



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date Amended:	<b>03/24/11</b>	Bill No:	<a href="#"><u>Senate Bill 884</u></a>
Tax Program:	<b>Sales and Use Special Taxes</b>	Author:	<b>Calderon</b>
Sponsor:	<b>SecondMarket</b>	Code Sections:	<b>GC 16587</b>
Related Bills:		Effective Date:	<b>01/01/12</b>

**BILL SUMMARY**

Among other things, this bill authorizes the Board of Equalization (BOE) to sell to private investors those tax liabilities that are subject to an automatic stay on collection for bankruptcy cases.

**ANALYSIS**

**CURRENT LAW**

Existing Chapter 4.3 (commencing with Section 16580) of Part 2 of Division 4 of Title 2 of the Government Code (GC), known as the Accounts Receivable Management (ARM) Act, provides that a participant, including the BOE, may enter into a contract with a private debt collector for the assignment or sale of all or part of its accounts receivable (AR) under specified conditions. The ARM Act also:

- Requires state agencies to allocate collection resources based on giving highest priority to those AR's with the highest expected return. Each state agency is also required to consult with the Franchise Tax Board (FTB) or other state agencies which have established an effective AR collection system. (*Section 16583*)
- Allows a state agency to impose a reasonable fee, not to exceed the actual costs, for the costs of collection on a past due amount. (effective July 28, 2009, SBx4 16, Ch. 23 of the 4<sup>th</sup> Ex. Session) (*Section 16583.1*)
- Requires state agencies to submit an annual report to the State Controller's Office (SCO) of the AR and discharged accounts. The SCO would inform that state agency of the format and due date of the annual report. (effective July 28, 2009, SBx4 16, Ch. 23 of the 4<sup>th</sup> Ex. Session) (*Section 16583.2*)

Existing law authorizes the BOE to use various collection actions to collect delinquent AR's, including but not limited to: bank levies, liens, wage garnishments, till-taps or keeper warrants, permit revocations, alcoholic beverage license suspensions, seizures of assets, offsets, and court actions. The BOE's use of these tools is consistent with its established collection policies and procedures as provided in the Compliance Policy and Procedures Manual (CPPM), Chapter 7, [Collections](#).

The State's collection procedures to collect delinquent accounts are detailed in the State Administrative Manual (SAM) Section 8776 (et seq).

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

Title 11 of the United States Code contains the federal laws related to bankruptcy. As described in the BOE's CPPM, bankruptcy is a system of federal laws, rules, and procedures which generally allows persons or business entities to submit their assets, liabilities, and financial affairs to the jurisdiction of the US bankruptcy courts. Bankruptcy often involves consideration of both federal and state bankruptcy law.

There are thirteen Bankruptcy Courts in California, spread among four districts: Southern (San Diego area), Central (Los Angeles area), Northern (Bay Area), and Eastern (Fresno/Sacramento/Central Valley areas). Although many of the BOE's tax debtors file bankruptcy in California, cases affecting the BOE's tax debtors may be filed in bankruptcy courts throughout the country.

General notice that a bankruptcy case is commencing may come from many different sources such as actual written notice, verbal notice from a taxpayer, attorney or trustee, a search in the Public Access to Court Electronic Records (PACER) system, or the news. After receiving notification and verifying that a bankruptcy case has commenced, the bankruptcy information is entered into the BOE information system if the BOE has either a current interest (current liability due or active account) or future interest (potential liability due) in the case.

US Bankruptcy Code Section 362 places a "stay" (stop order) on most collection activity starting the moment the debtor files bankruptcy. Most collection efforts **must** be immediately released, removed and/or stopped from that date until the automatic stay and the discharge injunction no longer restrain the BOE's collection actions.

BOE collection actions prohibited by the automatic stay include:

1. Revocation of a seller's permit.
2. Supplier cut off letters.
3. Liens.
4. Levies or withholds.
5. Warrants (including keepers, till taps, and seize and sells).
6. Demands for payment (including demand notices).
7. FTB, EDD and other offsets.
8. Suspension of Liquor License.
9. Earnings Withholding Orders for Taxes (wage garnishments).

BOE actions that are *not* prohibited by the automatic stay include:

1. Demands for tax returns to be filed.
2. Assessments including compliance assessments, field billing orders, dual determinations, successor billings, and audits.
3. Issuing notices of tax deficiencies.
4. Issuance of a notice and demand for payment in conjunction with a notice of assessment.
5. Providing Statements of Account.
6. Continuance of any petition or appeal.
7. Withholds on transfer of liquor licenses.
8. Filing of criminal complaints.

---

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

9. Correspondence or discussions with the debtor and counsel regarding the things specifically listed in this section.

When a debtor has a current or potential unpaid tax or fee liability to the BOE, the Bankruptcy Team in the Special Operations Branch reviews the bankruptcy case to determine whether the BOE has a right to receive a distribution from a bankruptcy estate and collect from a debtor. If so, the Bankruptcy Team takes appropriate action to protect the BOE's right to receive a distribution from the bankruptcy estate and to collect from a debtor outside the bankruptcy case.

Ordinarily, to receive distributions in bankruptcy cases, creditors, including tax agencies, must file proofs of claim. The Bankruptcy Team monitors the status of bankruptcy cases, files proofs of claim, and collects liabilities for accounts in bankruptcy.

Once a case exits bankruptcy, i.e. the case has been discharged, dismissed, or a plan has been confirmed, the Bankruptcy Team will remove it from "bankruptcy" status, and, if a liability remains collectible, return collection responsibilities to the district office.

The BOE is prohibited from collecting from a tax debtor outside of bankruptcy when a tax or fee is discharged in a bankruptcy case. If a debtor has a liability that is excepted from the bankruptcy discharge, creditors may continue to take collection action against the debtor, since the debtor is no longer protected by the automatic stay provided by filing bankruptcy.

#### PROPOSED LAW

With respect to BOE, this bill would add Section 16587 to the GC to authorize the BOE to sell to investors those tax liabilities under the jurisdiction of the BOE that are subject to an automatic stay on collection of taxes, pursuant to a bankruptcy proceeding under Title 11 of the US Code. In conducting these sales the BOE would be empowered to compromise and settle the amount which they will receive through the sale of these account receivables.

#### IN GENERAL<sup>1</sup>

A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts. This goal is accomplished through the bankruptcy discharge, which releases debtors from personal liability from specific debts and prohibits creditors from ever taking any action against the debtor to collect those debts.

Six basic types of bankruptcy cases are provided for under the Bankruptcy Code. The cases are traditionally given the names of the chapters that describe them.

**Chapter 7**, entitled **Liquidation**, contemplates an orderly, court-supervised procedure by which a trustee takes over the assets of the debtor's estate, reduces them to cash, and makes distributions to creditors, subject to the debtor's right to retain certain exempt property and the rights of secured creditors. Because there is usually little or no nonexempt property in most chapter 7 cases, there may not be an actual liquidation of the debtor's assets. These cases are called "no-asset cases." A creditor holding an unsecured claim will get a distribution from the bankruptcy estate only if the case is an

---

<sup>1</sup> The following excerpt is provided by Bankruptcy Judges Division, Administrative Office of the United States Courts, (2010, April). *Bankruptcy BASICS, April 2010, Revised Third Edition*. Retrieved from <http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics.pdf>

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

asset case and the creditor files a proof of claim with the bankruptcy court. In most chapter 7 cases, if the debtor is an individual, he or she receives a discharge that releases him or her from personal liability for certain dischargeable debts. The debtor normally receives a discharge just a few months after the petition is filed.

Amendments to the Bankruptcy Code enacted in to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 require the application of a “means test” to determine whether individual consumer debtors qualify for relief under chapter 7. If such a debtor’s income is in excess of certain thresholds, the debtor may not be eligible for chapter 7 relief.

**Chapter 13**, entitled **Adjustment of Debts of an Individual With Regular Income**, is designed for an individual debtor who has a regular source of income. Chapter 13 is often preferable to chapter 7 because it enables the debtor to keep a valuable asset, such as a house, and because it allows the debtor to propose a “plan” to repay creditors over time – usually three to five years. Chapter 13 is also used by consumer debtors who do not qualify for chapter 7 relief under the means test. At a confirmation hearing, the court either approves or disapproves the debtor’s repayment plan, depending on whether it meets the Bankruptcy Code’s requirements for confirmation. Chapter 13 is very different from chapter 7 since the chapter 13 debtor usually remains in possession of the property of the estate and makes payments to creditors, through the trustee, based on the debtor’s anticipated income over the life of the plan. Unlike chapter 7, the debtor does not receive an immediate discharge of debts. The debtor must complete the payments required under the plan before the discharge is received. The debtor is protected from lawsuits, garnishments, and other creditor actions while the plan is in effect. The discharge is also somewhat broader (*i.e.*, more debts are eliminated) under chapter 13 than the discharge under chapter 7.

**Chapter 11**, entitled **Reorganization**, ordinarily is used by commercial enterprises that desire to continue operating a business and repay creditors concurrently through a court-approved plan of reorganization. The chapter 11 debtor usually has the exclusive right to file a plan of reorganization for the first 120 days after it files the case and must provide creditors with a disclosure statement containing information adequate to enable creditors to evaluate the plan. The court ultimately approves (confirms) or disapproves the plan of reorganization. Under the confirmed plan, the debtor can reduce its debts by repaying a portion of its obligations and discharging others. The debtor can also terminate burdensome contracts and leases, recover assets, and rescale its operations in order to return to profitability. Under chapter 11, the debtor normally goes through a period of consolidation and emerges with a reduced debt load and a reorganized business.

A bankruptcy discharge releases the debtor from personal liability for certain specified types of debts. In other words, the debtor is no longer legally required to pay any debts that are discharged. The discharge is a permanent order prohibiting the creditors of the debtor from taking any form of collection action on discharged debts, including legal action and communications with the debtor, such as telephone calls, letters, and personal contacts.

Although a debtor is not personally liable for discharged debts, a valid lien (*i.e.*, a charge upon specific property to secure payment of a debt) that has not been avoided (*i.e.*, made unenforceable) in the bankruptcy case will remain after the bankruptcy case.

---

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE’s formal position.*

Therefore, a secured creditor may enforce the lien to recover the property secured by the lien.

Not all debts are discharged. The debts discharged vary under each chapter of the Bankruptcy Code. Section 523(a) of the Code specifically excepts various categories of debts from the discharge granted to individual debtors. Therefore, the debtor must still repay those debts after bankruptcy. Congress has determined that these types of debts are not dischargeable for public policy reasons.

Generally speaking, the exceptions to discharge apply automatically if the language prescribed by section 523(a) applies. The most common types of non-dischargeable debts are certain types of tax claims, debts not set forth by the debtor on the lists and schedules the debtor must file with the court, debts for spousal or child support or alimony, debts for willful and malicious injuries to person or property, debts to governmental units for fines and penalties, debts for most government funded or guaranteed educational loans or benefit overpayments, debts for personal injury caused by the debtor's operation of a motor vehicle while intoxicated, debts owed to certain tax-advantaged retirement plans, and debts for certain condominium or cooperative housing fees.

## COMMENTS

- 1. Sponsor and Purpose.** This bill is sponsored by SecondMarket and is intended to authorize a company, similar to SecondMarket, to act as a broker of the state's bankruptcy claims.
- 2. Sale of tax liabilities or sale of bankruptcy claims?** The bill refers to the sale of "tax liabilities," not the bankruptcy claim. There is a distinct difference between the two. If it is the author's intent to sell "tax liabilities" that would seem to imply the sale of the account receivable (A/R), which is already authorized under existing law. If this is to specifically authorize the sale of liabilities that are subject to the bankruptcy court, would that mean the sale must be completed before the filing of the bankruptcy claim? Once BOE files a claim that is how the BOE would receive a distribution in the bankruptcy case. So, if the A/R is sold, it would seem the purchaser would then have to file a claim and stand in place of the BOE. Is that the policy the Legislature wishes to enact?

If this bill is intended to authorize the sale of the bankruptcy claim, then taxpayer confidentiality would be a concern of the BOE and the purchaser. When the BOE files a claim with the federal bankruptcy court, the state is essentially waiving its sovereign immunity and the bankruptcy court becomes the court of jurisdiction, able to hear and decide issues regarding the underlying liability (basis of the claim). The BOE is concerned that if it were to sell the claim, and the claim was disputed by the debtor, the BOE could be placed in a position to provide the purchaser confidential taxpayer information to defend the claim. Otherwise, if the BOE is prohibited from providing confidential taxpayer information to the purchaser, what debtor would not contest the claim? What potential purchaser would be interested in a bankruptcy claim that could not be defended as a valid claim?

- 3. There may be constitutional issues regarding the sale of bankruptcy claims.** It appears the sponsor intends for the bankruptcy claims to be monetized and sold to prospective buyers. There has been no detail provided in how these "sales" would be structured, but it would need to be structured so that it does not violate Article

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

XVI, Section 6 of the California Constitution, which prohibits the Legislature from pledging the credit of the state, in any manner, for the payment of liabilities of any individual or corporation. That same article also prohibits the BOE from making a gift of public money. The sale of a liability for less than the amount due could be construed to be just such a gift.

4. **Effect on a tax lien if a bankruptcy claim were sold.** In general, the BOE files a priority claim for state taxes owed. The state tax lien is filed with the county recorder's office when a taxpayer has a delinquent liability. In those cases in which a debtor owns a real property in the county in which the BOE has a lien recorded, the agency is considered to be a secured creditor. In terms of a debtor's bankruptcy case, the BOE files a priority claim that is secured by the state's tax lien against the real property.

The sales proposed by this bill prompt a series of questions. What would happen to the tax lien if the BOE sold the bankruptcy claim? Would the BOE release the tax lien on the sale? Would the claim still be treated as a priority claim? Would the purchaser be required to amend the claim and file as an unsecured creditor? If the tax lien is not released at sale, would the BOE release the lien when the bankruptcy trustee satisfies the claim? If the claim is not satisfied, would the purchaser have the ability to foreclose using the state's tax lien? If the property is not foreclosed, but the tax lien is expiring, would the state extend the tax lien in order to protect the purchaser's interest in the property?

5. **Who would be entitled to payments from other sources?** In the normal course of business, the BOE receives payments from other sources that are applied to liabilities that are included in the bankruptcy claim. These other sources may include collection actions against non-bankrupt partners, surety bond claims, and sales of liquor licenses. The BOE would need direction as to how these payments would apply to sales of bankruptcy claims.
6. **Effect on local and district taxes.** This bill adds a provision for local governments to also sell those tax liabilities under the jurisdiction of the local government that is subject to an automatic stay of action pursuant to a bankruptcy proceeding. The BOE administers local sales and use taxes under the Bradley-Burns Uniform Local Sales and Use Tax Law and the Transactions and Use Tax Law. Cities and counties are required to contract with BOE to perform all functions in the administration and operations of the ordinances imposing the Bradley-Burns local taxes and the district taxes. Since most bankruptcy claims include local and district taxes, would the BOE need the local governments to provide separate consent for the sale? If so, and if a local government decided not to sell their portion of a claim, the BOE would have additional administrative burdens related to the preparation and sale of such claims. If not, it should be made clear that the local taxes are not included in the tax liabilities that the city and county governments are authorized to sell.
7. **Proceeds from the sale.** The different taxes and fees administered by the BOE involve many different funds. Some of these funds include the Retail Sales Tax Fund, Transportation Tax Fund, Alcohol Beverage Control Fund, Cigarette Tax Fund, and the General Fund. This measure needs to be clarified as to how the funds from the sales of the claims are to be allocated. Since there can be multiple, competing taxes and fees, the bill should specify as to how the sale proceeds are allocated.

---

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

**8. Other issues and concerns.** The following are additional questions which need to be answered:

- Do any other states currently sell their tax liabilities, or bankruptcy claims? If so, what have been the results of these sales? Are there any legal issues related to such sales?
- What is the bankruptcy courts attitude toward the sale of claims? What legal issues has the private sector encountered with the sale of bankruptcy claims?
- Is it the author's intent to sell the bankruptcy claim? If so, is the claim being sold, or the right to the proceeds from that claim?
- Would the BOE be involved after the sale and provide collection services related to the claim or the liability?

### COST ESTIMATE

The BOE would incur costs to administer this bill, however, given the lack of detail related to the sale of tax liabilities and/or bankruptcy claims, the BOE is unable to provide a detailed estimate at this time. Costs could be attributable to providing confidential taxpayer information and documentation, modifying bankruptcy claims, creating regulations, procedures, forms, and publications related to the sale of liabilities or claims, preparing and/or reviewing contracts related to the sale, evaluating legal and/or legislative issues, analyzing bids related to the purchase of liabilities or claims, and answering inquiries from contractors and the public. As the bill proceeds and more details are provided, the BOE will prepare an estimate of these costs.

### REVENUE ESTIMATE

As of April 13, 2011, the BOE had filed a total of 2,698 claims for currently active bankruptcy cases in chapters 7, 11, and 13. The total amount of these claims is \$179,388,379; chapters 7 and 11 claims represented over 90% of the total. Additionally, over 98% of the affected account liabilities were attributable to sales and use tax.

Of the \$179 million of total claims, the following is a breakdown of the different bankruptcy claims:

Claim Type	Bankruptcy Chapter			TOTALS
	Ch. 7	Ch. 11	Ch. 13	
Expense of Administration	\$13,498,859	\$7,328,675	\$156,879	20,984,413
Gap	\$350,663			\$350,663
Priority	\$56,391,372	\$66,993,282	\$12,807,632	\$136,192,286
Unsecured	\$12,307,171	\$6,558,411	\$2,995,434	\$21,861,016
<b>TOTALS</b>	<b>\$82,548,065</b>	<b>\$80,880,368</b>	<b>\$15,959,945</b>	<b>\$179,388,378</b>

**Qualifying Remarks.** Priority, Expense of Administration, and Gap claims are required to be paid 100% under chapters 11 and 13, and payments are typically spread over five

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

years. However, priority payments may not be paid to completion if the business/debtor fails during the process. Additionally, chapter 11 claims are subject to a higher degree of litigation, as these typically involve business entities that are reorganizing and have the financial ability to dispute and litigate claims. Finally, chapter 7 cases are liquidations, so the priority claims are typically paid only a fraction of the amount claimed. Unsecured general claims typically receive a percentage after higher priority claims are satisfied.

Assuming the author intends for the BOE to sell those bankruptcy claims that would be of higher quality and interest to prospective buyers, and assuming all legal and administrative issues would not require an additional cost or impediment, and assuming the BOE members would authorize such a sale, the BOE would estimate that prospective buyers would be interested in those claims which the BOE would eventually expect to collect, such as the chapter 11 and 13 expense of administration and priority claims. These types of claims amount to \$87,286,469.

The BOE is unaware of the compensation structure for these types of purchases; it would seem necessary to have this information from the sponsor, SecondMarket, or possibly from a prospective buyer, in order to provide a comparison between the amount a claim would be sold for today and the amount that same claim would be worth in future dollars discounted by the interest foregone while waiting to collect those funds.

At this point, given the lack of detail in the bill and the lack of information provided to the BOE, we are unable to estimate the revenue impact. As details are provided, the BOE can revise its estimate.

---

Analysis prepared by:	John Cortez	916-445-6662	05/16/11
Contact:	Margaret S. Shedd	916-322-2376	
ls			0884sb021811jc.doc

---

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*