APPENDIX F

GOVERNMENT

APPENDIX F-1

Final Report of the Tax Advisory Committee

FINAL REPORT OF THE TAX ADVISORY COMMITTEE

TO THE

NATIONAL BANKRUPTCY REVIEW COMMISSION

August 1997
Washington, D.C.

Introduction:

Under the auspices of the National Bankruptcy Review Commission (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 is attached as Appendix 1. Professor Jack Williams of the Georgia State University College of Law was appointed chair of the Advisory Committee.

Commission's Charge:

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the Advisory Committee had determined are susceptible to agreement among its members and those proposals that had been withdrawn from consideration by the Advisory Committee as unimportant, unclear, or considered elsewhere.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 has 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.[1]

[1]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.

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.

Previous Undertakings:

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 Advisory Committee applauds these efforts and has carefully considered these comments in reaching its recommendations.

The combined efforts of the parties described above have led to the development of a Tax Matrix in excess of ninety pages. 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). A copy of the most recently Revised Tax Matrix has been attached as Appendix 2. **Nonetheless, the Advisory Committee seeks to clarify one potential issue: The proposals as identified and discussed in the Preliminary and Final Reports are given the precise meaning attached to them by the Advisory Committee and not the meaning, if any, attached by the original sponsors of the proposals.** Thus, the Preliminary and Final Reports are self-contained studies.

Procedures Employed:

The Advisory Committee has reviewed and established levels of priority as to all 145 proposals on the Revised Tax Matrix. Initially, the Advisory Committee identified those proposals worthy of consideration. Those proposals found unanimously by the Advisory Committee to be unimportant, unclear, or considered elsewhere were withdrawn from consideration. A list of those proposals is attached as Appendix 3. The Advisory Committee assumes that the Commission will not further consider these proposals.[2] However, should the Commission desire to do so, the Advisory Committee urges that the Commission make a public announcement to that effect so that interested parties may comment on these proposals and that the Advisory Committee may then further consider the previously withdrawn proposals.

The remaining proposals were then considered to determine whether any proposals would be susceptible to agreement among the members of the Advisory Committee. After identifying those proposals susceptible to agreement, the Advisory Committee reviewed the remaining proposals to identify whether each proposal was:

[2]Obviously, this observation applies only to proposals that the Advisory Committee determined are either unimportant or unclear.

1. Very Important
2. Important
3. Moderately Important
4. Unimportant or Unclear

Each proposal was further analyzed to determine the level of controversy surrounding the proposal. The levels of controversy include:

1. Highly Controversial
2. Controversial
3. Noncontroversial

In the Final Report, the Advisory Committee has considered those proposals that are Very Important and Highly Controversial to Controversial. The voting protocol employed by the Advisory Committee was straightforward. First, only members of the Advisory Committee could vote on specific proposals. Second, each member's vote was assigned equal weight. Third, rather than merely providing to the Commission a tally of the votes alone, the Final Report also identifies how each member of the Advisory Committee cast his or her vote. Where a matrix item contained more than one proposal, the Advisory Committee discussed and voted on each of the proposals. Each member of the Advisory Committee could then cast a vote for or against (or abstain from) each of the proposals within a given matrix item. When this situation arose, the Advisory Committee undertook a second vote to ascertain its preference among competing proposals. The Final Report contains a brief discussion of these proposals and provides to the Commission the Advisory Committee's recommendation, where appropriate, and voting record.

Findings:

This Report is divided into several sections. The first section reports on those proposals where a consensus has been reached (including those proposals withdrawn from consideration). That section contains discussion on twenty-eight proposals reported out of the Advisory Committee as consensus items.[3] The second section reports on those proposals where a consensus has been reached by all members of the Advisory Committee except those members from the federal government who expressed no views on Internal Revenue Code provisions. That section contains a discussion of six proposals. The third section sets forth the differing position

[3]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. These items have previously been identified and discussed in the April 1997 Preliminary Report filed with the Commission. The Advisory Committee has supplemented the initial list to include additional consensus items, including Track Nos. 441, 513(a), and 700.

statements for each of the remaining Very Important and Highly Controversial to Controversial items upon which the Advisory Committee has taken action. That section contains a discussion of twenty-nine items containing, in many instances, multiple proposals. Another fifty-one proposals were carefully considered and withdrawn from further consideration by the Committee. A list of the fifty-one withdrawn proposals is attached as Appendix 3.

As of July 1997, the Commission has taken the following action with respect to bankruptcy taxation proposals. The Commission has unanimously adopted the following items: 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 (discussions of which are contained in Section 1 of this Report). The Commission has unanimously adopted Government Working Group Proposal Nos. 8 (burden of proof on tax matters in bankruptcy) and 13 (setoff of tax refunds against prepetition tax claims). By a vote of 6 to 2, the Commission adopted the second alternative to the §724(b) proposal contained in the Government Working Group Proposal as modified at the June 1997 meeting, providing for the exemption of ad valorem taxes from the provisions of §724(b) and marshaling and surcharge under §506(c).

SECTION 1:
CONSENSUS ITEMS[4]

101 **In Chapter 9 cases, require as a condition of confirmation that all prepetition taxes be paid in full in cash in a manner as set forth in 11 U.S.C. §1129(a)(9)(C).**

This proposal would require an amendment to 11 U.S.C. §901 making 11 U.S.C. §1129(a)(9)(C) applicable to Chapter 9 cases and would conform Chapter 9 practice to that under Chapter 11 of the Bankruptcy Code. Because Chapter 9 debtors are not generally taxpayers, most of the taxes involved will be employment or other trust fund taxes. The Commission may expect this proposal to be controversial from a political perspective. Furthermore, there is some concern that including a payment provision in Chapter 9 may pose Tenth Amendment concerns even though the proposal applies to municipalities only.

[4]All of these items, except Track Nos. 441, 513(a), and 700, were contained in the April 1997 Preliminary Report filed with the Commission.

105, 106 & 109 **Clarify provisions of the Bankruptcy Code on providing reasonable notice to governmental units.**

The Advisory Committee has agreed 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 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 Advisory Committee suggests that the Commission 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 Commission 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 Advisory Committee recommends 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 Advisory Committee wants to emphasize that reasonable notice is a key consideration running throughout the proposals in this Final Report.

214 Part II 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. It is the consensus 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 Advisory Committee recommends 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 Advisory Committee to provide the same stated statutory rate for all governmental units in the bankruptcy case. Although short of a consensus, a majority of members of the Advisory Committee suggest that the fixed federal deficiency rate under IRC §6621(a)(2), without regard to IRC §6621(c), be employed.[5]

[5]The Advisory Committee representatives of the federal government believe that the interest rate described under IRC §6621(c) should apply in the case of "large corporate underpayments," as that term is used in the IRC.

216 **Amend 11 U.S.C. §505(b) to require debtor taxpayers and trustees seeking an expedited audit to comply with local notice and specificity requirements to assist governmental units in making a timely response.**

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). It is the consensus of the Advisory Committee that 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, it is the consensus of the Advisory Committee that the Commission propose the creation and maintenance of 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. See comments to Proposal #106. Finally, the Advisory Committee recommends that all notice issues affecting governmental units should be taken up as one overall proposal.

217(a) 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.

311 **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 consensus of the Advisory Committee is 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).

313 **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. It is the consensus 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.

315 **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.**

It is the consensus 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 Advisory Committee strongly suggests 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. There is an emerging consensus to include all business debtors under this requirement. However, expanding the proposal to include large business debtors needs more thought.

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

The consensus of the Advisory Committee is to amend §1141(d)(3) to except from discharge taxes unpaid by a business debtor where the nonpayment arose from fraud. The Advisory Committee, however, has not reached a consensus on what conduct and intent are sufficient to constitute fraud.

326 **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. It is the consensus 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 Advisory Committee suggests that the law be clarified by permitting the appeal of tax court decisions without violating the automatic stay. The Advisory Committee also 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.

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

A consensus has been reached that as to 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.

334 **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. One member of the Advisory Committee believes this amendment should be tied to providing some de minimis exemptions to the federal tax lien for bankruptcy purposes. Such an amendment would prevent a debtor from having to buy off the tax lien in clothing, furniture, personal effects, and tools of the trade. Other members of the Advisory Committee oppose such an amendment for the reasons described with respect to Track 506.

421 **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.

422 **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). Three members of the Advisory Committee believe that postpetition ad valorem taxes should be charged to secured creditors as a §506 expense. A §506 surcharge prevents the secured creditors from receiving a windfall. Cf. E & C Holding Co. v. Piscataway (In re E. Steel Barrel Corp.), 164 B.R. 477 (D.N.J. 1994)(secured creditor would receive windfall if not charged with assessed property taxes and sewer charges), with New Brunswick Sav. Bank v. Scranton Elecs., Inc. (In re Scranton Elecs.), 163 B.R. 740 (Bankr. M.D. Pa. 1994)(court stated that estate has burden of proving that taxes paid benefited the secured creditor and estate did not carry its burden); In re Swann, 149 B.R. 137 (Bankr. D.S.D. 1993)(tax due on sale of oversecured estate property not chargeable against secured creditors under §506(c)).

423 **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 consensus of the Advisory Committee is 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.

424 **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 consensus of the Advisory Committee is 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.

426 Amend the Bankruptcy Code to conform the treatment of state and local tax claims to that treatment provided for federal tax claims.

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702 Amend 11 U.S.C. §346 to conform state and local tax attributes to the federal list in IRC §1398.

The Advisory Committee recommends the following changes to 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.

435(a) 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.

437 **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.

505 **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.

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

The Advisory Committee recommends 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.

711 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 Advisory Committee proposes 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." The Advisory Committee's proposal is a housekeeping amendment designed to minimize future litigation that may arise from a literal reading of the statute.

441 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 Advisory Committee has reached a consensus on filing return requirements in Chapter 13 cases.[6] 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.

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[6] *Comment by SC:* Tax return filing has been a significant problem in a large number of Chapter 13 cases. Track No. 441 would require the filing of tax returns as a condition of confirmation of a Chapter 13 plan. The proposal also has a number of other elements, including postponement of confirmation until the returns are filed. I am concerned that the Consumer Working Group or the Commission may view some of these other elements as overly burdensome and may recommend that the package of proposals be modified. I would like to take this opportunity to express my views that the essential elements of any proposal relating to tax return filing requirements in Chapter 13 are as follows: (1) the filing of prepetition tax returns should be an express requirement of Chapter 13; (2) the failure to file such returns should be treated in the same manner as the failure to file schedules, a budget, or information requested by the Chapter 13 trustee; (3) the Chapter 13 trustee should police compliance with this requirement either at the §341 meeting as proposed or otherwise; (4) confirmation should be postponed, as proposed, but the taxing authority should be allowed to waive this requirement by agreement with the debtor in return for a firm deadline for filing the returns and such other consideration as may be agreed upon; (5) if a plan may be confirmed before all returns are filed, the confirmation should be considered conditional and the debtor should be required to amend the plan when the returns are filed; and (6) the debtor should not be permitted to file an objection to a proof of claim for a tax for which the debtor has not filed a tax return.

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.[7]

Three 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. This proposal impacts Track No. 441(a), captioned "Obligation of a Chapter 13 debtor to pay all priority taxes when a proof of claim for such taxes is not filed," but does not purport to resolve Track No. 441(a) altogether. 3. "Returns" for purposes of this section would include substitutes for return that the debtor has signed and nonbankruptcy tax tribunal stipulations of liability.[8]

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[7]*Comment by JP:* While I strongly support requiring the filing of tax returns as a prerequisite to the confirmation of a Chapter 13 plan, I prefer the details of implementation to be left to the discretion of the court. I do, however, see the necessity of a statutory enactment modifying the bar date for taxing authorities, as proposed in paragraph 8.

[8]The representative of the IRS has reservations on the issue of what constitutes a filed return. For dischargeability purposes under Bankruptcy Code §523, the IRS position is that the Internal Revenue Code definition controls <u>See</u> Track No. 513(b).

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

There is consensus on 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.

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

If there is no proposal from the Consumer Working Group on this subject, the Advisory Committee, by consensus, recommends the following proposal to dismiss and enjoin certain Chapter 13 cases:

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. In re Merrill, 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.); In re Jones, 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.) **Alternative remedies.** 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.

Other proposals before the Commission. None at present, although the Consumer Working Group is believed to be discussing the "serial filer" problem. Preliminary discussion in the Consumer Working Group has focused on possible "up front" hurdles that a repeat-filer debtor would have to clear before proceeding in a new case. The foregoing proposal addresses the "back end" of a case -- i.e., whether the case is dismissed with or without prejudice -- and is designed to be complimentary to any "front end" proposal that the Consumer Working Group may make. The "back end" focus is particularly appropriate in the tax area, because it is at the end of the case that a court can determine if a debtor has incurred postpetition tax liability in violation of 11 U.S.C. §364(b) (that requires court authorization to incur postpetition debt out of the ordinary course of business) and 28 U.S.C. § 959(b) and 960 (that require trustees and debtors in possession to operate businesses in compliance with state law, including tax laws). In summary, this proposal is made independently of any "front end" controls on serial filers that may be proposed by the Consumer Working Group, but it should work in tandem with any proposal that may come from that group.

SECTION 2: ITEMS FEDERAL GOVERNMENT DID NOT TAKE POSITION ON IN TAX ADVISORY COMMITTEE DISCUSSIONS BUT WOULD OTHERWISE BE CONSENSUS ITEMS[9]

4121 **Create a method by which a trustee may obtain a safe harbor and certainty regarding the nature, amount, and consequences of debt discharged.**

A date of discharge in bankruptcy cases should be fixed for purposes of tax attribute reduction.

[9] *The federal participants on the Advisory Committee abstained from consideration of these proposal.*

714 **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 Advisory Committee 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.

411 Availability of one-time exclusion of $125,000 of capital gain on sale of residence to the trustee of an individual debtor.

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436(a) Tax treatment of the sale by the estate of a debtor's homestead.

Under current law, an individual over the age of fifty-five can sell a personal residence and exclude $125,000 of gain. There is bipartisan support in Congress to raise the exclusion amount, make it available to all taxpayers, regardless of age, and make it available every two years. See Dep't of Treasury, TAXPAYER BILL OF RIGHTS 3 AND TAX SIMPLIFICATION PROPOSALS 19 (April 16, 1997). 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).

If Congress increases the amount of the exclusion and eliminates the age restriction, the Committee 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.

If Congress does not change the exclusion rule, the Advisory Committee believes the over fifty-five, once-in-a-lifetime exclusion should still be available to the bankruptcy estate, provided the estate's use of the exclusion does not eliminate the debtor's right to a once-in-a-lifetime use of the exclusion. The Advisory Committee suggests that the subsequent use of the exemption by the debtor be limited to the amount of the exclusion not used by the bankruptcy estate. For example, if the bankruptcy estate excludes $50,000 of gain from income, the debtor would be limited to a $75,000 exclusion.

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 Committee 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 Committee 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.

4312(a) 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.

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

There is consensus among the members 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 <u>Commissioner v. Tufts</u>, 461 U.S. 300 (1983), and follow the position taken by Professor Wayne G. Barnett in an amicus to the <u>Tufts</u> 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.

SECTION 3:
ADVISORY COMMITTEE DISPOSITION OF VERY IMPORTANT AND HIGHLY CONTROVERSIAL TO CONTROVERSIAL ITEMS

100 Subordinating tax liens to administrative expenses and priority claims in a Chapter 7 case.

Statement in support of proposal to retain present 11 U.S.C. §724(b), which requires subordination of tax liens to administrative expenses and priority claims in a Chapter 7 case:

Under bankruptcy law, there is a long-standing bankruptcy policy beginning with the 1938 Chandler Act amendments that has subordinated tax liens to administrative expenses. On each subsequent occasion in which Congress has revisited the issue, it has broadened the extent of such subordination. If the bankruptcy system is to be viable, all administrative expenses must be paid. Failure to provide for administrative expenses will undermine the system in all cases. In some cases, failure to provide funds will prevent the trustee from recovering for all creditors, including governmental creditors, substantial assets. The Bankruptcy Code creates its own set of priorities, in which administrative expenses are superior to tax claims. In Chapter 7 cases, this fundamental structure should not be nullified because a state legislative body gives itself a tax lien that results in circumventing the system of priorities created by the federal Bankruptcy Code. It may be that in some cases consensual secured creditors should contribute to administrative expenses of the estate, including property taxes. The Commission, if it feels that such change is needed, should deal with this question directly, rather than undermining the bankruptcy system through repeal of § 724(b)(2). Additionally, complexity in the current statute is not a ground for repealing it. If its underlying principles can be validated through simplification, let the Commission do it.

Statement against the proposal to retain §724(b):

The section is complicated and obscure, making it difficult to understand and apply. Thus, it is applied inconsistently or not at all, creating disparate results in different districts. The section imposes a hardship upon individual debtors because property that would have been used to pay nondischargeable tax debts, is instead used to pay dischargeable accountant's and attorney's fees. The section also works a particular hardship on local school districts and city/county governments that may be very dependent on the revenue at risk under §724(b). Additionally, §724(b) presents an ethical dilemma for tax authorities by discouraging them from moving to convert Chapter 11 cases to Chapter 7 cases in otherwise appropriate instances because of the availability of §724(b). The section encourages debtors and their attorneys to allow unsuccessful cases to linger in Chapter 11 because they know that even if the case is converted to Chapter 7, unpaid salary and attorney's fees accrued in the case will ultimately be paid out of prepetition tax liens.

Expanding the scope of §506(c) would be a fairer method of dealing with the need to allow for the payment of truly necessary administrative expenses. Alternatively, if neither expansion of §506(c) nor an outright repeal of §724(b) is possible, it should at least be modified to limit its applicability to administrative and/or priority wage and benefit claims.

RECOMMENDATION:

By a vote of 5 to 4 (with 1 abstention), the Advisory Committee recommends to the Commission the repeal of 11 U.S.C. §724(b).

Vote:

For proposal to retain §724(b): PA, RMcK, GN, MS

Against proposal to retain §724(b): MB, SC, RM, JP, JW

Abstain: KW

211 **Application of the burden of proof rules to tax issues in bankruptcy.**

Proposal 1:

IRS position that burden of proof in bankruptcy should follow applicable nonbankruptcy law:

Clarify that when an IRS determination of tax is challenged, the burden of proof is on the debtor or trustee unless the Internal Revenue Code shifts the burden. In our system of self-assessment and voluntary compliance with tax laws, because the taxpayer has control of the facts that govern the determination of tax, the taxpayer generally has the burden of proof in tax cases litigated outside of bankruptcy. In the Tax Court, generally the burden of proof is on the taxpayer for all issues raised in the statutory notice. Similarly, in refund or collection cases, an IRS assessment is presumed to be correct and the taxpayer has the burden of proving otherwise. In a bankruptcy proceeding, a proof of claim filed by a creditor is presumed to be correct, but the presumption essentially disappears when the debtor files an objection to the proof of claim. Some courts have concluded that this allocation of burdens overrides the allocation of burdens that generally applies in tax litigation and have placed the burden of going forward and the burden of persuasion on the United States. See Franchise Tax Bd. of Cal. v. MacFarlane (In re MacFarlane), 83 F.3d 1041, 1044-1045 (9th Cir. 1996), cert. denied, __ U.S. __ (March 17, 1997); Placid Oil Co., 988 F.2d 554 (5th Cir. 1993), non acq. 1995-1 C.B. 1; In re Premo, 116 B.R. 515 (Bankr. E.D. Mich. 1990); In re Fullmer, 962 F.2d 1463, 1466 (10th Cir. 1992); In re Gran, 108 B.R. 668 (Bankr. E.D. Ark. 1989), aff'd, 131 B.R. 843 (E.D. Ark. 1991), aff'd., 964 F.2d 822 (8th Cir. 1992); United States v. Coleman, 26 B.R. 825 (Bankr. D. Kan. 1983). Other courts have concluded that the burden of proof remains with the taxpayer/debtor. See In re Landmark Equity Corp., 973 F.2d 265 (4th Cir. 1992); Resyn Corp. v. United States, 851 F.2d 660, 663 (3d Cir. 1988). The proposal specifically provides that when an IRS determination of tax is challenged, the burden of proof is to be on the party who would have it under nonbankruptcy law.

Proposal 2:

Proposal to conform the government's burden of proof with the burden of proof for other creditors:

The government should not receive treatment different from other creditors in bankruptcy courts. The prevailing rule in circuits where the government has the identical burden as other creditors can be expressed as follows: A properly filed claim constitutes prima facie evidence of a claim's validity; the debtor has the burden of rebutting this prima facie validity; if that burden is met, the creditor must present evidence to prove the claim. Franchise Tax Bd. of Cal. v. MacFarlane (In re MacFarlane), 83 F.3d 1041, 1044-1045 (9th Cir. 1996), cert. denied, __ U.S. __ (March 17, 1997). A primary objection to leaving the ultimate burden on the government is that the taxpayer has the records. However, if the taxpayer does not produce those records, then the taxpayer cannot rebut the prima facie validity of the proof of claim. Thus, the issue of "who has the records" is a red herring. The proposed burden shifting rule also adds unnecessary work for the creditor or trustee who objects to the government's claim. The government's burden of proof should be identical to any other creditor's.

Proposal 3:

Proposal shifting burden to taxing authority upon proper showing:

A debtor should not be able to gain an advantage in a tax controversy with the government by litigating his claims in the bankruptcy court rather than a traditional tax tribunal. The allocation of the burden of proof should generally mirror the burden outside the bankruptcy court, including placement on the government in cases of fraud or where new issues are raised by the government at trial. The allocation of the burden of proof in tax matters results from the debtors personal knowledge of its own transactions. That rationale does not support uniformly placing the burden on the party objecting to a tax claim where the debtor is not the real party in interest. Where the trustee or a creditor files the objection, upon motion to the court, the court should be able to place the burden of proof on the government if, based upon prior audits of the debtor's return or other factors, shifting the burden would be equitable. In such case, the trustee or other objector should be required to turn over all records in its possession to the government.

RECOMMENDATION:

By a vote of 9 to 1, the Advisory Committee recommends the rejection of Proposal 2, which follows the McFarlane rule. By a vote of 9 to 1, the Advisory Committee endorses Proposal 1, the IRS proposal, and by a vote of 8 to 2, endorses Proposal 3, the burden shifting proposal. When asked to state a preference for one of the Proposals, 5 of the 10 members favored Proposal 3, 4 members favored Proposal 1, and 1 member favored Proposal 2.

Vote:

For Proposal 1: All Committee Members except KW

Against Proposal 1: KW

For Proposal 2: KW

Against Proposal 2: All Committee Members except KW

For Proposal 3: PA, MB, RMcK, GN, JP, MS, KW, JW

Against Proposal 3: SC, RM

212 Obligation of a debtor to file prepetition and postpetition returns and pay postpetition taxes and the consequences for failure to comply.

Statement in support of the proposal:

Add as grounds for conversion or dismissal in Chapter 11, 12, and 13 cases the following: failure to file prepetition tax returns; failure to file postpetition tax returns; and failure to file postpetition returns and pay postpetition taxes. The purpose of this proposal is to encourage a bankruptcy court to grant motions to dismiss or convert when the debtor fails to meet its tax obligations. While the failure on the part of the debtor to pay prepetition taxes would not be a basis for dismissal or conversion, the proposal contemplates that the continued failure to file prepetition tax returns, and the failure to file postpetition tax returns or pay postpetition taxes can be legitimate bases for dismissal or conversion, depending on the facts and circumstances. A debtor’s inability to become current will indicate problems for the feasibility of a reorganization plan. Passage of this proposal may also help to prevent a debtor from pyramiding employment taxes, a practice that insures the failure of many Chapter 11 plans.

Statement against the proposal:

The devil is in the details. If Track 212 proposes that the nonpayment of postpetition tax for more than one period can be considered as one of many factors for converting or dismissing a Chapter 13 case, then there is no objection. If Track 212 proposes making a Chapter 13 case dismissable if any postpetition tax goes unpaid, then the objection is strong. Consider also the effects of such a proposed rule on 11 U.S.C. §1305(a)(1), which allows a governmental unit to file a claim for unpaid postpetition taxes.

RECOMMENDATION:

By a vote of 7 to 3, the Advisory Committee recommends that the Commission adopt the proposal.

Vote:

For proposal: MB, SC, RMcK, RM, GN, JP, JW

Against proposal: PA, MS, KW

213 Application of the superdischarge in Chapter 13 cases to tax claims.

Proposal 1:

Proposal to retain the current Chapter 13 superdischarge:

The current superdischarge in Chapter 13 should be retained. Chapter 13 provides a more robust discharge in return for greater recovery for creditors then they would have received in a Chapter 7 case. The superdischarge breathes life into the fundamental bankruptcy policy of providing an individual debtor a fresh start. The major problem with Proposal 3 is that a court could read the requirement of an affirmative act to mean only a de minimis act.

Proposal 2:

IRS proposal to conform the discharge of Chapter 13 to that of Chapter 7:

Eliminate the superdischarge of priority taxes in a Chapter 13 case, and clarify that postpetition taxes for which a proof of claim is filed under § 1305(a)(1) are not subject to discharge. The proposal would align the Chapter 13 exceptions to discharge to those of Chapter 7 and an individual Chapter 11. The Bankruptcy Code now discharges a Chapter 13 debtor from taxes that are provided for by the plan or are disallowed under § 502. Several courts have held that priority taxes mentioned in the plan are "provided for" and can be discharged whether or not they are actually paid. Similarly, claims for priority taxes that have been disallowed in the bankruptcy proceeding under § 502 and would not be dischargeable in a Chapter 7 or 11 proceeding have been held to be dischargeable because they were mentioned in the Chapter 13 plan. The problem most often arises in those cases where the Service's claim was untimely filed or where the Service failed to file a claim at all. See In re Tomlan, 102 B.R. 790 (E.D. Wash. 1989), aff'd, 907 F.2d 114 (9th Cir. 1990) (untimely claim disallowed, then discharged); In the Matter of Border, 116 B.R. 588 (Bankr. S.D. Ohio 1990) (unfiled claim discharged); In re Ryan, 78 B.R. 175 (Bankr. E.D. Tenn. 1987) (prepetition tax claims assessed postpetition were discharged because no claim filed). The most serious concern of the Service occurs with derivative liabilities, such as the trust fund recovery penalty, where the debt is prepetition but the determination of liability does not occur until after the bar date. Additionally, under present law a Chapter 13 debtor may obtain a discharge for taxes fraudulently underreported or evaded more than 3 years ago. Certain tax penalties can also be discharged under Chapter 13, although those same taxes and penalties would not be dischargeable for individuals in a Chapter 7 or 11 case.

Proposal 3:

Proposal for modest modifications to the superdischarge of Chapter 13:

Amend 11 U.S.C. §1328(a) to deny a discharge to those Chapter 13 debtors who have filed fraudulent returns or who have engaged in an affirmative act or acts in an attempt to willfully and fraudulently evade a tax where the governmental unit proves in accordance with applicable nonbankruptcy law the fraudulent conduct in the bankruptcy case. Evidence suggests that taxing authorities receive a greater recovery in Chapter 13 cases than they do in Chapter 7 cases. In fact, the Bankruptcy Code recognizes this consequence in Chapter 13 cases and provides incentives for individual debtors to seek relief under Chapter 13. These incentives include relief from postpetition interest on unsecured tax claims, an expanded scope of the automatic stay, and the broad discharge in §1328(a). These incentives for filing under Chapter 13 as opposed to Chapter 7 should be continued. Thus, a broader scope of discharge is justified under Chapter 13. At the same time, however, the Chapter 13 process should not result in a haven from tax liabilities for those taxpayers that have defrauded a governmental authority. Although the requirement that any Chapter 13 plan must be proposed in good faith may operate as a gate to prevent abuses of the bankruptcy process by tax protestors and defrauders, courts are not in agreement on the meaning of good faith in these circumstances and present law lacks clarity. Thus, a specific amendment to 11 U.S.C. §1328(a) is necessary to except from the scope of the Chapter 13 discharge tax claims with respect to which the debtor made a fraudulent return or with respect to which the debtor engaged in an affirmative act or acts in an effort to willfully and fraudulently attempt to evade a tax where the governmental unit proves in accordance with applicable nonbankruptcy law the fraudulent conduct in the bankruptcy case.

Two related issues are directly affected by this proposal and are considered here. The first related issue is the strong argument by governmental units relating to notice of derivative tax liabilities. Presently, a Chapter 13 plan may be confirmed in an expedited fashion without proper notice to taxing authorities regarding trust taxes. A notice provision along the lines as proposed in the Final Report should address this concern. The second but related issue concerns non-filers. Again, a related proposal seeks to address the nonfiler issue.

RECOMMENDATION:

By a vote of 8 to 2 and 6 to 4, respectively, the Advisory Committee recommends the rejection of Proposals 2 and 3, which state the IRS proposal and the proposal suggesting modest changes to the Chapter 13 discharge, respectively. However, the Advisory Committee failed to reach a majority on remaining Proposal 1, which would retain the Chapter 13 superdischarge in all respects. As to Proposal 1, 4 members voted for, 4 voted against, and 2 abstained. When asked to state a preference for one of the Proposals, 4 members favored Proposal 1, 4 members favored Proposal 3, and 2 members favored Proposal 2.

Vote:

For Proposal 1: PA, RMcK, MS, KW

Against Proposal 1: MB, SC, RM, JP

Abstain: GN, JW

For Proposal 2: SC and RM

Against Proposal 2: All Committee Members except SC and RM

For Proposal 3: MB, GN, JP, JW

Against Proposal 3: PA, SC, RMcK, RM, MS, KW

Statement by KW: At some point the door must open for tax debtors to reenter the system. I remain deeply concerned over the Government's dischargeability proposal that would close the door or, at best, leave it only slightly ajar.

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

Proposal 1:

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.

Proposal 2:

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 3:

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.

RECOMMENDATION:

By a vote of 7 to 3, the Advisory Committee recommends that the Commission adopt Proposal 1. All 7 members who voted for Proposal 1 also identified the Proposal as their preferred proposal, whereas 1 member preferred Proposal 2, and 2 members preferred Proposal 3.

Vote:

For Proposal 1: PA, RMcK, GN, JP, MS, KW, JW

Against Proposal 1: MB, SC, RM
For Proposal 2: MB, GN, JW

Against Proposal 2: PA, SC, RMcK, RM, JP, MS, KW

For Proposal 3: MB, SC, RM, JP

Against Proposal 3: PA, RMcK, GN, MS, KW, JW

215 Application of the automatic stay to the setoff of tax refunds against tax claims.

Proposal 1:

Proposal to modify the stay to permit setoff of prepetition tax refunds against prepetition tax claims:

Permit taxing authorities to setoff prepetition refunds against prepetition taxes without first seeking relief from the automatic stay. Under §362(a)(7), the filing of a petition in bankruptcy stays the setoff of any debt owed to the debtor that arose before the commencement of the bankruptcy case against any claim against the debtor. None of the exceptions to this stay apply to setoffs of tax liabilities against tax credits or refunds. Thus, while the stay is in effect, a taxing authority is not allowed to setoff a prepetition refund owed to a taxpayer regardless of whether the taxpayer owes taxes of a different nature or for different taxable periods. A proposed change to §362(b) would remedy this situation by allowing a taxing authority to setoff prepetition refunds against prepetition taxes owed by the debtor.

Outside the context of a bankruptcy proceeding, tax overpayments are routinely and systematically credited by the IRS against outstanding tax liabilities by computer, pursuant to I.R.C. § 6402(a). Notice that an overpayment has been credited against a tax liability is automatically issued to the taxpayer by the Service Center.

When the IRS receives notice of a bankruptcy proceeding, the Service Center is notified by the local Special Procedures Function (SPF), and routine offsets by the computer at the Service Center are prevented by the input of a freeze code. The actions taken by the IRS with respect to the overpayment vary depending upon the judicial district. In most judicial districts, the overpayment is simply frozen and remains so until court action is initiated by the IRS or the debtor and/or trustee. IRS instructions provide that these cases may be referred to counsel for lifting of the automatic stay so the amount can be collected by setoff during the pendency of the bankruptcy.

The IRS function responsible for preparing and filing proofs of claim in bankruptcy cases is the Special Procedures Function (“SPF”). When a proof of claim is prepared by SPF, the taxpayer’s account is researched by reading the computer file of that taxpayer maintained at the Service Center. If this research reveals the existence of an overpayment, the amount of the overpayment is listed on the proof of claim form. The debtor/trustee can dispute the application of the overpayment by filing an objection to the proof of claim. Even if the setoff has already occurred, there is no question that relief can be provided if the court so determines.

In many jurisdictions, local rules or standing orders authorize the IRS or other taxing authorities to offset tax refunds against tax liabilities subject to different local law imposed conditions.

Proposal 2:

IRS proposal to modify stay to permit setoff of tax refunds against prepetition tax claims and postpetition nondischargeable tax claims:

The IRS proposal would go further by permitting the setoff of postpetition tax refunds against taxes excepted from discharge. Section 553 refers specifically to the offset of prepetition debts owed to a debtor against prepetition claims. Thus, it allows only the setoff of prepetition tax refunds against prepetition tax claims. It is not equitable to require a taxing authority to make a refund to a debtor at a time when the debtor owes a nondischargeable tax. The proposed amendment would allow a government unit to offset a postpetition refund against a prepetition nondischargeable tax.

Proposal 3:

Proposal that no change in the law is necessary:

Where the need for an order permitting setoff of tax refunds is necessary and appropriate, a particular district may enter into a standing order permitting such setoff. Otherwise, the taxing authority may seek relief from the stay in appropriate circumstances. A major problem with Proposal 1 is that it does not contain a notice provision for the debtor or other creditors who might have a claim to the refund. Proponents for change have failed to make their case.

Proposal 4:

Proposal to overrule all standing stay orders and to retain the stay against setoff:

The taxing authority should have no greater rights to setoff than any other creditor. Overruling standing stay orders that exist in some districts would promote uniformity. The taxing authority may seek relief from the stay in appropriate circumstances.

RECOMMENDATION:

By a vote of 8 to 1 (with 1 abstention), the Advisory Committee recommends that the Commission adopt Proposal 1. The Advisory Committee recommends that the Commission reject Proposal 2 by a vote of 6 to 4 and Proposal 4 by a vote of 9 to 1. The Advisory Committee is split 5 to 5 on the merits of Proposal 3. As to preferences, the Advisory Committee is split, with 4 members preferring Proposal 1 and 4 members preferring Proposal 2.

Vote:

For Proposal 1: MB, SC, RMcK, RM, GN, JP, MS, JW

Against Proposal 1: PA

Abstain: KW

For Proposal 2: SC, MB, RM, JP

Against Proposal 2: PA, RMcK, GN, MS, KW, JW

For Proposal 3: PA, RMcK, GN, MS, KW

Against Proposal 3: MB, SC, RM, JP, JW

For Proposal 4: PA
Against Proposal 4: All Committee Members except PA

312 Effect of a subsequent filing or default on the status or nature of a tax claim provided for in a Chapter 11 plan.

Proposal 1:

Proposal to preserve status of tax claims in subsequent bankruptcy plans or liquidation cases following a failed plan or dismissal:

Existing law is unclear with respect to whether a taxing authority can take administrative collection action when a plan is dismissed or the debtor defaults on payment of taxes. The taxing authorities take the position that tax claims remain collectable as taxes in the event of a dismissal of a bankruptcy or a default by the debtor as to the terms of payment of taxes under the plan. Some debtors have argued, however, that the only remedies upon dismissal or default are contractual. The uncertainty regarding the rights of taxing authorities leads to needless litigation and requires clarification. The rights of taxing authorities to collect tax debts as taxes rather than as contractual claims in the event a bankruptcy is dismissed or the debtor defaults by failing to comply with the terms of payment of taxes under a plan should be clarified.

Statement against the proposal:

The priority status of a tax claim provides certain negotiation rights that are limited to the initial confirmed plan. Once the plan has been confirmed, the priority tax claim is replaced with a contract claim based on the terms of the plan.

Proposal 2:

Proposal 1 above with the addition that the taxing authorities may not begin to collect the tax after default on payment of taxes until the taxing authority has provided thirty-days' notice of the default to the taxpayer:

The thirty-day notice requirement provides the taxpayer reasonable notice without unduly burdening the taxing authorities. A notice provision should also permit the debtor/taxpayer an opportunity to cure any default and promote the reorganizational efforts of the debtor. Also, status of a tax claim as priority, or not, should not be frozen by the Chapter 11 plan if there is a subsequent default.

RECOMMENDATION:

By a vote of 7 to 3, the Advisory Committee recommends to the Commission the adoption of Proposal 2. By a vote of 6 to 4, the Advisory Committee recommends to the Commission the adoption of Proposal 1. As to preferences, the Advisory Committee prefers Proposal 1 to Proposal 2 by a vote of 6 to 4.

Vote:

For Proposal 1: MB, SC, RM, GN, JP, JW

Against Proposal 1: PA, RMcK, MS, KW

For Proposal 2: PA, RMcK, GN, MS, KW, JP, JW

Against Proposal 2: MB, SC, RM

313(a) Effect of an installment payment agreement on 240-day assessment period applicable to certain tax priorities.

IRS proposal to extend tolling to installment agreements:

Provide that the 240-day period after the filing of a petition, in which taxes must be assessed in order to be entitled to priority treatment, is suspended for installment agreements in the same manner as it is suspended for offers in compromise. Under current law, taxes that are assessed within 240 days of the date of petition in bankruptcy are entitled to eighth priority. If an offer in compromise is made by the taxpayer within 240 days of the assessment date, the IRS refrains from taking collection action during the pendency of the offer, the time during which the offer was pending plus 30 days is added to the 240 days. There is nothing under current law that similarly applies if an installment agreement is entered into within 240 days of the assessment date, even though the IRS is prohibited from collection action while the installment agreement is in effect. The purpose of this proposal is to treat installment agreements the same as offers in compromise. Otherwise, the IRS is disadvantaged by entering into an installment payment agreement in return for a deferral of collection.

Statement against tolling priority periods where an installment agreement is outstanding:

The IRS recommendation to stay the 240-day period for installment agreements should be rejected unequivocally. Given the frequency with which installment agreements are entered, this rule could make the nondischarge period for a tax unlimited. This is especially true since the collection division of the IRS is very skilled at convincing taxpayers that installment agreements are in their best interest and the statute of limitation on collection must be extended as part of the installment agreement process.

The IRS's proposed rule would harm compliant taxpayers who are trying to pay off their tax while benefitting those taxpayers who thumb their noses at the government and say no to an installment agreement.

One argument used by the IRS to support its position is that the IRS "administratively does not collect" taxes when an installment agreement is in place. This is unpersuasive. The whole point of the installment agreement is the collection of taxes. The IRS has enacted very tough cost of living guidelines, so that a taxpayer who has entered an installment agreement has little or no fluff in the budget.

RECOMMENDATION:

By a vote of 6 to 3 (with 1 abstention), the Advisory Committee recommends to the Commission the rejection of the Proposal.

Vote:

For IRS Proposal: MB, SC, RM

Against IRS Proposal: PA, RMcK, GN, MS, KW, JW

Abstain: JP

314 Priority of taxes assessable at the time of the petition but attributable to fraudulent and unfiled returns.

IRS proposal to clarify the list of priority tax claims:

The IRS proposes that § 507(a)(8)(A)(iii) be clarified so that priority will be denied for taxes attributable to fraudulent and unfiled returns only when the taxing authorities ability to assess those taxes results solely from the taxpayer's fraud or failure to file. The IRS proposal would provide priority status to those tax claims still assessable at the time of the filing of the petition for reasons that are totally unrelated to the debtor's fraud or failure to file. The statement against the IRS proposal misinterprets the proposal.

Statement against the IRS proposal:

The scope of the proposed rule is unclear. If Track No. 314 codifies the rule that each priority provision of §507(a)(8) and each nondischargeability provision of §523(a) represent independent bases for priority and nondischargeability, there is no objection. See, Etheridge v. Ill. Dep't of Revenue (In re Etheridge), 91 B.R. 842 (Bankr. C. D. Ill. 1988); Smith v. United States (In re Smith), 114 B. R. 473 (W. D. Ky. 1989). Query whether such an amendment is needed, as courts have been fairly consistent in recognizing this "independent basis" rule.

However, it appears that Track No. 314 expands the scope of what is nondischargeable. See I.R.S. Statement for Proposal that includes overruling In re Verdunn, 160 B.R. 682 (Bankr. M. D. Fla. 1993), which was correctly decided under current law. If the proposal is to expand nonpriority claims, then the objection of the private practitioners is strong. This expansion of priority claims would force full payment of all nonfiled returns in Chapter 13 where the tax has not been previously assessed.[10] It would give governmental units an incentive not to pursue nonfilers because the government would be in a better position if the tax is never assessed prepetition.

To illustrate, consider the following: Debtor is a nonfiler for the tax year 1990, a substitute for return has not been filed, the tax due has not been assessed, and debtor files a bankruptcy petition in 1997. Under current law, the 1990 tax year would be a nonpriority/nondischargeable tax obligation in Chapter 7. In addition, the 1990 tax year could be paid off with a best efforts plan in Chapter 13 because

[10] Verdunn dealt with fraud returns. However, it appears the I.R.S. proposal applies to nonfiled returns as well as fraud returns.

the 1990 tax year is nonpriority. Under the proposed rule change, because the tax due is still assessable, the 1990 tax year would be a priority/nondischargeable tax obligation in Chapter 7. In addition, the 1990 tax year would be payable in full in Chapter 13 because the 1990 tax year would be given priority.

If the facts were changed so that the government assessed the tax in 1994 after filing a substitute for return, the proposed expansion of the priority rule would have no effect on current law. The 1990 tax year would still be nonpriority/nondischargeable in Chapter 7 and payable with best efforts in Chapter 13. In other words, under the proposed rule change, the government would have been better off if it had never assessed the tax. This disincentive to assess tax should not be written into the Bankruptcy Code.

RECOMMENDATION:

By a vote of 7 to 3, the Advisory Committee recommends that the Commission adopt the IRS proposal.

Vote:

For IRS Proposal 1: PA, MB, SC, RM, GN, JP, JW

Against IRS Proposal 1: RMcK, MS, KW

321 **Efficacy of an order allocating Chapter 11 plan payments to trust fund taxes and collection remedies available to taxing authorities after order is entered.**

Proposal in support of Energy Resources and a bankruptcy court's power to allocate Chapter 11 plan payments to trust fund taxes:

The Energy Resources decision is already a compromise. It gives no right to either the government or the debtor to make a designation but allows the Bankruptcy Court to approve a designation on a case-by-case basis. To confirm the plan the bankruptcy judge must make a finding based on evidence that the plan is feasible. The taxing authority may be heard on that issue. If the plan is feasible, then the government will ultimately collect 100 percent. Allocation of early payments to trust fund taxes may encourage (or be used as a tool to encourage) insiders to invest further capital or key employees to continue to work for the debtor. Working off the trust fund taxes may thus increase the likelihood of success of a reorganization. Allowing the government to hold responsible officers hostage until the last tax payment is made as a practical matter makes these people personally liable for taxes as to which they have no personal responsibility. The result is unfair. The government's position can be justified only to the extent that the payments can be said to be "involuntary." Involuntary has historically meant that the payment was made under legal process or compulsion. This is not true of payments in a Chapter 11.

Statement against Energy Resources:

Provide that taxing authorities can allocate tax payments made in the course of a bankruptcy to preserve alternative sources of collection. This proposal is aimed at Chapter 11 plans that provide for the payment of corporate trust fund taxes first, in order to protect the corporation's officers from personal liability to the taxing authorities. Generally, a corporate debtor owes both trust fund and nontrust fund taxes when it files a bankruptcy petition. If the corporate debtor's nontrust fund taxes are paid first and the Chapter 11 reorganization fails before all outstanding taxes have been paid, the IRS may collect the unpaid trust fund taxes from the responsible officers as well as from the corporation. If the trust fund taxes are paid first and the reorganization fails before the nontrust fund taxes are paid, the IRS has no alternative means of collecting the outstanding tax liability. The IRS proposal would prevent corporations from designating that trust fund taxes be paid first, which improperly shifts the risk of failure of the reorganization from responsible officers, whose misconduct caused the tax deficiency and who are personally liable for the trust fund tax, to the taxing authorities. Following Energy Resources, the Ninth Circuit held that a bankruptcy court could authorize the payment of trust fund taxes first in a liquidating Chapter 11. See In re Deer Park, Inc., 10 F.3d 1478 (9th Cir. 1993). This would allow officers to get personal relief even where the aim of the bankruptcy is not to reorganize the debtor.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission adopt the proposal in support of Energy Resources.

Vote:

For the Proposal: PA, RMcK, GN, MS, KW, JW

Against the Proposal: MB, SC, RM, JP

329(a) Proposal to limit the scope of Bankruptcy Code §505(a): Procedural limitations.

Statement in support of procedural limits to §505(a):

This proposal is to limit the intervention of Bankruptcy Courts in determining tax liability to situations in which a non-bankruptcy forum would have jurisdiction to hear the matter. In such cases as In re Piper Aircraft Corp., 171 B.R. 415 (Bankr. S.D. Fla. 1994), In the Matter of East Coast Brokers & Packers, Inc., 142 B.R. 499 (Bankr. M.D. Fla. 1992), and In re Ledgemere Land Corp., 135 B.R. 193 (Bankr. D. Mass. 1991), courts found jurisdiction to consider the debtor's liability for taxes notwithstanding the debtor's failure to timely challenge the assessments under applicable state law procedures. Thus, under this proposal, if the time for appeal of an assessment to an administrative tribunal or appeal of a tribunal's decision to a state court would otherwise have expired or is premature because the administrative appeal is ongoing, the Bankruptcy Court would similarly lack the jurisdiction to hear the matter. Likewise, if under state law, the time for the filing of a tax refund or redetermination of a property tax assessment has expired, no such request for reconsideration can be made to the Bankruptcy Court. Where, however, a debtor could properly take an appeal from a decision in an non-bankruptcy forum, the Bankruptcy Court could hear such a matter, applying the same burdens of proof and standards of review as would be applicable in the non-bankruptcy forum.

The reasons for such a change are as follows: (1) Current law rewards the negligent or miscreant taxpayer for his previous behavior and encourages forum shopping; (2) current law permits court interference with the appeal procedure even if it is at a stage of development where the matter can be resolved quickly and efficiently; (3) current law treats tax claims differently than all other claims against the estate where concepts such as statute of limitations, laches and full faith and credit, are applicable; (4) the argument that the right to reconsider previously determined tax liabilities is a protection for other creditors is flawed, when the vast majority of bankruptcy filing are no-asset Chapter 7 cases; (4) current law encourages tax determinations by Bankruptcy Courts with little experience of a foreign jurisdiction's tax law, making decisions of significant impact on that state and locality, and consequently diminishing the uniformity and consistency of those tax laws; (5) current law places a difficult administrative burden on states and localities, forcing them to expend considerable sums to defend their tax determinations in a foreign jurisdiction; (6) many states and localities maintain records for certain definite periods of time based upon their state law that limits the period during which appeals can be taken or requests for reconsideration of tax determinations made. Allowing the taxpayer an unlimited period of time during which a tax determination can be brought before the Bankruptcy court unfairly prejudices states and localities. Finally, there is a serious question as to whether §505(a) is constitutional in light of the Seminole decision. That issue is being litigated now in In re Warren Dean Stuart Case No. 96-20025 (Bankr. W.D.N.Y.).

Certain accommodations can be made to ensure that decisions made in state or local forums are made promptly so as not to interfere with the bankruptcy process. Thus, if an appeal was still timely at the time of the bankruptcy filing, § 108 could be amended to allow a debtor additional time to take his appeal, either through the state system or in Bankruptcy Court. Finally, §505(a) could impose certain timetables on states and localities to ensure that any decisions remaining to be made at that level are made promptly and permit the Bankruptcy Court's interference if the time periods are not met.

Statement against the proposal:

Congress had addressed the issue carefully and thoughtfully when it enacted §505(a). Cogent reasons existed and still exist for the continuation of present §505(a), including the concern that some state law procedures do not permit a judicial determination of the tax and taxes often assessed without the thoughtful participation of the taxpayer. The experience of the tax practitioners on the Advisory Committee is that claims arising from uncontested proceedings are grossly overstated. Track 329(a) would eliminate one of the most valuable, equitable tools of the bankruptcy court -- to establish the correct balance due. Without § 505(a), many taxpayers who are otherwise deserving would be denied Chapter 13 relief simply because of an overstated, incorrect tax claim.

RECOMMENDATION:

By a vote of 7 to 1 (with 2 abstentions), the Advisory Committee recommends that the Commission reject the Proposal.

Votes:

For proposal to limit §505(a): JP

Against proposal to limit §505(a): PA, MB, RMcK, GN, MS, KW, JW

Abstain: SC, RM

329(b) Proposal to limit the scope of Bankruptcy Code §505(a): Limitation on Bankruptcy Court's power to determine tax liability of nondebtor.

Statement in support of the proposal to limit the scope of Bankruptcy Code §505(a):

Unless state law similarly permitted it to happen, or the parties so stipulated, the Bankruptcy Court would be barred from determining the tax liability of non-debtors. (See Government Working Group Proposal #6, concerning the release of non-debtors). With respect to the issue of the court's determination of the tax liabilities of non-debtors, equity demands that anyone wishing to avail himself of the benefits of bankruptcy protection should also be required to submit his assets to the court and creditors and his financial affairs to the public scrutiny demanded of all debtors. Courts are not in agreement on the issue of the jurisdiction of the Court. Contrast In re Brandt Airflex 843 F.2d 90 (2nd Cir. 1988), with Pacor v. Higgins (In re Pacor), 743 F.2d 984, 994 (3rd Cir. 1984).

Statement against the proposal:

The proposal goes too far. There are times when it is beneficial and in the best interests of the bankruptcy process to permit the bankruptcy court to determine the tax liability of a nondebtor, for example, in the consolidated return situation. Furthermore, 28 U.S.C. §1334 provides ample support for jurisdictional limitations where necessary. Thus, the proponents of the proposal have not made out their case.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission reject the Proposal.

Votes:

For the proposal to limit bankruptcy court jurisdiction relating to nondebtors: MB, SC, RM, JP

Against the proposal: PA, RMcK, GN, MS, KW, JW

331 **Discharge of tax penalties where the tax to which the penalties relate is not discharged.**

IRS proposal to provide that a penalty computed with reference to a tax liability is discharged only when the underlying tax is discharged:

Section 523(a)(7) should be clarified to provide that a penalty computed with reference to a tax liability is discharged only when the underlying tax is discharged. This proposal would change the language of the Bankruptcy Code to comport with the legislative intent of the drafter's of the Code and eliminate a loophole for fraudulent debtors. This proposal would reject the holdings in In re Burns, 887 F.2d 1541 (11th Cir. 1989); In re Roberts, 906 F.2d 1440 (10th Cir. 1990); In re McKay, 957 F.2d 689 (9th Cir. 1992). In their opinions, the courts expressed the view that the statutory language was unambiguous so that the legislative history to the contrary had to be ignored. These decisions greatly expand the number and types of tax penalties discharged in bankruptcy and will have a particularly adverse effect on fraud penalties. Indeed, by the time fraud penalties are asserted by the IRS in the wake of a criminal investigation, the penalties will be subject to discharge under the holdings of Roberts, Burns, and McKay.

Statement against IRS proposal:

The government is adequately protected if a debtor's liability for taxes is nondischargeable. Making old penalties nondischargeable as well impinges upon the fresh start principle. If the object is to punish wrongdoing, then nondischargeability of three-year-old penalties should be confined to cases of fraud.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission reject the IRS Proposal.

Vote:

For the IRS proposal: MB, SC, RM, JP

Against the IRS proposal: PA, RMcK, GN, MS, KW, JW

333 **Release of a tax lien in a Chapter 13 case before completion of all payments under the plan.**

Proposal 1:

Proposal that the tax lien cannot be discharged before completion of plan payments:

It is proposed that language be inserted in §§1222 and 1322 prohibiting the voidance of liens under §506(d) (as opposed to a determination of secured status), until the debtor completes all payments required under the confirmed plan.

There is a conflict among courts concerning when a lien in Chapter 13 may be declared void following a determination that the claim is unsecured under §506(a). In In re Hornes, 160 B.R. 709, 719 (Bankr. D. Ct. 1993), the court, relying on dicta from a decision of the Second Circuit, Bellamy v. Fed. Home Loan Mortgage Corp., (In re Bellamy), 962 F.2d 176 (2nd Cir. 1992), held that in Chapter 13, §506(d) operates to void a second mortgage lien that is determined to be unsecured and that it is void regardless of whether the required plan payments have been made. The court in Richards v. Citicorp Mortgage, Inc. (In re Richards), similarly avoided the unsecured portion of an unsecured lien prior to the completion of plan payment. Likewise, in In re Murray-Hudson, 147 B.R. 714 (Bankr. N.D. Cal. 1992), the court approved the immediate voiding of an automobile lien following payment of the secured portion, even though the plan had not been fully consummated. In In re Jones, 152 B.R. 155 (Bankr. E.D. Mich 1993) the court articulated some very good reasons as to why the immediate voiding of liens prior to completion of a plan is inadvisable. The first point raised is that since under §1327(b) property generally ceases to be property of the estate following confirmation, if the lien has been determined to be void, then debtor is free to sell the property (or encumber it) to an unsuspecting third party on the technically correct representation that the property is unencumbered. However, if the case is then dismissed and the lien "reinstated" as provided for under §349(b)(1)(C), then either the unsuspecting purchaser (or encumbrancer) or the formerly secured creditor will be unfairly prejudiced. (Parenthetically, it should be noted that even if the plan provides that property remains property of the estate after confirmation, if the debtor is allowed to void the lien at the outset of the case he can then immediately thereafter dismiss the case, and before notice is given to creditors of the dismissal, sell the property to an unsuspecting purchaser. Again, in such an instance, either the formerly secured creditor or the purchaser is seriously prejudiced). The second point suggested by the Jones court is that if the general idea behind §349(b)(1)(C) is for all parties, upon dismissal of the case, to be restored as much as possible to their rights as they existed when the petition was filed, that goal could be seriously undermined if the debtor is permitted to invalidate liens prior to performing the duties specified in the plan. Three, the court pointed out that since there is no provision for reinstating void liens once a Chapter 13 case is converted to Chapter 7, this fact could encourage unscrupulous debtors to circumvent the holding of the Supreme Court in Dewsnup v. Timm 112 S. Ct. 773 (1992), which prohibits §506(d) lien avoidance in Chapter 7 cases. A debtor could file Chapter 13, avoid the liens in question, and then immediately convert to Chapter 7. Finally, the court noted that to permit the voiding of liens at the outset of the case dilutes one important incentive designed to encourage the debtor to complete his plan. For similar reasons, the court in In re Kinder, 139 B.R. 743, 744-45 (Bankr. W.D. Okla. 1992), a Chapter 12 case, also refused to void an under secured claim prior to the completion of plan payments. See also In re Rogers, 57 B.R. 170, 173 (Bankr. E.D. Tenn. 1986); Castle v. Parrish (In re Parrish), 29 B.R. 869, 874 (S.D. Ohio 1983).

Proposal 2:

Proposal for capping tax lien at confirmation of plan:

Chapter 13 has a "lien capping" provision that establishes the value of property securing a lien. To complete a Chapter 13 plan, the debtor must buy off the lien at the established value. Disputes arise over what happens to the "capped" lien if the established value is paid in full but the case is dismissed or converted to Chapter 7 before the plan is completed. The issue has been raised in at least three separate ways, and no consensus has been reached. As to dismissed cases, compare In re Campbell, 160 B.R. 198 (Bankr. M.D. Fla. 1993) (lien released), aff'd, 180 B.R. 686 (M.D. Fla. 1995), with Gibbons v. Opechee Distributors, Inc. (In re Gibbons), 164 B.R. 207 (Bankr. D.N.H. 1993) (lien not released). As to converted cases, compare In re Stoddard, 167 B.R. 98 (Bankr. S.D. Ohio 1994) (lien released), with In re Jordan, 164 B.R. 89 (Bankr. E.D. Mo. 1994) (lien not released). As to using 11 U.S.C. §§ 349(b)(1)(C) and 506(d) to reinstate the lien, compare In re Cooke, 169 B.R. 662 (Bankr. W.D. Mo. 1994) (lien not reinstated), with In re Scheierl, 176 B.R. 498 (Bankr. D. Minn. 1995) (lien reinstated).

Both the Justice Department and the IRS have proposed that tax liens remain in place unless and until the Chapter 13 plan is completed and that federal tax liens only be discharged as to particular property, rather than generally released with respect to a debtor’s exempt, abandoned, or excluded property. The position in opposition is that the IRS should only be paid once. The government's lien should not reattach to property against which the debtor has previously paid off a tax lien. The government's windfall is particularly troubling in cases involving "small" debtors. Under current case law, a debtor cannot avoid the federal government's lien in household goods. See Track 506. Under the current proposal, a debtor might be required to buy off a lien in household goods and clothing once in a bankruptcy and a second time in an offer in compromise (at least to the extent those goods exceeded $2,500 in value).

Some judges void the government's lien at the time of plan confirmation. The position in opposition believes that the lien should not be avoided in a specific piece of property unless the secured claim in the specific piece of property is paid in full.

Statement against Proposal 2:

With respect to a federal tax lien, the lien attaches to all property and rights to property of the taxpayer under IRC §6321, and, is unique from other liens in that it attaches to property exempt, abandoned, or excluded from the bankruptcy estate. Allowing debtors to obtain the release of a federal tax lien by paying the allowed amount of the IRS's secured claims as determined under §506(a) means that the IRS loses its right to enforce the lien against exempt, abandoned, or excluded property. Furthermore, Proposal 2 would allow the determination of the secured value of a tax lien at plan confirmation to be binding on the tax creditor once the secured liability is satisfied, even if the plan is never completed and later dismissed. In certain cases, the effect of this proposal would be to allow a Chapter 13 debtor to have the court determine the secured value of a tax lien to be zero and then immediately thereafter, voluntarily dismiss the case. Notwithstanding the dismissal and the failure of the tax creditor to receive payment, (even of the unsecured portion of its claim), the tax creditor would be prohibited from placing a new lien on the property and thus benefitting from any future increase in the value of the asset. This proposal would invite fraud and abuse by debtors seeking to rid their encumbered assets of unwanted tax liens.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission adopt Proposal 2. As to Proposal 1, the Advisory Committee split 5 to 5 and, therefore, makes no recommendation.

Vote:

For Proposal 1: MB, SC, RM, JP, JW

Against Proposal 1: PA, RMcK, GN, MS, KW

For Proposal 2: PA, RMcK, GN, MS, KW, JW

Against Proposal 2: MB, SC, RM, JP

335 **Simplification of the terms in the priority tax provisions.**

Proposal to provide the same treatment for nontrust fund excise and employment taxes as that given income taxes and gross receipts taxes:

Section 507(a)(8) identifies those tax claims entitled to priority and provides a general three-year rule for income taxes and for the nontrust portions of employment taxes and excise taxes. However, in the case of income and gross receipts taxes, §507(a)(8)(A)(ii) and (iii) provide two additional priority categories that are not presently extended to the nontrust fund portions of employment taxes and excise taxes. These two categories include: (1) the 240-day assessment rule, generally giving taxing authorities 240 days to collect taxes; and (2) the still assessable rule. Taxpayers are required to file tax returns with respect to federal employment taxes and many excise taxes. Often, taxpayers are delinquent in filing their federal employment and excise tax returns, or the items taxpayers report on these returns require audits, the same as for income taxes. The Internal Revenue Code's deficiency procedures, allowing the taxpayer an opportunity to contest the Service's tax audit determinations for income taxes in the U.S. Tax Court, do not generally apply to employment taxes or to excise taxes. However, the Service may still require more than two years and 125 days (three years minus 240 days) from the due dates of these employment or excise returns or from the transactions giving rise to an excise tax, in order to: (i) solicit the taxpayers' delinquent returns; (ii) complete audits of those returns or of the taxpayer's transactions; (iii) afford the taxpayer administrative appeal rights; and (iv) give due consideration to the taxpayer's offers in compromise.

Accordingly, the same logic for applying the 240-day rule and the "assessable but not assessed" priority rules to income taxes also applies in the case of the non-trust fund portions of employment taxes and of excise taxes. The trust fund portions of employment taxes and excise taxes never lose their priority, pursuant to present §507(a)(8)(C). The proposal would treat these three types of tax obligations in a parallel fashion.

Statement against the proposal providing the same priority treatment for excise taxes and nontrust fund employment taxes as that given income taxes and gross receipts taxes:

Expanding the list of those tax claims entitled to priority in §507(a) is inconsistent with the traditional treatment of unsecured claims in bankruptcy. Each addition to the list of claims entitled to priority chips away at the time-honored policy that all unsecured claims should be treated equally. Additionally, each new priority claim has the effect of reducing the dividend paid to other consensual and *nonconsensual* unsecured creditors.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission reject the proposal.

Vote:

For the proposal: MB, SC, RM, JP

Against the proposal: PA, RMcK, GN, MS, KW, JW

425 **Tax treatment of abandonment of property by an estate to the debtor.**[11]

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:

[11]The federal participants on the Advisory Committee abstained from consideration of the proposals under this track number.

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.

Proposal 3:

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.

RECOMMENDATION:

By a vote of 7 to 1, the Advisory Committee recommends the adoption of Proposal 2, and by a vote of 6 to 2, the adoption of Proposal 3. The Advisory Committee recommends that the Commission reject Proposal 1 by a vote of 6 to 2. Five members identified Proposal 3 as their preferred choice, while three members identified Proposal 2 as their preferred choice.

Vote:

For Proposal 1: MB, KW

Against Proposal 1: PA, RMcK, GN, JP, MS, JW

For Proposal 2: PA, MB, RMcK, GN, JP, MS, JW
Against Proposal 2: KW

For Proposal 3: PA, RMcK, GN, MS, KW, JW

Against Proposal 3: MB, JP

432 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.

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 Mo. Dep't of Rev. (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.

Proposal 3: 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.

RECOMMENDATION:

By a vote of 7 to 3, the Advisory Committee recommends that the Commission adopt Proposal 2 -- No bifurcated tax year. The Advisory Committee recommends the rejection of Proposal 1 by a vote of 6 to 4, and split 5 to 5 on a recommendation for Proposal 3. Six members preferred Proposal 2, 3 preferred Proposal 3, and 1 preferred Proposal 1.

Vote:

For Proposal 1: PA, RMcK, GN, MS

Against Proposal 1: SC, MB, RM, JP, KW, JW

For Proposal 2: MB, SC, RM, GN, JP, KW, JW

Against Proposal 2: PA, RMcK, MS

For Proposal 3: PA, RMcK, JP, MS, KW

Against Proposal 3: MB, SC, RM, GN, JW

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

Statement 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. See 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 as proposed in Track No. 701. 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.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission adopt the proposal.

Vote:

For the proposal: PA, RMcK, GN, MS, KW, JW

Against the proposal: MB, SC, RM, JP

438(a) 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. In re Fondiller, 125 B.R. 805 (N.D. Cal. 1991); In re Rode, 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. In re West Texas Marketing Corp., 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).[12]

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

[12]*Comment by JP:* The right of a trustee to invoke the quick audit procedure should be limited to one request at the end of the case, for the reasons stated in support of proposal No. 438(b). With said limitation in place, I would support a clarification of §505(b) to extend the effect of its discharge provision to the estate. Without such a limitation, I think an extension would be an unfair burden on the taxing authorities.

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).

RECOMMENDATION:

By a vote of 6 to 3 with 1 abstention, the Advisory Committee recommends that the Commission adopt the proposal.

Vote:

For the proposal: PA, RMcK, GN, MS, KW, JW

Against the proposal: MB, SC, RM

Abstain: JP

438(b) Annual requests by a trustee for a prompt audit.

Statement in support of proposal limiting trustee's ability to invoke quick audit:

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. 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, the trustee and the estate should remain liable for taxes that the trustee failed to report correctly and should not be allowed to avoid such liability. The usual period for assessment of a tax is three years from the due date of the return. 26 U.S.C. § 6501(a). Under the prompt audit provisions contained in 11 U.S.C. § 505(b), a return must be selected for audit within 60 days and the examination must be completed within 180 days or such additional time as the court allows for cause. Curtailment of the normal audit and examination time frames should be reserved for circumstances requiring prompt action rather than automatically starting the audit clock with the filing of every tax return. A trustee should be able to invoke 11 U.S.C. § 505(b) only once during a case. This would give the trustee one opportunity for a prompt audit to facilitate closing of the estate.

Statement against the proposal limiting a trustee's ability to seek a "quick audit":

Generally, trustees invoke §505(b) by filing a request for audit simultaneously with the filing of a return. This procedure is consistent with the letter and the spirit of 11 U.S.C. § 505(b). Section 505(b) is a mechanism by which a trustee may cleanse a tax year and avoid liability for any unpaid tax in certain circumstances. Consequently, §505(b) discharges the trustee from any tax liability incurred by the estate covered by the prompt audit request. The need for this discharge is not limited to the close of the case. The prompt-audit request's purpose -- to protect trustees in those circumstances delineated in §505(b) -- is also furthered by its application *during* the case. The proposal 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, benefits from this action.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission reject the proposal.

Vote:

For the proposal: MB, SC, RM, JP

Against the proposal: PA, RMcK, GN, MS, KW, JW

441(a) Obligation of a Chapter 13 debtor to pay all priority taxes when a proof of claim for such taxes is not filed.

Statement in support of proposal:

Section 1322(a)(2) provides that all Chapter 13 plans provide for the payment of all claims entitled to priority under § 507. Courts, however, construe § 1322 to require only that a Chapter 13 plan provide for payment of allowed claims. A claim cannot be an allowed claim under Chapter 13 unless a proof of claim is filed. If a plan provides for payment of allowed priority claims and a proof of claim for priority taxes is not filed before the bar date, two consequences may occur: (1) the IRS will not receive any distribution with respect to the claim; and (2) because the plan "provided for" the tax claim, the claim will be discharged under § 1328. See In re Tomlan, 102 B.R. 790 (E.D. Wash. 1989), aff'd, 907 F.2d 114 (9th Cir. 1990); In re Border, 116 B.R. 588 (Bankr. S.D. Ohio 1990); and In re Daniel, 107 B.R. 789 (Bankr. N.D. Ga. 1989). The current treatment of priority tax claims in Chapter 13 cases provides an unjustified benefit to many debtors who are delinquent in their taxes. Frequently, the debtor is a nonfiler; thus, the taxing authority may not know of the liability, much less the amount. Further, the debtor may be a responsible person of a corporation and thus be liable for trust fund tax recovery penalties. If the individual debtor's case makes no reference to the corporation, the taxing authority may not connect the individual debtor to the delinquent corporation until after the bar date. Finally, if the taxing authority mistakenly fails to file a proof of claim in time, the entire liability is discharged.[13]

Statement against the proposal:

The taxing authorities should have no greater rights in this respect than any other priority creditor. The two driving concerns -- reasonable notice and filing return requirements -- are adequately addressed by other proposals. Given adequate notice, a return filing requirement, and the 180-day bar date, the taxing authority should be required to file timely its proof of claim like any other holder of a priority claim.

RECOMMENDATION:

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[13]*Comment by JP:* If as a prerequisite to confirmation of a Chapter 13 plan, a debtor is required to file missing tax returns, then this proposal would seem to be unnecessary since the problem created by the non-filing of returns would be obviated. In the absence of such a requirement, it would be appropriate to require the payment of all priority tax claims regardless of the non-filing by the taxing authorities of a proof of claim.

By a vote of 7 to 2 with 1 abstention, the Advisory Committee recommends that the Commission reject the proposal.

Vote:

For the proposal: SC, RM

Against the proposal: PA, MB, RMcK, GN, MS, KW, JW

Abstain: JP

442 **Clarify the treatment of postpetition taxes for which claims are filed under §1305.**

Statement in support of the proposal for clarification of §1305:

Bankruptcy Code §1305 allows, inter alia, for the filing of postpetition proofs of claim for taxes that become payable to a governmental unit while a case is pending. Only the governmental unit itself can file the claim; neither the trustee nor the debtor can do so on behalf of the governmental unit. The filing of such a claim is generally beneficial to a debtor because it allows the structuring of payment over the life of the plan and, depending upon the terms of the plan, may allow the debtor to use the same dollars that would have gone to pay a dischargeable debt to, pay an otherwise nondischargeable one. If the governmental unit does not file a claim under this section, then it is free either to move to convert the case to Chapter 7, for relief from the stay, or wait until the plan is completed and then pursue the debtor for the entire tax plus accrued interest. Obviously, any one of those options could have very disastrous consequences for the debtor.

Governmental units make infrequent use of §1305. One major reason is that the statute requires the claim to be treated as if it had arisen prior to the bankruptcy. As stated by Collier on Bankruptcy at ¶1305.02, "the congressional purpose behind § 1305 is to permit the same treatment of certain postpetition credit extended to the chapter 13 debtor as for a prepetition claim for purposes of proof, allowance and priority." Since in most cases the tax would have been a priority claim, it is not entitled to receive post-petition interest. Unlike §1129(a)(9)(C), §1322 does not require priority tax creditors to receive payments of a value equal to the allowed amount of the claim.

An amendment that would allow for the awarding of interest, either by treating such a claim as a §503(b) expense or by providing for payment in a manner similar to that provided under §1129(a)(9)(C), would encourage governmental units to make more frequent use of §1305. Allowing for the awarding of interest would:

- Enhance the likelihood that a debtor will be able to successfully complete his plan.
- Discourage additional tax delinquencies. Governmental units do not like to file claims because it simply encourages debtors to continue using government money, interest free.
- Eliminate the unfair and advantageous treatment afforded a debtor who incurs tax debts in the continued operation of this business over a similarly situated individual who is not in bankruptcy.

- Reflect the current practice that most Chapter 13 plans provide for the retention of all property in the estate until completion of the plan. In the Gyulafia case, in which the court refused to find post-petition taxes to be administrative expenses, the court based its ruling in part, upon the finding that upon confirmation of the plan, all property vests back in the debtor, concluding therefore, that the expenses were incurred by the debtor and not by the estate.

- Resolve the confusion that exists in this section as it relates to §503(b). At least two courts have found that post-petition tax claims are administrative expenses: In re Venable, 48 B.R. 853, 857 (Bankr. S.D. N.Y. 1985), and In re Busone, 71 B.R. 201, 206 (Bankr. E.D. N.Y. 1987).

- Resolve the question as to how to treat post-petition interest that has accrued on the tax claim up until a request for treatment under §1305 has been made and incorporated into the plan.

- Eliminate the necessity of governmental units going through time consuming and expensive procedures in order to collect post-petition indebtedness, in full.

Statement against the proposal:

Unless otherwise provided in the plan, confirmation of the Chapter 13 plan vests all the property of the estate in the debtor and releases the estate from all claims and interests of creditors. 11 U.S.C. § 1327(b) and (c). Thus, postconfirmation taxes are incurred by the debtor and are not administrative expenses. Under § 1305(a)(1), the taxing authority has the option of filing a proof of claim and having the postpetition claim treated as if it were a prepetition claim. If the taxing authority so chooses, the claim must be paid in full but without interest.

The state taxing authorities report that the current system is unfair to them. When postpetition taxes are not paid, the debtor is borrowing money from the taxing authority to fund the plan. Thus, for example, attorney's fees can be paid ahead of the taxing authority. The state taxing authorities also report that debtors are frequently providing that all property remains within the bankruptcy estate. Thus, the ability of the state taxing authorities to collect the postpetition tax outside of the plan is effectively nullified until the plan is concluded.

From a tax practitioner's perspective, § 1305(a)(1), provides breathing space for the debtor. If the tax is included within the plan, it gives the debtor additional time within which to satisfy the postpetition obligation. The additional time can be advantageous to the debtor, e.g., when an accident results in an inability to pay and plan payments are suspended.

If the tax is not included within the plan, the taxing authority collects its interest and is not economically disadvantaged. The granting of early discharges should be an incentive for taxing authorities to file claims. The cost of the lost interest will be smaller, and the taxing authorities must be paid before the debtor is discharged.

As a general rule, governmental creditors should be treated identically with general unsecured creditors. A difference in treatment between the two does not seem warranted. However, the concerns expressed by the state taxing authorities are valid. One solution is to retain § 1305(a)(1) and provide that the failure to pay more than two postpetition tax obligations is an additional cause for dismissal under § 1307.

RECOMMENDATION:

By a vote of 6 to 3 with 1 abstention, the Advisory Committee recommends that the Commission adopt the proposal.

Vote:

For the proposal: PA, MB, SC, RM, JP, JW
Against the proposal: RMcK, MS, KW

Abstain: GN

503(a) Whether a debtor should be required to pay interest on deferred priority taxes payable under a Chapter 13 plan.

Statement in support of the IRS proposal that debtors should be required to pay interest on deferred priority taxes payable under a Chapter 13 plan.

Current §1322(a)(2) permits a debtor to make deferred payments on priority tax claims but, unlike deferred payment of priority taxes in Chapter 11 cases, no interest on these deferred payments is required under current law. Because the time value of money is not taken into account, the full value of a priority tax claim is not required to be paid in Chapter 13. This proposal equalizes treatment of priority tax claims in Chapter 11 and Chapter 13 cases by requiring Chapter 13 debtors to pay interest on all priority taxes, unless the holder of a particular claim agrees in writing to a different treatment of the claim.

Statement against the IRS proposal:

The Bankruptcy Code constructs incentives for individual debtors to file for relief under Chapter 13 as opposed to Chapter 7 or 11 in order to enhance the return to all creditors of the debtor. One of these incentives is the abatement of postpetition interest on priority claims. It makes good sense and policy to continue the abatement of postpetition interest on priority claims to provide a greater overall payout to the creditors and to increase the number of debtors who can propose confirmable plans.

RECOMMENDATION:

By a vote of 8 to 2, the Advisory Committee recommends that the Commission reject the IRS proposal.

Vote:

For the proposal: SC, RM

Against the proposal: PA, MB, RMcK, GN, MS, JP, KW, JW

506 **Attachment of a federal tax lien to exempt property**.

Statement in support of proposal that the determination of the taxing authority's secured claim under §506 should exclude the value of property exempt from levy under the Internal Revenue Code:

The determination of the amount of the taxing authorities secured claim under §506 of the Bankruptcy Code should exclude the value of property otherwise exempt from levy under Internal Revenue Code §6334(a)(1)-(3). Section §6334 of the Internal Revenue Code exempts from levy by the IRS various items of personal property owned by a taxpayer. For example, (i) necessary items of wearing apparel and school books, (ii) $500 in value of the fuel, provision, furniture and personal effects in the taxpayer's household and of arms for personal use, livestock and poultry, and (iii) as much as $1,250 in aggregate value of books and necessary tools of the trade, business or profession of the taxpayer, are exempt. IRC § 6334 (a)(1) - (a)(3). Despite exemption for IRS collection purposes, prevailing bankruptcy case law allows a federal tax lien to attach to all property owned by the debtor. Present case law in bankruptcy situations is inconsistent with the exemption philosophy expressed by Congress in § 6334 and gives the taxing authority a bankruptcy windfall not contemplated by Congress. It is the experience of at least two tax practitioners on the Advisory Committee that at the conclusion of a Chapter 7 case, the IRS does not liquidate assets exempt from the levy even if a tax lien is attached. Chapter 13 debtors should not have to buy off the IRS lien in assets exempt from levy when Chapter 7 debtors do not have to buy off the lien. Very little revenue is raised by forcing debtors to buy back their household goods and personal effects. It is purely punitive to force debtors to repurchase their necessities as part of the reorganization process. Section 6334 clearly shows Congress has no desire for the IRS to operate a second-hand clothing and furniture business. It is believed the IRS has no interest in or manpower available for seizing and selling such property of debtors/taxpayers.

Statement against the proposal:

The IRS is against this lien stripping provision aimed only at reducing the power of the federal tax lien. Under IRC § 6321, a federal tax lien attaches to "all property and rights to property" of any person liable to pay taxes who neglects or refuses to pay the same after demand.

The Supreme Court has noted that the language of IRC § 6321 "is broad and reveals on its face that Congress meant to reach every interest in property that a taxpayer might have." United States v. National Bank of Commerce, 472 U.S. 713, 719-20 (1985). "Stronger language could hardly have been selected to reveal a purpose to assure the collection of taxes." Glass City Bank v. United States, 326 U.S. 265, 267 (1945).

In defining fresh start, Congress took cognizance of the fact that tax liens would survive as against exempt property by enacting §522(c)(2)(B). Isom v. United States, 901 F. 2d 744, 746 (9th Cir. 1990).

There is a distinction between the function of a levy and the function of the federal tax lien. A levy is used in enforced collection; it forces debtors to relinquish their property. The federal tax lien, however, is merely a security interest and does not involve the immediate seizure of property. A lien enables the taxpayer to maintain possession of protected property while allowing the government to preserve its claim should the status of the property later change.

Contrary to the statement in support's assertion that the practice of the Service in Chapter 7 cases is to abate all tax liability otherwise secured by a tax lien to the extent the security is property of a kind otherwise falling within the terms of IRC §6334 (a) (1) - (3), IRS practice throughout the country, as set by the Internal Revenue Manual, is that taxes are not to be immediately abated if the liability can be collected from exempt or abandoned property. See IRM 57(13)4.521:(1).

The proposal reduces only the IRS' security interest; other secured creditors' lien interests (which can be protected by up front filings) are not diminished. The fact that the Internal Revenue Code exempts certain property from an administrative collection procedure does not support the conclusion that the security interest of the federal tax lien should also be reduced.

RECOMMENDATION:

By a vote of 8 to 2, the Advisory Committee recommends that the Commission adopt the proposal.

Vote:

For the proposal: PA, MB, RMcK, GN, JP, MS, KW, JW

Against the proposal: SC, RM

513(b) 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.

RECOMMENDATION:

By a vote of 8 to 1 with 1 abstention, the Advisory Committee recommends that the Commission adopt the proposal.

Vote:

For the proposal: PA, MB, RMcK, GN, JP, MS, KW, JW

Against the proposal: RM

Abstain: SC

602 **Clarify the exception to discharge in §523(a)(1)(C) ("willfully attempt in any manner to evade or defeat such tax").**

Statement in support of the proposal requiring a showing by a taxing authority in the bankruptcy case of an affirmative act or acts of misconduct and a state of mind requirement:

The term "willful" as used in §523(a)(1)(C) 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" within the meaning of §523. 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.

Statement against the proposal:

A legislative effort at this time to attempt to define the types of behavior that may constitute a willful attempt to evade or defeat tax for purposes of §523(a)(1)(C) 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. The ABA Task Force 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 debt being excepted from discharge. The requirement of proof of an affirmative act on the part of debtors to evade or defeat the 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 the willfulness standard of §523(a)(1)(C) 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.

RECOMMENDATION:

By a vote of 7 to 3, the Advisory Committee recommends that the Commission adopt the proposal.

Vote:

For the proposal: PA, RMcK, GN, JP, MS, KW, JW

Against the proposal: MB, SC, RM

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

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.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission adopt the proposal.

Vote:

For the proposal: PA, RMcK, GN, MS, KW, JW

Against the proposal: MB, SC, RM, JP

704 Whether the payment of postpetition tax penalties should be subordinated.

Proposal to subordinate postpetition tax penalties:

The payment of postpetition tax penalties 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.

Statement against subordination proposal:

The subordination of postpetition penalties would be at odds with long-standing Supreme Court precedent that held that postpetition penalties incurred by the trustee or debtors-in-possession must be paid from the assets of the bankruptcy estate to ensure compliance with the laws. See Boteler v. Ingels, 308 U.S. 57, 61 (1939); Nicholas v. United States, 384 U.S. 678, 692-95 (1966). Additionally, such subordination would allow trustees and debtors-in-possession to disregard their legal obligations. Creditors may influence debtors-in-possession or trustees to prevent the accrual of post-petition penalties and should not be permitted to benefit from the false economies recognized by the estate through its failure to comply with applicable nonbankruptcy law.

RECOMMENDATION:

The Advisory Committee divided 5 to 5 and makes no recommendation.

Vote:

For the proposal: PA, RMcK, GN, MS, KW

Against the proposal: MB, SC, RM, JP, JW

705 **Whether trust fund taxes should be eligible for superdischarge in Chapter 13 after seven years from the date of assessment.**

Proposal for discharge of trust fund taxes in Chapter 13:

Under present law, trust fund taxes cannot be discharged. This proposal would provide that trust fund taxes should be eligible for the superdischarge in a Chapter 13 case after seven years from the date of assessment. This proposal would further the fresh start policy in bankruptcy.

Taxpayers who owe trust fund taxes are consigned to "tax purgatory." Beyond offers in compromise, which are extraordinarily difficult to obtain, there are no bankruptcy or tax code remedies available for these debtors. In addition, taxing authorities know how to threaten the use of draconian collection methods to coerce extensions of the statute of limitation on collection. Thus, an individual who owes trust fund taxes faces a lifetime of unpayable debt. This means no house, no college savings for kids, and no retirement savings.

While some taxpayers most assuredly have used unpaid employment taxes for personal gain, the experience of the tax practitioners on this Advisory Committee is that the funds are generally used to pay other creditors in a fruitless attempt to keep the business alive. Many taxpayers are unaware of the severity of the penalty involved and the threat of a lifetime of indebtedness. Many who are aware of the penalty have an overly optimistic view of their ability to turn their troubled business around. Thus, a better balance is needed between protecting the fisc and rehabilitating debtors.

This proposal makes the superdischarge in Chapter 13 available to trust fund tax debtors. Under the proposal, the superdischarge would not be available for seven years after the tax is assessed. Including a minimum of three years in Chapter 13, the taxing authorities would still collect funds over the full ten-year collection period. To protect governmental interests, it is proposed that a discharge not be available in Chapter 7 and the tolling provisions for a previous bankruptcy filing apply. See Track No. 311.

Statement against the proposal:

There is a long-standing history making the trust fund tax nondischargeable in bankruptcy. Any attempt to make these taxes dischargeable would reward debtors who, in effect, had taken funds belonging to the government. A discharge of such taxes is inconsistent with the voluntary nature of the tax system. Furthermore, taxing authorities are involuntary creditors in the case and have not chosen to deal with the debtor.

RECOMMENDATION:

By a vote of 6 to 4, the Advisory Committee recommends that the Commission reject the proposal.

Vote:

For the proposal: PA, RMcK, MS, KW

Against the proposal: MB, SC, RM, GN, JP, JW

Conclusion:

The Advisory Committee submits this Final Report for consideration by the Commission.

Respectfully,

_/s/___________________________
Jack F. Williams
CHAIR, **TAX ADVISORY COMMITTEE**

APPENDICES

1. List of Tax Advisory Committee Members

2. Revised Tax Matrix

3. List of Withdrawn Proposals

TAX ADVISORY COMMITTEE

Chair:

Professor Jack Williams (JW)
Georgia State University
College of Law
P.O. Box 4037
Atlanta, Georgia 30302-4037

Members:

Paul Asofsky (PA)
Weil, Gotshal & Manges, L.L.P.
700 Louisiana, Suite 1600
Houston, TX 77002-2272

Mark Browning (MB)
Office of the Attorney General
Collections Division
300 W. 15th St., 7th Floor
Austin, TX 78701

Stephen Csontos (SC)
Department of Justice, Tax Division
950 Pennsylvania Ave. NW, Room 4612
Washington, DC 20530

Robert McKenzie (RMcK)
McKenzie & McKenzie, P.C.
5450 N. Cumberland, Suite 120
Chicago, IL 60656-1484

Robert Miller (RM)
Department of the Treasury
Internal Revenue Service
1111 Constitution Ave. Room 2000
Washington, DC 20224

Professor Grant Newton (GN)
Pepperdine University
24255 Pacific Coast Highway
Malibu, CA 90263

TAX ADVISORY COMMITTEE (cont'd)

Joan Pilver (JP)
Office of the Attorney General
55 Elm Street
Hartford, CT 06106-1797

Mark Segal (MS)
Segal & McMahan, Chtd.
720 S. 4th Street, Suite 200
Las Vegas, NV 89101

Kenneth Weil (KW)
Law Office of Kenneth Weil
1001 4th Ave., Suite 3130
Seattle, WA 98154-1101

SUMMARY OF TAX MATRIX ITEMS

Tra	Topic	TAPProposal	TAPI
100	Repeal BC sec. 724(b), with exception for		Important--'
101	In chapter 9, require as a condition of confirmation		Unimportar
104	Extend to all creditors present rule of chapter 11 that		WITHDRA\
105	Strengthen provisions of BC on giving notice to	Recommend	Important
106	Provide that when debtor fails to provide notice to		Combined \
107	Require schedules for individual ch. 7 drs. to report		Important
108	Require schedules for corporate/partnership debtors		Important
109	Provide exception to bar date and discharge for tax		Combined \
211	Burden of proof in bankruptcy tax issues same as in		Important--'
212	Require all mandatory tax filings to be brought		Important--'
213	Add 523(a)(1) to superdisch. except. in ch. 13 as is		Important--'
214	Fix BC 1129(a)(9) and 1322(a)(2) so debtors cannot		Important--'
214	Amend the Bankruptcy Code to prescribe applicable	Consensus to	Important
215	Amend 362(b) and 553 to permit automatic setoff of		Important--'
216	Amend 11 U.S.C. section 505(b) to require taxpayers	Same as topic	Important
217	Repeal BC sec. 1231(b)		Important
217	Conform BC sec 346 to IRC sec1398(d)(2)	Conform federal and	Important
218	Amend 11 U.S.C. sections 1141, 1227, & 1327 to		Important
219	Amend Bankruptcy Rule 9020 to require a good faith		WITHDRA\
311	Amend 11 U.S.C. sections 507(a)(8) and	Same as topic	Important
312	Amend 11 U.S.C. sections 349(b), 1141, 1227 &		Important--'
313	Amend 11 U.S.C. section 507(a)(8)(ii) to toll the 240-	Offer in compromise	Important
313	Amend 11 U.S.C. section 507(a)(8)(ii) to toll the 240-		Important--'
314	Amend 11 U.S.C. sections 507(a)(8)(A)(iii) and		Important
315	Amend 11 U.S.C. sections 704, 1106, 1202, & 1302	Small business	Important
316	Clarify certain tax consequences of sale of exempt		WITHDRA\
321	Overrule Energy Resources; deny bky ct pwer:		Important--'
322	Overrule U.S. v. Luker; give first priority to		WITHDRA\
323	Amend statutes to provide that taxes for certain late		WITHDRA\
324	Amend BC to except from discharge debts owed by		WITHDRA\
324	Impose requirement that attorney signing POC has		Important
324	Require objections to governemtn's late-filed claims		Important
325	Amend 11 U.S.C. section 1141(d)(3) to except from	Amend 11 U.S.C.	Important
326	Amend 11 U.S.C. section 362(a)(8) to confine it to	Same as topic	Important
327	Amend 11 U.S.C. section 362(b)(9)(D) to except from		WITHDRA\
328	Amend 11 U.S.C. section 362(b)(9) to except form		Important
329	Prevent taxing authority from pursuing debtor for		Important
329	Amend 11 U.S.C. section 505 to provide that the		Important
331	Amend 11 U.S.C. section 523(a)(7) to provide that		Important--'
332	Amend 11 U.S.C. section 1129(a)(9)(A) to limit		Important--'
333	Amend 11 U.S.C. section 523(a)(7) to except tax		Important--'
334	Amend 11 U.S.C. section 545(2) to overrule cases	Same as topic	Important

335	Give excise taxes and employment taxes on wages		Important--'
336	Amend 11 U.S.C. section 362 to provide that acts		WITHDRAW
337	Amend BC to exclude from ppty of estate amts held		Important
338	Exclude from avoiding powers payments of taxes		Important
339	Prohibit bankruptcy court from determining amount		WITHDRAW
411	Address the Mehr decision, to provide that trustee		Important--'
412	Clarify that 10% penalty tax does not apply to		Important
413	Clarify tax consequences of transfer of nondebtor		WITHDRAW
414	Fix BC sec. 704(8) to require trustee to make		WITHDRAW
414	Repeal BC sections 728(c) & (d)		Important
414	Overrule Babbin (or clarify that it does not apply after		Important--'
415	Very complicated: when partnership has certain		Important
415	Amend the Internal Revenue Coe to authorize the		Important
421	Amend BC secs. 503 and 28 USC sec. 960 to	Same as topic	Important--'
421	Allow jointly admininstered bankruptcy estates of		Important--'
421	Amend IRC sec 1398(h) to provide that deductible		Important
421	Create a way for trustee to achieve safe harbor and		Important
421	Clarify whether property abandoned is subject to		Important
421	Amend BC sec. 362(b)(3) to provide that civil arrest		WITHDRAW
421	Limit use of BC sec 105 to only implementation of a		WITHDRAW
421	Eliminate plenary consent to jurisdiction resulting		WITHDRAW
422	Comb with Track Nos. 423 & 424. Post-petition ad	Same as topic	Important
423	Comb with Track Nos. 422 & 424; Overrule North	Same as topic	Important
424	Combine with Track Nos. 422 & 423; Overrule	Same as topic	Important
425	Abandonment by trustee to debtor should not be	Same as topic	Important--'
426	Address overall question whether state-tax claims		Important
427	Apply the doctrine of relation back to abandonment;		Combined w
428	Permit individual chapter 7 debtor and chapter 11		WITHDRAW
429	Clarify who should pay state inheritance tax when		WITHDRAW
431	Have statute provide for taxing authority to issue		Important
431	Amend tax statutes to excuse trustees from duty to		Important
431	Find a good way to deal with cases where the		Important
431	Give state and local government the same waiver of		WITHDRAW
431	IRC fails to address whether there is double taxation		WITHDRAW
431	Require estate representative to fill all delinquent		Important
431	Sec. 382 and stock-for-debt issues		Important--'
432	Should "bifurcated-year" cases be overruled which		Important--'
433	Expressly deny bankruptcy court power to grant		Important--'
434	Clear up omission in law and provide that debtor's		WITHDRAW
434	Clarify which administrative expenses are capitalized		Important
435	IRCode says code excluded only if debtor both under		WITHDRAW
435	Amend law to provide that for tax purposes individual	Codify Kreedle	Important
436	Are NOL's "property"? Clarify distinction of tax		Important--'
436	Clarify how amount realized, basis and resulting gain		Important--'
437	Clarify that bankruptcy estates are subject to	Same as topic	Important

437	Clarify treatment of excess deductions and NOL's		WITHDRA
438	Exculpate the bankruptcy trustee from personal		Important
438	Clarification of issue raised in West Texas case		Important
438	Limit the scope of sectoin 505(b)		Important--
439	Clarify effect of revocation of discharge or dismissal		WITHDRA
441	Retroactively nullify nonconforming plans		Important--
441	Require payment of priority taxes in chapter 13		Important--
442	All postpetition taxes covered by 1305 are priority		Important--
443	No stay on imposition of lien on ch. 13 debtor with		Important
500	Retain sec 502(b)(9) passed in 1994 which gives		WITHDRA
501	Combine with Track no. 321		WITHDRA
502	Combine with Track Nos. 321 & 501		WITHDRA
502	See also Track No. 441 Pay POSTpetition tax claims		WITHDRA
503	Overrule Campbell; provide that federal tax lien may		Combined
503	Pay PREpetition tax claims in full in ch. 13 with		Important--
504	Combined with Track No. 312		WITHDRA
504	Same as Track No. 212		WITHDRA
505	See also Track Nos. 513 & 514; Provide in BC that	Same as topic	Important
505	General policy on tax benefits for debtors		WITHDRA
506	Federal tax lien attaches to all assets; some under		Important
506	Affirm case which says bankruptcy court cannot		WITHDRA
507	Combine with Track No. 311		WITHDRA
507	Combine with Track Nos. 212 & 504		WITHDRA
508	Combine with Track Nos. 312 & 509		WITHDRA
509	Combine with Track Nos. 312 & 508		WITHDRA
510	Combine with Track No. 321		WITHDRA
511	Combine with Track No. 321		WITHDRA
512	Combine with Track No. 321		WITHDRA
513	Combine with Track Nos. 505, 514; Provide in BC		Important
513	Combine with Track No. 216		WITHDRA
514	Combine with Track Nos. 505(2) and 503		WITHDRA
515	Clarify definition of property of estate in chapter 13 to		Important
516	Combine with Track No. 217		Combined
601	Combine with Track No. 331		WITHDRA
602	Clarify definition of "willfully attempts" et cetera		Important--
603	Overrule Robins decision and the like granting		Important
604	Should a filing by one member of a consolidated		WITHDRA
604	Jurisdiction of bankruptcy court to bind subsidiary		Important
604	Jurisdiction of bankruptcy court to bind parent entity		Important
700	Amend BC 1307 to explicitly authorize the bankruptcy		Important
701	Clarify tax issues that must be discussed in a chapter		Important
702	Amend IRC 1398 to permit tax attributes under state		Important
703	Subordination of nonpecuniary loss policies outside		Important
704	Subordination of postpetition tax penalites		Important
705	Amend chapter 13 to include trust fund taxes within		Important

706	Treat workers' compensation and employee benefits'		Important
707	Overrule McDermott		Important
708	Prohibit IRS from executing on a federal tax lien		Important
709	Clarify timing as to valuation of collater in chapter 13		Important
710	Amend BC 506(c) to charge secured creditor for		Important
711	Clarify BC 726(a)(1) to require tax creditors to file		Important
712	Repeal 507(a)(8)(G)		WITHDRAV
713	Modify IRC 1001 to provide equal treatment for		Important--'
714	Modify IRC 1398(e)(3)		Important
715	Relief for failure to file IRC 1398(b)(2) elections		Important
716	Simplified reporting of taxes by trustees to taxing		Important
717		Withdraw	
718	Clarify §1305	Withdraw	

WITHDRAWN PROPOSALS

The following proposals have been withdrawn by the Advisory Committee as unimportant, unclear, or as considered elsewhere:

Track Number
104*
107
108
219*
316
322
323
324
327
329
336
338*
339
412*
413
414
414(b)
4212*
4213
4214
4215
4216
427
428
429
4311
4311(a)
435
436
437(a)
439
434
504
505(a)
506(a)
507
507(a)
508
509
510
511
512
513(a)
514
516
601
604
604(b)
712
717
718*
TOTAL: 51

*Proposal may be important but is unclear or is being considered elsewhere.

Proposed Legislative Language for Fresh Start NOL Proposal

A Bill

To amend the Internal Revenue Code of 1986 to allow corporations undergoing bankruptcy reorganization to elect a fresh start rather than attribute reduction with respect to indebtedness discharged in the bankruptcy.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. FRESH START ELECTION FOR CORPORATIONS UNDERGOING BANKRUPTCY REORGANIZATION.

(a) IN GENERAL. -- Section 108 (relating to income from discharge of indebtedness) is amended by adding at the end the following new subsection:

"(h) FRESH START ELECTION FOR CORPORATIONS UNDERGOING BANKRUPTCY REORGANIZATION. --

"(1) GENERAL RULE. -- If --

"(A) the discharge of indebtedness to which subsection (a) applies occurs in a title 11 case involving an ownership change to which this subsection applies, and

"(B) both the old loss and new loss corporations with respect to the ownership change elect the application of this subsection,

then the provisions of this subsection shall apply in lieu of the provisions of subsection (b) (and any related provisions).

"(2) EFFECT OF ELECTION. -- For purposes of this title --

"(A) IN GENERAL. -- If this subsection applies with respect to any discharge of indebtedness --

"(i) the old loss corporation shall be treated as having sold all of its assets to an unrelated person for their fair market value, and "(ii) except as provided in paragraph (3), the new loss corporation shall not succeed to, or take into account, the tax attributes of the old loss corporation described in subsection (b).

"(B) TIME FOR INCLUSION. -- The deemed sale under subparagraph (A) shall be treated as having occurred on the last day of the taxable year of the old loss corporation ending with the ownership change (and any gain or loss shall be taken into account for such taxable year).

"(3) NET OPERATING LOSS CARRYOVERS; BASIS --

"(A) 5-YEAR NET OPERATING LOSS CARRYOVER. --

"(i) IN GENERAL. -- The new loss corporation shall be allowed a net operating loss carryover in an amount equal to the lesser of --

"(I) 5 times the section 382 limitation applicable to the new loss corporation, or

"(II) the pre-change losses.

Such carryover shall be to each of the first 5 post-change years.

] "(ii) COORDINATION WITH SECTION 382. -- Section 382 shall not apply to any net operating loss carryover under clause (i), except that the active business requirements of subsection (c)(1) thereof shall apply to the new loss corporation.

"(B) BASIS. -- The basis of the new loss corporation in any asset of the old loss corporation shall be its fair market value as of the last day of the taxable year of the old loss corporation ending with the ownership change.

(4) OWNERSHIP CHANGES TO WHICH SUBSECTION APPLIES. -- This subsection applies to an ownership change with respect to which --

"(A) the old loss corporation was (immediately before the change) under the jurisdiction of the court in a title 11 case, and

"(B) the creditors of the old loss corporation before such change own, after such change and as a result of being creditors immediately before such change, stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy) which meets the requirements of section 1504(a)(2) (determined by substituting '50 percent' for '80 percent' each place it appears),

"(5) OTHER DEFINITIONS. -- Any term which is used in this subsection which is also used in section 382 shall have the meaning given such term by such section.

"(6) REGULATIONS. -- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations --

"(A) providing for the application of this subsection in the case of split or separate elections by members of an affiliated group filing a consolidated return, and

"(B) providing limits similar to those under section 382(l)(6) which limit the equity value of a corporation to the post-restructuring equity value or the pre-restructuring gross asset value."

(b) MINIMUM TAX. -- Section 56(d) is amended by adding at the end the following new paragraph:

"(3) SPECIAL RULE FOR BANKRUPTCY FRESH START ELECTION. -- In the case of a corporation which is treated as having sold all of its assets under section 108(h)(2)(A), subparagraph (A) of paragraph (1) shall be treated as if it read as follows:

"'(A) the amount of such deduction shall not exceed the sum of --

"'(i) 90 percent of alternative minimum taxable income without regard to gain or losses from such deemed sale, plus

"'(ii) the net gain (if any) from such deemed sale, and'".

(c) EFFECTIVE DATE. -- The amendments made by this section shall apply to ownership changes occurring after the date of the enactment of this Act.