Calendar No. 1026

95TH CONGRESS } SENATE { REPORT
2d Session } { No. 95-1106

BANKRUPTCY REFORM ACT OF 1978

AUGUST 10 (legislative day, MAY 17), 1978.—Ordered to be printed

Mr. LONG, from the Committee on Finance,
submitted the following

REPORT

[To accompany S. 2266]

The Committee on Finance, to which was referred the bill (S. 2266) to establish a uniform law on the subject of bankruptcy, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY

S. 2266, the Bankruptcy Reform Act of 1978, was reported by the Committee on the Judiciary on July 14, 1978 (S. Rept. 95-989), and, by prior agreement, was referred to the Committee on Finance for a period not to exceed 30 days for consideration and recommendations concerning tax-related provisions of the bill. The referral specifically covers sections 346, 505, 507, 523, 728, 1146 and 1331 of the proposed new title 11 of the United States Code (contained in sec. 101 of the bill). These provisions deal with determining tax liabilities in bankruptcy, clarifying the jurisdiction of different courts to rule on these issues, and defining the priority and dischargeability of tax claims against the debtor's estate.

S. 2266 and H.R. 8200, the House-passed bill on the same subject, would modernize bankruptcy law for the first time in 40 years, in light of major changes in debtor-creditor relations during this period. The current bankruptcy system originated in 1898, and the last major revision of the Bankruptcy Act occurred in 1938.

The overall objectives of S. 2266 and H.R. 8200 are to make bankruptcy procedures more efficient, to balance more equitably the interests of different creditors, to give greater recognition to the interests of general unsecured creditors who enjoy no priority in the distribution of the assets of the debtor's estate, and to give the debtor a less encumbered "fresh start" after bankruptcy.

In the case of tax liabilities of debtors, S. 2266 balances the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors with the interests of governmental tax authorities who, as to tax liabilities of the debtor or his estate, are also creditors in the proceeding.

The Committee on Finance has modified several tax-related provisions covered by the referral of the bill, and has added related technical and conforming amendments to other provisions. After studying the referred provisions, the committee has also added further amendments dealing with tax-related subjects collateral to, but not specifically covered by, the sections of the bill referred to the committee. One of these recommended amendments deals with a problem concerning recapture of investment credits on transfers of assets in bankruptcy reorganizations. This problem was brought to the committee's attention in connection with transfers of the assets of certain insolvent railroads to the Consolidated Rail Corporation in 1976.

II. BACKGROUND OF BANKRUPTCY LEGISLATION

A. Judiciary Committee Bills (S. 2266 and H.R. 8200)

S. 2266 and H.R. 8200, the House-passed bill dealing with basic bankruptcy reform, are outgrowths of the work of the Commission on the Bankruptcy Laws of the United States. The Commission was created in 1970 by Public Law 91–354. It was composed of nine members, including bankruptcy practitioners, academicians, District Court judges, two Congressmen (Edwards of California and Wiggins), and two Senators (Burdick and Cook). The Commission filed its report, along with bankruptcy and Federal income tax proposals, on July 30, 1973.[1]

On February 1, 1978, the House of Representatives passed H.R. 8200, which would revise the Federal bankruptcy laws by codifying and enacting a new Title 11 of the United States Code.[2]

S. 2266 was introduced by Senators DeConcini and Wallop on October 31, 1977. That bill followed H.R. 8200 in several basic respects but differed from the House bill on other important provisions, particularly the nature and status of the revised court system to hear bankruptcy cases. On July 14, 1978, the Committee on the Judiciary reported S. 2266, with amendments.[3]

By agreement for a sequential referral, S. 2266 was referred to the Committee on Finance for a period not to exceed thirty days in order to permit the Committee on Finance to consider and offer recommendations covering certain tax-related provisions of the bill. These provisions deal generally with determinations of tax liability, the jurisdiction of courts to rule on tax questions arising in bankruptcy, and with the priority and dischargeability of taxes in bankruptcy cases.

B. H.R. 9973

In the course of considering revisions of the bankruptcy laws, the Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee proposed a series of tax-related amendments to the Internal Revenue Code. The amendments were designed to modernize the tax treatment of insolvency proceedings and bankruptcy cases, and to conform the tax rules to H.R. 8200. The proposed rules deal generally with cancellation of indebtedness, the method of taxing bankruptcy estates, survival of tax attributes after an insolvency reorganization, and return filing requirements. In order to reflect these tax proposals, H.R. 9973 was introduced on November 3, 1977, by several members of the House Judiciary Committee and was referred to the Committee on Ways and Means.

A hearing was held on H.R. 9973 by the Ways and Means Committee on February 22, 1978. The bill is currently pending in that Committee.

---

[1] *Report of the Commission on the Bankruptcy Laws of the United States* (July 1973); H. Doc. No. 93–137, 93rd Cong., 1st Sess. (September 6, 1973).

[2] H.R. 8200 was reported by the House Committee on the Judiciary on September 8, 1977. H. Rept. 95–595, 95th Cong., 1st Sess. (1977).

[3] S. Rept. 95–989, 95th Cong., 2nd Sess. (1978).

III. GENERAL DESCRIPTION OF S. 2266

A. Nontax Aspects

S. 2266, along with H.R. 8200, seeks to reflect the widespread adoption of the Uniform Commercial Code, the spread of consumer credit and the resulting increase in the number of bankruptcies in the economy, and the increased complexity of business reorganizations. Both bills also deal with a variety of special problems, such as bankruptcies of railroads, stock brokerage firms, and commodity futures brokers, and the protection of investors when a public company is reorganized in bankruptcy.

The bill reduces the number of different "chapters" under which a debtor can have his affairs administered in court (such as present chapters 10, 11 and 12 for business reorganizations and a separate section 77 for railroads). For the bulk of cases, S. 2266 substitutes a single chapter 7 for "liquidations" of debts, chapter 11 for business reorganizations of corporations, partnerships and sole proprietorships, and chapter 13 for "workouts" of debts of an individual or sole proprietor whose income consists chiefly of wages, self-employment income, or similar kinds of regular income.

S. 2266 would also change the existing structure of the bankruptcy courts. The bill would retain the present status of the bankruptcy court as an adjunct of the U.S. district court, but would upgrade the status of bankruptcy judges in a variety of ways. S. 2266 would also remove certain jurisdictional limitations on the bankruptcy courts which have led to administrative delays, unnecessary expense and duplicate litigation.[4]

S. 2266 preserves the basic principles of present bankruptcy law giving priority in the distribution of assets of the debtor's estate to certain claims with special social importance. In general, the priority rules affect claims of unsecured creditors. Among this group, priority in payment from the estate's assets is given (in a defined order) to wages and fees earned while the bankruptcy case is pending, employee wages earned but not paid during a three-month period just before the case began, contributions to employee benefit plans, certain customer "layaway" deposits, and taxes (Federal, State and local). In addition, the bill preserves the basic concept of coordinating priority and discharge of debts. This means that debts which are not discharged in bankruptcy are generally given priority in distribution of the debtor's assets, so that as much as possible of the debt which would otherwise continue to burden the debtor after bankruptcy can be paid out of his current assets being administered by the court.

The general effective date of the bill is October 1, 1979.

---

[4] By comparison, H.R. 8200 would establish a separate bankruptcy court under Article III of the Constitution, as well as federally appointed U.S. Trustees to take over many supervisory duties now being performed by bankruptcy judges.

B. Tax Aspects

As indicated above, S. 2266 balances the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding.

The bill recognizes that the tax law places numerous restrictions on the collection of taxes. These limitations, which do not encumber private creditors, often complicate the collection of prepetition taxes. S. 2266 also recognizes that tax collection rules for bankruptcy cases have a direct impact on the integrity of Federal, State and local tax systems. To the extent that debtors in bankruptcy are freed from paying their tax liabilities, the burden of making up the lost revenues must be shifted to other taxpayers.

A three-way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumulation of taxes for past years; (2) the debtor, whose "fresh start" should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law has restrained him from collecting.

In balancing these interests, S. 2266 gives governmental units a priority claim on assets of a debtor's estate for certain taxes which have not grown so "stale" as to constitute an unjustifiable burden on general unsecured creditors (who may have extended new credit to the debtor since the tax liability arose). To avoid unduly burdening the debtor's fresh start, the bill, with some exceptions, continues the basic coordination of priority and discharge provisions in the case of taxes.

In general, the bill retains two important priority rules of present bankruptcy law: first, for tax claims for which the tax return was due not more than three years before the bankruptcy petition was filed, and, second, for taxes collected or withheld from others, such as withheld income taxes and the employees' shares of social security taxes, regardless of the due date of the return.

S. 2266 contains a longer list of tax priorities than is found in present law, in part to cover a number of complex situations in which tax collection issues arise. The new categories deal with some uncertainties and ambiguities in present bankruptcy law, as well as with certain defects in the law under which some debtors have been able to exploit the collection processes of a governmental unit in order to escape taxes unfairly.

The bill contains several provisions designed to minimize the administrative problems that governmental tax authorities may face in collecting taxes in bankruptcy proceedings, and also contains safeguards to assure normal administrative procedures and to prevent tax avoidance.

Other tax-related provisions of S. 2266 continue several rules of present law, such as that the tax authority may collect dischargeable prepetition tax liabilities of a debtor from his exempt property (other than property exempted from levy under the applicable tax collection rules. Also, tax liens on personal property not seized before bankruptcy would continue to be subordinated to payment of higher pri-

ority claims (in contrast to H.R. 8200, which would subordinate tax liens on both real and personal property).

S. 2266 also preserves sovereign immunity for tax authorities by excepting government tax claims from the preference rules, under which creditors who receive payments from the debtor under certain conditions shortly before a bankruptcy petition must return the payments for orderly administration of the estate. The bill also modifies the effective veto which the Secretary of the Treasury presently holds over confirmation of business reorganization plans not providing for full payment of taxes.

IV. COMMITTEE AMENDMENTS TO S. 2266

A. Special Tax Provisions (section 346 of title 11*)

S. 2266

This section provides special tax provisions dealing with the treatment, under State or local tax (but not Federal tax law), of the method of taxing bankruptcy estates of individuals, partnerships, and corporations; survival and allocation of tax attributes between the bankrupt and the estate; return filing requirements; and the tax treatment of income from discharge of indebtedness.

In addition, the bill provides that, for Federal, State and local law purposes, the trustee is required to comply with the normal withholding rules applicable to the payment of wages and other payments.

Committee Amendments**

State and local rules

Federal tax rules dealing with the subject matter of this section of title II will be the subject of legislation expected early in the next Congress. There is general agreement that rules for State and local tax law should be as similar as possible to the comparable Federal rules. In order to prevent the enactment of rules governing State and local taxes which would then have to be amended when Congress considers the Federal tax rules, the committee amendment deletes these State and local rules.

The substance of the rule in S. 2266 concerning tax withholdings from wages and other payments would be retained (in revised wording), because the rules of S. 2266 dealing with the priority and dischargeability of withholding taxes are premised on the trustee's complying with the various Federal, State and local withholding requirements.

In addition, a conforming amendment provides that amounts withheld by the trustee (or by a debtor in possession, who has the duties of a trustee (sec. 1107 of title 11)) are not subject to the general rule requiring payment of expenses within a priority category pro rata among the creditors in that category. The effect of this rule is that the trustee must pay the full amount of the withheld taxes to the appropriate governmental tax authority. (This conforming amendment appears as a new subsection 726(b)(2) of title 11.)

When taxes considered "incurred"

The committee amendments add several new rules to this section of the bill. First, the committee amendments add a general definition of when a tax is "incurred" for purposes of the various tax collection rules

---

*These sections refer to the proposed new title II of the U.S. Code under S. 2266.

**Unless otherwise specified, the committee amendments to S. 2266 are to section 101 of the bill.

affecting the debtor and the estate. The substance of these definitions appears in various places in S. 2266 and would be consolidated in one place. Under the amendment, a tax on income of a particular period is "incurred" on the last day of that period. A tax on or measured by some event, such as the payment of wages or a transfer by gift, death or sale, is "incurred" on the date of that event.

Penalty for failure to pay tax

The committee amendments also would relieve the debtor and the trustee from certain tax penalties. In general, the purpose of these rules is to prohibit a penalty for failure to make timely payment of a tax to the extent that the bankruptcy rules prevent the trustee or the debtor from paying the tax on time. Thus, if the due date of a debtor's tax return occurs after he has filed a petition in bankruptcy, the debtor loses the ability to pay the tax. No late payment penalty would be imposed in such a case. When the due date of the debtor's return occurred before the filing of the bankruptcy petition, a penalty for late payment of taxes could be imposed but not to the extent it is based on the passage of time after the filing of the petition and during the pendency of the bankruptcy case.

If the trustee fails to pay on time a tax liability of the estate incurred during the proceeding, no penalty for failure to pay the tax on time could be imposed if the trustee acts under an order of the court finding that there will be insufficient funds in the estate to pay all administrative expenses.

The above rules prohibiting imposition of a penalty for failure to pay a tax on time would not apply to the payment or deposit of any employment tax required to be withheld by the debtor or trustee.

B. Determination of Tax Liability (sec. 505 of title 11)

S. 2266

Authority of bankruptcy court to rule on merits

This section follows present law (sec. 2a(2A)) of the Bankruptcy Act) in authorizing the bankruptcy court to rule on the merits of tax claims involving an unpaid tax of the debtor, provided that no court or administrative tribunal has previously ruled, in a contested proceeding, on the debtor's liability for the tax.

Under present bankruptcy law (sec. 17 of the Bankruptcy Act) a creditor or a debtor who is an individual can file an application with the bankruptcy court (either before or after the bankruptcy case is closed) to ask that court to rule on the extent of his personal liability after the case for nondischargeable taxes. The intention of S. 2266 is to retain the substance of this rule, although the rule does not appear in express terms in the bill (S. Rept. 95–989, pp. 153–154).

Audit of trustee's returns

S. 2266 also provides a procedure for obtaining a mandatory audit of tax returns filed by the trustee in a liquidation or reorganization case (sec. 505(c) of title II). Under the procedure, before the case can be closed, the trustee would be required to request a tax audit by the local, State or Federal tax authority of all tax returns filed by the trustee. The taxing authority would have to notify the trustee and the bankruptcy court within 60 days whether it accepts the returns or desires to audit the returns more fully. If an audit is conducted, the taxing authority would have to notify the trustee of any tax deficiency within 4 months (subject to extension of time if the bankruptcy court approves). If the trustee did not agree with the results of the audit, the trustee could ask the bankruptcy court to resolve the dispute. Once the trustee's tax liability for administration period taxes has thus been determined, the legal effect in a liquidation case under chapter 7 of title 11 would be to discharge the trustee (and any predecessor of the trustee), and also the debtor, from any further liability for these taxes.

In a reorganization case the trustee could obtain a discharge from personal liability through the prompt audit procedure, but the tax authority could still claim a deficiency against the debtor (or his successor) for additional taxes due on returns filed during the proceeding.

The prompt audit procedure would not be available with respect to any tax liability as to which any return required to be filed on behalf of the estate is not filed with the proper tax authority.

Committee Amendments

Audit of trustee's returns

The committee's amendment would modify this provision of S. 2266 by making the prompt audit mandatory only if the trustee determines that a surplus is reasonably likely to be returned to and individual debtor in either a liquidation case under chapter 7 or a reor-

ganization under chapter 11. Where application for a prompt audit is mandatory, both the personal liability of the trustee and the liability of the debtor as a transferee would be decided conclusively by the bankruptcy court.

If the debtor is a corporation, or if a surplus is not likely to be returned to an individual debtor, the trustee would be permitted, but not required, to make application for a prompt audit. If he requests the prompt audit, only the trustee would be discharged from liability for the administration period tax.

The amendment also specifies that a discharge of the trustee or the debtor which would otherwise occur under the prompt audit rule will not be granted, or will be void and of no legal effect, if the return filed on behalf of the estate reflects fraud or any material representation of facts.

Authority of bankruptcy court to rule on merits

Another amendment authorizes the bankruptcy court to rule on a refund claim by the trustee (in addition to an unpaid tax of the debtor), as well as on a tax penalty asserted against the debtor's estate. If the refund results from an offset or counterclaim to a claim or request for payment by the Service (or other tax authority), the trustee would not first have to file an administrative claim for refund with the tax authority. If the trustee requests a refund in other situations, he would first have to submit an administrative claim for the refund.

The committee amendment does not adopt the provision in present law that the bankruptcy court can rule on the merits of a debtor's prepetition tax liability even though a prior adjudication of the same liability has occurred, if the prior judgment was entered by default of the debtor. Under the amendment, any prior adjudication by a court of competent jurisdiction, including a default judgment, would foreclose an initial examination of the liability by the bankruptcy court.

Another amendment changes certain rules under present law concerning the jurisdiction of various courts to deal with tax issues affecting an individual debtor personally. The committee amendments add several rules designed to make clear the rules and procedures governing an individual debtor's rights to contest his liability for a nondischargeable tax, including rules concerning the courts in which any such contest may be made. In general, these rules are limited to cases involving an individual's debts under title 11. A corporation seeking reorganization under the new chapter II is considered to be personally before the bankruptcy court for purposes of giving that court jurisdiction over the debtor's personal liability for a nondischargeable tax. One committee amendment in this area adopts in express terms a rule similar to section 17 of the present Bankruptcy Act, but limited to determinations of an individual debtor's liability for nondischargeable taxes (whether Federal, State or local).[5]

---

[5] Under bankruptcy law, the statute excepts certain categories of debts from discharge. This fact does not automatically make the debtor liable for the balance of any specific tax liability which is not satisfied from property of the estate. When and if the creditor seeks to collect any unpaid balance from the debtor (usually after the bankruptcy case has been closed), the debtor can contest the merits of the particular claim on his own behalf and, in addition, even if he is liable on the merits, the debtor can argue that the general category of debts involved is dischargeable.

A further modification of present law is that under this amendment, only the debtor, and not the creditor (the tax authority), could request a determination of tax liability by the bankruptcy court.

Another amendment (sec. 321 of the bill) would remove a rule of present law which, under certain circumstances, denies the debtor the right to contest his personal liability for taxes in the Tax Court. Under present section 6871(a) of the Internal Revenue Code, the Internal Revenue Service may immediately assess taxes against a debtor who files a petition in bankruptcy.

The amendment also removes another rule of the Code (sec. 6871(b)) which prevents a debtor from filing a petition in the Tax Court after he has begun a bankruptcy case. Sec. 6871(b) of the Code does not, however, prevent a Tax Court proceeding which is already underway at the filing of a petition in bankruptcy from continuing to a conclusion. These amendments will assure an individual debtor a right to have his personal liability for a nondischargeable tax determined in the Tax Court (or in a refund suit), following normal receipt of a deficiency notice from the Service.

Under the committee amendments, once an individual debtor files a bankruptcy petition, the Internal Revenue Service (or State or local tax authority) would have to send the debtor a deficiency notice (with a copy to the trustee) if it finds an unpaid liability for pre-petition income, estate, gift, or certain excise taxes. If a claim for taxes is to be made against the estate, the deficiency notice must be sent before the due date for filing claims against the estate (generally 6 months from the first meeting of creditors). If the deficiency notice is not sent by the due date, assets of the bankruptcy estate may not be distributed in satisfaction of a claim for those taxes.

After the deficiency notice is mailed, the debtor would have 150 days (rather than the usual 90 days) in which to decide whether to file a petition in the Tax Court. The debtor would also have 150 days from the commencement of the case in which to file a petition in the Tax Court when the time for filing such a petition had begun, but had not expired, before the commencement of the bankruptcy case. If the debtor files a petition in the Tax Court, the bankruptcy court cannot rule on the amount of the same tax liability (whether or not the trustee intrevenes in the Tax Court on behalf of the estate) but would have to defer to the decision of the Tax Court. It is expected that the bankruptcy court may request the Tax Court to decide the case expeditiously when a prompt decision is necessary to avoid unreasonable delay of the bankruptcy case.

The Tax Court decision on the merits of a tax liability would bind both the bankruptcy estate and the debtor himself for nondischargeable taxes not paid from the estate, whether or not the trustee intervened in the Tax Court.

If the debtor chooses not to go to the Tax Court, the bankruptcy court could then decide the merits of the tax claim either on objection by the trustee or application of the debtor. If the debtor is not bound by the decision of the bankruptcy court under principles of collateral estoppel or res judicata, the debtor could later contest his personal liability for any unpaid balance of a nondischargeable tax by means of a refund suit. In any event, if the debtor decides not to litigate his

tax liability in the Tax Court, the trustee could not file the petition in that court.

The committee amendment makes appropriate changes in the automatic stay provisions of the bill to reflect the procedures described above.

The repeal of the immediate assessment rule of present Code section 6871(a) would also apply to corporations in bankruptcy The committee's amendment, however, modifies the Code rules dealing with deficiency notices (sec. 6213) to provide that the Internal Revenue Service will not be required to send a corporation in bankruptcy a deficiency notice for unpaid pre-petition taxes (sec. 318 of the bill). The bankruptcy court would thus be the only prepayment forum in which the corporation could contest its liability for taxes.

The amendments to section 6213 of the Code also provide that a deficiency notice will not have to be sent to either an individual or corporate debtor for administration period taxes, but no assessment of these taxes can be made until a determination of the bankruptcy court concerning these taxes becomes final.

Thus, under the committee's amendments, a deficiency notice would only have to be sent to an individual debtor in a liquidation, wage-earner, or reorganization case with respect to taxes incurred before the case began. No assessment of pre-petition or administration period taxes of an individual or corporate debtor could be made until the court which hears the tax issues has determined the amount, if any, of these tax liabilities and that determination has become final following any appeal that may occur. Actual collection of taxes is stayed under S. 2266 until the close of the case or until the court lifts the stay (sec. 362 of title 11).

[Access to Tax Court—Reserved, to be supplied for a later galley.]

Appeals of pending cases

Another amendment transfers to a different place in the bill, without change, a rule authorizing the trustee in bankruptcy to appeal (or request review of) an adjudication by a court or administrative body of a prepetition tax liability of the debtor (if the time for appeal has otherwise not expired).[6]

---

[6] The amendment transfers this rule from section 505(b) of title 11 to a new subsection (h)(2) of section 362 of title 11, relating (among other things to stays of court proceedings pending the filing of the bankruptcy petition.

C. Priorities (section 507 of title 11)

S. 2266

Section 507 of title 11 specifies the kinds of unsecured debts entitled to priority in the distribution of assets from the debtor's estate, as well as the order of priority. In general, secured debts are first satisfied out of the estate's assets. In the group of unsecured claims, priority in payment of the estate's assets is given, in general, to wages, taxes, fees, commissions, and other expenses incurred while the bankruptcy case is pending; certain employee wages earned but not paid during the 90-day period just before the case began; certain unpaid contributions to employee retirement plans; certain customer deposits; and certain unpaid taxes (Federal, State, and local). Claims of creditors not entitled to priority are treated as general claims and are satisfied pro rata from the remaining asets, if any, of the estate.

Under S. 2266, taxes receive priority under the rules stated below.

1. *Administrative expenses.*—Taxes incurred during the administration of the estate share the first priority given to administrative expenses generally. S. 2266 makes exceptions, however, for certain administrative expenses (including some taxes) which are specifically given a lower priority.[7] Among the taxes which receive first priority are both the employees' and the employer's shares of employment taxes on wages earned and paid after the title 11 petition is filed.

2. "*Involuntary gap*" *claims.*—"Involuntary gap" creditors, granted first priority under current law, are granted second priority by paragraph (2) of section 507(a). This priority covers claims arising in the ordinary course of the debtor's business or financial affairs after he has been placed involuntarily in bankruptcy (see sec. 303 of title 11), but before a trustee is appointed or before the order for relief. The debts payable by the estate in this category include income, employment and other taxes incurred during this period.

3. *Certain taxes on prepetition wages.*—Wage claims entitled to third priority are for compensation which does not exceed $1,800 and was earned during the 90 days before the filing of the bankruptcy petition or the cessation of the debtor's business. Certain employment taxes receive third priority in payment from the estate along with the payment of wages to which the taxes relate. In the case of wages earned before the filing of the petition, but paid by the trustee (rather than by the debtor) after the filing, claims for the employees' share of the employment taxes (withheld income taxes and the employees' share

---

[7] Examples of these specially treated expenses are the estate's liability for recapture of an investment tax credit claimed by the debtor before the title 11 case (this liability receives sixth priority) and the estate's employment tax liability on wages earned before, but paid after, the petition was filed (this liability generally receives the same priority as the wages).

No request for payment has to be filed for an administrative expense.

of the social security or railroad retirement tax) receive third priority to the extent the wage claims themselves are entitled to this priority.

The priority given to the employer's share of the employment taxes (unemployment taxes and the employer's share of the social security or railroad retirement tax) depends on whether the related wages were paid by the debtor or were paid by the trustee after the petition is filed. In the case of wages both earned from and paid by the debtor before the filing of the petition, the employer's share of the employment taxes due on these wages paid by the debtor receives the sixth priority (as discussed later) or, if not entitled to that priority, are treated only as general claims. The employer's share of employment taxes on wages earned by employees of the debtor, but paid by the trustee after the filing of the bankruptcy petition, receive third priority to the extent that claims for the wages themselves receive third priority. However, the employer's share of the employment tax is to receive this priority only to the extent that funds remain after payment of the third priority wages themselves.[8] To the extent the claims for wages do not receive third priority, but instead are treated only as general claims, claims for the employer's share of the employment taxes attributable to those wages will also be treated as general claims. (In calculating the amounts payable as general wage claims, the trustee must pay the employer's share of employment taxes on such wages.)

4. *Prepetition tax liabilities of the debtor.*—Paragraph (6) of section 507(a) provides the general tax priority for prepetition taxes. These taxes, which the tax authority can claim against the estate as sixth priority items, cover the unsecured claims listed below.

a. Income taxes for a taxable year that ended on or before the date of the filing of the petition, if the last due date of the return for that year was not more than 3 years before the date on which the petition was filed (sec. 507(a)(6)(A)(i)). For purposes of this rule, the last due date of the return is the last date under any extension of time to file the return which the taxing authority may have granted the debtor. Income taxes for a year which ends on or before the petition date receive sixth priority even if the last due date of the return for that year occurs after the petition is filed.

b. Transaction taxes (including gift, estate, sales, use or other excise taxes) and the employer's share of employment taxes not covered by higher priorities, if the transaction or event which gave rise to the tax occurred before the petition was filed, and if the required return for the transaction or employment tax was last due within 3 years before the filing of the petition, or thereafter (sec. 507(a)(6)(A)(ii)).

c. Taxes for which the last due date of the return was more than 3 years before the filing of the title 11 petition, but which were assessed within 3 years after the last due date of the return and within 240 days before the petition was filed. This rule brings into the sixth priority tax liabilities for some years which would not qualify for priority

---

[8] The bill thus creates a class of tax claims entitled to payment which falls between payment of third and fourth priority claims. Because of the policy importance of paying the wages in this priority, S. 2266 does not allow payment of the employers' taxes before the wage claims entitled to priority (as well as the related "trust fund" taxes) are paid in full.

under the general 3-year rule of section 507(a)(6)(A)(i) (sec. 507(a)(6)(B)(i)).[9]

d. Taxes which the tax authority was barred by law from assessing or collecting at any time during the 300 days before the bankruptcy petition was filed. This rule covers, for example, Federal tax liabilities for which the last due date of the return was more than 3 years before the petition was filed, but which the debtor and the Internal Revenue Service were negotiating after audit or which were the subject of Tax Court litigation (sec. 507(a)(6)(B)(ii)).[10]

e. Taxes for which an offer in compromise was withdrawn by the debtor, or rejected by a governmental unit, within 240 days before the petition date (sec. 507(a)(6)(B)(iii)).[11]

f. Certain taxes for which no return or report is required by law if the taxable transaction occurred within three years before the petition was filed (sec. 507(a)(6)(C)).

g. Taxes (not covered by the third priority) which the debtor was required by law to withhold or collect from others and for which he is liable in any capacity, regardless of the age of the tax claims (sec. 507(a)(6)(D)). This category covers the so-called "trust fund" taxes, that is, income taxes which an employer is required to withhold from

---

[9] For example, assume that the last due date of an individual taxpayer's 1978 tax return, with extensions, is February 15, 1980, and that after audit the tax authority makes a proper assessment on January 30, 1983. If the taxpayer files a petition in bankruptcy at any time before February 15, 1983, the tax for 1978 would receive priority under subparagraph (A). However, the 1978 tax would not receive priority under that general rule if the debtor files in bankruptcy at any time on or after February 15, 1983. Nevertheless, the tax liability would receive priority under subparagraph (B)(i) if the bankruptcy petition was filed not more than 240 days after the assessment. Thus, if the petition was filed on July 1, 1983, the 1978 tax would receive sixth priority under subparagraph (B)(i). However, if the petition was filed on December 1, 1983, the 1978 tax would not receive priority under either (A) or (B)(i).

[10] In such situations, Federal tax law suspends the Internal Service's right or assess a tax deficiency until 90 days after the Service sends the taxpayer a deficiency letter or, if the taxpayer filed a petition in the Tax Court during that 90-day period, until the outcome of the litigation. A similar priority exists in present law, except that the tax authority is allowed no time to assess and collect the taxes after the restrictions on assessment (discussed above) are lifted. Some taxpayers have exploited this defect by filing in bankruptcy immediately after the end of the 90-day period or immediately after the close of Tax Court proceedings.

S. 2266 remedies this defect by preserving a priority for taxes, the assessment of which was barred by law, by allowing the tax authority 300 days after the restriction on assessment ends within which to make the assessment and then to collect the tax or file notice of its tax lien. The 300-day period is based on allowing the tax authority 60 days in which to assess the tax after the restrictions on assessment are removed, plus 240 days after the assessment in which to collect. Thus, if a taxpayer files a bankruptcy petition at any time during the 300-day period, the tax deficiency (if not collected before the petition) will be entitled to the sixth priority. If the petition is filed more than 300 days after the restriction on assessment is lifted, the taxing authority will not have priority for the tax.

[11] This rule remedies a defect in present law under which, following an assessment of tax, some taxpayers have submitted a formal offer in compromise, dragged out negotiations with the taxing authority until the tax liability lost priority under the 3-year priority period of present law, and then withdrew the offer and filed in bankruptcy before the governmental unit could take collection steps.

the pay of his employees, and the employees' shares of social security and Federal unemployment insurance. This category also includes excise taxes which a seller of goods or services is required to collect from a buyer and pay over to a taxing authority.

In addition, this category includes the liability of a responsible officer under the Internal Revenue Code (sec. 6672) for income taxes or for the employees' share of employment taxes which that officer was responsible for withholding from the wages of employees and paying to the Treasury, although he was not himself the employer. This priority will operate when a person found to be a responsible officer has himself filed in title 11, and the priority will cover the debtor's responsible officer liability regardless of the age of the tax year to which the tax relates. The U.S. Supreme Court has interpreted present law to require the same result as the rule under S. 2266. *U.S.* v. *Sotelo*, 436 U.S. —— (1978).

h. Property taxes which were required to be assessed within 3 years prior to the date of the petition (sec. 507(a)(6)(E)).

i. Taxes attributable to a tentative carryback adjustment received by the debtor before the petition was filed, such as a "quickie refund" received under section 6411 of the Internal Revenue Code (sec. 507(a)(6)(F)). However, the tax claim against the debtor will receive sixth priority only to the extent that the loss carryback occurred in a prepetition loss year for which the tax return was last due, including extensions, within 3 years before the petition was filed, or thereafter. This rule overrules *In Re Able Roofing & Sheet Metal Co.*, 425 F.2d 699 (5th Cir. 1970).

j. Taxes resulting from recapture, occasioned by a transfer during bankruptcy, of a tax credit or deduction taken during an earlier tax year (sec. 507(a)(6)(G)).[12]

k. Taxes owed by the debtor as a transferee of assets from another person who is liable for a tax, if the tax claim against the transferor would have received priority had the transferor filed a title 11 petition within 1 year before the date of the petition filed by the transferee (sec. 507(a)(6)(H)).

l. Certain tax installment payments which fell due within one year immediately before the petition was filed, if the debtor had previously entered into a deferred payment agreement to pay an agreed liability in periodic installments, but had become delinquent in one or more installments (sec. 507(a)(6)(I)).[13]

m. Certain tax-related liabilities which are not true taxes or which are not collected by regular assessment procedures (sec. 507(a)(6)(J)).[14]

---

[12] A typical example is a sale by the trustee of depreciable property during the proceeding and the recapture, under section 1250 of the Internal Revenue Code, of depreciation deductions taken in prepetition years.

[13] This priority covers all types of deferred or part payment agreements including payments under an offer in compromise. The priority does not come into play, however, if before the case began, or during the case, the debtor and the taxing authority agree to a further extension of time to pay the delinquent amounts.

[14] One type of liability covered in this category is the liability under section 3505 of the Internal Revenue Code of a lender who pays wages directly to

(Continued)

n. Certain unpaid customs duties which have not grown unreasonably "stale" (sec. 507(a) (6) (K)).[15]

o. Interest accrued on all these sixth priority claims before the filing of the petition.

p. Any fine or penalty, however denominated, in addition to the so-called responsible officer "penalty," which actually represents collection of a tax. (Under the bankruptcy law, such penalties are called "pecuniary loss" penalties). Penalties which are punitive in nature are not to receive this priority.

S. 2266 also provides that a claim arising from an erroneous refund or credit of tax is to be given the same priority as the tax to which the refund or credit relates (except for the special priority rule for "quickie" refunds described above).

5. *Summary of priorities given to employment taxes.*—The priority rules under S. 2266 governing employment taxes can be summarized as follows.

In the case of employee wages earned, but not paid, before the filing of the bankruptcy petition, claims for the employees' share of employment taxes receive third priority to the extent the wages themselves receive third priority. All claims for the employees' shares of employment taxes attributable to wages both earned and paid prior to the filing of the petition are to receive the sixth priority.

Claims which relate to wages earned before the petition, but not paid before the debtor went into bankruptcy (and which are not entitled to the third priority under the rule set out above), will receive the same treatment as the wages to which they relate. Since such wages would receive no priority and would be paid as general claims, the related employment taxes would also be paid as nonpriority general claims.

The employer's share of the employment taxes on wages earned and paid before the bankruptcy petition will receive sixth priority to the extent the return or report for these taxes was last due within 3 years before the filing of the petition. Older tax claims of this nature will be payable as general claims. In the case of wages earned by employees before the petition, but actually paid by the trustee (as claims against

(Continued)

employees of another employer or supplies funds for the payment of wages. Another is the liability under section 6332 of the Internal Revenue Code of a person who fails to turn over money or property of the taxpayer in response to a levy. Since the taxing authority must collect such liabilities from the third party by suit rather than through normal assessment procedures, an extra year is added for these liabilities to the normal 3-year priority period. If a suit was commenced for older liabilities by the taxing authority within the 4-year period and before the petition was filed, the priority is also preserved, provided the suit had not terminated more than 1 year before the petition date.

[15] This category includes duties on imports entered for consumption within 3 years before the filing of the petition, but which are still unliquidated on the petition date. In general, liquidation is an administrative determination of the value and tariff rate of the imported item. Once an import entry is liquidated or reliquidated, the customs liability is to receive priority for 2 years following the date of the liquidation or reliquidation. If the Secretary of the Treasury certifies that customs duties were not liquidated because of possible assessment of antidumping or countervailing duties, fraud penalties, unliquidated items entered for consumption within 5 years before the importer filed in title 11 will also receive sixth priority.

the estate) after the title 11 case commenced, the employer's share of the employment taxes on these wages will receive the same priority as the wage claims themselves. Thus, the employer's share of the taxes on third priority wages will be payable as third priority items, and the employer's taxes on wages which are treated only as general claims will be payable only as general claims. Employer taxes which receive third priority under this rule, are to be paid only to the extent that funds remain in the estate after the payment of third priority wages and the employees' shares of employment taxes on those wages.

In the case of employment taxes relating to wages earned and paid after the petition, both the employees' shares and the employer's share will receive first priority as administration expenses of the estate.

Committee Amendments

Changes in the administrative expense priority

One committee amendment inserts a reference to exceptions from normal first priority treatment, in order to allow certain employment taxes to receive a position in the order of distribution lower than first priority, although these taxes are paid by the trustee (as explained earlier).

Another amendment makes clear that even administrative expenses entitled to first priority in the normal case are to be paid after the "superpriority" authorized by section 364(c) of title 11 for trustees operating the debtor's business who would otherwise be unable to obtain credit for the business.

Taxes withheld from third priority compensation

Under the third priority rules of S. 2266, discussed above, employees' shares of the employment taxes attributable to third priority wages, salaries, or commissions are to share the third priority. However, as to these taxes, the tax authority would not be subject to the general rule requiring payment of creditors pro rata within a given priority (sec. 726(b) of title 11), because of a conforming amendment that any tax withheld or collected from others is to be paid in full at the time, and in the manner, required by applicable Federal, State, or local law. (This amendment is made to sec. 726(b) of title 11). The amendment eliminates the need for the existing specific reference to these taxes in the priority provisions.

Sixth priority rules

Without changing the substance of the general 3-year priority rule of section 507(a)(6)(A), another committee amendment revises the (A) and (C) categories to reflect the addition of a specific definition of when a tax is considered "incurred" for purposes of the bill (see the discussion of the committee amendments to section 346 of title 11).

Recapture items

Another committee amendment deletes the category which makes a recapture of a pre-bankruptcy credit or deduction (caused by a sale of property by the trustee) a sixth priority item. As a result of the deletion, recapture taxes incurred by a bankruptcy trustee will receive first priority as normal administration period taxes incurred by the estate.

Pending offers in compromise

Another committee amendment deals with taxes for which an offer in compromise has been made but has not been accepted as of the filing of the bankruptcy petition. These taxes would also receive sixth priority, but only if the tax would have been entitled to priority if the debtor had filed in bankruptcy on the date of the original offer in compromise.

The amendment also modifies S. 2266 with regard to the priority for taxes for which an offer in compromise was withdrawn by the debtor, or rejected by a governmental unit, within 240 days before the petition date. Under the amendment, this priority would apply only if the tax would have been entitled to priority had the bankruptcy case begun when the offer was originally submitted.

Deferred payment agreements

Another amendment conforms the treatment of a part payment agreement (sec. 507(a)(6)(I)) to the bankruptcy policy of accelerating the principal of all installment obligations and paying them to the extent possible out of assets of the estate. (S. Rept. 95–989, p. 63). Then, only the unpaid balance of the amounts covered by the agreement would burden the debtor as a nondischargeable liability after the case.

The committee's amendment changes S. 2266 by extending priority to all past due payments under the deferred payment agreement (and not just to one-year's delinquent payments). The amendment also limits the priority to situations in which the underlying tax liability would have been entitled to priority under some other provisions of section 507(a)(6) if the title 11 case had been begun on the date of the original agreement between the debtor and the tax authority.[16]

Customs duties

S. 2266 gives priority for certain customs duties which were entered for consumption within 5 years before the date of the importer's filing a bankruptcy petition, but which were not yet liquidated as of the petition, if the Secretary of the Treasury certifies that the customs duties were not determined because of possible antidumping or countervailing duties, or fraud. A committee amendment requires the Secretary of the Treasury or his delegate to certify that the failure to liquidate was due to an existing investigation into the possibility of antidumping or countervailing duties, or fraud. The requirement of an existing investigation should make the possibility of antidumping or countervailing duties or fraud more real and substantial in order for a priority to be given for such duties.

Rule of judicial construction

Another committee amendment provides a rule of judicial construction that a tax liability is to receive the sixth priority if it satisfies any one of the subparagraphs of section 507(a)(6) of title 11, even if it fails to meet the requirements of another subparagraph which might be deemed to apply to the particular type of tax liability. For exam-

[16] The "lookback" to the priority of the original extension agreement, as provided under the amendment, insures that a tax liability which received priority in a title 11 case will again receive priority if the debtor negotiates a second extension after the title 11 case and then is involved in a second bankruptcy case.

ple, if a tax liability fails to qualify for priority under the 300-day rule of seccti0n 507(a)(6)(B) because the tax authority fails to assess within 300 days before the title 11 petition is filed, the tax liability could nevertheless qualify for priority under section 507(a)(6)(A)(i), as amended, if the last due date of the debtor's return was within 3 years before the date of the filing of the petition.

Erroneous refunds or credits

Another committee amendment makes clear that "quickie refund" situations are not to be subject to the general rule for other taxes for which the tax authority had erroneously granted a refund.[17]

Other conforming amendments

The committee amendments contain several changes designed to clarify the distinction between a "claim" (which generally relates to a debt incurred before the bankruptcy petition is filed) and an administrative expense (which is an expense incurred by the trustee after the filing of the petition).

Another committee amendment clarifies in express terms the treatment of interest on tax debts (as well as on other kinds of debts). Amendments are made to the definition of "claim" (sec. 101(4) of title 11) and to the definition of an administrative expense (sec. 503(b) of title 11) to make clear that these items include unpaid interest provided by law or contract.

In light of the committee amendments, the treatment given to interest on tax claims under S. 2266 may be summarized as follows. Interest on taxes incurred during the period of administration of the estate is given first priority as an administration expense, along with the related tax. Similarly, interest on the second priority "involuntary gap" taxes is given second priority. Interest which accrued before the title 11 petition receives the same priority as the tax claim itself. If the tax is entitled to the sixth priority, so also is the related interest. If the tax is only a general unsecured claim, the interest on the tax is a portion of the same claim, and therefore receives the same treatment.

Interest accruing after the petition on a prepetition tax liability will not receive the same treatment as the tax claim itself. Under section 726(a)(5) of title 11, post-petition interest on a prepetition tax is to be paid only after payment of all other creditors' claims. (This subordination rule follows present law, in that postpetition interest on prepetition taxes is paid only out of any surplus which would otherwise be returned to the debtor.) Under the committee amendments, postpetition interest on a prepetition tax is to be discharged,

[17] As indicated earlier, S. 2266 gives sixth priority to a tax liability resulting from an excessive allowance of a tentative carryback adjustment (the so-called quickie refund) if the tax would receive priority measured from the year of the loss, rather than the year to which the loss was carried back. To measure the priority period from the earlier year to which the loss was carried back would frequently cost the taxing authority its priority even though it did not have an adequate opportunity to audit the claimed loss before it issued the refund. In other situations, in which the taxing authority had a reasonable opportunity to audit a refund claim based on a carryback adjustment, the priority period should be measured from the earlier year to which the loss is carried back. In such cases, the tax authority can perform an adequate audit of the facts giving rise to the refund claim.

so that any such interest accruing during the proceeding and not paid from the estate will not be a nondischargeable liability of the debtor even if the underlying tax is nondischargeable (sec. 523(b), as added by the committee's amendments). Interest on tax debts which are not discharged in the title 11 proceeding will commence running again after the close of the case.[18]

[18] See the discussion of interest under the committee amendments to section 523 of title 11.

D. Nondischargeable Taxes (sec. 523 of title 11)

S. 2266

Under S. 2266, in general, nine kinds of debts, including certain prepetition tax liabilities of the debtor, cannot be discharged in bankruptcy (sec. 523 of title 11). As indicated in the discussion of section 505 of title 11, the nondischarge provisions of bankruptcy law specify only the general kinds of debts which survive as a liability of the debtor after bankruptcy. These provisions do not make the debtor automatically liable for the unpaid balance of any particular debt unless the debtor was personally before the bankruptcy court. An individual debtor who had not contested the merits before the court can therefore contest the extent of his personal liability after the case for the unsatisfied balance of a particular debt (including a tax liability) which is of a general kind that the bankruptcy law makes nondischargeable.

Taxes that are excepted from discharge under S. 2266 (as well as under present law) include claims against the debtor which receive priority in distribution of property of the estate.

Certain prepetition tax liabilities are not given priority in distribution from property of the estate, but under S. 2266 would survive as liabilities of the debtor after the case. This category includes (1) taxes for which the debtor had not filed a return as of the bankruptcy petition, or for which a return had been filed beyond its due date but within 3 years before the petition, and (2) taxes with respect to which the debtor filed a fraudulent return, or as to which he fraudulently attempted to evade or defeat any tax.[19] The standard to be applied is the same as that used for asserting the civil fraud penalty under the applicable tax law.

This section of the bill also makes nondischargeable certain tax payments due under an agreement for deferred payment of taxes, which a debtor had entered into with the Internal Revenue Service (or State or local tax authority) before the bankruptcy petition. S. 2266 also makes nondischargeable certain liabilities for penalties, including tax penalties, if the underlying tax with respect to which the penalty was imposed is also nondischargeable (sec. 523(a)(7) of title 11).

Committee Amendments

Deferred payment agreements

A committee amendment deletes the rule under S. 2266 dealing with taxes for which a deferred payment agreement had been negotiated

[19] The bankruptcy policy for this treatment is that it is not fair to penalize private creditors of the debtor by paying out of the "pot" of assets in the estate tax liabilities arising from the debtor's deliberate misconduct. On the other hand, the debtor should not be able to use bankruptcy to escape these kinds of taxes. Therefore, these taxes have no priority in payment from the estate but would survive as continuing debts after the case. (Not giving priority to a debt means that the creditor can still collect part or all of the debt from the estate, but the creditor must do so as a general creditor, sharing pro rata with other general creditors.)

between the debtor and the tax authority (sec. 523(a)(1)(D)). This change conforms to a related change in the priority rules and coordinates priority and discharge as to these deferred payment agreements (see the discussion under sec. 507).

Tax penalties

A second committee amendment adds to the rules concerning nondischargeability of tax penalties (contained in subsection (a)(7) of this section) a further rule for penalties which, under the Internal Revenue Code (or State or local tax law), are not computed by reference to a specific principal amount of tax liability. Such penalties include, for example, penalties imposed for failure to file certain information returns. The amendment makes tax penalties of these kinds nondischargeable only if the transaction or event giving rise to the penalty occurred during the 3 years immediately before the date on which the petition under title 11 was filed.

A separate technical amendment affecting tax penalties deletes the references in S. 2266 to "addition to tax." The committee does not intend this change to affect to any extent the substance of the rule of nondischargeability in S. 2266, which is to apply the rule to certain penalties which, under the Internal Revenue Code or any State or local tax law, are punitive in nature, regardless of the term used to describe any specific penalty of this basic kind. (The Internal Revenue Code, for example, uses several alternate terms to refer to punitive penalties, such as "addition to tax" and "additional amount"). The amendment deletes the reference to "addition to tax" because, although this term has a defined meaning under Federal tax law, its meaning may be uncertain under State or local tax law; under such law, for example, this term may not be limited to punitive tax penalties. The committee amendment, therefore, is intended not to bring under this subsection taxes which are not penalties. On the other hand, any "addition to tax" which is by nature a punitive tax penalty will be covered by this subsection.

Failure to file proof of claim

Another amendment adds a rule that if the Service (or State or local tax authority) fails to file a timely proof of claim for a prepetition tax liability of the debtor, any later collection which the Service makes from the debtor's after-acquired assets (assuming the tax is otherwise nondischargeable) must be reduced by the amount of additional nonpriority liabilities that were paid from property of the debtor's estate because the tax claim was not timely filed and sustained against the estate.[20]

This proposal relieves the inequity of burdening the debtor's "fresh start" because of the governmental unit's failure (through neglect or often by choice) to try to collect a nondischargeable tax out of the

[20] To illustrate how the rule of this amendment is to operate, assume that the tax authority fails to file, or files late, a claim for an additional nondischargeable tax and prepetition interest of $5,000, so that no distribution is made on that liability from property of the estate. Assume further that the tax authority succeeds in establishing the debtor's personal liability for this amount. If all sixth priority taxes were paid, and $3,000 of nonpriority liabilities were paid by the estate by reason of the tax authority's failure to claim the $5,000 liability, $3,000 of the unclaimed tax would be discharged under the amendment.

assets being administered by the court. Inequity occurs in this situation when the tax authority's failure to claim results in the estate being distributed to others who may hold dischargeable claims, leaving the nondischargeable tax hanging over the debtor's head. The committee believes that this amendment does not impose an unreasonable burden on the Service or other tax authority to file claims against estates having so few assets that the tax authority might otherwise consider the administrative processes involved in filing the claim not "worth" the amount likely to be paid from the estate. In a "no assets" case (where the debtor's estate has few, if any, assets available for creditors to reach), even if the tax authority chooses not to file a claim against the estate, the amount that the tax authority would have collected if it had filed a claim would be correspondingly low.

The committee amendment does not prohibit a tax authority which failed to fix a proof of claim from seeking to establish the debtor's personal liability for a nondischargeable prepetition tax. The amendment only requires a reduction in the amount of any such liability if and when that liability is successfully established and finally determined.

The committee's amendment would affect only unsecured claims and not secured creditors, who are not required to file a proof of claim. The committee amendment would also apply only if the tax authority received timely notice of the commencement of the bankruptcy case. (Such notice is provided for under section 342 of title 11.) The reduction would not apply, moreover, to any tax liability which is nondischargeable but which is not given priority in payment from the estate. This latter category covers the no-return, late-return and fraud situations described in paragraphs (B) and (C) of section 523(a)(1). There may be justified excuse for the tax authority not to have discovered the tax liability arising in these kinds of situations in enough time to file a claim against the estate. Consequently, and nondischargeable liability established on these grounds will not be adjusted under the amendment.

The amount that would have been paid from property of the estate had a proof of claim been filed by the tax authority is to be based on the assumption that the proof of claim would have been timely filed and, further, that the claim would be paid to the extent of the ranking it would have held among claims against the estate, e.g., in the case of an unsecured claim, with the normal priority assigned to the particular type of unsecured tax claim.

Interest

Another proposed amendment relieves the debtor of interest which runs during the proceeding on a nondischargeable tax liability. Since, under the bill, interest accruing during the proceeding is payable only in a subordinated position (see sec. 726(a)(5)), and since the debtor lacks the right to pay interest to creditors while his affairs are being administered in court, it is not considered consistent with bankruptcy policy to make nondischargeable a tax liability for interest if that interest does not receive priority in payment from assets of the debtor's estate.

Nondischargeable taxes following a reorganization under chapter 11

Another committee amendment transfers to a different place in the bill the rules dealing with taxes that are to be , in effect, nondischarge-

able following a reorganization pursuant to chapter 11 of title 11. These rules, which now appear as section 1146(e), supplement the general exceptions to discharge contained in section 523 and deal specifically with the liability after the reorganization of the debtor, or his successor under the plan, for prepetition taxes and for taxes incurred by the estate during the administration of the case in bankruptcy court. The amendment transfers these rules to section 1141 of title 11, which deals generally with the effects of confirming a plan of reorganization.

The committee amendment clarifies and defines in greater detail the taxes for which a debtor in a reorganization will remain liable, and also deals specifically with the different kinds of debtors that may be involved in a reorganization under the new chapter 11.

Corporations.—In the case of a corporation in reorganization under the chapter 11 rules, the amendment makes clear that the debtor corporation (or the company which acquires it under the plan, or is otherwise a successor to the debtor company) will remain liable for the same unpaid prepetition taxes as an individual debtor would continue to owe under the priority rules of section 507(a) of title 11. Under another provision of the bill, prepetition priority tax liabilities for Federal taxes must be paid in cash within 120 days after the plan is confirmed, unless the Internal Revenue Service agrees to other terms or kinds of payment (sec. 1130(a)(10) of title 11). The debtor company will also continue to be liable for any tax incurred by the company (as an estate in bankruptcy) during the period of administration of the case in court. These administrative period taxes are set forth in section 503(b)(1)(B) and (C) of title 11.

In general, a corporate debtor will not continue to be liable, after the plan has been confirmed, for prepetition taxes which receive no priority in payment from the estate but which are nevertheless nondischargeable. This category covers taxes arising in no-return, late-return and fraud situations (see the discussion of these rules in the earlier discussion of section 523 of title 11). In general, if former creditors or new outside investors take over complete ownership of a corporate debtor, it is not equitable to require the new owners, in effect, to bear the burden of a tax liability attributable to these kinds of fault by the prior owners. This rationale should not provide relief from these taxes, however, if the same former owners emerge from the proceeding still in control of the company. In order to have a rule that can be relatively easily administered, the committee's amendment attempts to recognize this distinction by providing that no-return, late return and fraud taxes will remain nondischargeable if any former shareholders of the company, as of the beginning of the bankruptcy proceeding, retain or receive, by reason of their former equity ownership, any debt or equity interest in the debtor company or in its successor under the reorganization plan.[21]

Sole proprietorships, etc.—In the case of an individual under chapter 11, that is, in situations where a sole proprietorship or a partnership engaged in business is attempting to reorganize the business and con-

---

[21] The committee amendment retains, without change, the provision of S. 2266 authorizing the tax authority and the debtor to override the general rules on nondischargeable taxes generally, as well as administration period taxes, by negotiating any special terms for the liability for, or payment of, taxes as they may agree upon.

tinue it (as an alternative to selling the assets and liquidating the business), no change is made in the provision of S. 2266 that an individual debtor continues liable for any unsatisfied prepetition tax liability excepted from discharge by section 523 of title 11. (These prepetition priority taxes must be paid in cash within 120 days after the plan is confirmed, as indicated above).

An individual in a reorganization proceeding will also continue liable for taxes incurred during the administration period of the case before the court, but this rule will not apply, under a committee amendment, (1) if the debtor is discharged from liability for these taxes under the prompt audit rules of section 505(d) as amended by the committee; (2) if the tax authority agrees to accept specially negotiated provisions of the plan dealing with the payment of these taxes; or (3) if the substance of the transaction is a liquidation of the debtor's business (even though the case proceeds to a conclusion under the reorganization rules).[22]

[22] The specific circumstances in which a so-called "liquidating reorganization" may occur are set forth in section 1141(d)(4) of title 11, as renumbered by other conforming committee amendments.

E. Special Tax Provisions: Liquidations (sec. 728 of title 11)

S. 2266

This section provides special tax provisions concerning the treatment of liquidation cases for purposes of State and local law. These provisions deal with the taxable year of an individual debtor who files in bankruptcy, return filing requirements for a debtor's estate, and allocations of tax liability and refunds between a bankrupt partner and the partnership of which he is a member.

Committee Amendment

A committee amendment deletes these provisions dealing with State and local tax rules for the reasons set forth in the discussion above of section 346 of title 11. One effect would be to defer consideration of the provisions dealing with allocations of tax liability and tax refunds between insolvent partners and an insolvent partnership because these rules, in particular, pose difficult administrative and conceptual problems which warrant further study.

F. Special Tax Provisions: Reorganizations (section 1146 of title 11)

S. 2266

Subsections (a) and (b) of section 1146 of the bill provide rules on the effect of bankruptcy on the taxable year of the debtor and on tax return filing requirements.

Subsection (c) exempts from Federal, State, or local stamp taxes the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan.

Subsection (d) permits the court to authorize the proponent of a reorganization plan to request from the Internal Revenue Service (or State or local tax authority) an advance ruling on the tax effects of the proposed plan. If a ruling is not obtained within 270 days after the request was made, or if a ruling is obtained but the proponent of the plan disagrees with the ruling, the bankruptcy court may resolve the dispute and "declare" the tax effects of the plan.

Subsection (e) provides that prepetition taxes which are nondischargeable in a reorganization, and all taxes arising during the administration period of the case, may be assessed and collected from the debtor or from the debtor's successor in the reorganization.

Committee Amendments

The committee amendment would:

1. Delete the rules governing the taxable years and return-filing requirements for the reasons set forth above in the discussion of section 346 of title 11 (see A. above).

2. Retain without change the rule exempting transfers of securities from any stamp tax or similar tax.

3. Delete the provisions permitting the bankruptcy court to declare the tax effects of a reorganization plan following a request for a private ruling from the Service. The committee believes that it is unfair to permit the bankruptcy court to issue a declaratory judgment, in effect, on tax matters for bankrupt individuals and corporations when other taxpayers generally do not have similar rights, particularly in reorganizations outside bankruptcy of financially shaky companies. Moreover, S. 2266 is unclear as to whether the jurisdiction of the bankruptcy court to determine the tax effects of a reorganization plan would extend to findings of factual matters as well as matters of law. Deletion of the court's authority to declare the tax effects is not intended, however, to affect the parties' opportunity to request and obtain an advance ruling from the Internal Revenue Service on the Federal tax effects of the proposed reorganization plan.

4. Transfer the rules dealing with the liability of the debtor or his successor for prepetition taxes, or administrative period taxes, to a different place in the bill (sec. 1141) which deals generally with the effects of confirming a reorganization plan.

5. Place in this section the substance of a rule contained in section 1130(d) of title 11 providing that a plan may not be confirmed if its principal purpose is avoidance of taxes. In addition, the rule would be modified so that a finding by the bankruptcy court on the tax purpose of the plan is not required in all cases, but only if the governmental unit asserts that the principal purpose is tax avoidance. Thus, if the governmental unit does not make such an argument to the bankruptcy court, the governmental unit would not be barred from later asserting a tax avoidance motive (under, for example, section 269 of the Internal Revenue Code).

G. Special Tax Provisions: Wage Earner Plans (sec. 1331 of title 11)

S. 2266

This provision permits the taxing authority to collect nondischargeable taxes, as well as administrative period taxes, from the debtor after the bankruptcy case is closed. However, the taxing authority could accept other provisions of the plan in a particular case dealing with the payment of taxes.

Committee Amendment

The committee amendment would make it clear that a nondischargeable tax may be collected from the debtor after bankruptcy only within the restrictions of law otherwise applicable (such as the statute of limitations), and that payment of a nondischargeable tax is subject to other general rules for wage earner plans. Thus, a wage earner who continues to owe taxes could ask the bankruptcy court to allow him to pay taxes in deferred installments rather than in a single lump sum.

H. Other Amendments

In reviewing the provisions of S. 2266, the committee has found several tax-related matters as to which it recommends further amendments to the bill. These matters deal with tax-related areas which are not included in the specific sections of title 11 referred to the Committee on Finance. These areas are indicated below.

1. Extensions of the statute of limitations (section 108 of title 11)

S. 2266

S. 2266 provides rules concerning the effect of bankruptcy on the running of the statute of limitations. In the case of Federal tax liabilities, the Internal Revenue Code suspends the statute of limitations on a tax liability of a taxpayer while his assets are in the control or custody of a court and for 6 months thereafter (sec. 6503(b)). The Committee Report of the Judiciary Committee indicates that this Code rule is intended to apply in bankruptcy cases (S. Rept. 95–989, pp. 30–31). However, the bill is unclear on this point.

Committee Amendment

The committee amendment would make clear that the Internal Revenue Code rule suspending the statute of limitations (for tax purposes) for the duration of the case and 6 months thereafter applies to bankruptcy cases.

2. Avoidance of certain tax liens (section 506 of title 11)

S. 2266

Section 506(d) of title 11 provides that a lien relating to a claim which is not an allowed secured claim is to be automatically void unless certain conditions are satisfied. As appled to tax liens, this provision requires the automatic voiding of tax liens if the tax authority fails to file a claim and the claim is therefore not allowed (unless the tax authority had no notice or knowledge of the case).

Committee Amendment

The committee amendment would add a new paragraph (3) to section 506(d) to provide that the failure of the tax authority to file a claim would not cause a secured claim to be void if the tax claim is nondischargeable. If, for example, there are no assets in the estate, the tax authority may decide to avoid unnecessary expenses by not filing a claim in the title 11 case. In the case of a secured claim for a dischargeable tax, the lien does not attach to a debtor's assets acquired after the filing of a title 11 petition, whether or not the claim is filed and allowed.[28]

[28] As it pertains to secured claims for dischargeable tax claims, this rule follows present law (*U.S.* v. *Sanabria, et al.*, 424 F.2d 1121 (7th Cir. 1970).)

3. Federal Unemployment Tax (FUTA) credit (section 511 of title 11)

S. 2266

S. 2266 prevents any reduction of the Federal tax credit against the Federal unemployment tax in situations where the trustee makes a late payment of a contribution to a State unemployment compensation fund. The Internal Revenue Code normally requires a reduction in the Federal credit for late contributions to a State fund (sec. 3302). However, it is considered inappropriate to penalize general creditors because the trustee may be barred from making a timely payment of the State contribution (on behalf of the debtor) because the pendency of bankruptcy proceedings.

Committee Amendment

The committee's amendment retains the provision of S. 2266, but adds a new provision to govern situations in which the debtor, rather than the trustee, made a late payment of the State unemployment contribution. A Federal tax claim could result from late payment of a State contribution by the debtor if he thereafter erroneously claimed the entire credit in paying his Federal unemployment tax, and then filed in bankruptcy. The committee amendment treats the Federal claim attributable to the reduction of the credit as a claim for a penalty which is essentially punitive in nature. Accordingly, the claim would not be entitled to priority and would be subordinated to the payment of most other claims against the debtor's estate, pursuant to the general rules governing collection of punitive penalties (sec. 726(a)(4) of title 11).

4. Collection of Taxes Out of Exempt Property (section 522 of title 11)

S. 2266

Section 522 of title 11 provides that certain property of a bankrupt individual debtor is to be exempt from distribution as property of the estate. Section 522(c), however, specifies that certain claims may be collected from this property which is otherwise exempt. Among these claims are those "for taxes owing to a governmental unit" (whether the taxes are dischargeable or nondischargeable) and claims secured by liens which cannot be avoided by the trustee or debtor. These provisions of S. 2266 leave unclear whether exempt property could be applied to the payment of taxes which are secured by a tax lien which is avoided by the trustee or debtor.

Committee Amendment

The commitee amendment adds a provision to S. 2266 to ensure that taxes secured by an avoided lien may be collected from property of the debtor which is exempt from most claims. This corrects an oversight in the language of S. 2266. There is no reason to give taxes which are secured by avoidable liens a weaker potential in bankruptcy collection than is given to taxes which are not secured by any lien at all.

5. Property of the estate (sec. 541 of title 11)

S. 2266

Section 541 of title 11 lists the types of property which are included in the estate. S. 2266 does not contain any provision dealing with property held by the debtor as a trustee for beneficiaries of the trust. However, the Committee Report on S. 2266 indicates that property held in trust by the debtor for another person is not property of the estate subject to administration for the benefit of creditors (S. Rept. 95–989, p. 82). In addition, the bill does not specifically deal with so-called "trust fund" taxes, which include amounts withheld from the wages of employees and sales taxes collected by a retailer.

Committee Amendment

Consistent with the intention expressed in the report of the Committee on the Judiciary, the committee's amendment makes clear that amounts held by the debtor as trustee for another are not property of the estate. Consistent with the Judiciary Committee report, the committee amendment provides that taxes withheld or collected by the debtor from others before the bankruptcy case began, such as Federal and State income taxes and the employees' share of social security taxes, are not property of the estate. These amounts will not be property of the estate regardless of whether such amounts have been segregated from other assets of the debtor by way of a special account, fund, or otherwise, or are deemed to be a special fund in trust pursuant to provisions of applicable tax law.[24] This rule supersedes cases holding that withheld amounts are property of the estate even though the amounts have been placed in a separate account or are deemed to be held in a special fund in trust.[25]

In some circumstances, it may appear unclear whether amounts were actually withheld from employees or others. However, in most cases, close analysis of the facts will indicate whether amounts have been withheld. For example, assume that a debtor owes an employee $100 for salary on which there is required withholding of $20. If the debtor paid the employee $80, there has been $20 withheld. If, instead, the debtor paid the employee $85, there has been withholding of $15 (which is not property of the debtor's estate in bankruptcy). The additional $5 required withholding for which the debtor is liable in this latter example could be claimed by the governmental tax authority against the estate (normally as a prepetition sixth priority claim).

6. Payment of taxes in wage earner plans (section 1325(c) of title 11)

S. 2266

S. 2266 permits payment of debts under a wage earner plan to be made in property other than cash (sec. 1325(a) (4) of title 11).

---

[24] See, for example, section 7501 of the Internal Revenue Code.

[25] See, for example, *Randall* v. *U.S.*, 401 U.S. 513 (1971) (holding that section 7501 of the Internal Revenue Code does not prevent withheld amounts from becoming property of the estate), and *Shakesteers Coffee Shops* v. *U.S.*, 546 F. 2d 821 (9th Cir. 1977) (holding that withheld amounts placed in a separate account were property of the estate).

Committee Amendment

The committee amendment provides that Federal tax debts must be paid in cash. The amendment also makes clear, however, that such taxes can be paid in deferred cash installments under the general rules applicable to the payment of debts in a wage earner plan (sec. 1322(c) of title 11), unless the Internal Revenue Service negotiates with the debtor for some different medium or time for payment of the tax liability.

I. Recapture of Investment Tax Credits in Bankruptcy Reorganizations (sec. 318 of the bill and sec. 47 of the Internal Revenue Code)

Present Law

Under recent Federal tax law, there is a recapture of investment tax credits upon an early disposition of an asset for which the investment credit was originally allowed (sec. 47 of the Internal Revenue Code). However, there is an exception to the recapture rules where the disposition is in connection with a transaction which is tax free under the normal rules governing tax-free reorganizations (secs. 47(b)(2) and 381(a) of the Code). There is no exception from the recapture rules where the reorganization is tax free under special rules governing bankruptcy and railroad reorganizations (secs. 371 and 374 of the Code).

The Judiciary Committee version of S. 2266 contains no provision on this issue.

Committee Amendment

The committee amendment amends the investment credit rules of the Code to prevent recapture of investment credits on a transfer of assets by a debtor corporation in a bankruptcy reorganization (sec. 371 of the Code) or a railroad reorganization (sec. 374 of the Code). This provision applies generally to a case commenced on or after October 1, 1979 (the general effective date of the other provisions of S. 2266).

The committee amendment also excepts from investment credit recapture the transfer of assets of certain insolvent railroads to the Consolidated Rail Corporation (ConRail) which occurred in early 1976. For these transactions the exception to recapture applies to transfers of rail assets after March 31, 1976, which are tax-free under the special rule governing the ConRail reorganization (sec. 374(c) of the Code).

Revenue Effect

It is estimated that this provision will reduce budget receipts by $3.5 million in fiscal year 1979, and by a total of less than $10 million during the next four fiscal years.

V. COSTS OF CARRYING OUT THE COMMITTEE AMENDMENT AND VOTE OF THE COMMITTEE IN REPORTING THE COMMITTEE AMENDMENTS TO THE BILL

Revenue Cost

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out the committee's amendments to S. 2266. The committee estimates that the amendments with respect to recapture of investment tax credits in bankruptcy reorganizations will reduce budget receipts by $3.5 million in fiscal year 1979 and by a total of less than $10 million during the next four fiscal years. The other committee amendments will have a negligible effect on budget receipts.

Vote of the Committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the committee amendments to the bill. S. 2266, as amended by the committee, was ordered favorably reported by a voice vote.

VI. REGULATORY IMPACT OF THE COMMITTEE AMENDMENT TO THE BILL AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

Regulatory Impact

Pursuant to rule XXIX of the Standing Rules of the Senate, as amended by Senate Resolution 4 (February 4, 1977), the Committee on Finance makes the following statement concerning the regulatory impact that might be incurred in carrying out the committee amendments to S. 2266.

A. *Numbers of individuals and businesses who would be regulated.*—Those individuals and businesses who would be regulated by the provisions (including the tax provisions) of S. 2266 are those who file title 11 (bankruptcy) petitions. In the statistical year ending June 30, 1977, there were 31,151 business and 182,106 nonbusiness voluntary filings in bankruptcy. In the statistical year ending June 30, 1978, there were 29,662 business and 172,282 nonbusiness voluntary filings in bankruptcy. In addition, there are approximately 14,000 involuntary filings yearly, including both business and nonbusiness filings.

B. *Economic impact of regulation on individuals, consumers, and businesses affected.*—In general, the tax provisions further the basic goals of S. 2266, which include promoting the position of general unsecured creditors in bankruptcy and enhancing the debtor's "fresh start" after bankruptcy. The general unsecured creditors represent the majority of the creditors affected by bankruptcy and frequently are small businesses. Therefore, S. 2266 may be expected to further the interests of small businesses generally and to encourage the extension of credit by small businesses. This, coupled with the fact that credit is usually extended more readily to a debtor after bankruptcy, should also promote the availability of credit to consumers.

C. *Impact on personal privacy.*—Bankruptcy is of necessity an open procedure which requires considerable disclosure of the debtor's financial situation. However, in comparison with present law, neither the tax provisions nor the bill in general is expected to have a significant impact upon the privacy of taxpayers.

D. *Determination of the amount of paperwork.*—The tax provisions of the bill should have no significant impact upon the amount of paperwork required of taxpayers. The nontax provisions of the bill change present law in that they no longer require creditors to file claims for unsecured debts in many situations, but they also would require the filing of claims for secured debts in certain situations in which filing would not be required under present law. Overall, the bill would have little impact upon the amount of paperwork required of creditors and debtors.

Consultation with Congressional Budget Office on Budget Effects

In accordance with section 403 of the Budget Act, the Committee on Finance advises that the Congressional Budget Office has examined the committee's estimate of budget effects of the committee amendments to S. 2266, and agrees with the resulting revenue estimate.

New Budget Authority

In compliance with section 308(a)(1) of the Budget Act, and after consultation with the Congressional Budget Office, the committee advises that the committee amendments to S. 2266 do not involve any new budget authority; therefore, there is no allocation of new budget authority provided.

Tax Expenditures

In compliance with section 308(a)(2) of the Budget Act (with respect to tax expenditures), and after consultation with the Congressional Budget Office, the committee states that the committee amendments to S. 2266 regarding investment tax credit treatment for certain bankruptcy reorganizations would involve increased tax expenditures of $3.5 million for fiscal year 1979 and by less than $10 million over the next four-year period. The other committee amendments to the bill would not involve any new or increased tax expenditures.

VII. CHANGES IN EXISTING LAW

In the opinion of the Committee on Finance, in order to expedite the business of the Senate, it is necessary to dispense with the requirements of subsection 4 of Rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).