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Does the Bankruptcy Court Really Have Unlimited Authority to Redetermine Taxes?

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Editor's Note: Please see *Value & Cents* on page 64 for a discussion of some of the points presented herein.

Over the years, many debtors have taken the position that 11 U.S.C. § 505 gives bankruptcy courts virtually unlimited discretion to redetermine the amount of taxes owed. However, both case law and amendments to § 505 establish limits to that discretion. This article details some of the statutory limits on that discretion, and some conclusions as to what is actually likely to be redetermined based on case law.

An Introduction to § 505 and Its Limitations



Elizabeth Weller

Section 505(a)(1) provides that, except as provided in paragraph (2), a bankruptcy court “may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to a tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.” Despite this very broad initial grant of authority, which seems to throw out the concept of *res judicata* entirely, § 505(a)(2) quickly places limits on that authority.

Section 505(a)(2)(A) provides that the court may *not* make those determinations “if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of com-

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petent jurisdiction before the commencement of the case.” In so doing, it incorporates the principles of *res judicata*, as well as the Rooker-Feldman Doctrine, when the matter is finally determined by a state tribunal.¹ An administrative order can constitute an adjudication for purposes of § 505.² Negotiated settlements, which would operate to bar further litigation in state court, also bar further action under § 505.³

which the refund is sought, including its time limits.⁴ Failure to comply with these requirements deprives the bankruptcy court of jurisdiction. “Simply put, no claim, no refund.”⁵

Until the amendments made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), if no final determination of the taxes owed had been made pre-petition—even where the debtor had not sought to contest the taxes—there was no time limit for bringing actions to determine the amount of an unpaid tax once the debtor filed its petition. Thus, for instance, there was a case where a debtor sought a refund (with interest) for taxes paid more than 10 years earlier.

Recognizing the potential for abuse with such a broad grant of jurisdiction,

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Next, § 505(a)(2)(B) provides that a court may not determine “any right of the estate to a tax refund before the earlier of—(i) 120 days after the trustee properly requests such refund from the governmental unit from which such refund is claimed; or (ii) a determination by such governmental unit of such request.” Thus, unless a refund has been “properly requested” from the relevant governmental unit, the court has no power to hear the matter. A proper request must comply with the refund procedures set forth by the governmental entity from

in 2005 Congress added § 505(a)(2)(C), which eliminated the court’s authority to redetermine “the amount or legality of any amount arising in connection with an *ad valorem* tax on real or personal property of the estate, if the applicable period for contesting or redetermining that amount under any law (other than a bankruptcy law) *has expired*.”⁶ To date, the author can find only four cases that cite this section, and only one, *In re The Village at Oakwell Farms Ltd.*,⁷ that includes any substantive discussion. That court found that where a debtor does not seek redetermination of *ad valorem* taxes under § 505(a) prior to the expiration for bringing an action under state law, the

¹ See *In re Cody*, 338 F.3d 89 (2d Cir. 2003); *In re Teal*, 16 F.3d 619 (5th Cir. 1994) (where debtor had “full and fair opportunity to contest” taxes, bankruptcy court lacks jurisdiction under § 505; matter has been “adjudicated” when judgment of court of competent jurisdiction has been decreed; § 505(a)(2)(a) incorporates concept of *res judicata*); *In re Baker*, 74 F.3d 906 (9th Cir. 1996); and *In re Reitnauer*, 152 F.3d 341 (5th Cir. 1998) (federal district courts do not have authority to review final state-court judgments).

² *In re Trans State Outdoor Advertising Co.*, 140 F.3d 618 (5th Cir. 1998).

³ *In re Teal*, 16 F.3d 619 (5th Cir. 1994); *In re El Tropicano*, 128 B.R. 153, 158-60 (Bankr. W.D. Tex. 1991).

⁴ *Custom Distribution Services Inc.*, 224 F.3d 235, 242-43 (3d Cir. 2000); *In re Venture Stores Inc.*, 54 Fed. Appx. 721 (3d Cir. 2002). See also *In re Armstrong*, 206 F.3d 465, 472 (5th Cir. 2000).

⁵ *In re Graham*, 981 F.2d 1135, 1138 (10th Cir. 1992).

⁶ Emphasis added.

⁷ *In re The Village at Oakwell Farms Ltd.*, 428 B.R. 372 (Bankr. W.D. Tex. 2010).

bankruptcy court loses the right to determine the tax liability.⁸

Section 108 and Taxes: Is the Time to Seek Redetermination or Other Relief Extended?

In reaching its conclusion, the *Oakwell Farms* court first had to consider whether 11 U.S.C. § 108 affected the time limits for the debtor's action under § 505. The bankruptcy filing does not toll the limitations period for protesting taxes.⁹ However, § 108 provides for an extension of time for taking certain actions. Under § 108(a), where a time is prescribed within which a debtor may commence an action and such period has not expired before the petition date, the trustee may begin such action before the later of the end of such period or two years after the order for relief. On the other hand, § 108(b) provides that if a period within which a debtor may file a pleading, demand, notice or claim, or cure a default or perform a similar act, has not expired before the petition date, the trustee may file, cure or perform before the later of the end of such period or 60 days after the order for relief. The distinction, the court explained, was between beginning a whole new action (provided for under § 108(a)) and filing some form of pleading in an ongoing matter (which was covered by § 108(b)).

In *Oakwell Farms*, the debtor filed an action under § 505(a) challenging various taxes. With respect to the debtor's 2009 taxes, an administrative hearing had been held prior to the filing of the bankruptcy, but the 60 days to appeal the administrative order to a *de novo* hearing before the district court had not expired when the case was filed. However, barring the application of § 108 or any extension of time due to the filing of the bankruptcy, the period to appeal the administrative order expired before the § 505 proceeding was filed.

The court first found that because the appeal would in fact result in a trial *de novo*, § 108(a) would apply rather than § 108(b), potentially giving the debtor up to an additional two years to file his challenge in the state court.¹⁰ Moreover, the application of § 108(a) meant that the action under § 505(a) was filed before the administrative adjudication was final, and so the court was not deprived of jurisdiction by § 505(a)(2)(A). However, the tax authority argued that, because the normal appeal period had expired

before the filing of the § 505 action, § 505(a)(2)(C) applied and would bar the bankruptcy court from having jurisdiction to hear the matter. The debtor argued that § 505(a)(2)(C) did not bar an extension of time under § 108, and the court undertook a lengthy analysis of the issue. Ultimately, the court concluded that in order to give full effect and meaning to the language of § 505(a)(2)(A) (which already barred review where an adjudication was final before commencement of the bankruptcy case), the "has expired" language in § 505(a)(2)(C) could not be confined to the pre-petition period and must apply during the post-petition period as well. The court held that the "more specific provision in section 505(a)(2)(C) [cutting off review in accordance with state time limits] can fairly be read to create an exception for a small subset of cases to which the more generic rule set out in section 108(a) [allowing extensions of such time limits] would otherwise apply."¹¹ Thus, it was now too late for the debtor to contest the 2009 taxes.

Although § 108 cannot be used to extend the time to contest taxes under § 505, as the *Oakwell Farms* court noted, it is a narrow exception, and § 108 does provide an extension of time for debtors and trustees to take other actions with respect to taxes. For example, several courts have found that § 108(b) has the effect of extending the time to redeem property sold at a tax foreclosure sale.¹²

If the time to redeem property from a foreclosure sale is not sufficiently extended under § 108, some courts may allow further extension through the operation of a confirmed plan. These courts have found that if a bankruptcy is filed prior to the expiration of the redemption period, 11 U.S.C. § 1322 gives the debtor the right to pay off the taxes over the term of the plan, and § 108(a) does not act as a bar cutting off rights to repay debt under a plan.¹³ Other courts have found to the contrary—that the terms of a plan cannot exceed the redemption period (as extended under § 108).¹⁴

¹¹ *Id.* at 379-80.

¹² See *In re Dumas*, 397 B.R. 883 (Bankr. N.D. Ill. 2008) (filing first bankruptcy had effect of extending redemption period 60 days, but second case filed after state redemption period had expired, but during original 60-day extension, did not result in additional extension; dismissal of first case cut off extension of redemption period); *In re Isom*, 342 B.R. 743 (Bankr. N.D. Miss. 2006) (§ 108(b) applies to right of redemption where it did not expire before commencement of case); *In re TEV Investment Properties LLC*, Case no. 04-17998 (Bankr. N.D. Miss. Aug. 25, 2006), 2006 Bankr. LEXIS 2121 (§ 108(b) operated to give trustee remaining time left in redemption period).

¹³ *In re McKinney*, 380 B.R. 515, 523-24 (C.D. Ill. 2008). See also *In re Hammond*, 420 B.R. 633 (Bankr. W.D. Pa. 2009), and *In re Kasco* (Bankr. N.D. Ill. 2007).

¹⁴ See *In re Murray*, 276 B.R. 869 (Bankr. N.D. Ill. 2002); *Smith v. Phoenix Bond & Indem.*, 288 B.R. 793 (N.D. Ill. 2001), and *S.I. Securities v. Dabal*, Case No. 03-C-274 (N.D. Ill. Aug. 1, 2003), 2003 U.S. Dist. LEXIS 13420, 2003 WL 21785625.

It should be noted that the benefit of the bankruptcy is not all one-sided in favor of the debtors. If the period to enforce a tax lien expires during the pendency of a confirmed plan, the creditor receives the benefit of the terms of the plan. A confirmed plan becomes a new contractual obligation which may materially modify a creditor's rights but also binds the debtor. The time to enforce a lien is extended for the term of the plan, and a nonrecourse "in rem" only debt may become a personal liability of the debtor due to the commitment to pay under the terms of the plan.¹⁵

Further, § 108 only applies to causes of action that arise pre-petition. "In examining § 108, courts have uniformly held that § 108(a) tolls only those claims which have arisen prior to the filing of the petition and *not* those which accrued after the filing of the petition."¹⁶ Additional courts that have considered the issue also have found that § 108 does not apply to causes of action or extended periods within which to act that arise post-petition.¹⁷

Section 505 and the Trend Toward Abstention

A further limitation on a debtor's ability to seek relief from taxes under § 505 is shown by recent cases that indicate a trend toward bankruptcy courts abstaining from hearing all but the most straightforward tax matters. The grant of jurisdiction in § 505 is permissive, as "the court *may* determine," not "*must* determine," the "amount or legality of any tax." While a few courts have found that abstention is only appropriate where an alternative forum exists for the debtor to seek relief,¹⁸ the majority have looked to the traditional basis for abstention and chosen to abstain where the determination of taxes would not benefit the bankruptcy estate or unsecured creditors, or would interfere with the uniformity of tax assessment within the tax jurisdiction. It should be noted that the precedential effect of cases denying abstention on the basis that there is no other forum available is somewhat in doubt

¹⁵ *In re Meyers*, 2007 Bankr. LEXIS 895 (Bankr. D. Neb. March 26, 2007).

¹⁶ *In re Hanna Coal Co.*, 1994 U.S. Dist. Lexis 16399 (W.D. Va. 1994) (emphasis in original) (citations omitted).

¹⁷ *In re Phillip*, 948 F.2d 985, 987 (5th Cir. 1991) (§ 108(a) does not extend time to file suit for cause of action that arose after petition filed); *Quilling v. Compass Bank*, 2004 U.S. Dist. LEXIS 18811 (N.D. Tex. 2004) (§ 108(a) does not protect debtor claims that arise post-petition); *In re Ward*, 42 B.R. 946 (Bankr. M.D. Tenn. 1984) (by its terms, § 108(a) only applies to extend time for actions that debtor had to the date of filing petition). See also *In re Coliseum Cartage Co. Inc.*, 975 F.2d 1022, 1027 (4th Cir. 1992) (dissent by Judge Wilkinson).

¹⁸ See, e.g., *In re Cable & Wireless USA Inc.*, 331 B.R. 568 (Bankr. D. Del. 2005).

¹⁹ *In re New Haven Projects Ltd. Liability Co.*, 225 F.3d 283, 289 (2d Cir. 2000); *In re Williams*, 190 B.R. 225, 228 (Bankr. W.D. Pa. 1995) (citations omitted).

⁸ *Id.* at 380.

⁹ *In re Armstrong*, 206 F.3d 465, 472 (5th Cir. 2000).

¹⁰ *Id.* at 377-78.

with the addition of § 505(a)(2)(C), which only allows bankruptcy courts to exercise jurisdiction if there is still time to do so under state law. If an alternative forum is not available, it is likely because the time to protest under state law has expired, thus depriving the court of jurisdiction and rendering an abstention argument moot.

There are six factors usually considered when determining whether to abstain in a proceeding seeking relief under 11 U.S.C. § 505(a): (1) the complexity of the issues; (2) the need to administer the bankruptcy case in an orderly, efficient manner; (3) the burden on the court's docket; (4) the length of time required for trial and decision; (5) the asset and liability structure of the debtor; and (6) any prejudice to the debtor or the taxing authorities.¹⁹ Other factors that may be considered include (7) whether bankruptcy issues predominate, (8) whether a bankruptcy purpose would be served and (9) the legislative purpose of § 505.²⁰ Recent cases in which courts abstained based on these factors include *Pilgrim's Pride Corp.*,²¹ *Lyondell Chemical Co.*,²² *Gilliam*,²³ *Kohl*²⁴ and *Kopp*.²⁵

Even without looking to the traditional abstention factors described above, many courts have abstained solely on the basis that redetermining the taxes of the debtor would interfere with the uniformity of local tax assessments. Where the effect of a court's ruling on the uniformity of local tax assessments will be great and there is no appreciable benefit to the progress of the case from having the issue determined, abstention is warranted.²⁶ Uniformity of assessment is generally an issue when debtors seek not just a revaluation of property as part of the redetermination of taxes, but the application of a different methodology of tax valuation or the introduction and reliance on evidence not permitted under state law. When a bankruptcy court redetermines taxes pursuant to 11 U.S.C.

§ 505, it must apply substantive applicable nonbankruptcy law.²⁷ The requirement to apply applicable state law encompasses not only the law concerning the method of valuation, but also the type of evidence that may be considered.²⁸

Conclusion

While a cursory reading of § 505(a)(1) may give the impression of a broad grant of authority to courts to redetermine taxes, not only is that authority narrowed by § 505(a)(2), but the availability for relief is even more limited. The best-case scenarios for a debtor seeking to have its taxes determined by a bankruptcy are where the time for appeal or protest under state law has not expired; the redetermination of the taxes will be based upon well-established principles of state law; there is no proceeding pending in a state court or administrative office of concurrent authority that will be heard in a reasonably short time; and the determination of the taxes will result in a benefit to the estate and the unsecured creditors. If any of these factors is missing, it is likely that relief under § 505 may be denied. ■

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²⁰ *In re Gilliam*, 2008 Bankr. LEXIS 4135, (Bankr. D. S.C. Oct. 22, 2008), citing *In re Luongo*, 259 F.3d 323, 330 (5th Cir. 2001); *In re Dees*, 369 B.R. 676, 677-78 (Bankr. N.D. Fla. 2007); and *In re Fyfe*, 186 B.R. 290-92 (Bankr. N.D. Ga. 1995).

²¹ *In re Pilgrim's Pride Corp.*, 2009 Bankr. LEXIS 2222 (Bankr. N.D. Tex. Aug. 17, 2009).

²² *In re Lyondell Chemical Co.*, 2010 Bankr. LEXIS 1271 (Bankr. S.D.N.Y. April 19, 2010).

²³ *In re Gilliam*, 428 B.R. 656 (Bankr. D. S.C. 2008), *aff'd*, *Gilliam v. United States* (*In re Gilliam*), 2009 U.S. Dist. LEXIS 102194 (D. S.C. Sept. 25, 2009).

²⁴ *In re Kohl*, 397 B.R. 840 (Bankr. N.D. Ohio 2008).

²⁵ *In re Kopp*, 355 B.R. 296 (Bankr. N.D. Okla. 2006).

²⁶ *In re Paolo*, 2009 U.S. Dist. LEXIS 69158, (D. R.I. July 23, 2009). See also *New Haven Projects*, 225 F.3d at 287-88; *In re ANC Rental Corp.*, 316 B.R. 153, 159 (Bankr. D. Del. 2004) (where resolution of dispute could affect uniformity of assessment of property taxes imposed on other taxpayers, there is compelling reason to abstain); *In re Metromedia Fiber Network Inc.*, 299 B.R. 251, 281-83 (Bankr. S.D.N.Y. 2003).

²⁷ *In re Fairchild Aircraft Corp.*, 124 B.R. 488, 492-93 (Bankr. W.D. Tex. 1991); *Metromedia Fiber Network*, 299 B.R. at 270.

²⁸ *In re Cable & Wireless U.S.A. Inc.*, 331 B.R. 568, 578-80 (Bankr. D. Del. 2005); *In re Quality Beverage Co. Ind.*, 170 B.R. 310 (Bankr. S.D. Tex. 1994).