

**THE TAX CHANGES TO
THE BANKRUPTCY CODE**

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made more than 20 changes to the treatment of taxes in bankruptcy cases. One of the tax changes works in favor of debtors – section 1222(a)(2)(A) now relieves Chapter 12 debtors from priority status for capital gain tax liabilities arising from the sale of farm assets. The majority of the changes, however, favor taxing authorities, by restricting a debtor's discharge rights, compelling compliance with return filing and tax payment requirements, and increasing the amounts taxing authorities can recover in bankruptcy.

The primary changes to tax treatment may be described as follows:

1. Tolling Rule for Priority Status.

New language at the end of Bankruptcy Code section 507(a)(8) tolls the three-year and 240-day periods for determining priority of a tax liability when collection of the liability was stayed by the debtor's involvement in a prior bankruptcy case or a collection due process appeal under Internal Revenue Code sections 6320 or 6330. The three- or 240-day periods do not run during the duration of the stay, and the pertinent priority period is extended by 90 days. The filing of an offer in compromise during the 240-day period continues to toll that period under section 507(a)(8)(A)(ii) and extends the 240-day period by an additional 30 days.

2. Tax Exceptions to the Superdischarge in Chapter 13 and Corporate Chapter 11 Cases. Amendments to section 1141(d) now exempt tax liabilities

associated with fraud or a willful attempt to evade or defeat the tax. These liabilities are no longer subject to the superdischarge granted to corporations in Chapter 11. No similar language compels exemption from discharge for a partnership or limited liability company. The superdischarge granted to debtors in Chapter 13 under section 1328(a) no longer eliminates: (1) liabilities associated with fraud or a willful attempt to evade or defeat the tax, (2) the trust fund portion of employment tax liabilities or other tax liabilities that have a withholding requirement, or (3) taxes associated with a period for which the debtor failed to file a return or filed the return late on a date less than two years prior to the petition date.

3. Mandatory Compliance with Postpetition Return Filing and Tax Payment Requirements.

Small business debtors in Chapter 11 are required to remain current on postpetition tax obligations and timely file all postpetition returns. Section 1116(b). If a small business debtor defaults on a postpetition tax obligation and fails to cure the default within the time prescribed by statute, the court must dismiss the case or convert it to a proceeding under Chapter 7, unless it is established that conversion or dismissal is not in the best interests of the estate. Throughout all chapters of bankruptcy, section 521(j) allows taxing authorities to obtain dismissal or conversion of a debtor's case if the debtor defaults on a postpetition return filing and does not cure it within 90 days after the taxing authority moved for conversion or dismissal.

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4. Mandatory Filing of Prior Four Years of Tax Returns in Chapter 13 Cases. Under new section 1308(a), Chapter 13 debtors who failed to file any prepetition tax returns that became due within four years prior to the petition date must file all such returns before the 341 meeting. The debtor can obtain a maximum of 150 additional days to file the returns. *Id.* If he or she fails to do so, the court is required to dismiss the case or convert it a case under Chapter 7, whichever is in the best interests of the estate.

5. Capital Gain Relief for Sales of Farm Assets in Chapter 12. Section 1222(a)(2) eliminates priority status for income tax liabilities arising from the disposition of farm assets, thereby allowing farmers who must dispose of capital-gain-rich property to confirm and complete liquidating plans without full payment of gains taxes arising from the sales. Gains taxes not paid under the plan may be discharged.

6. Statutory Interest Rate Required with Tax Claims. New section 511 requires use of the interest rate dictated by the pertinent tax laws whenever interest must be paid on a tax claim. In reorganization cases, the debtor must provide in the plan for payment of the interest rate in effect on the date of confirmation.

7. Income Tax Accounting in Individual Chapter 7 and 11 Cases. Section 346 of the Bankruptcy Code – which dictates the accounting rules for individuals in Chapters 7 and 11 with state and local income taxes – has been revised to eliminate differences with the accounting rules provided for federal tax purposes under Internal Revenue Code section 1398. New section 1115 of the Bankruptcy Code, however, makes postpetition earnings of an individual debtor in Chapter 11 property of the estate, possibly shifting the income tax consequences of any such postpetition earnings from the debtor to the estate. A number of problems may arise for the debtor if this is the case.

8. Mandatory Disclosure of Return Filed for Most Recent Year Prior to Bankruptcy at 341 Meeting. Section 521(e)(2)(A) requires all debtors in bankruptcy to provide the Trustee, not less than seven days prior to the 341 meeting, with a copy of the income tax return (or a transcript reflecting that return) for the most recent tax year for which the debtor the debtor filed. The debtor's case must be dismissed if the debtor fails to timely produce the return, unless the debtor establishes that the failure

was due to circumstances beyond the debtor's control.

9. The Definition of "Return." Language added at the end of section 523(a)(1) now defines "returns" as documents that qualify as returns under applicable non-bankruptcy law or final orders of courts of competent jurisdiction on the amount of tax due. Within the Ninth Circuit and most other circuits, to be a return, a document must (1) be executed under penalties of perjury; (2) contain sufficient financial information for a tax to be computed; and (3) be filed in a good faith effort to declare a tax liability. *See, e.g., In re Hatton*, 220 F3d 1057 (9th Cir. 2002). "Substitutes for returns" and assessments that occur in the absence of the debtor's filing of an actual return accordingly do not qualify as returns for purposes of the nondischargeability provisions of section 523(a)(1)(B)).

10. Minimum Payment Requirements for Tax Claims in Chapter 11. Under amendments to section 1129(a)(9), Chapter 11 priority tax liabilities must receive treatment at least as favorable as the most favored class of unsecured claims, with the exception of administrative convenience claims. Secured tax claims that would be entitled to priority if they were unsecured must also be paid within five years of the petition date and receive treatment at least as favorable as all general unsecured claims.

11. Mandatory Discussion of Tax Consequences in Chapter 11 Disclosure Statements. Disclosure statements in Chapter 11 cases must contain a sufficient discussion of the tax consequences of the plan for a hypothetical investor to make informed decisions about acceptance or rejection. Section 1125(a)(1).

12. Stay Relief for Refund Offsets. New section 362(b)(26) allows taxing authorities to offset prepetition refunds against prepetition tax liabilities, unless there is a dispute about the amount of tax due, or unless the Trustee wishes to use the refund and establishes that it can be adequately protected.

13. Restrictions to Subordination of Tax Liens in Chapter 7 Cases. Ad valorem taxes are no longer subject to subordination in Chapter 7 cases under section 724. Secured claims for other forms of tax cannot be subordinated unless the Trustee marshals proceeds from unsecured assets of the estate and collects fees and expenses incurred in liquidation from the proceeds of the pertinent assets. Section

724(f). In cases that were converted to Chapter 7 from a reorganization proceeding, secured tax claims are not subordinated to administrative expenses incurred during the reorganization proceeding unless they are claims for wages, salaries, commissions, or contributions to an employee benefit plan. *Id.*, and section 724(b)(2).

14. Restricted Jurisdiction for Redetermination of Property Tax Assessments. Under an amendment to section 505(a), the bankruptcy court may not redetermine the amount of an ad valorem tax after expiration of the period designated by the pertinent tax laws for contesting the assessment.

15. Addresses for Prompt Determination Requests. Section 505(b)(1)(A) allows taxing authorities to designate an address with the clerk of the court for the filing of prompt determination requests for postpetition tax liabilities under section 505(b)(2). Debtors or trustees who fail to send a prompt determination request to the designated address will not obtain the safe harbor benefits provided by that section.

16. No Stay of Tax Litigation for Postpetition Tax Periods. Section 362(a)(8) has been amended to exempt U.S. Tax Court proceedings from the automatic stay if the litigation involves a postpetition tax liability.

The language of many of the tax amendments is less than precise, and Congress' intent with some of the new provisions is less than completely clear. Bankruptcy practitioners should review the language of the tax amendments carefully, with the understanding that the tax amendments will require development in the courts over the next few years.

Jeffrey M. Wong
Greene & Markley PC