April 26, 2000

The Honorable Orrin G. Hatch
Chair
Senate Judiciary Committee
United States Senate
131 Senate Russell Office Building
Washington, DC  20510

Dear Chairman Hatch:

Re:  Tax Provisions of the Proposed Bankruptcy Reform Act of 1999

The views expressed in this letter represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

For over three years, the Section of Taxation’s Bankruptcy Task Force has worked with the Senate Finance Committee staff, the Internal Revenue Service, the Department of Justice and the National Association of Attorneys General to provide technical guidance on the tax provisions in the pending bankruptcy legislation. We have addressed policy issues and administration of the tax laws as well as devoted a great deal of attention to the statutory language to assure that the proposed statutes, regardless of any compromise, "worked." We have not resolved all issues; reasonable minds differ.

From all indications, it appears that a conference committee may not formally consider the House and Senate resolutions. As we understand the current status of the legislation, in a practical sense, compromises are now evolving among the members of Congress in lieu of a formal conference committee consideration. We write now, to put before you what we view as the most serious and troubling unresolved issues in the tax provisions in the hope our perspective will be helpful to you in the course of your discussions.

We have identified three specific issues that we believe must be resolved before the proposed legislation becomes law. We respectfully request and urge your assistance in reviewing and revising these items. For ease of reference, we will use the section numbers in S.625, as reported by the Senate. The three specific issues are as follows:

1. An Exception to Discharge in Chapter 11 Business Reorganizations for Tax Liabilities;
2. Application of the Automatic Stay to Tax Court Proceedings; and
3. The Chapter 13 “Superdischarge.”
The Tax Exception to the Chapter 11 Discharge. Chapter 11 of the Bankruptcy Code governs the reorganization of businesses. The discharge in Chapter 11 is granted and governed by section 1141(d) of the Bankruptcy Code. In the current Bankruptcy Code, there are no exceptions to that discharge.

Section 708 creates a broad exception for fraudulent taxes of corporations. We are not aware of any case in which the IRS has discovered fraudulent returns or willful attempts to evade or defeat taxes after a successful Chapter 11 proceeding. The taxing authorities may, and in fact do, audit corporate tax returns during Chapter 11 cases. Even if we assume, in fairness, that such an occasional case might arise, the number of such cases must be so small that the failure to protect the tax revenue in those instances cannot have any significant impact on the administration of the tax laws.

Furthermore, from a creditor perspective, the reorganization process is a very delicate one. For example, financial institutions wishing to provide post-petition financing count on the fact that the debtor has been "cleansed" of all liabilities through the bankruptcy process, most particularly relying on the discharge contained in section 1141(d). The proposed exception will disrupt the reorganization process. No threat to the collection process has been demonstrated, in any way, that can be resolved by this amendment.

Perhaps more importantly, creating this one exception to Chapter 11 discharges gravely risks the addition of other exceptions, which thereafter may be only a matter of time. One has only to look at the potential of the current tobacco litigation, gun litigation, asbestos litigation and any other of the variety of class actions to see the potential for a complete erosion of the stability provided by the full and complete discharge in Chapter 11 under current law. Enacting such new exceptions would pose little difficulty, if this new exception for taxes were enacted.

Application of the Automatic Stay to Tax Court Proceedings. Section 709(a) will amend section 362(a)(8) of the Bankruptcy Code. Section 362 contains the automatic stay; the referenced subsection applies to the stay on Tax Court proceedings after a bankruptcy petition has been filed. The Section of Taxation supported the amendment to overrule the case of Halpern vs. Commissioner, 96 T.C. 895 (1991), in its Report of the Section of Taxation of the American Bar Association on the Provisions of H.R. 3150. See 51 TAX LAWYER 635, 642 (1998).

Unfortunately, the amendment creates more problems than it cures. As drafted, the stay applies only to taxable periods ending prior to the filing date. Under the amendment, the Tax Court could consider any matter for any taxable period "after the filing date." The automatic stay would then be removed and the Tax Court could consider any case of an
individual debtor's Chapter 13 proceeding and a corporation's tax liability in a Chapter 7 or Chapter 11 case, so long as the taxable year ends after the filing date.

With respect to the liabilities of individual debtors ending after the filing of the petition, the taxing authorities have valid reasons to have the Tax Court decide. We disagree with those reasons, but acknowledge that they have some validity.

Of more importance, we do not agree that valid reasons exist to allow the Tax Court to decide the tax liability of a corporate debtor in a Chapter 11 or Chapter 7 case when a taxable year ends after the filing date. None of the taxing authorities has expressed a clear-cut reason to allow the Tax Court to proceed in those matters.

A corporation is before the Bankruptcy Court for all purposes. The liabilities incurred during the ordinary course of the corporation's post-petition business are adjudicated by the Bankruptcy Court as a matter of course. Indeed, in any reorganization of a corporation, tax liabilities are routinely brought before the Bankruptcy Court and resolved. To force a corporate debtor into the Tax Court would be disruptive of the entire bankruptcy process.

This is an issue for the Internal Revenue Service only. By its terms this provision applies only to the jurisdiction of the Tax Court. We have engaged in some discussions with the Internal Revenue Service that would tend to support limiting this provision to individual debtors. However, those discussions have not been finalized.

We also note that under section 709(b), which was removed from the final version of S. 625, the automatic stay will not apply to appeals from Tax Court decisions. We have no objection to lifting the automatic stay to permit appeals of Tax Court decisions. However, that provision also contains language limiting the automatic stay for decisions from "administrative tribunals" in the various states. We do object to lifting the stay as to such administrative tribunals. The Bankruptcy Court routinely deals with tax liabilities determined by state taxing authorities. Removing the stay for administrative tribunals would be disruptive to the Bankruptcy Court process in the same manner as not allowing the Bankruptcy Court to consider federal tax matters for post-petition periods.

**Chapter 13 Superdischarge.** The Chapter 13 "superdischarge" poses a somewhat complex issue for those not familiar with consumer bankruptcies. Section 707 repeals the superdischarge.

The repeal of the superdischarge in the proposed bankruptcy legislation, as a practical matter, would eradicate much of the protection afforded taxpayers in the IRS Restructuring and Reform Act of 1998. Congress there imposed serious limitations and restraints upon the manner and methods used by the IRS in the collection of taxes, and encouraged the Service to work with taxpayers.
What happens when the Service, and other taxing authorities, cannot reach common ground to resolve a tax debt? The superdischarge affords the only possibility of relief, for individuals with regular income only, when a tax debt cannot, under the best of circumstances, be repaid. The superdischarge provides these taxpayer/debtors with the ultimate backstop. To remove that “ultimate protection,” by repeal of the superdischarge, runs contrary to the basic premise of the IRS Restructuring and Reform Act of 1998: Taxpayers must be afforded a reasonably practical opportunity to resolve their tax liabilities. It makes no sense to keep a tax debt of any nature on the books, even if from fraud or nonfiling, if it cannot be collected. The taxpayer cannot start over; and the taxing authorities are compelled to devote valuable resources to deal with patently uncollectible debt.

Repealing the superdischarge also conflicts with the proposed bankruptcy legislation’s central theme: Encourage debtors to use Chapter 13 rather than Chapter 7. If a tax debt cannot be discharged in a Chapter 13 or 7 proceeding, a debtor with a tax bill will choose Chapter 7, to eliminate all other debt in the Chapter 7 proceeding and then deal with the taxing authorities. Why should any debtor make an effort to repay any other debt if the tax bill cannot be repaid or discharged? In short, the repeal of the superdischarge will force debtors to reject Chapter 13 and choose Chapter 7 - directly the opposite of the bankruptcy reform bill’s non-tax provisions.

Adequate safeguards do exist in a Chapter 13 case to prevent abuse of the system for discharge of taxes by those individuals with the means to satisfy the unpaid tax liability. Any individual in a Chapter 13 having the means to pay the taxes, or having transferred assets to avoid payment, cannot obtain the superdischarge. Every debtor must satisfy a standard of good faith, to file a Chapter 13 petition and separately to confirm a Chapter 13 plan. Every taxing authority can, and they frequently do, object to the filing of the bankruptcy proceeding and then to the confirmation of the plan if filed or a plan proposed in bad faith. The cases are substantial in number and equally substantial in content. Anyone trying to avoid taxes in a Chapter 13 case will not be allowed to confirm his plan.

Finally, and lest there be any doubt, we would prefer a Bankruptcy Tax Reform Act addressing together the provisions of the Bankruptcy Code and the Internal Revenue Code. That occurred in 1980 with very sound results. The proposed legislation does not and cannot consider any changes to the Internal Revenue Code. Equally as important, the extraordinarily high profile of the non-tax provisions has effectively precluded meaningful consideration of the conflicting goals of tax and bankruptcy policies. We do not suggest that the tax provisions have been ignored, as we have enjoyed an excellent working relationship with the staff of the Senate Finance Committee. Nonetheless, our members who are engaged in bankruptcy and tax considerations on a routine basis have not had an opportunity to fully explore how the conflict between bankruptcy law and tax law should best be addressed and reconciled in the context of particular issues or of general policies, and we regard that as unfortunate.

In all events, the purpose of this letter is to enlist your support, good offices and effort to bring a favorable and sensible resolution to the three issues we have addressed above as being of superior importance. Do not commence the addition of exceptions to discharge in
Chapter 11 reorganizations. Keep corporate debtors before the Bankruptcy Court for post-filing tax periods. And maintain the “superdischarge,” to avoid unwittingly forcing debtors back into Chapter 7. We believe these three issues deserve the most immediate attention and that these issues must be addressed to avoid creating additional problems in the future.

An identical letter has been sent to members of the Senate Finance Committe, House Judiciary Committee and House Ways and Means Committee.

Thank you very much for your time, attention and, most respectfully, your consideration.

Sincerely,

Paul J. Sax
Chair

cc: Members of the Senate Judiciary Committee
Manus Cooney, Majority Staff Director, Senate Judiciary Committee
Bruce Cohen, Minority Staff Director and Chief Counsel, Senate Judiciary Committee
Tom Mooney, Sr., Majority Chief of Staff, House Judiciary Committee
Julien Epstein, Minority Chief Counsel and Staff Director, House Judiciary Committee
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Jonathan Talisman, Acting Assistant Secretary Tax Policy), Department of the Treasury
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