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National Bankruptcy Review Commission Tax Recommendations: Individual Debtors, Discharge, and Priority of Claims

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Articles

NATIONAL BANKRUPTCY REVIEW COMMISSION TAX RECOMMENDATIONS: INDIVIDUAL DEBTORS, PRIORITIES, AND DISCHARGE

by
*Jack F. Williams**

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Pursuant to congressional mandate, the National Bankruptcy Review Commission (NBRC) has reported its recommendations for modification to the Bankruptcy Reform Act of 1978, as amended (the "Bankruptcy Code"),¹ to the President, Congress, and Chief Justice of the Supreme Court on October 20, 1997. This Article focuses on the proposed revisions relating to taxation of individual debtor estates, tax return filing requirements, and the priority and dischargeability of tax claims.

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.²

The NBRC directed that the Advisory Committee deliver 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 in Detroit, Michigan. The Preliminary Reports identified those areas of bankruptcy taxation that the Advisory Committee had determined were susceptible to agreement among its members and those proposals that had been withdrawn from consideration by the Advisory Committee as unimportant, unclear, or considered elsewhere. The Advisory Committee continued the process of discussing and identifying those proposals that may be susceptible to agreement. The Final Report contains three sec-

¹ 11 U.S.C. §§ 101 et seq. (1994).

² The Advisory Committee members were Paul Asofsky, Mark Browning, Steve Csontos, Robert MacKenzie, Robert Miller, Grant Newton, Joan Pilver, Mark Seigel, and Ken Weil. I 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 I.R.C., title 26 of the United States Code.

tions.³ The first section contains a listing and discussion of twenty-eight consensus items.⁴ 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.⁵ The second section contains a listing and discussion of six consensus items.⁶ 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.⁷ Although short of a consensus on these contested issues, the Advisory Committee has provided to the NBRC its recommendations and voting record on the twenty-nine proposals.⁸

³ See Tax Advisory Committee Final Report at 5-6 (August 1997) (hereinafter "TAC Report").

⁴ See *id.* at 5.

⁵ 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 has supplemented the initial list to include additional consensus items, including Track Nos. 441, 513(a), and 700. *Id.* at 6.

⁶ See *id.*

⁷ *Id.* Rather than initiate a new numbering system to track bankruptcy tax proposals, the Advisory Committee continued the numbering and tracking system of the previous tax matrices as a matter of convenience and in an effort to reduce confusion over discussions concerning bankruptcy tax proposals. Those proposals added to the matrix by the Advisory Committee were assigned 700-series index numbers. Furthermore, where appropriate, the Advisory Committee split multiple proposals into component parts; thus, original proposal No. 414 has been redesignated Nos. 414, 414(a), and 414(b). See TAC Report, *supra* note 3, at 4.

⁸ 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 Taxation of the NBRC 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 ninety pages with well over 100 proposals. While many of the proposals adopted by the NBRC were recommendations by the Advisory Committee, on occasion, the NBRC rejected the recommendation of the Advisory Committee and adopted one of the competing proposals.

I. TAXATION OF INDIVIDUAL DEBTOR ESTATES

This part explores the NBRC proposals that are focused on certain substantive federal, state and local tax consequences associated with an individual seeking relief under the Bankruptcy Code.⁹ Presently, the Bankruptcy Code contains several tax provisions that apply to state and local taxes only.¹⁰ The treatment of federal taxes was deleted from the Bankruptcy Reform Act¹¹ and later considered in the Bankruptcy Tax Act of 1980 (the BTA).¹² Unfortunately, the treatment of federal taxes in bankruptcy under the BTA does not conform to the treatment of state and local taxes under the Bankruptcy Code even where the federal, state and local interests appear to be congruous. Much of the Advisory Committee's efforts were centered on conforming the treatment of taxes and taxing authorities in bankruptcy. Obviously, this task requires amendment both to the Bankruptcy Code and the Internal Revenue Code (I.R.C.).¹³ Each of these proposals is addressed below.

A. *Introduction to Taxation of Individual Debtor Estates*

Filing a petition for relief under the Bankruptcy Code creates an estate.¹⁴ Property subject to exemption from distribution to creditors is included in the definition of property of the estate until it is, in fact, set aside as provided in § 522.¹⁵ It is this property of

⁹ 11 U.S.C. §§ 101 et seq. (1994).

¹⁰ See, e.g., 11 U.S.C. §§ 346, 728, 1146, 1231.

¹¹ Bankruptcy Reform Act of 1994, Pub.L.No. 103-394, 108 Stat. 4106 (codified as amended at 11 U.S.C. § 101 et seq. (1994)).

¹² Bankruptcy Tax Act of 1980, Pub.L.No. 96-589, 94 Stat. 3389 (codified at 26 U.S.C. §§ 108 et seq.).

¹³ I.R.C. § 1-9853 (1988).

¹⁴ See 11 U.S.C. § 541(a). Property of the estate includes all of a debtor's legal or equitable interest in property at the time of filing of the petition wherever located and by whom ever held. Moreover, all the interest of a debtor and a debtor's spouse in community property that is under the sole, equal, or joint management of the debtor is included in the estate. See 11 U.S.C. § 541 (a)(2)(A). Furthermore, inheritances that come to a debtor within 180 days after the filing of the petition, an interest in property because of a divorce decree or property settlement agreement with a debtor's spouse, the proceeds of a life insurance policy or death benefit plan, and the proceeds, rents, and profits from property included in the estate are all included in the definition of property of the estate. See 11 U.S.C. §§ 541(a)(5) - (6).

¹⁵ 11 U.S.C. § 522(d). The Code initially allows a debtor to choose either the federal exemptions set out in § 522(d) or exemptions available under state law. See *id.* However, the Code permits the individual states to opt out of the federal exemption option so that debtors domiciled in a particular state may be limited to the exemptions available under the law of that

the estate that is subject to administration under the Bankruptcy Code and is used to satisfy, among other things, prepetition claims.¹⁶

The general rule is that the creation of a bankruptcy estate has no federal tax significance. Thus, any transfer of property by operation of law from a debtor to its bankruptcy estate, other than by sale or exchange, is not a taxable event under the I.R.C.¹⁷ Moreover, there is no change in the basis of any asset transferred.¹⁸ Although the transfer is technically a nontaxable event for the debtor, the debtor does lose the benefit of the use of certain tax attributes that automatically inure to the bankruptcy estate.¹⁹ However, where an individual debtor files for relief under either chapter 7 or 11, the

state. See 11 U.S.C. § 522(b)(1). Most states have opted out of the federal exemption system. See, e.g., *O.C.G.A.* § 51-1301.1(b) (1989). A few states permit debtors to choose the § 522(d) exemptions or the exemptions available under state law. See, e.g., *NCNB Tex. Nat'l Bank v. Volpe*, (*In re Volpe*), 120 B.R. 843, 846 (W.D. Tex. 1990) (permitting debtor to choose either federal or Texas exemptions because Texas has not enacted any law precluding debtors from choosing between federal and Texas exemptions), *aff'd*, 943 F.2d 1451 (5th Cir. 1991).

¹⁶ ELIZABETH WARREN & JAY L. WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 200 (1991).

¹⁷ See I.R.C. § 1398(f)(1).

¹⁸ The basis of an asset is generally its historic cost. See I.R.C. § 1012. Essentially, the function of basis in the context of realization of gain or loss is to prevent the same dollars from being taxed twice. Adjusted basis is the historic cost increased by capital expenditures such as improvements to the asset and decreased by allowed depreciation. See I.R.C. § 1016(a) (1988 & Supp. V 1993).

¹⁹ See I.R.C. § 1398(g) (1988). Presently, these tax attributes include net operating loss carryovers as determined under I.R.C. § 172; excess charitable contribution carryovers as determined under I.R.C. § 170(d)(1); the recovery of tax benefit items under I.R.C. § 111; certain credit carryovers; capital loss carryovers determined under I.R.C. § 1212; the basis, holding period, and character of property; the debtor's method of accounting; and other tax attributes of the debtor, to the extent provided in regulations carrying out the purposes of I.R.C. § 1398. See C. RICHARD MCQUEEN & JACK F. WILLIAMS, *TAX ASPECTS OF BANKRUPTCY LAW AND PRACTICE*, § 6.10 (1997) for a helpful explanation of the listed attributes. Because the tax attributes that pass from a debtor to his or her estate must be identified in I.R.C. § 1398(g) or in a regulation, the list of attributes quickly becomes stale. Richard M. Lipton, *Proposed 1398 Regs. Raise Conflict Between Debtors and Bankruptcy Trustees*, 79 J. TAX'N 12-13 (1993). Recently, the IRS added passive activity and at risk activity losses and credits to the list of tax attributes that pass from debtor to the estate and back upon termination. See Treas. Reg. §§ 1.1398-1(d), 2(d) (1995). For an example of the harm to the estate resulting from the failure to include passive activity and at risk activity losses and credits, see Lipton, *supra*, at 13. The new regulations apply to all cases filed after November 9, 1992. Treas. Reg. §§ 1.398-1(f), -2(f). After the petition is filed, the debtor may not use any of the tax attributes that were transferred to the estate. So, although the estate is responsible for the tax liability related to the debtor's assets, the bankruptcy estate also can use the debtor's tax attributes to reduce this liability. See Lipton, *supra*, at 12.

bankruptcy estate of an individual debtor is a new taxable entity separate from the individual debtor.²⁰

1. *The Separate Entity Rules: I.R.C. § 1398*

Before enactment of the BTA in 1980, there existed no I.R.C. provision regarding the tax treatment of a bankruptcy estate of an individual.²¹ The treatment of the bankruptcy estate of an individual debtor was often inconsistent, incoherent, and unclear. The IRS asserted that under the Bankruptcy Act, the estate of an individual was taxable as an estate under I.R.C. § 641.²² The IRS drew no distinction among straight or liquidating proceedings under chapter 7, arrangements under chapter 11, and real property arrangements under chapter 12.²³

As part of the BTA, Congress enacted I.R.C. § 1398.²⁴ Section 1398 applies to any case under either chapter 7 or chapter 11 where the debtor is an individual.²⁵ As previously noted, the bankruptcy estate is treated as a separate taxable entity that may incur and should pay its own tax liabilities.²⁶ However, if the debtor's case is

²⁰ See I.R.C. § 1398(c) (1988).

²¹ Although the Bankruptcy Act of 1898 (as amended) in chapter X (reorganization), chapter XI (arrangements), chapter XII (real property arrangements by persons other than corporations), and chapter XIII (wage earner plans) contained tax provisions regarding the treatment of discharged income, it was silent as to the tax treatment of an individual's estate in bankruptcy.

²² Rev. Rul. 72-387, 1972-2 C.B. 632; Rev. Rul. 68-48, 1968-1 C.B. 301.

²³ See Rev. Rul. 68-48, 1968-1 C.B. 301; see generally Tatlock, 466-2d T.M., *Discharge of Indebtedness, Bankruptcy and Insolvency*, A-28 through A-30.

²⁴ Pub. L. No. 96-589, § 3(a)(1), 94 Stat. 3389, 3397-400.

²⁵ I.R.C. § 1398(b)(1). A partnership is not an individual for § 1398 purposes. See I.R.C. § 1398(b)(2). However, an individual debtor's interest in a partnership is treated in the same manner as other property of the debtor.

²⁶ See Blake D. Rubin, *Tax Planning for the Debtor in Bankruptcy*, 19 J. REAL EST. TAX'N 322, 326 (1992). Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual. I.R.C. § 1398(c)(1). The estate is taxed at the same rate as a married individual filing separately. I.R.C. § 1398(c)(2)-(3). The chapter 7 or 11 trustee is required to file any returns required by law and to pay any taxes due. See Paul B. Geilich, *Essentials of Bankruptcy Tax Law*, 66 AM. BANKR. L. J. 323, 323-24 (1992). For a thorough treatment of a bankruptcy trustee's tax reporting and compliance duties, see 1A COLLIER ON BANKRUPTCY ¶ 10.03 (Lawrence P. King et al. eds., 15th ed. 1993). The trustee must file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount. For 1997, the basic standard deduction for a married individual filing a separate income tax return is \$3,450. I.R.C. § 63(c) (1988) (taking into account adjustments for inflation). Even if the estate generates no income from sales or the operation of a business, the estate may be liable for taxes generated by COD income or by sale and exchange, for ex-

later dismissed, § 1398 no longer applies.²⁷ Consequently, a previously made short-year election²⁸ is extinguished and all taxes incurred by the estate pass back to the debtor.²⁹

The transfer of property pursuant to Bankruptcy Code § 41(a), other than by sale or exchange, from the debtor to the new § 1398 taxable entity, the bankruptcy estate, is not a taxable event.³⁰ The estate is treated as the debtor with respect to the transferred property. Thus, any gain or loss realized by the estate will have the same character as though the property were still held by the debtor.³¹ Furthermore, specific enumerated tax attributes of the debtor pass to the estate under § 1398(g).³² After the petition is filed, the debtor may not use any of the tax attributes that were transferred to the estate.³³ The premise behind the transfer of enumerated tax attributes is a recognition that since the estate is responsible for the

ample, a foreclosure on property that is property of the estate.

²⁷ I.R.C. § 1398(b)(1).

²⁸ See *id.* § 1398(d)(2). For an explanation of the short-year election, see *infra* Part I.A.2.

²⁹ See Geilich, *supra* note 26, at 329 (after dismissal of case debtor remains liable for taxes not paid by estate).

³⁰ See I.R.C. § 1398(f)(1); Rev. Rul. 90-25, 1990-1 C.B. 10; see Rubin, *supra* note 26, at 326 ("[T]ransfer of assets by the debtor to the estate . . . is not treated as a disposition for purposes of . . . assigning tax consequences to a disposition.").

³¹ I.R.C. § 1398(g)(6) (1988).

³² For a list of these attributes, see *supra* note 19.

³³ The tax attributes are determined as of the first day of the debtor's taxable year in which the bankruptcy case commences. For example, if the bankruptcy case commenced on September 15, 1994, the tax attributes would be determined as of January 1, 1994. Just as the transferor in an I.R.C. § 381 transaction no longer can use its tax attributes after reorganization, the debtor cannot use his or her attributes in determining the debtor's tax liability for periods commencing after the beginning of the bankruptcy case and before the case's completion. Thus, if in the first year after commencement of the bankruptcy case, the debtor has taxable income and the bankruptcy estate has a net operating loss, any losses or credit carryovers of the debtor for the period prior to the bankruptcy case cannot be used by the debtor. Nor can the debtor carry back any losses or unused credits arising from its activities after the bankruptcy case commenced to the debtor's prebankruptcy taxable years. See I.R.C. § 1398(j)(2)(B). In order that the trustee of the bankruptcy estate may determine tax attribute carryovers and be able to carry back losses and tax credits to prebankruptcy years of the debtor, he or she must have access to the prior income tax returns of the debtor. The I.R.C. provides that, upon written request, the income tax returns of the debtor for the taxable year in which the voluntary bankruptcy case was commenced and for preceding years are open to inspection by or disclosure to the trustee of a bankruptcy estate. See I.R.C. § 6103(e)(5)(A). A debtor is given similar access to the returns of the bankruptcy estate. In an involuntary bankruptcy case, however, disclosure to the trustee is not permitted until such time as an order for relief has been entered by the bankruptcy court, or unless the bankruptcy court finds that disclosure is appropriate for purposes of determining whether an order for relief should be entered. I.R.C. § 6103(e)(5)(C).

tax liability related to the debtor's assets, the bankruptcy estate should use the debtor's tax attributes to reduce this liability.³⁴

Section 1398 furthers the fresh start policy embodied in the Bankruptcy Code for individual debtors. The BTA Committee Reports recognized that the purpose of bankruptcy is to enable a debtor to begin anew his or her economic life.³⁵ Congress recognized that any expenses incurred by the estate should not burden a debtor's fresh start.³⁶ Consistent with this purpose is the § 1398 requirement that the income and losses of the bankruptcy estate as a separate taxable entity are computed separately from an individual debtor.³⁷ Furthermore, by making the short-year election, a debtor can shift at least part of his or her tax liability to the estate as a Bankruptcy Code § 507(a)(8) priority claim.³⁸ As a priority claim, the tax liability will be paid in full before any payments are received by the unsecured creditors.

Section 1398 further provides that a debtor's gross income for any taxable year does not include any item to the extent it is included in the estate's gross income.³⁹ Conversely, gross income of the estate does not include any amount received or accrued by a debtor before the commencement of the case.⁴⁰ Thus, § 1398 does not allow double counting of income or losses by both the estate and the debtor.

The determination whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor while the debtor was still engaged in the trade or business in which the debtor was engaged before the commencement of the case.⁴¹ It would appear that the same accounting method used for income should be used for deductions. Additionally, the estate is permitted to characterize some of its expenditures as trade or busi-

³⁴ See Lipton, *supra* note 19, at 12.

³⁵ S. REP. NO. 96-1035, at 9-10, *reprinted in* 1980 U.S.C.C.A.N. at 7024-25.

³⁶ See 11 U.S.C. § 503 (1994) (providing for payment of administrative expenses incurred by estate); *id.* § 507(a)(1) (ranking administrative expenses first in order of priority of claims against the estate).

³⁷ I.R.C. § 1398(e).

³⁸ For a detailed discussion of the short-year election, see *infra* Part I.A.2.

³⁹ See I.R.C. § 1398(e)(2).

⁴⁰ See *id.* § 1398(e)(1).

⁴¹ See *id.* § 1398(e)(3).

ness expenses that can be used to offset current income of the estate.⁴²

2. *The Short-Year Election: I.R.C. § 1398(d)*

Section 1398(d)(2) permits a debtor to make an election by which his or her taxable year is split into two taxable years.⁴³ This election is an important pre-bankruptcy planning tool by which to minimize a debtor's tax liability. By electing in a timely fashion, a debtor may divide the taxable year into two segments. The first taxable year ends on the day before the day the bankruptcy case was commenced.⁴⁴ The second taxable year begins on the bankruptcy commencement date.⁴⁵ The effect of the short-year election is to make prepetition taxes a § 507(a)(8) priority claim against the estate.

The most significant effect of the short-year election is that any tax liability for the first short-year becomes an allowed Bankruptcy Code § 507(a)(8) priority claim against the estate. Thus, a debtor may essentially force his or her unsecured creditors to pay all or part of the first short-year claims. Of course, if there are insufficient assets to pay the first short-year tax claims in full, they do survive the bankruptcy as nondischargeable claims.⁴⁶ If the debtor fails to make the election, then any tax liability for the entire year is not an allowable claim against the estate, even though the taxes relate to income earned before the commencement of the case.⁴⁷ Moreover, if a debtor makes the election, then a debtor's tax attributes as of the end of the first taxable year are transferred to the estate to be used by the estate to shelter income. If the election is not made, a debtor's tax attributes as of the end of the full taxable year after commencement carryover to the debtor's net taxable year.

⁴² Furthermore, administrative expenses and any fees are deductible by the estate to the extent not disallowed under another I.R.C. section. *See id.* § 1398(h)(1). If the administrative expenses cannot be used in the current year, then they may be carried back as much as three years and carried forward as much as seven years. *See* I.R.C. § 1398(h)(2).

⁴³ *See id.* § 1398(d)(2); Geilich, *supra* note 26, at 329-30; Rubin, *supra* note 26, at 327-28.

⁴⁴ *See id.* § 1398(d)(2)(A)(i).

⁴⁵ *See id.* § 1398(d)(2)(A)(ii).

⁴⁶ *See* 11 U.S.C. § 523(a)(1) (1994).

⁴⁷ *See* S. REP. NO. 96-1035, at 26 reprinted in 1980 U.S.C.C.A.N. at 7040-41; Rubin, *supra* note 26, at 327.

Presently, an individual debtor must elect to bifurcate his or her tax year to take advantage of the tax benefits in I.R.C. § 1398. This election must be made on or within the fifteenth day of the fourth full month from the commencement of the case.⁴⁸ Failure to make the election in a timely manner results in a waiver of the § 1398 tax benefits.⁴⁹ The overwhelming majority of cases benefit from the § 1398(d)(2) short-year election. Yet, many debtors fail to make a timely election because of miscalculations or incompetent counsel.

In the case of a termination of a debtor's estate, a transfer other than by sale or exchange of an asset from the estate back to a debtor is not a taxable event.⁵⁰ Similarly, upon termination of a debtor's estate, a debtor succeeds to the unused tax attributes earlier passed to the estate.⁵¹ The I.R.C., however, is silent on what constitutes a "termination" of a debtor's estate. Clearly, when the case is closed under the Bankruptcy Code, the debtor's estate has terminated. The question, however, is whether something short of a closing may constitute a termination.⁵² This question is explored in Part I.D. in the discussion of the tax consequences of bankruptcy abandonment.

⁴⁸ See I.R.C. § 1398(d)(2)(D) (election must be made prior to due date for filing first short-year return); *Id.* § 6072 (returns made on basis of fiscal year to be filed by 15th day of fourth month following close of fiscal year); Temp. Treas. Reg. § 301.9100-14T (as amended in 1992) (permitting elections up to 15th day of fourth full month following close of taxable year); see also Geilich, *supra* note 26, at 329.

⁴⁹ See *In re Turboff*, 93 B.R. 523, 526 (Bankr. S.D. Tex. 1988) (debtor's reasons for failure to timely make election are irrelevant to application of § 1398).

⁵⁰ See I.R.C. § 1398(f)(2).

⁵¹ See *id.* § 1398(i) (1988); see also Treas. Reg. §§ 1.1398-1(e), -2(e) (1995). The IRS has been justifiably criticized for its delay in adding tax attributes to the § 1398 list. One distinguished commentator has suggested adding investment interest deductions, suspended S corporation losses, and percentage depletion carryovers. See Lipton, *supra* note 19, at 13 (criticizing omission of certain tax attributes from § 1398(g), allowing them to remain with debtor).

⁵² See Jack F. Williams, *The Tax Consequences of Abandonment Under the Bankruptcy Code*, 67 TEMP. L. REV. 13, 45 (1994):

To equate "termination" under I.R.C. § 1398(f)(2) with "closing the case" under Bankruptcy Code § 350 is improper. Although closing a case is a form of termination, it does not exhaust all forms of termination. . . . [Congress] could have easily used the term "closing" in I.R.C. § 1398(f)(2). . . . Congress chose not to do so. . . .

Id.

3. *Transfer of Tax Attributes under I.R.C. § 1398(g) and (i)*

Under I.R.C. § 1398(g), the estate succeeds to certain enumerated tax attributes of the debtor upon commencement of the case.⁵³ One of the more controversial issues concerning § 1398 is whether the IRS should add more tax attributes to the list of those attributes that pass to the estate from the individual under § 1398(g). Commentators have suggested adding investment interest deductions, suspended S corporation losses, percentage depletion carryovers, and one-time exclusions from the sale of a residence.⁵⁴ In the rush to add tax attributes to § 1398(g), one must remain cognizant of the effect of adding to the list. Courts take the position that only those attributes in § 1398(g), or those added to the list by the IRS, pass to the estate.⁵⁵ Any remaining tax attributes remain with the debtor. The effect of adding tax attributes is to transfer those attributes from the debtor to the estate at the expense of the debtor's fresh start. Thus, attributes not listed in § 1398(g), like exempt property, help fuel a debtor's fresh start by shielding future income.

B. *Proposals to Conform State and Local Tax Treatment*

Because of the different tracks taken by the Bankruptcy Code regarding state and local taxes as opposed to the BTA regarding federal taxes, different treatment of individual debtor chapter 7 and 11 estates by federal, state, and local taxing authorities exists. Several examples will prove the point. The Bankruptcy Code provides that the estate is taxed like an "estate" for state and local tax purposes,⁵⁶ while the I.R.C. provides that the estate is taxed as an individual.⁵⁷ The Bankruptcy Code provides that for state and local tax purposes, any unused attributes pass back to the individual when the case is "closed,"⁵⁸ while for federal tax purposes, the at-

⁵³ For a list of these attributes, see *supra* note 19.

⁵⁴ See Lipton, *supra* note 19, at 13; see also Nancy R. Crow, *Tax Tips and Tricks in Workouts and Bankruptcy*, REAL ESTATE WORKOUTS AND BANKRUPTCY, 1993 (PLI Real Est. L. Practice Handbook Series No. N4-4574, 1993).

⁵⁵ See *Distasio v. United States*, 22 Cl. Ct. 36, 52 (1990); *Reuter v. Robertson (In re Reuter)*, 158 B.R. 163, 166-67 (N.D. Cal. 1993); *In re Mehr*, 153 B.R. 430, 436-38 (Bankr. D.N.J. 1993).

⁵⁶ 11 U.S.C. § 346(b)(2) (1994).

⁵⁷ See I.R.C. § 1398(c)(1).

⁵⁸ 11 U.S.C. § 346(i)(2).

tributes pass back at "termination,"⁵⁹ an undefined event. The Bankruptcy Code provides that if a short-year election is made, the first-short year ends on the date of the order for relief,⁶⁰ while under the I.R.C. the first-short year ends on the day before the commencement of the case.⁶¹ These unjustifiable differences in how an estate is treated by the different taxing regimes lead trustees to keep several books to accommodate the discrepancies. The NBRC has attacked these discrepancies head on.

The Advisory Committee found that there is no justification to maintain two systems in the Bankruptcy Code that provide for the transfer of different tax attributes based on federal versus state and local tax questions. There is also no justification for the period of a federal tax year or years being different from a state and local tax year or years. Consequently, the NBRC found that state and local tax treatment should conform to federal treatment.

Pursuant to that end, the NBRC unanimously adopted Proposal 217(a). Proposal 217(a) provides that the treatment of state and local taxes should conform to that of federal taxes regarding a debtor's tax year election⁶² and regarding those tax attributes that are transferred to the bankruptcy estate upon the filing of the petition in bankruptcy.⁶³

Proposals 426 and 702 list many of the specific proposed amendments to 11 U.S.C. §§ 346, 728, 1146, and 1231 sought to achieve this conformity. The proposed amendments to § 346 include:

1. Section 346(a) should be revised to provide that for state and local tax purposes, the provisions of the I.R.C. of 1986 are to be used:
 - (a) to determine when a separate estate is created as the result of the filing of a bankruptcy petition;
 - (b) to determine which attributes, that are available under state and local tax laws, are transferred to the estate on the filing of a bankruptcy petition and are transferred back to the individual on termination of the estate;
 - (c) to determine how income (to the extent provided for under state and local laws) from the estate (when created) is taxed or

⁵⁹ I.R.C. § 1398(i).

⁶⁰ See 11 U.S.C. §§ 728(a), 1146(a).

⁶¹ See I.R.C. § 1398(d)(2)(A).

⁶² See *id.* § 1398(d).

⁶³ See *id.* § 1398.

- deductions (to the extent provided for under state and local laws) are allowed;
- (d) to determine how income from the cancellation of debt is to be reported and how basis and other tax attributes (to the extent they are available under state law) are reduced; and
- (e) to determine the tax consequences of transfers between bankruptcy estate and individual debtor.
2. A new subsection should be added to provide that the applicable state and local tax rates (rather than federal rates) should be used to determine any tax liability or refund for state and local taxes.
3. A new subsection should be added to provide that it is the responsibility of the trustee to file federal, state and local tax returns (when required under applicable federal, state and local laws) for a separate estate created by the filing of a bankruptcy petition and for partnerships and corporations filing bankruptcy petitions.⁶⁴
4. Sections 346(b) through (e) and (g) through (j) should be repealed. (Section 1398 addresses the applicable issues.)
5. Section 346(f) should be modified to provide that the same provisions apply to federal tax law as well as deals with payment of withheld items.

The Advisory Committee also recommended and the NBRC proposed the repeal of §§ 728(a) through (d), 1146(a), and 1146(b) because of the new proposed provisions in § 346.⁶⁵ Finally, the NBRC proposed that § 1231 should be repealed outright. No separate taxable entity should be created in chapter 12.

In Proposal 435(a), the NBRC advocated an amendment to 11 U.S.C. § 346 and I.R.C. § 1398 to provide that for purposes of making the election to close the debtor's tax year, the time period for making such election commences on the date the order for relief is entered. This Proposal is a direct response to the situation created by the commencement of an involuntary bankruptcy case under chapter 7 or 11 of the Bankruptcy Code. Presently, I.R.C. § 1398(d)(2) links the period by which an election must be made to the date the petition in bankruptcy is filed. This poses no problem in a voluntary case commenced under 11 U.S.C. §§ 301-302 (the date the petition is filed is also the date an order for relief is en-

⁶⁴ See James L. Shepard & Jack F. Williams, *The Duty of a Trustee to File Returns on Behalf of the Debtor Partnership*, 3 AM. BANKR. INST. L. REV. 295 (1995).

⁶⁵ Section 1146(c) dealing with stamp and similar taxes is not addressed. Section 1146(d) dealing with the request to determine the tax impact of a plan is listed as a separate item and should not be dealt with in the NBRC Report.

tered in the bankruptcy case). However, in an involuntary case commenced under 11 U.S.C. § 303, the petition may be filed sometimes months before the order for relief is entered by the court. During the involuntary gap period, the debtor may continue to operate as though no bankruptcy case has been filed. There appears no reason to link the election under I.R.C. § 1398(d)(2) to the filing of the petition in these circumstances. Rather, the more appropriate event to link the beginning of the time period by which to make the (d)(2) election is the entry of the order for relief.

Through Proposal 437, the NBRC has addressed a practical problem of tax practice. The Proposal seeks to clarify I.R.C. § 1398 to provide that the bankruptcy estate's income is subject to the alternative minimum tax⁶⁶ and capital gains tax treatment⁶⁷ if otherwise applicable. Some confusion exists as to whether the bankruptcy estate is exempt from the Alternative Minimum Tax (AMT). Presently, some bankruptcy trustees take the position that the bankruptcy estate is exempt from the AMT but may employ capital gains treatment. The NBRC concluded that these inconsistent positions should be reconciled.

In Proposal 714, the NBRC sought to clarify a troubling application of I.R.C. § 1398. In particular, the NBRC proposed an amendment to I.R.C. § 1398(e)(3) to provide that a debtor should be treated as an employee of the bankruptcy estate as to payments by the estate of estate assets to the debtor for services performed. Under present law, it is unclear whether when the estate pays estate assets to the debtor those payments should be treated as ordinary income, 1099 income, or a distribution.⁶⁸ The Proposal provides that payments of estate assets to the debtor for services performed are to be treated as ordinary income, providing the estate with a corresponding deduction. It is not the intent of the NBRC to suggest that income from future services performed postpetition by the individual debtor is itself property of the estate.⁶⁹ Rather, this clarification speaks to property that is already property of the estate

⁶⁶ National Bankruptcy Review Commission, Proposal 437 (1997).

⁶⁷ National Bankruptcy Review Commission, Proposal 714 (1997).

⁶⁸ See Priv. Ltr. Rul. 87-28-056 (Apr. 15, 1987).

⁶⁹ See 11 U.S.C. § 541(a)(6) (1994). See Jack F. Williams, *The Federal Tax Consequences of Individual Debtor Chapter 11 Cases*, 46 S.C. L. Rev. 1203, 1214-30 (1995) (discussing several views on this issue).

that the estate seeks to use to pay the debtor for services performed.

C. *Tax Consequences of a Sale of the Debtor's Residence*

Two of the most controversial proposals involve the tax consequences of a sale of the debtor's residence in bankruptcy. Proposals 411 and 436(a) would make available the exclusion of gain recognition on sale of an individual debtor's residence by the trustee. Under current law as amended by the Taxpayer Relief Act of 1997, any individual can sell a personal residence and exclude \$250,000 (or \$500,000 if joint filers) of gain. The exclusion is not available to bankruptcy estates because a bankruptcy estate cannot have a personal residence.⁷⁰

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

Under current law, if the trustee sells the personal residence, the trustee is responsible for 100% of the tax due.⁷¹ This is true even if a substantial portion of the proceeds are distributed to the debtor in the form of an exemption. If uniform exemptions are adopted and if the exclusion rule is expanded and made available to bankruptcy estates, then the NBRC believes current law should not be changed and the homestead should not carry tax. However, if wide variations in the personal residence exemption remain in the

⁷⁰ See *Pergament v. United States* (*In re Barden*), 105 F.3d 821 (2d Cir. 1997).

⁷¹ See *In re Card*, 114 B.R. 226 (Bankr. N.D. Cal. 1990); *Waldschmidt v. I.R.S.* (*In re Lambdin*), 33 B.R. 11 (Bankr. M.D. Tenn. 1983).

Bankruptcy Code, the NBRC believes a pro rata share of the gain should be taxed to the debtor. The following ratio could be used: exemption paid to debtor is to amount realized from sale, as tax allocable to debtor is to total tax due on sale. Regardless, these proposals evidence a change in how the sale of personal residences should be treated in bankruptcy.

D. *Tax Treatment of Abandonment*

Finally, Proposal 425 deals with the tax treatment of property which is abandoned by an estate and reverts to the debtor. This issue was one of the most problematic because it pits fundamental and opposed bankruptcy policies against one another. Let us unpack in greater detail just what is at stake in the abandonment context.

The issue of the tax consequences of abandonment is limited to individual bankruptcies under chapter 7 or chapter 11 because I.R.C. § 1398 creates a separate entity for tax purposes only in those types of cases—the bankruptcy estate.⁷² The engine that drives the controversy is a debtor's desire to avoid the deferred taxes on overencumbered property with a low basis. Ideally, a debtor seeks to capture the consequences of foreclosure in the estate so that, pursuant to I.R.C. § 1398, the tax is a liability of the estate and not the debtor.

Neither the Bankruptcy Code nor the I.R.C. considers the federal tax implications of property abandoned by the estate before the close of the case.⁷³ The conflicting interests at stake, however, may be understood easily with an example. Assume that an individual debtor owns an office building subject to nonrecourse indebtedness of \$1 million. The fair market value of the property is \$500,000. The adjusted basis in the property has been reduced over time to \$250,000. The debtor has incurred net operating losses ("NOLs") and carryovers of \$250,000 related to the business property. If the lender forecloses on the property in full satisfaction of the debt, the foreclosure is a taxable event giving rise to a

⁷² See Priv. Ltr. Rul. 8928012 (Apr. 7, 1989) (separate entity rules do not apply to chapter 12 estates).

⁷³ Authorities often refer to this as "midstream" abandonment. Nonetheless, 11 U.S.C. § 346(g)(1)(B) does provide that for state and local tax purposes, a midstream abandonment is not a taxable event. See Mark Wallace, *Is a Midstream Abandonment of Property by a Bankruptcy Trustee Taxable to the Estate?*, 77 TAX'N 27 (1992).

gain or loss.⁷⁴ Here, the amount realized is a gain of \$750,000, the difference between the amount of nonrecourse debt and the adjusted basis.⁷⁵ Often, this gain represents nothing more than phantom income.⁷⁶

If the foreclosure occurs while the property is property of the estate, then the estate must recognize the gain and pay the tax. In fact, the tax claim is a §§ 503(b)(1)(B) and 507(a)(1) priority claim, which is paid in full ahead of all other claims (such as employee wages, pension plan claims, and tort claimants) except secured claims and other administration expense claims (the latter sharing *pro rata* with the tax claim).⁷⁷ If there are insufficient assets in the estate to pay the tax, the tax goes unpaid; the debtor is not liable for any deficiency. If the property is abandoned by the trustee before foreclosure, the debtor must recognize the gain and pay the tax even though the tax attributes associated with the property remain with the estate to shelter estate tax liability. The opportunity to jettison burdensome or inconsequential property in these circumstances helps the trustee in his or her efforts to maximize the recovery of the unsecured creditors but at the expense of the debtor.⁷⁸

Under present law, the model of bankruptcy abandonment embraced by most courts and the IRS is explicated by the Eighth Circuit in *In re Olson*.⁷⁹ In *Olson*, the court held that abandonment was not a taxable event, rejecting the fresh start argument embraced later by the court in *In re A.J. Lane & Co.*⁸⁰ After the debtors filed a chapter 7 petition, the chapter 7 trustee abandoned certain prop-

⁷⁴ See *Crane v. Commissioner*, 331 U.S. 1 (1946). Because the debt is nonrecourse, no cancellation of indebtedness income will arise when property is used to satisfy the debt in full. See *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983). Tufts treats the nonrecourse debtor as having sold the underlying collateral for the amount of the debt.

⁷⁵ See Tufts, 461 U.S. at 300 (the one-step analysis is used for nonrecourse debt satisfied by property; the fair market value of the property is irrelevant to the calculation of the amount realized).

⁷⁶ See Marc E. Grossberg, *Tax Consequences of Abandonment of An Asset of a Bankrupt Estate*, 50TH N.Y.U. INSTITUTE 12-1, 12-2 (1992).

⁷⁷ See generally Wallace, *supra* note 73.

⁷⁸ See Williams, *supra* note 52, at 28-40 (discussing the power, limitations, and effort of abandonment in bankruptcy).

⁷⁹ See *Samone v. Olson* (*In re Olson*) 930 F.2d 6 (8th Cir. 1991). The Olson model is based, in part, on the opinions in *Erickson v. United States* (*In re Bentley*), 916 F.2d 431 (8th Cir. 1990), and *In re McGowan*, 95 B.R. 104 (Bankr. N.D. Iowa 1988).

⁸⁰ 133 B.R. 264 (Bankr. D. Mass. 1991).

erty that was subsequently sold by a secured creditor under state foreclosure proceedings.⁸¹ The individual debtors hired an accountant to prepare federal and state income tax returns for the bankruptcy estate. These returns reported a gain realized from the sale of the property as a liability of the bankruptcy estate. The debtors claimed that the estate was nevertheless liable for the tax. The trustee did not authorize the debtors to prepare and file the tax returns for the estate.

The bankruptcy court in *Olson* observed that under I.R.C. § 1398(f)(2) a "transfer"⁸² includes the release of an estate's interest in property by abandonment.⁸³ Nevertheless, the bankruptcy court stopped short of accepting the debtors' argument based on an extension of the holding in *Yarbro v. Commissioner*, which would equate bankruptcy abandonment with tax or property abandonment.⁸⁴ In *Yarbro*, the taxpayer abandoned property under principles of property and tax law. Pursuant to those principles, applicable nonbankruptcy law abandonment operates as a sale or exchange and is effective in relinquishing title in the property.⁸⁵ The *Yarbro* court suggested that the finding of an exchange requires a giving, a receipt, and a nexus between the two.⁸⁶ The bankruptcy court in *Olson* found that the bankruptcy abandonment did not transfer title, did not relinquish title in the debtors, and did not result in a "receipt" required for an exchange.⁸⁷

The Eighth Circuit affirmed. In holding that no taxable event occurred when the trustee abandoned the property, the Eighth Circuit said that it could see no reason why abandonment during the administration of the case should have any different tax consequences than abandonment of property at the close of the bankruptcy case, which is not a taxable event pursuant to I.R.C. § 1398(f)(2).⁸⁸

⁸¹ The debtors did not object to the proposed abandonment. *In re Olson*, 100 B.R. at 460.

⁸² For the broad definition of transfer, see 11 U.S.C. § 161 (54) (1994).

⁸³ See *In re Olson*, 100 B.R. at 462.

⁸⁴ 737 F.2d 479 (5th Cir. 1984).

⁸⁵ See *id.* at 483-84.

⁸⁶ See *id.*

⁸⁷ See *In re Olson*, 100 B.R. at 462-63.

⁸⁸ This was a point the bankruptcy court also asserted in justifying its holding. See *id.* at 463.

The court commented that *In re Bentley*⁸⁹ involved a separate but related issue of the bankruptcy estate's liability for tax on gain from the sale of "non-abandoned property of the estate." The taxable event in *Bentley* that triggered a tax liability chargeable to the estate was the sale of the property. However, title to property abandoned by the trustee reverts to the debtor as though it never had been property of the estate, and a subsequent sale of abandoned property is not a taxable event for which the bankruptcy estate can be held liable. In *Olson*, the sale of the debtors' property occurred after the trustee abandoned the property. Therefore, the Eighth Circuit concluded that abandonment is not a taxable event that triggered a tax liability of the estate. The court concluded that property abandoned by the trustee reverts to the debtor and is treated as though the property never had been property of the estate.⁹⁰

The IRS's position is consistent with *Olson* and its progeny. In a private letter ruling, the IRS stated that abandonment during a bankruptcy case has no tax consequences to the estate because "termination of the estate" as it appears in I.R.C. § 1398(f)(2) includes termination of the estate's interest in property because of abandonment or exemption.⁹¹

The IRS issued final regulations under I.R.C. § 1398, which provide that a transfer of an interest in a passive activity loss or credit or an at risk activity loss or credit under I.R.C. § 465 to the debtor as exempt under Bankruptcy Code § 522 or if abandoned

⁸⁹ See *Erickson v. United States (In re Bentley)*, 916 F. 2d 431 (8th Cir. 1990). In *Bentley*, the Eighth Circuit held that the postpetition sale of corn by a chapter 7 trustee was a taxable event for which the bankruptcy estate is liable. In that case, the chapter 7 trustee sold the debtor's corn crop and thereafter, retained the sale proceeds for approximately 30 months before abandoning the proceeds to a secured creditor. The IRS then asserted a tax claim against the debtor's estate upon the grounds that the proceeds and profits from the sale of the corn constituted property of the estate pursuant to 11 U.S.C. § 541(a)(6) and pursuant to I.R.C. § 1398(e)(1) which provides that the gross income of the debtor's estate includes the gross income of the debtor to which the estate is entitled under the Bankruptcy Code.

⁹⁰ It appears the *Olson* court used these legal fictions regarding bankruptcy abandonment. For other cases holding abandonment in bankruptcy is not a taxable event, see *Mason v. Commissioner*, 646 F.2d 1309 (9th Cir. 1980); *In re Burpo*, 148 B.R. 918 (Bankr. W. D. Mo. 1993); *In re Nevin*, 135 B.R. 652 (Bankr. D. Hawaii 1991); *First Carolina Fin. Corp. v. Trustee (In re Caron)*, 50 B.R. 27 (Bankr. N. D. Ga. 1984); *In re Cruseturner*, 8 B.R. 581 (Bankr. D. Utah 1981). See also *In re Ayers*, 137 B.R. 397 (Bankr. D. Mont. 1992).

⁹¹ See Priv. Let. Rul. 90-17-075 (Jan. 31, 1990). The IRS reaffirmed its position in a subsequent letter ruling. See Priv. Let. Rul. 92-45023.

under Bankruptcy Code § 554 is a nontaxable transfer.⁹² In support of the regulations, the IRS cited *Olson*.

In summary, there are several persuasive reasons against taxable abandonment. First, abandonment is a disclaimer of interest by the estate, a release of the trustee's judicial lien; title and/or possession have remained all along in the debtor. Thus, there was no sale, exchange, or other disposition from the estate to the debtor. Second, the termination of the estate's interest in property through abandonment is congruous to "termination of the estate" in I.R.C. § 1398(f)(2). To equate "termination" under I.R.C. § 1398(f)(2) with "closing the case" under Bankruptcy Code § 350 is improper. Although closing a case is a form of termination, it does not exhaust all forms of termination. After all, if Congress sought to equate termination under I.R.C. § 1398(f)(2) with case closings under Bankruptcy Code § 350, it could have easily used the term "closing" in I.R.C. § 1398(f)(2) instead of the term "termination." Congress chose not to do this even though Bankruptcy Code § 350 predates I.R.C. § 1398. Third, requiring foreclosure of the property while part of the estate results in any tax liability being treated as an administrative expense claim that will be paid not only before the unsecured creditors, but also before *all priority claims* under Bankruptcy Code §§ 507(a)(2) through (a)(7).⁹³ Therefore, the other administrative expense claims like attorney's fees of the debtor and trustee, the trustee's fees, bankruptcy fees, other estate taxes, and certain postpetition tort claims, may not be paid in full; they must share *pro rata* with the current-year tax claim. Moreover, certain employee wage claims, pension fund claims, and consumer claims may never receive any distribution. Thus, delaying an inevitable property foreclosure through a dilatory bankruptcy filing may reward a debtor at the expense of all his or her creditors. This result makes no sense. Fourth, if there are insufficient assets in the estate to pay the tax liability, it will never be paid. The debtor does not owe the tax.⁹⁴ Fifth, it would appear that because abandonment is treated as a taxable event, the basis of the property

⁹² See Treas. Reg. §§ 1.1398-1, 1.1398-2. Carryover of Passive Activity Losses and Credits and At Risk Losses to Bankruptcy Estates of Individuals, 57 Fed. Reg. 53300 (proposed Nov. 9, 1992).

⁹³ Accord JAMES L. SHEPARD, THE TRUSTEE'S BANKRUPTCY TAX MANUAL 88 (1992) (noting that taxes incurred during estate administration are first priority expenses).

⁹⁴ See *id.*

might be "stepped up" to its fair market value on abandonment.⁹⁵ This may result in a windfall to the debtor especially where the foreclosure never occurs.⁹⁶ Sixth, as constructed, I.R.C. § 1398 provides a mechanism by which a debtor may shift at least part of any tax liability by allowing the taxable event to occur before filing the bankruptcy petition and electing to terminate the taxable year.⁹⁷ Thus, the symmetry of I.R.C. § 1398 between liability and attributes may be preserved and settlements between a debtor and creditor before a bankruptcy filing encouraged. Seventh, abandonment is not tantamount to foreclosure. Most often, the automatic stay will prevent the foreclosure at least until the creditor obtains relief from the stay. Meanwhile, the debtor could attempt to settle the matter in a manner minimizing the tax consequences. Finally, although important, a debtor's fresh start is not absolute. In fact, under the Bankruptcy Code it is a rebuttable presumption.⁹⁸ Congress has subordinated a debtor's fresh start to several tax claims, including current-year taxes.⁹⁹

The case that supports the proposition that the estate should shoulder the tax consequences associated with the abandonment and subsequent foreclosure of property is *In re A.J. Lane & Co.*¹⁰⁰ *Lane* stands in stark contrast to *Olson* and is often referred to as the minority view. In *Lane*, the court denied the chapter 11 trustee's motion to abandon property of the estate essentially because the debtor's tax liability would impair the debtor's fresh start. There, the trustee sought to abandon two properties and a partnership interest in a partnership that owned a third property under Bankruptcy Code § 554.¹⁰¹ The debtor objected, arguing that the substantive grounds in Bankruptcy Code § 554 for abandonment were not met and that the abandonment "would shift foreclosure tax consequences from the bankruptcy estate to the debtor and would destroy debtor's opportunity for a fresh start."¹⁰² Clearly, the trus-

⁹⁵ See Williams, *supra* note 52, at 46 (noting the unfairness of a "stepped-up" basis in these circumstances).

⁹⁶ I.R.C. § 1398(d)(2).

⁹⁷ See *id.* § 1398(d)(2) (1988).

⁹⁸ See 11 U.S.C. § 727(a) (1994).

⁹⁹ Accord *id.* §§ 507(a), 523(a)(1).

¹⁰⁰ 133 B.R. 264 (Bankr. D. Mass. 1991).

¹⁰¹ The motion was amended to exclude two of the properties that were subsequently refinanced. See *id.* at 266-67.

¹⁰² See *id.* at 266.

tee's sole reason for abandoning the property was to avoid the substantial income tax liability upon foreclosure on property that was of inconsequential value to the estate and burdensome to administer.¹⁰³ The facts show that the estate would have incurred a tax liability of about \$3.27 million on all the properties after using available loss carryovers.¹⁰⁴ The debtor's tax liability would have been about \$13 million. The debtor probably would not have been able to reduce taxable income by loss carryovers because those tax attributes were transferred to the estate pursuant to I.R.C. § 1398(g) and would not be transferred back to the debtor, if at all, until the estate terminated.¹⁰⁵

The *Lane* court gave three reasons for denying the trustee's motion to abandon the property.¹⁰⁶ First, because the facts suggested that foreclosure on the property was imminent, the *Court Holding*¹⁰⁷ doctrine persuaded the court to view the abandonment as a transfer from the estate directly to the secured lender with the debtor as a mere conduit. Second, the court held that abandonment itself is a taxable event, and that to shift the tax consequences to the debtor would destroy the symmetry of I.R.C. § 1398 that intends to link a tax liability with its tax attributes. Third, the court held that to allow a trustee to abandon overencumbered, low-basis

¹⁰³ See *id.*

¹⁰⁴ See generally Craig W. Friedrich, *Workouts*, 1992 J. REAL EST. TAX'N 94, 95.

¹⁰⁵ See I.R.C. § 1398(i) (1988). Thus, there was a substantial difference between the debtor's and the estate's tax liability—a \$10 million dollar swing.

¹⁰⁶ Aside from the reasons discussed in the text of the Article, the *Lane* court also questioned the merits of the abandonment. Although there existed no equity in the properties, the court observed there, nevertheless, might be value in the properties for the estate. The court based this observation on two points: First, the court suggested that Bankruptcy Code § 506(a), which defines a secured claim, applied and made it more likely than not that value existed for the estate; second, a trustee could use the cramdown provisions in chapter 11, see 11 U.S.C. § 1129(b) (1994), to retain the property for the benefit of the unsecured creditors. Aside from the time-honored rule that vests in a trustee broad discretion in deciding to abandon property under Bankruptcy Code § 554, the *Lane* court's observations made no sense. The secured creditors were seeking foreclosure. Section 506(a) would not help, especially when the property is not appreciating. See *Dewsnup v. Timm*, 502 U.S. 410 (1992). The secured claims completely enveloped the value of the properties. Finally, cramdown is not a panacea; it is also a lot easier to threaten than it is to successfully invoke under § 1129(b). Thus, the value to which the *Lane* court alluded was whimsical at best.

¹⁰⁷ See *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (the substance of a transaction viewed as a whole is controlling for tax purposes). In *Court Holding*, the Supreme Court articulated the "step-transaction" doctrine which requires that we collapse each separate step in the transaction into one transaction, thereby ensuring that the substance of the transaction controls over its form.

property would severely throttle the fresh start policy of the Bankruptcy Code.¹⁰⁸ Each rationale for the *Lane* court's holding is addressed in turn.

The court's application of the *Court Holding* doctrine is unpersuasive even on the particular facts in *Lane*.¹⁰⁹ In essence, the court concluded that the estate would abandon directly to the creditor with the debtor being a conduit. Foreclosure, however, does not necessarily follow abandonment. In fact, most often a creditor could not have foreclosed until it obtained relief from the stay under Bankruptcy Code § 362(d). Furthermore, operation of the stay as well as any applicable statutory periods under state law would have permitted a now more motivated debtor to workout the situation with the creditor.¹¹⁰ Finally, NBRC Commissioner Jim Shepard cleverly and convincingly dispatches with the *Lane* court's reliance on the *Court Holding* doctrine. Shepard shows that the *Lane* court in fact extracted the abandonment from the "complete" transaction.¹¹¹ According to Shepard, the beginning point in viewing the *Court Holding* doctrine should include the point at which the debtor decided to seek relief under the Bankruptcy Code. Thus, bankruptcy relief is but one step through which the property passed from the debtor to his or her creditors.¹¹² In other words, where we begin the step-transaction analysis under the *Court Holding* doctrine is not as self-evident as the *Lane* court appears to suggest.

The second reason the court offered is that abandonment is a taxable event, a position inconsistent with all prior authorities.¹¹³ Clearly, a foreclosure or a deed in lieu of foreclosure is a taxable

¹⁰⁸ For a case adopting the *Lane* analysis, see *In re Rubin*, 154 B.R. 897 (Bankr. D. Md. 1992).

¹⁰⁹ The *Court Holding* doctrine is always a facts and circumstances test. See Grossberg, *supra* note 76, at 12-8.

¹¹⁰ See *id.*

¹¹¹ See Shepard, *supra* note 93, at 72.

¹¹² See *id.* at 73. The *Lane* court's reliance on the *Court Holding* doctrine denies the essential factual foundation of *Court Holding*. In *Court Holding*, the Supreme Court characterized the transaction as an attempt to evade taxes through the negotiations between the parties. See *Court Holding*, 324 U.S. at 708. There a corporation was attempting "to transfer property already the subject of a sales transaction to another party for the sole purpose of having the other taxed on the sale." *Id.* In the abandonment context there is no attempt to evade taxes, merely an attempt to shift liability from the debtor to the estate.

¹¹³ See, e.g., *In re Olson*, 930 F.2d 6 (8th Cir. 1991) (abandonment is not a taxable event); *In re McGowan*, 95 B.R. 104 (Bankr. N.D. Iowa 1988).

event.¹¹⁴ But is abandonment a taxable event? I think not. As suggested here, if a debtor's interest has always remained in the property, albeit subordinated to the estate's interest until abandonment, there can be no sale, exchange, or disposition from the estate to the debtor upon abandonment—the debtor always owned the property. Moreover, a basic tenet of tax law is that form does control sometimes.¹¹⁵ If bankruptcy law treats abandoned property as if it had never been property of the estate, tax law should acquiesce. If abandoned property is not property of the estate, abandonment cannot be a taxable event.¹¹⁶

To justify the conclusion that abandonment is a taxable event, the court reviewed I.R.C. § 1398(f)(2). Section 1398(f)(2) provides that the transfer back to a debtor from the estate is not a disposition when the transfer occurs with the termination of the estate, unless by sale or exchange. In *Lane*, the court held that the abandonment was not tantamount to the termination of the estate as required by I.R.C. § 1398(f)(2) and must, therefore, be a taxable event. This justification was expressly rejected by the court in *In re McGowan*, which held that "termination of the estate" for purposes of I.R.C. § 1398(f)(2) included the termination of the estate's interest in property under Bankruptcy Code § 554(a).¹¹⁷

The confusion is created by using the word "terminate" in I.R.C. § 1398(f)(2). Does "terminate" mean the case is closed under Bankruptcy Code § 350? The IRS has taken such a position, I believe unjustifiably.¹¹⁸ Exactly when the estate terminates for I.R.C. § 1398 purposes remains unclear. For example, in a chapter 11 case, confirmation of the plan and postconfirmation operation even for a number of years is not congruous to closing the case under Bankruptcy Code § 350. Thus, something less than a Bankruptcy Code § 350 "closing" should satisfy the termination requirement under I.R.C. § 1398(f)(2). Therefore, the better argument is that once the estate's interest in the property termi-

¹¹⁴ See *Helvering v. Hammel*, 311 U.S. 504, 510 (1941)(recourse debt); *Helvering v. Nebraska Bridge Supply & Lumber Co.*, 312 U.S. 666 (1941)(nonrecourse debt).

¹¹⁵ See *Friedrich*, *supra* note 104, at 96 n. 21.

¹¹⁶ See *Shepard*, *supra* note 93, at 76.

¹¹⁷ *In re McGowan*, 95 B.R. at 108.

¹¹⁸ See *Shepard*, *supra* note 93, at 66 (citing IRS letter for that proposition and noting that position is inconsistent with *In re Sonner*, 53 B.R. 859 (Bankr. E.D. Va. 1985)(for tax purposes a chapter 11 case terminates when plan is confirmed)).

nates through abandonment, it terminates for I.R.C. § 1398(f)(2) purposes as to the property abandoned.¹¹⁹

The *Lane* court embraced a "strict" interpretation of I.R.C. § 1398(f)(2) in concluding that abandonment is a "sale or exchange" for tax purposes. This argument, however, proves too much. I.R.C. § 1398(f)(1), which governs the transfer of assets and liabilities from the debtor to the estate upon the filing of the bankruptcy petition, makes the transfer a nonrecognition event unless it is by "sale or exchange." According to the *Lane* court, if the transfer—if one even exists—from the estate to the debtor pursuant to abandonment under Bankruptcy Code § 554 is a "sale or exchange," then the transfer from the debtor to the estate also would be a "sale or exchange," taking that transfer out of nonrecognition status under I.R.C. § 1398(f)(1). Thus, the transfer by a debtor to the estate becomes a realization event. Reliance on *Lane* and the *Court Holding* doctrine suggests such an analysis.¹²⁰ Of course, this analysis eviscerates the essential purpose behind I.R.C. § 1398.

In suggesting that bankruptcy abandonment is a taxable event, the *Lane* court also relied on *Yarbro v. Commissioner*¹²¹ and similar tax court decisions. In *Yarbro*, the Fifth Circuit characterized abandonment under tax law as a sale or exchange, and, thus, a taxable event. In a situation where an abandonment under applicable non-bankruptcy law of over-encumbered property has occurred, a taxpayer receives a taxable benefit in the amount the secured debt is discharged.¹²² Therefore, applicable nonbankruptcy abandonment becomes an event no different in tax significance than a foreclosure sale or deed in lieu. Asserting that a trustee conveyed property and received a benefit in the form of relief from the secured debt, the court regarded the reasoning in *Yarbro* as "inescapable."

Where the *Lane* court erred was in equating tax abandonment with bankruptcy abandonment. The concept of abandonment for general tax purposes borrows heavily from the common law of property. In contrast, bankruptcy abandonment is a creature of statute; it has a specific meaning in bankruptcy law. Bankruptcy abandonment is a disclaimer by the estate of any interest in a specific asset of the debtor. Thus, the debtor's interest in the property

¹¹⁹ *Accord In re Olson*, 930 F.2d 6 (8th Cir. 1991).

¹²⁰ See Wallace, *supra* note 73, at 29-30.

¹²¹ 737 F.2d 479 (5th Cir.1984).

¹²² *Accord In re A.J. Lane & Co.*, 133 B.R. 264, 270 (Bankr. D. Mass. 1991).

remains undisturbed. To attempt to artificially weld the two distinct concepts of abandonment together would deny a rich and vibrant history associated with bankruptcy abandonment and the peculiar nature and purpose of this statutory beast.¹²³

A corollary to the second justification relied on by the court in *Lane* is that to allow the trustee to abandon the property would destroy the symmetry between I.R.C. §§ 1398(f)(2) and 1398(i).¹²⁴ This point, I believe, is the most persuasive offered by the court. Section 1398(f)(2) provides that the transfer of property (other than by sale or exchange) from the estate to the debtor upon termination of the estate is not a taxable event. Section 1398(i) provides that the debtor succeeds to the estate's tax attributes on termination of the estate. By allowing the trustee to abandon property, the estate may shift the associated tax liability to the debtor while retaining the enumerated tax attributes that could have been used by the debtor to offset the amount realized from the subsequent foreclosure. Of course, this is also the result where the property is deemed abandoned because it was not administered by the trustee.¹²⁵ Moreover, any tax attributes not used by the estate will ultimately revert back to the debtor upon termination of the estate and will be available to offset taxable income in the year of foreclosure, possibly ameliorating some of the harshness.¹²⁶ Nevertheless, fairness remains an important element of bankruptcy and tax policy. It is not fair to allow a trustee to abandon property from the estate on the verge of foreclosure while, at the same time, retain for the estate the tax attributes associated with the very property.

One distinguished commentator seizes upon the lack of symmetry as a justification for characterizing abandonment as a taxable event.¹²⁷ Although the *Olson* model suggests this lack of symmetry, that conclusion is not inescapable. One could persuasively argue that if abandonment is congruous to termination under I.R.C. § 1398(f)(2), it should also be congruous to termination under I.R.C. § 1398(i). Thus, when property is abandoned, the tax attributes listed in I.R.C. § 1398(g) should also remain with the property to the extent they can be reasonably traced. This is the position

¹²³ See Williams, *supra* note 52, at 28-40.

¹²⁴ See *id.* at 273.

¹²⁵ See 11 U.S.C. § 554(c) (1994).

¹²⁶ Accord Shepard, *supra* note 93, at 74-75.

¹²⁷ See Lipton, *supra* note 19, at 14-15.

taken by the IRS in regulations concerning passive activity and at risk losses and credits.¹²⁸

The third reason offered by the *Lane* court is that abandonment of the property would shift the tax liability from the estate to the debtor, thus depriving the debtor of a robust fresh start. This is true. If the estate abandoned the property in our example, and the lender subsequently foreclosed the lien, then the postpetition tax would not be dischargeable. The debtor owes the tax. Nevertheless, as discussed previously, many tax claims weaken the fresh start policy. Section 523(a)(1) recognizes that the debtor's fresh start is subordinate to the government's interest in collecting certain taxes for its operations, in particular taxes entitled to priority under Bankruptcy Code § 507(a).¹²⁹

One can sense the struggle engaged in by Bankruptcy Judge Queenan in *Lane*. The ten million dollar swing in tax liability between the estate and the debtor forced by the superficial peculiarities of I.R.C. §§ 1398(f)(2) and (i) is patently unfair. Bankruptcy is a never-ending contradiction between creditor debt-collection activity and a debtor's discharge. Based on the failure of Congress to foresee the vagaries associated with mid-stream abandonment, Judge Queenan struck the balance in favor of the debtor. He denied the proposed abandonment. Thus, in a very real sense, Judge Queenan fashioned another implied limitation to the power to abandon property under Bankruptcy Code § 554, a limitation found nowhere in the language of the statute itself. In that fashion, he has done nothing more than the Supreme Court did in *Midlantic*.¹³⁰ In fact, there are several similarities between the two opinions. First, both the fresh start policy limitation in *Lane* and the environmentally motivated limitation in *Midlantic* are not supported by the language of Bankruptcy Code § 554—they are implied limitations on the power of abandonment. Second, both of these countervailing policies are of great force—the former draws its force from the Bankruptcy Code, while the latter draws its force from state and federal environmental laws. Third, because the effect of both limitations is to force the estate to retain burdensome or income-

¹²⁸ See Treas. Regs. §§ 1.1398-1(d)(2), 1.1398-2(d)(2).

¹²⁹ See Shepard, *supra* note 93, at 75; see also *In re Hanna*, 872 F.2d 829, 831 (8th Cir. 1989).

¹³⁰ *National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 393 (1986).

draining assets, both limitations feed off the priority claimants and unsecured creditors of the estate, effectively forcing these creditor classes to subsidize taxing and environmental authorities while allowing a debtor to walk free from the obligations (at least in the tax context).

Lane generated more questions than it answered. If abandonment is a taxable event, what is the new basis in the property? If the lender never forecloses on the property, does the debtor receive a stepped-up basis in the property? If that be the case, is it not unfair? Would this not result in a windfall to the debtor? These important tax questions go unanswered in *Lane*.

The NBRC recognized that the majority rule under present law treats debtors unfairly. The debtor is taxed on disposition gain without the availability of nonexempt assets to pay the tax. The debtor does not get the benefit of NOLs and other tax attributes (other than passive losses and credits) to offset the gain and tax liability. Had property been disposed of prior to bankruptcy, the debtor would not have suffered either of these adverse consequences. The current minority rule¹³¹ treats the abandonment as a taxable event to the bankruptcy estate. This is unfair to taxing authorities. The tax is an administrative expense and is not a liability of the debtor. Therefore, the debtor has effectively turned a nondischargeable tax into a dischargeable tax. Had the debtor disposed of the property immediately prior to bankruptcy, the tax would have been a nondischargeable tax. The ABA Task Force Proposal as modified by the Advisory Committee and the NBRC is to treat abandonment as a disposition by the debtor immediately prior to bankruptcy upon the actual transfer by sale or exchange of the property. To the extent that the tax is not satisfied out of the bankruptcy estate, the debtor will be responsible. The debtor's personal tax liability, however, would not arise until there has been an actual disposition of the asset. This is fair to both the taxing authorities and the debtor. The taxing authority will be able to recover the tax liability from estate assets. If such assets are insufficient to pay the liability, the debtor will continue to be responsible. The debtor will have a nondischargeable tax liability, the same as if he had disposed of the asset immediately prior to bankruptcy, and will not have beaten the system by having the gain treated as an ad-

¹³¹ By minority rule, I mean the treatment articulated in *Lane*.

ministrative expense. The unsecured creditors are no worse off than under the current minority rule, but are worse off than under the current majority rule.¹³² Arguably, under the current minority rule they have received a windfall, since had the foreclosure taken place immediately prior to bankruptcy they would have stood in line behind the taxing authority before receiving any distribution. Thus, the NBRC adopted with modification the ABA Proposal on abandonment outlined above as endorsed by the Advisory Committee.

There were, however, contrary proposals debated by the Advisory Committee. One competing proposal merely codified the majority rule as outlined in *Olson*. If property with a tax basis lower than fair market value remains in the bankruptcy estate at the time of sale or foreclosure, the resulting capital gains taxes must be borne by the estate—that is, by unsecured creditors. If, on the other hand, the property is abandoned to the debtor before sale or foreclosure (and the abandonment is deemed not to be a taxable event), the debtor bears the adverse tax consequences upon the ultimate disposition of the property. The policy choice presented is between burdening a debtor's fresh start and burdening the estate/creditors with adverse tax consequences of property that has no value to the estate. Three primary reasons argue in favor of leaving the tax burdens with the debtor, rather than the estate.

First is the effect on creditors. It is the debtor who has enjoyed prepetition use of the property and any tax benefits associated with the property (depreciation deductions, often accelerated depreciation for tax shelter investments), so it is only fair that the debtor bear the tax consequences upon disposition, not creditors. To do otherwise would require creditors to bear the adverse tax consequences associated with the disposition of property that has conferred no benefit upon the estate. The estate would, in effect, subsidize the debtor as to a postbankruptcy taxable event.

Second is consistency with nontax burdens. If property is burdensome to the estate or of inconsequential value to the estate for nontax reasons (such as environmental problems, title problems, overencumbrance by liens), the ability of a trustee to abandon property and thereby protect the estate from postpetition liability is clear. Property that is burdensome because of adverse tax characteristics (typically, basis less than fair market value) should not be

¹³² By majority rule, I mean the treatment articulated in *Olson*.

excepted from the general rule. Debtors should not get a "tax fresh start" on such property at the expense of the creditors of the estate when debtors do not get an "environmental fresh start" or other type of fresh start for burdensome property.

Third is trustee liability. Trustees are increasingly being threatened with personal liability or claims against their bonds for failing to abandon property from the estate prior to foreclosure or other taxable event triggering capital gains tax liability for the estate. Statutorily clarifying the rule that abandonment of burdensome property shifts adverse tax consequences to the debtor from the estate will protect trustees, as well as creditors.

Another competing proposal, put forth by the author,¹³³ observes that the majority rule that bankruptcy abandonment is not of itself a taxable event states the correct view of the law. Thus, a foreclosure or similar disposition of an asset abandoned by the estate may result in a tax incurred by the individual debtor and not by the estate. However, under § 1398, tax attributes such as net operating loss carry forwards have been transferred to the estate and remain with the estate for estate use even where the tax attributes are directly related to the abandoned asset. This result is unfair to the debtor. Taking its cue from the Final Regulations under § 1398, this Proposal requires that any tax attributes that passed to the estate under § 1398 that may be reasonably traced to the abandoned property follow the property upon abandonment and may be used by the debtor. This tracing and allocation of tax attributes does not require mathematical exactitude; any reasonable method of allocation should suffice such as the allocation rules for NOLs in regard to spouses. Moreover, the overwhelming majority of these cases involve single-asset real estate debtors or partners of debtor real estate partnerships where often times one substantial asset comprises the entire estate, thus making allocation an easier task. Thus, the debtor does get the benefit of NOLs and other tax attributes to offset the gain and tax liability, and the Proposal alleviates the inequity associated with the majority rule.

In sum, reasonable minds could disagree on just which approach is the best. Both the Advisory Committee and the NBRC, with broad constituencies, favored the modified ABA model of

¹³³ For a detailed discussion of the proposal, see Williams, *supra* note 52, at 59-63.

abandonment. I cannot conclude that the adoption of that model is unjustified.

II. TAX RETURN FILING REQUIREMENTS

Under the I.R.C., an individual earning a gross income that equals or exceeds the exemption amount and basic deduction generally must file a federal income tax return.¹³⁴ Many states that tax individual income also require that an individual that must file a federal income tax return must also file a state income tax return. Experience and anecdotal evidence suggest that the rate of nonfilers in bankruptcy is high. In studies on chapter 13 cases reported by James D. Newbold, Special Assistant Attorney General of Illinois, in the *American Bankruptcy Institute Journal*,¹³⁵ a nonfiling rate of 39.5% to 42.3% was discovered in the Northern District of Illinois.¹³⁶

A. Chapter 13 Tax Return Filing Requirement

The NBRC has adopted the recommendation of the Advisory Committee on filing return requirements in chapter 13 cases. Assistant Attorney General Mark Browning of Texas (with help from Steve Csontos of the United States Justice Department) essentially proposed the framework and drafted what was to become Track No. 441.¹³⁷ The Proposal contains several requirements that will dramatically change the landscape of chapter 13 practice if adopted by Congress.

First, as a prerequisite for confirming a chapter 13 plan, a debtor must file tax returns for all tax periods ending within six years prior to the petition date.¹³⁸ The requirement for six years of returns reflects a compromise on the part of tax authorities, who generally oppose discharge in bankruptcy for *any* period for which a

¹³⁴ See I.R.C. § 6012 (1988); see also *id.* § 63 (standard deduction amounts listed); see *id.* § 151 (exemption amount listed).

¹³⁵ See 16 AM. BANKR. INST. J. 12, 12 (October 1997).

¹³⁶ See *id.*

¹³⁷ See TAC Report, *supra* note 3, at 32-38.

¹³⁸ A debtor's written consent to a substitute for return prepared by a tax authority or written stipulation to a judgment in a nonbankruptcy tax tribunal will constitute a "filed return" for purposes of this proposal. See *id.* at 114-15.

debtor/taxpayer has failed to file returns.¹³⁹ Although any time period is arbitrary, a specific requirement that embraces a reasonable term of years is far superior to an ambiguous standard.

Second, a debtor must properly file prepetition tax returns with the appropriate tax authorities at least one day prior to the conclusion of the first meeting of creditors.¹⁴⁰ A debtor will evidence the satisfaction of this requirement by filing with the court a statement certifying, under penalty of perjury, that all required tax returns for the relevant periods have been properly filed with the appropriate tax authorities. The chapter 13 trustee may require that a debtor submit copies of returns to the trustee. The requirement that returns be filed at least one day before the completion of the § 341 meeting allows a chapter 13 trustee to ask meaningfully whether the debtor's plan provides for payment of the amount of taxes reflected in the filed returns. If the proposed chapter 13 plan does not provide for payment matching the tax shown on the filed returns, then presumably the trustee would not recommend confirmation.

Third, if a debtor has not filed tax returns by the date on which the first meeting of creditors commences, a chapter 13 trustee may continue the first meeting to allow additional time to file returns. Under the Proposal, a chapter 13 trustee may extend the time no longer than (1) 120 days from the order for relief for returns that are past due as of the order for relief; or (2) for returns not past due as of the order for relief date, the latter of (i) 120 days from the petition date or (ii) the automatic extension date for filing a return under applicable tax law. This provision in the Proposal also reflects a compromise on the part of tax authorities and debtors. A stricter standard requiring tax returns be current as of the date of the order for relief might delay or deny bankruptcy relief to debtors who need it for nontax reasons (pending home foreclosure or car repossession, for example). A looser standard allowing returns to be filed up until the government claim bar date (180 days from petition date) would put large-volume tax authorities under an unreal-

¹³⁹ In response to concerns expressed by debtor and trustee representatives at the NBRC sessions in Santa Fe and San Diego that requiring an unlimited number of returns to be filed would discourage bankruptcy nonfilers from "re-entering the system," tax authority representatives indicated a willingness to compromise on a limited number of years if return filing was an absolute prerequisite for confirmation and thus, indirectly, discharge. Six years was generally agreed to be a reasonable period for requiring returns to be filed.

¹⁴⁰ See 11 U.S.C. § 341 (1994).

istically short deadline to file or amend claims and would create havoc or delays in the confirmation process. The anticipated procedure in cases would be that the trustee would determine at the initial § 341 meeting if a debtor has filed necessary tax returns. If not, but the trustee is satisfied that the debtor is making a reasonable effort to prepare and file returns, the trustee may continue the § 341 meeting for up to 120 days or until the last available extension for a prepetition return.¹⁴¹

Fourth, a debtor's failure to file timely tax returns by the above deadline for prepetition returns, or by due dates (including extensions pursuant to applicable tax laws) for postpetition returns, shall constitute cause for conversion or dismissal under § 1307(c).¹⁴² Rather than automatic dismissal for failure to file tax returns (a position tax authorities had originally advocated), the Proposal adds the failure to file returns to the other "causes" for dismissal or conversion contained in § 1307. Most courts now dismiss or convert cases when debtors have failed to file tax returns. That practice would be codified.

Fifth, a court may extend the return filing deadline for good cause including circumstances for which the debtor should not justly be held accountable. Dismissal or conversion would be automatic if the extended deadline was missed. This provision of the Proposal provides a "safety valve" in case a debtor has made a good faith effort to get returns prepared and filed, but for unanticipated reasons beyond the debtor's control (delay in receiving necessary information from tax authorities or incapacitating injury, for example) has been unable to do so. Again, this provision is a compromise on the part of tax authorities, whose initial preference was for an absolute cutoff point for filing returns.

Sixth, the deadline for objecting to plan confirmation shall be at least sixty days after prepetition tax returns are filed with the tax authorities. This provision of the Proposal addresses two issues: (1) how long should tax authorities be given to act upon filed returns; and (2) can confirmation of a chapter 13 plan proceed before priority tax debts have been determined. From the perspective of debt-

¹⁴¹ For example, a chapter 13 debtor filing a bankruptcy petition on January 1, 1997 would have the option under tax law of obtaining an extension through August 15, 1997 to file a 1996 income tax return. Extensions for earlier years would have expired by the petition date.

¹⁴² See 11 U.S.C. § 1307.

ors and other creditors, problems are created when the entire bankruptcy process must be put on hold while tax authorities determine what they are owed. The proposed sixty day period would force tax authorities to act in a reasonably prompt manner to protect their claims at confirmation. From the tax authorities' perspective, it is a considerable waste of time and effort either to estimate (and later amend) claims for tax periods for which no returns have been filed or to file a "place-holding" confirmation objection until the extent of the claim is determined. This provision attempts to strike a reasonable balance: debtors must file returns before confirmation can proceed, but the confirmation process can proceed fairly quickly after returns are filed.

This provision also seeks to terminate the misguided practice of confirming chapter 13 plans before the amount of priority tax debt is known.¹⁴³ The districts that permit such practice create a number of complex legal and practical issues. For example, how can a court fairly assess feasibility of a plan under § 1325(a)(6) if the amount of priority tax debt that must be paid in full cannot be determined? Taking a debtor's word for the amount owed, or simply ignoring the issue, is contrary to reason and common sense. From a procedural standpoint, confirmation of a plan before tax debts are determinable results in a "preliminary confirmation order." Are such orders appealable as final orders? Do they have *res judicata* effect on tax creditors, or on other creditors if modification is required in the future? Who is responsible for undoing or modifying the preliminary confirmation order after tax claims are filed? What is the standard of proof when seeking to overturn or vacate such orders? Who has the burden of proof? These unnecessary and difficult questions are eliminated under this Proposal. This provision takes debtors who are delinquent in filing prepetition returns off the "confirmation fast track" as long as the delinquency continues. Debtors who are current on their returns, under this Proposal, remain on the fast track in jurisdictions that do early confirmations. Disparate treatment does not seem out of line in this context because the provision rewards debtors who have complied with the tax laws (or who promptly cure noncompliance) and delays those who are delinquent. From a procedural and policy standpoint, more time *should* be taken to deal with debtors who are

¹⁴³ For the requirements of chapter 13 confirmation, see 11 U.S.C. § 1325.

delinquent filers. Failure to file tax returns is often indicative of other financial problems that need to be addressed, and the Proposal above would serve to flag potential problem cases needing extra attention, appropriately taking them off the confirmation "fast track."

Seventh, a debtor may not file an objection to a proof of claim¹⁴⁴ for a tax required to be reported on a return unless the debtor has filed a return for that tax. This is so basic that it needs no further explanation. Practice in some districts to the contrary is fundamentally unfair.

Finally, the Proposal would modify the special governmental bar date¹⁴⁵ for tax claims only to allow tax authorities sixty days from the filing of tax returns by debtors to file proofs of claim; provided that the modification will not have the effect of shortening the governmental bar date in any case. As noted above, the practice of filing estimated "place holding" proofs of claim for periods for which no returns have been filed creates a number of problems for tax authorities, debtors, and courts. Tax authorities must spend considerable time and effort preparing debtor-specific estimated proofs of claim, which is a monumental task given the volume of chapter 13 filings. The task is unnecessary if debtors comply with filing obligations applicable to nondebtors, and the effort is simply wasted if returns are later filed and processed into amended proofs of claim, thereby mooting the estimated claims. Further, tax authorities are in a "no-win" situation on estimated proofs of claim. Some courts have directed tax authorities to file claims labeled as estimates to protect their position, while other courts have sanctioned tax authorities for filing incorrect estimates. Debtors resent estimated proofs of claim that may overestimate the amount of taxes owed, and "burden of proof" procedural battles often erupt in such cases. Courts are faced with hearing claim disputes with a dearth of evidence because debtors have not filed returns. To avoid such difficulties, the Proposal contains a simple rule: returns must be brought current before debtors can proceed with claim objections.¹⁴⁶ Consistent with the intent to eliminate "place-holding" estimated proofs of claim, adjustment to the gov-

¹⁴⁴ See 11 U.S.C. § 502(b).

¹⁴⁵ See *id.* § 502(b)(9).

¹⁴⁶ This requirement would not prevent debtors from objecting to audit claims covering periods for which returns have been filed.

ernmental claims bar date is proposed allowing the filing of tax claims based upon the returns filed by debtors rather than upon estimates.¹⁴⁷

This Proposal represented months of heated debate and negotiation among members of the Advisory Committee. The Proposal went through several iterations before it was approved for recommendation by the Advisory Committee and adopted by the NBRC. If enacted, this Proposal will have far-reaching effect, changing the face of chapter 13 practice in many districts.

B. *Special Court Powers Where Debtor Fails to File Returns*

The NBRC also embraced Proposal 700, authorizing a court to dismiss and enjoin the filing of a subsequent case where a court determines that a chapter 13 debtor is abusing the bankruptcy process. Presently, there is a wide variance among districts as to whether serial filing is a problem. The particular focus of tax authorities is on chapter 13 repeat filers, although the problem can also occasionally arise in individuals' chapter 11 cases. In some districts, effective monitoring of "serial filers" by chapter 13 trustees and/or courts limits the numbers of such cases to minimal levels. In other districts, it is not uncommon for debtors, particularly small business debtors, to file four, five, or more cases in a five to ten year span, incurring substantial new tax debts all the while and without a material change in the debtors' circumstances. Such cases expend an inordinate amount of resources of chapter 13 trustees, the court system and tax creditors. Some serial filers essentially use the bankruptcy system as a revolving door through which to duck when tax authorities undertake collection efforts. Many "serial filers" have no real hope of ever repaying constantly increasing tax debts in full, as required by §§ 1322(a)(2) and 1129(a)(9). Bankruptcy Judge Polly Higdon of Oregon presented data substantiating this problem at the September 1996 Commission meeting in Santa Fe.

The present Bankruptcy Code provides only limited tools to creditors, trustees and judges to deal with abusive serial filers.

¹⁴⁷ "Filing of returns" presumes returns are *properly* filed – that is, with the right agency, at the right address, with the right tax identification numbers, with the requisite signatures, and subject to penalties of perjury/false filing. If not taken up in the context of discussion on "notice rules," such presumptions may need to be added to this proposal. "Returns" for purposes of this section would include substitutes for return that the debtor has signed and non-bankruptcy tax tribunal stipulations of liability.

Bankruptcy Code § 109(g) prevents serial filings only if: (1) a prior case was dismissed by the court for "willful failure" to abide by court orders or to appear before the court in prosecution of the case; or (2) the debtor voluntarily dismissed the case after a creditor's filing of a request for stay relief. Although the case law is split, some courts have held that the limited circumstances described in § 109(e) constitute the *only* grounds for dismissing a case with prejudice.¹⁴⁸ Proposal 700 amends §§ 1307 and 1112 to give bankruptcy judges discretion to dismiss cases with prejudice to refiling under chapter 13 or 11 for a period determined by the court.¹⁴⁹ A nonexclusive laundry list of relevant factors for courts to consider in dismissing with or without prejudice would give courts some guidance, without compelling a result in a particular case. The factors to be considered include: (1) the number of prior cases filed by the debtor, (2) the extent to which new debts to creditors, including tax debts, have accrued during the present case or prior cases, (3) the good faith, or lack thereof, of the debtor in pursuing plan confirmation and plan compliance in the pending case or prior cases, or (4) the reasons why successful completion of prior cases did not occur.

This Proposal provides courts with the flexibility to keep the bankruptcy system open to the "honest, but unfortunate" debtor who suffers job loss, personal injury, or some unforeseen contin-

¹⁴⁸ See *In re Merrill*, 192 B.R. 245, 252 (Bankr. D. Colo. 1995) ("Although abuse of the bankruptcy system and creditors by frequent or repeat filers is a well-known problem, Congress has not chosen to combat the problem by authorizing courts to bar abusive debtors from future bankruptcy relief."). Debtor had filed 7 bankruptcy cases (6 chapter 13's and 1 chapter 7) between 1987 and 1995, incurring substantial additional tax liability during that time. Case dismissed on motion of state tax authority, but without prejudice to refiling. See also *In re Jones*, 192 B.R. 289 (Bankr. N.D. Ga. 1996) (quoting *Florida Hosp. Trust Fund v. Commissioner*, 71 F.3d 808, 813 (11th Cir. 1996) ("The Court is persuaded that it cannot deny a debtor future access to bankruptcy protection except as provided by the Bankruptcy Code. . . . The Court understands the frustration of the IRS caused by repetitive filings. But, it is not the role or power of the judiciary to remedy a legislative statute by opinion. Congress easily can change the statute whenever it is so inclined."). The Debtor was an optometrist who had filed three cases in three years, accumulating more than \$277,000 of tax debt to the IRS.

¹⁴⁹ One way to address the problem of abusive serial filers would be to provide for dismissal with prejudice if a certain number of cases have been unsuccessfully attempted within a certain period of time (no more than three petitions within a five year period). The primary downside to such arbitrary limits is obvious, however. Not all serial filings are abusive. A debtor legitimately pursuing chapter 13 rehabilitation may lose his or her job, go through a divorce, incur a serious personal injury, or face similar uncontrollable circumstances that may require starting over to achieve a discharge. To avoid inflexibility, but to provide courts the ability to police abusive filers, a less draconian remedy is possible.

gency, but would at the same time allow courts to exclude from the bankruptcy system for a period of time the "revolving door" debtors.

The present American tax system rests on the principle of voluntary compliance. One of the central requirements to the voluntary system is the filing and reporting of income. Substantial debtor noncompliance with filing requirements thwarts the system and calls the integrity of the tax process into question.

III. PRIORITY OF LIENS AND CLAIMS

In this section, I discuss the NBRC proposals on the priority and treatment of tax liens and tax claims. I begin with a short introduction to tax liens and claims in bankruptcy and then turn to the specific modifications endorsed by the NBRC.

A. *The Treatment of Tax Liens and Claims in Bankruptcy*

The Bankruptcy Code establishes certain rules and priorities with respect to the allowance, treatment, and satisfaction of claims. One of the major modifications of the Bankruptcy Code is the focus on and characterization of claims. State law generally focuses on the status of creditors as secured or unsecured. The Bankruptcy Code, however, focuses on the status of claims. Thus a creditor is said to have a fully secured claim, an undersecured claim, an oversecured claim, or an unsecured claim. For example, a creditor who is owed \$100,000 and possesses a lien in collateral worth \$75,000 possesses a secured claim for \$75,000 (the value of the underlying collateral) and an unsecured claim for \$25,000 (the deficiency).¹⁵⁰

1. *Secured Claims*

Although not expressly stated in the Bankruptcy Code, holders of secured claims are generally entitled to the collateral or to the value of the collateral securing their claims.¹⁵¹ Generally, the chapter 7 trustee will surrender the collateral under § 725, abandon the collateral under § 554, sell the collateral and turn over the proceeds

¹⁵⁰ Accord 11 U.S.C. § 506(a).

¹⁵¹ See *id.* § 725.

under § 363, or allow the creditor to seek relief from the automatic stay under § 362(d) and repossess and foreclose on the collateral.

A secured claim is allowed for the full amount of the claim, including postpetition interest on the claim and possible attorneys' fees to the extent, but not in excess, of the value of the collateral securing the claim, but only if the creditor is oversecured.¹⁵² Thus, if a creditor is undersecured, it will not be entitled to attorneys' fees or postpetition interest as part of its allowable secured claim.

Like all liens in bankruptcy, the federal tax lien in bankruptcy is a secured claim to the extent of the value of the collateral and is an unsecured claim for the debt exceeding the collateral value.¹⁵³ With a few notable exceptions, the federal tax lien is treated just like any other secured claim. Taxing authorities possess certain rights, such as the right of adequate protection under § 361, enjoyed by generally all secured claims.

The federal tax lien arises upon assessment; however, the tax lien is a secret lien. The assessment lien is good against the taxpayer and encumbers all of the property of the taxpayer, even property exempt under state law and federal tax law.¹⁵⁴ However, the federal tax lien that arises upon assessment does not rank certain identified parties, including judicial lien creditors. Thus, under § 544(a)(1) of the Bankruptcy Code, a trustee who is vested with the status of a hypothetical judicial lien creditor as of the filing of the petition in bankruptcy or, under § 544(a)(3), who is vested with the rights of a hypothetical bona fide purchaser for value of real property, will rank the unfiled tax lien.

2. *Avoidance of Tax Lien*

One noncontroversial Proposal adopted by the NBRC is to amend 11 U.S.C. § 545(2) to overrule cases that have penalized the government due to certain benefits for purchasers provided for in the lien provisions of the I.R.C. Section 6323 of the I.R.C. provides protection to certain purchasers of property even after a notice of federal tax lien has been filed in accordance with federal tax law. I.R.C. § 6323 defines "purchaser" as a person who, for adequate

¹⁵² See *id.* § 506(b); see also *Ron Pair v. United States*, 489 U.S. 235 (1989).

¹⁵³ See *id.* § 506(a).

¹⁵⁴ Recall that the exempt property under federal tax law is not exempt from the lien, it is just exempt from levy and distraint.

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

3. *Subordination of Tax Liens Under § 724*

Chapter 7 of the Bankruptcy Code sets forth special rules concerning the liquidation of a debtor's estate and the treatment of certain tax liens. Specifically, § 724 deals with the treatment of certain liens in a chapter 7 liquidation case, including certain penalties and tax claims.¹⁵⁵ Section 724 requires the partial subordination of the tax lien to certain priority claims and the complete subordination of tax penalties secured by that lien whether the lien encumbers personal or real property.

Under § 724(a), the trustee in a chapter 7 liquidation case "may avoid a lien that secures a claim of a kind specified in § 726(a)(4) of this title."¹⁵⁶ The lien referred to in § 726(a)(4) is a lien that secures a fine, penalty, forfeiture, or punitive damages to the extent such is not compensation for actual pecuniary loss.¹⁵⁷ Accordingly, § 724(a) protects unsecured creditors from the

¹⁵⁵ 11 U.S.C. § 724.

¹⁵⁶ See *id.* § 724(a).

¹⁵⁷ See *id.* § 726(a)(4).

debtor's wrongdoing by subordinating claims for such penalties to the claims of other unsecured creditors in a chapter 7 case.¹⁵⁸

The treatment of certain secured tax claims in a chapter 7 liquidation case is governed by § 724(b).¹⁵⁹ Under this subsection, secured tax liens on both real and personal property are subordinated to the payment of specific identified priority claims.¹⁶⁰ Section 724(b) provides a specific methodology for partial subordination. The property or the proceeds of the property that are subject to the valid tax lien are distributed pursuant to § 724(b) in the following manner:

First, lien claims that are senior to the tax lien are satisfied in full pursuant to § 724(b)(1). Moreover, these senior liens cannot be subject to avoidance under some avoidance power.

Second, pursuant to § 724(b)(2), a distribution is made to the priority claims under § 507(a)(1) through (a)(7) to the extent of the amount of the tax lien. In other words, an amount equal to the secured tax claims should be set aside and used to pay the priority claims. In other words, the taxing authority is fronting the costs of the bankruptcy. These priority claims may be paid only to the extent of the claim secured by the tax lien.

Third, § 724(b)(3) provides for a distribution to the secured tax claimant. The taxing authority will receive proceeds to the extent

¹⁵⁸ H.R. REP. NO. 595, 95th Cong., 1st Sess. 382 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 96 (1978).

¹⁵⁹ 11 U.S.C. § 724(b), which reads as follows:

Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title and that secures an allowed claim for taxes, or proceeds of such property, shall be distributed—

(1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is senior to such tax lien;

(2) second, to claims specified in sections 507(a)(1), 507(a)(2), 507(a)(3), 507(a)(4), and 507(a)(5) of this title, to the extent of the amount of such allowed tax claim that is secured by such tax lien;

(3) third, to the holder of such tax lien, to any extent that such holder's allowed claim that is secured by such tax lien exceeds any amount distributed under paragraph (2) of this subsection;

(4) fourth, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is junior to such tax lien;

(5) fifth, to the holder of such tax lien, to the extent that such holder's allowed claim secured by such tax lien is not paid under paragraph (3) of this subsection; and

(6) sixth, to the estate.

¹⁶⁰ 124 CONG. REC. H11114 (daily ed. Sept. 28, 1978); S. 17431 (daily ed. Oct. 6, 1978).

the amount of the secured tax claim exceeds the amount distributed to the priority claimants, that is, the residual, if any.

Fourth, secured claims that are junior to the tax lien are paid pursuant to § 724(b)(4).

Fifth, the secured tax claimant is essentially reimbursed for the fronted cost, that is, the costs of the administrative expense and priority claims paid under § 724(b)(2).

Sixth, any remaining property is distributed to the estate pursuant to § 724(b)(6).¹⁶¹

4. *NBRC Proposal on § 724*

One topic that generated lively debate among members of the Advisory Committee and the NBRC is the subordination of tax liens under § 724 in chapter 7 cases to certain priority claims, including the administrative expenses, priority wage claims, and priority employee plan contributions claims. Ultimately, the Advisory Committee voted six to four to recommend to the NBRC the repeal of § 724(b) outright. The four dissenting votes were cast by the four private bar representatives who were vigorously opposed to any modification to § 724(b). In the end, the NBRC rejected the recommendation of the Advisory Committee and adopted an exception and limitation on the subordination of tax liens in chapter 7.

However, on September 4, 1997, Senator Chuck Grassley (Iowa) preempted the NBRC by introducing S.1149, "The Investment in Education Act of 1997." One provision of the bill seeks significant changes to 11 U.S.C. § 724(b).

The Grassley Proposal to amend § 724(b) has garnered recent steam because of a similar proposal adopted by the NBRC¹⁶² and an outpouring of support by local tax authorities.¹⁶³ Short of an outright repeal of § 724(b), both S.1149 and the NBRC Proposal would continue the effect of a partial subordination of a tax lien to certain designated priority claims,¹⁶⁴ but exempt from subordina-

¹⁶¹ For an illustration of this methodology, see MCQUEEN & WILLIAMS, *supra* note 19, §§ 9:38-9:42.

¹⁶² NBRC Government Working Group Proposal No. 2: § 724(b).

¹⁶³ In my capacity as Chair of the Tax Advisory Committee, I received over fifty letters, calls, faxes, and e-mail messages from local tax authorities and school boards (including my own high school superintendent) seeking modification of § 724(b).

¹⁶⁴ The priority claims include those identified at 11 U.S.C. § 507(a)(1) through (a)(7). In particular, administrative expense claims can rank the otherwise unavoidable tax lien in accordance with the rules in § 724(b).

tion a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the estate.

The private bar has generally sought the retention or modest modification of § 724(b). According to this view, under bankruptcy law, there is a long-standing policy beginning with the 1938 Chandler Act amendments that has subordinated tax liens to administrative expenses. On each subsequent occasion in which Congress has revisited the issue, it has broadened the extent of such subordination. If the bankruptcy system is to be viable, all administrative expenses must be paid. The Bankruptcy Code creates its own set of priorities, in which administrative expenses are generally superior to tax claims. In chapter 7 cases, this fundamental structure should not be nullified because a state legislative body gives itself a tax lien that results in circumventing the system of priorities created by the federal Bankruptcy Code.

Nonetheless, the argument against partial subordination of tax liens under § 724(b) is persuasive. The section is complicated and obscure, making it difficult to understand and apply. Thus, it is applied inconsistently or not at all, creating disparate results in different districts. In fact, many trustees ignore the issue unless pressed, and some embrace the practice of not subordinating ad valorem tax liens already. Furthermore, the section imposes a hardship upon individual debtors because property that would have been used to pay nondischargeable tax debts, is instead used to pay otherwise dischargeable claims. Finally, the section places a particular hardship on local school districts and city/county governments that may be very dependent on the revenue at risk under § 24(b).¹⁶⁵

Both the NBRC Proposal and S.1149 strike a compromise position.¹⁶⁶ First, both models retain much of the efficacy of present § 724(b), making the private bar happy. Second, both models require a trustee to marshal unencumbered assets of the bankruptcy estate and surcharge secured claims under § 506(c) before seeking subordination under § 724(b). This will make the application of the statute more complex. But here, the models diverge significantly. The NBRC Proposal requires a trustee to marshal before subordinating *any* tax lien. S.1149 requires a trustee to marshal before subordinating a tax lien "which has arisen by virtue of state law." Under

¹⁶⁵ See *supra* note 159.

¹⁶⁶ The Tax Advisory Committee to the NBRC vigorously debated the issues posed by § 724(b) and voted 5 to 4 (with 1 abstention) to repeal § 724(b).

S.1149, it appears that federal tax liens may be subordinated without a trustee first seeking to marshal unencumbered assets of the bankruptcy estate. I see no persuasive justification for this difference.

Another significant difference between the NBRC Proposal and S.1149 is that S.1149 provides "an exemption to the exclusion." Let us take a minute to unpack what seeks to be new § 724(f). This proposed subsection provides that notwithstanding the exclusion of ad valorem tax liens from partial subordination, any claim for wages under § 507(a)(3) or for contributions to an employee benefit plan entitled to priority under § 507(a)(4) may be paid from property of the estate which secures "a tax lien" in accordance with § 724(b) so long as the marshaling requirements identified above have been met. Thus, in some limited circumstances, the ad valorem tax lien remains susceptible to partial subordination to certain wage and employee benefit plan contributions. At one point, the Government Working Group of the NBRC entertained the wage and contribution exemption, but the exemption did not make the final cut.

Both S.1149 and the NBRC Proposal seek modest modification to § 724. A bolder stroke is in order. Less complexity, not more, is called for. I am troubled by the complexities and difficulties posed by both the S.1149 and NBRC Proposals. However, my experience in this area has taught me enough to know that many of the complex issues posed by rewrite of § 724 may never be addressed. Why? Simply, because trustees are going to continue to ignore § 24 unless a simpler and more coherent model is embraced.

B. Unsecured Tax Claims

Unsecured claims arising prior to the filing of the petition are allowed only to the extent of the amount of the claim as of the date of filing. Except with respect to fully secured or oversecured claims, no postpetition interest is allowed on any claim unless a surplus remains after all creditors' claims are paid in full.¹⁶⁷

Claims filed by insiders and attorneys for services rendered to the debtor are disallowed to the extent that these claims exceed the reasonable value of services rendered by the parties. An insider of a corporate debtor includes a director, officer, person in control,

¹⁶⁷ See 11 U.S.C. §§ 502(b), 726.

partnership in which the debtor is a general partner, general partner of the debtor, a relative of a general partner, director, officer or person in control of the debtor, or an affiliate.¹⁶⁸ Claims of landlords for future rents are limited to any unpaid rent due under the lease as of the date of commencement of the case and the rent reserved under the lease for the greater of one year or fifteen percent (not to exceed three years) of the remaining term of the lease.¹⁶⁹

Not all unsecured claims are on an equal footing. Distributions in a chapter 7 case are made in accordance with priorities established by the Bankruptcy Code.¹⁷⁰ Unsecured claims are placed in various categories under the following priorities:

1. Administrative expenses of the case as defined in §§ 507(a) and 503.¹⁷¹ These include postpetition tax claims of the estate for which the debtor may not be liable.¹⁷²
2. Claims arising out of authorized postpetition transactions in involuntary cases.¹⁷³
3. Certain employee claims for wages and attendant payroll taxes accrued within ninety days of the bankruptcy filing (or cessation of business) and up to four thousand dollars per claimant.¹⁷⁴
4. Certain contributions to employee benefit plans within prescribed statutory limits.¹⁷⁵
5. Certain farmer and fishermen claims up to four thousand dollars per individual claimant.¹⁷⁶
6. Certain deposits in connection with consumer transactions up to eighteen hundred dollars per claimant.¹⁷⁷
7. Child support and alimony.¹⁷⁸
8. Certain tax claims, including (i) income or gross receipt taxes incurred within three years of the filing of the petition, assessed within 240 days of the filing, or still assessable after the filing;

¹⁶⁸ See *id.* § 101(31).

¹⁶⁹ See *id.* § 502(b)(6) .

¹⁷⁰ See *id.* § 726.

¹⁷¹ See *id.* §§ 503(b), 507(a)(1).

¹⁷² See *id.* § 1398 (1988).

¹⁷³ See *id.* § 507(a)(2).

¹⁷⁴ See *id.* § 507(a)(3).

¹⁷⁵ See *id.* § 507(a)(4).

¹⁷⁶ See *id.* § 507(a)(5).

¹⁷⁷ See *id.* § 507(a)(6).

¹⁷⁸ See *id.* § 507(a)(7).

(ii) property taxes, within one year of the filing; (iii) employer's share of employment taxes; (iv) trust fund taxes; (v) excise taxes within three years of the filing, (vi) custom duties; (vii) certain tax penalties; (viii) claims for erroneous refunds or credits receive the same priority level as the tax; and (ix) interest on priority claims.¹⁷⁹

9. Certain FDIC claims.¹⁸⁰

10. Allowed prepetition unsecured claims timely filed.¹⁸¹

11. Allowed prepetition unsecured claims tardily filed.¹⁸²

12. Fines and punitive damages.¹⁸³

13. Postpetition interest on prepetition claims.¹⁸⁴

The claims described in one through nine are defined as priority claims under § 507(a) of the Bankruptcy Code. Priority claims are unsecured claims afforded priority status over other unsecured claims; as a general rule priority claims do not disrupt secured claims. The priority scheme delineated in § 726 of the Code and set forth above provides that unsecured claims are paid in the priority established above and no claim in a lower class of priority will be paid prior to payment in full of all claims in a higher class of priority.

1. *Tax Claims Entitled to Priority Treatment*

The priority tax claims include the following: (1) involuntary gap tax claims under § 507(a)(2),¹⁸⁵ (2) income or gross receipts taxes incurred prepetition and within three years from the filing of the bankruptcy petition,¹⁸⁶ (3) income or gross receipts taxes as

¹⁷⁹ See *id.* § 507(a)(8).

¹⁸⁰ See *id.* § 507(a)(9).

¹⁸¹ See *id.* § 726(a)(2).

¹⁸² See *id.* § 726(a)(3).

¹⁸³ See *id.* § 726(a)(4).

¹⁸⁴ See *id.* § 726(a)(5).

¹⁸⁵ The second priority as set forth in § 507(a)(2) of the Bankruptcy Code is "unsecured claims allowed under § 502(f) of this title." Under § 502(f), an involuntary gap claim is one which arises in the ordinary course of a debtor's business after the filing of an involuntary petition against the debtor but before either the appointment of a trustee or the entry of an order for relief. An involuntary gap claim is allowed "the same as if such claim had arisen before the date of the filing of the petition."

¹⁸⁶ An eighth priority is allowed by § 507(a)(8)(A)(I) of the Bankruptcy Code for unsecured federal tax liens ("unsecured claims of governmental units") to the extent that such

claims are for income or gross receipts taxes incurred before the filing of the bankruptcy petition for which the due date of the tax return (including any extension) occurred within three years before the date the bankruptcy petition was filed or for which the due date of the return (including any extensions) occurred after the filing of the petition. As indicated, the due date of the return, and not the date when the taxes are assessed, determines the priority. See *In re Florence*, 115 B.R. 109 (Bankr. S.D.-Ohio 1990)(holding that although the debtor's tax returns were due and filed more than three years prior to the date of the filing of the debtor's chapter 7 case, the tax claims were nondischargeable because the debtor's assets were under protection of the bankruptcy court during the debtor's chapter 13 case, for the entire three year period prior to the filing of the chapter 7 petition); *In re Blackwell*, 115 B.R. 86 (Bankr. W.D. Va. 1990)(holding that a debt for state income taxes more than three years old was dischargeable, even though the debtor did not file an amended return with the State Department of Taxation disclosing certain adjustments to the debtor's federal taxable income); *In re Smith*, 114 B.R. 473 (W.D. Ky. 1989)(holding that the debtor's income tax liability for tax years in which a tax return was due less than three years before the bankruptcy filing was not dischargeable in the bankruptcy case, regardless whether such return was timely filed, filed late, or not filed at all). See also *In re Montoya*, 965 F.2d 554 (7th Cir. 1992)(holding that the three year nondischargeability period for unpaid taxes was tolled not just while the automatic stay was in place during earlier bankruptcy cases, but also during the time the claims were disallowed by the bankruptcy court based upon the debtor's objections); *United States v Cardinal Lines Supply, Inc.*, 916 F.2d 1087 (6th Cir. 1990)(holding that a priority federal tax claim, which was filed late because the IRS was not notified and had no knowledge of the debtor's bankruptcy case or of any bar date, was not subordinated to nonpriority unsecured claims); *In re Luke*, 142 B.R. 160 (Bankr. W.D. Mich. 1992)(holding that the proper period in determining whether a tax claim is nondischargeable as a priority tax claim is 3 years before the filing of the petition); *In re Rassi*, 140 B.R. 490 (Bankr. C.D. Ill. 1992)(holding that the appropriate date to consider for the "filing of the petition" for purposes of calculating the three year period for the dischargeability of tax debts, was the date on which the original involuntary petition was filed and not the date of conversion from a chapter 7 to a chapter 11 case); *In re Clark*, 138 B.R. 579 (Bankr. E.D. Ark. 1991)(holding that the debtors' tax return was deemed filed on the date the IRS recorded its receipt, for dischargeability purposes, rather than the date on which the debtors claimed to have mailed the return by regular post, absent any proof of postmark by the debtors); *In re Ross*, 130 B.R. 312 (Bankr. D. Neb. 1991)(holding that the three year statute of limitations for tax claim priority is suspended for federal claims until the debtor's assets are no longer under court control and for six months thereafter); *In re Wise*, 127 B.R. 20 (Bankr. E.D. Ark. 1991)(holding that the three year statute of limitations for determining the tax claim priority status in the debtor's current chapter 13 case was suspended while the debtor's prior chapter 7 case was pending, plus six months); *In re Cassidy*, 126 B.R. 94 (Bankr. D. Colo. 1991)(holding that a 10% penalty imposed upon the debtor for the early withdrawal of funds from a qualified retirement plan was a "penalty" and not a "tax" for the purpose of deciding whether it was entitled to priority); *In re Roberts*, 125 B.R. 534 (Bankr. C.D. Ill. 1991)(holding that federal tax penalties relating to tax years 1979 through 1984 would be discharged where the bankruptcy petition was filed in 1989); *In re Bryant*, 120 B.R. 983 (Bankr. E.D. Ark. 1990)(holding that a three year tax priority period was tolled when the debtor filed his first bankruptcy petition and did not begin to run again until the chapter 7 discharge was granted, for purposes of determining whether the IRS priority and nondischargeability claims were barred in a subsequent chapter 13 case); *In re Cross*, 119 B.R. 652 (W.D. Wis. 1990)(holding that the phrase "filing of petition" for the purpose of determining any income tax obligations for which a return was due within three years of the filing of the petition, refers to the filing of the original chapter 11 petition and not the conversion from a chapter 11 proceeding to a chapter 7 proceeding).

essed within 240 days from the filing of the bankruptcy petition,¹⁸⁷ (4) income or gross receipts taxes still assessable under applicable law at the time the bankruptcy petition is filed,¹⁸⁸ (5) recent prop-

¹⁸⁷ Also included are income and gross receipts taxes assessed at any time within 240 days before the date the bankruptcy petition was filed. The 240 day period is extended for the period of time an offer of compromise is considered by the IRS after submission by the taxpayer, plus 30 days after such offer is rejected. Under this rule, the date on which the IRS assesses the tax, rather than the date of the return, determines the priority. See *In re Linder*, 139 B.R. 950 (D. Colo. 1992)(holding that the I.R.C. provisions tolling the period of time for assessments and the collection of taxes when the taxpayer is in bankruptcy apply to the 240 day period prior to the bankruptcy filing during which assessed taxes are entitled to priority); *In re Gidley*, 138 B.R. 298 (Bankr. M.D. Fla. 1992)(holding that the debtor's application for an extension of time to file his 1986 tax return is valid and, therefore, extended the deadline for the filing of such tax return to within three years of the filing of the debtor's bankruptcy petition with the result that the debtor's unpaid taxes, penalties, and interest for the year 1986 were nondischargeable); *In re Blank*, 137 B.R. 671 (Bankr. N.D. Ohio 1992)(holding that the date the debtor was sent a notice of tax deficiency based upon a second assessment for the debtor's 1985 income taxes, rather than the date of the first assessment for the debtor's 1985 taxes, controlled for purposes of determining whether the debtor's obligation under the second assessment was entitled to priority and nondischarge); *In re Deitz*, 116 B.R. 792 (D. Colo. 1990)(holding that the 240 day period of limitations applicable when determining whether an obligation for income taxes is nondischargeable, was tolled when the debtor filed a chapter 7 petition, and the 240 day period of limitations was extended for an additional six months at the conclusion of the chapter 7 case); *In re Hartman*, 110 B.R. 951 (D. Kan. 1990)(holding that a federal income tax deficiency was "assessed" for bankruptcy dischargeability purposes when the IRS had taken the necessary steps for the tax liability to attach). See also *In re King*, 961 F.2d 1423 (9th Cir. 1992)(holding that California income taxes were "assessed" on the date that they became "final" which is 60 days after the notice is issued where no protest is filed, rather than on the date the tax deficiency notices were issued for purposes of the Bankruptcy Code provision that taxes "assessed" more than 240 days prior to the filing of the bankruptcy petition are dischargeable); *In re King* 122 B.R. 383 (B.A.P. 9th Cir. 1990)(holding that under California law, additional income taxes were "assessed" on the date that they became "final," rather than on the date the tax deficiency notices were issued); *In re Howell*, 120 B.R. 137 (B.A.P. 9th Cir. 1990)(holding that taxes assessed within 240 days of the petition date are nondischargeable, and those assessed outside of that 240 day period are dischargeable); *In re Oldfield*, 121 B.R. 249 (Bankr. E.D. Ark. 1990)(holding that for purposes of determining whether federal taxes were dischargeable in bankruptcy as assessed more than 240 days before the petition was filed, the IRS would be considered to have "assessed" deficient taxes when the IRS entered onto the debtor's master file that past taxes were due as adjudged by the tax court, and not when the debtor's tax returns were audited or when the judgment was entered for the IRS); *In re Shotwell*, 120 B.R. 163 (Bankr. D. Or. 1990)(holding that a tax is "assessed" for the purpose of the Bankruptcy Code provision granting seventh priority to claims for taxes assessed within 240 days prior to the bankruptcy petition, on the date a summary record is signed by the assessment officer, rather than when the debtor's returns are filed); *In re Garm*, 114 B.R. 414 (Bankr. M.D. Pa. 1990)(holding that the IRS "Certificate of Assessments and Payments" obtained from the IRS under seal of a director of the IRS Center, was self-authenticating under federal rules of evidence and, thus, no extrinsic evidence proving authentication was necessary at the time of trial).

¹⁸⁸ Section 507(a)(7)(A)(iii) grants priority to income and gross receipts taxes not assessed before the filing of a bankruptcy petition, but which are still permitted to be assessed

erty taxes assessed prepetition and last due without penalty within one year of the filing,¹⁸⁹ (6) trust fund taxes incurred at any time,¹⁹⁰ (7) the employer's share of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition to the extent the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed,¹⁹¹ (8) excise taxes related to transactions for which a return

under applicable tax laws. Accordingly, a prepetition and unsecured federal tax lien will still receive a seventh priority under this section if the statute of limitations still allows an assessment of the tax liability after the bankruptcy petition is filed, even though such assessment was not made within the 240 day period (plus any extension) prior to the bankruptcy filing. *See also In re Lemke*, 145 B.R. 1005 (Bankr. D. Idaho 1991)(holding that the debtor's state income taxes were assessable after commencement of the bankruptcy case with the result that the tax claims in question were entitled to priority status); *In re Crawford*, 144 B.R. 346 (Bankr. W.D. Tex. 1992)(holding that the debtors' federal income tax liability was still assessable after commencement of the bankruptcy case and was, therefore, entitled to priority status).

¹⁸⁹ An unsecured claim of a governmental unit for property taxes assessed before the bankruptcy petition was filed and last payable without penalty within one year before the filing of the petition is given an eighth priority.

¹⁹⁰ Taxes required to be collected or withheld and for which the debtor is liable in whatever capacity are given an eighth priority under § 507(a)(8)(C) of the Bankruptcy Code. *See, e.g., In re Official Comm. of Unsecured Creditors of White Farm Equip. Co.*, 943 F.2d 752 (7th Cir. 1991)(holding that a priority claim by the IRS for trust fund taxes in the first chapter 11 case remained a seventh priority claim for trust fund taxes in the debtor's second chapter 11 case, rather than a nonpriority general unsecured claim, despite the contention that the confirmation of the first plan discharged such priority claim); *In re Cain*, 145 B.R. 966 (Bankr. S.D. Ill. 1992)(holding that the obligation for taxes collected by a chapter 7 debtor retailer was an Illinois use tax obligation, rather than a retailer's occupation tax debt and, thus, was a nondischargeable trust fund obligation); *In re Malcuit*, 134 B.R. 185 (N.D. Tex. 1991)(holding that city and state sales taxes owed by the debtors were trust fund taxes, rather than gross receipts or excise taxes, and were not dischargeable); *In re Peiffer*, 126 B.R. 364 (Bankr. N.D. Ala. 1991)(holding that Alabama sales tax obligations, which the debtor was required to collect and remit to the state of Alabama, qualified as "trust fund taxes" that were nondischargeable in bankruptcy rather than "excise taxes" dischargeable after three years).

¹⁹¹ The employer's share of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition receives a seventh priority under § 507(a)(8)(D) of the Bankruptcy Code, to the extent the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed. Older tax claims of this nature are payable as nonpriority general claims. Likewise, the employee's share of employment taxes on wages earned from a debtor and paid before the filing of a bankruptcy petition also receives a seventh priority in the same manner as the employer's share of employment taxes. *See, e.g., In re Pierce*, 935 F.2d 709 (5th Cir. 1991)(holding that employment taxes on wages earned less than three years before the date of the filing of the bankruptcy petition are entitled to a seventh priority and are not nondischargeable); *In re Continental Minerals Corp.*, 132 B.R. 757 (Bankr. D. Nev. 1991)(holding that a claim for unpaid prepetition unemployment compensation contributions due from the debtor under Nevada law was entitled to priority treatment as an "employment

(if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition,¹⁹² and (9) certain customs duty under § 507(a)(8)(F) of the Bankruptcy Code.¹⁹³

Priority tax claims are driven by two engines: the first seeks to protect the tax collector by providing time periods tied to reasonable collection efforts;¹⁹⁴ the second is tied to debtor miscon-

tax" obligation).

¹⁹² Unsecured claims for excise taxes are given a seventh priority under § 507(a)(8)(E) of the Bankruptcy Code. The excise taxes claimed must relate to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition. If a return is due, the three year period is extended if the due date for filing the return was extended. 11 U.S.C. § 507(a)(8)(E)(1994). If a return is not required, the tax claim must relate to a transaction which itself occurred within three years prior to the filing of the bankruptcy petition. For purposes of this priority, excise taxes covered include sales taxes, estate and gift taxes, gasoline and special fuel taxes, wagering taxes, and truck taxes. See *Williams v Motley*, 925 F.2d 741 (4th Cir. 1991)(holding that the insured motor vehicle assessment imposed by the state of Virginia upon individuals as a condition for operating uninsured vehicles is an involuntary pecuniary burden levied upon uninsured motorists for proper governmental purposes, and thus such assessment is nondischargeable as a debt for "excise tax."); *In re C-T Va., Inc.*, 135 B.R. 501 (W.D. Va. 1991)(holding that the IRS's claim of excise tax upon the debtor, equal to 10% of the assets of the debtor/employer's qualified pension plan which had reverted to such employer, was not a penalty and was entitled to priority pursuant to the bankruptcy code). See also *In re C-TOF Va., Inc.*, 977 F.2d 137 (4th Cir. 1992)(holding that a tax imposed upon an employer equal to 10% of the assets of a qualified pension plan, when such assets reverted to the employer upon the plan's termination constituted an "excise tax" rather than a "punitive penalty" and, therefore, the tax claim was entitled to priority treatment in the employer's chapter 11 case); *In re The Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (6th Cir. 1991)(holding that the federal pension excise tax resulting from the debtor's failure to meet minimum funding requirements for a pension plan was an "excise tax" entitled to priority rather than a nonpriority "penalty"); *In re Suburban Motor Freight*, 134 B.R. 617 (Bankr. S.D. Ohio 1991)(holding that the obligation for workers' compensation premiums under Ohio law was an obligation for "excise tax" entitled to priority and distribution; *In re C-T Va., Inc.*, 128 B.R. at 628(holding that the flat 10% fee imposed on assets reverting to an employer upon termination of qualified employee benefit plans was not in the nature of an "excise tax" or "pecuniary penalty" but rather a "punitive penalty" and, therefore, not entitled to priority as an excise tax).

¹⁹³ Unsecured claims for customs duty are given an eighth priority under § 507(a)(8)(F) of the Bankruptcy Code. According to the legislative history, this priority covers duties on imports entered for consumption within one year before the filing of the petition, but which are still unliquidated on the petition date; duties covered by an entry liquidated or reliquidated within one year before the petition date; and any duty on merchandise entered for consumption within four years before the petition but not liquidated as of the petition date, if the Secretary of the Treasury or his or her delegate certifies that duties were not liquidated because of possible assessment of antidumping or countervailing duties or fraud penalties.

¹⁹⁴ See, e.g., 11 U.S.C. § 507(a)(8)(A)(i) - (iii).

duct.¹⁹⁵ There are several themes that run throughout those tax claims given priority status. First, any priority claim is inconsistent with the notion that unsecured claims should be treated with equal dignity. A compelling argument may be advanced that the tax collector is no more meritorious a creditor than those who provide unsecured credit that keeps the business going. Professor Marsh, Chairman of the Commission on the Bankruptcy Laws of the United States established in 1970 ("Commission I"), observed some thirty years ago:

Should tax claims be granted priority in bankruptcy? Does the traditional rule which has granted priority to all tax claims, at least over all general, nonpriority creditors, rest upon anything more than a naked assertion of power based upon the fact that this particular creditor happens to be writing the rules of distribution? It is possible that in a simpler day the priority given to tax claims in insolvency proceedings was of some real consequences in gathering together enough funds to keep the government running. There can be no doubt today that whatever amount the government is able to collect as a result of such a priority over what it would receive without it is insignificant; its sacrifice would go completely unnoticed in the vast federal bureaucracy. It is difficult to see how the government, absent a plea of necessity, has any equities superior to the other creditors of an insolvent.¹⁹⁶

Professor Marsh may have understated the significance of the tax collector's interest in bankruptcy returns, especially in a world of over a million bankruptcy filings a year. Nonetheless, his point is well taken. Particularly in chapter 7 and 13 cases, to the extent any estate assets remain after secured creditors are paid, tax claims gobble up the value. Priority treatment accorded most current taxes increases the number of "no-asset" cases filed in bankruptcy. Additionally, the many no payment or nominal payment chapter 13 plans are no or nominal payment plans precisely because the priority tax claims tap the unencumbered value of the estate. The favored treatment accorded tax claims also increases general creditor disenchantment with the entire bankruptcy process. The priority status accorded tax claims as opposed to other claims that are a cost of

¹⁹⁵ See, e.g., *id.* § 507(a)(8)(c).

¹⁹⁶ Harold Marsh, Jr., *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 729 (1967)(footnote omitted).

doing business or involve nonconsensual creditors reflects a government bent on protecting itself from the laws it enacts. Such an approach tends toward hypocrisy and deserves careful reconsideration.

Second, Congress is concerned that bankruptcy not become a tax haven. Of course, this point speaks most directly to dischargeability and not priority of a tax claim. But here one witnesses an interesting interdependency. To the extent a tax claim is both a priority and a nondischargeable claim, its priority status ensures some dividend that then redounds to the benefit of a debtor faced with an appealing reduction in the nondischargeable claim. Nonetheless, priority status harms marginal reorganization efforts because of the requirement that § 507(a)(8) priority tax claims be paid in full over six years from assessment¹⁹⁷ and reduces the ultimate dividend received by the unsecured creditors.

These two conflicting interests—concern that the tax collector locks out equally worthy and more vulnerable unsecured creditors and fear that bankruptcy becomes the preferred tool for tax protestors and cheats—are not easily reconciled. In fact, they cannot be reconciled in a coherent manner. The choice between the two competing policies is driven by nothing other than politics.

2. *Proposed Amendments to Administrative Tax Provisions*

The NBRC has recommended a series of amendments to alleviate the difficulty taxing authorities have had in collecting postpetition administrative taxes. First, the NBRC recommended amendment to § 503 and 28 U.S.C. § 960 to eliminate the need for a governmental unit to make a "request" to the debtor to pay tax liabilities that are entitled to payment as administrative expenses. Because governmental units are creditors in the vast majority of bankruptcy cases, this issue has been a real problem for taxing authorities.

Second, the NBRC recommended amendment to §§ 502(a)(1) and 503(b)(1)(B) to provide that postpetition ad valorem real estate taxes should be characterized as administrative expenses whether secured or unsecured and such taxes should be payable as ordinary course expenses. The treatment of postpetition ad valorem real es-

¹⁹⁷ See 11 U.S.C. § 1129(a)(9)(c).

tate taxes in bankruptcy has posed substantial problems for local taxing authorities. The Proposal suggests that these taxes should be treated as administrative expenses, whether secured or unsecured, and should be paid in the ordinary course of the debtor's affairs.¹⁹⁸

Third, the NBRC recommended overruling *Investors of The Triangle v. Carolina Triangle Ltd. Partnership (In re Carolina Triangle Ltd. Partnership)*,¹⁹⁹ and to ensure that postpetition ad valorem real estate taxes are a reasonable and necessary cost of preservation of the estate. The NBRC has adopted the recommendation of the Advisory Committee that postpetition ad valorem real estate taxes are a reasonable and necessary cost of preserving the estate and are entitled to treatment as administrative expenses payable in the ordinary course of affairs of the debtor. Cases that provide to the contrary should be overruled.

Fourth, the NBRC has adopted the recommendation of the Advisory Committee that postpetition ad valorem real estate taxes are incurred by the estate and are a reasonable and necessary cost of preserving the estate and are entitled to treatment as administrative expenses payable in the ordinary course of affairs of the debtor. Thus, the Bankruptcy Code should be amended to establish that ad valorem taxes are incurred by the estate and, therefore, are entitled to administrative expense priority status.

3. *Proposal Regarding Deadline by which Priority Tax Claim Must be Filed*

The NBRC has sought to clarify § 726(a)(1) to provide that a taxing authority must file a claim for a priority tax before the final order approving the trustee's report is entered by the court. In chapter 7, § 726(a)(1) allows a tardily filed claim for a priority tax if the claim is "filed before the date on which the trustee commences distribution." One court held that the date the trustee commences distribution is the date when the court approves the final report and accounting of the trustee.²⁰⁰ The court rejected the State of Missouri's argument that the date the trustee commenced distribution

¹⁹⁸ The proposal is not intended to overrule the limitation on paying property taxes imposed by § 502(b)(3) (prohibiting the payment of a tax assessed against property if the claim exceeds the estate's interest in the property).

¹⁹⁹ 166 B.R. 411 (B.A.P. 9th Cir. 1994).

²⁰⁰ See *In re Wilson*, 190 B.R. 860 (Bankr. E.D. Mo. 1996).

was the date the checks were mailed and rejected the trustee's argument that distribution commenced when the trustee's final report was sent to the United States Trustee for approval. The NBRC has adopted the recommendation of the Advisory Committee that the language to § 726(a)(1) be changed from "the date on which the trustee commences distribution" to "the date on which the court approves the final report and accounting of the trustee." This Proposal is a housekeeping amendment designed to minimize future litigation that may arise from a literal reading of the statute.

4. *Tolling of Time Periods to Preserve Priority Status*

The NBRC has adopted a recommendation of the Advisory Committee to amend §§ 507(a)(8) and 523(a)(1) to provide for the tolling of relevant periods in the case of successive filings. Thus, in the event of successive bankruptcy filings, the time periods specified in § 507(a)(8) shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of the prior case. Several tax claims that are identified in the Bankruptcy Code as priority claims or as claims that are nondischargeable are tied to certain time limits. For example, tax claims assessed within 240 days of the filing of the petition are priority claims under § 507(a)(8) and nondischargeable under § 523(a)(1). When the debtor has filed successive bankruptcy petitions, the issue posed is whether the first filing tolled the running of these time periods, thus maintaining the priority and nondischargeable character of the tax claims in the subsequent bankruptcy case.

The NBRC has adopted the recommendation of the Advisory Committee that in the event of successive bankruptcy filings, the time periods specified in § 507(a)(8) shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of the prior case. A debtor should not be entitled to stay the collection of a tax by filing a bankruptcy petition and then benefit from the pendency of the abortive case by reducing or eliminating the time in which the government's tax claims would otherwise have been entitled to priority, or altering the nondischargeability of a tax. Clarification of the law would eliminate unnecessary litigation and provide uniformity in the law.²⁰¹

²⁰¹ Compare *In re Waugh*, 1997 W.L. 135626 (8th Cir. Mar. 26, 1997); *West v. United States*, 5 F.3d 423 (9th Cir. 1993); *In re Richards*, 994 F.2d 763 (10th Cir. 1993); *Montoya v.*

The NBRC also supported a recommendation by the Advisory Committee to amend § 507(a)(8)(ii) to toll the 240 day assessment period for both pre- and post-assessment offers in compromise. Under current law, income or gross receipts taxes that are assessed within 240 days of the date the petition in bankruptcy is filed are entitled to an eighth priority.²⁰² If an offer in compromise is made by the taxpayer within 240 days of the assessment date, the time during which the offer in compromise was outstanding plus 30 days, is added to the 240 day period. This mirrors the reality that during a pending offer in compromise, the IRS refrains from taking collection action. In *United States v. Aberl*,²⁰³ the court held that the 240 day period is not suspended for offers in compromise made before the assessment date for those taxes. This Proposal speaks directly to some of the problems posed by pending offers in compromise. The NBRC has adopted the recommendation of the Advisory Committee that any offer in compromise pending within the 240 day period should toll that period whether the offer in compromise was made before or after assessment. The Proposal removes an arbitrary distinction between assessments that could have been made within days of each other.²⁰⁴

5. Subordination of Tax Penalties

The NBRC also addressed the highly controversial issue of whether payment of prepetition nonpecuniary loss tax penalties in chapter 11, 12, and 13 cases should be subordinated to payment of general unsecured claims. The payment of prepetition tax penalties in chapter 11, 12, and 13 cases should be subordinated to payment of general unsecured claims without a requirement of a finding of governmental misconduct. Granting a priority to penalties works an unfairness on general unsecured creditors by, in effect, punishing them for the debtor's misconduct. This is inequitable, especially

United States, 965 F.2d 554 (7th Cir. 1992); *In re Brickley*, 70 B.R. 113 (B.A.P. 9th Cir. 1986) (all tolling the § 507(a)(8) time periods), with *In re Quenzer*, 19 F.3d 163 (5th Cir. 1993); *In re Gore*, 182 B.R. 293 (Bankr. N.D. Ala. 1995). There was no consensus among members of the Advisory Committee on whether I.R.C. § 6503(h) provides a reasonable tolling mechanism that should be expressly applied to tax claims under §§ 507(a)(8) and 523(a)(1), or whether the more appropriate additional period is the 30 day period in § 507(a)(8)(A)(ii).

²⁰² See 11 U.S.C. § 507(a)(8) (1994).

²⁰³ 78 F.3d 241 (6th Cir. 1996).

²⁰⁴ This proposal does not extend to installment agreements as urged by the IRS.

when creditors have limited access and ability to monitor a taxpayer's compliance with tax reporting requirements.²⁰⁵

IV. DISCHARGE

In filing for relief under the Bankruptcy Code, an individual's most important objective is a discharge from debts. The discharge is the heart of the fresh start policy promoted by the Bankruptcy Code. The discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in certain prohibited conduct, usually some type of fraud or bankruptcy crime.²⁰⁶ The objecting party has the burden of establishing a ground for the denial of a discharge.²⁰⁷

A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the personal liability of the debtor with respect to a prepetition debt.²⁰⁸ The discharge also operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, including telephone calls, letters, and personal contacts, to collect, recover, or offset any discharged debt.²⁰⁹ In effect, the discharge is a total prohibition on debt collection efforts against the debtor. Furthermore, under § 524 of the Code, any attempt to reaffirm a particular debt is void unless the particular provisions of the Code delineating the requirements of reaffirmation are specifically followed.²¹⁰

Under § 727(a) of the Bankruptcy Code, the bankruptcy court must grant the individual debtor a discharge of prepetition debts unless one of ten conditions is met.²¹¹ Only an individual is eligible

²⁰⁵ The prepetition, nonpecuniary loss penalties of all creditors, including tax authorities, are subordinated to the claims of general unsecured creditors in a chapter 7 case, pursuant to § 726(a)(4). However, the Supreme Court has correctly found that outside of a chapter 7 liquidation context, prepetition tax penalties cannot be categorically subordinated to the claims of general unsecured creditors.

²⁰⁶ See 11 U.S.C. § 727(a).

²⁰⁷ If a debtor has been denied a discharge in a bankruptcy case, so that all his debts remain outstanding, the debtor may not include the same obligations in a subsequent case to obtain a discharge. The denial of the discharge is *res judicata* as to the obligations existing at that time, which are forever nondischargeable.

²⁰⁸ See 11 U.S.C. § 524(a).

²⁰⁹ See *id.*

²¹⁰ See generally *id.* § 524(c).

²¹¹ Not all debtors are entitled to a discharge under § 727(a) of the Code. The right to discharge is a right reserved for the honest debtor. Over-extending oneself, unforeseen contingencies, the inability to pay debt, or lack of business acumen are not reasons to deny a

for a discharge under chapter 7 pursuant to § 727(a); a partnership or corporation may not receive a discharge under chapter 7. Additionally, § 727(a) applies only in liquidation cases under chapter 7.²¹² The scope of the chapter 7 discharge is quite broad. Any debt that arose prior to the entry of the order for relief is discharged.²¹³

Under § 1141(d) of the Bankruptcy Code, the confirmation of the plan of reorganization discharges the debtor from any debt that arose before the confirmation of the plan. Unlike § 727(a), a partnership or corporation (as well as an individual) may receive a § 1141(d) discharge. The § 1141(d) discharge is broader than the § 727(a) discharge in that the latter discharges any debts that arose before the entry of the order for relief, while the former discharges any debts that arose before the confirmation of the plan.

Nevertheless, there are limits to the § 1141(d) discharge. First, debts excepted from discharge under § 523 are not discharged under § 1141(d) when the debtor is an individual. Second, if the plan provides for liquidation of all or substantially all of the property of the estate, the debtor does not continue in business, and the debtor would be denied a discharge under § 727(a), then confirmation of the plan does not discharge the debtor. These limitations are necessary so that an individual debtor may not employ a chapter 11 liquidation plan to evade the objections to discharge embodied in §§ 523(a) and 727(a).

Unlike chapter 11, the chapter 13 discharge is granted, not at confirmation, but after the debtor has completed performance under the chapter 13 plan. Under § 1328(a) almost all debts of the debtor are discharged, even those that are nondischargeable under § 523(a). Consequently, the chapter 13 discharge is broadest in scope. As a matter of fact, the only debts that survive the chapter 13 discharge are alimony and support payments, student loans un-

debtor's discharge. But fraud, criminal activity, and misconduct are. If a creditor or the trustee is successful in attacking the debtor's discharge under § 727(a), then all claims survive the bankruptcy case and may be enforced and ultimately satisfied. Grounds for denial of a discharge under chapter 7 include: (1) the debtor is not an individual; (2) a transfer or concealment of property within one year of bankruptcy by the debtor with the intent to hinder, delay, or defraud its creditors; (3) the debtor's failure to keep adequate financial records; (4) debtor misconduct during the bankruptcy case, including perjury, false statements, false oaths, or failure to obey a court order; (5) a debtor's inability to satisfactorily explain any losses or deficiencies of assets; or (6) a chapter 7 discharge within six years of the commencement of the pending case.

²¹² See 11 U.S.C. § 103.

²¹³ See *id.* § 727(b).

less failure to discharge would create an undue hardship, criminal fines, claims arising from driving under the influence, criminal restitution, and certain long term debts that the plan purports to pay out after the plan.²¹⁴

A. *Exceptions of Debt from Discharge*

Notwithstanding the debtor's discharge under the Bankruptcy Code, certain debts are excepted from discharge as a matter of public policy pursuant to § 523(a). These exceptions to discharge are strictly construed. An *exception* to discharge should be contrasted with an *objection* to discharge. If successful in an objection to discharge proceeding, the creditor's claim along with every other claim survives the bankruptcy case; that is, the debtor will not receive a discharge at all. It is significantly different with an exception to discharge proceeding under § 523(a). If successful in asserting § 523(a), the creditor's claim will not be discharged and will survive the bankruptcy case; that is, a § 523(a) claim may be enforced and ultimately satisfied even after the bankruptcy case. Thus, although the debtor receives a general discharge, the § 523(a) claims live on.

The burden of proof to assert that the debt is nondischargeable under § 523(a) falls squarely on the shoulders of the creditor asserting the exception.²¹⁵ Section 523 of the Bankruptcy Code specifies which debts of an *individual debtor* are not discharged in a bankruptcy case under § 727 of chapter 7, § 1141 of chapter 11, or § 1328(b) of chapter 13 (the "hardship discharge").²¹⁶ Included among these debts are certain taxes which are identified as nondischargeable.²¹⁷ The following taxes are excepted from discharge

²¹⁴ A chapter 13 debtor who fails to complete payments under the chapter 13 plan for reasons beyond the debtor's control may nevertheless be granted a "hardship" discharge. This hardship discharge is granted so long as the creditors have received as much under the plan as they would have under a chapter 7 liquidation. In effect, the hardship discharge is nothing but a chapter 7 discharge under a different guise. Thus, all the debts that are nondischargeable under § 523(a), which could have been discharged pursuant to completion of the chapter 13 plan, will remain in full force and effect like in a chapter 7 case.

²¹⁵ See 11 U.S.C. §§ 523(a)(1), 507(a).

²¹⁶ However, these taxes may be discharged in a chapter 13 under § 1328(a), that is, the chapter 13 superdischarge.

²¹⁷ In *In re Olson*, 123 B.R. 312 (Bankr. N.D. Ill. 1991), the bankruptcy court held that a nondischargeable tax claim survives bankruptcy regardless of whether such claim was filed or allowed in the bankruptcy case.

under § 523(a): (1) taxes entitled to priority under §§ 507(a)(2) and (a)(8), (2) taxes connected with fraudulent returns, late returns, or a failure to file returns, or taxes associated with a willful attempt to evade or defeat a tax, and (3) governmental fines and penalties to the extent that they are not compensation for actual pecuniary loss. Nonetheless, this third category of nondischargeable debt does not include tax penalties relating to dischargeable taxes or to any transaction or event that occurred more than three years before the filing of the bankruptcy petition.

B. Tax Claims not Subject to Discharge in Chapter 7 or 11 Cases

Section 523(a)(1) of the Bankruptcy Code sets forth the taxes or customs duties that are not dischargeable by an individual debtor in a chapter 7, 11 or 13 bankruptcy case under §§ 727, 1141 or 1328(b) (chapter 13 "hardship discharge"), respectively. However, the regular chapter 13 super-discharge does discharge debts (including tax claims) identified under § 523(a).

The first category of nondischargeable tax claims is set forth in § 523(a)(1)(A).²¹⁸ Under this section, a tax or customs duty specified in §§ 507(a)(2) as an involuntary gap claim²¹⁹ or 507(a)(8)²²⁰ as a priority claim is nondischargeable whether or not a claim for such tax was allowed by the court or filed in the case.²²¹ These priority and nondischargeable tax claims were identified above.²²²

²¹⁸ 11 U.S.C. § 523(a)(1), which reads as follows:

(a) A discharge under section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(6) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required—

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

²¹⁹ See 11 U.S.C. § 523(a)(1)(A); *id.* § 507(a)(2) (this section relates to the priority of involuntary gap claims).

²²⁰ See 11 U.S.C. § 523(a)(1)(A); *id.* § 507(a)(6) (this section relates to the priority of allowed unsecured tax claims of governmental units).

²²¹ See 11 U.S.C. § 523(a)(1)(A). See also, *e.g.*, *In re King*, 19 BRW 936 (Tenn. 1982) (holding that abandoned coal mine reclamation fees charged by the Federal Surface Mining

The second category of nondischargeable tax claims is set forth in § 523(a)(1)(B) and (C) and includes the following taxes: (1) tax liabilities relating to a tax return which was not filed,²²³ (2) tax liabilities reported by a tax return filed late *and* filed within two years prior to the filing of the bankruptcy petition or filed after the bankruptcy petition, or (3) tax liabilities reported by a fraudulent return²²⁴ or from an attempt by the debtor to willfully evade or defeat any tax.²²⁵

Act are excise taxes under § 507(a)(6)(E) and are therefore nondischargeable under § 523(a)(1) against individual debtors in a chapter 7 liquidation proceeding).

²²² See *supra* text accompanying notes 185-93.

²²³ See, e.g., *In re Bergstrom*, 949 F.2d 341 (10th Cir. 1991)(holding that the term "filed return" was not broad enough to include a substitute return prepared by the IRS, absent the debtor's signature thereon); *In re Grynberg*, 142 B.R. 415 (D. Colo. 1991)(holding that gift taxes owed by the chapter 11 debtors were nondischargeable because the debtors failed to file any gift tax return); *In re Arenson*, 145 B.R. 310 (D. Neb. 1992)(holding that the debtor's filing of amended federal income tax returns for prior tax years for which no returns had been filed, did not constitute the filing of "returns" which would prevent the discharge of the tax debt for the years in question); *In re Berzon*, 145 B.R. 247 (Bankr. N.D. Ill. 1992) (holding that a chapter 7 debtor's federal tax obligations were nondischargeable because the debtor failed to file tax returns); *In re Arenson*, 134 B.R. 934 (Bankr. D. Neb. 1991)(holding that a debtor's federal income tax liabilities were not dischargeable for years in which he did not file tax returns); *United States v D'Avanza*, 132 B.R. 462 (M.D. Fla. 1991)(holding that the debtor's late-mailed federal income tax return was not "filed" for dischargeability purposes, when the return was not received by the IRS); *In re Gushue*, 126 B.R. 202 (Bankr. E.D. Pa. 1991)(holding that neither substitute returns filed on behalf of a chapter 7 debtor by the IRS nor a stipulated decision settling a dispute with the IRS, qualified as a "return" under the Bankruptcy Code provision indicating that discharge does not discharge a debt for a tax for which a required income tax return was not filed); *In re Chastang*, 116 B.R. 833 (Bankr. M.D. Fla. 1990)(holding that the debtor's liabilities for federal income taxes for which the debtor failed to file returns were nondischargeable even though the IRS had prepared substitutes for the returns); *In re Crawford*, 115 B.R. 381 (Bankr. N.D. Ga. 1990)(holding that a tax obligation for which the debtor did not file a tax return is nondischargeable even though the IRS filed the return on the debtor's behalf); *In re Brookman*, 114 B.R. 769 (Bankr. M.D. Fla. 1990)(holding that the debt for unpaid income taxes was nondischargeable because the debtor failed to rebut prima facie evidence that the tax return for the applicable tax year was not filed); *In re Pruitt*, 107 B.R. 764 (Bankr. D. Wyo. 1989)(holding that substitute tax returns filed by the IRS when the debtor failed to file such returns for several years did not preclude application of the Bankruptcy Code rendering tax debts nondischargeable for any tax debt with respect to which a return was required and not filed).

²²⁴ See 11 U.S.C. § 523(a)(1)(B) and (a)(1)(C); see also 124 CONG. REC. 32362 (1978); 124 CONG. REC. 22998 (1978); *In re Graham*, 973 F.2d 1089 (3d Cir. 1992)(holding that a United States Tax Court judgment holding the debtors liable for income tax deficiencies resulting from fraudulent tax returns did not have claim preclusion or issue preclusion effect in determining whether the debtors' liability was nondischargeable); *In re Levinson*, 969 F.2d 260 (7th Cir. 1992)(holding that the evidence was sufficient to support a determination that the debtor had filed fraudulent tax returns so as to render the tax debts nondischargeable); *In re Hopkins*, 133 B.R. 102 (Bankr. M.D. Ohio 1991)(holding that the wife's signing of joint returns which

The third category of nondischargeable taxes is set forth in § 523(a)(7).²²⁶ This section provides that tax penalties that are punitive in nature are nondischargeable only if the penalty is computed by reference to a related tax liability that is also nondischargeable. It appears that if the amount of the penalty is not computed by reference to a tax liability, the transaction or event giving rise to the penalty must occur during a three year period ending on the date of the filing of the bankruptcy petition.²²⁷

However, in *In re Burns*²²⁸ and *In re Roberts*,²²⁹ the Eleventh and Tenth Circuits respectively held that a tax penalty is discharged if the tax to which it relates is discharged or if the transaction or event giving rise to the penalty occurred more than three years prior to

she knew were in error constituted the making of a fraudulent return or willfully attempting to evade such tax and, thus, such tax debts were nondischargeable in the wife's bankruptcy case); *In re Peterson*, 132 B.R. 68 (Bankr. D. Wyo. 1991)(holding that the debtor did not "willfully" attempt to evade tax by signing returns which the government admits were not fraudulent and then filing for relief under chapter 7 shortly after such taxes became eligible to be dischargeable); *In re Gilder*, 122 B.R. 593 (Bankr. M.D. Fla. 1990)(holding that when the debtor submitted false withholding statements for the express purpose for eliminating the withholding of federal income taxes from wages, such conduct was a "willful attempt to evade or defeat tax" within the meaning of the exception to discharge); *In re Carapella*, 115 B.R. 365 (N.D. Fla. 1990)(holding that the tax liability of a chapter 7 debtor for a fraudulent return filed by the debtor was nondischargeable); *In re Kirk*, 114 B.R. 771 (Bankr. N.D. Fla. 1990)(holding that the debtors' conduct demonstrated a purposeful attempt to evade income taxes and thus, the claim of the IRS for civil fraud penalties was allowed); *In re Fernandez*, 112 B.R. 888 (Bankr. N.D. Ohio 1990)(holding that the debtor's conduct concerning tax obligations was shown to be willful and evasive and thus, the tax obligations were deemed nondischargeable); *In re Graham*, 108 B.R. 498 (Bankr. E.D. Pa. 1989)(holding that a prepetition tax court decision holding the debtor liable to the IRS for the debtor's underpayment of taxes, but which did not decide that the underpayment was fraudulent, did not preclude the debtor from disputing the government's claim that such tax liabilities were nondischargeable for fraud).

²²⁵ See 11 U.S.C. § 523(a)(1)(C).

²²⁶ 11 U.S.C. § 523(a)(7), which reads as follows:

(a) A discharge under Section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt—

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

²²⁷ See 124 CONG. REC. 32362 (1978); 124 CONG. REC. 33993 (1978). See also Rev Rul 68-574, 1968-2 CB 595.

²²⁸ 887 F.2d 1541 (11th Cir. 1989).

²²⁹ 906 F.2d 1440 (10th Cir. 1990).

the filing of the bankruptcy petition. Moreover, in *In re Henderson*,²³⁰ the bankruptcy court held that tax penalties relating to non-dischargeable tax liabilities incurred more than three years before the filing of a bankruptcy petition were dischargeable in a chapter 7 case. Furthermore, in *In re Fullmer*,²³¹ the Tenth Circuit held that tax penalties imposed pursuant to nondischargeable tax debts are nondischargeable as well. Likewise, in *McKay v. United States*,²³² the Ninth Circuit held that civil fraud penalties imposed on unpaid taxes accruing more than three years before the filing of the debtor's bankruptcy petition were dischargeable, even though the debt for unpaid taxes was not dischargeable on the ground of fraud.

With respect to individual debtors in reorganization under chapter 11, § 1141(d)(2) of the Bankruptcy Code incorporates by reference the exceptions to discharge set forth in § 523 and discussed above.²³³ Section 1141(d)(2) of the Bankruptcy Code provides that the confirmation of a chapter 11 plan does not discharge an individual debtor from any debt excepted from discharge under § 523.²³⁴

With respect to all debtors (including corporations and partnerships), the confirmation of a chapter 11 plan does not discharge the debtor from any debts (including taxes) if: (1) the plan provides for the liquidation of all or substantially all of the property of the estate, (2) the debtor does not engage in business after consummation of the plan, and (3) the debtor would be denied a discharge under § 727(a) of the Bankruptcy Code if the case were a chapter 7 liquidation proceeding.²³⁵

Thus, a debtor is not discharged from any debt (including federal taxes) by the confirmation of a plan if the plan is a liquidation plan and if the debtor would be denied a discharge in a chapter 7 liquidation proceeding pursuant to § 727(a) of the Bankruptcy

²³⁰ 137 B.R. 239 (Bankr. E.D. Ky. 1991).

²³¹ 962 F.2d 1463 (10th Cir. 1992).

²³² 957 F.2d 689 (9th Cir. 1992).

²³³ See 124 CONG. REC. 32362 (1978); 124 CONG. REC. 33998 (1978).

²³⁴ See 11 U.S.C. §§ 1141(d)(2) and 523 (1994).

²³⁵ See *id.* § 1141(d)(3).

Code.²³⁶ Under § 727(a)(1), only an individual, and not a corporation or a partnership, may obtain a discharge.²³⁷

C. Tax Claims in Chapter 13 Cases

After a debtor has made all payments required by the chapter 13 plan, the bankruptcy court grants to the debtor a discharge of all debts provided for by the plan or disallowed under § 502, except the following debts: (1) debts with the final payment falling due *after* the final payment under the plan is due as set forth in § 1322(b)(5), that is, certain long-term debt;²³⁸ (2) debts owed to a spouse, former spouse, or child for alimony, maintenance, or support in connection with a separation agreement, divorce decree, or property settlement agreement as set forth in § 523(a)(5);²³⁹ (3) certain student loans that do not pose an undue hardship to the debtor as set forth in § 523(a)(8); (4) debts for death or personal injury caused by the debtor's operation of a motor vehicle while intoxicated as set forth in § 523(a)(9); and (5) debts for restitution included in a sentence on the debtor's conviction of a crime.²⁴⁰

Thus, § 1328 discharges most of the debts listed in § 523(a) that may not otherwise be discharged in a chapter 7 or chapter 11 case. Included in those debts discharged in a chapter 13 case are the tax claims identified in § 523(a)(1). However, all priority claims under § 507 of the Bankruptcy Code must be paid in full pursuant to the chapter 13 plan, including various kinds of taxes under § 507(a)(8) as discussed above. In addition, § 1328(e) of the Bankruptcy Code provides that the bankruptcy court may revoke a discharge if it had been obtained through fraud, provided the request for revocation is made within one year after the discharge is granted.²⁴¹

The chapter 13 discharge is much broader in scope than either the chapter 7 or chapter 11 discharge. Recall that under chapter 7 or chapter 11 (when the debtor is an individual), a creditor who persuades the court to except its debt under § 523(a) of the Bank-

²³⁶ See S. REP. NO. 95-989 at 129, *reprinted in* 1978 U.S.C.C.A.N. 3787 (1978).

²³⁷ See 11 U.S.C. § 727(a)(1).

²³⁸ See *id.* § 1328(a)(1).

²³⁹ See *id.* § 1328(a)(2).

²⁴⁰ See *id.* § 1328(a).

²⁴¹ See *id.* § 1328(e).

ruptcy Code may disregard any discharge order and enforce its claim even after discharge or plan confirmation. This is not true in the chapter 13 case. Under § 1328(a), almost all debts are discharged, even those that are nondischargeable under § 523(a). Consequently, chapter 13 may be a more useful tool for the debtor who has a substantial amount of debt that a court may find nondischargeable under § 523(a), like tax debts.

What happens to the chapter 13 discharge if a debtor is unable to complete performance under the plan? Section 1328(b) of the Code answers this question. If the chapter 13 debtor cannot perform under the plan due to reasons beyond the debtor's control, the debtor may receive a "hardship" discharge so long as the debtor has performed sufficiently to ensure that the creditors have received more under the chapter 13 plan as partially performed than they would have received under a chapter 7 liquidation. Nonetheless, the Code extracts a price from the chapter 13 debtor who by powers beyond the debtor's control must resort to the hardship discharge. A discharge granted under this subsection discharges the debtor from all unsecured debts provided for by the plan or disallowed under § 502 except claims with final payments falling due after the final payment under the plan is due as set forth in § 1322(b)(5);²⁴² and debts as specified in § 523(a).²⁴³ Thus, those § 523(a) debts that are generally nondischargeable but would have been discharged under chapter 13 remain nondischargeable if the debtor is granted the hardship discharge.²⁴⁴ In other words, the chapter 13 hardship discharge is but the chapter 7 discharge in a different guise.

Since the chapter 13 discharge discharges "all debts provided for by the plan," the critical issue is frequently the interpretation of the phrase "provided for by the plan," and, in the tax area, the ability of the chapter 13 debtor to discharge § 507(a)(2) and (a)(8) priority tax claims even though such claims may have been "provided for" in the debtor's plan, but not actually paid. Suppose, for exam-

²⁴² See *id.* § 1328(c)(1).

²⁴³ See *id.* § 1328(c)(2).

²⁴⁴ Section 523(a) of the Bankruptcy Code specifies certain taxes which are deemed nondischargeable in connection with a § 1328(b) hardship discharge. These nondischargeable taxes include federal taxes given a second priority as involuntary gap claims under § 507(a)(2), unsecured tax claims of governmental units under § 507(a)(7), tax liabilities relating to a tax return which was not filed, tax liabilities reported by tax returns filed late or filed after the bankruptcy petition, tax liabilities reported by fraudulent returns, and certain tax penalties.

ple, that the debtor's chapter 13 plan provides that the debtor will "pay one hundred percent of allowed priority claims to the IRS." Suppose further that the IRS receives a timely notice of the debtor's chapter 13 plan, however, the IRS does not file its proof of claim in a timely manner, and the IRS is legitimately owed a designated amount of prepetition taxes which qualify as a priority unsecured claim under § 507(a)(8). Upon consummation of the debtor's chapter 13 plan, are the prepetition priority taxes owed to the IRS discharged?

It is clear that § 1322(a)(2) of the Bankruptcy Code provides that a plan must provide for the full payment in deferred cash payments of all § 507(a)(8) priority claims, including tax claims. In the example as stated above, however, there is authority to support the debtor's position that the debtor will be discharged from the prepetition priority taxes owed to the IRS because the taxes were "provided for" under the debtor's plan combined (fortunately, for the debtor) with the lack of diligence by the IRS in failing to file its proof of claim in a timely manner. For example, in *In re Gregory*,²⁴⁵ the court stated that "provided for by the plan" means that plan must deal with the claim at issue or refer to it. The plan need not pay the claim or provide a benefit for the claim.²⁴⁶

Disallowed claims, including those claims for priority taxes under § 507(a)(8), are also discharged in a chapter 13 case. This most often happens where the IRS has failed to timely file a proof of claim and the claim is disallowed.

There existed a tremendous split of authority on this issue. In *In re Tomlan*,²⁴⁷ the court held that an untimely filed proof of claim is grounds for disallowance of that claim.²⁴⁸ But is failure to file a claim in a timely manner a ground for disallowance listed in Bank-

²⁴⁵ 705 F.2d 1118 (9th Cir. 1983).

²⁴⁶ See *In re Leber*, 134 B.R. 911 (Bankr. N.D. Ill. 1991)(holding that a tax claim by the Illinois Department of Revenue which had actual notice of the debtor's chapter 13 case, but which did not file a proof of claim for its prepetition tax claim, was discharged by the chapter 13 plan, despite the contention that the Department was not effectively "provided for" in the plan); *In re Daniel*, 107 B.R. 798 (Bankr. N.D. Ga. 1989)(holding that the tax claim of the IRS was "provided for" under the debtor's chapter 13 plan and such claim was therefore discharged upon completion of the plan); *In re Ryan*, 78 B.R. 175 (Bankr. Tenn. 1987).

²⁴⁷ 103 B.R. 790 (E.D. Wash. 1989), *aff'd*, 907 F.2d 114 (9th Cir. 1990); see also *In re Border*, 116 B.R. 588 (Bankr. S.D. Ohio 1990).

²⁴⁸ See *In re Workman*, 108 B.R. 826 (Bankr. N.D. Ga. 1989)(holding that the penalty claim of the IRS against a chapter 13 debtor was a "prepetition" claim in the chapter 13 case and was barred because the IRS failed to file a timely proof of claim).

ruptcy Code § 502 as required by § 1328(a)? The *Tomlan* line of authority holds yes.²⁴⁹ The opinion in *In re Hausladen*,²⁵⁰ leads the contrary line of authority that would hold that tardiness is not a ground listed under § 502 and, thus, the claim is not dischargeable. Although I believe that the *Hausladen* line of authority is right on the law, because one may quarrel with the meaning of the language but not with the language itself, I believe that the *Tomlan* line of authority states the better policy.

The Bankruptcy Reform Act of 1994 was designed to overrule *Hausladen*. In the section-by-section analysis to BRA 1994, Congress states that an "amendment to section 502(b) is designed to overrule *In re Hausladen* . . . by disallowing claims that are not timely filed." The only problem is that Congress may not have accomplished its stated goal. The overruling is supposedly accomplished by a new § 502(b)(9), which adds as a substantive ground for disallowance that "proof of such claim in not timely filed"—which alone would do the job—but the amendment goes on to say "except to the extent tardily filed as permitted under paragraph (1), (2), or (3) of [S]ection 726(a)"

The clearest resolution is for priority claims governed by § 726(a)(1). The new rule there would allow the tardily filed claim to share in the first tier of distribution if the claim is filed before the trustee commences distribution. In that event, *Hausladen*, and its progeny in the priority area, such as the Second Circuit's decision in *In re Vecchio*,²⁵¹ would be validated, not overruled. The amendment does not state, however, what happens to a priority claim filed after the trustee commences distribution. It cannot be a first-tier claim, but what is it—third tier under § 726(a)(3), or disallowed entirely under § 502(b)(9)?

For tardily filed, unsecured claims other than priority claims, the effect of the § 502(b)(9) is ambiguous. While Congress apparently thinks that it intended to disallow such late claims, the "except" clause muddies the waters. The "except" clause refers to late filings "permitted" under § 726(a)(3); that section apparently contemplates distribution in the third tier to "any allowed unse-

²⁴⁹ See *In re Border*, 116 B.R. 588 (Bankr SD Ohio 1990) (holding that a priority tax claim of the IRS, for which no proof of claim was filed, would be discharged upon completion of the debtor's chapter 13 plan even though no funds were distributed to the IRS).

²⁵⁰ 146 B.R. 557 (Bankr. D. Minn. 1992).

²⁵¹ 20 F.3d 555 (2d Cir. 1994).

cured claim proof of which is tardily filed" other than ones dealt with under subsection (2). Subsection (3), along with (2), seemingly covers all tardily filed claims. If so, then the "except" clause in § 502(b)(9) appears to swallow up the disallowance provision and renders it totally inoperative. The *Hausladen* problem thus may not be as dead as Congress thought.

D. *Thoughts on Priority and Dischargeability of Tax Claims: The NBRC Proposals*

Some fifty years ago, Professor MacLaughlin lamented about the creeping increase in the number of priority claims under the old Act and the insatiable appetite of the tax collector in bankruptcy. Rightly so, he made the point that unsecured creditors essentially pay priority claims and no matter how extensive one made the priority list, there is always one type of creditor at least as deserving who did not.

Priority claims are the antithesis to a strong notion in bankruptcy—that similar creditors be treated similarly. Obviously, some creditors are more equal than others. This inequality of treatment is not cost free. To the contrary, priority claims reduce the distribution to general creditors and make it more difficult to reorganize. Furthermore, to the extent the government insulates itself from the impact of bankruptcy through the use of priority and nondischargeability treatment for governmental claims, one cannot help but view bankruptcy as hypocritical if not contemptuous.

One common theme throughout priority claims viz a viz nondischargeable claims is that the former usually do not involve debtor misconduct. It is perceived as unfair to require the general creditors to pay for debtor misconduct. Thus many of the claims in § 523(a) are not priority claims. This should be no different for the tax collector. Tax claims based on debtor misconduct such as trust fund liabilities should not receive priority treatment. These claims may be nondischargeable, but we should revisit their status as priority claims.

Dischargeability is also going the way of priorities. There are now some eleven exceptions of debt from discharge. And, like with priorities, there is always one more type of creditor equally deserving of this benefit under § 523(a). However, unlike priority claims, a common thread for nondischargeable claims under § 523(a) is debtor misconduct. An honest debtor is worthy of the discharge

right, a dishonest one is not. Thus, the § 523(a)(1)(B) and (C) tax claims are consistent with this theme. Although "willfulness" under § 523(a)(2)(C) has proved to be a difficult issue, the answer will ultimately lie between the criminal fraud definition under I.R.C. § 7201 and the more relaxed definition under § 6672. However, the wholesale incorporation of priority tax claims, including those that do not involve debtor misconduct, is inconsistent with this theme. The tax collector's argument to protect current taxes from discharge is a persuasive one. After all, the argument goes, bankruptcy should not become a new tax haven. The obvious rejoinder, of course, is why not? In a real sense, bankruptcy is a haven from debt. Why should taxes be any different? The answer is not self-evident. We may want to revisit these issues with the thought of attempting to accommodate both the tax collector's and the debtor's interest.

The Advisory Committee's recommendations and the NBRC Proposals on dischargeability are modest in nature and in scope. First, the NBRC has proposed an amendment to the Bankruptcy Code to provide that the term "assessed or assessment" as used in §§ 362(b)(9) and 507(a)(8) shall mean "that time at which a taxing authority may commence an action to collect the tax." Some confusion has surrounded the use of the term "assessment" in the Bankruptcy Code when used in reference to state and local taxing authorities. Some taxing authorities have no assessment procedure whatsoever, some taxes are self-assessed, etc. The purpose of this Proposal is to provide to the extent possible a universal definition of assessment, regardless whether conventional "assessment" procedures are employed. The problem at which this Proposal is addressed arises only with respect to state or local tax collections. Thus, any definition of the term "assessment" should be specifically limited to state and local tax purposes to avoid any confusion about the meaning of the term for federal purposes. The Proposal is not meant to define "assessment" in § 1129(a) or to imply that the event of "assessment" or some other trigger is more or less appropriate under that section.

The NBRC's second Proposal seeks to resolve the issue whether an income tax return prepared by the taxing authority should be considered a filed income tax return for purposes of the Bankruptcy Code. The NBRC has adopted the recommendation of the Advisory Committee that an income tax return prepared by the

taxing authority should not be considered a filed income tax return for purposes of the Bankruptcy Code.

The Advisory Committee also entertained and debated several proposals seeking to reject, modify, or reaffirm the present scope of the chapter 13 discharge as it relates to tax claims.²⁵² Ultimately, the Advisory Committee did not reach agreement on any proposal. The NBRC also failed to reach agreement on any of the proposals, thus, in effect, voting to retain the scope of the chapter 13 discharge.

Arguments for retention of the chapter 13 discharge are well documented.²⁵³ Chapter 13 provides a more robust discharge in return for greater recovery for creditors than they would have received in a chapter 7 case.²⁵⁴ The superdischarge breathes life into the fundamental bankruptcy policy of providing an individual debtor a fresh start.²⁵⁵ The requirements that every plan must be proposed in good faith²⁵⁶ and be in the best interests of the creditors²⁵⁷ serve as sufficient gatekeepers to deter bad faith and abuse of the process.²⁵⁸

Nonetheless, the IRS proposed to conform the discharge of chapter 13 to that of chapter 7.²⁵⁹ Essentially, the IRS sought to eliminate the superdischarge of priority taxes in a chapter 13 case, and clarify that postpetition taxes for which a proof of claim is filed under § 1305(a)(1) are not subject to discharge. The Proposal would align the chapter 13 exceptions to discharge to those of chapter 7 and an individual under chapter 11.²⁶⁰ The Bankruptcy Code now discharges a chapter 13 debtor from taxes that are provided for by the plan or are disallowed under § 502. Several courts have held that priority taxes mentioned in the plan are "provided for" and can be discharged whether or not they are actually paid.²⁶¹

²⁵² See TAC Report, *supra* note 3, at 56-59.

²⁵³ See generally, DAVID G. EPSTEIN ET AL., BANKRUPTCY § 9-20 (1993) (discussing chapter 13 discharge).

²⁵⁴ See 11 U.S.C. § 1325 (a)(4) (1994).

²⁵⁵ See EPSTEIN, *supra* note 253, § 9-20.

²⁵⁶ See 11 U.S.C. § 1325 (a)(3).

²⁵⁷ See *id.* § 1325 (a)(4).

²⁵⁸ See IRS Submission to NBRC at 27 (on file with author).

²⁵⁹ See *id.*

²⁶⁰ See *id.*

²⁶¹ See, e.g., *In re Ryan*, 78 B.R. 175 (Bankr. E.D. Tenn. 1987); *In re Goodwin*, 58 B.R. 75 (Bankr. D. Me. 1986).

Similarly, claims for priority taxes that have been disallowed in the bankruptcy cases under § 502 and would not be dischargeable in a chapter 7 or 11 case have been held to be dischargeable because they were provided for in a chapter 13 plan.²⁶² The problem most often arises in those cases where the IRS's claim was untimely filed or where the IRS failed to file a claim at all.²⁶³ The most serious concern of the IRS occurs with derivative liabilities, such as the trust fund recovery penalty,²⁶⁴ where the debt is prepetition but the determination of liability does not occur until after the bar date.²⁶⁵ Additionally, under present law a chapter 13 debtor may obtain a discharge for taxes fraudulently underreported or evaded more than 3 years ago. Certain tax penalties can also be discharged under chapter 13, although those same taxes and penalties would not be dischargeable for individuals in a chapter 7 or 11 case.²⁶⁶

Short of the IRS Proposal, I proposed a modest modification to the superdischarge of chapter 13—amend 11 U.S.C. § 1328(a) to deny a discharge to those chapter 13 debtors who have filed fraudulent returns²⁶⁷ or who have engaged in an affirmative act or acts in an attempt to willfully and fraudulently evade a tax²⁶⁸ where the governmental unit proves in accordance with applicable nonbankruptcy law the fraudulent conduct in the bankruptcy case. Evidence suggests that taxing authorities receive a greater recovery in chapter 13 cases than they do in chapter 7 cases. In fact, the Bankruptcy Code recognizes this consequence in chapter 13 cases and provides incentives for individual debtors to seek relief under chapter 13.²⁶⁹ These incentives include relief from postpetition interest on priority tax claims,²⁷⁰ an expanded scope of the automatic stay,²⁷¹ and a

²⁶² See EPSTEIN, *supra* note 253, § 9-20, at 723.

²⁶³ See *In re Border*, 116 B.R. 588 (Bankr. S.D. Ohio 1990) (unfiled claim discharged); *In re Tomlan*, 102 B.R. 790 (E.D. Wash. 1989), *aff'd*, 907 F.2d 114 (9th Cir. 1990) (untimely claim disallowed, then discharged); *In re Ryan*, 78 B.R. 175 (Bankr. E.D. Tenn. 1987) (prepetition tax claims assessed postpetition were discharged because no claim filed).

²⁶⁴ See I.R.C. § 6672 (1988).

²⁶⁵ The "bar date" is the deadline by which a proof of claim must be filed to be timely.

²⁶⁶ See 11 U.S.C. § 523(a)(1) and (a)(7) (1994).

²⁶⁷ See *id.* § 523(a)(1)(B).

²⁶⁸ See *id.* § 523(a)(1)(C).

²⁶⁹ See, e.g., *id.* § 1328(a).

²⁷⁰ See Jack F. Williams, *Cramming the Chapter 13 Super Discharge*, 4 AM. BANKR. INST. L. REV. 553-54 (1996).

²⁷¹ See 11 U.S.C. § 1301.

broadier discharge.²⁷² These incentives for filing under chapter 13 as opposed to chapter 7 should be continued. Thus, a broader scope of discharge is justified under chapter 13.

At the same time, however, the chapter 13 process should not result in a haven from tax liabilities for those taxpayers who have defrauded a governmental authority. Although the requirement that any chapter 13 plan must be proposed in good faith may operate as a gate to prevent abuses of the bankruptcy process by tax protestors and defrauders,²⁷³ courts are not in agreement on the meaning of good faith in these circumstances and present law lacks clarity.²⁷⁴ Thus, a specific amendment to 11 U.S.C. § 1328(a) is necessary to except from the scope of the chapter 13 discharge tax claims with respect to which the debtor made a fraudulent return or with respect to which the debtor engaged in an affirmative act or acts to willfully and fraudulently evade a tax where the governmental unit proves in accordance with applicable nonbankruptcy law the fraudulent conduct in the bankruptcy case.

Interestingly, four votes were cast by members of the Advisory Committee in favor of this modest Proposal to limit chapter 13 discharges. Even more fascinating is the fact that those representatives from the federal government voted *against* the Proposal—obviously embracing an all or nothing stance. Big mistake. Adding the two votes held by the federal representatives to the four would have forged a majority in favor of modest modification to the chapter 13 discharge. Some NBRC Commissioners used the lack of majority vote to support inaction on their part—again, I believe, a big political mistake.

The chapter 13 discharge is the albatross around the neck of the NBRC. Who can justify expanded debt relief for a debtor who has filed fraudulent returns! Rejection by the NBRC of any modification to the chapter 13 discharge where a debtor files fraudulent returns or willfully attempts to evade or defeat a tax²⁷⁵ will return to haunt NBRC efforts at meaningful bankruptcy reform.

²⁷² See *id.* § 1328(a).

²⁷³ See *id.* § 1328(a)(3); see also Williams, *supra* note 270, at 553-54.

²⁷⁴ See, EPSTEIN, *supra* note 253, § 9-20.

²⁷⁵ A strong concern of opponents to a reduction in the scope of the chapter 13 discharge is what is precisely meant by a willful attempt to evade or defeat a tax. Track No. 602 should address this point. See TAC Report, *supra* note 3, at 116-17.

CONCLUSION

Historically, tax issues in bankruptcy get short-shrift. Much of the debate has been fettered by slogans designed to truncate debate. That was not the case with the NBRC and the Advisory Committee. Careful and thoughtful debate—although, at times, quite impassioned—was the rule. All parties focused on achieving consensus without sacrificing what was most important to them. The fruits of the efforts should be given careful consideration. While I may disagree with some of the specific tax proposals of the Advisory Committee and the NBRC, I am proud of the process and of those professionals who put much of their differences aside and got the work done. Their efforts should be applauded.