

## PROCEDURE

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# Liquidating Trustee Must File Returns and Pay Tax for Debtors, Supreme Court Says

The fact that the bankruptcy trustee has minimal discretion in carrying out the liquidation does not negate the trustee's duty to file and pay tax.

BY WILLIAM R. CULP, JR.

**I**n *Holywell Corp. v. Smith*, 112 S. Ct. 1021 (1992), *rev'g* 911 F.2d 1539 (CA-11, 1990), the Supreme Court held that a liquidating trustee in a chapter 11 bankruptcy proceeding had to file tax returns for the liquidating trust and pay income taxes due. All three lower tribunals (the bankruptcy court, district court, and Eleventh Circuit) had held that the liquidating trustee had no such duty under the plan of reorganization, which was silent on the matter.

## Background

*Holywell* involved the bankruptcy of Miami Center Limited Partnership, two affiliated corporations (Holywell Corp. and Miami Center Corp.), an affiliated partnership (Chopin Associates), and the individual developer, Theodore B. Gould. Each debtor filed for protection from the claims of creditors under chapter 11 of the Bankruptcy Code. The creditors, including the Bank of New York as primary lender, obtained confirmation of the plan of reorganization, and a trustee was appointed to liquidate the debtors' assets. The two principal assets of the bankruptcy estates were the equity in Miami Center, a Florida office building and hotel complex, and the proceeds from the post-bankruptcy sale of real property in Washington, D.C. Under the plan, the

debtors were required to give up their interests in these assets, but otherwise were permitted to stay in business. The plan directed that all the debtors' property be placed in trust for liquidation and distribution to the creditors of the various bankruptcy estates. It did not expressly require the liquidating trustee to either file returns or pay taxes.

The debtors had filed for bankruptcy on 8/22/84. The plan took effect on 10/10/85, and the liquidating trustee immediately sold Miami Center to the Bank of New York for cash and cancellation of its note. Holywell filed a return for its year ended 7/31/85, reflecting a liability for tax, interest, and penalties of \$264,309. That return included a capital gain on the sale of the Washington properties. The return was filed after the effective date of the plan, and Holywell asked the trustee to pay the taxes due. Neither the trustee nor the corporate debtors filed returns for years ending after 7/31/85. The income for the 7/31/86 fiscal year included capital gain from the sale of Miami Center.

The controversy regarding the liquidating trustee's duty to file returns and pay taxes arose only after the trustee filed a declaratory judgment action concerning his obligation to file returns and pay taxes in connection with the properties involved. The bankruptcy court had approved the plan prior to this action. IRS did not object to confirmation of the plan and did not file a claim for pre-confirmation taxes.

The three lower courts showed little sympathy for the Service's position that the liquidating trustee was liable for pre- and post-confirmation taxes. The Eleventh Circuit addressed three issues:

1. Was the appeal moot?
2. Did the bankruptcy reorganization plan require the liquidating trustee to file returns and pay tax on gains from pre- and post-confirmation sales of assets?
3. Did the tax law require the liquidating trustee to file and pay tax?

**Was appeal moot?** In bankruptcy, the mootness standard "is premised upon considerations of finality . . . and the court's inability to rescind . . . and grant relief on appeal." The court was guided by the bankruptcy law policy that court-approved reorganization plans should go forward unless a stay is obtained. The Eleventh Circuit simply refused to address the allegations made by IRS and the debtors,<sup>1</sup> which it characterized as challenges to the court-approved plan, and thus did not discuss the bankruptcy court's power to approve a plan that made no express provisions for income taxes.

**Did plan require trustee to pay tax?** The court concluded that the plan could not be construed as requiring the liquidating trustee to file returns and pay tax. The plan provided for the payment of necessary costs of preserving the estate as administrative expenses, and IRS contended that this

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permitted the recovery of income taxes. Payment of administrative claims, however, was conditioned on either the listing of the claim as a liability by the debtor or the filing of a proof of claim. Since neither condition was satisfied, the court rejected the Service's argument.

In addition, although the court agreed with IRS that pre-confirmation income taxes are recoverable as an administrative expense under Bankruptcy Code Section 503, the Service had not filed a timely proof of claim. Post-confirmation taxes are not such an expense, the court held, since administration of the estate ceases on confirmation of a plan of reorganization and the property rests in the reorganized debtor—a new entity. The Eleventh Circuit noted that its decision did not leave the Service without the ability to collect taxes on the post-confirmation sale of property. Its decision simply meant that the reorganized debtor, not the liquidating trustee, was responsible.

**Did tax laws require trustee to pay tax?** The Eleventh Circuit also rejected the Service's position that Section 6012 required the liquidating trustee to file returns and pay taxes. Under that section, the trustee in a case under title 11 or an assignee of corporate property, and the fiduciary of an individual debtor's estate, are responsible for filing returns and paying taxes. The court held that the liquidating trustee was not a trustee in a case under title 11 and was "more akin to a disbursement agent than an assignee or fiduciary" because of his limited and administrative duties.<sup>2</sup> A dissenting opinion interpreted Section 6012 broadly to require the liquidating trustee to file returns and pay taxes, and questioned the realistic ability of a reorganized debtor to pay any income taxes once substantially all the assets were transferred to a liquidating trust.

**Analysis.** As previously stated, the Eleventh Circuit had little sympathy for the IRS, which failed to protect its interests by either filing a proof of claim or objecting to confirmation of the plan. The Service simply sat on its hands until the liquidating trustee filed the declaratory judgment action to determine his liability to file and

pay taxes. The debtor apparently also did not specifically object to the plan's failure to provide for the payment of taxes attributable to the pre- and post-confirmation sale of assets. It appears the Eleventh Circuit was more concerned with the finality of the plan of reorganization than with the Service's ability to collect taxes from a liquidating trustee.

Under the appellate court's decision, the Service was forced to look to the reorganized debtors to collect any tax on gains from post-confirmation property sales.<sup>3</sup> Since substantially all the debtors' assets had been transferred to the liquidating trustee, the debtors had no means to pay the taxes on the income from liquidating those assets. In effect, under the Eleventh Circuit's holding, both the Service and the debtors would lose. Accordingly, both petitioned for a writ of certiorari.

## Supreme Court's Approach

In agreeing with IRS, the Supreme Court took a much broader view of the language in the Code. In a unanimous decision, the Court determined that the liquidating trustee was required, under Section 6012, to file returns and, under Section 6151, to pay tax in connection with the liquidating trust's income attributable to post-confirmation sales of property of the individual and corporate debtors. The Court also held that the Service's fail-

ure to object to the plan did not excuse the liquidating trustee from filing returns and paying taxes. The issues of mootness and whether the plan required taxes to be treated as administrative expenses were not addressed.

The Supreme Court did not examine the duties of the liquidating trustee on a functional basis. It merely analyzed the statutory language and held that Section 6012 required the liquidating trustee to file returns. Once the duty to file was established, Section 6151 required the filer to pay any tax due.

**Corporate debtors' returns.** The Court found the liquidating trustee was required to file and pay tax on behalf of the corporate debtors under Section 6012(b)(3), which provides that when a receiver, bankruptcy trustee, or court-appointed assignee has possession of or holds title to substantially all the property or business of a corporation (whether or not the property or business is being operated), "such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns."

The liquidating trustee did not dispute that he was an assignee. He argued, however, that courts have applied Section 6012(b)(3) only to a winding-up of the business of a dissolving corporation, or to a person standing in the place of management in

<sup>1</sup> The debtors contended that the Bank of New York committed fraud by submitting a plan of reorganization that failed to disclose the absence of any provision for the payment of income taxes, and questioned the propriety of approval of a plan that made no express provision for income taxes. The Service also objected to the declaratory judgment.

<sup>2</sup> The Eleventh Circuit cited *In re Alan Wood Steel Co.*, 7 Bkrpty. Rptr. 697 (Bkrpty. Ct. Pa., 1980), which had refused to extend Section 6012 to a disbursing agent under similar facts. See *In re Sonner*, 53 Bkrpty. Rptr. 859 (Bkrpty. Ct. Va., 1985), for a more complete discussion of the precedent involving liquidating trusts and disbursing agents.

<sup>3</sup> See *Redmond*, 36 Bkrpty. Rptr. 932 (Bkrpty. Ct. Kan., 1984), cited favorably by the Eleventh Circuit for the proposition that "post-confirmation tax is normally a liability of the debtor." See also *In re Sonner*, *supra*. Cf. *Stockton*, 335 F. Supp. 984 (DC Calif., 1971) (debtor was treated as grantor of a trust when he transferred assets to a third party who was to liquidate the assets and pay creditors in a trans-

action consummated outside bankruptcy). See the discussion in note 4, *infra*, regarding a debtor's obligation to pay income tax incurred post-petition but pre-confirmation.

<sup>4</sup> Application of Section 6012(b)(3) technically could be avoided if the corporate debtor does not transfer "substantially all" of its assets to the liquidating trust.

<sup>5</sup> While the Court held that the liquidating trust was not a grantor trust, it did not address the issue of whether the liquidating trust should be taxed (to the extent of the individual debtor's assets) as a complex trust or possibly as a corporation under Section 7701.

<sup>6</sup> Generally, a debtor does not have liability for income taxes incurred post-petition and pre-confirmation, except as provided in a plan of reorganization. Bankruptcy Code Sections 1141(b) and (c). See also *Redmond*, *supra*, at 934. (IRS, as stated in the text above, abandoned its claim for pre-confirmation taxes in its reply brief submitted to the Supreme Court.) See Falk, "Dischargeability of Taxes, Interest and Penalties in Bankruptcy," 32 Tax Management Memorandum 123 (5/6/91).

operating a bankrupt corporation. As the liquidating trustee, he did neither.

The Supreme Court rejected this argument, noting that nothing in Section 6012(b)(3) required that the business be wound up or that the assignee manage the business. Section 6012(b)(3) applies if substantially all the corporate assets are transferred to the liquidating trustee, "whether or not such property or business is being operated."<sup>4</sup>

**Individual debtor's returns.** All parties agreed that Section 6012(b)(3) applied only to assignees of corporate assets, and not to assignees of an individual debtor's property. The Court found that under Section 6012(b)(4), however, the liquidating trustee was required to file a return and pay taxes attributable to income from the individual debtor's assets that were transferred to the trust.

That section provides that "[r]eturns of an estate, a trust, or an estate of an individual under chapter 7 or 11 of title 11 . . . shall be made by the fiduciary thereof." The Court determined that the plan created a separate and distinct trust controlled by the liquidating trustee to hold the property of the individual debtor's estate. Further guidance was found in Reg. 301.7701-4(d), indicating that an entity organized for the primary purpose of liquidating and distributing the assets transferred to it is a liquidating trust, which is a trust for tax purposes. A fiduciary is a person who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest, under Reg. 301.7701-6. Thus, the liquidating trustee was required to file returns as the fiduciary of a trust.

The liquidating trustee's argument that he was not a fiduciary since he had almost no discretion in carrying out his duties, and essentially acted as disbursing agent, was rejected by the Court. His responsibilities under the plan met the definition of a fiduciary in the Regulations.

The trustee also argued that under the grantor trust rules of Sections 671-677, the individual debtor was the owner of the assets in the liquidating trust and therefore was obligated to file returns and pay the taxes arising from the sale of those assets. The

trustee noted that Reg. 1.677(a)-1(d) states that a grantor generally is treated as the owner of a portion of a trust the income of which is applied in discharge of a legal obligation of the grantor. *In re Sonner*, 53 Bkrptcy. Rptr. 859 (Bkrptcy. Ct. Va., 1985), cited by the trustee as authority for his position, applied the grantor trust provisions to a post-confirmation liquidating trust and treated the individual debtor as the owner of the trust assets. The Supreme Court distinguished that case, however, because pursuant to the plan in *Sonner*, some of the bankruptcy estate assets revested in

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### The Court's approach creates the potential for uncertainty, depending on the wording of a plan.

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the debtor, who then placed those assets in a trust to pay his creditors. In *Holywell*, the assets were placed in the liquidating trust by the plan rather than by the individual debtor. Thus, the Court reasoned, "[the individual debtor] himself did not contribute anything to the trust" and therefore could not be the grantor.<sup>5</sup>

**IRS failure to object.** Finally, the trustee contended that the Service, as a creditor, was barred from asserting claims for *any* taxes since the plan did not provide for such payments. Bankruptcy Code Section 1141(a) provides that a confirmed plan binds any creditor regarding a pre-confirmation matter, whether or not the creditor has accepted the plan. The trustee argued that if IRS had wanted a different result, it should have objected to the plan. In apparent recognition of this rule, the Service had abandoned its appeal regarding the liquidating trustee's liability for taxes owed for periods prior to his appointment (*i.e.*, post-petition, pre-confirmation taxes). The Service narrowed its position to a claim that the liquidating trustee must file returns and pay taxes under Sections 6012(b)(3) and (4) for periods after confirmation of the plan and creation of the liquidating trust.

The Supreme Court rejected the trustee's contention, noting that the

Service was not seeking from the trustee any tax that became due prior to his appointment. The Court stated that even if Bankruptcy Code Section 1141(a) "binds creditors of the corporate and individual debtors with respect to claims that arose before confirmation, we do not see how it can bind the United States or any other creditor with respect to postconfirmation claims."

### Analysis

The Supreme Court broadly interpreted Section 6012 (as opposed to the narrow, strained interpretation of the Eleventh Circuit) to require the liquidating trustee to file income tax returns. Once the requirement to file was established, the duty to pay taxes followed under Section 6151. The Court's holding effectively protected the fisc at the expense of the creditor/beneficiaries of the liquidating trust. With regard to corporate debtors, the Supreme Court simply required the liquidating trustee to file returns under Section 6012 as an assignee of substantially all the property of a corporation, without regard to whether the property or business was being operated. The holding was a straightforward matter of statutory construction that was totally supported by the language of the section.

As noted, the Court's holding that the liquidating trustee had a duty to file returns for the individual debtor required it to distinguish *Sonner*. There, an individual debtor was the grantor of a liquidating trust, who thus was required by Reg. 1.677(a)-1(d) to report the trust's income on his individual return and pay tax thereon. The Supreme Court framed the facts to differentiate *Sonner* by stating that in *Holywell*, the plan, not the individual debtor, created the liquidating trust. Thus, the individual debtor could not be the grantor of the trust.

The Court did not express any concern that viewing the transfer as made by the plan rather than by the individual debtor elevated the form of the transaction over its substance. While the Court's refusal either to immerse itself in the nuances of the substance-over-form doctrine or to unequivocally overrule *Sonner* is somewhat troubling, and creates the potential for uncertainty depending on the wording

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of a plan, it is a classic example of judicial restraint. Since the Court did not overrule *Sonner*, a grantor trust arguably would be created notwithstanding *Holywell* if, as part of a plan, the assets of an individual's bankruptcy estate were to revert to the individual prior to their transfer to a liquidating trust.

**Practical guidance.** *Holywell* underscores the need for caution by a trustee in bankruptcy or a liquidating trustee in determining who is required to file returns and pay taxes. In *Holywell*, the liquidating trustee protected himself from potential liability by filing an action for declaratory judgment to determine his duty to file and pay tax. A bankruptcy trustee also can protect itself by filing for an expedited 60-day audit of trust fiduciary returns under Bankruptcy Code Section 505. This procedure for determining tax liability should be standard operating procedure for trustees in bankruptcy when there is potential uncertainty regarding the tax liability and the priority of payments to claimants and creditors.

*Holywell* also provides debtors with welcome relief from the possibility that they would be liable for taxes on a liquidating trust's income when the debtors did not have access to the trust assets needed to pay the taxes.<sup>6</sup> An individual debtor, however, should be careful not to fall within the fact pattern of *Sonner* and be deemed the grantor of the liquidating trust under Section 677 since, as discussed above, *Holywell* merely distinguished *Sonner* and did not overrule it.

## Conclusion

The Supreme Court in *Holywell* unequivocally held that a liquidating trustee in a chapter 11 proceeding has a duty to file returns and pay taxes on income generated by post-confirmation sales of trust property. This finding provides welcome guidance in a developing area of law. The decision clarifies the duties of the liquidating trustee to file and pay tax in a corporate as well as an individual bankruptcy. This will facilitate the administration of bankruptcy estates, and generally will allow debtors to better understand and protect their rights in bankruptcy. ■