June 22, 1998

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate
104 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Bill Archer
Chairman, Committee on Ways and Means
United States House of Representatives
1236 Longworth House Office Building
Washington, D.C. 20515

The very sketchy report in the tax press of the tentative agreement between the House and the Senate regarding certain of the provision of H.R. 2676, the Internal Revenue Service Restructuring and Reform Act of 1998, as of June 19, 1998, states that the House would recede on the expansion of the attorney-client privilege to other tax practitioners, except that both the attorney-client privilege and the expanded tax practitioner privilege would not apply to communications relating to corporate tax shelters.

We write to express our deep concern about this tentative agreement. Unfortunately, because it has been only summarily reported and is not the subject of either the House or Senate bills, we find ourselves forced to comment without adequate knowledge of the conferees' decision or intent.

The American Bar Association has previously indicated its concern with Congressional efforts to tinker with the attorney-client privilege, including extending it to other tax practitioners, without first reaching a fuller understanding of the implications of that change. The attorney-client privilege is rooted in Anglo-American jurisprudence for a reason the long-standing recognition of the importance of encouraging privileged communications between a client and his or her lawyer. Extending it to non-lawyers in federal court proceedings is highly problematic. The possible removal of the privilege from communications between a taxpayer and its counsel in any situation is particularly disturbing. Moreover, because of the lack of details, we do not know whether "communications relating to corporate tax shelters" would extend to communications between a taxpayer and its lawyer during the audit of the taxpayer's return and any resulting administrative or judicial proceedings. How will a lawyer engaged to represent a corporation in such a situation be able to obtain knowledge of all relevant facts relating to the matter in issue if a taxpayer must fear that the IRS will be entitled to compel disclosure of information provided to the lawyer? Similarly, how can the lawyer be expected to provide full advice to the taxpayer, if the lawyer's work product is subject to discovery by the IRS? The fact that the client is a corporation is not a sufficient basis for denying the client the benefit of privileged communications with its counsel in such situations. Particularly is this the case of a communication that occurs following the initiation of a tax audit by the Internal Revenue Service.

As members of your staffs know, for some time the Tax Section has been troubled by the growth of corporate tax shelter activity. It may be entirely appropriate to adopt measures to stem the marketing of abusive tax shelters. However, restricting the ability of a taxpayer to deal on a confidential basis with its lawyer is not an appropriate response to perceptions of tax shelter activity.

The fact that we are forced to speculate about the scope of the conferees' action supports our view that it is unwise to broaden or narrow the scope of the attorney-client privilege in a hurried, behind closed doors manner. We continue to prefer that the Congress defer any change in the privilege, particularly as the change effects a backdoor amendment to the Federal Rules of Evidence. Absent such a deferral, we urge that the reported agreement of the conferees to narrow the attorney-client privilege be reconsidered and withdrawn.
We appreciate your consideration of our request.

Sincerely,

Phillip L. Mann

cc: Distribution Distribution

The Honorable Daniel Patrick Moynihan
The Honorable Charles B. Rangel
The Honorable Orrin G. Hatch
The Honorable Patrick Leahy
The Honorable Henry J. Hyde
The Honorable John Conyers, Jr.
The Honorable Robert E. Rubin
The Honorable Donald C. Lubick
Mr. Mark Prater
Mr. Nicholas Giordano
Mr. James D. Clark
Mr. John L. Buckley
Ms. Lindy L. Paul
Mr. Manus Cooney
Mr. Bruce Cohen
Mr. Tom Mooney, Sr.
Mr. Julian Epstein

Joint Report of the Section of Taxation and the
Section of Business Law of the American Bar Association
on the Tax Provisions of H.R. 3150

INTRODUCTION

This report of the Section of Taxation of the American Bar Association responds to tax provisions contained in H.R. 3150, 105th Congress, 2nd Session (1998) (the "Bill"), introduced by Congressman Gekas, Chairman of the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary of the House of Representatives. The Section of Business Law joins in Sections 1, 3-7, 9-16, 18, 19 and 21 of the report. The Section of Business Law has no objection to the remaining sections of the report, which relate solely to chapter 13 cases. The views expressed herein are presented on behalf of the Section of Taxation and the Section of Business Law. They 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.

The Bill follows the issuance on October 20, 1997 by the National Bankruptcy Review Commission (the "Commission") of a comprehensive report recommending changes in the bankruptcy laws of the United States, especially Title 11 of the United States Code (the "Bankruptcy Code"), although the Bill differs from the Commission's proposal in many material respects. As detailed below, a substantial portion of the Commission's time was consumed with recommendations to change the tax laws relating to bankruptcy by amending numerous provisions in both the Bankruptcy Code and the Internal Revenue Code. The Bill covers only a small portion of the Commission's tax output, and in several important respects differs from the recommendations made by the Commission and its Advisory Committee. On April 15, 1997, a special task force of the Section of Taxation on the tax recommendations of the Commission (the "Task Force") commented on proposals then pending before the Commission. On the whole, the Commission, following its Advisory Committee, adopted an approach that attempted to balance the needs, concerns and
entitlements of governmental tax authorities, debtors and creditors in the bankruptcy process. This balanced approach reflected the philosophy of the April 15, 1997 report of the Task Force.

The basis for the selection of the tax items included in the Bill is not obvious. The scope of the Bill's tax provisions is significantly narrower than the scope of the Commission's work. Moreover, the draftsmen of the Bill provide no insight as to why the Bill adopted individual items in the Commission's proposal, rejected others, and ignored still others. Congress now has an opportunity to draw upon the work put into the Commission's tax proposals by the Commission, its staff and the Advisory Committee, and also by many governmental and private groups that commented on the proposals considered by the Commission. We urge the Committee on the Judiciary to seize the opportunity now presented to rationalize the tax provisions of the bankruptcy law, which have not had substantial overhaul since the enactment of the present Bankruptcy Code in 1978.

**THE COMMISSION PROCESS**

The initial impetus for the Commission's tax agenda came from three sources. By letter dated August 28, 1996, the Internal Revenue Service (the "IRS") submitted to the Commission a thoughtful set of legislative proposals the IRS had been interested in for a long time. By report dated September 1996, a bankruptcy working group of the Department of Justice submitted a lengthy bound report to the Commission. The Justice Department report overlapped in substantial measure with the IRS submission, but some of the recommendations differ. Finally, the Commission held a meeting in Santa Fe, New Mexico on September 18, 1996, coincident with the meeting of the States' Association of Bankruptcy Attorneys. At that meeting, Commissioner James I. Shepard produced a lengthy memorandum of tax discussion issues.

Although non-governmental groups entered the process later, they contributed a substantial work product, the most significant of which was the report of the Task Force. Significant written submissions were also made by the Association of the Bar of the City of New York and the National Bankruptcy Conference.

In early February, 1997, Commission Chairman Brady Williamson appointed an informal tax advisory committee (the "Advisory Committee") to assist the Commission in "sifting and winnowing" the Commission's tax agenda. The Committee consisted of four government representatives, four private practitioners and two members of the academic community. The four government members included one high-ranking official of the Tax Division of the Justice Department, one person from the IRS National Office and assistant attorneys general from the states of Connecticut and Texas. The four private representatives included one partner at a large national law firm and three individual practitioners who regularly represent debtors in tax matters before the Bankruptcy Court. Thus, the Advisory Committee was designed, and proved, to be a forum in which all perspectives could be aired. The Advisory Committee held three all-day meetings in Washington and a number of ninety-minute conference calls over the course of the next five months. Although some of the early sessions were, at times, tense, the members grew to respect each other and respect each other's interest in having a well-functioning bankruptcy system that recognized the legitimate interests of the adversaries in the tax process. The Advisory Committee produced a report that divided all the tax issues according to their relative importance as agreed by the Advisory Committee members and by whether the proposals were controversial or subject to consensus. Although none of the Advisory Committee members had a formal mandate from a professional group or an employer, the Advisory Committee found or forged consensus on more than thirty proposals for important changes that would improve the administration of the bankruptcy laws in regard to taxes. With one exception, the Commission endorsed all the consensus recommendations. As to those important issues on which the Advisory Committee could not reach consensus, there was a full airing of views, a statement in support of each conflicting position, and a vote taken and recorded with respect to each proposal. Although as to some of these proposals all government members and all private members voted separately as a bloc, with the academic members sometimes breaking or reinforcing the tie, there were also instances in which individual members broke ranks with
their natural allies, revealing the effort of members to express an independent judgment on all questions of importance.

On some important issues where the Advisory Committee was divided, the Commission took up the items separately, and, after robust debate, made its own judgment. Some of these decisions were unanimous and others were themselves the product of a divided vote.

The work of the Advisory Committee and the Commission in the tax area drew wide praise both within and without the Commission. Some of the tax provisions in the Bankruptcy Code have simply not worked well in the twenty years since its enactment. The work of the Advisory Committee was the first systematic attempt to bring bankruptcy and tax professionals together to address these problems. There is widespread agreement that Congress should soon remedy the defects in the present statute. The Bill fails to seize that opportunity, and, in some cases, inexplicably departs from the consensus recommendations of the Advisory Committee and the Commission.

**PROVISIONS CONTAINED IN THE BILL**

This joint report responds to the tax provisions of the Bill. We hope and expect that the Committee on the Judiciary will hear from the government and other members of the private bar. We also hope Congress will not waste the important work of the Advisory Committee and the Commission and will consider all consensus proposals as part of the legislative process. Finally, we hope that with respect to both the consensus proposals and to those proposals where there continues to be disagreement between the government and the private bar, the Committee on the Judiciary will carefully listen to all sides and work toward a result that makes the bankruptcy and tax laws work well together.

1. Section 501 of the Bill would enact provisions first contained in the Investment in Education Act of 1997, introduced in the Senate by Senators Grassley and Durbin to accomplish two objectives. First, it would exempt ad valorem real or personal property tax liens from the operation of Section 724(b)(2) of the Bankruptcy Code. Thus, if a lien is properly perfected and unavoidable, it would be given effect as a secured claim in accordance with its usual priority, except that it would continue to be subordinated to claims for wages, salaries and commissions entitled to priority under Section 507(a)(3) of the Bankruptcy Code and to claims for contributions to an employee benefit plan entitled to priority under Section 507(a)(4) of the Bankruptcy Code. Other tax liens, for example, federal tax liens, would continue to be subordinated under the current provisions of Section 724(b)(2). However, before subordinating a tax lien in such a case, the trustee would be required to exhaust the unencumbered assets of the estate, and, in a manner consistent with Section 506(c) of the Bankruptcy Code, recover from property securing an allowed secured claim the reasonable and necessary costs and expenses of preserving or disposing of that property.

Local tax authorities dependent upon ad valorem taxes for financing governmental activities strongly support this amendment. In general, private bar groups, including the Task Force, making submissions to the Commission, opposed any repeal or modification of Section 724(b). Since then, the National Bankruptcy Conference has changed its position and now supports secured status for ad valorem real (but not personal) property tax liens.

Consideration of the proposal requires balancing two legitimate competing interests. On the one hand, local tax authorities, particularly school boards, that depend upon ad valorem taxes for substantially all of their revenue base, oppose any structuring of priorities in bankruptcy that would deprive them of a first claim upon property subject to a tax lien. On the other hand, the bankruptcy system, including Chapter 7 cases, must be financed out of the assets of the bankruptcy estate. Congress must decide whether the imperative of efficient administration of bankruptcy cases is sufficient to warrant treating these tax liens as a general priority item below administrative expenses, rather than as a secured claim that comes before those expenses. We believe that the federal interest in financing the bankruptcy system is superior. In opposing this provision of the Bill, we acknowledge that section 724(b) creates tensions in chapter 11
cases facing conversion. We believe that these problems should be addressed, and we offer our cooperation in doing so, but believe that the proposed solution is not the answer.

The second branch of Section 501 of the Bill would withdraw jurisdiction from the Bankruptcy Court to determine the amount or legality of any ad valorem real or personal property tax if the applicable period for contesting or redetermining that amount under non-bankruptcy law has expired. This proposal was never put before the Commission, and did not surface until hearings on the Investment and Education Act before the Committee on the Judiciary in the Senate. To the best of our knowledge, no bar association or similar group has yet taken a position on this portion of Section 501.

We oppose this proposal. The Bankruptcy Code has long conferred jurisdiction on the bankruptcy court to redetermine prepetition and administrative taxes. Jurisdiction exists when that tax was not previously "contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case." Under the literal language of the statute, the bankruptcy court has jurisdiction, even if the debtor has lost his rights, by neglect or otherwise, to challenge the assessment under local law.

Conferring jurisdiction on the bankruptcy court to determine liability where the statute of limitations has run is in the best interests of bankruptcy administration. Insolvent debtors facing liquidation may have had little incentive to exercise their rights to contest remedies in respect of taxes. Failure to do so visits unwarranted consequences on innocent unsecured creditors who may be required to stand behind meritless priority claims which would be required to be paid even if not substantively valid. Giving one last clear chance in the bankruptcy court obviates this injustice. There is no reasonable ground for excepting ad valorem taxes from this salutary principle.

2. Section 502 of the Bill purports to deal with spousal and child support, but appears to affect nondischargeable taxes as well. It is not clear whether any change from present law is intended. The language needs clarification at the least, and we reserve judgment on this provision if it is intended to change present law.

3. Section 503 of the Bill sets forth some specific requirements for notice given to governmental units of potential claims against a debtor. A similar provision was rejected by the Commission on the ground that it was properly a matter for the Advisory Committee on Bankruptcy Rules of the Judicial Conference (the "Rules Committee"). On the other hand, during the course of the Commission's deliberations, the Justice Department proposed a package of rules for consideration by the Commission that addressed the concerns of governmental entities. This package of rules was approved unanimously by the Advisory Committee and forwarded with a favorable recommendation by the Commission to the Rules Committee. The Rules Committee has yet to act on this proposal.

The content of any notice, together with sanctions for non-compliance, is a matter peculiarly within the province of the Rules Committee, as it can weigh the adequacy of notice to a governmental unit against the threat to a debtor's discharge resulting from technical, but insubstantial, non-compliance. Thus, the statute is no place for the kind of detail embodied in Section 503.

One portion of Section 503 is particularly disturbing in light of the history and development of this proposal. Proposed Section 342(g) of the Bankruptcy Code would provide in part, "If the debtor's liability to a governmental unit arises from a debt or obligation owed or incurred by another individual, entity, or organization, or under a different name, the debtor shall identify such individual, entity, organization or name." This proposal effectively requires a debtor to red flag a liability that has not yet arisen on pain of exception to discharge. A similar proposal was made by Commissioner Shepard at the Commission's meeting in Santa Fe on September 18, 1996. The Task Force and others objected to this proposal on the ground that it put the debtor in the position of notifying a governmental entity that he was potentially liable for a trust fund penalty, even if he were unaware of the potential liability or believed in good faith that no liability existed. The Advisory Committee reached a compromise, under which the debtor would
4. Section 504 of the Bill would amend Section 505(b) of the Bankruptcy Code to require that any request for a determination of tax liability under that section must be made “in the manner designated by the governmental unit.” Most groups that commented on a similar proposal, including the Task Force, agreed that a governmental agency should be entitled to notice to a person or address of its own choosing so notice would be calculated to be timely received by a person within the agency having jurisdiction of the subject matter. However, the equities of this proposal can be balanced only if the place for the notice is readily available to a debtor who seeks in good faith to comply. Thus, the Task Force suggested a court filing by a governmental unit wishing to enforce this form of notice upon the debtor. Without a central registry, at least within each judicial district or circuit, a well-intentioned debtor might be unable to locate the officer with whom the notice should be filed in the exercise of reasonable diligence because he would not know where to look. If this defect in the proposed statute is remedied, the proposal should be enacted.

5. Section 505 of the Bill provides that in any case where the Bankruptcy Code requires interest to be paid on deferred taxes, the rate of interest to be applied is the normal deficiency rate under Section 6621(a)(2) of the Internal Revenue Code, even for state and local taxes. The Task Force previously supported that proposal. This proposal was supported by the Task Force, agreed to by the private and the governmental representatives on the Advisory Committee and should be enacted.

6. Section 506 of the Bill would provide for the tolling of certain time periods provided in Section 507(a)(8)(A) of the Bankruptcy Code. Insofar as the proposal would add to the three-year nondischargeability period now applicable under Sections 507(a)(8)(A)(i) and 523(a)(1)(A) the period of time during which a prior bankruptcy case was pending, it is unobjectionable, and this provision received unanimous support in the Advisory Committee. Also, insofar as the provision would make the 240-day period under Section 507(a)(8)(A)(ii) for offers in compromise apply to pre-assessment as well as to post-assessment offers, it is also unobjectionable. However, the Bill goes further than the Advisory Committee agreement in two significant ways. First, the Bill would add six months to the tolling period in cases under Section 507(a)(8)(A)(i) in addition to the period during which the prior bankruptcy case was pending. Second, the Bill would toll the 240-day period under Section 507(a)(8)(A)(ii) for any time during which an installment payment agreement was in effect.

The apparent rationale for adding six months to the priority period under Section 507(a)(8)(A)(i) is to give a taxing authority sufficient time to reinstate collection proceedings after a dismissed case and to harmonize the government's rights with those granted the IRS under Section 6503(h) of the Internal Revenue Code. That Section tolls the periods for assessment and collection of taxes during the period in which a bankruptcy case is pending plus six months in the case of collection and sixty days in the case of assessment. In proposing to add six months to the priority period under Section 507(a)(8)(A)(i) to harmonize it with the Internal Revenue Code, the Bill goes too far. The IRS collection rights extend ten years after assessment under Section 6502, but assessment must be made within three years after return filing under Section 6501. Nothing in Section 507(a)(8)(A)(i) of the Bankruptcy Code impinges on those rights. If a taxing authority needs at least six months after the close of a bankruptcy case to reinstitute its procedures without losing its priority, we suggest that the tolling period be, for each prior case, the greater of six months or the time during which the prior case was pending.

We see no merit in the proposal to add any installment payment period to the 240-day rule of Section 507(a)(8)(A)(ii). This could add years to the tolling period and is a substantial departure from present law. The Advisory Committee rejected this proposal, noting that it would have the effect of punishing taxpayers who made a good faith effort to pay their entire tax liability while rewarding others who made no such attempt. We support tolling for a period during which a prior bankruptcy proceeding was
pending, oppose any add-ons that go beyond the philosophy of Section 6503(h) of the Internal Revenue Code, and oppose applying tolling during the pendency of installment payment agreements. These positions are consistent with the recommendations of the Advisory Committee.

7. Section 507 of the Bill would supply a definition of the term "assessment" to clarify a possible ambiguity in present law. Although the term "assessment" has a fixed and well-known meaning under the Internal Revenue Code, it is a much looser term under several state statutes, and some states do not use the term at all. State tax authorities requested a Bankruptcy Code definition, and the Advisory Committee unanimously agreed on the formulation. We support the provision as drafted.

8. Section 508 of the Bill would deny a discharge in Chapter 13 in respect of tax debts that could not qualify for a discharge in Chapter 7. As a result, the bill drastically restricts the relief available for tax debtors in Chapter 13. For example, recently assessed taxes (defined as taxes assessed within the last 240 days) are nondischargeable in Chapter 7. Section 506 of the Bill would extend the 240-day nondischarge period for any time period that installment agreements are in effect. In addition, some cases hold that taxes are nondischargeable in Chapter 7 if the taxpayer knew a tax obligation was due but failed to pay. Because Section 508 of the Bill would incorporate the tax nondischargeability rules of Chapter 7 into Chapter 13, the Chapter 13 "superdischarge" could be denied to taxpayers who simply fail to pay their taxes. Even scaling back the proposal to deny the superdischarge for fraud returns could produce unfortunate results if courts define the fraud necessary for nondischarge as only requiring a de minimis act.

Without the use of the Chapter 13 discharge, taxpayers are consigned to "tax purgatory." Beyond offers in compromise, which are extraordinarily difficult to obtain, there would be no Bankruptcy or Internal Revenue Code remedies available for these debtors. Thus, an individual who owes nondischargeable tax faces a lifetime of unpayable debt.

Proposals to lessen the relief available for tax debtors in bankruptcy are bad policy. At some point, the door must open for tax debtors to re-enter the system. The Bill also may have the unintended effect of reducing revenues. Chapter 13 trustees estimate that at least 10% of all Chapter 13 payouts are made to governmental units. Thus, in the FYE 1995, when trustees paid out over $2 billion in claims, the distributions to governmental units would have exceeded $200,000,000. Collection of this revenue required only the most minimal of governmental expenditures. Narrowing the scope of the Chapter 13 discharge may well have the effect of decreasing revenues collected.

Proposals to limit the scope of the Chapter 13 superdischarge failed before the Advisory Committee and the Commission. Enactment of such limitations would be a mistake. We oppose Section 508 of the Bill.

9. Section 509 of the Bill would deny Chapter 11 discharge to tax liabilities arising from fraudulent tax returns filed by corporations. We oppose this proposal. Unlike the Bankruptcy Code's individual discharge provisions, which have many exceptions (e.g., fraud, false financial statements, drunk driving liability, alimony and child support), the Chapter 11 discharge given to a corporation is complete. Making an exception, even for fraudulent taxes, is unfair to holders of claims as well as to lenders who provide post-confirmation financing. Moreover, if this exception is made, it will undoubtedly encourage other supplicants to Congress to urge their claims for other exceptions as equally worthy. This would be an unhealthy development for the reorganization process.

10. Section 510 of the Bill would provide an exception to the automatic stay for appeals from certain court and administrative decisions determining a tax liability of the debtor. It would also remove the automatic stay from any Tax Court proceeding involving a taxable year ending after the petition date. This provision is unobjectionable, and we support it.

11. Section 511 of the Bill would amend Section 1129(a)(9) of the Bankruptcy Code to require level periodic payments of deferred priority taxes. The Task Force supported this principle. The Advisory Committee also adopted a similar proposal. While proposed Section 511 is unobjectionable in principle, it needs some redrafting. The statute could appropriately require equal quarterly installments as a general
rule, thus preventing balloon payment plans, but should give the Bankruptcy Court discretion to depart from this requirement for good cause shown.

Section 511 would also apply the six-year payment stretch-out to secured tax claims that would otherwise qualify as priority claims. The Advisory Committee adopted the proposal by consensus and we support it.

Finally, we note that the Advisory Committee recommended that the six-year payment period in Section 1129(a)(9)(C) run from the date of the order for relief rather than from the date of assessment. The Bill fails to address this proposal.

12. Section 512 of the Bill would amend Section 545(2) of the Bankruptcy Code by adding the words "except where such purchaser is a purchaser described in Section 6323 of the Internal Revenue Code of 1986 or similar provision of state or local law." Under Section 545(2) as presently drafted, a statutory lien may be avoided by a trustee to the extent that such lien is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser. Under Internal Revenue Code Sections 6323(b) and (h)(6), a purchaser without knowledge of a tax lien can acquire stocks, securities, motor vehicles, inventory, certain goods purchased at retail, and certain household goods valued at less than $250.00 per item free and clear of a tax lien. A purchaser is one who takes for adequate and full consideration in money or money's worth. If the bona fide purchaser under Section 545 of the Bankruptcy Code is the same as the purchaser for adequate and full consideration under the Internal Revenue Code, then a trustee may avoid tax liens on all such property. However, several cases hold that a bona fide purchaser under Section 545 is not the same as a purchaser for adequate and full consideration in money or money's worth, i.e., the Bankruptcy Code standard is a lower standard, and thus the trustee cannot use Section 6323 to avoid a tax lien. The proposed amendment codifies this latter view. The Task Force did not object to this proposal before the Commission, and we support it now.

13. Section 513 of the Bill would amend the Bankruptcy Code and related statutes to require that postpetition taxes be paid in the ordinary course of business, that ad valorem real property taxes be paid when due, and that no request be required of a governmental unit as a condition for the debtor's payment of an administrative period tax liability in the normal course. The Advisory Committee adopted this proposal. We support this provision, but believe that an exception should be made in a case where the estate is administratively insolvent.

14. Section 514 of the Bill would cut off the date upon which a late-filed tax claim would be entitled to distribution in Chapter 7 on the date "the court approves the final report and accounting of the trustee," rather than the date on which "the trustee commences distribution." This provision was a consensus recommendation of the Advisory Committee and we support it.

15. Section 515 of the Bill would liberalize the exception to discharge under Section 523(a)(1)(B) of the Bankruptcy Code for taxes attributable to unfiled returns and certain late filed returns by providing that a return includes a return filed pursuant to Section 6020(a) of the Internal Revenue Code, or similar state or local law, or a written stipulation to a judgment entered by a non-bankruptcy tribunal. We support this proposal, which is based upon a consensus recommendation of the Advisory Committee. However, there is an ambiguous qualification in proposed Section 523(a)(1)(B)(iii)(II) that the return "must have been filed in a manner permitted by applicable non-bankruptcy law." The objective of this proviso is not apparent, and it would appear to contravene the basic thrust of the amendment. We believe the proviso should be deleted, but we otherwise support the proposed amendment.

16. Section 516 of the Bill would add the estate to the debtor, a successor to the debtor and the trustee as a person who would be protected from a tax claim upon the failure of a governmental unit to respond to a request for a determination of taxes under Section 505(b) of the Bankruptcy Code. The Task Force urged enactment of this change in its earlier report. This provision was adopted by the Advisory Committee and approved unanimously by the Commission. We support it.

17. Section 517 of the Bill would require debtors, as a condition for obtaining Chapter 13 relief, to have filed the last six years of tax returns prior to the first meeting of creditors. The six year cutoff was a
compromise and consensus recommendation of the Advisory Committee. We support the principle. However, the provision as drafted needs some clean-up.

First, the proposal provides that the trustee "may continue" the first meeting for prescribed short time periods to enable the debtor to file delinquent returns and returns under extension. The Trustee's discretion should not be unfettered. An otherwise compliant debtor should be entitled to these continuances.

Second, the Bill provides that further continuances may be granted by the court where the debtor demonstrates, by clear and convincing evidence, that the failure to file returns is due to circumstances beyond the control of the debtor. The clear and convincing standard goes beyond the recommendation of the Advisory Committee, and seems unnecessary. Third, the expanded definition of return mirrors the exception to discharge provision discussed in connection with Section 515 of the Bill, above. The same objection to the proviso language applies.

18. Section 518 of the Bill would require that "any disclosure statement under Section 1125(a) of the Bankruptcy Code include a full discussion of the potential material federal and state tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case."

The Bill as drafted goes beyond the original proposal of the Task Force by requiring a full discussion of material state tax consequences to the debtor and to the holders of claims and interests. Requiring a discussion of state tax consequences to the debtor is appropriate if there is an applicable state law differing from the provisions of the Internal Revenue Code that would have a material adverse impact on the debtor. Otherwise, no specific discussion of state tax consequences should be required. More important, no discussion of state and local tax consequences should be required in respect of holders of claims and interests. There seems no good reason to put the debtor to the expense of ascertaining and disclosing consequences under every conceivably applicable state law tax. Disclosure statements routinely refer such holders to their own tax advisors for this advice, and this would seem appropriate.

Finally, we note that Section 232 of the Bill would provide relaxed disclosure requirements in small business cases and Section 233 of the Bill envisions standard form disclosure statements in these cases. In enacting the disclosure statement requirement of Section 518 of the Bill, it should be made clear that its requirements must be applied in the light of, and consistently with, Sections 232 and 233 of the Bill in small business cases. As so amended, we support the proposal.

19. Section 519 of the Bill would give taxing authorities, without court approval, a limited right to set off prepetition income tax refunds against prepetition income tax liabilities. The Task Force opposed a more extensive setoff proposal made by the IRS. The Commission limited setoff rights to prepetition income tax refunds against uncontested prepetition income tax liabilities. We would be prepared to support such limited automatic setoff rights, but the Bill does not reflect the Commission proposal. First, the Bill would require a Bankruptcy Code Section 505 proceeding to have been commenced to avoid automatic setoff. There is no reason for this qualification if the court would still have jurisdiction to resolve any dispute through the claims objection process. Second, the Bill would allow the taxing authority to hold the refund pending resolution of the dispute. This is merely a setoff in a different guise and we oppose it. The Bill should be amended to carry out the Commission's recommendations and if that is done, the proposal would have our support. If it is enacted, existing local rules and standing orders containing broader setoff rights should be withdrawn.

20. Section 125 of the Bill provides that the holder of a secured claim retains the lien securing that claim until the earlier of payment of the underlying debt determined under non-bankruptcy law or discharge under Section 1328, and that if the Chapter 13 proceeding is dismissed or converted without completion of the plan, the lien will also be retained by the holder to the extent recognized by applicable non-bankruptcy law. A similar, but narrower, proposal was made by taxing authorities before the Commission. The Advisory Committee did not act on this proposal. The Task Force opposed the proposal.
because it gives the secured creditor a windfall. If the secured claim is discharged by payment, the secured creditor should not have the right to reattach the lien to the property, but if it otherwise has the right to have its lien attached to the debtor's property subsequent to dismissal of the case, the lien could attach to any property acquired postpetition or any property owned prepetition that was not included in valuing the government's secured claim. This problem is particularly acute when the property subject to the lien is household goods of a small debtor. For the reasons that caused the Task Force to oppose the narrower proposal, we oppose the broader one.

21. Section 403 of the Bill would extend the "deemed filed" rule to cases under Chapters 7 and 13 by providing that a proof of claim or interest is deemed filed under those chapters when the debtor's schedules list the claim other than as disputed, contingent, or unliquidated. The Task Force opposed this provision before the Commission. The Advisory Committee deemed it unimportant, and neither the Advisory Committee nor the Commission took it up. Schedules filed by the debtor are often replete with errors. This is more likely to be true in a consumer case under Chapter 7 or Chapter 13 than it is in business reorganizations under Chapter 11. Adoption of the deemed filed rule in consumer cases places an unnecessary burden on the trustee to determine the validity of every scheduled claim. The creditor is in a position to file a claim based on his own records and to support it with appropriate documentary evidence. The balance of the equities requires leaving present law undisturbed.

OTHER COMMISSION PROPOSALS

Equally important as the need for conforming the legislation proposed in the Bill to consensus items of the Commission and the Advisory Committee is the need to consider a number of consensus proposals that do not appear in the current draft of the Bill. Some of these are important to the administration of the bankruptcy laws.

The most important of these proposals is a systematic coordination recommended by the Advisory Committee and adopted by the Commission of the state and local tax provisions of the Bankruptcy Code with those in the Internal Revenue Code. The tax provisions of the Bankruptcy Code were part of the Bankruptcy Reform Act of 1978. The tax provisions of the Internal Revenue Code were part of the Bankruptcy Tax Act of 1980. The 1980 legislation was the product of extended consideration by the bankruptcy and tax bars and the Joint Committee on Taxation of the Congress of the United States. It was expected at the time of the Bankruptcy Tax Act that after enactment of the federal provisions, conforming changes would be made to the Bankruptcy Code. This never happened. As a result, there are many tax rules enacted for state and local tax purposes that differ from similar rules that apply for federal tax purposes. The Advisory Committee believed that it was absolutely necessary to conform these provisions because non-parallel treatment makes no sense and often created undue burdens on debtors and trustees. For example, the provisions relating to the taxable year of an individual for the year of bankruptcy filing under Section 1398 of the Internal Revenue Code differ from the corresponding provisions under the Bankruptcy Code. This is inappropriate, because most state income tax laws mirror the substantive provisions of federal tax law, and it is expected that a debtor's starting point for computing his state tax liability is federal taxable income. The Advisory Committee dealt with this by conforming the state tax provisions of the Bankruptcy Code to those that now appear in the Internal Revenue Code.

Another instance is the situation in which a family farmer files for bankruptcy under Chapter 12 of the Bankruptcy Code. Under the Bankruptcy Code, a separate taxable entity is created and the individual's income for the postpetition period is reported on a separate return and paid out of the assets of the estate. For federal income tax purposes, no separate taxable entity is created. Thus, the individual includes all of
this farm income on his personal tax return and is liable for the tax. This is a clear oversight that occurred because federal and state tax laws were not conformed when Chapter 12 was created. The Advisory Committee proposed eliminating the separate estate rule as it appears in Chapter 12 to conform Chapter 12 tax filing rules with those in Chapter 13. As in the case of the taxable year issue, the Advisory Committee proposals are non-controversial, and are absolutely necessary to a rational working of the bankruptcy laws. Congress should use this occasion to adopt all of the state/federal conformity rules proposed by the Advisory Committee.

There are other places where legislative action is urgently needed, but there may not be consensus as to the proper legislative fix. Any disagreement, however, does not obviate the necessity for Congress to act in the interest of rational administration of the bankruptcy law. For example, two Court of Appeals cases hold that the tax liability of a corporation for the year in which it files a bankruptcy petition should be divided into a prepetition component that can be stretched out under the provisions of Section 1129 of the Bankruptcy Code and an administrative component that must be paid currently as a course of business expense. Governmental taxing authorities object to these decisions, in part because they believe that such tax liability should be entirely an administrative expense, but also because a prepetition liability is created with respect to a period for which no tax return is due. Thus, the governmental taxing authority may lose its right to collect the tax altogether if it does not file a timely proof of claim. Although there are several possible responses to this problem, the Commission dealt with it by adopting a compromise proposal under which the liability for the year of bankruptcy filing would presumptively be treated as an administrative expense, but the debtor could bifurcate the tax year pursuant to an election. The advantage of this elective procedure is that it would require the debtor to file two returns for the year of bankruptcy filing, thus putting the government on notice that it must file two claims in the bankruptcy case instead of one.

**FEDERAL TAX MATTERS**

The Commission and the Advisory Committee also made a number of specific recommendations which would have the effect of amending federal tax rules contained in the Internal Revenue Code. Some of these are significant, including provisions relating to the carryover of net operating losses by Chapter 11 corporate debtors, provisions governing the tax treatment of abandonment of property by trustees in individual cases, and provisions setting forth the tax consequences of the use of property to satisfy non-recourse debt. For obvious reasons, the Bill does not address these issues. It is our intention to bring these issues to the attention of the tax writing committees of both Houses of Congress so that they can be considered in an orderly fashion on a parallel track with the Bankruptcy Code amendments. In seeking consideration of these issues by the tax writing committees, we do not in this report endorse any individual proposal, but reserve comment thereon until a later date.