

Real Property Transfers and Bankruptcy Tax Exemptions

Section 1146(c) of the Bankruptcy Code states that when real property is transferred under a plan confirmed under Chapter 11, the transaction is tax exempt. Congress enacted this provision because a reduction in tax obligations assists in producing successful reorganization plans by encouraging debtors to dispose of unnecessary assets, and by increasing the amount of money that will ultimately be available for distribution to creditors under the Plan.

Hechinger Investment Company of Delaware Inc. filed voluntary Chapter 11 petitions in an attempt to reorganize. The reorganization was ultimately unsuccessful, and it announced it would cease operations and liquidate. It then moved to sell real property owned by the corporation, and that the real estate transfer not be subject to recording taxes, pursuant to 1146(c), because the sales were necessary to reduce debt, and facilitate the eventual confirmation of a Chapter 11 Plan. The Maryland taxing authorities objected, and argued that the section only applied to sales conducted as part of a confirmed Chapter 11 Plan.

The Bankruptcy Court overruled the objections, and approved the transfers of real estate and tax exemptions. The court stated that this reading of the statute was consistent with the legislative intent of promoting successful Chapter 11 Plans. The court concluded that to benefit from the tax exemption, a Chapter 11 Plan must ultimately be confirmed; the timing of the sale was irrelevant.

The taxing authorities appealed, and the US District Court for District of Delaware affirmed the Bankruptcy Court's decision. To limit 1146(c) to post-confirmation transfers would undermine the purpose of the statute. The district court held that the 1146(c) exemption from transfer taxes applies to all sales conducted by a debtor throughout the course of a Chapter 11 bankruptcy, provided that the sales are necessary to confirmation. Here, the sales were clearly necessary to the Plan because the proceeds were to be used to fund the plan.

The taxing authorities appealed the district court decision to the 3rd Circuit Court of Appeals. The 3rd Circuit reversed the district court, holding that a transfer is made under a plan confirmed only when the sale is authorized by a previously confirmed Chapter 11 Plan. *Baltimore County v. Hechinger Liquidation Trust*, 335 F.3d 243 (3rd Cir. 2003). The court stated that even if the statute is ambiguous, tax exemption provisions are to be strictly construed. Secondly, federal laws that interfere with a state's taxation power are to be narrowly construed in favor of the state. Because 1146(c) provides for a tax exemption and interfered w/Maryland's provision of property taxation powers, the statute had to be construed in the taxing authorities' favor.

Today, the transfer of property under a plan confirmed tax exemption is only applied to sales authorized by a previously confirmed Chapter 11 Plan. Although no longer ambiguous, the benefits intended by the legislature are not often realized. Thus, 1146(c) relief does not apply to transfers made prior to confirmation of a Chapter 11 plan. This ruling will not be beneficial to Debtors that sell property pursuant to 363 before confirmation.