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Things Local Governments Wish Bankruptcy Attorneys Knew about Property Taxes

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It is clear from the perspective of those who primarily represent local governmental entities in bankruptcy cases that the Bankruptcy Code was not written with our clients in mind. It is equally clear that our local government clients are also not on the minds of those who regularly participate in the bankruptcy process (*i.e.,* counsel for debtors, committees, lenders and even the judges). Unfortunately, most local governments must rely on city or county attorneys with limited bankruptcy experience for representation, so they are not in a good position to let their concerns be known.

Being fortunate enough to spend my days almost entirely in the pursuit of better treatment (and more money) for my local government clients from debtors in bankruptcy, I have taken it upon myself to put together a "Top Five" list of things I believe most bankruptcy attorneys would benefit from knowing when dealing with local governmental entities as creditors. Hopefully, this information will prove helpful to all concerned.

Nothing Is Certain but Taxes

We've all heard the old adage that nothing is certain but death and taxes, but in bankruptcy, individual consumer debtors rarely die and corporations are often reincarnated as a "newco," so only taxes are certain. Most debtors' counsel remember to list the Internal Revenue Service (IRS) as a creditor, and often remember to list state departments of revenue. However, it is rare that cities, counties, school districts, utility districts, improvement districts and the many other local "municipal corporations" with taxation power are listed as creditors on the notice matrix, scheduled or even have their debts included in budgets, but they should be. In most states, there is some form of local taxation of real and/or personal property, commonly known as *ad valorem* taxes. If the debtor owns real or personal property, it is likely that he or she owes taxes on that property to one or more local government entities. The liability for these taxes arises on a certain date; for example in Texas (as well as in Tennessee, Virginia and Colorado), it is every Jan. 1, even though the tax bills are actually issued months later.

About the Author

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It is common for debtors to think that just because they paid a tax bill in December (to qualify as a deduction against that year's income tax return) and they will not receive a new bill until August, November or even the following January, they do not currently owe taxes. That is not correct. Whoever owns the property on the assessment date will owe taxes for that year, even if they dispose of the property by the date the bill is issued. Even though the exact amount of the taxes is unliquidated and may not be determined until an appraisal process is completed and tax rates set, these liabilities are not contingent, and current-year taxes will be a prepetition claim if the bankruptcy is filed after the assessment date.

Why is it beneficial to debtors and other parties to remember to list, schedule and otherwise provide notice of the case to local *ad valorem* tax creditors? The answer is simple: These creditors are entitled to procedural due process. If they are not included in the case from the outset, the tax debts may not be discharged and certain orders of the court may not be effective against them (at the least, it will turn out to be very expensive to the estate to litigate the issue). My advice is to avoid these problems by including local government entities in the case from the beginning.

Affairs of State

Ad Valorem *Taxes Are Secured Claims, Not Priority*

The Bankruptcy Code was written with the IRS in mind, and many provisions specifically address how to treat unsecured priority tax claims. However, as far as I know, all *ad valorem* taxes are secured by a lien on the property taxed. By definition, they are secured claims and not priority claims under 11 U.S.C. §507(a)(8), which only deals with *unsecured* claims. Interests in property are created and defined under state law, and tax liens, like other liens, should generally pass through a bankruptcy unaffected. *Butner v. U.S.*, 440 U.S. 48, 55 (1979); *Dewsnup v. Timm*, 502 U.S. 410, 418-

19 (1992). States have a strong interest in protecting the primary source of revenue for local governments, and in most states, *ad valorem* tax liens are the highest-priority liens, senior even to purchase money or other pre-existing liens. *See*, for example, Texas Property Tax Code 32.05; Tennessee Code Ann. 67-5-2101; and Virginia Code 58.1-3941 and 3942 and 1982-83 Ops Atty. Gen. 618.

Local tax authorities' secured claims are similar in many respects to those of other secured creditors, and they are entitled to the same treatment and benefits as other secured creditors. It is common for debtors to provide for "adequate protection" for consensual secured creditors in postpetition financing and sales of property. However, it is equally common for the liens and interests of local governments to be forgotten. If *ad valorem* creditors are not given notice and appropriate adequate protection similar to other secured creditors, the effectiveness of provisions giving postpetition lenders "superpriority priming liens" or selling property "free-and-clear of all liens" is called into doubt.

Because *ad valorem* tax claims are secured, they are also entitled to certain treatment in plans. They are entitled to lien retention and the payment of interest on their claims to protect the value as of the effective date, pursuant to 11 U.S.C.§§1129(b)(2)(A) and 1325(a)(5), like all other secured creditors. Property taxes are usually only a fraction of the value of the property, so these claims are entitled to interest pursuant to 11 U.S.C. §506(b) as well, which becomes part of the allowed secured claim to be paid pursuant to the plan. *Rake v. Wade*, 508 U.S. 464, 471, 124 L.Ed.2d 424, 113 S.Ct. 2187 (1993). Both the plan interest and the §506(b) interest is set at the state statutory rate, pursuant to 11 U.S.C. §511, even though they do not deprive *ad valorem* tax claims of the right to certain payment terms in a chapter 11 plan pursuant to §1129(a)(9)(C). Like unsecured priority tax claims, secured tax claims are entitled to be paid in regular installments over a period of no more than five years from the petition date, and in a manner not less favorable than the most favored nonpriority unsecured claim provided for in the plan. 11 U.S.C. §1129(a)(9)(D).

Automatic Stay Does Not Apply to the Taxation Process

Almost every week, one of my clients refers a debtor/taxpayer to my office who is complaining that the receipt of a tax bill, valuation notice, delinquency notice or other notice required under state law violated the automatic stay under 11 U.S.C. §362. When drafting §362, for once Congress was thinking of local governments, and there are not one but two exceptions to the automatic stay that are specifically designed to protect *ad valorem* tax authorities. Section 362(b)(9)(D) provides that the filing of a bankruptcy claim does not stay the making of an assessment for any tax and issuance of a notice and demand for payment of such an assessment. Section 362(b)(18) provides that the creation or perfection of a statutory *ad valorem* tax lien or a special assessment on real property does not violate the automatic stay. As a practical matter, the bankruptcy filing only operates as a stay of a local tax authority's right to seize, sue, foreclose or otherwise act to collect a debt—not to assess the tax or impose the related lien upon property of the debtor or of the estate.

Postpetition Taxes: Administrative Priority Expenses Should Be Timely Paid

We have all heard that bankruptcy is a process that gives a debtor a "fresh start," but it does not give a "head start" or otherwise provide an advantage in ongoing operations, at least as far as taxes are concerned. As a general rule, debtors and trustees that own property must operate in compliance with the applicable nonbankruptcy law, including tax laws. 28 U.S.C. §§959 and 960.

While most debtors-in-possession (DIPs) and trustees remember to file their IRS income tax returns and pay the states the sales, employment, income and other taxes owed postpetition, they often fail to file returns and timely pay postpetition *ad valorem* or other local taxes. The failure to comply with state and local tax laws will result in added penalties to the amounts owed. Taxes incurred by the estate postpetition, as well as any penalties thereon, are entitled to administrative expense status pursuant to 11 U.S.C. §503(b).

Tax authorities are not required to file administrative expense claims or requests for payment in order to have these amounts deemed "allowed." 11 U.S.C. §503(b)(1)(D). The failure to timely pay taxes owed after the petition date or to file tax returns (including *ad valorem* property returns, or as called in some jurisdictions, "renditions") may be grounds for dismissal of a chapter 11 case. 11 U.S.C. §1112(b)(4)(I). A trustee or DIP in a small business case must timely file all "tax returns and other required government filings," as well as timely pay all taxes entitled to administrative expense priority in order to avoid providing cause for dismissal of the case. 11 U.S.C. §1116(6). Further, because the postpetition taxes are secured, a chapter 11 plan should provide for the retention of these tax liens as well as for the liens for the prepetition taxes. The easiest way to deal with postpetition taxes that are not yet due is for the plan to provide for the postpetition taxes to be timely paid in the ordinary course of business pursuant to applicable nonbankruptcy law. Those who are responsible for postpetition operations will do themselves, as well as the other creditors of the estate, a favor by making sure that property tax returns are filed and postpetition taxes are paid timely.

Payment of Secured Tax Is Not a Preference or Fraudulent Conveyance

At least once a year, one of my clients receives a letter threatening the filing of an adversary proceeding if he or she does not refund a prepetition payment received in satisfaction of *ad valorem* taxes. Often clients just receive service of the adversary proceeding with no prior notice of the intent to file such an action. However, payment of a secured tax claim is not an avoidable preference because (1) the tax authority provides "new value" by releasing the lien on the property, (2) it is not a payment of an antecedent debt if the tax is paid before the tax becoming delinquent, (3) such payment is not more than the tax authority would otherwise receive in a chapter 7 because secured claims are generally paid in full and (4) the taxes are a debt incurred and paid in the ordinary course of business. 11 U.S.C. §547 (a)(2), (a)(4), (b)(5), (c)(1) and (c)(2).

A statutory tax lien may only be avoided, if at all, pursuant to 11 U.S.C. §545, and the release of the tax lien constitutes the receipt of "reasonably equivalent value" for the payment received. 11 U.S.C. §548(a)(1)(B). Because the statute defines the due date for taxes as the last date they may be paid before becoming delinquent, the timely payment of taxes can never be a preference. This is not an affirmative defense that the taxing authority must raise; rather, it is an essential element of the claim that the debtor must take into account when evaluating whether a preference action is warranted. Since the due date of taxes is a statutory matter that can easily be ascertained, it would behoove debtors and their special counsel to review those statutes before they initiate these causes of action in order to ensure that they meet the standards of Bankruptcy Rule 9011.

Hopefully being aware of these few simple facts of life will allow debtors and other parties to avoid common mistakes, which result in the filing of objections and the use of time and resources to resolve them that could be better spent elsewhere. ■

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