

**BANKRUPTCY ABUSE PREVENTION  
AND CONSUMER PROTECTION ACT OF 2005  
Analysis and Explanation of the  
Title VII Tax Provisions of Pub. L. No. 109-8, 119 Stat. 23**

THE UNPUBLISHED LEGISLATIVE HISTORY\*

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(\*This legislative history forms the basis for “U.S. Bankruptcy Code’s New State and Local Tax Provisions: Challenges and Opportunities for Debtors, Taxing Authorities,” by Jim Shepard and Karen Cordy, originally published in the BNA Tax Management Weekly State Tax Report, April 7, 2006.)

**11 U.S.C. § 346**

This amendment revises the separate entity rules for determining a chapter 7 and 11 bankruptcy estate’s state and local income taxes. They do not apply to other state or local revenue sources, such as sales, gross receipts, excise, or property taxes. State and local taxes, other than income taxes, are not ordinarily calculated or imposed differently because the taxpayer filed bankruptcy. *See* 28 U.S.C. § 960. Special rules are provided for determining the income taxes of individual cases under chapters 7 and 11 of the Code, consistent with § 541(a)(6), which provides that an individual debtor’s postpetition earnings from personal services are not property of the estate in such cases in contrast with cases under chapters 12 and 13 of the Code which include such property as property of the estate. 11 U.S.C. §§ 1207, 1306.

Section 728 and subsections (a) and (b) of §§ 1146 and 1231 are repealed and § 346 is substantially rewritten. The overarching purpose of this amendment is to harmonize the treatment of state and local income taxation of bankruptcy estates with the treatment for federal tax purposes under the Internal Revenue Code, particularly §§ 1398 and 1399. This amendment corrects several anomalies between state and federal rules in the current statutes. At least an even dozen inconsistencies have been identified between the treatment of state and federal taxes. For instance, the termination of the taxable year in which the case commences is an election under the Internal Revenue Code but is mandatory for state income taxes. Similarly, a separate taxable estate is created in chapter 12 cases for state income tax purposes but not for federal tax purposes and for federal tax purposes the individual bankruptcy estate is taxed as an “individual” and as an “estate” for state income tax purposes. These provisions eliminate the confusion which arises because bankruptcy estates are currently required to use different, and often

contradictory, rules for state and Federal income tax purposes, notwithstanding that nonbankruptcy state income tax systems often “piggy back” on federal taxes.

**Technical Correction Required.** Section 1231(b), purporting to impose the “separate taxable entity rules” in Chapter 12 cases, was repealed because the inclusion of the debtor’s income and property, acquired after the date of the petition, in the bankruptcy estate would cause such income to be taxed twice, once by the debtor when realized and again in the estate as provided by the rule, without any offsetting deduction under any tax law. Chapter 13 cases were omitted of from such rules for that very reason. New § 1115(a) now provides that in individual Chapter 11 cases the debtor’s income and property acquired after the date of the petition are included in the estate, which causes the same problems which led to the omission of Chapter 12 and 13 cases from the separate entity rules. Unfortunately, because new § 346(a) refers to I.R.C. § 1398(a) for the rules governing the taxation of individual Chapter 11 cases for state income tax purposes, both federal and state income tax returns must be filed on behalf of those estates reporting the debtor’s postpetition income and after-acquired property—but the debtor must also report such income on his or her individual return, and there is no deduction for the transfer of such property to the estate. Thus, § 1398(a) of the Internal Revenue Code must be amended by striking the reference to individual Chapter 11 cases. *See* the discussion of § 1231(a), *infra*.

#### **11 U.S.C. § 362(a)(8)**

Section 362(a)(8) stays the commencement and continuation of a proceeding before the United States Tax Court concerning the debtor. This section of the bill amends section 362(a)(8) to provide that the stay of proceedings in Tax Court applies only to an individual debtor’s tax liabilities for taxable periods which end *before* the commencement of the case. The amendment is intended to overrule the Tax Court’s decision in **Halpern v. Comm’r**, 96 T.C. 895 (1991), which held that this section of the Code stays the commencement or continuation of a proceeding involving an individual debtor’s *postpetition* tax liabilities, even though such taxes are not an administrative expense of the estate. The amendment is not intended to change the result under current law as to a corporate debtor. In other words, while the stay remains in effect, a corporate debtor may not initiate or continue a Tax Court case concerning the corporate debtor’s liability for a prepetition or an administrative period tax.

### **11 U.S.C. § 362(b)(18)**

An amendment to § 362(b)(18), which was not one of the title VII Tax Provisions, exempts the creation or perfection of liens for *ad valorem* property taxes from the § 362(a) stay of proceedings, *i.e.*, it permits such liens to attach to property of the estate, if they come due after the filing of the petition, and includes special taxes or special assessments on real property if imposed by a governmental unit whether or not they are an ad valorem tax, to also attach to property of the estate.

### **11 U.S.C. § 362(b)(26)**

Section 362(b) is amended to permit taxing authorities to setoff an income tax refund that arose prepetition against an income tax liability which similarly arose prepetition. Under current law, after a petition in bankruptcy is filed, a taxing authority is required to seek relief from the automatic stay on a case-by-case basis if it wants to offset a refund of prepetition taxes against a claim for prepetition taxes, even if the claim is not disputed. The cost to the government of prosecuting generally uncontested and routine motions as a prerequisite to enforcing an undisputed, mutual obligation is substantial. Because the interest and penalties which may continue to accrue are often nondischargeable, the inability to promptly apply income tax refunds against tax claims can cause individual debtors undue hardship. For these reasons, many courts have adopted local rules that permit such setoffs to be made, on a routine basis; this amendment endorses that procedure. Where the government is not allowed to actually make the setoff under applicable nonbankruptcy law, due to a pending dispute, the taxing authority may nevertheless hold the refund, unless the debtor provides adequate protection in order to get the refund.

### **11 U.S.C. § 501(e)**

Commercial motor carriers operating in multiple jurisdictions and motor fuel suppliers are subject to the “International Fuel Tax Agreement,” an interstate agreement on collecting and distributing fuel use taxes paid by motor carriers, developed under the auspices of the National Governors’ Association. Motor fuel use taxes collected each time fuel is purchased by motor carriers throughout the United States and several foreign jurisdictions are distributed to the various jurisdictions entitled to share in the funds according to the Agreement. The Agreement provides for the designation of a base jurisdiction which collects and distributes all fuel taxes owed to the members of the Agreement. This amendment provides that claims filed by the state or province designated as the base jurisdiction pursuant to the International Fuel Tax Agreement arising from the liability of a debtor for fuel tax

assessed under 49 U.S.C. § 31705 shall be treated as a single claim. Thus, a claim will not have to be filed by each of the participating member jurisdictions.

#### **11 U.S.C. § 502(b)(9)**

Section 502(b)(9) is amended to provide that a claim of a governmental unit filed pursuant to new section 1308 shall be timely if the claim is filed on or before the date that is 60 days after the date on which the return was filed as required.

#### **11 U.S.C. § 503(b)(1)(B)(i)**

This amendment is intended to make clear that property taxes, when payment is required, are an administrative expense of the estate and that they are to be paid whether they are secured or unsecured, and whether the liability is *in personam*, *in rem*, or both. Cases have held that because a postpetition property tax was secured by a lien upon property of the estate the tax could not be paid as an administrative expense. *See, e.g., In re Sylvia Development Corp.*, 178 B.R. 96 (Bankr. D. Md. 1995). Other cases have held that because the liability for real property taxes was only *in rem* the taxes accruing during administration of a bankruptcy estate were not “incurred” by the estate and therefore were not an administrative expense. *In re Carolina Triangle LTD. Partnership*, 166 B.R. 411 (9th Cir. BAP 1994). Administrative expense status has also been denied where the benefit to the estate was not found. *See, e.g., In re Soltan*, 234 B.R. 260 (Bankr. E.D. N.Y. 1999). The amendment is intended to overrule such cases.

#### **11 U.S.C. § 503(b)(1)(D)**

This amendment is intended to eliminate the need for the taxing authority to make a request for payment of administrative expense taxes and to make it clear that ad valorem property taxes incurred by the estate are an administrative expense whether secured or unsecured and to overrule *In re Carolina Triangle LTD. Partnership*, 166 B.R. 411 (9th Cir. BAP 1994), and other similar cases. Further, the amendment is intended to overrule decisions and local rules which require not only that a request for payment be filed but that a motion must also be filed to obtain payment. *See, e.g., In re Glen Eden Hosp. Inc.*, 172 B.R. 538 (Bankr. E.D. Mich. 1994; *In re Quid Me Broadcasting, Inc.*, 181 B.R. 715 (Bankr. W.D. N.Y. 1995).

#### **11 U.S.C. § 505(a)(2)(C)**

This provision is intended to overrule those cases which have permitted debtors to redetermine state or local ad valorem property taxes and obtain refunds of taxes paid where the time for doing so according to nonbankruptcy law has elapsed before the petition in bankruptcy. *See, e.g., In re Piper Aircraft Corp.*, 171 B.R. 415 (Bankr. S.D. Fla. 1994) (debtor permitted to challenge ad valorem tax assessments even though debtor failed to follow applicable nonbankruptcy procedures and notwithstanding sale of underlying tax obligation by county to third party).

### **11 U.S.C. § 505(b)(1), (2)**

Section 505(b) of the Bankruptcy Code permits a trustee to request a prompt audit of the estate's income tax returns filed on behalf of the estate from a taxing authority. If the taxing authority fails to respond within sixty days to the request, the trustee is discharged from liability for any taxes beyond the taxes shown on the return. Presently, the Internal Revenue Service has directed that section 505(b) requests be filed with the local District Director. Rev. Proc. 81-17, 1981-1 C.B. 688. Nonetheless, some courts have held that a trustee may ignore the IRS directive. *See, e.g., In re Carie Corp.*, 128 B.R. 266 (D. Alaska 1989). Moreover, there is no specific method by which state or local taxing authorities may direct where such notices may be sent. Because governmental units are entitled to timely and reasonable notice in the bankruptcy process if their right to assert an administrative expense claim is to be barred under this expedited procedure, it is critical that the government be able to require that all such requests be directed to an address at which it can assure that they will be given priority attention.

Accordingly, § 505(b)(2) is amended to require that the notice must be served in accordance with the procedures prescribed by the taxing authority in order to receive the benefit of the discharge provision. In addition, the clerk of each district is required to maintain a listing where federal, state, and local governmental units may designate an address where the trustee or debtor in possession may deliver a request for the prompt determination of the estate's taxes and the procedure for delivering such notices where an address has not been designated. If no address is supplied to the clerk a notice may be sent to the location where returns are filed.

Section 505(b)(2) of the Bankruptcy Code also provides that on the request for a determination of the tax by the taxing authority, the trustee, the debtor, and any successor to the debtor are discharged from any tax liability other than that reflected on the return, unless the taxing authority notifies the taxpayer that the return will be examined. Courts have held, however, that this discharge of liability for

additional tax does not apply to the estate. *See, e.g., Matter of West Texas Marketing Corp.*, 54 F.3d 1194 (5th Cir. 1995); *Matter of Fondiller*, 125 B.R. 805 (N.D. Cal. 1991). Section 505(b) is amended to overrule these cases and provide that the estate is discharged from any liability for additional taxes if the taxing authority fails to pursue its rights to assert additional taxes due as provided in that section.

#### **11 U.S.C. § 506(b), (c)**

The amendment to § 506(b) is intended to provide state governmental agencies an opportunity to recover the costs of protecting their interests in property where a tax lien is oversecured, in the same fashion as private creditors with contractual rights to recover their expenses.

Section 506(c) is amended to permit a trustee to recover unpaid ad valorem property taxes from the proceeds of a secured creditor's collateral. This amendment also makes it clear that *ad valorem* property taxes incurred by the estate are an administrative expense whether secured or unsecured to avoid possible uncertainty regarding the status of *ad valorem* property taxes in respect of property abandoned during the administration of an estate. *See, In re Carolina Triangle Ltd. Partnership*, 166 B.R. 411 (9th Cir. BAP 1994). Property taxes in regard to property that is abandoned from the estate within a reasonable time after the lien attaches generally need not be paid. *See* 28 USC § 960(b)(1), as amended by the bill.

#### **11 U.S.C. § 507(a)(8)(A)**

Section 507(a)(8)(A) is amended to avoid an ambiguity created by a series of decisions holding, in effect, that the income tax of a corporate debtor for the taxable year in which the case commences is allocated between first and eighth priority based on the accrual of the income, because the tax had not been assessed and was still assessable when the petition was filed, under 11 U.S.C. § 507(a)(8)(A)(iii). The amendment is intended to overrule *In re Pacific–Atlantic Trading Co.*, 64 F.3d 1292 (9th Cir. 1995), *In re L.J. O’Neill Shoe Co.*, 64 F.3d 1146 (8th Cir. 1995), and *In re Hillsborough Holdings Corp.*, 116 F.3d 1391 (11th Cir. 1997).

## 11 U.S.C. § 507(a)(8)(A)(ii)

Sections 507(a)(8)(A) and 523(a)(1) of the Bankruptcy Code identify several tax claims as priority, and thus nondischargeable, by reference to certain time limits, *e.g.*, taxes due for taxable years ending within three years of the filing of the petition are priority claims under § 507(a)(8)(A)(i) and nondischargeable under § 523(a)(1). Currently, where the debtor has filed successive bankruptcy petitions it is not clear whether the prior filing tolls the running of these time periods in the subsequent case—if not, the debtor is able to prevent collection of the tax while sheltered by the stay of proceedings in one or more cases, and can then discharge the taxes in a subsequent bankruptcy case after the time limits have run, directly undermining the principle that such taxes should be nondischargeable only if the taxing authority makes no effort to collect the taxes after they have been assessed. Where the government’s collection of such taxes is prevented by the debtor’s bankruptcy filings the taxpayers should not be penalized by the loss of priority status for the tax claims. This amendment is intended to codify such cases as *In re Waugh*, 109 F.3d 489 (8th Cir. 1997), and *In re Taylor*, 81 F.3d 20 (3d Cir. 1996), and to provide the taxing authority with a full and unimpeded three years to collect taxes.

Because of the time it takes to re-activate collection activities which have been stayed by a bankruptcy case, the requisite periods are tolled for 90 days or 30 days, as the case may be, in addition to the actual amount of time the taxing authority was prevented from collecting taxes.

This amendment addresses another problem encountered regarding federal taxes, the use of an Offer in Compromise (“OIC”) to forestall collection efforts while waiting for the 240-day period to lapse. While § 507(a)(8)(A)(ii) provides for tolling of the 240 days while an OIC is “pending,” an Offer in Compromise is only pending from the time it is signed by the IRS official until it is accepted, withdrawn or rejected and until an appeal of a rejection is resolved. *In re Genung*, 220 B.R. 505 (Bankr. N.D. N.Y. 1998) (suspension of running of 240 days under 11 U.S.C. § 507(a)(8)(A)(ii) for amount of time an Offer in Compromise (OIC) is pending includes time during appeal of IRS rejection of debtor/taxpayer’s OIC, pursuant to language in Form 656, which provides that statute of limitations on collections is suspended during time OIC is pending, including appeal of rejection; Form 656 was revised in 1992). Thus, § 507(a)(8)(A)(ii)(I) is also amended to account for the time during which collection efforts are suspended while the time the OIC is in effect, the time during which the taxpayer is to perform according to his or her agreement with the IRS.

**Technical Correction Required.** Sub-paragraph (A) of § 507(a)(8) comprises three related clauses which are to be read in the alternative. Clause (ii) contains two sub-clauses and, naturally, is followed by clause (iii). Prior to its amendment clause (ii) provided that a tax claim was entitled to priority status if it was, “assessed within 240 days, . . . before the date of the filing of the petition; or”, and was then followed by clause (iii) which completed the sub-paragraph. BAPCPA created new sub-clause (II) and amended what is now sub-clause (I) by striking former clause (ii) in its entirety and inserting the amendments to that clause and sub-clauses as new language. Unfortunately, in drafting this amendment a period was placed at the end of sub-clause (II) and the word “or” which was to follow clause (ii) and precede clause (iii) was omitted. As it presently reads, § 507(a)(8)(A) makes little sense because of the possibility of requiring that to be entitled to priority status a tax claim must satisfy the requirements of both clauses (i) *and* (ii), *or* satisfy the requirements of clause (iii), contrary to the intent of the amendment. Clearly, a technical correction is required.

#### **11 U.S.C. § 507(a)(8)(B)**

Some confusion has arisen because of the use of the terms “assessed” and “assessment” in the Bankruptcy Code when referring to state and local taxes. Some state and local taxing authorities do not assess taxes; many jurisdictions require that property taxes be “levied” as the first step in the collection process. *See In re Columbia Gas Transmission Corp.*, 37 F.3d 982 (3d Cir. 1994), *cert. denied sub nom. West Virginia Dep’t of Tax and Rev. v. I.R.S.*, 514 U.S. 1082, 115 S. Ct. 1793, 131 L. Ed.2d 721 (1995) (for purposes of determining priority of payment of taxes incurred by estate, determination of when tax is incurred is governed by state law; under West Va. law, by filing public service business tax return ownership of property is fixed so that owner of property on that date will be charged with taxes thereon, even though assessment occurs at later date; because taxes were incurred prepetition they were not entitled to administrative expense priority); *In re T & T Roofing and Sheet Metal, Inc.*, 156 B.R. 780 (Bankr. N.D. Tex. 1993) (under 11 U.S.C. § 507(a)(7)(B), property taxes assessed prepetition but payable without penalty postpetition constitute a prepetition claim with priority, not a postpetition administrative expense under 11 U.S.C. § 503(b)(1)(B); under Texas law, Tex. Prop. Tax Code §§ 23.01, 32.07(a) (Vernon 1992), taxable property is assessed as of January 1 or each year, and although effective January 1, the actual assessment does not take place until after September 1; the person who owns the property on January 1 of the year for which the tax is imposed has liability even if the owner as of January 1 does not own the property for the entire year). *But see In re 7003 Bissonnet, Inc.*, 153 B.R. 455 (Bankr. S.D. Tex. 1992) (proration of ad valorem real property tax to determine the amount

owed prepetition versus postpetition is an appropriate method of determining the amount of tax incurred by the estate for purposes of 11 U.S.C. § 503(b)(1)(B)(ii); penalty portion of the tax, whether construed as interest or as a penalty, properly follows the administrative status of the tax itself under 11 U.S.C. § 503(b)(1)(C)).

The amendment to § 507(a)(8)(B) changes the word “assessed” to “incurred,” the effect of which will more nearly approximate nonbankruptcy law. The amendment is intended to eliminate uncertainty and litigation regarding the question of whether a property tax is a prepetition claim or an administrative expense. For purposes of §§ 503(b)(1)(B)(i) and 507(a)(8)(B), a property tax will be incurred when, according to the applicable state or local law, liability for the debt arises. Such liability may arise, for instance, by reason of either a levy or an assessment by an authorized governmental body, may be *in rem*, *in personam*, or both, and may arise before the tax becomes due and payable, becomes secured, or the final amount is determined.

#### **11 U.S.C. § 507(a)(8) flush language**

The amendment to § 507(a)(8) further provides that in the event of successive bankruptcy filings, the relevant time periods shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of a prior case. In addition, such periods of time are suspended where the collection of a tax is prohibited, under nonbankruptcy law, because of a hearing or an appeal of the propriety of such tax and while the debtor was performing under one or more confirmed plans or the stay was in effect in a prior case. Clarification of the law eliminates unnecessary litigation and provides uniformity. The amendment is intended to codify the result in *In re West*, 5 F.3d 423 (9th Cir. 1993).

**Technical Correction Required.** The flush language at the end of § 507(a)(8) states that any “applicable time periods specified in this paragraph shall be suspended for any period during which” the government is barred from collecting a tax, thereby maintaining the priority for such taxes—and, consequently, their nondischargeability under § 523(a)(1)(A). Section 523(a)(1)(B)(ii) provides, in essence, that taxes shown on a return filed after two years before the date the petition in bankruptcy is filed shall not be discharged. Logically that time limit on dischargeability should also be suspended if there is a bankruptcy filing during that period, which would interfere with the government’s ability to collect those taxes in a subsequent bankruptcy case. However, the flush language in § 507(a)(8) only refers to an “otherwise applicable time period specified in this paragraph,” but the two-year period

provided in § 523(a)(1)(B)(ii) is not a time period specified in § 507(a)(8). Hence, a cross-reference needs to be added to ensure that the time limits will similarly be suspended to provide priority treatment of taxes shown on returns filed late but within the two years before a prior bankruptcy case.

## **11 U.S.C. § 511**

The Bankruptcy Code does not specify the interest rate which tax claims are entitled to receive, requiring frequent litigation to determine a market rate or some other rate of interest to be applied. This wastes valuable judicial resources, results in inconsistent rates even within the same jurisdiction, and often costs taxpayers considerable lost revenue where rates are set unreasonably low. Moreover, if interest rates under the Code are substantially different from those applicable under nonbankruptcy law, this can encourage the filing of bankruptcy cases simply to obtain a low-cost loan from the government. The loss of revenue to state and local governmental subdivisions which finance the operation of schools, police and fire departments, and other essential governmental services with *ad valorem* taxes is particularly troublesome. Therefore, consistent with the enhanced protection for ad valorem taxes under the amendments to § 724(b) of the Bankruptcy Code, this section amends chapter 5 of the Code to add new § 511 which provides that where a governmental unit, state, local or federal, is entitled to receive interest on its claim, the applicable nonbankruptcy rate will apply in the case of *ad valorem* taxes, administrative expense taxes, secured tax claims, and where the payment of interest is required to enable a creditor to receive the present value of the allowed amount of such tax claim.

A Third Circuit decision determined that the Penn Hills School District and Allegheny County, Pennsylvania, were entitled to the statutory rate of interest on a chapter 13 debtor's outstanding taxes. **Rankin v. DeSarno**, 89 F.3d 1123 (3d Cir. 1996). Similar decisions have been rendered elsewhere. This amendment is intended to codify the result in those decisions. In addition, this amendment may encourage debtors to more readily pay their taxes, rather than delaying payment to take advantage of a favorable rate of interest or to prefer administrative or other creditors before paying taxes, as is sometimes presently done. See, ***In re Coney Island Amusement, Inc.***, 2006 WL 617979 (S.D. N.Y. 3/13/06) (pre-BAPCPA, City of New York allowed to collect its statutory 18% rate on delinquent secured taxes; because tax liens arise by operation of law and not by agreement it is more difficult to obtain the kind of protections that secured lenders often have, such as title insurance, so it was reasonable to allow a higher rate on the tax claims).

## **11 U.S.C. § 521(j)**

This provision requires that a bankruptcy court dismiss or convert a case if tax returns are not filed within 90 days after the taxing authority requests dismissal or conversion of the case for failure to timely file any tax return that becomes due post-petition. Timely filing includes any request for an extension for filing the taxing authority allows. Paragraph (2) is mandatory—if the debtor fails to comply with the court’s order the case is automatically converted or dismissed. Other creditors of the estate do not have standing to object and need not be notified of the taxing authorities request for dismissal or conversion. Procedures with regard to the request under this section may be provided by the Rules.

Because 28 U.S.C. § 960, permits payment of post-petition taxes to be deferred or excused in limited circumstances, this section does not provide for mandatory dismissal or conversion for non-payment. Nothing in this section should be read to create the negative implication that non-payment of post-petition taxes is excused for any other reason, and, in fact, the policies which underlie this section and section 960 should continue to support conversion or dismissal for failure to pay post-petition taxes. Such failures to pay are now routinely treated as cause for dismissal under sections 1209 and 1307 and it is intended that these principles continue to apply. *See, e.g., In re Santiago Vella*, 87 B.R. 229 (Bankr. D.P.R. 1988); *In re Sullivan*, 108 B.R. 555 (Bankr. E.D. Pa. 1989). The result in those cases is affirmed by this amendment.

## **11 U.S.C. § 523(a)(1)(A), (B)**

This amendment resolves an ambiguity in law where a state may require an amended return, a notice or, alternatively, a report after a change upon a federal audit. *See, e.g., COLO. REV. STAT. 39-22-601(6)(a)* (1997). Further, under state law the statute of limitations on assessment of that tax is generally tolled until after receipt of the report notifying the state of the federal change, until an amended return is filed, or until the state authorities discover the federal change. *See, e.g., COLO. REV. STAT. 39-22-601(6)(c), (d)* (1997).

The amendment clarifies § 523(a)(1)(B) by providing that a “report or notice” shall be treated as a return, where a “return” must have been filed for the tax to be discharged. This issue frequently arises after a Federal audit of a taxpayer’s returns where an additional tax is due. Most state taxes are determined by reference to the taxpayer’s computation of federal gross income, some states “piggy-

back” the federal tax returns, and taxpayers are required to notify the state if a federal audit changes the amount of income shown. States depend on receiving notice from either the taxpayer or the IRS to be able to account for the additional tax which may be owed on the state return. Some states require that a “return” be filed after a change on a federal audit, others require either a “report” or a “notice” of the additional tax due. In applying current section 523(a)(1)(B), a number of courts have found that the option to submit a notice or a “report” of the change is not a requirement to file a return under this section. *See, e.g., In re Jackson*, 184 F.3d 1046 (9th Cir. 1999); *In re Jerauld*, 208 B.R. 183 (9th Cir. BAP 1997), *aff’d*, 1999 U.S. App. LEXIS 18441 (9th Cir., Aug. 5, 1999); *In re Rowley*, 208 B.R. 942 (9th Cir. BAP 1997). The amendment is intended to overrule these and other decisions to the same effect. The amendment is intended to prevent debtors from obtaining a windfall where the additional state taxes found due on a federal audit are discharged, because of the fortuitous language in the state law. The dischargeability of the tax shouldn’t hinge upon the state’s more lenient rules for notification of additional tax due after a Federal audit.

**Technical Correction Required.** Due to an unfortunate oversight the two-year period for dischargeability provided in § 523(a)(1)(B)(ii) was not included in the amendments which impose tolling because of a prior bankruptcy on similar time-periods under the § 507(a)(8) flush language. A technical change is required to correct this oversight.

### **11 U.S.C. § 523(a) flush language**

Section 523(a)(1)(B) of the Bankruptcy Code provides that taxes which are excepted from the debtor’s discharge include those where the debtor has failed to file a return, but does not define a “return” or provide guidance as to the treatment of the various returns taxing authorities are permitted to make on behalf of delinquent taxpayers. Section 523(a)(1)(B) is amended to make it clear that the debtor must have filed a “return” as required by the appropriate taxing authority. Substitute returns made by taxing authorities, with the co-operation of the debtor and signed by the debtor allowing the tax to be assessed, are also included. This amendment is intended to codify the result of *In re Hindelang*, 164 F.3d 1029 (6th Cir. 1999), which found that a return filed too late to have any effect under nonbankruptcy tax law as to an assessment previously made cannot constitute “an honest and reasonable attempt to satisfy the requirement of the tax law”; a Form 1040 is not a return for purposes under 11 U.S.C. § 523(a)(1)(B) if it no longer serves any tax purpose under the Internal Revenue Code as to an assessment made prior to the submission of the Form 1040. The amendment is intended to overrule

*In re Nunez*, 232 B.R. 778 (9th Cir. BAP 1999), and other similar decisions holding that for dischargeability purposes a “return” does not have to have legal significance under nonbankruptcy tax law. For discharge purposes, a “return” must be a return according to the law of the jurisdiction to which the tax is owed.

Further, to qualify the return must be “filed” as required by the applicable nonbankruptcy law. The amendment is intended to overrule *In re Elmore*, 165 B.R. 35 (Bankr. S.D. Ind. 1994), holding that returns submitted to Tax Court as evidence were “filed” for dischargeability purposes.

### **11 U.S.C. § 545(2)**

Section 545(2) of the Bankruptcy Code permits a trustee to avoid a tax lien that is either not perfected or not enforceable at the time of the filing of the petition against a bona fide purchaser, “whether or not such purchaser exists.” Trustees and debtors in possession have attempted to employ § 545(2) to avoid tax liens on the basis that the trustee or debtor steps into the shoes of the hypothetical bona fide purchaser entitled to superpriority under the Internal Revenue Code. The purpose of the exceptions in the Internal Revenue Code is to facilitate the flow of these goods in commerce and should not be used to displace an otherwise valid lien for the protection of the public revenue. Further, applying current § 545(2) to tax liens may result in an unintended windfall to the debtor.

Section 545(2) of the Bankruptcy Code is amended to make it clear that a trustee is not a “hypothetical purchaser” for purposes of avoiding certain Federal tax liens. Section 6323 of the Internal Revenue Code provides protection to certain purchasers of property even after a notice of federal tax lien has been filed in accordance with federal tax law. A “purchaser” is defined as a person who, for adequate consideration, acquires an interest (other than a lien or security interest) in property, which is valid under local law against subsequent purchasers without notice. Applicable purchases include securities, motor vehicles, personal property purchased at retail, and personal property purchased at casual sales.

## 11 U.S.C. § 724(b), (e), (f)

Section 724(b) governs the order of distribution of both real and personal property subject to valid, nonavoidable federal, state and local tax liens in a chapter 7 case. That section currently departs from the general rule that unsecured priority claims are junior in priority to perfected secured claims and requires trustees to subordinate valid tax liens below the costs of administration and potentially a large number of other priority claims, as well as to liens with inferior priority under applicable nonbankruptcy law.

The current statute effectively enables unsecured priority claimants occupying the first through seventh rungs on the priority ladder to step into the position of the taxing authority's lien and receive distributions from property of the estate, despite the fact that the tax claim is properly allowed and secured. Under the analogous language in the former Bankruptcy Act, § 63(c)(3), former 11 U.S.C. § 107(c)(3), Congress sought to guarantee only the payment of the costs of administration in a chapter 7 case and small wage claims by subordinating tax liens solely on *personal* property, a relatively small component of all tax liens. The statute has since been significantly expanded beyond its original scope to allow an ever-increasing number of unsecured priority claimants to invade valid and properly perfected liens on *both* personal and real property. Further, by allowing all administrative claims to be paid prior to secured tax claims, lawyers and other professionals with unpaid fees incurred in a failed chapter 11 case can demand to be paid from assets that would otherwise be collateral for tax claims. *In re K.C. Machine and Tool Co.*, 816 F.2d 238 (6th Cir. 1987); see *In re A.G. Van Metre, Jr., Inc.*, 155 B.R. 118 (Bankr. E.D. Va. 1993) (under 11 U.S.C. § 724(b) payment of statutory tax liens is subordinated to payment of administrative expenses up to the amount of the tax liens, but senior consensual lien holder, junior consensual lien holder, and holders of unsecured claims are left undisturbed; thus, if administrative claims happen to equal or exceed amount of statutory tax liens, the tax liens are paid behind claims of junior consensual lienholders, but if proceeds from sale of estate property free and clear of liens are exhausted during payment of the junior liens, then the tax liens are treated as unsecured), *aff'd*, 16 F.3d 414 (4th Cir. 1994); *In re Grand Slam U.S.A., Inc.*, 178 B.R. 460 (E.D. Mich. 1995) (§ 724(b), which provides for subordination of county's tax lien to administrative expense claims, if liquidated value of bankruptcy estate was less than administrative expenses and tax lien interests, qualified as "legal proceeding" by which county could be compelled to accept less than full money satisfaction of its interest, within meaning of 11 U.S.C. § 363(f)(5), which governs trustee's ability to sell property free and clear of interests of creditors who can be compelled to accept such partial

money satisfactions). This amendment is intended to overrule this result. Because state law usually provides that a lien securing *ad valorem* property taxes “primes” all other consensual and nonconsensual liens, the application of § 724(b) invariably causes such attorneys’ fees and other priority claims to be paid from tax revenues which otherwise would be used for essential public purposes, *e.g.*, schools, police, and fire protection.

*Ad valorem* taxes, *i.e.*, taxes assessed based on the value of property, as opposed, for instance to income or sales taxes, are the primary source of revenue for counties, cities and towns, and to a lesser degree by most state governments. The amendment, therefore, generally excepts liens for such taxes from the subordination provisions of § 724(b), although it does allow for the invasion of liens for *ad valorem* taxes solely to pay employee claims for wages, salaries, and commissions, and for contributions to employee benefit plans. In so doing, the new language will substantially decrease the possibility that local and state jurisdictions will be denied revenues which they would have received absent the operation of the Bankruptcy Code, while ensuring that local employees will not suffer due to the bankruptcy of their employer.

As a further effort to reduce the impact of the subordination provisions in § 724(b) on non-*ad valorem* tax liens, the amendment also requires the trustee to first exhaust other unencumbered assets and surcharge other secured creditors, consistent with § 506(c), for the costs of preserving their assets, prior to seeking a recovery from tax liens subject to this section.

Additionally, under current law some courts have ruled that, despite the passage of considerable time and the expiration of statutory deadlines, they are still permitted to redetermine the value of property, and thus the property tax assessed, and order a refund of taxes even if it was fully paid years before. This practice severely disrupts the finances of state and local governmental entities which are powerless to budget for such events. The amendments to § 505(a) will allow a challenge to *ad valorem* tax assessments only if the time in which to do so has not lapsed under applicable nonbankruptcy law.

**Technical Correction Required.** Section 724(b)(2) provides for the distribution of the proceeds from secured property. The language in parentheses following “section 507(a)(1)”, inserted by BAPCPA, was intended to provide an exception for the payment of administrative expenses from tax liens, such that the invasion of tax liens for payment of administrative expenses (other than for employee wages and benefits) be limited to those incurred in Chapter 7 and not include those in a prior Chapter 11 case. The parenthetical exception should have followed the cross-reference to § 507(a)(2), providing

second priority to the payment of administrative expenses, including wages, salaries, and commissions. The parenthetical language was correctly placed according to the order of priorities before their amendment. However, when at a later point in the legislative process the domestic support obligation was moved up to first priority, and the other priorities were bumped down a notch, this cross-reference was not changed. The error becomes apparent in reading the language of the exception, which refers to “wages, salaries, or commissions,” while § 507(a)(1)(A) and (B) refer to “domestic support obligations.”

### **11 U.S.C. § 726(a)(1)**

Section 726(a)(1) allows a tardily filed claim for a priority tax if the claim is “filed before the date on which the trustee commences distribution” but does not specify when that event occurs. Courts have differed on whether it should be the date when the court approves the trustee’s final report and accounting, the date the checks are mailed, or the date the trustee’s final report is sent to the United States trustee for approval. The issue is resolved by amending § 726(a)(1) to provide that a tardy claim must be filed on or before the earlier of 10 days after the mailing of a summary of the trustee’s final report to the creditors or the date the trustee begins final distribution where, for instance, the taxing authority is not listed as a creditor and does not receive the summary of the trustee’s final report.

### **11 U.S.C. § 728**

Section 728 was repealed in its entirety and replaced by the revised section 346 which governs the taxation of bankruptcy estates for state income tax purposes. The current provisions, §§ 346, 728, 1146 and 1231, were drafted in anticipation of the Bankruptcy Tax Act of 1980 and were inconsistent in many respects. Those sections have been rewritten to consolidate the provisions governing the taxation of chapter 7 and 11 bankruptcy estates into § 346.

### **11 U.S.C. § 1125(a)(1)**

Section 1125(b) of the Bankruptcy Code is 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 the tax consequences of the plan to a hypothetical investor typical of the holders of claims or interests domiciled in the state in which the debtor resides or has its principal place of business. A chapter 11 plan’s tax consequences represent an important aspect of the plan. The failure to discuss the potential tax consequences of a plan of reorganization in the disclosure statement can result in seriously misleading creditor constituencies and other parties in interest about the plan’s financial effects.

## **11 U.S.C. § 1129(a)(9)(C)**

Currently, chapter 11 debtors are permitted to pay both secured and unsecured tax claims according to whatever plan the court approves. In some cases courts have approved plans providing no payments on tax claims until the end of the plan, thus favoring other creditors in the frequent event that the plan fails, placing the public revenue at risk. In other cases courts have permitted debtors to pay secured tax claims in much the same manner as a consensual lender's debt secured by a mortgage, over a period far in excess of the time permitted by law for the payment of taxes. Given that a tax claim becomes secured only after the taxpayer fails to pay the tax and that any tax obligation protected by a lien may be immediately collected under relevant nonbankruptcy law, the "stretch-out" of such taxes under a plan of reorganization is the forced public financing of the debtor's business and is contrary to good bankruptcy and tax policies.

Section 1129(a)(9) of the Bankruptcy Code is amended to require that chapter 11 plans provide that all tax claims be paid in regular installments over a period which is not more than five years from the date of the order for relief, in a manner not less favorable than that accorded to the most favored nonpriority unsecured claims. An exception is made to allow the payment of *de minimus* claims as a convenience, under § 1122(b), earlier than tax claims. In addition, secured tax claims which, but for their secured status would otherwise be payable as priority claims, must be paid in a manner which is no less favorable than if the claims were merely priority.

Prior to this amendment the maximum time allowed was six years from the date of the assessment of the taxes. This amendment changes the time to five years from the date of the order for relief, to provide a fixed, easily determinable time in which taxes must be paid under the plan, rather than requiring the parties to attempt to determine when each tax was assessed.

## **11 U.S.C. § 1141(d)(6)**

Currently the confirmation of a chapter 11 plan of reorganization discharges the debtor from any debt that arose before the date of confirmation, but does not discharge an *individual* debtor from taxes which arose because of fraudulent returns or an attempt to evade taxes. 11 U.S.C. § 1141(d)(3)(C). Corporate debtors, by contrast, currently receive a discharge of all taxes, even for taxes where a fraudulent return was filed or the debtor attempted to evade or defeat the tax. This provision amends § 1141(d) to make such taxes nondischargeable, consistent with the treatment of individuals.

This section limits the further benefit of the exclusion of debts under § 523(a)(2), related to the extension of credit because of fraud or false pretenses, to “a domestic governmental unit” and individuals entitled to a “whistle blower” judgment.

### **11 U.S.C. § 1146(a), (b)**

The amendment to § 1146 strikes subsections (a) and (b) and incorporates the bulk of those subsections in revised § 346, which will govern the taxation of bankruptcy estates for state tax purposes.

Unfortunately, none of the amendments address the problem encountered in a growing number of chapter 11 cases related to former § 1146(c), which will become § 1146(a) and generally provides that transfers of property under a confirmed plan are not subject to state or local transfer taxes. *See, e.g., In re Hechinger Inv. Co. of Delaware, Inc.*, 254 B.R. 306 (Bankr. D. Del. 2000) (transfers of real estate by chp. 11 debtor in anticipation of funding liquidating plan were not subject to state transfer taxes; motion pursuant to 11 U.S.C. § 505(a) for determination that transfers were exempt was not a “suit” for sovereign immunity purposes, “an action which the bankruptcy court can resolve under its jurisdiction over debtors and their estates rather than over the state itself, is not a ‘suit’ within the meaning of the Eleventh Amendment.”; *In re NVR, L.P.*, 189 F.3d 815 (4th Cir. 1999), distinguished (debtors were commercial retailers not in business of selling real estate) and disputed (“When Congress wants to impose a temporal condition on a bankruptcy transaction, it does so expressly.”); 11 U.S.C. § 1146(c) exempting transfers “under a plan confirmed” applies to transfers in anticipation of confirming a plan, not just postconfirmation transfers, it facilitates the purpose of the provision, “maximizing the proceeds from the sale of unneeded assets as a part of implementing and/or funding a plan”; the court, *sua sponte*, required “an appropriate escrow of funds to cover the tax liability in the event a chapter plan is not confirmed.”).

The court is reading the phrase “under a plan confirmed” as including “under a plan *which will be confirmed*.” “[Section] 1146(c) merely requires that a *plan* be confirmed under § 1129. It does not require a reorganization plan.” 254 B.R. at 317 (emphasis in original). Given that *confirmed* is defined as “having received confirmation,” the more natural reading of 11 U.S.C. § 1146(c) is that it means “under a plan *which was confirmed*.” American Heritage Dictionary 183 (1994). The result of those cases will not be overruled and may, in fact, become more viable because of the specific indication in the amendment to 28 U.S.C. § 960 which provides that a trustee need not pay a tax which is specifically excepted from payment in the Code.

## **11 U.S.C. § 1222(a)(2)**

This amendment is not found in the title VII Tax Provisions of S. 256, but apparently was intended to create a benefit for farm debtors by making it possible to discharge the tax liability incurred on the prepetition sale or involuntary transfer, a mortgage foreclosure, for instance. The amendment to § 1222 provides that the taxing authorities claim for the taxes incurred on the “sale, transfer, exchange, or other disposition of any farm asset used in the debtor’s farming operation . . .” shall be treated as an unsecured, nonpriority claim if the debtor receives a discharge.

An initial question arising because of this amendment is, when must the transfer of such property be made for the debtor to obtain the beneficial treatment of the taxes? Inasmuch as the amendment to § 1222(a)(2) provides for such treatment “of all claims entitled to priority under section 507,” which includes both administrative taxes entitled to priority under § 507(a)(2), if any, and taxes owed for a prepetition taxable year entitled to priority under § 507(a)(8), tax and bankruptcy law would suggest three alternatives: first, transfers occurring both prepetition and postpetition, including those pursuant to a confirmed plan of reorganization; second only those transfers occurring prepetition; and, third, only those taxes incurred because of a transfer in a taxable year ending prepetition. Because of the repeal of former § 1231(b), which attempted to establish a separate taxable entity for the chapter 12 estate but which was inoperable because of the inclusion of assets and income acquired by the debtor postpetition, there are no administrative expense taxes of the estate. Further, to be entitled to eighth priority in the scheme of distribution under § 507(a)(8) a tax must be a tax “for a taxable year ending on or before the date of the filing of the petition . . .” Thus, a chapter 12 debtor must suffer the transfer of the eligible farm asset in a taxable year ending before the petition is filed. This conclusion should not be affected by the conversion of a case filed under chapter 7 to one under chapter 12 because of § 348(a) which provides that conversion “does not effect a change in the date of the filing of the petition . . .”

Interpretation of this provision is assured of engendering considerable litigation. The requirement that the plan shall “provide for the full payment . . . of all claims entitled to priority” under § 507 and that, “the debt shall be treated in such manner only if the debtor receives a discharge,” would appear to indicate that Congress intended that the plan actually provide for full payment of what otherwise would be an eighth priority tax claim and that the treatment of such claim as a nonpriority, unsecured claim be deferred until all payments have been made and a discharge pursuant to § 1228(a) is entered. If this interpretation is correct, to take advantage of the perceived benefit the debtor must pay

the tax obligation in full, raising the question of whether a refund must be sought and for whose benefit are the funds to be applied, the creditors' or the debtor's. Other problems arise from this interpretation—must the application for a refund be timely made as required under nonbankruptcy law? If so, recovery of a significant portion of the payments made to the taxing authority may be time barred.

A different problematical interpretation can easily be made. The amendment does not require that the debtor's discharge be entered under § 1228(a). It is probable that the courts will read this provision as permitting a chapter 19 filing, the chapter 12 plan would be used to pay administrative creditors and trade creditors and the taxes then discharged after conversion to chapter 7, where they would be nonpriority claims. While such plan gerrymandering will be specifically prohibited under the amendment to § 1129(a)(9) there are no restrictions, other than a nebulous "good faith" objection, in chapter 12 cases. The amendment to § 1129(a)(9) may likely invite judicial "negative implication" findings that Congress intended creative plan drafting in chapter 12 cases or it would have placed similar restrictions in that chapter. Given the likelihood of the courts' interpretation of this amendment and the more liberal rules for qualifying as a farmer we may expect to see an increase in "farm" bankruptcies.

Another complication with the chapter 12 tax provision may be comparatively short lived. The effective date of § 1222(a) precedes the effective date of the tax provisions and the repeal of § 1231(b). Section 1003(c) of BAPCPA, which is not codified, provides:

(c) EFFECTIVE DATE; APPLICATION OF AMENDMENTS.—This section and the amendments made by this section shall take effect on the date of the enactment of this Act and shall not apply with respect to cases commenced under title 11 of the United States Code before such date.

If the sale of the farm assets occurred during the 180 days prior to October 17, 2005, the treatment of the gain realized is not clear. In order for a postpetition transfer of farm assets to receive the beneficial treatment under § 1222(a) the tax burden must create a claim in the estate. Administrative expense taxes would qualify if the postpetition transfer of a farm asset used in the debtor's farming operation occurred before a plan is confirmed. But if the transfer during that time is pursuant to a confirmed plan, arguably the debtor owes the taxes. Confirmation of the plan vests all of the property of the estate in the debtor. Thus, the estate no longer exists, there can be no administrative tax claim in the estate, the transfer is of property of the debtor, and the debtor incurs the tax. (Technical analysis of the tax consequences of such transfers is elusive. If the debtor performs services for a third party, payment of compensation can

be said to be income of the debtor; the debtor performed the services, not the estate. Thus, regardless of its treatment for bankruptcy purposes, for tax purposes the compensation should be taxable income of the debtor; assignment of income principles should apply. *But see*, Notice 2006-83, I.R.B. 2006-40 (Sept. 18, 2006) (for purposes of new 11 U.S.C. § 1115(a) the estate reports earnings from postpetition services of the debtor.)

### **11 U.S.C. § 1231(a), (b)**

As noted above, in the comments regarding §§ 346, 728 and 1146, the provisions governing the taxation of chapter 7 and 11 estates have been consolidated into § 346. Section 1231(b) would have imposed the separate entity rules on chapter 12 estates but they were ineffective because of the failure to account for the inclusion of after acquired property and postpetition earnings from the debtor's services in "property of the estate" used to fund the plan of reorganization. Chapter 13 estates were intentionally omitted from the "separate entity rules" because of the use of such property to fund a plan of reorganization.

The rationale for generally treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets. In a chapter 13 case, however, both future earnings of the debtor and exempt property may be used to make payments to creditors, and hence the bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 or 11 cases.

H..R. Rep. No. 833, 96th Cong., 2d Sess 20, n.2 (1980). This rationale for omitting chapter 13 estates from the separate entity rules applies not only in chapter 12 cases but will apply in the case of individual chapter 11 cases because of amendments made by other sections of the bill which will include both postpetition earnings from the debtor's services and after-acquired property in property of the estate used to fund the plan of reorganization. *See* new 11 U.S.C. § 1115(a). An amendment to I.R.C. § 1398 is necessary to account for this change in individual chapter 11 cases.

### **11 U.S.C. § 1231(b)**

As a general rule, bankruptcy judges can only resolve actual cases and controversies, whether the matter before the court is a core or noncore proceeding. 28 U.S.C. § 2201; *In re Hartman Material Handling Systems, Inc.*, 141 B.R. 802 (Bankr. S.D. N.Y. 1992). This amendment, another amendment not found in the title VII Tax Provisions of S. 256, purports to grant the bankruptcy court power to enter declaratory judgments regarding tax matters of “any governmental unit” such cases still require an actual controversy. The amendment broadens the scope to include the federal government, which may create heightened interest in attempts to declare the federal tax consequences of a chapter 12 plan, particularly when considered with the possibility of obtaining a tax benefit for the farm-debtor under § 1222(a)(2). Section 505(a) may also be used to obtain a determination of the application of § 1222(a)(2). *See, In re Swanson (Swanson v. I.R.S.)*, 2006 WL 1409127 (Bankr. D. Kan. 5/15/06).

### **11 U.S.C. § 1307(e)**

Section 1307 is amended to provide that, after notice and hearing, upon the failure to file the returns required under new § 1308, below, the case shall be dismissed or converted to one under chapter 7.

### **11 U.S.C. § 1308**

In a chapter 13 plan, the debtor is required to provide for the full payment of all claims entitled to priority, including taxes which have not been assessed but are still assessable. Where the debtor has failed to file a return the taxing authority has no practical means of determining the correct amount of its claim. In some instances, the taxing authority has attempted to protect the public interest by filing estimated claims in all cases where the debtors have “open” years. Filing estimated “place holding” proofs of claim for periods for which no returns have been filed, however, creates a number of problems for tax authorities, debtors and the courts. While some courts insist that tax authorities file estimated claims to protect their position, other courts have imposed sanctions for filing incorrect claims where the taxing authority cannot prove that taxes are owed.

This amendment creates new § 1308 which requires that chapter 13 debtors file all returns which are due for the four taxable years ending before the petition in bankruptcy. The amendment requires that the returns be filed for which the taxes are entitled to priority under § 507(a)(8)(A)(i). Because debtors are generally encouraged to file under chapter 13, returns filed by taxing authorities under I.R.C. §

6020(b) or similar state or local law qualify as a return for purposes of new § 1308, in comparison with the more restrictive definition of a “return” for discharge purposes under section 714 of the bill.

The bill also stated the sense of the Congress that the Advisory Committee on Bankruptcy Rules of the Judicial Conference should propose for adoption amended Federal Rules of Bankruptcy Procedure which provide that objections to plan confirmation filed on or before 60 days after the date on which the debtor files all required tax returns shall be treated as if timely filed preconfirmation and that no objection to a tax with respect to such required returns shall be filed until the returns have, in fact, been filed.

#### **11 U.S.C. § 1325(a)(9)**

Section 1325(a) is amended to require that the returns specified in new § 1308 be filed on or before the first meeting of creditors, section 1308(b) permits the trustee to hold open the first meeting of creditors for that purpose, for a period which is generally no more than 120 days after the date of that meeting, and further provides that the court, after notice and hearing and order entered before the tolling of any applicable filing period, may extend the time in which the returns must be filed where the debtor demonstrates that the failure to file a return as required is attributable to circumstances beyond his or her control.

#### **11 U.S.C. § 1328(a)(2)**

Currently, chapter 13 debtors are able to discharge their tax obligations arising from fraudulent returns, willful attempts to evade such taxes, and late and unfiled returns. These taxes are not dischargeable in cases filed under chapters 7, 11 or 12, they are specifically excepted from the discharge. 11 U.S.C. § 523(a)(1). Section 523(a)(1) refers to discharges granted under §§ 727, 1141, 1228(a), 1228(b) and 1328(b) of the Code; reference to discharges granted under section 1328(a) is specifically omitted. Normally, chapter 13 debtors obtain a discharge under section 1328(a), when they complete all payments under the plan. Section 1328(b) provides that a discharge may be entered in chapter 13 cases where hardship circumstances are shown.

Two rules unique to chapter 13 cases currently impact upon the treatment of these taxes—they are not excepted from the chapter 13 superdischarge and they are not required to be paid in full as a condition of confirmation of the chapter 13 plan, because they are not priority claims. 11 U.S.C. §§

1328(a)(2), 1322(a)(2), 507(a)(8)(A)(iii). The complexity of these two rules requires more detailed explanation to understand the problems this amendment is intended to resolve.

The exceptions to the discharge in chapter 13 cases are only for claims of a kind specified in paragraphs (5), (8) and (9) of section 523(a), which exceptions do not include tax claims. 11 U.S.C. § 1328(a)(2). However, in order to be confirmed, a chapter 13 plan must provide for the payment in full of all debts entitled to priority under section 507 of the Code. 11 U.S.C. § 1322(a)(2). Taxes which have not been assessed but which are still assessable at the commencement of the case are entitled to priority status, *other than a tax of a kind specified in section 523(a)(1)(B) or (C) of the Bankruptcy Code*. 11 U.S.C. § 507(a)(8)(A)(iii). Taxes for which a return had not been filed, for instance, would often still be “assessable” after the case was filed and would be entitled to priority treatment and payment in full in a chapter 13 case, but for this exception. Similarly, taxes related to fraudulent returns or the debtor’s willful evasion which have not been assessed, are not entitled to priority, and do not have to be paid in full under the plan. 11 U.S.C. §§ 507(a)(8)(A)(iii), 1322(a)(2). Thus, the unpaid balance of taxes in respect of a fraudulent return are discharged upon completion of a plan even though the plan provides for payment of only a small percentage or even nothing for such claims. 11 U.S.C. § 1328(a).

The problem which the amendment addresses is best understood by reference to a case in which the debtor declared he filed fraudulent returns and willfully omitted embezzlement income. *Matter of Zeig*, 206 B.R. 974 (D. Neb. 1997). The issue before the court was whether the tax arising from the admittedly fraudulent return and embezzlement income was entitled to priority for chapter 13 plan purposes, taxes which are described under both § 507(a)(8)(A)(iii) and § 523(a)(1)(C). The taxes which would have been nondischargeable in chapter 7 case were denied priority and were therefore dischargeable in Chapter 13, even though the IRS never asserted a fraud penalty; the debtors simply declared that they filed a fraudulent tax return. *Matter of Zieg*, 194 B.R. 469 (Bankr. D. Neb. 1996), *aff’d*, 206 B.R. 974 (D. Neb. 1997). The amendment made by this section is intended to overrule the result of these decisions.

The inequity of current law is readily apparent. A chapter 13 debtor owing taxes with respect to a return which was timely filed and free from fraud must pay any unpaid taxes in full over the course of the plan; a chapter 13 debtor who owes taxes with respect to admittedly fraudulent returns, in contrast, will never be required to pay any of the taxes if the bankruptcy court approves a “zero” payment plan, or will pay only a small portion depending on the percentage of debts required to be paid under the plan.

Moreover, the current law results in the spectacle of debtors affirmatively arguing that they filed a fraudulent return in order to obtain a discharge of the taxes.

As a result of the chapter 13 debtors' ability to take advantage of this incongruity considerable state and federal tax revenue have been lost. The claims for federal taxes which are currently dischargeable also include claims for the employer's withholding tax liability for trust fund taxes under § 6672 of the Internal Revenue Code, a tax liability which often has not been determined when the petition in bankruptcy is filed. *See, e.g., In re Lee*, 184 B.R. 257 (W.D. Va. 1995) (where IRS did not learn of existence of unpaid obligation for unassessed § 6672 penalty tax in time to file proof of claim in debtor's chp. 13 case liability was discharged). This amendment is intended to overrule the result in this and other such cases, that a withholding tax which has not been assessed but is still assessable on commencement of the case is dischargeable. These claims are entitled to priority and must be paid in full in chapter 13 and are nondischargeable in chapter 7, 11 and 12 cases, but because even priority claims may be discharged in chapter 13 if a claim is not filed, state tax authorities often may lose the ability to file a claim if they are not made aware of the results of a Federal audit until it is too late.

The rationale for not providing parallel treatment of priority taxes and taxes excepted from discharge was to benefit creditors, but was not intended to let the tax debtor benefit from his or her misdeeds. Taxes that have been evaded or for which the debtor has never filed returns do not deserve special, lenient treatment. It is unfair to honest taxpayers to allow such debtors to escape their tax.

The elimination of the discharge of these taxes is supported by the legislative history to the Bankruptcy Code which discusses the priority status granted tax claims where it states:

Since tax authorities are creditors of practically every taxpayer, another important element is that tax collection rules for bankruptcy cases have a direct impact on the integrity of the Federal, State and local tax systems. *These tax systems, generally based on voluntary assessment, works [sic] to the extent that the majority of taxpayers think they are fair.* This presumption of fairness is an asset which should be protected and not jeopardized by permitting taxpayers to use bankruptcy as a means of improperly avoiding their tax debts. To the extent that debtors in a bankruptcy are freed from paying their tax liabilities, the burden of making up the revenues thus lost must be shifted to other taxpayers.

S. Rep. No. 989, 95th Cong., 2d Sess. 13–14 (1978) (emphasis supplied), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5799–5800. Further, in explaining the priority and discharge provisions of the Bankruptcy Act which were largely preserved in the Bankruptcy Code, citing section 17a(1), the Committee Reports state:

There is an additional reason for the priority. . . . *An open-ended dischargeability policy would provide an opportunity for tax evasion through bankruptcy, by permitting discharge of tax debts before a taxing authority has an opportunity to collect any taxes due.*

H.R. Rep. No. 595, 95th Cong., 1st Sess. 190 (1977) (emphasis supplied) (citations omitted). These statements, written to provide guidance in interpreting the Bankruptcy Code, are hallmarks of legislative intent regarding the discharge of taxes under the Bankruptcy Code and are reaffirmed here.

To avoid the abuses discussed above, section 1328(a)(2) is amended; taxes in respect of unfiled returns, late returns filed within two years of the commencement of the case, fraudulent returns, and attempts to evade or defeat taxes are excepted from the chapter 13 superdischarge. In addition, debts for trust fund taxes—monies that the debtor withheld from other parties and failed to pay over to the government—are also excepted from the discharge. The current rules for claims priority are not altered, the other creditors paid under the plan are not directly affected.

**28 U.S.C. § 960(b)**

The amendment is intended to clarify existing language in title 28, United States Code, to require that taxes incurred by a bankruptcy estate must, in fact, be paid. Section 960 currently only states that a trustee is “subject to” all state, local and Federal taxes. Several courts have interpreted this language as not requiring that such taxes be paid as a matter of course. *See, e.g., McColgan v. Maier Brewing Co.*, 134 F.2d 385 (9th Cir. 1943) (section 960 represents Congressional intent to clarify that state, local and federal taxing authorities may seek payment as an administrative expense); **Markos Gurnee Partnership**, 182 B.R. 211 (Bankr. N.D. Ill. 1995), *aff’d sub nom.*, **Illinois Dep’t of Rev. v. Schechter**, 195 B.R. 380 (N.D. Ill. 1996). The amendment is intended to overrule the result of such cases and affirms **Swarts v. Hammer**, 194 U.S. 441, 24 S. Ct. 695, 48 L. Ed. 1060 (1904); it requires payment of taxes but creates exceptions where a trustee promptly abandons the property or where another provision in title 11 specifically excuses payment of the taxes. The amendment is not intended to overrule **California State Board of Equalization v. Sierra Summit, Inc.**, 490 U.S. 844, 853, 109 S. Ct. 2228, 2234–35, 104 L. Ed.2d 910 (1989) (chapter 7 estate, whether or not conducting the debtor’s business, is subject to state sales taxes).

#### **28 U.S.C. § 960(c)**

The requirement under 11 U.S.C. § 726(b) that all administrative expense claimants share the available funds pro rata when the estate is insolvent is preserved. To ensure the pro rata payment of administrative expenses under § 726(b) trustees are permitted to withhold payment of taxes after obtaining an order from the bankruptcy court finding a “probable insufficiency of funds” with which to pay the administrative expenses of the estate, similar to the requirements under which the trustee may avoid the penalty for failure to pay a federal tax. I.R.C. § 6658(a)(1). Further, in chapter 7 cases, the payment of taxes incurred by other than the chapter 7 trustee, in converted cases, may be deferred until distribution from the estate.