

UNITED STATES BANKRUPTCY CODE
BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005
(S-256 / HR-685)

Brief Recap – Title VII – Bankruptcy Tax Provisions¹

In the year 1995, inspired by a report written and submitted to the National Bankruptcy Review Commission by Karen Cordry, Bankruptcy Counsel for the National Association of Attorneys General (NAAG), as a representative of the National Association of the County Treasurers and Finance Officers (NACTFO) I became involved in attempting to consolidate and define issues within the United States Bankruptcy Code that were being used and interpreted to adversely effect the collection of local municipal, county, and state taxes.

Governments in the United States of America exist, function, and are funded through the voluntary consent of the governed. They survive because the vast majority of the populous willingly obey the law and pay their taxes. That cooperation depends on the belief of the citizenry that their neighbors in similar circumstances will also be expected to comply. If easy ways are found to avoid the payment of legitimate taxes, voluntary compliance begins to breakdown. Taxpayers see no reason why they should obey the law if their neighbors do not. Thus, whatever benefits are provided to the relatively small number of businesses or persons who receive a bankruptcy discharge, they must be balanced against the possibility of harm to society as a whole if debtors in bankruptcy are allowed to use a legal loophole to beat the established taxing system.²

Counties, cities, schools, and special districts rely heavily on real and personal property taxes as the largest single source of local government annual revenue. The property tax is universally recognized as providing necessary funding for local government services. In any federal bankruptcy case where taxes are due and owing, an outstanding tax claim makes a government entity an involuntary creditor. This fact alone should give added equity to a claim held by a party (government) who had no ability to avoid being embroiled with the debtor.²

Local governments serve unique functions – public education, law enforcement, taxing powers, mandated requirements, regulatory processes – not duplicated in the private sector. They cannot restrict their activities to only a portion of their territories or to a desirable segment of the population. Just as the rain falls on the just and the unjust, so too are police and fire protection given to both timely and delinquent taxpayers. Potholes outside a tax protestor's house will still be filled, and his children may still attend public school, despite his failure to pay the taxes he owes. All of these services are provided from taxes, and the citizen that accepts the privileges and benefits of citizenship must accept the reciprocal duties and obligations. In light of the unique responsibilities owed by a government to its citizens, the federal bankruptcy system must not undermine the duty that citizens owe to their government and each other.³

When anticipated revenue is lost by a federal bankruptcy ruling, every dollar of tax not collected from a debtor (taxpayer) must be paid by all other taxpayers. This can cause severe hardship to the local governments in forecasting and funding required responsibilities for schools, police protection, firefighters, hospital care, and roads.

Prior to passage of the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005", the ability of counties, municipalities, schools, and special districts to collect properly assessed and levied

¹ Prepared and distributed by the Honorable Ray Valdes, Seminole County Florida Tax Collector and Immediate Past President of NACTFO. (Email: rvaldes@seminoletax.org) March 25, 2005.

² Copied, modified, and condensed from the "NAAG Special Agenda" prepared for NBRC 1995, written by Karen Cordry, NAAG Attorney.

³ Karen Cordry, NAAG Attorney 9/96.

real and personal property taxes were being restrained and eliminated by some federal District Courts through a federal judge's interpretation of the United States Bankruptcy Code.

Conflict among federal court rulings resulted in the bankruptcy laws being applied differently in various parts of the country. Debtor attorneys continually spread decisions potentially favorable to their debtor clients into other jurisdictions. It was apparent that some debtor attorneys used certain aspects of bankruptcy proceedings as a positive financial tool in a business plan where they could reduce the assessed value of real or personal property by challenging an assessment that had been confirmed at the state level, downgrade the secured priority status of a tax lien, or encourage a judge's decision to lower state regulated interest rates on delinquent taxes.

As observed by one government attorney "some federal courts seem to take the position that local government tax liens are not real property interest in claims, but just the government's money. In fact, the public and other taxpayers are the ones who are burdened by these ill-founded conclusions and decisions".⁴

In business bankruptcies, the "fresh start" theory is that reorganization will provide a stronger and more viable entity that will be able to produce a greater economic return for creditors than would an immediate liquidation of the enterprise. The reality is that about **75% of cases that start in Chapter 11 never achieve a viable reorganization**. The prompt payment of taxes should be considered as an early litmus test when determining the feasibility of a Chapter 11 planned reorganization. "Payment of taxes on a timely basis is not an expectation that will overly burden and/or prejudice a debtor seriously contemplating reorganization."⁵

Therefore, it became the unified and coordinated position of NACTFO, NAAG, the National Association of Counties (NACo), the League of Cities, and a host of other bankruptcy attorneys representing the government sector that a position should be taken on behalf of all taxing authorities **to revise the Bankruptcy Code to adopt as the first principle, that taxes due and owing that are involved in a federal bankruptcy claim must be paid in a timely fashion in the ordinary course of the debtors activities**. The priority of taxes should not be subordinated or treated worse than other expenses that are incurred by a debtor, and should never be sacrificed to a generalized goal of achieving a "fresh start". When and if a debtor emerges from bankruptcy, it/he will again be required to pay all assessed taxes in full. An **equally important** principle that needed to be reestablished was that **a debtor should not be able to discharge or avoid prepetition taxes by filing for bankruptcy**.

Here are the accomplishments of the combined group of individuals and organizations named above that are included in the final language of "**Title VII – Bankruptcy Tax Provisions**" included in **S-256/HR 685**:

1. **Treatment of Certain Liens.** (Prior to this bill, a bankruptcy debtor was able to downgrade the status of real and personal property tax claims merely by passing them through one or more Chapter 11 cases down into a Chapter 7, effectively eliminating the priority status, and frequently, the payment of legitimate taxes).

The bills provide: **U.S.C. 11 § 724 (b)** – "Other than to the extent that there is a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the estate", after "under this title". In **§ 724(f)** that only priority wage and benefit claims can be used to subordinate ad valorem taxes, and then only to the extent allowed by (e) below:

⁴ Harlan Wright, Assistant County Attorney, Sanford, Florida 12/20/95.

⁵ Honorable John Clark, Palm Beach County Florida Tax Collector, 12/15/95.

§ 724 (e) – At the end of (d), add (new section):

(e) “Before subordinating a tax lien on real or personal property of the estate, the trustee shall –

(1) Exhaust the unencumbered assets of the estate; and

(2) In a manner consistent with Section 506 (c), recover from property securing an allowed secured claim the reasonable, necessary cost and expenses of preserving or disposing of such property.

2. Determination of Tax Liability. U.S.C. 11 § 505 (a)(2). Add the following:

“(C) The amount or legality of any amount arising in connection with an ad valorem tax on real or personal property of the estate, if the applicable period for contesting or redetermining that amount under any law (other than a bankruptcy law) has expired.”

(Prior to S-256/HR 685, one constant and reoccurring issue in bankruptcy cases involving ad valorem taxes was the determination of whether the bankruptcy court judge must apply non-bankruptcy substantive law.) It was necessary to “amend § 505 to clarify that the burden of proof rules and accompanying presumptions which would be applicable under non-bankruptcy law are equally applicable to bankruptcy court determinations under § 505.”⁶

(The language in the bill now eliminates discretion by a federal bankruptcy court to challenge the legality of the amount of any ad valorem tax assessment where the appeal process date has passed according to state statute, county or municipal ordinance. This is true whether or not those issues were adjudicated prior to the bankruptcy filing, and whether or not the taxes have been paid.)

3. Section 704 - Rate of Interest on Tax Claims. U.S.C. 11 § 511 (Prior to S-256 / HR 685 federal bankruptcy judges in some jurisdictions disallowed or reduced the statutory delinquent interest rate in a bankruptcy case to what they deemed a “current market rate”.⁷ This practice, not allowed in a non-bankruptcy court, relegated taxing authorities to being involuntary financial contributors to increasing the value of the debtors estate.)

Language added: **U.S.C. 11 § 511. Rate of Interest on Tax Claims.**

“(a) If any provision of this title requires the payment of interest on the tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable non-bankruptcy law.”

“(b) In the case of taxes paid under a confirmed plan under this title, the rate of interest shall be determined as of the calendar month in which the plan is confirmed.”

(After passage of S-256 / HR 685, federal bankruptcy judges will no longer be able to reduce the interest rate on a delinquent tax claim determined by applicable non-bankruptcy law. This will likely speed the payment of taxes in a Chapter 11 since the debtor will no longer have this source for cheap, long-term, low-interest rate financing of its plan.)

4. Section 708 – No Discharge of Taxes. (The bankruptcy debtor should not be able to avoid payment of post-petition taxes either because a government unit failed to make an

⁶ NBRC Gov’t Working Grp Proposal #8, Washington, DC, 1/23/97.

⁷ After the U.S. Supreme Court decision in Till v. SCS Credit Corp., 541 U.S. 465, the Bankruptcy Court judges generally began to assume they should award no more than the prime rate, plus a very modest added fractional interest as a “risk factor”.

administrative request for them, or because the debtor failed to fully implement a reorganization plan that did provide for proper payment of taxes.)

U.S.C. 11 § 1141 (d) add the following:

(6) notwithstanding paragraph (1), the confirmation of a plan does not discharge a debtor that is a corporation from any debt –

(A) of a kind specified in paragraph (2)(A) or (2)(B) of Section 523 (a) that is owed to a domestic governmental unit, ...

- 5. Section 710 – Periodic Payment of Taxes in Chapter 11.** (Private sector secured creditors negotiate with their customers over the terms of a loan, including the repayment plan and collateral to secure the loan. Governmental units, which are entitled to immediate payment to the full amount of taxes secured by a lien absent bankruptcy, should not be subjected to longer repayment periods.⁸ This provision limits the maximum time for the payment of claims to five years from the petition date, rather than the current six years from the date of assessment.)

U.S.C. 11 § 1129 (a)(9) in subparagraph (C), by striking “deferred cash payments”, and all that follows, and inserting “regular installment payments in cash –

- (i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim;
- (ii) over a period ending not later than 5 years after the date of the order for relief...
- (iii) in a manner not less favorable than the most favored non-priority unsecured claim provided for by the plan ...

Add at the end of (9) the following:

(D) with respect to a secured claim which would otherwise meet the description of an unsecured claim of a governmental unit under Section 507 (a)(8), but for the secured status of that claim, the holder of that claim will receive on account of that claim, cash payments, in the same manner and over the same period, as prescribed in subparagraph (C).

- 6. Section 712 – Payment of Taxes in the Conduct of Business.** (Disallowing or subordinating tax claims allows bankruptcy to be used as a tax evasion by lowering total tax liability on real or personal property. This is not justifiable. To the contrary, a perfected tax lien should receive preference under the Code.)

U.S.C. 11 § 503 (b)(B)(i) – “Payment of ad valorem taxes required” is amended by inserting “whether secured or unsecured, including property taxes for which liability is in rem, in personam, or both”, before “except”, to clarify the nature of taxes that receive administrative expenses.

U.S.C. 11 § 503(b)(1)(D) is added: “(D) notwithstanding the requirements of subsection (a), a governmental unit shall not be required to file a request for the payment of an expense described in subparagraph (B) or (C), as a condition of its being an allowed administrative expense.”

U.S.C. 11 § 506 (b) and (c) – The words “or state statute” are added after “agreement,” which will allow local and state governments to collect attorneys fees. (Previously, such amounts were only allowed for oversecured claims where provided for on a voluntary basis, not because it was imposed by state statute.) In subsection (c), insert the words “including the

⁸ Gov’t Working Grp Proposal #332, (Amended), Washington, DC, 1/23/97.

payment of all ad valorem taxes.....” to the provision allowing a secured creditor to be surcharged for the costs of maintaining and preserving its property. (Note: State statute must clearly allow for the collection of attorneys fees or other legitimate cost pertaining to ad valorem tax for this section to be utilized and the claim validated.)

It is a satisfying accomplishment that many good tax provision reforms are becoming a reality. That said, there is a need to pursue a follow-up bill in the near future of much smaller scope and impact to clear up a few issues, terminology, and legal intent.