

Tax Provisions in New Bankruptcy Law

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA of 2005”) contains several tax provisions that involve modifications of the Bankruptcy Code. Several of the provisions were recommendations made by the National Bankruptcy Review Commission (“NBRC”). However, a few of the provisions contradict the recommendations of both the NBRC and the Tax Advisory Committee appointed by the Chairman of the NBRC. Listed below are some comments and a summary of the tax provisions contained in BAPCPA of 2005.

1. Subordination of Tax Liens (section 701)

Section 724 of the Bankruptcy Code provides for the subordination of tax liens to administrative expenses and other priority taxes. This change will modify the subordination provision by not subordinating perfected, unavoidable tax liens arising in connection with an ad valorem tax on real or personal property. Additionally, administrative expenses incurred after the petition is filed is restricted to chapter 7 expenses unless the claim is for wages, salaries or commissions or employee benefits. BAPCPA of 2005, Section 701 also adds a subsection (e) to section 724 that provides that before a tax lien may be subordinated, the trustee shall (1) exhaust the unencumbered assets of the estate, and (2) in a manner consistent with section 506(c), recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving or disposing of that property.

Subsection (f) provides that notwithstanding the exclusion of ad valorem tax liens claims for wages, salaries, and commissions that are entitled to a section 507(a)(3) priority and claims for contributions to an employee benefit plan entitled to a 507(a)(4) priority may be paid from property of the estate which secures a tax lien, or the proceeds of such property.

Comment: The provision to not subordinate property taxes, to use unencumbered assets, and to subordinate property tax claims to wage holders appears fair.

However, the provision to limit the subordination to chapter 7 expenses will limit the recovery of assets for unsecured creditors. A trustee appointed in a chapter 11 case, where there is a tax lien on all assets, has no incentive to go after known or potential recoveries, because any costs that are incurred will not be allowed unless the tax claims are paid in full. Trustees are often better equipped to recover assets than the taxing authorities. Removing the incentive for the chapter 11 trustee may in fact result in less recovery to both the taxing authorities and to other creditors.

Studies have shown that state and local governments have suffered losses because of the subordination of ad valorem tax liens. However, that generalization should not be applied to the IRS and other state income taxing authorities. Abuses have occurred where administrative expenses have been in excess of what they should have been, resulting in less return to taxing authorities. In most cases, the U.S. trustee appoints chapters 7 and 11 trustees. The activities of trustees are monitored by the U.S. trustees, and their involvement should help control the actions of the appointed trustee.

2. Determination of Tax Liability (Section 701(b) 703).

Section 505(a)(2) is modified to provide that the court may not determine an ad valorem tax if the applicable period for contesting or redetermining the amount under any law, other than bankruptcy law, has expired. Some bankruptcy courts have redetermined the tax because the bankruptcy court may determine all claims. The NBRC did not recommend this change be made.

Comment: By not allowing the bankruptcy court to determine the ad valorem tax claim, the change allows a governmental unit to collect a tax that is greater than the amount allowed. If the tax were properly determined, the state will receive its priority payment. For example, in one case where a chapter 11 trustee was appointed, the debtor allegedly borrowed millions of dollars of debt under false pretense. The debtor did not file business tax forms and the taxing unit determined the tax based on values were significantly greater than the actual values of the assets. Under this provision, since the time for redetermining the tax expired, the business tax would remain, even though all parties knew the tax was incorrectly calculated. Taxes already have a priority over all other general unsecured claim holders, and this change will allow the taxing authority to collect or retain taxes for amounts that are greater than the amount that should be allowed.

3. Treatment of Fuel Tax Claims (Section 702)

BAPCPA of 2005 amend section 501(e) by adding the following provision:

(e) a claim arising from the liability of a debtor for fuel use tax assessed consistent with the requirements of section 31705 of title 49 may be filed by the base jurisdiction designated, pursuant to the International Fuel Tax Agreement and, if so filed, shall be allowed as a single claim.

4. Notice of Request for Determination of Taxes (Section 703)

Section 505(b) is modified to provide for the clerk of each district to maintain a listing under which a Federal, State or local governmental unit responsible for collecting taxes within in the district may designate an address for service of requests and describe further information concerning additional requirements for filing such requests. If a governmental unit fails to provide an address to

the clerk, requests should be served at the address for filing returns or protests with the appropriate taxing authority of that governmental unit.

Comment: Taxing authorities need to be notified of bankruptcy filings; however, the requirements for such notice including content, timing of notice, sanctions for non-compliance, etc., should have been covered by the Rules Committee. The modification to section 505(b) requiring notice be made according to the manner designed by the governmental units seems reasonable. However, section 505(b) should also have been modified, but was not, to provide that partnerships and S corporations in bankruptcy and chapter 13 debtors are within the provisions of section 505(b). The IRS has issued a policy statement stating that section 505(b) does not apply to partnerships and S corporations, and has refused to apply section 505(b) to chapter 13 cases.

5. Rate of Interest on Tax Claims (Section 704)

BAPCPA of 2005, Section 704 adds a new section 511 to the Bankruptcy Code that provides if interest is required on a tax claim, including tax claims qualifying as administrative expenses, or to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law.

In the case of interest paid under a confirmed plan, rate of interest is the rate determined as of the calendar month in which the plan was confirmed.

Comment: Currently, the Bankruptcy Code does not specify the interest rate that is to be used for tax claims that are entitled to interest, but it does indicate that a market rate should be used. Judicial consensus is that the Federal statutory rate is relevant in determining the appropriate market rate of interest. To avoid the wasting of both judicial and debtor resources by litigating the rate, the NBRC followed the recommendation of the Tax Advisory Committee that the rate be fixed at the statutory rate under section 6621(a)(2), without reference to section 6621(c) and it should be the rate in effect as of the confirmation date. The rate under section 6621 was included in early proposed modifications to the Code, but was subsequently modified to include the rate in section 1274(d), but did not indicate if the rate should be compounded quarterly or yearly. Section 1274 appeared to be a reasonable substitute. Subsequent drafts provided that section 1274 would apply to Federal taxes and other taxing units would use the rate under nonbankruptcy law. Section 704 as passed eliminates any reference to Internal Revenue Code by providing that nonbankruptcy law applies to all taxes where interest is required.

While the rate for Federal taxes approximates market value, the rate for state and local taxes could be in excess of 20 percent, resulting in state and local taxing authorities receiving interest in excess of

the market rate at the expense of other creditors. I see no reason for making a change such as this. Additionally, it violates the general philosophy underlying bankruptcy law that creditors should not receive consideration in excess of the value of such claim.

6. Priority of Tax Claims (Section 705)

This change provides that the period of three years before the filing of the petition under section 507(a)(8)(A) is modified to provide for any time during which an offer in compromise was pending during that 240 day time period, plus 30 days, and for any time during which a stay of proceedings against collection was in effect, plus 90 days.

Section 507(a)(8) is modified to provide that any time period provided for in the taxes described in subparagraph (A) through (G) will be suspended during any time period in which a governmental unit is prohibited from collecting such tax under nonbankruptcy law, plus 90 days and for any time period during which collection was precluded by the existence of 1 or more confirmed plans, plus 90 days. For example, the three years provided for priority for employment, excise or use tax, will now be extended beyond the three-year period, if collection of the tax is precluded.

Comment: The majority of courts (justifiably) have allowed for tolling of priority time periods during prior bankruptcies because the stay was in effect and the IRS was limited as to the type of action it could take. This provision codifies the impact of the tolling. The added time allows the IRS time to respond once the stay has been removed.

7. Assessment Defined (Section 706)

There has been some conflict with state law as to the meaning of the term “assessment,” partially, in reference to property taxes. To resolve this problem the word “incurred” is substituted for “assessed” in section 507(a)(8)(B).

8. Making Chapter 13 Nondischarge Provision Consistent with Chapter 7 (Section 707)

Section 1328(a)(2) of the Bankruptcy Code is amended by expanding the dischargeability of taxes to cover those taxes that are nondischargeable in chapter 7. Thus, tax discharge for fraudulent and unfiled tax returns under this change is now the equivalent to those in chapter 7.

Comment: In general, it can be argued (as the author did for several years) that there should be no difference between the dischargeability of taxes under chapter 7 and chapter 13. Chapter 13 facilitates the workout of tax claims and is consistent with other provisions of BAPCPA of 2005 that require taxpayers to pay some of their claims over the plan period. Taxing authorities collect substantial taxes because chapter 13 requires that all priority taxes be paid during the plan period and it places on the tax rolls individuals that have not paid taxes in several years.

On the other hand in chapter 7, prior year tax returns are often not filed and limited, if any, of the taxes are paid during the collection period. In the final analysis, taxing authorities may receive a very small percent of the taxes due and probably less than would have been received in chapter 13.

9. Nondischarge of Corporate Taxes (Section 708)

Section 1141(d) of the Bankruptcy Code is amended by providing that, the confirmation of a plan does not discharge a debtor, which is a corporation, from any debt incurred under false pretenses or by making false statements in writing or from a tax or customs duty with respect to which the debtor made a fraudulent return or willfully attempted, in any manner, to evade or defeat such tax or custom duty.

Comment: There was considerable opposition to this change, on the basis that the management of the company that was involved with the fraud is often replaced, and a provision that prohibits a nonpriority tax from being discharged limits the ability of the creditors to reorganize the debtor. Because of the inability to restructure the troubled business, due to the inability to obtain a discharge of nonpriority taxes, the Service may even collect less. Often a corporate officer that files false tax returns, or does not file tax returns, defrauds other creditors as well, including the obtaining of funds from banks by filing false statements. Should the Bankruptcy Code be modified to provide that these claims also be exempt from the discharge? Often in companies where fraud exists and parts (or even all) of the business are viable, the entire business, or several units of the business, may be sold as going concerns as part of a plan of reorganization or liquidation. What happens if most of the operating assets are transferred in bankruptcy to another entity? Is the acquiring entity responsible for the tax claims that were not discharged? If the operating assets are sold to three different companies, who is responsible for the debts not discharged?

The Service should file criminal action against the corporate officer that filed a fraudulent return, but the creditors should not be punished because of the errors of prior management.

10. Stay of Tax Proceedings (Section 709)

The stay under section 362(a)(8) is revised to apply only to a tax liability for an individual for a taxable period ending before the order for relief or for a corporation for a period the bankruptcy court may determine the tax.

11. Periodic Payment of Chapter 11 Taxes (Section 710)

BAPCPA of 2005, Section 710 amends the Bankruptcy Code to provide that the payments under section 1129(a)(9) must be regular installments in cash of a total value as of the effective date equal to the allowed amount of the claim, must not exceed a 5-year period from the order for relief, and must be

in a manner not less favorable than the most favored nonpriority unsecured claim other than administrative convenience claims.

The requirements of section 1129(a)(9) is modified to also apply to secured taxes that are entitled to priority absent their secured status.

Comment: Because of the difficulty of establishing the time of assessment, especially for some state and local taxes, both the NBRC and the Tax Advisory Committee recommend that the six-year period begin with the date of the order for relief. The six year period was subsequently reduced to 5 years from the date the order for relief is issued and payments were changed to require them to be in a manner not less favorable than most favored unsecured creditor claims. If stock were issued for the creditors claims, would this provision consider only one payment being made as of the effective date of the plan? In addition to creating a lot of unnecessary, unanswered questions, these provisions go beyond the recommendations of both the NBRC and the Tax Advisory Committee. With these changes it no longer is a provision that eliminates the inequities of the current law, but a law that provides additional benefits to the taxing authorities at the expense of creditors, employees and others that have an interest in the reorganization of the business.

12. Tax Avoidance of Statutory Tax Liens (Section 711)

BAPCPA of 2005, Section 711 amends section 545(2), as recommended by the NBRC and the Tax Advisory Committee, to overrule cases that penalize the government, due to certain benefits for purchasers provided for in the lien provision of the IRC or similar provisions of state or local law.

13. Course of Business Payment of Taxes (Section 712)

Payment of postpetition taxes is required when taxes are due in the course of such business, unless the tax is a property tax secured by a lien against property that is abandoned by the trustee under section 554 of the Bankruptcy Code within a reasonable time after the lien attaches, as provided for in BAPCPA of 2005, Section 712, or payment of the tax is excused under a provision in the Bankruptcy Code. In a case pending under chapter 7, payments may be deferred until final distribution is made under section 726 of the Bankruptcy Code, if the tax was incurred before the trustee was appointed, or before the due date of the return that the court determines there is a probability the debtor will not be able to pay in full the administrative expenses and other claims with the same priority as the tax claim.

Section 503 is modified to provide that property taxes are to be paid as an administrative expense, whether secured or unsecured, and that it is unnecessary for a governmental unit to make a request to the debtor to pay taxes that are entitled to payment as administrative expenses.

14. Tardily Filed Priority Tax Claim (Section 713)

BAPCPA of 2005 provides, as recommended by both the NBRC and the Tax Advisory Committee, that a taxing authority must file a claim for priority tax before the earlier of 10 days after the mailing to the creditors a summary of the trustee's final report or the date on which the trustee commences final distribution under this section.

Comment: It is important that the claim be filed before the final order approving the trustee's report is entered to avoid requiring the trustee to recalculate the amount paid to creditors and equity holders, to rewrite the report, and to reschedule the hearings to approve the report. Filing a claim after the report is filed clearly impacts the efficient court administration of the case. See *Pioneer Investment Servs. Co. v. New Brunswick Assocs. Ltd.* 113 S. Ct. 1489 (1993). Provision as modified should satisfy the questions raised by trustees.

15. Income Tax Returns Prepared by Tax Authorities (Section 714)

BAPCPA of 2005 amends section 523(a)(1)(B) by providing a definition of a tax return for purposes of dischargeability includes a return prepared under section 6020(a) of the I.R.C. or similar nonfederal statutes and does not include a return prepared under section 6020(b). On April 9 2001, the Service issued a legal memorandum taking the position set forth in BAPCPA of 2005.

Comment: Both the Tax Advisory Committee and the NBRC recommended that a return filed under federal, state, or local law provisions, should constitute a filed return for Bankruptcy Code dischargeability purposes where the taxpayer has taken reasonable steps to sign and file the return, even though the taxing authorities fail to accept such return for filing. The final modification appears to fall short of the recommendations of the Tax Advisory Committee and the NBRC.

16. Discharge of the Estate's Liability for Unpaid Taxes (Section 715)

The Bankruptcy Code in section 505(b) provides that the debtor-in-possession or trustee may request a determination of the tax at the time the tax return is filed. If upon payment of the amount shown on the return, the trustee, debtor, and any successor to the debtor is discharged, unless the governmental unit notifies the trustee or debtor-in-possession within 60 days that the return has been selected for examination, and completes the examination within 180 days after the request was made. BAPCPA of 2005 modifies section 505(b) to discharge the estate as well.

Comment. The wording in section 505(b) does not discharge the estate. Courts have held that the IRS may assess additional taxes against the estate, but not against the trustee or debtor. Thus, even though the estate received the letter stating that the taxes were accepted as filed, additional taxes may be assessed against the assets that remain in the estate. To correct this problem BAPCPA of 2005

follows the recommendation of the NBRC and the Tax Advisory Committee and proposes to amend section 505(b) of the Bankruptcy Code by inserting "the estate." The inclusion of the "estate" in section 505(b) is a change that was needed.

17. Tax Returns Required to Confirm Chapter 13 Plans (Section 716)

BAPCPA of 2005 amends section 1325 of the Bankruptcy Code to provide that one of the requirements for plan confirmation is the filing of income tax returns required under a new section 1308 of the Bankruptcy Code.

Section 1307 of the Bankruptcy Code is amended by BAPCPA of 2005 to provide that upon the failure of the debtor to file the returns required under section 1308, on request of a party in interest or the U.S. trustee and after notice and a hearing, the court shall dismiss or convert the chapter 13 case to chapter 7, whichever is in the best interest of the estate.

BAPCPA of 2005 amends section 502(b)(9) to provide that an objection to the confirmation of a plan is considered to be timely if it is filed within 60 days after the debtors' tax returns were filed under section 1308. Additionally, Congress direct the Advisory Committee on Bankruptcy Rules of the Judicial Conference to propose rules that provide for an opportunity for governmental units to object to (1) the confirmation of a plan, on or before 60 days after the debtor files all tax returns required under sections 1308 and 1325(a)(7) of the Bankruptcy Code, and (2) that no objection can be filed in reference to a tax return required to be filed under section 1308, until such return has been filed as required.

Comment: The Tax Advisory Committee concluded that this provision would help reestablish the chapter 13 debtor as a "taxpayer" and would determine the priority tax that must be paid for a debtor to qualify for the chapter 13 super discharge. The Tax Advisory Committee concluded, after discussion with federal and local taxing authorities, and with attorneys and accountants that render services for chapter 13 debtors, that requiring the chapter 13 debtor to file tax returns for six years, pay through the chapter 13 plan all of the priority taxes, and provide for some payment of the nonpriority taxes (realizing that some courts approve a zero plan for unsecured claim holders) along with other general unsecured claim holders, will most likely result in the taxing authorities collecting more taxes now, and in the future, than would be collected with the filing of a chapter 7 petition. With the repeal of the chapter 13 tax discharge provisions, tax professionals generally will not recommend that clients file chapter 13. As a result, this provision will not have the impact that was intended.

18. Standard for Tax Disclosure (Section 717)

Section 1125(a) of the Bankruptcy Code dealing with the disclosure requirements is expanded by requiring the proponent of the plan to include full discussion of the potential material Federal and State tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case.

Comment: In general, the disclosure requirements for income tax impact of the plan have not generated the desired results. Often, interested parties have been told to talk with their tax specialists to find out the income tax impact of the plan. Time will tell if this requirement will result in the tax impact of the plan being explained in such a manner that readers of the disclosure statement will understand tax consequences. The purpose of the amendment is not to change existing law, but to make plan proponents adhere to the original intent of the law, to effectively disclose the tax ramifications of the plan on the debtor.

19. Setoff of Tax Liability against Tax Refund (Section 718)

Section 362(b) of the Bankruptcy Code is amended to provide that the setoff of an undisputed prepetition tax liability against an income tax refund does not violate the automatic stay. Setoff could not be taken if, prior to the setoff, an action was commenced under section 505(a) to determine the amount or the legality of the tax. However, if the setoff is tolled during the 505(a) hearing, the taxing authority may hold the refund.

Comment: The writer supported the recommendation of the Tax Advisory Committee. However, it has been pointed out by some writers that the impact of *Seminole Tribe of Florida*, 116 S. Ct. 1114 (1996), suggests that no change should be made regarding the tax setoff because the debtor may be unable to recover tax refunds that were setoff improperly by a state taxing authority.

20. Special Provisions Related to the Treatment of State and Local Taxes (Section 719)

Section 346 of the Bankruptcy Code is amended to generally follow the same provisions that apply for federal income tax purposes. Considerable conflicts existed between state and local taxes and federal taxes. Congress indicated at the time the Bankruptcy Reform Act of 1978 became law that the state and local tax issues would be changed when the Congress passed the federal bankruptcy tax laws. A few years later Congress passed the Bankruptcy Tax Act of 1980 and no action has been taken to eliminate the tax problems that arise because of the differences between the two federal laws. To correct these problems, the amendment to section 346 of the Bankruptcy Code conforms section 346 to that of section 1398, etc.

21. Dismissal for Failure to Timely File Tax Returns (Section 720).

Section 521 is amended to provide that if the debtor fails to file tax returns that become due after the petition was filed or fails to obtain an extension, the taxing authorities may request that the court enter an order converting or dismissing the case. If the debtor does not file the return within 90 days after the request to convert or dismiss the case, the court shall convert or dismiss the case, whichever is in the best interest of the estate.