#### TREATMENT OF PRE-PETITON TAX DEBT IN BANKRUTPCY

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#### I. SCOPE

This topic relates not to tax consequences arising out of the filing of a bankruptcy, but rather to the treatment and discharge of taxes that arise pre-petition. The scope is so expansive that by necessity I have limited this manuscript to the basic concepts and selected advanced issues. I generally limit the discussion to federal tax issues, but touch on some issues related to state and local taxes. For those of you who already effectively represent debtors on tax issues, my goal is to improve your effectiveness and bring to your attention issues of which you may not be unaware. Others of you represent debtors, but lack the knowledge or confidence to represent clients who have complex tax issues. My goal is to increase your knowledge and install the confidence to represent debtors with tax issues. Several of the issues discussed are relevant to the administration of estates by chapter 7 and chapter 13 trustees. The primary questions to be answered are:

- 1. What is the effect of the bankruptcy on a pre-petition tax lien?
- 2. What is the effect of the bankruptcy on the debtor's personal liability on the tax debt?
- 3. In chapter 13, what treatment of the tax claim is necessary to obtain confirmation of the plan?

#### II. DEBTOR DISCHARGE RULES

The scope of this manuscript encompasses chapters 7 and 13 cases filed by individuals. A review of the basic discharge rules is set out below:

*Individual files a chapter 7:* Certain tax debts are excepted from discharge. 11 U.S.C. §727(b) and 11 U.S.C. §523(a)(1).

*Chapter 13:* Tax debts "provided for by the plan" are discharged, except with respect to any tax the debtor fails to file a required return or report, filed a late return or report within 2 year of filing the bankruptcy, made a fraudulent return or willfully attempted to evade. 11 U.S.C.  $\$1328(a)^1$ . If the debtor receives a "hardship" discharge under \$1328(b), the chapter 7 rules apply. 11 U.S.C. \$1328(c).

<sup>&</sup>lt;sup>1</sup> These exceptions to the discharge of tax debts in chapter 13 were added to the Code in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). This change in the law is significant.

#### III. TAX BASICS: Classification of Claims

#### A. Classification of Tax Claims

#### 1. Secured Tax Claims

A secured tax claim is one that is secured by virtue of a statute granting the taxing authority a lien on property. As all bankruptcy attorneys know, 11 U.S.C. §506(a) limits the amount of the secured creditor's claim "to the extent of the value of such creditor's interest in the estate's interest" in the property securing the claim. Section 506(a) applies to secured tax claims. U.S. v. Ron Pair Enterprises, Inc., 489 U.S. 235, 109 S.Ct. 1026, 103 L. Ed. 2d 290 (1989); In Re Wilson, 206 B.R. 808 (Bankr. W.D.N.C. 1996).

The most common federal, state and county tax liens are set out below.

#### (1) Federal Taxes

26 U.S.C. §6321 provides that the amount of any unpaid tax debt shall be a lien "upon all property and rights to property, whether real or personal" belonging to the taxpayer. The lien attaches immediately upon the assessment of the tax. In Re McTyre Grading & Pipe, Inc., 193 B.R. 983 (Bankr. N.D.Ga. 1996). The lien is often referred to as a "secret lien" because it not only attaches upon assessment, but without notice to anyone. Certain parties are protected from the secret lien. 26 U.S.C. §6323(a) provides that the lien is not "valid as against any purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor" until a notice of the lien has been properly filed. 26 U.S.C. §6323(f) provides that to give the IRS lien priority over the holders of such liens or interests in real property a Notice of Federal Tax Lien ("FTL") must be filed in the county in which the property is located with the proper official designated under state law. To have priority with respect to personal property the FTL must be filed in the county in which the taxpayer resides.<sup>2</sup> Whether the IRS has just the "secret lien" arising out of 26 U.S.C. § 6321 or the "noticed lien" arising out of the filing of the FTL pursuant to 26 U.S.C. § 6323 significantly effects the treatment of the lien in bankruptcy and is discussed at pages 7-8 and 10.

With respect to real property the FTL attaches essentially like a judgment lien on real estate.<sup>3</sup> However, with respect to personal property, the IRS lien works quite differently.

 $<sup>^2</sup>$  Don't assume the IRS has filed its tax lien in the proper county. When taxpayers live in one county, but have a mailing address in a post office in another county, the IRS usually files this notice in the wrong county. For example, I have found that those taxpayers who live in Franklin County, but have a Zebulon mailing address, the IRS files the FTL in Wake County.

<sup>&</sup>lt;sup>3</sup> A tax lien is a statutory lien, rather than a judgment lien, and cannot be avoided pursuant to §522(f). <u>In Re</u> <u>Morgan</u>, 2000 WL 1194144 (Bankr. E.D.N.C. 2000). With respect to tenants by entirety property, a federal tax lien against only one of the spouses attaches to his/her interest. <u>See</u> discussion of <u>Craft vs. U.S.</u>, 535 U.S. 274, 122 St. Ct. 1414, 152 L. Ed. 2d 437 (2002) at pages 284-85.

It is a "blanket lien" encumbering *all* of the taxpayer's interest in any property. <u>U.S. v.</u> <u>Ron Pair Enterprises, Inc., supra; U.S. v. Jones</u>, 260 B.R. 415 (E.D.Mich. 2000).

In the absence of external forces, the tax lien transfers no funds or property from the taxpayer to the IRS. Should the taxpayer attempt to sell real estate upon which a tax lien has attached or refinance the loan on said real estate, he must pay the tax lien or obtain its release to convey good title. Otherwise, tax liens are enforced through the process of levies governed by 26 U.S.C. §6330 et. seq. Exemptions are subordinate to the right of the IRS to levy on the taxpayer's interest in property. In Re Voelker, 42 F.3d 1050 (7th Cir. 1994); In Re Piper, 291 B.R. 20 (Bankr. D.Mass. 2003); In Re Evans, 1994 WL 760821 (Bankr. E.D.N.C. 1994). However, the IRS has no greater right to the property than the taxpayer. U.S. v. Bess, 357 U.S. 51, 78 S.Ct. 1054, 2 L. Ed. 2d 1135 (1958); U.S. v. Durham, 363 U.S. 522, 80 S.Ct. 1282, 4 L. Ed. 2d 1371 (1960). For example, even though the IRS has a lien on a taxpayer's interest in an ERISA-Qualified Pension Plan, it can access the funds only as they are paid to the taxpayer. Finally, 26 U.S.C. §6334 "exempts from levy" certain property, including unemployment benefits, workers compensation, wearing apparel, furnishings up to \$7,720.00, and \$3,860.00 in tools of the trade.<sup>4</sup>

#### (2) State Taxes

State taxing authorities can obtain liens to the secure the payment of taxes. For example, the North Carolina Department of Revenue ("NCDOR") may secure state tax liabilities by filing a certificate of tax liability with the clerk of superior court in the county in which the taxpayer resides or has property. N.C. Gen. Stat. §105-242(c). The lien attaches like a judgment lien with respect to the taxpayer's real property in the county in which the lien is filed.<sup>5</sup> Unlike the FTL blanket lien, with respect to personal property the state tax lien attaches only upon levy on particular property.

By contrast, Georgia has a tax lien structure very similar to the federal tax lien structure. O.C.G.A. § 48-2-56 grants the relevant taxing authority a lien on *all* the debtor's property, both real and personal. In the case of <u>Thomas v. State of Georgia, Dept. of</u> <u>Revenue</u>, 1992 WL 459585 (N.D. Ga. 1992), the county tax collector was allowed, over the objection of the chapter 7 trustee, to collect from the proceeds of the sale of real property sold by the trustee, not only the county taxes assessed against that property, but also county taxes assessed against other over-encumbered property abandoned by the trustee.

 $<sup>^4</sup>$  These amounts are in 2007 dollars. The amount increases each year by the increase in the cost of living. 26 U.S.C. 6334(g).

<sup>&</sup>lt;sup>5</sup> As a statutory lien, it cannot be avoided pursuant to 11 U.S.C. §522(f).

# (3) County and City Property Taxes

Taxes assessed on real estate by a county or municipality is a lien on the real estate as of the date the property is to be listed for such taxes. N.C. Gen. Stat. §105-355(a). Additionally, any property taxes assessed on personal property by a county or municipality are a lien on real property within the county or municipality as of the listing date. The liens are the first lien on the real estate. §105-356(a). Property taxes are a lien on personal property as of the date of levy or attachment on the property. §105-355(b). Upon such levy or attachment, the lien is a first lien insofar as it represents taxes imposed on said property, but is inferior to previously perfected lien insofar as it represents taxes imposed on other property §105-356(b).

Again by contrast, Georgia law extends the lien for such taxes to all the debtor's property.

# **B.** Priority Tax Claims

The priority tax claims are set out in 11 U.S.C. §507(a)(8). Seven types of taxes and penalties are included in the list of priority taxes. In this presentation, I limit the discussion to three types of taxes: income taxes, trust fund taxes, and property taxes.

#### (1) Income Taxes

An income tax is priority tax if it meets *any* of the following three (3) requirements:

(a) It is for a tax year in which the return was last due, including extensions, 3 years or less prior to the filing of the bankruptcy.

[Illustration: As of October 18, 2009, income taxes for tax years 2005 and earlier are not priority taxes. 2006 taxes are priority.]

- (b) The tax was assessed within 240 days of the filing of the petition. If an offer in compromise is made during the 240-day period, the running of the 240-day period is tolled during the time in which the offer is pending plus an additional 30 days after the offer in compromise is no longer pending. The assessment of the tax usually occurs within 30-45 days after the tax return is filed. Obviously, if the taxpayer is audited, or the tax is adjudicated for unreported income or other errors in the return, additional assessments may take place at a later date.
- (c) The tax was not assessed before the bankruptcy was filed, but was assessable under applicable law or agreement after the bankruptcy was filed. This third rule is inapplicable to taxes for which the debtor did not file the return, filed the return less than 2 years before filing the petition, filed a fraudulent return, or willfully attempted to evade the tax.

# (2) Trust Fund Taxes:

11 U.S.C. §507(a)(8)(C) includes within the priority claims "a tax required to be collected or withheld and for which the debtor is liable in whatever capacity." The owners of failed businesses often owe trust fund taxes, especially withholding taxes. In the absence of sufficient funds to pay ongoing expenses, one of the easiest bills to defer, in the short run, is the payroll tax deposit. 26 U.S.C. §6672 allows the IRS to assess personal liability against any "responsible person" within an organization who willfully fails to pay the withheld tax. An individual who has been assessed liability in such a capacity owes a priority tax claim pursuant to §507(a)(8).

North Carolina has a similar provision, N.C. Gen. Stat. §105-253, which provides for the individual liability of the "responsible officer" within a corporation or limited liability company which fails to pay trust fund taxes. The statute defines a responsible officer as "the president and the treasurer of a corporation, the manager of a limited liability company, and any officer of a corporation or member of a limited liability company who has a duty to deduct, account for, or pay" the trust fund taxes. §105-253(b). This statue appears to impose strict liability for the payment of the trust fund taxes. See In the Matter of Jonas, 70 N.C.App. 116, 318 S.E.2d 860 (1984).

# (3) **Property Taxes**

Pursuant to 11 U.S.C. §507(a)(8)(B), a property tax is a priority claim if it was payable without penalty within the year prior to the filing of the bankruptcy. A property tax occurs upon the date that the property is to be listed (January 1). <u>In Re Members</u> <u>Warehouse, Inc.</u>, 991 F.2d 116 (4th Cir. 1993). A tax assessed for a particular year must be paid by January 5 of the following year to avoid the payment of interest and penalty. N.C. Gen. Stat. §105-360(a).

# C. General, Unsecured Tax Claims

A tax claim that is neither a secured claim nor a priority claim falls into the category of general unsecured claim. As a general rule these claims receive the same treatment in distributions made in a bankruptcy case. However, with respect to tax penalties, 11 U.S.C. 726(a)(4) provides that tax penalties which are not in compensation for actual pecuniary loss in a group of claims (fines, forfeitures, punitive damages, etc.) that are paid only after all other claims are paid.

Under nonbankruptcy law each tax claim is comprised of three components: the tax itself, interest assessed in connection with the tax, and penalties. The tendency outside the bankruptcy context is to isolate the original tax in one category and to lump the interest and penalties together in another. However, in bankruptcy cases, the interest is treated the same as the tax. In Re Garcia, 955 F.2d 16 (5th Cir. 1992); In Re Larson, 862 F.2d 112 (7th Cir. 1988).

# IV. DISCHARGE OF TAX CLAIMS AND TAX PENALTIES

# 1. Chapter 7

#### A. Taxes

The discharge of tax claims in chapter 7 is governed by 11 U.S.C. §523(a)(1). Three basic classes of tax claims are excluded from the discharge. They are as follows:

- a. Priority tax claims. Therefore, the discussion of priority taxes on pages 4-5 applies to determine whether a debt is discharged.
- b. A tax for which the return or report was not filed, or was filed late and less than 2 years before the bankruptcy is filed.
- c. A tax with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

# **B.** Penalties

The discharge of non-priority tax penalties is governed by §523(a)(7). In what the Ninth Circuit has termed a statute of "excess negatives," <u>In Re McKay</u>, 957 F.2d 689, 693 (9th Cir. 1992), §523 (a)(7) follows a tortuous route. It begins by making a debt for a penalty to a governmental unit nondischargeable. It then removes from this category penalties which are not in compensation for actual pecuniary loss. This exception removes few tax penalties, because most tax penalties are nonpecuniary-loss penalties. However, subparagraph (A) removes from the nondischargeable category penalties arising out of a dischargeable tax claim ("of a kind *not* specified" in §523(a)(1)). Finally, since subparagraphs (A) and (B) are written in the disjunctive, subparagraph (B) removes from the nondischargeable category penalties imposed with respect to a transaction or event that occurred more than three years prior to the filing of the bankruptcy. The courts have uniformly held that the transaction or event is the date the tax return was due. <u>See In Re Roberts</u>, 906 F.2d 1440 (9th Cir. 1990).

#### 2. Chapter 13

Prior to the enactment of BAPCPA, there were no exceptions to discharge of tax debts in chapter 13. Personal liability on all tax debts was discharged in chapter 13.<sup>6</sup> However, BAPCPA amended the law to except some tax debts from discharge. The exceptions are:

1. A tax for which the return or report was not filed, or was filed late and less than 2 years before the bankruptcy is filed.

<sup>&</sup>lt;sup>6</sup> Most tax debts excepted from discharge in chapter 7 constitute priority debts in chapter 13, and therefore, such taxes must be paid in full through the chapter 13 plan.

2. A tax with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax

#### V. OBTAINING INFORMATION FROM TAXING AUTHORITIES

The foregoing discussion demonstrates the necessity of obtaining accurate information concerning the client's taxes. You need to know when the tax return was filed; whether the taxpayer filed the return or the IRS filed a substitute return; whether the debtor obtained an extension to file the return; when the tax was assessed; when an offer in compromise was pending; etc. Relying upon the client for such information is unwise. You need to obtain the information directly from the taxing authority. The form that will provide the information is called the account transcript or master file transcript (MFTRA). To obtain the transcript you will need to send the IRS a Tax Information Authorization (Form 8821). You can download copies of these forms from the IRS website (<u>www.irs.gov</u>). Send a copy of the form to the IRS Practitioner's Hotline requesting an "account transcript" or "record of accounts" for each tax period in issue.

# VI. TREATMENT OF TAX DEBT

# A. Chapter 7

# 1. Secured Tax Debt.

The rights of the parties with respect to federal tax liens revolves two factors: 1) Whether the tax lien is the secret lien arising out of § 6321 or the § 6323 filed lien; and 2) Whether the underlying tax debt was discharged.

Even though the secret lien is enforceable against the debtor, it is subordinate to the rights of a bona fide purchaser or a judgment lien creditor. Consequently, if the Notice of Federal Tax Lien has not been properly filed by the time the bankruptcy file, then the chapter 7 trustee (or chapter 11 debtor in possession) may utilize the strong-arm powers of § 544 to avoid the secret lien. In Re Focht, 243 B.R. 263 (Bankr. N.D. Ohio 1999); In Re Cole, 205 B.R. 668(Bankr. D. Mass. 1997). In those cases in which the tax lien has been properly filed, § 724(b)(2) allows the chapter 7 trustee to pay certain priority claims, including administrative expenses and domestic support obligations, from funds that would otherwise be paid to the IRS on its secured tax claim.<sup>7</sup> In Re Fearing, 2008 WL 4690967 (Bankr. C.D. Cal. 2008).

<sup>&</sup>lt;sup>7</sup> A large federal tax lien can lead a debtor's attorney to conclude that a case is a no-asset case because all the debtor's property is encumbered by the tax lien. Watch out for trustees utilizing § 724(b) to liquidate assets to pay DSOs or administrative expenses. Some trustees have been known to "bootstrap" their way to liquidation by churning an otherwise no-asset case, creating administrative expenses, and then asserting the right to sell property encumbered by a tax lien to pay the expenses. Since tax liens take priority over exemptions, the trustee can liquidate property that would have no non-exempt equity in the absence of the tax lien. See In re Laredo, 324 B.R. 401 (Bankr. N.D. Ill. 2005).

The properly filed tax lien survives the bankruptcy in the same manner in which other non-avoided liens survive a chapter 7 bankruptcy. <u>In Re Dinatale</u>, 235 B.R. 569 (Bankr. D. Md. 1999); <u>In Re Pansier</u>, 225 B.R. 657 (E.D. Wis. 1998). The property of the debtor encumbered by the tax lien on the petition date will continue to be encumbered post-discharge. If the debt is nondischargeable, then the lien retains the ability to attach to and encumber property acquired after the discharge. However, if the debt is discharged, the lien does not encumber property acquired post-discharge. <u>In Re Dinatale</u>, <u>supra</u>.

The issue gets more complicated when no notice of the federal tax lien has been filed prepetition. If the tax debt is a dischargeable debt, then the IRS loses its lien on any property that the debtor exempted. At first, this result seems contrary to the combination of two basic principles that liens, unless avoided, survive bankruptcy, and that IRS tax liens take priority over exemptions. Why then, doesn't the IRS retain the right to seize and sell exempt property post-petition? The answer lies in § 522(c)(2)(B). That provision provides that exempt property not liable for claims during or after a case "except a debt secured by a lien that is a tax lien, notice of which is properly filed." (emphasis added). By negative implication, if the tax lien is one for which notice was not properly filed, then the debtor's exempt property is free of the lien. Not every asset that the debtor owns pre-petition and retains post-discharge has been exempted. The trustee may decline to administer some non-exempt property and abandon it pursuant to § 554(c). Some property is excluded from the estate pursuant to  $\S$  541(b)(1)-(9) and (c)(2). See In Re Rich, 197 B.R. 692 (Bankr. N. D. Okla. 1996) (retirement account was property of estate and then exempted from estate, so IRS could not seize payments from retirement account to collect discharged debts which were secured by unfiled tax lien); U.S. v. Rogers, 558 F. Supp. 2d 774 (N.D. Ohio 2008) (retirement account was excluded from estate by § 541(c)(2), so IRS could seize retirement benefits as they were distributed to collect discharged tax debts secured by unfiled tax lien).

The exclusion by § 522(c) of exempt property for the payment of pre-petition debts is generally not limited to dischargeable debts. For example, a debtor is permitted to avoid judgment liens on exempt property even thought the judgment is for a nondischargeable debt. See In Re Lawson, 342 B.R. 98 (Bankr. E.D. Okla. 2006) (avoidance of lien securing nondischargeable student loan). Why then does the IRS have the ability to seize exempt property to collect a tax debt that was not discharged if it failed to file notice of its tax lien? The answer is contained in § 522(c)(1) which excepts § 522(c)'s protection of exempt assets from nondischargeable tax claims and DSO (domestic support obligations) claims.

# **3.** General Unsecured Tax Debts and Penalties

In the rare chapter 7 case in which there is a distribution to general, unsecured creditors, non-penalty, unsecured, nonpriority tax debts are paid on a pro rata basis with other holders of unsecured claims. Pursuant to 11 U.S.C. 726(a)(4), penalties are paid after other claims are paid in full. Whether these claim are discharged or not depends upon the application of \$523(a)(1)(B) and (C) and \$523(a)(7).

# 4. Priority Tax Debt

In an asset chapter 7, priority tax debt is paid in accordance with its eighth place priority status to the extent estate funds are available. As previously stated, priority tax debts are automatically excepted from discharge. Since very few chapter 7 cases are asset cases, the significant consequence that arises from a tax debt's priority status is not that it is paid, but that it is not discharged. However, in these rare assets in which the debtor owes a tax debt, especially if it is priority tax debt, the debtor's attorney should be alert to take the following actions:

- (a) Make sure that the taxing authority files a proof of claims and if it fails to do so file one for it within 30 days after the claim bar date pursuant to Bankruptcy Rule 3004. Otherwise, funds that would be used to pay non-dischargeable debts will be disbursed to other creditors whose debts are dischargeable. Even if all deadlines are missed, get the taxing authority to file a proof of claim or file one for it. 11 U.S.C. Sec. 726(a)(1) provides that priority claims are still paid if the proof of the claim is filed before the trustee begins distribution and within 10 days of the date the trustee mails the summary of the trustee's final report to creditors.
- (b) File motion to delay the granting of the discharge or file an adversary proceeding to enjoin the taxing authority from collecting the tax debt between the time the discharge is granted and the trustee distributes fund to creditors. Otherwise, the taxing authority may collect the debt directly from the debtor from future tax refunds, through garnishment, or through other means. The law appears to be that the debtor has no right to subrogation to the taxing authority's priority claim. The end result is that the debtor ends up paying the debt from his or her own funds that could have been paid by the bankruptcy estate.
- (c) File an election for a short tax year pursuant to 26 U.S.C. Sec 1398(d). The effect of the election is to split the calendar year in which the debtor files the bankruptcy into two tax "years", with the first beginning on January 1 and ending on the day prior to filing the bankruptcy, and the second beginning on the petition date and ending on December 31. If it appears that the debtor is going to owe taxes for the year in which the petition is filed by not making the "short-year" elections, the tax debts will be a post-petition debt that will not

# B. Chapter 13

#### 1. Secured Tax Debt

Pursuant to 11 U.S.C. §1325(a)(B)(5), unless the taxing authority agrees otherwise, the plan must provide for either the payment of present value of the allowed amount of the claim, or the debtor must surrender the property securing the collateral to the creditor. Since surrender of the collateral to the taxing authority is unusual, the typical provision for the secured tax claim is to pay it in full. Section 506(a) operates to limit the value of the secured tax claim to the value of the property securing the claim. With respect to the IRS blanket lien, the value is the debtor's interest in all property of the estate. In calculating this amount, the debtor may not reduce the amount of the secured claim excluding his exempt property. First, 11 U.S.C. §522(c)(2)(B) excludes exemptions from a tax lien notice of which has been property filed. Secondly, under the Supremacy Clause of the United States Constitution, the provisions of 26 U.S.C. §6321 et seq. that grant the IRS a lien on the debtor's property preempts state exemption laws.

The discussion earlier under chapter 7 about "secret liens" and filed liens is relevant to chapter 13. Secret liens are subject to avoidance under § 544. Additionally, \$522(c)(2)(B) provides that the debtor's interest in exempt property is superior to an unfiled tax lien. Consequently, when the IRS files its proof of claim in a chapter 13 case, it files a secured claim only when it has filed its Notice of Federal Tax Lien.

In practice, the IRS, not knowing the nature and value of the debtor's property, will originally file each secured claim in chapter 13 as a fully secured claim. My experience has been that upon providing the IRS with copies of the debtor's schedules, it will amend its proof of claim to reflect the actual value of the debtor's property. Since §1325(a)(5) requires a secured creditor to receive the present value of its claim, a secured tax claim receives interest on the claim. BAPCPA added a new provision to the Bankruptcy Code, § 511, which provides that the interest rate to be paid on secure tax claims through Chapter 13 plan is the amount of the interest plan is confirmed.

# 2. Priority Tax Debt.

Pursuant to 11 U.S.C. §1322(a)(2), a chapter 13 plan must provide for the full payment of all priority tax claims, unless the taxing authority agrees to a different treatment. Section 1322 (a)(2) allows for the full payment in deferred cash payments, so the priority tax claim does not receive interest.

It is not uncommon for the priority tax debt to be too great to be paid within the maximum 60-month term of a chapter 13 plan. However, you can comply with \$1322(a)(2) by obtaining the consent of the IRS to a plan that fails to pay the claim in full. The IRS rarely consents.

# **3.** General, Unsecured Claims.

The claims of the taxing authority that are neither secured nor priority are paid on a pro rata basis with other unsecured claims.

# 4. Allocation of FTL to Claims

It is not uncommon for a FTL to be filed with respect to taxes, interest and penalties that, in the absence of the FTL, would be partially priority claims and partially general, unsecured claims. When the value of the debtor's property exceeds the total amount of the claims, no issue arises since the entire claim is secured. However, when the claim exceeds the value of the property, the issue of allocation of the lien to the separate components of the claim arises. Consider the following example:

The debtor owes taxes and interest of \$6,000.00 for 2005 and \$5,000.00 for 2006. He owes penalties of \$2,500.00 for both years. He has total equity in all his property of \$7,500.00. The IRS has filed a FTL for both tax years.

Under these facts, the debtor would prefer to apply the tax lien to the 2006 taxes first. By doing so, he would have a \$7,500.00 secured claim, no priority claim and a \$6,000.00 general, unsecured claim. The IRS, on the other hand, would prefer to apply the tax lien to the 2005 taxes, then to the penalties, and finally to the 2006 taxes. Upon such an allocation, the IRS has a \$7,500.00 secured claim, a \$5,000.00 priority claim, and a \$1,000.00 general, unsecured claim.

In my experience the IRS allocates its claims to the various components as follows: First, to the taxes from the oldest to newest,<sup>8</sup> and then to penalties. Applying this allocation to the example, the \$7,500.00 in property fully secures the 2005 taxes and partial secures

<sup>&</sup>lt;sup>8</sup> In determining which claim is the oldest, the IRS goes by assessment date. For example, if the 2006 taxes were assessed before the 2005 taxes, the 2006 taxes are older.

(\$1,500.00) the 2006 taxes. The balance of the 2006 taxes (\$3,500.00) is a priority claim. The penalties are general, unsecured claims.

I am not aware of any published opinions from a North Carolina court directing this application. There is an unpublished opinion from the Eastern District holding that penalties are the last to be secured. <u>In Re Rich</u>, Case No. 90-02657-ATS (Bankr. E.D.N.C., June 11, 1991) (A. Thomas Small, J.). <u>See also In Re Specialty Cartage, Inc.</u>, 115 B.R. 164 (Bankr. N.D. Ind. 1989) (allocation from oldest tax period to newest and within each such period allocation first to tax and interest, then to penalty); <u>cf. In Re Buzek</u>, 116 B.R. 82 (Bankr. N.D. Ohio 1990) (IRS permitted to apply collateral to penalty first).

# VII. INTERRELATIONSHIP OF PRIORITY, SECURED AND NON-DISCHARGEABLE TAX CLAIMS

# A. Basic Rule: Priority Equals Nondischargeable

Nondischargeable tax debts are identified in \$523(a)(1)(A)-(C). Subparagraph (A) excepts from the discharge a tax "of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed." Since \$507(a)(8) identifies all the priority tax debts, a priority tax debt is a nondischargeable debt in chapter 7. As set out at page 6, subparagraph (B) and (C) of \$523(a)(1) identify other nondischargeable tax debts, which may be, but are not necessarily, priority tax debt. Therefore, a nondischargeable tax debt is not automatically a priority tax debt. For example, \$507(a)(8)(A) provides that an income tax for a taxable year in which the return was due three years or less prior to the filing of the petition is a priority tax debt. If a debtor has not filed his 2006 income tax return and is filing a bankruptcy on November 21, 2009, his income tax liability for 2006 will be a priority tax debt, but also pursuant to \$523(a)(1)(B) because the return was not filed. However, if the unfiled tax return is for tax year 2005, the tax will not be a priority tax debt, but will be nondischargeable in chapter 7.

# B. Exception to Rule: Erroneous Refunds Are Priority And Dischargeable

11 U.S.C. §507(c) provides as follows:

For the purpose of subsection (a) of this section, a claim of a governmental unit arising from an erroneous refund or credit of a tax has the same priority as a claim for the tax to which such refund or credit relates.

Prior to the enactment of Bankruptcy Amendments and Federal Judgeship Act of 1984, 99 Stat. 333 ("1984 Act"), §507(c) read that "...a claim of a governmental unit arising from an erroneous refund or credit of a *tax shall be treated the same* as a claim for the tax

to which such refund or creditor relates." 11 U.S.C. §507(c) (1983) (emphasis added). In interpreting this provision the courts held that an erroneous refund was not only a priority claim, but also nondischargeable claim if the underlying tax it related would have been such. See Bleak v. United States, 817 F.2d 1368 (9<sup>th</sup> Cir. 1987). However, the 1984 Act amended §507(c) by replacing "shall be treated the same" with "has the same priority." Subsequent to this amendment the courts have held that erroneous refunds are discharged.<sup>9</sup> In Re Jackson, 253 B.R. 570 (N.D. Ala. 2000); But see In Re Frontone, 383 F.3d 656 (7<sup>th</sup> Cir. 2004). Under the rationale utilized by the Seventh Circuit, the erroneous refund must be in the nature of an accounting error, rather than a miscalculation of the amount of tax owed by the taxpayer to be dischargeable.

#### VIII. ADVANCED ISSUES

#### A. Secured Claim Cannot Be Priority; Secured Status Might Affect Dischargeability

Section 523(a)(1)(A) excepts from discharge tax debts "of the kind and for the periods specified in section 507(a)(2) and §507(a)(8) of this title, whether or not a claim for such tax was filed or allowed." (emphasis added) Section 507(a) grants priority status only to "allowed *unsecured* claims." Therefore, a secured claim by definition is not a priority claim. The more intriguing issue is whether a secured tax debt that would otherwise be a priority debt is "of the kind" set out in §507(a)(8). If not, then the debt can be discharged. The following illustrates the significance of this issue.

The debtor files a chapter 7 bankruptcy on November 21, 2002 and provides in her statement of intention to surrender her residence to the mortgage company. She owes both 2001 and 2002 property taxes in the total amount of \$2,200.00. If such taxes were not secured they would be priority taxes pursuant to \$507(a)(8)(B) because they were last payable without penalty one year or less prior to the filing of the petition. However, they are not priority taxes because pursuant to N.C. Gen. Stat. \$105-355 the county has a first lien on the real estate to secure payment of the taxes. The debtor is granted her discharge in February, 2003. The mortgage company delays foreclosure and, by April the taxes have not been paid. The tax collector under pressure to bring in revenue by the end of the fiscal year (June 30) implements a wage garnishment of the debtor's salary pursuant to N.C. Gen. Stat. \$105-368.<sup>10</sup>

If the taxes are "of the kind" set out in 523(a)(B), they were not discharged, and the tax collector's actions are proper. However, if the fact that they are secured excludes

<sup>&</sup>lt;sup>9</sup> Depending upon the facts of the case, the erroneous refund might be excepted from discharge pursuant to 523(a)(6).

<sup>&</sup>lt;sup>10</sup> A similar problem confronts the debtor for the next tax year. If the debtor owns the property on January 1, 2003 then she is liable for the 2003 property taxes. Since this debt is clearly a post-petition tax debt, it is not discharged.

them from being such "kind", the tax collector has violated the discharge injunction. The courts have split on the issue of whether a secured debt can be of the kind set out in §523(a)(8). Some courts have held that "of a kind" in §523(a)(1)(A) refers to the criteria for being a priority tax debt set out in §507(a)(8) other than being an allowed or unsecured claim. In Re Gust, 1997 F.3d 1112 (11 Cir. 1999); In Re Miller, 284 B.R. 121 (Bankr. N.D. Cal. 2002). These courts have based their decisions primarily on the following rational:

Pursuant to \$507(a)(8) a priority claim must be an "allowed claim." Section 523(a)(1)(A) provides that debts of the kind specified in \$507(a)(8) are excepted from discharge, "whether or not a claim for such tax was filed or allowed." The fact that a disallowed claim can still be a nondischargeable claim manifests Congress's intent to include within the category of nondischargeable taxes those taxes that would be priority but for the fact they are disallowed or secured. See In Re Gust, supra.

Other courts have reasoned that a secured claim by definition is "not of the kind" specified in \$507(a)(8), which includes only unsecured claims. Therefore, they are not excepted from discharge pursuant to \$523(a)(1)(A).<sup>11</sup> See In Re Victor, 121 F.3d 1383 ( $10^{th}$  Cir. 1997). A North Carolina case worthy of note on this issue is In Re Spruill, 83 B.R. 359 (Bankr. E.D.N.C. 1988). In Spruill the timely-filed claim for pre-petition taxes of the South Atlantic Production Credit Association ("PCA"), as subrogee of the Franklin County Tax Collector, was disallowed. In Re Spruill, 78 B.R. 766 (Bankr. E.D.N.C. 1987). Post-discharge PCA sought to collect the tax debt as a nondischargeable debt. PCA argued that its claim was excepted from discharge despite the fact that the claim had been disallowed, citing the language in \$523(a)(1)(A) that excepts debts of the kind set out in \$507(a)(8) "whether or not such tax claim was filed or allowed." The court reviewed the legislative history of \$523(a)(1)(A) and concluded that Congress intended to except from discharge only those \$507(a)(8) claims that were disallowed because the claim had not been filed. The court quoted the following from the House Judiciary Committee Report's explanation of \$523(a)(1):

Subsection (a) lists eight kinds of debts excepted from discharge. Taxes that are entitled to priority are excepted from discharge under paragraph (1)... H.R. Rep. No. 95-595, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess. 363-64 (1977), U.S. Code Cong. & Admin. News 1978, p. 6319.

<u>In Re Spruill</u>, 83 B.R. at 359-61. An advocate asserting that secured tax claims do not fall within <sup>523</sup>(a)(1)(A) would be wise to cite <u>Spruil</u> and this legislative history in support of the assertion.

The import of this issue is not limited to the area of secured property tax claims. As discussed at pages 2-3, a FTL is a blanket lien on all of the debtor's property. If a

<sup>&</sup>lt;sup>11</sup> A secured tax might still be non-dischargeable pursuant to §523(a)(1)(B) or (C).

secured claim cannot be a priority claim, then most secured tax claims will be discharged.<sup>12</sup> Consider the following example:

The debtor, a self-employed house framer with a dependant child, owes the IRS \$10,000.00 for 2007-2008 income taxes. The debtor timely filed all tax returns. The IRS has properly filed a FTL. The debtor files a chapter 13 bankruptcy on March 15, 2010. His schedules included \$1,500.00 in wages deposited in his bank account, an unencumbered work truck with a liquidation value of \$4,000.00, \$4,000.00 in furnishings, \$1,250.00 in tools, and accounts receivable of \$1,200.00. The IRS files a proof of claim in the chapter 13 case as a fully secured claim, and the claim is allowed. On September 15, 2010, the debtor converts his case to a chapter 7.

Under this scenario, but for the fact the IRS claim is secured, the 2007-2008 income tax debts would be priority and nondischargeable. Pursuant to the rationale of <u>In Re Victor</u>, <u>supra</u>, the debts are discharged. But under <u>In Re Gust</u>, <u>supra</u>, despite the fact the tax claims are secured, they still are "of the kind" set out in 11 U.S.C. §507(a)(8) and are excepted from discharge. If the debtor were to obtain confirmation of his plan, providing for payment of the IRS claim as a fully secured claim, and then convert to chapter 7, the debtor has a strong case for establishing that his personal liability on the debt is discharged in the chapter 7.

# B. The Meaning of "Provided For" in Chapter 13

Pursuant to \$1322(a) the discharge granted in a chapter 13 case discharges debts "provided for by the plan or disallowed under section 502." If the chapter 13 plan makes the proper provision for the payment of the tax debts, but they are not paid because of the failure of the IRS to file timely a proof of claim, the debts are discharged. <u>In Re Dixon</u>, 218 B.R. 510 (B.A.P. 10<sup>th</sup> Cir. 1998), <u>In Re Thibodaux</u> 201 B.R. 827 (Bankr. N.D. Ala. 1996).

The boiler plate language in a chapter 13 plan providing for the payment of priority debts in full and the payment of unsecured debts in some fashion should be sufficient to provide for the tax debt. However, the plan I file for my clients contains under the section providing for the payment of priority debts the following:

"Taxes: Debtors are not aware of any priority tax claims, but the debtors propose to pay such allowable claim in full."  $^{13}$ 

If the taxing authority does not receive notice of the bankruptcy, in time to file a proof of claim, then the plan has not provided for the debt. Plans pay only allowed claims; claims

<sup>&</sup>lt;sup>12</sup> Only those secured tax claims with respect to which the debtor did not file a return, filed a late return within 2 years prior to filing the petition, made a fraudulent return, or willfully attempted to evade or defeat the tax will be excepted from discharge. 11 U.S.C. \$523(a)(1)(B) and (C).

<sup>&</sup>lt;sup>13</sup> If there are priority debts, they are listed, and the provision reads the same except "any" is replaced with "any other."

must be filed to be allowed. If the taxing authority does not have the opportunity to file a proof of claim, the plan has not provided for its debt. To hold otherwise would violate principles of fundamental fairness.<sup>14</sup> In Re Herndon, 188 B.R. 562. (Bankr. E.D. Ky. 1995). In In ReTrembath, 205 B.R. 909 (Bankr. N.D. Ill. 1997), the debtor was the sole shareholder of a corporation that operated a retail appliance store. The corporation had failed to pay \$60,000.00 in withholding taxes. When the debtor filed his chapter 13 petition the IRS had not yet assessed him with responsible person liability for the unpaid trust fund portion of the taxes pursuant to 11 U.S.C. §6672. He listed the IRS on Schedule E as the holder of a contingent, unliquidated and disputed priority debt in an "unknown" amount. On the Statement of Financial Affairs he provided no information at paragraph 15 related to his ownership and management of the corporation. The court found that the debtor had fraudulently concealed his prior business operations, and therefore had essentially failed to give the IRS notice of the bankruptcy, since he had prevented the IRS from tying his contingent liabilities for the trust fund taxes to the corporation.

The procedure that debtors' attorneys should follow is to always list the IRS and the State Department of Revenue as a creditor using the address mandated by local rule. By doing so you accomplish the following objectives:

- 1. You bring out into the open any tax debts your client didn't disclose. You can deal with these debts much more effectively by discovering them early in process.
- 2. If the taxing authority fails to file a proof of claim, your client can discharge the tax debt with no payment on the debt.
- 3. In some cases your client may owe taxes that have not yet been assessed. In those cases, the taxing authority may not realize the debtor owes taxes until after the claims bar date.<sup>15</sup> In such cases the late filed proof of claim should be disallowed.

#### **D.** Priority Tax or Tax Penalty?

The distinction between a tax and a penalty is most relevant in the context of chapter 13 cases. In no-asset chapter 7 cases, whether the debt is a priority tax or a penalty is not important. It will be excepted from discharge either pursuant to \$523(a)(1)(A) or \$523(a)(7). However, discharge is not the issue for the chapter 13 debtor in proposing a

<sup>&</sup>lt;sup>14</sup> Governmental entities are not protected under the due process clauses of the Fifth or Fourteenth Amendments.

<sup>&</sup>lt;sup>15</sup> The issue of whether the debts has been "provided for" is distinct from the issue of whether the taxing authority should be allowed to file a tardy proof of claim once it becomes aware of the bankruptcy. The courts are split in this issue. <u>Compare Internal Revenue Service v. Hildebrand</u>, 245 B.R. 287 (M.D. Tenn. 2000) (allowing tardy claim) with In Re Brogden, 274 B.R. 287 (Bankr. M.D. Tenn. 2001) (disallowing tardy claim).

confirmable plan. The concern is providing for the full payment of priority claims. If a tax claim is a penalty, it is not a priority claim unless it is in compensation for actual pecuniary loss.<sup>16</sup> 11 U.S.C. \$507(a)(8)(G).

This issue arises with respect to the ten percent "additional tax" imposed upon individual taxpayers who take an early withdrawal of a qualified retirement plan. Consider an individual who took an early withdrawal in 2007 in the amount of \$50,000.00 from her 401-K retirement account to pay living expenses after being laid off by Nortel. If the 10% early withdrawal assessment is a tax, it is either a priority income tax under \$507(a)(8)(A) or a priority excise tax under \$507(a)(8)(E). As a priority tax it must be paid in full in a chapter 13 plan. However, if the assessment is a nonpecuniary-loss penalty, it is a non-priority, unsecured debt, which can be discharged in a chapter 13 without being paid in full. The Tenth Circuit in <u>In Re Cassidy</u>, 983 F.2d 161 (10<sup>th</sup> Cir. 1992), held that the assessment is a nonpecuniary-loss penalty, and therefore is not entitled to priority status. <u>See also In Re Mounier</u>, 232 B.R. 186 (Bankr. S.D. Cal. 1998).

In 2008, the Bankruptcy Court for the Eastern District of North Carolina held in <u>In Re</u> <u>Cespedes</u>, 393 B.R. 403 (Bankr. E.D.N.C. 2008), that the 10% "additional tax" is in fact a penalty, and therefore, is not a priority clam in a chapter 13.

The reporting and payment of the 10% penalty occurs on Form 1040, Line 57, along with the taxpayer's income taxes. Therefore, the early withdrawal penalty is contained in the amount of 1040 tax owed. A debtor's attorney must interrogate each client with respect to income tax liability to ascertain whether the client has any early withdrawal penalties "embedded" is his income tax debt. If the client is uncertain, you can obtain a copy of the transcript or the tax return itself.

Anyone familiar with the 1040 Form knows that all of the various liabilities (income tax, self-employment tax) are tabulated, and then the tax credits and payments (estimated tax payments, withholding payments, etc.) are tabulated. The difference in the two reflects the taxpayer's refund or amount due. What is to prevent the IRS from applying (or reapplying) the payments and credits first to the early withdrawal penalty and then contend that the penalty has been paid and that the remaining amount due represents priority income tax debt? At least one Bankruptcy Court has held that the IRS can do just that. In In Re Edgington, 2001 WL 889741, 89 A.F.T.R. 2d 2002-438 (Bankr. N.D. Cal. 2000),<sup>17</sup> the IRS conceded that the early withdrawal penalty is a nonpriority debt. However, it re-allocated the withholding payments to the payment of penalty, and filed an amended claim reflecting that the unpaid taxes were the priority income taxes. The court held that the IRS could re-allocate the payments unless the taxpayers has made a

<sup>&</sup>lt;sup>16</sup> As short hand for tax penalties that are not in compensation for actual pecuniary loss, I have coined the term "nonpecuniary-loss penalty".

<sup>&</sup>lt;sup>17</sup> Above the caption, the following appears: "This case disposition has no value as precedent and is not intended for publication. Any publication, either in print or electronically, is contrary to the intent and wishes of the court. DO NOT PUBLISH"

voluntary payment and designated the liability to which payments are to be applied. The debtor argued that taxes withheld from wages to pay income taxes are designated for income taxes. Judge Jaroslovsky rejected this argument and held that, assuming the withholding payments are voluntary payments, the debtor has not designated the payments to be applied to income taxes.

If confronted with this issue as a debtor's attorney, I suggest that you argue that taxes withheld from income and designated on a taxpayer's paystub as federal taxes are impliedly, but clearly, designated to the payment of income taxes. Furthermore, point out that the taxpayer participates in this process because the amounts that are withheld are based upon the W-4 form completed by the taxpayer.

The allocation of payment issue arose in the <u>Cespedes</u> case cited above. The debtor withdrew \$58,496.00 in 2006 creating an early withdrawal penalty of \$5850.00 on her 2006 form 1040. Her regular income tax liability from wages and the early withdrawal was \$4,124.00 creating a total liability on the form 1040 of \$9,974.00. The tax liability on the 1040 was reduced by \$1,154 in tax withheld from her wages and a \$51.00 telephone tax credit. The debtor's 2005 tax refund (the debtor filed her 2006 tax return before she file her 2005 tax return) of \$2,699.00 was applied to the debt. Finally, interest accrued on the debt in the amount of \$263.00. Therefore on the petition date, the total liability was \$6,333.00. The IRS argued that it could apply all these payments to the tax penalty, leaving unpaid penalty of \$1,946.00 plus its pro rata share of the interest. The debtor argued that the balance of the payments should be applied to the tax and the penalty on a pro rata basis. The court agreed with the debtor.

Similar penalty-versus-tax issues had arisen in chapter 11 cases with respect to assessments made against employers in connection with their funding or termination of pension plans sponsored under Employers Retirement Income Security Act of 1974 ("ERISA"). For example, 26 U.S.C. §4971(a) imposes a 10 percent "tax" on any "accumulated funding deficiency" of a pension fund sponsored under ERISA, and 26 U.S.C. §4980 imposes a 20 percent "tax" on any employer reversion from a qualified plan under ERISA. If these assessments are excise taxes, they are entitled to priority status if the return for such tax was due within 3 years of the filing of the petition. 11 U.S.C. §507(a)(8)(E). However, if they are nonpecuniary-loss penalties, they are general unsecured claims.

The Fourth Circuit held in <u>In Re C-T of Virginia, Inc.</u>, 977 F.2d 137 (4<sup>th</sup> Cir. 1992) that the assessment imposed pursuant to 26 U.S.C. §4980 is an excise tax entitled to priority status. However, in <u>United States v. Reorganized CF&I Fabrications of Utah, Inc.</u>, 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506 (1996), the issue was whether the "tax" imposed by 26 U.S.C. §4971(a) was a nonpriority penalty or a priority excise tax. The Supreme Court granted certiorari to resolve a split among the circuits on the issue. At footnote 3 it cited C-T of Virginia<sup>18</sup> as one of the circuits holding such taxes to be a

<sup>&</sup>lt;sup>18</sup> The court also cited <u>Cassidy</u>, <u>supra</u>, as one of the split circuits. Therefore, the Court's holding in this case impliedly endorses the holding in <u>Cassidy</u>.

priority excise tax. The Supreme Court held that the "tax" was a nonpecuniary-loss penalty. Therefore, the holding of the Fourth Circuit in  $\underline{C-T}$  of Virginia is not longer valid.

# E. What is a "Required" Return?

As set out earlier, §523(a)(1)(B)(i) excepts from discharge a tax debt in which a required return is not filed. The issue usually arises with respect to income tax returns. Prior to BAPCPA the Bankruptcy Code did not define a "return". The courts looked to four factors in determining whether a document qualifies as a return. It must: (1) purport to be a return; (2) be executed by the taxpayer under penalty of perjury; (3) contain sufficient data to allow the calculation of the tax liability; and (4) represent an honest and reasonable effort on the part of the taxpayer to satisfy the requirements of the tax law. In <u>Re Halton</u>, 220 F.3d 1057 (9<sup>th</sup> Cir. 2000); In <u>Re Hindenlang</u>, 164 F.3d 1029 (6<sup>th</sup> Cir. 1999) cert. denied, 528 U.S. 810, 120 S. Ct. 41, 145 L. Ed. 2d 37 (1999); In <u>Re Hetzler</u>, 262 B.R. 47 (Bankr. D.N.J. 2001).

In applying this general definition of a return to particular fact situations, these guidelines had emerged:

- A substitute for return ("SFR") prepared by the IRS pursuant to 26 U.S.C. §6020(b) or by a state taxing authority does not constitute a return. <u>In Re</u> <u>Bergstrom</u>, 949 F.2d 341 (10<sup>th</sup> Cir. 1991).
- Several courts held that signed IRS forms, other than a Form 1040, can qualify as the return required by \$523(a)(1)(B)(i). In Re Mathis, 249 B.R. 324 (S.D. Fla. 2000) (Form 4549 signed by the debtor and prepared with his co-operation qualified as a return).
- 3. A slight majority of the courts have held that once the SFR has been filed by the IRS for the taxpayer and the tax assessed pursuant to the SFR, the taxpayer's subsequent filing of a return does not qualify as a required return. In Re Halton, supra; In Re Hindenberg, supra; In Re Hetzler, supra; In Re Walsh, 260 B.R. 142 (Bankr. D. Minn. 2001). In essence, these courts hold the once the SFR is filed the taxpayer cannot "fix" the problem by filing a return.
- A minority of courts has held that the subsequent filing of the return qualifies as a return, and prevents the application of §523(a)(1)(B) to except the tax debt from discharge. <u>In Re Woods</u>, 285 B.R. 284 (Bankr. S.D. Ind. 2002); <u>In Re Savage</u>, 218 B.R. 126 (B. A. P. 10<sup>th</sup> Cir. 1998); <u>In Re Ralph</u>, 258 B.R. 504 (Bankr. M.D. Fla. 2000); <u>In Re Crawley</u>, 244 B.R. 121 (Bankr. N.D. Ill. 2000).

BAPCPA simplified the analysis. It added a "hanging paragraph" at the end of § 523(a)(19) that defines a "return" as follows:

For purposes of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankrupcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.

26 U.S.C. § 6020(a) provides as follows:

(a) Preparation of return by Secretary -- If any person shall fail to make a return required by this title or by regulations prescribed thereunder, but shall consent to disclose all information necessary for the preparation thereof, then, and in that case, the Secretary may prepare such return, which, being signed by such person, may be received by the Secretary as the return of such person.

Upon the failure of a taxpayer to file a return, 26 U.S.C. § 6020(b) gives the IRS the authority to prepare and file a return for him upon information available to it. This return is nominated a "substitute for return" (SFR). Once the IRS has filed the SFR pursuant to § 6020(b), overcoming the exception to discharge for failing to file the tax return appears extremely difficult. See In Re Link, 2009 WL 2966162 (Bankr. N.D. Ohio 2009); In re Creekmore, 401 B.R. 748 (Bankr. N.D. Miss. 2008).

# F. Tolling the Look-back Period: In Re Young

In numerous cases courts have been confronted with the issue of the effect of a prior bankruptcy on the expiration of the look-back periods needed to render tax debts nonprority/nondischargeable. Does the filing of a bankruptcy toll the running of the look-back periods? The courts were split on this issue. Most of the earlier courts held that the imposition of the automatic stay tolled the running of the look-back periods. In Re Taylor, 81 F.3d 20 (3d Cir. 1996); In Re West, 5 F.3d 413 (9th Cir. 1992). They primarily based their holdings on the application of 11 U.S.C.§108(c), which tolls the running of periods for commencing or continuing a civil action fixed by nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement. These courts generally gave effect to 26 U.S.C. § 6503(h), which tolled the running of the look-back periods for an additional 6 months following the termination of the automatic stay. The more recent cases recognized that utilizing §108(c) to toll the running of the look-back periods violated the plain meaning of the provision, and held that the time periods continued to expire during prior pending cases. In Re Little, 216 B.R. 769 (Bankr. E.D.N.C. 1997); In Re Nolan, 205 B.R. 885 (Bankr. M.D. Tenn. 1997). The effect of these later holdings was very beneficial to the debtors in some cases. If a debtor filed a chapter 13 before the look-back period expired, the case dismissed after the look-back

period expired, the debtor could then file a chapter 7 and discharge the taxes, or file a second chapter 13 in which the tax debts would not be priority debts entitled to payment in full.

The Supreme Court appeared to the settle the issue in the case of <u>In Re Young</u>, 535 U.S. 43, 122 S. Ct. 1036, 152 L. Ed. 2d 79 (2002). The court reached the conclusion that "the look-back period of 11 U.S.C. \$507(a)(8)(A)(i) is tolled during the pendency of a prior bankruptcy petition." <u>Id</u>. at 1043. The court did not base its holdings on the application of \$108(c), but rather found the look-back period to be a limitations period subject to principles of equitable tolling. It then applied these principals to toll the running of the look-back period.

In <u>Young</u>, the IRS assessed \$15,000.00 in tax debt for the debtors' 1992 income tax liability January 3, 1994. Between April, 1994, and the date of this chapter 13 filing (May 1, 1996), they made minor payments on the tax debt reducing it to \$13,000.00. Their case was dismissed on March 13, 1997, prior to confirmation. One day *prior* to the dismissal the debtors filed a chapter 7.

Has the Supreme Court left the door open for debtors to argue that equitable tolling should not apply in every case? The court stated that tolling was appropriate in the <u>Young</u> case regardless of whether the petitioners' filed the chapter 13 in a good faith attempt to pay debts or solely for the purpose of running out the look-back period. It reasoned that in either case, the IRS had been prevented from collecting its debt. Not every case has facts as bad as <u>Young</u>. In many cases the only significant payment on tax claims occurs while the debtor is in chapter 13. Whether equity requires the tolling of the look-back period should be made on a case-by-case basis. With the right facts, a debtor may be able to prevent the tolling of the look-back period during a prior bankruptcy. But see the author's failed attempt to do so on a case with good facts for the debtor. In re<u>Ann Edwards</u>, 03-01823-5-ATS (Bankr. E.D.N.C. March 9, 2004) (A. Thomas Small, J.).

# G. Federal Tax Liens and Entireties Property: U.S. v. Craft

In the area of secured federal taxes, a case of great significance is <u>United States v. Craft</u>, 535 U.S. 274, 122 S. Ct. 1414 152 L. Ed. 2d 437 (2002). Prior to <u>Craft</u> most everyone assumed that a FTL filed against an individual taxpayer did not encumber real estate the taxpayer owned with his or her spouse as tenants by the entirety. <u>Craft</u> held that an individual's interest in entireties property is an interest in property to which a FTL attaches. As to the valuation of the interest, the Court expressly declined to express a view.

One Bankruptcy Judge who has grappled with the valuation issue is Judge Diane Weiss Sigmund of Bankruptcy Court for the Eastern District of Pennsylvania. She has written three opinions in connection with a chapter 13 bankruptcy filed by Mark V. Basher. See In Re Basher, 2002 WL 3185672 (Bankr. E.D. Pa. 2002) ("Basher I"); In Re Basher, 291 B.R. 357 (Bankr. E.D. Pa. 2003) ("Basher II"); In Re Basher, 2003 WL 22110780 (Bankr. E.D. Pa. 2003) ("Basher III"). The court held in Basher II that the value of the

debtor's interest in the entireties property was 50% adjusted downward by the respective survivorship interests between the debtor and his wife who was slightly younger. The court rejected the debtor's argument that the market value of his interest was essentially nothing due to the contingent nature of the interest arising out of the survivorship component. The court pointed first the Supreme Court's opinion in Associates Commercial Corp. v. Rash, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148 (1997), in which the court held that in chapter 13, §506(a) requires that secured property be valued at the replacement value from the debtor's perspective. More significantly, the court cited United States v. Rodgers, 461 U.S. 677, 103 S. Ct. 2132, 76 L. Ed. 2d 236 (1983), upon which the Supreme Court heavily relied in Craft.<sup>19</sup> In Rodgers, the Court held that 26 U.S.C. §7403 grants a federal district court power to order the sale all parties' interests in property to facilitate the collection of a tax lien, despite the fact that state law requires the consent of the non-taxpayer spouse to sell the property.<sup>20</sup> Another case of note is  $\underline{In}$ Re Hatchett, 330 F.3d 875 (6th Cir. 2003), in which the court held that pursuant to Craft, the IRS can sell the both the taxpayer's and his spouse's interest in the entireties property without utilizing §7403.

Based on the current status of the law, I recommend that debtors' counsel proceed cautiously in filing chapter 13 bankruptcies for debtors who own entireties property which have substantial equity and which are encumbered with a FTL filed only against the debtor.

#### H. Filing Claims For Tax Creditors

Whether the debtor should file a proof of claim for a taxing authority in a chapter 13 depends upon numerous factors and inevitably will involve the exercise of judgment. The following guidelines are designed to assist in exercising that judgment.

- 1. Personal liability on tax debts is discharged in chapter 13 unless the tax return was not filed, filed late and less than 2 years prior to filing, or a fraudulent return. So if there are no tax liens, *and the debtor completes the chapter 13*, filing the claim on behalf of the taxing authority will result in the unnecessary distribution on the tax claim.
- 2. If the tax claim is a priority tax claim, and if in the absence of tax claim the plan distribution to general unsecured creditors over 36 months is an amount

<sup>&</sup>lt;sup>19</sup>A breakdown in the votes in <u>Rodgers</u> and <u>Craft</u> disclose an interesting shift in position by Chief Justice Rehinquist and Justice O'Connor. The rationale supporting the <u>Craft</u> opinion cannot be reconciled with the view of the dissenters in <u>Rodgers</u>. Rehnquist and O'Connor were in the minority in the 5-4 <u>Rodgers</u> decision. They were in the majority in the 6-3 <u>Craft</u> decision, which relied heavily upon the majority opinion in <u>Rodgers</u>. Had they maintained the views they expressed <u>Rodgers</u>, the holding in <u>Craft</u> would have been the opposite.

<sup>&</sup>lt;sup>20</sup> In this regard 26 U.S.C. §7403 operates in a fashion similar to 11 U.S.C. §363(g).

*equal to or greater than the tax claim*, you should consider filing the claim for the taxing authority. The failure to file the tax claim will result in the distribution to dischargeable, unsecured debts that would otherwise be distributed to tax debts. If the case is eventually converted to chapter 7 or dismissed, this distribution will be to the debtor's disadvantage. This consideration has more significance in the Eastern District of North Carolina, which utilizes "pot plans."

- 3. If the tax debt is one that will be excepted from discharge, and the plan provides for a substantial distribution to general unsecured creditors, then filing the claim will divert funds from these creditors to the nondischargeable taxes.
- 4. If the tax claim is secured, then the lien will survive the bankruptcy unless it is paid through the plan. The proper decision on whether to file the claim depends in part upon the amount and type of debtor's property that secured the claim. If the property includes real estate that the debtor intends to retain, the failure to file the claim will result in the lien remaining attached to the property subsequent to the discharge and jeopardize the debtor's fresh start. However, if the property consists primarily of depreciable and consumable personal property, it is unlikely that the taxing authority will ever levy on its lien. In these circumstances filing the claim for the taxing authority will result in an unnecessary distributions on the claim.
- 5. In a chapter 7 filed by an individual, it is almost always beneficial for the debtor to file the proof of claim for the taxing authority. The claim will usually be for priority tax debt, which will be one of the first claims paid, and which will be excepted from discharge to the extent it is not paid.

#### **APPENDIX A**

#### §506. Determination of secured status

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest on the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

#### §507. Priorities

(a) The following expenses and claims have priority in the following order:

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—

- (A) A tax on or measured by income or gross receipts—
  - (i) for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;
  - (ii) assessed within 240 days, plus any time plus 30 days during which an offer in compromise with respect to such tax that was made within 240 days after such assessment was pending; before the date of the filing of the petition; or
  - (iii) other than a tax of a kind specified in section 523(a)(I)(B) or 523
    (a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case;
- (B) a property tax assessed before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition;
- (C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

- (D) an employment tax on a wage, salary, or commission of a kind specified in paragraph (3) of this subsection earned from the debtor before the date of the filing of the petition, whether or not actually paid before such date, for which a return is last due, under applicable law or under any extension, after three years before the date of the filing of the petition;
- (E) an excise tax on—
  - a transaction occurring before the date of the filing of the petition for which a return, if required is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or
  - (ii) if a return in not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition;
- (G) a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss.

#### §522. Exemptions

- (c) Unless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except—
  - (1) a debt of a kind specified in section 523(a)(1) or 523(a)(5) of this title;
  - (2) a debt secured by a lien that is--
  - (B) a tax lien, notice of which is property filed; or

#### §523. Exceptions to discharge.

- (a) A discharge under section 727, 1141. 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
  - (1) for a tax or a customs duty--
    - (A) of the kind and for the periods specified in section 507(a)(2), 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;
    - (B) with respect to which a return, if required--

- (i) was not filed; or
- (ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or
- (7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—
  - (A) relating to a tax of a kind not specified in paragraph (1) of the subsection, or
  - (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.
- (14) incurred to pay a tax to the United States that would be nondischargeable pursuant to paragraph (1);

#### §724. Treatment of certain liens.

- (b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title and that secured an allowed claim for a tax, or proceeds of such property, shall be distributed—
  - (1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is senior to such tax lien;
  - (2) second, to any holder of a claim of a kind specified in sections 507(a)(1), 507(a)(2), 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title, to the extent of the amount of such allowed tax claim that is secured by such tax lien;

#### **§726.** Distribution of property of the estate.

- (a) Except as provided in section 510 of this title, property of the estate shall be distributed--
  - first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed before the date on which the trustee commences distribution under this section;
  - (2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which

is—

(A) timely filed under section 501(a) of this title;

#### §1141. Effect of confirmation

- (d)(1) Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan—
  - (A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section 502(g), 502(h) or 502(i) of this title, whether or not—
    - (i) a proof of the claim based on such debt is filed or deemed filed under section 501 of this title;
    - (ii) such claim is allowed under section 502 of this title; or
    - (iii) the holder of such claim has accepted the plan; and
  - (2) The confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge under section 523 of this title.
  - (3) The confirmation of a plan does not discharge a debtor if--
    - (A) the plan provides for the liquidation of all or substantially all of the property of the estate;
    - (B) the debtor does not engage in business after consummation of the plan; and
    - (C) the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title.

#### §1328. Discharge

- (a) As soon as practicable after completion by the debtor of all payments under the plan, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title, except any debt—
  - (1) provided for under section 1322(b)(5) of this title;
  - (2) of the kind specified in paragraph (5), (8), or (9) of section 523(a) or 523(a)(9) of this title, or [sic]

- (3) for restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime.
- (c) A discharge granted under subsection (b) of this section discharges the debtor from all unsecured debts provided for by the plan or disallowed under section 502 of this title, except any debt—
  - (1) provided for under section 1322(b)(5) of this title; or
  - (2) of a kind specified in section 523(a) of this title.

#### **APPENDIX B**

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IRS EMPLOYEE \_\_\_\_\_

DATE REQUESTED

PRINT DATE: \_\_9-05-2009\_\_

FORM NUMBER: 1040

TAX PERIOD: 2005

#### TAXPAYER IDENTIFICATION NUMBER: 555-55-5555

JOE DOE \_\_\_\_ WOODS AVE. RALEIGH, NC \_\_\_\_\_

BODC-SB BODCLC-V

\*\*FILING STATUS: SINGLE

ANY MINUS BELOW SIGNIFIES A CREDIT AMOUNT—

ACCOUNT BALANCE:	3,568.27
ACCRUED INTERST:	1,634.54 AS OF 09-05-2009
ACCRUED PENALTY	794.99 AS OF 09-05-2009

ACCOUNT BALANCE PLUS ACCRUALS: 5,997.60

EXEMPTIONS: 01 ADJUSTED GROSS INCOME: 24,462.00 TAXABLE INCOME: 17,512.00 TAX PER RETURN: 5,887.00 SE TAXABLE INCOME TAXPAYR: 21,291.00 SE TAXABLE INCOME SPOUSE: 0.00 TOTAL SELF EMPLOY TAX: 3,258.00

PER RETURNE OR AS ADJUSTED

10-19-2006 RETURN DUE DATE OR RETURN RECEIVED DATE (WHICHEVER IS LATER) 11-22-2006 PROCESSING DATE

#### TRANSACTIONS

CODE EXPLANATION	DATE	MONEY AMOUNT (IF APPLICABLE)
150 RETURN FILED AND TAX ASSESSED	11-22-2006	5,887.00
49211-303-58117-9		-,
806 CREDIT FROM WITHHELD TAXES & EXCESS FICA	04-15-2006	255.00-
610 PAYMENT WITH RETURN	10-19-2006	300.00-
170 ESTIMATED TAX PENALTY	11-22-2006	254.00
199945		
166 LATE FILING PENALTY	11-22-2006	1,267.20
199945		
276 FAILURE TO PAY TAX PENALTY	11-22-2006	223.78
199945		
196 INTERST ASSESSED	11-22-2006	340.13
19945		
971 INTENT TO LEVY COLLETIONDUE PROCESS NOTICE	11-14-2007	
LEVY NOTICE ISSUED		
706 OVERPAID CREDIT APPLIED	03-02-2008	207.82-
1040 199612		

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971 INTENT TO LEVY COLLECTIONDUE PROCESS NOTICE 11-22-2007		
RETURN RECEIPT SIGNED		
670 SUBSEQUENT PAYMENT	03-28-2008	320.00-
670 SUBSEQUENT PAYMENT	04-30-2008	320.00-
706 OVERPAID CREDIT APPPLIED	04-15-2008	1,107.02-
1040 200012		
670 SUBSEQUENT PAYMENT	05-31-2008	320.00-
670 SUBSEQUENT PAYMENT	07-16-2008	320.00-
706 OVERPAID CREDIT APPLIED	09-03-2008	300.00-
1040 200012		
670 SUBSEQUENT PAYMENT	08-23-2008	320.00-
670 SUBSEQUENT PAYMENT	10-17-2008	320.00-
670 SUBSEQUENT PAYMENT	12-14-2008	320.00-
582 FEDERAL TAX LIEN	03-08-2009	

PAGE NO-0001

DATE REQUESTED 4-18-2003

FORM NUMBER: 1040

#### TAXPAYER IDENTIFICATION NUMBER: 555-55-5555

\$16,431.77

JOE DOE \_\_\_\_WOODS AVE RALEIGH, NC \_\_\_\_\_

---ANY MINUS BELOW SIGNIFIES A CREDIT AMOUNT---

ACCOUNT BALANCE:	\$12,641.42
ACCRUED INTEREST:	\$ 2,069.37 AS OF 09-09-2009
ACCRUED PENALTY:	\$ 1,720.98 AS OF 09-09-2009
ACCOUNT BALANCE	

**EXEMPTIONS: 01	<b>**FILING STATUS: SINGLE</b>
**ADJUSTED GROSS INCOME:	\$41,835.00
**TAXABLE INCOME:	\$34,785.00
TAX PER RETURN:	\$11,514.00
**SE TAXABLE INCOME TAXPAYR:	\$33,490.00
**SE TAXABLE INCOME SPOUSE:	\$ 0.00
**TOTAL SELF EMPLOY TAX:	\$ 5,124.00

\*\*PER RETURN OR AS ADJUSTED

PLUS ACCRUALS:

# 12-07-2007 RETURN DUE DATE OR RETURN RECEIVED DATE (WHICHEVER IS LATER) 01-08-2008 PROCESSING DATE

#### TRANSACTIONS

CODE	EXPLANATION	DATE	MONEY AMOUNT (IF APPLICABLE)
150 RETURN F 19221-344-	ILED AND TAX ASSESSED	01-08-2008	\$11,514.00
	OM WITHHELD TAXES & EXCESS FI	CA 04-15-2007	\$ 1,853.00-
670 SUBSEQUE	NT PAYMENT	04-15-2007	\$ 100.00-
170 ESTIMATE	D TAX PENALTY	01-08-2008	\$ 215.00
200052			
166 LATE FILIN	IG PENALTY	01-08-2008	\$ 430.24
200052			
276 FAILURE T	O PAY TAX PENALTY	01-08-2008	\$ 714.20
200052			
196 INTEREST	ASSESSED	01-08-2008	\$ 0.00
200052			
	LEVY COLLECTION DUE PROCESS	11-22-2008	
	TURN RECEIPT REQUESTED		
PAGE NO-0002		IRS EI	MPLOYEE 1228231372
		04.16.0000	0.00
	AL TAX ASSESSED	04-16-2009	0.00
582 FEDERAL 7	TAX LIEN	06-08-2009	

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IRS EMPLOYEE 1228231372

PRINT DATE 09-05-2009

TAX PERIOD: DEC 2006

BODC-SB BODCLC-V