OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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MEMORANDUM FOR DELAWARE - MARYLAND DISTRICT COUNSEL'S OFFICE
Attn: Sandra Jefferson

FROM: Michael Roach
Chief, Branch 7 CC:EBEO:7

SUBJECT:

- PROPOSED CLOSING AGREEMENT

Taxpayers A =

Court X = United States District Court for the District of Delaware
State A = New Jersey
Attorney B = Ms. Sandra Jefferson
Newspaper X =
$E =
$F =
$G =
$H =
Z =
date M =
date N =
date O =
date P =
date Q =
date R =
date S =
date T =
date V =
date W =
date X =
date Y =
date Z =
date A =

date C =
date D = August 17,1999
date E =

This is in response to your request for assistance on or about date D regarding the proposed closing agreement in the above-referenced case. You have requested our response no later than date Z. Our understanding of the facts and discussion of the issues and recommendation regarding the proposed closing agreement is set forth below.

ISSUES

1. Whether IRC §4980 is a tax or a penalty for purposes of determining the government's priority status for such claims under the Bankruptcy Code.

2. Whether the excise tax on the amount received by Taxpayers A on the reversion of their pension assets is a pre-petition priority tax claim or an administrative claim.

3. If it is a penalty and not a tax, whether the penalty is the type of penalty covered under BC §503(b)(1)(C).

4. If it is a tax and not a penalty, may the tax claim be subordinated to the claims of general unsecured creditors.

5. Whether the Service can and/or should consider a compromise of a tax liability while a bankruptcy proceeding is pending.

BACKGROUND

Taxpayers A filed a petition under Chapter 11 of the Bankruptcy Code in Court X on date M. The case was opened as a non-SAUSA large case in your office on date N, 21 days after date M, and was assigned to Attorney B. On date O, the Service filed a proof of claim for over $E, which has since been settled. Sometime thereafter, the Service filed additional smaller claims, most of which we understand have since been resolved or withdrawn.

Sometime in early date P, over 19 months after Taxpayers A filed their petition in bankruptcy, an article appeared in Newspaper X indicating that Taxpayers A had terminated their pension plan and intended to use a portion of the proceeds to fund a corporate reorganization. Although a plan termination during the pendency of Taxpayers A's bankruptcy would require Bankruptcy Court approval, your office did not receive any pleadings from the Bankruptcy Court regarding a plan termination. We understand that the reversion occurred on date Q, over 2 years after Taxpayers A filed

their petition in bankruptcy. We also understand that Taxpayers A claim to have established a qualified replacement plan, as described in IRC §4980(d)(2). Attorney B of your office initially believed that the reversion may have occurred before assets were transferred to the replacement plan and, as such, the excise tax under IRC §4980 may apply at a 50 percent rate, rather than a 20 percent rate. It now appears more probable than not that the assets were transferred to the replacement plan on date R, prior to the reversion on date Q. Accordingly, absent further facts to support a determination that Taxpayers A failed to establish a qualified replacement plan, we have assumed that the excise tax under IRC §4980 would apply at a 20 percent rate.

The Reorganization Plan and Disclosure Statement, which was subsequently amended on or about date S, was filed with the Bankruptcy Court on or about date T (during the 20th month after Taxpayers A filed their petition in bankruptcy). The Service filed objections to the Reorganization Plan on or before date V, approximately 1 month later. The Reorganization Plan was confirmed by the Bankruptcy Court on date W, approximately 1 month after date V. We understand from Attorney B that the effective date of the Reorganization Plan was date X, 4 days after the Plan was confirmed and 5 days after Taxpayers A received the reversion.

The Reorganization Plan provides that the new retailer is responsible for any post-petition and post-confirmation tax liabilities. The post-confirmation tax liabilities are substantial, including an approximate $F IRC §4980 excise tax liability which, according to Taxpayers A's estimates[1], is attributable to the approximate $G pension plan reversion that was used to fund the Reorganization Plan. We understand that all of the Government's objections to the Reorganization Plan were resolved, except that no agreement was reached regarding whether the excise tax liabilities would have pre-petition priority status or administrative status because Taxpayers A wanted to preserve the right to challenge any administrative claim filed. On date Y, 29 days after the effective date of the Reorganization Plan, the Service and Taxpayers A executed an escrow agreement under which Taxpayers A agreed to hold approximately $F in escrow until a decision is made by the Service regarding the proposed closing agreement on or before date Z (45 days later), or as necessary until a judicial determination is made as to the characterization of the exaction and the amount of the IRC §4980 liability. (The $F is the amount of the approximate potential IRC §4980 excise tax liability if a 20 percent rate applies.)

We understand that your office has taken the position that the excise taxes (and income taxes) due are post-petition administrative claims rather than pre-petition claims under BC §§507(a)(8)(E) or 507(a)(8)(G). We also understand that, based on United States v. Reorganized CF&I Fabricators of Utah, Inc.,518 U.S. 213 (1996) and In re Unitcast, Inc., 219 B.R. 741(BAP 6th Cir. 1998), Taxpayers A have taken the position

[1] Taxpayers A's estimates were used since the Forms 5330 relating to the excise taxes were not due until date Y.

that the IRC §4980 excise tax is not an administrative expense because it is a penalty, and it is not the type of penalty referred to in BC §503(b)(1)(C). However, as stated above, the two cases which have explicitly discussed whether IRC §4980 imposes a tax or a penalty, have both held that the exaction was a tax, not a penalty. In re C-T of Virginia, Inc., 977 F.2d 137,140 (4th Cir. 1992)(decided prior to CF&I), and In re Juvenile Shoe Corporation of America, 99 F.3d 898 (8th Cir. 1996)(decided after CF&I).

Sometime in date A, approximately 2 years after filing their petition in bankruptcy, Taxpayers A submitted the proposed closing agreement, a copy of which was forwarded by your office to State A District Counsel on date C, and to our office by email on date D, the approximate date of this assistance request. Sometime thereafter, Taxpayers A filed a motion requesting an estimation of certain disputed, contingent and unliquidated claims. The Government filed an objection to the motion with respect to the inclusion of the excise and income taxes relating to the reversion on the grounds that those taxes are administrative claims. The hearing on that motion took place on date E. In addition, because of the uncertainty regarding whether Taxpayers A established a qualified replacement plan, we understand that Special Procedures, upon your office's advice, filed an administrative claim based on a potential 50 percent excise tax liability under IRC §4980.

DISCUSSION

ISSUE 1

The leading case on whether a liability under the Internal Revenue Code is a tax or a penalty for purposes of the Bankruptcy Code priority provisions is the Supreme Court's decision in United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996). CF&I involved whether the IRC §4971 accumulated funding deficiency excise tax was a tax or a penalty for purposes of determining priority status under the Bankruptcy Code. Relying on earlier decided cases, such as City of New York v. Feiring, 313 U.S. 283, and United States v. New York, 315 U.S. 510 (1942), the Court reasoned that the operation of the provision using the term in question, not the label placed on the exaction, is dispositive of the exaction's characterization under the Bankruptcy Code. Under New York, "a tax is a pecuniary burden laid upon individuals or property for the purpose of supporting the Government." New York, 315 U.S., at 515. Under Feiring, a tax is a "pecuniary burden laid upon individuals or their property...for the purpose of defraying the expenses of government or of undertakings authorized by it." Feiring, 313 U.S., at 285. Under United States v. La Franca, 282 U.S. 568, 572 (1931), a penalty is "an exaction imposed by statute as punishment for an unlawful act." Based on these standards, the Court concluded that the exaction imposed under IRC §4971 was a penalty.

In concluding that the IRC §4971 exaction was penal in character, the Supreme Court also emphasized the excise tax structure (i.e., a flat percentage tax, followed by a substantially greater flat tax percentage if certain action did not occur) and legislative

history. H.R. Rep. No. 93-807, p.28 (1974) ("...For this reason, the bill places the obligation for funding and the penalty for underfunding on the person on whom it belongs –namely, the employer.")

Before the Supreme Court decided CF&I, the Fourth Circuit considered a similar issue: whether IRC §4980 imposed a tax or a penalty for purposes of the Bankruptcy Code. In re C-T of Virginia, Inc., 977 F.2d 137 (4th Cir. 1992). Because the legislative history provided little guidance on this issue, the Fourth Circuit applied a standard similar to the "operation of the provision" standard subsequently applied by the Supreme Court in CF&I. [2] In holding that the exaction imposed under IRC §4980 is a tax for purposes of bankruptcy, the Fourth Circuit noted the deterrent effect of the §4980 exaction, but concluded that that attribute alone did not prevent the exaction from being considered an excise tax entitled to priority treatment in bankruptcy. In re C-T of Virginia, Inc. involved a tax year in which IRC §4980 was imposed at a 10 percent rate.

After the Supreme Court decided CF&I, the Eighth Circuit decided In re Juvenile Shoe Corporation of America, 99 F.3d 898 (8th Cir. 1996), which involved whether a 15 percent exaction under IRC §4980 was a tax or a penalty for purposes of the Bankruptcy Code. The Eighth Circuit applied the "operation of the provision" standard set forth in CF&I, and recognized the provision's revenue recapture attributes:

> Congress granted a corporate tax exemption to employers for placing money in an employee pension fund. As the pension fund grows, it includes earnings on the money that would have been taken as tax revenue at the corporate tax rate had it not been placed in the pension fund. Although the employer must pay the corporate tax rate on funds reverted from the pension plan, the employer earns interest while the funds are in the pension plan, and the government is denied the use of the tax revenue during the same period forcing the government to borrow from other sources to fund its operations. Capturing the tax benefit the employer received at the expense of the government has the same purpose and

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[2] The Fourth Circuit in In re C-T of Virginia, Inc. applied the following standard: (i) a tax includes a "pecuniary burden laid upon individuals or their property...for the purpose of defraying the expenses of government or of undertakings authorized by it" (quoting City of New York v. Feiring, 313 U.S.283, 285 (1941)), (ii) an excise tax is an indirect tax, one not directly imposed upon persons or property, and is one that is 'imposed on the performance of an act, the engaging in any occupation, or the enjoyment of a privilege'" New Neighborhoods, 886 F.2d at 719 (quoting In re Tri-Manufacturing & Sales Co., 82 B.R. 58, 60 (Bankr. S.D.Ohio 1988)), and (iii) a penalty is "[a]n enactment which has as its purpose the punishment of conduct perceived as wrongful ... regardless of the terminology employed by the legislature." In re Kline, 403 F.Supp. 974, 978 (D.Md.1975), aff'd, 547 F.2d 823 (4th Cir. 1977).

> similar effect as assessing the tax prior to the employer's placement of the funds in the pension plan.

In re Juvenile Shoe Corporation of America, 99 F.3d at 901 (citations omitted).

The court acknowledged that the use of a flat rate may not accurately reflect the government's revenue loss, but noted that Congress imposed a flat rate for the sake of simplicity. Moreover, a General Accounting Office report reviewed by Congress in 1990 in considering whether to increase the rate concluded that in many cases a 15 percent rate is not sufficient to recapture the tax benefits received by an employer. In re Juvenile Shoe Corporation of America, 99 F.3d at 902.

With respect to CF&I, the court stated:

> The Reorganized CF&I definition of a penalty requires that the exaction be imposed "as punishment for an unlawful act." Although Congress disfavors the reversion of pension plan funds to employers, it has not made such reversions unlawful, instead giving employers that inadvertently over fund their employee pension plans the right to revert the overfunding. In re Juvenile Shoe Corporation of America, 99 F.3d at 902.

The court noted that IRC §4971, unlike IRC §4980, was not enacted to generate or recapture revenue since it "imposes a tax on conduct that does not deny the government any tax revenue." In re Juvenile Shoe Corporation of America, 99 F.3d at 903. It also noted that, unlike IRC §4980, the conduct taxed by IRC §4971 is prohibited under federal law, citing to the minimum funding requirements applicable to pension plans. See 29 U.S.C. §1001 (1988). Accordingly, the court concluded that the primary operation of IRC §4980 is to support the government rather than to penalize an unlawful act and, thus, the assessment constitutes an excise tax entitled to priority in bankruptcy. In re Juvenile Shoe Corporation of America, 99 F.3d at 903.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We believe that the decisions in In re C-T of Virginia, Inc. and In re Juvenile Shoe support the conclusion that the 20 percent IRC §4980 exaction involved in this case is a tax under a CF&I "operation of the provision" analysis. [redacted]

[redacted]

[redacted][3]

[redacted]

[redacted]

[redacted]

[3] [redacted]

[redacted]

ISSUE 2

Taxpayer A has taken the position that the IRC §4980 liability, insofar as it is a tax, is a prepetition liability because it compensates the Government for tax revenue which was lost prepetition. Taxpayer A is comparing this case to situations where an employer incurs liabilities post-petition as a result of failing to meet the statutory funding obligations for a pension plan with respect to work performed by employees prepetition. The courts have held that such liabilities should be treated as prepetition debts insofar as they arise from obligations incurred with respect to employees' prepetition services. PBGC v. CF&I Fabricators of Utah, Inc., 150 F.3d 1293 (10th Cir. 1998), cert. denied 119 S. Ct. 2020 (1999) (PBGC claim for post-petition funding obligations); PBGC v. Sunarhauserman, Inc., 126 F.3d 811 (6th Cir. 1997) (same); PBGC v. Skeen (In re: Bayly Corp.), 163 F.3d 1205 (10th Cir. 1998) (PBGC claim for unfunded benefit liabilities); In re Unitcast, 219 BR 741 (6th Cir. BAP 1998) (IRC §4971 penalties).

These cases are distinguishable because they involve debts arising from obligations to employees incurred prepetition. In contrast, the excise tax at issue in this case arises only as a result of a post-petition event. A tax claim is properly claimed as an administrative expense under BC §503(b)(1)(B) if it is incurred by the estate, except a tax of the kind specified in BC §507(a)(8). BC §507(a)(8)(E) applies generally to excise taxes imposed on transactions occurring before the petition. This case involves an excise tax on a transaction, the reversion of assets from a qualified plan, occurring post-petition. Thus, BC §507(a)(8) does not apply and instead the tax was incurred by the estate under BC §503(b)(1)(B)(i). The fact that one purpose of the IRC §4980 tax is

to recapture tax benefits received prepetition is not relevant, because this tax is not in fact imposed on any activities or events occurring prior to the reversion. IRC §4980 liability is imposed as a result of the reversion, and the tax is computed based on the assets reverted. Cf. In re Hillsborough Holdings Corp., 116 F.3d 1391 (11th Cir. 1997) (income tax for tax period ending post-petition, but derived from prepetition events, is a prepetition claim); In re Pacific-Atlantic Trading Co., 64 F.3d 1292 (9th Cir. 1995) (same); In re L.J. O'Neill Shoe Co., 64 F.3d 1146 (8th Cir. 1995) (same).

Based on the 20 percent rate applicable in this case, we conclude that the IRC §4980 liability is a tax incurred by the estate post-petition, which is payable in full as an administrative tax claim pursuant to BC §503(b)(1)(B)(i).

ISSUE 3

If the court were to find that the IRC §4980 liability is a penalty, we do not recommend that your office argue that the penalty in this case is the type of penalty covered under BC §503(b)(1)(C). Therefore, if the IRC §4980 liability is a penalty, we recommend that it be treated as a general unsecured claim.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

ISSUE 4

The Supreme Court held in CF&I, supra, that a claim cannot be categorically subordinated in a manner inconsistent with the statutory priorities in the Bankruptcy Code. While CF&I addressed the IRC §4971(a) liability deemed to be a penalty in that case, the Court's analysis is equally applicable to other types of claims. If the IRC §4980 liability is a tax, it must be paid as an administrative expense pursuant to BC

§503(b) and cannot be equitably subordinated to claims of general unsecured creditors.

ISSUE 5

We believe that the Service's current policy not to consider compromises of tax liabilities submitted by a debtor in bankruptcy, IRM 5.9.4.7 (Bankruptcy Handbook), is intended to apply to a compromise regarding doubt as to collectibility, rather than a compromise such as the one proposed in this case that is based on the hazards of litigating claim classification issues. Accordingly, we do not believe that the current policy precludes consideration of a compromise. We also note that if the Service's request for payment of the IRC §4980 liability is objected to, then this matter should be referred to the Department of Justice and consideration of any settlement would be within their office's jurisdiction. IRC §7122; CCDM 34.10.1.6(6).

CONCLUSIONS

1. The IRC §4980 reversion tax, as applicable at a 20 percent rate in this case, is a tax for purposes of determining the government's priority status for such claims under the Bankruptcy Code.

2. The excise tax on the amount received by Taxpayers A on the reversion of their pension assets is an administrative claim.

3. If the exaction were considered a penalty, we do not recommend that your office argue that the penalty in this case is the type of penalty covered under BC §503(b)(1)(C). Therefore, if the IRC §4980 liability is a penalty, we recommend that it be treated as a general unsecured claim.

4. No tax claim can be subordinated to the claims of general unsecured creditors.

5. The Service can and should consider a compromise of a tax liability while a bankruptcy proceeding is pending, unless the compromise is based on doubt as to collectibility.

RECOMMENDATION

If Taxpayers A properly established a qualified replacement plan as described in IRC §4980(d)(4) and, thus, the 20 percent rate is applicable, we believe that the Service 's assertion that the IRC §4980 excise tax liability is a tax, which is payable in full as an administrative expense under BC §503, is reasonable and supportable in law. [redacted]

This response has been coordinated with General Litigation and Employee Plans. If you have any questions regarding this matter, please call me or Amy Speetjens at the branch telephone number.

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MICHAEL J. ROACH