

THE MAJOR TAX ISSUES IN
THE 2005 ACT
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- I. Introduction – There are important tax changes which are incorporated into the 2005 Act. Unfortunately the tax changes are scattered all over the bankruptcy code and are not incorporated into one special tax section. This material is designed to discuss the major areas of the bankruptcy case and identify the tax changes within that area. In this way, tax issues are set forth in a practical perspective.

- II. Dismissal or conversion of cases for failure to pay taxes.
 - a. Section 710 - amends S 1129 (a) (9) (C) and deals with periodic payment of taxes in chapter 11 and imposes time limits (not more than 5 years) and requires regular installment payments in a chapter 11 plan. All priority taxes are required to be paid within 5 years after the order for relief has been entered.

 - b. Section 716 - amends S 1325 (a) and adds a new S 1308, which requires a chapter 13 debtor to have filed tax returns for the 4 years immediately prior to the filing of the petition. The chapter 13 debtor has until the first scheduled S 341(a) meeting to comply with this requirement for filed tax returns.

Failure to file tax returns could result in dismissal of the case or conversion to liquidation. This applies to chapter 13.

Limited extensions of time for filing tax returns are available, but during the extension period the first meeting of creditors remains open. The open period is no longer than 120 days.

There is a 90 day period, which begins to run after the taxing authority has filed a request for dismissal or conversion. During the 90 day period the debtor can correct the failure to file or obtain an extension. If the 90 day period passes and the debtor has done nothing there is a mandatory dismissal or conversion required by the bankruptcy court, whichever is in the best interests of the creditors.

The request for dismissal can be made by a party in interest or the United States Trustee.

- c. Section 720 - amends S 521 and adds S 521 (j) (1) and (2) and provides for the option of dismissal or conversion of a case, on request of a taxing authority, if the debtor fails to file post petition tax returns that come due after the case is commenced; or if the debtor has not obtained an extension of the due date for filing the return, or if the debtor fails to pay post petition taxes. This applies to any case under the Code.
- d. Section 712 - post petition taxes must be paid in the ordinary course of conduct of the business (this amends 28 U.S.C. 960). The taxes include income, ad valorem, and presumably all other types of taxes. See also S 1112 (b) (4) (I) where failure to timely pay taxes owed after the order for relief is cause for the dismissal or conversion of a chapter 11 case or grounds for the appointment of a trustee.

III. Bankruptcy Court Jurisdiction.

- a. Notice provisions in connection with request for determination of taxes.
 - 1. Section 703 - amends S 505 (b) and allows taxing authorities to register an address with the bankruptcy clerk for the place of service of requests for determination of taxes, for the filing of tax returns, and for the filing of tax protests. The registration can also describe the place where requirements and further information regarding such matters can be located. The bankruptcy clerk must maintain the list of taxing authorities addresses. All taxing authorities are affected by this change.
- b. Restriction on ad valorem tax request for redetermination.
 - 1. Section 701 (b) creates new S 505 (a) (2) (C) which deals with determination of tax liability by the bankruptcy court and restricts its jurisdiction to redetermine ad valorem taxes, if the limitation period for contesting the tax has expired by non-bankruptcy law. There is no jurisdiction if that circumstance has occurred.
- c. Discharge of estate's liability for unpaid taxes.
 - 1. Section 715 amends S 505 (b) (2) to give the bankruptcy estate the benefit of a discharge when a trustee requests a prompt assessment of tax from a taxing authority and it does not respond or comply with the procedures in S 505 (b). Under prior law only the trustee and the debtor were discharged from any claim for unpaid taxes.

The amendment now includes the estate in the discharge from any tax liability in excess of the tax liability on the tax return.

- d. Limiting the Stay of Tax Court Proceedings - Section 709
 - 1. Presently, the filing of a bankruptcy petition stays commencement or continuation of proceedings before the United States Tax Court. (S. 362 (a)(8)). The amendment to S 362 (a)(8), permits the bankruptcy court to determine the period the stay would be applicable to a corporate debtor's tax liability. This gives the bankruptcy court discretion to stay the Tax Court proceeding for a corporate debtor's tax liability for either pre-petition or post-petition tax liabilities, or both.
 - 2. In the case of an individual the automatic stay only applies to pre petition tax liability before the entry of an order for relief. The automatic stay of the Tax Court does not apply to the individual's post petition tax liability.

IV. Tax Priority Issues.

- a. Tax lien issues – Section 701 amends S 724 with regard to secured tax claims. Presently secured tax claims are granted a priority as priority unsecured tax claims. The amendment exempts downgrading secured lien ad valorem taxes, which would now be paid after wage and employee benefit plan claims. This change is an advantage to real and personal property tax liens held against property of the Estate.
- b. Priority tax claims.
 - 1. Section 705 amends S 507 (a) (8) (A) and changes the priority of the income tax liability of a corporate and individual debtor.
 - (a) Tax liability of a corporate debtor for the year of filing is an administrative expense, and the tax year would not be bifurcated into a prepetition tax claim before the petition filing and a postpetition administrative tax claim after filing.
 - (b) Tax liability of an individual debtor under the change proposed affects priority status of tax claims as follows:
 - (i) Priority status of a tax claim under existing law is granted if the return for the tax is last due after three years before the date of filing the petition. If there

was a prior bankruptcy case, the three year period was generally tolled during the time that a stay against assessment or collection was in effect.

The change allows the three year period to be tolled during the stay period of a prior filed bankruptcy case plus an additional 90 days.

- (ii) Priority status of a tax claim under existing law is granted if the tax was assessed within 240 days prior to the filing of a bankruptcy petition. The 240 day period is also tolled during the time an offer in compromise was pending, plus an additional 30 days.

The change regulates the tolling of the 240 days as follows – the period when an offer in compromise was in effect plus 30 days, and during the time a prior bankruptcy case was in effect, plus 90 days.

By way of background, see Young v. U.S., 535 U.S. 43 (2002).

- (c) Property tax priority.

- (i) Section 706 amends S 507 (a) (8) (B) and regulates the priority of property taxes. Presently priority is granted to property taxes assessed before the bankruptcy case is begun and last payable without penalty after 1 year before the filing of the petition.

Instead of the word assessed for property taxes, it is property taxes INCURRED before bankruptcy.

V. Late filed property tax claims.

- a. Section 713 amends S 726 (a) (1) requiring late filed priority tax claims to be filed within 10 days of the filing of the trustee's summary of the final report to creditors. This changes the prior law where late filed priority tax claims would be paid so long as they were filed before the trustee began distribution.

VI. Interest Rate on Tax Claims – Section 704.

- a. A new Section 511 is created to provide for the applicable interest rate to be paid, when allowed, on pre-petition and administrative tax claims as well as deferred tax payments made in chapter 11 under S 1129 (a)(9)(C). The interest rate provided is the rate under non-bankruptcy law. This new treatment of interest may possible conflict with the prime plus method of calculating interest on deferred tax payments that was apparently approved in Till v. SCS Credit Corp., 541 U.S. 465, 124 S. Ct. 1951 (2004). However, note that prior bankruptcy law did not have a specific code section that dealt with the applicable rate of interest on tax claims.

VII. The Effect of Fraud

- a. Fraudulent tax/or willful attempt to evade and defeat tax - discharge barred

1. Chapter 13

- (a) Section 707 - amends S 1328 (a)(2) and affects S 507 (a)(8)(C) to bar a discharge because there are tax returns which have not been filed, or the tax returns filed are fraudulent.

This changes existing chapter 13 law which allows a discharge from all taxes, whether or not fraudulent, by provisions in the plan to commit future income, on a best efforts basis, to pay tax liabilities even though tax liabilities may not ultimately be fully paid.

Additionally, no discharge for tax returns due 2 years before the date of filing the petition.

2. Chapter 11

- a. Section 708 - amends S 1141(d) and affects the corporation's discharge. If the corporation made a fraudulent tax return or willfully attempted in any manner to evade or defeat taxes or customs duty no discharge is granted, even though the chapter 11 plan is confirmed.

This changes existing chapter 11 law, as now confirmation of a Corporation's plan discharges the corporation from all debts, except where the plan is a liquidating plan.

VIII. Changes to the Automatic Stay Affecting Tax

- a. Section 362 (b) (18) is amended and expanded to extend the tax coverage of no automatic stay affecting property tax liens to special taxes or a

special tax assessment on real property. These types of taxes to create liens can be filed after a bankruptcy is pending without violating the automatic stay.

The law which existed before the amendment, permitted ad valorem property tax liens for taxes becoming due after the filing of a petition to be unaffected by operation of the automatic stay but did not include special taxes, or special assessments.

IX. Special Provisions Related to the Treatment of State and Local Taxes – Amendment of S 346.

- a. Section 719 amends S 346 and conforms the state and local tax rules to corresponding provisions of the Internal Revenue Code.

S 346 now provides that Internal Revenue Code provisions govern state and local tax provisions regarding specific tax filing requirements and substantive tax rules. The amendment and rewriting of S 346 makes for uniformity of tax treatment.

X. Standard For Tax Disclosure

- a. Section 717 is new. The disclosure statement must now contain a discussion of potential material federal tax consequences of the plan of reorganization to the debtor, any successor to the debtor, and a hypothetical investor typical of holders of claims or interests in the case.

Prior law did not specify in the Code what constitutes adequate information as to tax consequences of the plan.

XI. Treatment of Fuel Tax Claims

- a. Section 702 creates a new S 501 (e). This section provides that a claim arising from the debtor's fuel use tax may be filed by the base jurisdiction designated pursuant to the International Fuel Tax Agreement, and if the claim is filed, it is allowed as a single claim.

XII. Tax Documents Provided to and Destroyed by the Bankruptcy Court. This is a new concept.

- a. Section 1228 of the 2005 Act deals with tax document production and retention in an individual's chapter 7, and chapters 11, and 13.
- b. In chapter 7 an individual may not be granted a discharge unless requested tax documents have been provided to the bankruptcy court.

- c. In chapter 11 and 13, in the case of an individual, no plan shall be confirmed unless requested tax documents have been filed with the bankruptcy court.
 - d. The documents submitted to the bankruptcy court must be retained by the court for 3 years after the date of the conclusion of the bankruptcy case.
 - 1) After 3 years the documents shall be destroyed.
 - 2) If there is a pending audit or enforcement action, the bankruptcy court may extend the time for destruction of requested tax documents.
- XIII. All statutory provisions or amendments affecting tax changes and tax treatment in the Bankruptcy Code are effective on October 17, 2005 (180 days after enactment). All amendments apply to bankruptcy cases filed on or after October 17, 2005. A listing of Bankruptcy Code provisions covering tax changes and treatment is set forth for convenience. Additionally, the United States Code provision (28 U.S.C. 960) relating to tax liability of officers and agents conducting business under authority of a United States Court, was amended and added to. This statutory provision is set forth for convenience.

There are two proposed interim rules which relate to taxes. These are set forth for convenience.

BANKRUPTCY CODE SECTIONS AMENDED OR AFFECTED BY BAPCPA 2005

Sec. 346. Special tax provisions.....

Sec. 362. Automatic stay.....

Sec. 501. Filing of proofs of claims or interests.....

Sec. 502. Allowance of claims or interests.....

Sec. 503. Allowance of administrative expenses.....

Sec. 505. Determination of tax liability.....

Sec. 506. Determination of secured status.....

Sec. 507. Priorities.....

Sec. 511. Rate of interest on tax claims.....

Sec. 521. Debtor’s duties.....

Sec. 523. Exceptions to discharge.....

Sec. 545. Statutory liens.....

Sec. 724. Treatment of certain liens.....

Sec. 726. Distribution of property of the estate.....

Sec. 1112. Conversion or dismissal.....

Sec. 1116. Duties of trustee or debtor in possession in small business case.....

Sec. 1125. Post-petition disclosure and solicitation.....

Sec. 1129. Confirmation of plan.....

Sec. 1141. Effect of confirmation.....

Sec. 1146. Special tax provisions.....

Sec. 1222. Contents of plan.....

Sec. 1231. Special tax provisions.....

Sec. 1307. Conversion or dismissal.....

Sec. 1308. Filing of pre-petition tax returns.....

Sec. 1325. Confirmation of plan.....

Sec. 1328. Discharge.....

U. S. CODE TAX PROVISION
RELATING TO BANKRUPTCY CODE CASES

28 U.S.C. Sec. 960. Tax liability.

- (a) Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.

- (b) A tax under subsection (a) shall be paid on or before the due date of the tax under applicable nonbankruptcy law, unless -
 - (1) the tax is a property tax secured by a lien against property that is abandoned within a reasonable period of time after the lien attaches by the trustee in a bankruptcy case under title 11; or

 - (2) payment of the tax is excused under a specific provision of title 11; or

- (c) In a case pending under chapter 7 of title 11, payment of a tax may be deferred until final distribution is made under section 726 of title 11; if -
 - (1) the tax was not incurred by a trustee duly appointed or elected under chapter 7 of title 11; or

 - (2) before the due date of the tax, an order of the court makes a finding of probable insufficiency of funds of the estate to pay in full the administrative expenses allowed under section 503(b) of title 11 that have the same priority in distribution under section 726(b) of title 11 as the priority of that tax.

VARIOUS PROPOSED INTERIM RULES (“PIR”) RELATED TO TAXES.

PIR 3002(c)(1): A governmental unit must file a proof of claim based on a return filed under new §1308 of the Bankruptcy Code not later than 60 days after the date on which the return was filed as required by §1308.

PIR 5003: A governmental unit and certain taxing authorities may file a statement designating an address for service of requests made under §505(b)(2) of the Bankruptcy Code (request by a trustee for determination of unpaid liability of the estate for any tax incurred during the administration of the case). The clerk shall maintain a list of the designations. Mailing to that address provides effective notice – failure to use that address does not invalidate a notice sent to another address which is otherwise effective under applicable law.