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The Nature of a Parent-Subsidiary Relationship Determines How to Allocate a Refund in a Tax Sharing Agreement

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Introduction

Often, a parent corporation and its subsidiaries will file a consolidated tax return because it comes with many benefits, such as being able to offset gains and losses and deferring tax consequences for sales between consolidated groups.[1] The parent corporation and the subsidiaries will often enter into a tax sharing agreement, which will determine each entity's respective tax liability. In the event that a refund is issued, the tax sharing agreement will usually dictate how to allocate the refund amongst the parent and the subsidiaries.

A tax sharing agreement is "an agreement among members of an affiliated group of entities that file consolidated or combined tax returns that allow for the allocation or apportionment of certain tax attributes among affiliates."[2] State law determines the "validity and interpretation" of the tax sharing agreement.[3] In particular, the plain language of the tax sharing

[1] "The most notable advantage of filing a consolidated return is that the loss from one member can be used to offset the income of the other members of the consolidated group. Another advantage relates to intercompany transactions, specifically gains on intercompany sales. A sale of property between members of a consolidated group generally has no immediate tax effect for either corporation. Any gain is deferred until certain events occur, usually the property's transfer to a nonmember. This is advantageous because the tax on this gain is deferred until this event occurs. In addition, the capital gains of one member can be used to offset the capital losses of another member in the current tax year." Amy T. Whittington, *Back to Basics: Consolidated Tax Returns,* Executive's Tax and Management Report (last visited April 16, 2015), http://tax.cchgroup.com/images/fot/backtobasics.pdf.
[2] 11-TX12 Collier on Bankruptcy P TX12.05
[3] 11-TX11A Collier on Bankruptcy P TX11A.09

agreement will determine its "validity and interpretation." The parties to the tax sharing agreement are free to allocate the rights of the tax benefits amongst themselves.[4] A tax sharing agreement may allocate the tax benefits by explicitly stating which entity is entitled to the tax benefits under the tax sharing agreement or by implicitly relying on the past relationship of the parties.[5] Most tax sharing agreements explicitly provide how to allocate the tax benefits amongst the affiliated group.[6] However, "these agreements often differ in their precise language, and these differences can be critical" to determining the rights of each party.[7] Although the IRS will return the tax refund to one entity initially, the tax sharing agreement will determine how the tax refund will be distributed amongst the parent corporation and its subsidiaries.

The language of the tax sharing agreement will create relationships that will determine which entity owns the tax refund. The types of relationships formed are generally a debtor-creditor, agency, or trust relationship. On one hand, if a debtor-creditor relationship was created under the tax sharing agreement, a tax refund is "considered to be 'owned' by the entity receiving it."[8] Some courts have found that words such as "payments" and "reimbursements" will create a debtor-creditor relationship.[9] However, on the other hand, at least two circuit courts have recently rejected such an analysis.[10] Those circuit courts stated that those words do not indicate a debtor-creditor relationship was formed between the parent corporation and the subsidiary.[11] If a debtor creditor relationship was not created in the tax sharing agreement, courts

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[4] *See* 11-TX12 Collier on Bankruptcy P TX12.05; *see also* FDIC v. Siegel (*In re* IndyMac Bancorp, Inc.), 554 Fed. Appx. 668, 669–70 (9th Cir. 2014).
[5] Id.
[6] Philip D. Anker & Nancy L. Manzer, *How 11th Circ. Muddied The Law On Bank Tax Refunds,* Law 360 (Sept. 6th, 2013), http://www.law360.com/articles/470442/how-11th-circ-muddied-the-law-on-bank-tax-refunds.
[7] *Id.*
[8] 11-TX12 Collier on Bankruptcy P TX12.05.
[9] *See* FDIC v. AmFin Fin. Corp., 757 F.3d 530 (6th Cir. 2014); *see also* Zucker v. FDIC (*In re* BankUnited Financial Corp.), 727 F.3d 1100 (11th Cir. 2013).
[10] *See AmFin Fin. Corp.*, 757 F.3d 530; *see also In re BankUnited Financial Corp.*, 727 F.3d 1100.
[11] *See AmFin Fin. Corp.*, 757 F.3d 530; *see also In re BankUnited Financial Corp.*, 727 F.3d 1100.

will generally determine that an agency or trust relationship was formed. If the court determines that an agency or trust relationship exists, the entity that receives the tax benefit will be considered to be holding the benefit in trust of the other entity.[12]

This Article is separated into two parts. Part I discusses the different results when the tax sharing agreement is either explicit, silent, or ambiguous as to who owns a tax refund between a parent corporation and its subsidiary. Part II summarizes the implications of the conflicting court decisions regarding tax sharing agreements.

I. Resulting Relationships of Tax Sharing Agreements

When determining whether a parent or a subsidiary owns all or a part of a tax refund pursuant to a tax sharing agreement, a court will examine the agreement's plain language.[13] On one hand, if the tax sharing agreement explicitly states how and when a parent corporation will disperse a tax refund (either in part or in whole), the agreement's plain language will determine which party "owns" the tax refund.[14] On the other hand, if a tax sharing agreement does not explicitly state who may claim a portion of the tax refund,[15] the court must determine, by examining extrinsic evidence, the nature of the relationship between the parent company and its subsidiaries.[16] The court will likely hold that the entity that receives the tax refund from the IRS owns the tax refund if the court determines that the tax sharing agreement created a debtor-creditor relationship between the parties.[17] Alternatively, the court will likely hold that the entity

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[12] 11-TX12 Collier on Bankruptcy P TX12.05.
[13] FDIC v. AmFin Fin. Corp., 757 F.3d 530, 535 (6th Cir. 2014) (citing *Alexander v. Buckeye Pipe Line Co*., 53 Ohio St. 2d 241, 374 N.E.2d 146, 150 (Ohio 1978)).
[14] See *In re* IndyMac Bancorp, Inc., 2012 Bankr. LEXIS 1462. In *In re IndyMac Bancorp Inc*, the tax sharing agreement specifically stated when the parent corporation would disburse funds from a tax refund to subsidiaries and whether they had to do it at all. *See id.*
[15] See Zucker v. FDIC (*In re* BankUnited Financial Corp.), 727 F.3d 1100 (11th Cir. 2013).
[16] FDIC v. AmFin Fin. Corp., 757 F.3d 536 (6th Cir. 2014).
[17] *In re* IndyMac Bancorp, Inc., 2012 Bankr. LEXIS 1462. When determining whether a debtor-creditor relationship exists, courts look to the tax sharing agreement to see if there are " protection[s] for the creditor [bank] that would

that does not receive the refund owns the tax refund if the court determines that the tax sharing agreement creates a trust or agency relationship between the parties. The entity that does not receive the refund owns the refund in a trust or agency relationship because the entity that receives the refund would only have legal title to the refund with the other entity holding beneficial title.

A. Debtor-Creditor Relationship

A tax sharing agreement will create a debtor-creditor relationship if the agreement contains language that provides protections for the creditor in order to guarantee repayment for the creditor. For example, in *In re IndyMac Bancorp*[18], the Ninth Circuit held that the tax sharing agreement clearly indicated that a debtor-creditor relationship had been created. In that case, the tax sharing agreement provided that the parent corporation would pay the tax liabilities for the entire consolidated group.[19] The tax sharing agreement further provided that each of the subsidiaries must then pay their respective tax liabilities to the parent corporation.[20] Under the terms of the tax sharing agreement, the parent also had the "sole discretion" to determine whether to provide any subsidiary with its respective tax refund or whether to use such refund as a credit for future tax payments.[21] The tax sharing agreement also provided for payments or reimbursements from the parent corporation to its subsidiary if the subsidiary suffered losses that would have entitled it to a refund had it filed a separate tax return.[22]

This language clearly established which entity was liable for the tax liability and which entity will own the tax refund when the parent corporation receives the refund. Specifically, the

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help guarantee the debtor [parent company's] obligation, such as a fixed interest rate, a fixed maturity date, or the ability to accelerate payment upon default." *AmFin Fin. Corp.*, 757 F.3d at 535.
[18] FDIC v. Siegel (*In re* IndyMac Bancorp, Inc.), 554 Fed. Appx. 668 (9th Cir. 2014).
[19] *In re* IndyMac Bancorp, Inc., 2012 Bankr. LEXIS 1462 at 42.
[20] *Id.*
[21] *Id.*
[22] *Id.*

IndyMac Bancorp[23] court stated that the tax sharing agreement "clearly adjust[ed] the parties' ultimate tax liability."[24] In particular, the court stated that the tax sharing agreement "expressly stated the circumstances under which the parent corporation would disburse refunds to the group and gave the parent corporation discretion as to whether to distribute the refunds at all."[25] This express language in the tax sharing agreement created a debtor-creditor relationship between the parent corporation and its subsidiary. The court also stated that the tax sharing agreement did not create a principle-agency relationship or a trust relationship and that "the absence of language creating a trust relationship is explicitly an indication of a debtor-creditor relationship in California."[26]

Similarly, in *Superintendent of Insurance v. Ochs (In re First Central Financial Corp.*),[27] a parent corporation filed for bankruptcy and its bank subsidiary was placed in FDIC receivership. In *First Central*, the parent corporation and the bank subsidiary had entered into a tax sharing agreement that stated how tax refunds were to be distributed among the parties.[28] The tax sharing agreement also "provided that if any tax refunds were generated, [the bank subsidiary] was entitled to receive at least the amount that it could have claimed on its own behalf had it filed individual returns and claimed refunds on a stand alone basis."[29] After receiving a tax refund, the parent corporation's bankruptcy trustee refused to turn over the refund to the bank subsidiary as due in the tax sharing agreement, arguing that the refund belonged to

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[23] *Id.*
[24] *Id.* at 670
[25] *AmFin Fin. Corp.*, 757 F.3d at 534.
[26] *In re* IndyMac Bancorp, Inc., 554 Fed. Appx. at 670
[27] Superintendent of Ins. v. Ochs (*In re* First Cent. Fin. Corp.), 377 F.3d 209 (2nd Cir. 2004).
[28] *Id.* at 211.
[29] *Id.* at 209.

parent corporation's bankruptcy estate.[30] The bank subsidiary argued that the refund was held in trust for the bank subsidiary and that it is not part of the parent corporation's bankruptcy estate.

The bankruptcy court in *First Central* ruled that the bank subsidiary did not own the portion of the tax refund because the parties' tax sharing agreement merely created a debtor-creditor relationship between the parent corporation and the bank subsidiary.[31] The district court affirmed the bankruptcy court's ruling that the bank subsidiary did not own a portion of the tax refund.[32] The Second Circuit stated that "to the extent that [the bank subsidiary] was entitled to any portion of the refund, the [b]ankruptcy [c]ourt's ruling effectively required it to pursue the funds as an unsecured creditor in the bankruptcy proceedings."[33] First, the Second Circuit stated that a trust or agency was not created because "it did not require the refund to be segregated or restricted in use."[34] Second, the Second Circuit went on to state that a constructive trust was not allowed because under New York law, the relationship was governed by a written agreement.[35] The Second Circuit opined that there was no constructive because the four elements of a constructive trust were not satisfied as governed by New York Law.[36] As a result of a trust and an agency relationship not being created, the court concluded that there was a debtor-creditor relationship and the subsidiary would have to pursue the refund as an unsecured creditor.[37]

B. Agency or Trust Relationship

A tax sharing agreement could create an agency or trust relationship if the there is an absence of language creating an express debtor-creditor relationship. If the language of the tax

[30] *Id.*
[31] *Id.*
[32] Ochs v. Lipson, 2000 U.S. Dist. LEXIS 22005 (E.D.N.Y. Mar. 2, 2000)
[33] Superintendent of Ins. v. Ochs (*In re* First Cent. Fin. Corp.), 377 F.3d 209, 212 (2nd Cir. 2004).
[34] *Id.*
[35] *Id.*
[36] *Id.* ("New York law generally requires four elements for a constructive trust: (1) a confidential or fiduciary relationship; (2) a promise, express or implied; (3) a transfer of the subject res made in reliance on that promise; and (4) unjust enrichment).
[37] *Id.*

sharing agreement created a trust or an agency relationship, then the subsidiary will be entitled to have the parent corporation forward or return the refund to the subsidiary. For example, in *Zucker v. FDIC (In re BankUnited Financial Corp.)*,[38] the tax sharing agreement did not state when the holding company would have to forward the tax refund to the subsidiaries.

BankUnited involved a tax sharing agreement between a parent corporation and its bank subsidiary.[39] The tax sharing agreement stated that the parent would pay the all of the taxes that were due, and within thirty days of such payment, each subsidiary or the parent corporation would reimburse the bank subsidiary for a portion of the tax payment that was attributed to such subsidiary or the parent corporation.[40] The tax sharing agreement also stated that within thirty days of filing the tax refund, the banking subsidiary would pay each of the subsidiaries and the parent corporation any tax refund it expected or was entitled to receive.[41]

On May 29, 2009, the subsidiary was placed into an FDIC receivership. On the following day, the parent corporation filed for bankruptcy under chapter 11 of the Bankruptcy Code.[42] Both the banking subsidiary and the parent corporation requested a tax refund from the IRS for the two previous fiscal years.[43] After the IRS sent the refund to the parent corporation, the parent corporation retained the refund, arguing that it was entitled to retain such funds as an asset of its estate instead of forwarding the refunds to the FDIC for distribution to the other subsidiaries as provided in the tax sharing agreement.[44] The FDIC responded by filing a claim in the chapter 11 proceeding claiming that they were entitled to the refunds in order to comply with their

[38] Zucker v. FDIC (*In re* BankUnited Financial Corp.), 727 F.3d 1100 (11th Cir. 2013).
[39] *Id.*
[40] *Id.* at 1103.
[41] *Id.*
[42] *Id.*
[43] *Id.* at 1103.
[44] *Id.*

contractual obligations under the tax sharing agreement.[45] The bankruptcy court determined that the refunds were assets of the parent corporation's estate and that the FDIC was only entitled to an unsecured claim for the refunds.[46] The parties thereafter requested the bankruptcy court to certify its judgment for appeal to the Eleventh Circuit. The Eleventh Circuit granted their request and logged the appeal.

The Eleventh Circuit reversed the bankruptcy courts ruling. In so holding, the Eleventh Circuit noted that the tax sharing agreement created a trust relationship between the parent corporation and the bank subsidiary under which the bank subsidiary retained title to the refunds. The Eleventh Circuit went on to note that the tax sharing agreement between the parent corporation and the subsidiaries was ambiguous because it failed to state when the parent corporation must forward the tax refund to the bank subsidiary, and it does not explain whether the parent corporation owns the refunds before forwarding them to the subsidiary.[47] Although the Eleventh Circuit stated that the tax sharing agreement was ambiguous, it went on to opine that it was "obvious" that the parties "did not intend that the [parent corporation] keep the refunds and incorporate them into its own portfolio, as if the [bank subsidiary] had loaned the refunds to the Holding Company unencumbered."[48] Moreover, the Eleventh Circuit found that the tax sharing agreement did not contain any words from which it could reasonably be inferred that the parties intended to create a debtor-creditor relationship between them with respect to the tax refunds. Had a debtor-creditor relationship been formed, the Eleventh Circuit noted that it "would expect to find some means of protection for the creditor that would help guarantee the debtor's

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[45] *Id.*
[46] *Id.* at 1104.
[47] *Zucker* 727 F.3d 1100 at 1107 ("Section 4 is ambiguous in two respects: first, section 4 does not state when the Holding Company must forward the tax refunds to the Bank, and second, it 10 of 16 does not explain whether the Holding Company "owns" the refunds before forwarding them to the Bank").
[48] *Id.* at 1108

obligation, such as a fixed interest rate, a fixed maturity date, or the ability to accelerate payment upon default."[49] Moreover, the Eleventh Circuit noted that the bankruptcy court's determination that the tax sharing agreement created a debtor-creditor relationship undermined the "paramount purpose" of the tax sharing agreement which was to ensure that the tax refunds were delivered to both the parent corporation and the group's members.[50] Therefore, the Eleventh Circuit directed the bankruptcy court to instruct the parent corporation to forward the refunds to the FDIC as received for distribution to the parent corporation and its subsidiaries because the Eleventh Circuit concluded that a trust relationship had been formed by the tax sharing agreement.

C. Ambiguous Tax Sharing Agreements

A tax sharing agreement is ambiguous as to what type of relationship has been created if the agreement does not contain any language that indicates which party will own the tax refund. If the tax sharing agreement is ambiguous because it does not contain language that explicitly provides for the allocation of the funds is not present in the agreement, a court will likely consider extrinsic evidence when determining whether there is a debtor-creditor, a trust, or an agency relationship under such an agreement. For example, in *FDIC v. AmFin Financial Corp.*,[51] the tax sharing agreement at issue did not indicate which party owned the tax refund. Instead, the tax sharing agreement only spoke to "the allocation of liability in the event of an adjustment such as a loss carryback refund."[52] Accordingly, the Sixth Circuit held that a tax sharing agreement between a holding company and its bank subsidiary was ambiguous as to the ownership of an

[49] *Id.*
[50] *Id.* at 1108.
[51] 757 F.3d 530 (6th Cir. 2014).
[52] *Id.* at 534.

income tax refund.[53] In so holding, the court opined that the district court erred in refusing to consider extrinsic evidence concerning the parties' intent as to the ownership of the funds.[54]

AmFin, the bank holding company, filed for chapter 11 bankruptcy protection in 2009.[55] As a result of that filing, the Office of Thrift Supervision closed the bank subsidiary and placed it into an FDIC receivership.[56] Later, the holding company filed a consolidated 2008 federal tax return on behalf of itself and its affiliates, showing a total net operating loss of $805 million, with the bank subsidiary's losses accounting for $767 million of that total.[57] After the IRS issued a refund of approximately $195 million to the holding company, the FDIC claimed that over $170 million of that refund belonged to the bank subsidiary as a result of a trust being formed in the tax sharing agreement.[58] Finding that the tax sharing agreement was unambiguous, the District Court concluded that the tax sharing agreement created a debtor-creditor relationship between the holding corporation and its affiliates, including the subsidiary with respect to tax refunds, and thus, the holding corporation owned the refund.[59]

The Sixth Circuit reversed the district courts decision and remanded the case to the district court with instructions that the district court consider extrinsic evidence when determining whether the tax sharing agreement created either a debtor-creditor relationship, or a trust or agency relationship under Ohio law with respect to the tax refund at issue. In so holding, the Sixth Circuit opined that the tax sharing agreement contained no protections for the holding company existed that would suggest that a creditor-debtor relationship had been created. Like the BankUnited court, the Sixth Circuit stated that the tax sharing agreement "[said] nothing about

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[53] *Id.*
[54] *Id.*
[55] *Id.* at 532.
[56] *Id.*
[57] *Id.*
[58] Brief for Appellant at 1, FDIC v. AmFin Fin. Corp., 757 F.3d 530 (6th Cir. 2014) (No. 13-3669), 2013 WL 6144206 at 1.
[59] *Id.* at 534.

tax refunds received by [the holding company] on behalf of the group and include[d] no protections for the putative creditor, as one would expect if the parties intended a debtor-creditor relationship."[60] The Sixth Circuit further opined that words such as "payment" or "reimbursement" did not indicate that the parties intended to create a creditor-debtor relationship.[61] Therefore, the Sixth Circuit determined that the tax sharing agreement was ambiguous as to what type of relationship had been created under the agreement. The Sixth Circuit remanded the case to the district court with instructions that the court considers extrinsic evidence concerning the parties intent in light of Ohio agency and trust law.[62]

II. Implications of the Type of Relationship

The cases discussed above are significant because they demonstrate the desirability of drafting a tax sharing agreement in a way that explicitly provides for the allocation of the ownership of the tax refund. Parties can provide for such allocation by having the tax sharing agreement clearly state the type of relationship that will exist between the parent corporation and its subsidiaries or by explicitly stating which party will be the owner of the tax refund.

That being said, when representing parties in a bankruptcy proceeding, it is important to be able to determine which party may claim ownership of all or a portion of a tax refund under a tax sharing agreement. If the tax sharing agreement's language explicitly created a debtor-creditor relationship, the parent corporation will be entitled to retain the refund and the refund will be part of the parent corporation's bankruptcy estate. However, if the language explicitly created a trust or an agency relationship, then the subsidiary will be entitled to have the parent corporation forward or return the refund to the subsidiary. Finally, if the tax sharing agreement is ambiguous because it does not contain language that explicitly provides for the allocation of the

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[60] *AmFin Fin. Corp.,* 757 F.3d at 535.
[61] *Id.*
[62] *AmFin Fin. Corp.,* 757 F.3d at 536 (noting that the court declined to apply federal common law).

funds is not present in the agreement, a court will likely consider extrinsic evidence when determining whether there is a debtor-creditor, a trust, or an agency relationship under such an agreement. Accordingly, drafting an ambiguous tax sharing agreement will likely increase all of the party's costs in the litigation. Therefore, when drafting the tax sharing agreement, the parties can reduce the possibility of unnecessary litigation in the future, by including clear language in the tax sharing agreement.

Finally, its important to remember that a party is not without recourse if the court determines that the tax sharing agreement created a debtor-creditor relationship. Indeed, even if a court determines that a parent corporation owns the tax refund because there was a debtor-creditor relationship between the parties, the subsidiary, as a creditor, would still be entitled to file a proof of claim for the amount it was owed under the tax sharing agreement at issue. Yet, under such circumstances, the subsidiary will likely recover less than the full amount of the refund it is owed because creditors do not recover in full in most bankruptcy cases.

Conclusion

Courts are being relied upon to determine the type of relationship between a parent corporation and their subsidiaries when interpreting a tax sharing agreement. Some courts have concluded that a debtor creditor relationship is formed when the language clearly establishes who is liable for the tax liability and who will own the tax refund when the parent corporation receives it. Other courts have concluded that a trust or agency relationship exists when the tax sharing agreement does not state when the holding company would have to forward the tax refund to the subsidiaries. Finally, some courts have concluded that the tax sharing agreement is ambiguous as to the relationship formed when the language does not explicitly state who owns the refund, and therefore, will consider extrinsic evidence when determining what type of relationship was formed.