

Alert

Supreme Court Defers to State Law on Ownership of Tax Refund

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Federal courts should “turn to state law to resolve” a “fight over a tax refund,” held a unanimous Supreme Court on Feb. 25, 2020. *Rodriguez v. FDIC (In re United W Bancorp., Inc.)*, 589 U.S. ___, 2020 WL 889191 (Feb. 25, 2020). Vacating a Tenth Circuit decision, the Supreme Court remanded the case for the lower court to apply state law in resolving “the distribution of a consolidated corporate tax refund.” The bankruptcy trustee of a bank holding company was litigating against the Federal Deposit Insurance Corporation (“FDIC”), as receiver for the subsidiary bank that had incurred losses generating the refund. According to the Supreme Court, it was not deciding “[w]ho is right about all this” *Id.* at *4. Instead, the court rejected the Tenth Circuit’s application of the Ninth Circuit’s so-called *Bob Richards* rule. *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262, 265 (9th Cir. 1973) (in absence of tax allocation agreement, refund belongs to group member responsible for losses that led to it). In so doing, the court rejected the *Bob Richards* rule as inappropriate federal “common lawmaking.”

Relevance

The court granted certiorari in *Rodriguez* not only to resolve a split among the circuits, but also “to decide *Bob Richards*’ fate.” *Id.* *3. As it evolved over time, *Bob Richards* supplied a federal common law rule that, absent a clear agreement to the contrary, tax refunds belong to a taxpayer group member responsible for the losses that led to the refund.

Facts

The Internal Revenue Service in *Rodriguez* paid a tax refund to the bank holding company, although the tax refund had resulted from losses incurred by its bank subsidiary. The bankruptcy trustee of the holding company sued the FDIC, as receiver for the bank, claiming ownership of the refund. The Tenth Circuit, applying *Bob Richards*, affirmed the district court’s judgment that the tax refund belonged to the FDIC, finding that the parties’ tax allocation agreement was “ambiguous.” Nevertheless, the Tenth Circuit relied on the terms of the document providing that any “ambiguity ... shall be resolved ... in favor of any insured depository institution.” The parent holding company had an agency relationship “with respect to federal tax refunds” and had agreed to an “equitable allocation of tax liability.” According to the agreement, tax benefits would be computed “on a separate-entity basis for each” member of the affiliated corporate group.

The Supreme Court

The court explained how federal courts should resolve a dispute when “the group members dispute the meanings of the terms found in their agreement State law is replete with rules readymade for such tasks — rules for interpreting contracts, creating equitable trusts, avoiding unjust enrichment, and much more.” *Id.* at *2.

Limited Federal Common Law. The court stressed that “there is ‘no federal general common law.’” *Id.* at *3, quoting *Erie R. Co., v. Tompkins*, 304 U.S. 64, 78 (1938). Federal judges “may appropriately craft the rules of decision” in such limited areas as admiralty disputes and “certain controversies” between states. But unless Congress authorizes it, “common lawmaking must be ‘necessary to protect uniquely federal interests.’” *Id.*, quoting *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 640 (1981).

Federal Government’s Indifference to Distribution of Refunds. The federal government regulates how it receives and “also may have an interest in regulating a *delivery* of any tax refund due a corporate group.” *Id.* at *3. But it has no “unique interest ... in determining how a consolidated corporate tax refund, once paid to a designated agent, is *distributed* among group members.” *Id.*

State Law Dispositive. “ ... [S]tate law is well equipped to handle disputes involving corporate property rights ... like the one” in *Rodriguez*. *Id.* Although this dispute arose in a bankruptcy case, “the determination of property rights” in a debtor’s assets is governed by state law. *Butner v. United States*, 440 U.S. 48, 54 (1979).

The court rejected the *Bob Richards* rule because it “made the mistake of moving too quickly past important threshold questions at the heart of our separation of powers.” *Id.* at *4. Emphasizing the “care federal courts should exercise before taking up an invitation to try their hands at common law making,” the court reasoned that the *Bob Richards* rule tipped the scales in favor of one party. Instead of a judge-made rule presuming that entities responsible for losses get the resulting tax refund in the absence of a clear agreement to the contrary, the issue must be resolved under applicable state law on remand to the Tenth Circuit. *Id.*

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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