

a) State and Local Taxes—Bankruptcy Code §§346, 728 and 1146.

Because the United States Constitution provides that all tax legislation must originate in the House of Representatives, the Bankruptcy Code, originating in the Senate Judiciary Committee, does not contain any provisions governing the federal tax consequences of bankruptcy.¹ As initially drafted, the Bankruptcy Code contained provisions which would have governed the taxation of bankruptcy estates generally but which were removed because of differences with the House Ways and Means Committee but were later reinserted in the Code as finally adopted, for study purposes only.

The Senate bill removed these rules [the Special Tax Provisions] pending adoption of Federal rules on these issues in the next Congress. The House amendment returns the State and local tax rules to § 346 so that they may be studied by the bankruptcy and tax bars who may wish to submit comments to Congress.²

The legislative history to 11 U.S.C. §§ 346, 728 and 1146 clearly states that those provisions were intended to express the “policy” that the House Committee on the Judiciary felt should be applied in federal, state and local taxes, they were left in the Bankruptcy Code to be studied by the bench and bar in anticipation of the adoption of the Bankruptcy Tax Act of 1980.³

¹ U.S. CONST. art. I, § 7.

² 124 CONG. REC. H11,109 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards); 124 CONG. REC. S17,426 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini).

³ Pub. L. No. 96-589; 124 CONG. REC. H11,092 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards); 124 CONG. REC. S17,408 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini).

Because of the many significant differences between the Special Tax Provisions and the separate entity rules, together with the legislative history quoted above a case can be made that the legal efficacy of those Bankruptcy Code sections is questionable. Unfortunately, Congress has apparently forgotten this clear statement of intent, inasmuch as these Special Tax Provisions have never been repealed or modified in spite of the adoption of the Bankruptcy Tax Act of 1980⁴ shortly after passage of the Bankruptcy Reform Act of 1978.⁵ Even more unfortunately, there have been numerous and substantial amendments to the Bankruptcy Code, many of which have amended certain parts of the Special Tax Provisions. The adoption of Chapter 12, for instance, contained a number of changes including the addition of 11 U.S.C. § 1231(b) purporting to affect the state income tax treatment of bankruptcy estates. Recently the Bankruptcy Reform Act of 1994 was enacted making significant changes in a number of areas of the Bankruptcy Code. The result of this repeated Congressional action is quite contrary to the expressed intent of Congress at the time of the adoption of the Bankruptcy Code—by means of the doctrine of “legislative reenactment” the Special Tax Provisions are undoubtedly filled with as much force as any laws.

The Special Tax Provisions of the Bankruptcy Code, §§ 346, 728, 1146, and 1231(b) as finally adopted pertain only to the computation of state income taxes. These rules are unique and little understood. The taxation of bankruptcy estates for state income tax purposes, in many instances, is not only foreign to the laws of taxation in most if not all states, but generally is quite dissimilar to the federal rules for determining the income tax of bankruptcy estates. Bankruptcy Code § 728(b), for instance, requires that a trustee shall make tax returns for the Chapter 7 estate of an individual debtor or a corporation only if the estate or corporation has “net” taxable income for the entire period of the bankruptcy case. If the estate does not have net income for the entire period, no state or local tax returns are due. For partnerships and corporations a federal return is required for each taxable period regardless of the income. Any taxes paid by the estate are an administrative expense deductible on the estate’s returns.⁶ In comparison with federal law, the Special Tax Provisions specifically state that the administrative expenses are a “deduction attributable to a business”; if they create an NOL they may be carried back to preceding taxable years of the debtor or the estate.⁷

The separate entity rules promulgated in the Bankruptcy Tax Act, effective generally for Chapter 7 and 11 cases filed after March 24, 1981,⁸ while containing

⁴ Pub. L. No. 96-589 (1980).

⁵ Pub. L. No. 95-598 (1978).

⁶ 11 U.S.C. §§ 346(e), 503(b)(1)(B).

⁷ 11 U.S.C. §§ 346(e), (i)(3), 503(b)(1)(B).

⁸ Pub. L. No. 96-589, § 7(b) (1980).

provisions similar to those found in 11 U.S.C. §§ 346, 728 and 1146, are markedly different in a number of very significant ways:

(1) The Bankruptcy Code states that the estate's income tax is to be computed in the same manner as an "estate" while the Internal Revenue Code states that it is computed in the manner as for an "individual."⁹

⁹ 11 U.S.C. § 346(b)(2); I.R.C. § 1398(c)(1).

(2) The Bankruptcy Code requires that a trustee shall make state income tax returns for the estate of an individual debtor or for a debtor that is a corporation only if the estate or corporation has “net” taxable income for the entire period of the bankruptcy case.¹⁰ If the estate does not have net income for the entire period, no state or local tax returns are due. For partnerships and corporations a federal return is required for each taxable period regardless of the income.¹¹ Like the federal taxes, any state income taxes paid by the estate will be an administrative expense, deductible on subsequent returns.

(3) While the Bankruptcy Code merely bars the debtor from carrying back any postpetition net operating losses to prepetition taxable years while the case is pending, the Internal Revenue Code entirely bars the debtor from any carry back activity to prepetition taxable years.¹²

(4) The Bankruptcy Code states that any remaining tax attributes are transferred back to the debtor after the case is “closed” while the Internal Revenue Code provides that such attributes are transferred to the debtor when the estate “terminates,” two entirely different concepts.¹³

(5) For debtor’s filing bankruptcy under either Chapter 7 or 11, the Bankruptcy Code provides that the debtor’s taxable year is terminated on the date of the order for relief but does not specify when the debtor’s second taxable year begins; the Internal Revenue Code, in contrast, provides that the debtor may *elect* to terminate his taxable year on the day before the case commences and specifies that the second taxable begins on the commencement date.¹⁴ The case commences the date the petition is filed.¹⁵

(6) Under the Internal Revenue Code, the separate entity rules do not apply to a case which is dismissed.¹⁶ Under the Bankruptcy Code, however, dismissing a case does not affect the estate’s tax consequences to that point, the estate must file returns

¹⁰ 11 U.S.C. § 728(b).

¹¹ I.R.C. §§ 6012(b)(3), 6031.

¹² 11 U.S.C. § 346(i)(3); I.R.C. § 1398(j)(2)(B).

¹³ 11 U.S.C. § 346(i)(2); I.R.C. § 1398(i). *Compare* 11 U.S.C. § 350(a) *with* Treas. Reg. § 1.641(b)-3(a).

¹⁴ 11 U.S.C. §§ 728(a), 1146(a); I.R.C. § 1398(d)(2)(A).

¹⁵ I.R.C. § 1398(d)(3); 11 U.S.C. §§ 301, 302, 303.

¹⁶ I.R.C. § 1398(b)(1).

for taxable periods prior to dismissal.¹⁷ Curiously, the Bankruptcy Code is silent with regard to the duty to report any income received or accrued during that portion of an estate's taxable year which has not closed prior to the dismissal—is the debtor obligated to report such income on his or her personal return filed for a taxable period which includes the estate's transactions occurring after the beginning of its last taxable year or is the trustee required to file a return for that short period taxable year, treating the dismissal as termination of the taxable year? Problems such as these may be the reason why many of the proposed Special Tax Provisions were not incorporated in the Bankruptcy Tax Act and why these Provisions were only reinserted in the Bankruptcy Code as policy, as discussed above.

¹⁷ 11 U.S.C. § 346(i)(2).

(7) The tax attributes adjusted as a result of the exclusion of debt discharge income under the Internal Revenue Code include net operating losses, general business credits, capital loss carryovers, the basis of property, passive-loss amounts, minimum tax credits, and foreign tax credits.¹⁸ The debtor's suspended at-risk losses are an attribute transferred to the estate but not adjusted under I.R.C. § 108(b).¹⁹ Conversely, the debtor's minimum tax credits are an attribute adjusted under § 108(b) but not transferred to the bankruptcy estate.²⁰ The Bankruptcy Code, in contrast, requires that only net operating losses and the basis of property be reduced because of the exclusion of debt discharge income.²¹

(8) The Bankruptcy Code provides that after the estate's remaining tax attributes are transferred back to the debtor after the case is closed or dismissed, the debtor may use such tax attributes as though any applicable time limitations "were suspended during the time during which the case was pending."²² The Internal Revenue Code does not contain any comparable provision, the period of limitations on the use of net operating losses and investment tax credits, for instance, continues to run during bankruptcy.²³

The failure of the Internal Revenue Code to suspend the running of the period of limitations during which these attributes may be used is clearly proper and intentional as shown by viewing the separate entity rules when applied to Chapter 11 estates. On commencement of the case the attributes are transferred to the estate where they will be available for use by the debtor-in-possession in the continued operation of a business or farm. During the taxable years when the farm or business was operated from within the bankruptcy estate depreciation will be claimed on the estate's returns, otherwise net taxable income may be set-off by an NOL, capital gains from the sale or other taxable disposition of assets may be offset by carryforward capital losses, or the estate may benefit from the use of the attributes in some other manner. On confirmation of the plan the estate terminates, as discussed earlier, all of the property of the estate vests in the debtor and the debtor is generally discharged from any debts not provided for in the plan. Also, on termination of the estate, i.e., confirmation of the plan, any attributes remaining after the adjustment required under I.R.C. § 108 because of the exclusion of debt discharge income are transferred back to the debtor, where they

¹⁸ I.R.C. § 108(b)(2).

¹⁹ Treas. Reg. § 1.1398-2(c).

²⁰ I.R.C. § 108(b)(2)(C).

²¹ 11 U.S.C. § 346(i)(3), (5).

²² 11 U.S.C. § 346(i)(2).

²³ I.R.C. §§ 172(b)(1)(B), 39(a)(1)(B).

may be used on his or her personal returns. The estate, in a sense, has been more of a conduit through which not only property passes, but tax attributes as well. Because of the use of the attributes during the taxable years of the estate, the continued running of the period of limitations on their use is entirely proper.

(9) The Bankruptcy Code provides that the termination of the debtor's taxable year on commencement of the case, creating two short period years, is ignored for purposes of determining the number of years during which the estate, or the debtor if attributes remain when the estate terminates, may use a loss carryover or carryback.²⁴ The Internal Revenue Code contains no such comparable provision, if the debtor elects to terminate the taxable year, the first and second short period taxable years are taxable years for loss carryover purposes.

(10) The Internal Revenue Code includes charitable contributions carryovers as a tax attribute transferred to the estate, the Bankruptcy Code does not.²⁵

(11) The Bankruptcy Code requires trustees to "make" a tax return on behalf of a partnership in bankruptcy.²⁶ There is no comparable requirement for federal partnership returns.

(12) The Internal Revenue Code provides that the transfer of property from the debtor to the estate on commencement of the case and the transfer of property from the estate to the debtor on termination of the estate are not taxable dispositions.²⁷ The Bankruptcy Code provides that neither gain nor loss shall be recognized on a transfer, by operation of law, of property to the estate and, other than a sale, of property from the estate to the debtor.²⁸ Thus, any transfer from the estate to the debtor is tax free under the Bankruptcy Code while only transfers of property on termination of the estate are expressly tax free under the Internal Revenue Code, creating the abandonment controversy.

State taxing authorities seem to rely for the most part on the debt discharge and bankruptcy tax provisions of the Internal Revenue Code. For the most part trustees are advised to prepare and file federal income tax returns according to the Internal Revenue Code and state returns according to 11 U.S.C. § 346.²⁹ An alternative reading of § 346(a) holds that bankruptcy estates are to

²⁴ 11 U.S.C. § 346(h).

²⁵ I.R.C. § 1398(g); 11 U.S.C. § 346(i)(1).

²⁶ 11 U.S.C. §§ 346(c)(2), 728(b).

²⁷ I.R.C. § 1398(f)(1), (2).

²⁸ 11 U.S.C. § 346(g)(1).

²⁹ *In re Page*, 163 B.R. 196 (Bankr. D. Kan. 1994) (where debtor's claim for federal income tax refund based on carryback of prepetition NOL in reliance on 11 U.S.C. § 346(i), which allows debtors to carry back tax attributes after their case is closed as though any statute of limitations on use of such attributes was suspended during the time the case was pending, was denied by IRS on grounds that statute of limitations for refunds due to carryback of NOL's, I.R.C. §

file state income tax returns in reliance on the directive found in § 346(a) of the Bankruptcy Code that the balance of § 346 is subject to the Internal Revenue Code, that where in conflict the Bankruptcy Code is subordinate to the Internal Revenue Code for both state and federal tax purposes, forcing states to conform to federal tax law.

6511(d)(2)(A), had lapsed prior to application for refund, held 11 U.S.C. § 346(i), “along with the rest of the statute is . . . subject to the IRC and does not supersede any of its provisions,” the listed subsections of § 346 do not apply to the Internal Revenue Code but only to state and local laws); 5 COLLIER ON BANKRUPTCY ¶ 1300.65[1] (15th ed. 1989).