

Determining Tax Liability Under Section 505(a) of the Bankruptcy Code

Section 505(a) of the Bankruptcy Code (the “Code”) provides the means by which a debtor or trustee in bankruptcy may seek a determination of tax liability by the Bankruptcy Court with minimal restriction. This article will examine some of the nuances of § 505(a), including the impact of the section upon debtors and trustees in bankruptcy and those measures that may be taken to facilitate a determination of a debtor’s tax liability by the Bankruptcy Court.

11 U.S.C. § 505(a) of the Code provides as follows:

- (1) Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to a tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.
- (2) The court may not so determine –
 - (A) the amount or legality of a tax, fine, penalty or addition to tax if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under this title; or
 - (B) any right of the estate to a tax refund, before the earlier of –
 - (i) 120 days after the trustee properly requests such refund from the governmental unit from which such refund is claimed; or
 - (ii) a determination by such governmental unit of such request.

The foregoing section represents a seemingly broad grant of jurisdiction to the Bankruptcy Court to determine the amount or legality of any tax, or any fine or penalty relating to a tax. This determination may be made whether or not the subject tax, fine or penalty has been previously assessed or paid, and whether or not it has been contested before and adjudicated by a court or administrative body of competent jurisdiction.

There are, however, limitations to this grant of jurisdiction to the Bankruptcy Court. If *prior* to the commencement of a case under the Code a tax, fine or penalty was contested before and adjudicated before a judicial or administrative tribunal of competent jurisdiction, the Bankruptcy Court may not adjudicate it.

The procedure to be employed for having a Bankruptcy Court review and adjudicate a tax assessment under § 505(a) is not specifically defined by the Code or the Federal Rules of Bankruptcy Procedure. However, the case law suggests that the issue has been raised before the Bankruptcy Court in several different ways. One way is by the commencement of an adversary proceeding, or lawsuit, in the bankruptcy case. The issue may also be raised in the context of a contested matter, either by motion or as a challenge to the legality or amount of a filed tax claim.

By virtue of § 505(a), the Bankruptcy Court and the tax court retain concurrent jurisdiction to adjudicate tax liability not contested and adjudicated prior to the commencement of the bankruptcy case. Certainly, there may be advantages and disadvantages to be considered in litigating a tax issue before one forum over another. However, insofar as its jurisdiction under § 505(a) is, unlike the state tax court's jurisdiction, not limited by state law procedural requirements and restrictions, the Bankruptcy Court may offer the only realistic opportunity for a debtor or trustee to challenge a tax liability not contested or adjudicated pre-petition.

In this regard, a common area in which a debtor or a trustee may seek relief under § 505(a) relates to the challenge of real property tax assessments. Notably, courts have allowed debtors and trustees to contest real property tax assessments despite state law statute of limitations and financial requirements. For example, in Subrani v. City of Atlantic City (In re Market Towers Associates), Case No. 87-00217, Adv. Pro. No. 89-0027 (Bankr. D.N.J. 1989), the Bankruptcy Court authorized the challenge by a Chapter 11 trustee of real property tax assessments even where there had been no compliance with the state statutory jurisdictional

requirement that a taxpayer pay the taxes assessed as a condition precedent to contesting the assessment.

Section 505(a) was enacted to protect and preserve the interests of both debtors and creditors. In recognition that a trustee in bankruptcy (including a debtor in possession pursuant to 11 U.S.C § 1107(a)) is a fiduciary and representative of the bankruptcy estate and its creditors, the underlying policy of § 505(a) is to protect the estate and its creditors from a dissipation of a bankruptcy estate's assets that could result if the estate and its creditors were bound by a tax liability that an ailing, negligent or indifferent debtor had failed to challenge prior to the commencement of the bankruptcy case.

Another goal of § 505(a) is to eliminate a potential obstacle to the orderly administration of a bankruptcy case. Section 505(a) thus grants the Bankruptcy Court jurisdiction to determine tax liability so as to expedite the adjudication of tax issues and afford a forum for ready determination of the legality or amount of tax claims which might delay conclusion of the administration of the estate if left to other proceedings.

Section 505(a) has been broadly interpreted to allow the Bankruptcy Court to determine the legality or amount of any tax. Importantly, the Bankruptcy Court must apply, and give full faith and credit to the state law upon which the tax to be determined is based.

Some of those taxes which the Bankruptcy Court may adjudicate under § 505(a) include income, "responsible person", estate, gift, employment, excise, real or personal property, sales, franchise, use, and stamp. As a practical matter, the Bankruptcy Court may determine anything that can be construed as a tax. In this regard it bears noting that, in the real estate context, a debtor's right to challenge a tax liability before the Bankruptcy Court, is not limited simply because the tax sale certificate has been sold to a third party.

As noted above, the Bankruptcy Court may not determine the amount or legality of any tax, fine, penalty or addition to a tax if such amount or legality was "contested before and adjudicated by" a judicial or administrative tribunal before the commencement of the

bankruptcy case. Whether or not there has been a contest before and adjudication by a judicial or administrative tribunal is often a fact-sensitive question.

Courts have held that a pre-petition settlement of a contested tax liability, at least where the debtor was adequately represented, the settlement fairly arrived at and properly entered into, and where the settlement resolved what otherwise would have to have been litigated, is generally reviewed as binding, final and conclusive as a judgment, thus constituting an “adjudication” under § 505(a)(2). On the other hand, courts have generally held that the mere expiration of the time during which a debtor may pursue its state law remedies does not constitute a contest and adjudication, and that a default does not deprive the Bankruptcy Court of jurisdiction to determine a tax liability under § 505(a).

Although the Bankruptcy Court may determine tax liabilities of debtors, it may also determine tax liabilities of non-debtors under certain circumstances. Thus, in the Third Circuit, it is settled law that a Bankruptcy Court, pursuant to 28 U.S.C. §§ 1334 and 157(a), may adjudicate the tax liability of a debtor regardless of the impact and binding effect that such adjudication might also have on non-debtors, but may not determine the tax liability of non-debtors in those instances where such determination would not, in any way, directly and substantially affect the debtor’s bankruptcy case.

In Quattrone Accountants Inc. v. I.R.S., 895 F.2d 921 (3rd Cir. 1990), the Third Circuit ruled that § 505(a), which grants the Bankruptcy Court jurisdiction to determine the amount or legality of any tax, neither grants nor denies the Bankruptcy Court jurisdiction to adjudicate the tax liabilities of non-debtors. Rather, § 505(a) was intended to clarify the Bankruptcy Court’s jurisdiction over tax claims, not limit its jurisdiction only to debtors. In deciding that the Bankruptcy Court did not have jurisdiction to adjudicate “responsible person” liability on the part of a non-debtor principal of a debtor accounting firm, the court relied upon and analyzed the “related to” language contained in 28 U.S.C. § 1334(c)(2). The court concluded that:

“an action is related to bankruptcy if the outcome could alter the debtor’s rights, liabilities, options or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankruptcy estate.... However, the mere fact that there may be common issues of fact between a civil proceeding and controversy involving the bankruptcy estate does not bring the matter within the scope of Section [1334].

Judicial economy itself does not justify general jurisdiction.”

[Quattrone at 926].

The Bankruptcy Court’s jurisdiction to adjudicate tax liability is not limited in terms of how far back in time the court may go. However, at some point the staleness of those tax years which may otherwise be subject to challenge under § 505(a) does become relevant. Thus, a dated tax claim may be less relevant to the administration of the bankruptcy estate than a more recent claim, and therefore be more susceptible to the court’s exercise of abstention.

In In re AWB Associates, G.P., 144 B.R. 270 (Bankr. E.D. Pa. 1992), the debtor sought to challenge real estate tax assessments by the City of Camden for years 1985 through 1991. The debtor had not previously paid taxes for any of those tax years. The City contended that if the Bankruptcy Court were to hear the matter it would undermine the State’s tax laws and result in chaos in the tax assessment system because the City would be unable to rely upon the finality of its tax assessments. The Bankruptcy Court nevertheless concluded that the mere lapse of time between a tax year and the time of the filing and determination of a § 505(a) motion did not, itself, preclude adjudication of the amount or legality of a tax for any year in question.

Under 28 U.S.C § 157(b)(1), bankruptcy judges may hear and determine all “core proceedings”, *i.e.*, those arising under title 11 or arising in a case under title 11 (as opposed to “non-core proceedings”, *i.e.*, those related to a case under title 11 but not arising under title 11

or arising in a case under title 11). Although 28 U.S.C. § 157 does not define “core proceedings”, subsections 157(b)(2)(A) through (O) contain a non-exclusive laundry list of “core proceedings”. As the ability to contest a tax assessment has been conferred upon the Bankruptcy Court by § 505(a), courts have construed this to mean that the determination of a debtor’s tax liability is a “core proceeding”.

Because Bankruptcy Courts generally treat § 505(a) proceedings as “core”, such proceedings are not subject to the doctrine of mandatory abstention as set forth at 28 U.S.C. § 1334(c)(2) (under this doctrine the Bankruptcy Court must abstain from hearing a matter if certain elements are met). Nevertheless, the exercise of jurisdiction under § 505(a) is discretionary and subject to the doctrine of permissive abstention.

Under the doctrine of permissive abstention, which is set forth at 28 U.S.C. § 1334(c)(1), the Bankruptcy Court may decline the exercise of its jurisdiction under § 505(a). Those factors considered by the Bankruptcy Court in deciding whether to exercise jurisdiction under § 505(a) or abstain include the following:

- the effect or lack thereof on the efficient administration of the estate;
- the extent to which state law issues predominate over bankruptcy issues;
- the complexity or unsettled nature of the tax issues to be decided and applicable state law;
- the asset and liability structure of the debtor;
- prejudice or potential prejudice to the debtor and the taxing authority;
- the jurisdictional basis, if any, other than 28 U.S.C. § 1334;
- the degree of relatedness or remoteness of the tax liability adjudication to the main bankruptcy case;
- the feasibility of severing state law claims from “core” (see 28 U.S.C. § 157) bankruptcy matters to allow judgments to be entered in state courts with enforcement left to the Bankruptcy Court;
- the burden on the Bankruptcy Court’s docket;

- the likelihood that the commencement of proceedings in the Bankruptcy Court involves forum shopping by one of the parties;
- the existence of a right to trial by jury;
- the presence in the proceeding of non-debtor parties; and
- uniformity of assessment.

Some courts have adopted a “bright-line” rule regarding abstention in cases where no distribution will be made to creditors. These decisions conclude that no bankruptcy purpose is served by a Bankruptcy Court adjudicating a tax issue unless the interests of creditors will be furthered, which occurs only if the creditor body will receive a distribution. These decisions suggest that any other rule would lead to wide scale forum shopping.

A second line of cases expressly rejects this “bright-line” test. In these cases the courts exhibit a disinclination to apply a rule which eliminates a statutory right expressly enacted by Congress. In In re D’Alessio, 181 B.R. 756, 761 (Bankr. S.D.N.Y. 1995) the court reasoned that, “[h]ad Congress wanted to except a large segment of the debtor population from this statutory right, it would have included another subsection of § 505 which expressly excludes from court review tax disputes in no asset cases.” This court also observed that the “bright-line” rule failed to properly weigh the significance of a bankruptcy discharge to the honest and deserving debtor, and thus chose to decide on the issue of abstention on a case-by-case basis.

Importantly, § 505(a) and the case law construing it distinguish between the Bankruptcy Court’s broad jurisdiction to adjudicate tax liability issues under § 505(a)(1) irrespective of the debtor’s failure to comply with state law procedural requirements, and the limitations on that jurisdiction in terms of granting refunds under § 505(a)(2)(B). Section 505(a)(2), which sets forth the exceptions to the broad jurisdictional grant contained in § 505(a)(1), provides in pertinent part:

- (2) The court may not so determine --

* * * *

- (B) any right of the estate to a tax refund, before
the earlier of—
 - (i) 120 days after the trustee properly requests such refund from the governmental unit from which such refund is claimed; or
 - (ii) a determination by such governmental unit of such request.

In In re Constable Terminal Corp., 222 B.R. 734 (Bankr. D.N.J. 1998), the debtor was assessed for real estate taxes pre-petition by the City of Bayonne. Some of the assessed taxes were paid, while others were not. After filing for Chapter 11 relief, the debtor commenced an adversary proceeding against the City alleging that it had been over-assessed and seeking a refund for the over-payments. Prior to the commencement of the bankruptcy case the debtor had not filed an appeal because of its inability to meet the statutory precondition of paying the taxes due, nor had it filed for a refund request relative to those tax years forming the subject matter of the adversary proceeding.

On a motion for partial summary judgment dismissing the debtor's claims for tax refunds or credits, the City argued that § 505(a)(2)(B), by its own terms, restricts the Bankruptcy Court's ability to authorize refunds or credits. In granting the City's motion, the Bankruptcy Court focused on the key, albeit ambiguous, statutory terms, "properly request". In doing so, the Court drew upon legislative history, as well as decisions in other jurisdictions wherein "properly request" has been construed to mean that the refund request be made timely in accordance with state procedural law. Additionally, the Court referred to the opening clause of § 505(a)(1) which reads, "Except as provided in paragraph (2) of this subsection", as evidencing an intention to limit the Bankruptcy Court's jurisdiction in accordance with subsection (2). Finally, the Court distinguished between paid and unpaid taxes under § 505(a), observing that, as a policy consideration, recovery of taxes previously paid can raise havoc with the financial stability of a municipality, particularly a small one.

Section 505(a) represents an important tool by which critical tax issues can be adjudicated with minimal restriction by the Bankruptcy Court. Consequently, it is essential that consideration be given, during pre-bankruptcy planning and subsequent to the filing of a bankruptcy petition, as to whether and how § 505(a) might be utilized effectively to benefit a debtor or otherwise enhance the value of a bankruptcy estate.