

BANKRUPTCY REFORM ACT OF 1978

HEARING
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
NINETY-FIFTH CONGRESS
SECOND SESSION
ON
SECTIONS 346, 505, 507, 523, 728, 1146, AND 1331 OF S. 2266

AUGUST 4, 1978

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BANKRUPTCY REFORM ACT OF 1978

FRIDAY, AUGUST 4, 1978

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Jr., of Virginia, Long, and Hansen.

[The committee press release announcing this hearing and secs. 346, 505, 507, 523, 728, 1146, and 1331 of S. 2266 follow:]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT RESCHEDULES
HEARINGS ON THE BANKRUPTCY REFORM ACT OF 1978

Senator Harry F. Byrd, Jr., Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, announced today that the Committee's hearings previously scheduled for July 28, 1978, on Sections 346, 505, 507, 523, 728, 1146 and 1331 of S. 2266 and H.R. 8200, the Bankruptcy Reform Act of 1978, will be held on Friday, August 4.

The hearings will begin at 9:30 a.m. in room 2221 of the Dirksen Senate Office Building.

Senator Byrd noted that the hearings would be limited to those sections of the Act which relate to taxation and collection of taxes. Senator Byrd stated that in connection with the Judiciary Committee consideration of the Act, the staff of the Joint Committee on Taxation has developed certain proposed amendments to the Act; those proposed amendments will be considered at the hearings.

Witnesses who desired to testify at the hearings should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, by no later than the close of business on August 2, 1978.

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advanced written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should limit their testimony to these tax sections of the Act and should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their ten-minute oral presentations to a summary of the point included in the statement.

(5) Not more than 10 minutes will be allowed for oral presentation.

Written Testimony.—Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in

the record should be typewritten, not more than 26 double-spaced pages in length and mailed with five copies by August 7, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 227 Dirksen Senate Office Building, Washington, D.C. 20510.

[S. 2266, 95th Cong., 2d sess.]

A BILL to establish a uniform law on the subject of bankruptcies

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

* * * * *

§ 346. Special tax provisions

(a) Except to the extent otherwise provided in this section, subsections (b), (c), (d), (e), (g), (h), (i), and (j) of this section apply notwithstanding any State or local law imposing a tax, but subject to the Internal Revenue Code of 1954 (26 U.S.C. 1 et seq.).

(b) (1) In a case under chapter 7 or 11 of this title concerning an individual, any income of the estate may be taxed under a State or local law imposing a tax on or measured by income only to the estate, and may not be taxed to such individual. Except as provided in section 728 of this title, if such individual is a partner in a partnership, any gain or loss resulting from a distribution of property from such partnership, or any distributive share of income, gain, loss, deduction, or credit of such individual that is distributed, or considered distributed, from such partnership, after the commencement of the case is gain, loss, income, deduction, or credit, as the case may be, of the estate.

(2) Except as otherwise provided in this section and in section 728 of this title, any income of the estate in such a case, and State or local tax on or measured by such income, shall be computed in the same manner as the income and the tax of an estate.

(3) The estate in such a case shall use the same accounting method as the debtor used immediately before the commencement of the case.

(c)(1) The commencement of a case under this title concerning a corporation or a partnership does not effect a change in the status of such corporation or partnership for the purposes of any State or local law imposing a tax on or measured by income. Except as otherwise provided in this section and in section 728 of this title, any income of the estate in such case may be taxed only as though such case had not been commenced.

(2) In such a case, except as provided in section 728 of this title, the trustee shall make any tax return otherwise required by State or local law to be filed by or on behalf of such corporation or partnership in the same manner and form as such corporation or partnership, as the case may be, is required to make such return.

(d) In a case under chapter 13 of this title, any income of the estate or the debtor may be taxed under a State or local law imposing a tax on or measured by income only to the debtor, and may not be taxed to the estate.

(e) A claim allowed under section 502(f) or 503 of this title, other than a claim for a tax that is not otherwise deductible or a capital expenditure that is not otherwise deductible, is deductible by the entity to which income of the estate is taxed unless such claim was deducted by another entity, and a deduction for such a claim is deemed to be a deduction attributable to a business.

(f) The trustee shall withhold from any payment of claims for wages, salaries, commissions, dividends, interest, or other payments, or collect, any amount required to be withheld or collected under applicable State or local tax law, and shall pay such withheld or collected amount to the appropriate governmental unit at the same time and with the same priority as the claim from which such amount was withheld was paid.

(g) (1) Neither gain nor loss shall be recognized on a transfer—

(A) by operation of law, of property to the estate;

(B) other than a sale, of property from the estate to the debtor; or

(C) in a case under chapter 11 of this title concerning a corporation, of property from the estate to a corporation that is an affiliate participating in a joint plan with the debtor, or that is a successor to the debtor under the plan, except that gain or loss may be recognized to the same extent that such transfer results in the recognition of gain or loss under section 371 of the Internal Revenue Code of 1954 (26 U.S.C. 371).

(2) The transferee of a transfer of a kind specified in this subsection shall take the property transferred with the same character, and with the transferor's basis, as adjusted under subsection (j) (5) of this section, and holding period.

(h) Notwithstanding sections 728(a) and 1140(a) of this title, for the purpose of determining the number of taxable periods during which the debtor or the estate may use a loss carryover or a loss carryback, the taxable period of the debtor during which the case is commenced is deemed not to have been terminated by such commencement.

(1) (1) In a case under chapter 7 or 11 of this title concerning an individual, the estate shall succeed to the debtor's tax attributes, including—

- (A) any investment credit carryover;
- (B) any recovery exclusion;
- (C) any loss carryover;
- (D) any foreign tax credit carryover;
- (E) any capital loss carryover; and
- (F) any claim of right.

(2) After such a case is closed or dismissed, the debtor shall succeed to any tax attribute to which the estate succeeded under paragraph (1) of this subsection but that was not utilized by the estate. The debtor may utilize such tax attributes as though any applicable time limitations on such utilization by the debtor were suspended during the time during which the case was pending.

(3) In such a case, the estate may carry back any loss of the estate to a taxable period of the debtor that ended before the order for relief under such chapter the same as the debtor could have carried back such loss had the debtor incurred such loss and the case under this title had not been commenced, but the debtor may not carry back any loss of the debtor from a taxable period that ends after such order to any taxable period of the debtor that ended before such order until after the case is closed.

(j) (1) Except as otherwise provided in this subsection, income is not realized by the estate, the debtor, or a successor to the debtor by reason of forgiveness or discharge of indebtedness in a case under this title.

(2) For the purposes of any State or local law imposing a tax on or measured by income, a deduction with respect to a liability may not be allowed for any taxable period during or after which such liability is forgiven or discharged under this title. In this paragraph, "a deduction with respect to a liability" includes a capital loss incurred on the disposition of a capital asset with respect to a liability that was incurred in connection with the acquisition of such asset.

(3) Except as provided in paragraph (4) of this subsection, for the purpose of any State or local law imposing a tax on or measured by income, any net operating loss of an individual or corporate debtor, including a net operating loss carryover of such debtor, shall be reduced by the amount of indebtedness forgiven or discharged in a case under this title, except to the extent that such forgiveness or discharge resulted in a disallowance under paragraph (2) of this subsection.

(4) A reduction of a net operating loss or a net operating loss carryover under paragraph (3) of this subsection or of basis under paragraph (5) of this subsection is not required to the extent that the indebtedness of any individual or corporate debtor forgiven or discharged—

(A) consisted of items of a deductible nature that were not deducted by such debtor; or

(B) resulted in an expired net operating loss carryover or other deduction that—

(i) did not offset income for any taxable period; and

(ii) did not contribute to a net operating loss in or a net operating loss carryover to the taxable period during or after which such indebtedness was discharged.

(5) For the purposes of a State or local law imposing a tax on or measured by income, the basis of the debtor's property or of property transferred to an entity required to use the debtor's basis in whole or in part shall be reduced by the lesser of—

(A) (i) the amount by which the indebtedness of the debtor has been forgiven or discharged in a case under this title; minus

(ii) the total amount of adjustments made under paragraphs (2) and (3) of this subsection; and

(B) the amount by which the total basis of the debtor's assets that were property of the estate before such forgiveness or discharge exceeds the debtor's total liabilities that were liabilities both before and after such forgiveness or discharge.

(6) Notwithstanding paragraph (5) of this subsection, basis is not required to be reduced to the extent that the debtor elects to treat as taxable income,

of the taxable period in which indebtedness is forgiven or discharged, the amount of indebtedness forgiven or discharged that otherwise would be applied in reduction of basis under paragraph (5) of this subsection.

(7) For the purposes of this subsection, indebtedness with respect to which an equity security, other than an interest of a limited partner in a limited partnership, is issued to the creditor to whom such indebtedness was owed, or that is forgiven as a contribution to capital by an equity security holder, other than a limited partner in the debtor, is not forgiven or discharged in a case under this title—

(A) to any extent that such indebtedness did not consist of items of a deductible nature; or

(B) if the issuance of such equity security has the same consequences under a law imposing a tax on or measured by income to such creditor as a payment in cash to such creditor in an amount equal to the fair market value of such equity security, then to the lesser of—

(i) the extent that such issuance has the same such consequences; and

(ii) the extent of such fair market value.

§ 505. Determination of tax liability

(a) The court may determine the amount or legality of any unpaid tax, whether or not previously assessed, that has not been contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under this title.

(b) The trustee may prosecute an appeal or review of an adjudication by a judicial or administrative tribunal of competent jurisdiction of any tax, whether or not paid, if the time for appeal or review, as the case may be, of such adjudication has not expired before the date of the filing of the petition.

(c) (1) Before the case can be closed under section 850 of this title, the trustee shall apply in writing to the governmental unit responsible for determining and collecting the liability of the estate for any tax incurred during the administration of the case for a prompt audit of such liability. The trustee shall submit, with such application, an exact copy of the return of the tax to which such application relates, and shall state the name and location of the office where such return was filed. Within 60 days after receiving the application, the governmental unit shall notify the trustee and the court, by mail, whether the returns are accepted as filed or are selected for examination. If such returns are selected for examination, the governmental unit, within 120 days after giving such notice to the trustee, shall notify the trustee by mail of the amount of any unpaid tax for which the estate is liable for the taxable year and shall file a request for payment with the court for any such unpaid tax. If an examination of the return cannot be completed within the 4-month period, the court, upon application by the governmental unit before the period has expired and for good cause shown, shall grant a reasonable extension of time to permit completion of the examination.

(2) The estate, the trustee, predecessors of the trustee in the administration of the estate, and a debtor under chapter 7 shall be discharged from liability, personal or otherwise, for a tax—

(A) if the governmental unit charged with responsibility for collection or determination of such tax—

(i) gives notice to such trustee under this subsection that the return made with respect to such tax is accepted as filed.

(ii) fails to give notice to the trustee as required by this subsection that such return is either accepted as filed or is selected for examination, or

(iii) in the event such return is selected for examination as described in this subsection, fails to give notice to the trustee as required by this subsection of the amount of any unpaid tax for which the estate or a debtor is liable, or

(B) upon payment of such tax in accordance with the final order of the court determining the liability of the estate for such tax, unless a notice of appeal from such order is timely filed.

A discharge from personal liability pursuant to this subsection shall not affect the liability of the debtor or any successor to the debtor in a proceeding under chapter 11 of this title.

(3) For purposes of this subsection—

(A) in the case of a Federal tax, the governmental unit charged with the collection or determination of such tax is the internal revenue district in which the case is pending, and

(B) notice shall be deemed to be given by mail on the date of the United States postmark stamped on the cover in which such notice is mailed.

§ 507. Priorities

(a) The following expenses and claims have priority in the following order :

(1) First, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28.

(2) Second, unsecured claims allowed under section 502(f) of this title.

(3) Third, allowed unsecured claims for, or requests for payment of—

(A) wages, salaries, or commissions, including vacation, severance, and sick leave pay—

(i) earned by an individual within 90 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first, but only

(ii) to the extent of \$1,800 for each such individual ;

(B) taxes withheld from or required to be withheld from such wages, salaries, or commissions, and

(C) taxes imposed on the estate with respect to such wages, salaries, or commissions, but only if and to the extent that funds remain after full payment of the amounts referred to in subparagraphs (A) and (B).

(4) Fourth, allowed unsecured claims for contributions to employee benefit plans—

(A) arising from services rendered within 120 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first ; but only

(B) for each such plan, to the extent of—

(i) the number of employees covered by such plan multiplied by \$1,800, less

(ii) the aggregate amount paid to such employees under paragraph (3) of this section, plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.

(5) Fifth, allowed unsecured claims of individuals each of those adjustable gross income from all sources derived, does not exceed \$20,000, to the extent of \$600 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

(6) Sixth, allowed unsecured claims, including interest thereon accrued before the date of the filing of the petition, to the extent that such claims are for—

(A) taxes—

(i) on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition, or

(ii) on or measured by employment, production, or use of property, transfers by death, gift, sale, or otherwise, or other transactions or events, if such transaction or event occurred before the date of the filing of the petition, and

for which a return or report was last due, including extensions, within 8 years before the date of filing of the petition or thereafter ;

(B) taxes described in subparagraph (A) (i) or (ii)—

(i) if assessed at any time within 240 days immediately before the date of the filing of the petition : *Provided*, That the assessment was made within 8 years after the return of such taxes was last due, including extensions, or

(ii) the collection or assessment of which was, pending the exhaustion of administrative or judicial remedies, prohibited at any time during the 900 days immediately before the date of the filing of the petition, or

(iii) for which an offer in compromise was withdrawn by the debtor, or rejected by the governmental unit, during the 240 days immediately before the date of the filing of the petition ;

(C) taxes described in clause (ii) of subparagraph (A), if no return or report is prescribed by law and if the taxable transaction occurred within 8 years before the date of the filing of the petition ;

(D) except as provided in paragraph (3) of this subsection, taxes required to be collected or withheld from others and for which the debtor is liable in any capacity;

(E) property taxes, if the date as of which the taxes were required to be assessed was within 8 years before the date of the filing of the petition;

(F) taxes for any taxable year attributable to a tentative carryback adjustment which the debtor received before the petition was filed, if the taxable year from which the carryback resulted ended on or before the date of the filing of the petition and the return for such year was last due, including extensions, within 8 years before the date of the filing of the petition, or thereafter;

(G) taxes arising from the recapture, in connection with a transfer of property in a case under this title, of deductions or credits allowed for a taxable year ending on or before the date of the filing of the petition;

(H) liability of the debtor as transferee from another person who is liable for any tax, if a claim against the transferor for such tax would have been entitled to priority under subparagraph (A) if a proceeding under this title had been commenced against the transferor within 1 year before the date of the filing of the petition;

(I) taxes not included under the preceding subparagraphs of this paragraph, for which an extension of time for payment was granted at the request of the debtor, to the extent of any installments that first become due within 1 year before the date of the filing of the petition and remained unpaid at such date, unless the debtor and the governmental unit agree to extend the time for payment of such installment;

(J) liabilities of the debtor as a third party for failing to surrender property or to pay an obligation in response to a levy for taxes of another, or for paying or providing funds for the payment of wages without provision for taxes required to be withheld therefrom, if the event giving rise to such liability occurred within 4 years before the earlier of—

(i) the date of the filing of the petition, or

(ii) the commencement of an action against the debtor with respect to such liability, if such action was pending at the date of the filing of the petition or was terminated not more than 1 year before such date;

(K) customs duties arising out of the importation of merchandise—

(i) entered for consumption during the 8 years immediately preceding the date of the filing of the petition but unliquidated on such date;

(ii) covered by an entry liquidated or reliquidated within 2 years immediately preceding the filing of the petition; or

(iii) entered for consumption during the 5 years immediately preceding the date of the filing of the petition but unliquidated on such date, upon certification of the Secretary of the Treasury that such failure to liquidate was due to possible assessment of anti-dumping or countervailing duties or fraud.

(b) For purposes of this section—

(i) A fine, penalty, or addition to tax that is in compensation for actual pecuniary loss of a governmental unit and that is attributable to a tax liability referred to in subsection (a) shall be treated in the same manner as such tax liability.

(ii) A claim arising from an erroneous refund or credit of tax shall be treated in the same manner as a claim for the tax to which the refund or credit relates.

• • • • •

§ 523. Exceptions to discharge

(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 customs duty—

(A) which would be entitled to priority under paragraphs (3) (B) or (C), or (6) of section 507 (a) of this title, whether or not a claim for such tax was filed or was secured or unsecured;

(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, within 3 years before the date of the filing of the petition or thereafter; or
 - (C) with respect to which the debtor filed a fraudulent return, entry, or invoice or fraudulently attempted to evade or defeat;
 - (D) for which an extension of time for payment was granted, at the request of the debtor, prior to the date of the filing of the petition, provided that the tax to which such extension relates would have received priority under section 507(a)(6) of this title if a case under this title concerning the debtor had been commenced on the date on which such extension was first granted, to the extent of any amounts which become due under such extension agreement during the pendency and after the closing of a case under this title.
- (2) for obtaining money, property, services or a refinancing, extension or renewal of credit, by—
- (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition; or
 - (B) use of a statement in writing—
 - (i) that is materially false;
 - (ii) respecting the debtor's or an insider's financial condition;
 - (iii) on which the creditor to whom the debtor is liable for obtaining such money, property, services, or credit reasonably relied; and
 - (iv) that the debtor made or published or caused to be made or published with intent to receive;
- (3) neither listed nor scheduled under section 521(1) of this title, with the name, if known to the debtor, to the creditor to whom such debt is owned, in time to permit—
- (A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or
 - (B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;
- (4) fraud while acting in a fiduciary capacity, defalcation, embezzlement, or misappropriation;
- (5) for willful and malicious conversion or injury by the debtor to another entity or to the property of another entity;
- (6) any liability to a spouse or child for maintenance or support, or for alimony due or to become due, in connection with a separation agreement or divorce decree. A debt shall not be excepted from discharge, however, solely because the spouse is obligated in any manner to pay the debt, and except that if such maintenance, support or alimony award includes liability for debts accrued prior to the separation agreement or divorce decree then the court may determine that such debts may be discharged;
- (7) to the extent such debt is for a fine, penalty, addition to tax, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, except that this paragraph shall not apply to a fine, penalty, or addition to tax under any law imposing a tax if the tax to which such fine, penalty, or addition to tax relates is entitled to discharge under paragraph (1) of this subsection; or
- (8) to the extent that it is educational debt if the first payment of any installment thereof is not yet due or was due on a date less than five years prior to the date of the filing of the petition, unless if the court finds that payment of the debt from future income, or other wealth will impose an undue hardship on the debtor and his dependents;
- (9) that was or could have been listed or scheduled by the debtor in a prior case concerning the debtor under this title or under the Bankruptcy Act in which the debtor waived discharge, or was denied a discharge under section 727(a)(2), (3), (4), (5), (6), or (7) of this title, or under section 140(1), (2), (3), (4), (6), or (7) of such Act.

(b) Notwithstanding subsection (a) of this section, a debt that was excepted from discharge under subsection (a) (3) of this section or under section 17a (3) of the Bankruptcy Act in a prior case concerning the debtor under this title or under such Act, is dischargeable in a case under this title.

(c) Except as provided in subsection (a) (3) (B) of this section, the debtor shall be discharged from a debt specified in paragraph (2), (4), or (5) of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (5), as the case may be, of subsection (a) of this section.

(d) If a creditor requests a determination of dischargeability of a consumer debt under subsection (a) (2) of this section, and such debt is discharged, the court may award to the debtor the costs of and a reasonable attorney's fee for the proceeding to determine dischargeability if it finds that the proceeding was frivolous or not brought by the creditor in good faith.

* * * * *

§ 728. Special tax provisions

(a) For the purposes of any State or local law imposing a tax on or measured by income, the taxable period of a debtor that is an individual shall terminate on the date of the order for relief under this chapter, unless the case was converted under section 1112 of this title.

(b) Notwithstanding any State or local law imposing a tax on or measured by income, the trustee shall make tax returns of income for the estate of an individual debtor in a case under this chapter or for a debtor that is a corporation in a case under this chapter only if such estate or corporation has net taxable income for the entire period after the order for relief under this chapter during which the case is pending. If such entity has such income or if the debtor is a partnership, then the trustee shall make and file a return of income for each taxable period during which the case was pending after the order for relief under this chapter.

(c) If there are pending a case under this chapter concerning a partnership and a case under this chapter concerning a partner in such partnership, a governmental unit's claim for any unpaid liability of such partner for a State or local tax on or measured by income, to the extent that such liability arose from the inclusion in such partner's taxable income, of earnings of such partnership that were not withdrawn by such partner, is a claim only against such partnership.

(d) Notwithstanding section 541 of this title, if there are pending a case under this chapter concerning a partnership and a case under this chapter concerning a partner in such partnership, then any State or local tax refund or reduction of tax of such partner that would have otherwise been property of the estate of such partner under section 541 of this title—

(1) is property of the estate of such partnership to the extent that such tax refund or reduction of tax is fairly apportionable to losses sustained by such partnership and is not reimbursed by such partner; and

(2) is property of the estate of such partner otherwise.

* * * * *

§ 1146. Special tax provisions

(a) For the purposes of any law imposing a tax on or measured by income, the taxable period of a debtor that is an individual shall terminate on the date of the order for relief under this chapter, unless the case was converted under section 706 of this title.

(b) The trustee shall make a tax return of income for the estate of an individual debtor in a case under this chapter for each taxable period after the order for relief under this chapter during which the case is pending.

(c) The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1180 of this title, may not be taxed under any law imposing a stamp tax or similar tax.

(d) The court may authorize the proponent of a plan to request a determination, by a governmental unit charged with responsibility for collection or determination of a tax on or measured by income, of the tax effects, under section 846 of this title and under the law imposing such tax, of the plan. In the event of an actual controversy, the court may declare such effects after the earlier of—

(1) the date on which such governmental unit responds to the request under this subsection; and

(2) 270 days after such request.

(e) Any tax which is nondischargeable pursuant to section 1141(d)(e) of this title, or any tax payable by the estate that arises out of a taxable event that occurs after the commencement of the case, may be assessed against and collected from the debtor or from a successor to the debtor under the plan, but the governmental unit to which such tax is owing may accept the provisions of such plan dealing with the assumption, settlement, or payment of any such tax.

* * * * *

§ 1331. Special tax provision

Any tax which is nondischargeable under section 523, of this title, or any tax payable by the debtor that arises out of a taxable event that occurs after the commencement of the case, may be assessed against and collected from the debtor, but the governmental unit to which such tax is owing may accept the provisions of such plan dealing with the assumption, settlement, or payment of any such tax.

* * * * *

Senator BYRD. The hour of 9:30 having arrived, the subcommittee will be in order.

The hearings today will focus upon the tax aspects of S. 2266, the Bankruptcy Reform Act of 1978.

The bankruptcy bill has been reported by the Judiciary Committee and is before the Finance Committee to consider the tax-related provisions of the bill.

The movement for change in the bankruptcy laws began in 1970 when the Congress established a commission to review the present law and make recommendations about changes. The bill now before this subcommittee is an outgrowth of the work of the Commission on the Bankruptcy Laws of the United States.

In reviewing the tax provisions of the proposed bankruptcy changes, it is important to keep in mind the several conflicting interests which occur in a bankruptcy case. The debtor, his creditors, and Federal, State, and local taxing authorities each often have opposite interests which the law must reconcile.

It is also important to consider whether or not the bill and proposed amendments have ramifications which go beyond the confines of the bankruptcy law. Proposed amendments to the current bill which were prepared by the Joint Committee on Taxation have been printed in the Congressional Record on July 27, 1978, to provide interested parties an opportunity to review and comment upon these amendments.

It is hoped that these hearings today will develop a meaningful analysis of the impact on our tax system of S. 2266 and the proposed joint committee amendments.

Senator Long?

Senator LONG. I have no statement.

Senator BYRD. Our first witness will be Daniel I. Halperin, Deputy Assistant Secretary of the Treasury.

STATEMENT OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY OF THE TREASURY

Mr. HALPERIN. Thank you, Mr. Chairman. I welcome the opportunity to appear before you today to discuss S. 2266, a bill which reforms the law of bankruptcy. While the bankruptcy bills may be the first choice of those representing the interests of other creditors, they do

not always respond to the results that the IRS would have chosen if we considered only the needs of the tax collector.

However, with the one exception I will note, we support the amendments before you. We think that they are a proper balancing of the interests and therefore deserve our support.

My testimony refers to those amendments related to the seven sections specifically referred to this committee by the Judiciary Committee, and those in other areas where the staffs have found tax-related matters that the committee may want to consider.

A number of these amendments strike provisions of the present bill which concern the tax treatment under State and local laws of the entity undergoing bankruptcy. We think it is appropriate to do that. The treatment for Federal tax purposes is not covered by this bill. That is because it is the subject of a separate bill, H.R. 9973, which the Ways and Means Committee had hearings on in February and which the staffs are continuing to work on to try to resolve the difficulties. We hope that there will be further action on H.R. 9973 in the not too distant future, and it is appropriate to apply to the same tax rules for Federal, State, and local purposes. Therefore, if we are going to defer treatment of Federal tax matters, it is premature to consider State and local tax matters until the tax committees have had the time to consider appropriate rules.

We also have mentioned in our statement that there are a number of areas where the Senate bill, S. 2266, differs significantly from the House-passed bill, H.R. 8200. We want to particularly emphasize our strong preference for the Senate bill as opposed to the House bill in a number of areas. These are discussed beginning on page 8 of my full statement which I am submitting for the record. One point that I would like to emphasize is that, as discussed on page 10 of my statement, S. 2266, like current law provides that any taxes a debtor was required to withhold from wages or collect from customers, those taxes, for which the debtor is basically acting as trustee or as collection agent for the Government, are entitled to priority and nondischargeability.

H.R. 8200 would limit that in a number of ways. We think that withheld taxes are different from other taxes paid by the debtor. They are held in special trust for the Government. They are not the debtors' liability, but are the liability of employers or customers. Further, delinquency in this area is continually increasing and represents a serious problem.

The Senate bill's treatment of the priority and nondischargeability of trust fund taxes appropriately reflects the special nature of this form of liability and the serious breach of the public's trust which results when such funds are used to pay other creditors. Accordingly, we support the Senate approach in this area.

As I said earlier, we have only one objection to the proposed amendments before you. This is discussed beginning on page 4 of our statement, and it concerns the forum for litigating liability of the debtor in bankruptcy.

You might have cases where the debtor owes some taxes prior to the instituting of bankruptcy proceedings. The Government would seek to collect those taxes out of the bankrupt estate. If the estate is inadequate and that tax is nondischargeable, which means that the debtor would continue to be liable after the end of the proceedings if the Government fails to collect it out of the estate, the IRS would have the right to go after the debtor.

The issue is, where would that tax liability be litigated? Under current law, upon bankruptcy, the debtor cannot go into the Tax Court. Rather the debtor either can litigate the issue in the bankruptcy court at the same time that the liability of the estate is being litigated, or the debtor can stay out of the bankruptcy court and pay the tax and sue for refund in the Court of Claims or in the local district court. Some have argued that even if the bankruptcy court had decided in favor of the Government in determining that the estate had to pay the tax, that in the subsequent law suit in the district court or the Court of Claims, the court would not be bound by that decision and could decide in favor of the taxpayer.

Under the proposed amendment, the debtor generally is given a choice of prepayment forums. If the debtor chooses, he could ask the bankruptcy court to determine his tax liability at the same time that the bankruptcy court is determining the liability of the estate. If the debtor did not choose that, he could stay out of the bankruptcy court and subsequently institute a proceeding in the Tax Court to determine his individual liability.

The proposed amendment makes clear that if that happens, neither the Government nor the debtor can rely on the decision of the bankruptcy court. You start all over again when you get into the Tax Court.

If the bankruptcy court held that the estate was liable for taxes but the estate did not have enough money to pay the taxes and the Government seeks to collect it against the debtor, the Tax Court could hold that the debtor was not liable.

The debtor, therefore, could have his tax liability litigated twice, and he would normally stay out of the bankruptcy court unless by doing so the debtor runs the risk of losing in the Tax Court in cases where the Government lost in the bankruptcy court. The debtor might be taking a risk because if the bankruptcy court holds in favor of the estate—that is, that the taxes are not due—the IRS would still have the opportunity of asserting the taxes and forcing the debtor into the Tax Court.

Now, that risk is not real unless the IRS will actually relitigate cases that it loses. So, in order to prevent the debtor from having a free choice of two forums to litigate, the IRS has to have a policy in which it will relitigate in one form cases that it has already lost in another forum, and we think that this is unfortunate and a waste of judicial resources.

The effect of current law is, in almost all cases, to consolidate all determinations of the debtor's tax liability in the bankruptcy court. Identical facts and legal issues apply in determining the debtor's liability and the liability of the estate and we think current law is appropriate and ought to be continued.

There is concern, and that is the reason that the staff has suggested the proposed amendment, that the debtor ought to have the opportunity to go into the Tax Court if he wants to and not be forced to litigate in the bankruptcy court.

We believe that the main reason that taxpayers are allowed a hearing in the Tax Court is that they should be able to have their tax liability determined without having to first pay it and then sue for a refund. That opportunity is available to debtors in the bankruptcy court and the Tax Court forum is not necessary in these cases.

We also believe that the structure of current law could be retained by granting most debtors the right to go into Tax Court and by giving that opportunity in no-asset cases—that is, if there are no assets in the bankruptcy estate, there is no reason for the Government to press its tax claim in the bankruptcy court, and in those cases, the Tax Court forum can be available to the debt just as it is to everybody else.

And that is the one concern we have with the amendments before you. We hope to be able to continue to discuss them with the members of the staffs and try to come to a solution that is at least satisfactory to the Treasury and to your staff before the mark-up session takes place, which I understand is scheduled for next week.

Aside from that, we support the amendments before you as an appropriate balancing of the interests of creditors and debtors in bankruptcy and of a sound tax system.

That concludes my statement. If you have any questions, I would be glad to try to answer them.

Senator BYRD. Thank you, Mr. Secretary.

First, you might explain for the benefit of us nonlawyers where does the priority now lie under the present law? Does the Government have first priority if taxes are owed if there are assets in the estate?

Mr. HALPERIN. No, the first priority is, of course, for claims of administration and then priority is given to certain wage claims.

Senator BYRD. Given what?

Mr. HALPERIN. To claims for wages by employees. The taxes that are given priority are sixth in the list of priorities.

Do you want to add to that, David?

Senator BYRD. Does this change this list of priorities, these new amendments?

Mr. SHAKOW. Mr. Chairman, the list of priorities in both the House and the Senate bills and in the amendments change the priority rules from those under current law and, to some extent, restrict the priorities that Federal taxes receive under bankruptcy. They do it in somewhat different ways.

But most taxes do receive priority under current law.

Senator BYRD. Most taxes do receive priority?

Mr. SHAKOW. Right.

Senator BYRD. I understood you to say they did not, that they were No. 6.

Mr. SHAKOW. They receive priority as opposed to being treated as general claims.

Mr. HALPERIN. They might not necessarily have priority over everything else.

Senator BYRD. Do the proposed amendments change the priority insofar as wages are concerned, for example?

Mr. SHAKOW. No.

Senator BYRD. It does not change it?

Mr. SHAKOW. No; they do not.

Senator BYRD. Well, where is the priority changed, insofar as taxes are concerned?

Mr. SHAKOW. Excuse me, Mr. Chairman, are you referring to the proposed amendments of the staff, or are you referring to the changes made by the House and Senate bills, as opposed to current law?

Senator BYRD. I am speaking of the proposed amendments, amendments recommended by the staff, as compared to current law.

Mr. SHAKOW. As compared to current law, most of the changes made by the staff bring the bill closer to current law than is true of the bills as they stand now. But the amendments' changes in the priority section are not very significant as compared to the Senate bill as it stands now.

Mr. HALPERIN. There are only minor changes in the priority of tax claims between the bill as it now stands in the Judiciary Committee and in the proposed amendments before you for consideration.

Senator BYRD. Well, now, we have three things involved, do we not? I might say that this is a bit complicated for someone who is not used to working with this.

Senator LONG. If I might just interject—it has been a long time ago, I regret to say, but I once took a course in bankruptcy—not bankruptcy tax law, but bankruptcy. They gave me a little smattering of tax law and they also gave me a little smattering of bankruptcy. They did not give me a course in bankruptcy taxation, and I must say I find myself completely at sea, having heard the statement, as to just exactly what we are doing here.

Mr. HALPERIN. Mr. Chairman, I have never taken a course in—

Senator LONG. I think I am supposed to know a little bit about both, and I must say that I am not only at sea, but at sea in a heavy fog after hearing the explanation.

Mr. HALPERIN. Well, I have not taken a course in bankruptcy and over the last week or two I have been regretting it. These are extremely complicated and technical matters and the differences between the House bill and the Senate bill and the staff amendments and our recommendations are not, you know, global matters, they tend to be over very technical narrow aspects.

Senator LONG. We used to meet in that little room right behind us, back in the days before we had open sessions. We would use black boards and nobody was particularly ashamed to confess his ignorance. Somebody would get up there and draw us a picture. You would go from here to there, and from there to here and so forth. You could sit there and figure this thing out. But I must say that somebody has got to do his homework on this thing before we bring it to the full committee.

Senator BYRD. Let me see if we can put this much in focus.

We have, No. 1, the present law. Then we have S. 2266 which is the Senate bankruptcy bill, and that has certain tax aspects to it, vis-a-vis the present law.

Mr. HALPERIN. That is correct.

Senator BYRD. And then, aside from that, we have the recommendations of the Joint Committee staff, which recommendations are different from the present law and which are different from the bill.

Mr. HALPERIN. Yes, Mr. Chairman, that is true.

Senator BYRD. And then, aside from that, we had the recommendation of the Treasury Department which basically are the same as the Joint Committee staff recommendations, with one exception.

Mr. HALPERIN. That is correct. Our staff has been working with the joint committee staff and the staff of this committee for a period of time in trying to work on these technical matters, and we have generally been able to come to agreement on these issues, with the one exception that I stated.

I would hope that, before the markup occurs on this bill, that we will be in complete agreement with the staff of the Joint Committee.

Senator BYRD. This is a copy of the bankruptcy bill. It is 621 pages long.

Senator LONG. It makes me think of what Harold Cooley used to say when he was managing the old Sugar Act. He would say it was too complicated to explain. You just have to take it on faith.

Mr. HALPERIN. Mr. Chairman, we should have the people who complain about the complexity of the tax law read that for awhile.

Senator BYRD. Well, now, let me see if I can understand this aspect of it.

The recommendations of the Joint Committee are more in line with the present law than are the recommendations contained in the Senate and the House bills, is that correct?

Mr. HALPERIN. That is my understanding, yes, that they are moving back toward the provisions of present law and not accepting some of the changes.

Do you want to comment on it?

Mr. SHAKOW. Some of the changes—the changes, in general, that are suggested by the staff of the Joint Committee are, as Mr. Halperin said, not of a global nature for the most part, and they do deal also with certain technical problems that exist even under current law relating to certain timing matters as to exactly when a tax has to have arisen in order to be discharged in unusual circumstances and, in many cases, not in the common, everyday situation.

Most of the major matters of difference that exist between the House bill and any version of the Senate bill already exist in the version of S. 2266 that exists now, without reference to any amendments suggested by the staff of the Joint Committee.

So the particular amendments that they have suggested are, in general, not very major in terms of the changes they made. But they are important as a technical matter.

Senator BYRD. Now, is it correct that the reason that the Joint Committee changes are modest is that a comprehensive change is contemplated next session along the lines of the House Ways and Means Committee bill. Is that correct?

Mr. HALPERIN. That is correct, Mr. Chairman. With one minor exception, this bill does not amend the Federal tax law itself. I mean, there are a lot of provisions of the Federal tax law—reorganizations, or discharge of indebtedness, which are particularly applicable to bankrupts or insolvent taxpayers. Those provisions are not under consideration today. They have been reserved for a separate bill which has had hearings in the House and we would hope that that would move early in the next session.

This bill deals only with the bankruptcy law itself and those provisions which involve collection of claims and priority of claims, which have an impact on the Federal tax system. But they are not amendments to the Internal Revenue Code.

Senator BYRD. Well, now, in regard to the priority of claims, are the employees treated any less well under the proposed amendments than they are under present law?

Mr. SHAKOW. All versions of the new bankruptcy law treat employees more favorably because they increase the dollar limit of wages

that receive priority, and the amendments that are before you proposed by the Joint Committee do not affect those wage claims.

Senator BYRD. Could you list one, two, three, four, five, six, whatever it might be, the order of priority under the present law until you get down to the Government's position?

Mr. SHAKOW. The first priority under current law would be for administration expenses, and that is the same as is true under all versions of the bill.

Second is a priority for wages and commissions, which is essentially the same as exists under all versions of the bill, although a technical problem relating to certain involuntary bankruptcies is taken care of under the House and Senate bill so that wage bills are actually third priority technically under the House and Senate bills, but as a practical matter, it is the same.

Senator BYRD. But the second priority under the Joint Committee recommendations?

Mr. SHAKOW. I am saying, under all—the Joint Committee recommendations have no effect on any of these priorities that I have spoken of in any significant way. Basically, administration expenses come first, because the trustee, in order to operate the estate, has to have that priority.

Senator BYRD. I think that is appropriate.

Mr. SHAKOW. Right.

And, after that, wage claims come next.

Senator BYRD. All right. Now, what is next?

Mr. SHAKOW. Now, under present law, next comes certain expenses of creditors in obtaining—

Senator BYRD. Withholding and trust fund taxes come next, do they not?

Mr. SHAKOW. Withholding and trust fund taxes, as well as certain other taxes, are the next major priority, if I am not mistaken, under current law.

Under both the House and Senate versions of the bill—and this is not changed by the Joint Committee revisions—there is a priority before them for amounts paid into an employee benefit plan, a retirement plan, something of that nature.

The bills do make clear that to the extent wages are paid out as the second major priority, those priority wages that are earned by persons immediately before bankruptcy, if there is any amount that ought to be withheld from those wages, those amounts get paid in the same priority as the wages.

But in terms of other withheld amounts that might have been owed before bankruptcy, those do not receive any special priority under any version of the bill until we get to the sixth priority under—

Senator BYRD. Which is Government income taxes.

Mr. SHAKOW. Right. And I should add that, again, both the House and Senate bills add a fifth priority which is for consumer deposits, with certain restrictions, and that is also different from current law and there, again, there is no major difference between the House and Senate bills and there is no change at all made in that area by the Joint Committee amendment.

Senator BYRD. The only thing we have not established, then, what are the fourth and fifth priorities under the present law. We have one, two, three, and six.

Mr. SHAKOW. Well, taxes under current law are fourth priority. Senator BYRD. Taxes are what—we have income tax is sixth.

Mr. SHAKOW. No; taxes are sixth priority under the proposed bills. Under current law, taxes are fourth priority. Third priority relates to certain expenses of creditors where the confirmation of certain plans has been refused or revoked or set aside. I am not familiar with the details of that priority, but I think it is a very narrow one under present law.

So that—if one looks at the whole picture, the real differences between current law and the proposals made—and this is really uniform in both the House and Senate versions of the bill—is that they expand the wage priority from \$600 to either \$1,800 or \$2,400 for each individual wage earner. They add a priority for employee benefit plans which comes right after the wage priority, and they insert a priority for consumer deposits, all before Federal taxes.

They do, on the other hand, make clear that the withheld amounts, if they are in respect of the actual wages paid under the wage priority, do get paid along with the wages.

I guess I should add that, under current law, other debts to the United States also receive priority, and this is eliminated under both the House and the Senate bills and, again, it is not a tax matter and it is not affected at all by the Joint Committee's suggestions.

Senator BYRD. Well, take a simplified example. Assume an individual takes bankruptcy and that individual owes \$10 million and within the \$10 million are obligations to the Government for Federal income taxes.

So he has \$5 million in assets and \$10 million in liabilities. Then the first thing that happens with the \$5 million, is that it is utilized to pay administrative expense. And then what is left over from that is used to pay any wages that might be owed to employees up to a certain figure.

And then, after that, you get into the payment of withholding taxes or trust fund taxes, as the case might be.

Mr. HALPERIN. On those particular wages that received priority.

Senator BYRD. Yes. And then after that is when the Government gets from the \$5 million whatever it can to satisfy the Government's claim for Federal income taxes. Is that the way it goes?

Mr. SHAKOW. Right. After those consumer deposits are returned, and for most, though not all, of Federal taxes and State and local taxes there would be priority.

Senator BYRD. Well, No. 1, there is nothing in either the House bill or the Senate bill or in the joint committee recommendations, or in Treasury recommendations, that have any general application other than to bankruptcy cases?

Mr. HALPERIN. That is correct, sir.

Senator BYRD. And you concur with that also?

Mr. SHAKOW. That is correct.

Senator BYRD. Both of you concur?

Mr. SHAKOW. Right.

Senator BYRD. No. 2, Treasury prefers, with one exception, the recommendations of the Joint Committee staff rather than either the Senate or House bill provisions?

Mr. HALPERIN. That is correct.

Senator BYRD. I wonder if it would be helpful in the markup session if the Treasury were to prepare a chart comparing the proposed

recommendations with the current law and how each of those areas are treated in the Senate and House bills.

I do not like to suggest additional work, but it is a complicated piece of legislation and it may be helpful to the committee when the time comes to mark up the bill.

Mr. HALPERIN. We will try, Mr. Chairman.

Senator BYRD. Well, as I understand it also, Treasury will get together with the Finance Committee staff and attempt to iron out what differences there are prior to the markup session.

Mr. HALPERIN. Yes; that is certainly our intention.

Senator BYRD. Thank you.

I think that will take about all we can do on that bankruptcy bill this morning, but while Treasury is here, I would like to get the Treasury's position, if the Treasury is prepared to so state, in regard to a proposal that will be made by Mr. Daniel L. Kiley, vice president for taxation for the Norfolk & Western Railroad. Mr. Secretary, if you have the time, if you could remain here just a short time, we could hear Mr. Kiley and then the committee would need to have Treasury's comments on your proposal.

Mr. HALPERIN. Fine.

[The prepared statement of Mr. Halperin follows:]

STATEMENT OF DANIEL I. HALPERIN, ACTING DEPUTY ASSISTANT SECRETARY, TAX LEGISLATION, DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the subcommittee, I welcome the opportunity to appear before you today to discuss S. 2266, a bill which reforms the law of bankruptcy.

S. 2266, and its counterpart on the House side, H.R. 8200, embody the first major attempt in forty years to revise the bankruptcy laws of the United States. Since the United States Government, as a result of its role as tax collector, is a frequent creditor in bankruptcy, many of the provisions of these bills have an important impact on the tax collection process. Questions of priority, dischargeability, and collection of tax claims in bankruptcy have a direct impact on the integrity of our Federal tax system. The Federal tax system, based on voluntary assessment, can only work as well as it does today if the majority of taxpayers think it is fair. This presumption of fairness is an asset which must be protected. A modernized bankruptcy law may well allow more debtors to avail themselves of bankruptcy relief. Provisions which reduce or minimize tax liabilities in bankruptcy will inevitably increase the attractiveness of bankruptcy for both debtors and creditors (other than the Federal Government), and thus may undermine taxpayer confidence in the equity of our tax system. It is very important, in protecting the integrity of the Federal tax system, that any increased use of the bankruptcy laws not be viewed by taxpayers at large as providing a loophole for other taxpayers to avoid their tax debts unfairly by going into bankruptcy.

The competing considerations of tax policy and bankruptcy policy express themselves in a number of provisions in S. 2266, the bill before you today. Several solutions suggested in S. 2266 differ from those advanced in its counterpart, H.R. 8200. On occasion, a third solution is suggested by the proposed amendments before you. These proposed amendments were developed by the staff of the Joint Committee on Taxation. We appreciate the opportunity we were given to work with the staff in the development of the amendments. Although the result is not always the one we would have chosen, we believe that S. 2266, if modified by the proposed amendments, would generally follow a reasonable middle ground between protecting the integrity of the tax system and yet allowing for the policy of the bankruptcy laws.

In our testimony, we will review some of the important issues raised in the various sections which have been referred to you by the Committee on the Judiciary;¹ discuss various issues raised in other sections which affect tax claims

¹ All references to sections in S. 2266 and H.R. 8200 are to sections of the proposed new Title 11 of the United States Code, which is embodied in section 101 of each bill.

and raise issues which invite amendments; explain differences between S. 2266 and its counterpart, H.R. 8200, to make clear why we favor the provisions in the Senate version; and express our reservations on one of the provisions in S. 2266 for your further consideration.

I. SECTIONS REFERRED TO THIS COMMITTEE BY THE COMMITTEE ON THE JUDICIARY

The Treasury, with the exception noted below with respect to section 505, supports the proposed amendments to the seven sections referred to the Finance Committee. A discussion of the issues raised by the amendments to these sections follows.

1. *Section 346. Special tax provisions.* The provisions in this section deal with certain substantive tax issues which must be resolved in bankruptcy for Federal, State, and local purposes, such as the allocation of tax attributes between a debtor and the debtor's estate. However, section 346 generally applies only to State and local tax issues. The resolution for Federal tax purposes is left to another bill now being considered by the Ways and Means Committee. Since we believe the same rules should apply for Federal, State and local purposes, we think it is premature to legislate in these areas before the Federal rules are finally determined. Thus, we agree with the proposed amendment which would delete all the rules in section 346 of the bill, except for the rule concerning withholding or collection of taxes, such as employment taxes withheld from wages. The rules governing withholding must be integrated with the principles of priority and dischargeability of liabilities, principles which are determined in other sections of S. 2266. For this reason, it is appropriate to deal with those provisions, for Federal as well as State and local purposes, in this bill.

2. *Section 505. Determination of tax liability.* This section follows present law and authorizes the Bankruptcy Court to determine the tax liability of the debtor where no court has previously ruled on the debtor's liability. The section also requires the trustee to request a prompt tax audit from any Federal, State, or local taxing authority. Under the bill, the Governmental unit would be required to respond to the request for a quick audit within specified time periods. This would apply to tax returns filed by the trustee in the proceeding.

One aspect of the procedure for quick audits under S. 2266 creates unnecessary paperwork, contrary to the needs of a streamlined bankruptcy policy and efficient tax administration. The vast majority of bankruptcy cases are cases in which there are little or no assets in the debtor's estate. Once this is determined, the trustee would have no reason to keep the estate open for purposes of obtaining a quick tax audit. Although in some situations there is a theoretical possibility of personal liability for the trustee, in the absence of an audit, there would be no such liability as a practical matter. Accordingly, it is appropriate (as the proposed amendments provided) to allow the trustee to determine by election whether he wishes to request a prompt audit. If the quick audit is made elective with the trustee, rather than mandatory, it will significantly reduce the amount of paperwork required in many cases both for the trustee and for the taxing authority.

The proposed amendments also revise the procedures for choice of forum for litigating the tax liability of the debtor and the debtor's estate, in cases where the tax liability is not dischargeable in bankruptcy. Under current law, upon bankruptcy, a debtor is generally denied entry into the Tax Court. The issue of the debtor's tax liability may be raised by the debtor without prepayment of the tax if the debtor institutes a proceeding in the Bankruptcy Court under section 17c of the Bankruptcy Act. If the debtor chooses not to contest personal tax liability in the Bankruptcy Court, and the Federal government asserts a tax liability against the debt individually, the debtor can litigate only by paying the tax and suing for a refund in the District Court or the Court of Claims. Some have argued that the decision of the Bankruptcy Court in determining the liability of the estate may have binding effect only on the Government in a subsequent refund suit.

Under the proposed amendment, the debtor would be given a choice of prepayment forums. If the debtor so chose, the debtor could ask the Bankruptcy Court to determine individual tax liability for prepetition taxes, a determination which the Bankruptcy Court would, in any event, normally make in measuring the liability of the debtor's estate.

If the bankrupt did not choose to have personal liability determined in the Bankruptcy Court, the amendments would allow the debtor to bring a separate suit in the Tax Court. The bill makes clear that neither the government nor the

debtor could rely on the decision of the Bankruptcy Court in the Tax Court action. The Tax Court would be free to reach a contrary result. Thus, the debtor could formally choose to stay out of the Bankruptcy Court in order to be free to relitigate the claim in the event the Government succeeds in the Bankruptcy Court. The debtor will follow this course in every case unless by doing so the debtor runs the risk of further liability even if the Government loses in the Bankruptcy Court. This risk is not real unless the Internal Revenue Service will actually relitigate cases it does not win in the Bankruptcy Court.

The structure embodied in the amendment to S. 2266 thus raises a significant possibility of duplicative litigation for the IRS in its determination of a single taxpayer's tax liability. The effect of current laws, in almost all cases, to consolidate all determinations of the debtor's tax liability for prepetition years in the Bankruptcy Court. Since identical facts and legal issues apply in determining the debtors' tax liability and the tax liability of the debtor's estate, we would prefer that current law be continued. The basis for the proposed amendment is concern that present law deprives the debtor of the opportunity to make a presentation in the Tax Court. We believe that taxpayers are allowed a hearing in Tax Court so that they will have a prepayment forum. The debtor in bankruptcy has such a forum in the Bankruptcy Court. Also, we believe that the structure of current law could be retained while granting to most debtors—those whose estates have little or no assets—the right to go into Tax Court.

3. *Section 507. Priorities.* S. 2266 provides a significant advance over current law by indicating more clearly the priority which various tax liabilities will be given in bankruptcy. The proposed amendments in this section are important because they eliminate various devices which taxpayers have used to thwart the purposes of the priority rule in bankruptcy. In general, the priority of taxes depends on their age—many old taxes (those that are more than 3 years old) do not receive priority and, under the general rule which coordinates priority and discharge, are discharged through bankruptcy. Very often a tax becomes "stale" because the Government and the taxpayer are negotiating the taxpayer's potential liability. Taxpayers who wish to take advantage of this rule have entered into such negotiations for the purpose of transforming their liability into a "stale" tax liability. Once the tax has been sufficiently aged, the taxpayer is able to go into bankruptcy to discharge the tax liability.

The proposed amendment would preclude that possibility. Under the amendment, if an offer in compromise is withdrawn by the debtor, or rejected by a Governmental unit, within 240 days before the petition date, the tax involved will receive sixth priority as long as the tax would have been entitled to priority had the bankruptcy case begun when the offer was originally submitted. This is a useful addition to the rules in order to prevent abuse.

4. *Section 523. Nondischargeable taxes.* This section of S. 2266 provides that priority taxes will not be discharged. However, proper exceptions are made to the general rule coordinating priority and discharge of tax liabilities. These exceptions are for taxes as to which the debtor had not filed a required return as of the date the bankruptcy petition was filed, for certain taxes as to which a later return was filed within three years before the petition, and for taxes with respect to which the debtor filed a fraudulent return or as to which the debtor fraudulently attempted to evade or defeat any tax. A proposed amendment to this section, coupled with a proposed amendments the section 507, will help determine in a reasonable fashion the proper treatment of liabilities for taxes as to which a deferred payment plan had been negotiated between the debtor and a taxing authority prior to bankruptcy.

The proposed amendments add a rule that if the Service fails to file a timely proof of claim for a prepetition tax liability of the debtor, and any later collection which the Service makes from the debtor's after-acquired assets and exempt and abandoned property must be reduced by the amount of that debt that could have been paid from property of the debtor's estate if the tax authority had filed a timely claim. In general, the Service will fail to file a proof of claim only in a "no asset" case. It should be stressed that the rule provides an exception to its application where the taxpayer's nondischarged liability results from fraud or the failure to file, or late filing of, a return.

5. *Section 728. Special tax provisions in liquidations.* This section provides special tax provisions concerning the treatment of debt liquidation cases under State and local tax laws. For the reasons stated in connection with section 346, this provision should be deleted at this time. Comparable provisions which would also apply to Federal taxes will be dealt with in later legislation.

6. *Section 1146. Special tax provisions in reorganizations.* To the extent the provisions of S. 2266 deal with the tax rules under State and local law, they should be deleted for the reasons discussed in connection with sections 846 and 728.

The proposed amendments would delete provisions in S. 2266 which permit the Bankruptcy Court to "declare" the tax effects of a reorganization plan following a request for a private ruling made to the taxing authority. We support this deletion. The provision would have created serious administrative problems because the IRS could have been required to respond to many alternative proposed plans in a single reorganization. It would also have allowed creditors in a bankruptcy reorganization to have the tax effects of a plan determined by a court before the plan went into effect. Under the amendment, creditors participating in a bankruptcy reorganization will simply make the same kinds of business decisions that other businessmen make outside the bankruptcy context.

7. *Section 1331. Special tax provisions in wage earner plans.* We agree with the proposed amendments to this section, which subject the collection of nondischargeable taxes after bankruptcy to the normal restrictions on assessment and collection of taxes, and which indicate that the payment of nondischargeable taxes under a wage earner plan are generally subject to other rules for wage earner plans.

II. OTHER PROPOSED AMENDMENTS

Before this Subcommittee for consideration are several amendments on tax-related matters which appear in sections of the bill which have not been referred specifically to the Finance Committee. Because the Finance Committee may want to suggest further amendments to the bill in these areas, we would like to offer our comments on these proposals.

As in the case of the amendments to the seven sections which were specifically referred to the Finance Committee, we believe the amendments before you reach appropriate positions reconciling the conflicting purposes of tax and bankruptcy law.

1. *Section 108. Extensions of the statute of limitations.* The amendment here is a technical one, making clear in the statute what the Judiciary Committee in its report on S. 2266 indicates should be the rule regarding the effect of bankruptcy on the running of the statute of limitations with respect to the collection of assessed taxes by levy or suit.

2. *Section 508. Avoidance of certain liens.* Under S. 2266, tax liens would be automatically voided if the Internal Revenue Service fails to file a proof of claim and the claim is therefore not allowed (unless the Service had no notice or knowledge of the case). Under the proposed amendment, failure of the Service to file a proof of claim would not cause a tax lien securing the claim to be void if the tax claim is nondischargeable. As indicated before, the Service will often fail to file a proof of claim in a "no asset" case. If the rule in S. 2266 were adopted, the Service would be required to file a proof of claim in all these cases in order to maintain its liens. This would be nothing more than useless paperwork. Accordingly, we support the proposed amendment.

3. *Section 511. Federal unemployment tax (FUTA) credit.* Under the Internal Revenue Code, the tax credit against the Federal unemployment tax for payments into a State compensation fund is normally reduced in the case of a late contribution to the State fund. S. 2266 provides that the credit will not be reduced if a trustee in bankruptcy makes a late payment, since the trustee may be barred by the bankruptcy proceedings from making a timely payment of the State contribution. The amendment to S. 2266 would expand this rule so that in the case of a prepetition FUTA credit which would have been available to the debtor absent late payment, the Federal Government's claim attributable to a reduction of such credit because of a late payment would be treated as a tax claim which is not entitled to priority. Although we might have preferred a more stringent rule in this area, we defer to the bankruptcy policy considerations which have led to the expansion of this rule as embodied in the amendment.

4. *Section 522. Collection of taxes from exempt assets.* The proposed amendment would make it clear that taxes may be collected out of exempt property, even if the property had been subject to a lien for taxes that was avoided by the debtor or the trustee. The authority to collect taxes out of exempt property is an important one, and this clarification supports the general structure which allows for such collections.

5. *Section 541. Property of the estate.* One proposed amendment to this section would make clear that property of the estate includes a refund of any tax arising from the carryback of a loss or a credit of the debtor to a taxable year

before the first taxable year of the estate. This is a useful clarification of the statute.

This section would also be amended to state specifically that property of the estate does not include certain "trust fund taxes," including amounts withheld from the wages of employees and sales taxes collected by a retailer. It seems inappropriate for other creditors to collect their debts from such amounts, which the debtor does not receive for the debtor's own account. If S. 2266 is amended as proposed there will be a conflict between S. 2266 and H.R. 8200 in this area. We would hope that, at least in a case where these amounts are placed in a segregated trust account, the amounts would not be considered property of the estate.

6. *Section 1325(c). Payment of taxes in wage earner plans.* The proposed amendment would require that tax debts be paid in cash under a wage earner plan. As a general rule, it is very important for the proper administration of the tax laws that taxes be paid in cash rather than in kind. The debtor or the trustee is in a better position than the Internal Revenue Service to dispose efficiently of property in the estate, and payments in kind to the IRS should not be encouraged in the bankruptcy context. Accordingly, we strongly support this amendment.

III. DIFFERENCES BETWEEN H.R. 8200 AND S. 2266

In a number of tax-related areas, S. 2266 differs significantly from H.R. 8200. We think it is important for the Committee to be cognizant of these areas, and to understand why we prefer the approach taken in S. 2266.

1. *Section 507. Priorities.* Under S. 2266, like current law, any taxes that a debtor was required to withhold from wages or collect from customers and turn over to the Government would be entitled to priority and be nondischargeable regardless of age. In contrast, H.R. 8200 would deny priority for, and make dischargeable, liabilities for such "trust fund" taxes if the accompanying return was due more than two years before bankruptcy.

Withheld taxes differ from other taxes payable by a debtor, and by law they must be held in special trust for the Government. Nevertheless, delinquency in this area is continually increasing and represents a serious problem. The Senate bill's treatment of the priority and dischargeability of trust fund taxes appropriately reflects the special nature of this form of liability and the serious breach of public trust which results when such funds are used to pay other creditors prior to bankruptcy. Accordingly, the Treasury Department supports the approach taken in the Senate bill.

Another difference between the Senate and House bills is that the former recognizes that collection efforts generally do not commence until a liability is assessed. Absent an extension of the statute of limitations, the assessment must usually be made within three years of the filing of the return. But under current law and under the House bill, a tax may lose priority and be dischargeable although the Service never had any realistic opportunity to collect. The Senate bill ameliorates this problem by affording priority to a tax and forbidding its discharge when the tax assessment was made within 240 days before the bankruptcy petition was filed, but only if the assessment was made within three years of the due date of the return. This relatively modest change of current law will be helpful in curing present abuses and we strongly endorse this provision.

2. *Section 522. Exemptions.* Under current law, tax authorities are permitted to collect both nondischargeable and dischargeable taxes from exempt property. Under H.R. 8200, only nondischargeable taxes are collectable from a debtor's exempt property. Under both the Senate and the House bills, the debtor is permitted to elect exemptions under state laws which may be quite generous. There is no reason to restrict the rule of present law which allows collection of all taxes from exempt property. Accordingly, we support the version in S. 2266.

3. *Section 547. Preferences.* Under H.R. 8200, it is not stated explicitly that pre-petition tax payments are not preferential transfers which can be avoided by the trustee. S. 2266 makes clear that the preference rules may not be applied to tax payments. Since the Government is an involuntary creditor that must continue to extend credit regardless of past non-payment by the debtor, the general evil at which the preference rules are addressed does not apply to a taxing authority. Accordingly, it is appropriate that the preference rules not be applied to tax payments. It is important that this issue be made clear in the statute itself, as S. 2266 does.

4. *Section 1130 (section 1129 of H.R. 8200). Confirmation of plan.* Under H.R. 8200, a taxing authority could be paid in property other than cash on its

claims. As indicated before, the trustee is in a better position than the Internal Revenue Service to dispose of property in the estate. It would be extremely difficult for the Government to monitor and properly dispose of such property at full value. S. 2266 makes clear that the Government is to be paid in cash for its priority taxes. This is an important and appropriate result, which we strongly support.

IV. OTHER POSSIBLE AREAS FOR AMENDMENT OF S. 2266

There are a number of sections in S. 2266 which may profit from further technical improvements. We are discussing these issues with the staffs of your Committee and of the Joint Committee on Taxation, and expect to resolve them.

There is one issue which we would bring to your attention at this time, however. Under S. 2266, the Government may receive property in kind in payment of its non-priority taxes. As indicated above, the trustee of an estate is generally in a better position than the Internal Revenue Service to dispose of property in the estate. Because of restrictions on the flexibility granted to the Government in its disposition of property, the Internal Revenue Service may not be able to obtain full fair market value for property it receives. Moreover, when the property it receives consists of stock or securities of a newly reorganized corporation, the Government may be placed in the inappropriate position of owning an equity interest (or a creditor's interest which is, in effect, an equity interest) in a private enterprise. Such a position could lead to the appearance of impropriety in the Government's dealings with the newly-reorganized debtor and its competitors. This result must be avoided. Accordingly, we would recommend that S. 2266 provide that all tax payments be made in cash rather than in kind.

V. CONCLUSION

In summary, we believe that the tax-related provisions in S. 2266, if amended in the manner suggested by the proposed amendments before you, will provide a reasonable and appropriate compromise between the conflicting policies of tax and bankruptcy law. We believe the amendments before you, taken as a whole, represent a useful improvement to S. 2266 in those areas where the tax and bankruptcy laws interact in the administration of a debtor's estate.

I am authorized to say that the Justice Department agrees with the views expressed in this statement.

I would be pleased to try to answer any questions that you might have.

Senator BYRD. Mr. Kiley?

Mr. KILEY. I have a short statement that I would like to submit for the record.

Senator BYRD. Yes. If you would state the case in a way that both the committee and the Treasury Department could understand it, and then the committee would need to obtain the view of the Treasury Department in regard to the proposal.

STATEMENT OF DANIEL L. KILEY, VICE PRESIDENT FOR TAXATION, NORFOLK & WESTERN RAILWAY CO.

Mr. KILEY. Mr. Chairman, this goes back to the enactment in March 1976 of legislation proposed by ConRail in regard to the transfer of assets from a bankrupt railroad to ConRail.

That legislation amended section 374, which provided for non-recognition of gain or loss on the transfer of those assets.

Norfolk & Western becomes involved by reason of our forced inclusion at a cost of some \$55 million to acquire the Erie-Lackawanna. That company is included in our consolidated tax return. The oversight specifically occurred in that the transfer was treated without recognition of gain or loss, but no provision was made to prevent the recapture of investment credit by reason of the transfer.

What we propose is an amendment merely to correct that oversight, to bring the tax treatment in line with what is normally afforded any transfer of assets to which gain or loss does not apply.

Senator BYRD. Now, if I may interrupt at this point, what you are proposing is an amendment to S. 2266, the bankruptcy bill?

Mr. KILEY. That is right. I might add, Mr. Chairman, that the House bill, H.R. 9973, which is the companion bill to H.R. 8200 does provide for a correction of this oversight.

Senator BYRD. That is in the House bill?

Mr. KILEY. That is correct, sir.

That completes my testimony.

Senator BYRD. Mr. Secretary, would you comment to Treasury on this proposal?

Mr. HALPERIN. If I have the right provision, this is the same provision, as I understand it, that was recently the subject of a hearing before the Subcommittee on Miscellaneous Tax Matters on the House side, which has been approved by that subcommittee on another bill unrelated to bankruptcy and is being presented to the full committee, fairly shortly, I would expect.

At that time, the Treasury Department stated that this provision would be consistent with the normal treatment in reorganization, and as far as we understood it then, we had no objection to this provision. And that is now on a separate bill—which may well proceed faster than the bankruptcy bills might. I do not know. But we did state no objection to it before Mr. Waggoner's subcommittee on miscellaneous matters.

Senator BYRD. Well, this could be considered as a hearing on this proposed amendment. I am trying to think through how this ought to be handled.

It is not a new piece of legislation. It is an amendment to the pending measure.

Mr. KILEY. That is correct.

I might add, Mr. Chairman, that Mr. Halperin is absolutely correct, that it was amended to another bill. Now, whether that other bill will move while this bill moves, I do not know. But the benefit of this amendment on the Senate side is to make it compatible with the House provision.

Senator BYRD. This is identical with the House proposal?

Mr. KILEY. That is correct.

Senator BYRD. I think that will take care of it.

Thank you, gentlemen.

[The prepared statement of Mr. Kiley follows:]

STATEMENT OF DANIEL L. KILEY, VICE PRESIDENT, TAXATION, NORFOLK & WESTERN RAILWAY CO., ROANOKE, VA.

In March, 1976, Conrail proposed tax legislation (P.L. 94-253) relating to the exchanges under the Final System Plan for reorganizing the Eastern railroads. The legislation amended IRC section 374 to provide for nonrecognition of gain or loss where rail properties are transferred to Conrail in exchange for Conrail securities and also provide a carryover basis of assets conveyed to Conrail. The legislation was progressed to passage in a very short time which probably accounts for the fact that it overlooked the problem of recapture of investment credit resulting from the transfers.

Specifically, the difficulty relates to the transfer by Erie Lackawanna (Erie) of certain of its assets to Conrail as part of the Final System Plan. Erie is a member of the Norfolk and Western (NW) consolidated group with tax results reflected in the NW consolidated return. NW, following protracted litigation opposing the inclusion, was ordered by the ICO in 1968 to acquire Erie at a cost:

of \$55 million in NW common stock. Erie entered bankruptcy reorganization proceedings in 1972. Subsequently, pursuant to the Conrail legislation, Erie conveyed a large portion of its assets to Conrail.

Since the basis of Erie assets transferred to Conrail was greatly in excess of the value of Conrail securities received by Erie, the effect of the legislation was to deny Erie a substantial tax loss. Notwithstanding this adverse tax effect on a member of the NW consolidated group, NW supported the legislation because of the possibility that allowing a higher asset basis to carry over to Conrail might ultimately help Conrail and assist the Eastern railroad situation to the betterment of the entire railroad industry.

The section 374 amendment, however, did not cover the problem of investment credit recapture. Accordingly, under section 47 an early disposition occurred with respect to the Erie assets transferred to Conrail notwithstanding the fact that the exchanges involve no other tax effects. The recapture in this situation would cost NW approximately \$3.8 million.

Investment credit recapture in this situation is an obvious oversight. To alleviate the hardship created, it is proposed to provide that no investment tax credit recapture should occur in such an exchange. The purpose of the section 374 amendment was to permit a higher carryover basis in Conrail for the assets which it received. The amendment was never intended to be a revenue-raising measure nor to reduce the cash flow of any element of the railroad industry. Accordingly, we believe the amendment to S. 2268 to prevent recapture is fully warranted. This provision has been discussed in detail with both Treasury and the staff of the Joint Committee who have agreed that it is appropriate.

Senator BYRD. We have another witness, Mr. Charles P. Normandin, member of the National Bankruptcy Conference. The committee would be glad to get your views on this legislation.

**STATEMENT OF CHARLES P. NORMANDIN, ESQ., MEMBER,
NATIONAL BANKRUPTCY CONFERENCE**

Mr. NORMANDIN. Thank you, Mr. Chairman. My name is Charles P. Normandin. I am a member of the law firm of Ropes & Gray in Boston and a member of the National Bankruptcy Conference and of its tax committee. I am also chairman of the Bankruptcy Committee of the Massachusetts Bar Association and have lectured on bankruptcy and insolvency matters and continuing legal education programs put on by various parties.

The National Bankruptcy Conference has, of course, studied the progress over the last several years of proposed new bankruptcy legislation carefully and that study has included those provisions relating to taxation and the treatment of tax claims in bankruptcy.

The National Bankruptcy Conference has not had the opportunity to review the proposed amendments by the staff, because time did not permit.

Senator BYRD. How long do you think it would take to review those and let the committee know your views, if you have contrary views?

Mr. NORMANDIN. I think that we could come up with the views of the tax committee on the technical aspects of these changes relatively quickly. A week or so, I think, would be the most that it would take.

I think, from the nature of my remarks in a minute it will be apparent that I think there are differences of opinion on substantive areas which have been expressed. There is other legislation, of course, on the House side and other members of the National Bankruptcy Conference have testified in connection with that legislation and a lot of the issues are the same.

Senator BYRD. Have you had access to the recommendations of the joint committee?

Mr. NORMANDIN. No, I have not.

Senator BYRD. Do you have them now?

Mr. NORMANDIN. No, I do not.

Senator BYRD. They are available. They were published in the Record on July 27.

Mr. NORMANDIN. I have not seen those.

Senator BYRD. You may want to get a copy of the Record. Ed Beck of my staff will furnish you with a copy after the hearing.

Mr. NORMANDIN. Thank you.

With respect to the proposed changes in S. 2266, I think my review would indicate the following. First, there is obviously some concern among bankruptcy lawyers who are going to have to work under this act if it is passed at the deletion of the special tax provisions in section 346 and some of the other tax provisions that appeared in S. 2266 as originally filed.

Now, I understand what the problems are in coordinating all of these complicated bills as they go through the enactment process, but I think it should be apparent that there are going to have to be some replacement provisions put in at an early date to replace what these amendments are taking out, because the amendments which are proposed on such sections as 346 do not consist of amendments which change the nature of the provision in the bill as introduced. They are really substitutions of sections dealing with a different subject matter.

Insofar as the subject matter goes, I think that some of these provisions are desirable in that they tighten up drafting in S. 2266 as it was reported out of the Judiciary Committee. The provisions in section 346 dealing with determining when a tax will be deemed to have been incurred, dealing with under what circumstances penalties will be incurred by the estate or penalties will continue to run against the debtor when a petition is filed preventing him from paying taxes, these are desirable.

I would say that insofar as the view of a bankruptcy lawyer is concerned, the differences which we would have with some of the provisions are basically differences which would apply both to S. 2266 as originally proposed out of the Judiciary Committee and to the new proposed amendment, and I would like to just address those a moment.

They relate to three main areas: Priorities, discharge and determinations of tax liability. Other members of the Bankruptcy Conference testified on these previously.

With respect to priority claims, the general view is that taxes which fell due, or for which a return was past due within 3 years prior to the filing of the bankruptcy petition should be retired to priorities and should not be discharged. That is carried on in S. 2266. I think there is no general disagreement with that.

The Treasury has maintained that its audit and collections process is geared to a cycle where it is impossible for it to move as quickly as a normal trade creditor or bank creditor would, and I think that is generally true and there is general recognition of that.

On the other hand, gearing in priority taxes and non-dischargeable taxes to assessments to the IRS, which is entirely within their control, we think imposes a difficult burden on debtors and bankrupt estates and the administration of the estate and we also believe that, while there clearly should be different treatment for withholding taxes and trust fund taxes that, there to, some sort of limitation should be

considered so that the IRS is not in a position to where it has allowed these taxes to accumulate beyond a reasonable period and then is in a position to collect them out of the estate at the expense of other creditors.

These are difficult problems and some sort of compromise is obviously going to have to be made between the bankruptcy aspects and the tax aspects, and I would just urge that the bankruptcy aspects not be completely forgotten.

The determination of tax liability in a bankruptcy proceeding is also something of great interest, because it can seriously slow down the estate. I listened with interest to Mr. Halperin's testimony this morning. I certainly would agree with him that there is no utility in having a system where you can have a determination in a bankruptcy court and then have a separate determination in the Tax Court which would be possibly inconsistent with the Bankruptcy Court's determination of tax liability except under very unusual circumstances.

My feeling on reviewing the proposed staff redraft of section 505 is that, while this suits the Treasury's purposes admirably in that it gears into the normal auditing procedure of the IRS more than some of the earlier proposed versions of the legislation would, that it does not wholly comport with the simplicity of administration of a bankruptcy case, which is desirable.

There are restrictions placed on collateral, estoppel and res judicata effects of a Bankruptcy Court's determination of tax liability.

Now, I do not want to suggest that a debtor should be free to go out and relitigate against the Treasury. However, it seems to me that to the greatest possible extent, what should be done is making the Bankruptcy Court's determination of an issue which it has decided binding on all parties for all purposes to the greatest possible extent.

The proposed legislation, the new Bankruptcy Act as a whole, greatly expands the jurisdiction of the Bankruptcy Courts to hear all sorts of claims and controversies between third parties which are related in any way to a bankrupt estate. The National Bankruptcy Conference has supported this expanded jurisdiction and I think that, to put it simply, that if you are going to have a bankruptcy court with full jurisdiction to hear antitrust cases or any other sort of litigation relating to a bankruptcy, it ought to have the same jurisdiction with respect to tax claims, and that once it determines what the tax liabilities are or whether a tax liability is dischargeable, or any other matter, that that ought to be entitled to conclusive effect on all parties.

We do feel—I do feel—that some of the proposed extensions as to priority tax claims beyond the basic taxes due within 3 years provision are going to impose a burden on estates. I appreciate that the Internal Revenue Service may feel that, in some cases, they have entered into a deferral agreement on taxes or an offer of compromise has been made to them and that they have been, in effect, led down the garden path by debtors. Indeed, that may also have happened.

But it happens to other creditors all the time. The other creditors do not get a special priority claim on that basis and, basically, I would support the 3-year limitation consistent with that in present law, without a lot of extensions.

Finally, I would note that these are extremely complicated tax measures, but that the proposed amendments make some changes in

the areas of the Bankruptcy Act not directly related to taxes—definition of claims, property of the estate, and so forth.

Senator BYRD. Well, now this committee has no jurisdiction over areas that do not relate to taxes.

Mr. NORMANDIN. All right. I think most of these minor modifications were intended to be very minor. I think there may be technical problems, but since they do not fall within this committee's jurisdiction, I think I will conclude my remarks.

Senator BYRD. Thank you, sir.

Do you have a written statement you would want to submit for the record?

Mr. NORMANDIN. No, I did not bring a written statement.

Senator BYRD. Well, now, what you may want to do is to review the committee recommendations, that is, the staff recommendations, and if you or the Bankruptcy Conference have different views or suggestions, you may want to get those to this committee, to the Finance Committee in written form, so that your views, or the views of the Bankruptcy Conference, could be considered at the time this legislation is considered.

But you will have to act reasonably fast. Senator Hansen?

Senator HANSEN. I have no questions, Mr. Chairman.

Senator BYRD. Thank you very much.

As there is no further business, the committee will stand in adjournment.

[Thereupon, at 10:25 a.m., the subcommittee recessed, to reconvene at the will of the Chair.]

[By direction of the chairman the following communications were made a part of the record:]

LOS ANGELES, CALIF., August 9, 1978.

Re S. 2266 the bankruptcy bill.

Hon. RUSSELL B. LONG,

U.S. Senate,

Russell Building, Washington, D.C.

DEAR SENATOR LONG: I understand that the above-mentioned bill enacting a new bankruptcy law has been reported to the Senate by the Judiciary Committee and presumably will shortly be called up for a vote on the floor of the Senate (after a limited hearing before the Finance Committee). I am writing to you concerning this proposed legislation because I served for three years as the Chairman of the Commission on the Bankruptcy Laws of the United States created by Congress in 1970, which was composed of two Senators, two Congressmen, two Federal District Judges and three other persons appointed by the President, and which rendered its Report to Congress, the Chief Justice and the President in July, 1973. That was the genesis of the presently pending bills—H.R. 8200, which has been passed by the House of Representatives, and S. 2266 which is now pending before the Senate.

While the work of the Commission on the Bankruptcy Laws of the United States, as indicated above, inspired the current legislative process, the two bills are "almost completely in conflict with the Bankruptcy Commission's basic conclusions as to what a sensible system of bankruptcy administration should be." This quotation is from a letter dated March 22, 1978, from the Honorable Hubert L. Will of the United States District Court for the Northern District of Illinois (a member of the Bankruptcy Commission) to Senator DeConcini, which letter related to H.R. 8200. Unquestionably, the same thing can be said of S.2266.

The most fundamental defect in the existing system of bankruptcy administration is that it involves an inherent conflict of interests and the serious possibility of prejudice on the part of the official adjudicating controversies between the trustee (or debtor where no trustee is appointed) and third parties, and in any event the appearance of prejudice. The reasons for this conclusion are twofold. In the first place, the judge (formerly called referee) frequently appoints the trustee whose controversies with third parties he subsequently adjudicates.

Secondly, and much more important, the intimate involvement of the judge in the day-to-day administration of the estate, and particularly the conduct of a business where a Chapter proceeding is concerned, inevitably tends to make him appear to be the "partner" of the trustee in the attempt to work out a constructive solution to the various problems. The judge constantly receives information in a nonadversary context which may influence his judgment in a subsequent controversy between the trustee and a third party, although it may have been wholly inadmissible in that adjudication and in any event was received entirely without an opportunity for cross-examination by the adverse party.

The judge presides at the first meeting of creditors and hears all kinds of assertions, both sworn and unsworn, which may later be highly relevant in connection with some litigation. The judge must constantly authorize or approve actions by the trustee on an ex-parte basis concerning the day-to-day conduct of the proceeding. It is probably impossible for him to completely purge his mind of this mass of information, which he may have accumulated over a period of perhaps two or three years, when he is sitting on the trial of a case between the trustee and some third party.

It should be emphasized that this situation is a fault of the system and not because any Bankruptcy Judge is doing anything improper. On the contrary, these other activities are a part of his job, and he has no choice but to perform them. There is no one else to do so. Therefore, the only way in which this situation can be corrected is to change the system. Giving the occupants of the bench life tenure (as proposed in H.R. 8200) will do nothing to correct this problem unless the system is changed. It is my understanding that certain cases were transferred from the jurisdiction of the District Judge in charge of the Penn Central reorganization under Section 77 for this very reason—he could hardly be presumed to be an impartial adjudicator of disputes between the trustees and third parties when he had the responsibility for keeping the railroad running.

The Bankruptcy Commission and the National Conference of Bankruptcy Judges (which sponsored a rival bill) both agreed that it was imperative that the basis for this possibility of prejudice, and in any event the appearance of prejudice, be removed as a condition to any enlargement of the jurisdiction of the Bankruptcy Court, although there was disagreement over the details of what should be labeled "administrative" and therefore taken from the judge and assigned to some other person.

Neither S. 2266 nor H.R. 8200 does anything whatever to resolve this conflict of interests or to remove any of the administrative functions from the purview of the Bankruptcy Judge, although H.R. 8200 would place the appointment of trustees in other hands. However, both Bills would grant vastly increased jurisdiction and powers to these administrators—judges, while perpetuating the present inherently unfair structure.

The Ad Hoc Committee on Bankruptcy Legislation of the Judicial Conference, consisting of 13 distinguished Federal Judges (including Judge Edward Weinfeld of the United States District Court for the Southern District of New York, who was also a member of the Bankruptcy Commission), recommended to the Subcommittee of the Senate Judiciary Committee that an office of "Bankruptcy Administrator" be created "to assume most of the administrative duties now performed by referees in bankruptcy." I am enclosing herewith a copy of that portion of the Ad Hoc Committee's statement dealing with this recommendation. The recommendation was ignored.

The Board of Governors of the State Bar of California has adopted the following resolution:

Resolved further, That the State Bar of California opposes any expansion of the jurisdiction of the Bankruptcy Court unless and until provision is made to separate the adjudicatory and administrative functions presently combined in the bankruptcy judges and to confine the judge hearing contested matters essentially to the adjudication of such proceedings, in order to avoid conflicting statutory duties and obligations of bankruptcy judges.

I am enclosing a copy of that portion of the Report of the Business Law Section of the State Bar of California giving the reasons for recommending this resolution to the Board of Governors.

I am also enclosing a copy of a letter dated August 30, 1977, to Senator DeConcini from the Honorable Robert L. Ordlin, Bankruptcy Judge for the Central District of California. I commend the careful reading of this letter to your earnest attention, since it documents the existence of the conflict of interests mentioned above from the point of view of one who is actually subjected to these conflicting duties.

It would appear that thus far, in the five years that this legislation has been grinding its way through Congress, the only effective voices which have been heard are those whom Judge Will referred to in his letter mentioned above as "functionaries with vested interests in the bankruptcy field [who desired] to aggrandize their own positions and secure even greater economic benefits than they already enjoy at the expense of bankrupts and creditors".

A handful of people throughout this process have protested the direction in which the legislation was going, but their protests have been ignored and the issues raised have been refused even to be publicly debated. My only personal interest in this matter is that of having served (as considerable financial cost both to myself and to my law firm) as Chairman of a Commission appointed to recommend a reform of the bankruptcy laws. The ensuing legislation proposed at this time consists of revision without reform. However, that legislation would vastly increase the number of litigants subject to an inherently unfair tribunal and its enactment would be a disgrace to the American system of justice.

I urge you to vote "No" on S. 2266 and leave bad enough alone.

Sincerely yours,

HAROLD MARSH, JR.

Enclosures.

STATEMENT ON BEHALF OF THE AD HOC COMMITTEE ON BANKRUPTCY LEGISLATION
OF THE JUDICIAL CONFERENCE OF THE UNITED STATES

(C) BANKRUPTCY ADMINISTRATORS

Section 209 of S. 2266 provides for the creation of a panel of private trustees in each district court under regulations to be adopted by the Director of the Administrative Office of the United States Courts. Basically this provision retains the trustee system in its existing form.

In view of the concept advocated by the Bankruptcy Commission of separating administrative and judicial functions, the Ad Hoc Committee is recommending the creation of an office of "bankruptcy administrator" to assume most of the administrative duties now performed by referees in bankruptcy. A bankruptcy administrator would be appointed in each district court by the circuit council for a term of five years. His duties would include the creation of panels of private trustees and the supervision of the work of trustees. Disputes arising in the administration of estates would be referred to the referee in bankruptcy or the district judge for judicial determinations.

The bankruptcy administrator would select trustees from the established panels to serve as trustees in liquidation cases in accordance with law and would also appoint standing trustees in Chapter XIII cases when the volume of such cases so warrants. The bankruptcy administrator would conduct the first meeting of creditors, allow or disallow claims, set aside exemptions, determine the priority of claims, grant discharges, and perform such other duties as may be prescribed under regulations adopted by the Judicial Conference.

It is the view of the Ad Hoc Committee that if there is to be a separation of the administrative and judicial duties of referees in bankruptcy, it would best be accomplished through the creation of the office of bankruptcy administrator as set out in the Committee report.

SECTION OF TAXATION, AMERICAN BAR ASSOCIATION,
August 7, 1978.

MICHAEL STERN,
Staff Director, Senate Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: As stated in the letter of August 4, 1978 from my predecessor, John S. Pennell, the Section of Taxation of the American Bar Association proposed to express its views on the tax provisions of S. 2266, the Bankruptcy Reform Act of 1978. We have had the opportunity as of this time, however, to study the bill only very briefly and will limit this submission to three points; we will continue our study and plan to submit further comments to the Joint Committee Staff by way of supplement to Mr. Pennell's testimony of February 21, 1978 before the Ways and Means Committee of the House of Representatives on the substantive tax provisions of H.R. 9078.

TAX COURT JURISDICTION

Under present law, the Tax Court may retain jurisdiction over a case if a petition has been timely filed prior to an adjudication of bankruptcy. However, there is no opportunity to file a petition if the Internal Revenue Service makes an assessment under IRC § 6871 and files a claim in the bankruptcy court. This places an individual debtor at a severe disadvantage. His income tax liability is not dischargeable in bankruptcy and he may have assets subject to collection which are not within the jurisdiction of the bankruptcy court. If the Service's claims are not satisfied in the bankruptcy proceeding, it has one year to proceed against the debtor with respect to the unsatisfied portion of the claim. In many cases where there is a bona fide dispute as to liability, the debtor may be satisfied to join the Trustee in contesting liability in the bankruptcy court. However, the pre-assessment form provided to solvent taxpayers in the Tax Court is denied him.

A proposed Joint Committee staff amendment to § 505 of S. 2266 would enable the taxpayer to either (1) petition the bankruptcy court for a determination of his personal liability or (2) proceed in the Tax Court. The Section of Taxation agrees with this approach. We see no reason why a distressed debtor, in addition to his other disabilities, should be deprived of remedies available to other taxpayers.

The bill makes one other significant change. Under present law, the trustee may intervene in a Tax Court litigation already in progress, but has no right to initiate a petition in the Tax Court (i.e., in a situation where a notice of deficiency has been mailed and the time to file a petition has not yet expired). A proposed Joint Committee staff amendment to § 346 of S. 2266 would enable the trustee to proceed in the Tax Court in this situation too. The Section supports this change. The Tax Court serves an important function in the administration of our income, estate and gift tax laws. Its expertise and body of precedents are a vital factor in the resolution of many tax disputes. There is nothing in bankruptcy policy which requires that the trustee be deprived of this expertise. It may be argued that the Tax Court's procedures are not as expeditious as those of the bankruptcy court, and it may take longer for a case to be reached for trial in the Tax Court. However, delay is a problem principally for the general creditors, and if the trustee, as their representative, opts for a Tax Court forum, this objection would seem to be obviated.

In those cases under current law where there is already concurrent jurisdiction, there may be some advantage to the debtor in remaining aloof from the bankruptcy court proceedings. There is some authority for the proposition that if he does, he may take advantage of a disallowance of a tax claim but be unaffected by its allowance. A proposed Joint Committee staff amendment to § 505 of S. 2266 would end this inconsistent treatment by providing that the Service may contest the debtor's petition in the Tax Court where it has lost in the bankruptcy court and the debtor has not intervened. The Section of Taxation supports this proposal.

DECLARATORY JUDGMENTS

S. 2266 originally contained a proposal in § 1146(d) that a bankruptcy judge could "declare" the tax effects of a plan of reorganization on motion of a proponent when the Service failed to respond to a request for an advance ruling within 270 days or issued an unfavorable ruling. H.R. 9973 contained a similar proposal, as did the Bankruptcy Commission's proposal bill. A proposed Joint Committee staff amendment would delete this provision.

Although our initial reactions to this proposal gave rise to some disagreement within the Section, at this time we favor § 1146(d) as originally proposed and we oppose its deletion. The uncertainty over tax consequences could have an adverse effect on the structuring of a plan of reorganization. Should the Service take an adverse position, its views would have undue finality since proponents of a plan might not want to risk subsequent tax litigation even where they believe their position properly expresses the applicable law. In this situation, declaratory relief seems appropriate.

The choice between the Tax Court and the bankruptcy court as the appropriate forum is difficult. On the one hand, the bankruptcy court has the parties before it and is familiar with the facts, and the injection of the Tax Court could give rise to delay. On the other hand, the bankruptcy court may not be a completely disinterested party in developing a reorganization plan and is less likely than the Tax Court to reach results which would be uniform and con-

sistent on a national basis. But this is no different than in other tax cases and is correctible by appeal. Accordingly, we favor Section 1146(d) with the declaratory judgment power in the bankruptcy court.

"QUICKIE" REFUNDS

Finally, we note an apparent omission from the Joint Committee staff's amendments. § 117 of H.R. 9973 would have enabled the Service to withhold a refund arising from an application for a tentative carryback adjustment from a taxpayer in a bankruptcy proceeding. We would have opposed this provision without some guarantee of a prompt audit. Proposed § 507 of S. 2266 does give special priority status to an erroneous refund from a tentative carryback adjustment actually paid to the taxpayer prior to the commencement of a bankruptcy case. We have no problem with this but wish to be sure that if the situation covered by § 117 of H.R. 9973 is re-inserted, we have the opportunity for review and comment, at least to insure a provision for prompt audit.

The Section is continuing to review the proposed legislation and may submit further comments on its other provisions. We appreciate the opportunity to comment, and we offer our assistance in further developing sound legislation in an area which is not widely understood and where clarification of the law is sorely needed.

Very truly yours,

LIPMAN REDMAN,
*Chairman, Section of Taxation,
American Bar Association.*

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