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# National Bankruptcy Review Commission Tax Recommendations: Notice, Jurisdiction, and Corporate Debtors

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# Articles

## NATIONAL BANKRUPTCY REVIEW COMMISSION TAX RECOMMENDATIONS: NOTICE, JURISDICTION, AND CORPORATE DEBTORS

by  
*Jack F. Williams\**

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Pursuant to congressional mandate, the National Bankruptcy Review Commission (NBRC) reported its recommendations for modification of the Bankruptcy Reform Act of 1978, as amended (the "Bankruptcy Code"),<sup>1</sup> to the President, Congress, and Chief Justice of the Supreme Court on October 20, 1997. This Article, the second and final installment analyzing the tax recommendations of the NBRC, focuses on the proposed revisions relating to, among other things, taxation of corporate and partnership debtor estates. In particular, this Article discusses the requirement of reasonable notice to the government, bankruptcy court jurisdiction over tax controversies, bankruptcy administration affecting tax matters, chapter 11 plan requirements, and substantive tax matters.

Under the auspices of the NBRC, the Tax Advisory Committee (the "Advisory Committee") was formed in February 1997. The members of the Advisory Committee were appointed by the NBRC and include representatives from the private bar, federal and state governments, and academia.<sup>2</sup>

The NBRC directed the Advisory Committee to report back with a Final Report by the August 1997 meeting in Washington, D.C. The NBRC further requested that the Advisory Committee prepare Preliminary Reports for the April 1997 meeting in Seattle, Washington, and the June 1997 meeting of the NBRC in Detroit, Michigan. The Preliminary Reports identified those areas of bankruptcy taxation that the Advisory Committee had determined to be susceptible to agreement among its members, and those proposals that had been withdrawn from consideration by the Advisory Committee as unimportant, unclear, or considered elsewhere. The Advisory Committee continued the process of discussing and identifying those proposals that might be susceptible to agreement. The Final

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<sup>1</sup> 11 U.S.C. §§ 101-1330 (1994).

<sup>2</sup> The Advisory Committee members were Paul Asofsky, Mark Browning, Steve Csontos, Robert MacKenzie, Robert Miller, Grant Newton, Joan Pilver, Mark Seigel, and Ken Weil. My compliments to the fellow members of the Advisory Committee. They all performed passionately and, as a body, accomplished much. The author chaired the Advisory Committee. The NBRC'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.

Report contains three sections.<sup>3</sup> The first section contains a listing and discussion of twenty-eight consensus items.<sup>4</sup> The first twenty-five of the twenty-eight items were presented to the NBRC at the May 1997 meeting and twenty-four of the items were adopted unanimously.<sup>5</sup> The second section contains a listing and discussion of six consensus items.<sup>6</sup> 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.<sup>7</sup> Although short of a consensus on these contested issues, the Advisory Committee has provided the NBRC with its recommendations and voting record on the twenty-nine proposals.<sup>8</sup>

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<sup>3</sup> See TAX ADVISORY COMMITTEE FINAL REPORT at 5-6 (August 1997) (hereinafter "TAC Report").

<sup>4</sup> See *id.* at 5.

<sup>5</sup> The items adopted by the NBRC at the May 1997 meeting were: 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 NBRC but not adopted. The Advisory Committee was assigned 700-series index numbers. Furthermore, where appropriate, the Advisory Committee split multiple proposals into component parts, thus, the original proposal No. 414 has been redesignated Nos. 414, 414(a), and 414(b). See *id.*, at 4.

<sup>6</sup> See *id.*

<sup>7</sup> See *id.* Rather than initiating 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, the original proposal No. 414 has been redesignated Nos. 414, 414(a), and 414(b). See *id.*, at 4.

<sup>8</sup> 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 National Association of Attorneys General also submitted a number of tax proposals for consideration. The NBRC held at least two working meetings in San Diego, California, and Santa Fe, New Mexico, where many bankruptcy taxation issues were discussed and developed. NBRC 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 NBRC 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 NBRC. The combined efforts of the parties described above have led to the development of a Tax Matrix in excess of 90 pages with well over 100 proposals. While many of the proposals adopted by the NBRC were recom-

## I. REASONABLE NOTICE TO TAXING AUTHORITIES

One of the most difficult issues in the area of bankruptcy tax involves the issue of what constitutes reasonable notice to governmental authorities. To be sure, the issue of adequate notice to the government transcends tax disputes, particularly with greater local and state involvement in bankruptcy cases. The Advisory Committee sought to clarify the provisions of the Bankruptcy Code addressing reasonable notice to governmental units.

The Advisory Committee agreed that notice provisions in the Bankruptcy Code must be clarified as those provisions relate to governmental units. There was a consensus that the government should not lose its rights against the debtor or the bankruptcy estate in a bankruptcy case because of a 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 reviewed the Tax Related Information Items contained in the Justice Department's letter of March 7, 1997, to the Advisory Committee on Bankruptcy Rules.<sup>9</sup> The Advisory Committee found the items contained in the letter penned by the Justice Department reasonable. Ultimately, the NBRC unanimously adopted the notice proposal urged by the Advisory Committee.

The Advisory Committee suggested that the NBRC 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.

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mentations by the Advisory Committee, on occasion the NBRC rejected the recommendation of the Advisory Committee and adopted one of the competing proposals.

<sup>9</sup> Letter from the Justice Department to the Advisory Committee on Bankruptcy Rules (Appendix IV) (March 7, 1997) (on file with author).

Second, to facilitate proper notice, the NBRC should recommend to Congress 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 who practices in Nevada may be aware of the governmental department to which one must provide notice regarding state sales tax in Nevada, but may be unaware of the department with sales tax responsibility in Georgia, a state where the client has done business. However, there was 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 clerk's 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 provide 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 non-dischargeability of tax claims where the debtor has not provided reasonable notice in a manner consistent with the applicable Bankruptcy Code section or Rule. A notice requirement is too central to the design of the Bankruptcy Code to be aspirational. Thus, some type of sanctioning tool is necessary to the overall utility of a notice provision.

Finally, the Advisory Committee recommended 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.<sup>10</sup> A piecemeal approach to notice serves the best interests of no one. Unfortunately, it appears that the Committee on Bankruptcy Rules does not have the same sense of urgency that those who practice in the area have.

One area of controversy that was not resolved by the notice proposal involved the potential derivative tax liability of debtors. For example, an individual debtor may have held high-level positions with several companies, some or all of which may not have paid over trust fund taxes like payroll to the government.<sup>11</sup> To what extent must the debtor disclose potential trust fund liabilities in her own bankruptcy case?<sup>12</sup> Obviously, if any of the trust fund liabilities have been assessed against the debtor, anyone that asserts these liabilities should be listed in the schedules filed with the bankruptcy court. The controversy begins, however, with *potential* trust fund liabilities. Just how much investigation must a debtor and her attorney undertake before they discharge any duty to reasonably report derivative tax liabilities? A conservative approach runs the risk of incurring the wrath of sanctions, including nondischargeability of otherwise dischargeable tax debts. A liberal approach amounts to a "come and get me" cry to the government. A better approach, an approach that accommodates both debtors and the government, is a reporting requirement that asks the debtor to list key positions with businesses within a certain period before her personal bankruptcy filing.

The Advisory Committee also recommended and the NBRC adopted a proposal to 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.<sup>13</sup> 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.<sup>14</sup> Presently, the IRS has directed that § 505(b) requests

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<sup>10</sup> Although it may be more appropriate for the Rules Committee to address the notice issues, the Advisory Committee emphasized that reasonable notice is a key consideration running throughout the proposals in this Final Report.

<sup>11</sup> See C. RICHARD MCQUEEN & JACK F. WILLIAMS, *TAX ASPECTS OF BANKRUPTCY LAW & PRACTICE* §§ 10:18-10:19 (3ed. 1997).

<sup>12</sup> IRC § 6672.

<sup>13</sup> See 11 U.S.C. § 505(b) (1994).

<sup>14</sup> See *id.*



be filed with the local District Director.<sup>15</sup> Nonetheless, some courts have held that a trustee may ignore the IRS directive and file a § 505(b) request with the IRS Service Center.<sup>16</sup> It was 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 often depends on obtaining information in order to identify the appropriate governmental representative. Consequently, it was the consensus of the Advisory Committee that the NBRC 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.<sup>17</sup>

## II. BANKRUPTCY COURT JURISDICTION OVER TAX CONTROVERSIES

One of the most controversial issues addressed by the Advisory Committee was the jurisdiction of the bankruptcy court to decide tax controversies.<sup>18</sup> This is one of those delightful areas that serves as a window to a deeper understanding of the debate among many interests. Much of the debate on bankruptcy reform turns on the trust that constituencies have in the bankruptcy courts' ability to effectuate the intent of Congress. This particular area of the law is no different.

### A. *Introduction to Bankruptcy Court Jurisdiction Over Tax Matters*

The broad grant of jurisdiction allowing the bankruptcy court to determine tax liability is actually codified in two places in the Bankruptcy Code. First, and sometimes overlooked, are Bankruptcy Code §§ 501 and 502, which permit the bankruptcy court to estimate and determine the allowability of claims, including tax claims, against the estate.<sup>19</sup> Second, Bankruptcy Code § 505(a)(1) provides:

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<sup>15</sup> See Rev. Proc. 81-17, 1981-1 C.B. 688.

<sup>16</sup> See *In re Carie Corp.*, 128 B.R. 266 (Bankr. D. Alaska 1989).

<sup>17</sup> See Comments to Proposal #106.

<sup>18</sup> See, e.g., *U.S. v. Kearns (In re Kearns)*, 1998 WL 153996 (8th Cir. 1998); *Carlson v. U.S. (In re Carlson)*, 126 F.3d 915 (7th Cir. 1997); *Maryland v. Antonelli Creditors' Liquidating Trust*, 123 F.3d 777 (4th Cir. 1997). See generally MCQUEEN & WILLIAMS, *supra* note 11, ch.3.

<sup>19</sup> See 11 U.S.C. §§ 501-502 (1994)

Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.<sup>20</sup>

The bankruptcy court is authorized under Bankruptcy Code § 505(a)(1) to rule on the merits of any tax claim involving any unpaid tax, fine, or penalty relating to a tax, or any addition to tax, of the debtor or the bankruptcy estate. In general, this authority applies whether the tax penalty, fine, or addition to tax has been previously assessed. This section provides taxpayers in bankruptcy with an alternative prepayment forum to the tax court and is an exception to the *Flora*<sup>21</sup> rule requiring full payment of the tax prior to non-tax court litigation. The language of § 505(a)(1) is very broad.<sup>22</sup>

A bankruptcy court's ability and authority to determine the tax liability of a debtor and a bankruptcy estate often may turn on the procedural stage at which the determination is sought and the tax is owed. The first stage involves taxes that arose before the petition in bankruptcy was filed. The second stage involves taxes that arose postpetition but before the case was closed or a plan of reorganization was confirmed. The third stage involves taxes that arise after a plan of reorganization is confirmed.

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<sup>20</sup> *Id.* § 505(a).

<sup>21</sup> *Flora v. United States*, 362 U.S. 145 (1960) (full payment of tax is prerequisite to filing suit in federal district court).

<sup>22</sup> See *In re Eua Power Corp.*, 184 B.R. 631 (Bankr. D.N.H. 1995) (holding that the bankruptcy court had no jurisdiction to consider and determine the question of a chapter 11 debtor's right to a property tax refund where the debtor did not request an abatement or refund with the applicable taxing agency within the time required by state law); *In re D'Alessio*, 181 B.R. 756 (Bankr. S.D.N.Y. 1995) (holding that the factors which must be considered in determining whether to abstain from resolving a debtor's tax liability include the complexity of the tax issues involved, the need to administer the case in an orderly and efficient manner, the burden of the bankruptcy court's docket, the time required for trial and decision, the asset and liability structure of the debtor, and the prejudice to the debtor relative to the prejudice to the taxing authority from inconsistent judgments); *In re Starnes*, 159 B.R. 748 (Bankr. W.D.N.C. 1993) (holding that the bankruptcy court had jurisdiction to hear a chapter 7 debtor's postdischarge adversary proceeding to determine the debtor's federal income tax liability, where no evidence was presented to the court which indicated that any prior adjudication of the merits of the tax claim had occurred in a contested proceeding before a court of competent jurisdiction).

Generally, a bankruptcy court may assert jurisdiction to determine tax matters involving prepetition and postpetition-preconfirmation tax claims subject to abstention by the bankruptcy court where appropriate. As to postconfirmation tax matters, the authorities are in disagreement, with the IRS asserting that a bankruptcy court lacks authority to declare the federal tax consequences of a plan of reorganization. Each procedural stage will be analyzed in turn to provide a better understanding of the proposals considered by the NBRC.

### 1. *Determination of Prepetition Taxes*

Both 11 U.S.C. §§ 505(a)(1) and 502 permit a bankruptcy court to determine the merits of any prepetition tax claim involving an unpaid tax, fine, or penalty relating to a tax, or any addition to tax, of the debtor or the bankruptcy estate.<sup>23</sup> Generally, this authority is present regardless of whether the tax, penalty, fine, or addition to tax has been previously assessed. However, there are limits to the broad grant of power under 11 U.S.C. § 505(a). These limits may be found in § 505(a)(2) and in relevant case law.<sup>24</sup>

Cases have strongly endorsed the view that § 505(a) provides a broad grant of jurisdiction to determine prepetition taxes. For example, in *In re Barry*,<sup>25</sup> the bankruptcy court held that it had jurisdiction pursuant to 11 U.S.C. § 505(a)(1) to determine a debtor's various objections to tax claims, and that such objections were a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B).<sup>26</sup> Moreover,

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<sup>23</sup> See 11 U.S.C. §§ 502, 505(a)(1) (1994).

<sup>24</sup> See *id.* § 505(a)(2). See, e.g., *St. John's Nursing Home v. City of New Bedford (In re St. John's Nursing Home)*, 169 B.R. 796 (D. Mass. 1994); *In re Dunhill Medical Inc.*, 1996 WL 354696 (Bankr. D.N.J. 1996).

<sup>25</sup> 48 B.R. 600 (Bankr. M.D. Tenn. 1985).

<sup>26</sup> See *In re Palm Beach Resort Prop., Inc.*, 51 B.R. 363 (Bankr. S.D. Fla. 1985) (holding that the bankruptcy court had the jurisdiction to determine a tax which was not seasonably "contested"); see also *In re Fyfe*, 186 B.R. 290 (Bankr. N.D. Ga. 1995) (holding that abstention of the bankruptcy court from determining the debtor's tax liability and the validity of a tax lien on the debtor's property was warranted until the debtor showed that he had exhausted all administrative and legal remedies to resolve the disputed tax claims that were available to him without first having to pay the claim); *In re 150 North Street Assoc. Ltd. Partnership*, 184 B.R. 1 (Bankr. D. Mass. 1995) (holding that a chapter 11 debtor's liability for real estate taxes was not "adjudicated" for purposes of the Bankruptcy Code provision limiting a bankruptcy court's power to determine a tax liability if the amount was contested or "adjudicated" by a judicial or administrative tribunal of competent jurisdiction prepetition, even though the debtor had sought and obtained an abatement from the city, where the

in *Smith v. U.S.*,<sup>27</sup> the bankruptcy court held that use of the term “may” in the Bankruptcy Code provision, which grants a bankruptcy court the authority to determine the validity and amount of a tax, is the grant of power to determine tax liability rather than merely a permissive option. In addition, the bankruptcy court may not abstain from exercising jurisdiction over a motion requesting the determination of tax liability unless the interest of creditors and debtors would be served by an abstention. Furthermore, in *In re AH Robins Co.*,<sup>28</sup> the bankruptcy court held that a debtor’s failure to challenge certain West Virginia tax assessments did not deprive the bankruptcy court of jurisdiction to decide the validity of such tax claims even though the West Virginia tax statute provided that assessment became final and conclusive and was not subject to administrative or judicial review unless the taxpayer petitioned for reassessment within sixty days. In *Kilen v. U.S.*,<sup>29</sup> the bankruptcy court held that the IRS had a “claim” recognizable in bankruptcy against the debtor with potential trust fund tax liability as the “responsible person” of numerous taxpayer corporations with the result that such “claim” provided an actual controversy for adjudication by the bankruptcy court. Finally, in *In re K-Fabricators, Inc.*,<sup>30</sup> the bankruptcy court held that it had the power to determine the amount and legality of any tax on a debtor which had not previously been contested.

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debtor was not given a hearing and was unable to appeal the decision because of outstanding tax arrearages); *In re St. John’s Nursing Home, Inc.*, 169 B.R. 795 (D. Mass. 1994) (holding that the filing of a tax abatement application by the chapter 11 trustee was a prerequisite to the bankruptcy court’s jurisdiction concerning the estate’s request for a refund of Massachusetts real property taxes).

<sup>27</sup> *In re Smith*, 122 B.R. 130 (Bankr. M.D. Fla. 1990).

<sup>28</sup> 126 B.R. 227 (Bankr. E.D. Va. 1991).

<sup>29</sup> *In re Kilen*, 129 B.R. 538 (Bankr. N.D. Ill. 1991).

<sup>30</sup> 135 B.R. 654 (Bankr. W.D. Wash. 1992). See also *Cumberland Farms, Inc. v. City of Bainstable (In re Cumberland Farms, Inc.)*, 175 B.R. 138 (Bankr. D. Mass. 1994) (holding that the bankruptcy court had jurisdiction to adjudicate the legality and the amount of a chapter 11 debtor’s unpaid taxes, even though the debtor had not contested the taxes under state procedure and even though the time for doing so had expired); *Holly’s, Inc. v. City of Kentwood (In re Holly’s, Inc.)*, 172 B.R. 545 (Bankr. W.D. Mich. 1994) (holding that the bankruptcy court had subject matter jurisdiction to render a final judgment on the debtor’s preconfirmation real property tax liability, but that the doctrine of *res judicata* barred the debtor’s request to determine its preconfirmation tax liability); *In re Camp*, 170 B.R. 610 (Bankr. N.D. Ohio 1994) (holding that the federal government’s tax claim was contingent and disputed, as listed on the debtors’ bankruptcy schedules, absent any indication in the schedules that the debtors had scheduled the government’s claim in bad faith).

## 2. *Determination of the Tax Liability of the Estate for the Period of Administration*

Section 505(b) of the Bankruptcy Code provides:

A trustee may request a determination of any unpaid liability of the estate for any tax incurred during the administration of the case by submitting a tax return for such tax and a request for such a determination to the governmental unit charged with responsibility for collection or determination of such tax. Unless such return is fraudulent, or contains a material misrepresentation, the trustee, the debtor, and any successor to the debtor are discharged from any liability for such tax—

- (1) upon payment of the tax shown on such return, if—
  - (A) such governmental unit does not notify the trustee within 60 days after such request, that such return has been selected for examination; or
  - (B) such governmental unit does not complete such an examination and notify the trustee of any tax due, within 180 days after such request or within such additional time as the court, for cause, permits;
- (2) upon payment of the tax determined by the court, after notice and a hearing, after completion by such governmental unit of such examination; or
- (3) upon payment of the tax determined by such governmental unit to be due.<sup>31</sup>

Section 505(b) allows the trustee (including a debtor-in-possession when no trustee is appointed) discretion in all cases to ask the local, state, or federal taxing authority for a prompt audit of the trustee's returns on behalf of the estate, although such audits are allowed only on the basis of tax returns filed by the trustee for completed taxable periods.<sup>32</sup> Thus, before a bankruptcy case is closed or at any time during the administration of the case, the trustee may request the taxing authority to audit all returns filed by the trustee and to determine liability for any tax incurred during the bankruptcy case. The procedure for filing a request for prompt determination is set forth in Rev. Proc. 81-17.<sup>33</sup> To make such a re-

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<sup>31</sup> 11 U.S.C. § 505(b) (1994).

<sup>32</sup> See *id.*

<sup>33</sup> Rev. Proc. 81-17, 1981-1 C.B. 688.

quest, the trustee must provide the Special Procedures function with a written application, a complete copy of the return(s), and a statement of where the original return was filed.<sup>34</sup> To summarize, a trustee must take the following steps to comply with Rev. Proc. 81-17:

1. The trustee must file a request for prompt determination in accordance with Rev. Proc. 81-17;
2. The IRS must notify the trustee within 60 days after receipt of the request as to whether it accepts the return as filed or desires to examine the return;
3. If an examination is conducted, the IRS is required to notify the trustee of any tax deficiency within 180 days of the request, subject to extensions of time approved by the bankruptcy court;
4. If the trustee disagrees with the results of the examination, the trustee may ask the bankruptcy court to resolve the dispute;
5. If the IRS either fails to notify the trustee within sixty days of the request for determination of tax that the return has been selected for examination, or fails to complete the examination and notify the trustee of any tax due within 180 days (plus any extension of time granted by the bankruptcy court), the trustee, the debtor, and any successor to the debtor are discharged from any further liability for such taxes, unless the return filed is fraudulent or contains a material misrepresentation.<sup>35</sup>

In *U.S. v. McElmore*,<sup>36</sup> the district court held that the personal liability of the trustee and the debtors was terminated where the trustee requested the determination of the tax liability when he filed late returns and the IRS failed to notify him within sixty days that the return had been selected for examination. However, in *In re Rode*, the bankruptcy court held that the bankruptcy estate is not the "successor to the debtor" within the meaning of the provision of the Bankruptcy Code stating that the debtor, trustee, and any "successor to the debtor" are discharged from liability resulting from tax if the taxing authority fails to act within the time limits of

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<sup>34</sup> See *id.*

<sup>35</sup> See *id.*

<sup>36</sup> *In re Estes*, 87 B.R. 52 (M.D. Tenn. 1988).

statute.<sup>37</sup> Additionally, in *In re Fondiller*,<sup>38</sup> the district court held that the statute discharging the trustee, the debtor, and the debtor's successors from liability for tax, if the government does not respond within sixty days after a request for determination of tax, did not discharge the debtor's estate from liability for tax on the theory that the estate was the debtor's successor.<sup>39</sup>

Section 505(b) is intended to provide prompt audit procedures. It is a reasoned procedure for both the trustee and the debtor to obtain discharge from further tax liability for those taxes incurred during the period of estate administration. Of course, should the trustee fail to request a prompt audit, and assets are returned to the debtor, the debtor is not discharged from possible transferee liability for taxes relating to such assets.<sup>40</sup>

### 3. *Determination of Post Confirmation Tax Liability*

This stage presents some of the most important and problematic jurisdictional issues in all of bankruptcy. Here is a violent clash between bankruptcy and tax policies. In order for bankruptcy courts to determine tax ramifications related to plan confirmation under § 505(a)(1), they need to first find that § 505(a)(1) applies to more than just preconfirmation tax claims. Although there is nothing in the legislative history to § 505(a)(1) which indicates it was intended to apply to tax issues other than preconfirmation tax claims, the legislative history does not explicitly limit § 505(a)(1)'s application to only those types of tax issues.

The current ability of bankruptcy courts to make determinations regarding the income tax consequences of chapter 11 reorganization plans is best addressed by dividing income tax issues into

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<sup>37</sup> 119 B.R. 697, 698 (Bankr. E.D. Mo. 1990).

<sup>38</sup> 125 B.R. 805 (N.D. Cal. 1991).

<sup>39</sup> See also *Kellogg v. U.S.*, (*In re West Tex. Mktg Corp.*), 54 F.3d 1194 (5th Cir. 1995) (holding that a bankruptcy estate is not a "successor to the debtor" entitled to a discharge of the tax obligation under Bankruptcy Code § 505(b), and thus that the IRS did not violate the tax liability discharge provision of the Bankruptcy Code when it assessed an estimated tax penalty against the bankruptcy estate more than sixty days after the chapter 7 debtor's request for determination).

<sup>40</sup> See, e.g., *In re Vale*, 180 B.R. 1017 (Bankr. N.D. Ind. 1994) (holding that a chapter 7 trustee's motion to determine tax liability of the bankruptcy estate could not be withdrawn except by order of the bankruptcy court, and upon such terms and conditions as the court deemed proper, because the IRS filed an objection to such motion which was the equivalent of an answer to the motion).

two categories: (1) those related to state and local taxes on the one hand and (2) those related to federal taxes on the other. This classification highlights the fact that these two categories have different statutory bases regarding the ability of bankruptcy courts to make determinations of the income tax consequences of reorganization plans.

There is a general agreement among authorities that a bankruptcy court has the power to determine state and local tax consequences of a confirmed plan of reorganization under chapter 11 of the Bankruptcy Code.<sup>41</sup> There exists no such consensus regarding a bankruptcy court's ability to declare the federal tax consequences of a confirmed plan of reorganization. Generally, declaratory judgments on federal tax issues are prohibited by the Declaratory Judgment Act.<sup>42</sup> Nevertheless, an express exception to the Declaratory Judgment Act permits declaratory judgments in the case of "a proceeding under § 505 or § 1146 of Title 11." Hence, it would appear that a bankruptcy court may enter a final judgment declaring the federal tax consequences if an actual controversy over federal taxes is otherwise within its jurisdiction.

The ability of bankruptcy courts to render declaratory relief regarding the federal tax consequences of chapter 11 plans presents a much more difficult question than state or local tax determinations because there is no explicit statutory authority allowing such relief. All references to federal taxes in the draft of § 1146 were deleted by a last-minute amendment prior to enactment of the Bankruptcy Code. Congress took this action to prevent the Bankruptcy Code from becoming stalled in Congress and because it intended to pass a comprehensive bill the following year to address the federal tax ramifications of bankruptcy.

Meanwhile, Congress amended the Declaratory Judgment Act. It now provides:

[I]n a case of actual controversy within its jurisdiction, except with respect to Federal taxes other than . . . a proceeding under section 505 or 1146 of title 11 . . . any court of the United States, upon the filing

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<sup>41</sup> See 11 U.S.C. § 1146(d) (1994); GORDON D. HENDERSON & STEWART J. GOLDRING, *FAILING AND FAILED BUSINESSES II* ¶ 1012.03, at 168(a) n.150(b). See also *Stayner v. Village of Sugargrove* (*In re Stayner*), 185 B.R. 557 (Bankr. N.D. Ill. 1995) (holding that the bankruptcy court lacked subject matter jurisdiction to resolve a postconfirmation tax liability allegedly owed to the State of Illinois).

<sup>42</sup> 28 U.S.C. § 2201 (1994).



of an appropriate pleading, may declare the rights and other legal relationships of any interested party seeking such declaration.<sup>43</sup>

As one will see, this provision in the Declaratory Judgment Act provides some mischief. Although a court may not use § 1146(d) to address federal tax issues, it may use Bankruptcy Code § 505 and the exception of § 505 from the provision generally prohibiting the use of declaratory judgments in tax matters.

Currently, determinations are made by bankruptcy courts concerning the federal income tax consequences of chapter 11 plans of reorganization outside of § 505(a)(1) of the Bankruptcy Code and the Declaratory Judgment Act. As an obvious example, bankruptcy courts are required to determine whether a plan of reorganization is feasible under § 1129(a)(11) of the Bankruptcy Code.<sup>44</sup> That section states:

The court shall confirm a plan only if all of the following requirements are met: Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.<sup>45</sup>

The bankruptcy court has a mandatory duty to determine whether a reorganization plan satisfies the confirmation requirements in § 1129(a), and the plan proponents have the burden of proving that all those requirements have been met. Consequently, the impact of the federal income tax consequences of the proposed reorganization plan is one of the "related matters" that the bankruptcy court must consider in making a finding that confirmation of the plan will not likely be followed by the need for further financial reorganization. In a chapter 11 case, the federal income tax issues and liabilities surrounding the reorganization plan should be contained in the debtor's disclosure statement in order to provide the creditors and interest holders with adequate information to allow them to make an informed decision when voting on the plan. Moreover, the tax implications of the reorganization plan and the reorganized company should be reflected in the debtor's financial

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<sup>43</sup> *Id.*

<sup>44</sup> 11 U.S.C. § 1129(a)(11) (1994).

<sup>45</sup> *Id.*

projections as part of its disclosure statement because taxes play a significant role in determining the profitability of a business and, consequently, the feasibility of the business's reorganization plan. All of these materials, some of which project future events and are based in part on contingencies which may or may not occur, are reviewed by the bankruptcy court in determining plan feasibility. Accordingly, the bankruptcy court must inherently make a determination under § 1129(a)(11) that any adverse tax consequences resulting from confirmation of the plan or events beyond confirmation are not so great as to jeopardize the success of the postconfirmation company.<sup>46</sup>

Thus, in *Unsecured Creditors Committee of Goldblatt Brothers v. U.S.*,<sup>47</sup> a bankruptcy court upheld its authority to issue a declaratory judgment regarding whether an account established pursuant to the terms of a chapter 11 plan of reorganization would be required to pay federal, state, and local income taxes and file returns. The bankruptcy court, among other things, rested its conclusion on the precise language in the Declaratory Judgment Act exception.<sup>48</sup> In determining whether it had jurisdiction to issue a declaratory judgment in the matter, the bankruptcy court stated that:

[I]n the absence of any provision expressly excluding federal and state income taxation from the adjudicative power of bankruptcy courts, determination of whether a bankruptcy court can adjudicate tax issues would be evaluated under § 157 standards like any other jurisdiction issue. If the tax dispute involved a core controversy, then a bankruptcy court could enter final enforceable orders. If the tax dispute was only "related to" the case under title 11 the bankruptcy court could submit proposed findings of fact and conclusions of law. If neither of those tests were satisfied, then the bankruptcy court would not have jurisdiction to hear the case at all.<sup>49</sup>

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<sup>46</sup> See Donald D. Haber, *Federal Tax Issues in Bankruptcy Reorganizations: What Role Should Bankruptcy Courts Have in Declaring the Federal Income Tax Liability of Debtors and the Federal Income Tax Consequences of Chapter 11 Plans of Reorganization*, 3 AM. BANKR. INST. L. REV. 407 (1995). The author strongly recommends this article as one of the most lucid treatments of the issues.

<sup>47</sup> *In re Goldblatt Bros., Inc.*, 106 B.R. 522 (Bankr. N.D. Ill. 1989).

<sup>48</sup> *See id.*

<sup>49</sup> *Id.* at 525.

The court found the tax dispute at issue to be a core proceeding under § 157 because the account was created as part of the debtor's confirmed plan of reorganization. The court commented that under its holding:

[T]he parameters of a bankruptcy court's jurisdiction over the subject matter of federal and state taxation under [Bankruptcy Code § ] 505(a)(1) corresponds with general principles governing a bankruptcy court's power to adjudicate at least core matters under 28 U.S.C. § 157.<sup>50</sup>

Consequently, the court upheld its authority to issue a declaratory judgment regarding the matter. Thus, it would appear that *Goldblatt* suggests that a bankruptcy court, pursuant to its declaratory judgment power, may declare the federal income tax consequences of a confirmed chapter 11 plan of reorganization.

In *In re McLean Industries, Inc.*,<sup>51</sup> a bankruptcy court concluded that it did not have the authority to declare the federal tax consequences of a confirmed chapter 11 plan of reorganization under the Bankruptcy Code because of the procedural stage at which the request was made. The court stated:

This court will not render an advisory opinion as to the possible danger to the debtors' NOLs because such a threat remains purely hypothetical at this juncture. A court can only determine an issue that presents a "real, substantial controversy between parties having adverse legal interest, a dispute definite and concrete, not hypothetical or abstract." Until the regulations are officially promulgated, there could not be concrete controversy concerning the debtors' tax situation.

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In the future, if the proposed regulations are ultimately adopted, then the appropriate issue would be whether a retroactive application of the IRC would divest the debtors of their NOLs. Additional issues

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<sup>50</sup> *Id.* at 529.

<sup>51</sup> Unpublished opinion (Bankr. S.D.N.Y. 1980) (quoted in Henderson & Goldring, *supra* note 41, at ¶1012.03).

would involve jurisdictional conflicts between the tax authorities and the bankruptcy courts.<sup>52</sup>

There are several persuasive reasons to conclude that bankruptcy courts have the authority consistent with the Declaratory Judgment Act and 11 U.S.C. §§ 505 and 1129 to declare the federal tax consequences of a confirmed chapter 11 plan of reorganization. First, section 1146(d) specifically permits a bankruptcy court to issue declaratory judgments concerning plan feasibility with respect to state and local taxes.<sup>53</sup> Under § 1146(d), a bankruptcy court is authorized to permit the proponent of a plan of reorganization to request from the appropriate state and local tax authorities a determination of the tax effect of a plan of reorganization.<sup>54</sup> This request to state and local authorities is limited to questions of law and not fact.<sup>55</sup> On an adverse determination by a state or local taxing authority, or on the completion of 270 days, a bankruptcy court may declare the effect of a confirmed chapter 11 plan of reorganization on state and local taxes.<sup>56</sup> Thus, the power of the bankruptcy court to determine the tax affects of the plan is limited to issues of law and not to questions of fact, such as the allowance of specific deductions. The bankruptcy court could declare whether the reorganization qualified for tax free status under state or local tax rules, but it could not declare the dollar amount of any tax attributes that survive the reorganization.<sup>57</sup>

Second, exceptions to the Declaratory Judgment Act strongly suggest that a bankruptcy court has the power to determine the tax consequences of a confirmed plan of reorganization under § 505. Third, section 1129 of the Bankruptcy Code requires, among other things, that a plan of reorganization must be feasible before it can be confirmed by the bankruptcy court.<sup>58</sup> Feasibility often turns on the tax consequences of the proposed plan of reorganization. Shackling a bankruptcy court so that it may not rule on the federal tax consequences of a proposed plan may force a bankruptcy court

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<sup>52</sup> *Id.*

<sup>53</sup> 11 U.S.C. § 1146(d) (1994).

<sup>54</sup> *See id.*

<sup>55</sup> *See id.*

<sup>56</sup> *See id.*

<sup>57</sup> *See* 123 CONG. REC. H 11,115 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards), 123 CONG. REC. S 17,432 (daily ed. Oct. 6, 1978) (statement of Sen. Deoncinini).

<sup>58</sup> 11 U.S.C. § 1129(a)(11).

to deny confirmation because the feasibility of the proposed plan, which may turn on the tax status of the surviving entity or the existence and usability of valuable tax attributes such as net operating losses (NOLs), may be too remote.<sup>59</sup>

**B. *Limitations on the Power of the Bankruptcy Court to Determine Tax Matters***

After providing a very broad (virtually limitless) jurisdictional grant of § 505(a) (1), Congress limited the exercise of such power by adding 11 U.S.C. § 505(a) (2). Section 505(a) (2) reads:

The court may not so determine—

- (A) the amount or legality of a tax, fine, penalty, or addition to tax if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under this title; or
- (B) any right of the estate to a tax refund, before the earlier of—
  - (i) 120 days after the trustee properly requests such refund from the governmental unit from which such refund is claimed; or
  - (ii) a determination by such governmental unit of such request.<sup>60</sup>

Among other things, this subsection preserves the validity of much of the ruling in *Arkansas Corporate Commission v. Thompson*.<sup>61</sup> There, the United States Supreme Court held that the bankruptcy court lacked the power to redetermine or alter a tax claim that had been previously determined by a local, state, or federal agency, at least as long as the agency had acted in a quasi-judicial capacity and had obeyed applicable law.<sup>62</sup>

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<sup>59</sup> One avenue of obtaining a prospective ruling should not be overlooked. A chapter 11 plan proponent may seek a private letter ruling from the IRS. Private letter rulings are issued by the IRS to specific taxpayers and are not precedent for others. The IRS has the discretion to deny requests for private letter rulings and will issue one only in the interests of sound tax administration. Requesting a letter ruling is time consuming and may prove unfruitful. Thus, some chapter 11 plans have expressly conditioned their plans' confirmation or effective date upon a favorable IRS ruling, such as in the Federated Department Stores bankruptcies.

<sup>60</sup> 11 U.S.C. § 505(a) (2).

<sup>61</sup> 313 U.S. 132 (1941). See also *In re Baker*, 172 B.R. 966 (Bankr. D. Or. 1994) (holding that bankruptcy court lacked authority to set aside a stipulated decision of the tax court concerning the debtors' income tax deficiencies).

<sup>62</sup> See *Thompson*, 313 U.S. 132.

## 1. Statutory Limits

As provided in Bankruptcy Code § 505(a)(2), the bankruptcy court does not have jurisdiction to rule on the merits of any tax claim previously adjudicated in a contested proceeding before a judicial or administrative tribunal of competent jurisdiction.<sup>63</sup> For this purpose, a proceeding in a tax court is considered contested if the debtor filed a petition therein and the IRS filed an answer to the petition. Accordingly, where a petition and answer were filed in the tax court before the filing of a petition in bankruptcy and the debtor later defaulted in the tax court, it was held that the bankruptcy court could not rule on the debtor's or the estate's liability for the same taxes.<sup>64</sup>

Under § 505(a)(2), the trustee must follow regular administrative procedures in order to obtain a tax refund, unless the refund results from an offset or counterclaim to a claim or request for payment by the taxing authority.<sup>65</sup> If the trustee files a regular refund request, the taxing authority has 120 days in which to act. If the 120-day period passes without action by the taxing authority, the bankruptcy court then may rule on the merits of the refund claim.<sup>66</sup>

Under § 6532 of the Internal Revenue Code, as amended, a suit for the refund of federal taxes may not be filed until six months following the filing of an administrative claim for refund with the IRS.<sup>67</sup> In bankruptcy cases, Congress shortened the period during which the IRS must act to 120 days, recognizing the expedited process in bankruptcy. Thus, in *In re Carie Corp.*,<sup>68</sup> the court held

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<sup>63</sup> 11 U.S.C. §505(a)(2).

<sup>64</sup> *But see In re Buchert*, 69 B.R. 816 (Bankr. N.D. Ill. 1987) (default judgment in state court did not bar relitigating matter in bankruptcy court). *See also Baker v. IRS*, 74 F.3d 906 (9th Cir. 1996) (holding that the tax court's stipulated judgment "adjudicated" the debtors' tax liability prepetition, precluding the bankruptcy court's determination of the amount and the legality of any tax); *In re Teal*, 16 F.3d 619 (5th Cir. 1994) (holding that under principles of *res judicata*, the bankruptcy court lacked jurisdiction to entertain claims regarding the debtor's tax liability for which a prepetition agreed order was entered in the tax court); *In re Cohen*, 169 B.R. 759 (Bankr. S.D. Fla. 1994) (holding that a stipulated decision entered in the tax court regarding a chapter 11 debtor's tax liability for a prior tax year precluded the bankruptcy court from redetermining the amount of the debtor's tax liability).

<sup>65</sup> 11 U.S.C. § 505(a)(2) (1994).

<sup>66</sup> *See id.*

<sup>67</sup> I.R.C. § 6532 (1994).

<sup>68</sup> 128 B.R. 266 (Bankr. D. Alaska 1989). *See also In re Flaherty*, 169 B.R. 267 (Bankr. D.N.H. 1994) (holding that the 60-day response period following the trustee's request for determination of tax liability did not commence on the trustee's filing such request with the

that a trustee had properly mailed a request for an expedited audit procedure to the IRS Service Center for the filing of returns and payments of taxes, and was not, therefore, required to submit an additional request to the office of the IRS District Director where the bankruptcy case was pending.

To summarize, under Bankruptcy Code § 505(a)(2), the trustee must follow regular administrative procedures in order to obtain a tax refund, unless the refund results from an offset or counterclaim to a claim or request for payment by taxing authority. If the trustee files a regular refund request, the taxing authority has 120 days in which to act. If the 120-day period passes without action by the taxing authority, the bankruptcy court may rule on the merits of the refund claim. Revenue Procedure 81-18 provides the procedure to be followed by a bankruptcy trustee or other fiduciary in filing a claim for credit or refund of any overpayment of tax.<sup>69</sup>

## 2. Court Limits

Several courts have held that the bankruptcy court's jurisdiction to resolve tax claims extends only to claims against the debtor or the estate, not against its officers (or any other third party). Although Bankruptcy Code § 505(a) is not by its terms so restricted, these courts have relied principally on the legislative history.<sup>70</sup> These courts have held that the bankruptcy court may not resolve claims against officers of the debtor corporation for failure to pay employment withholding taxes, even if the debtor corporation's chapter 11 plan provides for those claims to be satisfied fully.<sup>71</sup>

In the context of a consolidated return group where the common parent is in bankruptcy, it would seem that a substantive determination of the group's tax liability by the bankruptcy court should be binding on the IRS as to all group members (regardless of whether they are in bankruptcy), because under the consolidated

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IRS Service Center, as opposed to filing such request with the District Director Special Procedures Unit created to expedite bankruptcy tax returns, in view of the ambiguity of the statutory language construed).

<sup>69</sup> Rev. Proc. 81-18, 1981-1 C.B. 688.

<sup>70</sup> See, e.g., *In re Cadillac Recreation, Inc.*, 159 B.R. 244 (C.D. Ill. 1993) (holding that a bankruptcy court did not have jurisdiction over a tax claim relating to responsible person liability imposed on a nondebtor for failing to turn over withholding taxes that the chapter 11 debtor-employer collected).

<sup>71</sup> See *id.*

return regulations the common parent generally has the exclusive authority to represent the consolidated group in tax litigation matters. Moreover, it is possible that even where the bankruptcy court's determination purports to be binding on the IRS as to some, but not all, the members of the group—such as where the common parent is not in bankruptcy, but other members are—the IRS may nevertheless be bound by such determination as to all members of the group. This result is premised on the principles of *res judicata* and collateral estoppel, and has been referred to by some courts as the doctrine of “judicial estoppel.”

### C. Advisory Committee Proposals

Several proposals seeking to limit bankruptcy court jurisdiction were rejected by the Advisory Committee. Each of these proposals are addressed below.

#### 1. *Limit Scope of § 505(a)*

For example, the Advisory Committee rejected a proposal to limit the scope of Bankruptcy Code § 505(a).<sup>72</sup> This proposal limited the intervention of bankruptcy courts in determining a tax liability to situations in which a nonbankruptcy forum would have jurisdiction to hear the matter. In cases like *In re Piper Aircraft Corp.*,<sup>73</sup> *In re East Coast Brokers & Packers, Inc.*,<sup>74</sup> and *In re Ledge-mere Land Corp.*,<sup>75</sup> courts found jurisdiction to consider a debtor's liability for taxes notwithstanding the debtor's failure to challenge timely 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 reconsid-

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<sup>72</sup> By a vote of 7-to-1 (with two abstentions), the Advisory Committee recommended that the Commission reject the proposal.

<sup>73</sup> 171 B.R. 415 (Bankr. S.D. Fla. 1994).

<sup>74</sup> 142 B.R. 499 (Bankr. M.D. Fla. 1992).

<sup>75</sup> 135 B.R. 193 (Bankr. D. Mass. 1991).



eration can be made to the bankruptcy court. However, if a debtor could properly take an appeal from a decision in a nonbankruptcy 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 nonbankruptcy forum.

Those members of the Advisory Committee offered several good reasons for the proposed modification. These reasons included: (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 filings are no-asset chapter 7 cases, (5) 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, (6) 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, and (7) 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. Thus, 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.<sup>75</sup>

According to those members favoring limiting jurisdiction under § 505(a), certain accommodations could be made to ensure that decisions made in state or local forums are made promptly so as not to interfere with the bankruptcy process. For example, if an appeal

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<sup>75</sup> See *Seminole Tribe of Florida v. Florida*, 517 U.S. 44 (1996) (the court held that Congress lacked authority under the Indian Commerce Clause to abrogate the states' Eleventh Amendment Immunity). As this Article goes to press, the constitutionality of § 505(a) is being litigated in *In re Warren Dean*, Case No. 96-20025 (Bankr. W.D.N.Y.).

were still timely at the time of the bankruptcy filing, section 108 could be amended to allow a debtor additional time to take his appeal, either through the state system or in bankruptcy court. Moreover, section 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 assertion of jurisdiction if the time periods are not met.

The arguments against the proposal, however, were compelling. 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 taxes. Moreover, taxes are 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. This proposal would eliminate one of the most valuable, equitable tools of the bankruptcy court to establish the correct balance due.<sup>77</sup>

## 2. *Limits on Tax Jurisdiction Over Nondebtors*

A second proposal to limit the bankruptcy court's jurisdiction over tax matters was also rejected by the Advisory Committee.<sup>78</sup> Specifically, this proposal sought to impose a limitation on the bankruptcy court's power to determine the tax liability of a nondebtor. Under the proposal, unless permitted by state law, or the parties so stipulated, the bankruptcy court would be barred from determining the tax liability of nondebtors. With respect to the issue of the court's determination of the tax liabilities of nondebtors, 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.

However, the proposal went 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 non-

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<sup>77</sup> By a vote of 6-to-4, the Advisory Committee recommended that the NBRC reject the Proposal.

<sup>78</sup> Without § 505(a), many taxpayers who are otherwise deserving, would be denied chapter 13 relief simply because of an overstated, incorrect tax claim.

debtor, for example, in the consolidated return situation. Furthermore, 28 U.S.C. § 1334 provides ample support for jurisdictional limitations where necessary.

### 3. *Request for Prompt Tax Determination Under § 505(b)*

A troubling issue for the trustee and unsecured creditors of the estate is the application of the § 505(b) discharge to the estate as well as to the debtor, successor to the debtor, and the trustee where the taxing authority does not audit the estate's returns.<sup>79</sup> Section 505(b) provides that on the request for a determination of the tax by the taxing authority, trustee, debtor, and any successor to the debtor are discharged from any tax liability other than that reflected on the return unless the IRS 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.<sup>80</sup>

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. Relying on the language of the section, courts have consistently held otherwise.<sup>81</sup> This proposal is consistent with congressional intent for providing for expedited audits and speedy, final determination of tax liabilities in bankruptcy. 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

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<sup>79</sup> See, e.g., Steven J. Csontos *et al.*, *Congress' Role in Bankruptcy Tax Policy: A Roundtable Discussion*, 3 Am. Bankr. Inst. L. Rev. 257 (1995); Paul B. Geilich, *Essentials of Bankruptcy Tax Law*, 66 Am. Bankr. L. J. 323 (1992).

<sup>80</sup> See *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. See *Kellogg v. U.S.* (*In re West Tex. Mktg Corp.*), 54 F.3d 1194 (5th Cir. 1995).

<sup>81</sup> See, e.g., *In re Fondiller*, 125 B.R. 805; *In re Rode*, 119 B.R. 697; *In re West Tex. Mktg Corp.*, 54 F.3d 1194.

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.<sup>82</sup> If the decision of the Fifth Circuit<sup>83</sup> 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 whether 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). 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, section 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 purpose of the prompt audit request—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.

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<sup>82</sup> 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.

<sup>83</sup> See *In re West Tex. Mktg. Corp.*, 54 F.3d 1194 (5th Cir. 1995).

The proposal, however, was not without its detractors. 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 to permit closing of the case. 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. Furthermore, 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.

According to those opposed to the proposal, discharging the estate would constitute a windfall for the unsecured creditors. The IRS' resources are limited 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 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 of enacting the prompt audit procedure was to facilitate closing of the estate. Until such time as the estate is to be closed, it should remain liable for taxes that the trustee had failed to report correctly and should not be allowed to avoid such liability.<sup>84</sup>

#### 4. *Declaratory Judgments on Prospective Tax Issues*

One of the most controversial issues concerned a bankruptcy court's ability to grant declaratory judgments on prospective tax issues in chapter 11 plans of reorganization.<sup>85</sup> Historically, declara-

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<sup>84</sup> 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 William T. Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws: Tax Procedures*, 88 HARV. L. REV. 1360, 1439-40 (1975).

<sup>85</sup> See, e.g., *In re NVR L.P.*, 206 B.R. 831 (Bankr. E.D. Va. 1997); *Allis-Chalmers Corp. v. Goldberg (In re Hartman Material Handling Sys., Inc.)*, 141 B.R. 802 (Bankr. S.D.N.Y. 1992);

tory judgments have not been allowed in controversies regarding federal taxes.<sup>86</sup> The rationale is that a declaratory judgment is simply a way to circumvent the prohibition against injunctions contained in I.R.C. § 7421. Notwithstanding the foregoing, Congress has whittled away at the declaratory judgment restrictions over the years.<sup>87</sup>

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 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 IRS either disagrees with the intended tax consequences or for some reason refuses to rule.

The federal government has vigorously opposed any attempt to grant the bankruptcy court the power to declare the tax consequences of a confirmed plan. The Anti-Injunction Act<sup>88</sup> and the Declaratory Judgment Act<sup>89</sup> generally deny a court the 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,<sup>90</sup> qualification of a pension plan,<sup>91</sup> and the status of tax-exempt bonds. Those members of the Advisory Committee opposed to expanded jurisdiction assert that the case has not been made for a bankruptcy reorganization exception to the Declaratory Judgment Act. Corporate reorganizations, both in and outside of bankruptcy, are currently made on the basis

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Donald D. Haber, *The Declaratory Powers of Bankruptcy Courts to Determine the Federal Tax Consequences of Chapter 11 Plans*, 3 AM. BANKR. INST. L. REV. 407 (1995).

<sup>86</sup> See 28 U.S.C. §2201 (1994).

<sup>87</sup> These exemptions include the following:

Exempt organizations. I.R.C. § 7428;

Pension plans. I.R.C. § 7476;

Tax-exempt bonds. I.R.C. § 7478;

Section 367 transfer. Former I.R.C. § 7477 (repealed).

<sup>88</sup> 26 U.S.C. § 7421(1994).

<sup>89</sup> 28 U.S.C. § 2201(1994).

<sup>90</sup> 26 U.S.C. § 7428 (1994).

<sup>91</sup> 26 U.S.C. § 7476 (1994).

of opinions of corporate counsel, and rulings can be requested from the IRS. There is no greater need to drag the IRS into court in a bankruptcy reorganization than in any other form of reorganization. The disclosure statement in a chapter 11 case should discuss the tax consequences of the proposed plan of reorganization. Creditors should be entitled to rely on those representation without any need for the IRS or a court to issue a ruling in every case. The court can consider representations concerning tax consequences made in a disclosure statement in connection with a feasibility determination. Such a determination does not bind the IRS, but is a sufficient check on overly optimistic representations. If the IRS refuses to issue a ruling, the plan proponent can still consummate a plan in reliance on the opinion of corporate counsel.<sup>92</sup>

### III. ADMINISTRATION AFFECTING TAX MATTERS

The Advisory Committee intended that the NBRC use the opportunity to address several important tax problems in the administration of the bankruptcy case. Several proposals are discussed below.

#### A. *Segregated Account Requirements for Small Business Debtors*

It was 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 suggested that the Bankruptcy Code differentiate between failure on the part of the debtor and failure on the part of the trustee in maintaining segre-

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<sup>92</sup> Transactions that are 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.

gated accounts. When a debtor fails to comply with the segregation requirement, then the court should have the power to dismiss the bankruptcy case. When 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, and removal from the trustee panel.<sup>93</sup>

### B. *Straddle Tax Years for Corporate Debtors*

Another difficult issue concerned the potential bifurcation, for claim filing purposes, of a corporate tax year that straddles the petition date. 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.<sup>94</sup> Second, the IRS 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.<sup>95</sup> Third, the entire straddle tax year's liability could be treated as an administrative expense, except that corporations would be granted the same election to bifurcate the straddle tax year that is available to individuals.<sup>96</sup> Although each proposal is addressed in turn, the NBRC adopted the third proposal, thus providing the greatest amount of flexibility regarding tax matters to corporate debtors.<sup>97</sup>

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<sup>93</sup> There was an emerging consensus to include all business debtors under this requirement. However, a majority of the Advisory Committee concluded that expanding the proposal to include large business debtors needed more thought.

<sup>94</sup> See Missouri Dep't of Rev. (*In re* L.J. O'Neill Shoe Co.), 64 F.3d 1146 (8th Cir. 1995) [hereinafter *O'Neill*]; Towers v. U.S. (*In re* Pac-Atl. Trading Co.), 64 F.3d 1292 (9th Cir. 1995) [hereinafter *PATCO*].

<sup>95</sup> See 11 U.S.C. §§ 507(a)(1), 503(b) (1994).

<sup>96</sup> Compare IRC § 1398.

<sup>97</sup> By a vote of 7-to-3, the Advisory Committee recommended that the Commission adopt Proposal 2—No bifurcated tax year. The Advisory Committee recommended 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, three preferred Proposal 3, and one preferred Proposal 1.



Presently, in the straddle tax year, individuals can elect a bifurcated tax year, but corporations cannot.<sup>98</sup> When a straddle tax year is bifurcated, the prepetition tax liability receives an eighth priority.<sup>99</sup> 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.<sup>100</sup>

Unlike an individual, a corporation cannot exist separate 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.<sup>101</sup> 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.

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,<sup>102</sup> thus, these corporations are not allowed the same election as individual debtors.<sup>103</sup> Consequently, these corporations are not allowed the same election as individual debtors 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, 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 that of a corporate taxpayer not in bankruptcy. A corporate debtor's straddle tax year return also does not generally reflect during the straddle tax

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<sup>98</sup> See I.R.C. §§ 1398 (individuals) and 1399 (corporations).

<sup>99</sup> See 11 U.S.C. § 507(a) (8).

<sup>100</sup> See I.R.C. § 1398.

<sup>101</sup> See *O'Neill*, *supra* note 94; see also *PATCO* *supra* note 94.

<sup>102</sup> See IRC § 1399.

<sup>103</sup> *Id.* IRC § 1398(d) (2).

year (prepetition or postpetition) any particular items of income or expense 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.<sup>104</sup>

Because of the way corporate debtors file their Form 1120 returns in a straddle tax year and because of 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 within 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 postpetition 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.

The third proposal, adopted by the NBRC, permits a corporation to elect to bifurcate the 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 finan-

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<sup>104</sup> *O'Neill*, 64 F.3d at 1149.

cially-strapped corporation. The 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.<sup>105</sup> 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.<sup>106</sup>

### C. *Subordination of Prepetition Tax Penalties*

The Advisory Committee further proposed 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 the payment of general unsecured claims without a requirement of a finding of governmental misconduct.<sup>107</sup> Granting a priority to penalties treats general unsecured creditors unfairly by punishing them for the debtor's misconduct. This is inequitable, especially since the creditors have limited access and ability to monitor a taxpayer's compliance with tax reporting requirements.

The government vigorously opposed the 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). According to the government, 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.<sup>108</sup>

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<sup>105</sup> See 11 U.S.C. § 1129(a)(9)(C) (1994).

<sup>106</sup> A similar change to I.R.C. § 1398 might also be advisable. The IRS and Justice Department 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.

<sup>107</sup> See Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 AM. BANKR. INST. L. REV. 153, 196-97 (1995); see also IRC § 1399.

<sup>108</sup> See *United States v. Noland*, 517 U.S. 535 (1996).

#### IV. CHAPTER 11 PLAN REQUIREMENTS

The Advisory Committee recommended six changes to the chapter 11 process. Each of these proposals is discussed below.

*A. Amend § 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 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 representative 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 seriously mislead creditor constituencies and other parties in interest about the plan's economic effects.<sup>109</sup> 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.

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<sup>109</sup> See *Smith v. Bank of New York*, 161 B.R. 302 (Bankr. S.D. Fla. 1993).

- B. *Apply the periodic payment provisions of § 1129(a)(9)(c) to a secured tax that would be entitled to priority absent their secured status.*

A consensus has been reached by the Advisory Committee that, as to secured tax claims, 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. This proposal simply codifies the present rule of law. For all other purposes, the requirements of § 1129(b)(2) must still be met.

- C. *Amend § 1141(d)(3) to except from discharge taxes unpaid by business entities, where the 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, did not reach a consensus on what conduct and intent are sufficient to constitute fraud.

- D. *Require periodic payment for deferred payments of tax under § 1129(a)(9) and designate an interest rate to be used while making those deferred payments.*

The Advisory Committee considered a proposal to amend § 1129(a)(9) to require periodic payment for deferred tax payments 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. A majority of the Advisory Committee concluded that § 1129(a)(9) should be amended. It was agreed that to prevent unnecessary and time-consuming litigation, the section should provide that if interest must be paid on priority taxes, the rate should be determined by § 6621(a)(2) of the Internal Revenue Code, without regard to I.R.C. § 6621(c), in effect as of the confirmation date.<sup>110</sup> There is a consensus that because of prejudice to the taxing authorities and the greater risk of nonpayment, the section should expressly provide for

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<sup>110</sup> State and local taxing authorities vigorously challenge this proposal. Many fare much better under their applicable state interest rate and are not convinced that the right should be modified in bankruptcy.

periodic payments (monthly or quarterly), and that balloon payments be prohibited. It was discussed that the statute be amended to provide for a fixed period over which payments should be made, regardless of whether the tax had been "assessed." It was 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.

The proposal was not without its detractors. It was argued that the proposal weakened 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. There is much truth to this assertion. Under the proposal, for example, if trust fund taxes are four years old on the petition date, debtors would have a total of ten years to repay the taxes, including six years from the petition date, as compared to two years under current law. According to the detractor, this result 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 postconfirmation interest rates to reflect the heightened risk compared to straight-line amortization payments. Moreover, 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. Ironically, 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 cases get paid nothing until priority claims are paid in full.

E. *Clarify the effect of a subsequent filing or default on the status or nature of a tax claim provided for in a chapter 11 plan.*

The 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.<sup>111</sup> 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

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<sup>111</sup> See MCQUEEN & WILLIAMS, *supra* note 11, § 13:26.

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 and thus nonpriority, dischargeable claims. 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.

However, under the proposal, 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 permit the debtor/taxpayer an opportunity to cure any default and promote the reorganizational efforts of the debtor.

F. *The Allocation of chapter 11 plan payments to trust fund taxes and collection remedies available to taxing authorities after order is entered.*

One of the most controversial proposals of the Advisory Committee addressed several of the issues posed in *United States v. Energy Resources, Inc.*<sup>112</sup> and its progeny to allocate chapter 11 plan payments to trust fund taxes.

In *Energy Resources*, the Supreme Court concluded that a bankruptcy court has the authority to order the IRS to treat tax payments made by a chapter 11 debtor corporation to reduce trust fund liabilities where the bankruptcy court determines that the designation by the plan proponent is necessary for the success of a reorganization plan.<sup>113</sup> 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.<sup>114</sup> The taxing authority may be heard on that is-

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<sup>112</sup> 495 U.S. 545 (1990).

<sup>113</sup> *Id.* at 545, 549.

<sup>114</sup> See 11 U.S.C. § 1129(a)(11) (1994).

sue. If the plan is feasible, then the government will ultimately collect the tax.

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 payments have historically meant that the payments were made under legal process or compulsion. This is not true of payments in a chapter 11.

Government representatives vigorously opposed *Energy Resources*, arguing 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, 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 would improperly shift 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.<sup>115</sup>

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<sup>115</sup> 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. This would allow officers to get personal relief even where the aim of the bankruptcy is not to reorganize the debtor. See *In re Deer Park, Inc.*, 10 F.3d 1478 (9th Cir. 1993).



## V. SUBSTANTIVE TAX MATTERS

Although the Advisory Committee considered several substantive tax proposals, only two are discussed below. The first proposal seeks to resurrect a variation of the venerable stock-for-debt exception to the recognition of cancellation of indebtedness income.<sup>116</sup> The second proposal considers the tax consequences of the discharge of nonrecourse and recourse debt.

A. *Modification to IRC §§ 108 and 382 with respect to the issuance of stock for debt.*

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 (COD) realized as a result of the plan. The debtor, however, is required to reduce its tax attributes, including NOL carryforwards, capital loss and credit carryforwards, and assets basis in excess of post reorganization liabilities.

Prior to the Omnibus Budget and Reconciliation Act of 1993 ("OBRA 1993"), the stock-for-debt exception provided an exception to the requirement that tax attributes be reduced by the amount of any excluded COD income. Under current law, a corporation that issues stock to its creditors realizes substantial income from debt cancellation that must then be applied to reduce tax attributes.<sup>117</sup> 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.

Stock-for-debt exchanges are a historical exception to the recognition of COD income.<sup>118</sup> Under this exception, if a corporate

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<sup>116</sup> See generally MCQUEEN & WILLIAMS, *supra* note 11, chs. 22-23.

<sup>117</sup> See 11 U.S.C. § 108 (1994).

<sup>118</sup> See *Commissioner v. Motor Mart Trust*, 156 F.2d 122, 127 (1st Cir. 1946) (holding conversion of bonds into stock was not cancellation of indebtedness); *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691, 695 (1942) (recognizing stock-for-debt exchange differs from discharge of indebtedness and does not result in realization of gain), *aff'd*, 140 F.2d 382, 385 (1st Cir. 1944) (holding substitution of shares for bonds was recapitalization and not gain); Rev. Rul. 59-222, 1959-1 C.B. 80; Rev. Rul. 59-98, 1959-1 C.B. 76 (discussing exchange of stock and securities in certain reorganizations). "The cases arrived at this result under the somewhat questionable assertion that there was no satisfaction of the debt, but the issuance of the stock instead represented the creation of a new liability to substitute for the old." Paul H. Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980*, 27 ST. LOUIS U. L.J. 583, 600 (1983). Mr. Asofsky was a member of the Advisory Com-

debtor issued stock in exchange for debt, no COD income arose even when the stock was worth less than the debt satisfied.<sup>119</sup> The theory that led to the implementation of this exception was that the substitution of stock-for-debt continued a creditor's interest in the corporate debtor.<sup>120</sup>

Prior to the enactment of the stock-for-debt exception in § 108(e)(8), the House bill provided partial nonrecognition treatment for debtors who issued stock to creditors in satisfaction of debts other than securities.<sup>121</sup> The debtor was required to recognize as income any excess of the amount of the debt over the fair market value of the stock issued.<sup>122</sup> When a debtor transferred stock for securities, however, the House bill would have provided for a full nonrecognition treatment.<sup>123</sup> The logic behind this disparate treatment of exchanges of securities, as opposed to other debts, is not readily apparent. A possible explanation may be that a creditor holding a security would not be entitled to recognize a loss, whereas a holder of nonsecurity instruments would possibly be entitled to a bad debt deduction. The House bill sought to treat debtors and creditors symmetrically by requiring a debtor to recognize income only when the creditor would be able to take a deduction for the bad debt in the same situation.<sup>124</sup>

The Senate Finance Committee questioned the House's proposed version of the stock-for-debt exception and amended the bill which eventually became law to continue the prior case law rules governing stock-for-debt exchanges, except for de minimis cases.<sup>125</sup> In the words of Senator Russell Long, "by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the [Senate Finance] committee bill will encourage reorganization,

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mittee.

<sup>119</sup> See *Motor Mart*, 156 F.2d at 127 (finding such a transaction "a form of payment for the bonds" rather than cancellation of indebtedness).

<sup>120</sup> Mark A. Frankel, *Federal Taxation of Corporate Reorganizations*, 66 AM. BANKR. L.J. 55, 63 (1992).

<sup>121</sup> For a discussion of the legislative history of the enactment of the stock-for-debt exception in the Board of Tax Appeals, see Asofsky, *supra* note 118, at 602-04.

<sup>122</sup> H.R. REP. NO. 96-833, at 14 (Mar. 19, 1980).

<sup>123</sup> See *id.* at 13.

<sup>124</sup> See Asofsky, *supra* note 118, at 602-04, 613-14.

<sup>125</sup> The stock-for-debt exception was codified at I.R.C. § 108(e)(8) (1988) (amended 1993). For a discussion of de minimis cases, see McQueen & Williams, *supra* note 11.

rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.<sup>126</sup>

Thus, as enacted, the general rule was that no reduction of tax attributes or basis in depreciable property is required when a corporation issues stock, either voting or nonvoting, common or preferred, to discharge a debt.<sup>127</sup> The only time the stock for debt exception would not apply was in *de minimis* cases, which encompassed two situations: (1) where only a nominal or token amount of stock is issued;<sup>128</sup> or (2) where, in the case of an unsecured creditor, the ratio of the stock received, measured by value, to the debt canceled or exchanged for such stock was less than half the ratio of stock-to-debt computed for all unsecured creditors participating in the workout.<sup>129</sup> In cases where the exchange ratio was less than fifty percent of the ratio for all unsecured creditors, the debtor corporation would realize income to the extent the debt forgiven exceeds the value of the stock given in exchange for the debt.<sup>130</sup> In 1984, changes to the Internal Revenue Code narrowed the exception to include only title 11 debtors, or insolvent debtors to the extent of their insolvency.<sup>131</sup>

OBRA 1993 repealed the stock-for-debt exception to COD income.<sup>132</sup> The controversial repeal is effective for stock transferred after 1994, except for stock transferred in a title 11 or similar case that is filed before the end of 1993.<sup>133</sup>

There are persuasive arguments both for and against the stock-for-debt exception. Those opposing the exception have asserted that the exception incorrectly measures income, is a source of need-

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<sup>126</sup> 126 CONG. REC. 25,33913 (1980) (statement of Sen. Long).

<sup>127</sup> "It is obvious that there would be no necessity for a statutory restriction on the 'stock for debt exception' unless one such exception existed." Asofsky, *supra* note 118, at 604.

<sup>128</sup> See I.R.C. § 108(e)(8)(A) (1988) (repealed 1993).

<sup>129</sup> See I.R.C. § 108(e)(S)(B) (1988) (repealed 1993).

<sup>130</sup> Although the statute did not specifically define the terms "unsecured creditor" and "workout," the Senate Report added that a claim is considered secured by a property lien to the extent of the property's fair market value. See S. REP. NO. 96-1035, at 17 n.19 (Nov. 25, 1980). Any excess over fair market value is considered a separate claim of an unsecured creditor. See *id.* A "workout" was described as a title 11 case, transaction, or set of transactions resulting in a significant restructuring of a financially unstable corporation's debt. See *id.* at 17 n.20. Thus, it is possible that receivership, foreclosure, or similar proceedings in federal or state courts would be considered workouts.

<sup>131</sup> See Tax Reform Act of 1984, Pub. L. No. 98-369, § 59, 98 Stat. 494, 576 (1984).

<sup>132</sup> See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226(a), 107 Stat. 312, 487-88 (1993).

<sup>133</sup> See *id.* § 13226(a)(3).

less transactional complexity, unduly influences the structuring of transactions, promotes trafficking in loss corporations, and represents bad tax policy.<sup>134</sup> To be sure, difficult issues concerning the exception remained at the time of its repeal. Nonetheless, the IRS had issued guidelines throwing some light on these issues.<sup>135</sup> To doom the exception because of its influence on the structure of transactions or its complexity is unconvincing. Tax law is increasingly complex largely because business and commerce are increasingly complex.

Opponents of the exception, however, correctly point out that the exception is inconsistent with the horizontal equity principle.<sup>136</sup> An often stated goal of tax policy is the equal treatment of similar taxpayers with similar incomes. The stock-for-debt exception violates the horizontal equity principle because it allows insolvent and title 11 taxpayers to preserve their tax attributes while preventing solvent taxpayers from doing the same.<sup>137</sup> This certainly may be true. Nonetheless, although the policy of horizontal equity is important, it is not the only consideration. In fact, section 108 already violates the horizontal equity principle by permitting attribute reduction under § 108(b) by *solvent* title 11 debtors while denying similar benefits for solvent taxpayers not in bankruptcy. The Board of Tax Appeals, through § 108, provides this beneficial treatment to title 11 debtors in furtherance of the fresh start policy, which obviously trumps the horizontal equity policy in some circumstances.

Ken Kies opposes the stock for debt exception as an "anachronism remaining from a time when the theoretical groundings of the income tax system were less sophisticated."<sup>138</sup> He then dismisses the foundation for the exception—that the investor has changed the nature of its investment in the taxpayer from that of debt to equity—as lacking "any relationship with economic reality."<sup>139</sup> This author finds this statement quite puzzling. In bankruptcy, the absolute priority rule essentially treats creditors of a debtor as the "owners" of the firm.<sup>140</sup> Moreover, the debtor owes a

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<sup>134</sup> See Kenneth J. Kies, *Repeal the Stock-for-Debt Exception*, AM. BANKR. INST. J. 18 (July/Aug. 1993).

<sup>135</sup> See Rev. Proc. 94-26, 1994-1 C.B. 612.

<sup>136</sup> See, e.g., Kies, *supra* note 134, at 41.

<sup>137</sup> See *id.*

<sup>138</sup> See *id.* at 42.

<sup>139</sup> *Id.*

<sup>140</sup> See Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Con-*

fiduciary duty to its creditors in bankruptcy similar to the duty owed to its equity holders outside of bankruptcy.<sup>141</sup> With an insolvent or title 11 debtor, the essence of "economic reality" is that the creditors own the firm.<sup>142</sup>

Supporters of the stock-for-debt exception urge numerous justifications for their position. First, the exception treats equity more favorably than debt at the precise time when more equity and less debt are important and beneficial to insolvent and title 11 debtors.<sup>143</sup> Second, the exception encourages rehabilitation of businesses by allowing businesses in a precarious financial position to shield future income by the retention of tax attributes.<sup>144</sup> Third, repeal of the exception is inconsistent with I.R.C. § 382(1)(5) and (6), which provides special relief for businesses in bankruptcy as to the use of NOLs and carryovers.<sup>145</sup> Fourth, the transactions covered by the exception are essentially capital transactions in which creditors receive new instruments in exchange for their "ownership" interest.<sup>146</sup> Although opponents of the stock for debt exception make some important criticisms, many of these criticisms may be accommodated by minor modifications to the exception. On balance, proponents for the exception have the better argument. This conclusion is supported by the recent empirical work by Professors Newton and Wertheim.<sup>147</sup>

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*tours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 742 (1988) ("[T]he absolute priority role simply restates the idea of a layered ownership structure in which one owner has bargained for the right to be paid before others.").

<sup>141</sup> See *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355-56 (1985); *Wolf v. Weinstein*, 372 U.S. 633, 649-50 (1963) ("[S]o long as the Debtor remains in possession, it is clear that the corporation bears essentially the same fiduciary obligation to the creditors as does the trustee for the Debtor out of possession.").

<sup>142</sup> *Accord* Wayne I. Danson & Sharon P. Lyle, *Stock-for-Debt Exception is Essential*, AM. BANKR. INST. J. 18 (1993).

<sup>143</sup> See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PRESS RELEASE, STOCK-FOR-DEBT EXCEPTION TO CANCELLATION OF INDEBTEDNESS INCOME 2 (July 20, 1993) [hereinafter AICPA RELEASE].

<sup>144</sup> See Danson & Lyle, *supra* note 142, at 18.

<sup>145</sup> See AICPA RELEASE, *supra* note 143, at 2.

<sup>146</sup> See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184 (1942) ("When [in bankruptcy] the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of law to enforce their rights of full priority."). See also AICPA RELEASE, *supra* note 143, at 2.

<sup>147</sup> See generally Grant Newton & Paul Wertheim, *Examining the Impact From the Repeal of the Stock-For-Debt Exception*, 3 AM. BANKR. INST. L. REV. 355 (1995).

In a valuable empirical study conducted by Newton and Wertheim, it was convincingly shown that the limited amount of revenue generated by the repeal will be offset by other revenue losses because of business liquidations and a concomitant increase in unemployment.<sup>148</sup> The professors concluded that the majority of the 622 million dollars estimated as increased revenue from the repeal of the exception must ultimately come from smaller, non-public corporations<sup>149</sup>—ironically the very corporations that are least able to afford the loss of the benefit.<sup>150</sup> The professors contend that the repeal of the exception especially does not bode well for small businesses in California and the West Coast, where economic recovery has lagged behind other parts of the country.<sup>151</sup>

The statistical results and inferences drawn by the professors are deserving of greater attention and should be welcomed by those interested in this debate. More data is needed to evaluate the efficiency of this and other exceptions to COD income. Until that time, policy makers are not acting with the best information available.

It is proposed that I.R.C. § 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.<sup>152</sup>

*B. Modification of IRC § 1001 to provide for parallel tax treatment of recourse and nonrecourse debt.*

The NBRC has adopted the Advisory Committee's recommendation that Congress modify I.R.C. § 1001 to provide that tax consequences of the transfer of an asset to satisfy a nonrecourse debt (for example, foreclosure or transfer in lieu of foreclosure) should be the same as a transfer to satisfy a recourse debt.

Presently, what drives the controversy in this area of bankruptcy taxation is the disparate treatment by the Internal Revenue Code

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<sup>148</sup> *Id.* at 729-32.

<sup>149</sup> *Id.* at 730-32.

<sup>150</sup> *Id.* at 730-31.

<sup>151</sup> *Id.* at 732.

<sup>152</sup> *Tax Recommendations of the National Bankruptcy Review Commission*, ABA Tax Section Task Force (April 15, 1997) at 202-07 [hereinafter "ABA Task Force"].

between COD income under I.R.C. § 108 and gain realized upon foreclosure under I.R.C. § 1001(c). Under I.R.C. § 108, COD income that would otherwise be included in gross income under I.R.C. § 61(a) is excluded to the extent the taxpayer is insolvent or the discharge occurs pursuant to a court order in bankruptcy.<sup>153</sup> However, the Internal Revenue Code extracts a price for the I.R.C. § 108 exclusion—certain enumerated tax attributes must be reduced by the directives of § 108(b). If there are no tax attributes or the attributes have been used up, any remaining COD income evaporates in bankruptcy, and the taxpayer is no longer liable for the tax associated with the income. This is an important tax break for bankrupt or insolvent taxpayers not provided for other taxpayers.

This tax favoritism does not exist for amounts realized under I.R.C. § 1001(c) upon a sale or exchange such as a foreclosure sale. The I.R.C. § 108 exclusion applies *only* to COD income; the exclusion does not apply to reduce tax liability associated with gains realized from high-debt low-basis property.<sup>154</sup> What exacerbates the situation, however, is the way nonrecourse debt is treated upon foreclosure.<sup>155</sup> If the secured debt is recourse, the IRS has maintained the position that the full tax consequences take two steps to ascertain.<sup>156</sup>

First, the amount of cancellation of indebtedness income is equal to the difference between the fair market value of the property and the amount of the recourse debt.<sup>157</sup> This amount may be excluded in bankruptcy under I.R.C. § 108. Second, the amount realized for I.R.C. § 1001(c) purposes is equal to the difference between the asset's fair market value and its adjusted basis.<sup>158</sup> This I.R.C. § 1001(c) amount is not governed by the more generous rules of exclusion in I.R.C. § 108. This two-step method asserted by the IRS often leads the parties in informal workouts, or pursuant to agreed orders terminating the automatic stay in bankruptcy, to

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<sup>153</sup> See I.R.C. § 108(a) (1994).

<sup>154</sup> See *id.* § 108(a).

<sup>155</sup> For a detailed treatment of the tax consequences of foreclosure, see Alice Cunningham, *Payment of Debt with Property—The Two Step Analysis After Commissioner v. Tufts*, 38 TAX LAW. 575, 599-605 (1985); Richard C. Onsager & John R. Becker, *The Federal Income Tax Consequences of Foreclosures and Repossessions*, 18 J. REAL EST. TAX'N 291 (1991).

<sup>156</sup> See generally Onsager & Becker, *supra* note 155, at 293.

<sup>157</sup> See Treas. Reg. § 1.1001-2(c); Rev. Rul. 90-16, 1990-1 C.B.12.

<sup>158</sup> See *id.*

agree to a value for the underlying asset on the extreme low end of the range of fair market values to minimize gain and to maximize cancellation of indebtedness income.

If the secured debt is nonrecourse, the Supreme Court mandates significantly different treatment. If the secured debt is nonrecourse, the amount realized for I.R.C. § 1001(c) purposes is equal to the difference between the face amount of the debt and the adjusted basis in the asset.<sup>159</sup> The fair market value of the property is irrelevant to the calculation. This creates greater hardship when the assets in question have substantially declined in value as was experienced in the real estate markets in the Southwest. Furthermore, no cancellation of indebtedness income is generated by the satisfaction of nonrecourse debt by foreclosure. Thus, a taxpayer cannot use I.R.C. § 108 to alleviate any tax associated with the foreclosure sale and ultimate discharge of nonrecourse debt. This peculiar result has led some taxpayers to attempt to convert nonrecourse debt for which they are not personally liable to recourse debt for which they are personally liable in an attempt to use I.R.C. § 108 to minimize taxes owed from the contemplated foreclosure.<sup>160</sup>

An example may illuminate the disparate treatment of nonrecourse debt *vis a viz* recourse debt. Let us assume that a debtor, we shall call him Tinker, owns an office building subject to nonrecourse indebtedness of \$1 million. The fair market value of the property is \$500,000, and the adjusted basis is \$250,000. If the lender forecloses upon the property in full satisfaction of the debt, the amount realized under § 1001(c) is \$750,000, the difference between the amount of nonrecourse debt and the adjusted basis. In other words, Tinker is treated as though he sold the property for the face amount of the debt. None of this § 1001(c) gain may be excluded under I.R.C. § 108. Section 108 is reserved for cancellation of indebtedness income.

Let us assume that Chance operates a similar building on a property adjacent to Tinker's. In fact, Chance used the same lender and granted a lien in the property securing \$1 million of indebtedness. Chance is personally liable for the debt; that is, the debt is re-

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<sup>159</sup> See *Commissioner v. Tufts*, 461 U.S. 300 (1983); Treas. Reg. § 1001-2. See also *Onsager & Becker*, *supra* note 155, at 292.

<sup>160</sup> Of course, to the extent the conversion from nonrecourse to recourse is part of a tax avoidance scheme, I.R.C. § 269 will prevent its intended effects. Furthermore, the IRS may characterize the conversion as an "exchange" under I.R.C. § 1001(c).



course as to Chance. The fair market value of the property and the adjusted basis are exactly the same as in Tinker's example—\$500,000 and \$250,000, respectively. If the lender forecloses on the property in full satisfaction of the recourse debt, Chance's tax consequences are vastly different than Tinker's. Using the two-step analysis asserted by the IRS, Chance recognizes cancellation of indebtedness income of \$500,000, the difference between the amount of indebtedness and the fair market value of the property. The entire amount may be excluded from income pursuant to I.R.C. § 108. Chance also recognizes income under I.R.C. § 1001(c) of \$250,000, the difference between the property's fair market value and its adjusted basis. Thus, on the same facts, Chance recognizes \$500,000 less as income than Tinker *solely* because the former's debt was recourse, and the latter's debt was nonrecourse.

The ABA Task Force proposal provides that 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 I.R.C. § 61. The tax treatment of income from cancellation of debt would be governed by I.R.C. § 108. This treatment is consistent with the tax consequence of the transfer of property to satisfy recourse debt.

This change would overrule *Commissioner v. Tufts*,<sup>161</sup> and generally follow the position taken by Professor Wayne G. Barnett as *amicus curiae* in the *Tufts* case.<sup>162</sup> The change 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, the IRS has ruled that abandonment of property was not a taxable event to the estate but held that the recourse debt became nonrecourse as a result of the discharge.<sup>163</sup>

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. This agreement is made 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

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<sup>161</sup> 461 U.S. 300 (1983).

<sup>162</sup> See *id.* at n. 11 (discussing Professor Barnett's *amicus* brief).

<sup>163</sup> Priv. Ltr. Rul. 89-18-016 (Jan. 31, 1989).

agreement would be unnecessary.) This proposed change to § 1001 would eliminate action of this nature, eliminate the problems associated with attempting to determine if debt is recourse or nonrecourse, and eliminate attempts to convert nonrecourse debt to recourse or *vice versa*.

## VI. CONCLUSION

Since the preparation of the first installment,<sup>164</sup> Congress has sought to consider and potentially enact many of the proposals put forth by the Advisory Committee and adopted by the NBRC. Thus, the bold efforts on the part of the NBRC in seeking advice and confronting the tax issues may lead to several positive changes to a difficult but important body of law.

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<sup>164</sup> See Jack F. Williams, *National Bankruptcy Review Commission Tax Recommendations: Individual Debtors, Priorities, and Discharge*, 14 BANKR DEV. J. 1 (1998).

