790 (Bankr. E.D. Va. 1999) (finding a TSA ambiguous and holding in favor of the subsidiary under the *Bob Richards* doctrine).

of that refund. Rather, the subsidiary simply gets paid when it would have received a refund from the IRS if it had been a stand-alone taxpayer, regardless of whether the parent has obtained any refund from the IRS. Accordingly, a TSA is often silent about payments to or from the IRS, does not prescribe any rules for what should happen to IRS refunds after they are received, and instead focuses on payments between the parent and the subsidiary.

In effect, the owner theory cases interpret this silence regarding the first leg of the cash flow (from the IRS to the parent), coupled with ''reimbursement'' or ''payment'' language describing the second leg (from the parent to the subsidiary), to mean that the parent must be the owner of the refund received in the first leg because (1) there are two separate legs of the transaction, which are not mutually interdependent or necessarily equal in amount; (2) the subsidiary is not directly involved in the first leg; and (3) the second leg appears to be a debtor-creditor relationship.[61]

Another early decision supporting the owner theory that relied on the analysis of *Franklin Savings* and *First Central Financial* was *Team Financial*.[62] In addition to reciting the usual arguments in favor of the parent, the bankruptcy court rejected agent theory arguments that relied on the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure (the 1998 Interagency Statement),[63] stating that this policy guidance does not have the force of law.

The parents' winning streak was stopped during the Great Recession, when the trickle of refund ownership disputes turned into a flood. In the Eleventh Circuit, a couple of cases produced a subsidiary-friendly result. In *BankUnited Financial*,[64] the TSA was a bit unusual because the subsidiary bank, not the parent, paid all taxes to the IRS and was supposed to distribute IRS refunds to other group members. Thus, it was unclear whether the TSA contemplated two separate legs of cash flows for this subsidiary. Further, the Eleventh Circuit (reversing the bankruptcy court, which had held in favor of the parent) interpreted silence as beneficial to the subsidiary:

> [The TSA] is ambiguous in two respects: first, [it] does not state when the Holding Company must forward the tax refunds to the Bank, and second, it does not explain whether the Holding Company ''owns'' the refunds before forwarding them to the Bank.
>
> * * *
>
> Although the TSA does not contain a provision expressly requiring the Holding Company to forward the tax refunds to the Bank on receipt, it is obvious to us that this is what the parties intended. . . . A debtor-creditor relationship is created by consent, express or implied. We find no words in the TSA from which it could reasonably be inferred that the parties agreed that the Holding Company would retain the tax refunds as a company asset and, in lieu of forwarding them to the Bank, would be indebted to the Bank in the amount of the refunds.[65]

Notably, the Eleventh Circuit reached this ''obvious'' result despite acknowledging that the TSA was ambiguous and that it contained the usual language about reimbursements of intercompany tax receivables, which other courts have found dispositive in favor of the parent.

A few weeks later, the Eleventh Circuit doubled down in a similar case, *NetBank*[66] (once again reversing a lower court decision that had sided with the parent and the owner theory). Here the rationale for the subsidiary's victory on appeal was somewhat different. The TSA stated that it was intended to be consistent with the 1998 Interagency Statement and that intercompany tax payments should ''result in no less favorable treatment to the [subsidiary] than if it had filed its income tax return as a separate entity.''[67] Finding the TSA ambiguous, the court decided the 1998 Interagency Statement

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[61]For a classic recitation of this interpretation, see *Sharp*, 508 B.R. at 442: ''The TSA . . . entitles the Bank to payment even if the consolidated group did not receive a refund so long as it would have received a refund if the Bank had filed a separate tax return. . . . The Debtor would have owed the Bank sums it did not receive from the IRS if the Bank were entitled to receive a refund based on a separate return. This is indicative of a debtor-creditor relationship because it established the Debtor's obligation irrespective of whether a refund was obtained.''

[62]*In re Team Financial Inc.*, 2010-1 U.S.T.C. para. 50374 (Bankr. D. Kan. 2010).

[63]*See* 63 F.R. 64757 (Nov. 23, 1998). The 1998 Interagency Statement recommended the following standard for TSAs that include banking and savings institutions as subsidiaries: A ''parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members. Accordingly, an organization's tax allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.'' *Id.* at 64759 (citations omitted).

[64]*BankUnited Fin. Corp. v. FDIC (In re BankUnited Fin. Corp.)*, 462 B.R. 885 (Bankr. S.D. Fla. 2011), *rev'd sub nom., Zucker v. FDIC (In re BankUnited Fin. Corp.)*, 727 F.3d 1100 (11th Cir. 2013).

[65]*Zucker v. FDIC*, 727 F.3d at 1107-1108.

[66]*FDIC v. Zucker (In re NetBank Inc.)*, 729 F.3d 1344 (11th Cir. 2013).

[67]*See id.* at 1348.

cited therein was the tiebreaker, and it held in favor of the subsidiary and the agent theory.

However, contemporaneous decisions in other circuits quickly added victories to the parents' side of the ledger. The Ninth Circuit, in a terse opinion in *IndyMac Bancorp*, upheld a lower court decision in favor of the owner theory, stating that (1) the TSA did not establish an agency relationship because the subsidiary did not exercise control over the parent's activities; (2) the absence of language creating a trust relationship suggested a debtor-creditor relationship; and (3) the parent was not prohibited from using funds for its own purposes or commingling funds.[68] The court was aware of the contrary Eleventh Circuit decision in *NetBank* but distinguished it as based on Georgia law and the 1998 Interagency Statement, which was not mentioned in the TSA in question.[69] A lower court decision in *Vineyard National Bancorp*[70] distinguished the Eleventh Circuit cases on similar grounds, finding the TSA in its case unambiguous and noting that the 1998 Interagency Statement is a nonbinding policy statement that must not be given significant weight.

Soon thereafter, the Third Circuit also came down on the side of the owner theory in *Downey Financial*,[71] upholding a lengthy lower court decision in favor of the parent. Finally, the Sixth Circuit offered a glimmer of hope for the agent theory in *AmFin Financial*,[72] reversing a lower court decision in favor of the parent because the TSA was ambiguous and remanding the case for further fact-finding with a suggestion that either agency or a resulting trust would be possible outcomes.

C. What Can the Regulators Do?

The rash of recent court decisions, most of them upholding the owner theory (including the lower court opinions in *BankUnited Financial* and *NetBank* before the Eleventh Circuit came to the rescue on appeal), alarmed the federal banking regulators. In response, on December 19, 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively, the regulators) proposed an addendum to the 1998 Interagency Statement,[73] which was finalized on June 19, 2014.[74] No longer relying on mere policy guidance and recommendations for how a TSA should be drafted, the 2014 addendum stated that bank holding company groups that include insured depository institutions (IDIs) should amend their existing TSAs to incorporate language supporting the agent theory:

> Consolidated Groups should ensure the agreements (1) clearly acknowledge that an agency relationship exists between the holding company and its subsidiary IDIs with respect to tax refunds, and (2) do not contain other language to suggest a contrary intent. In addition, all Consolidated Groups should amend their tax allocation agreements to include the following paragraph or substantially similar language:
>
> > The [holding company] is an agent for the [IDI and its subsidiaries] (the ''Institution'') with respect to all matters related to consolidated tax returns and refund claims, and nothing in this agreement shall be construed to alter or modify this agency relationship. If the [holding company] receives a tax refund from a taxing authority, these funds are obtained as agent for the Institution. Any tax refund attributable to income earned, taxes paid, and losses incurred by the Institution is the property of and owned by the Institution, and shall be held in trust by the [holding company] for the benefit of the Institution. The [holding company] shall forward promptly the amounts held in trust to the Institution. Nothing in this agreement is intended to be or should be construed to provide the [holding company] with an ownership interest in a tax refund that is attributable to income earned, taxes paid, and losses incurred by the Institution. The [holding company] hereby agrees that this tax sharing agreement does not give it an ownership interest in a tax refund generated by the tax attributes of the Institution.[75]

The regulators further stated that they ''expect institutions and holding companies to implement fully [the 2014 addendum] as soon as reasonably possible, which the Agencies expect would not be later than October 31, 2014.''[76] Finally, the 2014 addendum also stated that TSAs not complying with these requirements may constitute a loan or

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[68] *See FDIC v. Siegel (In re IndyMac Bancorp Inc.)*, 554 Fed. App'x 668, 670 (9th Cir. 2014).

[69] *See id.* at 670-671.

[70] *See In re Vineyard National Bancorp*, 508 B.R. at 443-446.

[71] *See Giuliano v. FDIC (In re Downey Financial Corp.)*, 499 B.R. 439 (Bankr. D. Del. 2013), *aff'd sub nom.*, 593 Fed. App'x 123 (3d Cir. 2015).

[72] *See FDIC v. AmFin Financial Corp.*, 757 F.3d 530 (6th Cir. 2014).

[73] *See* 78 F.R. 76889.

[74] 79 F.R. 35228.

[75] *Id.* at 35230.

[76] *Id.* at 35228.

extension of credit from the bank subsidiary to the holding company parent and, as such, may be subject to the collateralization and other requirements of section 23A of the Federal Reserve Act.[77]

Time will tell whether the 2014 addendum can put an end to the wave of tax refund litigations, at least as far as the banking industry is concerned. The 1998 Interagency Statement was not specific enough and was widely ignored,[78] resulting in many cases described above in which the TSA did not contain language favorable to the subsidiary. The 2014 addendum is a more serious shot across the bow, but its effectiveness will ultimately depend on the regulators' ability and desire to enforce it, especially when it comes to forcing companies to amend existing TSAs. At a minimum, a consolidated group drafting a new TSA and seeking regulatory approval for it would be hard-pressed to omit the recommended language. In at least one instance when the magic language was present, the court held in favor of the agent theory.[79]

Another tool available to the regulators is reg. section 301.6402-7, issued under section 6402(j). These rules permit the IRS to issue a consolidated group's tax refunds attributable to losses of an insolvent financial institution directly to a statutory or court-appointed fiduciary of that institution (such as the FDIC or the RTC), and to deal directly with either the common parent or that fiduciary (which is also authorized to act as agent for the group) regarding the tax years involved in the refund claim.[80]

These rules are merely procedural; they govern payment and receipt of the tax refund but do not resolve the question of the refund's ownership — and the Treasury regulations themselves make that clear.[81] However, possession of the cash — while not quite "90 percent of the law" in this case — obviously cannot hurt, even while one is litigating a dispute over its ownership.

Finally, if all else fails, a subsidiary that anticipates a dispute with its parent involving a tax refund can reject the TSA if it contains unfavorable language and attempt to take advantage of the default agent theory rule of *Bob Richards*. As mentioned above, this technique may be available in a bankruptcy proceeding (assuming the subsidiary is not a bank or insurance company or otherwise ineligible to be a debtor in a bankruptcy case) or if applicable rules for a receivership or rehabilitation proceeding allow the subsidiary or its regulator to repudiate existing contracts.

IV. Conclusion

Family strife among members of a consolidated group involves unique tax pitfalls and opportunities. There are few ironclad rules, and the case law is often confusing and inconsistent. The war stories described above suggest the following checklist for members of a dysfunctional consolidated group family:

- Are you a parent or a subsidiary? Generally, parents have the advantage. Note that the parent typically holds the keys to the preparation of the consolidated tax return and any tax elections. Usually, but not always, the parent is also the recipient of IRS refunds for the group.
- Do you have tax attributes that your adversary can harm (for example, by claiming a worthless stock deduction or triggering taxable income for which you would be jointly liable)? On the flip side, is there any similar action you can take that would harm other members of the group? This may determine your leverage — or lack thereof.
- Are you a debtor in a bankruptcy proceeding? Is your affiliated adversary also in bankruptcy? Is any entity prohibited from filing for bankruptcy? If you are a debtor, you will most likely want the dispute to be adjudicated by your bankruptcy court and to claim that your tax attributes (or the IRS refund that just showed up in the mail) are property of the estate.
- If you are a bank or an insurance company that cannot file for bankruptcy but are in a receivership proceeding, can you adjudicate the dispute in that proceeding? Can your regulator take any administrative action on your behalf to enjoin the group from harming your tax attributes?
- Does your group have a TSA? Is the language favorable to you? If not, can you reject the TSA before it's too late?
- Is deconsolidation favorable to you? Regardless of the answer, is it even possible to keep the group together (for example, if the subsidiary is deeply insolvent and will undoubtedly be taken over by its creditors)?
- If keeping the group together is both possible and advisable, stop fighting and try to reach a deal. Ultimately, it may be best to keep it all in the family.

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[77] *See* 12 U.S.C. section 371c(c).

[78] *See* Lee G. Zimet, "New Guidance Requires Banks to Review Tax Sharing Agreements," *Tax Notes*, Jan. 12, 2015, p. 241.

[79] *See Lubin v. FDIC*, 2011 U.S. Dist. Lexis 21391 (N.D. Ga. 2011).

[80] *See* reg. section 301.6402-7(a).

[81] *See* reg. section 301.6402-7(j).