Treatment of Tax Claims in Chapter 11

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A. 11 USC 1129(a)(9). As to priority tax claims under Section 507(a)(8), Section 1129(a)(9) provides that the court can confirm a plan only if:

> Except to the extent the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that–
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> > (C) with respect to a claim of a kind specified in section 507(a)(8) of this title, the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

The emphasis is on six years from the date of assessment of the taxes, not six years from the date of the bankruptcy filing or the date of confirmation of the plan, a mistake commonly made by debtors' counsel.

I. Interest Rate for Discounting Deferred Payment of Priority Tax Claims. The IRS has taken the position that the interest rate specified in IRC Section 6621 is the appropriate discount rate to use when determining the present value of deferred payments of priority tax claims. In re Camino Real Landscape Maintenance Contractors, Inc., 818 F2d 1503 (9th Cir. 1987) held the appropriate interest rate must be determined on a case-by-case basis but must be at least equal to the debtor's available rate with a commercial lender. In re Southern States Motor Inns, Inc., 709 F2d 647 (11th Cir. 1983) held the applicable rate is the current market rate. In re Tacoma Recycling, Inc., 23 BR 547 (BC WD Wash 1982) held the applicable rate is the federal judgment rate under 28 USC 1961.

II. Effect of Confirmation on Nondischargeable Tax Claims. Section 1141(d) of the Bankruptcy Code provides in pertinent part:

> (1) Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan –
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> (A) discharges the debtor from any debt that arose before the date of such confirmation,

> and any debt of a kind specified in section 502(g), 502(h) or 502(i) of this title, whether or not (i) a proof of claim based on such debt is filed or deemed filed under section 501 of this title; (ii) such claim is allowed under section 502; or (iii) the holder of such claim has accepted the plan; and
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> (B) terminates all rights and interests of equity security holders and general partners provided for by the plan.
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> (2) The confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge under section 523 of this title.

D. Jurisprudence on Effect of Confirmation on Tax Claims.

In In re Howell, 84 BR 834 (M.D. Fla. 1988), a creditor had a non-dischargeable judgment resulting from a conversion claim. The debtor's plan provided for monthly payments of the debt until paid in full. The plan precluded the creditor from executing or collecting the debt outside the plan. The court held that, although the creditor "is entitled to participate in the distribution under the plan to unsecured creditors, it also has the right to execute or collect on its nondischargeable judgment debt free from the injunctive and other provisions of the plan." *Id.* at 835.

Howell relied on Friend v. Talcott, 228 US 27, 33 S.Ct. 505, 75 L.Ed 718 (1913) and the Supreme Court's statement there that

> It is apparent that the exemptions [from discharge] do not rest upon any theory of the exclusion of the creditor from the bankruptcy act, or of deprivation of right to participate in the distribution, but solely on the ground that, although such rights are enjoyed, an exemption from the effect of the discharge is superadded.

Friend involved a creditor who held a nondischargeable claim on which it received payment of a portion of it under the plan and sought to obtain the deficiency by suing the debtor in state court. The debtor reopened the case seeking to enjoin the creditor on the basis that the creditor had elected to be treated under the plan and, therefore, its claim should have been considered discharged. The court stated that it was a misconception to think the exception to discharge under the Act excludes treatment of that debt from the Act such that the creditor could not participate in the distribution of assets. Since the creditor had the right to participate in the plan and collect outside the plan because its claim was nondischargeable, the court rejected the debtor's theory of election and waiver of remedies based on filing the proof of claim and acceptance of the distribution in the plan.

In In re Amigoni, 109 BR 341 (Bankr. N.D. Ill. 1989), the debtors had been convicted under a federal criminal statute and ordered to make restitution over five years. The plan provided to pay this restitution our over ten years. The court denied confirmation on the basis that the debtors could not use bankruptcy law to alter the restitution and the party holding a nondischargeable debt could not be enjoined from enforcing its rights outside of bankruptcy.

Amigoni cited In re Adelman, 90 BR 1012 (Bankr. S.D. 1988). There the issue was whether the failure of a creditor holding a nondischargeable claim to participate in the plan process could result in a waiver of its rights to act outside the plan. The court held the creditor had not waived its nondischargeability claim by failing to participate in the confirmation process and "the confirmed plan did not bind [creditor] as to the dischargeability-nondischargeability of his claim, just as the Gurwitch confirmed plan did not bind the IRS as to the amount of nondischargeable taxes." *Id.* at 1018.

The plan of reorganization in In re Gurwitch, 794 F.2d 584 (11th Cir. 1986), provided for the payment of taxes in a lump sum. After the plan was consummated the IRS assessed additional tax penalties not set forth in its proof of claim. The 11th Circuit held that the penalties could be collected outside the terms of the plan. Responding to the debtor's argument that the amount of the tax should be fixed by the confirmation of the plan, the court said "Congress has made the choice between collection of revenue and rehabilitation of the debtor by making it extremely difficult for a debtor to avoid payment of taxes under the Bankruptcy Code." Gurwitch at 585-6. The court in Gurwitch had relied on In re Becker's Motor Transportation, Inc., 632 F.2d 242 (3rd Cir. 1980) which was also a tax case. There, after the plan had been consummated, the IRS assessed additional penalties on the debtor. The issue was whether the bankruptcy court could enjoin the IRS collection efforts. There, the court pointed to the Anti-injunction Statute providing "[N]o suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person." 11 USC §7421(a). Thus, the court in Becker's held that a federal statute specifically excluded such an injunction and found itself without power to ignore that limitation on its authority. The Gurwitch court went on to hold that the Bankruptcy Code "makes clear under 22 USC §1141(d)(2) that the confirmation of a plan of reorganization does not fix tax liabilities made nondischargeable under 11 USC §523. Moreover, the

Code states that these taxes are nondischargeable 'whether or not a claim for such tax is filed or allowed.' Section 523(a)(1)(A)." Gurwitch at 586.

In re Mercado, 124 BR 799 (Bankr. C.D. Calif. 1991), went through an exhaustive review of the jurisprudence up to the time of the decision and reached the conclusion that an injunction in a plan against a holder of a potential nondischargeable claim was not per se inconsistent with the Bankruptcy Code provision in §1141 prohibiting a confirmed plan from discharging nondischargeable debts. The court relied in large part on the Supreme Court's decision in United States v. Energy Resources Co., Inc., 495 U.S. 545, 110 S.Ct. 2139, L.Ed.2d 580 (1990), which approved a plan provision which required the IRS to apply payments under the plan on nondischargeable tax claims first to the trust fund portion of the claims and then to the remaining tax liability where the bankruptcy court finds that this action is necessary for a reorganizaton's success. The Mercado court stated that "a broad flexible approach to §1141(d)(2) to give a debtor the ability to deal effectively with its nondischargeable claims would not be inconsistent with the views of the Supreme Court as expressed in Energy Resources. In balancing the interests of the creditor against the needs of the debtor, unwarranted restrictions on bankruptcy courts and debtors in the reorganization setting are unnecessary and contrary to the goal in bankruptcy of giving debtors a 'fresh start'. Otherwise, a creditor holding a nondischargeable debt is in a position to undercut a debtor's attempt to reorganize, possibly harming other creditors who might benefit from the proposed plan." 124 BR at 803.

In 1993, the 10th Circuit decided the case of Grynberg v. U.S., 986 F2d 367 (10th Cir. 1993) in which the debtors had brought an adversary proceeding seeking an injunction against the IRS efforts to collect gift taxes. There, the court held that (1) gift taxes allegedly owed by the Chapter 11 debtors on intra-family transfers were nondischargeable as "excise taxes" on transfers occurring within three years prior to the filing; (2) the claims bar order did not preclude the IRS from collecting the nondischargeable gift taxes outside of bankruptcy after confirmation of the plan; and (3) the failure of the IRS to file a proof of claim for the gift taxes did not prevent it from having a "claim", even though it would not be allowed, and thus did not prevent disputed gift tax from being a "debt," for nondischargeability purposes. In this case, before the claims bar date, the IRS had filed a proof of claim for income taxes but not for the gift taxes. After the plan was fully consummated, the IRS moved to assess the gift taxes against the debtor. The court found that "these gift taxes fit within the §523(a)(1)(A) exception to discharge that covers taxes entitled to priority under §507(a)(7) . . . Although §507(a)(7) refers to 'allowed unsecured claims of governmental units,' §523(a)(1)(A) makes clear that these taxes remain nondischargeable 'whether or not a claim for such tax was filed or allowed.'" Finding the debtor's argument that the claims bar order disallowed the gift tax claim to be unconvincing, the court held that §523(a)(1)(A) "was intended to prevent the discharge of tax claims which were never filed or filed late but which would otherwise have been allowable." Citing with approval Spruill v. South Atl. Prod. Credit Assoc., 83 BR 359 (Bankr. E.D. N.C. 1988). The court also cited In re Olsen, 123 BR 312 (Bankr. N.D. Ill. 1991) with approval for the statement that "the Bankruptcy Code makes it clear that the actual allowance of a tax claim as a priority debt and the nondischargeability of a tax claim are not related." *Id.* at 314. The court also noted that the debtor could have alleviated some of its problems by filing a proof of claim for the IRS under §501(c) of the Bankruptcy Code.

In In re Martin, 150 BR 43 (Bankr. S.D. Cal. 1993), the bankruptcy court enjoined the IRS from attempting to collect pre-petition taxes outside the terms of the debtor's confirmed plan of reorganization. The IRS had filed a proof of claim covering the taxes and had objected to the terms of the plan on the basis that the debtors never filed tax returns for the years in question. To resolve the objection, the IRS and the debtors stipulated in open court that the debtors would file tax returns for the relevant years, that the IRS would then file supplemental or amended proofs of claim to which the debtors had the right to object. This agreement was incorporated into the terms of the plan and the plan was confirmed by the bankruptcy court. The IRS subsequently filed amended proofs of claim showing no tax due. Two and one-half years later the IRS issued notices of deficiency, followed by notices of levy, prompting the debtor to bring an adversary proceeding seeking to enjoin the collection of the taxes. The bankruptcy court noted that the IRS had "submitted its claim to the jurisdiction of the bankruptcy court," and could not "unilaterally withdraw the jurisdiction by employing unapproved, less confining procedures." *Id.* at 46. The court distinguished cases cited by the IRS on the basis that the IRS chose to participate in the plan and to enter into an agreement regarding "procedures [that would be used] for determining the amount of its nondischargeable claim." *Id.* at 46-47. The court noted that "the case law is clear that the IRS is authorized to enter into agreements regarding tax obligations and such agreements are final and binding." *Id.* at 45. On the basis of this finding, the bankruptcy court issued the injunction.

The 5th Circuit held similarly in Fein v. United States 22 F3d 631 (5th Cir. 1994) in rejecting a debtor's argument that allowing the IRS to wait until after confirmation of the plan to pursue its claim for pre-petition taxes, of which the debtor and the other creditors were not previously aware, would prejudice the debtor's reorganization and impair his fresh start. Noting that "the courts of appeals that have considered this issue have concluded that in the case of individual debtors, Congress consciously opted to place a higher priority on revenue collection than on Debtor rehabilitation or ensuring a 'fresh start,'" the court held that "[w]ith regard to individual debtors, . . . the deleterious effects of hidden liabilities . . . are outweighed by the desire for revenue collection." Fein at 633.

The following year, the 10th Circuit followed Fein in holding that the IRS was not barred by res judicata principles from assessing or collecting any additional taxes for a tax year beyond those provided for in the debtor's plan of reorganization and the IRS was not equitably estopped from pursuing the additional tax liabilities for that tax year. Depaolo v. United States, 45 F.3d 373 (10th Cir. 1995). In this case, the IRS and the debtors executed a stipulation providing that the amount of the allowed claim of the IRS provided for in paragraph 3.01 of the debtor's plan was $74,434.72 plus interest, that the debtors would begin monthly payments to the IRS under the plan in the amount of $1,400 within thirty days of the plan's confirmation, and that the claim would be paid in full upon the sixtieth payment. In connection with this stipulation, the IRS filed a second proof of claim with this for what it believed to be the debtor's tax liability for the years 1984, 1985, 1986 and 1987. The IRS did not object to the plan and it was confirmed by the bankruptcy court on April 19, 1988. The confirmation order provided that the debtors were "discharged from any debt that arose before the date of confirmation, subject to the conditions and exceptions contained in 11 USC §1141(d)(1)." In October of 1989, the bankruptcy case was closed. In November 1989, the IRS issued notice to the debtors that their 1986 tax returns were to be audited. The audit revealed a deficiency and the debtors moved to reopen the bankruptcy case to bring a declaratory judgment action on the principles that res judicata and equitable estoppel prohibited the IRS from assessing the additional taxes. The court of appeal found that the language of §§1141 and 523 prohibited the application of those principles to the facts of the case. "By expressly providing that the described taxes are not discharged "*whether or not* a claim for such taxes was filed or allowed," 11 U.S.C. §523(a)(1)(A) (emphasis added), Congress has determined that the IRS may make a claim for taxes for a particular year in a bankruptcy proceeding, accept the judgment of the bankruptcy court, then audit and make additional claims for that same year, even though such conduct may seem inequitable or may impair the debtor's fresh start." *Id.* at 376. The court found equitable estoppel inapplicable on the failure of the debtor to show "affirmative misconduct" on the part of the IRS.

In United States v. Victor, 121 F.3d 1383 (10th Cir. 1997), the 10th Circuit ruled on a Chapter 11 debtor's declaratory judgment action that the IRS' unasserted claims for postpetition, preconfirmation interest on its secured tax claim had been discharged upon plan confirmation as the IRS' failure to assert its claim for such interest or to object to the debtor's plans on grounds that they did not provide for interest precluded the IRS's recovery. Finding that "Sections

523(a)(1) and 507(a)(7) [now (8)] clearly instruct that tax debts are nondischargeable only if characterized as "allowed unsecured claims." The 10th Circuit rejected the argument of the IRS (later adopted by the 11th Circuit in In re Gust) that the meaning of §§523(a)(1) and 507(A)(8) cannot be reconciled under a reading that requires the tax debt to be an allowed unsecured claim because §523(a)(1) preserves debts for particular taxes "whether or not a claim for such tax was filed or allowed." §523(a)(1)'s concluding language, the IRS maintained under this argument, is rendered superfluous by this interpretation. The government argued the two sections can only mean the nature of the claim–as filed, as allowed, or as unsecured–has no bearing on whether it is of a kind intended to be excepted from dischargeability. Because the 10th Circuit found the interest to be part of the IRS's secured claim, it was rendered dischargeable and thus could not be pursued by the IRS outside of bankruptcy. Because the IRS failed to assert its right to the interest in the bankruptcy case, it was unable to collect it through the plan either. Under **Gust** in the 11th Circuit, the case would have had a different outcome since the interest would have been part of the IRS's nondischargeable claim. The 5th Circuit appears not to have spoken to the issue as of this time.

The 5th Circuit decision in In re Taylor, 132 F3d 256 (5th Cir. 1998), highlighted the potential use of 11 USC §505 to give some closure to tax claims in the chapter 11 process. Here, the court ruled that because the debtor failed to move under §505 for a determination of his tax debt, his "Plan [was] not res judicata as to the amount of his liability . . ., and the IRS [was] not barred from proceeding against him to collect" the sum due. In this case, the debtor listed the IRS on his schedules as a potential creditor with an "unassessed potential penalty–unpaid corporate taxes" claim estimated at $80,000.00, which the debtor characterized as contingent, unliquidated, and disputed. The debtor's disclosure statement included provision for a class of claims consisting of "all claims entitled to priority of payment in accordance with 11 U.S.C. §507 including: . . . [a]ny claim for taxes or penalties owed to the Internal Revenue Service, including but not limited to penalties under 26 U.S.C. §6672." The plan proposed that this class be treated as follows: "Pursuant to 11 U.S.C. §505, Debtor is not indebted for any claims in this class. All such claims, whether or not now asserted, are discharged without receiving payment." The disclosure statement contained nearly identical provisions, estimated the amount of prepetition tax claims to be "$0," and identified the debtor's position with the corporation with respect to which he was a responsible person for purposes of the withholding taxes. The IRS initially filed a proof of claim for unpaid personal income taxes for 1992 to which the debtor objected. After an audit, the IRS withdrew the claim. The plan was confirmed with appropriate notice to, but without participation of, the IRS at the hearing. When the IRS moved to assess a §6672 penalty against the debtor, the debtor initiated an adversary proceeding seeking a declaratory judgment that he was not indebted to the IRS for the penalty. The debtor argued that the res judicata effect of the plan under Republic Supply Co. v. Shoaf, 815 F2d 1046 (5th Cir. 1987) and collateral estoppel barred the IRS from proceeding against him to collect the trust fund penalty. In Shoaf, the 5th Circuit had given res judicata effect to a confirmed plan that released a third-party guarantor on one of the debtor's debts such that the nonobjecting creditor was barred from proceeding against the third-party guarantor despite the fact that the Bankruptcy Code's prohibition against the release of liability of a third party found in §524 might have led to a different result on direct appeal of the confirmation order. The court reviewed its previous decision in Simmons v. Savell (In re Simmons), 765 F2d 547 (5th Cir. 1985), which considered whether a confirmed plan could substitute for an objection to a secured claim. The court noted that:

> [u]nlike an objection to a proof of claim, the filing of a plan does not generally initiate a contested matter with respect to a particular claim, and when a plan is filed with a petition (as in the case of a Chapter 13), creditors may not have even contemplated filing proofs of claims. *Id*. at 552. In deciding that the plan could not substitute for an objection to the secured claim at issue, this court stated:
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>> given the differences in purpose and effect of filing a plan and lodging an objection, Simmons' filing of the plan did not clearly place the claim in issue. The plan is like a proof of claim to which objections are filed, thereby instituting contested matters, rather than a vehicle through which objections are made . . . *The Code and the Rules do not envision the use of a Plan as a means for objecting to proofs of claims.* Consequently, we hold that Simmons' plan did not constitute an objection to Savell's proof of secured claim.

The court then commented that the debtor failed to invoke the power of the bankruptcy court to determine the amount of the §6672 penalty. He did not file a proof of claim on behalf of the IRS or file a motion under §505, one of which is necessary to compromise a nondischargeable debt. "Taylor's listing of the debt in his schedules, disclosure statement, and Plan along with the recitation "Pursuant to §505" did not invoke in any way the tax determination process." In re Taylor at 262. Consequently, the plan did not operate as res judicata with respect to the amount of the §6672 penalty. In conclusion, the 5th Circuit stated:

> We do not hold that a bankruptcy court must have distinct proceedings in order to determine a tax debt or that the court cannot combine a §505 hearing and a plan confirmation hearing or address a tax debt in another manner. *See Cook*, No. 93-7459, slip op. At 5 (noting that a combined hearing would be acceptable and that surely creative bankruptcy courts have properly used other methods to efficiently deal with the issues before the court). Rather, we hold that the confirmation of a plan does not itself invoke the tax determination process.

Bartleson v. Bartleson, 253 BR 75 (BRAP 9th Cir. 2000) - Creditor held stipulated judgment declaring debt non-dischargeable which, along with another dischargeable claim of the creditor, was placed in the general unsecured class in a Chapter 11 plan of the debtor. The plan proposed to pay 100% of the unsecured claims. The plan described the assets of the debtor which would be used to fund the plan. The plan did not contemplate use of certain non-exempt assets, such as the debtor's post-petition earnings, to make plan payments. The plan did not contain any provision enjoining the holders of non-dischargeable debts from pursuing collection of such debts outside the plan. The holder of the non-dischargeable debt objected to the plan on grounds the discharge language was not explicit in carving out the creditor's claim as being excepted from the discharge. Upon amendment of the plan to so provide, the creditor voted for the plan and the plan was confirmed. Subsequently, when the creditor moved in the bankruptcy court to execute on the debtor's post-petition earnings, the bankruptcy court held the collection rights of the creditor were subject to the terms of the plan of reorganization. The bankruptcy appellate panel framed the issue as: "Whether a confirmed plan of reorganization setting forth a payment plan governing a nondischargeable debt precludes the holder of that nondischargeable debt from exercising collection rights outside the plan, even though the plan does not include any provision specifically restricting or enjoining such collection activity." Framed another way, the court stated: "the issue is whether, by including provisions in the Plan purporting to establish a payment plan governing the Total Debt [the creditor's discharged claims and non-dischargeable claims], Debtor can control the timing and payment of the nondischargeable portion of this debt, even though Debtor failed to include any provision in the Plan specifically restricting or enjoining Creditors' collection rights and failed to dedicate the Non-Plan Assets to the funding of the Plan." After reviewing the jurisprudence represented by the Mercado, Martin, Wood, Howell, Gynberg and Depaolo decisions, the bankruptcy appellate panel held that under facts of this case, (1) where the debtor did not specifically include an injunctive provision in his Plan, (2) where the debtor failed to dedicate his non-plan assets to fund the plan, and (3) where the creditors did not take any action which should stop them from pursuing collection activity, the panel elected to follow the Depaolo decision and what it viewed to be the majority line of cases, and held that the confirmed plan did not preclude the creditor from collecting their non-dischargeable claim outside of bankruptcy.

In re Matunas, 261 BR 129 (Bankr. D N.J. 2001), dealt with a stipulation agreement entered into by the debtors and the IRS determining the amount of secured, priority and unsecured tax claims owed by the debtor to the IRS. The debtors' Chapter 11 case was purely tax claim driven as the purpose of the filing was to resolve outstanding issues with the IRS regarding the amount of secured and unsecured tax claims. After the plan was confirmed, the debtors entered negotiations with the IRS to agree upon the amount of prepetition taxes and a payment schedule, resulting in an agreement supplementing the debtor's plan. A stipulation was filed which set out the amount of the IRS's secured claim, the unsecured priority claim, and the unsecured claim. The stipulation acknowledged there would be no payment on the unsecured claim. The debtors proceeded to pay out the secured and the unsecured priority claim within a year and actually overpaid the claim. At this time, the IRS asserted additional tax liability for one of the years that had been covered in the original stipulation. The bankruptcy court held the stipulation agreement remained binding on the IRS, and permanently fixed the pre-confirmation tax liability owed to the IRS by the debtors. The matter was therefore ruled res judicata.