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

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MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE), AREA 4, CLEVELAND

FROM: Lawrence H. Schattner
Chief, Branch 1 (Collection, Bankruptcy and Summonses)

SUBJECT: Priority Status of Interest on Administrative Tax Claims

This Chief Counsel Advice responds to your email dated October 9, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Whether interest that accrues on an administrative tax liability incurred during a Chapter 11 reorganization case, prior to a conversion to Chapter 7, is entitled to first priority status in distribution under the Bankruptcy Code after the case is converted.

2. Whether interest continues to accrue on the Chapter 11 administrative tax liability after the case is converted to Chapter 7.

CONCLUSIONS

1. Yes, interest that accrues pre-conversion on an administrative tax liability incurred during a Chapter 11 reorganization is considered an administrative expense under section 503 of the Bankruptcy Code and is entitled to first priority in distribution, even after the case is converted to one under Chapter 7.

2. Yes, interest continues to accrue, however, it is not entitled to first priority status under section 507 of the Bankruptcy Code because it is not an administrative expense under section 503. Therefore, the interest is relegated to fifth priority in distribution under section 726(a)(5).

FACTS

Debtor filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. Two years later the case was converted to a Chapter 7 liquidation. During the Chapter 11 portion of the bankruptcy the Chapter 11 estate incurred administrative tax liabilities, which remained unpaid when the case was converted. The Internal

Revenue Service ("Service") filed administrative claims in both the Chapter 11 and Chapter 7 cases. The Service also filed a proof of claim for pre-petition secured claims, priority claims and general unsecured claims. It is anticipated that after liquidation there will be some money remaining to pay the general unsecured claims.

The Chapter 7 trustee objected to the Service's claims. The trustee contends that post-petition interest on an administrative claim is not entitled to first priority status for distribution. Instead, the trustee argues that the interest should be paid as a fifth level priority pursuant to section 726(a)(5) of the Bankruptcy Code. For support the trustee relies on In re Weinstein, 251 B.R. 174 (B.A.P. 1st Cir. 2000) and In re Hospitality Assoc. of Laurel, 212 B.R. 188 (Bankr. D. N.H. 1997).

LAW AND ANALYSIS

On November 30, 2001, the First Circuit Court of Appeals overturned the decision in In re Weinsein, the trustee's primary support. In re Weinstein, 2001 U.S. App. LEXIS 25446 (1st Cir. 2001). Our position, which we review below, is fully set out in the Government's brief in Weinstein.

Analyzing the priority status of post-petition interest on the administrative tax liabilities in this case requires looking at distinct stages of interest accrual. First, we must determine the priority status of the Service's claim for post-petition interest that accrued on administrative liabilities incurred during the Chapter 11 portion of the case, prior to the conversion to Chapter 7. Next, we must determine whether the conversion to Chapter 7 affects the priority status of the Service's claim for post-petition interest. Last, we must determine the priority status of the Service's claim for interest on the Chapter 11 administrative tax liabilities that continues to accrue after the case has been converted.

Priority Status of Accrued Interest on Chapter 11 Administrative Claims

Under section 507(a) of the Bankruptcy Code, administrative expenses have first priority in bankruptcy distribution. Administrative expenses are defined in section 503(b). Section 503 provides in relevant part:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including -
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> (1) . . .
>
> (B) any tax -
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> (i) incurred by the estate, except a tax of a kind specified in section 507(a)(8) of this title . . .

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

B.C. § 503(b). Unless the creditor agrees otherwise, a court will only confirm a Chapter 11 reorganization plan if the holder of an administrative claim receives cash equal to the allowed amount of its claim on the effective date of the plan. B.C. § 1129(a)(9)(A).

Interest is not expressly mentioned as an administrative expense in section 503. The trustee in this case argues that because it is not expressly mentioned it can not be an administrative expense, therefore, it is not entitled to first priority status. However, this argument ignores the fact that every circuit to have addressed post-petition interest on administrative tax claims has found that the interest itself is an administrative expense entitled to the same priority as the underlying tax. In re Weinstein, 2001 U.S. App. LEXIS 25446 (1st Cir. 2001); In re Flo-Lizer, Inc., 916 F.2d 363 (6th Cir. 1990); In re Allied Mechanical Services, Inc., 885 F.2d 837 (11th Cir. 1989); In re Mark Anthony Constr., Inc., 886 F.2d 1101 (9th Cir. 1989); United States v. Friendship College, Inc., 737 F.2d 430 (4th Cir. 1984); see also In re Preferred Door Co., Inc., 990 F.2d 547 (10th Cir. 1993) (citing these circuit court cases favorably).

To determine whether interest is included as an administrative expense requires close analysis of section 503. The starting point of any statutory analysis must be "the language of the statute itself." Consumer Product Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980). Section 503 lists various administrative expenses. Because it uses the term "including," the statute suggests that the list is not exhaustive. The Bankruptcy Code itself states that the use of "including" is not limiting. B.C. § 102(3). Therefore, interest could be included as an administrative expense. This uncertainty over what exactly is included as an administrative expense makes the statute ambiguous. Flo-Lizer, 916 F.2d at 365; Allied Mechanical, 885 F.2d at 838-39; Mark Anthony, 886 F.2d 1106. When a statute is ambiguous the court must look to the legislative history to determine what it means. Flo-Lizer, 916 F.2d at 365, relying on, United States v. Ron Pair Enterprises, 489 U.S. 235 (1989).

The Senate's version of section 503 expressly provided for interest as an administrative expense. S. Rep. No. 989, 95th Cong., 2nd Sess. (1978). The final version of the statute did not. Congress gave no explanation for why it did not expressly include interest in the list of expenses given first priority status. Mark Anthony, 886 F.2d at 1107. Under the prior law, the Bankruptcy Act of 1898, interest was included as an administrative expense pursuant to the Supreme Court decision in Nicholas v. United States, 384 U.S. 678 (1966). Although the Bankruptcy Act did not specifically mention interest, the Supreme Court concluded that interest earned on taxes incurred during a Chapter 11 reorganization was entitled to the same priority status as the administrative tax. Id. at 389. Nowhere has Congress expressed an intent to abrogate the rule as laid out in Nicholas. Mark Anthony, 886 F.2d at 1107 ("There is no indication anywhere in the legislative

history that Congress intended to, or even was aware that its failure to list interest specifically would, alter the priority of post-petition interest."). It is a well established principle of statutory construction that "no changes in law or policy are to be presumed from changes in language in [a statute's] revision unless an intent to make such changes is clearly expressed." Finley v. United States, 490 U.S. 545 (1989). Without clear evidence that Congress intended to change the common law, a court cannot construe a statute to establish a new rule of law. Mark Anthony, 886 F.2d at 1107. Thus, the rule that post-petition interest on a post-petition tax liability of a bankruptcy estate is an administrative expense remains the law even after enactment of the Bankruptcy Code.

This rule is consistent with the general treatment of interest on tax claims. The Supreme Court has recognized that "[i]n most situations interest is considered to be the cost of use of the amounts owing a creditor and an incentive to prompt repayment and, thus, an integral part of a continuing debt. Interest on a tax debt would seem to fit that description." Bruning v. United States, 376 U.S. 358, 360 (1964). Thus, a claim for post-petition interest is part and parcel with a claim for administrative tax liabilities.[1] This is especially true given the importance of post-petition creditors to a debtor's ability to reorganize. The priority status given to the costs of administering the estate, including interest, is meant to encourage "those who either help preserve and administer the estate or who assist with the rehabilitation of the creditor so that all creditors will benefit." In re Colortex Industries, Inc., 19 F.3d 1371, 1383 (11th Cir. 1994). It is also meant to promote an "overriding policy that a debtor's efforts to reorganize shall be financed by the debtor, not the debtor's post-petition creditors." Allied Mechanical, 855 F.3d at 839. Congress recognizes that the Government is in a unique position as a creditor. First, the Government cannot chose to whom it extends credit. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. (1978). Second, businesses often pay other creditors before paying their taxes. Id. Given these realities, it would be unfair to require the Government to make "interest-free loans" while a debtor attempts to reorganize its financial affairs. Mark Anthony, 886 F.2d at 1108, n.10.

Another reason for concluding that the post-petition interest is included as an administrative claim is the fact that section 503 expressly provides for penalties.

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[1]We recognize that post-petition interest does not accrue on pre-petition claims. There are two reasons for this rule. First, because the interest accrues at different rates, interest on pre-petition claims is suspended upon filing so that one creditor is not advantaged over another. In re Colortex Industries, 19 F.3d 1371, 1380, citing, American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U.S. 261, 266 (1914). Second, interest is suspended to avoid administrative inconvenience. Colortex, 19 F.3d at 1380, citing, Bruning, 376 U.S. at 362 (1964). Neither of these concerns is implicated by allowing post-petition interest to accrue on post-petition claims. In Nicholas the Supreme Court determined that allowing interest on an administrative claim to accrue during a reorganization neither unfairly burdened the trustee nor disadvantaged other creditors. 384 U.S. 678.

The inclusion of penalties as an administrative expense shows that Congress was willing to have the bankruptcy estate pay for expenses that arise out of a debtor's failure to pay taxes. Flo-Lizer, 916 F.2d 363. All of the circuit courts to have considered this issue agree that it makes no sense for Congress to give penalties a higher priority than interest. Instead, "a rule which treats interest in the same manner as the underlying tax is consistent with the general treatment of taxes and interest in the [Bankruptcy] Code, and in the tax laws." Mark Anthony, 886 F.2d at 1107.

Priority Status of Accrued Interest on Chapter 11 Administrative Claims After Conversion to Chapter 7

As the above discussion shows, the great weight of authority concludes that post-petition interest is entitled to first priority status as an administrative claim in Chapter 11 cases. The trustee argues that post-petition interest can not be entitled to first priority status because section 726(a)(5) already provides for interest as a fifth priority, however, section 726(a)(5) is not implicated in this case. The interest at issue here accrued pre-conversion during the Chapter 11 portion of the case. Therefore, "[t]he Chapter 7 priority scheme should not affect the Chapter 11 claims, which were fixed at the time of conversion, except as expressly provided for in Chapter 7 of the Bankruptcy Code." In re Rocky Mtn. Refractories, 208 B.R. 709, 713 (B.A.P. 10th Cir. 1997); In the Matter of Peter Del Grande, Corp., 138 B.R. 458, 461-62 (Bankr. D. N.J. 1992) (finding that interest which accrued pre-conversion "retains its administrative expense status and is not affected by the conversion").[2] Several of the circuit court cases considering the priority status of interest on administrative tax claims involved cases which had been converted from Chapter 11 to Chapter 7 and none of them found that the conversion affected the analysis. Allied Mechanical, 885 F.2d 837; Mark Anthony, 886 F.2d 1101; see Preferred Door, 990 F.2d 547; see also Colortex, 19 F.3d 1371.

Section 726 provides for first priority distribution of administrative claims and fifth priority distribution of certain claims for interest:

> Except as provided in section 510 of this title, property of the estate shall be distributed -
>
> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title . . .
>
> . . . (5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection.

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[2]However, the administrative expenses incurred pre-conversion are paid after the Chapter 7 administrative claims are paid. B.C. § 726(b).

B.C. § 726(a)(1),(5). Section 507 gives first priority for "administrative expenses allowed under section 503(b)." B.C. § 507(a)(1). Section 726(a)(5) limits fifth priority to payment of interest from the date of the petition. Thus, (a)(5) does not apply to interest accrual during a prior Chapter 11. The First Circuit goes even further and says that (a)(5) does not apply to payment of interest accruing after the petition date on post-petition liabilities.

In Weinstein, a case dealing with the priority status of post-petition interest that accrued on administrative tax claims in a Chapter 7 case, the court examined the interplay between sections 503, 507 and 726. 2001 U.S. App. LEXIS 25446 *1. First, the court found that although section 726(a)(5) seems to provide for interest as a fifth priority status in distribution, when read in conjunction with sections 503 and 507 it is unclear exactly how section 726(a)(5) is meant to apply. Id. at *13. Therefore, the court looked at the prior law, the legislative history and the policy considerations behind the relevant code sections in order to clarify section 726(a)(5). The court's analysis mirrored the prior circuit decisions discussed above, therefore, we will not repeat it. Ultimately, the court concluded that "a proper reading" of section 503(b) includes post-petition interest incurred on administrative tax liabilities. Therefore, the interest should be paid as a first priority administrative expense under section 726(a)(1).

Interest Accrual on Chapter 11 Administrative Tax Liabilities Post-Conversion

The last issue to be considered is whether interest continues to accrue on the administrative tax liabilities incurred during the Chapter 11 portion of the case after it is converted to Chapter 7, and if so, what is its priority status under section 726.

Generally, a creditor may not file a claim for unmatured interest accruing after a bankruptcy petition is filed. B.C. § 502(b)(2). However, post-petition interest on non-dischargeable debts can be collected directly from the debtor after bankruptcy. Bruning v. United States, 376 U.S. 358 (1964); In re Cousins, 209 F.3d 38 (1st Cir. 2000); Leeper v. PHEAA, 49 F.3d 98 (3d Cir. 1995). The rationale for this is based on the recognition that there is a difference between allowing claims for interest on debts collectible from the bankruptcy estate and those collectible directly from the debtor. Leeper, 49 F.3d at 101. The purpose of not allowing claims for interest accrual once a bankruptcy petition is filed is to protect the assets of the estate for all creditors. Bruning, 376 U.S. at 362. If a debt with a high interest rate is allowed to deplete the assets of the estate the other creditors will be disadvantaged. Id. Prohibiting claims for post-petition interest also makes the estate easier to administer and less burdensome for the trustee. Id. Neither of these concerns are at issue once the bankruptcy is over and the debt is collected directly from the debtor. Id. at 363.

An exception to prohibiting claims for unmatured interest is section 726(a)(5), a codification of the "solvent debtor rule," which provides that any money remaining after distribution should be paid to compensate the creditors rather than the debtor. Colortex, 19 F.3d at 1376. Thus, post-petition interest will only be paid as fifth

priority before any excess assets of the estate is paid back to the debtor. In Nicholas the Supreme Court seems to hold that interest accruing during a Chapter 11 reorganization stops accruing after conversion to a liquidation case. This holding was based on the Court's determination that it would be inequitable to allow the interest accruing on a debt owed by the estate to absorb the assets available for the debtor's creditors Nicholas, 384 at 683-84; see also In re Sun Cliff, Inc., 143 B.R. 789 (Bankr. D. Colo. 1992); In re Peter Del Grande, 138 B.R. 458 (Bankr. D. N.J. 1992). In this case, however, because the post-petition interest is being paid out of funds that would otherwise go back to the debtor, this situation is different from the one presented in Nicholas.

Although the interest on the Chapter 11 administrative liabilities continues to accrue, it cannot be characterized as an administrative expense of the Chapter 7 estate under section 503(b). See B.C. § 726(b). Therefore, the post-petition interest on the Chapter 11 administrative liabilities continues to accrue, but will be paid as a fifth priority expense under section 726(a)(5).

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If you have any further questions please contact the attorney assigned to this matter at (202) 622-3620.