

Pass-Through Entities in Bankruptcy-Beware of Phantom Income

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Recently I discussed the tax issues created by the inadvertent inclusion of partnership tax provisions in an operating agreement for a LLC taxed as an S-corp. Today we have a different problem – not following what the operating says regarding dissolution and the potentially serious adverse tax consequences that can create. This is a bankruptcy case with important income tax lessons for members of pass-through entities.

LeClairRyan PLLC was a law firm in Virginia that was taxed as an S-corporation for federal and state income tax purposes. In 2019 LeClairRyan filed bankruptcy (initially Chapter 11 (reorganization) but converted to Chapter 7 (liquidation). On July 29, 2019, the firm voted to dissolve. On July 31, 2019, Mr. LeClair terminated his employment with the firm. Three years later, he was in bankruptcy court, asking the court to order the bankruptcy trustee to remove his name from the list of equity security holders (members of the law firm) on the ground he had terminated his interest.

Under Virginia's LLC act, an LLC "is bound by its operating agreement, which regulates the conduct of its business and the relations of its members." Most, if not all, state LLC acts contain similar provisions. Here, the law firm's operating agreement provided that a member's interest terminated on the date the member's employment with the firm ceased. For Mr. LeClair, this was July 31, 2019.

But the firm's operating agreement also provided that as long as a member-owned shares (instead of a membership interest, the law firm used common and preferred shares), no member could withdraw prior to dissolution and winding up of the [law firm]. Because the law firm voted to dissolve on July 29, 2019, two days **before** Mr. LeClair attempted to terminate his employment, the bankruptcy court ruled Mr. LeClair's termination was ineffective based on this provision of the operating agreement. Had it been the other way around, that is, had Mr. LeClair terminated his employment **before** the firm voted to dissolve, then he would not have been a member as of the date of dissolution.

So why was Mr. LeClair trying to do this, and what difference does all this really make? The reason: Taxes. The difference it makes: Potentially a big one, and here's why. Under the Bankruptcy Code, when an individual files bankruptcy, the bankruptcy estate is its own tax entity, meaning it, not the debtor (the individual who filed bankruptcy), is responsible for paying any taxes associated with the income from the bankruptcy estate. See IRC § 1398. However, this rule does not apply to corporations or partnerships. IRC § 1399. In the case of a C-corporation, this is no big deal because C-corporations are separate tax-paying entities anyway. But...where a **pass-through entity** (PTE) is involved (entity taxed as an S-corporation or partnership)...it can be a big (taxable) problem for the partners/shareholders/members.

Recall, with PTEs, items of profit and loss flow through to and are taxed at the shareholder/member/partner level. In bankruptcy, if the PTE has assets that continue to produce income, the bankruptcy estate—not the shareholders/members/partners—gets the income, **but** and this is a **BIG BUT** because the income flows through to the

individual shareholders/members/partners, they, not the PTE, must pay the taxes associated with that income. *Ouch!!*

So, coming back to Mr. LeClair's case, that meant that as the bankruptcy trustee collected the law firm's receivables (which are income), the bankruptcy trustee got to keep the money to pay the firm's creditors, but for tax purposes, the income was allocated to the members of the now bankrupt firm who had to pay income taxes on money they never received.

I know what some of you are thinking. Would the result have been different if the firm had made an election to pay tax at the entity level instead of at the shareholder/member/partner level? After all, Virginia has adopted pass-through entity tax (PTET) as a SALT workaround. Highly doubtful. PTET legislation, at least in Virginia as well as most states, does not create or define a property interest (IRS looks to state law to determine whether a taxpayer has a property interest, then federal law governs how that interest is taxed). Maybe a closer call in Connecticut, where PTET is mandatory but still doubtful, in my opinion.

Let this be a cautionary tale that if you are a shareholder/member/partner of a PTE that is contemplating bankruptcy, you should seek not only competent bankruptcy counsel but competent tax counsel as well, lest you wind up with phantom income for which you, not your now defunct PTE, will have to pay income taxes.

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