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Cover Page Footnote
This Note would not have been published without the insightful advice and instruction of Professor Susan Block-Lieb. In addition, I dedicate this Note to Dean John D. Feerick, who has been, and will continue to be, an inspiration to a generation of Fordham law students and alumni. Lastly, I thank my family and friends for all their support.
QUESTIONING HOW THE BANKRUPTCY PRIORITY SCHEME TREATS TAX CLAIMS ARISING FROM THE TERMINATION OF OVERFUNDED PENSION PLANS

Michael J. Cohen*

INTRODUCTION

The Employee Retirement Income Security Act of 1974 ("ERISA")\(^1\) prescribes the metes and bounds of pension plan funding and termination.\(^2\) Funding rules assure employees that they will receive income from pension plans when they retire. Nonetheless, a plan sponsor may terminate a plan in a number of situations, including a bankruptcy filing. Upon termination, a pension plan may be overfunded or underfunded.\(^3\) The Internal Revenue Code ("IRC")\(^4\) provides two kinds of assessments\(^5\) that a plan sponsor may be obligated to pay when it terminates a pension plan. The nature of the exaction depends on whether the plan that the sponsor terminated was overfunded or underfunded.\(^6\) Specifically, IRC § 4980 assesses an obligation on overfunded plans, while § 4971 levels an exaction on underfunded plans.\(^7\) Moreover, if a pension plan sponsor terminates a plan and files a bankruptcy petition, the priority rules of the Bankruptcy Code channel each of these obligations as they mature.

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2. See infra text accompanying notes 59-85.
5. This Note uses the words "assessment," "exaction," or "obligation" interchangeably to denote various compulsory payments imposed by the IRC and state tax codes. The use of the words "tax," "excise tax," or "penalty," each of which is subject to distinct treatment by the bankruptcy claim payment scheme, are reserved for passages in which this Note discusses and analyzes the case law debate regarding the significance of those words in the bankruptcy context. For more on the excise tax-penalty debate, see infra Part II.B.
6. See infra Part I.C-D.
7. See infra Part I.D.
into different types of bankruptcy claims, each of which entitles the
government to varying degrees of repayment. The differing
treatment of these tax claims by the bankruptcy priority scheme is the
result of a test fashioned by the Supreme Court in United States v.
Reorganized CF&I Fabricators of Utah, Inc. However, the
Fabricators test does not acknowledge the competing policies of the
three federal regulatory regimes—namely, ERISA, the IRC, and the
Bankruptcy Code—that collide when the bankruptcy priority
scheme orders overfunding and underfunding tax claims.

This Note argues that the current state of the law does not
sufficiently consider the competing pension, tax, and bankruptcy
policies and proposes that Congress amend IRC § 4980 to advance
bankruptcy policies that maximize distribution to creditors and
protect innocent creditors from bearing the cost of a debtor's
misdeeds. Part I provides a brief overview of the ERISA statute,
 focusing specifically on the provisions governing pension plan funding
and termination; it describes why and how a plan can become
overfunded or underfunded, and explains IRC §§ 4980 and 4971. Part
II focuses on the bankruptcy context, describing the priority scheme
that orders claim payment in bankruptcy and delving into the case law
debate over whether a particular obligation is a claim for a penalty or
a tax entitled to special treatment in the priority scheme. Part II
concludes by examining how the current state of the law treats the
competing tax, pension, and bankruptcy policies. Part III argues that
courts, in their treatment of § 4980, have overlooked the bankruptcy
policies of maximized distribution and innocent creditor protection.
Part III concludes by presenting judicial and legislative solutions that
promote the relevant bankruptcy policies, and by advocating the
narrowest option: amending IRC § 4980 to exempt bankrupt plan
sponsors from liability. This amendment would expand the
bankruptcy estate, enabling a greater distribution to general
unsecured creditors.

8. See infra Part I.C.
   by Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353,
   98 Stat. 355, amended by Bankruptcy Judges, United States Trustees, and Family
   Code”).
11. An entity filing under Chapter 7 is exempt only from the higher of the two
   exaction rates assessable under § 4980. See infra text accompanying notes 107-123.
   This Note proposes to expand the exemption to preclude application of both rates to
   all debtors.
I. OVERVIEW OF THE LAW OF PENSION PLAN FUNDING AND TERMINATION

This part will illustrate the operation of certain ERISA and IRC sections that regulate pension plan overfunding and underfunding. It is important to note, however, that pension plans existed for several decades before Congress enacted ERISA in 1974. The pre-ERISA era demonstrates how the adverse effects of corporate policy on generations of workers brought about the evolution of retirement income security regulation—an often misunderstood and obscure niche in commercial law practice. Thus, the first section will describe the pre-ERISA legal regime and its effects, summarizing the ills Congress sought to cure when it drafted the act. The second section will explain ERISA's pension plan funding and termination requirements. The third section will discuss the mechanics of pension plans, demonstrating how they become overfunded or underfunded. The last section will highlight the relevant IRC sections that assess exactions payable by a plan sponsor which overfunds or underfunds its pension plan.

A. The ERISA Backstory

Pension plans existed in the nineteenth century but to a very limited extent. In 1875, the American Express Company, then in the railroad transportation business, established the nation's first formal pension plan, providing benefits to its disabled workers over sixty years old who served the firm for at least twenty years. Through the first third of the twentieth century only the largest corporations established pension plans for their employees; by 1925 these companies had established 400 plans. The number of pension plans in the United States increased during the twentieth century primarily because of the growth of the domestic economy. Indeed, the evolution of the pension plan rides on the coattails of the evolution of modern capital markets. As companies grew in the postwar economy, pension and welfare benefits substituted for wages that were stabilized because of government-mandated wage freezes during World War II and the Korean War. The number of employees covered by pension plans increased five-fold between 1940 and 1960. Since 1940, the number and aggregate asset base of pension plans steadily increased from 4,000,000 covered employees and $2.4 billion

13. Id. at 27-28.
17. See id.
in plan assets to almost 70,000,000 and $4.8 trillion, respectively, in 2000. Companies established pension plans for reasons that are still salient today—namely, to secure a steady employee base for the long term and to take income tax deductions in the amount of the funds contributed to the plan.

Before Congress passed ERISA, the regulatory requirements that accompanied corporate pension plan funding were limited to a number of tax provisions and superficial disclosure rules. For example, before Congress’s revision of the tax code in 1938, a company could “reclaim not merely plan assets in excess of the value of liabilities, but the entire corpus of the trust.” Congress later adopted several legislative measures that nonetheless proved inadequate. The relevant pre-ERISA federal statutes governing pensions were the Welfare Pension Plans Disclosure Act (“WPPDA”), the Labor-Management Relations Act (“LMRA”), and the 1954 version of the IRC. The WPPDA was adopted to “protect the interest of welfare and pension plan participants and beneficiaries through disclosure of information with respect to such plans.” The statute required plan administrators to file with the Secretary of Labor and send to plan participants upon written request a plan description and annual report. The LMRA addressed pension issues not covered by the WPPDA, providing guidelines on the establishment and operation of plans administered jointly by unions and employers. The 1954 IRC continued the policy of allowing “various tax advantages to accrue to employers who establish[ed] and maintain[ed] pension plans which . . . qualif[ied] for such tax benefit privileges.”

Several problems arose under the former, pre-ERISA legal regime. Congressional leaders found that the WPPDA was “weak in its limited disclosure requirements and wholly lacking in substantive fiduciary standards.” Specifically, they pointed out that “[i]ts chief procedural weakness can be found in its reliance upon the initiative of

18. Id. at 4839-40.
22. Id. at 162.
24. Id.
25. Id.
26. Id.
27. Id.
the individual employee to police the management of his plan."

The report deemed the scope of the LMRA too narrow, and the congressional leaders stated that the 1954 IRC "provide[d] only limited safeguards for the security of anticipated benefit rights in private plans." Among the specific problems that the report cited were reliance by plan participants on the equitable remedies of the common law of trusts to vindicate their rights, inadequate coverage, misuse of pension funds, capricious losses of benefits as a result of draconian funding and vesting provisions in plan indentures, and the unintended consequences of business failure. Congress drafted ERISA as a response to these statutory limitations and empirical problems.

The simple purpose of ERISA is to protect individual pension rights. ERISA sets forth minimum vesting, funding, and fiduciary standards and a system of compulsory benefit insurance in order to achieve that purpose. Congress hoped ERISA would

\[ ((1)) \text{ assure American workers that they may look forward, with anticipation, to a retirement with financial security and dignity . . . .} \\
\[ ((2)) \text{ increase stability within the framework of our nation's economy . . . .} \\
\[ ((3)) \text{ restore credibility and faith in the private pension plans . . . .} \\
\[ ((4)) \text{ encourage rather than diminish efforts by management and industry to expand pension plan coverage and to improve benefits for workers.} \]

The next section will explain the operation of specific ERISA provisions that govern pension plan funding and termination in greater detail.

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28. Id.
29. Id.
30. Relying on the common law of trusts is far from ideal for workers. It would be onerous for workers to meet the requirements of the law of trusts before making out a claim because they would be forced to depend on a substantive body of law not designed to meet the specific problems that pension disputes present. Additionally, their claims would then be subject to conflicting applications by state courts.
34. Id. §§ 1081-1086.
35. Id. §§ 1101-1114.
36. Id. §§ 1301-1461.
B. Pension Plan Funding and Termination Under ERISA

This section distinguishes the defined benefit plan from other ERISA-qualified plans, explains the funding rules that apply to the defined benefit plan, and discusses the rules governing the termination of overfunded and underfunded plans. Because ERISA protects a broad array of plans and in order to avoid confusion, it is necessary to explore the mechanics distinguishing each type of plan in order to understand why ERISA's funding and termination rules are selectively applicable to defined benefit plans. A summary of ERISA's funding and termination rules provides the foundation for understanding the treatment of pension issues in the business failure context.

ERISA generally applies to qualified plans. In order for a plan to be qualified—that is, subject to the requirements and protections of ERISA—it must be a writing38 that is communicated to employees eligible for coverage39 and it must operate for the exclusive benefit of those employees or their beneficiaries.40 It also must prohibit the assignment or alienation of benefits41 and satisfy minimal standards on vesting and accrual of benefits.42

ERISA distinguishes between the defined benefit plan and the defined contribution plan. Thus, before explaining ERISA's specific provisions, a brief summary of the taxonomy of pension plans is in order. While both the defined benefit and the defined contribution plan may meet the definition of an ERISA-qualified plan, their respective mechanics differ.

The term "defined contribution plan" encompasses stock bonus plans, profit sharing plans, money purchase plans, and 401(k) plans.43 Despite their mechanical diversity, these plans share some basic characteristics. In a defined contribution plan, an employer allots an individual account to each participating employee44 and contributes a specified amount to the account, investing the funds on the employee's behalf.45 Importantly, the employee bears the investment risk; he or she keeps whatever is left in the account upon retirement,

38. 29 U.S.C. § 1102(a)(1) ("Every employee benefit plan shall be established and maintained pursuant to a written instrument.").
42. Boren & Stein, supra note 39, § 2.16, at 51.
44. Boren & Stein, supra note 39, § 1.06, at 12-13.
for better or worse.\textsuperscript{46} Employers are not subject to ERISA's funding and insurance requirements\textsuperscript{47} because there is no underfunding risk to insure.\textsuperscript{48} An employer's funding obligation ends when it contributes periodically to the plan.\textsuperscript{49} Thus, fund assets need not reach a defined value upon distribution.\textsuperscript{50}

The IRC prosaically describes a "defined benefit plan" as "any plan which is not a defined contribution plan,"\textsuperscript{51} but, nevertheless, the central distinguishing feature of the defined benefit plan may be identified as the benefit formula. While the defined benefit plan establishes neither the exact amount that an employee receives upon retirement nor the amount an employer will contribute annually, it does set forth the formula that determines the amount of an employee's ultimate retirement benefit.\textsuperscript{52} The variables in the benefit formula are usually the number of years worked and the average monthly wage earned during an employee's final years of service.\textsuperscript{53} The benefit is distributed as a monthly or yearly payment that commences upon retirement and continues until the employee's death.\textsuperscript{54} Unlike under a defined contribution plan, an employer that creates a defined benefit plan bears the investment risk and must eventually be able to meet its promise to pay out a specific known amount to a retiring employee.\textsuperscript{55} Additionally, the employer must comply with ERISA's weighty regulatory requirements that spell out strict rules for plan funding, benefit vesting, fiduciary duties, plan termination, and pension insurance.

Just as pension plans generally fall into either the defined benefit or defined contribution category, they also must be either multi-employer or single-employer plans. These types are distinguished principally by how they are created and who governs them. The labor union is the nucleus of a multi-employer plan. Often a union will negotiate for the establishment of a pension plan for its members. In such a case, the employer's obligation to create and fund the plan will be written into a collective bargaining agreement.\textsuperscript{56} Large unions may create their own pension funds, to which employers will be required

\textsuperscript{46} Id.  
\textsuperscript{47} Daniel Keating, Chapter 11's New Ten-Ton Monster: The PBGC and Bankruptcy, 77 Minn. L. Rev. 803, 806 (1993) [hereinafter Keating, Monster].  
\textsuperscript{48} Id.  
\textsuperscript{49} See id.  
\textsuperscript{50} See id.  
\textsuperscript{52} Boren & Stein, supra note 39, § 1.07, at 13-20.  
\textsuperscript{53} Norman P. Stein, Reversions From Pension Plans: History, Policies, and Prospects, 44 Tax L. Rev. 259, 265 (1989) [hereinafter Stein, Reversions].  
\textsuperscript{54} Boren & Stein, supra note 39, § 1.07, at 13-20.  
\textsuperscript{55} See Keating, Monster, supra note 47, at 806.  
by the collective bargaining agreement to contribute.\textsuperscript{57} Section 302(c)(5) of the Taft-Hartley Act requires the union and employers to jointly administer a plan.\textsuperscript{58} In contrast, a single-employer plan is simply created by an employer for the sole benefit of its own employees. The employer is then responsible for funding and administering the plan. This Note focuses on defined benefit plans, without regard to whether they are multi-employer or single-employer plans.

Currently, the aggregate asset base for the 38,000 American defined benefit plans that cover 43 million participants\textsuperscript{59} is $2.2 trillion.\textsuperscript{60} ERISA provides several rules that aim to protect the employee retirement income generated by these plans. Rules pertaining to plan funding and termination relate directly to the central question raised in this Note.

ERISA and the IRC are the primary statutory sources for plan funding. The basic notion that the funding rules advance is that a pension plan sponsor must maintain a minimum level of funding in order to take advantage of the concomitant tax benefits. IRC § 401(f) permits employers to fund pensions through trusts, insurance contracts, or other instruments.\textsuperscript{61} A basic system of funding principles applies to all of these funding vehicles.\textsuperscript{62} Pension funding requires employers to pay now for future benefits whose exact value is uncertain. Accordingly, funding principles rely on actuarial assumptions that attempt to predict the eventual cost of pension benefits.\textsuperscript{63}

ERISA requires employers to conduct funding activity through what it calls a "funding standard account."\textsuperscript{64} The funding standard account operates on the basis of a sponsor's actuarial assumptions and is charged annually for currently-accruing liabilities, amortized liabilities for work performed before the plan's inception, and losses to the plan's asset base.\textsuperscript{65} On the other side of the ledger, the account

\textsuperscript{57} Id.
\textsuperscript{58} 29 U.S.C. § 186(c)(5) (1994); Soble et al., supra note 56, at 158.
\textsuperscript{59} Pension Benefit Guaranty Corp., 2000 Annual Report 12 (including active and retired participants).
\textsuperscript{61} See 26 U.S.C. § 401(f) (1994); Stein, Reversions, supra note 53, at 264.
\textsuperscript{62} See Stein, Reversions, supra note 53, at 264.
\textsuperscript{63} Id. The factors that plan sponsors consider in reaching their actuarial assumptions include the plan's predicted rate of return on investment, the plan's administrative expenses, employee turnover, employee mortality, terminal annuity costs, and salary scale. Id. at 268-69. Once an employer establishes its actuarial assumptions, it must make them known to the Treasury Department and cannot revise them without the Secretary of the Treasury's consent. 29 U.S.C. § 1082(c)(5)(A).
\textsuperscript{64} 29 U.S.C. § 1082(b); see Stein, Reversions, supra note 53, at 272.
\textsuperscript{65} Stein, Reversions, supra note 53, at 272.
is credited with a sponsor's annual contribution and gains to the asset base. Therefore, after making actuarial assumptions about the growth of plan assets and the cost of providing benefits, plan sponsors create a long-term schedule that sets forth the amount of each of its annual contributions to the pension trust. In theory, an employer's goal is to reach plan maturity in a timely fashion by fulfilling its funding obligations.

Despite a sponsor's best efforts, a plan may arrive at an underfunded or overfunded state. Primarily, this occurs because a plan's actuarial assumptions are incorrect, but there is no adverse penalty if an actuarial model has an off year so long as a plan meets its minimum funding standard. Plan sponsors expect that the good years will balance out the bad and that the plan will have no problem distributing benefits in the end.

Nonetheless, there are provisions built into ERISA should a plan sponsor need a temporary respite from the rigors of complying with funding rules, or if it simply wants to discontinue the plan. First, ERISA § 303(a) offers a waiver from its minimum funding rules to employers that fail to meet their minimum funding obligations because of "temporary substantial business hardship." The second option for an employer struggling with ERISA's funding rules, and the more central one to the issue raised by this Note, is plan termination.

ERISA prescribes two methods for termination—standard and distress. Standard termination is available to companies that can pay their pension liabilities and whose plans are thus not underfunded; they terminate for other reasons. ERISA allows employers to satisfy their liabilities by purchasing irrevocable insurance annuities that pay plan benefits. These annuities usually defer payment of benefits until the employee reaches retirement age under the plan.

66. Id.
67. See id. at 265-66.
68. Id. at 270.
69. 29 U.S.C. § 1083(a); Keating, Monster, supra note 47, at 810. The non-inclusive statutory factors for analyzing whether a company is experiencing a "temporary substantial business hardship" are (1) whether the company is operating at an economic loss; (2) whether there is a company- and industry-wide trend of substantial unemployment or underemployment; (3) whether the company's industry is undergoing a period of declining or depressed sales and profits; and (4) whether it is reasonable to expect that the plan will survive only if the employer receives the waiver. 29 U.S.C. § 1083(b). While the waiver frees an employer from meeting its annual funding obligations, id. § 1083(a), the deficiency must be amortized over a period of no more than five years. Id. § 1082(b)(C). An employer can obtain a maximum of three waivers every fifteen years. Id. § 1083(a).
70. 29 U.S.C. § 1341(b).
71. See infra at Part I.C. for elaboration on why employers terminate well-funded plans.
Sometimes, however, plans provide for a lump sum cash payment equal to the present value of an employee's vested benefits. A plan sponsor can recover the residual plan assets remaining after it satisfies its plan liabilities.

The second kind of plan termination is a distress termination. The key player in distress terminations is the Pension Benefit Guaranty Corporation ("PBGC"), a non-profit federal corporation modeled along the lines of the Federal Deposit Insurance Corporation. ERISA established the PBGC to insure failing pension funds by paying vested benefits to participants whose employers have terminated their underfunded plans. The PBGC receives no money from the federal government; instead, it is funded entirely from premiums paid by pension plan sponsors and income generated from the assets of terminated plans under its control.

In the case of a distress termination, the employer is generally sponsoring an underfunded plan, thus triggering the PBGC's role as insurer. This role requires PBGC to step into the employer's shoes and pay the vested benefits of plan participants. The employer must meet one of the following four tests in order to effect a voluntary distress termination: (1) the employer is in a liquidation proceeding; (2) the employer is in a reorganization proceeding in which the bankruptcy court has approved the termination and has determined that the employer "will be unable to pay its debts... and will be unable to continue in business outside the Chapter 11 reorganization process"; (3) absent termination, the employer will be unable to pay all its debts as they come due and will be unable to continue in business; or (4) the cost of maintaining a pension plan has become unreasonably burdensome solely because of a declining workforce. Additionally, the PBGC can effect an involuntary

73. See 29 C.F.R. § 4044.73(a)(1) (2001); Stein, Taxing, supra note 72, at 1132.
74. See 29 U.S.C. § 1344(d)(1); Stein, Taxing, supra note 72, at 1132. IRC § 401(a)(2) permits an "employer to recover at termination of the [plan] trust and only at termination of the trust, any balance which is due to erroneous actuarial computation." Stein, Reversions, supra note 53, at 261. However, in practice, the IRS generally does not enforce this provision to the letter because it considers every surplus to be the result of erroneous actuarial computation. See id.
75. See Daniel Keating, Pension Insurance, Bankruptcy and Moral Hazard, 1991 Wis. L. Rev. 65, 69 [hereinafter Keating, Hazard].
76. 29 U.S.C. § 1302(a); see Keating, Monster, supra note 47, at 807.
78. See infra text accompanying notes 94-102 (discussing underfunded plans).
80. See Keating, Monster, supra note 47, at 808.
82. Id. § 1341(c)(2)(B)(ii)(IV).
83. Id. § 1341(c)(2)(B)(iii)(I).
84. Id. § 1341(c)(2)(B)(iii)(II).
termination if (1) a plan has failed to meet its minimum funding obligations or will be unable to pay benefits when due, (2) the PBGC will likely suffer an unreasonable long-term loss, or (3) upon the occurrence of a statutorily-prescribed event.85

With a basic grasp of the legal principles of plan funding and termination, the next section points out how plans become underfunded or overfunded in practice and why sponsors terminate them.

C. The Mechanics and Effect of Pension Plan Overfunding and Underfunding

Every year many plan sponsors terminate their pension plans. There may be several reasons that lead a sponsor to terminate. Some plans may be overfunded, which triggers a reversion of the residual assets to the plan sponsor. Other plans may be underfunded, thereby requiring the PBGC to administer the plan and pay guaranteed benefits to the plan’s participants. This section explores the various business circumstances that lead a company to terminate its overfunded or underfunded plan.

In 2000, the PBGC reported the successful standard termination of 1,880 plans.86 The sponsors of those plans chose the standard termination method because their plans had sufficient funds to pay their benefit obligations. A sponsor is entitled to keep the plan assets that remain after paying its benefit liabilities; however, the IRC assesses a special exaction on these assets, reducing a terminating plan sponsor’s net asset recovery.87

A plan sponsor may overfund its plan because the plan’s erroneous actuarial assumptions projected a need for contributions greater than the actual accrued benefits.88 For example, if a company’s workforce is young and expanding, contributions to the plan will rise faster than benefits distributed by the plan, causing an overfunded state.89 In contrast, a plan will be underfunded if fund assets underperform the predicted rate of return on investment or employees quit at a greater

85. Id. § 1342(a); Keating, Hazard, supra note 75, at 70. The reportable event that permits the PBGC to file an involuntary termination is as follows:

[W]hen there is a distribution under the plan to a participant who is a substantial owner... if—(A) such distribution has a value of $10,000 or more; (B) such distribution is not made by reason of the death of the participant; and (C) immediately after the distribution, the plan has nonforfeitable benefits which are not funded...


87. See infra Part I.D. for more on the taxation of plan asset reversions.


89. See Veal & Mackiewicz, supra note 21, at 156-57.
rate than predicted.\(^90\) Often, a plan continues to operate and overfunded years are later balanced out by underfunded years, and vice versa.\(^91\) In the previous example, the young employees will age and many may retire at once and receive retirement benefits, tipping the scales in the opposite direction and causing a plan to be underfunded. However, a company may choose to terminate its plan before the end of its intended life cycle for many reasons, the most germane of which, for the purposes of this Note, is financial hardship.

A company in bankruptcy liquidation or reorganization proceedings may terminate its plan in order to use excess funds to satisfy the claims of creditors.\(^92\) In order to stave off the need for bankruptcy protection, a company may free up residual assets from its pension plan and use them to prevent business failure.\(^93\)

Reaching an underfunded state is usually less often the result of employer strategy than reaching an overfunded state. Most of the time, plans are underfunded simply because their sponsors cannot

\(^{90}\) See Stein, Reversions, supra note 53, at 270.

\(^{91}\) See id.


\(^{93}\) See Veal & Mackiewicz, supra note 21, at 9. Other reasons for terminating a plan may have nothing to do with financial hardship. It is important to realize, however, that it is possible for a sponsor to terminate its overfunded plan for a non-bankruptcy reason and later find cause to file Chapter 11, in which case the \$ 4980 claims would become claims in the bankruptcy proceeding. For instance, a company may terminate because it is participating in a merger. In that case, the combined entity, in its effort to integrate operations, would want a uniform benefits policy, eliminating one or both plans. See id. Another reason for termination is a change in the employer's labor policies. See id. A company may decide that its defined benefit plan is no longer meeting its objectives, move to terminate the plan, and then establish another type of plan, perhaps a defined contribution plan. See id. A more democratic basis for termination is a change in employee preference. See id. Especially when the equity markets are performing well, employees learn of the benefit of investment control that an individual retirement account offers through publicity or the rising spikes in the net worth of peers participating in stock bonus plans. As a result, employees may want their retirement returns to perform as well as the market and demand a different employee benefit vehicle that enables them to do so. See id. Another reason may be of import to lawmakers: that is, termination as a result of a company's inability to cope with legal and regulatory changes. See id. at 10. Constant changes in the tax and ERISA systems resulting from statutory revisions, agency rulings, new regulations, and judicial decisions increase the legal compliance burden. See id. Employers, especially smaller ones, frustrated by the complexity of the law, may opt out of their defined benefit plans and create simpler alternatives. See id. The statistics offer at least correlative proof: the number of defined benefit plans decreased from 114,000 in 1985 to 38,000 in 2000, while participants in defined benefit plans who are currently working declined sixteen percent between 1988 and 1998. Pension Benefit Guaranty Corp., 2000 Annual Report 12 (2001). Additionally, tax-exempt companies have a special incentive to terminate. They can terminate their plans and recoup residual assets without the Internal Revenue Service ("IRS") assessing harsh taxes on those assets. See Veal & Mackiewicz, supra note 21, at 10.
meet their minimum funding obligations. Among the most dramatic recent examples include Eastern Air Lines and Pan American World Airways, each of which terminated pension plans with over $500 million in unfunded liabilities. Furthermore, there is a bankruptcy incentive to terminate an underfunded plan while under the protection of the Bankruptcy Code. First, in bankruptcy an employer’s obligation to contribute to a plan will cease. Second, the employer can satisfy the PBGC’s claim for a fraction of its statutory liability, assuming that general unsecured creditors are paid below one hundred cents on the dollar.

Just as a default on debt generally raises doubts about a company’s ability to continue as a going concern, underfunded pension plans signal a state of financial distress. However, there are two strategic reasons for a plan sponsor to voluntarily underfund. First, one commentator has posited that plan sponsors have engaged in tax avoidance behavior in connection with the exaction assessed on residual assets reverting to an employer following termination of an overfunded plan. He suggests that increases in the exaction rate have created an incentive for many plan sponsors voluntarily to limit their ongoing plan funding to a minimal but legal level that, upon termination, would result in a shortfall of assets because previously amortized past service liabilities would become due. A second incentive is the moral hazard that employers face as a result of the existence of PBGC insurance; they have less incentive to fund their plans properly because they know the PBGC will bail them out.

95. See id. at 24-14; Edwin McDowell, U.S. Moves On Pan Am Pensions, N.Y. Times, July 25, 1991, at D1; Agis Salpukas, Eastern Pact With Agency Assures Pension Payments, N.Y. Times, Sept. 19, 1990, at D1. There is no doubt that the recent Enron bankruptcy has brought retirement income security into sharper focus. See Richard W. Stevenson & Stephen Labaton, Bush to Propose More Flexibility on 401(k) Plans, N.Y. Times, Feb. 1, 2002, at A1. However, most Enron employees were not enrolled in defined benefit plans; rather, they had 401(k) accounts heavily invested in company stock. See Jo Thomas, Labor Dept. Reviews Ban On Stock Sale, N.Y. Times, Jan. 24, 2002, at C6. Ordinarily, 401(k) account holders have more control over their portfolios and can adjust the investment risk according to their preference. However, Enron’s plans were in a “lockdown” or “blackout” period during which employees could not control their accounts. See id. Consequently, these accounts lost most of their value as the price of Enron’s stock plunged. See id. Indeed, some Enron employees were saved by the comparatively conservative defined benefit accounts they retained after their former employers were acquired by Enron. See Saul Friedman, Enron Fiasco Shows 401(k)s’ Dangers, Newsday (New York), Jan. 29, 2002, at B10.
97. PBGC claims usually are general unsecured claims. See id.
98. See id.
100. See id.; Keating, Monster, supra note 47, at 811-12.
101. See Keating, Hazard, supra note 75, at 71-76.
This particular consequence is an utter failure of taxation and pension policies, a failure that vitiates ERISA's purpose of ensuring payment of benefits.\textsuperscript{102} Easing the tax rules concerning overfunded plans would lessen these two incentives and undercut the desirability of voluntary underfunding. The next section will elaborate on the tax rules that govern plan terminations, thereby facilitating a better understanding of how tax, pension, and bankruptcy policies collide.

D. Tax Rules Governing Pension Plan Termination

Pension plan termination naturally gives rise to certain tax consequences. Thus, the IRC provides rules in the event that a plan sponsor terminates an overfunded or underfunded pension plan. Termination of overfunded pensions yields residual assets. These assets must first satisfy an employer's pension liabilities.\textsuperscript{103} The remainder reverts to the employer and is taxable as ordinary income.\textsuperscript{104} Reverted assets are treated as ordinary income primarily because they recapture tax benefits that resulted from previously deducted contributions and from the tax-free growth of those contributions over the life of the plan.\textsuperscript{105} Thus, the government taxes these assets to recover these benefits upon termination.\textsuperscript{106} Specifically, IRC § 4980\textsuperscript{107} provides an exaction of twenty percent on

\begin{itemize}
  \item \textsuperscript{102} See Ippolito, supra note 99, at 223. Congress has not yet addressed this unintended consequence. See infra at Part III.B for my conclusion that Congress should study this policy problem.
  \item \textsuperscript{103} 29 U.S.C. § 1344 (1994).
  \item \textsuperscript{104} Veal & Mackiewicz, supra note 21, at 216.
  \item \textsuperscript{105} See id.
  \item \textsuperscript{106} See id.
  \item \textsuperscript{107} Section 4980 provides, in pertinent part, the following:
    \begin{enumerate}
      \item \textbf{IMPOSITION OF TAX.} There is hereby imposed a tax of 20 percent of the amount of any employer reversion from a qualified plan.
      \item \textbf{LIABILITY FOR TAX.} The tax imposed by subsection (a) shall be paid by the employer maintaining the plan.
      \item \textbf{INCREASE IN TAX FOR FAILURE TO ESTABLISH REPLACEMENT PLAN OR INCREASE BENEFITS.}
        \begin{enumerate}
          \item \textbf{IN GENERAL.} Subsection (a) shall be applied by substituting "50 percent" for "20 percent" with respect to any employer reversion from a qualified plan unless—
            \begin{enumerate}
              \item \textbf{PARTICIPATION REQUIREMENT.} At least 95 percent of the active participants in the terminated plan who remain as employees of the employer after the termination are active participants in the replacement
            \end{enumerate}
        \end{enumerate}
    \end{enumerate}
\end{itemize}
the total value of residual assets.\textsuperscript{108} This tax rises to fifty percent if funds are not eventually diverted to a replacement plan.\textsuperscript{109} The combined ordinary income taxation and § 4980 taxation can whittle away up to eighty-three percent of a reversion.\textsuperscript{110} However, § 4980(d) limits the tax rate to twenty percent if the plan sponsor has commenced a liquidation proceeding under Chapter 7 of the Bankruptcy Code.\textsuperscript{111} Firms reorganizing under Chapter 11, however, are taxed under the normal bifurcated 20/50 scheme.

Congress enacted § 4980 in response to a trend that peaked in the early to mid-1980s in which an alarming number of sponsors strategically terminated overfunded plans in order to extract the residual assets left over after pension liabilities were paid.\textsuperscript{112} This practice functioned essentially as a tax shelter because, while ordinary income tax applied to the reversion, the sponsor would still profit from recapturing assets that grew in the plan tax-free.\textsuperscript{113} Congress was concerned that companies were bucking the intent of ERISA by creating plans, not for the sole benefit of employees, but also for their own tax advantage.\textsuperscript{114} The § 4980 exaction aimed to eliminate this practice by taxing the reversion so that a sponsor could not gain a tax benefit. Congress stated that the exaction was pegged at a fixed rate and not scaled according to the extent that plan assets grew tax-free because the latter structure would have been too complex.\textsuperscript{115}

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plan.

(6) SUBSECTION NOT TO APPLY TO EMPLOYER IN BANKRUPTCY. This subsection shall not apply to an employer who, as of the termination date of the qualified plan, is in bankruptcy liquidation under chapter 7 of title 11 of the United States Code or in similar proceedings under State law.


108. Id. § 4980(a).

109. Id. § 4980(d)(1).

110. Veal & Mackiewicz, supra note 21, at 215.


112. See Clyde H. Farnsworth, Washington Watch: Pension Plans' Surplus Assets, N.Y. Times, Aug. 12, 1985, at D2 ("[R]ecaptured funds have been used for general corporate purposes, including financing acquisitions and defending against hostile takeover bids."); Tamar Lewin, Business and the Law: Terminating Pension Plans, N.Y. Times, July 10, 1984, at D2 ("[A]lmost every company with an overfunded plan is at least considering whether to end the pension plan and take the cash. (Sometimes, the motivation is less a need for cash than a fear that such an enticing pool of money will make the company a takeover target.").

113. See Stein, Taxing, supra note 72, at 1132.


115. See Stein, Reversions, supra note 53, at 320 n.261.
On the other hand, should an employer fail to meet its funding standard, IRC § 4971 imposes a two-tier exaction. The first tier sets forth a tax of ten percent of the amount of the funding deficiency, imposed each year the deficiency exists. The second tier provides an additional tax of one hundred percent of the deficiency amount if the deficiency is not corrected by the time the first tier tax is assessed. The first tier exaction is nonwaivable, while the Secretary of the Treasury may waive the second tier exaction. It is important to note that a § 4971 exaction can be assessed whether or not a company terminates its plan, while plan termination is a sine qua non of a § 4980 exaction.

Congress enacted § 4971 to "provide[] new and more effective penalties where employers fail to meet the funding standards." Congress believed that the previous sanctions failed to incentivize a sponsor to fund its plan. By imposing a substantial exaction under §

116. I expressly avoid using the term "underfunded" because a plan can be legally funded yet be underfunded because it is unable to meet its liabilities if it were terminated.

117. 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 an 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.

   (d) NOTIFICATION OF THE SECRETARY OF LABOR. Before issuing a notice of deficiency with respect to the tax imposed by subsection (a) or (b), the Secretary shall notify the Secretary of Labor and provide him a reasonable opportunity (but not more than 60 days) --
   (1) to require the employer responsible for contributing to or under the plan to eliminate the accumulated funding deficiency, or
   (2) to comment on the imposition of such tax. In the case of a multiemployer plan which is in reorganization under section 418, the same notice and opportunity shall be provided to the Pension Benefit Guaranty Corporation.
   (e) LIABILITY FOR TAX.
   (1) In general. Except as provided in paragraph (2), the tax imposed by subsection (a), (b), or (f) shall be paid by the employer responsible for contributing to or under the plan the amount described in section 412(b)(3)(A).


118. Id. § 4971(a); Boren & Stein, supra note 39, § 9.10, at 40-40.4.


120. Boren & Stein, supra note 39, § 9.10, at 40-40.4.


II. HOW THE BANKRUPTCY PRIORITY SCHEME ORDERS § 4980 AND § 4971 CLAIMS

Part I demonstrated the tax and pension regulatory requirements pension plan sponsors must satisfy. This part delves into another layer of statutory regulation: the Bankruptcy Code. Should a plan sponsor file for bankruptcy protection, the Bankruptcy Code would guide the operation of the sponsor and the administration of its creditors' claims. The first section describes the payment of claims in bankruptcy, focusing on certain unsecured tax claims for which the Bankruptcy Code accords priority of payment over other unsecured claims. The second section delves into a case law debate over how to determine which tax claims should be considered "excise taxes" and thus accorded priority treatment.

A. Claim Payment in Bankruptcy and the Priority Scheme

When an entity, be it an individual or a corporation, files for bankruptcy protection, the federal bankruptcy regime corrals the creditors of that entity into its grasp, effectively enjoining any one of them from independently pursuing a remedy under state law.124 A creditor's right to state law collection remedies is among the many rights the Bankruptcy Code instantaneously alters overnight. Another notable transformation is the lexical shift the Bankruptcy Code forces upon debtors125 and creditors126 that had been enforcing their rights under state law. The Bankruptcy Code defines a "claim" broadly as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."127 In a liquidation proceeding, claims are generally paid from the proceeds realized from a sale of the debtor's unencumbered

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125. Truly, if bankruptcy is a world unto itself, it has taken that dictum to heart and created its own language as well. The Bankruptcy Code defines a "debtor" as a "person or municipality concerning which a case under... title [11] has been commenced." 11 U.S.C. § 101(13) (2000). "Person" is defined broadly to include an "individual, partnership, and corporation." Id. § 101(41).
126. "Creditor" means an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A).
127. Id. § 101(5)(A).
assets, while in a Chapter 11 reorganization the debtor repays its creditors through a court-approved plan.

As a first principle, the Bankruptcy Code segregates creditors into three rough but distinct categories: secured, priority unsecured, and general unsecured. Secured creditors are parties whose claims are subject to a valid security interest or mortgage. Unsecured priority creditors have claims that are subject neither to a security interest nor a mortgage, but belong to one of nine claim classes designated in Bankruptcy Code § 507. This section entitles creditors to be paid ahead of other unsecured creditors; however, courts narrowly construe eligibility for priority treatment. General unsecured creditors hold claims that are not secured by any property and that are not eligible for priority treatment.

The Bankruptcy Code entitles a secured creditor a secured claim up to the value of the collateral underlying its security interest or mortgage. The secured creditor holds an unsecured claim to the extent that a deficiency remains on the claim after accounting for the collateral's value. The Bankruptcy Code provides for the payment of unsecured priority claims out of the unencumbered property of the estate. Priority claims are subdivided into a hierarchy of nine distinct subclasses. Each claim belonging to a given subclass is paid in full before the next subclass can be paid at all. If the assets in the debtor's estate are insufficient to pay all the claims in a given subclass, then the claims in that subclass split the remaining assets on a pro rata basis. Whatever assets remain after the satisfaction of priority claims are distributed to general unsecured creditors. This system is necessary because bankruptcy estates usually do not have enough funds to fully satisfy all of their creditors' claims.

If the debtor has filed under Chapter 7 or is liquidating under Chapter 11, it pays creditors through the sale of all its assets. Liquidating corporations generally cease to exist after liquidation. In a reorganization under Chapter 11, however, a debtor intends to

128. See id. § 541.
129. See id. § 1129.
132. See id. § 507; 2 Norton, supra note 130, § 42.1.
133. See 3 Collier on Bankruptcy ¶ 507.01 (Lawrence P. King ed., 15th ed. 1998) [hereinafter Collier].
135. Id.
136. 2 Norton, supra note 130, § 42.1.
138. Id. § 726(b); 2 Norton, supra note 130, § 42.1.
139. 2 Norton, supra note 130, § 42.1.
140. Id.
141. Id.
continue operating after bankruptcy. The priority scheme governs both Chapter 7 and Chapter 11 cases, whether or not the debtor sells its assets to pay its creditors' claims.

This Note focuses on two specific, related types of unsecured claims that fall into different creditor classes: the priority system's treatment of tax claims based on § 4980 exactions on pension plan reversions and § 4971 exactions on incidences of pension plan underfunding. The next section will explain the labels that courts have attached to these claims and the reasoning behind the relevant judicial determinations.

B. The Excise Tax-Penalty Debate

The priority scheme treats excise taxes and tax penalty claims differently.142 Excise taxes that a debtor owes to the government are entitled to eighth priority distribution under § 507 of the Bankruptcy Code.143 The legislative history of § 507 cites sales tax, estate and gift taxes, gasoline and special fuel taxes, and wagering and truck taxes as examples of excise taxes covered by this category.144 As a debtor emerges from Chapter 11 protection, it must pay the present value of these claims in full within six years after they were assessed pursuant to its plan of reorganization;145 by similar logic, these claims are non-dischargeable in a liquidation proceeding.146 The reason cited by Congress for according priority to tax claims is that taxing authorities are involuntary creditors and they cannot secure their claims before a tax is due.147

In contrast, tax penalties that do not compensate for the government's actual pecuniary loss are subordinated to general unsecured claims.148 Section 726 sets out the following order of distribution for the payment of unsecured claims out of the debtor's unencumbered assets: (1) priority claims; (2) timely-filed general

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142. This disparate treatment is a result of the broad array of tax claims that are processed through the bankruptcy system. Accordingly, it is important to understand that "excise tax" and "penalty" are merely two of many categories into which a tax obligation may fall.


144. 124 Cong. Rec. S34,016 (daily ed. Oct. 5, 1978) (remarks of Sen. DeConcini) ("All Federal, State or local taxes generally considered or expressly treated as excises are covered by this category, including sales tax, estate and gift taxes, gasoline and special fuel taxes, and wagering and truck taxes.").


146. Id. § 523(a)(1)(A).

147. H.R. Rep. No. 95-595, at 190 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6150-51; see also 3 Collier, supra note 133, § 507.10[1][b]. However, this rationale is wanting because not all involuntary creditors are accorded priority treatment. For example, tort creditors are involuntary creditors whose claims are of the general unsecured variety.

unsecured claims; (3) tardily-filed general unsecured claims; (4) fines, penalties, and non-compensatory damages; (5) post-petition interest; and (6) any remaining surplus.\textsuperscript{149} The policy underlying the subordination of non-compensatory penalties to general unsecured claims is to protect unsecured creditors from paying for the debtor's wrongdoing.\textsuperscript{150} Section 726(a)(4) treats fines and penalties that the debtor owes to a governmental unit the same as those owed to private parties.\textsuperscript{151} If a claim is not clearly non-compensatory on its face and the claimant argues that it is compensatory, a court will intervene to analyze the operation of the fine or penalty.\textsuperscript{152} Because the resolution of such issues can dramatically alter the fortunes of competing creditors, they are often resolved through litigation. For example, on the question of whether a penalty for oil overcharges payable to the Department of Energy was compensatory, the Federal Circuit disagreed with the Tenth Circuit's theory of indirect restitution, holding that a claim is non-compensatory when a company pays funds not to actual victims but to the government in their stead.\textsuperscript{153}

Courts are responsible for construing whether a claim should be classified as an excise tax or penalty. Once a court holds a given claim to be a penalty, it will determine whether the penalty is compensatory or not; if it is a tax, then the court would classify it as a priority claim. Often, it is not evident from the statutory source of a given exaction whether it is intended as an excise tax or as a penalty. Indeed, these terms are merely labels created by the Bankruptcy Code. The statutes themselves offer scant insight; the IRC is not always explicit about whether a given exaction is an excise tax or penalty, nor does the Bankruptcy Code define these terms.\textsuperscript{154} However, because the disputed assessment may claim millions of dollars, a court's decision regarding whether it is an excise tax or a penalty may determine whether, and to what extent, general unsecured creditors are paid.

In re Mansfield Tire & Rubber Co.\textsuperscript{155} and In re Cassidy\textsuperscript{156} are two cases that represent the competing interpretive rubrics courts have created in response to the excise tax-penalty question, which the Supreme Court ultimately resolved in United States v. Reorganized CF&I Fabricators of Utah, Inc.\textsuperscript{157} The Sixth Circuit in Mansfield

\textsuperscript{149} Id. § 726.
\textsuperscript{151} See 6 Collier, supra note 133, § 726.02[4].
\textsuperscript{152} See id.
\textsuperscript{153} Compare Tex.-Am. Oil Corp. v. Dep't of Energy, 44 F.3d 1557, 1565-71 (Fed. Cir. 1995), with In re Seneca Oil Co., 906 F.2d 1445, 1455-56 (10th Cir. 1990).
\textsuperscript{155} 942 F.2d 1055 (6th Cir. 1991).
\textsuperscript{156} 983 F.2d 161 (10th Cir. 1992).
\textsuperscript{157} 518 U.S. 213 (1996).
employed a plain language analysis and held that a § 4971 claim for an underfunding assessment was an excise tax,\textsuperscript{158} while the Tenth Circuit in Cassidy, utilizing an extratextual approach, held that a claim for an assessment on an early retirement account withdrawal arising under IRC § 72(t) was a penalty.\textsuperscript{159} The following subsections probe deeper into these varying methodologies.\textsuperscript{160}

1. The Extratextual Approach

The lower courts in Mansfield and the Tenth Circuit in Cassidy spearheaded the ascendance of the extratextual approach for resolving excise tax-penalty questions. While some of the courts employing the extratextual approach discussed general bankruptcy policy, none thoroughly commented or relied upon the interplay of the various federal policies in reaching their conclusions. The bankruptcy court in Mansfield inquired into the purpose of § 4971, stating that the exaction’s label was not dispositive.\textsuperscript{161} The court reiterated a four-part test that the federal courts created in response to City of New York v. Feiring.\textsuperscript{162} The test defines a “tax” as follows:

(1) [a] voluntary pecuniary burden, regardless of name, laid upon individuals or property; (2) [i]mposed by, or under authority of the legislature; (3) [f]or public purposes, including the purposes of defraying expenses of government or undertakings authorized by it; and (4) [u]nder the police or taxing power of the governmental unit.\textsuperscript{163}

The court found that the underfunding assessment provision met all but the third prong, which it determined by inquiring into the purpose of § 4971.\textsuperscript{164} After a review of the legislative history of § 4971, the court held that Congress, through the enactment of the underfunding assessment provision, aimed to punish employers that abused ERISA’s minimum funding standards.\textsuperscript{165} The court also pointed to the non-compensatory mechanics of the underfunding assessment

\textsuperscript{158} See infra text accompanying notes 197-207.

\textsuperscript{159} See infra text accompanying notes 174-182.

\textsuperscript{160} It is important to note that litigation in the line of cases leading up to the Fabricators decision encompasses many types of exactions, not only those related to pension plans.


\textsuperscript{162} 313 U.S. 283 (1941). The Feiring Court defined the exactions to which priority treatment extended as “those pecuniary burdens laid upon individuals or their property, regardless of their consent, for the purpose of defraying the expenses of government or of undertakings authorized by it.” Id. at 285.

\textsuperscript{163} Mansfield, 80 B.R. at 398 (citing In re Lorber Indus. of Cal., Inc., 675 F.2d 1062, 1066 (9th Cir. 1982); In re Skjonsby Truck Line, Inc., 39 B.R. 971 (Bankr. D.N.D. 1984); In re Farmers Frozen Food Co., 221 F. Supp. 385 (N.D. Calif. 1963)).

\textsuperscript{164} Id. at 399-400.

\textsuperscript{165} Id. at 400.
provision for support; the provision assessed an exaction regardless of whether a company corrected its funding deficiency or whether the PBGC assumed control and disbursed payments under the plan.\textsuperscript{166}

The Mansfield district court agreed with the bankruptcy court and added to the analysis.\textsuperscript{167} To support its conclusion that the underfunding assessment provision was a penalty, the court reasoned that the words “penalties,” “penalize,” and “sanctions” in the legislative history of the underfunding assessment provision demonstrated its punitive intent.\textsuperscript{168} The district court also rejected the inference that § 4971 must be an excise tax because prior courts had to assume as much before reaching the question of whether post-petition underfunding claims could be entitled to first priority as administrative expense claims.\textsuperscript{169} The court held that non-pecuniary loss penalties could not be afforded administrative status.\textsuperscript{170} The court stated that the policy embodied in Bankruptcy Code § 726(a)(4), which subordinates non-pecuniary loss penalties to general unsecured claims, is intended to deny priority to all non-pecuniary loss penalties, regardless of whether claimants attempt to color them as administrative expenses or excise taxes.\textsuperscript{171} While the court did refer to how the policy of protecting innocent creditors from a debtor’s punitive debts supports the subordination of penalties to unsecured claims,\textsuperscript{172} it did not analyze the specific tax or pension policies behind § 4971.

The Tenth Circuit in \textit{Cassidy} employed the extratextual approach to IRC § 72(t),\textsuperscript{173} holding that the provision is a penalty.\textsuperscript{174} IRC § 72(t) imposes an exaction, or, in IRC parlance, an “additional tax,” of ten percent on the amount of an early withdrawal from a pension plan

\begin{itemize}
\item \textsuperscript{166} See id.
\item \textsuperscript{167} See \textit{In re Mansfield Tire & Rubber Co.}, 120 B.R. 862, 865 (N.D. Ohio 1990).
\item \textsuperscript{169} \textit{Id.} at 865-66 (citing \textit{In re A.C. Williams}, 81 B.R. 437 (Bankr. N.D. Ohio 1986); \textit{In re Overly-Hautz}, 57 B.R. 932 (Bankr. N.D. Ohio 1986), \textit{aff’d} 81 B.R. 434 (N.D. Ohio 1987)).
\item \textsuperscript{170} \textit{Id.} at 866.
\item \textsuperscript{171} \textit{Id.} at 866-67.
\item \textsuperscript{172} \textit{Id.} at 864.
\item \textsuperscript{173} Section 72(t) provides, in pertinent part:
\begin{quote}
(1)10-percent additional tax on early distributions from qualified retirement plans.
\end{quote}
\begin{quote}
(1)Imposition of additional tax. If any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c)), the taxpayer’s tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.
\end{quote}
\item \textsuperscript{174} See United States v. Dumler (\textit{In re Cassidy}), 983 F.2d 161, 164 (10th Cir. 1992).
\end{itemize}
The Tenth Circuit rejected the argument that the extratextual approach applied only to state, not federal, obligations, citing United States v. New York and United States v. Sotelo, two pre-Bankruptcy Code cases in which the Supreme Court looked beyond the statutory text to decide whether particular federal obligations were entitled to priority.

With this precedential support, the Cassidy court then applied the Feiring four-prong test. In order to determine the third prong—namely, whether the obligation was imposed for a public purpose, such as the purpose of defraying the cost of government—the court analyzed the purpose of the early withdrawal assessment provision. The court concluded that Congress enacted § 72(t) to advance a multitude of purposes, rendering the Feiring test inconclusive on the issue. The court then turned to bankruptcy policy to resolve the tax-penalty question. The court cited the policy of protecting innocent creditors from paying for the debtor's bad conduct, a policy articulated by the Supreme Court in Simonson v. Granquist. Applying this principle without referring to the applicable tax and pension policies behind § 72(t), the court concluded that the bankruptcy context nullified the deterrent purpose of the early withdrawal assessment provision because the cost of noncompliance would be borne by the innocent creditors, rather than the culpable debtor. Consequently, the court held that § 72(t) was a non-pecuniary penalty and thus not entitled to priority.

Another pertinent case applying the extratextual approach is In re C-T of Virginia, Inc. The Fourth Circuit was faced with the question of whether an overfunding exaction assessed pursuant to IRC § 4980 was an excise tax or penalty. After it declared that the legislative history of § 4980 shed no light on whether the exaction was an excise tax or penalty, the Fourth Circuit adopted the reasoning of

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175. 26 U.S.C. § 72(t).
176. 315 U.S. 510 (1942).
178. Cassidy, 983 F.2d at 163; see also Sotelo, 436 U.S. at 275; New York, 315 U.S. at 515.
179. Cassidy, 983 F.2d at 163-64.
180. Specifically, the purposes cited by the court were "to prevent retirement plans from being treated as savings accounts, to recapture a measure of tax benefits that have been provided prior to the withdrawal, and to deter the use of retirement funds for nonretirement purposes." Id. at 164.
181. 369 U.S. 38 (1962). The Simonson Court stated that "[e]nforcement of penalties against the estates of bankrupts ... would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors." Id. at 41.
182. See Cassidy, 983 F.2d at 164.
183. Id. at 165.
185. C-T, 977 F.2d at 140.
the district court.\textsuperscript{186} The C-T district court disavowed reliance on the conclusion of the lower courts in\textit{Mansfield}, while nonetheless expressly rejecting the Sixth Circuit’s plain language methodology in\textit{Mansfield}.\textsuperscript{187} The district court instead relied on\textit{New Neighborhoods, Inc. v. West Virginia Workers’ Compensation Fund},\textsuperscript{188} a Fourth Circuit precedent that provided an interpretive gloss on the Feiring test.\textsuperscript{189} The\textit{New Neighborhoods} court defined an excise tax as “an indirect tax, one not directly imposed upon persons or property, and one that is ‘imposed on the performance of an act, the engaging in any occupation, or the enjoyment or [sic] a privilege.’”\textsuperscript{190} The district court’s conclusion did not consider bankruptcy, tax, or pension policies.\textsuperscript{191} Instead, the court held that the underfunding assessment provision demonstrated “substantially more of the attributes of an excise tax than of a penalty,”\textsuperscript{192} finding, without substantive comparison, that § 4971 was indistinguishable from other exactions listed in IRC Subtitles D\textsuperscript{193} and E,\textsuperscript{194} including the gas guzzler tax\textsuperscript{195} and the tax on ozone-depleting chemicals.\textsuperscript{196} This rationale is dubious because it sidesteps the extratextual analysis it claims to employ, cites Feiring but does not faithfully apply it, and rejects Mansfield while nonetheless relying upon the labels and the proximate location of other exactions in the IRC subtitles with the words “excise taxes” in their headings.

2. The Plain Language Approach

The Sixth Circuit in\textit{Mansfield} rejected the lower courts’ reliance on legislative history and extratextually-driven analysis.\textsuperscript{197} Instead, the

\begin{itemize}
  \item \textsuperscript{186} It seems troubling that the Fourth Circuit and the district court did not address IRC § 7806(b)’s exhortation that “[n]o inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion of this title.” 26 U.S.C. § 7806(b) (1994).
  \item \textsuperscript{187} See C-T, 135 B.R. at 503.
  \item \textsuperscript{188} 886 F.2d 714 (4th Cir. 1989).
  \item \textsuperscript{189} C-T, 135 B.R. at 503.
  \item \textsuperscript{190} New Neighborhoods, 886 F.2d at 719 (alteration in original) (citations omitted).
  \item \textsuperscript{191} At a critical juncture in the Fourth Circuit’s opinion, the court stated, “The legislative history apparently gives little or no clue as to the answer to [whether § 4980 is an excise tax or penalty]. Nor do the underlying background facts point conclusively in one direction or the other.” United States v. Unsecured Creditors’ Comm. (In re C-T of Va., Inc.), 977 F.2d 137, 140 (4th Cir. 1992). This was a prime opportunity for the court to delve into the various policies behind the provision and the context in which it was being applied.
  \item \textsuperscript{192} C-T, 135 B.R. at 503.
  \item \textsuperscript{193} This subtitle is entitled “Miscellaneous Excise Taxes.”
  \item \textsuperscript{194} This subtitle is entitled “Alcohol, Tobacco and Certain Other Excise Taxes.”
  \item \textsuperscript{195} 26 U.S.C. § 4064 (1994).
  \item \textsuperscript{196} \textit{Id.} § 4681.
  \item \textsuperscript{197} See In re Mansfield Tire & Rubber Co., 942 F.2d 1055, 1060-61 (6th Cir. 1991).
\end{itemize}
Sixth Circuit relied on the plain language principle of statutory construction that the Supreme Court established in United States v. Ron Pair Enterprises, Inc., the (in)famous "comma case." The Ron Pair decision set forth the proposition that where the language of a provision was plain, "the sole function of the courts is to enforce it according to its terms." The court of appeals believed that, because Congress did not define "excise tax" in the Bankruptcy Code, courts were not meant to provide a special definition for the term in bankruptcy. As a second support for its decision, the court stated that Congress extended priority treatment to all obligations that the federal government labels as "excise taxes," even those that are meant to regulate undesirable conduct. According to the court's logic, because § 4971 was listed under an IRC heading bearing the title "Miscellaneous Excise Taxes," the provision was plainly an excise tax for all federal purposes, including bankruptcy, and should be accorded priority treatment under then-Bankruptcy Code § 507(7)(E).

Specifically, the court stated: "[W]e will not independently decide whether Congress meant 'excise tax' when it said 'excise tax.'" The Sixth Circuit rejected the argument that § 4971 is based on the bankruptcy policy of preventing innocent creditors from paying for the misdeeds of the debtor, stating that "we needn't concern ourselves with that policy decision. Congress has already made that choice." Nor did the court delve into the tax and pension policies behind § 4971. Furthermore, the court ruled that application of the Feiring test was limited to non-federal taxes because it was designed to

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200. Ron Pair, 489 U.S. at 241 (citing Caminetti v. United States, 242 U.S. 470, 485 (1917)).
201. Mansfield, 942 F.2d at 1058.
202. Id.
203. The numeration of the section governing the priority treatment of excise taxes has changed twice since its enactment. At the inception of the Bankruptcy Code in 1978, the excise tax priority section was located at § 507(6)(E); the 1984 Amendments displaced it to § 507(7)(E). Since the enactment of the 1994 Amendments it has been located at § 507(8)(E).
204. Mansfield, 942 F.2d at 1059.
205. Id.
206. The court repeatedly referred to § 4971 as a "tax" without discussing what tax policy interest would be advanced by its holding. See id. at 1058 n.3, 1059. Citing the absence of the words "excise tax" and "tax" in the Bankruptcy Code, the court also rejected the proposition that the bankruptcy context requires an analysis that, at the very least, acknowledges the confluence of various interests in that context. Id. at 1058 ("[W]e are not persuaded that Congress intended to give a special bankruptcy-context meaning to those words.").
prevent state and local authorities from promoting their claims in bankruptcy simply by labeling them "taxes."\textsuperscript{207}

3. The Fabricators Functional Test

The approach espoused by the Sixth Circuit in \textit{Mansfield} brought the circuits into conflict on the issue of how to resolve excise tax-penalty questions. To review, the Sixth Circuit in \textit{Mansfield} applied a restrictive plain language principle to read \S 4971 as an excise tax; the Tenth Circuit in \textit{Cassidy} applied an extratextual analysis, examining the purpose of the underlying tax provision and finding it a penalty pursuant to the \textit{Feiring} test; and the Fourth Circuit in \textit{C-T} held \S 4980 to be an excise tax despite its dubious methodology. No court of appeals has comprehensively analyzed the different policy interests at stake and, as this Note shall illustrate, the Supreme Court would soon join in this deficiency.

The Supreme Court ended the conflict by clarifying the appropriate test in \textit{United States v. Reorganized CF&I Fabricators of Utah, Inc.}\textsuperscript{208} The Court, in deciding whether an underfunding assessment levied pursuant to IRC \S 4971 was an excise tax or penalty, expressly repudiated \textit{Mansfield}'s plain language approach to excise tax-penalty determinations. Instead, the Court announced that the proper test requires courts to undertake a "functional examination" of the contested statute, which involves analyzing its mechanics and legislative history.\textsuperscript{209}

The Supreme Court began its analysis by dismissing the proposition first enunciated in \textit{Mansfield} that courts should restrict their statutory analysis to the plain language of a federal tax provision when interpreting whether a particular exaction was a "tax" for bankruptcy purposes.\textsuperscript{210} The Court, citing \textit{Feiring} and its progeny for support, pointed out that, historically, when the Court considered such questions in the context of \S 64(a) of the Bankruptcy Act it "rested its answer directly on the operation of the provision."\textsuperscript{211} It noted that it had done so in \textit{New York} and \textit{Sotelo} and, absent any congressional directive in the Bankruptcy Reform Act of 1978 to change course, there was no reason to deviate from this interpretive method.\textsuperscript{212}

The Court began its functional examination of the underfunding assessment provision by distinguishing a tax from a penalty, quoting

\begin{itemize}
\item \textsuperscript{207} \textit{Id.} at 1060.
\item \textsuperscript{208} 518 U.S. 213 (1996).
\item \textsuperscript{209} \textit{See id.} at 224.
\item \textsuperscript{210} \textit{See id.} at 222-24.
\item \textsuperscript{211} \textit{Id.} at 220. Justice Thomas, the lone dissenter, claimed that the Court should not make such an inquiry into federal taxes. \textit{See id.} at 230 (Thomas, J., concurring in part, dissenting in part).
\end{itemize}
United States v. LaFranca: "A tax is an enforced contribution to provide for the support of government; a penalty . . . is an exaction imposed by statute as punishment for an unlawful act."213 The Court then stated that the two-tiered structure of § 4971, whereby the IRS assesses a one hundred percent exaction on top of the obligatory ten percent when a plan sponsor fails to correct a funding deficiency, evinced the "obviously penal character" of the provision.214 Quoting the punitive language in the underfunding provision's legislative history, the Court concluded that § 4971 was a penalty for the purposes of the bankruptcy priority provisions.215 Specifically, the legislative history of § 4971 stated:

[ERISA] provides new and more effective penalties where employers fail to meet the funding standards. . . . [The prior procedure has] proved to be defective since it does not directly penalize those responsible for the underfunding. For this reason, the bill places the obligation for funding and the penalty for underfunding on the person on whom it belongs—namely, the employer.216

The Court then noted the underfunding provision's "patently punitive function" and held that it was a penalty.217 However, the Court failed to discuss the bankruptcy, pension, and tax policies that affect the operation of § 4971 in the bankruptcy context.218

4. Post-Fabricators Case Law

The Eighth Circuit in In re Juvenile Shoe Corp.219 was one of the first courts of appeals to apply the Supreme Court's functional test set out in Fabricators. After applying the Fabricators test to exactions levied pursuant to IRC § 4980, the overfunding assessment provision, the court held that the claims were excise taxes entitled to priority.220 The Juvenile Shoe court examined the language of § 4980221 as a first

217. Id.
218. Indeed, the Court, by relying on legislative history alone, appears to be considering § 4971 in a vacuum and strictly on the basis of its hypothetical operation, not its actual operation during bankruptcy. Perhaps a comparative analysis of the strength of various policy interests both in and out of bankruptcy would have shed more light on how courts should treat § 4971.
219. 99 F.3d 898 (8th Cir. 1996).
220. See id. at 902.
221. At the time, § 4980 provided, in pertinent part:
   (a) Imposition of tax. There is hereby imposed a tax of 15 percent of the amount of any employer reversion from a qualified plan.
   (b) Liability for tax. The tax imposed by subsection (a) shall be paid by the employer maintaining the plan.
step in its analysis.\textsuperscript{222} In the court’s view, the language of the statute proved inconclusive.\textsuperscript{223} The court, therefore, considered the operation and legislative history of the overfunding assessment provision.\textsuperscript{224} Although the court found the legislative history inconclusive, it determined that Congress intended to assess an excise tax through § 4980.\textsuperscript{225} In reaching its conclusion, the Eighth Circuit contrasted the overfunding assessment provision with § 4971, the underfunding provision.\textsuperscript{226} The court pointed out that, while the underfunding provision deters conduct that is illegal under ERISA, Congress regulates permissible conduct—namely, employer reversions—under § 4980.\textsuperscript{227} Furthermore, the court was persuaded by the contrast between the punitive character of § 4971’s second-tier one hundred percent exaction rate and § 4980’s then-fifteen percent flat rate, characterizing the flat rate as a simplified means of recovering lost tax revenues.\textsuperscript{228} The court compared § 4980 with other excise taxes affecting consumptive behavior and noted that, though the overfunding provision had a regulatory function, such a function did not automatically render § 4980 a penalty.\textsuperscript{229} While the court thoroughly discussed the purpose and operation of § 4980, it did not compare the various policy interests at stake, nor did it specify reasons for favoring tax policy in the bankruptcy context.\textsuperscript{230}

Other post-\textit{Fabricators} cases have applied the functional test to exactions arising under federal law, demonstrating the entrenchment of this test in multiple contexts. The tax-penalty question arose in \textit{In re Mounier}\textsuperscript{231} as a preliminary issue regarding whether an exaction under IRC § 72(t), the early withdrawal assessment provision at issue in \textit{Cassidy}, was dischargeable under Bankruptcy Code § 523.\textsuperscript{232} The bankruptcy court in \textit{Mounier} determined whether the early withdrawal assessment provision was a tax or penalty before analyzing whether it was dischargeable.\textsuperscript{233} The \textit{Mounier} court, employing the \textit{Fabricators} test, relied heavily on the Tenth Circuit’s characterization

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\textsuperscript{222} 26 U.S.C. § 4980 (1986).
\textsuperscript{223} See \textit{Juvenile Shoe}, 99 F.3d at 901.
\textsuperscript{224} Id.
\textsuperscript{225} Id.
\textsuperscript{226} Id. at 902.
\textsuperscript{227} Id. at 902-03.
\textsuperscript{228} Id. at 903.
\textsuperscript{229} Id. at 902.
\textsuperscript{230} Id.
\textsuperscript{231} 232 B.R. 186 (Bankr. S.D. Cal. 1998).
\textsuperscript{232} Id. at 190; see also 11 U.S.C. § 523 (1994).
\textsuperscript{233} \textit{Mounier}, 232 B.R. at 190.
The court clarified that taxpayers must first pay ordinary income tax on early withdrawals from qualified retirement accounts pursuant to which the § 72(t) exaction represents an additional obligation. Alluding to the purpose of the early withdrawal provision, the court stated that § 72(t) was designed to prevent the treatment of retirement accounts as savings accounts and "to deter the use of retirement funds for non-retirement purposes." Thus, following Cassidy, the court held that the early withdrawal provision was not intended to support the government and, therefore, was a penalty, not a tax. Interestingly, while the court mentioned that § 72(t) was not meant to raise revenue for the government and that granting the exaction priority treatment would disadvantage innocent creditors by diminishing the bankruptcy estate, these issues were not essential to its conclusion.

The Tenth Circuit in In re Sunnyside Coal Co. applied the Fabricators test to premiums assessed under the Coal Industry Retiree Health Benefit Act of 1992 ("Coal Act"). Under the Coal Act, the debtor was one of many companies required to pay premiums to fund special pension and health benefit plans for retired coal workers. The Tenth Circuit followed the analysis and holding of the Second Circuit in LTV Steel Corp. v. Shalala (In re Chateaugay Corp.), which found that the coal premium provision was a tax because it created involuntary burdens intended for a public purpose. While the Tenth Circuit did not overtly mention tax or bankruptcy policy, it did refer to the Coal Act's policy of protecting the retirement of coal miners, especially those employed by companies no longer in business. The court emphasized the "undeniably involuntary nature of these assessments as crafted by the Coal Act to directly remediate continuing crises in the nation's production of coal" and held the premium to be a tax.

III. PROPOSING A LEGISLATIVE SOLUTION: AMEND § 4980

This part explores solutions to the current treatment of IRC § 4980 in the bankruptcy context. The first section examines the effect of the
present state of the law on the various policies implicated when claims under §§ 4971 and 4980 become enmeshed in the bankruptcy priority scheme. The second section explores the feasibility of a judicial solution, while the final section proposes four legislative solutions, favoring the narrowest course of action—namely, amending IRC § 4980.

A. Unraveling the Policy Choices

Bankruptcy, pension, and tax policies collide when claims arising from the underfunding and overfunding assessment provisions are filtered through the bankruptcy priority scheme. The relevant bankruptcy policies are maximizing asset distribution to general unsecured creditors and preventing innocent creditors from paying for the debtor's malfeasance. A key tax policy specifically behind § 4980 is to compensate the government upon termination of a pension plan for the accrual of tax benefits during the life of the plan. Section 4971 demonstrates the pension policy of deterring non-compliance with the minimum funding requirements that secure retirement income.

The Supreme Court did well in Fabricators to permit bankruptcy courts to inquire beyond the plain language of tax provisions under which claims arise. However, the Supreme Court's approach was narrow in vision. The Court made no reference to the competing bankruptcy, tax, and pension policies that were implicit in the issue it faced. When two or more federal statutes conflict, the question about how to reconcile their competing policies will be difficult. The Court in Fabricators had the opportunity to address a policy conflict between federal tax, pension, and bankruptcy law, but instead viewed the issue as purely a problem of statutory construction.246

The effect of Fabricators is that lower courts facing a tax-penalty dispute apply a test that analyzes the nature of a statute’s operation.247 In some cases, this analysis may not lead to a clear-cut answer. Juvenile Shoe exemplified this problem, expressly stating that neither the operation nor the legislative history of § 4980 was conclusive on whether the provision imposed an excise tax or not.248 The Juvenile Shoe court nonetheless believed that on balance the overfunding

246. The Fabricators opinion is not the first instance where the Court has taken a narrow approach to solving bankruptcy problems; in fact, it seems to reflect a regular pattern. One commentator, after reviewing every Supreme Court bankruptcy decision, concluded that the Court consistently overlooked substantive bankruptcy policy and decided bankruptcy disputes solely on interpretive grounds. See Karen M. Gebbia-Pinetti, Interpreting the Bankruptcy Code: An Empirical Study of the Supreme Court's Bankruptcy Decisions, 3 Chap. L. Rev. 173, 268-82 (2000). The Court's course of action has effectively impeded the development of substantive bankruptcy policy. See id. at 278-82; see also Carlos J. Cuevas, The Rehnquist Court, Strict Statutory Construction and the Bankruptcy Code, 42 Clev. St. L. Rev. 435, 477-82 (1994).

247. See supra text accompanying notes 208-218.

248. See supra text accompanying notes 219-229.
assessment provision resembled an excise tax (or, rather, did not resemble a penalty). Considering that the court admitted its inconclusiveness on the issue and yet awarded priority treatment to the § 4980 claims, it is difficult to conclude that the court followed the bankruptcy principle of construing priority status narrowly. Indeed, overreliance on an interpretive rubric may cause courts, like Juvenile Shoe, to lose sight of important policies that undergird the bankruptcy system.

The end result in Juvenile Shoe was that the IRS’s claim for overfunding assessments diminished the distribution to general unsecured creditors. In its analysis, the Juvenile Shoe court compared the overfunding assessment provision to § 4971, the underfunding provision, noting that § 4971’s two-tiered structure demonstrated its punitive character. If the structural distinction of the two provisions was the key factor in the court’s decision, then it would reach the opposite conclusion if the case were decided today because Congress has since amended § 4980. That section now has a two-tiered structure as well—it taxes twenty percent of the original reversion, which rises to fifty percent should the sponsor fail to divert the funds into a replacement plan. The previous version exacted a fifteen percent assessment uniformly on residual assets. In the legislative history of the Omnibus Budget Reconciliation Act of 1990 ("OBRA"), Congress stated that the fifteen percent rate failed to recapture tax benefits accruing to the plan sponsor through tax deductions on funds dedicated to the plan. Congress explained that the addition of the fifty percent rate “provide[s] an incentive for an employer terminating a defined benefit plan to maintain a qualified retirement plan following the termination or to provide benefit increases to plan participants before terminating the plan.”

If courts consider the changes in structure and language to the overfunding assessment provision, they may be inclined to find that the overfunding assessment provision is a non-compensatory tax provision and thus not entitled to priority. Surely, one can now argue that the operation—which is the precise aspect of a disputed provision that courts are required to analyze under the Fabricators test—of § 4980 is non-compensatory and punitive. The overfunding assessment provision wields the threat of a fifty percent exaction to encourage the good behavior of an employer—namely, to share the reversion with its


employees. However, some courts may defer to the Eighth Circuit's decision in *Juvenile Shoe*, reading it as persuasive precedential authority, and reject the argument that the overfunding provision is a penalty as a result of § 4980's new language and structure. Indeed, Congress used neutral language in the legislative history to describe why it amended § 4980, and what little it did say may lead a court to conclude that the provision functions as a compensatory tax under the *Fabricators* test. Moreover, a court may not view Congress's revision of § 4980 in context. The revision of § 4980 was an infinitesimal provision that did not warrant significant debate or commentary as part of OBRA, which was a sprawling omnibus statute that made myriad revenue-related changes across the spectrum of the United States Code. Consequently, a court, reading the legislative history alone, may not feel constrained under the *Fabricators* test to upset the holding in *Juvenile Shoe* because the plainly-written legislative history is bereft of punitive language.

If courts do not conclude that § 4980 is a non-compensatory penalty, they may need legislative guidance from Congress. Though legislative solutions are slow in the making and offer no greater promise of perfect results than judicial solutions, legislative action may be the only way to reset the courts' approach to the overfunding assessment provision in the bankruptcy context. Specifically, Congress needs to implement a solution that elevates bankruptcy policy over tax policy.

The bankruptcy policies on which Congress should focus with respect to claims arising as a result of pension plan overfunding and underfunding are maximizing distribution to unsecured creditors.

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252. See Boren & Stein, supra note 39, § 17.15.50, at 119.

253. The following passage provides the extent of Congress's remarks on why it amended § 4980:

> Congress recognized that contributions to [pension] plans, as well as the earnings on such contributions, are intended to provide for the pension benefits of plan participants. To the extent that amounts in such plans are not used the [sic] pension purposes, Congress believed that the tax treatment of reversions, should recognize that the tax on earnings on pension funds is deferred and, thus, the benefits of this treatment should be recaptured. In many cases, a 15-percent excise tax is not sufficient to recapture [sic] that [sic] tax benefits received. Therefore, the committee believes it is appropriate to increase the excise tax to better approximate the tax benefits of the income deferral. The committee [sic] also believes it is appropriate to structure the excise tax to provide an incentive for an employer terminating a defined benefit plan to maintain a qualified retirement plan following the termination or to provide benefit increases to plan participants before terminating the plan.


254. For a discussion of my legislative proposal, see infra Part III.C.

and protecting innocent creditors from the debtor's malfeasance.\textsuperscript{256} First, the policy of maximizing distribution to creditors is often cited as a fundamental bankruptcy goal, which is balanced by the policy of offering the debtor a fresh start. Pursuant to the policy of maximized distribution, unsecured creditors are grouped together and paid a prorated share of the bankruptcy estate. The trustee's avoidance power, permitting him or her to reach back into the pre-petition period to avoid transactions and prevent a creditor from selectively dismembering the debtor's estate, also demonstrates the advancement of this policy.\textsuperscript{257} Second, beyond the general bankruptcy policy of protecting creditors is the specific protection of creditors against a debtor's wrongdoing.\textsuperscript{258} For example, the Bankruptcy Code recognizes that innocent unsecured creditors should not bear the pecuniary burden of the debtor's penalties. Accordingly, Bankruptcy Code § 726 subordinates penalty claims to unsecured claims.\textsuperscript{259} Additionally, courts approve payment of the debtor's attorneys from the estate in order to protect creditors from paying for unreasonable billing practices.\textsuperscript{260}

With a grasp of the relevant bankruptcy policies, one must also examine the competing tax and pension policies that generally undergird the overfunding and underfunding assessment provisions. Section 4971, but not § 4980, advances the important pension policy of

\begin{enumerate}
\item \textsuperscript{256} See In re Fishgold, 206 B.R. 50, 55 (Bankr. W.D.N.Y. 1997) (discussing "the policies of fresh start and protecting an innocent but wronged creditor"); In re Joe-
\item \textsuperscript{257} See Simonson v. Granquist, 369 U.S. 38, 40-41 (1962) ("Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors.").
\item \textsuperscript{258} See Simonson v. Granquist, 369 U.S. 38, 40-41 (1962) ("Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors.")
\item \textsuperscript{259} See id. § 330.
\end{enumerate}
guaranteeing employees' retirement income through minimum funding rules. The underfunding assessment provision strongly advances this pension policy by punishing incidences of underfunding with a ten percent exaction on the deficiency amount, which increases in severity to one hundred percent if such behavior continues.\textsuperscript{261} In contrast, when a plan sponsor triggers the operation of the overfunding assessment provision the plan ceases to exist. Accordingly, in the standard termination scenario, the pension security system neatly ties its loose ends by requiring the plan sponsor first to pay its obligations under the plan before claiming the residual assets.\textsuperscript{262} Once a sponsor pays its pension obligations, pension policy is no longer relevant and it is tax policy that takes primacy. The tax policy stands against the reversion in order to recover the tax benefits that the plan sponsor would enjoy had it been able to recapture plan assets that had grown tax-free. Similarly, tax policy is embodied in the underfunding provision by penalizing plan sponsors which fail to meet the funding requirements of ERISA, a government program that confers special tax benefits to qualified plan sponsors.

So far, courts have concluded that § 4971 claims are penalties.\textsuperscript{263} Thus, the Bankruptcy Code subordinates claims for underfunding assessments to the claims of general unsecured creditors. This is certainly consistent with the bankruptcy policy of protecting innocent creditors from a debtor's misdeeds. Distribution to unsecured creditors is also maximized because these claims do not diminish the estate as priority claimants. In contrast, overfunding claims are entitled to priority status.\textsuperscript{264} According priority status to these claims does not comport with bankruptcy policy. Rather, tax policy defeats bankruptcy policy in this case, even though the applicable tax policy is nearly mooted in the bankruptcy context, as explained below.

The collection of § 4980 exactions outside of bankruptcy validly serves the tax policy of recovering tax benefits.\textsuperscript{265} However, in the bankruptcy process a debtor-in-possession is acting not only for itself but for the benefit of its creditors as well.\textsuperscript{266} A debtor usually chooses to terminate a pension plan not to recover assets from a tax shelter—which is Congress's typical concern outside the insolvency context— but, rather, to augment the bankruptcy estate in order to maximize distribution to creditors.\textsuperscript{268} Furthermore, a terminating debtor has not deliberately overfunded its plan in order to recover tax benefits. That

\textsuperscript{261} See supra text accompanying notes 28-37.
\textsuperscript{262} See supra text accompanying notes 70-77.
\textsuperscript{263} See supra text accompanying notes 208-217.
\textsuperscript{264} See supra text accompanying notes 219-229.
\textsuperscript{265} See supra text accompanying notes 103-111; see also Stein, Taxing, supra note 72, passim.
\textsuperscript{266} See 11 U.S.C. §§ 1106, 1107 (1994).
\textsuperscript{267} See supra text accompanying notes 112-115.
\textsuperscript{268} See supra text accompanying notes 92-93.
is, the debtor is not intentionally terminating its overfunded plan solely to retain the residual assets. Rather, the debtor has become insolvent when, coincidentally, its plan's actuarial basis has caused the plan to be overfunded. Absent bankruptcy, such a plan would not be terminated, and its overfunded state likely would have leveled off with the passage of time as retiring employees extracted benefits. Furthermore, once a plan sponsor is in bankruptcy, it is not required to terminate its plan. There will be parties that are in favor of termination—namely, the creditors—and others that are against—the employees; but neither group can twist the debtor’s arm and force termination. Therefore, assessing overfunding exactions on debtors and according them priority treatment is a misguided practice that does not account for the actual reasons behind a debtor’s plan termination.

In fact, the most troubling consequence, one that improperly defeats pension policy, is that priority treatment of § 4980 claims creates a disincentive for an employer to fund its plan adequately. For example, before it files for bankruptcy protection, a failing company may be encouraged by its creditors to stop funding its pension plans. This course of action would yield a diminution in pension obligation payments and confer unsecured status upon both the PBGC’s claims arising from insuring those obligations and the IRS’s concomitant underfunding penalty claim, leading to a larger bankruptcy estate when compared with the adequate funding scenario. Only Congress can eliminate this disincentive.

There are other general arguments against tax priority that require broad and radical changes to the Bankruptcy Code’s distributional system. Some commentators believe that the government receives eighth priority for its tax claims purely as a result of its power and not on the basis of any principle that warrants excepting these claims from being treated pari passu with general unsecured claims. In line with this argument, one commentator advocates that the tax claims of government should be denied priority because the amounts of these claims are trifling in the scheme of the whole revenue collection system and, if paid below one hundred percent, the government’s losses would be an insignificant sacrifice on the part of the federal bureaucracy. In fact, many countries agree with this policy, generally restricting priority treatment to a bare minimum of claim

269. See supra text accompanying note 68.
270. See generally 11 U.S.C. § 365 (granting the trustee or debtor-in-possession power to assume or reject any executory contract).
271. See supra text accompanying note 101.
273. See Williams, supra note 272, at 51.
categories or specifically abolishing priority treatment of government claims. For example, Germany, inspired by an academically-conceived policy, has eliminated priority treatment of many types of claims, including government claims. Australia has eliminated tax priority, with England, New Zealand, and Canada following suit to a lesser extent.

Another consequence of tax priority is that it erodes the bankruptcy estate, a phenomenon that fosters discontent among general unsecured creditors within the bankruptcy system. The cost of alienating creditors, such as trade suppliers, is that they may refuse to continue trading with the reorganized company, significantly diminishing the chance for the company to reorganize successfully. The flip side to this point is that a greater distribution to general unsecured creditors will make them happier. Thus, these creditors may facilitate a successful reorganization by readily engaging in transactions with the reorganized debtor because a positive bankruptcy experience has caused them to perceive less risk in such activity.

The foregoing demonstrates the poor policy choice inherent in priority treatment of claims for overfunding assessments. The next section delves into the likelihood of the courts properly accounting for bankruptcy policy and correctly interpreting § 4980.

B. Can the Courts Solve this Problem?

One entity that can promote bankruptcy policies in the treatment of § 4980 claims is the judicial branch of government, as represented by the federal courts. In this instance, a judicial solution may be more feasible than a legislative one. A court can act to solve the narrow problem posed by § 4980 more quickly and cheaply than Congress can because the time and expense required to obtain a remedy in the courts may be less than that required to lobby Congress. The courts can effect a change in the treatment of claims for overfunding assessments to reflect the changes Congress made to the language and structure of § 4980 since the Eighth Circuit decided Juvenile Shoe. Indeed, courts may apply the Fabricators functional test differently because the new overfunding provision provides a departure from the normal twenty percent rate to a fifty percent rate should plan sponsors fail to divert residual assets to a replacement plan. Courts may view the fifty percent rate as a sanction against employers that do not share their residual assets with their employees and find that the

275. Id. at 491-93.
276. Id. at 500-01.
277. See Williams, supra note 272, at 51-52.
overfunding provision is punitive in operation. However, whether courts will take this approach is uncertain and unpredictable. Courts, especially those in the Eighth Circuit, may feel constrained, despite the revision of § 4980, to follow Juvenile Shoe, which specifically found the overfunding provision to be an excise tax. Further, opinions may vary within and among circuits, requiring the Supreme Court to again intervene as it did in Fabricators. Such a conflict may take years to develop—and even more time before the Court finally resolves it. Further, it is undesirable and unfeasible for the high court to resolve every application of the Fabricators test, though the development of conflicting interpretations would demonstrate the inherent unworkability of the test.

The next section suggests an array of legislative solutions to the current problem with claims for overfunding assessments. It advocates for the narrow option of amending § 4980 as the best means of advancing bankruptcy policy.

C. Can Congress Provide a Legislative Solution?

A viable solution for remediating the disincentives raised by the overfunding assessment provision is a legislative amendment. There are a number of ways to promote bankruptcy policy through legislation. One possibility would be for Congress to follow members of the international community and amend the Bankruptcy Code to eliminate priority unsecured claims altogether or surgically remove some or all tax claims from priority treatment. Second, Congress could also amend Bankruptcy Code § 507(a)(8)(E), adding an inclusive list of tax claims that courts should consider as excise taxes. In a third alternative, Congress could supply a standard for courts to apply, or a definition for courts to interpret, in order to determine whether a given exaction is an excise tax or penalty.

However, the foregoing legislative options are unlikely. First, abolishing the priority scheme would be an overbroad, not to mention radical, step. It would be a very difficult congressional feat to dismantle certain priority categories that represent concessions to special interest groups. Specifically abolishing tax priority may be just as difficult because it would require Congress to expressly disable the government from collecting certain revenues in bankruptcy. Second, incorporating an express list of taxes that fall under § 507(a)(8)(E) may be a worthy idea, as it would be a bright line solution that would lay to rest any future tax-penalty questions. However, congressional crafting of such a list may not reflect the advancement of bankruptcy policy. If Congress's experience with other priority categories is any example, a putative list of excise taxes may be composed of those that advance special interests irrespective

278. See Warren, Imperfect World, supra note 272, at 359-61.
of the substantive policy considerations. Third, amending § 507(a)(8)(E) to incorporate congressional insight into a test or a definition for solving excise tax-penalty questions would be an overbroad measure, and, in any case, would only be valuable to the extent Congress's test or definition was workable. For example, incorporating the *Fabricators* test into § 507(a)(8)(E) would accomplish nothing at great expense. Any alternative that would lead to conflicting judicial outcomes would not guarantee the advancement of bankruptcy policy in the administration of § 4980 claims.

The best alternative is for Congress to amend IRC § 4980(d)(6) to exempt its operation against entities in bankruptcy proceedings. The provision in subsection (d)(6) currently exempts entities liquidating under Chapter 7 from the fifty percent exaction rate if they do not transfer the residual assets into a replacement plan. This measure is more a function of logic than any recognition of bankruptcy policy because a liquidating business, which ceases to exist after the bankruptcy proceeding, generally would have no reason to establish a replacement plan. In any case, there is no exemption built into § 4980(d) applicable to reorganizing debtors. The following is a simple proposed revision of subsection (d)(6), intended to replace the limited exemption for plan sponsors involved with a liquidation proceeding with a broader exemption:

(6) Exempted entities. This provision shall not apply to any entity filing a liquidation or reorganization proceeding under applicable federal or state law.

The proposed revision would exempt eligible parties from both the twenty percent and fifty percent rates assessed under the provision.

This legislative solution is more preferable than the others because it is parsimonious in design. It does not affect the treatment of any other priority claims or tax claims. Therefore, this solution can be achieved more easily than a wholesale revision of the Bankruptcy Code. More importantly, such an amendment would advance the relevant bankruptcy policies while allowing tax policy to prevail in standard terminations outside of bankruptcy. It is important to note that the debtor would not be shirking its tax obligation in toto; it still

279. Priority treatment of special interest parties, like grain producers or fishermen, see 11 U.S.C. § 507(a)(5), does not advance any substantive bankruptcy policy. See Warren, *Imperfect World*, supra note 272, at 359-61. In bankruptcy, where funds are scarce and efficiency is paramount, unjustifiably favoring such interests leads to a less efficient and less fair distribution to creditors further down the payment chain.


281. In the alternative, should Congress be unwilling to abolish overfunding assessments against debtors, it could amend § 4980 to explicitly accord such claims unsecured status in bankruptcy. While the bankruptcy estate may not be maximized as much as it would be under the exemption solution, distribution to general unsecured creditors would still increase compared with the current state of the law.
must pay ordinary income tax on the reversion. This solution is
cognizant of the bankruptcy context, in which a sponsor is terminating
its overfunded plan for the benefit of its creditors, and not for its own
gain. Furthermore, it eliminates the moral hazard that may tempt a
sponsor to underfund its plan before filing in order to expand the
bankruptcy estate. Moreover, this solution still preserves the estate
for general unsecured creditors and relieves the PBGC from having to
pay the benefits owed by an underfunded plan.

CONCLUSION

Congress should amend IRC § 4980 to exempt it from operating
against residual plan assets reverting to a company seeking
bankruptcy protection. To date, the case law has not seriously
considered the interplay of the various federal policies when a debtor
incurs a § 4980 exaction before or during bankruptcy. Amending §
4980 would advance the bankruptcy policies of maximizing the
distribution to general unsecured creditors and protecting innocent
creditors from paying for the debtor’s malfeasance. The scope of this
solution is narrowly tailored to the problem it addresses and does no
violence to the tax policy that seeks to recover the residual assets of
terminated plans that benefited from tax-free growth. Expanding the
distribution available to unsecured creditors will result in greater
satisfaction among such creditors with the bankruptcy system.
Consequently, they may perceive less risk in dealing with the
reorganized debtor, thereby increasing the chances of a successful
reorganization. In addition, amending § 4980 would diminish the
debtor’s incentive to undertake the pre-petition moral hazard in which
it may choose to underfund pension plans in order to expand the
putative bankruptcy estate.