Re: TAX PROVISIONS OF THE PROPOSED BANKRUPTCY REFORM ACT OF 1999

DATE: May 17, 2000

ABSTRACT: This letter responds to concerns raised by tax consultant James I. Shephard regarding the Section's earlier letter identifying unresolved issues in the tax provisions of the proposed Bankruptcy Reform Act of 1999.

RECIPIENTS:

TO:

The Honorable Orrin G. Hatch, Chair, Senate Judiciary Committee
The Honorable Patrick J. Leahy, Ranking Member, Senate Judiciary Committee
The Honorable Henry J. Hyde, Chair, House Judiciary Committee
The Honorable John Conyers, Ranking Member, House Judiciary Committee
The Honorable William V. Roth, Chair, Senate Finance Committee
The Honorable Daniel Patrick Moynihan, Ranking Member, Senate Finance Committee
The Honorable Bill Archer, Chair, House Ways and Means Committee
The Honorable Charles B. Rangel, Ranking Member, House Ways and Means Committee

CC:

Members, Senate Judiciary Committee
Members, Senate Finance Committee
Members, House Judiciary Committee
Members, House Ways and Means Committee
Manus Cooney, Majority Staff Director, Senate Judiciary Committee
Bruce Cohen, Minority Staff Director and Chief Counsel, Senate Judiciary Committee
Mark Prater, Chief Tax Counsel, Senate Finance Committee
Russell Sullivan, Minority Tax Counsel, Senate Finance Committee
Tom Mooney, Sr., Majority Chief of Staff, House Judiciary Committee
Julien Epstein, Minority Chief Counsel and Staff Director, House Judiciary Committee
The views 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.

By letter dated April 26, 2000, the Section of Taxation addressed three specific tax provisions of the pending bankruptcy reform legislation. By letter dated May 5, 2000, Mr. James I. Shepard took exception to the Section’s positions. Mr. Shepard, a long-time bankruptcy tax consultant to various state tax authorities, in our view fails adequately to balance the need for effective tax administration against the concept of a fresh start underlying our current bankruptcy code.

Each provision addressed in our original letter presents a serious policy issue.

1. The Exception to Discharge in Chapter 11 Business Reorganization for Fraudulent Tax Liabilities.
The entire Chapter 11 reorganization process rests on the sound and historically validated foundation that no exceptions to discharge exist after a business has been successfully reorganized. As noted in our earlier letter, opening the door for one exception, fraudulent taxes, will undermine that foundation. The reorganization process maintains jobs and provides for payments to creditors with the continuation of a viable entity.

If taxes are excepted from discharge the ultimate harm must be borne by the unsecured creditors of the reorganized entity. They will be forced to stand behind government claims for fraudulent taxes that they could not, even with vigorous due diligence, have known existed. With no historical basis for recognizing an exception to the Chapter 11 discharge, why should we now add a single isolated exception for fraudulent taxes? As a policy matter, no positive answer can be found.

Adding an exception to the bankruptcy discharge will not punish the ultimate tax cheats, the officers and employees of the entity. The officers and employees should be investigated and as appropriate prosecuted. Taking money from creditors rather than putting the officers in jail makes no sense. Certainly the officers and employees perpetuating a tax fraud do not escape punishment just because the company reorganizes. Even after the reorganization process, such individuals can be prosecuted.

Again, and perhaps more importantly, no taxing authority, federal or state, has indicated any real need for a provision excepting fraudulent taxes from the Chapter 11 discharge. If such a need existed, the Internal Revenue Service, the Department of Justice and the National Association of Attorneys General would have made that need quite clear. None of those authorities have expressed any need for such an exception. No revenues have been lost. Nor does a bankruptcy proceeding stay the investigation and punishment of tax crimes. We believe it is appropriate to use criminal sanctions to punish the cheats; and inappropriate to punish the unsecured creditors for the sins of others, when they are also, in a sense, victims.

The proposed exception to discharge in a Chapter 11 proceeding serves no real world purpose. Indeed, the proposed exception will do more harm than good. We urge the Senate and the House to remove the exception.


First, let us note that the IRS and the Section on Taxation have reached an understanding as to this provision. See IRS Fax Cover Sheet and Memorandum, dated May 1, 2000 attached. Additionally, we do not dispute that the IRS should be able to appeal Tax Court decisions that have become final prior to the commencement of a bankruptcy proceeding. More importantly, an appeal should not be stayed by the commencement of a bankruptcy proceeding as to
decisions of state courts that have become final prior to the commencement of the bankruptcy proceeding as to matters initiated by the debtor.

That leaves unresolved one area: "the appeal of decisions of administrative tribunals." Each state in the union has a tax infrastructure, spanning from tax appraisal boards to informal administrative boards for different types of taxes. No conformity exists, nor do we suggest it should.

Rather, we do suggest that the bankruptcy courts will be flooded with litigation attempting to define which boards come within the meaning of an "administrative tribunal" and which actions by those tribunals constitute "decisions". The concept of "a final decision by a court" has a fixed meaning and poses no such dangers. Mr. Shepard’s letter cites no pressing need to permit the appeal of decisions of administrative tribunals free of the automatic stay. He does not suggest any harm and he does not suggest any benefit.

The stay has a purpose. The stay prevents creditors, including taxing authorities, from acting without first moving for relief from the stay. If all "administrative tribunals" can proceed without any motion for relief from the stay, the Bankruptcy Courts lose a significant amount of control over the process. Adding "administrative tribunals" creates additional litigation for the Bankruptcy Court in defining what authorities, or other administrative configurations, fall within the definition of the term "administrative tribunal." We do not need legislation that does not resolve a problem and that will create additional problems.

3. Exception to Discharge of Tax Liability in Chapter 13.

The Section of Taxation addresses this exception strictly as a matter of sound bankruptcy policy. If an individual has no assets, and has not engaged in any conduct to transfer or dispose of assets, and has paid all of the priority taxes, why then should that individual be denied a discharge even for fraudulent taxes, if the purpose of bankruptcy reform is to obtain repayment under Chapter 13?

If the Chapter 13 petition has been filed in good faith and the plan has been proposed in good faith, the Bankruptcy Court can confirm the plan. The taxpayer then makes payments over three to five years. Priority taxes are paid. No injustice occurs. More importantly, none of the taxing authorities have demonstrated any harm on either of two fronts, loss of revenue or harm to administrative enforcement and compliance. Those are the goals.

The current bankruptcy reform legislation’s focuses on requiring individuals to use Chapter 13, and avoid Chapter 7. Removing the so-called "Superdischarge" in Chapter 13, discharging taxes, will force individuals to act aggressively to use Chapter 7. As we stated in our earlier letter, an
individual faced with non-dischargeable tax liabilities, will not consider Chapter 13 as a practical matter. Legally, an individual with a non-dischargeable tax liability cannot, under the current legislation, be compelled to use Chapter 13. Therefore, repealing the discharge of taxes in Chapter 13 will defeat the primary purpose of the bankruptcy reform legislation, to obtain repayment in Chapter 13.

Discharging taxes in a Chapter 13 plan represents the last available option to an individual who has attempted to work out his liabilities with the Internal Revenue Service and the state taxing authorities. Chapter 13 provides an honorable means by which an individual can pay his creditors and his priority taxes. It is not a free ride. For 3 or 5 years, the debtor-taxpayer devotes his earnings to the plan. By discharging taxes, which in reality can never be paid, and allowing the debtor to earn their fresh start, Congress will restore confidence in the bankruptcy system. Pay what you can for 3 or 5 years and you can start over.

This is not an area subject to abuse. Every individual considering Chapter 7 or Chapter 13 has little or no assets. If assets do exist or fraudulent transfers have occurred, the bankruptcy system has more than adequate tools to deal with it. Nearly always, the taxing authorities will have previously identified any debtor who attempts to abuse the system. That taxpayer’s bankruptcy will be monitored and action taken to prevent the discharge. In that case, the discharge will be denied because of bad faith. The Courts routinely review such cases and routinely deny discharges where abuse occurs.

Removing the superdischarge will not enhance tax administration. Most if not all of the tax debt discharged in Chapter 13 proceedings will never be collected. The assets and income do not exist. Any tax administrator with any experience knows that statement is a fact. Ask any taxing authority about how much real money is actually lost through Chapter 13. Even if not discharged, those accounts will go uncollected and require time and effort to manage without any real prospect of recovery. The only constructive approach requires and compels a discharge of taxes that cannot, in any event, be collected.

Thank you very much for your consideration. If you have any questions, please do not hesitate to contact Bob Pope at (615) 244-6242 ext. 224 or bpope@gsrm.com, or Paul Asofsky at (713) 546-5118 or paul.asofsky@weil.com, Co-Chairs of our Bankruptcy Task Force.

Sincerely,

Paul J. Sax
Chair