In general, Congress in the Bankruptcy Code attempted to balance the need for government entities to collect taxes, the need to promote a fresh start for debtors, and the desire to create a relatively balanced playing field for competing creditors. As you will see from this chapter, tax creditors will do well when they quickly collect the debts due to them. They will do much less well if the debts have gotten old. Exceptions to this general rule exist for tax debts secured by a tax lien or debts arising from the debtor's collection of funds on behalf of the government--trust funds.

The current Bankruptcy Code came into existence in 1978 replacing the 1898 Bankruptcy Code (which had received substantial revisions in 1938.) Congress spent the better part of a decade developing the current code and seeking to match its provisions with the economy that had substantially changed since the prior revisions. Substantial revisions were made in 2005. Each of the revisions impacted the collection of taxes.

One of the major changes in 2005 was the requirement that Chapter 13 debtors file outstanding tax returns. Judges had grown weary of the constant objections filed by the Service to debtor plans where returns were outstanding. Congress has paid careful attention to the role of taxes in bankruptcy matters. To properly represent your client in collection matters, you should as well.

This chapter focuses on federal tax debts but the rules for state and local tax debts, with almost no exceptions, mirror the rules for federal tax debts.

Footnotes

a1 Ken Weil practices law in Seattle, Washington, where he specializes in tax collection and bankruptcy issues. He served as a member of the Tax Advisory Panel to the Bankruptcy Commission created by Congress in 1994. He writes regularly on issues involving the intersection of tax and bankruptcy. Nancy Ryan is currently the Director of the Low Income Tax Clinic at Legal Services of Northern Virginia. She spent many years practicing consumer bankruptcy law in Northern Virginia. She started her career at the Office of Chief Counsel, IRS, where she was the Large Case Bankruptcy Coordinator. Grace Lee, 3rd year student at George Washington University Law School, and Elizabeth Segovis of Rhode Island Legal Services provided editorial assistance for this chapter.
21.1.1 Overview

This chapter has two goals. First, it seeks to allow a tax lawyer who represents individuals to understand the bankruptcy treatment of tax debts in order to make an informed decision on the best options available to clients dealing with such debt. Second, it seeks to aid a tax lawyer in understanding the consequences of bankruptcy when a client with tax debt arrives having already gone through bankruptcy. The chapter may allow the tax lawyer to respond to the client's concerns or to identify when a bankruptcy specialist must join in the representation. Because the Service handles a high volume of bankruptcy cases, it has a significant infrastructure devoted to bankruptcy; however, as with other segments of responsibility for the Service, its resources are stretched thin and it can make mistakes. 

Do not assume that the Service has properly handled your client's debts in bankruptcy, and always check its work.

21.1.1.1 Introduction

Bankruptcy provides a significant weapon in the tax professional's arsenal. Taxes are frequently one of the major debts of individuals and businesses. The filing of a petition in bankruptcy can result in the elimination or reduction of large amounts of tax. Bankruptcy may also serve as an effective technique to deal with an uncooperative Revenue Officer (RO), and it can substitute for an offer in compromise. (See ¶ 21.2.2 infra for a comparison of offers in compromise and bankruptcy.)

Note: This chapter focuses on individual bankruptcies (personal and business). The law regarding bankruptcies of other entities (such as trusts, corporations, or partnerships) is beyond the scope of this chapter and the practitioner should consult other sources for guidance.

As mentioned above, the Bankruptcy Code (Title 11 of the U.S.C.) represents a balancing act by Congress. With the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Congress tilted the field more favorably towards creditors and taxing authorities. BAPCPA notwithstanding, bankruptcy still grants both short-term and long-term benefits to debtors.

The principal short-term benefit of filing a bankruptcy petition results from the “automatic stay” that “freezes” most actions by creditors, the Service included. The primary long-term benefits are (1) a discharge from personal liability for most pre-petition debts, and (2) the opportunity to establish a plan to pay off debts pursuant to a manageable timetable without pressure or harassment from creditors. Debtors can also litigate the underlying tax liabilities, which may be a great benefit if the jurisdictional requirements of the other tax litigating courts cannot be met (e.g., inability to pay tax required for refund litigation).
For creditors, the law seeks to secure an equitable division of the debtor’s property. Toward this goal, the trustee has a fiduciary responsibility to maximize the bankruptcy estate for the benefit of unsecured creditors. The Bankruptcy Code makes it possible for creditors, who did not perfect their interests or otherwise “race to the courthouse,” to receive something. It also prevents debtors from acting in a manner detrimental to creditors’ interests. For example, if a debtor prefers certain creditors to others or acts in a manner that might significantly reduce assets available for paying debts, the trustee may be able to bring a preference or fraudulent transfer action to undo the “bad” act and bring the property into the bankruptcy estate for distribution according to the Bankruptcy Code provisions thereby thwarting the debtor’s desires.

**Note:** This chapter seeks to introduce its readers to concepts and issues that arise in bankruptcy cases where the debtor owes taxes. The chapter cannot cover all the concepts necessary for a complete understanding of bankruptcy law. Therefore, the chapter assumes that the reader has a basic understanding of bankruptcy law and procedure or that the reader will consult broader bankruptcy texts for an explanation of concepts, such as preferences, that get mentioned here with little explanation. To stop and explain each of these concepts would make the chapter unwieldy.

**Practice Tip:** Issues that create special challenges in working with the Service present themselves in bankruptcy cases as well, and the combination can create further complications. For example, ID Theft can impact taxpayers in bankruptcy. The Service has special transaction codes and procedures for this situation. 4 For the general rules on ID Theft see Chapter 22. Innocent spouse and injured spouse issues can arise in bankruptcy as well. The injured spouse may find that the noninjured spouse has filed bankruptcy making the determination of the amount of the refund one that requires coordination not only with the Service but also with the bankruptcy trustee. 5

To get some perspective on the number of bankruptcy cases filed each year, this chart shows the total number of cases by chapter. 6 In general, about 40% of debtors going into bankruptcy have an outstanding tax obligation.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>TOTAL FILINGS</th>
<th>CHAPTER 7</th>
<th>CHAPTER 11</th>
<th>CHAPTER 12</th>
<th>CHAPTER 13</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>794,492</td>
<td>488,417</td>
<td>7,105</td>
<td>457</td>
<td>298,348</td>
</tr>
<tr>
<td>2016</td>
<td>794,960</td>
<td>490,365</td>
<td>7,292</td>
<td>461</td>
<td>296,655</td>
</tr>
<tr>
<td>2015</td>
<td>844,495</td>
<td>535,047</td>
<td>7,241</td>
<td>407</td>
<td>301,705</td>
</tr>
<tr>
<td>2014</td>
<td>936,795</td>
<td>619,069</td>
<td>7,234</td>
<td>361</td>
<td>310,061</td>
</tr>
<tr>
<td>2013</td>
<td>1,071,932</td>
<td>728,833</td>
<td>8,980</td>
<td>395</td>
<td>333,626</td>
</tr>
<tr>
<td>2012</td>
<td>1,221,091</td>
<td>843,545</td>
<td>10,361</td>
<td>512</td>
<td>366,532</td>
</tr>
<tr>
<td>2011</td>
<td>1,221,091</td>
<td>843,545</td>
<td>10,361</td>
<td>512</td>
<td>366,532</td>
</tr>
<tr>
<td>2010</td>
<td>1,593,081</td>
<td>1,139,601</td>
<td>13,713</td>
<td>723</td>
<td>438,913</td>
</tr>
</tbody>
</table>
21.1.1 Introduction to the Bankruptcy Process

21.1.2 Chapter 7 and Chapter 13 Bankruptcies

The ultimate goal of all bankruptcies is a “fresh start.” Ideally, this means emerging with no debts and at least some property. Debt-laden individuals may obtain relief under the Bankruptcy Code through liquidation (Chapter 7) or a debt repayment plan (Chapter 13). (Debt relief for individuals is also available in a Chapter 11 bankruptcy, but, because of its cost, it is rarely a practical remedy for individuals. Debt relief for individual farmers may occur in a Chapter 12 but because of the specificity of the circumstances it covers, Chapter 12, like Chapter 11, will not receive attention in this text.)

The Chapter 7 liquidation is prototypical and the most frequently filed type of bankruptcy. In exchange for the debtor relinquishing all nonexempt assets to the trustee in bankruptcy (who then liquidates them and distributes the proceeds to creditors), the debtor receives a discharge of personal liability for most pre-petition debts. Certain debts are nondischargeable, including many taxes. The debtor does not have to commit any future earnings or property to repaying creditors, only current nonexempt property. It can be a relatively quick process, as the debtor generally meets with the trustee within five to six weeks of filing, and the discharge is granted 60 days later. The vast majority of Chapter 7 cases carry the “no asset” case label because the debtor has no assets available for the trustee to administer. These debtors only have assets that may be exempted or excluded from the bankruptcy estate leaving unsecured creditors with no further means of payment unless the debt owed to them does not get discharged.

Chapter 13 allows a debtor to discharge obligations by making payments pursuant to a Chapter 13 plan. The plan must be proposed in good faith. The Chapter 13 plan is monitored by the Chapter 13 trustee, who receives a fee for providing those services. To be eligible for Chapter 13, the debtor must not have more than $394,725 of noncontingent, liquidated, unsecured debt, as adjusted every three years for inflation, and $1,184,200 of noncontingent, liquidated, secured debt, as adjusted every three years for inflation. The next adjustment is April 1, 2019. To be completed successfully, a Chapter 13 plan must accomplish the following:

- All secured claims must be paid in full with interest. “Paid in full” can be accomplished in one of three ways, as the debtor can return the collateral to the secured creditor; cure any arrearages and maintain current payments; or pay the debt in full, whether in cash or by selling the collateral for the benefit of the creditor. Cure and maintain is not an available payment method for tax debts.

- All priority debt must be paid in full. This full payment occurs under the plan without interest. At the conclusion of the plan, with the exception of nondischargeable taxes that are priority taxes and trust fund taxes, the discharge relieves the debtor of any obligation to pay post-petition interest.

- All administrative expenses, including trustee's fees and attorney's fees, must be paid in full.
• Creditors must receive at least what they would have received in a Chapter 7 liquidation (“liquidation equivalent distribution”). This requirement frequently yields nothing for the Chapter 13 creditors as there would have been nothing distributed to creditors if a Chapter 7 had been filed.

• The debtor must make payments to unsecured creditors equal to projected disposable income, which is a monthly concept, times the applicable commitment period, not to exceed 60 months.

21.1.1.3 Key Concepts

All debts in bankruptcy can be categorized as either (1) a tax or not a tax; (2) pre-petition or post-petition; (3) secured or unsecured; (4) if unsecured, priority unsecured, or general unsecured; and (5) if unsecured, dischargeable or nondischargeable. To understand how bankruptcy works, one must be familiar with these key terms and concepts.

21.1.1.3.1 Is the Debt a “Tax?”

There are different rules in the Bankruptcy Code for tax debt, as opposed to nontax debt. Thus, one must determine whether a claim is for a tax or a penalty or a nontax debt (e.g., a user fee). One of the more interesting places where this issue arose was in National Federation of Independent Business v. Sebelius, 567 U.S. 519 (2012). In that case, for constitutional purposes, the Supreme Court found that the exaction for failure to comply with buying insurance under the new health care act was a tax even though labeled a penalty. But, for interpretation of the exaction, it should be treated as a penalty.

Determining the difference among an excise tax, a penalty, and a user fee can be tricky. An excise tax is a tax on an event or transaction, while a penalty is designed to punish a certain behavior. Excise taxes receive priority, but penalties do not. Examples of excise taxes include the real estate excise tax and the gift tax. User fees are voluntary payments for a private benefit, while taxes are used for public purposes. User fees do not receive priority.

To determine whether the assessment is a tax, courts ask whether the assessment is:
- An involuntary pecuniary burden, regardless of name, laid upon individuals or property.
- Imposed by, or under, authority of the legislature.
- For public purposes, including the purposes of defraying expenses of government or undertakings by it.
- Under the police or taxing power of the state.

21.1.1.3.2 Pre-Petition Versus Post-Petition Tax Debts

Pre-petition describes the time period before the bankruptcy petition is filed. Post-petition describes the time period after the bankruptcy petition is filed. The debtor's goal in bankruptcy is to discharge debt (i.e., eliminate the legal obligation owed to creditors). Pre-petition debts are potentially dischargeable; post-petition debts are not. Note, the income taxes of the debtor for the year in which the petition is filed are generally post-petition debt, since the debt is treated as arising on the last day of the calendar year. The result is different if a short-year election is made pursuant to section 1398 of the Code.
21.1.1.3.3 Secured Tax Claims

A “claim” is a potential right to payment from bankruptcy estate assets. A “secured claim” is a claim protected by rights in property that assure payment, whether by voluntary agreement (security interest, deed of trust, or mortgage); court order (judgment lien); or operation of law (statutory lien). The importance of a secured claim is that the secured creditor stands first-in-line as to any asset to which the security interest is attached.

The secured claims of taxing authorities (i.e., tax liens) arise by operation of law. A lien is a charge against property to secure payment of a debt. Once it arises, a lien sticks to property like glue. Until the lien is discharged from a specific piece of property or removed from all of the debtor's property, the lien generally remains attached regardless of ownership changes.

Liens represent in rem obligations (i.e., obligations against a thing). Bankruptcy discharges in personam or personal obligations like credit card debt, where only the debtor's good word backs-up or “protects” the debt. Bankruptcy does not discharge in rem obligations, and, therefore, does not discharge a valid tax lien that has attached to the debtor's property. The advantage to filing for bankruptcy before the Service properly files its Notice of Federal Tax Lien (NFTL) is that the bankruptcy will prevent the Service from perfecting the lien, and the tax lien will not reach its full priming power. In most cases in which the Service has not filed a NFTL before the bankruptcy petition, the tax debt remains an in personam obligation and potentially dischargeable (as discussed in ¶ 21.1.3 infra).

The federal tax lien arises automatically if, after demand, a person “neglects or refuses to pay the tax.” Thus, the lien is a secret lien. The tax lien secures tax, interest, penalty, and costs. For a federal tax lien to arise, the tax must be assessed; the Service must make notice and demand on the taxpayer; and the taxpayer must fail to pay within 21 calendar days (ten business days if the debt equals or exceeds $100,000). The lien relates back to the date of assessment.

For a tax lien to reach its full priming or secured power, a valid notice of tax lien must be filed. The NFTL must properly identify the debtor. It must also be filed in the correct place. Some states (e.g., New York, Pennsylvania, and Illinois) have one-stop filing for the Service. That is, one filing allows the lien to attach against both real and personal property. Other states (e.g., Oregon and Washington) require the notice of tax lien to be filed in two places. For real property, the notice is filed in the county where the property is located. For personal property, the notice is filed in the central filing location for notices of lien against personal property (i.e., the UCC filing office). Note that if the underlying tax debt is discharged, the bankruptcy discharge will prevent the lien from attaching to any property acquired after the bankruptcy filing even if filing of the NFTL preceded the filing of the bankruptcy petition.

The reason the Service wants a NFTL filed prior to the filing of the bankruptcy petition stems from section 544(a) of the Bankruptcy Code which deems the trustee a judgment creditor as of the filing date, and from I.R.C. section 6323(a). The combination of these provisions places a judgment creditor ahead of a tax lien when the NFTL did not precede the filing of the bankruptcy petition.

A special rule for tax liens exists in Chapter 7. The distribution rules of section 726(a)(1) of the Bankruptcy Code provide that property of the estate shall first be distributed in the order specified in section 507 of the Bankruptcy Code from the value of the tax lien. This rule receives further attention below.

In addition to holding a secured claim when the NFTL filing occurred prepetition and attached to property with equity, the Service holds a secured claim when it has an offset claim. The Service will have a claim secured by offset when it holds money (an overpayment) due the debtor in addition to having money owed to it. Almost all courts allow the IRS to exercise its setoff rights against a debtor's exempt tax refund, even if the refund is being applied to a tax that is dischargeable in the bankruptcy...
21.1.1 Overview, Effectively Representing Client Before New IRS 21.1.1

... proceeding.  A similar controversy exists when the setoff is used to satisfy tax liabilities versus setoffs to satisfy other non-tax government liabilities under the Treasury Offset Program, which authorizes the Secretary of the Treasury to intercept an individual's tax overpayment and apply it to preexisting non-tax debts.

21.1.1.3.4 Priority (Tax) Claims Versus General Unsecured Claims

The word “priority” refers to the ranking of a creditor's claim for purposes of asset distribution. Bankruptcy is not an egalitarian place where every person receives an equal amount. In bankruptcy, the first person or class is paid in full before the next person or class receives a distribution. Thus, the priority ranking is important. If the word “priority” is used as an adjective to modify the word “tax” (e.g., priority tax claim), priority refers to the class of unsecured tax claims that are paid ahead of general unsecured claims.

Secured creditors come first as to assets in which they have a security interest. A list of the ten unsecured items entitled to priority is found in section 507(a) of the Bankruptcy Code. Child support and alimony come first. Bankruptcy estate administrative expenses are next. Priority tax claims are eighth. A separate prioritization scheme building on section 507(a) exists in section 726 of the Bankruptcy Code and in that scheme the debtor is paid last.

There are nine types of priority taxes, and they are: taxes due on recent years; recently assessed taxes; other still assessable taxes; certain property taxes; trust-fund-type liabilities; certain employers' employment taxes; certain excise taxes; certain custom taxes; and pecuniary loss penalties. Section 507(a)(8) seeks to describe each of these types of taxes and provide the circumstances under which each type of tax receives priority treatment.

21.1.1.3.5 Dischargeability and Nondischargeability of Tax Debts

The goal of a debtor in bankruptcy is the discharge of the legal obligation to pay creditors. If the legal obligation cannot be removed, a debt is nondischargeable. Because sections 523(a)(1) and 507(a)(8)(A)(iii) of the Bankruptcy Code intertwine the concepts of priority and dischargeability, one author divides the world of unsecured, tax, penalty, and interest claims of individuals in Chapter 7 into three parts as follows:

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>ACTION STEP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type 1</td>
<td>Priority and nondischargeable (Bankr. Code sections 523(a)(1)(A) and 507(a)(8))</td>
<td>Pay or delay</td>
</tr>
<tr>
<td>Type 2</td>
<td>Nonpriority and nondischargeable (Bankr. Code sections 523(a)(1)(B) and (C), and 507(a)(8)(A)(iii))</td>
<td>Correct if possible</td>
</tr>
<tr>
<td>Type 3</td>
<td>Nonpriority and dischargeable (residual category)</td>
<td>Chapter 7</td>
</tr>
</tbody>
</table>

Type 1 taxes are the priority taxes listed above. If there is an asset estate, there is some chance that the Type 1 taxes will be paid during the bankruptcy. Type 2 taxes encompass such bad acts as failing to file an income tax return, filing a return late and within two years of the petition date, fraud returns, and willfully attempting to evade or defeat the tax. Because they are nondischargeable, Type 2 taxes can be very bad if corrective action is not possible (e.g., taxpayer lives in a jurisdiction where the tax on a late-filed return is always nondischargeable).\textsuperscript{37} If a tax is not Type 1 or Type 2, then it is Type 3, and the tax is dischargeable in Chapter 7. An example of a Type 3 tax is a five-year old income tax obligation. (Remember, these categories apply to unsecured taxes in Chapter 7.) Except for some minor differences (e.g., post-petition interest does not run on Type 1 taxes in Chapter 13 as long as the tax is not a trust fund tax or a tax that is simultaneously Type 1 and Type 2 and all tax penalties are dischargeable in Chapter 13), the tax discharges in Chapter 7 and Chapter 13 are substantially the same.

**Practice Tip:** When a taxpayer files bankruptcy and owes the Service, the taxpayer should list the Service on the schedule of creditors. Some taxpayers fail to do this either because they forget to inform their bankruptcy counsel or they decide to file the bankruptcy pro se and do not properly complete the schedules. If you represent someone who has left the Service off the schedules your biggest concern is whether the debts would otherwise have been discharged.\textsuperscript{38} The bankruptcy schedules should use the following address for the Service: Internal Revenue Service, c/o Centralized Insolvency Operations, P.O. Box 7346, Philadelphia, PA 19101-7346. Some prudent practitioners routinely list the Service and the state and local taxing authorities in every case.

**21.1.1.4 Which Bankruptcy Chapter Provides the Best Relief for Your Client?**

Because the discharges in Chapter 7 and Chapter 13 are substantially coterminous, the advantages of Chapter 13 over Chapter 7 are quite limited. Chapter 13 is still useful in the following situations:

- Chapter 13 can be used to cure mortgage arrearages and prevent foreclosure.

- It discharges priority taxes paid for with a credit card pursuant to section 523(a)(14) of the Bankruptcy Code, provided the original intent was to pay the card in full.

- It discharges certain types of hold-harmless obligations set forth in section 523(a)(15) of the Bankruptcy Code.

- It discharges all types of tax penalties, except the trust fund recovery penalty, which is treated as a tax and not a penalty.\textsuperscript{39}

- Priority and nondischargeable tax obligations other than trust fund taxes and taxes that are both priority taxes and nondischargeable taxes can be paid without post-petition interest being incurred. The tradeoff is the cost of the trustee's fee versus the savings from no interest accruing.

- As to most secured debt, Chapter 13 effectively caps the payment to the secured creditor at the plan confirmation value and allows the debtor to benefit from post-petition appreciation.

- Repayments of pension plan loans reduce the required payment to unsecured creditors.\textsuperscript{40}

**21.1.1.5 IRS Handling of Bankruptcies**
The office within the Service principally responsible for handling bankruptcies is the Insolvency Section, which is a part of the collection function for the Small Business/Self Employed Operating division of the Service. Insolvency is divided into a Field function consisting of more than 80 posts of duty geographically distributed throughout the country and a single Centralized Insolvency Operation (CIO) in Philadelphia.”

CIO works all no-asset Chapter 7 cases, monitors Chapter 13 cases for confirmation of the plan and after confirmation, and processes Chapter 13 payments. CIO also works Chapter 7 business and individual asset cases transferred from the Field investigator after initial case review is completed and all proofs of claim are completed and acknowledged. The toll-free telephone number for CIO is (800)973-0424. The Field function conducts the initial Chapter 13 case review, prepares the proof of claim, handles all business and individual asset Chapter 7 cases, and generally oversees Chapter 11 cases (e.g. reviews schedules and plans and monitors payments). The Field caseworkers also make referrals to Chief Counsel, attend section 341 of the Bankruptcy Code meetings if allowed in that district, and negotiate with debtors. In general, Field is designed to work complex issues and CIO is designed to work routine or “mechanical” matters. A good working relationship with local Field employees can sometimes help practitioners resolve otherwise difficult issues.

The Department of Justice represents the Internal Revenue Service in Bankruptcy Court. Although the Assistant Attorney General (Tax Division) has the authority to handle most bankruptcy referrals, the normal practice for the Tax Division is to delegate that authority to the United States Attorney in most routine proceedings.

Service on the United States in adversary proceedings (law suits in bankruptcy) is made by serving the United States Attorney General, the local United States Attorney, and the designated Service office. For motion practice, the less formal matters referred to as contested matters in bankruptcy terminology, service of pleadings and other court documents should also be made by serving the same three parties. Practically, service on the local United States attorney and the designated Service office will usually be sufficient for motion matters.

Footnotes

7 Data for 2017 was taken during 12-month period ending March 21, 2017.

a1 Ken Weil practices law in Seattle, Washington, where he specializes in tax collection and bankruptcy issues. He served as a member of the Tax Advisory Panel to the Bankruptcy Commission created by Congress in 1994. He writes regularly on issues involving the intersection of tax and bankruptcy. Nancy Ryan is currently the Director of the Low Income Tax Clinic at Legal Services of Northern Virginia. She spent many years practicing consumer bankruptcy law in Northern Virginia. She started her career at the Office of Chief Counsel, IRS, where she was the Large Case Bankruptcy Coordinator. Grace Lee, 3rd year student at George Washington University Law School, and Elizabeth Segovis of Rhode Island Legal Services provided editorial assistance for this chapter.

1 TIGTA, 2014-30-013, BANKRUPTCY PROCEDURES DESIGNED TO PROTECT TAXPAYER RIGHTS AND THE GOVERNMENT'S INTEREST WERE NOT ALWAYS FOLLOWED (Mar. 6, 2014). See one of the major holdings of the report, which is “Bankruptcy Procedures Designed to Protect Taxpayer Rights and Government's Interest Were not Always Followed.”


3 The automatic stay generally prevents the Service from taking action to collect on pre-petition debts. 11 U.S.C. § 362(a)(6). It does not prevent taxing authorities from examining tax returns and making assessments. 11 U.S.C. § 362(b) (9).

4 Memorandum from Director of Collection Policy, Small Business/Self-Employed Division, SBSE 05-0113-008 (Jan. 30, 2013).

5 In particular, bankruptcy courts have struggled with how to divide the tax refund between a filing and nonfiling spouse. They have taken four approaches, which are (i) allocation by withholding; (ii) 50/50 split; (iii) allocation by income earned; and (iv) the separate filings rule, which is the method used by the IRS. See, e.g., In re Duarte, 492 B.R. 100, 105-06 (Bankr. E.D.N.Y. 2013). The separate filings rule seems to be winning the day. Duarte describes the separate filings rule in the following manner:
[E]ach spouse's separate tax liability is determined based on a calculation of what each spouse's tax obligation would have been if the spouses had filed separately and a calculation of the contributions each spouse has actually made to the total payments.  


The data from this chart was retrieved from the yearly bankruptcy reports released by the United States courts and is available online at http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx.


Grynberg v. United States (*In re* Grynberg), 986 F. 2d 367 (10th Cir. 1993) (gift tax incurred within three years of petition date is nondischargeable).


The Sixth Circuit has suggested that the public purpose test is overly broad in that all taxes are for a government purpose. Yoder v. Ohio Bureau of Worker's Compensation (*In re* Suburban Motor Freight, Inc.), 998 F.2d 338, 340-42 (6th Cir. 1993). A Tenth Circuit dissent that cites *Yoder* with approval suggests that a more appropriate test would be whether the obligation is for the purpose of supporting government. United Mine Workers of Am. 1992 Benefit Plan v. Rushton (*In re* Sunnyside Coal Co.) 146 F.3d 1273, 1280-81 (10th Cir. 1998) (Brorby, J., dissenting).


See ¶ 21.1.5 infra.

See ¶ 21.1.4 infra for a detailed discussion of this topic.

The term “claim” describes a right to payment from the debtor that arose pre-petition. When a right to payment from the debtor arises post-petition, the person to whom the debt is owed files a “request for payment” instead of a claim. Post-petition liabilities are sometimes called administrative expenses and the request for payment is the mechanism for seeking these post-petition liabilities from the bankruptcy estate.


*I.R.C.* § 6321. See discussion in Chapter 11.

Assessment is a Tax Code word of art indicating the date “the summary record is signed by the assessment officer.” Reg. § 301.6203-1. It is a word more often associated with federal taxes, and the elimination of its use by BAPCPA in the priority provisions of section 507(a)(8)(B) was meant to reduce confusion in those state and local jurisdictions where it is not used.

*I.R.C.* § 6322.

*I.R.C.* § 6323. See discussion in Chapter 11 for a full discussion on the NFTL and its perfection of the underlying federal tax lien.
In practice, in all jurisdictions except the 8th Circuit, a substitute-for-return assessment cannot be overridden 

This approach to looking at tax claims was developed by Kenneth C. Weil, one of the chapter authors. 
See 11 U.S.C. § 726(a)(6). Last here means after all of the general unsecured claims have been paid. The debtor 

The ten subparagraphs of 507(a) list the priority provisions in order of their priority. All of the claims entitled 
so on down the line. If money runs out during the payment of one of the subparagraphs, then the claims within 

The negative implication of Isom supports the conclusion that the lien does not attach to after-
acquired property although through its attachment to pre-petition property the lien enjoys the benefit of appreciation (or the burden of depreciation) during the period of the bankruptcy case.

Matter of Elcona Homes Corp., 863 F.2d 483, 484-85 (7th Cir. 1988); In re Carpenter, 367 B.R. 850, 854 

If money runs out during the payment of one of the subparagraphs, then the claims within that subparagraph receive payment pro rata and claims in lower subparagraphs receive nothing. General unsecured claims receive nothing unless all priority claims have been satisfied and general unsecured claims receive payment pro rata with each other.

To priority under subparagraph (a)(1) must be paid before the trustee can move onto subparagraph (a)(2) and 


IRS v. Luongo (In re Luongo), 259 F.3d 323 (5th Cir. 2001) (debtor is only entitled to a tax refund to extent 
overpayment exceeds unpaid tax liability; once offset occurs, there is no property interest in the tax refund in the bankruptcy estate); Gould v. United States (In re Gould), 603 F.3d 1100 (9th Cir. 2010) (adopting reasoning of the bankruptcy appellate panel at 401 B.R. 415). The United States also argues that sovereign immunity prevents a debtor from bringing a claim. See Luongo, 259 F.3d at 336-44 (Garza J., dissenting) (Bankruptcy Code section 505(a)(2) does not waive sovereign immunity to allow a debtor to make a refund claim); United States v. Bond, 762 F.2d 255 (2d Cir. 2014) (United States successfully asserted sovereign immunity defense against a liquidating trustee of a bankruptcy estate; liquidating trustee not a Chapter 11 bankruptcy trustee under 11 U.S.C. §1104); and United States v. Copley, Case No. 16-207, 2017 U.S. Dist. LEXIS 53194 (E.D. Va. Mar. 31, 2017) (overpayment case remanded to bankruptcy court for consideration of sovereign immunity issue). On remand, the Bankruptcy Court found that sovereign immunity had been waived. Copley v. United States (In re Copley), 572 B.R. 808 (Bankr. E.D. Va. 2017). Taxpayer victories in this area are rare. In re Vargas, 342 B.R. 762 (Bankr. N.D. Ohio 2006) (debtors granted refund).


11 U.S.C. § 507(a)(6). Last here means after all of the general unsecured claims have been paid. The debtor is not a claimant from the estate since the debtor is not a creditor. In the rare case in which the bankruptcy estate has sufficient funds to satisfy all valid claims, then the money remaining returns to the debtor.

See ¶ 21.1.2 infra for a detailed discussion of this topic.

This approach to looking at tax claims was developed by Kenneth C. Weil, one of the chapter authors. Mr. Weil has written other materials that explain his concept of tax claims in greater detail. See, e.g., TAX LIABILITIES AND BANKRUPTCY (CCH 3rd ed. 2014).

In practice, in all jurisdictions except the 8th Circuit, a substitute-for-return assessment cannot be overridden by a subsequently filed return. The SFR is not a return but an account notation that triggers an audit 
and the issuance of 30-day and 90-day letters. The assessment accompanying this “return” is zero. The 

In re Hindenlang, 164 F.3d 1029 (6th Cir. 1999). There are three different appellate positions on the dischargeability of taxes arising from an SFR. For an in-depth discussion of this issue, see Keith Fogg, What is a Return - The Long Slow Fight in Bankruptcy Courts, Procedurally Taxing (Dec. 4, 2013), http://www.procedurallytaxing.com/what-is-a-return-the-long-slow-fight-in-the-bankruptcy-courts/; Keith Fogg, Another Circuit Weighs in on the Discharge of Unfiled Returns,
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38 11 U.S.C. § 523 (a)(3); White v. Nielson (In re Nielson), 383 F.3d 922, 927 (9th Cir. 2004) (“If she had a dischargeable debt, its discharge was not brought about by the lack of notice. If she had a non-dischargeable debt, she still has it. The lack of notice had no effect on her.”). Memorandum from Director of Collection Policy, Small Business/Self-Employed Division, SBSE-05-1213-0089 (Dec. 6, 2013). For a discussion on this issue see also Kenneth Corey-Edstrom, First Circuit Bucks Majority on Discharge of Unlisted Debt in No-Asset Case, 28 AM. BANKR. INST. J. 58, n.1 (Nov. 1, 2009).

39 United States v. Soleto, 436 U.S. 268 (1978) (liability imposed for failure to pay over collected tax, which fits squarely within language making nondischargeable tax required to be collected or withheld).


41 See I.R.M. 5.9.1.1(2).

42 I.R.M. 5.9.1.4(4).

43 I.R.M. 5.9.1.4(4.a).

44 I.R.M. 5.9.1.4(5.a).

45 Id.

46 See I.R.M. 5.9.1.4(5) for a list of complex issues that Field will work.

47 FED. R. BANKR. P. 7004(d)(4); see Scott v. United States (In re Scott), 437 B.R. 376 (9th Cir B.A.P. 2010) (discussing how to serve the United States).

48 FED. R. BANKR. P. 9013.
21.1.2 Priority Tax Claims

All claims can be categorized as either secured or unsecured. If they are secured, they are given special treatment, as secured creditors are first in line for payment from the asset securing the creditor's lien. If claims are unsecured, their treatment will depend on whether the claim is a priority claim or a general claim. The priority claims are listed in section 507(a)(1)-(10) of the Bankruptcy Code. Most tax claims are listed in section 507(a)(8) of the Bankruptcy Code. If a claim is listed in section 507(a)(8) and not paid in full during the bankruptcy, it will not be discharged. This coupling of the priority and dischargeability rules leads to the three types of taxes discussed in ¶ 21.1.1.3.5. If a claim is not listed in section 507(a) of the Bankruptcy Code and is not secured through the filing of a NFTL that attaches to equity in the debtor's assets, it is a general unsecured claim.

As discussed above, within the ten classes of priority debt, the first priority claim is paid in full before the next claim is paid. For example, the first priority claim is for domestic support obligations, and it is paid before any other priority debt, including administrative expenses, which have second priority. If assets cannot pay a priority class in full, then the members of the class share in any available distribution pro rata.

Note: The priority given to taxes in section 507(a)(8) of the Bankruptcy Code reflects competing concerns faced by Congress. On the one hand, Congress felt it was important to grant priority status to taxes because of a host of restrictions imposed upon governments in securing their interests and in timely pursuing their claims. On the other hand, Congress did not want to overly burden general creditors since, as stated, it is from their proceeds that prioritized government claims are paid. In striking this balance, Congress generally did not give priority status to claims where the debtor's bad behavior in the tax setting caused tax liabilities, such as penalties, that might not otherwise have existed. Instead of giving liabilities for bad behavior priority status in the bankruptcy case that would have allowed them to receive distributions ahead of general unsecured claims, Congress excepted the liabilities for bad behavior from discharge making the debtor liable for them after the completion of the bankruptcy case.

A Chapter 13 plan cannot be confirmed unless it provides for full payment of priority debt. If the plan is completed, the debtor will not be liable for post-petition interest on the priority tax debt unless it is trust fund debt, or if the priority tax is simultaneously a nondischargeable tax.

21.1.2.1 Priority Tax Claims Other Than Eighth Priority Tax Claims

Section 507(a) of the Bankruptcy Code specifies ten classes of priority claims, and they are:
1. Payments for child support and maintenance, whether owed to the spouse or a governmental entity, and trustee expenses incurred in liquidating assets to pay those claims;

2. Administrative expenses;

3. Involuntary gap payments; 60

4. Certain wages;

5. Certain pension contributions;

6. Certain claims for farmers and fishers;

7. Certain consumer deposits;

8. Certain claims of governmental units;

9. Certain claims owed to governmental agencies by failed banking institutions; and

10. Claims arising from personal injury or death caused by driving, piloting, or boating under the influence of alcohol, drugs, or other substances.

Tax claims can arise in many of these categories. For example, post-petition taxes owed by the bankruptcy estate are an administrative expense. These arise as the trustee administers estate assets (e.g., from operating a business or selling an appreciated asset). There may be taxes due on the wages paid under the fourth priority. Even the first priority, which does not involve taxes per se, can involve the taxing authority, as the taxing authority may be charged with collecting a past-due support obligation. 61

21.1.2.2 Eighth Priority Tax Claims

Taxes in the eighth priority position of section 507(a)(8) of the Bankruptcy Code comprise the bulk of a debtor's outstanding tax liabilities. It not only includes amounts due the Service, but it also includes amounts due states and municipalities. Section 507(a)(8) of the Bankruptcy Code cuts a broad swath, encompassing most income, employment, and excise taxes, and all trust fund taxes, each controlled by different criteria.

21.1.2.2.1 Income and Gross Receipts Taxes

The eighth priority position includes income or gross receipts taxes for a taxable year ending on or before the date of the filing of the petition. 62

• For which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition--“the three-year rule;”

• That were assessed within 240 days before the date of the filing of the petition exclusive of any time period for which an offer in compromise was outstanding during that 240-day period plus 30 days and any time during which the automatic stay or a pending plan was in effect during that 240-day period plus 90 days--“the 240-day rule;” or
• Have not been assessed at the petition date, but are still assessable, other than taxes arising from unfiled and late-filed returns (where the late return is filed within two years of the date of the bankruptcy petition) and taxes arising from a fraudulent return or the willful attempt to evade or defeat tax—“not assessed but still assessable rule.”

The three-year and 240-day time periods may be stayed, plus an additional 90 days added onto the applicable period, if (1) the automatic stay or a pending plan is in place during that period and the taxing authority is prevented from collecting, or (2) the taxing authority is prohibited from collecting under applicable law because the debtor requested a hearing and an appeal of a collection due process action taken or proposed against the debtor. 63 There are two 90-day add-ons for automatic stays arising during the 240-day period. One is found within the 240-day rule, and the other is found in the flush language rules at the end of section 507(a)(8) of the Bankruptcy Code. 64

21.1.2.2.1.1 The Three-Year Rule

To determine whether an obligation is nondischargeable under the three-year rule, go back three years from the petition date and look forward into the future. Any return due date, taking into account extensions, arising after the date established by the three-year look back from the petition date, that can be “seen” as one looks into the future will mean that year is a priority obligation. Example: Assume a debtor filed a petition in bankruptcy on November 7, 2017. At the time the petition was filed there were outstanding income tax debts for the taxable years of 2012 through 2016 (and the taxable year ends on December 31 of each year). The debtor requested a filing extension to October 15 for each year and filed all returns by the applicable extended due date. Under sections 523(a)(1)(A) and 507(a)(8)(A)(i) of the Bankruptcy Code, the tax debts for 2012 and 2013 are Type 3 (nonpriority and dischargeable) because their extended due dates (October 15, 2013, and October 15, 2014) were more than three years before the filing (November 7, 2017). The income taxes for the years 2014-2016 are within the eighth priority and Type 1 (priority and nondischargeable).

The three-year period does not run during any time that the automatic stay or a bankruptcy plan is in place that prevents the taxing authority from taking collection action against the debtor. The automatic stay rule prevents a taxpayer from filing one bankruptcy, hiding in bankruptcy, dismissing the first case, and filing the second case in order to discharge the taxes because of elapsed time periods. If the three-year period stops running because of a prior bankruptcy filing, there is also a 90-day add-on to the three-year period. 65 Practice Tip: It is good due diligence to run a search of a client's social security number through the PACER (Public Access to Court Electronic Records) system to determine whether the client filed bankruptcy previously.

The three-year period is also suspended if the taxing authority is prohibited from collecting a tax because the debtor requested a hearing and appeal of any collection action taken or proposed. As with suspensions because of the automatic stay, if the three-year period is suspended, 90 days are added to the three-year period.

The Bankruptcy Code does not clearly define the meaning of the word “prohibited.” Does it mean partial prohibition or total prohibition? For example, section 6330(e)(1) of the Internal Revenue Code suspends levy activity during a collection due process hearing. Nonetheless, there is not a total ban on collection activity in section 6330 of the Internal Revenue Code, and the Service is still allowed to file a notice of tax lien or execute an offset or file a suit to foreclose its lien. 66 Also, jeopardy levies are allowed. Although this rule was clearly written (and the committee reports so indicate) 67 with the idea of tolling time periods for collection due process hearings, it is unclear whether the rule is effective as written. 68
The Service takes the position that offers in compromise do not suspend the three-year period. Likewise, an installment agreement does not suspend this period.

In cases converted from one chapter to another (e.g., Chapter 11 to Chapter 7), the conversion date does not change the date of filing, the commencement of the case, or the order of relief. Thus, in cases converted from one chapter to another, the three-year period is measured from the date the case is first filed.

**Example:** Assume the same facts as the above example except that the case was originally filed as a Chapter 11 bankruptcy on October 4, 2016, and that the November 7, 2017 date above was the date that the Chapter 11 case was converted to a Chapter 7 bankruptcy. On these facts, the taxes due for the years 2012 and 2013 would be eighth priority or Type 1 (priority and nondischargeable) because three years prior to the petition date is October 4, 2013, and the extended due dates are after October 4, 2013 (e.g., the extended due date for 2012 is October 15, 2013).

### 21.1.2.2.1.2 The 240-Day Rule

**Practice Tip:** The 240-day period rarely causes priority status for taxes that were reflected on a timely filed tax return, as such amounts are assessed shortly after the return is filed. More likely, the 240-day rule is applied to additional taxes the Service asserts as the result of an examination, since such amounts will be assessed much later in the process. When taxes are assessed other than through a timely filed return, you must carefully review the applicable account transcript to determine the precise day on which the assessment occurred. Do not rely on secondary sources; review and calculate from a transcript.

The critical element for purposes of the 240-day rule is the date the tax is “assessed.” The determination of the precise date of assessment is accomplished by reference to the specific federal, state, or local tax law. While the word itself is arcane, the concept of assessment usually anticipates some formal fixing of the tax liability.

**Practice Tip:** It should be clear that the priority (and dischargeability) rules are time and date sensitive. No tax-related bankruptcy petition should be filed without a thorough review of the taxpayer's tax history, viz., the account transcript. A practitioner with a power of attorney can order the tax history from the tax practitioner hotline, (866) 860-4259 or order it online through TDS (Transcript Delivery Service) from the e-services on www.irs.gov.

The 240-day period is adjusted as follows:

- It does not run for any time that an offer in compromise is pending or in effect during the 240-day period. In addition, 30 days is added to the 240-day period.

- The 240-day time period does not stop running until the offer is accepted for processing. The 240-day period restarts when the statute of limitations on collection is no longer stayed.

- It is not clear whether there are additional 30-day add-ons if more than one offer is made during the 240-day period. A literal reading of the statute would indicate there is only one add-on.

- The 240-day period also does not run for any time the automatic stay is in effect, plus 90 days. There appears to be a double add-on. This is because there are dual add-ons for invoking the automatic stay. One 90-day add-on is found in section 507(a)(8)(A)(ii)(II) of the Bankruptcy Code, and the other 90-day add-on is found in the flush language at the end of section 507(a)(8) of the Bankruptcy Code.
• The 240-day period will also be suspended for collection due process appeals requested by the taxpayer where collection is prohibited, plus 90 days.

In summary, the 240-day time period is stayed by certain events, and the events have different add-on periods. Collection due process appeals stay the 240-day period with a 90-day add-on; bankruptcy proceedings stay the 240-day period with a 180-day add-on; and offers in compromise stay the 240-day period with a 30-day add-on.

Example: Assume debtor timely files a 2013 income tax return and on April 15, 2014, the Service assesses the $40,000 tax liability reflected on the return. The debtor makes no payment on this liability. After an examination of the return, a deficiency assessment is made on December 2, 2015, of $50,000. The debtor files a petition in bankruptcy on April 7, 2018.

Under section 507(a)(8)(A)(ii) of the Bankruptcy Code, both the $40,000 assessment pursuant to the return and the $50,000 deficiency assessment are nonpriority or Type 3 (nonpriority and dischargeable), as 240 days expired before the bankruptcy petition was filed. (The three-year rule does not change the result.)

Example: Assume the same three facts as above except that the assessment was December 2, 2016, an offer in compromise (OIC) was filed on March 18, 2017, and was rejected on January 8, 2018. Since the 240-day period was suspended during the period the OIC was pending and for 30 days thereafter, the $50,000 deficiency assessment is Type 1 (priority and nondischargeable) even though the $40,000 automatic assessment is Type 3 (nonpriority and dischargeable). From December 3, 2016, to March 17, 2017, inclusive, there are 105 days. From January 9, 2018, to April 6, 2018, inclusive there are 88 days. This total of 193 days leaves the debtor substantially shy of the 240 (plus 30, or 270) days “‘that are needed.”

21.1.2.2.1.3 The Not Assessed But Still Assessable Rule

Taxes that have not been assessed and are still assessable receive priority treatment pursuant to section 507(a)(8)(A)(iii). For example, this rule applies to still assessable deficiencies because a case is pending in Tax Court or because of the execution of an open-ended waiver of the statute of limitation on assessment. Note, not all still-assessable taxes receive priority treatment. Any still-assessable tax that is due from (i) nonfiled returns, (ii) returns filed late but within two years of the petition date, and (iii) a fraudulent return or the taxpayer willfully attempted to evade or defeat the still-assessable tax will be nondischargeable and not receive priority treatment.

Example: Assume that the taxpayer in the first example under the 240-day rule did not consent to the assessment of the $50,000 deficiency. Instead, the taxpayer filed an action in the U.S. Tax Court, which is still pending on the date the bankruptcy petition is filed: April 7, 2018. The $50,000 deficiency, or whatever the amount the court determines, is in the eighth priority and Type 1 (priority and nondischargeable) since the statute of limitation on assessment permits its assessment after April 7, 2018.

Practice Tip: Carefully consider whether any provision to toll or extend the normal three-year statute of limitations exists. The three most likely situations where the statute might be longer than expected are (1) when the taxpayer executed a Form 872 or 872-A waiving the statute of limitations on assessment, (2) when a proceeding regarding the tax is brought before the Tax Court (section 6503 suspends the statute of limitations on assessment until the decision of the court is final), or (3) when a taxpayer omits from gross income an amount properly includible therein which is in excess of 25% of the amount of gross income stated on the return.

21.1.2.2 Nontrust Fund Portion of Employment Taxes and Sales and Use Taxes

The eighth priority rules for the nontrust fund portion of employment, excise, and sales and use taxes are simpler, being concerned only with the return's due date. The date the tax was assessed (the 240-day rule) and whether the tax is still assessable
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These taxes are included in the eighth priority if they relate to returns the due date of which was within the three-year period before the bankruptcy petition date. The three-year period is also extended for pending bankruptcy filings and collection due process appeals.

The nontrust fund employment taxes encompass only the employer's share of social security, railroad retirement, and unemployment insurance taxes. The trust fund amounts collected from employees or customers are covered separately in the next section. Be aware that the three-year lookback period for the quarterly returns of employment taxes will be the April 15th of the calendar year following the quarter for which the return is filed. For example, the three-year period for the first quarter 2018 employment taxes starts on April 15, 2019, even though the return for that quarter was due on April 30, 2018.

The concept of tax or not tax is brought most sharply into focus by the priority granted excise taxes. Determining the difference between an excise tax, penalty, and user fee can be tricky. An excise tax is a tax on an event or transaction, while a penalty is designed to punish a certain behavior. Excise taxes receive priority, but penalties do not. User fees are voluntary payments for a private benefit, while taxes are used for public purposes. User fees likewise do not receive priority. To illustrate, consider bridge tolls. Are they a user fee or a tax assessed to defray the cost of building the bridge? This matters because the penalties can be very large. Penalties on a tax are dischargeable while the penalties on a user fee are not.

In California, sales tax is considered collected from the seller not the buyer and is an excise tax and not a trust fund tax.

21.1.2.2.3 Trust Fund Portion of Employment Taxes and Sales and Use Taxes

Trust fund taxes are those federal, state, or local taxes that a debtor is required to withhold from another and collect on behalf of the taxing authority. For individuals the most common types of taxes covered by Bankruptcy Code section 507(a)(8)(C) are the responsible person penalty imposed under I.R.C. section 6672 and state and local sales taxes. Taxpayers with assessments for these types of trust fund taxes get little relief from bankruptcy because these taxes retain their priority status forever, meaning no time limit exists for moving these taxes out of the nondischargeable category.

For example, if the debtor were an employer, there would be a requirement to withhold from the earnings of employees and pay over to the taxing authorities both federal and state income tax withholdings, as well as the employees' contributions for social security taxes. If the taxpayer-debtor failed to satisfy this obligation by the time of the bankruptcy petition filing, the taxing authorities would hold eighth priority or Type 1 (priority and nondischargeable) tax claims against the bankruptcy estate. This is true regardless of the age of the obligation or the capacity in which the debtor is liable. For example, the debt is included in the eighth priority even if the taxes were collected from employees' paychecks seven years ago and the debtor was a sole proprietor (primary responsibility) or a nonactive partner in a general partnership (secondary responsibility). In a Chapter 11 of the corporation primarily liable for the unpaid trust fund taxes, the corporate debtor may be able to get language in the plan at confirmation that designates plan payments will go first to the trust fund portion of the unpaid taxes. This could greatly assist the responsible officer; however, the Service need not wait for payments from the corporate bankruptcy case and could seek to collect directly from the responsible individual.

21.1.2.2.4 Property Taxes

Property taxes are included within the eighth priority only if they were incurred before the filing of the bankruptcy petition and last payable without penalty within the preceding year. For example, if taxes were incurred against property three years prior to filing the bankruptcy petition, but a penalty were imposed against the outstanding taxes within the one-year pre-petition
period, the tax claim would still not be given priority. As section 502(b)(3) of the Bankruptcy Code disallows tax claims assessed against property of the estate in excess of the value of the estate's interest in the property, this priority is seen infrequently.  

21.1.2.2.5 Penalties

As to payment priority for penalties, only pecuniary loss penalties are given payment priority.  As there are no known federal pecuniary loss penalties, for all practical purposes, tax penalties do not receive payment priority.  In Chapter 7, pre-petition penalties are paid only before post-petition interest and the debtor.

21.1.2.2.6 Interest

Interest on tax claims, including secured claims, is paid at the applicable nonbankruptcy rate. Prepetition interest on unsecured pre-petition tax debt takes the same priority as the underlying tax.

As to post-petition interest on pre-petition taxes, the rules vary by bankruptcy chapter.

• In Chapter 7, post-petition interest continues to accrue but it receives the lowest payment priority, just above the debtor. If the tax is not discharged in bankruptcy, the debtor will emerge owing the tax, pre-petition interest, and all post-petition interest.

• In a Chapter 11 reorganization, if priority taxes are paid on a deferred basis, the payments must have a total value equal to the taxing authority's claim. Hence, interest on such claims must be paid from the plan's effective date. The rate used is the applicable rate under nonbankruptcy law. Interest is not required to be paid on nonpriority tax debt.

• Under a Chapter 13 plan, post-petition interest is not paid on unsecured pre-petition taxes. If the tax debt is discharged (i.e., all priority taxes save trust fund taxes and nondischargeable taxes that are priority taxes) then no post-petition interest is owed. If the tax is not discharged (i.e., taxes arising from nonfiled returns; late-filed returns within two years of the petition date; fraudulent return; willful intent to evade or defeat; and trust funds), then post-petition interest does accrue. It will be collectible from the debtor after the plan is completed, even if all pre-petition tax and interest is paid in full under the plan.

Practice Tip: When the Service seeks post-petition interest on nondischargable claims in a Chapter 11 or trust fund taxes in a Chapter 13, it can come as a shock to debtors who have been led to believe that making all of their payments in bankruptcy will eliminate their tax liability. If you have a client in one of these situations, be sure to alert them to the prospect that certain interest on nondischargable taxes may be collected from the debtor by the Service after the bankruptcy so that the bill from the Service does not come as a shock.

Footnotes

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49 See ¶ 21.1.4, infra.
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See ¶ 21.1.2.1, infra.


Some debtors have tried to reclassify tax debts as loans or some other type of obligation that will not receive the benefits under the bankruptcy code given to the Service. See, e.g., Bryan v. United States (In re Bryan), 2014-1 U.S.T.C. ¶ 50,198 (Bankr. N.D. Cal. 2014) (debtors argued that their liability to Service for home buyer's credit was a loan and not a tax; court disagreed).

See 11 U.S.C. § 101(14A) for the definition of domestic support obligation.

Debts incurred by the bankruptcy estate post-petition are administrative expenses, while debts incurred by the debtor pre-petition are claims.

11 U.S.C. §§ 507(a)(1) (domestic support obligations) and 507(a)(2) (administrative expenses).

H.R. Rep. No. 595, 95th Cong., 1st Sess. 190 (1977). Since the passage of the current Bankruptcy Code in 1978 the priority provision for taxes has moved from the sixth position to the eighth position. If you read cases or commentary on the Bankruptcy Code for cases filed between its inception in 1978 and the passage of the 1984 amendments, you will see the priority tax claims occupying position (a)(6).

11 U.S.C. §§ 507(a)(8)(A)(i), (ii), and (iii).

This language was added in 2005 to deal with the situation of the inability of the IRS to collect because of some action the debtor had taken. In striking the balance to give priority status to tax debts, Congress sought to allow priority for relatively recent taxes and forego priority for older taxes. In setting up the time frames it recognized that because of the deficiency procedures or certain collection rules, such as the automatic stay, the time frames could come and go without a meaningful opportunity for the Service to collect the taxes in those circumstances in which the debtor exercised certain rights. Congress extended the time frames in those situations. In the case of extending it for prior bankruptcy cases, the Supreme Court had already created judicial precedent for this by the time Congress got around to acting in 2005. See Young v. United States, 535 U.S. 43 (2002).

There are also special nondischargeability rules to prevent this tactic. See, e.g., 11 U.S.C. § 1328(f) (debtor cannot receive a discharge in Chapter 13 if, in the four years prior to filing the Chapter 13 case, the debtor filed a Chapter 7 case and received a discharge).

Reg. §§ 301.6330-1(g)(2)(A-G3); the suspension of the time period for a tax to retain its priority status caused by collection due process only applies to the collection due process cases involving levy under section 6330 and does not apply to collection due process cases involving liens under section 6320. See CCA 201152017 (Dec. 30, 2011).

Whether this interpretation is correct is unclear. By its terms, section 6320(c) makes the section 6330(e) collection suspensions arising from levies also applicable to collection due process hearings requested because of a lien filing. Section 6330(e) specifically references section 6330(a)(3)(B) and tolls collection periods arising during the 30-day period available to request a collection due process hearing. One might just as easily assume that if section 6330 applies to levies and suspends collection during the time period...
when the collection due process rights are pending, the same type of levy suspension applies to the 30-day period given to request a hearing after the notice of lien filing. See Reg § 301.6320-1(g) (“Effect of request for CDP hearing and judicial review on periods of limitation and collection activity”).


King v. Franchise Tax Board of Cal. (In re King), 961 F. 2d 1423, 1427 (9th Cir. 1992).


See United States v. Montgomery (In re Montgomery), 475. B.R. 742 (D. Kan. 2012) (more than one bankruptcy filing, only one 90-day add-on).


In practice, the Service has been adding only one 90-day period. Before filing, when determining whether a tax is dischargeable, the careful practitioner will add on two 90-day periods.

See In re Montgomery, 446 B.R. 475 (Bankr. D. Kan. 2011). Montgomery states affirmatively the rule that is being applied implicitly in the example, which is that you count only full days that the IRS has to collect and not partial days.

I.R.C. § 6501(e).

These additional tests are not relevant to employment and excise taxes because, with rare exception, these types of taxes do not require the Service to follow the deficiency procedures in order to assess and collect the tax. This makes the additional protections unnecessary.


I.R.C. § 6501(b)(2).


11 U.S.C § 523(a)(7) (penalties on taxes payable to a governmental unit potentially dischargeable; penalties on user fees payable to a government unit not mentioned). The issue of tax versus penalty was a central issue in National Federation of Independent Business v. Sebelius, 567 U.S. 519 (2012). In that case, for constitutional purposes, the Supreme Court found that the exaction for failure to comply with buying insurance under the new health care act was a tax even though labeled a penalty. But, for interpretation of the exaction, it should be treated as a penalty. See Bryan Camp, Is the Liability a Taxpayer Incurs under the Affordable Care Act for Failing to Obtain Insurance a Tax or a Penalty for Bankruptcy Purposes, Procedurally Taxing (Sept. 7, 2016), http://www.procedurallytaxing.com/is-the-liability-a-taxpayer-incurs-under-the-affordable-care-act-for-failing-to-obtain-health-insurance-a-tax-or-a-penalty-for-bankruptcy-purposes.

See Raiman v. State Bd. of Equalization (In re Raiman), 172 B.R. 933 (9th Cir. B.A.P. 1994) (discussing dischargeability of sales tax assessed against the debtor.).


But see Raiman v. State Bd. of Equalization (In re Raiman), 172 B.R. 933 (9th Cir. B.A.P. 1994) (California sales tax is not a trust fund tax; it is an excise tax on gross receipts).

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94 11 U.S.C. § 726(a)(4). In theory, interest might be viewed as a pecuniary loss penalty, as it compensates for the time value of money. See In re Garcia, 955 F.2d 16 (5th Cir. 1992) (pre-petition interest fits snugly within 11 U.S.C. § 507(a)(8)(G)). Actually, interest does not fit snugly here because there is no time limit in 11 U.S.C. § 507(a)(8)(G). If interest fit here, tax could be dischargeable, and the underlying interest would not be.
96 In re Garcia, 955 F.2d 16 (5th Cir. 1992); In re Larson, 862 F.2d 112 (7th Cir. 1988).
98 See Ward v. Bd. of Equalization of Cal. (In re Artisan Woodworkers), 204 F.3d 888 (9th Cir. 2000) (applying rule in Chapter 12).
101 The interest paid on priority debt is pre-petition interest and post-confirmation interest. The debtor does not pay interest from the petition date to the date of confirmation. For individuals, all preand post-petition interest is due on nondischargeable taxes whether paid through the plan or outside of plan payments. See Bruning v United States, 376 U.S. 358 (1964); In re Tuttle, 291 F.3d 1238 (10th Cir. 2002); and Ward v. Bd. of Equalization of Cal. (In re Artisan Woodworkers), 204 F.3d 888 (9th Cir. 2000) (also applying rule in Chapter 11).
102 Ward v. Bd. of Equalization of Cal. (In re Artisan Woodworkers), 204 F.3d 888 (9th Cir. 2000); In re Foster, 319 F.3d 495, 496 (9th Cir. 2003) (post-petition interest due on nondischargeable child support).
21.1.3 Nondischargeable Tax Claims

An adversary proceeding initiated by the filing of a complaint can be used to determine the dischargeability of debts. There is no time limit for the debtor to file the complaint, including after the case is otherwise closed. If no adversary proceeding is filed, the Service may determine that the taxes are dischargeable and after collecting the value of its lien on any exempt or abandoned property, release the liens and abate the tax.

Since the enactment of BAPCA, the discharge rules are much the same in Chapters 7 and 13.

21.1.3.1 Tax Claims in Chapter 7

Under section 523(a)(1) of the Bankruptcy Code, a tax debt will not be discharged in a Chapter 7 if the taxpayer committed any one of several “bad acts.” These bad acts include: (1) failing to file a return, (2) filing a return sufficiently late that it was filed less than two years before the debtor petitioned for bankruptcy relief, (3) filing a fraudulent return, or (4) acting in a manner to defeat the payment or collection of the tax. Though these bad acts are most frequently associated with income tax returns, discharge is denied on these facts for all taxes.

Note: In the unfiled and fraudulent return situations, one might believe their nondischargeability derives from the fact that they are eighth priority tax debts, since the statute of limitations in section 6501 makes the tax associated with those years still assessable. However, section 507(a)(8)(A)(iii) of the Bankruptcy Code specifically denies these liabilities priority status, even though they are nondischargeable: “... other than a tax of a kind specified in [sections] 523(a)(1)(B) or 523(a)(1)(C) [of the Bankruptcy Code] ...”

21.1.3.1.1 Unfiled Returns and Late Filed Returns—The “Two-Year Rule”

To avoid nondischargeability, the taxpayer must have filed returns. The word “return” is defined in a hanging paragraph found after section 523(a)(19) of the Bankruptcy Code. The first sentence of section 523(a)(4) reads as follows: For purposes of this subsection, the term “return” means a return that satisfies the requirement of applicable nonbankruptcy law (including applicable filing requirements).

The pressure points are the phrases “applicable nonbankruptcy law” and “applicable filing requirements.” In the federal tax code, applicable nonbankruptcy law is found in the Beard case. It is considered the applicable nonbankruptcy law as almost
all Tax Court and Bankruptcy Court cases have used its test to determine whether a document qualifies as a return. The four elements of the *Beard* test follow:

1. Does the document contain sufficient data to allow calculation of tax?

2. Does the document purport to be a return?

3. Does the document represent an honest and reasonable attempt to satisfy the requirements of the tax law?

4. Is the document signed under penalty of perjury?

The *Beard* test does not contain a timeliness requirement per se. Nonetheless, timeliness is absolutely a part of the consideration whether the taxpayer has made an honest and reasonable attempt to comply with the law.

The other pressure point is “including applicable filing requirements.” Some courts have interpreted this phrase to mean that a return must be timely filed for the tax on that return to be dischargeable. In other words, timeliness is an applicable filing requirement. Under this interpretation, the tax on a return filed one-day late is nondischargeable (the “one-day-late rule”). Courts that follow the one-day late rule essentially believe that “applicable filing requirements” overrides the *Beard* test, i.e., “applicable nonbankruptcy law.” The best-reasoned case in opposition argues that the one-day-late rule glosses over the importance of reading a statute in context with the words around it and the overall statutory scheme. When read in the context of the overall statutory scheme, the one-day-late rule makes no sense. The Service does not follow the one-day-late rule.

Section 523(a)(*) continues with a second sentence, which further fleshes out the definition of a return. Under the rules of the second sentence, a document is considered a return if (i) prepared pursuant to section 6020(a) or similar state or local law, (ii) it is a written stipulation to a judgment or it is a final order entered by a nonbankruptcy tribunal; but (iii) a document is not considered a return if prepared by the Service under section 6020(b). The goal was to allow discharge for the honest and cooperative taxpayer while denying discharge for those that were not.

Some comments are in order. Under section 6020(a), the Service may prepare a return for a person provided the person (i) discloses all information necessary for the preparation of the return and (ii) signs the return. This is an illusory provision, as returns are almost never prepared under section 6020(a). The provision regarding written stipulations or a final judgment was designed to resolve the controversy over whether Tax Court stipulations could be considered returns.

The final provision makes clear that returns prepared by the Service are not considered returns for the purposes of section 523(a)(1) of the Bankruptcy Code. This is true whether the return is filed under section 6020(b) or under the Service's deficiency procedures.

The Service prepares returns for the taxpayer so that it can assess tax. This is because the Service needs a return on file to make an assessment. When the Service does not have an income tax return on file, it prepares a substitute for return (SFR). The taxpayer is notified of the tax due on the SFR by a 30-day nonfiler letter. If the taxpayer does not respond, then, a 90-day letter is sent. The 90-day letter states that if the taxpayer does not contest the proposed deficiency by filing a petition in Tax Court, the Service will assess the proposed deficiency. This assessment, whether accomplished under the deficiency procedures or section 6020(b), is known as an SFR Assessment.

The Service takes the position that any return filed by the taxpayer after the SFR Assessment is not a return for the purposes of section 523(a)(1) of the Bankruptcy Code. It litigates this position ferociously, and it has had some success. Its primary argument is that the self-assessing tax system relies upon taxpayer cooperation and compliance with the law. A taxpayer that
makes the Service go through the SFR Assessment process has not made an honest and reasonable attempt to comply with the law.

The majority rule applies a subjective test to determine whether the document filed after the SFR Assessment should be considered a valid return. In determining whether the taxpayer made an honest and reasonable attempt to comply with the law under Beard, the subjective test goes beyond the four corners of the document and asks why the document in question was filed so late. Generally, the document is filed in response to collection activity of the IRS. As a result, there are no known cases holding that the subsequently filed document is a valid return under the subjective test.

One court applies an objective test and only looks to the four corners of the applicable document to determine whether an honest and reasonable attempt was made to comply with the law.

If the document is filed in a jurisdiction where the one-day-late rule applies, then, the question of subjective test versus objective test never arises. That is because any document filed after the due date is not considered a valid return.

In summary, the late-filed cases can be separated into four types. Below, the cases are presented in the order of most favorable to the taxing agency to most favorable for the taxpayer.

• Some jurisdictions follow the one-day-late rule. This is the IRS position.

• Some jurisdictions use a subjective test to determine if the document filed after the SFR Assessment is an honest and reasonable attempt to comply with the law. There are no known cases that apply the subjective test and find the subsequently filed documents to be a valid return.

• One jurisdiction uses an objective test to determine if the document filed after the SFR Assessment is an honest and reasonable attempt to comply with the law.

21.1.3.1.2 Fraudulent Returns

Section 523(a)(1)(C) of the Bankruptcy Code holds that the tax attributable to a fraudulent return is not dischargeable. Nondischargeability is the rule regardless of the age of the tax.

Normally, the fact that the Service believes a return was fraudulent is apparent because a fraud penalty would have been asserted in the Notice of Deficiency. However, merely because the government (1) did not assert fraud in the Notice or in a tax proceeding to determine the taxpayer's deficiency, or (2) settled the case without continuing to assert fraud, does not collaterally estop the government during the bankruptcy proceedings from arguing that the return was fraudulent. Likewise, a debtor may litigate the fraud issue in Bankruptcy Court even if fraud were agreed to in a tax dispute, unless it was a judicial decision on the merits entitled to res judicata.

21.1.3.1.3 Willful Attempts to Evade the Tax Obligation

Section 523(a)(1)(C) of the Bankruptcy Code provides that a tax is nondischargeable if the taxpayer willfully attempted to evade or defeat the tax obligation. This is the most frequently litigated bankruptcy-tax issue.
21.1.3 Nondischargeable Tax Claims, Effectively Representing Client Before New IRS...

The courts of appeal split on the applicable test. The Second, Third, Seventh, Tenth, and Eleventh Circuits use a two-part test. The government must prove a conduct requirement; i.e., evading or defeating tax; and a state-of-mind requirement; i.e., willfulness, to prevail. The Fifth Circuit uses the following three-part test when the debtor is financially able to pay: (i) debtor had a duty under the law; (ii) debtor knew of that duty; and (iii) debtor voluntarily and intentionally violated that duty. The Ninth Circuit imported the definition of willful injury from 11 U.S.C. § 523(a)(6) and Kawaauhau v. Geiger, 523 U.S. 57 (1998) into the definition of willful intent to evade or defeat tax under 11 U.S.C. § 523(a)(1)(C).

Practice Tip: Section 523(a)(1)(C) of the Bankruptcy Code denies discharge for tax debts that the taxpayer has willfully attempted to evade paying. This rule can cut a broader swath than the other nondischarge rules. The other provisions relating to priority and discharge are analyzed on a basis that is specific to the particular tax return in issue, such as whether the returns' due date is more than three years in the past. By contrast, this rule looks to the taxpayer's lifestyle and spending patterns from the point the tax liability is incurred and forward to the date of determination. As such, if a debtor were found to have violated this requirement, it is quite possible that discharge would be denied for all applicable years. The Service has been successful in obtaining a determination of nondischargeability where it can show nonpayment of taxes over a period of years coupled with purchases of items that have the appearance of luxury items. Conversely, if the debtor's nonpayment instead pairs with a subsistence lifestyle, the Service will generally not assert nondischargeability.

What constitutes “willful attempt to evade the payment or collection of the tax” turns on a combination of factors. Applicable factors can include recurrence of income understatements, implausible explanations, lack of records, asset transfers, circumstances under which the taxes arose, and the taxpayer's awareness of the situation. Furthermore, the level of conduct necessary to make a tax nondischargeable may change from panel to panel or from Circuit to Circuit. For example, in the Ninth Circuit, the government's burden is more difficult because it must prove the taxpayer intended to not pay the taxes. Common sense is an excellent guide. Can there be any doubt that the court would find the tax nondischargeable when the second sentence of the factual background describes where the debtor lives as follows: “on Amelia Island Plantation, a golfing resort community that offers amenities such as tennis courts, a spa, boutique-style shops, a golf club, and a grocery store.”

Practice Tip: Usually a debtor concludes the bankruptcy without a determination as to which tax debts qualified for discharge and which did not. The Service will make a determination at the time of discharge and send those accounts it believes were excepted from discharge back out for collection. Sometimes the Service makes an incorrect determination. When it does, the taxpayer can pay a filing fee, reopen the bankruptcy case, and ask the court to enjoin the Service from collecting. Taxpayers can also request damages related to the collection action.

21.1.3.1.4 Tax Fines and Penalties

Section 523(a)(7) of the Bankruptcy Code provides broadly that fines and tax penalties payable to a governmental unit are nondischargeable. Despite this language, there are two exceptions permitting discharge: (1) if the fines and penalties relate to a tax claim that is itself dischargeable, or (2) if the fines and penalties relate to a tax and the event giving rise to the penalty occurred more than three years before the filing of the petition in bankruptcy.

With respect to the first exception, penalties follow the treatment of the tax against which they are charged. If the tax is dischargeable, so is the penalty. If the tax is not dischargeable, neither is the penalty.
The second exception is different. Even if the underlying tax is nondischargeable, the penalty is separately discharged if it were imposed on a transaction that is more than three-years old when the bankruptcy petition is filed. The second exception subsumed the first. 127

**Example:** Debtor files a fraudulent 2016 return on April 15, 2017. The Service asserts a fraud penalty and the Tax Court finds in favor of the government on this issue. The tax is not dischargeable due to section 523(a)(1)(C) of the Bankruptcy Code. However, the fraud penalty is dischargeable if the debtor files a petition in bankruptcy after April 15, 2020. 128 If the debtor were only negligent in filing the return instead of fraudulent, a petition in bankruptcy filed after April 15, 2020, would discharge both the tax and the penalty.

### 21.1.3.1.5 Debts Incurred to Pay Nondischargeable Federal Taxes

Section 523(a)(14) of the Bankruptcy Code provides that any debts incurred by a debtor to pay outstanding federal taxes that would have qualified as nondischargeable tax debts under section 523(a)(1) of the Bankruptcy Code, are similarly nondischargeable. If the debt were incurred to pay local taxes, section 523(a)(14A) of the Bankruptcy Code similarly excludes the debt from discharge. The rule does not clarify what happens if the tax were nondischargeable when paid but dischargeable at the time of the bankruptcy filing. Also, this debt is dischargeable in Chapter 13. 129

**Practice Tip:** Do not have your client borrow money to pay off nondischargeable taxes. Like the preference rules, careful planning for bankruptcy is necessary to achieve the results a debtor will want. This chapter seeks to assist you to spot issues and not to make you a bankruptcy lawyer. If the facts suggest that bankruptcy might serve as a viable alternative for your client with significant tax debt, seek out a bankruptcy lawyer with specific experience in addressing tax issues and work with that lawyer prior to the filing of the bankruptcy petition.

### 21.1.3.2 Tax Claims in Chapter 13

Chapter 13 provides for a personal reorganization or repayment plan. The purpose of Chapter 13 is to encourage people to pay their debts instead of merely seeking a discharge. Chapter 13 is more flexible than Chapter 7. For example, payments to satisfy liens on property can be set at the property's confirmation date value, which means post-petition appreciation can be used to fund a plan. Payments can also be irregular to reflect seasonal earnings. The more powerful discharge for taxes was mostly eliminated by the BAPCPA, but Chapter 13 still contains a superdischarge for certain types of hold harmless divorce debt obligations, priority taxes paid by borrowing from another (e.g., by credit card), all tax penalties, and post-petition interest on priority tax obligations other than trust fund taxes and nondischargeable taxes that are also priority taxes.

To successfully complete a Chapter 13 plan, a debtor must do the following things:

- **Secured claims.** Pay all secured claims in full with interest. Payment in full can be accomplished in one of three ways, as the debtor can return the collateral to the secured creditor, cure any arrearages and maintain current payments, or pay the debt in full, whether in cash or by selling the collateral for the benefit of the creditor. Cure and maintain is not an available payment method for tax debts. Secured claims in Chapter 13 are discussed in more detail at ¶ 21.1.4.2.

- **Administrative expenses.** Pay all administrative expenses in full without interest. Included in this category are attorney's fees and trustee's fees. The trustee's fee cannot exceed 10%, and it is often considerably less.

- **Priority claims.** Pay all priority claims in full without interest. 130 The categories of priority claims are discussed in ¶ 21.1.2. Priority payments may be backloaded (i.e., they do not have to be made equally over the life of the plan). Holders of priority claims do not receive interest under the plan.
• **Required Payment to unsecured creditors.** Make a required payment to general, unsecured creditors equal to projected disposable income (a monthly concept) times the applicable commitment period, which is either 36 or 60 months depending upon whether the debtor's current monthly income is above (60 months) or below (36 months) the applicable median.  

Disposable income is current monthly income less expenditures necessary for support. The phrase “current monthly income” is a term of art that defines average pre-petition income for a period of six months prior to filing. It excludes some items that are considered taxable income (e.g., social security), and it includes some items that are not considered taxable income (e.g., regular gifts). Expenditures necessary for support are defined in great detail, and, to a large extent, the definition tracks the national expense standards issued by the Service. If the debtor's median income is below the applicable median, then the debtor is bound by reasonableness and not the Service standards. For example, the above-median debtor is allowed the following expenditures:

- Secured payments, including payments to cure and maintain;

- All priority debts, not just those payable inside 60 months;

- Service standard and other necessary expenses, and clothing and food can be increased five percent with documentation;

- Reasonable payments for dependents;

- Up to an additional $1,925 for school expenses as adjusted for inflation, if the expenses are reasonable and necessary;

- Documented energy costs above the Service standards; and

- Chapter 13 trustee's fee.

A debtor must pay projected disposable income into the plan, not disposable income. The word “projected” is a forward-looking concept and provides flexibility for trustees to deal with debtors who have fluctuating income. Otherwise, a six-month seasonal worker could file at the start of the work season and argue that current monthly income is zero based on the prior six months of inactivity. The Supreme Court stated as follows: A court taking the forward-looking approach should begin by calculating disposable income, and in most cases, nothing more is required. It is only in unusual cases that a court may go further and take into account other known or virtually certain information about the debtor's future income or expenses.

Courts are slowly resolving expense issues that have been open to debate. For example, the Supreme Court held that debtors without any current-ownership costs are not allowed an expense for car ownership. The same issue arises with housing expense. Yet another issue is the treatment of secured debt amortization if the debtor might relinquish the asset or if the lien will be stripped because it has no value. As to lien strip-offs, courts are not allowing the expense. Another common issue is whether a Chapter 13 debtor is permitted to make voluntary contributions to a retirement plan. The courts have taken three general approaches as follows: (a) voluntary contributions are permitted as long as the Debtor is proceeding in good faith; (b) voluntary contributions are never permitted in Chapter 13; and (c) voluntary contributions are permitted, but only if they are consistent with the debtor's pre-petition history of contributions. Projected disposable income was a phrase used in Chapter 13 prior to BAPCPA, and there is a substantial body of case law analyzing its meaning. For example, tax refunds were considered actual disposable income and not projected disposable income unless the trustee could show that the tax refunds
would be received regularly over the life of the plan. Note that if a debtor is strapped for cash, tax refunds can be applied voluntarily to the plan and make the plan more affordable for the debtor.

• **Liquidation Equivalent Distribution.** Pay creditors more than they would have received if Chapter 7 had been elected.

• **Good Faith.** Act in good faith in proposing the Chapter 13 plan and in making the plan payments. This good faith requirement places a watchful eye over the debtor, and it can be used by governmental entities to block plan confirmation. Factors considered by a court when the good faith argument is made include (1) debtor's accuracy in stating debts and expenses; (2) debtor's honesty throughout the bankruptcy process; (3) whether the Bankruptcy Code is being unfairly manipulated; (4) type of debt sought to be discharged; (5) whether the debt is nondischargeable in Chapter 7; and (6) debtor's motivation and sincerity in seeking Chapter 13 relief. The percentage payment to creditors should not be a factor in determining good faith, although failure to accurately compute the required payment could be.

• **Miscellaneous.** For a debtor to qualify for Chapter 13, the debtor's noncontingent, liquidated unsecured debts cannot exceed $394,725 as adjusted for inflation every three years, and the debtor's noncontingent, liquidated secured debts cannot exceed $1,184,200, as adjusted for inflation every three years.

Under section 1308, a debtor must file tax returns for the four most recent tax years ending on or before the petition date. These returns will report income due for the priority taxes under section 507(a)(8)(A)(i). A plan cannot be confirmed unless these returns are filed.

Confirmation of the plan binds the debtor and each creditor to its provisions. Unlike a Chapter 11 confirmation order, the confirmation order in a Chapter 13 case does not act as a discharge. A Chapter 13 discharge is granted after the plan is completed.

The tax discharge in Chapter 13 is very similar to the tax discharge in Chapter 7. A Chapter 13 debtor cannot discharge trust fund taxes, taxes arising from non-filed and late-filed returns within two years of the petition date, taxes arising from a fraudulent return, and taxes that the debtor willfully attempted in any manner to evade or defeat. (Other nondischargeable claims include domestic support obligations; student loans; criminal restitution; civil restitution if the claim arose from a willful or malicious injury; and claims arising from driving, piloting, or boating under the influence of drugs or alcohol.) Furthermore, a discharge in Chapter 13 is not available for any debtor who filed a Chapter 7, for which a discharge was granted, within four years of the filing of the current bankruptcy case. Notwithstanding, there are still situations where Chapter 13 provides a better discharge than Chapter 7. A Chapter 13 discharge is available for tax penalties, priority taxes paid by borrowing from another, and hold-harmless divorce obligations. The only priority and nondischargeable Chapter 7 tax that is specifically denied a discharge is the trust fund tax. This means that post-petition interest will run on trust fund taxes that are otherwise paid through a Chapter 13 plan, but it will not run on any of the other priority and nondischargeable taxes (e.g., taxes captured by the three-year rule of section 507(a)(8)(A)(i) of the Bankruptcy Code) unless those taxes are also nondischargeable and nonpriority.

If the debtor fails to complete payments under the plan, a “hardship” discharge may be granted if modification of the plan is not practicable, default is beyond the control of the debtor, and the creditors have already been paid under the plan as much as they would have received under Chapter 7. A hardship discharge relieves the debtor only from debt that would otherwise have been nondischargeable under Chapter 7.
Four other rules are worthy of note. First, the filing of a Chapter 13 petition operates as a stay not only as to the debtor, but also as to any codebtors on consumer debt (tax debt is not consumer debt) unless the codebtor was liable on or secured the debt in the ordinary course of the codebtor's business.  

Second, post-petition tax creditors may file a proof of claim and elect to have the post-petition tax debt treated as a pre-petition claim. Section 1305 does not clarify how the deemed pre-petition tax is entitled to payment priority, as it does not fit into any category of section 507(a)(8) of the Bankruptcy Code. In practice, taxing authorities seldom use this rule.  

Third, claims can be contested in Chapter 13, which a Chapter 7 court might otherwise abstain from hearing. Under Section 505(a) of the Bankruptcy Code, the grant of power to hear a dispute regarding the amount of the tax is permissive. Courts routinely decline jurisdiction in no-asset cases because the amount of the tax has no bearing on the case. In Chapter 13, the amount of the claim must be known so that distributions to all creditors can be calculated. For example, a questionable trust fund assessment can be litigated in Chapter 13.  

Fourth, one of the hallmarks of the BAPCPA was removing super discharge powers of Chapter 13 as to taxes. This has created puzzling ambiguity. To illustrate, assume (i) a Chapter 13 petition date of 1/1/18, (ii) applicable tax law year of 2015, and (iii) filing of 2015 tax return on 3/1/17. In Chapter 7, taxes on the 2015 return are both priority and nondischargeable because it is less than three years old, but also nonpriority and nondischargeable because the tax return was filed late within two years of the petition date. There is no ambiguity in Chapter 7 because under either scenario the tax is non-dischargeable, and so survives the bankruptcy. In contrast, in Chapter 13, priority claims must be paid in full, without interest, under Bankruptcy Code section 1322(a)(2). Nondischargeable claims accrue post-petition interest, which must be paid after conclusion of the bankruptcy plan. In Chapter 13, if the three-year rule is applied, the tax is dischargeable under section 1328(a)(2), and a priority debt under section 507(a)(8)(A)(i). Yet, if the late-filed rule is applied, the tax cannot be discharged, but is not a priority debt.  

Can the Service double dip? Can it assert the benefit of the priority tax treatment—which requires full payment without interest—yet still argue that the tax is not dischargeable pursuant to sections 523(a)(1)(B)(ii) and 1328(a)(2), in order to collect post-petition interest? The practitioner who wants to challenge the double dipping should add language to the Chapter 13 plan providing that, if the Service wants payment priority, the debt will be discharged. This addresses the issue head-on. If the Service does not object to the plan and it is approved with payment priority, the Service is bound by that treatment.  

Even though BAPCPA limited the discharge in Chapter 13, there are still times when a Chapter 13 filing will help a debtor. Chapter 13 is useful in the following situations:  
• Chapter 13 can be used to cure mortgage arrearages and prevent foreclosure.  
• It discharges priority taxes paid for with a credit card pursuant to section 523(a)(14) of the Bankruptcy Code, provided the original intent was to pay the card in full.  
• It discharges certain types of hold harmless divorce obligations set forth in section 523(a)(15) of the Bankruptcy Code.  
• It discharges all types of tax penalties, except the trust fund recovery penalty, which is treated as a tax and not a penalty.  
• Priority and nondischargeable tax obligations other than trust fund taxes and taxes that are both priority taxes and nondischargeable taxes can be paid without post-petition interest being incurred. The tradeoff is the cost of the trustee's fee versus the savings from no interest accruing.  
• As to most secured debt, Chapter 13 effectively caps the payment to the secured creditor at the plan confirmation value and allows the debtor to benefit from post-petition appreciation.
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- Repayments of pension plan loans reduce the required payment to unsecured creditors. 173

Footnotes

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FED. R. BANKR. P. 4007, 7001-04.

103 The hanging paragraph is cited as 11 U.S.C. § 523(a)(*).

104 The hanging paragraph is cited as 11 U.S.C. § 523(a)(*). See CC-2010-16 at 2 (“the supposed ‘safe harbor’ of section 6020(a) is illusory”); and Wogoman v. IRS (In re Wogoman), 475 B.R. 239, 249 (10th Cir. B.A.P. 2012) (citing CC-2010-16 with approval and acknowledging the Service’s statement that relief under section 6020(a) is illusory because it prepares returns under section 6020(a) “in only a minute number of cases”).

110 United States v. Hindenlang (In re Hindenlang), 164 F.3d 1029 (6th Cir. 1999).

111 Giacchi v. United States (In re Giacchi), 856 F. 3d 244 (3d Cir. 2017); Smith v. United States (In re Smith), 828 F.3d 1094 (9th Cir. 2016); Justice v. United States, 817 F.3d 738, 743 (11th Cir. 2016) (explicitly). The phrases “subjective test” and “objective test” are adopted from United States v. Martin (In re Martin), 542 B.R. 479, 482 (9th Cir. B.A.P. 2015) (analysis of the bankruptcy court was objective).

112 Colsen v. United States (In re Colsen), 446 F.3d 836 (8th Cir. 2006).

113 McCoy v. Miss. State Tax Comm’n (In re McCoy), 666 F.3d 924 (5th Cir. 2012); Mallo v. IRS (In re Mallo), 774 F.3d 1313 (10th Cir. 2014); and Fahey v. IRS, 779 F.3d 1 (1st Cir. 2015). This is also the position of Judge Easterbrook in his Payne dissent. In re Payne, 431 F.3d 1055, 1060 (7th Cir. 2005) (Easterbrook, J., dissenting).

114 Id.

115 United States v. Hindenlang (In re Hindenlang), 164 F.3d 1029 (6th Cir. 1999).
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See cases cited supra, note 111

See, e.g., *In re Carapella*, 115 B.R. 365 (M.D. Fla. 1990), aff’d, 925 F.2d 1474 (4th Cir. 1991) (mem.). See also Levinson v. United States, 969 F.2d 260 (7th Cir. 1992) (illustrates that even if the Service concedes the fraud penalty in a civil fraud case, it can still assert fraud for discharge purposes and is not barred by res judicata because the decision in the civil tax case was not a decision concerning discharge). The general principles on this issue are captured in two Supreme Court cases that do not involve taxes. See *Brown v. Felson*, 442 U.S. 127 (1979) and *Archer v. Warner*, 538 U.S. 314 (2003).

Graham v. Internal Revenue Service, 973 F.2d 1089 (3d Cir. 1992); Palmer v. United States (In re Palmer), 207 F.3d 566 (9th Cir. 2000) (debtor not estopped where prior fraud judgment was deemed admitted rather than actually litigated); See also *In re Sigerseth*, 2014-1 U.S.T.C. ¶ 50,210 (Bankr. N.D. Cal. 2014).

Tudisco v. United States (In re Tudisco), 183 F.3d 133, 137 (2d Cir. 1999); United States v. Fegeley (In re Fegeley), 118 F.3d 979 (3d Cir. 1997); *In re Birkenstock*, 87 F.3d 947 (7th Cir. 1996); *Dalton v. IRS*, 77 F.3d 1297 (10th Cir. 1996); and *Griffith v United States* (In re Griffith), 206 F.3d 1389 (11th Cir. 2000); *Stamper v. United States* (In re Gardiner), 360 F. 3d 551 (6th Cir. 2004).

Bruner v. United States (In re Bruner), 55. F.3d 195 (5th Cir. 1995), and United States v. Conlet, 689 F.3d 365, 374 (5th Cir. 2012).

Hawkins, III v. Cal. Franchise Tax Bd., 769 F.3d 662 (9th Cir. 2014).

See United States v. Schmidt, 118 A.F.T.R.2d 2016-6895 (E.D. Wash. 2016) (court applied Hawkins test and found government did not meet its burden to prove the taxpayers willfully intended to not pay their taxes).


United States v. Jacobs (In re Jacobs), 490 F.3d 913, 916 (11th Cir. 2007). A list of cases can be found in Kenneth Weil, *Taxes and Bankruptcy*, ¶ 645 (CCH Intelliconnect Service) (online only) (3d. ed. 2014).

See Memorandum from Division Counsel, Small Business/Self-Employed Division to Analyst, Collection Policy, Insolvency, PMTA-2011-026 (Apr. 13, 2011) for a discussion of the balancing the Service does in making these decisions. With respect to holding the Service liable for violating the discharge injunction see, e.g., *In re Murphy*, 113 A.F.T.R.2d 2014-208 (Bankr. D. Me. 2013) leave to appeal denied, 554 B.R. 533 (D. Me. 2014). For further discussion see 2 Rep. Bankr. Taxpayer § 10:93. The damage provisions are in sections 7430 and 7433. These provisions have detailed and cumbersome rules that courts have enforced strictly. Obtaining a damage award requires attention to detail and perseverance.

If the penalty were with respect to a pecuniary loss sustained by the government, it would be treated as an eighth priority tax debt. 11 U.S.C. § 523(a)(8)(G). As such, it is not dischargeable due to the general rule of 11 U.S.C. § 523(a)(1) precluding discharge for eighth priority debts.

*McKay v. United States*, 957 F.2d 689 (9th Cir. 1992); *Roberts v. United States* (In re Roberts), 906 F.2d 1440 (10th Cir. 1990); *Burns v. United States* (In re Burns), 887 F.2d 1541 (11th Cir. 1989).

Id.

11 U.S.C. § 1328(a)(2) (Bankruptcy Code section 523(a)(14) is not one of the listed exceptions). Beware. Even if the client charges the tax debt and pays the credit card bill timely, the debt may still be nondischargeable. This is because the credit card company is likely to use a FIFO system to allocate the payment. In other words, the credit card company will argue that an earlier debt was paid and not the tax debt.


11 U.S.C. § 1325(b)(2). The bankruptcy rules of procedure contain special forms designed to assist in making these calculations. In addition, any reputable bankruptcy filing software program will have a form that can be used.


A full discussion of the differences between the Service standards and the allowable bankruptcy expenses is beyond the scope of these materials. For example, the Service sets limits on housing standards, but the Bankruptcy Code allows full housing costs if the house payment is made in the form of an amortized, secured debt payment to a secured creditor. 11 U.S.C. § 707(b)(2)(A)(iii)(I). See Kenneth Weil, *Taxes, Liabilities and Bankruptcy* at ¶ 525.06, 910, and 920 (CCH 3rd ed. 2014) for a more in-depth discussion.
of these rules. For a broader discussion of the issues presented when Congress imported the financial standards from the Internal Revenue Manual into the Bankruptcy Code, see Matthew Stephenson & Kristin Hickman, The Administrative Law of Borrowed Regulations: Legal Questions Regarding the Bankruptcy Law's Incorporation of IRS Standards, 1 Norton Bankruptcy Law Advisor 1 (Jan. 2008).

In Chapter 7, a debtor is entitled to take the full amount of the National and Local standards if the debtor incurs an expense in that category, even if the actual expenses are less than the standardized amounts. Lynch v. Jackson, 853 F.3d 116 (4th Cir. 2017); In re Christianson, 2015 WL 4761265 (Bankr. D. Or. Aug. 12 2015) (in Chapter 13, if debtor incurs expense for an allowable item, then the debtor may use the full amount provided for in the Service standards). Contrast this to the Service's administrative collection's practices, which in certain categories only allow for the lesser of the standard amount and the actual expense. See, e.g., I.R.M. 5.15.1.9(1b) (car ownership expense).


Id. at 519.


Compare In re Farrar-Johnson, 353 B.R. 224, 230-231 (Bankr. N.D. Ill. 2006) (debtors entitled to housing expense even though they did not have a housing expense because they lived in military housing), with In re Rezentes, 368 B.R. 55, 61-62 (Bankr. D. Hawaii 2007) (actual expense, which was lower than the Service standard, allowed). See also In re Christianson 2015 WL 4761265 (Bankr. D. Or. Aug. 12 2015).

In re Turner, 574 F.3d 349 (7th Cir. 2009) (not allowed); American Express Bank, FSB v. Smith (In re Smith), 418 B.R. 359 (9th Cir. B.A.P. 2009). Judge Posner warned judges not to engage in speculation about future income or expenses; but, “in this case, there is no speculation” as it was clear the secured debt would disappear before confirmation. Turner, 574 F.3d at 356.


In re Seafort, 669 F.3d 662 (6th Cir. 2012).

Anderson, Jr. v. Satterlee, Jr. (In re Anderson, Jr.), 21 F.3d 355 (9th Cir. 1994) (debtor required to pay projected disposable income, not actual disposable income); In re Schiffman, 338 B.R. 422, 430 (Bankr. D. Or. 2006) (if debtor receives substantial tax refunds during life of Chapter 13 plan, absent contrary evidence, the debtor is likely overwithholding, and such receipts should be included in future income); Itule v. Heath (In re Heath), 182 B.R. 557 (9th Cir. B.A.P. 1995) (tax refund treated as not probable unless trustee can show debtor has consistently received a tax refund with similar income and withholding); In re Abner, 234 B.R. 825 (Bankr. M.D. Ala. 1999) (same).

Profit v. Savage (In re Profit), 283 B.R. 567, 574 (9th Cir. B.A.P. 2002); Midkiff v. Stewart (In re Midkiff), 342 F. 3d 1194 (10th Cir. 2003) (tax refunds pledged to plan; tax refund for 2000 accrued before case closed, but paid after trustee closed case; held, bankruptcy court could vacate discharge order so refund could be distributed to creditors); see Freeman v. Schulman (In re Freeman), 86 F. 3d 478 (6th Cir. 1996) (where debtor pledged tax refunds as part of plan, larger than expected tax refund had to be paid to trustee as part of debtor's disposable income).


See In re Smith, 286 F.3d 461, 468 (7th Cir. 2002) (“percentage repayment is a function of the size of the debt relative to the debtor's anticipated earnings; this factor is not relevant to determining whether the debtor has acted in good faith”).


Espinosa involved student loans rather than taxes but the same or similar issue can arise with respect to taxes when the plan says one thing and the Service later wants different treatment. This can get tricky because Chapter 13 plans get confirmed very quickly and sometimes the Service has little or no way to know of prepetition derivative liabilities of a debtor such as the liability under section 6672. A couple of cases illustrate the problems the Service can have here. See In re Hamilton (Bankr. D. Mont. 2014) In Hamilton, the Service misapplied plan payments where the plan scheduled the section 6672 liability but the Service did not assess until after confirmation. The payments received prior to assessment were sent to Michigan to satisfy child support obligations pursuant to the offset provisions of section 6402. Only after the assessment of the section 6672 liability did payments get posted correctly. See also United States v. Bond and United States v. Bond, 2013-2 U.S.T.C. ¶ 50,574(E.D.N.Y. 2013) (res judicata effect of plan did not prevent the Service from exercising its offset rights not discovered until after confirmation).

But see 11 U.S.C. § 1141(d)(5) (discharge in individual Chapter 11 occurs upon plan completion, unless debtor requests discharge sooner).

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21.1.4 Secured Tax Claims, Effectively Representing Client Before New IRS 21.1.4

Secured nontax creditors are entitled to distribution in order of their secured status; that is the secured creditors are entitled to the collateral or proceeds from the collateral in the order of their secured status prior to anyone else. To the extent the total amount of the secured debt is greater than the value of the collateral, the lowest secured creditor is undersecured. In this situation, the balance of the debt is treated as an unsecured, general claim. To the extent the reverse is true (i.e., the value of the collateral exceeds the total amount of all secured claims), the creditors may take the proceeds from the sale of the assets to the extent of the debt plus post-petition interest.

Secured tax creditors are treated very differently. Tax claims are secured if the taxing authority filed a Notice of the Federal Tax Lien (NFTL) in the appropriate recording office pursuant to section 6323, or otherwise perfected its claim, before the petition date. In a Chapter 13 bankruptcy, the debtor must repay the government an amount equal to the retail sales value of the property securing the debt (without a reduction for selling expenses), plus interest that accrues during the repayment period. In exchange, the government must release the lien as to the balance. Pre-petition penalties and interest are classified as either secured or unsecured in the same manner as the underlying tax based on the value of the collateral.

In a Chapter 7, the secured government creditor is entitled to payment after the creditors in the first seven priority positions. To the extent the underlying debt is not paid and not discharged, the lien remains in force after the debtor receives a discharge. In a Chapter 7, pre-petition nonpecuniary loss penalties, such as late filing or late payment and accuracy-related penalties, are never accorded secured status regardless of the status of the underlying tax. Pre-petition interest, on the other hand, tracks the underlying tax.

**Practice Tip:** Know the lien filing rules in your jurisdiction. If the lien is not properly noticed, filed in the wrong place or with the wrong name, the lien can be avoided. Sometimes the Service may have a lien against the real property but not against the personal property because the state rules may require two separate filing locations. If you discover that a NFTL is filed in the wrong place, it is a good idea to call the Insolvency Specialist listed as the contact on the filed proof of claim and ask that the claim be amended and treated as unsecured; i.e., point out the incorrect lien filing. Most will agree to amend the proof of claim and a motion objecting to claim will be unnecessary.

**Example:** Debtor owes a mortgage company $75,000 on a parcel of real estate. The debtor owes the Service $100,000, all of which is subject to a NFTL properly filed by the Service after the mortgage was recorded. The only asset the taxpayer has is the parcel. If the value of the taxpayer's real estate is $120,000, the Service lien is secured to the extent of $45,000 ($120,000 value of property - $75,000 first mortgage = $45,000 equity for FTL to attach) and unsecured for $55,000 ($100,000 amount
of tax obligation - $45,000 secured portion of claim). If the real estate is worth $60,000, the entire tax debt is unsecured as is $15,000 of the amount due to the holder of the mortgage.

**Practice Tip:** If a secured tax debt is paid in full, or otherwise avoided, make sure the Service (Insolvency Section) takes the necessary steps after the conclusion of the bankruptcy proceedings to file a Form 6682 (Certificate of Release of Tax Lien).  

**Practice Tip:** The credit reporting companies are notoriously behind the curve on clearing an individual's credit report because of released liens. This problem is so widespread, effective July 1, 2017, credit reporting firms are no longer including information about tax liens or civil court judgments in credit reports unless those records include a name, an address, and a social security number or date of birth to match them to a specific consumer file. LexisNexis Risk Solutions estimates that half of all tax liens (and 96% of all civil judgments) do not meet these new identification criteria. To be safe, after a couple of months, it is wise to follow up with the credit reporting agencies, (Experian, Equifax, and Transunion) or the appropriate lien filing records to check that the liens are removed. If necessary, file the Certificates of Release with all of them. It may also be beneficial to request the Service to withdraw the NFTL after release. See the discussion in Chapter 11 (Federal Tax Liens).

Experian

P.O. Box 2002

Allen, TX 75013

1-800-397-3742

http://www.experian.com/consumer/index.html

Transunion Corporation

P.O. Box 2000

Chester, PA 19016-2000

1-800-888-4213

http://www.transunion.com/Personal/PersonalSolutions.asp

Equifax Credit Reporting Agency

P.O. Box 740241

Atlanta GA 30374

1-800-685-1111

https://www.econsumer.equifax.com/equifax.app/Welcome

21.1.4.1 Secured Tax Liens in Chapter 7
21.1.4.1 The Surviving Tax Lien

If the Service has filed a NFTL to secure outstanding tax obligations, the amount of relief a Chapter 7 liquidation provides the debtor is limited. While a Chapter 7 discharge provides the debtor with relief from personal liability (in personam liability) it does not affect the validity of the tax lien (in rem liability). To the extent the debtor emerges from bankruptcy with exempt, nonexempt, or abandoned property that was subject to a NFTL, the NFTL will survive the bankruptcy and will be enforceable against such property. Normally, at the conclusion of a Chapter 7 case, the Service abates the assessments on its books for discharged taxes. Be aware, however, that such an abatement does not erase the tax liability or the lien and if the Service later decides it can collect from exempt or abandoned property (or discovers other property that may not have been included in the debtor's schedules) it may simply reverse the abatement to account for later collection. In addition to abating the assessment on its books, the Service often files a certificate of release under section 6325(a). If the Service files a lien release, then the property is free of the tax lien until such time as the Service reinstates the lien pursuant to section 6325(f)(2). Reinstatement of the lien is not retroactive.

Practice Tip: The impact of a NFTL can be great. For example, assume a debtor in bankruptcy owned a house, a retirement plan and an Individual Retirement Account (IRA). To some degree, depending on the state in which the person is domiciled, all or a part of these assets would be exempt or excluded from the bankruptcy estate. If the debtor received a discharge of all tax debts and no NFTL had been filed prior to bankruptcy and the assets were not exempted in the bankruptcy, the IRS may still hold a lien claim at the conclusion of the bankruptcy. If the NFTL were filed prior to bankruptcy, pursuing the assets after bankruptcy is much easier for the Service. The most controversial issue surrounds ERISA plans. The Service takes the position that ERISA plans cannot be included in the bankruptcy estate and the secret lien remains after the bankruptcy. Those that believe ERISA plans can be included point to the permissive language in Patterson v. Shumate, which says that ERISA plans may be excluded from the bankruptcy estate, not shall be excluded. The Ninth Circuit bought this argument in Rains v. Flinn (In re Rains), which found an ERISA plan could be included in a Chapter 7 case. To date, the issue has not been framed properly. In two Tax Court cases, the debtors waffled on whether they were including the ERISA plan in the bankruptcy estate, and, the Tax Court found they were not included. Thus, the secret lien remained attached to the ERISA plan.

The surviving tax lien securing a discharged debt is enforceable only against the property that secured the tax claim at the time the petition was filed; it does not attach to, nor is it enforceable against, any post-petition property acquired by a debtor. If, however, a portion of the tax claim is neither discharged nor paid, the surviving tax lien attaches to all post-petition property and rights to property of the debtor.

21.1.4.1.2 The “7-1/2 Priority” Status

In a Chapter 7, secured tax claims enjoy a unique priority in the distribution order. Section 724(b)(2) of the Bankruptcy Code provides that the unsecured priority claimants listed under sections 507(a)(1) through 507(a)(7) of the Bankruptcy Code are paid before the secured tax claimants.

Thus, secured tax claims have a priority between the normal seventh and eighth priority debts and, as such, are sometimes called the “7-1/2 priority” claims.

Subordinating the secured tax claim to the unsecured priority creditors in the first seven priority positions prevents the tax claim from depleting the bankruptcy assets, and makes payment to the first seven priority unsecured creditors more likely. The amount of the proceeds from the liquidation of the property to which these claimants are entitled is limited to the amount of the allowed secured tax claim because allowing unsecured creditors to take from any private secured creditor would create
constitutional problems. Congress sought to aid the group of priority creditors but only at the expense of the government and not other secured creditors.

If the total amount of the priority claims that are ahead of the tax claim is less than the amount of the allowed secured tax claim and if there is money remaining from the proceeds of the encumbered property after paying those claims and the secured tax claim has not been satisfied in full, the secured tax claimant and junior secured claimants are entitled to receive the excess, respectively in that order. This limitation preserves the expectation of secured claimants that are junior to the secured tax claims. Thus, secured claims junior to the tax claimant are paid what they would otherwise have received and remain unaffected by the use of the IRS secured claim to satisfy certain priority creditors. If all of the junior secured creditors receive payment and funds remain, the secured claim of the Service then receives payment followed by the eighth priority claims and those below.

**Example:** Assume that at the time a debtor files a petition for relief under Chapter 7 of the Code, the debtor's primary asset is a parcel of real property, which has an estimated value of $100,000. There is a $80,000 mortgage against the debtor's property, an outstanding tax lien to secure the payment of $15,000 in unpaid federal taxes, as well as a junior equity mortgage to secure an outstanding loan for $4,000. Administrative expenses incurred in the sale of the property were $1,000, and there are outstanding alimony and child support payments against the debtor for $5,000. These two unsecured claims qualify as priority claims under sections 507(a)(1) and (7) of the Bankruptcy Code, respectively. There are general unsecured claims valued at $50,000.

Pursuant to section 724(b) of the Bankruptcy Code, the $100,000 of proceeds from the sale of the property would be distributed in the following order:

- First, $80,000 would be paid to the senior mortgage holder because of its secured status.
- Next, $6,000 would be paid for administrative expenses ($1,000) and alimony and child support payments ($5,000) as priority debts in the third and first positions, respectively, under Bankruptcy Code section 507(a).
- Next, $9,000 would be paid to the taxing authority with respect to the secured tax claim. (Although there would be $14,000 remaining from the proceeds of the liquidated property, under section 724(b), the secured tax claimant would only be entitled to receive the value of its secured tax claim ($15,000) less the amounts paid to the first seven priority claimants ($1,000 + $5,000), or $9,000.)
- Next, $4,000 would be distributed to the junior equity mortgage holder to pay the equity loan that was secured by the property.
- The remaining $1,000 would be paid to the taxing authority with respect to its secured tax claim. (Since all of the proceeds from the encumbered property have been exhausted, the tax claim would remain unpaid to the extent of $5,000 and the general unsecured claimants would receive nothing. To the extent the tax claim remains unpaid, it is unsecured and will be treated according to the bankruptcy rules governing unsecured tax claims. Depending on the tax involved, this may put it into the eighth priority or into the general unsecured creditor pool.)

**Example of Chapter 7 distribution with no secured claims:** Assume a trustee has $500,000 in assets to pay off the debtor's unsecured liabilities. Priority debts under sections 507(a)(1)-(7) of the Bankruptcy Code total $200,000. The debtor owes $300,000 in trust fund taxes and $400,000 in dischargeable income taxes. The debtor owes $100,000 in nontax general unsecured claims.

The trustee would distribute $200,000 to the priority debts under sections 507(a)(1)-(7) first. Then, the trust fund taxes of $300,000 would be paid in full in the eighth priority. Because the trustee has no money left, the remaining taxes will be discharged without payment as well as the nontax general unsecured claims, the debtor will not owe any taxes upon emerging from the bankruptcy and the nontax general unsecured claims will disappear as well (absent an exception to discharge.) The debtor has a true fresh start, save for the post-petition interest on the trust fund tax.
Example of Chapter 7 distribution with secured tax claims and priority tax claims: By contrast, if there were a NFTL filed with respect to the income taxes only, the trustee would first pay the 507(a)(1)-(7) creditors $200,000 pursuant to 724(b). Next, the trustee would pay $300,000 of the $400,000 claim with respect to income taxes supported by the NFTL. No money would remain to satisfy the rest of the Service's lien claim ($100,000) or the Service's claim for trust fund taxes or the nontax general unsecured claims. Here, however, the debtor does not walk away from the bankruptcy with a fresh start. The remaining unsecured income tax claim ($100,000) and the unpaid nontax general unsecured claims are discharged. The trust fund claim is not discharged and the debtor comes out of bankruptcy owing $300,000 to the Service because the Service filed the NFTL on the income taxes and not the trust fund tax. The more likely scenario is that the NFTL will cover both the income tax and the trust fund tax. In that case, the result in the example will not change. The Service is free to apply the proceeds as it elects, and it will apply to the proceeds to the dischargeable income taxes.

21.1.4.2 Secured Tax Liens in Chapter 13

21.1.4.2.1 Paying Secured Tax Claims and Stripping the Balance

A Chapter 13 plan must provide for the full payment of all secured claims with interest. The lien is not removed until final payment is made, and the plan is completed. Secured claims include liens attached to otherwise exempt property. This section discusses collateral valuation, payment, interest, lien stripping, and miscellaneous issues.

Collateral valuation. Lien claimants receive the full fair value of their lien plus interest. The meaning of full fair value depends on whether the applicable property was acquired for personal, family, or household purposes. If so, full fair value means replacement value. In turn, replacement value means the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time of valuation. Otherwise, if the debtor retains the property, the value of the property is not reduced for selling costs, and the property is valued after considering the purpose of the valuation and the proposed use or disposition of the property. There are two special collateral valuation rules found in the flush language at the end of section 1325(a) of the Bankruptcy Code, but they do not apply to tax liens and are not discussed further.

Payment. A plan can provide for payment of a secured claim in one of three ways, although the second method does not apply to tax debt. First, the property can be sold or given to the secured creditor. Second, the property can be retained, any arrearages cured, and all current payments made as they come due. Third, the property can be retained, and the secured claim paid in full under the plan. If a confirmed plan provides for retaining property and during the plan the debtor decides to surrender the property, the full secured amount under the plan must be paid. Thus, the debtor must pay any amounts that remain unpaid after the resale proceeds are applied against the claim.

Interest. As to interest on secured tax claims, applicable nonbankruptcy law interest rates apply. In those jurisdictions where there is a market, or fluctuating, rate, the applicable rate is the rate for the calendar month of confirmation. For federal tax claims, the applicable rate is determined under the rules of section 6621(a)(1).

Lien stripping. A debtor can cap the value of the lien at the property's value, except that a debtor cannot cap a lien solely secured by a personal residence. Tax liens can always be stripped because they are not a security interest, which is a consensual lien. Lien stripping is done by adversary proceeding.
Miscellaneous issues. Often the Service's claim is not fully secured. What happens if the Service has an undersecured lien and its claim contains both priority and nonpriority items? Courts generally hold that a debtor's plan cannot force the Service to allocate the secured portion of its claim to the priority debt. In other words, the Service can maximize its payment under the Chapter 13 plan by allocating payment to the nonpriority part of its claim; the priority part of the claim is then paid in full as an unsecured priority claim.

If a plan does not provide for payment of the secured lien, the lien will remain attached to the property. This rule applies even if the Service does not schedule the lien on its proof of claim and a discharge is granted. To avoid the lien, the debtor must object to the secured claim or file an adversary proceeding.

Footnotes

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174 As is discussed herein, the results flowing from the Service having filed a NFTL are dramatically different and adverse compared to situations where there has been no such filing. If the Service has not yet filed a NFTL, filing a petition in bankruptcy and taking advantage of the discharge injunction is something for the taxpayer to consider.

175 See Chapter 11 (Federal Tax Liens) for an extensive discussion of the requirements for properly filing the NFTL.

176 See Taffe v. United States (In re Taffe), 96 F.3d 1190 (9th Cir. 1996) (to value lien in Chapter 11, house valued at fair market value; lien value not reduced for costs of sale).


180 I.R.C. § 6325 (Service required to release unenforceable liens).

181 In re Isom, 901 F.2d 744 (9th Cir. 1990). See also In re Wernimont, 183 B.R. 181, 186 (Bankr. N.D. Iowa 1994); In re Street, 165 B.R. 408 (Bankr. D. Md. 1994); In re Leslie, 103 B.R. 775, 777 (Bankr. S.D.W. Va. 1989); I.R.M. 25.17.2.9.1.1.


183 The secret lien arises automatically after notice and demand for payment is made and payment is not made. I.R.C. § 6321. The Bankruptcy Code provides by implication that the debtor takes exempt property free and clear of the secret lien. 11 U.S.C. § 522(c)(2)(B) (exempt property remains liable after the case if the tax is secured by a properly filed notice of federal tax lien). If property is not included in the bankruptcy estate, or, if it is included but not exempted, then, the lien scrapping process of section 522(c)(2)(B) will not operate. See ¶ 21.2.3, infra. See also Wadleigh v. Commissioner, 134 T.C. 280 (2010) in which the Tax Court held the secret lien remained attached to an ERISA plan allowing the Service to collect after the bankruptcy case. The debtor in this case did not include the plan in the bankruptcy estate and then exempt it which may make a difference under 11 U.S.C. § 522(c)(2)(B). See Patterson v. Shumate, 504 U.S. 756 (1992) (ERISA plans may be excluded from the bankruptcy estate; not must or shall); Rains v. Flinn, 428 F.3d 893 (9th Cir. 2005) (ERISA plans may be included in the bankruptcy estate). Keith Fogg, Filed versus unfiled federal tax liens and exempt versus excluded property come together for a “Gross” outcome for the taxpayer, PROCEDURALLY TAXING (May 29, 2014), http://www.procedurallytaxing.com/filed-versus-unfiled-federal-tax-liens-and-exempt-versus-excluded-property-come-together-for-a-gross-outcome-for-the-taxpayer/.

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185 428 F. 3d 893 (9th Cir. 2005).
186 Wadleigh v. Commissioner, 134 T.C. 280 (2010); Gross v. Commissioner, T.C. Memo 2010-176, aff’d, 556 F. App’x 631 (9th Cir. 2014) (ambiguity in schedules construed against the debtor). See also Keith Fogg, supra note 183.
187 See, e.g., In re Fuller, 134 B.R. 945, 948-49 (9th Cir. 1992); United States v. Sanabria, 424 F.2d 1121, 1123 (7th Cir. 1970); In re Braund, 423 F. 2d 718 (9th Cir. 1970).
189 This treatment of secured tax claims in relation to the unsecured priority claims under 11 U.S.C. § 724(b) reflects Congress’ concern for providing preferential treatment to creditors of the debtor that may be the most adversely affected by the debtor's bankruptcy and least protected against such an event. By allowing the unsecured priority claimant to step into the shoes of the secured tax claim where the estate has insufficient unencumbered assets to pay these claims (for the creditor providing services during the administration of the bankruptcy estate, the unpaid employee of the debtor, or the ex-spouse or child in need of delinquent support payments), the Bankruptcy Code provides a special opportunity for these claims to receive something from a situation that may appear to be hopeless. This provision also reflects a recognition of the vast reach of tax liens over all of a debtor's assets and a choice by Congress to limit its impact with respect to unsecured priority claimants. Practitioners should also be aware of a penalty-lien-stripping provision. 11 U.S.C. § 724(a). This rule may allow priority nondischARGEABLE taxes to be paid at the expense of IRS penalties. See, e.g., In re Bolden, 327 B.R. 657 (Bankr. C.D. Cal. 2005) (trustee claimed almost $340,000 for creditors by avoiding tax lien on penalties). If operable, practitioners should make sure that the trustee is aware of this somewhat arcane rule. See Holloway v. IRS (In re Odom Antennas, Inc.), 340 F.3d 705, 708 (8th Cir. 2003) (section 724(a) avoidance power only available to trustee).
193 See, e.g., In re Ryan, 64 F. 3d 1516, 1523 (11th Cir. 1995) (Service free to allocate overpayments to maximize its collections).
196 United States v. Barbier, 896 F.2d 377 (9th Cir. 1990).
204 11 U.S.C. § 511. As to nontax, secured claims, Till v. SCS Credit Corp., 541 U.S. 465 (2004) controls. In Till, the Supreme Court applied a formula approach, which in practice has been substantially less than the market rate charged by creditors, to determine interest payable to secured creditors in Chapter 13.
206 Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993). Appellate courts have unanimously held that a junior lien in a personal residence in Chapter 13 can be stripped if it is wholly unsecured. See, e.g., McDonald v. Master Fin., Inc. (In re McDonald), 205 F.3d 606 (3rd Cir. 2000). If the lien is capped, the debt must be paid in full within the life of the plan. Enewally v. Wash. Mutual Bank (In re Enewally), 368 F.3d 1165, 1171-72 (9th Cir. 2004) (under pre-BAPCPA law, cure and maintain provision of 11 U.S.C. § 1322(b)(5) could not be coupled with lien stripping under prior 11 U.S.C. § 506(a); debtor must complete plan within five years pursuant to prior 11 U.S.C. § 1322(d)).
207 In re Williams, 273 B.R. 834, 838 (Bankr. S.D. Cal. 2002) (Bankruptcy Code section 1322 prohibition against modification only applies to security interests and not a state or county statutory lien).
See, e.g., Bates v. United States (In re Bates), 974 F.2d 1234 (10th Cir. 1992).
21.1.5 The Short Taxable Year

A debtor's income tax liability for the calendar year in which the petition is filed is a post-petition debt of the debtor. The bankruptcy filing does not """"automatically"""" terminate an individual's taxable year. The debtor is liable for that tax, just as the debtor is liable for any other post-petition debt.

However, the debtor can change that result by an affirmative election filed with the Service. Section 1398(d)(2) permits an individual debtor in a Chapter 7 or Chapter 11 bankruptcy to divide the taxable year in which the bankruptcy petition is filed into """"two taxable"""" years. The first year ends on the day before the bankruptcy petition is filed; the second starts on the day the petition is filed and ends on December 31st of the same year. The election creates a new """"pre-petition"""" tax liability that can be paid from the debtor's assets as a priority claim.

Practice Tip: While this section focuses on the benefits or the considerations of the debtor in electing a short pre-petition taxable year, the short post-petition taxable year deserves mention as does the tax year of the bankruptcy estate. Whether the debtor elects a short taxable year or chooses not to do so, the liability for post-petition taxes becomes a debt of the debtor that will follow the debtor out of bankruptcy. The short-year election allows more of the tax debt to potentially get paid through the bankruptcy if funds exist in the estate, but the debtor's post-petition taxes, even the ones incurred while the bankruptcy exists, become debts of the debtor that the debtor owes.

In addition to the post-petition taxes the debtor owes, a brief mention of the post-petition taxes of the estate of the individual in Chapter 7 or 11 will help in understanding what happens to the estate. The debtor's property goes into the estate at the time of the petition. The trustee has the duty to liquidate that property to make it available, in dollars, to the creditors. To accomplish that task, the trustee frequently sells the property. Such sales can generate taxable income and the property of the estate could itself generate taxable income. The trustee has a duty to pay these taxes, and they do not fall back on the debtor. Trustees are generally expected to include the tax liability generated by a sale, which is an administrative expense, when determining whether a sale will result in distribution to unsecured creditors. Bankruptcy courts generally will not approve sales in which only secured claims, trustee fees, sales costs and taxes are the only items being paid.

Limitations and Restrictions:

• **No Assets--No Election.** If the bankruptcy estate is a no-asset estate, section 1398 expressly prohibits the election.

• **Not Available in Chapter 13.** The election is available only for debtors who have filed under Chapter 7 or Chapter 11.

• **Timing.** The election must be made on what would be the due date for the """"first short"""" year. That is three months and 15 days after the end of the month in which the bankruptcy petition was filed.
• **Irrevocable.** Once the election has been filed the debtor cannot revoke it.

• **Extensions for Filing Returns and Making Elections.** Section 1398(d) contains no express language prohibiting a debtor/taxpayer from requesting an extension of time for filing the tax return for both taxable years. Unfortunately, section 1398 does not contain any express language allowing an extension of time to file the election. (The Service does not often see short year elections. Do not be surprised if the Service has trouble processing the short-year return correctly. For example, if the short-year return is filed in January or February of the following year, the first short-year return is likely to be processed as a full-year return. The debtor may need to file a proof of claim for the Service for the pre-petition short year.)

**CAUTION:** The election should be filed on the due date of the first return regardless of whether an extension for filing is requested.

When one is a partner in a partnership, the partner's share of partnership income, etc., is included on the partner's return “with or within which the partnership year ends.” A bankruptcy filing by a partner during the partnership's year transfers the partner's interest to the trustee but does not terminate the partnership's year. Absent the partner and the partnership each having a December 31st year-end and the debtor filing the bankruptcy petition on December 31st, a partner's share of income for the year of filing becomes income of the bankruptcy estate. This is good planning if the partnership is having a good year; and, it is bad planning if the partnership is having a bad year and the debtor wants to use the loss on the debtor's personal return.

**Practice Tips: Evaluating whether to make the election.**
1. Does the debtor have a substantial pre-petition tax debt without making the election?

If a substantial pre-petition tax liability already exists, carefully review the estate's assets and the probable distribution on the priority tax claim. Any doubt should be resolved in favor of filing the election.

Why? No harm will arise from filing the election. The debtor has two liabilities, (1) for the year ending on the day prior to the filing of the petition and (2) for the period beginning with the date of the filing and ending on December 31st. Not making an election simply creates one liability for the entire taxable year that the debtor must pay.

2. Individual Chapter 11 Debtors:

Consider filing an election to create a short taxable year if tax is due. The priority tax claim created for the short taxable year can be paid over 5 years. Some will argue against the election in an individual Chapter 11 suggesting that the debtor's tax liability reported on a regular return without the election would be an administrative expense after the changes to section 1115 of the Bankruptcy Code, after the 2005 amendments. That seems unlikely. New section 1115 of the Bankruptcy Code only includes “post-petition” earnings as property of the estate. Administrative expenses are limited to taxes incurred by the estate. Pre-petition earnings cannot create a tax incurred by a bankruptcy estate unless those earnings were not paid before the case was commenced. The contrary argument is that the liability does not arise until the last day of the tax year.

3. Individual Chapter 11s after the addition of section 1115 of the Bankruptcy Code by BAPCPA will be a tax minefield until the Service proposes new legislation. None have been proposed. See generally Notice 2006-83, 2006-2 C.B. 596. The minefield is caused by trying to create decision rules for allocating income and expenses between the debtor (who earns the money and spends the money for personal expenses) and the bankruptcy estate (which is taxed on the money earned even though never seen by it).
Footnotes

a1 Ken Weil practices law in Seattle, Washington, where he specializes in tax collection and bankruptcy issues. He served as a member of the Tax Advisory Panel to the Bankruptcy Commission created by Congress in 1994. He writes regularly on issues involving the intersection of tax and bankruptcy. Nancy Ryan is currently the Director of the Low Income Tax Clinic at Legal Services of Northern Virginia. She spent many years practicing consumer bankruptcy law in Northern Virginia. She started her career at the Office of Chief Counsel, IRS, where she was the Large Case Bankruptcy Coordinator. Grace Lee, 3rd year student at George Washington University Law School, and Elizabeth Segovis of Rhode Island Legal Services provided editorial assistance for this chapter.

210 See, e.g., In re Feiler, 218 F.3d 948 (9th Cir. 2000); In re Nichols, 309 B.R. 41 (Bankr. D. Ariz. 2004).

211 See FED. R. BANKR. P. 3004.

212 I.R.C. § 706(a).

213 11 U.S.C. §§ 1129(a)(9)(c) and 507(a)(8).
21.1.6 Determination of Tax Liability, Effectively Representing Client Before New IRS...

Effectively Representing Client Before New IRS 21.1.6

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Effectively Representing Your Client Before the IRS
Keith Fogg, Editor-in-Chief; Kenneth C. Weil and Nancy Ryan

Chapter 21: Utilizing Bankruptcy to Reduce Outstanding Tax Debts
21.1 Statement of the Law Relating to Tax Debt

21.1.6 Determination of Tax Liability

21.1.6.1 Authority of the Bankruptcy Court to Rule on Tax Matters

The bankruptcy court's authority to rule on tax matters is found in section 505(a) and section 505(b) of the Bankruptcy Code. Section 505(a)(1) of the Bankruptcy Code expressly provides that a bankruptcy court may rule on the merits of any tax claim. 214 Section 505(a) may be of great benefit to the debtor; for example, if the 90 days to file a petition with the Tax Court has expired, 215 a bankruptcy court may still determine the tax liability even if the taxpayer has not fully paid the tax. Most taxpayers who miss their opportunity to go to Tax Court must fully pay the liability in order to litigate the determination of the Service because jurisdiction of the United States District Courts and the Federal Court of Claims cannot be invoked without full payment of the tax, penalty, and interest. 216 Thus, even if access to the Tax Court or a United States District Court is jurisdictionally precluded, a bankruptcy court can rule on the merits of a tax claim.

Section 505(a)(1) of the Bankruptcy Code, while broad, has limits. Somewhat obviously, a bankruptcy court cannot rule on the merits of any tax claim that has previously been adjudicated in a contested proceeding before a judicial or administrative tribunal of competent jurisdiction. 217

A bankruptcy trustee must follow the normal administrative procedures to obtain a tax refund, unless the refund results from an offset; or counterclaim to a claim; or request for payment by the taxing authority. If the trustee files a normal refund request, the taxing authority then has 120 days in which to act. If the “120-day” period passes without action by the taxing authority, a bankruptcy court may rule on the merits of the refund claim. 218

If a bankruptcy court renders a final judgment with regard to any tax, the Service, if otherwise permitted by the Internal Revenue Code, may assess that tax against the bankruptcy estate, the debtor or a successor to the debtor. 219

A trustee (including a debtor in possession acting as a trustee) may request the Service to determine any liability for any tax incurred during the bankruptcy case. 220 The procedure for filing a request for prompt determination is set forth in Revenue Procedure 81-17, 1981-1 C.B. 688. To make such a request, the trustee must submit a written application to the local Insolvency Section of the Service with a complete copy of the returns, and a statement saying where the originals were filed. Section 505(b) of the Bankruptcy Code makes it clear that such a request only applies to post-petition returns.

A bankruptcy court can estimate any contingent or unliquidated claim that might unduly delay administration of the estate (i.e., precludes reorganization, sale of a critical piece of property, etc.). 221 That applies to all claims, not just tax claims. At an estimation hearing, the Court will determine the maximum value of the disputed claim. The actual value is determined later in a
full trial on the merits. Since an estimation hearing is less than a trial, the court has the authority to short-circuit discovery. Such a procedure is a “no win” situation for the Service and a “win” situation for the debtor. The court can cap the Service's claim; but the debtor can later seek to further reduce the claim at trial.

21.1.6.1.1 Judicial Restraint

The grant of power under section 505(a) of the Bankruptcy Code is permissive, and courts may decide not to make a tax determination. This generally occurs in no-asset cases where the issue of determination is the validity of the tax due. Courts view this as a two-party dispute and take the position that the outcome of the dispute can have no impact on the administration of the case. Conversely, if there are assets in the estate, determination of the tax liability can have an impact on the size of the distribution received by creditors and a court is more likely to hear the case.

In what would otherwise be a no-asset Chapter 7 case, there is still a possible remedy for the debtor. A Chapter 13 can be filed. A determination of the validity of the taxing authority's claim and the amount to be paid to the taxing authority, as opposed to other creditors, is an essential part of the Chapter 13 process.

Section 1334(c)(1) of Title 28 also gives the bankruptcy court the power to abstain from hearing a case if it is (i) in the interest of justice, (ii) in the interest of comity with state courts, or (iii) out of respect for state law. Sovereign immunity may also prevent a bankruptcy court from hearing a case. The decision to abstain cannot be reviewed on appeal.

21.1.6.1.2 Burden of Proof

The general rule is that “[a] proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim.” The claim is deemed allowed unless a party in interest objects.

In the state-tax case of Raleigh v. Illinois Dept’ of Revenue, the Supreme Court held that, under the Bankruptcy Code, the burden of proof with respect to a tax claim in bankruptcy court lies wherever it would lie under the governing substantive tax law. Note: Make sure to distinguish between the burden of proof to establish underlying theories and the burden of proof to determine dischargeability of the claim; Raleigh above describes the burden of proof in determining the actual tax liability. To bar a debtor's discharge or the dischargeability of specific debts, the burden of proof is on the party objecting to discharge or dischargeability of the debt.

These two items are easily confused in the context of tax administration and bankruptcy. One deals with determining the existence and amount of a tax liability. The second deals only with whether the tax claim can be discharged.

21.1.6.1.3 Authority of the Bankruptcy Court to Rule on Tax Matters: Determination of Bankruptcy Estate's Right to a Refund

Under section 505(a)(2)(B) of the Bankruptcy Code, the bankruptcy court can determine the bankruptcy estate's right to a tax refund. Before that authority arises, (i) the trustee must make a request for the refund and (ii) the taxing authority must fail to act within 120 days from the date of the refund request or the taxing authority simply denies the claim.
21.1.6.1.4 Authority of the Bankruptcy Court to Rule on Tax Matters: Determination of Bankruptcy Estate's Liability

Under section 505(b) of the Bankruptcy Code, a trustee may request a determination of any unpaid liability of the estate incurred during the administration of the estate. Such a determination relieves the trustee and the estate of the liability for any amount not determined.

Pursuant to Rev. Proc. 2006-24, all written requests for determination must be filed in duplicate with the Centralized Insolvency Operation, P.O. Box 21126, Philadelphia, PA 19114. Each request must contain the following:

- Exact copy of a valid tax return;
- Statement indicating that it is a request for prompt determination and specifying the return type and tax period for each request;
- Name and location of office where return filed;
- Name of debtor with debtor's social security number, employee identification number, or taxpayer identification number, as applicable;
- Type of bankruptcy estate; and
- Case number and court where case is pending.

Section 505(b)(1) of the Bankruptcy Code establishes the procedure for governmental units to designate the place where the trustee's quick determination requests should be filed. The clerk of each district is required to keep a list of addresses provided by federal, state, and local taxing authorities that trustees can use for making their request for a quick determination. In addition, taxing authorities can provide information on where to find additional requirements for filing such requests.

21.1.6.2 Jurisdiction of the Tax Court in Bankruptcy Cases

The filing of a bankruptcy petition automatically stays the “commencement or continuation of a proceeding before the United States Tax Court” for individual debtors for any tax period ending before the date of the order of relief. The 90-day period for filing a Tax Court case stops running, and there is a 60-day add-on. Note, if the Service has yet to issue its notice of deficiency, that process can continue and the notice can be issued. A bankruptcy court is authorized to modify the automatic stay and permit the debtor to institute a Tax Court proceeding involving the tax liability of the debtor if the Service has issued a Notice of Deficiency to the debtor. If the stay is lifted, there are no provisions in the Internal Revenue Code that prohibit the debtor from filing a Tax Court petition.

When the stay is lifted and the debtor litigates in the Tax Court, the merits of the tax controversy will be determined by the Tax Court. That decision will bind all parties. The matter is then res judicata in the bankruptcy case, but only as to liability, not dischargeability.

When a proceeding is pending in the Tax Court at the start of a bankruptcy case, further action in the Tax Court is stayed unless the stay is modified by the bankruptcy judge. This gives the trustee sufficient time to determine whether to join the Tax Court proceeding on behalf of the estate. The trustee may intervene as a matter of right in the Tax Court case to which the debtor is a party. The Tax Court will determine the merits of the tax liability, and its decision will bind both the debtor and the
trustee as to the tax claim against the estate. The individual debtor may also request relief from the stay to allow the Tax Court to determine the amount of personal liability.\footnote{241}

\subsection{21.1.6.2.1 Jurisdiction Regarding Collection Actions Post-Bankruptcy}

After the bankruptcy case is concluded, the Service may collect pre-petition tax debts from which it believes the taxpayer was not discharged. If the debt were discharged, the Service may still enforce its NFTL in any property that was exempt, excluded, or abandoned. If the debt were discharged, the Service may only enforce its secret lien rights in property that was not exempted.

The Tax Court has determined that it has jurisdiction to rule on the validity of post-discharge collection matters in CDP hearings under sections 6320 and 6330, including whether the tax debt in question was discharged in bankruptcy.\footnote{242}

Footnotes

\footnoteline{a1} Ken Weil practices law in Seattle, Washington, where he specializes in tax collection and bankruptcy issues. He served as a member of the Tax Advisory Panel to the Bankruptcy Commission created by Congress in 1994. He writes regularly on issues involving the intersection of tax and bankruptcy. Nancy Ryan is currently the Director of the Low Income Tax Clinic at Legal Services of Northern Virginia. She spent many years practicing consumer bankruptcy law in Northern Virginia. She started her career at the Office of Chief Counsel, IRS, where she was the Large Case Bankruptcy Coordinator. Grace Lee, 3rd year student at George Washington University Law School, and Elizabeth Segovis of Rhode Island Legal Services provided editorial assistance for this chapter.

\footnoteline{214} The language of \textit{Bankruptcy Code} § 505(a)(1) covers the waterfront: “Including an unpaid tax, fine, or penalty relating to a tax, or any addition to tax, of the debtor or the bankruptcy estate, whether or not the tax, penalty, fine, or addition to tax has been previously assessed.” Although the power is broad, exercise of the power is permissive. See \footnote{21.1.6.1.1, infra.}

\footnoteline{215} Filing within 90 days is a jurisdictional requirement.


\footnoteline{219} 11 U.S.C. § 505(c); see also \textit{I.R.C.} § 6871(b).

\footnoteline{220} 11 U.S.C. § 505(b)(2).

\footnoteline{221} 11 U.S.C. § 502(c)(1).


\footnoteline{223} Compare \textit{In re Beisel}, 195 B.R. 378 (Bankr. S.D. Ohio 1996) (court declined to exercise jurisdiction over employee/independent contractor dispute in no-asset case); \textit{Donoff v. United States} (\textit{In re Donoff}), 99-1 USTC ¶ 50,328 (Bankr. S.D. Ohio 1999) (court exercised its jurisdiction over dischargeability issue but declined to exercise jurisdiction over amount due in no-asset case); and \textit{In re Stone}, 329 B.R. 882 (Bankr. S.D. Fla. 2005) (bankruptcy court declined to decide whether debtor wife was liable for trust fund taxes as it would have no impact on the administration of the case), \textit{with Miller v. IRS} (\textit{In re Miller}), 300 B.R. 422, 431-434 (Bankr. N.D. Ohio 2003). In \textit{Miller}, the 90-day notice of deficiency time period had run subsequent to the bankruptcy filing. Beyond paying the tax, the debtors were without remedy. The amount of tax at issue was enormous. In taking the case, the bankruptcy court emphasized the prejudice to the debtors if it did not hear the case, stating that “[b]etter they should fly to the moon under their own power” than pay the tax and contest the liability in district court. \textit{Accord Melvin v. IRS} (\textit{In re Melvin}), 410 B.R. 705, 709 (Bankr. M.D. Ala. 2009) (in declining to abstain court wrote that the debtors were without the financial wherewithal to pay the tax and sue for the refund).

\footnoteline{224} \textit{In re Swain}, 437 B.R. 549 (Bankr. E.D. Mich. 2010). The court did not buy the argument that the case was a core proceeding under matters concerning administration of the bankruptcy estate. See 28 U.S.C. § 157(a)(2).
See In re Bush, 2016 WL 4261867 (S.D. Ind. Aug. 12 2016) (court affirmed refusal to hear penalty issues; while there were assets to pay creditors, there were not enough assets to pay all claims and some penalties).


28 U.S.C § 1334(d); and United States v. Paolo (In re Paolo), 619 F.3d 100, 101 (1st Cir. 2010).

FED. R. BANKR. P. 3001(f).


FED. R. BANKR. P. 4005.

See United States v. Sterling Consulting Corp. (In re Indian Motorcycle Co.), 261 B.R. 800, 810 (1st. Cir. B.A.P. 2001) (administrative tax liability should not be estimate as § 505(b) [now § 505(b)(2)] controls over § 502(c)).

11 U.S.C. § 505(b)(2). Estates were added to Bankruptcy Code § 505(b)(2) by BAPCPA effectively overruling Kellogg v. United States (In re W. Tex. Mktg. Corp.), 54 F.3d 1194, 1199-1200 (5th Cir. 1995) (Congress did not intend discharge to apply to estates).


11 U.S.C. § 362(a)(8). When a Tax Court case remains open the stay clearly stops the case and causes the parties to stop everything until the bankruptcy court issues an order lifting stay to allow the case to proceed or until the stay lifts by operation of law. The stay may also impact an appeal from a Tax Court that is pending in the Court of Appeals. Five circuits hold the Tax Court proceeding is brought by the taxpayer and not an attempt to collect a debt. Thus, the appeal continues. Schoppe v. Commissioner, 711 F.3d 1190 (10th Cir. 2013) (listing cases). The Ninth Circuit believes the automatic stay applies. Delpit v. Commissioner, 18 F.3d 768 (9th Cir. 1994).

I.R.C. § 6213(f).


The tax will be nondischargeable as it is a “not assessed but still assessable” tax. 11 U.S.C. § 507(a)(8) (A)(iii).


The guiding case for bankruptcy judges faced with a decision of whether to allow a Tax Court case to continue or to complete the litigation in the bankruptcy court is In re Hunt, 95 B.R. 442 (Bankr. N.D. Tex. 1989). This case involved one of the largest personal bankruptcies ever filed. Two of the famous Hunt brothers from Texas filed bankruptcy following their failed attempt to corner the silver market. The bankruptcy judge analyzed several factors before ultimately allowing the Tax Court case to continue.

Washington v. Commissioner, 120 T.C. 114 (2003); Swanson v. Commissioner, 121 T.C. 111 (2003). The bankruptcy court should be better equipped than the Tax Court to make discharge determinations.
Bankruptcy can be an effective weapon to reduce a client's tax liability or to get property back that is needed to continue a business. The ultimate goal, of course, is to have the client emerge from bankruptcy with the least debt and the most unencumbered property possible. Other valuable benefits gained from filing a bankruptcy petition include the automatic stay provisions and the jurisdiction of the bankruptcy court to resolve tax liabilities.

Practice Tip: In 1983 the Supreme Court made clear in the Chapter 11 case of Whiting Pools that the bankruptcy estate could seek return of property the Service had seized but not yet sold provided the IRS receives adequate protection. The same principle applied in Whiting Pools to recover equipment of a business can also apply to prepetition levies on wages, commissions, bank accounts and other levy sources where the funds do not get to the Service until after the filing of the bankruptcy case.

Through creative employment of procedures available under the Internal Revenue Code and the Bankruptcy Code, the tax practitioner can eliminate or reduce much of the client's tax debt.

To accomplish this, the tax advisor should first explore whether a better result is obtainable outside of bankruptcy within the administrative framework of Service procedures. Normally, this means filing an offer in compromise, which can be thought of as an administrative fresh start. See ¶ 21.2.2 infra. Other alternatives also exist and they are discussed below.

Practice Tip: The IRS Restructuring and Reform Act of 1998 (the “1998 Reform Act”) added section 6331(k), effective for offers pending on or after December 31, 1999, which provides for suspended levy action while an offer in compromise or an installment agreement is pending with the Service. The 1998 Reform Act also added sections 6320 and 6330 that provide appeal rights for a taxpayer prior to the Service serving a levy and prior to or shortly after filing a notice of tax lien. During the pendency of a timely appeal, collection action is suspended. Consequently, the taxpayer may be able to accomplish essentially a nonbankruptcy stay by pursuing such actions. (Keep in mind this also suspends the collection statute of limitation and extends the time that tax debt remains nondischargeable.)

If Service procedures are insufficient and the client elects to go forward with a petition in bankruptcy, additional steps should be taken before or during the proceedings to optimize the benefits to the client. These include the following:

• Using the short-year election to convert what would otherwise be post-petition income or tax debts of the debtor into income or tax debts of the estate.

• Delaying filing of the bankruptcy petition to minimize taxes being classified in the dreaded eighth priority.
• Planning around the “bad acts” nondischarge rules.

• Filing sooner rather than later to avoid having the government become a secured creditor with a proper NFTL filing.

• Paying the client's nondischargeable debts before filing the bankruptcy petition. See infra, ¶ 21.2.4, for strategy considerations.

• Getting joint obligors to help pay nondischargeable tax debts.

Footnotes

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243 Simultaneous with the filing of a petition in bankruptcy, the Bankruptcy Code automatically imposes on creditors a stay of all acts to collect or perfect the debts of the debtor. In the tax context, this can be useful to preclude harmful collection action by an uncooperative revenue officer. (The 1998 Reform Act added sections 7433 and 7430, which provide damages for willful violations the Service of the automatic stay or of the discharge provisions.) If the Service willfully violates the automatic stay or the discharge injunction, the acts are generally treated as being void and the Service may be subject to court sanctions as well as monetary damages and attorney's fees. 11 U.S.C. § 362(h).

244 See ¶ 21.1.6.1, supra.


246 See, e.g., In re Reisbeck, 505 B.R. 546 (Bankr. D. Mont. 2014) (Chapter 13 case requiring the Service to turn over commissions received after the filing of the bankruptcy petition; found that the Service has a better chance of being repaid if property returned to debtor).
21.2.2 Offers in Compromise--An Administrative “Fresh Start”, Effectively Representing...

Effectively Representing Client Before New IRS 21.2.2

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Effectively Representing Your Client Before the IRS
Keith Fogg, Editor-in-Chief; Kenneth C. Weil and Nancy Ryan

Chapter 21: Utilizing Bankruptcy to Reduce Outstanding Tax Debts
21.2 Planning Associated With Reducing An Individual's Tax Liability

21.2.2 Offers in Compromise--An Administrative “Fresh Start”

Tax relief without a bankruptcy is a good result. Therefore, it is critical for the practitioner to be familiar with the available procedures within the Service for reducing taxes or making payment over a time period that is acceptable to the taxpayer.

Offers are most often filed based on doubt as to collectability. The Service may even consider the impact of bankruptcy when deciding whether to accept an offer in compromise. Prior to the announcement of this rule, taxpayers would mention in their offers based on doubt as to collectability that the ability to discharge a debt through the filing of bankruptcy created doubt concerning the collectability of the debt; however, the Service did not formally recognize the dischargeability of a debt as a basis for doubt. Now, in theory, it will do so. In formulating your offer, carefully review the types of tax debts the taxpayer has and explain in the offer how filing bankruptcy would impact the Service's ability to collect those taxes. If the Service will allow a compromise at a more manageable amount because of the possibility of bankruptcy, a taxpayer may get the best of both worlds--the elimination of the tax debt without the stigma and restrictions caused by filing bankruptcy. The Service can also benefit if by compromising it gets more than it would have received had it forced the taxpayer into bankruptcy. In reality, getting an appeals officers to consider the impact of bankruptcy filing is very difficult. Their training is grounded in collections and not bankruptcy. Practice Tip: Be very wary of submitting an offer and mentioning the possibility of a bankruptcy filing if a notice of federal tax lien has not been filed. The offer is an open invitation to the Service to file its notice of lien.

21.2.2.1 Comparing Bankruptcy to an Offer in Compromise

An OIC can be thought of as an administrative bankruptcy for taxes. If the Service agrees to an offer and the taxpayer satisfies all the terms, the tax debt will be effectively discharged and liens released. Which avenue is better--an OIC or bankruptcy? Each has its advantages and its disadvantages. Practice Tip: While there was litigation in the late 1990s and early 2000s seeking to force the Service to consider offers in compromise while bankruptcy cases were pending, the Service's position ultimately prevailed. Pursuant to that position the Service refuses to accept offers in compromise while a bankruptcy case is pending. So, you must choose one or the other; offers and bankruptcy are not available simultaneously.

As has been described, some taxes can be discharged in a bankruptcy while others cannot. Not so in an offer in compromise where all tax liabilities are “‘on the table.” Therefore, if one owes trust fund taxes or recent income taxes, an offer in compromise might be better.
An offer in compromise is more private. Creditors do not know that the taxpayer received a discharge. In addition, one's credit report looks clean, with the exception that there might have been a tax lien filed, which has since been released.

Another advantage to an OIC is that liens are released if the offer is accepted. As discussed above, at the conclusion of a bankruptcy proceeding, the debtor may still own property subject to a tax lien.

On the other hand, a bankruptcy is advantageous if one has substantial unsecured debt, like credit cards. Bankruptcy may be better because it eliminates all the debt a person has, not just taxes. Furthermore, bankruptcy does not require a five-year “probation” that could result in the entire tax coming back, like an OIC does.

Bankruptcy may be the best solution if the Service is too rigid on the definition of disposable income for purposes of the amount it expects from the person's future income. Since the IRS determines allowable living expenses using national and local standards that are, in many situations, unrealistically low, the expected offer amount may be significantly higher than what the taxpayer can afford. After BACPA, the amount of one's living expenses may be irrelevant in a Chapter 7 bankruptcy because of the means test, which does not apply if a majority of the debt is tax debt (i.e., nonconsumer debt). The amount of one's living expenses may be more generous in a Chapter 13 than an OIC because of allowance of secured payments in computing available income. Of course if the taxpayer does not have some means to fund the OIC amount, bankruptcy may remain the only option.

Bankruptcy may also be advantageous if the taxpayer has assets of value that must be included in the calculation of the taxpayer's assets available for collection for OIC purposes that can be excluded or exempted out of the bankruptcy estate. For example, the cash value less penalties of a taxpayer's 401(k) or similar retirement fund is included in the available asset calculation for an OIC, whereas in bankruptcy those funds are completely off-limits to the bankruptcy trustee and creditors. Bankruptcy protects tenants by the entireties property from the individual debts of married debtors, whereas the IRS generally includes fifty percent of the value of tenants by the entireties property in its valuation calculations for an OIC submitted by only one of the owners.

**21.2.2.2 Filing Bankruptcy Before Completing an Offer in Compromise**

If a taxpayer executes an offer in compromise which has been accepted by the Service, and, before full payment files a Chapter 13 bankruptcy petition, the government should file a protective proof of claim for the full amount of the liability with the notation that it is being filed “in the event the debtor does not assume the accepted offer as an executory contract in the plan.” In addition, the Service should object if the plan does not expressly assume the accepted offer or provide for its full payment.

If a Chapter 7 bankruptcy is filed in this situation, the Service should file a proof of claim for the full amount as if no offer in compromise were executed. If the taxpayer promptly resumes payments under the offer once the bankruptcy case is concluded, or the amount of the offer was paid in full as a result of distributions in the bankruptcy case, the Service should, at that time, still honor the offer with respect to the post-petition debtor. The five-year compliance provisions of the OIC are still applicable.

**Practice Tip:** If you know that an offer in compromise will shortly thereafter be followed by a bankruptcy petition, try hard to make all payments under the offer before filing the bankruptcy case to avoid having the bankruptcy undo the offer. If a taxpayer is planning to file a Chapter 7 bankruptcy for non-tax-related reasons, it may be more expedient to do the bankruptcy first and then submit the OIC after all other debts have been discharged.

**Practice Tip:** One is not precluded from filing a petition in bankruptcy merely because an installment agreement is in place. In fact, executing an installment agreement and then filing bankruptcy when all the conditions for dischargeability (e.g., three years have elapsed from the due date of the return) are satisfied is wise practice. The installment agreement can serve as a good place to wait while the time frames run their course. Because it takes a court action to extend the statute of limitation on
collection, a pending installment agreement prevents the Service from filing a case to obtain a judgment.\textsuperscript{258} Unlike an offer in compromise, which can extend the time in which a tax debt retains priority status, installment agreements do not extend priority time periods. Yet, they provide many of the same protections from ongoing collection that exist while an offer in compromise is being considered. Bankruptcy does not terminate a valid installment agreement; it only suspends the installment agreement.\textsuperscript{259}

Footnotes

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\textsuperscript{247} See I.R.M. 5.8.10.2.2(1); see generally Offer in Compromise, https://www.irs.gov/payments/offer-in-compromise.

\textsuperscript{248} See I.R.M. 5.8.10.2.2. For a dated but still helpful discussion comparing the pros and cons of OIC versus bankruptcy see Howard Levy, Bankruptcy or Offer in Compromise? Where the Bankruptcy Code and IRS Policy Meet, 2 J. TAX PRAC. & PROC. 33 (Mar. 2000).


\textsuperscript{250} I.R.M. 5.8.5.10(4).

\textsuperscript{251} 11 U.S.C. § 522(b)(3)(C) (exempt if state exemptions used); 11 U.S.C. § 522(d)(12) (exempt if federal exemptions used).

\textsuperscript{252} Bunker v. Peyton (\textit{In re Bunker}), 312 F.3d 145 (4th Cir. 2002).

\textsuperscript{253} I.R.M. 5.8.5.13(6).

\textsuperscript{254} I.R.M. 5.9.4.10.1(6). \textit{But see In re Mead Jr.}, 2013-1 USTC 50,140 (Bankr. E.D.N.C 2013) (Service's claim in full amount of tax disallowed; court would only allow claim in amount of accepted offer). See 11 U.S.C. § 525(a) (individual cannot discriminate against debtor because of a bankruptcy filing).

\textsuperscript{255} I.R.S. Legal Memorandum 200027050, 2000 TAX NOTES TODAY 132-66 (May 16, 2000).

\textsuperscript{256} I.R.M. 5.9.4.10.1(4).

\textsuperscript{257} See I.R.M. 5.9.4.10.1 for the Service approach to handling situations where there was an OIC filed before the bankruptcy petition.

\textsuperscript{258} I.R.C. § 6331(k)(3)(A).

\textsuperscript{259} I.R.M. 5.9.4.19(3) (citing § 6159(b) and Reg. § 301.6159-1(c) and (c)(2)(i)).
21.2.3 The Secret Lien in Exempt Property, Effectively Representing Client Before New IRS 21.2.3

Tax liens are either unsecured or secured. In the case of the Service, tax claims in bankruptcy reach their full priming power only after the government files its NFTL as prescribed by section 6323(f).

Once a bankruptcy petition is filed, whatever actions are possible to strip property of a tax lien lie with the trustee, not the debtor. While the trustee can easily avoid the secret tax lien and totally unsecured liens, avoiding secured tax liens is highly unusual. Thus, the debtor is best advised to take all available actions to keep the taxing authority from filing its NFTL in the first place. After the NFTL notice is filed and a bankruptcy petition is filed, the most one can do is to bring the avoidance powers to the attention of the trustee and encourage him to use them. The hard reality is that there is no incentive for the trustee, as fiduciary for the general creditors, to do so.

If the Service has not filed its NFTL, it has a secret lien. In this case, the taxpayer should take care to exempt as much property as possible in the bankruptcy. The reason is that the exemptions will scrub the secret lien off the exempt assets.

Consider the following hypothetical. Assume the debtor has property that goes into the bankruptcy estate that exceeds the amount that can be exempted. Assume the Service is owed dischargeable tax debt but the IRS never filed its notice of lien. The simplest solution for both the trustee and the debtor is to have the debtor buy the nonexempt property out of the bankruptcy estate. If a secret lien is attached to the property, any sale order needs to provide for a sale free and clear of liens pursuant to 11 U.S.C. §§ 363(b) and (f)(1) and (f)(2). Otherwise, the Service can execute on the secret lien after the property is “repurchased” by the debtor.

21.2.3.1 Tax Lien Avoidance of Unsecured Tax Liens Under Section 545(2) of the Bankruptcy Code

Section 545(2) of the Bankruptcy Code provides that statutory liens, such as a tax lien, may be avoided by the trustee if the lien is unperfected or would not be enforceable against a “bona fide purchaser” under nonbankruptcy law as of the commencement of the case. Under this provision, the trustee is given the same rights of avoidance a hypothetical bona fide purchaser would have over the tax lien holder under applicable federal, state or local law. If a bona fide purchaser would have had priority over the tax lien at the time of the filing of the petition in bankruptcy under the relevant nonbankruptcy law, the lien may be avoided. This is the most frequently used avoidance rule with respect to unsecured tax liens, federal and local. It is of little help against a secured Service tax lien because of section 6323(a).

In cases where, at the time of the commencement of a bankruptcy case, a tax lien notice has not been recorded properly, and providing notice of the tax lien is required under nonbankruptcy law for the tax claimant to have superior rights in the
encumbered property over a bona fide purchaser, the lien is subject to avoidance by the trustee under section 545(2)\textsuperscript{263} of the Bankruptcy Code. This rule would rarely, if ever, apply to a properly filed NFTL.

Footnotes

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\textsuperscript{260} 11 U.S.C. § 522(h) grants the debtor authority to employ some of the avoiding powers of the trustee to preserve encumbered exempt assets for the debtor's benefit. However, most courts have interpreted the avoidance authority granted the debtor under 11 U.S.C. § 522(h) not to include a debtor's right to avoid tax liens. This interpretation is based on the language in 11 U.S.C. § 522(c)(2)(B), which specifically states that perfected tax liens remain enforceable against exempt property. See \textit{In re DeMarah}, 62 F.3d 1248, 1251-52 (9th Cir. 1995); \textit{In re Walkup}, 183 B.R. 884, 887 (Bankr. E.D. Cal. 1995); \textit{In re Robinson}, 166 B.R. 812, 815 (Bankr. D. Vt. 1994). The debtor may avoid the tax lien against exempt property under 11 U.S.C. § 522 only if proper notice of the tax lien has not been filed, resulting in a flawed perfection of the tax lien. 11 U.S.C. § 522(c)(2)(B). \textit{In re Suarez}, 182 B.R. 916, 923 (Bankr. S.D. Fla. 1995). In practice, the Service recognizes that its secret lien is not enforceable post-petition against the debtor's exempt property, provided the tax obligation was discharged.

While the debtor may lack standing to avoid a tax lien against exempt property under 11 U.S.C. § 522(h), a Chapter 13 trustee may intervene and do so under the trustee's general avoiding powers. In \textit{United States v. Branch}, 170 B.R. 577 (Bankr. E.D.N.C. 1994), a trustee intervened on behalf of a Chapter 13 debtor to avoid a tax lien against exempt property pursuant to 11 U.S.C. § 545, which the debtor lacked standing to do. This allowed the debtor to reduce the Service's secured claim, which otherwise had to be paid under the plan or the applicable property surrendered. See ¶ 21.1.4.2.1, supra. Presumably, the lien avoidance made the Chapter 13 plan more feasible.

\textsuperscript{261} 11 U.S.C. § 551 enables the trustee to increase the assets of the estate for distribution to unsecured creditors by automatically preserving any liens voided by the trustee for the benefit of the bankruptcy estate. The trustee's power to preserve the voided lien for the benefit of the estate allows the trustee to step into the shoes of the lien creditor who had the voided lien. \textit{In re Barry}, 31 B.R. 683, 686 (Bankr. S.D. Ohio 1983). Monies the trustee preserves for the benefit of the estate through lien avoidance is made available for distribution to unsecured claimants, priority or general, in a Chapter 7 liquidation, or increases the amount paid to unsecured claimants in a Chapter 13 rehabilitation plan. To the extent the lien is avoided, the tax claim is treated as an unsecured tax claim.

The powers granted to the trustee to avoid the tax lien in bankruptcy and to preserve the assets for the benefit of the estate support the theory of equal treatment among all creditors of the bankrupt debtor and provide unsecured claimants with an opportunity to share in the assets of the bankruptcy estate. The debtor will benefit from lien avoidance and sale only if the sale proceeds will be sufficient to pay all priority taxes and some general, unsecured debt. Otherwise, the trustee will not avoid the lien.

\textsuperscript{262} 11 U.S.C. § 522(c)(2)(B).

\textsuperscript{263} See \textit{City of Boerne v. Borne Hills Leasing Corp. (In re Boerne Hills Leasing Corp.)}, 15 F.3d 57 (5th Cir. 1994) (taxing authority failed to perfect lien and its lien was avoidable; held, because lien was never avoided, lien retained its priority); \textit{In re Fandre}, 167 B.R. 837, 840 (Bankr. E.D. Texas 1994) (notice of the tax lien was properly filed before the commencement of the case and lien was not avoidable); \textit{In re de la Vergne}, 156 B.R. 773 (Bankr. E.D. La. 1993) (the tax authority misfiled the public notice so that it would not have disclosed the existence of the lien to interested parties making a search; held, lien avoided).
21.2.4 Paying Nondischargeable Tax Debts Before Filing for Bankruptcy

No matter how much one employs the techniques mentioned above, the fact remains that most taxes are not dischargeable and will eventually have to be paid. The question is whose money is going to be used to pay these debts--the debtor or others?

If the debtor does not take any special planning steps, nondischargeable debts must be paid (if at all) from exempt and property acquired post-petition after the conclusion of the proceedings. However, with planning, one may be able to get others to pay some or all the debts that would otherwise follow the debtor out of bankruptcy.

To understand this planning concept, one must accept the fact that any money in the bankruptcy estate used to pay the debtor's dischargeable claims is wasted money. Instead, the debtor should plan to reduce the amount of the property going into the estate.

To avoid having "too much" property in the estate, the debtor should be encouraged to sell assets before filing the bankruptcy petition and to use the proceeds and any other cash to pay as many of the nondischargeable debts as possible. So long as this is done with great care and precision, it is legal. Every such payment, or transfer, must be viewed as a potential preference (section 547 of the Bankruptcy Code) or a fraudulent conveyance. Said payments and transfers should be transparent and disclosed on the statement of Financial Affairs. Any attempt to conceal or otherwise reduce the visibility of those transactions does nothing other than increase a trustee's suspicion, with justification.

When a debtor makes payments to the Service on a voluntary basis, the debtor may designate against which debts the Service should apply payment. One would obviously designate the payment to recent income taxes or employment taxes, if any. It may be critical that payments are made more than 90 days before the petition in bankruptcy is filed. Otherwise, they risk classification as a "preference" and would be subject to the avoidance powers of the trustee. This obviously requires significant advance planning. The key question is whether the funds, used to pay the creditor that are "clawed back" into the bankruptcy estate, are going to be returned to the priority-tax creditor.

Practice Tip: Certain payments are not subject to avoidance even if made within the “90-day” period. The most important is payment by a business with respect to trust fund taxes. The Supreme Court held that taxes collected by the debtor business from a third party in trust for the government were never the property of the debtor and thus cannot become property of the estate. Consequently, if the debtor pays these amounts over to the Service, the trustee cannot force their return from the Service to apply to other debts.

In addition to paying down nondischargeable debts, the debtor might be able to get a third party who is jointly liable on certain nondischargeable taxes to pay. For example, if the debtor owes nondischargeable trust fund employment taxes in the capacity as
a “responsible person,” payment by the business or other responsible parties before, during, or after the bankruptcy case lessens the post-bankruptcy liability of the debtor. In such a case, it is important to ensure that the tax payment is applied to the trust fund portion of the employment taxes only, since doing so reduces not only the debts of the business but also those of the officers.

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264 Rev. Proc. 2002-26, 2002-1 C.B. 746. After the bankruptcy petition is filed, payments cannot be designated because they are involuntarily made. See, e.g., In re Bates, 974 F.2d 1234 (10th Cir. 1992) (in a Chapter 13, debtor could not designate how payments were to be applied between secured and priority claims; this being the province of the bankruptcy court). But, payments must be allocated in accordance with the proof of claim that is filed and allowed by the court. As a result, if a business or other persons responsible to pay trust fund taxes are not debtors in the proceeding, they can designate their voluntary payments for joint and several taxes. The Supreme Court has held that the Bankruptcy Court has the power in a Chapter 11 to confirm a plan which proposes to direct payments first to the trust fund or priority nondischargeable claims, and then to the other (dischargeable) claims if the designation is necessary for the success of the reorganization. United States v. Energy Resources Co. Inc., 495 U.S. 545 (1990).


21.3 EXEMPT, ABANDONED, AND EXCLUDED PROPERTY

In general, all of a debtor's property becomes property of the estate when a debtor files a bankruptcy petition; however, certain property that goes into the estate comes back out and certain other property, primarily ERISA pensions, never goes into the bankruptcy estate. It is helpful to at least understand the concept of exempt, abandoned and excluded property to understand the overall impact of bankruptcy.

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267 See ¶¶ 21.1.3.3 and 21.1.4.1.1, supra.
21.3.1 Exempt Property

Individual debtors get to keep a certain amount of their property when they go into bankruptcy because the Bankruptcy Code allows them to exempt certain property from the estate. Bankruptcy Code section 522 sets out the provisions regarding exemptions. While certain exemptions exist under the provision, a majority of states opt out of the federally allowed exemptions and have created their own scheme. Other states allow the debtor to choose between the state-exemption system and the federal-exemption system. The default rule is the dual-exemption system. Some states have very generous provisions while others carefully restrict the property a debtor may exempt. Most Chapter 7 cases fall into the category of no-asset because the debtors' property either gets exempted under this provision or has a lien encumbering it.

In evaluating the benefit of bankruptcy, you must take into account the benefits of exempt property and how your client's property will match the available exemptions. One area regarding exemptions that has received attention in recent years concerns benefits available under the Internal Revenue Code and whether these benefits fall into the social welfare category, specifically the earned income tax credit and the child tax credit. In general, bankruptcy trustees will seek to have nonexempt tax refunds turned over to them for distribution to creditors of the estate. If your client lives in a state that exempts social benefit payments and receives the earned income credit, this issue deserves monitoring.

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270 On the CTC side, see, e.g., Hardy v. Fink (In re Hardy), 787 F. 3d 1189 (8th Cir. 2015) (found additional child tax credit exempt under Missouri exemption statutes as a public assistance benefit). On the EITC side, see, e.g., In re Matsuura, 2013 WL 6577389 (Bankr. D. Idaho Dec. 16 2013) (tax refund deposited into empty bank account; under Idaho exemption law, CTC nonexempt and EITC exempt; tax refund consisted
of both CTC and EITC; debtor withdrew amount equal to the CTC; held, remaining bank balance exempt as attributable to the EITC). Many states now specifically exempt EITC and CTC tax refunds.
21.3.2 Abandoned Property

The trustee's job in bankruptcy focuses on turning the debtor's assets into cash the trustee can pay to the unsecured creditors. In essence, the trustee works for the unsecured creditors. If the debtor's property coming into the estate has no value for the unsecured creditors, the trustee will abandon the property—think throw the property out of the estate or discard the property—because the property has no benefit to the estate. This typically happens when the property does not qualify as exempt property but has liens against it which exceed the value of the property. For example, if the debtor owns a small piece of undeveloped land worth $25,000 but the property has a mortgage lien against it for $30,000, and the trustee cannot negotiate a deal with the lender to sell the property for the lender for a fee that benefits unsecured creditors, the trustee will abandon the property because it adds nothing to the estate that the trustee can use to satisfy the claims of the unsecured creditors. If the lien, or one of the liens encumbering the property that cause the trustee to abandon the property is a FTL, the Service can pursue this property after it leaves the bankruptcy estate.

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21.3.3 Excluded Property

Excluded property never enters the bankruptcy estate. The Service can pursue excluded property if it does not get paid through the bankruptcy case. It takes the position that the secret lien, even with no notice filed, continues to attach to excluded property, allowing the Service to execute on the secret lien even when the underlying tax was discharged. \(^{271}\)

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See ¶ 21.1.3.3 and 21.1.4.1.1, supra.
21.4 Conclusion

Bankruptcy deserves consideration when trying to work out tax debts and provides strong relief when the taxes have become dischargeable. If tax debts constitute the only or the primary debts of your client, you should look closely at offer in compromise prior to pursuing bankruptcy. If available at a cost your client can afford, the offer in compromise allows the taxpayer to eliminate all taxes even those that bankruptcy would not discharge or where the FTL would continue to attach to property. In many circumstances your client will benefit from bankruptcy because an offer requires more money than the taxpayer would pay in bankruptcy or the taxpayer has nontax debts that require bankruptcy relief. In those situations, you can assist the individual by carefully calculating the effect of bankruptcy so the taxpayer will know what to expect with respect to collection of their taxes after the bankruptcy ends.

This chapter seeks to raise your awareness of bankruptcy issues so you will know when to seek the advice of a bankruptcy specialist and will know how to spot common issues. It also seeks to help you decide when an offer or a bankruptcy might best suit your client's situation. It does not seek to serve as a substitute for the knowledge and skills a bankruptcy specialist can bring to the situation and some cases will require coordination with a lawyer holding those skills.

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