# New Bankruptcy Tax Act: Tax Issues Relating to the Closely Held Business and Its Owners

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# I. INTRODUCTION[1]

This outline addresses the tax provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act") generally affecting the closely held business and its owners.

The tax provisions of the 2005 Act have a very long history, dating back to at least the mid-1990s. Prior to or concurrent with the creation of the Bankruptcy Review Commission, state and local taxing authorities developed a "wish list" for amendments to the Bankruptcy Code and actively lobbied for the inclusion of their wish list in the recommendations of the Bankruptcy Review Commission.

At approximately the same time, the Section of Taxation of the American Bar Association created a Bankruptcy Task Force to address bankruptcy tax proposals and recommendations coming before the Bankruptcy Review Commission. The Task Force not only reviewed recommendations made by others; it also made many proposals of its own, culminating in a very impressive volume of approximately 250 pages proposing numerous amendments in both the Bankruptcy Code and the Internal Revenue Code affecting bankruptcy taxation.

Most of the bankruptcy law changes advocated by the state and local taxing authorities (the Internal Revenue Service not participating to any significant extent) found their way into the final report and recommendations of the Bankruptcy Review Commission. A number of the recommendations of the Section of Taxation' s Bankruptcy Task Force (chaired at the time by Paul Asofsky, Esq. of Weil Gotshal & Manges) also found their way into the Commission's report.

What occurred next confirmed the truth of Bismarck's maxim that it is better not to know how laws and sausages are made. Bankruptcy "reform" legislation was introduced into Congress in the latter part of the 1990s that bore only a passing resemblance to the Commission's recommendations. The provisions of the "reform" legislation – crafted by representatives of creditor interests – made it clear that its proponents had a different agenda than the Bankruptcy Review Commission.

On the tax side of the proposed legislation, Bankruptcy Review Commission recommendations favoring state and local taxing authorities were almost fully incorporated into the proposed legislation, whereas recommendations favoring taxpayers advocated by the Bankruptcy Task Force generally were not included in the proposed legislation. (There are a few exceptions).

The proposed legislation came close to enactment on a number of occasions. Democratic and liberal interests generally opposed the legislation, so it was hardly surprising that it failed to be enacted during the Clinton Administration. Following George Bush's election in 2000 it seemed the legislation was certain to sail through a Republican-controlled Congress, but that did not happen in President Bush's first term. Finally, the legislation was enacted in President Bush's second term and, as we all know, became generally effective on Monday, October 17, 2005.

[1] A portion of this outline was used by Mark S. Wallace in connection with a presentation to the Beverly Hills Bar Association on the 2005 Bankruptcy Act.

## II. DISCLOSURE STATEMENTS

The old days of tersely stating in a disclosure statement that parties in interest should consult their own tax advisors and not providing any other tax information are gone forever. Under the 2005 Act, the definition of "adequate information" for purposes of a chapter 11 disclosure statement is broadened to include a "discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case." 2005 Act section 717, amending Bankruptcy Code section 1125(a)(1).[2]

This type of statement cannot be assembled in the 24 hour period prior to the filing of the plan and disclosure statement (unlike a statement telling everyone to go see their own tax advisors). It will require a fair amount of investigation into the debtor entity's tax position and tax analysis of the plan's provisions. Given the complexity of tax law, bankruptcy practitioners will be well advised to seek the assistance of tax professionals in preparing the tax section of the disclosure statement.

A disclosure statement that fails to make the statutorily-required tax disclosure – or whose tax disclosure is inaccurate or incomplete – would be subject to objection. Practitioners will have another arrow in their quiver when they want to derail or delay a plan and disclosure statement.

## III. PAYMENT OF TAX CLAIMS UNDER A PLAN

### A. Time of Payment.

The 2005 Act requires eighth priority tax claims to be paid under a chapter 11 plan over a period not exceeding 5 years from the date of entry of the order for relief. Previously, such claims could be paid over a period not exceeding 6 years from the date of assessment.

If two years elapse from the order for relief to the effective date of the plan, eighth priority claims will have to be paid over a three year period. In other words, the running of time prior to the plan effective date consumes the repayment period.

For purposes of claim administration, it will be easier to identify a single date (the entry of the order for relief) than potentially hundreds of dates (the date of assessment of the various tax claims in the case). In addition, financial advisors who crunch numbers to determine plan feasibility should have an easier time of it.

### B. Most Favored Unsecured Creditor Status.

Under revised section 1129(a)(9)(C)(iii), the payment under the plan of eighth priority tax claims must be "in a manner not less favorable than the most favored nonpriority unsecured claim" (excluding convenience class claims).

Prior to the 2005 Act, it was not unheard of to draft a plan that offered unsecured creditors more generous payment terms than holders of eighth priority tax claims received. For example,

[2] Unless otherwise stated, all Section references herein are to the Bankruptcy Code.

general unsecured creditors might be paid in cash in full on the effective date, whereas the beleaguered taxing authorities were strung out over a period of 6 years from the date of assessment.

Now, under the 2005 Act, holders of eighth priority tax claims must be paid "in a manner" not less favorable than the most favored non-priority unsecured claim. It is not precisely clear what this means. For example, can time value of money be taken into account? How would one treat the high rate of interest that must now be paid on tax claims? What does "in a manner" refer to?

C. Regular Amortization of Tax Claims.

Prior to the 2005 Act, chapter 11 plans sometimes provided for a balloon payment of tax claims on the sixth anniversary of the assessment date. This was controversial. The trend in more recent years, even before the 2005 Act, was to provide for regular amortization of principal and interest through periodic payments, typically on a quarterly basis.

Now, under section 1129(a)(9)(C) as revised by the 2005 Act, "regular installment payments" are required. Note, however, that the statute does not require equal installment payments. Perhaps there is still some room left to maneuver on this matter.

D. Interest Payments on Administrative Expense Taxes and Tax Claims.

The 2005 Act creates an entirely new Bankruptcy Code section – section 511 – that requires the payment of interest on administrative expense taxes and tax claims in a chapter 11 plan at the same rate that is required on delinquent taxes under applicable nonbankruptcy law. In other words, if the State of Confusion provides for an interest rate of 12 percent on delinquent sales taxes, State of Confusion sales tax claims paid over time under a plan must carry a 12 percent interest rate.

This provision has the potential to become burdensome to debtors and plan administrators because in a large case there may be dozens or even hundreds of different taxing jurisdictions, each having their own specific rules about the interest rate on delinquent taxes. Perhaps a first day order can require a taxing authority that files a proof of claim to state on the claim the interest rate it believes it is entitled to receive and the statutory or other authority supporting the use of such rate.

E. Interaction of Bankruptcy Code sections 511 and 1129.

Note that neither section 511 nor section 1129 changes the definition of "present value" for purposes of applying the Bankruptcy Code. If a state or local taxing authority is entitled to an above market rate of interest on a tax claim (say, 16 percent), then quite possibly the principal amount of the claim can be adjusted downwards (less than 100 cents on the dollar, in other words) to ensure that the present value of the stream of payments under the plan is equal to 100 cents on the dollar. So the taxing authority would receive its 16 percent interest as required by section 511, but the principal amount would be adjusted below 100 cents on the dollar to reflect the higher-than-market rate of interest being paid.

## F. Payment of Secured Tax Claims Under a Plan.

The 2005 Act requires that secured tax claims, which would otherwise qualify as eighth priority tax claims but for the security interest, must be paid in the same manner and over the same period as eighth priority tax claims. Consequently, the payment of such claims cannot be stretched out beyond the fifth anniversary of the entry of the order for relief.

# IV. NEW RULES FOR ADMINISTRATIVE EXPENSE TAXES

## A. Request For Payment of Administrative Expense Not Required.

Under Bankruptcy Code section 503(b)(1)(D) as amended by the 2005 Act, a taxing authority is no longer required to file a request for the payment of an administrative expense tax as a pre-condition to being paid. One wonders, then, how a taxing authority is expected to communicate its desire to be paid to the bankruptcy estate. The answer, presumably, is that it will communicate in the traditional manner: it will send a tax bill to the estate. Query what happens in the event that the bill does not arrive until after the estate is liquidated and no moneys remain.

Note also that the so-called "scream or die" procedure of Bankruptcy Code section 505(b) can be used to force a taxing authority to act quickly with respect to an administrative expense tax. (see discussion below of revised section 505(b)).

The main significance of revised section 503(b)(1) may be to undercut the use of an administrative expense bar date to deal with tardily-asserted administrative taxes.

## B. Property Taxes.

Revised Bankruptcy Code section 503(b)(1)(B) requires administrative property taxes to be paid as administrative expenses, irrespective of whether such taxes are secured. Note that there is no "ad valorem" qualifier in the statute. Thus, Mello-Roos obligations may be within the scope of the statute (such taxes arguably are property taxes, although not ad valorem taxes because they are not determined on the basis of value).

If there is no equity in a particular property item because of tax and non-tax security interests, the estate may find it advantageous to quickly abandon such property before administrative taxes accrue to any significant extent.

Normally, in a Chapter 7 liquidation, when property of the estate is sold, the claims of secured creditors must be satisfied before payment is made to priority or unsecured creditors. There is an exception, however to this general rule that secured tax claims are subordinated to the payment of administrative and certain other priority claims. The 2005 Act modified this exception and now liens securing claims for ad valorem real and personal property taxes must be paid (with certain exceptions) before claims for administrative and certain other priority claims are paid.

## V. TAX CONTROVERSIES

### A. Re-Determination of Property Tax Values.

Although a bankruptcy court generally has broad jurisdiction under Bankruptcy Code section 505(a) to determine the amount or legality of any tax, revised section 505(a) strips the court of jurisdiction to determine the amount or legality of any ad valorem property tax on real or personal property if the applicable period for contesting the amount or legality of such tax under non-bankruptcy law has expired. Bankruptcy Code section 505(a)(2)(C).

### B. United States Tax Court Proceedings.

Although the automatically stay does not operate to prevent an individual from filing a Tax Court petition to re-determine the amount of a proposed tax deficiency under revised Bankrupcty Code section 362(a)(8), the prohibition against the institution of such proceedings by a corporate debtor remains. But what happens to a limited liability company in this situation?

## VI. NEW SECTION 505(b) PROCEDURES

Under revised section 505(b), the clerk of the bankruptcy court must create and maintain a registry of addresses of taxing authorities for use in connection with serving section 505(b) requests. Although the statute doesn't say so in so many words, section 505(b) requests mailed to some address other than a designated address appear to be invalid and ineffectual. Revised section 505(b) suggests – although doesn't expressly provide – that a taxing authority may impose "additional requirements" for filing 505(b) applications.

If a taxing authority fails to designate an address, a 505(b) request can be served at the same place as the underlying tax return (or tax protest) is filed.

## VII. DISMISSAL OR CONVERSION OF CASE FOR FAILURE TO TIMELY PAY TAXES OR FILE TAX RETURNS OR ABUSE

Revised Bankruptcy Code section 1112(b)(4)(I) defines "cause" for purposes of determining whether a chapter 11 case should be dismissed or converted to chapter 7 to include a failure to pay "taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief."

What are taxes "owed after the date of the order for relief?" Presumably, they would not include prepetition taxes (which, as prepetition items, typically are paid under a plan and not during the period of administration absent a special order of the bankruptcy court).

Debtors who are cavalier about timely filing tax returns due after the order for relief (whether for administrative or prepetition periods) may incur severe sanctions in the form of dismissal or conversion of their chapter 11 cases.

Note, however, that even if a movant establishes "cause", a bankruptcy court may yet deny a motion to dismiss or convert based upon language in section 1112(b)(2). There appears to be an unintended double negative in this statute: ". . . shall not be granted absent unusual circumstances specifically identified by the court that establish that such relief is not in the best interest of creditors and the estate . . ."

Under the 2005 Act, the chapter 13 debtor is required to have filed tax returns for the four taxable years immediately preceding the filing of the petition. Limited extensions will be permitted, during which the trustee will hold open the first meeting of creditors. Conversion to chapter 7 or dismissal will result if the debtor fails to file within the extended periods. Failing to file post-petition tax returns may cause the case may be converted to a chapter 7 or dismissed.

Under the 2005 Act, an individual's chapter 7 case may be dismissed (or converted to a chapter 13 case with the debtor's consent) by the trustee or certain creditors for "abuse". Section 707(b)(1). When the debtor's monthly income exceeds a formula amount a presumption of abuse arises. The debtor's attorney must certify that the petition and schedules are correct after an inquiry which should increase the accuracy of the determination of debtor's income.

## VIII. SMALL BUSINESS CASES

New Code section 1116 establishes special rules for a "small business case." A small business cases is defined in section 101(51C) as a chapter 11 case filed by a "small business debtor". A small business debtor, under section 101(51D), generally is a debtor whose liquidated, noncontingent, secured and unsecured debt as of the petition date is $2,000,000 or less (excluding debt to affiliates or insiders) in a case where no creditors committee is appointed or where the court determines that such a committee is not active to the requisite extent.

Section 1116(1) requires the debtor to attach its most recent federal income tax return to the chapter 11 petition or, if no such return as been filed, then to attach a penalty-of-perjury declaration to that effect.

Additionally, the small business debtor must timely file tax returns and, subject to section 363(c)(2), timely pay all taxes entitled to administrative priority except those being contested by appropriate proceedings being diligently prosecuted.

The reference to section 363(c)(2) apparently is intended to make it clear that a debtor cannot use the cash collateral of a secured creditor to pay taxes under section 1116.

Query whether, by negative implication, a debtor now can invade cash collateral to pay taxes required to be paid under any provision of the Bankruptcy Code other than section 1116.

## IX. PRIORITY AND SUBORDINATION OF TAXES

### A. Priority Status of Straddle-Year Tax Claims.

Before the 2005 Act, some courts held that when a corporate debtor filed bankruptcy its taxable year was deemed ended as of the filing and, thus, its income tax liability for the entire year was partially pre-petition and partially an administrative expense. The 2005 Act changed this and now income and gross receipts taxes for the entire year are considered post-petition administrative expense claims that must be paid in full in the ordinary course, rather than partially pre-petition priority claims. Section 507(a)(8).

### B. Priority Status of Old Tax Claims.

A claim for income taxes of a debtor receives priority status in either of the following situations: (a) if the return in respect of such tax is due, including extensions, after three years before the date of the filing of the petition; or (b) the claim for income taxes was assessed within 240 days before the filing of bankruptcy. Prior to the 2005 Act, the courts generally tolled the three year and 240 day periods for the time when a stay was in effect during a prior bankruptcy case of a debtor. Under prior law, the 240 day period was also tolled by statute during the period an offer in compromise was pending plus 30 days, if made within 240 days after the assessment. The 2005 Act makes couple of modifications to these rules. First, the 240 day period will continue to be tolled when an offer in compromise is actually in effect plus 30 days and now, by statute, it will also be tolled during the time a prior bankruptcy case is in effect plus 90 days. Second, under the 2005 Act, tolling will apply during any period when a taxing authority is prohibited from collecting a tax as a result of a collection due process request, some innocent spouse claims or similar requests by the debtor, plus any other time that a stay was in effect under a prior bankruptcy case. Section 507.

### C. Priority Status of Property Taxes.

The 2005 Act clarified that when determining if priority status applies to property taxes, it is only necessary that such taxes be "incurred" before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition. Before the 2005 Act, the law used the term "assessed" instead of "incurred" and property taxes may not ever be assessed under certain local tax statutes.

## X. DISCHARGE OF TAX CLAIMS

### A. Rules for Discharge of Taxes in Chapter 7 and Chapter 13 Cases.

Before the 2005 Act, individuals who filed under Chapter 7 faced more strict requirements to discharge of taxes than individuals who filed under Chapter 13. In order for income taxes to be discharged in a Chapter 7 case, the individual must have filed returns with respect to the taxes whose discharge is being sought and must have done so in timely fashion if the taxes in question arose in the last two years prior to bankruptcy. In a Chapter 13 case, taxes can be discharged without any return being filed. Additionally, a taxpayer who files a fraudulent return or willfully attempts to evade or defeat a tax cannot discharge that tax in a Chapter 7 case, but can in a Chapter 13 case. The 2005 Act modified these rules and generally requires the more difficult requirements under Chapter 7 to also apply in Chapter 13 cases. In other words, a Chapter 13 debt cannot discharge taxes if a return was not file, the taxes involve fraud or, in some cases, the return was filed late.

## B. No Discharge of Fraudulent Taxes in Chapter 11.

Prior to the 2005 Act, confirmation of a (non-liquidating) plan of reorganization discharges a corporate debtor from all debts, except when the plan is a liquidating plan. The 2005 Act modified this rule to provide that a corporation cannot discharge a tax if it relates to a fraudulent return or the debtor willfully attempted to evade the tax.

## C. Discharge of Debts Incurred to Pay Non-Dischargeable Taxes

The 2005 Act added a new section 523(a)(14A) which provides that debts incurred to pay non-dischargable taxes to state and local taxing authorities are non-dischargeable.

# XI. SETOFF OF TAX REFUNDS OUTSIDE OF BANKRUPTCY.

The IRS is generally permitted to set off refunds owed to a taxpayer against unpaid taxes owed by that taxpayer. Prior to the 2005 Act, the government had the right of setoff with respect to pre-petition taxes but the taxing authority was prevented from exercising that right while the automatic stay was in place. Under the 2005 Act, setoffs will generally be permitted if setoff would have been permitted outside bankruptcy and if the taxable periods giving rise to both the overpayment and the deficiency are pre-petition. If setoff is not permitted under nonbankruptcy law because of a contest over the amount or legality of the deficiency, the taxing authority will be permitted to hold the refund pending resolution of the contest, unless the court grants adequate protection.

# XII. HIGHLIGHTS OF NON-TAX CHANGES IN 2005 ACT

## A. Exempt Assets

Section 522 was amended by the 2005 Act to permit debtors to exempt up to $1 million in any account which is exempt from taxation under IRC sections 401, 403, 408, 408A, 414, 457 and 501(a) with the exception of an IRA (other than a SEP under IRC sections 408(k) or 408(p)) not created by a roll over from a non-IRA account.

## B. Repetitive Filings

If a debtor files a new case within one year after an earlier dismissed case, the automatic stay terminates 30 days after the new case was filed unless the court, after notice and a hearing extends the stay because the new case is filed in good faith. There is a presumption that the case is not in good faith if the debtor had been in more than one case in the prior 12 months or if certain other conditions exist. A new case is also presumptively in bad faith as to any creditor that filed a motion for relief from the automatic stay that was pending at the time of dismissal or was resolved by terminating or limiting the stay. If a debtor files a case after two or more dismissed cases were pending in the previous year no automatic stay will arise.

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The 2005 Act amended section 727(a)(8) to extend the time between a prior chapter 7 or 11 discharge from six to eight years. Also, a chapter 7 discharge may not be entered if the debtor received a discharge in a case under chapters 7, 11 or 12 during the four years preceding the date of a chapter 13 order for relief or in a prior chapter 13.

C. Fraudulent Transfers

The 2005 Act amended section 548 regarding fraudulent conveyances. Transfers made within two years, rather than only one year, before the petition date will now be subject to avoidance in bankruptcy cases filed on or after April 20, 2006. Also certain transfers and obligations to or for the benefit of an insider under an employment contract are now subject to avoidance if the debtor failed to receive reasonably equivalent value. Section 548 now provides that the trustee may avoid any transfer of the debtor's property that was made within 10 years before the commencement of the case if the transfer was made by the debtor to a self-settled trust or similar device, the debtor is the beneficiary and the transfer was made with actual intent to hinder, delay or defraud any entity to which the debtor was or became indebted on or after the date of the transfer. Arguably all asset protection trusts are set up to hinder or delay creditors and, thus, this provision may sweep most or all asset protection trusts into its net unless the settlor is careful not to name himself or herself as a beneficiary.