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Developing a Strategy for a Failing Company

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§101 DEVELOPING A PLAN

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As a company begins to approach a failing condition, management strategy should include a plan to deal with creditors when and if the time comes that the company will be unable to pay its obligations as they fall due. The plan should include a decision as to whether the company should seek concessions from creditors without resorting to proceedings under the Bankruptcy Code, or whether the makeup of its creditor and stockholder groups suggests that resort to the Bankruptcy Code may be necessary. As the troubles of the company become apparent to the creditors, they, too, should reach a decision on this point. The considerations involved in choosing between a bankruptcy or a nonbankruptcy proceeding are discussed beginning at §201.

§102 AVOIDING TOO MUCH BUSINESS SHRINKAGE

The strategy for the company should include a plan for preserving its NOLs, capital loss carryovers, ITC carryovers, and foreign tax credit carryovers. Although the company may need to pare down operations in order to save expenses, and it may have to sell off assets in order to pay debts, the company should be careful not to wind down its activities so far as to jeopardize its ability to preserve these tax attributes in the event of a restructuring of its capital or the consummation of an acquisitive transaction. A severe shrinkage of the company's activities may make it difficult or impossible for the company later to surmount the hurdles for survivability of these attributes that are raised by Code §§269, 382 and 383. These provisions are discussed later in this volume.

In addition, the company should be careful in its planning to avoid speculating about the possibility of engaging in a two-company reorganization, as opposed to an

internal recapitalization, until it becomes clear that this must be done to save the company. As discussed below in the chapter dealing with two-company reorganizations, the IRS has developed the ruling policy that it will begin to measure the "substantially-all-assets" test and certain aspects of the "continuity-of-interest" test for tax-free reorganizations from the time the company first decides to embark on a two-company, rather than an internal, approach to restructuring. Premature planning for a two-company transaction may therefore have the perverse result of eventually making it impossible for the company to satisfy these tests by the time the company is finally ready to launch the transaction.

§ 103 AVOIDING LIABILITY FOR EMPLOYMENT TAXES

A company suffering cash flow problems typically becomes slow in paying its liabilities even before it reaches the point where it cannot pay its obligations as they become due. Management will keep current on those liabilities that as a practical matter cannot be delayed, such as wages, but will fall behind on other items that seem less pressing. In these circumstances, there is a temptation for management to fall behind in paying payroll taxes withheld from its employees. If this occurs, the company may eventually reach the point where it does not have enough cash to pay over the withheld amounts to the appropriate levels of government.

This should be avoided. Penalties can be severe. Code § 7501 states that all taxes collected or withheld are to be considered held in trust for the benefit of the United States. Code § 7202 provides that a person who is required to collect and pay over taxes and who willfully fails to do so is guilty of a felony and can be fined up to $10,000 or imprisoned for up to five years, or both. Under Code § 7215, a person who fails to make withholding tax deposits may be guilty of a misdemeanor and fined not more than $5,000 or imprisoned for not more than one year or both. Code § 6672 provides a civil penalty—equal to 100 percent of the taxes withheld—on any person responsible for collecting the tax who willfully fails to collect it or truthfully account for and pay it over.[1] A penalty of up to 15 percent is imposed by Code § 6656 for the

[1] **§ 103** The liability for employment taxes arises at the time of withholding, not at the time the withheld amount is due for payment. Consequently, a responsible person cannot avoid the penalty by resigning prior to the date the taxes are due. *See, e.g.*, *Brown v. United States*, 591 F.2d 1136, 79-1 U.S.T.C. ¶ 9285 (5th Cir. 1979); *Long v. Bacon*, 239 F. Supp. 911, 65-1 U.S.T.C. ¶ 9289 (S.D. Iowa). A three-year statute of limitations on assessments generally applies for purposes of the Code § 6672 penalty—Action on Decision CC-1996-006, July 15, 1996; *see also* Code § 6672(b)(3), as added by the Taxpayer Bill of Rights 2 (referencing statute of limitations under Code § 6501)—and, effective July 1, 1996, no Code § 6672 penalty generally may be assessed unless the IRS first provides a notice of proposed assessment. Code § 6672(b). Where, however, the company is subject to an unlimited assessment period for its employment tax liability—as in the case of fraud—the IRS takes the position that an unlimited assessment period similarly applies for purposes of the related Code § 6672 penalty. IRS Chief Counsel Advice 200532046, June 30, 2005, *reprinted at* 2005 TNT 156-12.

For a further discussion of the Code § 6672 100 percent penalty, particularly where the debtor has filed for bankruptcy under Chapter 11, *see* §§ 1006.3, 1006.3.2 and 1014 in Chapter 10. *See also* Hertz, Personal Liabilities of the Unsuspecting Executive for Penalties Under Section 6672 and Other Nightmares, 32 Inst. on Fed. Tax'n 1171 (1974).

failure to deposit taxes when due in an appropriate government depository. In addition to these penalties, interest can be imposed on the underpayment.

For possible actions that the debtor company might take—either before filing a bankruptcy petition or in a bankruptcy plan—that might help relieve responsible persons of the 100 percent civil penalty, *see* §§1006.3.2 and 1016.2 below.

§104 POTENTIAL CREDITOR LIABILITY FOR DEBTOR'S WITHHOLDING TAXES

As a failing business moves from bad to worse, creditors may find themselves taking on major responsibilities relating to the control and management of the business. If this is done in the wrong way, the creditor will run the risk of having its claims subordinated to those of other creditors and of becoming subject to liability for unpaid withholding taxes of the debtor.

Where a lender, surety, or other person who is not the employer with respect to an employee or group of employees pays wages directly to the employee or group of employees, or to an agent on their behalf, it will have personal liability to the United States under Code §3505 for the taxes (with interest) required to be withheld from such wages.[1] Moreover, if the lender, surety, or other person supplies funds to or for the account of the employer for the specific purpose of paying wages and has actual notice or knowledge that the employer will not make timely payment or deposit of the required withholding amounts, it will be personally liable for the withheld taxes (together with interest), although in this instance its liability is limited to 25 percent of the amount it supplied to the employer for this purpose.[2] A creditor's liability under

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[1] **§104** Code §3505(a). Code §6303(a) generally requires the Commissioner to give notice of an assessment, within 60 days after making it, to each person liable for the unpaid tax. However, in *Jersey Shore State Bank v. United States*, 87-1 U.S.T.C. ¶9131, 107 S. Ct. 782 (1987), the Supreme Court held that the IRS is not required by Code §6303(a) to give notice of an assessment for unpaid withholding taxes against an employer to a creditor potentially liable under Code §3505 for "a sum equal to" the unpaid tax. *See* Note, Jersey Shore State Bank v. United States: Lender Liability and Notice—When a Summons Is Enough, 7 Va. Tax Rev. 179 (1987); Note, Taxation: Lender Liability Under I.R.C. §3505(a), 39 Okla. L. Rev. 348 (1986) (pre-Supreme Court decision).

For a more detailed discussion of Code §3505, *see, e.g.*, Saltzman, IRS Practice and Procedure, 17.11 (Rev. Second Edition); Goldring & Mayo, Lenders Beware: Potential Liability for Unpaid Employment Taxes, 4 J. Bank Tax'n #1 (Fall 1990); Makel & Chadwick, Lender Liability for a Borrower's Unpaid Payroll Taxes, 43 Bus. Law. 507 (1988); Winston, Lender's Liability for Borrower's Unpaid Employment Taxes, 46 Tex. B.J. 1253 (1983); explanation at Stand. Fed. Tax Rep. (CCH) ¶35,006. *See also* Douglas-Hamilton, When Are Creditors in Control of Debtor Companies, 26 Practical Law No. 7, pp. 61, 70-72 (1980) (hereafter Douglas-Hamilton, Creditors in Control); Douglas-Hamilton, Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor, 31 Bus. Law. 343 (1975).

[2] Code §3505(b); *see, e.g., United States v. Park Cities Bank & Trust Co.*, 481 F.2d 738, 73-2 U.S.T.C. ¶9503 (5th Cir. 1973) (Code §3505 penalty imposed on bank where bank approved overdrafts, the proceeds of which were deposited in a payroll account from which the employer failed to withhold); *In re Brandt-Airflex Corp.*, 87-1 U.S.T.C. ¶9194, 69 B.R. 701 (Bankr. E.D.N.Y. 1987), *rev'd on other grounds*, 78 B.R. 10 (E.D.N.Y. 1987), *aff'd* 843 F.2d 90 (2d Cir. 1988) (held that lender was liable under Code §3505(b) where the lender approved overdrafts for the payment of net wages but "bounced" employer's checks for the payment of withholding taxes); *United States v. Swiftships, Inc.*, 1995 U.S.

these provisions does not relieve the debtor of its responsibility for any unpaid withholding taxes, except to the extent of amounts actually paid by the creditor.[3]

The IRS may institute collection proceedings against a creditor under these provisions any time within ten years after assessment of the *employer's* tax.[4] Because the employer's tax must generally be assessed within three years after the filing date of its employment tax return (which is treated as occurring no earlier than April 15 of the succeeding calendar year to which the return relates), this means that the collection proceeding against the lender may be brought more than 13 years after the original liability for the tax arose.[5] There is a conflict in the courts as to whether the lender's collection period is further extended automatically by any period for which the employer's statute of limitation on collection is tolled or extended, such as by the automatic stay in bankruptcy or by the employer's agreement to extend the statute of limitations.[6]

Creditors should make special note of these provisions and be certain that, in the circumstances described therein, the withheld taxes are paid to the appropriate taxing authority.[7] Even beyond these particular circumstances, however, creditors (and even prospective purchasers) who take over practical control of the failing company may find that they have become subject to the civil and criminal provisions, discussed

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(Footnote Continued)

Dist. LEXIS 17643, 76 A.F.T.R.2d (P-H) 8006 (E.D. La. 1995) (Code § 3505(b) imposes no duty on a lender to investigate outside of its own organization).

[3] Code § 3505(c); *In re Brandt-Airflex Corp.*, *supra* note 2.

[4] Reg. § 31.3505-1(d)(1) (effective August 1, 1995, the collection period was increased from six to ten years to be consistent with the general statute of limitations for collections); Code § 6502(a) and Reg. § 301.6502-1 (statute of limitations for collection extended from six to ten years, effective for all taxes for which the limitations period had not expired by November 5, 1990). *See also United States v. R.C. Ziegler Co., Inc.*, 76 A.F.T.R.2d ¶ 95-5339 (W.D. Wash. 1995) (rejected IRS position that the collection period under Code § 3505 should be interpreted as coterminous with general statute of limitations for collections prior to the effective date of the change in the regulations).

[5] *See* Code § 6501 (a) and (b)(2); *O'Hare v. United States*, 878 F.2d 953, 89-2 U.S.T.C. ¶ 9436 (6th Cir. 1989).

[6] *Compare United States v. Harvis Construction Co.*, 857 F.2d 1360, 88-2 U.S.T.C. ¶ 9524 (9th Cir. 1988) (lender's collection period not extended), *with United States v. Associates Commercial Corp.*, 721 F.2d 1094, 83-2 U.S.T.C. ¶ 9689 (7th Cir. 1983) (extended; viewed absence of any statement in the regulations to parallel suspensions as an oversight). *See also United States v. Olympic Savings and Loan Ass'n*, 677 F. Supp. 1079 (W.D. Wash. 1988) (employer's agreement to extend the statute of limitations on collection of employment withholding taxes also bound lender liable for such taxes under Code § 3505, even though the lender received no notice of the agreement). A similar debate exists with respect to the assessment period for the 100 percent penalty imposed on responsible persons under Code § 6672. *See* IRS Chief Counsel Advice 200532046 (June 30, 2005), *reprinted at* 2005 TNT 156-12.

[7] In this regard, it should be noted that even a late payment of withholding taxes by a company on the eve of bankruptcy is not regarded as a voidable preference in bankruptcy. *See Begier, Jr. v. IRS*, 110 S. Ct. 2258 (1990), discussed in Chapter 10 at § 1005.2. Moreover, even if the company is in bankruptcy, the company may be able to obtain the court's permission to pay such withholding taxes or, as part of a plan of reorganization, direct that such withholding taxes be paid before other prepetition tax claims. *See United States v. Energy Resources Co.*, 110 S. Ct. 2139 (1990), discussed in Chapter 10 at § 1016.2.

above at § 103, that are applicable to responsible corporate officers and other responsible persons, including the 100 percent civil penalty under Code § 6672.[8]

It should be noted that Code § 6672, which imposes a civil penalty on "responsible persons" of 100 percent of the taxes that should have been withheld, does not mention interest. Thus, it has been held that under this provision the "responsible person" has no liability for interest on the unpaid withholding taxes to the extent that it accrues between the date that the employer's tax should have been paid and the date on which the IRS assesses the penalty against the "responsible person."[9] In contrast, Code § 3505, which applies to lenders, mentions interest for such period and makes the lenders to which it applies liable for such interest as well. Moreover, it has

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[8] *See, e.g.*, *Commonwealth Nat'l Bank of Dallas v. United States*, 665 F.2d 743, 82-1 U.S.T.C. ¶ 9149 (5th Cir. 1982) (Code § 6672 100 percent penalty imposed on creditor, even though creditor's employees did not manage debtor corporation); *Merchants Natl. Bank of Mobile v. United States*, 878 F.2d 1382, 89-2 U.S.T.C. ¶ 9511 (11th Cir. 1989) (same); *Pacific Natl. Ins. Co. v. United States*, 422 F.2d 26, 70-1 U.S.T.C. ¶ 9238 (9th Cir. 1970), *cert. denied* (Code § 6672 100 percent penalty imposed on surety where surety approved wage payments to employees and declined to advance funds for the payment of withheld taxes, even though surety approved and funded payments to nonemployee creditors); *United States v. Vaccarella*, 735 F. Supp. 1421, 90-1 U.S.T.C. ¶ 50,305 (S.D. Ind. 1990), *aff'd sub nom. United States v. Security Pacific Business Credit, Inc.*, 956 F.2d 703, 92-1 U.S.T.C. ¶ 50,125 (7th Cir. 1992) (lender, rather than corporate officers, was liable under Code § 6672 and under Code § 3505(b) where the lender had complete control of the debtor's finances through a lock-box system, exercised veto power over funding requests, directed that other creditors be paid before the IRS, funded net wages through wire transfers directly into the debtor's payroll account, and knew that the debtor had no other source of funds to pay the withholding tax); *Mercantile Bank of Kansas City v. United States*, 856 F. Supp. 1355, 94-2 U.S.T.C. ¶ 50,379 (W.D. Mo. 1974) (Code § 6672 liability *not* imposed, even though bank had the ability to exercise discretionary control over payments and had knowledge that tax payments were not made, because the bank never in fact exercised such control); *United States v. North Side Deposit Bank*, 83-2 U.S.T.C. 9503 (W.D. Pa.) (Code § 6672 100 percent penalty and, alternatively, Code § 3505(b) penalty imposed on bank where funds continued to be lent even after bank directed debtor to have its receivables paid directly to the bank, a bank officer was appointed to manage the receivables, and bank's officers knew of the debtor's inability to continue paying payroll taxes and did not intend to clear any further checks for such taxes); *Caterino v. United States*, 794 F.2d 1, 86-1 U.S.T.C. ¶ 9452 (1st Cir.), *cert. denied*, 107 S. Ct. 1347 (1987) (upheld imposition of Code § 6672 100 percent penalty against the president/principal stockholder of the purchaser of a troubled company, where evidence supported the finding that the president had the "ability to significantly determine the flow and disbursements of funds" of the troubled company and it was undisputed that, having knowledge of the unpaid withholding taxes, the president consciously disregarded his obligation to pay them; the president had arranged or guaranteed substantial loans to the troubled company, was instrumental in installing a new general manager of the troubled company and, as evidenced by an employee's mailing of the withholding tax returns of the troubled company to him for his review, was deferred to regarding management decisions); *United Siding Supply Inc. v. United States*, 95-1 U.S.T.C. ¶ 50,269 (N.D. Okla. 1995) (100 percent penalty imposed on creditor who, pursuant to collateral protection order, had authority to determine which of debtor's creditors would be paid); *Clouse v. United States*, 87-2 U.S.T.C. ¶ 9595 (D. Mich.) (granted IRS motion for judgment notwithstanding the verdict and imposed Code § 6672 100 percent penalty on an employee/principal creditor/minority shareholder who had a "significant voice" in management, co-signed checks on several occasions, received substantial sums in payment of obligations due him, and, given his knowledge of the company's financial position and his experiences as a former 80 percent shareholder of the company's predecessor, should have inquired if any withholding taxes were owing). *See also* Saltzman, *supra* note 1, at ¶ 17.08(2)(a); Makel & Chadwick, *supra* note 1; Hertz, *supra* § 103 note 1, at 1178; Winston, *supra* note 1; Douglas-Hamilton, Creditors in Control, *supra* note 1; Lundgren, Liability of a Creditor in a Control Relationship with Its Debtor, 67 Marq. L. Rev. 523 (1984).

[9] *See United States v. Security Pacific Business Credit, Inc.*, *supra* note 8.

been held that the government can maximize its recovery by recovering the unpaid tax from a "responsible person" and recovering the interest on the unpaid tax from a lender under Code § 3505.[10]

An interesting variation from the approach taken in the foregoing authorities can be found in an IRS Chief Counsel Advice[11] dealing with a situation where a factor had purchased wage claims from employees of a bankrupt company. Pointing to Code § 3401(d)—which provides that if the person for whom the individual performs services does not have control of the payment of wages for such services, the term "employer" means a person having control of the payment of wages—the Chief Counsel held that the factor had become the "employer" and was liable for the withholding of income and employment tax and the payment of the employer's FICA and FUTA taxes on the payments (which presumably were less than the face amount of the wage claims themselves) that it actually made to the employees, and that the debtor would not be obligated to withhold or pay taxes on any payments that it might make of these wages to the factor (even if these payments equaled the face amount of the wage claims).

The issuer of a performance bond to protect a contractor against default by a subcontractor has been held not to be liable for the defaulting subcontractor's federal and state employment taxes.[12] The contractor was the only beneficiary of the performance bond; the federal and state tax authorities were neither stated nor implied beneficiaries.

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§ 105 CREDITOR BAD DEBT DEDUCTIONS

Creditors of a failing business will generally want to take appropriate bad debt deductions at as early a date as possible.[1] The amount and timing of the deductions will depend on whether the creditor takes a partial or a complete worthlessness deduction. The creditor who fails to take adequate bad debt deductions may find itself faced with a capital, rather than an ordinary, loss when the debt of the failing business is eventually restructured. As mentioned below at § 502.4, however, bad

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[10] Id. In this case, the bank was found to be both a "responsible person" under Code § 6672 and a lender liable under Code § 3505(b). The IRS was allowed to recover the full amount of the unpaid tax from the bank under Code § 6672, and the interest on the unpaid tax from the date the tax was due under Code § 3505(b). The 25 percent limit contained in Code § 3505(b) applied in this case only to the recovery of the unpaid interest.

[11] IRS Chief Counsel Advice 200019009, February 7, 2000, *reprinted at* 2000 TNT 94-99.

[12] *Island Ins. Co. v. Hawaiian Foliage & Landscape Inc.*, 2000 U.S. Dist. LEXIS 16749 (D. Hawaii 2000).

[1] **§ 105** *See generally* Blanchard, Jr., Bennett and Speer, The Deductibility of Investments in Financially Troubled Subsidiaries and Related Federal Income Tax Considerations, 80 Taxes 91 (2002). Where the creditor was induced to purchase the security by fraudulent representations, the loss might be deductible as a theft loss rather than as a bad debt deduction. Rev. Rul. 71-381, 1971-2 C.B. 126. However, mere decline in value of a security caused by illegal acts of corporate officers will not convert the investor's loss into a theft loss. *Mehdi Taghadoss*, T.C. Memo 2008-44. For the timing of bad debt deductions or theft losses, *see Johnson v. United States*, 80 Fed. Cl. 96, 2008-1 U.S.T.C. ¶ 50,142 (2008); Chief Counsel Advice 200811016, June 22, 2007.

debt deductions may cause any stock received in exchange for the debt to be treated as Code § 1245 property to the extent of such deductions.

An exception to the foregoing advice may apply where the creditor is, or expects to become, a stockholder while still being a creditor. If the creditor in such a situation were to write down the debt and then later contribute the debt to the capital of the debtor, the debtor could have cancellation of debt consequences under Code § 108 that the parties might wish to avoid. In addition, special considerations may apply where the debtor and creditor are members of the same consolidated group (*see* § § 508.2.4, 804.2, and 804.4).

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