

FTX's \$24B Tax Bill Could Wipe Out Any Creditor Recovery

By **Alex Wittenberg**

Law360 (December 15, 2023, 8:59 PM EST) -- A process intended to resolve a \$24 billion dispute in FTX Trading Ltd.'s bankruptcy case threatens to render moot the fallen crypto company's plan to repay millions of customers who lost money after the exchange collapsed in late 2022, experts told Law360.



Experts caution that FTX customers who lost money on the cryptocurrency exchange may not recover any of their losses in the company's Chapter 11 bankruptcy if the IRS is allowed to claw back tens of billions of dollars in unpaid taxes before any other party. (Jonathan Raa/NurPhoto via Getty Images)

FTX has been feuding with the Internal Revenue Service over an alleged tax bill that the agency first estimated at \$44 billion before revising to \$24 billion, an amount FTX says bears "no relation to reality." On Wednesday, a Delaware bankruptcy judge ordered an estimation hearing in the case that will determine whether the IRS claim can be counted against FTX.

Estimation offers an alternative to the typical claim process, emphasizing speed over "litigating all the narrow particulars," said Douglas Baird, a professor at the University of Chicago Law School and chair of the National Bankruptcy Conference.

"It's a flexible process that gives good bankruptcy judges the ability to figure out what's going on and make sure the case proceeds as best it can," Baird said.

But the efficient process means FTX is due to receive a decision about the scope of the IRS claim around the same time it's soliciting votes on a Chapter 11 plan that is wholly dependent on the diminution of the claim itself. That's because the IRS bill, which would take priority over customer claims, far exceeds the total funds FTX plans to distribute to customers under its bankruptcy plan.

"If the IRS claim is even one half of what it says, it moots the entire bankruptcy because creditors will get nothing," said Bruce Markell, a professor at the Northwestern University Pritzker School of Law and former bankruptcy judge.

Estimation allows a judge to determine a claim that risks holding up the bankruptcy case and interfering with the confirmation of a plan. It's been used several times to deal with mass tort claims that would otherwise take years to litigate outside of bankruptcy.

Judges have broad discretion to decide how best to assess a claim through the estimation process, and the U.S. Bankruptcy Code does not describe what type of evidence or proof should be relied on during estimation.

"In one sense, the estimation hearing is the platypus of bankruptcy," Markell said. "It weighs discounting the future to get something done in the present."

The basic flexibility of estimation is a risk for FTX, given the freedom afforded to judges through the process and the fact that an unfavorable decision could torpedo the plan it has been negotiating for about a year. The IRS, for example, could persuade U.S. Bankruptcy Judge John T. Dorsey that FTX's famously shoddy record-keeping had made it impossible for the debtor to disprove the agency's claim.

"If the numbers are not clear because of fraudulent activity, the court may decide that's a problem of their own making," Joshua Smeltzer, a tax attorney who co-leads Gray Reed & McGraw LLP's blockchain and digital assets practice, said of FTX.

The IRS says it settled on the \$24 billion sum using pleadings in the case and a report by FTX CEO John J. Ray III in conjunction with tax returns submitted by the debtor. According to the agency, FTX has underreported income it generated through the fraudulent activity that the exchange's former leader, Sam Bankman-Fried, was found guilty of in November.

In estimation, the IRS could also focus on bank deposit analyses showing money flowing in and out of FTX accounts, provided that authentic documents exist, Smeltzer said. But much of the agency's strategy will depend on whether the court decides to abandon the typical presumption of correctness applied to the IRS and force it to prove its claim.

"The court is indicating that it hasn't decided that the IRS should get that presumption," Smeltzer said. "It may stick them with the burden of proof."

But if estimation is something of a gamble, it's one FTX is eager to take.

The debtor itself implored Judge Dorsey to estimate the claim on an expedited basis so that it can stay on track with a reorganization plan that it wants to confirm early next year. FTX thinks it owes the IRS exactly \$0, and evident in its request for quick estimation is a high level of confidence that it's right.

Judge Dorsey granted FTX's wish on Wednesday, setting an estimation hearing for March. During the hearing, the judge expressed skepticism about the IRS's claim, saying that during testimony he heard "no real basis to make that determination at this time" regarding the \$24 billion figure.

Judge Dorsey declined to rule that day on which side will bear the burden of proof at the estimation hearing, asking for more briefing before making that decision.

At the estimation hearing, FTX is likely to invoke the many tax professionals it has hired to help substantiate forms that put its taxable losses at more than \$11 billion. The debtor says that from 2020 to 2022, it earned \$334 million in taxable income, reflecting about \$34.7 million in tax liability — about 700 times less than the IRS claim.

"The IRS claims are facially absurd," it said in a motion for estimation.

Absurd or not, the IRS claim risks "subverting" FTX's progress in the case, the debtor said. And while

estimation avoids an undue delay, it brings forward a decision that could effectively determine whether the roughly \$7 billion FTX has raised so far to pay customers will instead end up in government coffers.

"Right now, the single largest obstacle to moving forward with distributions to creditors is the Internal Revenue Service," FTX counsel James Bromley of Sullivan & Cromwell LLP said at the hearing.

A spokesperson for the U.S. Department of Justice declined to comment Friday. Representatives for FTX didn't respond to a request for comment.

FTX Trading Ltd. is represented by Adam G. Landis, Kimberly A. Brown and Matthew R. Pierce of Landis Rath & Cobb LLP and Andrew G. Dietderich, James L. Bromley, Brian D. Glueckstein and Alexa J. Kranzley of Sullivan & Cromwell LLP.

The IRS is represented by Elisabeth M. Bruce and Stephanie A. Sasarak of the U.S. Department of Justice.

The case is In re: FTX Trading Ltd. et al., case number 1:22-bk-11068, in the U.S. Bankruptcy Court for the District of Delaware.

--Editing by Dave Trumbore.