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Avoiding Fraudulent Transfer Liability for S Corporation Tax Payments

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It is a common arrangement for chapter S corporations, which pass business profits through to the shareholders for tax purposes, to reimburse the shareholders for tax liability associated with corporate profits. A recent bankruptcy court decision considered whether such tax reimbursement payments by an S corporation were "fraudulent transfers" or transfers for insufficient consideration, which could be recovered by the trustee in the bankruptcy of the S corporation. *In re Kenrob Info. Technology Solutions, Inc.*, 474 B.R. 799 (Bankr. E.D. Va. 2012) (Kenrob). The *Kenrob* decision provides guidance to avoid fraudulent transfer risks for shareholders who receive tax reimbursement payments from their companies.

In *Kenrob*, a chapter S corporation reimbursed its shareholders for tax liabilities attributable to pass-through liability from the corporation. The corporation subsequently filed for bankruptcy. The trustee for the bankrupt corporation sought to recover from the shareholders those amounts that were paid to the shareholders during the two preceding years on account of reimbursement for pass-through tax liabilities. The trustee alleged that the payments could be clawed back as constructive fraudulent transfers under section 548 of the Bankruptcy Code. Constructive fraudulent transfers are those made by a corporation for less than reasonably equivalent value while the corporation is insolvent.

In response, the shareholders argued that they provided reasonably equivalent value to the corporation by electing on behalf of the corporation to be taxed as a chapter S corporation. If the shareholders had not elected chapter S status, the corporation would have owed the tax liabilities directly. The shareholders therefore argued that the value of the election was equivalent to the value of the taxes reimbursed by the corporation to the shareholders.

The trustee discovered that the shareholders did not sign any shareholder agreement memorializing the corporation's obligation to reimburse the shareholders. The trustee therefore argued that the payments made by the corporation were gratuitous because no written document compelled the corporation to reimburse the shareholders.

The bankruptcy court decided for the shareholders, holding that: (1) an unsigned

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shareholder agreement was legally sufficient to obligate the corporation to reimburse the shareholders for their pass-through tax liability; and (2) the chapter S election by the shareholders constituted reasonably equivalent value for the reimbursement payments because the chapter S election prevented the corporation from making tax payments directly.

The *Kenrob* decision is a reminder for shareholders seeking reimbursement from their corporation for pass- through tax liabilities to memorialize the corporation's obligation to make such reimbursements in a written, signed shareholder agreement. Doing so makes clear that the reimbursement is in consideration of the chapter S election and may provide an important defense against subsequent fraudulent transfer allegations.

Please contact your Reinhart attorney or any attorney in Reinhart's Business Reorganization Practice if you have any questions concerning the Kenrob decision and its implications for your business.

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