OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

May 27, 1999

Number: **199939004**
Release Date: 10/1/1999

CC:EL:GL:Br1
GL-746984-96

UILC: 09.03.00-00
9999.98-00

MEMORANDUM FOR ALBERT B. KERKHOVE
ASSOCIATE DISTRICT COUNSEL, MIDWEST DISTRICT,
OMAHA CC:MSR:MWD:OMH

FROM: Alan C. Levine
Chief, Branch 1 (General Litigation) CC:EL:GL:BR1

SUBJECT:

This is in response to your memorandum dated April 7, 1999. This document is not to be cited as precedent.

LEGEND:

Debtor
Date A
Date B
Date C
Date D
Date E
Date F
Date G
Plan Year A
Plan Year B
Plan Year C
Amount A
Amount B

ISSUE:

Whether I.R.C. § 4971(a) and (b) excise taxes should be classified as administrative claims pursuant to B.C. § 503(b), priority claims pursuant to B.C. § 507(a)(8), or general unsecured prepetition claims in debtor's bankruptcy proceeding.

CONCLUSION:

Due to the unfavorable precedent of In re Unitcast, Inc., 219 BC 741 (6th Cir. BAP 1998), we do not believe that the Internal Revenue Service (Service) should assert that any of the I.R.C. § 4971 claims are administrative claims pursuant to B.C.
§ 503(b). Due to the holding in United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996), we do not believe the Service has any basis to assert that any of the I.R.C. § 4971 claims qualify as priority claims pursuant to B.C. § 507(a)(8). Accordingly, the claims should be classified as prepetition general unsecured claims.

FACTS:

Debtor was an equipment manufacturer in Western Nebraska. On or about Date A, all but future benefits under Debtor's pension plan were frozen and employees were only entitled to collect benefits that were vested on that date. Employees did not accrue benefits under the plan for work performed after that date.

Debtor filed for bankruptcy relief under Chapter 11 of the Bankruptcy Code on Date B. The United States timely filed alternative proofs of claim on Date C for I.R.C. § 4971(a) and (b) taxes based upon Debtor's accumulated funding deficiency under its pension plan. The Service asserted both priority claims under then B.C. § 507(a)(7)[now (a)(8)] and administrative claims under B.C. § 503.

Prior to filing for bankruptcy, Debtor had requested that the Service waive the minimum funding standard for Pension Plan Years A and B. On Date D, after the bankruptcy proceeding had been filed, the Service approved the waiver of the minimum funding standard for Pension Plan Year A, contingent upon Debtor making contributions to satisfy the minimum funding standard for Pension Plan Years B and C. During the bankruptcy proceeding Debtor moved the court to terminate its pension plan. By Order dated Date E, the court approved the motion.

Debtor (as debtor-in-possession) and the committee for unsecured creditors retained several professionals to assist in the reorganization. Most of the professionals received interim payment of fees throughout the proceeding. Debtor was not successful in reorganizing its business. Most of its property was sold while Debtor was still in a Chapter 11 proceeding. On Date F, Debtor converted to Chapter 7 and a trustee was appointed.
On Date G, the Service timely filed alternative proofs of claim in the Chapter 7 proceeding. The administrative claims totaled Amount A, and the alternative unsecured claims totaled Amount B.

The Trustee has taken disgorgement actions against several of the professionals who received interim payments during the Chapter 11 bankruptcy proceeding, but has not yet recovered all the assets he expects to be returned to the bankruptcy estate. Therefore, the final size of the bankruptcy estate is unknown at this time.

The trustee requested that the Service withdraw its claims, citing United States v. Reorganized CF&I Fabricators of Utah, 518 U.S. 231 (1996); In re Chateaugay Corp., 146 BR 626 (S.D.N.Y. 1992); and In re Wheeling-Pittsburgh Steel Corp., 103 BR 672 (W.D. Pa. 1989) as support for his allegation that the United States' claims were not administrative claims entitled to administrative payment priority. Inasmuch as the bankruptcy estate is probably not sufficient to pay all of the administrative claims, the Trustee did not address the United States' alternative priority unsecured claims.

LAW AND ANALYSIS

I.R.C. § 4971 imposes taxes 1/ upon an employer for the failure to meet minimum funding standards applicable to qualified pension plans. Section 4971 provides, in pertinent part:

> (a) Initial tax. - For each taxable year of an employer who maintains a plan to which section 412 applies, there is hereby imposed a tax of 10 percent (5 percent in the case of a multiemployer plan) on the amount of the accumulated funding deficiency under the plan, determined as of the end of the plan year ending with or within such taxable year.
>
> (b) Additional tax. - In any case in which the initial tax is imposed by subsection (a) on an accumulated funding deficiency and such accumulated funding deficiency is not corrected within the taxable period, there is hereby imposed a tax equal to 100 percent of such accumulated funding deficiency to the extent not corrected.

An "accumulated funding deficiency" generally equals the amount by which the statutory minimum contribution to a qualified pension plan exceeds the amount actually contributed to the plan. I.R.C. § 4971(c)(1) referencing I.R.C. § 412(a).If an accumulated funding deficiency is not reduced to zero (see I.R.C. § 4971(d)(2)) within the specified periods (see I.R.C. § 4971(c)(3)), the employer incurs liabilities pursuant to sections 4971(a) and (b).

1/ The Supreme Court in CF&I Fabricators, supra, determined that, for bankruptcy purposes, the section 4971 "tax" for failure to meet minimum funding standards is a non-pecuniary loss penalty.

At issue is the treatment of the I.R.C. § 4971(a) and (b) penalties imposed against the Debtor. In order to be entitled to administrative expenses pursuant to B.C.§ 503(b)(1) 2/, the Government's section 4971 claim must be an actual and necessary expense of preserving the bankruptcy estate and the liability must arise post-petition. In re Bayly Corporation, 163 F.3d 1205 (10th Cir. 1998); In re Sunarhauserman, Inc., 126 F.3d 811, 817 (6th Cir. 1997); In re Unitcast, 219 BR 741 (6th Cir. BAP 1998).

In In re Bayly, supra, the Pension Benefit Guaranty Corporation (PBGC) assumed control of the underfunded pension plan of the Bayly Corporation. In the Bayly Corporation's bankruptcy proceeding, the PBGC filed a proof of claim for the amount of the underfunding pursuant to 29 U.S.C. § 1362(b). The PBGC sought administrative status for its claim pursuant to B.C. § 503(b)(1). The Eleventh Circuit stated that even though the payment for the amount of the underfunding did not become due and owing until the post-petition termination of the plan, the PBGC's claim for the unfunded benefit liabilities, predicated solely on benefits accrued by the debtor's employees as a result of prepetition labor, represented a prepetition claim. Consequently, the court determined that the liability was not incurred by the bankruptcy estate and did not qualify as an administrative expense under B.C. § 503(b)(1)(B).

The Sixth Circuit reached the same conclusion in In re Sunarhauserman, Inc, supra. The court determined that to the extent the PBGC's claim for administrative expenses was based on unpaid minimum funding contributions pursuant to 29 U.S.C. § 1082 and I.R.C. § 412, the claim was limited to the portion related to pension benefits actually earned by the employees of the debtor (normal costs of benefits) during the corporation's post-petition

---

2/ In relevant part, B.C. § 503(b) provides:

After notice and hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including –

(1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case;

(B) any tax –

(i) incurred by the estate, except a tax of a kind specified in section 507(a)(8) of this title; ... and

(C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph.

operations. The Sixth Circuit rejected the PBGC's argument that the date the debtor became bound to eliminate the funding deficiency under ERISA was controlling in determining administrative expense status. The Sixth Circuit determined that "regardless of the substantive law on which the claim is based, the proper standard for determining that claim's administrative priority looks to when the acts giving rise to a liability took place, not when they accrued." Id. At 818.

Likewise, the Sixth Circuit BAP recognized in In re Unitcast, supra, that it is an absolute requirement that administrative expenses be post-petition expenses and that the proper standard for determining whether a claim is an administrative expense is whether the acts giving rise to the expense occurred (not accrued) before or after the petition is filed. Citing In re Sunarhauserman, the Sixth Circuit BAP determined that the debtor's minimum funding obligations under I.R.C. § 412 is a post-petition obligation only to the extent that it can be tied to hours actually worked post-petition. The Sixth Circuit BAP determined that for the years in which the acts which gave rise to most of the I.R.C. § 4971 claims were prepetition acts, the I.R.C. § 4971 claims were prepetition expenses.

The Unitcast court then looked to the post-petition portion of the Government's I.R.C. § 4971 claim, and stated that the claim will be an allowed administrative expense only to the extent it can be tied to hours actually worked by the debtor's employees post-petition and only to the extent it otherwise qualifies under B.C. § 503(b). The BAP determined that because the I.R.C. § 4971 claims were not a tax (or tax claims) incurred by the estate, but rather were non-pecuniary loss penalties, the I.R.C. § 4971 claims did not qualify for administrative expense status pursuant to B.C. § 503(b)(1)(B). Additionally, the BAP determined that pursuant to B.C. § 503(b)(1)(C), the penalty must relate to a tax incurred by the bankruptcy estate to receive administrative expense status. The BAP determined that I.R.C. § 4971 does not relate to any tax in the Internal Revenue Code because the minimum funding standard set forth in I.R.C. § 412 is not a tax. Therefore, in In re Unitcast, the BAP concluded that even the I.R.C. § 4971 claims which arose post-petition were not entitled to administrative priority.

In the instant case, the pension plan was frozen prepetition so no work was performed after the bankruptcy petition was filed which could entitle any employee to additional benefits. Based upon the rationale of In re Bayly, In re Sunarhauserman, and In re Unitcast, the I.R.C. § 4971 claims constitute prepetition claims. 3/ We recognize that your case, if litigated, would be appealed

---

3/ In In re Bayly and In re Sunarhauserman, at issue was the underfunding of the pension plan. Under ERISA, the PBGC becomes the statutory trustee of any plan terminated without sufficient funds to pay guaranteed benefits. See 29 USC §§ 1322,

(continued...)

to the Eighth Circuit, not the Sixth or Tenth Circuit. However, the Eighth Circuit has previously decided that an administrative claim is based upon the date that the acts giving rise to the liability occurred. See In re L.J. O'Neill Shoe Co., 64 F.3d 1146 (8th Cir. 1995). It follows, therefore, that the Eighth Circuit may well conclude that the section 4971 claims are prepetition claims because the acts giving rise to the liability (work performed by the debtor's employees) occurred prepetition.

Having determined that the claims based upon I.R.C. § 4971 constitute prepetition claims, the next issue is whether these prepetition claims receive priority under B.C. § 507(a)(8). Based upon the Supreme Court decision in Reorganized CF&I Fabricators, Inc., supra, that a claim in bankruptcy based upon I.R.C. § 4971(a) is not entitled to priority under B.C. § 507(a)(7)[now (a)(8)], we do not believe the Service should assert priority for these claims. Accordingly, we believe the claims in the instant case should be classified as general unsecured prepetition claims.

You have advised that the Trustee has requested that the United States withdraw its claim or be prepared to litigate its claims in response to a formal objection to the United State's claim. Based upon the above analysis, we recommend that the United States file an amended proof of claim classifying the I.R.C. § 4791 liability as general unsecured prepetition claims. 4/

3/(...continued)
1342, 1361. Upon termination of an underfunded plan, the plan sponsor incurs liability to the PBGC for a mandatory termination payment to reimburse the PBGC for the benefits the PBGC must pay to the plan's beneficiaries. See 29 U.S.C. § 1362. In such circumstances, the PBGC has a claim against the plan sponsor for the total amount of the underfunded guarantees benefits of the plan, subject to a limitation of thirty percent of the net worth of the employer. In the instant case, in contrast, at issue is the section 4971 penalty for underfunding the pension plan. This is a non-pecuniary loss penalty. Therefore, we believe our litigation position in this case would be weaker than that of the PBGC in those cases.

4/ You have proposed an alternative solution in which you would encourage the Trustee not to object to the United State's claim, but, instead to propose a distribution of estate assets which does not include payment of the United State's claims as priority or administrative claims. You state that the United States can then either allow the proposed distribution to stand or can object to the distribution and litigate its claims. You state that this alternative allows the United States' claims to retain the status that it appears the Courts will support - as general unsecured claims entitled to payment pro rata with other general unsecured claims. We recommend that the Service affirmatively file an amended proof of claim asserting the correct status for the I.R.C. § 4971 claims
(continued...)

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As we are advocating that the Service file an amended proof of claim asserting a general unsecured prepetition claim, we see no risks or hazards in the position stated above.

If you have any further questions, please call 202-622-3610.

cc: Assistant Regional Counsel (Midstates Region)

4/(...continued)
rather than passively obtain this status by not objecting to the Trustee's distribution.