TAXATION AND THE BANKRUPTCY CODE

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RECOMMENDATIONS

4.2.1 Clarify provisions of the Bankruptcy Code on providing reasonable notice to governmental units.

4.2.2 Amend the Bankruptcy Code to prescribe that to the extent that a tax claim presently is entitled to interest, such interest shall accrue at a stated statutory rate.

4.2.3 The Commission should submit to the Advisory Committee on Bankruptcy Rules of the Judicial Conference ("Rules Committee") a recommendation that the Federal Rules of Bankruptcy Procedure require that notices demanding the benefits of rapid examination under 11 U.S.C. § 505(b) be sent to the office specifically designated by the applicable taxing authority for such purpose, in any reasonable manner prescribed by such taxing authority.

4.2.4 Conform § 346 of the Bankruptcy Code to IRC 1398(d)(2) election; also conform local and state tax attributes that are transferred to the estate to those tax attributes that are transferred to the bankruptcy estate under IRC § 1398.

4.2.5 Amend 11 U.S.C. § 507(a)(8) and 523(a)(1) to provide for the tolling of relevant periods in the case of successive filings. Thus, in the event of successive bankruptcy filings, the time periods specified in § 507(a)(8) shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of the prior case.

4.2.6 Amend 11 U.S.C. § 507(a)(8)(ii) to toll the 240-day assessment period for both pre- and post assessment offers in compromise.

4.2.7 Amend the Bankruptcy Code to require "small business debtors" to create and maintain separate bank accounts for trust fund taxes and nontax deductions from employee paychecks. Also, any proposal should provide for sanctions for failure to comply with this Bankruptcy Code requirement.

4.2.8 Amend 11 U.S.C. § 1141(d)(3) to except from discharge taxes unpaid by businesses entities, which nonpayment arose from fraud.

4.2.9 Amend 11 U.S.C. § 362(a)(8) to confine its application to proceedings before the Tax Court for tax periods ending on or prior to the filing of the petition in the bankruptcy case and to permit appeals from Tax Court decisions.

4.2.10 Application of the periodic payment provisions of § 1129(a)(9)(C) to secured tax that would be entitled to priority absent their secured status.

4.2.11 Amend 11 U.S.C. § 545(2) to overrule cases that have penalized the government due to certain benefits for purchasers provided for in the lien provisions of the Internal Revenue Code.

4.2.12 Amend 11 U.S.C. § 503 and 28 U.S.C. § 960 to eliminate the need for a governmental unit to make a "request" to the debtor to pay tax liabilities that are entitled to payment as administrative expenses.

4.2.13 Amend 11 U.S.C. §§ 502(a)(1) and 503(b)(1)(B) to provide that postpetition *ad valorem* real estate taxes should be characterized as an administrative expense whether secured or unsecured and such taxes should be payable as an ordinary course expense.

4.2.14 Amend the Bankruptcy Code to overrule *Investors of The Triangle v. Carolina Triangle Ltd. Partnership (In re Carolina Triangle Ltd. Partnership), 166 B.R. 411 (9th Cir. B.A.P. 1994)*, and to ensure that postpetition *ad valorem* real-estate taxes are a reasonable and necessary cost of preservation of the estate.

4.2.15 Amend the Bankruptcy Code to establish that *ad valorem* taxes are incurred by the estate and, therefore, are entitled to administrative expense priority status.

4.2.16-4.2.17 Amend the Bankruptcy Code to conform the treatment of state and local tax claims to that treatment provided for federal tax claims by, among others, amending 11 U.S.C. § 346 to conform state and local tax attributes to the federal list in IRC § 1398.

4.2.18 Clarify IRC § 1398 to provide that the bankruptcy estate's income is subject to alternative minimum tax and capital gains tax treatment if otherwise applicable.

4.2.19 Amend the Bankruptcy Code to provide that the term "assessed or assessment" as used in 11 U.S.C. §§ 362(b)(9) and 507(a)(8) shall mean "that time at which a taxing authority may commence an action to collect the tax."

4.2.20 Amend 11 U.S.C. § 1125(b) to establish standards for tax disclosures in a Chapter 11 disclosure statement.

4.2.21 Clarify 11 U.S.C. § 726(a)(1) to provide that a taxing authority must file a claim for a priority tax before the final order approving the trustee's report is entered by the court.

4.2.22 Conformity of Chapter 13 plans with provisions of the Bankruptcy Code: Requirement to file returns.

4.2.23 Whether an income tax return prepared by the taxing authority should be considered a filed income tax return for purposes of the Bankruptcy Code.

4.2.24 Dismissal and injunction against filing subsequent case where court determines that a Chapter 13 debtor is abusing the bankruptcy process.

4.2.25 Create a method by which a trustee may obtain a safe harbor and certainty regarding the nature, amount, and consequences of debt discharged.

4.2.26 Amend IRC § 1398(e)(3) to provide that a debtor should be treated as an employee of the bankruptcy estate as to payments by the estate of estate assets to the debtor for services performed.

4.2.27 & 4.2.28 Tax treatment of the sale by the estate of a debtor's homestead: Availability of capital gain exclusion on sale of residence to the trustee of an individual debtor.

4.2.29 Whether changes are needed in IRC §§ 108 and 382 with respect to the issuance of stock for debt.

4.2.30 Whether IRC § 1001 should be modified to provide for parallel tax treatment of recourse and nonrecourse debt.

4.2.31 Tax treatment of abandonment of property by an estate to the debtor.

4.2.32 Application of § 505(b) discharge to estate as well as to the debtor, successor to the debtor, and trustee where taxing authority does not audit.

4.2.33 Bifurcation for claim filing purposes of a corporate tax year that straddles the petition date.

4.2.34 Requirement of periodic payment for deferred payments of tax under § 1129(a)(9) and designation of interest rate used while making those deferred payments.

4.2.35 Authority of bankruptcy courts to grant declaratory judgments on prospective tax issues in Chapter 11 plans of reorganization.

4.2.36 Whether payment of prepetition nonpecuniary loss tax penalties in Chapter 11, 12, and 13 cases should be subordinated to payment of general unsecured claims.

4.2.37 Whether a substitute for return shall constitute a filed return for purposes of dischargeability issues.

DISCUSSION

Some of the most difficult issues in bankruptcy concern the computation, compliance, reporting, and treatment of federal, state, and local taxes. The National Bankruptcy Review Commission ("Commission") confronted these challenging issues head on. Under the auspices of the Commission, the Tax Advisory Committee (the "Advisory Committee") was formed in February 1997. The members of the Advisory Committee were appointed by the Commission and include representatives from the private bar, federal and state governments, and academia. A list of the members of the Advisory Committee can be found in the Appendix. Professor Jack Williams of the Georgia State University College of Law was appointed chair of the Advisory Committee.

The Commission's charge to the Advisory Committee was broad, including the jurisdiction to propose and discuss all issues related to federal, state, and local tax collection, compliance, and reporting related to bankruptcy, the bankruptcy process, and the administration of the bankruptcy estate. By necessity, this charge included an analysis of existing authority under both the Bankruptcy Code, title 11 of the United States Code, and the Internal Revenue Code, title 26 of the United States Code.

The Commission directed that the Advisory Committee report back by way of a Final Report by the August 1997 Meeting of the Commission in Washington, D.C. The Commission further requested that the Advisory Committee prepare Preliminary Reports for the April 1997 meeting of the Commission in Seattle, Washington, and the June 1997 meeting of the Commission in Detroit, Michigan. The Preliminary Reports identified those areas of bankruptcy taxation that the Advisory Committee had determined are susceptible to agreement among its members and those Proposals that had been withdrawn from consideration by the Advisory Committee as unimportant, unclear, or considered elsewhere. The Advisory Committee continued the process of discussing and identifying those Proposals that may be susceptible to agreement. The Final Report contains three sections. The first section contains a listing and discussion of twenty-eight consensus items. The first twenty-five of the twenty-eight items were presented to the Commission at the May 1997 meeting and twenty-four of the items were adopted unanimously.[2412] The second section contains a listing and discussion of six consensus items. The federal participants on the Advisory Committee abstained from consideration of these Proposals. The third section contains a listing and discussion of twenty-nine Proposals concerning those areas of bankruptcy taxation that the Advisory Committee has determined are Very Important and Highly Controversial to Controversial. Although short of a consensus on these contested issues, the Advisory Committee has provided to the Commission its Recommendations and voting record on the twenty-nine Proposals.

Before the Advisory Committee was formed, much work on the interface between bankruptcy and tax had been accomplished. The Department of Treasury, through the Internal Revenue Service ("IRS"), and the Department of Justice prepared working papers on relevant topics and Proposals, and participated informally in discussions. The views expressed by the government representatives are their personal views and are not binding on their respective agencies. The National Association of Attorneys General also submitted a number of tax Proposals for consideration. The Commission held at least two working meetings in San Diego, California, and Santa Fe, New Mexico, where many bankruptcy taxation issues were discussed and developed. Commission Member James I. Shepard has also undertaken an extensive study of the tax issues posed in the bankruptcy process. Furthermore, the Government Working Group has discussed several tax issues. The Special Task Force on the National Bankruptcy Review Commission of the Section of Taxation of the American Bar Association has prepared an extensive report on bankruptcy tax issues. The National Bankruptcy Conference has already prepared a report on bankruptcy tax issues. Judges, trustees, and other concerned parties have submitted Proposals for consideration by the Advisory Committee and the Commission. The combined efforts of the parties described above have led to the development of a Tax Matrix in excess of ninety pages with well over 100 Proposals.[2413] A copy of the Final Report as submitted by the Advisory Committee to the Commission in August 1997 can be found in the Appendix.

[2412] The items adopted by the Commission at the May 1997 meeting are: Track Nos. 105, 106, 109, 214 Part II, 216, 217(a), 311, 313, 315, 325, 326, 332, 334, 421, 422, 423, 424, 426, 702, 435(a), 437, 505, 701, and 711. Track No. 101 was considered by the Commission but not adopted. The Advisory Committee has supplemented the initial list to include additional consensus items, including Track Nos. 441, 513(a), and 700.

[2413] Rather than initiate a new numbering system to track bankruptcy tax Proposals, the Advisory Committee continued the numbering and tracking system of the previous tax matrices as a matter of convenience and in an effort to reduce confusion over discussions concerning bankruptcy tax Proposals. Those Proposals added to the matrix by the Advisory Committee were assigned 700-series index numbers. Furthermore, where appropriate, the Advisory Committee split multiple Proposals into component parts; thus, original Proposal No. 414 has been redesignated Nos. 414, 414(a), and 414(b).

The following Proposals were adopted by the Commission at its May 1997 and June 1997 meetings. While many of the Proposals adopted by the Commission were Recommendations by the Advisory Committee, on occasion the Commission rejected the Recommendation of the Advisory Committee and either rejected the Proposal outright or adopted one of the competing Proposals.

4.2.1 Clarify provisions of the Bankruptcy Code on providing reasonable notice to governmental units.

The NBRC has agreed with the Recommendation of the Advisory Committee that notice provisions in the Bankruptcy Code must be clarified as those provisions relate to governmental units. There is a consensus that the government should not lose its rights against the debtor or the bankruptcy estate in a bankruptcy case because of the debtor's failure to provide notice reasonably calculated to reach the proper representatives of the government. Although the details as to what constitutes reasonable notice are not self-evident, the NBRC notes that the Advisory Committee has reviewed the Tax Related Information items contained in the Justice Department’s letter of March 7, 1997, to the Advisory Committee on Bankruptcy Rules (Appendix IV) and generally finds these requests reasonable. The NBRC follows the Advisory Committee suggestions that the Congress consider three parts to any Proposal on notice to the government.

First, notice to the government must be reasonably calculated to reach the proper representatives of the government and must reasonably identify the debtor. Without a reasonably targeted notice requirement under the Bankruptcy Code or Rules, one can continue to expect the government to experience special difficulties because of the large and diffuse nature of governmental units and the difficulty governments may have in identifying claims and interests in the bankruptcy case. Improved notice would enhance the fairness and efficiency of the bankruptcy process. Improved notice should also reduce inadvertent violations of the automatic stay and reduce costs associated with the bankruptcy case.

Second, to facilitate proper notice, the Congress should recommend some mechanism to provide sufficient information to permit a debtor to properly identify the relevant federal, state, or local governmental authority for purposes of providing reasonable notice under the circumstances. For example, a debtor’s attorney may be aware of the governmental department to provide notice regarding state sales tax in Nevada, where that attorney practices, but may be unaware of the department with sales tax responsibility in Georgia, a state where the client has done business. However, there is a strong belief among the majority of the Advisory Committee members that a national central registry for all government units is impractical. When one considers the vast array of local governmental units, one quickly envisions reams of phone book-like volumes of listings that may quickly become outdated. Presently, there is no logical entity to support such a system. The consensus of the Advisory Committee is that the bankruptcy clerks' offices compile and maintain the registry (that would presumably be available nationally on PACER). A district or local approach, as opposed to a national registry, should lead to more manageable lists. The clerk's offices are capable of organizing a notice list into appropriate subdivisions (federal agencies, state agencies, local governmental agencies) in an effort to make the district registries user-friendly. The creation and maintenance of a local registry provides a necessary resource to aid in giving adequate notice. If a governmental unit is not listed in the registry, the debtor would be expected to provide reasonable notice and would be protected if the debtor made a good faith effort to provide reasonable notice.

Third, failure to provide reasonable notice should result in some sanction, including exception to any bar date and the nondischargeability of tax claims where the debtor has not provided notice in a manner consistent with the applicable Bankruptcy Code section or Rule.

Finally, the NBRC adopts the Advisory Committee's Recommendation that all notice issues affecting governmental units should be taken up as one overall Proposal with amendments coming in the form of changes to the Bankruptcy Rules. Although it may be more appropriate for the Rules Committee to address the notice issues, the NBRC wants to emphasize that reasonable notice is a key consideration running throughout the Proposals in the Tax Section of this Report.

4.2.2 Amend the Bankruptcy Code to prescribe that to the extent that a tax claim presently is entitled to interest, such interest shall accrue at a stated statutory rate.

The Bankruptcy Code does not specify the interest rate to which tax claims are entitled over the life of a Chapter 11 reorganization plan. Emerging judicial consensus is that a market rate of interest must be determined and that the statutory rate is relevant to that determination, but not binding. The NBRC has agreed with the Recommendation of the Advisory Committee that judicial resources are wasted litigating the issue of what rate of interest is appropriate for tax claims entitled to interest in bankruptcy. Therefore, the NBRC adopts the Recommendations of the Advisory Committee that the Bankruptcy Code be amended to provide for interest at a stated statutory rate where the claim is in fact entitled to interest. This Proposal is not intended to enlarge the universe of claims entitled to interest in bankruptcy. It is also the consensus of the NBRC to provide the same stated statutory rate for all governmental units in the bankruptcy case. Finally, the NBRC adopts as the appropriate rate the fixed federal deficiency rate under IRC § 6621(a)(2), without regard to IRC § 6621(c), be employed.

4.2.3 The Commission should submit to the Advisory Committee on Bankruptcy Rules of the Judicial Conference ("Rules Committee") a recommendation that the Federal Rules of Bankruptcy Procedure require that notices demanding the benefits of rapid examination under 11 U.S.C. § 505(b) be sent to the office specifically designated by the applicable taxing authority for such purpose, in any reasonable manner prescribed by such taxing authority.

Section 505(b) permits a trustee to request a prompt audit from a taxing authority. If the taxing authority fails to respond within sixty days to the request, the trustee is discharged from liability for any taxes beyond the taxes shown on the return. Presently, the Internal Revenue Service has directed that § 505(b) requests be filed with the local District Director. See Rev. Proc. 81-17, 1981-1 C.B. 688. Nonetheless, some courts have held that a trustee may ignore the IRS directive and file a § 505(b) request with the IRS Service Center. *See In re Carie Corp.*, 128 B.R. 266 (Bankr. D. Alaska 1989). Governmental units are entitled to timely and reasonable notice in the bankruptcy process. However, adequate and timely notice is often dependent on obtaining information in order to identify the appropriate governmental representative. Consequently, the NBRC adopts the Recommendations of the Advisory Committee to create and maintain a local or district registry maintained by the bankruptcy court clerks that would provide sufficient information so that a debtor may comply with more stringent notice requirements. Finally, the NBRC recommends that all notice issues affecting governmental units should be taken up as one overall Proposal.

4.2.4 Conform § 346 of the Bankruptcy Code to IRC 1398(d)(2) election; also conform local and state tax attributes that are transferred to the estate to those tax attributes that are transferred to the bankruptcy estate under IRC § 1398.

The treatment of state and local taxes should be conformed to that of federal taxes regarding a debtor's tax year election and regarding those tax attributes that are transferred to the bankruptcy estate upon the filing of the petition in bankruptcy. There is no justification to maintain two systems in the Bankruptcy Code that provide for the transfer of different tax attributes based on federal versus state and local tax questions. There is also no justification for the period of a federal tax year or years being different from a state and local tax year or years.

4.2.5 Amend 11 U.S.C. § 507(a)(8) and 523(a)(1) to provide for the tolling of relevant periods in the case of successive filings. Thus, in the event of successive bankruptcy filings, the time periods specified in § 507(a)(8) shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of the prior case.

Several tax claims that are identified in the Bankruptcy Code as priority claims or as claims that are nondischargeable are tied to certain time limits, for example, tax claims assessed within 240 days of the filing of the petition are priority claims under § 507(a)(8) and nondischargeable under § 523(a)(1). Where the debtor has filed successive bankruptcy petitions, the issue posed is whether the first filing tolled the running of these time periods, thus maintaining the priority and nondischargeable character of the tax claims in the subsequent bankruptcy case. The NBRC has adopted the Recommendation of the Advisory Committee that in the event of successive bankruptcy filings, the time periods specified in § 507(a)(8) shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of the prior case. A debtor should not be entitled to stay the collection of a tax by filing a bankruptcy petition and then benefit from the pendency of the abortive case by reducing or eliminating the time in which the government's tax claims would otherwise have been entitled to priority, or altering the nondischargeability of a tax. Clarification of the law would eliminate unnecessary litigation and provide uniformity in the law. Compare In re Waugh, 1997 W.L. 135626 (8th Cir. Mar. 26, 1997); West v. United States, 5 F.3d 423 (9th Cir. 1993); In re Richards, 994 F.2d 763 (10th Cir. 1993); Montoya v. United States, 965 F.2d 554 (7th Cir. 1992); In re Brickley, 70 B.R. 113 (9th Cir. B.A.P. 1986) (all tolling the § 507(a)(8) time periods, with In re Quenzer, 19 F.3d 163 (5th Cir. 1993); In re Gore, 182 B.R. 293 (Bankr. N.D. Ala. 1995). At present, there is no consensus among members of the Advisory Committee on whether IRC § 6503(h) provides a reasonable tolling mechanism that should be expressly applied to tax claims under §§ 507(a)(8) and 523(a)(1) or whether the more appropriate additional period is the 30-day period in § 507(a)(8)(A)(ii).

4.2.6 Amend 11 U.S.C. § 507(a)(8)(ii) to toll the 240-day assessment period for both pre- and post assessment offers in compromise.

Under current law, income or gross receipts taxes that are assessed within 240 days of the date the petition in bankruptcy is filed are entitled to an eighth priority. See 11 U.S.C. § 507(a)(8). If an offer in compromise is made by the taxpayer within 240 days of the assessment date, the time during which the offer in compromise was outstanding plus 30 days, is added to the 240 day period. This mirrors the reality that during a pending offer in compromise, the IRS refrains from taking collection action. In United States v. Aberl, 78 F.3d 241 (6th Cir. 1996), the court held that the 240-day period is not suspended for offers in compromise made before the assessment date for those taxes. This Proposal speaks directly to some of the problems posed by pending offers in compromise. The NBRC has adopted the Recommendation of the Advisory Committee that any offer in compromise pending within the 240-day period should toll that period whether the offer in compromise was made before or after assessment. The Proposal removes an arbitrary distinction between assessments that could have been made within days of each other. This Proposal does not extend to installment agreements.

4.2.7 Amend the Bankruptcy Code to require "small business debtors" to create and maintain separate bank accounts for trust fund taxes and nontax deductions from employee paychecks. Also, any Proposal should provide for sanctions for failure to comply with this Bankruptcy Code requirement.

The NBRC has adopted the Recommendation of the Advisory Committee that the Bankruptcy Code should be amended to require that "small business debtors" create and maintain separate bank accounts for trust fund taxes and nontax deductions from employee paychecks. Present law does not require the trustee or the debtor in possession to segregate funds for the payment of trust fund taxes and nontax deductions from employee paychecks. The result is that these taxes may go unpaid when the reorganization fails and the case is converted to a case under Chapter 7 of the Bankruptcy Code. As to the sanction imposed for failure to comply with this requirement, the NBRC has adopted the Recommendation of the Advisory Committee that the Bankruptcy Code differentiate between failure on the part of the debtor and failure on the part of the trustee in maintaining segregated accounts. Where a debtor fails to comply with the segregation requirement, then the court should have the power to dismiss the bankruptcy case. Where a trustee fails to comply with the segregation requirement, such as in a Chapter 7 case or in some Chapter 11 cases, then dismissal is inappropriate. Rather, more appropriate sanctions in these circumstances include denial of fees to the trustee, surcharge against the trustee's bond or personal liability for willful failure, or removal from the trustee panel.

4.2.8 Amend 11 U.S.C. § 1141(d)(3) to except from discharge taxes unpaid by businesses entities, which nonpayment arose from fraud.

The NBRC has adopted the Recommendation of the Advisory Committee to amend § 1141(d)(3) to except from discharge taxes unpaid by a business debtor where the nonpayment arose from fraud. The NBRC and the Advisory Committee, however, have not reached a consensus on what conduct and intent are sufficient to constitute fraud. The actual difficulty is not in identifying what conduct constitutes fraud but in what conduct constitutes a willful attempt to evade or defeat a tax, a recognized extension of the doctrine of tax fraud. One proposal is that the term “willful” would require that a finding of a willful attempt to evade or defeat a tax must be supported by an affirmative act as evidence of a wrongful intention to avoid paying a lawful tax. Passive omissions such as failure to file or pay should not be sufficient to support a finding of “willful.” This proposal is consistent with the notion that the honest debtor is deserving of the bankruptcy discharge and reestablishment as a productive and taxpaying member of society.

A competing proposal states that a legislative effort at this time to attempt to define the types of behavior that may constitute a willful attempt to evade or defeat a tax will neither reduce nor streamline litigation on this question between tax authorities and taxpayers. The inquiry must always be fact specific in each case. The judicial standard emerging from the case law now fairly applies the statutory standard to the facts presented in court. Any proposal to require taxing authorities to meet a criminal standard for willfulness is inappropriate to the civil nature of the debt restructuring process that bankruptcy represents and to the purely civil consequences of a tax being excepted form discharge. The requirement of proof of an affirmative act on the part of debtors to evade or defeat imposition of the tax, as adopted in In re Gathwright, 102 B.R. 211 (Bankr. D. Or. 1989), has been rejected by the majority of courts to address the issue. In re Bruner, 55 F.3d 195 (5th Cir. 1995; see also Dalton v. Internal Revenue Service, 77 F.3d 1297, 1300 (10th Cir. 1996). A taxpayer's culpable conduct for purposes of proving a case under a willfulness standard should include, but not be limited to: (1) concealing or obscuring assets through dubious transfers or otherwise; (2) failing to file returns for an extended period; (3) dealing in large amounts of cash; (4) filing false W-4 or W-2 forms; and (5) failing to cooperate with the government.

4.2.9 Amend 11 U.S.C. § 362(a)(8) to confine its application to proceedings before the Tax Court for tax periods ending on or prior to the filing of the petition in the bankruptcy case and to permit appeals from Tax Court decisions.

Section 362(a)(8) stays the commencement and continuation of a proceeding before the United States Tax Court concerning the debtor. The Tax Court held in Halpern v. Commissioner, 96 T.C. 895 (1991), that § 362(a)(8) stays the commencement or continuation of a proceeding involving an individual debtor's postpetition tax liabilities, even though the IRS may not file a proper request for payment of an administrative expense for the individual debtor's own postpetition tax liabilities. The NBRC has adopted the Recommendation of the Advisory Committee to amend § 362(a)(8) to overrule the Tax Court's decision in Halpern v. Commissioner, 96 T.C. 895 (1991). Additionally, the NBRC has adopted the Recommendation of the Advisory Committee that suggests that the law be clarified by permitting the appeal of tax court decisions without violating the automatic stay. The NBRC has also adopted the Recommendation of the Advisory Committee that suggests that the relevant event for triggering the application of § 362(a)(8)'s limitation is the filing of the petition in bankruptcy and not the entry of the order for relief.

4.2.10 Application of the periodic payment provisions of § 1129(a)(9)(C) to secured tax that would be entitled to priority absent their secured status.

The NBRC has adopted the Recommendation of the Advisory Committee that secured tax claims that, without the security, would otherwise be payable as priority, the period over which payments should be made and the manner of their payment shall be the same as if the claims were merely priority. For all other purposes, the requirements of § 1129(b)(2) shall continue to be required to be met.

4.2.11 Amend 11 U.S.C. § 545(2) to overrule cases that have penalized the government due to certain benefits for purchasers provided for in the lien provisions of the Internal Revenue Code.

Section 6323 of the Internal Revenue Code provides protection to certain purchasers of property even after a notice of federal tax lien has been filed in accordance with federal tax law. IRC § 6323 defines "purchaser" as a person who, for adequate consideration, acquires an interest (other than a lien or security interest) in property, which is valid under local law against subsequent purchasers without notice. Applicable purchases include securities, motor vehicles, personal property purchased at retail, and personal property purchased at casual sales. Section 545(2) of the Bankruptcy Code permits a trustee to avoid a tax lien that is either not perfected or not enforceable at the time of the filing of the petition against a bona fide purchaser, "whether or not such purchaser exists." Trustees and debtors in possession have attempted to employ § 545(2) to avoid tax liens on certain of the above-described assets, on the basis that the trustee or debtor steps into the shoes of the hypothetical bona fide purchaser entitled to superpriority under the Internal Revenue Code. The purpose of the exceptions in the Internal Revenue Code is to facilitate the flow of these goods in commerce. Applying § 545(2) to tax liens may result in an unintended windfall to the debtor. Additionally, while no reported cases have yet attempted to apply the same legal arguments to state tax liens with similar provisions, the same legal argument could be made to penalize state taxing authorities. Thus, any amendment should not be limited to the federal government but should also include state and local governments.

4.2.12 Amend 11 U.S.C. § 503 and 28 U.S.C. § 960 to eliminate the need for a governmental unit to make a "request" to the debtor to pay tax liabilities that are entitled to payment as administrative expenses.

Because governmental units are creditors in the vast majority of bankruptcy cases, this issue has been a real problem for taxing authorities. The Proposal would eliminate the need to make a request to the debtor to pay taxes that are entitled to payment as an administrative expense and are required to be paid under 28 U.S.C. §§ 959(b) and 960. These taxes are bona fide expenses of the administration of the bankruptcy estate. A requirement that a governmental unit must file a "request" for payment of taxes that constitute an administrative expense unnecessarily burdens governmental units and clogs the bankruptcy docket.

4.2.13 Amend 11 U.S.C. §§ 502(a)(1) and 503(b)(1)(B) to provide that postpetition *ad valorem* real estate taxes should be characterized as an administrative expense whether secured or unsecured and such taxes should be payable as an ordinary course expense.

The treatment of postpetition *ad valorem* real estate taxes in bankruptcy has posed substantial problems for local taxing authorities. The Proposal suggests that these taxes should be treated as administrative expenses, whether secured or unsecured, and should be paid in the ordinary course of the debtor's affairs. The Proposal is not intended to overrule the limitation on paying property taxes imposed by 11 U.S.C. § 502(b)(3) (prohibiting the payment of a tax assessed against property if the claim exceeds the estate's interest in the property). Local taxing authorities, such as school districts, rely heavily on *ad valorem* real estate taxes to fund their operations. Delay or failure to pay poses significant hardship on the local taxing authority and those constituents they serve.

4.2.14 Amend the Bankruptcy Code to overrule *Investors of The Triangle v. Carolina Triangle Ltd. Partnership (In re Carolina Triangle Ltd. Partnership), 166 B.R. 411 (9th Cir. B.A.P. 1994)*, and to ensure that postpetition *ad valorem* real-estate taxes are a reasonable and necessary cost of preservation of the estate.

The NBRC has adopted the Recommendation of the Advisory Committee that postpetition *ad valorem* real-estate taxes are a reasonable and necessary cost of preserving the estate and are entitled to treatment as administrative expenses payable in the ordinary course of affairs of the debtor. Cases that provide to the contrary should be overruled.

4.2.15 Amend the Bankruptcy Code to establish that *ad valorem* taxes are incurred by the estate and, therefore, are entitled to administrative expense priority status.

The NBRC has adopted the Recommendation of the Advisory Committee that postpetition *ad valorem* real-estate taxes are incurred by the estate and are a reasonable and necessary cost of preserving the estate and are entitled to treatment as administrative expenses payable in the ordinary course of affairs of the debtor.

4.2.16 & 4.2.17 Amend the Bankruptcy Code to conform the treatment of state and local tax claims to that treatment provided for federal tax claims by, among others, amending 11 U.S.C. § 346 to conform state and local tax attributes to the federal list in IRC § 1398.

The NBRC has adopted the Recommendation of the Advisory Committee to amend 11 U.S.C. §§ 346, 728, 1146, and 1231.

Section 346

1. Section 346(a) should be revised to provide that for state and local tax purposes the provisions of the Internal Revenue Code of 1986 are to be used:

   - ! to determine when a separate estate is created as the result of the filing of a bankruptcy petition.
   - ! to determine which attributes, that are available under state and local tax laws, are transferred to the estate on the filing of a bankruptcy petition and are transferred back to the individual on termination of the estate.
   - ! to determine how income (to the extent provided for under state and local laws) from the estate (when created) is taxed or deductions (to the extent provided for under state and local laws) are allowed.
   - ! to determine how income from the cancellation of debt is to be reported and how basis and other tax attributes (to the extent they are available under state law) are reduced.
   - ! to determine the tax consequences of transfers between bankruptcy estate and individual debtor.

2. A new subsection should be added to provide that the applicable state and local tax rates (rather than federal rates) should be used to determine any tax liability or refund for state and local taxes.
3. A new subsection should be added to provide that it is the responsibility of the trustee to file federal, state and local tax returns (when required under applicable federal, state and local laws) for a separate estate created by the filing of a bankruptcy petition and for partnerships and corporations filing bankruptcy petitions.
4. Section 346(b) should be repealed. (Section 1398 addresses the applicable issues - when an estate is created, how an estate is taxed and the accounting methods to use).
5. Section 346(c) should be repealed. (Sections 1398 and 1399 and proposed change in section 346 addresses these issues - filing status for corporations and partnerships and responsibilities for filing tax returns (item 3 above)).
6. Section 346(d) should be repealed (Section is not needed if section 1398 applies - a separate estate is not created in Chapter 13).
7. Section 346(e) should be repealed (Section is not needed since 1398 provides for how income is handled by the estate and the allowance of expenses).
8. Section 346(f) should be modified to provide that the same provisions apply to federal tax law as well - deals with payment of withheld items.
9. Section 346(g) should be repealed (Section 1398 addresses the applicable issues - transfers between bankruptcy estate and individual debtor).
10. Section 346(h) should be repealed (Section 1398 addresses the applicable issues - preservation of NOL and provides that short tax years do not create a separate year for NOL carryover periods (Note the current § 346(h) is inconsistent with IRC.)).

11. Section 346(I) should be repealed (Section 1398 addresses the applicable issues - attribute carryover and use of NOL carryovers).
12. Sections 346(j) should be repealed (Sections 1398 and 108 address the applicable issues - income from cancellation of debt, tax attributed reduction, etc.)

Section 728

1. Section 728(a) should be repealed. (Section 1398 provides that the estate's year ends the day before the petition is filed if the election for a short year is timely filed).
2. Section 728(b) should be repealed (provisions regarding the requirement of the filing of returns are now included in § 346 (see item 3).
3. Section 728(c) and (d) should be repealed. (With the suggested changes above, we see no useful purpose for these provisions).

Section 1146

1. Section 1146(a) should be repealed. (Section 1398 provides that the estate's year ends the day before the petition is filed if the election for a short year is timely filed).
2. Section 1146(b) should be repealed (provisions regarding the requirement of the filing of returns are now included in § 346 (see item 3)).
3. Section 1146(c) dealing with stamp and similar taxes is not addressed.
4. Section 1146(d) dealing with the request to determine the tax impact of a plan is listed as a separate item and should not be dealt with here. (It is a controversial issue.)

Section 1231

Section 1231 should be repealed—a separate estate is not created in Chapter 12.

Amend 11 U.S.C. § 346 and IRC § 1398 to provide that for purposes of making the election to close the debtor's tax year, the time period for making such election commences on the date the order for relief is entered.

This Proposal is a direct response to the situation created by the commencement of an involuntary bankruptcy case under Chapter 7 or 11 of the Bankruptcy Code. Presently, IRC § 1398(d)(2) links the period by which an election must be made to the date the petition in bankruptcy is filed. This poses no problem in a voluntary case commenced under 11 U.S.C. §§ 301-302 (the date the petition is filed is also the date an order for relief is entered in the bankruptcy case). However, in an involuntary case commenced under 11 U.S.C. § 303, the petition may be filed sometimes months before the order for relief is entered by the court, if ever. During the involuntary gap period, the debtor may continue to operate as though no bankruptcy case has been filed. There appears no reason to link the election under IRC § 1398(d)(2) to the filing of the petition in these circumstances. Rather, the more appropriate event to link the beginning of the time period by which to make the (d)(2) election is the entry of the order for relief.

4.2.18 Clarify IRC § 1398 to provide that the bankruptcy estate's income is subject to alternative minimum tax and capital gains tax treatment if otherwise applicable.

Some confusion exists as to whether the bankruptcy estate is exempt from the Alternative Minimum Tax ("AMT"). Presently, some bankruptcy trustees take the position that the bankruptcy estate is exempt from the AMT but may employ capital gains treatment. These inconsistent positions should be reconciled.

4.2.19 Amend the Bankruptcy Code to provide that the term "assessed or assessment" as used in 11 U.S.C. §§ 362(b)(9) and 507(a)(8) shall mean "that time at which a taxing authority may commence an action to collect the tax."

Some confusion has surrounded the use of the term "assessment" in the Bankruptcy Code when used in reference to state and local taxing authorities. Some taxing authorities have no assessment procedure whatsoever, some taxes are self-assessed, etc. The purpose of this Proposal is to provide to the extent possible a universal definition of assessment, regardless whether conventional "assessment" procedures are employed. The problem at which this Proposal is addressed arises only with respect to state or local tax collections. Thus, any definition of the term "assessment" should be specifically limited to state and local tax purposes to avoid any confusion about the meaning of the term for federal purposes. The Proposal is not meant to define "assessment" in § 1129(a) or to imply that the event of “assessment” or some other trigger is more or less appropriate under that section.

4.2.20 Amend 11 U.S.C. § 1125(b) to establish standards for tax disclosures in a Chapter 11 disclosure statement.

The NBRC has adopted the Recommendation of the Advisory Committee that 11 U.S.C. § 1125(b) be amended to require a discussion of the potential material federal and state tax consequences of the plan to the debtor and any entity created pursuant to the plan, and a discussion of the potential material federal tax consequences of the plan to a hypothetical investor typical of the holders of claims or interests. A failure to discuss the potential tax consequences of a plan of reorganization in the disclosure statement can result in seriously misleading creditor constituencies and other parties in interest about the plan's economic effects. See Smith v. Bank of New York, 161 B.R. 302 (Bankr. S.D. Fla. 1993). There is no justification for allowing a plan proponent to ignore a plan's tax consequences in the disclosure statement. A plan's tax consequences represent an important aspect of the plan and should be fully discussed to the extent they are material. A Chapter 11 debtor or other plan proponent who possesses the financial resources to propose a plan of reorganization and draft a disclosure statement is likely to possess the necessary resources to analyze the plan's tax effects. A debtor or other plan proponent cannot be expected to provide each creditor with individually tailored tax information; it would be impractical and unreasonably expensive. On the other hand, addressing the material federal tax matters affecting a hypothetical creditor or equity security holder in each class created under the plan is not burdensome, and a plan proponent fairly can be required to supply such information in its disclosure statement.

4.2.21 Clarify 11 U.S.C. § 726(a)(1) to provide that a taxing authority must file a claim for a priority tax before the final order approving the trustee's report is entered by the court.

In Chapter 7, § 726(a)(1) allows a tardily filed claim for a priority tax if the claim is "filed before the date on which the trustee commences distribution." One court held that the date the trustee commences distribution is the date when the court approves the final report and accounting of the trustee. In re Wilson, 190 B.R. 860 (Bankr. E.D. Mo. 1996). The court rejected the State of Missouri's argument that the date the trustee commenced distribution was the date the checks were mailed and rejected the trustee's argument that distribution commenced when the trustee's final report was sent to the United States Trustee for approval. The NBRC has adopted the Recommendation of the Advisory Committee that the language to § 726(a)(1) be changed from "the date on which the trustee commences distribution" to "the date on which the court approves the final report and accounting of the trustee." This Proposal is a housekeeping amendment designed to minimize future litigation that may arise from a literal reading of the statute.

4.2.22 Conformity of Chapter 13 plans with provisions of the Bankruptcy Code: Requirement to file returns.

Consensus on additional Chapter 13 requirements regarding, among others, the filing of returns:

The NBRC has adopted the Recommendation of the Advisory Committee on filing return requirements in Chapter 13 cases. Following is an outline of the Proposal.

1. As a prerequisite for confirming a Chapter 13 plan, a debtor must have filed tax returns for all tax periods ending within six years prior to the petition date. A debtor's written consent to a substitute for return prepared by a tax authority or written stipulation to a judgment in a

nonbankruptcy tax tribunal will constitute a "filed return" for purposes of this Proposal.

2. Prepetition tax returns must be properly filed with the appropriate tax authorities at least one day prior to the conclusion of the first meeting of creditors. At or before the conclusion of the first meeting of creditors, the debtor must file with the court a statement certifying, under penalty of perjury, that all required tax returns for the relevant periods have been properly filed with the appropriate tax authorities. The Chapter 13 trustee may require that a debtor submit copies of returns to the trustee.

3. If tax returns have not been filed by the date on which the first meeting of creditors commences, the trustee may continue the first meeting to allow additional time to file returns. The additional time allowed shall be no longer than (1) 120 days from the order for relief for returns that are past due as of the order for relief, or (2) for returns not past due as of the order for relief date, the latter of (i) 120 days from the petition date or (ii) the automatic extension date for filing a return under applicable tax law.

4. Failure to timely file tax returns by the above deadline for prepetition returns, or by due dates (including extensions pursuant to applicable tax laws) for postpetition returns, shall constitute cause for conversion or dismissal under § 1307(c).

5. The court, for good cause shown due to circumstances for which the debtor should not justly be held accountable, may extend the return-filing deadline. Dismissal or conversion would be automatic if such extended deadline were missed.

6. The deadline for objecting to plan confirmation shall be at least sixty days after prepetition tax returns are filed with the tax authorities.

7. A debtor may not file an objection to a proof of claim for a tax required to be reported on a return unless the debtor has filed a return for that tax.

8. The § 502(b)(9) “governmental bar date” will be modified (for tax claims only) to allow tax authorities sixty days from the filing of tax returns by debtors to file proofs of claim; provided, however, that this modification will not have the effect of shortening the governmental bar date in any case.

Rationale. Part 1 - The requirement for six years of returns reflects a compromise on the part of tax authorities, who generally oppose discharge in bankruptcy for *any* period for which a debtor/taxpayer has failed to file returns. In response to concerns expressed by debtor and trustee representatives at the Commission sessions in Santa Fe and San Diego that requiring an unlimited number of returns to be filed would discourage bankruptcy non-filers from "re-entering the system," tax authority representatives indicated a willingness to compromise on a limited number of years if return filing was an absolute prerequisite for confirmation and thus, indirectly, discharge. Six years was generally agreed to be a reasonable period for requiring returns to be filed.

Part 2 - The requirement that returns be filed at least one day before the completion of the § 341 meeting would allow Chapter 13 trustees to ask two important questions at § 341 meetings:

1. Have you filed your tax returns for the six-year prepetition period?

2. Does your plan provide for payment of the amount of taxes reflected in your returns?

If returns have been filed at least one day before the § 341 meeting, a trustee (or tax creditor) may ask for copies or other evidence of filing. The debtor would not be in a position to say, "I'm filing them today" (or tomorrow or next week or next month), but would have to answer yes or no as to an event occurring in the past. If the answer to the second question is that the preliminary plan does not provide for payment matching the returns, then the trustee would presumably not recommend confirmation until the discrepancy had been corrected.

Part 3 - Part 3 also reflects a compromise on the part of tax authorities and debtors. A stricter standard of requiring that tax returns be current as of the petition date might delay or deny bankruptcy relief to debtors who need it for nontax reasons (pending home foreclosure or car repossession, for example). A looser standard of allowing returns to be filed up until the government claim bar date (180 days from petition date) would put large-volume tax authorities under an unrealistically short deadline to file or amend claims and create havoc or delays in the confirmation process. The anticipated procedure in cases would be that the trustee would determine at the initial § 341 meeting if a debtor has filed necessary tax returns. If not, but the trustee is satisfied that the debtor is making a reasonable effort to get the returns prepared and filed, the trustee may continue the § 341 meeting for up to 120 days or until the last available extension for a prepetition return. (For example, a Chapter 13 debtor filing a bankruptcy petition on January 1, 1997, would have the option under tax law of obtaining an extension through August 15, 1997, to file a 1996 income tax return. Extensions for earlier years would have expired by the petition date).

Part 4 - Rather than automatic dismissal for failure to file tax returns (a position tax authorities had originally advocated), the failure to file returns would be added to the other "causes" for dismissal or conversion contained in § 1307. Most courts now dismiss or convert cases when debtors have failed to file tax returns. That practice would be codified.

Part 5 - Part 5 provides a "safety valve" in case the debtor has made a good faith effort to get returns prepared and filed, but for unanticipated reasons beyond the debtor's control (delay in receiving necessary information from tax authorities or incapacitating injury, for example) has been unable to do so. Again, this provision is a compromise on the part of tax authorities, whose initial preference was for an absolute cutoff point for filing returns.

Part 6 - Part 6 addresses two issues: (1) How long should tax authorities be given to act upon filed returns?; (2) Can confirmation proceed before priority tax debts have been determined? From the perspective of debtors and other creditors, problems are created when the entire bankruptcy process must be put on hold while tax authorities determine what they are owed. The proposed sixty-day period would force tax authorities to act in a reasonably prompt manner to protect their claims at confirmation. From the tax authorities' perspective, it is a considerable waste of time and effort to either have to estimate (and later amend) claims for tax periods for which no returns have been filed or to file a "place-holding" confirmation objection that says, in essence, "We don't know how much we're owed, so don't confirm a plan until we find out." Part 4 of the Proposal attempts to strike a reasonable balance: debtors must file returns before confirmation can proceed, but the confirmation process can proceed fairly quickly after returns are filed. Part 6 would end the practice in some districts of confirming Chapter 13 plans before the amount of priority tax debt is known. Such practice creates a number of legal and practical issues. First and foremost, how can a court assess feasibility of a plan under § 1325(a)(6) if the amount of priority tax debt that must be paid in full cannot be determined? The practice of taking the debtor's word for the amount owed, or simply ignoring the issue, is contrary to reason and common sense. From a procedural standpoint, confirmation of a plan before tax debts are determinable results in a "preliminary confirmation order." Are such orders appealable as final orders? Do they have res judicata effect on tax creditors, or on other creditors if modification is required in the future? Who is responsible for undoing or modifying the preliminary confirmation order after tax claims are filed? Such questions are eliminated under this Proposal. Part 6 of the Proposal takes debtors who are delinquent in filing prepetition returns off the "confirmation fast track" as long as the delinquency continues. Debtors who are current on their returns as of the order for relief date or, at least the date of the § 341 meeting, would remain on the "fast track" in jurisdictions that do early confirmations. The disparate treatment does not seem out of line, since it rewards debtors who have complied with the tax laws (or who promptly cure noncompliance) and delays those who are delinquent. From a procedural and policy standpoint, more time *should* be taken to deal with debtors who have difficulty bringing their tax returns current. Failure to file tax returns is often indicative of other financial problems that need to be addressed, and the Proposal above would serve to red flag potential problem cases needing extra attention, appropriately taking them off the confirmation “fast track”.

Parts 7 and 8 - As noted above, the practice of filing estimated, “place holding” proofs of claim for periods for which no returns have been filed creates a number of problems for tax authorities, debtors and courts. Tax authorities must spend considerable time and effort preparing debtor-specific estimated proofs of claim, which is a monumental task given the volume of Chapter 13 filings. The task is unnecessary if debtors comply with return-filing obligations applicable to non-debtors, and the effort is simply wasted if returns are later filed and processed into amended proofs of claim, thereby mooting the estimated claims. Further, tax authorities are in a “no-win” situation on estimated proofs of claim. Some courts have directed tax authorities to file claims labeled as estimates to protect their position, while other courts have sanctioned tax authorities for filing incorrect estimates. Debtors resent estimated proofs of claim that may overestimate the amount of taxes owed, and “burden of proof” procedural battles often erupt in such cases. Courts are faced with hearing claim disputes with a dearth of evidence (due to returns being unfiled). To avoid such difficulties, a simple rule is proposed: returns must be brought current before debtors can proceed with claim objections.

Note: this would not prevent debtors from objecting to audit claims covering periods for which returns have been filed. Consistent with the intent to eliminate “place-holding” estimated proofs of claim, the governmental claims bar date is proposed to be adjusted to allow tax claims to be filed based upon the returns filed by debtors, rather than estimates.

Two additional notes to Proposal: 1. “Filing of returns” presumes returns are *properly* filed -- *i.e.*, with the right agency, at the right address, with the right tax identification numbers, with the requisite signatures, and subject to penalties of perjury/false filing. If not taken up in the context of discussion on “notice rules”, such presumptions may need to be added to this Proposal. 2. "Returns" for purposes of this section would include substitutes for return that the debtor has signed and nonbankruptcy tax tribunal stipulations of liability.

4.2.23 Whether an income tax return prepared by the taxing authority should be considered a filed income tax return for purposes of the Bankruptcy Code.

The NBRC has adopted the Recommendation of the Advisory Committee that an income tax return prepared by the taxing authority should not be considered a filed income tax return for purposes of the Bankruptcy Code.

4.2.24 Dismissal and injunction against filing subsequent case where court determines that a Chapter 13 debtor is abusing the bankruptcy process.

There is a wide variance among districts around the country in terms of whether serial filing is a problem. The particular focus of tax authorities is on Chapter 13 repeat filers, although the problem can also occasionally arise in individuals' Chapter 11 cases. In some districts, effective monitoring of "serial filers" by Chapter 13 Trustees and/or courts limits the numbers of such cases to minimal levels. In other districts, it is not uncommon for debtors, particularly small business debtors, to file 4 or 5 or more cases in a 5-10 year span, incurring substantial new tax debts all the while and without a material change in the debtors' circumstances. Such cases require an inordinate amount of resources of Chapter 13 trustees, the court system and tax creditors. Some serial filers essentially use the bankruptcy system as a revolving door through which to duck when tax authorities undertake collection efforts. Many "serial filers" have no real hope of ever repaying constantly-increasing tax debts in full, as required by §§ 1322(a)(2) and 1129(a)(9). Bankruptcy Judge Polly Higdon of Oregon presented data substantiating this problem at the September 1996 Commission meeting in Santa Fe.

The present Bankruptcy Code provides only limited tools to creditors, trustees and judges to deal with abusive serial filers. Bankruptcy Code § 109(g) prevents serial filings only if (1) a prior case was dismissed by the court for "willful failure" to abide by court orders or to appear before the court in prosecution of the case, or (2) the debtor voluntarily dismissed the case after a creditor's filing of a request for stay relief. Although the case law is split, some courts have held that the limited circumstances described in § 109(e) constitute the *only* grounds for dismissing a case with prejudice. <u>In re Merrill</u>, 192 B.R. 245, 252 (Bankr. D. Colo. 1995)("Although abuse of the bankruptcy system and creditors by frequent or repeat filers is a well-known problem, Congress has not chosen to combat the problem by authorizing courts to bar abusive debtors from future bankruptcy relief." Debtor had filed 7 bankruptcy cases (6 Chapter 13's and 1 Chapter 7) between 1987 and 1995, incurring substantial additional tax liability during that time. Case dismissed on motion of state tax authority, but without prejudice to refiling.); <u>In re Jones</u>, 192 B.R. 289 (Bankr. N.D. Ga. 1996) ("The Court is persuaded that it cannot deny a debtor future access to bankruptcy protection except as provided by the Bankruptcy Code.... The Court understands the frustration of the IRS caused by repetitive filings. But, it is not the role or power of the judiciary to remedy a legislative statute by opinion. Congress easily can change the statute whenever it is so inclined." The Debtor was an optometrist who had filed 3 cases in 3 years, accumulating more than $277,000 of tax debt to the IRS.)

<u>Alternative remedies</u>. One way to address the problem of abusive serial filers would be to provide for dismissal with prejudice if a certain number of cases have been unsuccessfully attempted within a certain period of time --*e.g.*, no more than 3

petitions within 5-year period. The primary downside to such arbitrary limits is obvious, however. Not all serial filings are abusive. A debtor legitimately pursuing Chapter 13 rehabilitation may lose his or her job, go through a divorce, incur a serious personal injury or face similar uncontrollable circumstances that may require starting over to achieve a discharge. To avoid inflexibility, but to provide courts the ability to police abusive filers, a less-draconian remedy is possible. Proposed solution. Amend §§ 1307 and 1112 to give bankruptcy judges discretion to dismiss cases with prejudice to refiling under Chapter 13 or 11 for a period determined by the court. A non-exclusive laundry list of relevant factors for courts to consider in dismissing with or without prejudice would give courts some guidance, without compelling a result in a particular case. The factors to be considered would include:

(i) the number of prior cases filed by the debtor;

(ii) the extent to which new debts to creditors, including tax debts, have accrued during the present case or prior cases;

(iii) the good faith, or lack thereof, of the debtor in pursuing plan confirmation and plan compliance in the pending case or prior cases; and

(iv) the reasons why successful completion of prior cases did not occur.

This would give judges the flexibility to keep the bankruptcy courts open to the "honest, but unfortunate" debtor who suffers job loss, personal injury, etc., but would at the same time allow judges to exclude from the bankruptcy system for a period of time the "revolving door" debtors.

4.2.25 Create a method by which a trustee may obtain a safe harbor and certainty regarding the nature, amount, and consequences of debt discharged.

Although cancellation of indebtedness income is not recognized if the discharge occurs while the taxpayer is a debtor under title 11, IRC § 108 does not require that certain enumerated tax attributes be reduced in accordance with the formulae provided in that section. Presently, there is little certainty in bankruptcy regarding the nature, amount, and consequences of debt discharge. Thus, trustees are required to estimate when, for example, a discharge of indebtedness has occurred for purposes of the attribute reduction rules under IRC § 108. Consequently, a date of discharge in bankruptcy cases should be fixed for purposes of tax attribute reduction.

4.2.26 Amend IRC § 1398(e)(3) to provide that a debtor should be treated as an employee of the bankruptcy estate as to payments by the estate of estate assets to the debtor for services performed.

Under present law, it is unclear whether when the estate pays estate assets to the debtor those payments should be treated as ordinary income, 1099 income, or a distribution. See PLR 8728056 (April 15, 1987). The Proposal provides that payments of estate assets to the debtor for services performed are to be treated as ordinary income, providing the estate with a corresponding deduction. It is not the intent of the NBRC to suggest that income from future services performed postpetition by the individual debtor is itself property of the estate. See 11 U.S.C. § 541(a)(6). Rather, this clarification speaks to property that is already property of the estate that the estate seeks to use to pay the debtor for services performed.

4.2.27 & 4.2.28 Tax treatment of the sale by the estate of a debtor's homestead: Availability of capital gain exclusion on sale of residence to the trustee of an individual debtor.

Under current law, any individual can sell a personal residence and exclude a certain dollar amount of capital gain depending on that person's marital status. The exclusion is not available to bankruptcy estates because a bankruptcy estate cannot have a personal residence. Pergament v. United States (In re Barden), 105 F.3d 821 (2d Cir. 1997).

Because Congress increased the amount of the exclusion and eliminated the age restriction, the NBRC believes the exclusion should be available to bankruptcy estates. Not allowing the exclusion to the bankruptcy estate creates a hidden, nonuniform exemption and runs counter to the Proposals to create uniform exemptions. All else being equal, debtors with low-basis residences receive a larger exemption than debtors with high-basis residences. Trustees recognize this and are less likely to sell the low-basis residence. Also, a hidden incentive is created to file for bankruptcy, if the debtor recognizes that the trustee will have to abandon the residence because of the burdens of secured debt, homestead, and tax gain on sale. For example, assume a capital gain on sale of $56,000 (.28 x $200,000). If the debtor sells the residence after filing for bankruptcy, the debtor keeps the $56,000 gain, in lieu of a payment to the unsecured creditors.

Under current law, if the trustee sells the personal residence, the trustee is responsible for 100% of the tax due. Waldschmidt v. I.R.S. (In re Lambdin), 33 B.R. 11 (Bankr. M.D. Tenn. 1983); and In re Card, 114 B.R. 226 (Bankr. N.D. Cal. 1990). This is true even if a substantial portion of the proceeds are distributed to the debtor in the form of an exemption. If uniform exemptions are adopted and if the exclusion rule is expanded and made available to bankruptcy estates, then the NBRC believes current law should not be changed and the homestead should not carry tax. However, if wide variations in the personal residence exemption remain in the Bankruptcy Code, the NBRC believes a pro rata share of the gain should be taxed to the debtor. The following ratio could be used: exemption paid to debtor is to amount realized from sale, as tax allocable to debtor is to total tax due on sale.

4.2.29 Whether changes are needed in IRC §§ 108 and 382 with respect to the issuance of stock for debt.

Statement for modified stock for debt exception to recognition of cancellation of indebtedness income and the preservation of tax attributes:

Under current law, if a corporation is reorganized pursuant to a Chapter 11 plan, that corporation will not include in income any cancellation of indebtedness realized as a result of the plan. It will, however, be required to reduce its tax attributes, including net operating loss carryforwards ("NOLs"), capital loss and credit carryforwards, and assets basis in excess of post reorganization liabilities. Prior to the Omnibus Budget and Reconciliation Act of 1994 ("OBRA 1993"), the stock for debt exception provided an exception to the requirement that tax attributes be reduced by the amount of any excluded cancellation of indebtedness. Under current law, however, a corporation that issues stock to its creditors realizes substantial income from debt cancellation that must then be applied to reduce tax attributes. Thus, companies emerging from bankruptcy may have a tax balance sheet lower than their financial balance sheet with greater levels of income for tax purposes and a greater likelihood of liquidation over reorganization.

It is proposed that IRC § 108 be amended to provide that a corporation undergoing a reorganization in bankruptcy be permitted to make a fresh start election when undergoing bankruptcy reorganization. The election is identical to the proposed election of the ABA Tax Section Task Force on the Tax Recommendations of the National Bankruptcy Review Commission ("ABA Task Force") dated April 15, 1997, at 202-207.

Statement against:

Elimination of the stock for debt exception to the recognition of cancellation of indebtedness income generates tax revenue and preserves horizontal equity.

4.2.30 Whether IRC § 1001 should be modified to provide for parallel tax treatment of recourse and nonrecourse debt.

The NBRC has adopted the Recommendation of the Advisory Committee that the Commission should recommend that Congress modify IRC § 1001 to provide that tax consequences of the transfer (for example, foreclosure or transfer in lieu of foreclosure) of an asset to satisfy a nonrecourse debt should be the same as a transfer to satisfy a recourse debt.

Under this Proposal, the difference between the basis of the property and the fair market value of the property would be a gain or loss on transfer and the difference between the fair market value and the amount of the nonrecourse debt would be income from the cancellation of debt under IRC § 61. The tax treatment of income from cancellation of debt would be governed by IRC § 108. This treatment is consistent with the tax consequence of the transfer of property to satisfy recourse debt.

This change would overrule Commissioner v. Tufts, 461 U.S. 300 (1983), and follow the position taken by Professor Wayne G. Barnett in an amicus to the Tufts case. It would eliminate the problems that arise when recourse debt is converted to nonrecourse debt over which the taxpayer has no control such as when the trustee abandons property to the debtor. For example, in Private Letter Ruling 8918016 (January 31, 1989), the IRS ruled that the abandonment was not a taxable event to the estate but held that the recourse debt became nonrecourse as a result of the discharge.

Taxpayers that plan to transfer property to satisfy a nonrecourse debt often work out an agreement with the creditor to forgive all or part of the debt in excess of the value of the property as a separate transaction prior to transferring the property to avoid all of the gain being taxed as a gain on transfer. (Of course, if the taxpayer has capital loss carryovers, this agreement would be unnecessary.) This proposed change to § 1001 would eliminate action of this nature and the problems associated with attempting to determine if debt is recourse or nonrecourse or attempting to convert nonrecourse debt to recourse or visa versa depending on the needs of the taxpayer.

4.2.31 Tax treatment of abandonment of property by an estate to the debtor.

The majority rule under present law treats debtors unfairly. The debtor is taxed on disposition gain without the availability of nonexempt assets to pay the tax. The debtor does not get the benefit of NOLs and other tax attributes (other than passive losses and credits) to offset the gain and tax liability. Had property been disposed of prior to bankruptcy, the debtor would not have suffered either of these adverse consequences. The current minority rule treats the abandonment as a taxable event to the bankruptcy estate. This is unfair to taxing authorities. The tax is an administrative expense and is not a liability of the debtor. Therefore, the debtor has effectively turned a nondischargeable tax into a dischargeable tax. Had the debtor disposed of the property immediately prior to bankruptcy, the tax would have been a nondischargeable tax. The ABA Task Force Proposal is to treat abandonment as a disposition by the debtor immediately prior to bankruptcy. To the extent that the tax is not satisfied out of the bankruptcy estate, the debtor will be responsible. The debtor's personal tax liability, however, would not arise until there has been an actual disposition of the asset. This is fair to both the taxing authorities and the debtor. The taxing authority will be able to recover the tax liability from estate assets. If such taxes are insufficient to pay the liability, the debtor will continue to be responsible. The debtor will have a nondischargeable tax liability, the same as if he had disposed of the asset immediately prior to bankruptcy, and will not have beaten the system by having the gain treated as an administrative expense. The unsecured creditors are no worse off than under the current minority rule, but are worse off than under the current majority rule. Arguably, under the current minority rule they have received a windfall, since had the foreclosure taken place immediately prior to bankruptcy they would have stood in line behind the taxing authority before receiving any distribution. The NBRC adopts the ABA Proposal on abandonment outlined above as endorsed by the Advisory Committee.

Contrary Proposals:

Proposal 1:

If property with a tax basis lower than fair market value remains in the bankruptcy estate at the time of sale or foreclosure, the resulting capital gains taxes must be borne by the estate—*i.e.*, by unsecured creditors. If, on the other hand, the property is abandoned to the debtor before sale or foreclosure (and the abandonment is deemed not to be a taxable event), the debtor bears the adverse tax consequences upon the ultimate disposition of the property. The policy choice presented is between burdening a debtor's fresh start and burdening the estate/creditors with adverse tax consequences of property that has no value to the estate. Three primary reasons argue in favor of leaving the tax burdens with the debtor, rather than the estate. (1). *Effect on creditors*- It is the debtor who has enjoyed prepetition use of the property and any tax benefits associated with the property (depreciation deductions, often accelerated depreciation for tax shelter investments), so it is only fair that the debtor bear the tax consequences upon disposition, not creditors. To do otherwise would require creditors to bear the adverse tax consequences associated with the disposition of property that has conferred no benefit upon the estate. The estate would, in effect, subsidize the debtor as to a post-bankruptcy taxable event. (2). *Consistency with non-tax burdens*—If property is burdensome to the estate or of inconsequential value to the estate for non-tax reasons (such as environmental problems, title problems, overencumbrance by liens), the ability of a trustee to abandon property and thereby protect the estate from postpetition liability is clear. Property that is burdensome because of adverse tax characteristics (typically, basis less than fair market value) should not be excepted from the general rule. Debtors should not get a "tax fresh start" on such property at the expense of the creditors of the estate when debtors do not get an "environmental fresh start" or other type of fresh start for burdensome property. (3). *Trustee liability* -- Trustees are increasingly being threatened with personal liability or claims against their bonds for failing to abandon property from the estate prior to foreclosure or other taxable event triggering capital gains tax liability for the estate. Statutorily clarifying the rule that abandonment of burdensome property shifts adverse tax consequences to the debtor from the estate will protect trustees, as well as creditors.

Proposal 2:

The majority rule that bankruptcy abandonment is not of itself a taxable event states the correct view of the law. Thus, a foreclosure or similar disposition of an asset abandoned by the estate may result in a tax incurred by the individual debtor and not by the estate. However, under § 1398, tax attributes such as net operating loss carry forwards have been transferred to the estate and remain with the estate for estate use even where the tax attributes are directly related to the abandoned asset. This result is unfair to the debtor. Taking its cue from the Final Regulations under § 1398, this Proposal requires that any tax attributes that passed to the estate under § 1398 that may be reasonably traced to the abandoned property follow the property upon abandonment and may be used by the debtor. This tracing and allocation of tax attributes does not require mathematical exactitude; any reasonable method of allocation should suffice such as the allocation rules for NOLs in regard to spouses. Moreover, the overwhelming majority of these cases involve single-asset real estate debtors or partners of debtor real estate partnerships where often times one substantial asset comprises the entire estate, thus making allocation an easier task. Thus, the debtor does get the benefit of NOLs and other tax attributes to offset the gain and tax liability, and the Proposal alleviates the inequity associated with the majority rule.

4.2.32 Application of § 505(b) discharge to estate as well as to the debtor, successor to the debtor, and trustee where taxing authority does not audit.

Statement in support of the Proposal extending § 505(b) to the estate:

The internal logic of § 505(b) suggests that the estate should be included in the provision providing for the discharge of tax liabilities where the taxing authority has failed to comply with the strict time requirements in that section. This Proposal rejects the holdings in In re Fondiller, 125 B.R. 805 (N.D. Cal. 1991); In re Rode, 119 B.R. 697 (Bankr. E.D. Mo. 1990); and In re West Texas Marketing Corp., 54 F.3d 1194 (5th Cir. 1995). This Proposal is consistent with Congressional intent for providing for expedited audits and speedy, final determination of tax liabilities in bankruptcy.

Section 505(b) provides that on the request for a determination of the tax by the taxing authority, the trustee, debtor, and any successor to the debtor are discharged from any tax liability other than that reflected on the return unless the Service notifies the taxpayer that the return will be examined. If the return is selected for examination, the taxing authority completes the examination within 180 days, and the taxpayer pays any additional tax resulting from the examination as determined by the court or by the governmental unit, no additional tax can be assessed. Until 1990, tax practitioners worked under the assumption that this provision applied to the estate since it applied to the trustee who is responsible for administering the assets of the estate. However, in the early 1990s two bankruptcy courts held that this provision did not apply to the estate. <u>In re Fondiller</u>, 125 B.R. 805 (N.D. Cal. 1991); <u>In re Rode</u>, 119 B.R. 697 (Bankr. E.D. Mo. 1990). In 1995, the Fifth Circuit also held that this provision did not apply to the estate. <u>In re West Texas Mktg. Corp.</u>, 54 F.3d 1194 (5th Cir. 1995).

Suggested change: insert "estate" along with "trustee, debtor, and any successor to the debtor." Discharging the trustee from any tax liability, but not discharging the estate, provides little assistance to the trustee who is attempting to administer the estate. The trustee will find it difficult to administer the estate not knowing the estate's tax liability. Presumably the trustee would have to wait for the statute of limitation to run before the amount of tax would be certain. Thus, until the trustee makes the final distribution or until the statute of limitation runs, the trustee has no assurance that an unexpected tax deficiency would not be asserted by a governmental tax unit. The ability of the trustee to make partial distributions may be hindered because of the uncertainty of tax claims. Additional cost to the estate and resulting reduction in payments to creditors would be incurred even if the trustee prevails in a claim inserted at the end of the case. A modification of this provision to provide that the discharge provisions apply only to the final request for tax determination (return) would encourage trustees to wait until the end of the case to file tax returns. No party, including the taxing authorities, would benefit from this change. If the decision of the Fifth Circuit is adopted by other courts, trustees, even without a change in § 505(b), may elect to file returns at the end of the case rather than as the returns are due. To limit these provisions to the trustee and not to the estate provides limited benefit to the trustee other than providing that the trustee may not be liable for the tax if an error is made in the filing of the return. However, it is questionable if this limitation would apply to the damages creditors may have sustained due to a last-minute assertion of a priority tax claim (*i.e.*, suits may be filed against the trustee's bond).

Statement against the Proposal extending § 505(b) to the estate:

The quick audit procedure of 11 U.S.C. § 505(b) was intended to provide a trustee with a means for determining the tax liability incurred by the trustee during administration of a case in order to permit closing of the case. The courts have held that a quick audit request made by a trustee under 11 U.S.C. § 505(b) discharges only the trustee and the debtor, but not the estate. The Proposal to discharge an estate from liability when a trustee requests an audit would change the fundamental purpose of the § 505(b) procedure—to determine the trustee's liability for tax. An estate should not be discharged of a tax that it is capable of paying simply because the trustee invokes the quick audit procedure. No justification exists for expanding this procedure. An IRS audit typically involves two or three years of returns because an audit of a single return is inefficient and not cost effective. Allowing trustees to discharge their liability one year at a time under 11 U.S.C. § 505(b) is questionable as a matter of policy. Discharging the estate would constitute a windfall for the unsecured creditors. IRS resources are thinly stretched and only a small percentage of tax returns are audited. One can understand why participants in the bankruptcy process would want to curtail the opportunity for audits, but submit that further curtailment of tax audits of the estate is contrary to sound tax administration. Many trustees invoke 11 U.S.C. § 505(b) by filing a request for audit simultaneously with the filing of a return. This procedure is consistent with the letter of 11 U.S.C. § 505(b), but not with its spirit since the purpose for enacting the prompt audit procedure was to facilitate closing of the estate. Until such time as the estate is to be closed, it should remain liable for taxes that the trustee failed to report correctly and should not be allowed to avoid such liability.

Although the statement in favor indicates that the Proposal for extending § 505(b) to the estate is consistent with Congressional intent, this does not appear to be the case. As originally proposed by the Commission on the Bankruptcy Laws of the United States, the prompt determination procedure was not intended to relieve the debtor or successor corporation in a reorganization or rehabilitation case of taxes incurred during administration. See Plumb, The Tax Recommendations of the Commission on the Bankruptcy Laws: Tax Procedures, 88 Harv. L. Rev. 1360, 1439-40 (1975).

4.2.33 Bifurcation for claim filing purposes of a corporate tax year that straddles the petition date.

At least three Proposals have been made for the treatment of the corporate tax liability accruing in the straddle tax year (the tax year in which the bankruptcy petition is filed). First, the decisions of the Eighth and Ninth Circuits could be codified, establishing the rule that the tax liability is apportioned between prepetition eighth priority and postpetition first priority administrative expense. Second, the I.R.S. and Justice Department have proposed that the entire straddle tax year's liability be treated as an administrative expense, thereby overruling the Eighth and Ninth Circuit cases. Third, the entire straddle tax year's liability could be treated as an administrative expense except that corporations could be granted the same election to bifurcate the straddle tax year that is available to individuals. The NBRC adopts Proposal 3 of the Final Report of the Advisory Committee concerning the straddle tax year.

NBRC Proposal: Allow election to bifurcate straddle tax year

If there is a significant, prepetition, filing year liability, an election to bifurcate the straddle tax year might provide some breathing room for a financial strapped corporation. An ability to pay the tax over the six-year period granted for the payment of priority taxes might be a critical element in proposing a successful reorganization. See 11 U.S.C. § 1129(a)(9)(C). To prevent a trap for the unwary, the due date for the election and the due date for the return could be the same date as the due date for the first postpetition return. (A similar change to IRC § 1398 might also be advisable.)

IRS and Justice have expressed concern over whether the United States would be able to make a claim for the prepetition amount before the claims bar date passed. The bar date for the prepetition liability incurred in the year of filing could be extended to 180 days after the due date of the return, including extensions.

At the Government Working Group meeting in Seattle, Commissioner Shepard expressed concern over the ability of corporate accountants to manage the income of the corporation. However, taxpayers have always had some ability to manage the size of their income in a taxable year. Allowing for bifurcation neither lessens nor increases that ability.

Competing Proposals:

Proposal 1: For bifurcated straddle tax year:

In the straddle tax year, individuals can elect a bifurcated tax year, but corporations cannot. IRC §§ 1398 (individuals) and 1399 (corporations). When a straddle tax year is bifurcated, the prepetition tax liability receives an eighth priority. The postpetition liability is the individual's personal obligation and not an administrative expense of the bankruptcy estate. The reasoning for this bifurcated treatment is that two juridic entities exist where only one existed previously--the bankruptcy estate and the individual.

A corporation cannot exist separate and apart from itself. Accordingly, it was thought that a bankruptcy filing by a corporation would not create a bifurcated straddle tax year. The entire tax liability accruing in the straddle tax year would be a first priority expense of administration.

However, both the Eighth and Ninth Circuits have apportioned the straddle tax year liability. See Missouri Dep't of Revenue (In re L.J. O'Neill Shoe Co.), 64 F.3d 1146 (8th Cir. 1995)(herein "O'Neill"), and Towers v. United States (In re Pac.-Atl. Trading Co.), 64 F.3d 1292 (9th Cir. 1995)(herein "PATCO"). Thus, at least in those circuits, the liability accrued as of the petition date is given an eighth priority, and the liability accruing after the petition date is given a first priority expense of administration.

Proposal 2: No bifurcated straddle tax year

The IRS Proposal seeks to overrule PATCO and O'Neill by providing that only income or gross receipt taxes incurred by a corporate debtor prepetition are excluded from treatment as administrative expenses. Corporations filing Chapter 7 and 11 cases do not have a separate bankruptcy estate for federal income tax purposes, pursuant to § 1399 of the Internal Revenue Code, so these corporations are not allowed the same election as individual debtors, pursuant to § 1398(d)(2) of the Internal Revenue Code, to bifurcate their straddle tax year between a prepetition period and a postpetition period of the year. Under this Proposal, for the straddle tax year a corporation files bankruptcy, the corporation files just one Form 1120 corporate federal income tax return at the end of its usual tax reporting year, reflecting all income, expenses, and other tax items for the entire straddle tax year. A corporate debtor's straddle tax year return need not be filed with the IRS any earlier, with applicable extensions, than for a corporate taxpayer not in bankruptcy. A corporate debtor's straddle tax year return also does not generally reflect when during the straddle tax year (prepetition or postpetition) any particular items of income or expense were received or accrued by the corporation. Federal income taxes are incurred and computed on an annual accounting basis.

Section § 503(b)(1)(B)(i) classifies as an administrative priority expense any tax "incurred" by the estate, except a tax of a kind specified in § 507(a)(8). The legislative history indicates that Congress intended straddle tax year income taxes to be considered "incurred" on the last day of the taxable period of a corporate debtor for purposes of §§ 503 and 507, the same as under the Internal Revenue Code. The Eighth and Ninth Circuits in O'Neill and PATCO, however, held that the straddle tax year income tax of a corporate debtor may also be "a tax of a kind specified in § 507(a)(8), and thereby be excluded from administrative priority treatment, even though the tax is not "incurred" until after the petition date.

Because of the way corporate debtors file their Form 1120 returns in a straddle tax year and the existence of early prepetition claim bar dates in bankruptcy cases, the issues raised by these cases for tax authorities go beyond whether straddle tax year income tax liabilities will be paid first as administrative expenses under § 507(a)(1). In most cases, corporate debtors do not even file their straddle tax year Form 1120 returns before 180 days after their petition dates (the ordinary prepetition claim bar date for governmental creditors). When corporate debtors do file their straddle year Form 1120 returns, there is no requirement that the returns bifurcate income and expenses for the taxpayer between prepetition and post-petition periods. Accordingly, if these decisions are not overruled, taxing authorities will be left with the options of: (1) missing the prepetition claim bar date for the straddle tax years of every corporation that files bankruptcy; or (2) filing estimated protective straddle tax year claims in every corporate bankruptcy case, then burdening the debtor, the courts, and taxing authorities with later audits, amended pleadings, and other litigation that might otherwise have been unnecessary.

4.2.34 Requirement of periodic payment for deferred payments of tax under § 1129(a)(9) and designation of interest rate used while making those deferred payments.

NBRC Proposal:

A Proposal to amend § 1129(a)(9) to require periodic payment for deferred payments of tax under § 1129(a)(9), designation of interest rate used while making those deferred payments, and establishing a six-year period from the date of the order for relief by which such taxes are to be paid:

Section 1129(a)(9) should be amended. It has been agreed that to prevent unnecessary and time consuming litigation, the section should provide that where interest is required to be paid on priority taxes that the rate be determined by § 6621(a)(2) of the Internal Revenue Code, without regard to IRC § 6621(c), in effect as of the confirmation date. There is a consensus that because of prejudice to the taxing authorities and the greater risk of non-payment, the section should expressly provide for periodic payments (monthly or quarterly), and that balloon payments be prohibited. There has been a discussion that the statute be amended to provide for a fixed period over which payments should be made, regardless of whether the tax has been "assessed". It is agreed that the use of the word "assessment" can be confusing and sometimes difficult to apply to the types of taxes asserted by states (such as sales taxes). Thus, the Proposal provides a period of up to six years from the date of the order for relief regardless of the age of the tax owed as the length of time over which payments may be made.

Competing Proposals:

Proposal 1:

A Proposal to maintain present § 1129(a)(9):

Proposal 1 weakens the priority status of taxes by giving debtors an unreasonably long period of time to pay taxes that are past-due on the petition date. Under Proposal 1, if trust fund taxes are 4 years old on the petition date, debtors would have 10 years total to repay the taxes, including 6 years from the petition date, compared to 2 years under current law. This undermines the historic priority treatment Congress has given taxes and encourages prepetition delay and abuse of the tax system. Further, the Proposal allows "stairstep" payment plans, with no increase in post-confirmation interest rates to reflect the heightened risk compared to straight-line amortization payments. There is no prohibition on payments to general unsecured creditors in cash or stock (which can be sold for cash) while so-called "priority" tax creditors are being stretched out. Essentially, the "priority" and risk of default as between general unsecured and "priority" creditors have been reversed. By comparison, general unsecured creditors in Chapters 7, 12 and 13 get paid nothing until priority claims are paid in full. Finally, the asserted need to abandon "assessment" as the commencement date for measuring the tax pay-back period is greatly exaggerated. "Assessment" is a well-defined and well-understood term under federal tax law, and adequate case law has developed to deal with state and local tax laws that do not define "assessment." Cases have generally considered the tax return due date or date of audit liability notification as being "assessments" under state and local law, and the state of the law in this respect is adequate.

Proposal 2:

IRS Proposal to modify § 1129(a)(9):

The appropriate interest rate should be the IRC § 6621 rate. Section 1129(a)(9)(C) should be clarified to require that payments pursuant to the plan must be in equal payments, no more than three months apart, with no authority for a plan term providing for a balloon payment or the back-loading of distributions. No change should be made in the current requirement that deferred payments must be completed no later than six years from the date of assessment for prepetition assessments and the confirmation date for assessments made postpetition and preconfirmation.

4.2.35 Authority of bankruptcy courts to grant declaratory judgments on prospective tax issues in Chapter 11 plans of reorganization.

NBRC Proposal in support of a bankruptcy court's power to issue declaratory judgments under 11 U.S.C. § 1146(d) on prospective federal tax issues:

Historically, declaratory judgments have not been allowed in controversies regarding federal taxes. <u>See</u> 28 U.S.C. § 2201. The rationale is that a declaratory judgment is simply a back door way of skirting the prohibition against injunctions contained in IRC § 7421. Notwithstanding the foregoing, Congress has whittled away at the declaratory judgment restrictions over the years.

- Exempt organizations. IRC § 7428
- Pension plans. IRC § 7476
- Tax-exempt bonds. IRC § 7478
- Section 367 transfer. Former IRC § 7477, repealed as deadwood.

Each of these exceptions is premised upon the overwhelming importance to the taxpayer of receiving an advance determination rather than being left at the mercy of an unfavorable IRS ruling. The same justifications apply to bankruptcy reorganizations. The debtor cannot stay in bankruptcy forever. It must confirm a plan or liquidate. Creditors must know the tax consequences of a plan of reorganization on which they are required to vote in order to make an informed decision. Failure of the IRS to issue a favorable ruling may put the plan proponents in the practical position of not being able to consummate a plan simply because the Service either disagrees with the intended tax consequences or for some reason refuses to rule.

Statement in opposition to the Proposal:

The Anti-Injunction Act, 26 U.S.C. § 7421, and the Declaratory Judgment Act, 28 U.S.C. § 2201, generally deny a court jurisdiction to determine the prospective tax consequences of an event or transaction. Declaratory judgments are permissible only with respect to tax-exempt status of an organization, 26 U.S.C. § 7428, qualification of a pension plan, 26 U.S.C. § 7476, and the status of tax-exempt bonds. The case has not been made for a bankruptcy reorganization exception to the Declaratory Judgment Act. Corporate reorganizations in and outside of bankruptcy are currently made on the basis of opinions of corporate counsel, and rulings can be requested from the IRS. There is no more need to drag the IRS into court in a bankruptcy reorganization than in any other form of reorganization. The disclosure statement in a Chapter 11 case should discuss the tax consequences of the proposed plan of reorganization. Creditors should be entitled to rely on those representation without any need for the IRS or a court to issue a ruling in every case. The court can consider representations concerning tax consequences made in a disclosure statement in connection with a feasibility determination. Such a determination does not bind the IRS, but is a sufficient check on overly optimistic representations. If the IRS refuses to issue a ruling, the plan proponent can still consummate a plan in reliance on the opinion of corporate counsel. Transactions complicated enough to raise concerns about the tax effect of a bankruptcy reorganization are put together by sophisticated taxpayers and the tax departments of large accounting and law firms. Financial transactions involving billions of dollars are consummated in reliance on such opinions without advance IRS rulings or judicial declarations.

4.2.36 Whether payment of prepetition nonpecuniary loss tax penalties in Chapter 11, 12, and 13 cases should be subordinated to payment of general unsecured claims.

NBRC Proposal to subordinate prepetition tax penalties in Chapter 11, 12, and 13 cases:

The payment of prepetition tax penalties in Chapter 11, 12, and 13 cases should be subordinated to payment of general unsecured claims without a requirement of a finding of governmental misconduct. Granting a priority to penalties works an unfairness on general unsecured creditors by, in effect, punishing them for the debtor's misconduct. This is inequitable, especially where creditors have limited access and ability to monitor a taxpayer's compliance with tax reporting requirements.

Statement against the subordination Proposal:

The prepetition, nonpecuniary loss penalties of all creditors, including tax authorities, are subordinated to the claims of general unsecured creditors in a Chapter 7 case, pursuant to § 726(a)(4). However, the Supreme Court has correctly found that outside of a Chapter 7 liquidation context, prepetition tax penalties cannot be categorically subordinated to the claims of general unsecured creditors. The ABA Task Force Proposals to single out tax penalties for subordination in reorganization cases and to remove the priority status of actual pecuniary loss tax penalties are completely unwarranted. Combining the ABA Task Force Proposals with present widespread debtor efforts to classify all pension excise taxes as "penalties" for bankruptcy purposes may also have important implications for the nation's present pension plan protection system.

4.2.37 Whether a substitute for return shall constitute a filed return for purposes of dischargeability issues.

Proposal for treating a written consent to tax liability signed by the debtor with respect to a return prepared under IRC § 6020(b), or similar federal, state, or local law provision regarding substitute for return as a filed return for dischargeability purposes under the Bankruptcy Code:

A written consent to tax liability signed by the debtor/taxpayer or a nonbankruptcy tax tribunal stipulation signed by the taxpayer agreeing to the tax owed should constitute a filed return under the Bankruptcy Code for purposes of determining dischargeability issues. Furthermore, an IRC § 6020(b) or similar federal, state, or local law provision regarding substitute for return 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 authority has failed to accept such return for filing.

Statement against the proposal treating such return as filed for Bankruptcy Code purposes:

Section 523(a)(1)(B) was meant to encourage honest and self-generated reporting by taxpayers, not to immunize nonreporting debtors who, once caught, seek to discharge their discovered tax obligations along with other debts in bankruptcy.

If a document does not qualify as a filed tax return under the Internal Revenue Code, the document should also not constitute a filed return for dischargeability purposes. The effect of lessening the standards of a "filed return" by adopting this provision would reduce voluntary compliance with the tax laws. The Tax Advisory Committee recommends that the Commission adopt the proposal.