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Bankruptcy Court Asserts Jurisdiction to Determine Debtor's State Tax Liability

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At a time when practitioners debate the reach of bankruptcy court jurisdiction, the Delaware court continues to assert its jurisdiction in the face of new challenges. In *In re Indianapolis Downs LLC,* the U.S. Bankruptcy Court for the District of Delaware held that it had jurisdiction to decide whether a state taxing authority could continue to collect a state tax on part of the debtor's revenue from slot-machine wagering. In doing so, the court turned back several challenges by the state authority based on sovereign immunity, the Tax Injunction Act and various abstention doctrines.

Indianapolis Downs, a Chapter 11 debtor, operated a combined horse-racing track and casino — a racino — in Indiana. The Indiana racino statute imposed a graduated tax on the adjusted gross receipts (AGR) that the debtor received from slot-machine wagering. In addition, the racino statute required the debtor to distribute 15 percent of its slot-machine AGR — the set-aside funds — to various third parties, including the state tobacco Master Settlement Agreement fund, the Indiana Horse Racing Commission, various horsemen's associations and the state general fund.

For some time prior to the bankruptcy, the debtor calculated and paid the graduated tax on its slot-machine AGR without excluding the set-aside funds. Shortly before filing for bankruptcy, the debtor sought a refund of the taxes it had paid up until that time on the set-aside funds, contending that since it was statutorily obligated to distribute those funds to others, it never actually "received" them. The Indiana Department of Revenue denied the claim and the debtor lost its initial state appeal.

After filing for bankruptcy, the debtor filed a motion seeking an order under §505(a)(1) of the Bankruptcy Code that it need not include the set-aside funds in its calculation and payment of the graduated tax. The motion was prospective only; it did not seek a refund of the taxes the debtor previously paid. The department objected to the motion, arguing that either sovereign immunity or the Tax Injunction Act shielded it from the court's jurisdiction. Alternatively, the department asked the court to abstain from hearing the dispute to allow an Indiana state court to decide it. The court rejected each of the department's arguments.

First, the court held that it had jurisdiction over the parties and the subject matter of the tax motion based on §505(a) of the Bankruptcy Code. Section 505(a) provides that the court may determine the amount or legality of any unpaid tax that has not been contested before or adjudicated by a judicial or administrative tribunal of competent jurisdiction prior to the Chapter 11 proceeding. The court noted the 3rd U.S. Circuit Court of Appeals interprets §505(a) as a jurisdictional statute that confers authority on the bankruptcy court to determine certain tax claims, and other courts have interpreted the section to apply to state tax claims consistent with the purpose of §505 to afford prompt and centralized estate administration and to avoid having estates litigate tax claims or assessments in several state jurisdictions.

The court held that the department's sovereign immunity defense, grounded in the 11th Amendment, had no bearing on the court's jurisdiction. The department argued that the relief sought in the tax motion was injunctive in nature because it was aimed at "regulating the future interactions between [the debtor] and ... Indiana" and not at adjudicating the property of the estate. Therefore, the department said, the court must have personal jurisdiction over the party to be enjoined, but the bankruptcy court lacks in personam jurisdiction over sovereign states.

The court disagreed that the tax motion did not adjudicate issues concerning property of the estate. As the debtor generates revenue post-petition, the court wrote, the revenue becomes property of the estate.

"Up to now, the debtor's estate has, each day, paid a portion of that revenue [i.e. that property] over to the department in the form of the graduated tax on the set-aside funds," the court wrote. "The tax motion asks the court to determine whether the estate must keep making those payments. If the debtor prevails and the court finds the payments need not be made, then the amount of money in the estate will increase."

Thus, the motion directly affects property of the debtor's estate, and the court's power to adjudicate issues involving property of the estate stems from its in rem jurisdiction over the bankruptcy estate, not its in personam jurisdiction over the department. Quoting former Justice John Paul Stevens in *Central Virginia Community College v. Katz,* the court concluded that state sovereign immunity is waived when a bankruptcy court exercises its in rem jurisdiction.

Second, the court held that the Tax Injunction Act did not bar the court from exercising jurisdiction over the tax motion. The TIA provides that federal courts “shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under state law where a plain, speedy and efficient remedy may be had in the courts of such state.”

After noting that the tax motion sought declaratory relief — and not an injunction — the court cited cases holding that the TIA does not affect a bankruptcy court’s subject matter jurisdiction under §505. Section 505 reflects Congress’ choice to allow bankruptcy courts to determine a debtor’s tax liability and constitutes an exception to the TIA.

Finally, the court rejected the department’s argument that it must or should abstain from deciding the tax motion. The court noted that mandatory abstention does not apply to core proceedings, and the tax motion was a core proceeding as it sought to enforce a substantive right provided by Title 11 — the right under §505 to have the court determine the debtor’s tax liability.

The court identified six factors that the bankruptcy courts have considered in deciding whether to abstain in a §505 context: 1) the complexity of the tax issue; 2) the need to administer the bankruptcy case in an orderly and efficient manner; 3) the asset and liability structure of the debtor; 4) the prejudice to the debtor and the potential prejudice to the taxing authority; 5) the burden on the bankruptcy court’s docket; and 6) the length of time required for trial and decision.

Applying these factors to the case before it, the court found that the tax issue raised in the motion was not complex, requiring only that the court interpret and apply the Indiana statute using traditional tools of statutory interpretation, and there were no issues of uniformity of assessments since there were only two racinos in Indiana and both were parties to the bankruptcy proceeding. In addition, the bankruptcy case was at an early stage and the tax motion had been fully briefed and argued. Thus, all the factors weighed against abstention.

The department also claimed that abstention was warranted under the *Burford* doctrine, which holds that abstention may be warranted “where the exercise of federal review of the question in a case and in similar cases would be disruptive of state efforts to establish a coherent policy with respect to a matter of substantial public concern.”

The department argued that the state's interest in independently and uniformly addressing its tax imposition statutes was a matter of great state concern. In rejecting this argument, the court observed that this concern is present any time a debtor invokes §505 to determine its state tax liability, yet Congress provided in §505 for a means of resolving such liability in the bankruptcy forum.

The court agreed with U.S. District Court Judge Leif M. Clark of the Western District of Texas, writing in *In re Super Van,* that *Burford* abstention is not at issue "because we do not here have the mere resort to a federal court in order to attack or evade a state regulatory scheme; rather we have the incidental ability to employ the federal forum to do what would otherwise have to be done in the state's administrative scheme, in service to the larger policies underlying the administration of the bankruptcy case."

In the end, the court rejected all of the department's jurisdictional challenges and proceeded to decide the underlying issue. In so doing, the court affirmed its authority to decide significant issues concerning a debtor's state tax liability. (On the merits of the tax issue, the court found in favor of the debtor and against the department, holding that the debtor need not include the set-aside funds in its calculation and payment of the graduated tax, a ruling that the debtor estimated would result in an additional $15 million per year for the estate.)

As everyone knows, the odds always favor the house.

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