AMERICAN COLLEGE OF BANKRUPTCY

Best Federal Income Tax Practices in Corporate Reorganizations

October 2006

Carl M. Jenks
Jones Day
New York and Cleveland

TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

Page

I. Pre-Filing Practices

Decision to File for Bankruptcy

No well-counseled corporation files for bankruptcy merely to avoid taxes. Indeed, tax consequences generally play a relatively minor role in the decision to file. Nevertheless, a filing will change some of the substantive tax rules that would apply to a company that is restructuring its debt outside bankruptcy. Those changes are generally favorable to the debtor, but the company's tax advisors should attempt to quantify the dollar value of these more favorable rules prior to filing in order to advise the company whether the tax results under the rules are material.[1]

Commentary

The two most important tax benefits associated with restructuring debt inside bankruptcy are: (a) cancellation of debt ("COD") income (i.e., the amount by which the debt being discharged exceeds the value of the consideration being transferred to the creditor in connection with the discharge) is always excluded from taxable income if the discharge occurs in connection with a title 11 bankruptcy, but if the cancellation occurs outside of bankruptcy the resulting COD income is only excluded from income if and to the extent that the corporation can demonstrate to the IRS that it was insolvent prior to the discharge;[2] and (b) the rules that govern the future use of the company's net operating losses ("NOLs") and other tax attributes are much more favorable if the debt is restructured in bankruptcy rather than outside bankruptcy.[3]

While filing for bankruptcy does provide potential benefits to the company in connection with COD income and future NOL usage, many, many other tax consequences flow from a filing,[4] and some of them are not favorable to the company. For example, a bankruptcy filing may well stimulate and accelerate audit activity by the IRS and other taxing jurisdictions, which must file proofs of claim in the bankruptcy just like any other creditor.[5] Moreover, there is a tendency for taxing authorities to file large, protective claims in bankruptcy, because they are concerned that they have not had time to conduct a full and complete audit of all pre-petition years prior to the bar date for tax claims.[6]

---

[1] *See generally* Jenks, Ridgway, and Purnell, 790 T.M., *Corporate Bankruptcy* II.A. (2004) ("*BNA Corporate Bankruptcy Portfolio*").

[2] IRC § 108(a)(1)(A) (bankruptcy); IRC § 108(a)(1)(B), 108(a)(3) (insolvency). *See BNA Corporate Bankruptcy Portfolio* II.A.1.

[3] IRC § 382(l)(5), (6). *See BNA Corporate Bankruptcy Portfolio* II.A.2.

[4] *See, e.g., id.* II.A. n.119.

[5] *See id.* VIII.B.

[6] *See id*. IX.B.

Involving Tax Professionals in First-Day Planning

Corporations that are giving serious consideration to filing for bankruptcy are normally reluctant to share this information widely within the corporation, for fear that employee morale will plummet and word will spread to suppliers and creditors, with potentially disastrous consequences. As a result, the team of corporate officers and outside advisors that actually prepares the papers needed to implement a filing is normally kept as small as possible and is sworn to absolute secrecy about the process. This situation may result in the company's tax professionals not being involved in either the planning leading up to the decision to file or in the first-day order.[7] While understandable, this approach should be avoided if possible, because it can lead to important tax issues being missed entirely. For example, the bankruptcy lawyers involved in drafting the request for first-day motions may not correctly assess whether it would be important to seek an injunction against trading in equity or claims.[8]

Commentary

As will be seen later in this paper, there are a number of things that can happen early in a bankruptcy case that could have a permanent and potentially disastrous effect on the debtor's NOLs and other tax attributes. The earlier that tax professionals are included in the process, the greater the likelihood that this result can be avoided by adopting appropriate prophylactic measures.

Venue Selection

Tax considerations will rarely if ever be decisive in deciding where to file a corporation for bankruptcy. Nevertheless, large companies that are in a position to file in a variety of venues should at least be aware of the tax consequences that will flow from their venue decision.

Commentary

There are several areas of law of relevance to bankruptcy tax issues on which the courts have split in recent years.[9] For example, the courts are split as to whether preconfirmation sales pursuant to Bankruptcy Code Section 363 are exempt from stamp and similar taxes under Bankruptcy Code Section 1146(a).[10] If the debtor expects to sell significant properties during the

---

[7] *See* 15 *Collier on Bankruptcy* ¶ TX18.01 (15th ed. rev. 2005) ("The most difficult problem for a tax professional advising a corporation or group of corporations contemplating a chapter 11 filing is that the fiscal exigencies of the situation may result in non-tax professionals and management ignoring tax considerations until after the case has been filed and the most immediate problems have been brought under control. Resources may not be allocated to tax matters. This is a mistake.")

[8] *See generally BNA Corporate Bankruptcy Portfolio* IV. Best tax practices with respect to first-day orders are discussed in some detail later in this paper.

[9] *See generally id.* II.B. *See also* Ball and Palans, "Circuit-by-Circuit Review of Case Decisions on Critical Bankruptcy Issues," American College of Bankruptcy Best Practices Paper (forthcoming).

[10] Formerly B.C. § 1146(c). *Compare In re Smoss Enters. Corp.*, 54 B.R. 950 (E.D.N.Y. 1985), *aff'd mem.*, 1986 App. LEXIS 28677 (2d Cir. Mar. 31, 1986) (B.C. § 1146(c) applicable to preplan sales under certain circumstances); *In re Beulah Church of God in Christ Jesus, Inc.*, 316 B.R. 41 (Bankr. S.D.N.Y. 2004) (same); *In re Webster Classic Auctions, Inc.*, 318 B.R. 216 (Bankr. M.D. Fla. 2002) (same); *In re Bethlehem Steel Corp.,* Case

case and is concerned about triggering large real estate transfer taxes in the process, it might be wiser to file in one of the circuits that has read Section 1146(a) expansively. Similarly, the circuits are split on whether taxes owed under a lease covering the filing date are pre-petition or administrative.[11] For a debtor with large amounts of leasehold interests, this difference in the law could have material cash-flow significance.

Which Members of the Corporate Family Should File?

Once again, non-tax considerations are almost universally controlling in determining which of the members of an affiliated group of corporations will initially file for bankruptcy. Nevertheless, the debtor should consult its tax advisors with respect to the filing decision, because there are circumstances in which filing less than all of the corporations that are included in the debtor's consolidated tax returns for federal income tax purposes (or not filing its foreign subsidiaries) can result in negative consequences to the debtor.

Commentary

When a parent corporation and its subsidiaries elect to file consolidated returns, they become subject to the provisions of the consolidated return regulations. Those regulations make the common parent the sole agent for the group and the only one authorized to speak for it in connection with matters relating to the group's tax liability (which is itself computed on a consolidated basis). Nevertheless, each affiliate remains severally liable for the entire federal income tax obligation of the group.[12] When less than all the members of the group file for

---

(continued…)

Nos. 01-15288 (BRL) through 01-15302, 01-15308, through 01-15315 (BRL) (Bankr. S.D.N.Y.), Bench ruling abstract dated Apr. 22, 2003 (holding that purchase agreement governing the B.C. § 363 asset sale was itself the basic outline of the plan of reorganization); *In re Linc Capital, Inc.*, 280 B.R. 640 (Bankr. N.D. Ill. 2002) (same); *In re Permar Provisions, Inc.*, 79 B.R. 530 (Bankr. E.D.N.Y. 1987) (pre-confirmation sale covered by B.C. § 1146(c), even where sale occurred more than one year before confirmation and plan omits mention of previous sale.), *with In re Hechinger Inv. Co. of Del., Inc.*, 335 F.3d 243 (3d Cir. 2003)(B.C. § 1146(c) only applicable to sales occurring "under a plan confirmed"); *In re NVR, LP*, 189 F.3d 442 (4th Cir. 1999) (same); *States of Ill. & Wash. v. Nat'l Steel Corp.*, 2003 U.S. Distr. LEXIS 15695 (N.D. Ill. 2003) (same).

[11] *Compare In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125 (7th Cir. 1998) (real estate taxes arising under lease and coming due post-petition subject to proration); *In re Winn-Dixie Stores, Inc.*, 333 B.R. 870 (Bankr. M.D. Fla. 2005) (same); *In re Dunn Industries, LLC*, 320 B.R. 86 (Bankr. D. Md. 2005) (same); *In re Ames Dept. Stores, Inc.*, 306 B.R. 43 (Bankr. S.D.N.Y. 2004) (rental expenses arising under lease and coming due post-petition subject to proration); *In re Troutman Inv. Co.*, 2004 Bankr. LEXIS 1040 (Bankr. D. Or. Apr. 13, 2004) (adopting proration approach for share of common area maintenance costs, property damage insurance, and property taxes); *In re Phar-Mor, Inc.*, 290 B.R. 319 (Bankr. N.D. Ohio 2003) (distinguishing the rent payments at issue in *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986 (6th Cir. 2000), and adopting the proration approach for real estate taxes); *In re Child World*, 161 B.R. 571 (S.D.N.Y. 1993) (same), *with In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001) (proration rejected; status of obligation tested by date on which debtor became obligated to make payment under terms of lease); *In re FFP Operating Partners, L.P.*, 2004 Bankr. LEXIS 884 (Bankr. N.D. Tex. June 16, 2004) (following *Montgomery Ward*), and *In re Rhodes, Inc.*, 321 B.R. 80 (Bankr. N.D. Ga. 2005) (adopting a variation of the billing approach and holding that "an obligation to pay rent, taxes or some other expense under an unexpired lease arises at the time that the tenant's liability on that obligation becomes fixed in an amount unalterable by subsequent events, such as the termination of the lease").

[12] *See* Treas. Reg. § 1.1502-6(a). *See generally BNA Corporate Bankruptcy Portfolio* XVIII.A.

bankruptcy, it is at least theoretically possible for the IRS to file a claim for pre-petition taxes in the cases involving the filed affiliates while the case is pending, and then attempt to collect that entire claim from one or more of the non-filing affiliates, on the theory that the automatic stay has no application to them.[13] If the IRS begins to take steps along these lines, there may be no alternative but to file all the remaining members to protect them from collection efforts.

A somewhat similar problem can arise with respect to foreign subsidiaries. It is not uncommon for a debtor corporation to stop meeting its minimum funding obligations with respect to its qualified retirement plans. When that happens, a statutory lien against all of the debtor's property (including the debtor's stock interests in its foreign subsidiaries) and all property belonging to any corporation within the debtor's controlled group (including its foreign subsidiaries) automatically arises in favor of the plan under both the Internal Revenue Code and ERISA.[14] The lien is perfected and enforced by the PBGC, and the Internal Revenue Code provides that the lien is treated as a tax lien. Although the law is far from clear, it is conceivable that the creation of a lien against the assets of a foreign subsidiary could cause potentially severe tax consequences for a debtor that has foreign subsidiaries with earnings and profits.[15] As a result, prudence may dictate filing the debtor's foreign subsidiaries in the U.S. bankruptcy case to ensure that the lien cannot be enforced and in turn these adverse tax consequences cannot occur.

Payment of Pre-Petition Trust Fund Taxes Just Before Filing

As we will see in the next section of this paper, one of the functions of the first-day order is to authorize the debtor to pay pre-petition taxes, in particular those pre-petition trust fund taxes that may result in the imposition of personal liability on the debtor's responsible persons if they are not paid. Despite the fact that some type of authorization to pay pre-petition trust fund taxes post-filing is a nearly universal feature of first-day orders, most companies that are preparing to file for bankruptcy make efforts to actually pay their estimated pre-petition trust fund taxes shortly before the filing in order to eliminate any issue with respect to personal liability. This would typically involve a determination of all the types of company taxes that might give rise to personal liability,[16] an estimation of how much the company's liability for each of these taxes might be on the filing date, and then payment of those amounts using methods (such as wire transfer) that ensure receipt prior to filing.

II. First-Day Order Practices

Authorization to Pay Pre-Petition Taxes

Filing for bankruptcy radically changes a corporation's ability to manage its affairs. First, until the debtor corporation is given permission by the bankruptcy court (after scrutiny and

---

[13] *See id*. II.A.4. *Accord,* 15 *Collier on Bankruptcy, supra* note 7, ¶ TX18.02.

[14] IRC § 412(n); ERISA § 302(f).

[15] IRC § 956. *See BNA Corporate Bankruptcy Portfolio* XVII.B.4.b.

[16] Examples would include federal income tax and FICA (social security) withholding on employee wages, and state and local sales taxes. *See generally id*. III.A. and B.

possible objection from the creditors' committee), the debtor is prohibited from taking any steps that are not in the ordinary course of business.[17] Second, the automatic stay has the effect of freezing pre-petition claims—including claims for taxes—until they can be examined (and possibly contested) and then provided for under a confirmed plan of reorganization.[18] If these rules were applied literally to a recently filed debtor corporation, they might well prevent the corporation from paying pre-petition trust fund taxes, thereby exposing the debtor's officers to personal liability. To prevent this from happening, corporations filing for bankruptcy should always seek a first-day order from the bankruptcy court that authorizes the debtor to pay all trust fund taxes that were incurred pre-filing.[19] The most important decision that the debtor-to-be must make in this connection is whether the scope of the authorization to be sought should extend beyond trust fund taxes.

Commentary

Requesting a first-day order authorizing the payment of pre-petition trust fund taxes (i.e., those taxes that the debtor collects from third parties and holds in trust for the taxing authority) is non-controversial, since those amounts are truly held in trust and therefore are not property of the estate in the first place.[20] This approach also has the advantage (at least from the creditors' point of view) of minimizing the cash that the debtor is authorized to pay on pre-petition taxes without specific court approval.

Increasingly, however, debtor corporations are seeking—and generally being granted—broader first-day authority to pay pre-petition taxes.[21] This trend appears to reflect two factors. First, limiting the first-day order to pre-petition trust fund taxes increases the effort that the debtor corporation must expend in determining which taxes are trust fund taxes and which are not, while also creating potential controversy with state and local taxing authorities over the distinction between pre- and post-petition taxes. Second, this narrow approach to pre-petition taxes will not insulate the debtor's officers from those state and local taxes that give rise to personal liability upon non-payment by the corporation, even though they are not trust fund taxes at all.[22]

As a result of these concerns, a number of recent first-day orders authorize the debtor corporation to pay a broad range of pre-petition taxes, including all sales and use taxes (not just those that are trust fund taxes), excise taxes, gross receipts taxes, franchise taxes, business

---

[17] *See* B.C. § 363(b)(1).

[18] *See* B.C. §§ 362 (automatic stay) and 549 (granting debtor power to avoid certain post-petition transactions). *See generally BNA Corporate Bankruptcy Portfolio* III.A., V.D.

[19] *See BNA Corporate Bankruptcy Portfolio* III.A.

[20] *See, e.g.*, *Begier v. IRS*, 496 U.S. 53 (1990) (payments made on federal withholding obligations during 90-day preference period not voidable as preferences because funds held in trust for government, not property of debtor). *See generally* 2 *Collier on Bankruptcy, supra* note 7, ¶ 547.03[2].

[21] *See BNA Corporate Bankruptcy Portfolio* III.B. n.169 (collecting cases).

[22] *Id*. (giving examples).

license fees, regulatory fees, universal service fees, and even property taxes.[23] Nothing in these orders requires that the debtor pay all such taxes, however: they merely authorize the debtor to do so if and when it sees fit.

A middle ground would be to authorize the payment of all pre-petition taxes—whether trust fund taxes or not—that can give rise to personal liability.

Payment of Oversecured Property Taxes

Although interest does not normally accrue on pre-petition tax claims during the administrative period,[24] interest can accrue in the case of taxes (such as certain property taxes) that are secured by property worth more than the tax claim.[25] Consideration should therefore be given to including in the first-day motion permission to pay oversecured property taxes in order to cut off the running of interest.

Commentary

A recent change in the bankruptcy law will tend to make it more likely that corporations filing for bankruptcy will find it desirable to pay oversecured property taxes promptly. Before the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), the law was silent on the applicable rate of interest on oversecured tax claims.[26] New Section 511 of the Bankruptcy Code provides (in the case of corporate bankruptcies filed on or after October 17, 2005) that the interest rate paid on pre-petition tax claims shall be the applicable rate under non-bankruptcy law. This provision will generally increase the rate of interest that debtors pay on oversecured pre-petition tax claims,[27] thereby increasing the incentive to pay oversecured pre-petition property tax claims early in the case.

Protecting Tax Attributes

Most corporations filing for bankruptcy have been losing money for years. As a result, they have large amounts of NOLs and other tax attributes. If the debtor can arrange its affairs in such a way as to use its tax attributes to avoid tax (either on asset sales or future operating income), the value of the estate will have been enhanced. As a result, one of the most important

---

[23] *See BNA Corporate Bankruptcy Portfolio* III.B.2. n.169 (collecting cases).

[24] B.C. § 502(b)(2) (claims for "unmatured interest" not allowable); *City of New York v. Saper*, 336 U.S. 328 (1949) (payment of post-petition interest on pre-petition New York City taxes prohibited). *See generally BNA Corporate Bankruptcy Portfolio* III.D; 4 *Collier on Bankruptcy*, *supra* note 7, ¶ 502.03[3][a]; Henderson and Goldring, *Tax Planning for Troubled Corporations* §§ 301, 1006.1.2 (2006 ed.).

[25] B.C. § 506(b). *See United States v. Ron Pair Enters., Inc*., 489 U.S. 235 (1989).

[26] *See generally* Jenks, "The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Summary of Tax Provisions," 79 *Am. Bankr. L.J*. 893, 902 (2005) ("BAPCPA Tax Summary").

[27] *See id*. at 902–03.

aspects of first-day order practice is deciding what steps should be taken to protect the debtor's tax attributes during bankruptcy.[28]

There are at least three areas of concern, each of which may require first-day order protection: (a) a more than 50% change of the debtor's stock ownership during the bankruptcy would render the debtor's tax attributes virtually worthless; (b) the debtor's tax attributes might be rendered worthless if a substantial shareholder were to claim a worthless stock deduction for federal income tax purposes; and (c) the debtor's ability to qualify for the so-called "bankruptcy exception" to IRC Section 382[29] can be jeopardized or even eliminated by claims accumulation during the case.[30]

1. Change of Stock Ownership. A corporation will be treated as undergoing an ownership change if the percentage of the corporation's stock that is owned by 5% shareholders has increased by more than 50 percentage points during the last three years.[31] The tax consequence of undergoing a change of ownership is that the corporation's future use of its tax attributes will be subject to an annual limitation equal to the long-term tax-exempt bond rate times the value of the corporation's stock on the date of the change. Because a debtor corporation's stock is normally worth at most only a nominal amount during the bankruptcy case, a change of ownership would be catastrophic. Therefore, the debtor's tax advisors should give serious consideration to including in the first-day order an appropriate injunction against stock sales by 5% shareholders.[32]

Commentary

The risk of a change of ownership during the case is most obvious where the debtor corporation has a majority shareholder which could, simply by selling its stock, eliminate the value of the debtor corporation's tax attributes. And such a stockholder may have its own tax reasons to sell: it may have a large unrealized tax loss in that stock, and may not be able to claim that loss without selling, because (despite the bankruptcy) the debtor's stock may have some residual value (and indeed, if the debtor is a public company, may still be trading). A sale may be the only way that the majority shareholder can trigger its loss for tax purposes. Appropriate

---

[28] *See generally BNA Corporate Bankruptcy Portfolio* IV.

[29] IRC § 382(l)(5).

[30] Two other areas of concern with respect to preserving tax attributes during bankruptcy can normally be addressed later in the case. First, negative tax consequences can flow from the deconsolidation of a subsidiary that has preferred stock outstanding, but this issue need not be addressed in the first-day order because the problem cannot arise until dividends on the preferred have gone unpaid for many months. *See generally BNA Corporate Bankruptcy Portfolio* IV.A.5. Second, a profitable affiliate's use of a debtor affiliate's tax attributes may be thought to violate the automatic stay and require compensation, but the law on point does not yet appear to be sufficiently developed to justify first-day relief. *See id*. IV.A.4. A better approach would be to address the issue along with all other inter-corporate issues as they develop later in the case.

[31] IRC § 382(g).

[32] *See generally BNA Corporate Bankruptcy Portfolio* IV.A.1.

safeguards, either a first-day injunction barring sale without court approval or some sort of contractual agreement between the debtor and its shareholder, are very much in order.[33]

It is important to recognize, however, that a debtor can easily undergo a change of stock ownership during its bankruptcy even if it has no majority shareholder. Because the statutory test for a change of stock ownership aggregates owner shifts involving 5% shareholders over the past three years, sales by relatively small 5% shareholders can put the debtor corporation over the edge. Since stock offerings are treated for these purposes as counting toward the 50 percentage point test, this problem can also occur where the debtor corporation has acquired a number of corporations in recent years using newly issued shares as the acquisition currency.[34]

2. Worthless Stock Deduction. In some circumstances, the same unfortunate result can occur where a current (or former) majority stockholder does nothing more than claim a worthless stock deduction on its federal income tax return with respect to its debtor stock.[35] The debtor's tax advisors should therefore consider whether first-day relief is appropriate here as well.

3. Acquisition of Claims Against the Debtor. 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. 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.[36] 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.[37] In order to qualify for this result, several things must happen: (a) shareholders and "qualified creditors"[38] 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.

---

[33] *See id*. IV.B. and n.286 (collecting cases).

[34] *See id*. IV.A.1 Example (2).

[35] *See* IRC § 382(g)(4)(D).

[36] IRC § 382(l)(6). *See generally BNA Corporate Bankruptcy Portfolio* X.C.3.

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

[38] For these purposes, a "qualified creditor" is one who receives stock in satisfaction of indebtedness that (x) 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 (y) 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.

Commentary

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.[39] 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.[40] 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.[41]

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.[42] 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 trading by unrelated third parties.[43] 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.[44]

[39] *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, *supra* note 24, §§ 508.2.4, 1002.4.1.

[40] *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.

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

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

[43] *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.

[44] *In re UAL Corp.*, 412 F.3d 775 (7th Cir. 2005). *See generally* Henderson and Goldring, *supra* note 24, §§ 508.2.4, 1002.4.1.

III. Post-Filing Tax Compliance Practices

Continuing Duty of Debtor to File Tax Returns

The automatic stay does not extend to the filing of tax returns. After the filing, as before, a corporate debtor should continue to prepare and file its tax returns by the normal due date, with any applicable extensions, even if the periods to which the returns relate are entirely pre-petition.[45] And those returns should be prepared in a fashion that is essentially unchanged from pre-filing practice.[46]

Commentary

When a corporation files for bankruptcy, the vast majority of the rules contained in the Internal Revenue Code and regulations continue to apply to it without change: (a) the corporation is the same taxable entity after the filing that it was before;[47] (b) the corporation's taxable year does not close;[48] (c) if the corporation was a member of an affiliated group filing consolidated returns before filing for bankruptcy, it will remain so afterward (even if less than all of the members of the affiliated group file);[49] and (d) if the corporation had elected to be treated as an S corporation before the filing, that election will remain in effect afterward.[50]

Continuing Right of Taxing Authorities to Audit and Assess

The automatic stay will not preclude the taxing authorities from auditing the debtor, issuing a notice of deficiency, or demanding tax returns from a debtor.[51] Moreover, the Federal Rules of Bankruptcy Procedure make it clear that the debtor should assist in this process by notifying all state and federal governmental representatives who are responsible for collecting taxes that a bankruptcy filing has occurred.[52] Corporate debtors should notify any governmental unit with which they have any current relationship, in order to make sure that all potential tax claimants are put on notice.

---

[45] B.C. § 362(b)(9)(C). *See generally BNA Corporate Bankruptcy Portfolio* V.B.

[46] *Id.*

[47] IRC § 1399. *Compare* IRC § 1398(e) (estate and individual debtor separate taxpayers in both Chapter 7 and individual Chapter 11 cases). Enactment of new B.C. § 1115 by BAPCPA suggests that this rule should be eliminated in the case of individual Chapter 11 cases. *See* BAPCPA Tax Summary, *supra* note 26, at 912–13.

[48] 15 *Collier on Bankruptcy*, *supra* note 7, ¶ TX 3.02[2][b] n. 30 (construing IRC § 1399). *Compare* IRC § 1398(d) (individual debtor may elect to treat taxable year of filing as two separate taxable years).

[49] Rev. Rul. 63-104, 1963-1 C.B. 172.

[50] *See Mourad v. Comm'r*, 121 T.C. 1 (2003), *aff'd*, 387 F.3d 27 (1st Cir. 2004).

[51] B.C. § 362(b)(9). The automatic stay also permits assessment, but the Internal Revenue Code effectively prevents the IRS from assessing a tax during the pendency of the bankruptcy, under most circumstances. *See generally BNA Corporate Bankruptcy Portfolio* V. C. n.307.

[52] Fed. R. Bankr. P. 2002(j)(3). *See* 3 *Collier on Bankruptcy*, *supra* note 7, ¶ 342.02 & n.4 (collecting legislative history references).

Requests to Extend the Statute of Limitations

The IRS takes the position that the statute of limitations with respect to the assessment of taxes continues to run during bankruptcy.[53] As a result, the IRS will periodically seek extensions of the statute with respect to pre-petition periods, and will continue to do so even if the IRS files its claim before the applicable bar date.[54] It is generally advisable to acquiesce in these requests for extension, just as it is normally advisable to acquiesce in similar requests made outside bankruptcy.

Proper Forum For Resolving Audit Disputes

Outside of bankruptcy, the IRS has extremely broad powers to examine books and records "as may be relevant or material" to its audit responsibilities.[55] As noted above, it is clear that the automatic stay will not preclude tax audits from taking place once the taxpayer corporation has filed for bankruptcy. What is less clear, however, is whether the fact that a corporation has filed for bankruptcy means that any disputes that might arise during the course of an IRS audit are to be resolved in bankruptcy court or in district court.[56] For example, there is very little published authority on the question of whether the IRS can enforce an administrative summons against a corporate debtor in district court, and the authority that does exist is inconsistent.[57] Although it may be tempting to a corporate debtor involved in a contentious audit to bring discovery disputes with the IRS into bankruptcy court, doing so may produce a longer and more difficult audit that may be substantially delayed while the jurisdictional issue is litigated.[58]

Prohibition on Payment of Pre-Petition Taxes

---

[53] Internal Revenue Manual 4.27.4.3 (last amended July 31, 2001). *See generally* B.C. § 362(b)(9) (since 1994, automatic stay has not barred assessment of taxes). There is a literal (but implausible) reading of IRC § 6503(h) that suggests that the federal statute of limitations on assessment is tolled during bankruptcy as a result of the fact that the Internal Revenue Code has never been amended to reflect the 1994 change to the automatic stay. *See BNA Corporate Bankruptcy Portfolio* VIII.D.

[54] *See id*.

[55] IRC § 7602(a).

[56] *See generally* 15 *Collier on Bankruptcy*, *supra* note 7, ¶ TX 5.06[2] at 5-57.

[57] *Compare In re Spencer*, 123 B.R. 858 (Bankr. N.D. Cal. 1991) (issuance of IRS administrative summons to debtor and motion to enforce same violate automatic stay), *with In re Greene*, 50 B.R. 785 (Bankr. S.D.N.Y. 1985) (contrary result in context of third-party summons), and *Xelan, Inc. v. United States*, 361 F. Supp. 2d 459 (D. Md. 2005) (same).

[58] The resolution of this jurisdictional issue will ultimately depend on the courts' reading of the word "audit" in B.C. § 362(b)(9)(A), the provision of the Bankruptcy Code that expressly excepts an "audit by a governmental unit to determine tax liability" from the scope of the automatic stay. Although the limited case law on point does not draw this distinction very clearly, the word "audit" is arguably best read as including the issuance of an administrative summons, but as excluding a motion filed in court to enforce such a summons. That reading would be consistent with the purpose behind the automatic stay (since it would result in all judicial proceedings of relevance to pre-petition tax claims against the debtor being heard in bankruptcy court) while still respecting the audit exception to the automatic stay (since it would allow the IRS to continue to use in bankruptcy any non-judicial audit techniques that are available to it outside bankruptcy).

The filing of a bankruptcy petition has the effect of dividing the debtor's tax payment obligations into two distinct types: taxes that are classified as pre-petition and therefore cannot be paid absent bankruptcy court approval, and those that are classified as post-petition and therefore must be paid currently in the ordinary course.[59] Although this line-drawing exercise might sound simple or even trivial, it is anything but: numerous areas of uncertainty abound, and it is important that those responsible for the debtor corporation's tax-paying function put in place a system for dealing with this line-drawing immediately after the filing.

Commentary

A corporation's tax compliance department is accustomed to paying the taxes that the corporation owes, and doing so in full and in timely fashion. The bankruptcy filing is therefore highly disruptive, because the new rule is so different: pay nothing until you are absolutely sure that it is a post-petition tax.

Income and gross receipts taxes for years that end before the filing date are pre-petition, and those for years beginning after the filing date are administrative. Taxes for the period that includes the petition date (the "Straddle Year") have been a source of controversy in the past. Prior to the enactment of BAPCPA, it was not clear whether income and gross receipts taxes for Straddle Years should be bifurcated (and therefore treated partly as pre-petition claims and partly as administrative period claims) or treated entirely as administrative claims.[60] For cases filed on or after October 17, 2005, income and gross receipts taxes for Straddle Years will be treated as entirely administrative.[61]

Property taxes produce endless difficulties, largely because the key events that might be used to delineate pre-petition from post-petition taxes—assessment, determination of the amount of the tax, and due date for payment—occur in many states on different dates.[62] For example, the assessment may occur as of January 1st (i.e., pre-petition), but the due date for payment may fall on September 1st (i.e., post-petition), leaving the resolution of the issue unclear.[63] The

---

[59] *See generally BNA Corporate Bankruptcy Portfolio* I.F. Prior to the enactment of BAPCPA, it was not clear that all post-petition taxes had to be paid when due. *See generally* BAPCPA Tax Summary, *supra* note 26, at 905–06. BAPCPA made a number of changes to existing law in an effort to make it clear that current payment is required. *See id.*

[60] *See* BAPCPA Tax Summary, *supra* note 26, at 898. *See generally BNA Corporate Bankruptcy Portfolio* V.D.3.a. (collecting cases).

[61] B.C. § 507(a)(8) The technical draftsmanship of the BAPCPA amendment left something to be desired. By failing to also amend B.C. § 503(b)(1)(B) to make it clear that the pre-petition portion of Straddle Year taxes would be treated as "incurred by the estate" (one of the statutory requirements for being classified as an administrative claim), BAPCPA left open the bizarre and presumably unintended possibility that such taxes are neither pre-petition priority taxes nor administrative period claims, but fall instead into the general unsecured claim pool. *See* BAPCPA Tax Summary, *supra* note 26, at 898 n.34. Professor Germain reads the statutory language as producing precisely this result. *See* Gregory L. Germain, "Taxing Income in the Year of Bankruptcy under BAPCPA," 24 *Am. Bankr. Inst. J*. 14, 58 (2006).

[62] *See generally BNA Corporate Bankruptcy Portfolio* I.F., V.D.3.b.

general rule should be to treat as pre-petition any property tax that is not clearly administrative under controlling state or local law.

Property taxes owed under a lease are subject to a different sort of analysis. Before October 2001, most courts prorated between pre- and post-petition periods real property taxes that arose under a lease and came due post-petition.[64] More recently, however, some courts have taken the position that the terms of the lease should govern the issue, and that the key question is whether the lessee's obligation to pay the taxes under the lease arose before or after the filing.[65] This approach requires the debtor to determine, on a lease-by-lease basis, when the obligation to pay property taxes arose. The courts remain split on the issue.[66]

Sales and use taxes generally present few classification issues. The transaction date governs.[67] Other more specialized taxes, such as franchise fees, annual reporting fees, and unclaimed property levies tend to turn on state law, and therefore may require state-by-state analysis.[68]

Impact of Filing on Debtor's Tax Return

1. Accrual of Post-Petition Interest. Corporations that file for bankruptcy generally stop making interest payments on their pre-petition debt. The tax question is whether an accrual basis debtor can continue to accrue interest deductions while in bankruptcy, despite the fact that interest payments are not being made currently (and in fact may never be made). Although the law is not clear, there is enough case law support for continuing to accrue interest deductions post-petition that a debtor corporation's advisors should consider the possibility of filing the corporation's post-petition tax returns on that basis.

Commentary

(continued…)

[63] For what it may be worth, BAPCPA attempted to clarify this entire area by replacing the word "assessed" with the word "incurred" in B.C. § 507(a)(8)(B), apparently on the theory that it will be easier for courts to determine when a property tax has been incurred than it has been to determine when a property tax has been assessed.

[64] *See supra* note 11; *BNA Corporate Bankruptcy Portfolio* V.D.3.b.(4) (collecting cases).

[65] *See*, *e.g.*, *In re Montgomery Ward Holding Corp*., 268 F.3d 205 (3d Cir. 2001). *See generally BNA Corporate Bankruptcy Portfolio* V.D.3.b.(4).

[66] *See BNA Corporate Bankruptcy Portfolio* V.D.3.b.(4)(b). *See also supra* note 11.

[67] *See id.* V.D.3.d.

[68] *See id*. V.D.3.e and V.D.3.f.

The existing authorities in the area have been divided.[69] However, a recent, well-reasoned decision involving Dow Corning comes down solidly in favor of continued accrual.[70] In that case, the IRS took the position that the accrual of interest during bankruptcy was barred by Section 502(b)(2), which generally precludes claims "for unmatured interest." The IRS acknowledged that Sections 726(a)(5) and 1129(b)(1) can in tandem result in the payment of post-petition interest in those rare "solvent debtor" cases in which the debtor's assets are more than sufficient to pay all pre-petition claims in full. But the IRS argued that these provisions operated to create a fixed liability only at the conclusion of the case and after the court would have determined that the assets were indeed sufficient to pay fully all pre-petition claims. Therefore, argued the IRS, accrual under the "all events" test should never occur.

The Bankruptcy Court for the Eastern District of Michigan rejected the government's arguments and concluded that the "rule" against post-petition interest set forth in Section 502(b)(2) is a "rule of liquidation practice rather than . . . a rule of substantive law," thereby allowing post-petition interest to continue to accrue against the debtor even though it stops accruing against the estate. The court also rejected the government's suggestion that the debtor's interest deduction should be denied because the debtor may have been insolvent. In the court's words, "we summarily reject the proposition that an unconditional payment obligation becomes contingent—i.e., conditional—in the event the obligor goes broke."[71]

The battle over post-petition interest accrual is clearly not over, but some debtors will choose to accrue post-petition interest right up to the effective date, and then treat the discharge of the unpaid interest as COD income. Although in many cases the result will be a wash, there will be circumstances in which a net benefit (in addition to potential cash tax savings during the administrative period) may result.

2. Deductibility of Professional Fees. As all corporate debtors soon discover, bankruptcy is a very expensive proposition. Not only do most large corporate debtors require the professional services of lawyers, accountants, and financial advisors, but the debtor will also be responsible for paying the professional fees incurred by the creditor and other committees appointed by the U.S. Trustee.[72] In larger cases, total fees will be in the tens of

---

[69] *Compare Zimmerman Steel Co. v. Comm'r*, 130 F.2d 1011 (8th Cir. 1942) (accrual of interest deduction permitted even though no reasonable expectation that accrued interest would actually be paid); Rev. Rul. 70-367, 1970-2 C.B. 37 (taxpayer undergoing railroad reorganization permitted to accrue interest deduction despite no reasonable expectation of payment); *In re Cajun Elec. Power Co-op., Inc.*, 185 F.3d 446, 455 (5th Cir. 1999) (debtor's obligation with respect to post-petition interest terminates only if and when debtor obtains discharge from bankruptcy court), *with In re Continental Vending Mach. Corp.*, 77-1 U.S.T.C. ¶ 9121 (E.D.N.Y. 1976) (accrual of interest deduction on unsecured debt denied until determination at end of case that sufficient assets exist to pay all claims plus post-petition interest); *Kellogg v. United States (In re West Texas Marketing Corp.)*, 155 B.R. 399 (Bankr. N.D. Tex. 1993), *aff'd*, 94-1 U.S.T.C. ¶ 50,063 (N.D. Tex. 1993), *aff'd*, 54 F.3d 1194 (5th Cir. 1995) (similar).

[70] *In re Dow Corning Corp.*, 270 B.R. 393 (Bankr. E.D. Mich. 2001).

[71] *Id.* at 406.

[72] B.C. § 503(b).

millions of dollars—or even more—before the debtor limps out of bankruptcy.[73] From the debtor's point of view, more is at stake than just the amount of cash that must be paid out: there is also the crucial question of whether the fees can be deducted for tax purposes, or must instead be capitalized in some fashion. Unfortunately, the law in the area remains murky, and debtor corporations should make every effort to classify their professional fee expenses on a contemporaneous basis into the three basic "buckets" developed by the case law: immediately deductible, capitalized initially but amortized over time, or capitalized permanently. This will allow the debtor corporation the best chance of convincing an IRS agent on audit that not all of the debtor's professional expenses should be permanently capitalized.

Commentary

The basic tax issue is whether professional fees incurred in a bankruptcy case are ordinary and necessary expenses that may be deducted under IRC Section 162, or capital expenditures that cannot be. Under controlling Supreme Court authority, capitalization is required to the extent that the expenditure produces significant benefits that will be enjoyed beyond the close of the current tax year.[74] Cases dealing with the professional fees issue outside of bankruptcy have historically looked to the "origin of the claim" in resolving the question.[75] The Service's principal pronouncement on the topic[76] generally follows the origin of the claim approach, but also takes the position that costs and expenses incurred with respect to the institution and administration of a bankruptcy reorganization are not deductible because those expenses will benefit the corporation in future years.

The principal decided cases have not been very illuminating. In *In re Placid Oil Co.*, the bankruptcy court agreed as a theoretical matter that some expenses (such as those incurred in objecting to creditor claims) would be deductible, but found that the taxpayer had not met its burden of proving which expenses qualified and therefore treated all expenses as capital on the theory that they were incurred in connection with a "reorganization."[77] On appeal, the Fifth Circuit rejected the lower court's theory that all expenses should be swept into the capitalization category merely because the case involved a reorganization, and remanded for the lower court to classify the expenses as (a) currently deductible, (b) amortizable over the useful life of the underlying asset or transaction, or (c) allocable to nonamortizable intangible assets (and therefore permanently capitalized).[78] More recently, in *In re Hillsborough Holdings Corporation*,[79] a bankruptcy judge in Florida held that all professional expenses incurred by the

[73] One recent study concluded that public companies generally incur professional fees equal to between 1% and 3% of the value of their assets. *See* LoPucki and Doherty, "The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases," 1 *J. Empirical Legal Stud.* 111, 141 (Mar. 2004).

[74] *See INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992).

[75] *See, e.g.*, *United States v. Gilmore*, 372 U.S. 39 (1963).

[76] Rev. Rul. 77-204, 1977-1 C.B. 40.

[77] 140 B.R. 122 (Bankr. N.D. Tex. 1990), *aff'd*, 148 B.R. 464 (N.D. Tex. 1991).

[78] 988 F.2d 554 (5th Cir. 1993).

[79] 295 B.R. 679 (Bankr. M.D. Fla. 2003), *adopting and incorporating by reference* 99-1 U.S.T.C. ¶ 50,514 (Bankr. M.D. Fla. 1999).

various creditor committees had to be capitalized as a matter of law since "'but for' the original bankruptcy filings, there would not have been these expenses incurred." On the other hand, the *Hillsborough* court did allow the debtor to deduct expenses that it incurred in connection with veil-piercing litigation, claims disputes, and credit facilities that were pursued but never created. Debtor expenses incurred in connection with case administration and plans of reorganization were capitalized.

Finally, in December 2003 the IRS issued final regulations governing the capitalization of intangible asset expenses.[80] With respect to bankruptcy fees, the new regulations generally follow the guidance previously set forth in Rev. Rul. 77-204: amounts paid to institute or administer a chapter 11 reorganization must be capitalized on the theory that they are paid to facilitate a reorganization. On the other hand, the regulations provide that amounts paid to formulate, analyze, contest or obtain approval of the portion of a plan of reorganization that resolves tort liabilities will be deductible so long as the amounts in question would have been deductible had the bankruptcy proceeding not been instituted. The regulations also permit the debtor to treat all employee compensation—including compensation paid for secretarial and clerical services provided by outside contractors—as not subject to capitalization.

IV. Tax Refund Practices

Creditor Interest in Tax Carrybacks

If a debtor has been a taxpayer in recent years, it may be possible for it to carry back losses incurred in the year of filing or early in the administrative period to obtain a tax refund. The timing and amount of such a refund can take on particular importance in the early stages of a bankruptcy, when ready cash is at a minimum. Later on in the case, deductions generated by payments made pursuant to the plan of reorganization may be carried back to generate a refund that can help fund the plan itself.[81] Debtor corporations and their advisors should therefore scrutinize carefully the possibility of obtaining a tax refund at some point during the case.

Commentary

The current carryback period is two years.[82] Importantly, however, carrybacks for most product liability losses are subject to a special 10-year carryback period,[83] which will often dramatically increase the tax refund possibilities available to corporations that file for bankruptcy in order to deal with personal injury and tort claims arising from the manufacture and sale of products.

Outside of bankruptcy, corporations occasionally find it beneficial to elect to carry forward their losses, rather than carrying them back, and the Internal Revenue Code permits that

[80] T.D. 9107, 69 Fed. Reg. 436 (Jan. 5, 2004) (effective Dec. 31, 2003).

[81] *See generally BNA Corporate Bankruptcy Portfolio* VII.

[82] IRC § 172(b)(1)(A)(i).

[83] IRC § 172(b)(1)(C), (f).

to be done.[84] In bankruptcy, however, creditors and debtors are normally aligned in preferring to carry losses back, in order to obtain immediate cash and to avoid the reduction and limitation on carryforward losses that normally occurs when the plan of reorganization goes effective. Indeed, if a debtor corporation makes an election to carry losses forward in an attempt to deprive the creditors of cash and to preserve those losses for the benefit of post-emergence equity, the courts have held that such an election is subject to avoidance, even though it is final and irrevocable under the Internal Revenue Code.[85]

Debtors frequently generate large tax deductions as a result of distributions made pursuant to the plan of reorganization, but also incur large amounts of COD income that will offset those deductions at year end. Until recently, it was not clear whether the net loss for the year of emergence could be carried back to prior years without reduction to reflect COD income. Treasury has now made it clear, however, that NOL carrybacks will be treated as taking place before attribute reduction is given effect, thereby allowing some corporate debtors (especially those that are eligible for the special ten-year product liability carryback) to literally finance the cash portions of their plan of reorganization with a refund obtained from the IRS.[86]

"Quickie Refund" Claims

Outside of bankruptcy, corporations are entitled to file so-called "quickie refund" claims based on the carryback of a loss to a prior year.[87] Quickie refunds are an extremely valuable tool outside of bankruptcy, because the IRS generally processes quickie refund requests within 90 days, and only reviews the request for omissions and computational errors, rather than auditing the underlying basis for the losses that are being carried back.[88] The IRS is, however, permitted outside bankruptcy to set off taxpayer refunds (including quickie refunds) against unpaid taxes.[89]

Prior to the enactment of BAPCPA, the government's right of setoff with respect to pre-petition taxes was preserved in bankruptcy, but the Bankruptcy Code generally prevented the taxing authority from exercising that right while the automatic stay was in place.[90] Under BAPCPA, however, setoffs by the IRS and other taxing authorities will generally be permitted if setoff would have been permitted outside bankruptcy and if the taxable periods giving rise to both the overpayment and the deficiency are pre-petition. If setoff would not be permitted outside of bankruptcy because of a contest over the amount or legality of the deficiency, the taxing authority will be permitted post-BAPCPA to hold the refund pending resolution of the contest, unless the court grants adequate protection.[91] This change will tend to reduce the value

[84] IRC § 172(b)(3).

[85] *See*, *e.g.*, *In re Russell*, 927 F.2d 413 (8th Cir. 1991).

[86] *See* Treas. Regs § 1.108-7.

[87] IRC § 6411. "Quickie refunds" are technically known as "tentative carryback adjustments."

[88] IRC § 6411(b); Treas. Regs. § 1.6411-3.

[89] IRC §§ 6402(a), 6411(b). *See generally BNA Corporate Bankruptcy Portfolio* VII.B.1.b.

[90] B.C. §§ 362(a)(7), 553.

[91] B.C. § 362(b)(26). *See generally* BAPCPA Tax Summary, *supra* note 26, at 910.

of the quickie refund process, because the IRS may argue that it can hold the refund until a final determination has been made with respect to any pre-petition claims arising in other years that the IRS has asserted may be owed.

Commentary

Note that the debtor's receipt of a quickie refund will not foreclose the IRS from auditing the returns involved. Indeed, the Bankruptcy Code establishes a specific procedure that allows the IRS to file a claim to recover a quickie refund previously issued to a debtor, automatically treating any such claim as an administrative claim, whether or not the years from which or to which the NOL is being carried are post-petition.[92] If the IRS files such a claim, then the debtor corporation could object to the claim and try the case in bankruptcy court.[93] A victory for the taxpayer in Bankruptcy Court (if not overturned on appeal) would resolve any doubts about the debtor's right to retain the quickie refund. On the other hand, if the IRS makes no claim under Section 503(b)(1)(B) but raises the issue on audit post-emergence, it is not clear whether the Service's failure to make use of Section 503(b)(1)(B) would preclude it from challenging the refund later.[94]

What about Section 505? Could it be used by the debtor to obtain certainty prior to emerging from bankruptcy that it will be able to retain its quickie refund? Apparently not. Section 505(b) is by its terms limited to "a determination of any unpaid liability for the estate for tax" for post-petition years. Since in the refund context the return for the post-petition year in question will show a loss, Section 505(b) will not be available.[95] Moreover, Section 505(a) will not be available, because it is limited to determining the right of the debtor to receive a refund, which is no longer in doubt once the quickie refund has been paid.

Finally, if a refund is received by the parent of a consolidated group of corporations, to whom does the refund belong? The question is a complicated one, with the answer turning on a number of factual matters, including the location of the loss giving rise to the carryback, the location of the income giving rise to the original tax payment, and the status and content of any tax sharing agreements that might exist among the members of the group.[96]

V. Practices Involving Tax Claims Against the Debtor

Despite the fact that most corporations that file for bankruptcy have been losing money for years, large tax claims are filed in a surprising number of cases.[97] The impact of material tax claims on the case tends to be exacerbated by the fact that they are sometimes filed rather late in

[92] B.C. § 503(b)(1)(B). *See generally BNA Corporate Bankruptcy Portfolio* VII.B.1.c and VII.D.2.

[93] *BNA Corporate Bankruptcy Portfolio* VII.D.2.

[94] *Id*.

[95] *Id*. V.D.1.

[96] *Id.* V.E and XVIII.

[97] *See id.* IX n.715 (collecting cases).

the day, once tentative deals among other classes of creditors have already been discussed.[98] If tax claims are large enough, it may not be feasible for the debtor to emerge until they have been resolved. In these circumstances, the debtor corporation and its tax advisors should give careful consideration to whether these claims should be resolved consensually, using the methods normally employed outside bankruptcy, or through litigation, normally in bankruptcy court.[99]

Consensual Resolution of Tax Claims

If a debtor corporation decides to pursue the consensual route, the process will play out in much the same way that it would have outside bankruptcy.[100] Until the debtor files an objection to the IRS' claim (which it should definitely NOT do if it is pursuing a consensual resolution), governmental jurisdiction over the claims process remains with IRS audit and appeals.[101] Government lawyers may become involved, but their role will normally be limited to procedural matters.

The biggest difference that bankruptcy makes on the IRS negotiation process is the requirement that the settlement be approved by the bankruptcy court after notice and hearing.[102] In the absence of court approval, the settlement may not be enforceable against the debtor.[103]

Commentary

A settlement with the IRS will normally be embodied in a written closing agreement, which may contain detailed information about the debtor's operations. If public disclosure of that information might be competitively damaging to the debtor, consideration should be given to seeking court approval to file the sensitive portions of the settlement under seal.[104] Tax advisors to the debtor should also consider whether it will be easier to obtain creditor committee approval for a settlement with the IRS if the committee's tax advisors are kept generally informed about the process of negotiation with the IRS.[105]

Litigation of Tax Claims

---

[98] By statute, the bar date applicable to claims made by the IRS and other taxing authorities must be at least 180 days after the filing date. B.C. § 502(b)(9). By rule, the bar date can be set later "for cause shown." Fed. R. Bankr. P. 3003(c)(3).

[99] For a discussion of the pros and cons of resolving tax claims consensually or through litigation, see *BNA Corporate Bankruptcy Portfolio* IX.C, D.

[100] *See generally id.* IX.E.

[101] *See* 15 *Collier on Bankruptcy*, *supra* note 7, ¶ TX5.13[1][d].

[102] *See id*. ¶ TX5.13 n.1.

[103] *See In re Sparks*, 190 B.R. 842 (Bankr. N.D. Ill. 1996).

[104] *See* B.C. § 107(b) (bankruptcy court authorized to protect trade secrets or commercial information). *See, e.g.*, *In re Orion Pictures Corp.*, 21 F.3d 24 (2d Cir. 1994).

[105] *See generally BNA Corporate Bankruptcy Portfolio* IX.E.

The bankruptcy court has broad jurisdiction to determine the amount of any tax, provided that the tax had not actually been determined by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case.[106] As a result, the bankruptcy court initially has exclusive jurisdiction over all contested tax matters, whether they arose pre-petition or during the case.[107] If a debtor decides to litigate an IRS tax claim in bankruptcy court, it need only file a written objection to that claim.[108]

Commentary

While it is technically true that the Federal Rules of Civil Procedure do not apply in bankruptcy,[109] 77 of the 89 Civil Rules have been imported in whole or in part into the Bankruptcy Rules.[110]

Prior to 2000, dozens of courts had addressed the question of whether, once the IRS files a claim for taxes, the IRS bears the ultimate burden of persuasion with respect to its claim.[111] In 2000, the Supreme Court finally resolved the issue in the government's favor in *Raleigh v. Illinois Department of Revenue*.[112] Ironically, however, at the same time that *Raleigh* was wending its way to the Supreme Court, Congress changed the underlying non-bankruptcy law by providing that under certain circumstances involving small taxpayers the burden is on the IRS.[113] Therefore, since 2000 the burden of persuasion with respect to tax claims against corporations in bankruptcy depends on whether the debtor corporation has fewer than 500 employees.[114]

Although the bankruptcy court's jurisdiction to resolve pending tax controversies is initially exclusive, the bankruptcy court has the power to lift the automatic stay in order to allow tax claims to be litigated in some other forum.[115] Most requests to lift the stay come from taxing authorities (who generally view bankruptcy court as a pro-debtor forum), but debtors

---

106 B.C. § 505(a). BAPCPA pared this jurisdiction back slightly by providing that it will no longer extend to *ad valorem* real or personal property taxes if the period of limitations for contesting the tax has expired under applicable non-bankruptcy law. *See* B.C. § 505(a)(2)(C). *See generally* BAPCPA Tax Summary, *supra* note 26, at 895–96.

107 *See generally* B.C. §§ 362(a), 362(a)(8).

108 *See generally BNA Corporate Bankruptcy Portfolio* IX.F.2.

109 Fed. R. Civ. P. 81(a)(1).

110 *See* Klein, "Bankruptcy Rules Made Easy (2001): A Guide to the Federal Rules of Civil Procedure that Apply in Bankruptcy," 75 *Am. Bankr. L.J*. 35 (2001).

111 *See* Henderson and Goldring, *supra* note 24, § 1013.4 (collecting cases); 15 *Collier on Bankruptcy*, *supra* note 7, ¶ TX5.03[5] (same).

112 530 U.S. 15 (2000).

113 IRC§ 7491 (limited to individuals and to partnerships, corporations, and trusts with net worth of less than $7 million and no more than 500 employees). *See generally BNA Corporate Bankruptcy Portfolio* IX.F.4.

114 The other requirement under IRC § 7491—a net worth of less than $7 million—is presumably met by virtually every corporation that files for bankruptcy.

115 B.C. § 362(d). *See generally BNA Corporate Bankruptcy Portfolio* IX.F.5.

occasionally file motions to lift the stay where litigation is already well under way in some other forum at the time of the filing.

Use of Section 505(b) to Determine Post-Petition Tax Liabilities

Special procedures apply if a corporate debtor wishes to obtain some level of closure with respect to administrative period tax liabilities. Section 505(b) allows a debtor to submit a tax return for a post-petition period and request a prompt determination by the relevant taxing authority, which has 60 days to notify the debtor that it has selected the return for examination and 180 days to complete that examination. While this provision can be a valuable tool in certain circumstances, it has several inherent limitations: (a) it does not allow a debtor corporation to resolve all of its administrative period tax issues before emergence, because it will never be possible to have the return for the final year in bankruptcy examined before emergence, (b) Section 505(b) is expressly limited to the debtor's tax liability, and therefore cannot be used to obtain certainty with respect to the debtor's tax attribute carryforwards;[116] and (c) filing a Section 505(b) motion must increase substantially the risk of an IRS audit, which most corporate tax directors would rather avoid.

Deferred Payment of Allowed Taxes Post-Emergence

Prior to the enactment of BAPCPA, payment of a corporate debtor's pre-petition liabilities for unsecured priority taxes could be spread over a six-year period beginning upon emergence, provided that the taxing authority received payments having a present value at emergence that was not less than the allowed amount of the claim.[117] Much litigation ensued over how the bankruptcy court was to calculate present value, and whether the payment schedule could be back-end-loaded.[118] BAPCPA made several important changes to this regime, almost all of them anti-debtor: (a) the payment period has been shortened from six years to five, (b) the five-year period begins on the filing date, not the date of emergence, (c) the payments must be in "regular" installments, (d) the taxing authority must be treated not less favorably than the most favored non-priority unsecured claimant other than a convenience class, and (e) for the first time, these deferred payment provisions will apply to secured tax claims.[119]

Commentary

The change in the period over which deferred tax payments can be made will materially shorten the actual deferral period in many major corporate bankruptcies. Under prior law, it was very common for reorganized debtors to have a full six years from emergence to pay pre-petition federal income taxes, because actual IRS assessment had been delayed throughout the case. Under BAPCPA, on the other hand, the new five-year period will begin on the petition date. As

[116] *See* Henderson and Goldring, *supra* note 24, § 1011.

[117] B.C. § 1129(a)(9)(C). *See generally* BAPCPA Tax Summary, *supra* note 26, at 904–05. The statutory language prior to amendment called for payments to be made "over a period not exceeding six years after the date of assessment," but in practice the six-year period did not normally begin to run until emergence.

[118] *See generally BNA Corporate Bankruptcy Portfolio* IX.J.

[119] B.C. § 1129(a)(9)(C). *See generally* BAPCPA Tax Summary, *supra* note 26, at 904–05.

a result, in major cases in which the debtor is in bankruptcy for several years, the deferral benefit conferred by the statute will dwindle markedly.[120] And the debtor's new-found ability to defer payment of secured taxes may turn out to be the bankruptcy equivalent of giving away ice in the wintertime: because secured tax claims will earn interest during the case at the higher state law rates mandated by BAPCPA, many debtors will conclude that it is cheaper to seek permission to pay secured tax claims at the beginning of the case in order to stop the interest meter from running, even if doing so means foregoing the possibility of paying off secured tax obligations over a several-year period.

VI. Disclosure Statement Practices

Cases Filed Before BAPCPA

Prior to solicitation of acceptances for a Chapter 11 plan, a proponent must submit and have approved by the court a disclosure statement containing adequate information.[121] The Bankruptcy Code is silent with respect to what constitutes adequate information as to the tax consequences of the plan. Practice varied widely. It has been standard procedure for many years for large corporate debtors—especially public companies—to include a lengthy and detailed federal tax consequences section in every disclosure statement. On the other hand, it was not uncommon in smaller cases for tax consequence disclosure to be extremely limited or even non-existent.

Cases Filed After BAPCPA

Under BAPCPA, the disclosure statement will be required to contain a detailed discussion of the potential material federal tax consequences to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case.[122] Nevertheless, if the case qualifies as a "small business case" as that term is defined in Section 101(51C), the bankruptcy court may conclude that the plan itself contains adequate tax information and that no separate disclosure statement—much less one that discusses the plan's federal income tax consequences—need be prepared.[123]

Application of Circular 230 to Disclosure Statements

Circular 230 sets forth the standards with which tax practitioners must comply if they wish to practice before the IRS.[124] Changes to Circular 230 that became effective in June 2005 resulted in tax professionals routinely including a disclaimer in every e-mail and memorandum (and most opinions). The disclaimer is intended to put the recipient on notice that he cannot rely

[120] Some relief may be provided by BAPCPA's prohibition on extending the debtor's exclusivity period beyond 18 months, if and to the extent that that prohibition actually promotes shorter corporate bankruptcies. B.C. § 1121(d)(2)(A).

[121] B.C. § 1125(b). *See generally* BAPCPA Tax Summary, *supra* note 26, at 909.

[122] B.C. § 1125(a)(1).

[123] B.C. § 1125(f).

[124] 31 CFR part 10, *reprinted as* Treasury Department Circular 230.

on any U.S. federal tax advice contained in the communication to avoid penalties under the Internal Revenue Code or to market a transaction. Including the disclaimer relieves the practitioner of complying with the complex and onerous rules that Circular 230 otherwise applies to tax opinions. There is an exception to the application of the Circular 230 disclaimer rules for most written advice that is "included" in documents required to be filed with the SEC.

The question is whether a Circular 230 disclaimer should be included in bankruptcy disclosure statements, on the theory that the tax consequences section contains written advice on U.S. federal tax matters. After some initial uncertainty, most law firms seem to have concluded that Circular 230 disclaimers need not be included in disclosure statements prepared on behalf of debtor corporations that are subject to SEC filing requirements,[125] since the disclosure statements will themselves be filed with the SEC.[126] Where the debtor is not subject to SEC filing requirements, Circular 230 does seem to apply to disclosure statements.[127]

VII. Post-Confirmation Tax Practices

Debtor Assets Held by Liquidating Trusts or LLCs Post-Petition

Creditors often insist that certain assets held by the debtor—claims against professionals, avoidance actions, unwanted assets—be transferred to the creditors and liquidated by them post-emergence. While tax considerations are far from paramount, it is important that attention be given to the form of entity used to house these assets. The two most common vehicles are liquidating trusts and limited liability companies.[128] They both have the same objective: to allow the creditors' business objectives to be met without incurring a separate level of tax on any income generated by the entity. Both liquidating trusts and LLCs can accomplish that goal, but each presents pros and cons that need to be carefully weighed before the plan is finalized.[129]

---

[125] *But see In re Congoleum Corp., et al.*, Case No. 03-51524 (KCF) (Bankr. D. N.J.), Proposed Disclosure Statement with Respect to the Ninth Modified Joint Plan of Reorganization, dated Aug. 11, 2006 (Circular 230 notice included in public company's disclosure statement); *In re Three-Five Systems, Inc.*, Case No. 05-17104 (RTB) (Bankr. D. Ariz.), Disclosure Statement in Support of Amended Joint Plan of Reorganization, dated Mar. 15, 2006 (same); *In re O'Sullivan Industries, Inc.*, Case No. 05-83049 (Bankr. N.D. Ga.) First Amended Disclosure Statement, dated Jan. 3, 2006 (same).

[126] Regulation FD requires simultaneous public dissemination of material nonpublic information that has been disclosed to certain persons under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information. Disclosure statements filed with the bankruptcy court typically contain material nonpublic information regarding the debtor. Because bankruptcy court filings do not by themselves result in the broad public dissemination of that information as contemplated by Regulation FD but instead result in limited dissemination of that information to persons, including members of the investment community, that monitor the court's docket, most companies simultaneously file the disclosure statement with the SEC as an exhibit to a Current Report on Form 8-K in order to ensure broad public dissemination in a manner contemplated by Regulation FD. 17 C.F.R. part 243 (2006).

[127] *See e.g.*, *In re JL French Automotive Casings, Inc.*, Case No. 06-10119 (MFW) (Bankr. D. Del.), Second Amended Disclosure Statement dated May 12, 2006 (Circular 230 notice included in private company's disclosure statement).

[128] *See generally BNA Corporate Bankruptcy Portfolio* XIX.B.

[129] *Id.*

Disputed Claims Reserves and Qualified Settlement Funds

Major corporate debtors often emerge from bankruptcy without resolving all disputes involving general unsecured claims. The solution is often the creation of a disputed claims reserve and the establishment of a "dribble-out" process by which quarterly payments to holders of allowed claims are made when and as remaining disputed claims are resolved. The tax issue here is whether and how the reserve will be taxed on any income it earns on the cash or other property it is holding on behalf of the reserve's beneficiaries. Unlike liquidating trusts and LLCs, claims reserves are usually at least partially taxable on their earnings, but the exact results may vary depending on whether the reserve is taxed as a taxable trust, a disputed ownership fund,[130] or a grantor trust.[131] In recent cases, debtors have formed distribution trusts that are treated to the extent of allowed claims as liquidating/grantor trusts of the creditors (with income of the trust taxed to the creditors), and to the extent of the disputed claims as disputed ownership funds (with income taxed to the fund either as a corporation or as a qualified settlement fund, depending on the property contributed).[132] Attention should therefore be paid to the way in which the reserve is structured and the tax consequences that will flow from the structure selected.

Mass tort bankruptcies present a different sort of issue: the claims that remain unresolved at emergence are not the sort of minor, incidental claims for which disputed claims reserves are often created, but are instead the claims that gave rise to the bankruptcy filing in the first place. Qualified settlement funds generally offer the best tax result for this situation:[133] if the technical requirements are met (including the requirement that the claims arise out of, among other things, tort, breach of contract or violation of law), the funds transferred by the debtor to the fund are immediately deductible, even though the exact identity of the ultimate recipient may be unknown. Funds transferred to the fund are not taxable to it, but income earned on those funds will be taxed at the maximum individual rate.

Post-Petition Reporting and Withholding Requirements

A corporate debtor preparing to emerge from bankruptcy often assumes that, by retaining a disbursing agent such as a bank to handle the actual distribution of stock, cash, and debt to creditors, the reorganized debtor need not be concerned with any reporting and withholding requirements associated with plan distributions. This is generally not the case: the disbursing agent will not be familiar with the claimants or the nature of their claims and will therefore look to the debtor to determine the extent to which reporting or withholding is required.

---

[130] Treas. Reg. § 1.468B-9(c) provides that a disputed ownership fund is taxable as a C corporation, unless all the assets transferred to the fund by or on behalf of transferors are passive investment assets, in which case it is taxed as a qualified settlement fund under Treas. Reg. § 1.468B-2.

[131] *See BNA Corporate Bankruptcy Portfolio* XIX.C.1.

[132] *See, e.g.*, *In re Alpart Jamaica Inc. and Kaiser Jamaica Corp.*, Case Nos. 03-10144 and 03-10151 Jointly Administered Under Case No. 02-10429 (JKF) (Bankr. D. Del.), Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code with Respect to the Third Amended Joint Plan of Liquidation for Alpart Jamaica Inc. and Kaiser Jamaica Corporation, dated Feb. 25, 2005, at 46 (Docket #6266).

[133] Treas. Reg. § 1.468B-2.

The subject can be a complex one. Distributions to employees in discharge of pre-petition claims may or may not constitute wages. If they do, wage and FICA withholding will be required. If the distributions consist of non-cash items like stock, some mechanism will need to be created to either sell off stock to generate cash that can be withheld or offering employees the opportunity to fund the withholding obligation with their own cash. Distributions to foreign creditors create additional difficulties, as do the rules governing back-up withholding.[134]

In light of these complexities, the corporate debtor and its tax advisors should review the debtor's reporting and withholding requirements well in advance of emergence, and develop a process for dealing with those requirements.

[134] *See generally BNA Corporate Bankruptcy Portfolio* XIX.D.