

Department
of the
Treasury

Internal
Revenue
Service

Office of
Chief Counsel

Notice

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Subject: Administrative Expense Claims for Pension Underfunding Penalties in Bankruptcy Cases
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Purpose

This Notice provides guidance regarding the Service's position that pension underfunding taxes set forth under section 4971(a) and (b) of the Internal Revenue Code that relate to postpetition pension obligations of the bankruptcy estate are entitled to administrative expense priority under section 503 of the Bankruptcy Code. This Notice also requires coordination with the National Office concerning any bankruptcy case with section 4971 tax issues.

Background

Section 4971(a) imposes a tax of 10 percent on the amount of an accumulated funding deficiency under a pension plan to which section 412 applies for each taxable year an employer maintains the plan. Section 4971(b) imposes an additional tax equal to 100 percent of the accumulated funding deficiency if the deficiency is not corrected before the mailing of a notice of deficiency with respect to the 10 percent tax, or the time the 10 percent tax is assessed. While liabilities imposed under section 4971 are termed "taxes" under the Internal Revenue Code, they are considered penalties for bankruptcy purposes. United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 225-26 (1996).

Section 503 of the Bankruptcy Code governs the payment of "administrative expenses" of the bankruptcy estate. Section 503(b) lists a number of specific categories of expenses that "shall be allowed [as] administrative expenses . . . , including . . . the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b)(1)(A). Administrative expenses are accorded priority of payment above most prepetition claims. 11 U.S.C. § 507(a)(2), as amended by the Bankruptcy Abuse

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Prevention and Consumer Protection Act of 2005, effective for cases filed on or after October 17, 2005.

In Reading Co. v. Brown, 391 U.S. 471, 483 (1968), the Supreme Court held that actual and necessary costs of preserving the bankruptcy estate include costs ordinarily incident to the operation of a business. Rejecting the argument that “necessary” expenses include only those expenditures without which operation of the business would be impossible, the Court held that tort claims arising from a bankruptcy trustee’s negligence while he operated the debtor’s business were administrative expenses of the bankruptcy estate. 391 U.S. at 477, 485.

Non-compensatory penalties imposed under a state’s environmental laws also have been allowed as administrative expenses of the Chapter 11 bankruptcy estate. In re N.P. Mining Co., Inc., 963 F.2d 1449 (11th Cir. 1992). In N.P. Mining, the Eleventh Circuit held that penalties assessed under state law as a consequence of the operation of the debtor’s mining business were “actual, necessary costs and expenses of preserving the estate” under section 503(b)(1)(A). 963 F.2d at 1458-59; see also Cumberland Farms, Inc. v. Florida Department of Environmental Protection, 116 F.3d 16 (1st Cir. 1997). Similarly, in In re Hemingway Transp., Inc., 993 F.2d 915, 935 (1st Cir. 1993), the court held that costs incurred by a purchaser of contaminated property from the debtor-in-possession for which the debtor-in-possession was liable under federal environmental law could be administrative expenses under section 503(b)(1)(A). See Yorke v. NLRB, 709 F.2d 1138, 1143 (7th Cir. 1983) (damages incurred based on a trustee’s failure to bargain with the union over the effects of his decision to terminate operations, as required by federal law, are administrative expenses under section 503(b)(1)(A)).

Section 4971(a) and (b) taxes also should be allowed as administrative expenses if they relate to postpetition pension obligations of the bankruptcy estate. The debtor-in-possession has an obligation to operate its business in accordance with federal pension laws that require the timely funding of its pension plans. Because a bankruptcy debtor remains responsible for operating its business in accordance with federal nonbankruptcy law, it remains liable for penalties that are the result of its failure to do so. Like penalties arising under other nonbankruptcy laws from the operation of the debtor’s business, the section 4971 taxes are allowable expenses of administration. See also 28 U.S.C. § 960(a) (officers conducting business under the authority of a United States court shall be subject to federal taxes).

Two bankruptcy courts have held that section 4971 taxes are not administrative expenses of the bankruptcy estate under section 503(b)(1)(C). In re Unitcast, 219 B.R. 741 (B.A.P. 6th Cir. 1998); In re CF&I Fabricators of Utah, Inc., 148 B.R. 332, 341 (Bankr.D.Utah 1992), appealed on other grounds and affirmed 53 F.3d 1155 (10th Cir. 1995), affirmed on other grounds 518 U.S. 213 (1996). Section 503(b)(1)(C) provides that a penalty relating to a tax that is entitled to be paid as an administrative expense of the bankruptcy estate must also be paid as an administrative expense of the estate. The courts reasoned, by negative inference, that any penalty that does not relate to a

tax must not be entitled to administrative expense priority. Because section 4971 penalties do not relate to a tax, these courts held that they were not entitled to administrative expense priority. Unitcast, 219 B.R. at 750-752; CF&I Fabricators, 148 B.R. at 341. The Unitcast opinion and the CF&I bankruptcy court opinion did not consider the application of section 503(b)(1)(A).

Position

The Service will argue in appropriate cases that the pension underfunding penalties in section 4971(a) and (b) that relate to postpetition pension obligations are entitled to administrative expense priority under section 503(b)(1)(A). Section 503(b)(1)(C) was not intended to exclude from administrative expense status penalties that do not relate to a tax. Rather, section 503(b)(1)(C) creates a timing rule for penalties that relate to taxes. A penalty relating to a tax is entitled to administrative expense priority not based on when the penalty arises (before or after the petition date), but based upon when the tax to which it relates arises. There is nothing in section 503(b) to prevent penalties that do not relate to taxes from being paid under section 503(b)(1)(A) as administrative expenses if the penalties are actual and necessary costs and expenses of preserving the bankruptcy estate.

Attorneys with any bankruptcy case with section 4971 tax issues must coordinate their case with the Significant Bankruptcy Case Coordinator in Branch 2, Collection, Bankruptcy and Summonses Division, Office of the Associate Chief Counsel (Procedure and Administration). Questions about this Notice should be directed to the Significant Bankruptcy Case Coordinator at (202) 622-3620.

/s/
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