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Section 1129(d)'s Firm Stance: The Effect of Reorganization as a Vehicle for Tax Avoidance

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Recently, in *In re South Beach Securities, Inc.*, the Seventh Circuit affirmed the old adage that a bankruptcy court could not confirm a chapter 11 plan when the plan's sole purpose is designed to make use of the debtor's net operating losses (NOLs) as a tax benefit for the creditor.[1] The plan intended to obtain a tax deduction for the debtor's sole creditor through the plan.[2] In a scolding opinion by Judge Posner, the court held that the plan violated of section 1129(d), and therefore, was proposed in bad faith.[3] Section 1129(d) states that a plan cannot be confirmed when its *principal purpose* is tax avoidance.[4]

The Seventh Circuit, in no uncertain terms, noted that section 1129(d) requires courts to reject a plan whose sole purpose is to avoid taxes.[5] This is not limited to the *debtor's* tax avoidance;[6] creditors cannot use a plan solely for tax avoidance either.[7] Here, the creditor sought to obtain the tax benefit from the debtor's NOLs.[8] NOLs provide an opportunity for a taxpayer to offset past or future income[9] by applying a tax loss as a deduction against past or future income.[10] NOLs are triggered in a year that the taxpayer has income. When NOLs are involved in reorganization, presumably the tax benefit would inure to the creditors who are treated as owners.[11] Thus, creditors may seek to gain a tax benefit through reorganization.

Under the plan, the creditor would infuse capital into the shell corporation debtor after emergence from chapter 11. The capital infusion would trigger the debtor's existing NOLs as a deduction and the tax benefit would inure to the benefit of the creditor as owner of the reorganized debtor. The court explained that in this particular situation, the plan could not be confirmed because the creditor tried to obtain a tax benefit by manipulating the rules of bankruptcy.[12] While this may seem like a clear-cut case for denying plan confirmation, there are situations where creditors will not be penalized for taking advantage of tax benefits through reorganization.[13] A debtor may be able to transfer those tax benefits if the debtor is trying to preserve the business as a going concern.[14] However, if the main purpose of the plan is tax avoidance, it is not in accordance with the policies behind reorganization and may be rejected.[15]

Under the Seventh Circuit's ruling, tax avoidance, as the principal purpose of reorganization, is a serious violation of the Bankruptcy Code.[16] In fact, it is so serious that the Seventh Circuit invited the U.S. Trustee to move for sanctions.[17] The court stated, "[t]he object of bankruptcy is to adjust the rights of the creditors of a bankrupt company; it is not to allow a solvent company to try to lighten its tax burden."[18] Normally practitioners would think that section 1129(d) applies to debtors in the context of tax avoidance, but[i] the Seventh Circuit's holding stretches section 1129(d)'s application to creditors as well. Tax benefits may still be available in chapter 11. A plan must have other stated purposes besides tax avoidance in order to get those benefits. If the plan does not have another purpose besides that of tax avoidance, a practitioner may be sanctioned for filing such a plan.

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[1] 606 F.3d 366 (7th Cir. 2010). *See also* 11 U.S.C. § 1129(d) (2006) (rejecting plan confirmation if *the* principal purpose of the plan is to avoid taxes).

[2] *In re* South Beach Secs., Inc., 606 F.3d 366. 372–73 (7th Cir. 2010).

[3] *See id.* at 376.

[4] *See id*. ("[W]e know that a plan of reorganization may not be confirmed if that is its principal purpose…).

[5] *See South Beach*,606 F.3d at 376.

[6] *See id.* at 374; *see also In re* Luster, 981 F.2d 277, 279 (explaining debtor's NOLs could be transferred through reorganization).

[7] *See South Beach*, 606 F.3d at 375; *In re Luster*, 981 F.2d at 279.

[8] *See South Beach*, 606 F.3d at 375; *see also* 26 U.S.C. § 382(l)(5) (2006) (allowing debtor to transfer NOL through chapter 11 plan).

[9] *See* 7 Mertens L. of Fed. Income Tax'n § 29:1 (2010).

[10] *See id.* (explaining that a taxpayer has a loss

[11] *See South Beach*, 606 F.3d at 375–76.

[12] *See id.* at 376.

[13] *See* 26 U.S.C. § 382(l)(5); *see also South Beach*, 606 F.3d 375.

[14] *See South Beach*, 606 F.3d 376.

[15] *See id*.

[16] *Id.* at 378.

[17] *Id.*

[18] *Id.* at 376.