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Corporate Bankruptcy: Treatment of Filing Year Income Tax −− a Suggested Approach

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The focus of this article is the proper treatment in a chapter 7 or 11 bankruptcy proceeding [2] of the federal income tax [3] incurred by a corporate debtor for the year in which the bankruptcy petition is filed, the so−called "straddle−year." Bankruptcy law requires that the straddle−year income tax be apportioned between the pre−petition and post petition portions of the year for priority purposes. [4] Yet, neither the relevant statutes nor the reported cases provide a principled method of apportionment. Under relevant tax law there are only two possible methods of apportionment: (1) to apportion ratably over time; or (2) to terminate the straddle year as of the date the bankruptcy petition is filed and to treat the pre−petition and post−petition portions of the year as separate taxable periods. [5] Since the tax law in a bankruptcy−specific provision prohibits the second method, it is this author's contention that the tax must be apportioned ratably over time.

Normally, when two well developed bodies of law such as bankruptcy law [6] and tax law [7] intersect, one would expect the ensuing cases initially to attempt to interpret the relevant provisions in such a manner as to eliminate or, at least, to minimize, any potential conflict. Only if conflict avoidance is not possible, should the cases go on to the next step, which is to carefully examine each set of rules together with the Congressional policies behind the rules and then to determine which should take precedence. However, in the issue under consideration it appears as if the courts have simply applied the bankruptcy rules and almost completely ignored the tax rules. While some lip service has been paid to the need not to violate the tax rules, it is questionable whether any real attempt to accomplish this occurred. Even if it is determined that policy concerns require the bankruptcy provisions to dominate in this intersection with the tax law, the author believes there exists a simple means to satisfy the bankruptcy policies without seriously violating the relevant tax provisions. Unfortunately, none of the cases have even focused on the possibility, much less adopted it. Only one case [8] in an analogous context has come close to getting it right, but stopped short of taking the final step.

The issue under discussion implicates most directly only two tax and two bankruptcy provisions, and one basic background feature of the tax law. The basic background feature of the tax law involved is that normally, for federal income tax purposes, the obligation to pay tax arises at the end of the taxable period, whether that is a calendar or fiscal year. [9] The two tax provisions involved are IRC sections 1398 and 1399. These sections provide that when an individual files a bankruptcy petition under chapters 7 or 11 of the Bankruptcy Code, the bankruptcy estate created is a separate taxable entity from the debtor [10] and the debtor has an election available to terminate his taxable year as of the day before the petition is filed. [11] When a corporation is involved in a bankruptcy proceeding, the estate is not a separate entity [12] and no election to terminate the debtor's taxable year is available. [13] Accordingly, under the IRC, when a bankruptcy petition is filed by a corporate taxpayer in middle of the tax year, the tax for that year would be determined in the usual manner, without regard to the bankruptcy petition.

The two key bankruptcy provisions that come into play are 11 U.S.C. sections 503 and 507(a)(8). Bankruptcy law places great emphasis on when a tax is incurred and gives different priority to taxes incurred pre and post−petition. [14] Under 11 U.S.C. section 503, generally, every tax incurred by the bankruptcy estate, *i.e.*, post−petition, is an administrative expense entitled to first priority status. [15] Other income taxes of the debtor, including pre−petition federal income tax, generally would be within section 507(a)(8), entitled to eighth priority status. [16] In determining how to treat the straddle year income tax, no one seems inclined to simply treat the tax under the normal income tax rules − − as if it arose at the end of the taxable year − − since this would give the income tax administrative expense status. [17] Instead, every court that has addressed this issue has determined it is necessary to bifurcate the straddle year tax into pre and post−petition portions and to extend first priority administrative expense status to only the post−petition portion, while the pre−petition portion receives eighth priority status. While some of the courts have addressed the fact that such treatment is, or, at least, may appear to be inconsistent with the federal income tax rules, [18] no court has actually focused on how the division between pre and post−petition portions of the year is, or should be, accomplished. [19] It is the author's contention that if it is necessary to divide the straddle year taxes into pre and post−petition portions, it must be done in accordance with the IRC's normal apportioning mechanism, and that is to apportion based solely on the amount of time in each period. What empathetically may not be done is to apportion based on the net income earned pre−petition and the net income earned post−petition. Unfortunately, not only do the courts not focus on this issue, it is not even possible to surmise how the apportionment was done in the reported cases.

I. Bankruptcy Law

A. Relevant Statutory Provisions

Although 11 U.S.C. sections 346(c)(1), 728(a) and 1146(a) which are analogous to IRC sections 1398 and 1399 also are involved [20] and are sometimes quite important, the focus of all the cases in this area is on 11 U.S.C. sections 503(b)(1)(B)(i) and 507(a)(8)(A)(iii). 11 U.S.C. section 507(a)(1) grants first priority status to "administrative expenses allowed under section 503(b)." The relevant portion of section 503(b) provides:

"(b) . . . there shall be allowed administrative expenses . . . including –

1. . . .

A. any tax –

(i) incurred by the estate, except of a kind specified in section 507(a)(8) . . ."

Accordingly, the test to determine whether a tax is entitled to first priority treatment is two part: (1) the tax must be incurred by the bankruptcy estate; and (2) the tax may not be of a kind specified in 11 U.S.C. section 507(a)(8) [21] which defines eighth priority claims. If the tax is not incurred by the bankruptcy estate, or even if a tax is incurred by the estate, but is within section 507(a)(8), it is not entitled to first priority status.

The relevant portion of 11 U.S.C. section 507(a)(8) provides: [22]

§ 507. Priorities

a. The following expenses and claims have priority in the following order: . . .

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for –

A. a tax on or measured by income or gross receipts – . . .

(iii) . . . not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case….

B. Relevant Cases

Since there are only a handful of relevant cases, a brief summary of each of the cases, in chronological order, follows.

The first [23] case under the Bankruptcy Code to focus on the straddle year income tax is *In re O.P.M. Leasing Services, Inc*. [24] In *O.P.M. Leasing* the Debtor filed a voluntary chapter 11 petition for reorganization on March 11, 1981. The Debtor was on a fiscal year ending on November 30th. When the Trustee filed the Debtor's Indiana income tax return for the fiscal year ended November 30 1981, it paid in full the tax [25] for only the post−petition portion of the year, from March 11, 1981 through November 30, 1981, but did not pay any tax for December 1, 1980 to March 10, 1981, the pre−petition portion of the year. [26] The Trustee claimed that the pre−petition portion of the tax was not an administrative expense priority under 11 U.S.C. section 503(b)(1)(B), but was a pre−petition claim. Since Indiana filed its claim well after the bar date for pre−petition claims, the Trustee argued that this portion of the claim must be disallowed. [27] Indiana argued that the entire 1981 fiscal year was one indivisible tax year terminating post−petition, the income generated pre−petition was inseparable from the income generated post−petition and that the entire amount was an administrative expense. [28] The court stated the issue presented as ". . . whether the estate of a corporation which files a bankruptcy petition in the middle of its fiscal year, incurs an administrative expense liability for corporate income taxes allocable to the pre−petition period of that year, when the tax liability is not scheduled for determination until the close of the fiscal year." [29]

In *O.P.M. Leasing* the court held the pre−petition portion of the tax was separate and different from the post−petition portion and was not eligible for administrative claim status. [30] The court held that both parts of the 11 U.S.C. section 503(b)(1)(B)(i) test for administrative claim status were not met. [31] The court first addressed whether the pre−petition portion of the straddle year income tax was listed in what is today 11 U.S.C. section 507(a)(8). [32] The court had very little difficulty holding that it was within section 507(a)(8). [33] The court noted that while the estate is not a "wholly new entity" distinct from the pre−petition debtors, there is a definite "cleavage" which separates the two. [34] This cleavage creates a barrier between the pre and post−petition income, and the pre−petition income is not an administrative expense. [35] The court with no further elaboration simply held that the pre−petition portion of the tax fit within section 507(a)(8), as a tax "not assessed before, but assessable . . . after, the commencement of the case." [36]

The court in *O.P.M. Leasing* had much more difficulty in finding that the pre−petition tax was not "incurred by the estate", the other prong of the 11 U.S.C. section 503(b)(1)(B)(i) test for an administrative expense. [37] As an initial matter, the court would not accept the Trustee's argument that the tax was incurred on the date it accrued, rather than when it was assessed, since the precedent relied upon by the Trustee was not "totally analogous." [38] According to the court, all of the cases relied upon by the Trustee involved periods that either ended prior to the filing of the bankruptcy petition or covered a post−confirmation period. [39] Nevertheless, since the tax at issue was allocable to pre−petition business activities, the court held it was not entitled to administrative expense priority. [40] The court had three grounds for its decision. First, the legislative history of 11 U.S.C. section 503(b)(1)(B) supports this conclusion. [41] The court cited a passage which provided that administrative expenses should include taxes, "which the trustee incurs in administrating the debtor's estate, including taxes on capital gains from sales of property by the trustee and taxes on *income earned by the estate during the case*." (emphasis added by *O.P.M. Leasing*). [42] Accordingly, the tax on any income earned pre−petition and not by the estate, is not entitled to administrative expense priority. [43] The court's second ground was that under Indiana law corporations were required to make quarterly, estimated tax payments. [44] Since the Debtor's pre−petition income tax liability should have been subject to such an estimated tax payment, it was a "claim" by Indiana that could have been listed with other pre−petition claims. [45] This, according to the court, belied Indiana's argument that it had no right to collect the tax prior to the filing of the bankruptcy petition. [46]

Without getting into an extended discussion at this point, this ground seems to be a bootstrap argument by the court. As will be discussed in more detail later, [47] typically there is not any liability for estimated tax that is independent of the actual final liability for tax for the year. [48] Estimated tax is just a method of prepaying the ultimate annual tax liability. For example, if income, were earned during the first quarter of the year, but for the entire year a loss resulted, there is no obligation to pay estimated tax for the first quarter.

The third ground given by the court for its holding was the general principle that statutory priorities be interpreted very narrowly, since they are fundamentally inconsistent with the basic thrust of the Bankruptcy Code, that the debtor's limited resources be distributed equally among the creditors. [49]

While the court did not explicitly so state, its reliance on legislative history and rules of statutory construction suggest the court felt the statute on its face did not clearly resolve the issue. It is only in the face of statutory ambiguity that resort to such extrinsic aids to statutory construction are utilized.

The next straddle year case to arise was *In re Prime Motor Inns, Inc*. [50] In *Prime Motor* the issue involved the Debtors' fiscal year running from July 1, 1990 to June 30, 1991. [51] On July 2, 1990 the Debtors (a group of related corporations) sold assets for $170 million. [52] On September 18, 1990 the Debtors filed for bankruptcy reorganization under chapter 11. [53] In the schedule of assets and liabilities submitted by the Debtors, they did not list the dollar amount of state income tax due to New Jersey. [54] Instead, the Debtors listed the amount due to New Jersey as "unliquidated, contingent and disputed." [55] Subsequently, the bar date for submitting pre−petition claims was set as May 15, 1991, [56] and New Jersey did not file a proof of claim for income tax before the bar date. [57] Ultimately, when the Debtors' income tax returns for the year ending June 30, 1991 were filed, it turned out that New Jersey was owed over $2.6 million in tax, due to the gain realized on the July 2, 1990 sale of assets. [58] One of the issues before the court was whether the New Jersey tax was pre−petition; since the sale occurred pre−petition, and was therefore barred because of New Jersey's failure to file a timely claim, or whether the tax was post−petition since the tax year ended and the tax did not become due until well after the petition and the bar date. [59]

In *Prime Motor* the court spent very little time on this issue. It simply held:

Because the Sale giving rise to the tax liabilities occurred prior to the Petition Date, the Tax Obligations were incurred prior to the Petition Date. Accordingly, the Court concludes that the Tax Obligations constitute pre−petition obligations of the Prime Debtors, notwithstanding the fact that the obligations were not payable or even assessable until after the Petition Date. [60]

The court's reasoning was very conclusory. Relying on *In re Davidson Lumber Co*., [61] it held that "a tax accrues on the date it is *incurred*, not on the date of assessment or the date it is payable." [62] While *Davidson* is distinguishable, since it did not involve straddle year tax but tax due to recapture of a pre−petition investment tax credit necessitated when the Trustee abandoned the property for which the investment tax credit was claimed, the point adopted by *Prime Motors* is simply that a tax is deemed incurred when it accrues. [63] Neither *Davidson* nor *Prime Motor* focus on when a tax accrues, both seem to simply assume it accrues when the underlying activity occurred. It appears that in *Davidson*, this is assumed to be when the original tax return claiming the investment tax credit was filed; [64] in *Prime Motor* it is when the sale occurred. [65]

Interestingly, in stating its conclusion *Prime Motor* seems to mix up the concepts. Under 11 U.S.C. section 503(b)(1)(B)(i) (which *Prime Motor* does not even cite), the issue is when the tax is incurred. *Prime Motor,* following *Davidson*, held this occurs when the tax accrues. However, in presenting its holding, *Prime Motor* reverses the two and states "that a tax accrues on the date it is *incurred* . . ." [66]

The next case is *Missouri Department of Revenue (In re L.J. O'Neill Shoe Co.)* [67] In *O'Neill Shoe* the Debtors, a group of related corporations, filed for chapter 11 bankruptcy protection on January 24, 1991. [68] The Debtors' relevant fiscal year began on February 25, 1990 and ended on February 23, 1991. [69] Thus, the Debtors' taxable year ended about one month after they filed for bankruptcy. In *O'Neill Shoe* the bankruptcy court set July 1, 1991 as the bar date for filing all claims except first priority administrative expense claims. [70] More than five months after the bar date, Missouri filed a proof of claim for state income tax for the straddle year. [71] Missouri claimed the full amount of such tax was an administrative expense priority and therefore its claim was timely. [72] In a proceeding brought by the Debtors objecting to this claim, the bankruptcy court held that only the portion of the tax that related to post−petition income qualified as an administrative expense claim. [73] The portion attributable to pre−petition income, was not an administrative expense claim and was therefore barred since it was filed late. [74] The district court affirmed, [75] and Missouri appealed. The Eighth Circuit formulated the question on appeal as "whether the portions of . . . [Missouri's] corporate income tax claims that relate solely to the income of the debtors earned before the date they filed for bankruptcy . . . qualify as administrative expense claims . . ." [76]

The Eighth Circuit started its analysis by noting that under 11 U.S.C. section 503(b)(1)(B)(i) there is a two−prong test to qualify as an administrative expense claim: the tax must be incurred by the estate and the tax must not be specified in what is today 11 U.S.C. section 507(a)(8). [77] Both the bankruptcy and district courts below addressed both prongs of the test. [78] According to the Eighth Circuit, both courts held the entire Missouri corporate tax was incurred by the estate, but that the portions of the tax attributed to pre−petition income fit within 11 U.S.C. section 507(a)(8) and were therefore not administrative claims, but were time−barred eighth priority claims. [79] In deciding the issue on appeal, the Eighth Circuit declined to address the "difficult question" of whether the portion of the tax attributed to pre−petition income was incurred by the estate, since it held that the pre−petition portion of the tax was within 11 U.S.C. section

507(a)(8). [80]

While both lower courts found that the plain meaning of 11 U.S.C. section 507(a)(8) covered the pre−petition portion of the taxes in issue since the tax was not assessed before, but assessable after, the filing of the bankruptcy petition, [81] the Eighth Circuit did not agree. Missouri argued that the plain meaning of section 507(a)(8) was not possible since that would completely vitiate 11 U.S.C. section 503(b). [82] According to Missouri, under its "plain meaning," section 507(a)(8) ("a tax . . . (iii) . . . not assessed before, but assessable . . . after, the commencement of the case") would apply to all post−petition tax, even tax for years beginning and ending post−petition. [83] Tax for such subsequent entirely post−petition years would also be "not assessed before, but assessable after" the petition. Therefore, the "plain meaning" according to Missouri would eliminate all post−petition taxes from administrative priority status. [84] While the lower courts simply found such an interpretation "absurd," the Eighth Circuit agreed with Missouri. The Eighth Circuit held that this was one of those "rare cases" within *United States v. Ron Pair Enterprises, Inc.*, [85] where the plain meaning interpretation produces a result at odds with what Congress intended, and the plain meaning did not govern. [86]

Since the simple "plain meaning" interpretation was not possible, the Eighth Circuit read 11 U.S.C. section 507(a)(8)(A)(iii) to address only pre−petition taxable activity or events. This reading would make subsection (iii) consistent with subsections (i) and (ii), which address, respectively, a pre−petition tax year ending on or before the date of filing and a tax assessed within the 240 days prior to filing. Thus, according to the Eighth Circuit, 11 U.S.C. section 507(a)(8)(A)(iii) addresses taxes from pre−petition events "not assessed before, but assessable . . . after, the commencement of the case." [87] Accordingly, this reading also would place the tax attributable to the pre−petition portion of the Debtors' straddle year within section 507(a)(8) and therefore preclude it from receiving administrative expense status. According to the Eighth Circuit, this reading would effectuate Congress' intent in 11 U.S.C. section 503(b)(1(B)(i) that only post−petition taxes should be administrative expense claims. [88]

In adopting its interpretation of section 507(a)(8), the Eighth Circuit rejected Missouri's proposed alternative reading of section 507(a)(8)(A)(iii). Missouri argued that subsection (iii) applies to tax claims where the tax was fully assessable at the date of the petition but not yet assessed, and remained assessable after the petition. [89] While conceding that Missouri's reading was not implausible, the Eighth Circuit believed its reading to be more consistent with the statute. [90] Rather than attempt to paraphrase the Eighth Circuit's reasoning, its own words are best: (In the following excerpt "MDOR" refers to the Missouri Department of Revenue.)

We believe that MDOR's alternative reading is not true to the language of subsection (iii). The statute's phrase "after the commencement of the case," qualifies the word "assessable" in a temporal sense. MDOR's interpretation overlooks this temporal qualification and treats "assessable" as applicable to the time periods both before and after the filing of the bankruptcy petition. To do so, MDOR must read the word "remains" into the last clause of the statute. While MDOR's reading is not implausible, we believe our reading is more consistent with the statute as it is written. [91]

Apparently, the Eighth Circuit did not see that Missouri's proposed reading of section 507(a)(8)(A)(iii) simply focused on the phrase "not assessed before" and read into it a simple implication that it applied only to tax that could have been assessed before. [92]

The final argument raised by Missouri is very relevant to our inquiry. Missouri argued that splitting the straddle year tax into pre and post−petition portions violated both I.R.C. section 1399 and 11 U.S.C. section 346(c)(1) which provide that no separate entity is created when a corporation files in bankruptcy. [93] Missouri argued that by treating different portions of the straddle year tax differently, the court was treating the pre−petition debtor and the post−petition estate as separate entities. [94] The Eighth Circuit rejected the contention that it was splitting the Debtors' year. [95] It felt that it was treating each Debtor corporation as a single entity and was simply assigning different priorities to different portions of the annual tax. [96]

The next case, *Towers for Pacific−Atlantic Trading Co. v. United States (In re Pacific−Atlantic Trading Co.),* [97] ("*Patco*") is the earliest to involve federal income tax rather than state income tax. In *Patco*, an involuntary chapter 7 petition was effective on November 2, 1988. [98] The Debtor was on a calendar year for tax purposes. [99] The bar date for filing proofs of claim with the bankruptcy court was set as October 12, 1989. [100] The IRS did not file any claim by this date because its records showed no outstanding assessments or unassessed tax liabilities by the Debtor. [101] The records showed, however, that the Debtor had not filed income tax returns for 1985 through 1988. [102] Subsequently, on May 1, 1991 the Trustee filed the Debtor's 1988 income tax return, but the return reported only transactions occurring post−petition. [103] The IRS determined that there was unreported tax liability for 1988 of almost $5.2 million plus interest and penalties of approximately $3.2 million. [104] The Trustee instituted this action for declaratory judgment that the claim for 1988 tax was not an administrative expense. [105] The Trustee argued that since the Debtor engaged in no business activity post−petition, all the income was pre−petition and therefore the tax was not an administrative expense. [106] The IRS responded that the claim was an administrative expense since it was incurred post−petition. [107] The bankruptcy court granted summary judgment to the Trustee. [108] It held that since the income was earned pre−petition, the tax was not incurred by the estate and was therefore not an administrative expense. [109] On appeal, the district court affirmed the bankruptcy court's judgment, but on different grounds. [110] The district court held that the 1988 tax fit squarely within what is now 11 U.S.C. section 507(a)(8)(A)(iii), [111] to wit, it was not assessed before the commencement of the case and was assessable after. [112] As an alternative ground, the district court held that even if the tax was not within 11 U.S.C. section 507(a)(8)(A)(iii), nevertheless, the tax did not satisfy the "incurred by the estate" requirement of section 503(b)(1)(B)(i), because all the relevant taxable activity occurred pre−petition. [113] In holding the 1988 tax was within 11 U.S.C. section 507(a)(8)(A)(iii), the district court held the language of this provision was "not overtly ambiguous" and therefore both rejected resort to legislative history and would not accept other interpretive problems with the language argued by the Government. [114]

The Ninth Circuit affirmed the district court's decision, but its reasoning differed. The Ninth Circuit carefully analyzed both portions of the 11 U.S.C. section 503(b)(1)(B)(i) test for administrative claim status. The Ninth Circuit held that the 1988 tax was incurred by the estate since a tax always is incurred on the last day of taxable year. [115] However, the Ninth Circuit also held that the tax was not eligible for administrative claim status since it is described in today's 11 U.S.C. § 507(a)(8). [116]

With respect to whether the 1988 income tax was "incurred by the estate", the Ninth Circuit commenced its analysis by first focusing on the language of the statute. [117] While the term "estate" did not give the court any problem, [118] "incurred" did. The Bankruptcy Code does not define incurred, and the dictionary definition of "become liable or subject to" does not help. [119] Here, the income subject to tax accrued pre−petition, before the existence of the estate, but became payable after the estate's creation. [120] According to the Ninth Circuit it was unclear whether the Debtor or the estate "became liable or subject to" the 1988 tax. [121] Accordingly, since the statute is facially ambiguous, and there is no Ninth Circuit precedent, the Ninth Circuit looked to the statute's legislative history. [122]

In reviewing the legislative history, the Ninth Circuit became convinced that "[t]he pertinent legislative history clearly demonstrates that the drafters of § 503(b)(1)(B)(i) intended that a tax on income should be treated as 'incurred' on the last day of the taxable period." [123] When the House version of what ultimately became the Bankruptcy Code of 1978 came to the Senate, one of the amendments recommended by the Senate Finance Committee was a general definition of when a tax is incurred as follows: [124]

a. For purposes of this title − −

1. a tax on

or measured by income or gross receipts for a taxable period shall be considered incurred on the last day of the taxable period; . . .

While this provision did not survive in the House and Senate compromise bill that ultimately was enacted, nevertheless, final statements made by both the House and Senate sponsors of the bill on their respective house floors convinced the Ninth Circuit that the intent of the legislation was to follow the substance of the proposal, though the language was dropped due to other interpretative concerns. [125]

Interestingly, while the Ninth Circuit adopted the Government's argument that a tax accrues on the last day of the taxable period based on the legislative history of the Bankruptcy Code, it refused to even consider the Government's argument that the Internal Revenue Code mandates the same result. [126]

Turning to the section 507(a)(8) prong of the test for administrative expense status, the Ninth Circuit seems to have done a 180 degree turnaround. As eager as the Ninth Circuit was to look to the legislative history of "incurred by the estate," it was absolutely adamant in refusing to consider the legislative history of 11 U.S.C. section 507(a)(8)(A)(iii)'s "not assessed before, but assessable . . . after . . ." language. The Ninth Circuit would not accept any argument offered by the Government that section 507(a)(8)(A)(iii) was ambiguous and that resort to legislative history or other interpretational guidance was necessary. [127] Indeed, the Ninth Circuit rejected the very same arguments that the Eighth Circuit in *O'Neill Shoe* accepted. [128] Instead, the Ninth Circuit held simply that section 507(a)(8)(A)(iii) was unambiguous and its plain meaning included the 1988 income tax at issue here. [129] Therefore, the 1988 income tax was not eligible for administrative expense status. [130]

The last case directly on point is *United States v. Hillsborough Holdings Corp. (In re Hillsborough Holdings Corp.)* [131] Here, too, the issue involved was the treatment of federal income tax for the straddle year. [132] The Debtor and its subsidiaries operated on a fiscal year ending May 31st. [133] On December 27, 1989, the Debtors filed a voluntary chapter 11 petition. [134] For the tax year ending May 31, 1990, the Debtors filed a consolidated income tax return and paid in full only an amount they characterized as the pro rata portion of the tax attributable to the post−petition portion of the year. [135] The IRS filed an application with the bankruptcy court seeking allowance of the unpaid tax as a first priority administrative expense. [136] In ruling against the IRS's claim, the bankruptcy court held the IRS's claim fit squarely within today's 11 U.S.C. section 507(a)(8) and also that, to the extent the income was earned pre−petition, the tax was not incurred by the estate. [137] On appeal, the district court affirmed the bankruptcy court and both parts of its holding. [138]

In affirming the district court's holding, the Eleventh Circuit did not address the issue of whether the tax was incurred by the estate. It assumed, *arguendo*, that it was. [139] Nevertheless, since the pre−petition portion of the tax was within 11 U.S.C. section 507(a)(8)(A)(iii), the Eleventh Circuit held it was not eligible for administrative expense treatment. [140]

In its analysis of section 507(a)(8)(A)(iii), the Eleventh Circuit refused to accept the IRS's argument that the provision's plain language results in the absurdity that all post−petition tax, even for years that begin and end post−petition, would not be eligible for administrative claim status and therefore section 507(a)(8)(A)(iii) should be interpreted as applying only to tax that was assessable though not assessed before, but was assessable after the filing. [141] The Eleventh circuit noted that it was following both the Eighth and Ninth Circuits in *O'Neill Shoe* and *Patco* in rejecting the IRS's proposed interpretation. [142] Instead, the Eleventh Circuit adopted the *O'Neill Shoe* interpretation of section 507(a)(8)(A)(iii) that it "address[es] taxes derived from pre−petition events 'not assessed before, but assessable . . . after, the commencement of the case.'" [143]

Without much discussion, the Eleventh Circuit also followed *O'Neill Shoe* and held that allowing division of the straddle year tax into a pre−petition eighth priority portion and post−petition administrative expense portion did not subvert the Internal Revenue Code. [144] The Eleventh Circuit, following *O'Neill Shoe* held that creating two "portions" for priority purposes did not permit the debtor to create separate taxable years. [145] Instead, and without any explanation, the Eleventh Circuit simply asserted that the tax for the straddle year was imposed as if no bankruptcy petition were filed, as required by the tax law, though the payment of the tax would be governed by principles and priorities of the bankruptcy laws. [146] This assertion by the Eleventh Circuit is especially mystifying since in a footnote a few lines further in the opinion the court acknowledges it does not know how the pre and post−petition portions of the tax were calculated. [147]

Although not directly on point, some attention must be given to *In re Bayly Corp.* [148] since it stated, albeit in *dicta*, that income tax on income earned during the portion of the straddle year before the bankruptcy petition is filed is a pre−petition claim [149] and it also focused on 11 U.S.C. section 503(b)(1)(B)(i). [150]

As general background for the issue involved in *Bayly*, it is necessary to focus briefly on one aspect of ERISA. [151] Under ERISA, the Pension Benefit Guaranty Corporation ("PBGC") becomes the statutory trustee of any plan terminated without sufficient funds to pay its guaranteed benefits. [152] The plan sponsor, which is generally the employer, becomes liable to the PBGC for the total amount of the unfunded guaranteed benefits of the plan, up to a limitation of thirty percent of the net worth of the employer. [153] If the employer fails to pay the amount of its liability upon demand by PBGC, PBGC can establish a lien on all property of the employer. [154] Under ERISA, for bankruptcy purposes such lien is treated in the same manner as a tax due and owing the United States. [155]

In *Bayly,* the debtor, which was a corporation, filed for reorganization under chapter 11 on December 14, 1990. [156] When the Debtor failed to reorganize, on November 29, 1992, the bankruptcy court converted the case to a liquidation under chapter 7. [157] Under an agreement between the Trustee and the PBGC, the Debtor's pension plan was terminated on September 1, 1991. [158] At the termination date, the plan had unfunded benefit liabilities of almost $1.1 million. [159] PBGC then filed a proof of claim for approximately $352,000, which was thirty percent of the Debtor's net worth on the termination date. [160] At issue was whether this claim was entitled to administrative expense priority under 11 U.S.C. section 503(b)(1)(B)(i) since it was post−petition, if it was deemed to arise on September 1, 1991, the plan termination date. [161]

Bayly

is distinguishable from the issue under discussion since it does not involve an income tax. [162] In fact, in *Bayly*, the PBGC never obtained a valid lien for its claim since the bankruptcy stay was already in place when the pension plan terminated, [163] so the PBGC claim never even ripened into "tax" status. [164]

When the Tenth Circuit reviewed the lower court's determination that the PBGC's claim was not entitled to administrative expense status, it focused on 11 U.S.C. section 503 (b)(1)(B)(i). [165] Since the PBGC's claim was not within 11 U.S.C. section 507(a)(8), according to the Tenth Circuit, the issue hinged on whether the claim was a "tax" and whether it was "incurred by the estate." Since the Tenth Circuit agreed with the lower courts that the claim was not incurred by the estate, because all the work rendered by Debtor's employees occurred pre−petition, it sidestepped the issue of whether the claim was a tax. [166] Ultimately, the Tenth Circuit treated this PBGC claim as simply a situation where liability is created pre−petition, despite the fact that some triggering event occurs post−petition. [167] As such, under the Tenth Circuit's analysis, the claim here is similar to a guaranty undertaken pre−petition, but where payment occurs post−petition, and real estate taxes that accrue pre−petition, but are not calculated or do not become payable until post−petition, both of which are treated as pre−petition, non−administrative expenses. [168]

Although *Bayly* is totally distinguishable from the straddle year issue under examination, in the course of its discussion, it did include income taxes on income earned pre−petition as an example of claims that are treated as pre−petition, though there is a post−petition triggering event. [169] *Bayly*, however, seems not to have focused on the issues implicated when an income tax is involved. *Bayly* contains absolutely no discussion of any pertinent issues, just a statement of its conclusion that the tax on pre−petition income is not an administrative expense. Similarly, *Bayly* cites only *OPM Leasing* as its authority, and recognizes through a "cf." cite that *Patco* is to the contrary. [170] However, *Bayly* completely misses *O'Neill Shoe* and *Hillsborough*, despite the fact they are more recent and decided in circuit courts. Similarly, later in the opinion *Bayly* does not distinguish income taxes from other taxes in its discussion of when a tax is incurred under the Bankruptcy Code. [171] *Bayly*, though it does refer to income tax in its analysis, simply seems not to have focused on the issues raised when an income tax is involved−−most likely because *Bayly* did not involve even a "tax."

II. Tax Law

To properly understand the relevant tax considerations, it is necessary to briefly review some general tax principles and then to examine IRC sections 1398 and 1399 through the prism of these general principles. [172]

A. General Principles

One of the most fundamental concepts of our federal income tax system is that the tax is an annual tax. The tax due for the year, if it has not been prepaid by withholding or estimated tax payments [173] must be paid, without assessment and without notice or demand, with the tax return due shortly after the end of the year. [174] The concept of an annual taxable period −− the taxable year −− has been a feature of our modern income tax since its inception. [175] In an early landmark decision, [176] the Supreme Court upheld the taxable year convention recognizing that it was a necessity if the government was to operate efficiently:

It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. [177]

Today, the taxable year concept is codified in IRC Section 441 which permits taxpayers to utilize either a calendar or fiscal year [178] as their taxable year. [179]

Normally, the determination of taxable income and, consequently, the amount of tax due, is based on the taxable year. [180] From a practical standpoint, the taxable year is a rather artificial concept. If one prolonged financial transaction spans several taxable years it is nevertheless necessary to report the segment that occurs this year on this year's tax return. [181] Similarly, all transactions occurring within this artificial period must be aggregated and reported on this year's tax return, regardless of whether the gain may have accrued over an extended period of time. [182] From a tax standpoint, it normally makes no sense to attempt to determine how much tax was incurred in a portion of the tax year, since the tax consequences are dependent upon what happens during the remainder of the taxable year. Thus, even if a profit is earned in the first half of the year, whether any tax is incurred and also, perhaps, the rate of tax, will be indeterminable until the end of the year. A large loss during the second half of the year may totally eliminate any tax for the year. [183]

There are very few instances in the Internal Revenue Code when it is necessary to determine taxable income and/or components thereof for a portion of a taxable year. Whenever such a determination is required, there seem to be only two possible methods to accomplish this result. The first method is to take the amounts determined for the entire taxable year and to prorate them based on the time before and after the triggering event. The second method is to terminate the taxable year on the date of the triggering event and to treat each partial year as a separate taxable period.

Although the situations in which it is necessary to determine tax results for a portion of a year are quite diverse, the approach taken to effectuate the result is quite uniform. With only one slight exception, what normally happens is one of two possibilities: Either one of the two possible methods of allocation is mandated, or else the taxpayer is permitted to choose which of the two methods the taxpayer wishes to utilize.

Five situations in which it is necessary to make a partial year determination are now presented to illustrate how the Internal Revenue Code generally handles such situations. The last situation is the one in which the normal pattern is modified somewhat.

Situation 1: Midyear Termination of Interest by S Corporation Shareholder

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An S corporation is very different from an ordinary corporation that is referred to as C corporation. [184] An ordinary C corporation is a separate, independent taxable entity. It pays tax on its net income. For tax purposes, its shareholders have no direct connection with the corporation's income. The shareholders report income only when the corporation distributes income to them in the form of a dividend. [185] An S corporation on the other hand is a conduit for tax purposes. [186] Its income and expenses flow through to its shareholders and must appear on the shareholders' income tax returns, regardless of whether the corporation made any distributions to the shareholders. [187] An S corporation generally does not pay any corporate level income tax. [188] An S corporation's items of income and expenses normally flow through to its shareholders annually at the end of the taxable year. The corporation's items of income and expenses for the taxable year are attributed to each shareholder on a pro rata basis. Each item of income and expense is apportioned equally to each day of the taxable year, and each daily amount in turn is apportioned to each share of stock outstanding on that day. [189] When a shareholder terminates his or her interest in the S corporation, it is necessary to determine the tax attributes for the pre−termination and post−termination portions of the year. The attributes of the pre−termination portion of the year are attributable also to the terminated shareholder, while the attributes of the post−termination portion of the year are attributable only to the continuing shareholders. The allocation may be accomplished by the normal method of proration−based−on−time. However, if all affected shareholders and the corporation agree, an election is available to apportion the corporation's attributes for that year by the closing−of−the−year method. That is, as if the corporation's taxable year consisted of two taxable periods, the first of which ends on the day the shareholder terminated his/her interest in the corporation, [190] and the second of which runs from the next day until the end of what would have been the regular taxable year.

Situation 2:Midyear Termination of Corporation's S Status

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Similar to Situation 1, when an S corporation's election to be treated as such terminates during a taxable year, [191] the need arises to allocate its tax items for that year to the pre and post−termination portions of the year so that each set of tax items may be appropriately treated under either the S corporation or C corporation tax regimes. Here too, the statute provides that the apportionment generally shall be done on a strictly based−on−time method, by taking the totals for the S termination year and assigning an equal portion to each day of the year. [192] Alternatively, and subject to certain conditions, an election is available to utilize the closing−of−the−year method and to treat each portion of the year as a separate taxable year. [193]

Situation 3: Limitation On Corporation's Net Operating Loss Carryover.

Another illustration of the proration based−on−time versus the closing−of−the−year dichotomy is contained in IRC section 382. When a corporation incurs a loss in any taxable year, the loss may be carried back or carried forward and offset taxable income of the year to which it is carried. [194] When a corporation undergoes a change in ownership, [195] IRC section 382 imposes a limitation on the deductibility of any pre−change net operating losses. [196] To precisely apply the limitation, it is necessary to divide the taxable income or loss for the year in which the ownership change occurs into pre and post−ownership change segments. The pre−ownership change results are free of section 382's limitations and will either utilize (if net income) or increase (if net loss) the existing net operating loss under the normal rules. The post−ownership change results will be subject to the section 382 limitations. To allocate the year of the change results, section 382(b)(3)(A) provides that the corporation's taxable income for such year shall be allocated ratably on a daily basis, [197] *i.e.*, based−on−time. An election is provided in the Regulations to make the allocation based on a closing−of−the−year method, as if the corporation's books were closed on the date of the ownership change. [198]

Situation 4: Corporation Enters or Leaves Consolidated Group Midyear.

Under the consolidated return rules an affiliated group of corporations may make a consolidated return for the group rather than separate returns for each member of the group. [199] If a corporation enters or leaves a group during a taxable year and is a member of the affiliated group for only a portion of the year, the consolidated return may include this corporation's tax results for only that portion of the year during which it was a member of the group. [200] Under the Regulations, the entering or departing corporation's tax results for the year of change is determined by the closing−of−the year method; i.e., by treating its taxable year as terminating on the day it either becomes or ceases to be a member of the affiliated group. [201] Under certain circumstances, an election of the based−on−time method is available, to ratably allocate its tax results over the days in its original tax year. [202]

Situation 5: Partner's Midyear Termination of Interest −− The Exception

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The only situation that differs somewhat from the general closing−of−the−year versus proration−based−on−time dichotomy is found in the partnership area. A partnership, like an S corporation, is a conduit. Although it must file a tax return, [203] it is not subject to income tax. [204] Instead, its partners are liable for the tax in their separate or individual capacities. [205] Under IRC section 706(c)(2)(A), whenever a partner's entire interest in a partnership terminates, the partnership's taxable year closes with respect to such partner. Under the Regulations, [206] "[i]n order to avoid an interim closing of the partnership books, such partner's distributive share of items . . . may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year." So far this is simply another illustration of the based−on−time versus closing−of−the−year methods. However, the Regulations go on to provide that "[t]he proration may be based on the portion of the taxable year that has elapsed prior to the . . . [termination] *or may be determined under any other method that is reasonable*." [207] (emphasis added). While this latter language opens up the possibility of a proration based on some method other than time, this provision, it is submitted, is really a function of the intricacies of partnership allocations and not any encroachment on the general closing−of−the−year versus examples of proration−based−on−time dichotomy. The history of partnership taxation is replete with both taxpayer manipulation of allocations [208] and government responses thereto. [209] In addition, partnership allocations are intrinsically difficult to limit since the factual variations that need to be accommodated are almost infinite. For instance, partners may devote differing amounts of time or capital to the partnership; partners may have different expertise or different levels of expertise, etc. It seems the purpose of the language in the Regulations is simply to accommodate the additional flexibility that might be required in the partnership area rather than to change the basic closing−of−the−year versus proration−based−on−time dichotomy.

B. Bankruptcy−Specific Tax Provisions

IRC sections 1398 and 1399 specifically address certain tax issues arising in bankruptcy proceedings. [210] While these provisions were already briefly examined, [211] it would be appropriate to review them again briefly so they might be placed in proper context in light of the general principles just discussed.

Taken together, IRC sections 1398 and 1399 establish the broad overall tax scheme applicable to debtors who file bankruptcy petitions. When an individual files a bankruptcy petition under chapters 7 or 11 of the Bankruptcy Code, the bankruptcy estate created is a separate taxable entity from the debtor [212] and the debtor is given an election as to whether s/he wishes to terminate the taxable year as of the day before the petition is filed. [213] When a corporation files for bankruptcy, the estate is not a separate entity [214] and there is no election to terminate the taxable year. [215] This is the plain meaning of the statute, it effectuates Congress' intent [216] and, with respect to the treatment of corporations, is identical to the treatment provided in the Bankruptcy Code for corporations vis−à−vis state and local income taxes. [217]

From the prism of the general tax principles discussed above, when Congress does not permit corporations to terminate their taxable year as a result of filing in bankruptcy, what must obviously be intended is that the tax for such straddle year be calculated on the basis of the normal taxable year concept. Under the normal taxable year concept, it would not be possible to determine how much of the annual tax is specifically attributed to any portion of the year, since all segments of the year are inexorably intertwined. The profitable sale that occurs during the first part of the year will not generate any tax if sales during other portions of the year generate losses of equal magnitude. Similarly, the rate of tax for the year might differ, depending on how much income or loss is generated during other parts of the year. It is not possible, other than by terminating the year, to determine what is pre and what is post−petition tax. If it were absolutely necessary to treat different portions of the annual tax differently, a proration−based−on−time would seem to be the only permissible method. Congress in a bankruptcy−specific tax provision, has explicitly said that termination−of−the−taxable−year is not available to corporate bankrupts.

III. Analysis/Critique of the Existing Cases

In reviewing the handful of cases on point, the author is struck by the fact that the cases seem to focus only on bankruptcy concerns. There is no attempt to comprehend the relevant tax issues. Nor, more importantly, is there any real attempt to reconcile the bankruptcy and tax regimes so as to eliminate, or at least minimize, any resulting conflicts. If these cases are analyzed strictly from a bankruptcy vantage, they seem to make sense. All the cases, including three circuits, and, if the *dicta* in *Bayly* is counted, four circuits, reach the unanimous conclusion that only the post−petition portion of straddle year income tax is entitled to first priority administrative claim status. From a technical perspective, this result is arrived at by meshing the two−part test of 11 U.S.C. section 503(b)(1)(B)(i) with the rather ambiguous language of 11 U.S.C. section 507(a)(8)(A)(iii). Whether achieved by holding the pre−petition portion of the straddle year income tax is not "incurred by the estate," [218] or that it is described in section 507(a)(8)(A)(iii), [219] the result is the same −− bifurcation of the straddle year income tax into pre and post−petition portions.

From a bankruptcy policy perspective, this result may be correct and desirable. It is consistent with the general principle that only taxes incurred by the estate are administrative expenses entitled to first priority. Until the petition is filed there is no estate. Hence, first priority cannot be extended to pre−petition taxes. [220] Similarly, there is legislative history of 11 U.S.C. section 503(b)(1)(B)(i) suggesting that first priority administrative expense status is only to be extended to tax on income earned by the estate. [221] Finally, priorities under the Bankruptcy Code are exceptions to the general principle that all creditors are to be treated equally and therefore are construed very strictly. [222]

From a tax law perspective, the cases are most striking for their failure to really focus on the tax issues implicated and for their consequent failure to even attempt to reconcile the bankruptcy and tax schemes. *OPM Leasing* and *Prime Motor* never even mentioned tax law. [223] In *Patco*, though the taxpayer argued that under the Internal Revenue Code a tax is incurred at the end of the taxable year, the Ninth Circuit did not address the point. [224] Instead, the Ninth Circuit held that the straddle year tax is "incurred by the estate" based solely on the legislative history of the Bankruptcy Code. [225] While *O'Neill Shoe* and *Hillsborough* did address the argument that bifurcating the straddle year tax into pre and post−petition portions violates IRC sections 1398 and 1399, [226] they did so only in a very abbreviated and shallow manner. They simply asserted that bifurcating the tax for priority purposes is not the same as terminating the taxable year. [227] They even suggested they were treating the straddle year tax as a unit, despite its bifurcation for priority purposes, even though neither case indicated how the tax for the year was determined nor how the division into pre and post−petition portions was accomplished. [228] In fact, *Hillsborough* admitted that "[t]he actual method . . . used to calculate the pre−petition and post−petition portions of . . . [the] tax liability is somewhat of a mystery." [229]

Even a cursory review of tax principles discloses that income tax is an indivisible unitary amount, that generally is determined annually on the basis of all events transpiring during the taxable year. In the relatively rare instances during the lifetime of a taxpayer when it is necessary to determine the tax (and/or some other tax attribute) for only a portion of a taxable year, there are only two methods available: (1) closing−of−the−taxable year; and (2) apportionment−based−on−time. Since Congress in IRC sections 1398 and 1399 explicitly eliminated the closing−of−the−taxable−year option, the only possible method available is to apportion−based−on−time. However, not only do the relevant cases fail to attempt to reconcile these tax principles with the bankruptcy result they wish to obtain −− to bifurcate the straddle year tax for priority purposes −− they fail to even indicate any comprehension of the tax principles involved.

It is especially difficult to understand why the cases make no attempt to glean the tax law and to attempt to reconcile it with the bankruptcy principles in this area. The issue involved here is not simply the result of a chance intersection of a general tax provision with the carefully crafted bankruptcy scheme. Instead, IRC sections 1398 and 1399 are bankruptcy−specific tax provisions. Congress was focusing specifically on the bankruptcy scheme when it provided that for corporate taxpayers the bankruptcy estate is not a separate taxpayer from the pre−petition debtor and there is no election available to terminate the taxable year. Indeed, based on general principles of statutory construction that when there is a conflict between different statutes the most recent one normally takes precedence, [230] IRC sections 1398 and 1399 should take precedence since the Bankruptcy Code was enacted in 1978 [231] while IRC sections 1398 and 1399 were enacted as part of the Bankruptcy Tax Act of 1980. [232] Similarly while the United States Supreme Court has held that the bankruptcy scheme take priority over the tax scheme, [233] that was just for the particular conflicts involved, it was not a general grant of precedence to the bankruptcy scheme over the tax scheme. [234]

While none of the relevant cases seems to have gone beyond purely bankruptcy concerns to attempt to properly fathom the tax principles and then to mesh the competing policy concerns of bankruptcy and tax laws in this intersection of the two schemes, a related bankruptcy case in an analogous area seems to have gotten the tax concerns exactly right.

In re Michaelson [235]

involved the confirmation of a chapter 13 bankruptcy plan by husband and wife debtors. [236] The Debtors, who were calendar year taxpayers, filed a chapter 13 petition on September 15, 1995. The IRS did not file a claim for any 1995 income tax contending that the tax liability arose on December 31, 1995, the last day of the Debtors' taxable year, and was therefore entirely a post−petition debt. On March 25, 1996 the Debtors filed a claim on behalf of the IRS [237] contending that the amount of estimated tax they should have paid for the first and second quarters of 1995 were pre−petition claims entitled to eighth priority status under 11 U.S.C. section 507(a)(8)(A)(iii). The IRS objected to such treatment of the 1995 tax claim and consequently objected to the confirmation of the chapter 13 plan. [238]

Although *michaelson* involves an individual debtor and a plan under chapter 13 of the Bankruptcy Code, [239] it is nevertheless analytically very close to the cases discussed above. The issue in *Michaelson* involves proper treatment of the straddle year federal income tax. [240] Also, although the Debtors in *Michaelson* were individuals, in chapter 13 proceedings individual debtors are not authorized to terminate their taxable year. [241] Instead, they are in exactly the same position in this regard as a corporation involved in a chapter 11 or 7 bankruptcy proceeding.

In reaching its decision, the court in *Michaelson* gave its analysis and then, since it was within the Eighth Circuit and bound by *O'Neill Shoe*, the conclusion mandated by the *O'Neill Shoe* precedent. [242] The court commenced its analysis with an examination of 11 U.S.C. section 507(a)(8)(A)(iii), since, ultimately, the issue for decision was whether any portion of the straddle year tax was an eighth priority claim within this provision and, to that extent, not an administrative expense. To be within section 507(a)(8)(A)(iii), the court reasoned, there must be a pre−petition claim. [243] Under the Bankruptcy Code, a "claim" is defined as a "right to payment." [244] In determining that logic supports the IRS's view that the right to payment did not arise until the last day of the taxable year, here December 31, 1995, the court stated:

A right to payment of the tax cannot exist without a corresponding liability for payment. Liability for income taxes arises at the end of a taxpayer's tax period, when all events have occurred that are necessary to determine whether a tax is owing for the period. Tax liability is determined by computing taxable income for the entire year, based on income, deductions, exemptions, credits, etc., for the entire year. Tax related events are not restricted in application to the quarter in which they occur, but apply as part of a gross calculation of events for the entire taxable year. Thus, for instance, income realized in one quarter can be subject to deductions based on events occurring in another quarter. It seems evident then, that the IRS had no right to payment of 1995 taxes from the Debtors at filing of their bankruptcy case on September 15, 1995. [245]

According to *Michaelson*, the obligation to pay quarterly estimated tax payments did not create any right to payment, since estimated tax is just a deposit towards the final liability for the year. [246] Each quarter's estimated payment bears no relationship to income earned that quarter. Instead, it is based either on the final tax due ultimately for this year or the tax due for last year. In fact, if it turns out no tax is due for the year, then there is no obligations to pay estimated tax.

The court's conclusion was:

If the foregoing analysis were applied, it seems clear that the Debtors' liability for 1995 income taxes could only first arise on December 31, 1995, at the close of their tax period, when their income taxes for the year became capable of assessment. At that point, the IRS would have a right to payment of the tax even though actual payment was not due until April 15, 1996. It would follow that: the Debtors' entire 1995 income tax liability arose postpetition; the IRS' right to payment of the tax first arose postpetition; and the entire claim for 1995 income taxes would be a postpetition claim. [247]

In reaching its conclusion, the court focused on the language of section 507 (a)(8)(A)(iii) (a tax "not assessed before, but assessable… after, the commencement of the case") and decided it would have accepted the position put forth by the IRS in *O'Neill Shoe* that this provision applies to situations where the tax period was closed and the tax is still capable of assessment but where the tax was not assessed due to negotiations or some dispute that was in process of resolution. [248] In *O'Neill Shoe*, while the Eighth Circuit conceded that the IRS's interpretation was not implausible, they did not seem very impressed with the IRS's proposed interpretation and they held that their own "permissible" interpretation, that section 507(a)(8)(A)(iii) applies only to pre−petition taxable activity or events, was more consistent with the Bankruptcy Code. Similarly, in *Patco* the analysis of the IRS's proposed interpretation left the reader with the feeling that there was not much substance there. However, the court in *Michaelson* quoted a passage from the legislative history of section 507(a)(8) that put the IRS's proposed interpretation in a much stronger light. The passage quoted indicated that in section 507(a)(8) Congress was addressing a situation where the tax remained assessable under the statute of limitations but where there had been a restriction on assessment and collection of the tax due, for instance, to litigation in Tax Court, thus strongly supporting the IRS's proposed interpretation. [249]

Notwithstanding its analysis, *Michaelson* recognized that it was bound by the Eighth Circuit's opinion in *O'Neill Shoe* which held that section 507(a)(8)(A)(iii) applied to the portion of the straddle year taxes that relates to pre−petition income. [250] At this point the *Michaelson* court pretty much threw its hands up in despair! After reviewing Missouri's argument that both the bankruptcy provisions (vis−à−vis state income tax) and the Internal Revenue Code (vis−à−vis federal income tax) prohibit bifurcating the straddle year and *O'Neill Shoe's* rather glib response that it was not bifurcating the year but simply taking the income tax liability for the entire year and, for priority purposes, assigning the pre−petition portion to eighth priority status and the post−petition portion to administrative expense status, the court did not know how to proceed:

The response suggests that the tax for the taxable year is to be computed on the gross income, deductions, exemptions, credits, etc. for the entire period; and then, the resulting tax should be somehow apportioned to pre and postpetition liability. But, how is the tax to be apportioned? "Prepetition taxable events" affect, and are affected by, postpetition taxable events in computing a single indivisible tax for the period. There exists no apparent measure for relating a portion of the tax to prepetition income, other than through bifurcating the tax period prior to determining the tax.

How then can the Debtors relate their 1995 income tax liability to their prepetition income? It seems that the Debtors must first identify their 1995 prepetition income. Then, it seems, the Debtors must show how pre and postpetition deductions, exemptions, credits, etc., affected that income to produce a calculated portion of their 1995 income tax liability. The question, more precisely, is: how can the Debtors relate their 1995 tax liability to their prepetition income without bifurcating the tax period? Perhaps, the answer is that they cannot. [251]

IV. A Suggested Approach

The solution proposed is that the straddle year tax be determined under normal tax principles based on results for the entire year, without any attempt to terminate the year. To determine the pre and post−petition portions of the tax, apportionment based−on−time should be utilized. In this way the bankruptcy goal of treating pre and post−petition tax differently for priority purposes is achieved while the dictates of IRC sections 1398 and 1399 not to terminate the taxable year are not violated. [252]

To illustrate, if a bankruptcy petition is filed by a calendar year corporate debtor on March 12th, the tax for the entire year should be apportioned 70/365 to the pre−petition period and 295/365 to the post−petition period, based on the number of days in each period. [253] Any attempt to determine the exact income earned and the tax incurred in the pre and post−petition periods would simply be a termination of the taxable year, though perhaps under the guise of a different name.

As a technical means to achieve the suggested result and to further reconcile the bankruptcy and tax provisions and limit the potential conflict between them as much as possible, the following approach to 11 U.S.C. section 503(b)(1)(B)(i) is suggested. In applying the first prong of the two part test to determine administrative expense status, the Ninth Circuit's holding in *Patco* should be adopted. The straddle year tax should always be deemed "incurred by the estate" since a tax is always deemed incurred on the last day of the taxable year. While *Patco* based its holding solely on bankruptcy law, i.e., on the legislative history of 11 U.S.C. section 503(b)(1)(B)(i), [254] this holding is consistent with the tax law's taxable year concept and the fact that the tax becomes due at the end of the year. [255] The second prong of the test, that any tax within 11 U.S.C. section 507(a)(8) is not entitled to first priority status, would then be used to eliminate the pre−petition portion of the straddle year tax from first priority status, as *OPM Leasing*, *O'Neill Shoe*, *Patco* and *Hillsborough* all held.

The only perceived criticism of the suggested approach is that apportioning the straddle year tax based−on−time is arbitrary, since it is purely mathematical and does not reflect actual results in either the pre or post−petition periods. However, IRC sections 1398 and 1399 mandate this result. As *Michaelson* so perceptively realized, short of terminating the taxable year, there is really no way to determine the actual pre and post−petition tax. [256] In addition, since the suggested approach apportions the straddle year income tax based solely on time, the result will not change much if the sale of a substantial asset of the bankrupt occurred the day before rather than the day after the petition was filed. It would therefore seem to reduce any incentive to strategically time the filing to affect tax outcomes that might exist under other apportionment methods.

In crafting what, hopefully, is a very simple solution to the issue of the treatment of the straddle year tax, the author was guided by two overarching principles. First, as in any instance when two statutory schemes conflict, or potentially conflict, it is necessary to reconcile and mesh the two schemes. Without a very good reason, it is not permissible to simply ignore one scheme. Accordingly, the approach taken by the existing cases of pretty much ignoring the tax scheme and looking only at the bankruptcy scheme is rejected. The second overarching principle is that the result reached by the existing cases −− that only the post−petition portion of the straddle year tax should be treated as a first priority administrative expense −− is probably correct and should be effectuated. This conclusion is based on the following:(1) all of the relevant cases reach the same result, including three Circuits; [257] four, if the dicta in *Bayly* [258] is considered; and (2) as indicated above, the legislative history of 11 U.S.C. section 503(b)(1)(B)(i) does suggest that only tax on income earned by the estate is to be given first priority status and it is difficult to rationalize how pre−petition income may be deemed to be "earned" by the estate. Finally, while bankruptcy law seems to require this result, the tax law has no strong policy requiring a different result. So long as the tax year is not inappropriately terminated, the tax law seems indifferent to whether all or only some portion of the straddle year tax is given first priority status.

In conclusion, under the tax law only two methods of apportionment are ever permitted: (1) apportioning ratably based on time; and (2) terminating the taxable year. Since IRC sections 1398 and 1399 prohibit terminating the taxable year, the apportionment must be done ratably over time. It is a simple method; it creates no artificial planning opportunities and does not conflict with bankruptcy policy. The existing cases that do not face the apportionment issue create a conflict between bankruptcy and tax law where none exists.

FOOTNOTES:

[1] Professor of Law, St. John's University School of Law. The author gratefully acknowledges the very helpful comments of G. Ray Warner, Professor of Law, University of Missouri−Kansas City. The author also wishes to acknowledge the very able research assistance of Kyle Barry, class of '01 and Carl Fiore, class of '99. Back To Text

[2] 11 U.S.C. § 701 (1994) (setting out provisions of chapter 7 bankruptcy); id. § 1101(setting out provisions of chapter 11 bankruptcy). Back To Text

[3] Neither the relevant bankruptcy priority provisions, 11 U.S.C. §§ 503(b)(1)(B)(i) and 507 (a)(8), nor the cases distinguish between the federal income tax and similar state income taxes. See id. § 503(b)(1)(B)(i) (stating "[a]fter notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under § 502(f) of this title, including. . . any tax. . . incurred by the estate, except a tax of a kind specified in § 507(a)(8) of this title"); see id. § 507(a)(8) (setting forth priority of unsecured governmental unit claims). Of the four leading cases in this area, In re Hillsborough Holdings Corp., 116 F.3d 1391 (11th Cir. 1997); L.J. O'Neill Shoe Co. v. Missouri Dep't of Revenue (In re L.J. O'Neill Shoe Co.), 64 F.3d 1146 (8th Cir. 1995); Towers for Pacific−Atlantic Trading Co. v. United States (In re Pacific−Atlantic Trading Co.), 64 F.3d 1292 (9th Cir. 1995); and In re O.P.M. Leasing Services, Inc., 68 B.R. 979 (Bankr. S.D.N.Y. 1987), two (O'Neill Shoe and O.P.M. Leasing) involve state income tax and the cases cite one another indiscriminately. Accordingly, the discussion is also applicable to state income taxes that are similar to the federal income tax. Taxes other than the federal income tax and similar state income taxes as, for instance, excise or personal property taxes are not addressed herein since they may accrue or be triggered differently than income taxes. See In re Overly−Hautz Co., 57 B.R. 932, 937 (Bankr. N.D. Ohio 1986) (involving excise tax); In re Scrap Disposal, Inc., 24 B.R. 178, 180 (Bankr. S.D. Calif. 1982) (describing personal property tax), aff'd, 38 B.R. 975 (B.A.P. 9th Cir. 1984). Back To Text

[4] See infra notes 15−21 and accompanying text. See generally Jack F. Williams, National Bankruptcy Review Commission Tax Recommendations: Notice, Jurisdiction and Corporate Debtors, 14 Bankr. Dev. J. 261, 291−94 (1998) (discussing current status and proposed changes to straddle−year bifurcation requirements of corporate debtors). Back To Text

[5] See infra note 179 and accompanying text. Back To Text

[6] Bankruptcy law is contained in the Bankruptcy Code of 1978, as amended, codified at title 11 of the United States Code. Back To Text

[7] Tax law is contained in the Internal Revenue Code of 1986, as amended, codified at title 26 of the United States Code. [Hereinafter IRC]. Back To Text

[8] In re Michaelson, 200 B.R. 862, 868 (Bankr. D. Minn. 1996) (denying debtor's chapter 13 plan for failure to properly classify IRS claim). Back To Text

[9] See infra notes 172−182 and accompanying text. Back To Text

[10] See I.R.C. § 1398 (1994); see also S. Rep. No. 96−1035, at 24−25 (1980), reprinted in 1980 U.S.C.C.A.N. 7017 (describing "[d]ebtor and bankruptcy estate as separate entities"); C. Richard McQueen & Jack F. Williams, Tax Aspects of Bankruptcy Law and Practice Ch. 20 (3d ed. 1997) (explaining tax effects of filing under chapter 7 or 11 of the Bankruptcy Code); Jack F. Williams, National Bankruptcy Review Commission Tax Recommendations: Notice, Jurisdiction, and Corporate Debtors, 14 Bankr. Dev. J. 261, 292−93 (1998) [hereinafter Williams] (showing straddle−year filing requirements). Back To Text

[11] See I.R.C. § 1398(d)(2) (1994) (stating "the debtor may …elect to treat the debtor's taxable year which includes the commencement date as 2 taxable years (i) the first of which ends on the day before the commencement date, and (ii) the second of which begins on the commencement date"). Back To Text

[12] See id. § 1399 (stating "except in any case to which section 1398 applies, no separate taxable entity shall result from the commencement of a case under title 11 of the United States Code"). Back To Text

[13] See id. §§ 1398−99 (providing election only for individuals involved in chapter 7 or 11 bankruptcy proceeding). The legislative history of these provisions make it clear that the election was intended only for individuals. See e.g., S. Rep. No 96−1035 on H.R. 5043 – Bankruptcy Tax Act of 1980, 96th Cong. 2d Sess. at 24−26; see also Williams, supra note 9, at 292 (noting election available to individual debtors does not extend to corporations). It should be noted that when a state income tax is involved, IRC sections 1398 and 1399 are inapplicable. However, a very similar result is obtained under 11 U.S.C. §§ 346(c)(1), 728(a) and 1146(a). See 11 U.S.C. §§ 346(c)(1), 728(a), 1146(a) (1994). 11 U.S.C. § 346(c)(1) provides that the status of a corporation does not change for state and local tax purposes as a result of a filing in bankruptcy. In other words, the bankruptcy estate is not a separate entity. Id. § 346(c)(1). 11 U.S.C. §§ 728(a) and 1146(a) provide that an individual's tax year terminates on the date a petition is filed under chapters 7 and 11, respectively. Id. §§ 728(a), 1146(a). Unlike IRC § 1398, for state and local tax purposes the year is automatically terminated, so there is no election available. Id. Back To Text

[14] See e.g., 11 U.S.C. § 1129(a)(9) (1994) (requiring that in chapter 11 proceedings, first priority administrative expenses must be paid in full at time of the plan confirmation, while eighth priority claims may be paid, with interest, over ensuing six years); id § 726 (providing that in chapter 7 proceedings, no payment is made to any lower priority claim until all claims having higher priority status are paid in full). Back To Text

[15] 11 U.S.C. § 503(b) (1994); id. § 507(a)(1) (providing "[t]he following expenses and claims have priority in the following order: (1) First, administrative expenses allowed under section 503(b) of this title….”). Back To Text

[16] Id. § 507(a)(8). Back To Text

[17] Assuming that the bankruptcy proceeding has not terminated prior to the last day of the taxable year. Back To Text

[18] See infra text accompanying notes 225−228. Back To Text

[19] See infra text accompanying notes 224−228. Back To Text

[20] See supra note 12 and accompanying text. Back To Text

[21] This provision was originally enacted as 11 U.S.C. § 507(a)(6). Pub. L. No. 101−647, 98 Stat. 358 (1984), renumbered it as section 507(a)(7), and in turn, the Bankruptcy Reform Act of 1994 renumbered 11 U.S.C. § 507(a)(7) as section 507(a)(8). The substance of the provision was not changed by either renumbering. The earlier cases refer to 11 U.S.C. § 507(a)(6) or (7) and sixth or seventh priority, but the substance is the same. Throughout this article the current designation will be used. Back To Text

[22] 11 U.S.C. § 507(a)(8) (1994). 11 U.S.C. § 507(a)(8)(A)(i) and (ii) are not relevant since they address, respectively, a taxable year that ended within three years of the bankruptcy filing and a tax assessed within 240 days of the bankruptcy filing. The full version of 11 U.S.C. § 507(a)(8)(A)(iii) reads:

(iii) other than a tax of a kind specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case;

Id. The reference to section 523(a)(1)(B) and (C) is not relevant to our discussion since 11 U.S.C. § 523(a) applies only to individual debtors. Back To Text

[23] In re Davidson Lumber Co., 47 B.R. 597 (Bankr. S.D. Fla. 1985) which is discussed briefly in connection with In re Prime Motor Inns, Inc., 144 B.R. 554 (Bankr. S.D. Fla. 1998), actually predates O.P.M. Leasing by two years. See infra notes 68−71 and accompanying text. However, Davidson, while perhaps relevant, is not on point since it involves the treatment of tax incurred by virtue of the recapture of investment tax credit applied to equipment abandoned post−petition by the Trustee rather than to the straddle year income tax. In any event, Davidson was simply quite conclusory on the issues relevant to our inquiry. Back To Text

[24] 68 B.R. 979 (Bankr. S.D.N.Y. 1987). Back To Text

[25] See id. at 981 (noting tax return was filed late and interest and penalties were also paid for this portion of year). Back To Text

[26] See id. Back To Text

[27] See id. Back To Text

[28] See id. at 982−83. Back To Text

[29] In re O.P.M. Leasing, 68 B.R. at 982. Back To Text

[30] Id. at 986. Back To Text

[31] See id. at 985. Back To Text

[32] See id. at 982. The court noted that the provision was originally in 11 U.S.C. section 507(a)(6), but that was renumbered as section 507(a)(7). Id. That provision was again renumbered and is today section 507(a)(8). See supra, note 25. Back To Text

[33] See In re O.P.M. Leasing, 68 B.R. at 983. Back To Text

[34] See id. Back To Text

[35] See id. (relying on Supreme Court's decision in NLRB v. Bildisco & Bildisco for cleavage point); see also NLRB v. Bildisco & Bildisco, 465 U.S. 513, 516 (1984) (holding chapter 11 debtor−in−possession may reject debtor's collective bargaining agreement, thereby treating debtor−in−possession differently than debtor who was bound by agreement). Back To Text

[36] In re O.P.M. Leasing, 68 B.R. at 983. Back To Text

[37] Id. at 983−85. Back To Text

[38] See id. at 983. Back To Text

[39] See id. Back To Text

[40] See id. at 983−84. Back To Text

[41] See In re O.P.M. Leasing, 68 B.R. at 984. Back To Text

[42] Id. Back To Text

[43] See id. Back To Text

[44] See id. at 984 (stating quarterly payments are required although exact tax liability will not be determined until end of year); see also Ind. Code Ann. §§ 6−2.1−5−1, 6−3−4−4(c) (Burns 1984). Back To Text

[45] See In re O.P.M. Leasing, 68 B.R. at 984. Back To Text

[46] See id. Back To Text

[47] See infra notes 245−47 and accompanying text. Back To Text

[48] See I.R.C. § 6315 (1994) (providing "[p]ayment of the estimated income tax, or any installment thereof, shall be considered payment on account of the income taxes imposed by subtitle A for the taxable year."). Back To Text

[49] See In re O.P.M. Leasing, 68 B.R. at 985. Back To Text

[50] 144 B.R. 554 (Bankr. S.D. Fla. 1992). Back To Text

[51] Id. at 555. Back To Text

[52] See id. Back To Text

[53] See id. Back To Text

[54] See id. Back To Text

[55] In re Prime Motor Inns, 144 B.R. at 555 Back To Text

[56] See id. Back To Text

[57] See id. Back To Text

[58] See id. (noting full amount of tax due by debtors did not become fixed until April 13, 1992 when debtors filed final New Jersey corporation tax returns to replace earlier "tentative" tax returns). Back To Text

[59] The court never specified if it was focusing on June 30, 1991, the last day of the tax year or some other date such as the return's due date or filing date. See id. Back To Text

[60] In re Prime Motor Inns, 144 B.R. at 555. Back To Text

[61] 47 B.R. 597 (Bankr. S.D. Fla. 1985). Back To Text

[62] In re Prime Motor Inns, 144 B.R. at 555. Back To Text

[63] Id.; see In re Davidson Lumber, 47 B.R. at 598−99. Back To Text

[64] In re Davidson Lumber, 47 B.R. at 598−99. Back To Text

[65] In re Prime Motor, 144 B.R. at 555. Back To Text

[66] Id. Back To Text

[67] 64 F.3d 1146 (8th Cir. 1995). It is really a bit of a toss−up whether O'Neill Shoe or In re Pacific−Atlantic Trading Co. is chronologically earlier. O'Neill indicates it was "filed" on August 30, 1995 while Pacific−Atlantic was decided on August 23, 1995. O'Neill is discussed first because it is published 146 pages earlier in the Federal Reporter volume, and O'Neill states it is addressing a case of first impression in the circuit courts. See id. at 1148. Back To Text

[68] Id. at 1147. Back To Text

[69] Apparently the debtors were using a 52−53 week fiscal year, which is the only instance in which a full year may end on a date other than the last day of a calendar month. See I.R.C. § 441(f)(1994). For state purposes, the year was stated as being from March 1, 1990 to February 28, 1991. See In re L.J. O'Neill Shoe Co., 64 F.3d at 1147−48. Back To Text

[70] In re L.J. O'Neill Shoe Co., 64 F.3d at 1147. Back To Text

[71] See id. Back To Text

[72] See id. at 1147−48. Back To Text

[73] See Id. at 1149. Back To Text

[74] In re L.J. O'Neill Shoe Co., 143 B.R. 707, 714 (Bankr. E.D. Mo. 1992). Back To Text

[75] See In re L.J O'Neill Shoe Co., 64 F.3d at 1149. (noting district court affirmed, although district court opinion is not reported). Back To Text

[76] See id. at 1148. Back To Text

[77] See id. at 1149. Back To Text

[78] See id. Back To Text

[79] See id. Back To Text

[80] See In re L.J O'Neill Shoe Co., 64 F.3d at 1149. Back To Text

[81] See id. at 1150; see also In re Interco, 143 B.R. at 713 (reporting decision of bankruptcy court). Back To Text

[82] See In re L.J O'Neill Shoe, 64 F.3d at 1150. Back To Text

[83] See id. Back To Text

[84] See id. Back To Text

[85] 489 U.S. 235 (1989). Back To Text

[86] In re L.J. O'Neill Shoe, 64 F.3d at 1150−51. Back To Text

[87] See id. at 1151. Back To Text

[88] See id. Back To Text

[89] See id. at 1151 n.6. Back To Text

[90] See id. Back To Text

[91] See In re L.J. O'Neill Shoe, 64 F.3d at 1151 n. 6. Back To Text

[92] See id. Back To Text

[93] See id. at 1151. I.R.C. § 1399 applies to splitting the year for federal income tax purposes while 11 U.S.C. § 346(c)(1) applies to splitting the year for state and local tax purposes. Obviously, 11 U.S.C. § 346(c)(1) was directly on point in O'Neill Shoe. See 11 U.S.C. § 346(c)(1) (1994) (providing "the commencement of a case under this title concerning a corporation or a partnership does not effect a change in the status of such corporation or partnership for the purposes of any State or local law imposing a tax on or measured by income."); I.R.C. § 1399 (1994) (providing "[n]o taxable entity shall result from the commencement of a case under title 11 of the United States Code."). Back To Text

[94] See In re L.J. O'Neill Shoe Co., 64 F.3d at 1151−52. Back To Text

[95] See id. at 1152 (arguing state of Missouri still taxes each debtor as one continuous corporate entity). Back To Text

[96] See id. (explaining tax is being imposed against single corporate entity as 11 U.S.C. § 346(c)(1) mandates, but payment of tax imposed is being apportioned in accordance with bankruptcy laws which determine priority of payment of those claims). Back To Text

[97] 64 F.3d 1292 (9th Cir. 1995). Back To Text

[98] Id. at 1294−95 & n.2. The involuntary petition was filed on September 15, 1988. However, under 11 U.S.C. § 502(f) the operative date is the earlier of the date of entry of the appointment of a trustee or the date of entry of the order for relief. In Patco both of these occurred on November 2, 1988. See id; see also 11 U.S.C. § 502(f) (1994). Section 502(f) states "[i]n an involuntary case, a claim arising in the ordinary course of a debtor's business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief shall be determined as of the date such claim arises…." Id; see also 4 Collier on Bankruptcy ¶ 503.4 at 19 (Lawrence P. King et al. eds., 15th ed. Rev. 1997). Section 502(f) claims are normally referred to as involuntary "gap" claims and claims of this type are treated as if such claim had arisen before date of filing of petition. Id. Back To Text

[99] In re Pacific−Atlantic Trading Co., 64 F.3d at 1295. Back To Text

[100] See id. Back To Text

[101] See id. Back To Text

[102] See id. (noting Patco did, however, file extension requests for 1985 and 1987). Back To Text

[103] Id. Back To Text

[104] In re Pacific−Atlantic Trading Co., 64 F.3d at 1296. Back To Text

[105] See id. (explaining IRS had originally instituted claim for taxes owed for years 1985−1988 and then reclassified its claim for 1988 taxes as administrative expenses). Back To Text

[106] See id. at 1295−96. Back To Text

[107] See id. Back To Text

[108] See id. at 1296. Back To Text

[109] See id. at 1296−97. Back To Text

[110] See In re Pacific−Atlantic Trading Co., 64 F.3d at 1297. Back To Text

[111] See In re Pacific−Atlantic Trading Co., 160 B.R. 136, 138 (Bankr. N.D. Cal. 1993). This case arose before 11 U.S.C. § 507(a)(7) was renumbered as section 507(a)(8). Back To Text

[112] See In re Pacific−Atlantic Trading Co., 64 F.3d at 1297. Back To Text

[113] See id. at 1297. Back To Text

[114] See id. The interpretive issue raised by the government was the same one accepted by the Eighth Circuit in O'Neill Shoe that under the statute's "plain meaning," no post−petition tax would ever qualify for administrative expense treatment. See supra notes 83−85 and accompanying text. Back To Text

[115] In re Pacific−Atlantic Trading Co., 64 F.3d at 1301 (concluding legislative history clearly demonstrates income tax is "incurred on the last day of the taxable period."); see 124 Cong. Rec. 32,416 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. 34,016 (Oct. 5, 1978) (statement of Rep. DeConcini). Back To Text

[116] See In re Pacific−Atlantic Trading Co., 64 F.3d at 1304. Back To Text

[117] See id. at 1298. Back To Text

[118] See id; see also 11 U.S.C. § 541(a)(1) (1994) (providing in pertinent part that "[t]he commencement of a case under 301, 302, or 303 of this title creates an estate."). Back To Text

[119] See Webster's Third New International Dictionary 1146 (4th ed. 1976) (defining "incur" to mean "become liable or subject to"); see also 11 U.S.C. § 101 (1994) (defining terms relevant to Bankruptcy Code; "incurred" not defined). Back To Text

[120] See In re Pacific−Atlantic Trading Co., 64 F.3d at 1298. Back To Text

[121] See id. Back To Text

[122] See id. Back To Text

[123] See id. at 1301. Back To Text

[124] See id. at 1299−1300 (quoting S. Rep. 95−2266, at 7−8 (1978), reprinted in Collier on Bankruptcy, Appendix Volume 3 at VII (15th ed. 1995)) (emphasis added by Ninth Circuit). Back To Text

[125] Towers for Pacific−Atlantic Trading Co. v. United States (In re Pacific−Atlantic Trading Co.), 64 F.3d 1292, 1300 (9th Cir. 1995) (holding final House and Senate floor statements, absent clear contrary definition, prove "incurred" refers to income period's final day). Back To Text

[126] See id. at 1300−01 (stating Internal Revenue Code's legislative history is unnecessary data regarding Congress' intent). Back To Text

[127] See id. at 1303 (listing three Government arguments: (1) section 507 (a)(7)(A)(iii) must be interpreted in relation to subsections (i) and (ii); (2) "not assessed before" phrase unnecessary and redundant; and (3) section 507(a)(7)(A)(iii) requires inquiry into legislative history to clarify ambiguities). Back To Text

[128] Compare, In re Pacific−Atlantic Trading Co. , 64 F.3d at 1301 (rejecting argument that plain meaning interpretation contradicts congressional intent), with, Missouri Dep't of Revenue v. L.J. O'Neill Shoe Co. (In re L.J. O'Neil Shoe Co.), 64 F.3d 1146, 1150 (8th Cir. 1995) (accepting argument claiming plain meaning interpretation contradicts congressional intent); see also supra notes 83−85 and accompanying text. Back To Text

[129] See In re Pacific−Atlantic Trading Co., 64 F.3d at 1303. Back To Text

[130] See id. at 1304. Back To Text

[131] 116 F. 3d 1391 (11th Cir. 1997). Back To Text

[132] See id. at 1392. Back To Text

[133] See id. Back To Text

[134] See id. at 1392−93. Back To Text

[135] See In re Hillsborough Holdings Corp., 116 F.3d at 1393. Back To Text

[136] See id. Back To Text

[137] See In re Hillsborough Holdings Corp., 156 B.R. 318, 320 (Bankr. M.D. Fla. 1993). Back To Text

[138] See In re Hillsborough Holdings Corp., 116 F. 3d at 1394. The district court's opinion is not reported. However, according to the Eleventh Circuit, the district court explicitly affirmed the first part of the bankruptcy court's opinion dealing with 11 U.S.C. § 507(a)(8) and impliedly affirmed the bankruptcy court's second holding that the pre−petition tax was not incurred by the estate. See id. Back To Text

[139] See id. Back To Text

[140] See id. at 1395. Back To Text

[141] See id. Back To Text

[142] See In re Hillsborough Holdings Corp., 116 F.3d at 1395 (holding "the Government's proposed interpretation stretches the statutory language [of section 507] so far from its plain meaning that we must reject it."). Back To Text

[143] See id. at 1395−96. Back To Text

[144] See id. at 1396. Back To Text

[145] See id. (explaining "[p]ermitting the tax claim to be divided into two 'portions' for priority purposes will have no effect on the total tax liability actually owed by Debtors, tax rate applied to Debtors' income, or length of Debtors' taxable year"). Back To Text

[146] See id. Back To Text

[147] See In re Hillsborough Holdings Corp., 116 F.3d at 1396, n.2 (acknowledging calculations conducted by Debtors "[were] somewhat of a mystery" because of differing terminology used by bankruptcy court, district court, and the United States.) Back To Text

[148] In re Bayly Corp., 163 F.3d 1205, 1209 (10th Cir. 1998). Back To Text

[149] See id. Back To Text

[150] See id. at 1208. Back To Text

[151] Employee Retirement Income Security Act ("ERISA") of 1974, Pub. L. 93−406, 88 Stat. 829 (codified mostly in 29 U.S.C. with some portions codified in 26 U.S.C., the Internal Revenue Code). Back To Text

[152] See 29 U.S.C. §§ 1322, 1342, 1361 (1994). Back To Text

[153] See id. § 1342 (d)(1)(B)(ii). Back To Text

[154] See id. § 1368(a) (1994), stating:

If any person liable to the corporation … neglects or refuses to pay, after demand, the amount of such liability (including interest), there shall be a lien in favor of the corporation in the amount of such liability (including interest) upon all property and rights to property, whether real or personal…except that such lien shall not be in excess of 30 percent of the collective net worth of [all such persons].

Id. Back To Text

[155] See id. § 1368 (c)(2). Back To Text

[156] See In re Bayly Corp., 163 F. 3d 1205, 1207 (10th Cir. 1998). Back To Text

[157] See id. Back To Text

[158] See id. Back To Text

[159] See id. Back To Text

[160] See id. Back To Text

[161] See In re Bayly Corp., 163 F.3d at 1211. Back To Text

[162] See id. at 1207. Back To Text

[163] See id. Back To Text

[164] See id. at 1208. Back To Text

[165] See id. (explaining "[i]n order to qualify for administrative expense priority as a tax under U.S.C. section 503(b)1(B)(i), PCBG's claim both must constitute a tax and must have been incurred by the estate post−petition.").

Back To Text

[166] See In re Bayly Corp., 163 F.3d at 1208. Back To Text

[167] See id. at 1210. Back To Text

[168] See id. at 1209−10. See generally 11 U.S.C. § 502(e)(2) (1994) (providing "[a] claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined. . . the same as if such claim had become fixed before the date of the filing of the petition."); see also 4 Collier on Bankruptcy ¶ 502.06(3) at 3 (Lawrence P. King et al. eds., 15th ed. Rev. 1997) (explaining where guarantor has made payment to underlying creditor post−petition, guarantor's claim will be allowed or disallowed under 11 U.S.C. section 502(e)(2) as though it had become fixed pre−petition). Back To Text

[169] See In re Bayly Corp., 163 F. 3d 1205, 1209 (10th Cir. 1998). Back To Text

[170] See id. Back To Text

[171] See id. at 1210 (citing both income tax and non income tax cases explaining when tax is incurred under the Bankruptcy Code.) For example, in the discussion, the opinion cites both In re Sunnyside Coal Co., 146 F.3d at 1278 (involving non−income taxes), and In re Pacific−Atlantic Trading Co., 64 F.3d at 1294 (involving income taxes). Back To Text

[172] See I.R.C. § 1398 (1994) (providing "[t]his section shall apply to any case under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of title 11 of the United States Code in which the debtor is an individual."); id. § 1399 (setting forth"[e]xcept in any case to which section 1398 applies, no separate taxable entity shall result [for partnerships, corporations, etc.] from the commencement of a case under title 11 of the United States Code."). Back To Text

[173] See id. § 3402 (stating "every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary."); id. § 6315 (explaining "[p]ayment of the estimated income tax, or any installment thereof, shall be considered payment on account of the income taxes imposed … for the taxable year."). Back To Text

[174] See id. § 6151(a) (providing "[e]xcept as otherwise provided…when a return of tax is required under this title or regulations, the person required to make such return shall, without assessment or notice and demand from the Secretary, pay such tax to the internal revenue officer with whom the return is filed, and shall pay such tax at the time and place fixed for filing the return (determined without regard to any extension of time for filing the return)."). Back To Text

[175] See Boris I. Bittker & Lawrence Lokken, 4 Federal Taxation of Income, Estates and Gifts § 105.1.2 (2d ed 1992); Stephen F. Gertzman, Federal Tax Accounting § 12.02 (2d ed 1993). Back To Text

[176] See Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931). Back To Text

[177] Id. at 365. Back To Text

[178] See I.R.C. § 441(e) (1994) (stating fiscal year is defined as twelve month period ending on last day of any month other than December). But see id. § 441(f) (providing limited exception to section 441(e)). Back To Text

[179] While a calendar year is always acceptable as the taxable year, the election of a fiscal year is subject to limitations and restrictions. See id. §§ 441(i), 706(b), 1378. Where a taxpayer has not established an accounting period or has an invalid accounting period, the calendar year is the default taxable year. See id. § 441(g). Back To Text

[180] See id. § 441(a) (stating "[t]axable income shall be computed on the basis of the taxpayer's taxable year."); see also id. § 451(a) (providing all gross income be included in taxable year); id § 461(a) (stating amount of deduction or credit is based on taxable year). Even in those relatively unusual situations when a taxable year is less than twelve months (i.e., a "short period") the determination is still made by reference to the short taxable year. See id. § 443. For an entity such as a corporation, a short taxable year is typically required for the year in which it is created or terminated. Back To Text

[181] See Burnet v. Sanford & Brooks Co., at 363. Back To Text

[182] See generally Treas. Reg. §§ 1.451−1(a), 1.461 (1)(a). Back To Text

[183] Ordinary tax planning is accomplished by making assumptions about what the tax position for the year will be. For instance, if a corporation assumes it will end up in the 34 percent tax bracket this year, as it did last year, it becomes possible to project how much after−tax proceeds may result from a given transaction. Back To Text

[184] Although I.R.C. § 1361(a) assigns the names to each of the corporations, the names are quite apt. The taxation scheme for ordinary corporations is contained in Subchapter C of the I.R.C., section 301(1986), et seq. while the taxation scheme for S corporations is contained in Subchapter S of the I.R.C., section 1361 et seq. Back To Text

[185] See I.R.C. § 61(a)(7) (1994). See generally Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶1.02, at. 1−6 (7th ed. 2000) [hereinafter, Bittker & Eustice]. Back To Text

[186] See I.R.C. §§ 1363, 1366 (1994); Bittker & Eustice, supra note 184, ¶6.01 at 6−6. Back To Text

[187] See I.R.C. § 1366 (1994). Back To Text

[188] See id. § 1363(a). An S corporation might incur a tax at the corporate level but only if it were a C corporation at some prior time, and even then only under certain limited circumstances. See id. §§ 1374−1375. Back To Text

[189] See id. § 1377(a)(1). Back To Text

[190] See id. § 1377(a)(2). Back To Text

[191] This may occur either voluntarily or involuntarily. It occurs voluntarily when an S election is voluntarily revoked and a prospective effective date for the termination is selected. See id. § 1362 (d)(1)(D) This occurs involuntarily if a corporation ceases to qualify for the S corporation election because, for example, it exceeds the number of shareholders permitted to S corporations or has a disqualified shareholder. Back To Text

[192] See I.R.C. § 1362(e)(2) (1994). Back To Text

[193] See id. § 1362(e)(3). The "elective" method becomes required under certain circumstances. See id. § 1362 (e)(6)(D). Back To Text

[194] See id. § 172. Back To Text

[195] See id. § 382(g) (defining when ownership change occurs). Back To Text

[196] See I.R..C. § 382(b) (1994) (explaining limits on net operating loss carry−forwards after ownership change). Back To Text

[197] See id. § 382(b)(3)(A). Back To Text

[198] See Treas. Reg. § 1.382−6(b) (2001). Back To Text

[199] See I.R.C. §§ 1501−1504. In this area of the I.R.C. the statute is rather short and skimpy while the intricate detailed requirements are contained in the Regulations. See, e.g., Treas. Reg. § 1.1502 (2001). Back To Text

[200] See I.R.C. § 1501. Back To Text

[201] See Treas. Reg. § 1.1502−76(b)(l)(ii) (2001). Back To Text

[202] See id. § 1.1502−76(b)(2)(ii); id. § 1.1502−76(b)(2)(ii)(B) (stating even if election is made, "extraordinary items" must be allocated to day taken into account for tax purposes). Back To Text

[203] See I.R.C. § 6031 (1994). Back To Text

[204] See id. § 701. Back To Text

[205] See id. Back To Text

[206] See Treas. Reg. § 1.706−1(c)(2)(ii) (2001). Back To Text

[207] See id. Back To Text

[208] See Orrisch v. Comm'r., 55 T.C. 395, 399 (1970) (holding partners cannot manipulate tax laws by creating special allocations based on the entire partnership, rather each partner's tax deductions must be based on their distributive share of the partnership); see also Estate of Carberry v. Comm'r., 933 F.2d 1124, 1130 (2d Cir. 1991) (finding appellant not entitled to special allocation deduction because it lacked statutorily required substantial economic effect). Back To Text

[209] See, e.g., I.R.C. §§ 704(b)(2), 704(c), 706(c)−(d) (1994). See generally S. Rep. No. 83−1622 (1954). Back To Text

[210] See I.R.C. § 1398 (dealing with rules which relate to title 11 cases for individuals); id. § 1399 (2001) (providing "[e]xcept in any case which section 1398 applies, no separate taxable entity shall result from the commencement of a case under title 11 of the United States Code."). Back To Text

[211] See supra notes 9−12 and accompanying text. Back To Text

[212] See I.R.C. § 1398 (1994). Back To Text

[213] See id. § 1398(d)(2). Back To Text

[214] See id. § 1399. Back To Text

[215] See supra note 12 and accompanying text. Back To Text

[216] See S. Rept. No. 96−1035, supra n. 8 at 24−26. Back To Text

[217] See 11 U.S.C. § 346(c)(1) (1994) (stating "[t]he commencement of a case under this title concerning a corporation or a partnership does not affect a change in the status of such corporation or partnership for the purposes of any state or local law imposing a tax on or measured by income."); see also supra note 10. Back To Text

[218] See In re O.P.M. Leasing Serv., Inc. 68 B.R. 979, 985 (Bankr. S.D.N.Y. 1987). Back To Text

[219] See e.g., In re Pacific−Atlantic Trading Co., 64 F.3d at 1304; In re Hillsborough Holdings Corp., 116 F.3d 1391, 1396 (11th Cir. 1997). Back To Text

[220] See In re Sunnyside Coal Co., 146 F.3d 1273, 1278 (10th Cir. 1998). Back To Text

[221] See supra note 38−48, and accompanying text. Back To Text

[222] See e.g., In re Bayly Corp., 163 F.3d 1208 (10th Cir. 1998) (commenting on narrow construction of priorities under section 503(b) due to presumption in bankruptcy cases that debtor's limited resources will be distributed equally among his creditors); In re L.J. O'Neill Shoe Co., 64 F.3d 1146, 1148 (8th Cir. 1995) (stating because administrative expense priority is contrary to Bankruptcy Code's general policy of equal distribution, these priorities should be construed narrowly); In re Englewood Comm. Hosp. Corp., 117 B.R. 352, 358 (Bankr. N.D. Ill. 1990) (stating bankruptcy priority status administrative expenses are to be strictly construed). Back To Text

[223] See In re Prime Motor Inns, Inc., 144 B.R. 554 (Bankr. S.D. Fla. 1998) (relying on case law only); In re O.P.M. Leasing Serv., Inc., 79 B.R. 161 (Bankr. S.D. N.Y. 1987) (relying on 11 U.S.C. §§ 356, 502 only). Back To Text

[224] See In re Pacific−Atlantic Trading Co., 64 F. 3d at 1297. Back To Text

[225] See supra note 125 and accompanying text. Back To Text

[226] See In re L.J O'Neill Shoe Co., 64 F.3d at 1151−52; In re Hillsborough Holdings Corp., 116 F.3d at 1396. Since O'Neill Shoe involved Missouri income tax, the court's discussion was really addressed to 11 U.S.C. § 346(c)(1), state and local tax analog to I.R.C. § 1399. In re L.J. O'Neill Shoe, 64 F.3d at 1152. In its argument, Missouri relied on both I.R.C. § 1399 and 11 U.S.C. § 346(c)(1). In re L.J. O'Neill Shoe, 64 F.3d at 1151−52. In any event, Hillsborough, which involved federal income tax for the straddle year, simply adopted O'Neill Shoe's approach. In re Hillsborough Holding Co., 116 F.3d at 1396. Back To Text

[227] Commenting on Missouri Department of Revenue's ("MDOR") argument that "dividing the tax claim into a pre−petition portion and a post−petition portion essentially splits the debtors' corporate income tax year between the pre−petition debtor and the post−petition estate . . . [and thus amounts to] treating the debtor and the estate as separate taxable entities in violation of section 346(c)(1)." The court noted "MDOR's analysis is based on a misconception of the function of an administrative expense determination. We are not allowing the debtor to be 'taxed' as two separate entities . . . As is quite common in bankruptcy claims adjudication, one portion of the claim is being treated as an administrative expense for distribution purposes, and the other portion is being treated as a priority claim entitled to a seventh priority for distribution purposes." In re L.J. O'Neill Shoe , 64 F.3d at 1151−52; In a similarly un−detailed explanation in Hillsborough the court noted, "[p]ermitting the tax claim to be divided into two 'portions' for priority purposes will have no effect on . . . the length of Debtors' taxable year." In re Hillsborough Holding Co., 116 F.3d at 1396. Back To Text

[228] See In re L.J. O'Neill Shoe Co., 64 F.3d at 1152 (asserting "the tax is being imposed against the single corporate entity in keeping with section 346(c)(1), but the payment of the tax imposed is being divided into separate components in accordance with the bankruptcy laws determining the priority of payment of those claims."); In re Hillsborough Holding Co., 116 F.3d at 1396 (stating "[i]n keeping with the tax code, the taxes will be imposed as if no bankruptcy petition had ever been filed. The payment of the taxes, however, will be governed by the principles and priorities of the bankruptcy laws."). Back To Text

[229] See id. at 1396 n.2. Back To Text

[230] See Norman Singer, Sutherland Statutory Construction § 51.02 (6th ed. 2000); see also, Watt v. Alaska, 451 U.S. 259, 266 (1981) (recognizing maxim of construction that more recent of conflicting statutes will apply); Radzanower v. Touche Ross & Co., 426 U.S. 148, 159−60 (1976) (applying rule that most recent of two conflicting statutes will prevail). Back To Text

[231] Act effective Nov. 6, 1978, Pub. L. No. 95−598, 92 Stat. 2549 (1978). Back To Text

[232] Act effective Dec. 24, 1980, Pub. L. No. 96−589, 94 Stat. 3389 (amending "the Internal Revenue Code of 1954 to provide for the tax treatment pf bankruptcy, insolvency, and similar proceedings, and for other purposes"). Back To Text

[233] See United States v. Energy Res. Co., 495 U.S. 545, 546 (1990) (holding bankruptcy court has power to require Internal Revenue Service to take actions not in accordance with its policies in certain situations where court deems necessary); see also In re Deer Park, 136 B.R. 815, 818 (B.A.P. 9th Cir. 1992) (holding bankruptcy courts also have power to "order IRS to apply the payments to trust fund liabilities if the bankruptcy court determines that this delegation is necessary to the success of a reorganization plan"). Back To Text

[234] See In re Deer Park, 136 B.R. at 818. Back To Text

[235] See In re Michaelson, 200 B.R. 862 (Bankr. D. Minn. 1996). Back To Text

[236] See id. at 863. Back To Text

[237] See id.; 11 U.S.C. § 501(c) (1994) (stating claim may be filed on behalf of creditor). Back To Text

[238] In re Michaelson, 200 B.R. at 863. Back To Text

[239] Id. Back To Text

[240] See id. Back To Text

[241] See I.R.C § 1398(d)(2) (1994) (extending election to terminate taxable year only to individuals involved in chapter 7 or 11 bankruptcies, but including no provision authorizing such an election in chapter 13 proceedings); In re Smith, 210 B.R. 689, 691 (Bankr. Md. 1997) (concluding section 1398 election is not available to chapter 13 debtors). Back To Text

[242] See In re Michaelson, 200 B.R. at 865 (finding debtor's analysis did not apply because of O'Neill Shoe). Back To Text

[243] See id. Back To Text

[244] See 11 U.S.C. § 101(5)(A) (1994). Back To Text

[245] In re Michaelson, 200 B.R. 862, 863−64 (Bankr. D. Minn 1996). Back To Text

[246] See id. at 868 (recognizing payment of installments under I.R.C. section 6654 does not constitute payment of tax liability but rather requires escrow against future tax liability); see also In re Ripley, 926 F.2d 440, 447 (5th Cir. 1991) (asserting while quarterly estimated installments are required, they are merely prepayments of person's income tax liability and do not change annual nature of taxes); United States v. Wilkoff (In re Wilkoff), 2001 Bankr. LEXIS 124, at *13 (Bankr. E.D. Pa. Jan. 24, 2001) (noting Federal income tax liability is determined and incurred on annual basis regardless of fact that estimated tax payments may be required during year). Back To Text

[247] See In re Michaelson, 200 B.R. at 865. Back To Text

[248] See id. at 865−66. Back To Text

[249] The legislative history quoted by Michaelson follows:

Third. Income and gross receipts taxes not assessed before the petition date but still permitted, under otherwise applicable tax laws, to be assessed. Thus, for example, a pre−petition tax liability is to receive sixth priority under this rule if, under the applicable statute of limitations, the tax liability can still be assessed by the tax authority. This rule also covers situations referred to in section 507(a)(6)(B)(ii) of the Senate amendment where the assessment or collection of a tax was prohibited before the petition pending exhaustion of judicial or administrative remedies, except that the House amendment eliminates the 300−day limitation of the Senate bill. So, for example, if before the petition a debtor was engaged in litigation in the Tax Court, during which the Internal Revenue Code [Title 26] bars the

Internal Revenue Service from assessing or collecting the tax, and if the tax court decision is made in favor of the Service before the petition under title 11 is filed, thereby lifting the restrictions on assessment and collection, the tax liability will receive sixth priority even if the tax authority does not make an assessment within 300 days before the petition (provided, of course, that the statute of limitations on assessment has not expired by the petition date).

200 B.R. at 864 (quoting from 124 Cong. Rec. H 11,112 (1978); S17,429 (1978) remarks of Rep. Edwards and Sen. DeConcini). Back To Text

[250] See id. at 865. Back To Text

[251] See id. at 867−68. Back To Text

[252] Another approach to resolve the issue of the treatment of the straddle year tax is to amend I.R.C. sections 1398 and 1399 to permit or mandate termination of the taxable year for corporate bankrupts. See e.g., Committee on Bankruptcy & Corporate Organization and the Council on Taxation, Response to Certain Proposals Made to the National Bankruptcy Review Commission Relating to Tax Issues, 52 The Record 418, 424−425 (1997) (proposing for corporate debtors, actual termination of debtor's taxable year should be on petition date). While this approach would work, it is not focused on since it involves changing the rules rather than reconciling the existing rules. Back To Text

[253] In the example, the day on which the petition was filed was included in the post−petition period. This is consistent with I.R.C. section 1398(d)(2) (1980) where, for individuals who elect, the straddle year is terminated as of the day before the filing of the petition. Compare, 11 U.S.C. §§ 728(a), and 1146(a) where, for state and local purposes, for individuals the year is terminated as of the day the petition is filed and the post−petition portion of the year commences as of the next day. Back To Text

[254] See supra text and accompanying note 125. Back To Text

[255] See I.R.C. § 6151(a) (1994). Back To Text

[256] See In re Michaelson, 200 B.R. at 867. Back To Text

[257] The Circuits are the Eighth (O'Neill Shoe, 64 F.3d at 1146), Ninth (In re Pacific−Atlantic Trading Co. ., 64 F.3d at 1292) and Eleventh (In re Hillsborough Holding Corp. ,116 F.3d at 1391). Back To Text

[258] 163 F.3d 1205, 1208−11 (10th Cir. 1998). Back To Text