

Chapter 11 and the Sales Tax Permit

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Effective July 1, 2013, Connecticut passed a new law providing that the state must refuse to issue or renew a sales tax permit to any person or entity that owes taxes to the state until the taxes are paid or satisfactory arrangements are made for their payment: P.A. 13-150. Whether this new law would be enforceable in the event the delinquent taxpayer files a case under Chapter 11 of the U.S. Bankruptcy Code has not been tested in the bankruptcy courts in this state, but case authority from other jurisdictions suggests that it may be rendered ineffective when bankruptcy intervenes.

There are two sections of the Bankruptcy Code that would arguably apply to prevent the state from refusing to issue or renew a sales tax permit because of unpaid taxes. When a bankruptcy is filed, section 362(a)(1) of the Bankruptcy Code imposes an automatic stay, applicable to all entities, including the government, of any action or proceeding designed to recover a claim against the debtor that arose before the bankruptcy was filed. Such a claim would, of course, include unpaid taxes. Therefore, the refusal to issue or renew a sales tax permit until delinquent taxes are paid can be construed as an action or proceeding to recover a claim against the debtor.

The second provision that would arguably apply to this situation is section 525(a) of the Bankruptcy Code, which provides, in pertinent part, that the government may “not deny, revoke, suspend or refuse to renew a license, permit...or other similar grant to, condition such a grant to, [or] discriminate with respect to such grant against..., a person that is or has been a debtor [under the Bankruptcy Code]...solely because such bankrupt or debtor is or has been a debtor [under the Bankruptcy Code]...or has not paid a debt that is dischargeable [in the bankruptcy case]...”

The theory for using section 525(a) to prevent the state from denying the issuance or renewal of a sales tax permit for unpaid taxes is that although most taxes, including sales taxes, are non-dischargeable in bankruptcy, Chapter 11 of the Bankruptcy Code allows the debtor to pay them over a period of five years from the date on which the bankruptcy is filed; and, a debtor under Chapter 11 is prohibited by law from making any payments on account of a claim that arose before the Chapter 11 was filed. Thus, a debtor in Chapter 11 would be legally prohibited from making payment on account of the particular unpaid taxes that would be holding up the issuance or renewal of a sales tax permit.

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In analogous contexts, sections 362(a)(1) and 525(a), either singly or in combination, have been utilized by federal courts in other jurisdictions to prevent a state from withholding other types of licenses or permits because of nonpayment of taxes. For example, courts have enjoined the state from refusing to renew or issue a liquor license, casino license and contractor's license to the debtor for its nonpayment of taxes. Thus, there is strong statutory support and case law precedent for achieving the same result in Chapter 11 for a sales tax permit that might otherwise be lost for nonpayment of taxes.

An additional benefit to filing Chapter 11 would be to avoid the penalty portion of the unpaid sales tax obligation and reduce the rate of interest that accrues on unpaid sales taxes under state law. Under Connecticut law, unpaid sales taxes accrue interest at the rate of 12 percent per annum and a penalty of 15 percent of the amount of the unpaid taxes is added to the tax obligation. In Chapter 11, however, the debtor taxpayer can pay the taxes over a period of five years at a rate of interest equal to the prime rate plus between one and three percentage points as a "risk factor." As to the penalty portion of the tax, the amount of unpaid taxes that is required to be paid over five years includes penalties only if they are to compensate for pecuniary loss. That, of course, is confined to interest, so that additional penalties on top of interest would not be part of the five-year payout obligation.

Irve J. Goldman has practiced in the areas of bankruptcy law and commercial litigation for more than 20 years and was one of the first attorneys in Connecticut to become a certified specialist in business bankruptcy. He has represented a diversity of interests in bankruptcy proceedings, including companies reorganizing under Chapter 11, secured creditors, equipment lessors, franchisees, landlords and other creditor groups and asset purchasers in 363 sales. Reprinted with permission from the November 2, 2013 issue of the Fairfield County Business Journal.

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