NATIONAL BANKRUPTCY CONFERENCE

Committee on Taxes

Report to the 2006 Annual Meeting

1. Ad Hoc Committee on Trustees in Individual 11s – Payment of Taxes

Prior to the enactment of BAPCPA, post-petition earnings from services performed by an individual debtor were not property of the bankruptcy estate in Chapter 7 or Chapter 11 cases, but were in Chapter 13 cases. While the basic rule governing post-petition service income in Chapter 7 and 11 cases was reasonably clear, the courts did wrestle with how exactly one drew the line under § 541(a)(6) between earnings arising from the debtor's post-petition services and earnings arising from some other aspect of the debtor's business (especially where the debtor operated his business as a sole proprietorship). BAPCPA resolved the issue by enacting new § 1115, which provides that earnings from services performed by an individual Chapter 11 debtor after the commencement of the case but before the case is closed, dismissed or converted are property of the estate.

At the mid-year meeting, concerns were expressed that this new provision could create problems in those individual 11 cases in which a trustee is appointed. In particular, some conferees were worried that the new individual Chapter 11 regime might result in a form of involuntary peonage in which the debtor loses control of his or her post-petition earnings, and that this loss of control might manifest itself in the trustee refusing to provide the debtor with the cash needed to pay taxes on post-petition earnings.

In response to these concerns, an Ad Hoc Committee (consisting of two members of the Committee on Taxes (Conferees Jenks and Sheinfeld) and two members of the Individual Debtor Committee (Conferees Markell and Wedoff)) was formed to study this issue.

After due deliberation, it is the recommendation of the Ad Hoc Committee that no changes in the applicable statute or rules be considered at this time, but that the committee remain in existence and prepare a follow-up report to the Conference in a year's time. This recommendation is based on the following points:

1. Trustees are rarely appointed in individual 11 cases. It is therefore quite possible that the concerns that have been expressed will occur very rarely, or perhaps not at all. Once another twelve months has passed, it may be reasonably clear that there is in fact nothing here to fix.

2. Existing § 1116(6) already makes it clear that a trustee in an individual 11 case must "timely file tax returns" and (with limited exceptions not relevant here) "timely pay all taxes entitled to administrative expense priority". Moreover, BAPCPA made a number of

changes in prior law to make it clear that all post-petition taxes must be paid when due.[1] Therefore, a trustee who took the position, for example, that the use of estate assets to pay the debtor's post-petition taxes did not benefit the estate would appear to be violating an express provision of the Bankruptcy Code.[2]

3. Technical concerns had been expressed that the enactment of § 1115, when coupled with the failure to amend IRC § 1398 (which continues to provide post-BAPCPA that the estate and the individual are separate taxpayers in Chapter 11 cases), might lead to awkward filing arrangements (and possibly double-reporting and withholding) as income is treated as first earned by the estate and then paid over in whole or in part by the estate to the individual debtor.[3] These concerns seem to have been put to rest, however, by the Internal Revenue Service's recent issuance of a notice laying out in considerable detail the reporting obligations of debtors, employers, information return preparers, and trustees involved in individual Chapter 11 cases.[4]

2. First-Day Orders on Claims Trading.

When a debtor corporation emerges from bankruptcy, it will typically undergo an ownership change. However, the tax consequences of a change of ownership pursuant to a plan of reorganization are much more benign than those triggered by a change of ownership during the case (when the debtor's tax attributes will normally be rendered worthless). In the normal situation, the result is that the debtor will be able to use its tax attributes to shelter future income post-emergence at an annual rate equal to the tax-exempt bond rate times the value of the debtor's equity immediately AFTER the plan has gone effective, thereby giving the debtor the huge benefit of any debt discharge that occurred pursuant to the plan.[5] Under certain circumstances, however, a potentially even more favorable result (the "bankruptcy exception" or "L5") can occur: the debtor will be permitted to use its tax attributes (after reduction to exclude certain interest deductions taken during the bankruptcy) to shelter future income for regular tax purposes without any annual limitation at all.[6] In order to qualify for this result, several things

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[1] *See* Carl M. Jenks, *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Summary of Tax Provisions*, 79 Am. Bankr. L.J. 893, 905-07 (2005).

[2] In theory, a well-counseled individual debtor whose income is largely in the form of wages might try to avoid the problem entirely by reducing the number of exemptions being claimed for wage withhoilding purposes so that no net tax (beyond the withheld amounts) would ever be due. In practice, however, this is not likely to be a practical solution in very many cases: (a) most individual debtors who file for Chapter 11 are self-employed, and (b) the trustee in a wage-earner case would presumably have the power to prevent the debtor from taking any steps that would reduce the net wages flowing to the estate during the pendency of the case.

[3] *See* Jack F. Williams & Jacob L. Todres, *Tax Consequences of Postpetition Income as Property of the Estate in an Individual Debtor Chapter 11 Case*, 13 Am. Bankr. Inst. L. Rev. 701 (2005).

[4] *See* Notice 2006-83, I.R.B. 2006-40 (October 2, 2006).

[5] IRC § 382(l)(6). *See generally* Jenks, Ridgway, and Purnell, 790 T.M., *Corporate Bankruptcy* X.C.3 (2004) ("*BNA Corporate Bankruptcy Portfolio*").

[6] IRC § 382(l)(5). *See generally BNA Corporate Bankruptcy Portfolio* X.C.4.

must happen: (a) shareholders and "qualified creditors"[7] must end up owning at least 50% of the reorganized debtor's stock (by vote and value); and (b) those shareholders and creditors must receive their 50% ownership in discharge of their interest in and claims against the debtor. Unless the debtor's tax advisors are certain that there is no reasonable possibility of the debtor proposing a plan that utilizes the bankruptcy exception to Section 382, serious consideration should be given to seeking first-day protection in this area.

Until recently, first-day orders restricting claims trading generally required court approval for any transaction that resulted in a claimholder owning a dollar amount of claims that the debtor believed could result in the claimholder becoming a 5% shareholder in the reorganized debtor.[8] More recently, however, there has been a trend toward first-day orders that permit free trading in claims, but that potentially require substantial claimholders to reduce their claimholdings below a specified level if the debtor proposes a plan of reorganization that relies on the L5 exception.[9] This trend is at least partly in response to a model order drafted in 2004 by the Bond Market Association and the Loan Syndication and Trading Association, which had as its objective the preservation of debtor tax attributes while minimizing disruption to the full functioning of the debt and equity markets.[10]

The area has become increasingly contentious. In one recent case involving Dana Corporation, numerous creditor groups filed objections to the debtor's proposed form of order, and after an extended factual hearing the debtor was ordered to produce a report demonstrating that the use of L5 was a "reasonable possibility" before the court would enter the order.[11] Despite the fact that there are undoubtedly circumstances in which the L5 exception will increase the value of the reorganized debtor by millions of dollars, the argument is increasingly being made by creditors and debt traders that the automatic stay cannot be applied to restrict claims

[7] For these purposes, a "qualified creditor" is one who receives stock in satisfaction of indebtedness that (a) had been held by the creditor for at least 18 months on the date of the bankruptcy filing (i.e., was "old and cold"), or (b) arose in the ordinary course of business and is held on the date of emergence by the same creditor who has held that indebtedness at all times since it was created.

[8] *See, e.g., In re WHX Corp.*, Case No. 05-11444 (ALG) (Bankr. S.D.N.Y.), Final Order dated Mar. 31, 2005, Interim Order dated Mar. 11, 2005; *In re Williams Communications Group, Inc.*, Case No. 02-11957 (BRL) (Bankr. S.D.N.Y.), Order dated July 24, 2002; *In re Phar-Mor, Inc*., 152 B.R. 924 (Bankr. N.D. Ohio 1993); *In re Southeast Banking Corp*., Case No. 91-14561-BKC-PGH (Bankr. S.D. Fla., Order dated July 21, 1994). For a discussion of recent developments in this area, see Henderson and Goldring, *Tax Planning for Troubled Corporations* §§ 508.2.4, 1002.4.1. (2006 ed.)

[9] *See, e.g., In re Dana Corp., et al.*, Case No. 06-10354 (BRL) (Bankr. S.D.N.Y.), Final Order dated Aug. 9, 2006, Interim Order dated Mar. 3, 2006; *In re Delphi Corp., et al.*, Case No. 05-44481 (RRD) (Bankr. S.D.N.Y.), Final Order dated Jan. 6, 2006, Interim Order dated Oct. 12, 2005; *In re Delta Air Lines, Inc*., Case No. 05-17923 (PCB) (Bankr. S.D.N.Y.), Final Order dated Dec. 19, 2005, Interim Order dated Sept. 16, 2005; *In re Northwest Airlines Corp*., Case No. 05-17930 (ALG) (Bankr. S.D.N.Y.), Final Order dated Oct. 28, 2005.

[10] The Bond Market Association/Loan Syndications and Trading Association Model NOL Order (Nov. 2004) is *available at* http://www.lsta.org.

[11] *In re Dana Corp., et al.*, Case No. 06-10354 (BRL) (Bankr. S.D.N.Y.), Order Continuing Hearing dated Apr. 4, 2006.

trading by unrelated third parties.[12] Those opposing claims trading orders have also been emboldened by the Seventh Circuit's recent statement in *dictum* that injunctions against stock trading to preserve the value of a debtor's NOLs should not be imposed unless the debtor provides a funded mechanism (such as a cash bond or an adequate protection order) for compensating those who might be hurt by the injunction.[13]

In light of the evolving nature of the issues and practices in this area, it is recommended that the Committee on Taxes and the Chapter 11 Committee continue their study of the area and report back at the next meeting of the Conference.

3. Technical Corrections to BAPCPA

The Conference's support is sought for sending the following recommendations to Treasury:

A. Proposed Technical Correction to (or Clarification of) § 1129(a)(9)(C)(iii)

Prior to its amendment in 2005, § 1129(a)(9)(C) permitted a debtor to spread payment of its pre-petition liability for unsecured priority taxes over a period ending not later than six years from the date of assessment of the tax, provided that the taxing authority received payments having a value not less than the allowed amount of the claim.[14]

BAPCPA amended this section in a number of ways. In particular, the statute now requires that taxing authorities must be treated not less favorably than the most favored non-priority unsecured claimant other than a convenience class (the "most-favored-unsecured-creditor" requirement).[15]

Read literally, the most-favored-unsecured-creditor requirement could be interpreted as prohibiting any deferral of payment of pre-petition priority taxes in the very common circumstance in which unsecured creditors receive all of their recovery (often just a few cents on the dollar) on (or very shortly after) the effective date. The argument would be that, since unsecured creditors are receiving immediately all that they will ever receive under the plan of reorganization, tax authorities must be paid immediately all that they will ever receive as well, even though they will be paid in full (rather than cents on the dollar). We are convinced that this interpretation of the statutory language is incorrect.

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[12] *See, e.g.*, Motion of American Real Estate Holdings Limited Partnership for Determination that the Automatic Stay Does Not Apply to Restrict Claims Trading or, in the Alternative, Relief from the Automatic Stay, *In re Dana Corp., et al.*, Case No. 06-10354 (BRL) (Bankr. S.D.N.Y.), dated Apr. 17, 2006.

[13] *In re UAL Corp*., 412 F.3d 775 (7th Cir. 2005). *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* §§ 508.2.4, 1002.4.1. (2006 ed.)

[14] 11 U.S.C. § 1129(a)(9)(C) (2000).

[15] 11 U.S.C. § 1129(a)(9)(C)(iii) (2005).

While the legislative history is silent on this point,[16] it seems clear from contemporaneous commentary that the intent of the most-favored-unsecured-creditor requirement was simply to require that the taxing authority be paid the same percentage of its claim at the same time that the unsecured creditors are paid. "In other words, if the holders of unsecured claims are receiving 25 percent recoveries in quarterly installments over the first two years, then the priority tax claims must receive at least a 25 percent recovery in quarterly installments over the first two years; the 75 percent balance then will be paid over the next four years in accordance with the plan."[17]

This interpretation strikes us as implementing the apparent intent of the draftsmen to put taxing authorities on the same footing as unsecured creditors, while still preserving the ability of a debtor to pay a portion of its pre-petition taxes over a longer period of time. The existing ambiguity could be eliminated in one of two ways. First, § 1129(a)(9)(C)(iii) could be amended to read as follows:

"(iii) that result in the holder of the claim receiving the same percentage of its claim at the same time as the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a class of creditors under section 1122(b))."

Second and alternatively, the following language could be inserted in the legislative history of the technical corrections legislation:

"The intent of § 1129(a)(9)(C)(iii) is to require that the taxing authority be paid the same percentage of its claim at the same time that the most favored unsecured creditors (other than members of a convenience class) are paid. For example, if the holders of the most favored class of unsecured creditors are to receive 25 percent recoveries in quarterly installments over the first two years, then priority tax claims must also receive at least 25 percent recoveries in quarterly installments over the first two years. The remaining 75 percent can then be paid over whatever portion of the five-year period provided for in § 1129(a)(9)(C)(ii) still remains."

B. Proposed Technical Correction to § 507(a)(8)(A).

Section 507(a)(8)(A) confers priority status on three different types of unsecured governmental claims: (i) those qualifying under the three-year lookback rule,[18] (ii) those qualifying under the 240-day rule,[19] and (iii) those qualifying under the "not assessed before but

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[16] H.R. Rep. No. 109-31, pt. 1, at 102 (2005).

[17] *See* Paul H. Asofsky & Robert E. McKenzie, *Report of the ABA Tax Section Task Force on the Tax Recommendations of the National Bankruptcy Review Commission* ¶ 6, *reprinted in* 97 TNT 90-22 (May 9, 1997). Note that the Task Force's example implicitly assumed that the payout period for tax claims would be the six years from assessment mandated under then-current law, rather than the five years from the date of the order for relief that will apply under BAPCPA.

[18] § 507(a)(8)(A)(i).

[19] § 507(a)(8)(A)(ii).

assessable after" rule.[20] Prior to BAPCPA, the three subsections of § 507(a)(8)(A) were clearly meant to be read in the disjunctive, because the word "or" appeared between the second and third subsections.[21]

BAPCPA added some additional language at the end of § 507(a)(8)(A)(ii), and in doing so struck out the word "or" that had always appeared after that subsection. This omission of the word "or" seems to have been completely inadvertent, because now there is a period after (ii) (rather than a semi-colon), and there is neither an "or" nor an "and" between (ii) and (iii). At least one commentator has suggested that this change, if read literally, will require that the three subsections of B.C. § 507(a)(8)(A) be read conjunctively rather than disjunctively, thereby dramatically reducing the class of pre-petition tax claims that will qualify as priority.[22]

In light of the fact that the elimination of the word "or" at the end of § 507(a)(8)(A)(ii) was almost certainly not intended by Congress and presum bly resulted from a simple editing error, we would recommend that a technical correction be made, retroactive to the general effective date of BAPCPA, reinserting the word "or" at the end of § 507(a)(8)(A)(ii).

Carl M. Jenks

[20] § 507(a)(8)(A)(iii).

[21] *See BNA Corporate Bankruptcy Portfolio* V.D. at note 315 (collecting cases holding that failure to fall within § 507(a)(8)(A)(i) not fatal to priority status because of independent status of § 507(a)(8)(iii)).

[22] *See* Gregory Germain, *Discharging Income Tax Liabilities in Bankruptcy: A Challenge to the New Theory of Strict Construction for Scriveners' Errors, available at the SSRN website at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=925840.