



## Business Reorganization Committee

### ABI Committee News

In This Issue:

Volume 10, Number 1 / February 2011

- [Taxing Problems for Debtors - Treatment of Property Taxes](#)
- [Digging the Nail Out of the Coffin: LLC Law Responds to \*Olmstead\*](#)
- [ABI's Winter Leadership Conference Educational Materials](#)
- [ABI's VALCON2011 - There's Still Time to Register!](#)

## Taxing Problems for Debtors - Treatment of Property Taxes

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In bankruptcy, a debtor often faces assessments for interest and penalties on property taxes from a variety of taxing jurisdictions. Addressing these claims can be frustrating and time-consuming. Frequently, the most confusing assessments are those for tax periods that straddle the petition date: Is the entire tax post-petition and thus entitled to administrative-expense treatment under § 503(b)(1)(B) of the Bankruptcy Code? Is the tax all pre-petition and thus a pre-petition unsecured claim entitled to priority status under § 507(a)(8)? Is the tax split according to the pre-petition and post-petition periods? The difference is important because administrative-expense claims must be paid in full before payment may be made on pre-petition unsecured claims, and administrative-expense claims may also be entitled to penalties and interest.

### Treatment of Priority vs. Administrative-Expense Claims

Significantly, § 507(a)(8)(G) requires that any penalty under § 507(a)(8) must be "in compensation for actual pecuniary loss." For this reason, although courts often award interest and penalties on taxes that receive administrative expense treatment under § 503(b)(1)(B), taxes that have pre-petition unsecured claim status generally do not receive such treatment. [2] Furthermore, priority claims may be paid over time, up to five years after the petition date, pursuant to § 1129(a)(9)(C), while administrative claims generally must be paid in full, in cash, upon emergence. In the end, determining whether property taxes [3] were incurred post-petition or pre-petition may save debtors from unnecessary interest and penalty costs and allow

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payment to be deferred. [4]

Section 507(a)(8)(B) establishes that “a property tax incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition” is a pre-petition claim entitled to priority status.

[5] To qualify, the tax must be (1) a tax on property, (2) incurred prior to the commencement of the case and (3) last payable without penalty more than one year before the case began. Failure to meet all of these criteria will result in a claim being treated as a general unsecured claim (provided that it is not secured by a lien, thus warranting secured status.) [6]

### **Incurrence Test Differentiates Between Priority and Administrative-Expense Claims**

The inquiry into whether a property tax claim is entitled to administrative-expense or priority status rests on when the tax was “incurred.” Determining when a tax is incurred is the complicated part, and it is possible for a tax to have been incurred pre-petition but for payment to be due post-petition. Regardless of when it becomes due, if a tax meeting the criteria of § 507(a)(8) was incurred pre-petition, then the tax merits priority status, while a tax incurred (by the estate) post-petition is entitled to administrative-expense status. [7]

By focusing on when taxes are incurred, the Bankruptcy Code avoids possible confusion created by tax periods that straddle the petition date. [8] Although courts in other contexts have sought to prorate other taxes to account for pre- and post-petition periods, [9] the entirety of a property tax incurred pre-petition is entitled to priority status, and the entirety of a property tax incurred post-petition is entitled to administrative-expense status. This principle does not hold if the debtor is a lessee who agreed to pay property taxes as part of the lease. These claims are governed by § 365(d)(3) and are often prorated for the portions of the lease that are prepetition and postpetition. [10]

State law governs when a tax is deemed to have incurred. [11] Courts typically find that a tax is incurred when it accrues and becomes a fixed liability. [12] Most courts find that the date on which a property tax is incurred is different from—and earlier than—the date on which payment is due. [13] Such a finding depends on the jurisdiction and the state taxing structure. For example, Maryland courts have held that property taxes are incurred on the “date of finality” (the valuation date), despite the fact that a property holder can transfer the tax liability by filing a timely report of transfer upon selling the property after that date. [14] Similarly, an Indiana court held that property taxes were incurred on the assessment date because that was

when the annual tax liability attached. The court relied in part on the fact that “the owner’s liability would not be affected even if the property were sold after this date.” [15] In Georgia, “the owner of real and personal property as of [Jan.] 1 [in any calendar year] is the person that incurs liability for the ad valorem taxes associated with that property.” [16] West Virginia courts look to the period of ownership itself, since it is “the event giving rise to the property tax...even though the amount of tax [has] not yet been determined.” [17]

## Conclusion

In determining whether taxes are entitled to priority or administrative-expense status, the inquiry should focus on when the taxes were incurred under state law. Establishing that a property tax was incurred pre-petition may allow the debtor to avoid penalties and interest and defer payment, while a determination that the tax was incurred post-petition would elevate the tax to administrative-expense status, entitling the taxing authority to immediate cash payment of its claim, including penalties and interest.

1. The authors thank Stephen Gikow for his contribution to this article.
2. Compare *In re Pacific-Atlantic Trading Co.*, 64 F.3d 1292, 1298 (9th Cir. 1995) (holding that administrative-expense treatment afforded to certain taxes also extends to interest and penalties that accrue on that debt), and *In re Mark Anthony Constr. Inc.*, 886 F.2d 1101, 1102 (9th Cir. 1989) (interest on post-petition taxes is administrative expense), with *In re Standard Johnson Co.*, 90 B.R. 41 (Bankr. E.D.N.Y. 1988) (classifying claims for interest on pre-petition claims as general unsecured claims because they were “punitive in nature, [and bore] no relationship to any actual pecuniary loss”), and *In re Fowler*, 394 F.3d 1208 (9th Cir. 2005) (denying interest on pre-petition unsecured tax claims in chapter 13 proceeding).
3. Excise taxes follow a similar model and generally are “entitled to administrative expense status if the transaction, event or occurrence on which the tax is based occurs postpetition and the tax is thus incurred by the estate.” See 4 *Collier on Bankruptcy* § 503.07[2][e] (15th ed. 2008 rev.).
4. Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), courts had also disagreed on how to treat straddle-year income taxes. BAPCPA amended the Code to provide that an income tax is entitled to eighth priority if it is “for a taxable year ending on or before the date of the filing of the petition.” 11 U.S.C. § 507(a)(8)(A). As a result, income taxes that straddle the petition date are entitled to administrative priority, although that result may not be enforced in all circumstances. For a discussion of tax treatment

after BAPCPA, see Gregory L. Germain, "Taxing Income in the Year of Bankruptcy under BAPCPA," 24-10 *Am. Bankr. Inst. J.* 14 (2006); Carl M. Jenks, "The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Summary of Tax Provisions," 79 *Am. Bankr. L. J.* 893 (2005).

5. BAPCPA replaced "assessed" with "incurred," presumably because courts had struggled to define "assessed" differently from "incurred." See 4 *Collier on Bankruptcy* § 503.07[2][e] (15th ed. 2008 rev.).

6. For an in-depth treatment of tax liens entitling claims to secured status, see Gordon D. Henderson and Stuart J. Goldring, *Tax Planning for Troubled Corporations* §1102.13.2 (2011).

7. *Id.* (For a tax to be entitled to administrative-expense status under § 503(b)(1)(B), a two-pronged inquiry must be satisfied: (1) the tax must have been incurred by the estate, and (2) the tax must not qualify as a prepetition unsecured claim entitled to priority under § 507(a). See, e.g., *In re L.J. O'Neill Shoe Co.*, 64 F.3d 1146, 1149 (8th Cir. 1995) (reiterating test and noting that "[i]f either of these two requirements is not satisfied, then the claim is not entitled to administrative-expense treatment.")).

8. 11 U.S.C. § 507(a)(8).

9. See, e.g., *L.J. O'Neill Shoe*, 64 F.3d 1146 (in decision rendered pre-BAPCPA, bifurcating taxes arising from pre-petition income and taxes arising from post-petition income). As noted, *supra*, n.4, BAPCPA amended the Code to provide that only tax claims for tax years that ended prior to the filing for bankruptcy are entitled to priority status.

10. See, e.g., *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125, 1128 (7th Cir. 1998); see also Henderson and Goldring, *supra*, n.6, §1102.13.3.

11. See *In re Columbia Gas Transmission Corp.*, 37 F.3d 982, 984 (3d Cir. 1994) (citing *Butner v. United States*, 440 U.S. 48, 55 (1979)).

12. See *In re Federated Dep't Stores Inc.*, 270 F.3d 994, 1001 (6th Cir. 2001); *In re Blue Lustre Prods. Inc.*, 214 B.R. 188, 189 (S.D. Ind. 1997).

13. See, e.g., *Blue Lustre*, 214 B.R. at 190. At least one state's courts have found that liability fixes upon the payment due date. See *Federated*, 270 F.3d at 1004 (applying New York law and holding that taxes were incurred when "the taxes became due and payable" and that because "the debtor's estate oversaw the property [it] is therefore responsible for paying the tax").

14. See, e.g., *In re Wang Zi Cashmere Prods. Inc.*, 202 B.R. 228, 232 (Bankr. D. Md. 1996).

15. *Blue Lustre*, 214 B.R. at 190.

16. *In re Anchor Glass Container Corp.*, 375 B.R. 683, 685 (Bankr. M.D. Fla. 2007).

17. *In re Columbia Gas Transmission Corp.*, 37 F.3d 982, 986 (3d Cir. 1994).