Bankruptcy Taxation/Consumer Bankruptcy (joint)

Tax Issues in Consumer Bankruptcy

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BANKRUPTCY BASICS APPLIED TO TAXES

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ILLUSTRATING THE BASICS WITH QUESTIONS AND ANSWERS

Three-year rule

1. Tax year 2002: Income tax of $10,000 reported on a timely filed tax return with no extensions, which tax is unpaid. Is the tax dischargeable on December 8, 2007?

Answer: Yes. More than three years have passed since the due date of the return, which was April 15, 2003.

2. Tax year 2003: Assume today's date is October 7, 2007; assume the 2003 tax return was filed August 31, 2004 with two extensions to October 15, 2004; tax owed is $8,000. Is the tax dischargeable on October 7, 2007?

Answer: No. Three years have not passed since the due date of the return, which was October 15, 2004. That the return was filed more than three years ago is a no-never-mind.

240-day rule

3. Tax year 2003: Assume today's date is December 8, 2007. Assume the 2003 tax return was filed August 31, 2004 with two extensions to October 15, 2004; tax owed is $5,000, which was assessed, after audit, on March 31, 2007. Is the tax dischargeable?

Answer: Yes. Both the three-year rule and 240-day rule are brought into play, and the additional tax assessment passes both rules. The due date was more than three years ago. The tax was assessed 251 days ago.

Variations on the three-year rule

4. Tax year 2002: Income tax of $10,000 reported on a timely filed tax return with no extensions, which tax is unpaid. An offer in compromise is accepted for processing on October 15, 2003 and

rejected on December 7, 2006. Is this tax dischargeable on December 8, 2007?

Answer: Yes. More than three years have passed since the due date of the return, which was April 15, 2003. The offer in compromise has no impact on the three-year period.

5. Tax year 2001: Income tax of $10,000 reported and paid on a timely filed tax return with no extensions; audit concludes with an additional $20,000 due and tax is assessed on September 30, 2003; collection action is set to begin, when on November 15, 2003, taxpayer files a collection due process appeal; the case goes through the appeal process and ultimately taxpayer loses in Tax Court and the IRS resumes collection on December 7, 2006. Is the tax dischargeable on December 8, 2007?

Answer: This question explores the three-year rule and the fact that the time period is probably stayed by a collection due process appeal. One year and seven months have run when time stops running. One year runs after time resumes running. The IRS has had only 2 years and seven months to collect, leaving this tax five months plus 90 days short of being dischargeable. Note, the 240-day rule is passed, as on December 8, 2007 more than 330 days have passed since December 7, 2006.

SFR assessments

6. Tax year 2000: No return filed; no response given to IRS notices; December 7, 2004 IRS assesses $15,000 of tax based on a substitute for return audit. Is the tax dischargeable on December 8, 2007?

Answer: This tax arises from a nonfiled return. It is Type 2, and it is nondischargeable. The three-year period in the question is a red herring. The three-year rule deals only with time from the last extension date.

7. Tax year 2000: No return filed; no response given to IRS notices; December 7, 2004 IRS assesses $15,000 of tax based on a substitute for return audit. On

December 7, 2005, the taxpayer files a corrected return showing that $20,000 is owed. The IRS accepts the return and changes the balance due to $20,000. Is the $20,000, dischargeable on December 8, 2007? Assume first that the taxpayer lives in Superior, Wisconsin (7th Circuit), and then assume the taxpayer lives on the other side of Lake Superior in Duluth, Minnesota (8th Circuit). Does your answer change if the Minnesota taxpayer filed a CDP request on December 7, 2006 and that request is still pending? Do any of your answers change if the tax is reduced instead of increased?

Answer: The question is whether the subsequent filing of a corrected return can undo the SFR assessment. *In re Payne*, 431 F.3d 1055 (7th Cir. 2005) says almost always no, which means that the taxpayer is considered a nonfiler regardless of corrective action taken. *In re Colsen*, 446 F.3d836 (8th Cir. 2006) says yes that the corrected return can be considered a valid return. CDP appeals do no stop the two-year period from running, and the answer does not change.

Liens

8. Assume the taxpayer owes $1,000,000 from a bad tax shelter investment over a 15-year period that ended five years ago. Due to extended examinations, the taxes were not assessed until 2004. The taxpayer owns a home with equity of $80,000 in Palm Springs. The taxpayer also has rights to pensions and social security that will allow the taxpayer to live comfortably (account assets less than $1,000,000). The IRS files a notice of tax lien in Riverside County, but it does not file a notice of tax lien in Sacramento. Assuming the taxes are otherwise dischargeable, what are the rights of the IRS in the equity and the pensions if the taxpayer files for relief in Chapter 7?

Answer: The IRS has full rights in all house "equity." There will be no funds available for distribution to the unsecured creditors, so the trustee will abandon the property. (Beware trustees trying to strike deals with the IRS to sell the property.) Given the IRS reluctance to foreclose against personal residences,

the taxpayer may be able to remain in the house until the tax lien self-releases. As to the pensions and the social security, they are fully exempt. Because the IRS did not file a notice of lien in Sacramento, it will have no rights in the pension and social security after the case is concluded.

Chapter 13

9. Your client has tax debt from 2004 and 2005. There are also substantial "three-prong" community business debts ($100,000+) remaining from a failed business. With the down turn in finances, your client's marriage failed. The divorce decree allocates the business debts to your client. Creditors have started harassing the other spouse, who is now making demands on your client. Are there any helpful bankruptcy remedies?

Answer: Yes, Chapter 13. The plan payments can be used to pay the 2004 & 2005 tax obligations. Chapter 13 will discharge the divorce obligations, even though they are nondischargeable in Chapter 7.

Taxes not consumer debt

10. Your client has substantial tax debt and business debt from a failed business, which debt exceeds the client's mortgage debt and credit card debt. Will your client be subject to means testing and forced into Chapter 13? If you tell this client to go see Weil, are you a debt relief agency?

Answer: The means test applies to debtors with primarily consumer debt. Tax debt is not consumer debt. Debtors with primarily tax debt are not subject to the means test. Note, mortgage debt is consumer debt. If you give bankruptcy advice to an assisted person for compensation, you are a debt relief agency and subject to those rules. Your client is not an assisted person because assisted persons must have primarily consumer debt. Don't take money for telling a client to see a bankruptcy attorney, and you will not be a debt relief agency. *In re Reyes*, 361 B.R. 276, 280-281 (Bankr. S.D. Fla. 2007) (*pro bono* attorney not debt relief agency).

Using the IRM for your client's benefit

11. Your client is teetering on the edge of being forced out of Chapter 7 and into Chapter 13. Can you increase your client's monthly expenses for § 707(b)(2) purposes with your attorney's fees? What about child support payments, which are mentioned specifically in § 1325(b)(2) but not in § 707(b)(2)?

Answer: At first blush, the answer might seem to be no, as attorney's fees are not included in allowable administrative expenses in § 707(b)(2)(A)(ii)(III). *See*, *In re McDonald*, 361 B.R. 527, 530 (Bankr. D. Mont. 2007) (deduction for Chapter 13 attorney's fees would likely be denied). Yet, the debtor's monthly expenses are computed under the IRS standards, and the IRM allows court-ordered payments as well as attorney's fees spent on resolving the debt problem as necessary expenses. IRM § 5.15.1.10.3 (May 1, 2004). Same answer for child support. This issue appears to have been missed in *In re Castle*, 362 B.R. 846, 849 (Bankr. N.D. Ohio 2006).

Inherited IRAs

12. Your client lives in Alabama or Texas, and, prepetition, inherited an IRA. Can that IRA be exempted under state exemptions?

Answer: Courts have not upheld an exemption for inherited IRAs under state exemption law. *In re Navarre*, 332 B.R. 24, 31 (Bankr. M.D. Ala. 2004) (Tax Code treats inherited IRAs differently; different treatment in Bankruptcy Code is also acceptable); and *In re Jarboe*, 365 B.R. 717, 724 (Bankr. S.D. Tex. 2007) (only very weak argument can be made that inherited IRA protects debtor's retirement income; post-BAPCPA case). These cases appear to be incorrect. 11 U.S.C. § 522(n) specifically provides an exemption for IRAs up to $1,000,000. If the debtor's IRA were greater than $1,000,000, then the Bankruptcy Code would override a state exemption statute such as Washington, where the IRA is unlimited. Similarly, § 522(n), should override state rules not allowing inherited IRAs to be exempt because, inherited IRAs are described in I.R.C. § 408.

Reporting to State Agencies

13. Your client lost a case in Tax Court in 1998, and the tax was assessed in 1999. The case was reported by the IRS to the Franchise Tax Board, but not by your client, and, an additional state tax was assessed in 2000. The state tax liability is now $25,000. Assume the date is December 8, 2007, and a bankruptcy petition is filed. Is the state tax debt dischargeable?

Answer: The answer is uncertain. On the one hand, 11 U.S.C. § 523(a) flush language at the end provides that a filed return includes a final order entered by a nonbankruptcy tribunal. Does it matter that the court ruled on the federal tax liability and not the state liability? On the other hand, 11 U.S.C. § 523(a)(1)(B) requires the taxpayer to give notice to the state taxing authority for the tax to be dischargeable, and notice of a federal determination is required to be given to the FTB.

CHAPTER 7 PRIORITY AND DISCHARGEABILITY

The concepts of priority and dischargeability are inextricably intertwined. The discharge rules of § 523 are directly linked in the Bankruptcy Code to the priority rules in § 507(a)(8). This leads to the classification of unsecured priority claims into three types as follows:

		Action Step
Type 1:	Priority/Nondischargeable §§ 523(a)(1)(A) and 507(a)(8)	Pay or delay
Type 2:	Nonpriority/Nondischargeable § 523(a)(1)(B) & (C) § 507(a)(8)(A)(iii) (taxes) § 523(a)(7) (penalties)	Take corrective action, if possible
Type 3:	Nonpriority/Dischargeable residual class	Chapter 7

A centerpiece of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), P.L. 109-8, 119 Stat. 23, was the elimination of special treatment for Type 2 taxes in Chapter 13. Before BAPCPA, the action step was file for Chapter 13. Now, corrective action may or may not be possible. For example, if the debtor is a nonfiler, returns will need to be filed and the debtor will need to wait two years. If the debtor committed fraud, it may be impossible to take any corrective action.

In summary, Chapter 7 works best to discharge liabilities, regardless of size, for which (i) the statute of limitation on assessment for the underlying tax year has run and (ii) the liability was not (A) assessed within the last 240 days nor (B) the subject of an offer in compromise. It provides no relief for relatively fresh tax liabilities or the § 6672 responsible person penalty, regardless of assessment date.

I. The Priority Taxes (Type 1: Priority/Nondischargeable).

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 subsequent return due date, including extensions, for a tax year ending before the petition is filed that can be "seen" as one looks into the future will mean that year is a priority obligation.

The tolling provisions (flush language rule). There are tolling periods found in the flush language at the end of § 507(a)(8). None of the priority time periods run during any time that there is an automatic stay or a bankruptcy plan in place that prevents the taxing authority from taking collection action against the debtor. There is also a 90-day add-on to the applicable time period.

The priority time periods are 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, 90 days are added to the applicable time period.

240-day rule. Any taxes assessed within 240 days of the petition date are not dischargeable. 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 limitation 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 does not run for any time the automatic stay is in effect, plus 90 days. There is 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 § 507(a)(8)(A)(ii)(II), and the other 90-day add-on is found in the flush language at the end of § 507(a)(8).

>Because the flush language add-ons apply, the 240-day period will also be suspended for collection appeals requested by the taxpayer where collection is prohibited.

Not assessed but still assessable rule. Taxes that have not been assessed and are still assessable receive priority treatment. For example, this rule applies to still assessable deficiencies because a case is pending in Tax Court or the taxpayer executed an open-ended waiver of the statute of

limitation on assessment. Not all still assessable taxes receive priority treatment. Any tax that is due from nonfiled returns, returns filed late but within two years of the petition date, and fraud or the taxpayer has committed fraud or willfully attempted to evade or defeat tax will be nondischargeable and not receive priority treatment. This is a bad result, and the potential debtor will need to take corrective action if possible, *e.g.* file a nonfiled return and wait two years.

Trust fund 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. The most common types are the § 6672 responsible person penalty and state and local sales taxes. These taxes are very onerous because there is no time limit to nondischargeability.

Nontrust fund employment taxes and excise taxes. The nontrust fund portion of employment taxes and excise taxes receive Type 1 treatment as long as they are less than 3 years old.

II. Type 2 Taxes (Nonpriority/nondischargeable).

Type 2 taxes are denied discharge by §§ 523(a)(1)(B) and (C). They are denied priority treatment because of a special carve out of the priority rules in § 507(a)(8)(A)(iii). Under the law prior to BAPCPA, these Type 2 taxes received special treatment in Chapter 13. Because Chapter 13 plans only required the payment of priority taxes in full, and, these were not priority taxes, they could be discharged with a payment of pennies on the dollar. BAPCPA changed this rule, and the discharges in Chapter 7 and Chapter 13 are now very similar.

Nonfiled and filed late within 2 years of the petition. Taxes arising from nonfiled returns and returns filed late within two years of the petition are nondischargeable. In determining what constitutes a return, bankruptcy law follows applicable nonbankruptcy law. It includes returns prepared pursuant to I.R.C. § 6020(a) or similar state or local law, a written stipulation to a judgment, or a final order entered by a nonbankruptcy tribunal. Case law has supported the execution of a Form 870 (Waiver of Assessment) after filing of a substitute return but before assessment, Form 4549 (Income Tax Examination Changes), and Form 1902-B (Report of Tax Examination Changes) admitting liability as returns because they established liability. In 2005, the Service changed its position as to all of these forms (870, 1902, 4549, and any successor forms). Because they are not filed under penalty of perjury, the Service

does not believe they should be considered returns. Rev. Rul. 2005-59, 2005-2 C.B. 505; and Chief Counsel Notice 2006-002 (November 22, 2005) (Service will not contest dischargeability of any Form 872, 1902, or 4549 submitted prior to September 12, 2005).

The most controversial issue has been the treatment of taxes arising from returns filed by taxpayers after the IRS does a substitute for return (SFR) assessment. This is a battle in which the IRS has had the upper hand, as three courts of appeal have held that returns filed after an SFR assessment are not valid returns for § 523(a) discharge purposes. *In re Payne*, 431 F.3d 1055 (7th Cir. 2005) (POSNER, J.); *Moroney v. United States (In re Moroney)*, 352 F.3d 902 (4th Cir. 2003); and *United States v. Hindenlang (In re Hindenlang)*, 164 F.3d 1029 (6th Cir. 1999), *cert. denied*, 528 U.S. 810 (1999). The Eighth Circuit has held otherwise. *Colsen v. United States (In re Colsen)*, 446 F.3d 836 (8th Cir. 2006). The issue is whether a return filed by the taxpayer after an SFR assessment can have legal validity. There is no clear textual answer in the Bankruptcy Code. The policy battle is easily summarized. SFR returns are onerous and burdensome for the IRS to prepare. Yet, returns filed by taxpayers after the SFR assessment narrow potential disputes and facilitate compromise. Should the returns filed after SFR assessments be viewed as invalid because the difficult work has been done, or should they be viewed as valid because they are helpful and useful? *See*, K. Weil, "Dischargeability of Taxes in Bankruptcy May Be Impossible If IRS Makes Substitute-for-Return Assessment," 104 J. of Tax. 166 (2006).

Fraud and willful attempt to evade or defeat tax. Any taxes with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat tax are Type 2. The majority position of the Courts of Appeal is that 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 willfulness standard is the same civil standard used in I.R.C. § 6672 for the responsible person penalty. The level of conduct necessary to make a tax nondischargeable is uncertain, and it varies across the country. In the Eleventh Circuit, the failure to file and pay was sufficient to make the tax nondischargeable. *United States v. Fretz (In re Fretz)*, 244 F.3d 1323 (11th Cir. 2001). Other courts require some additional egregious conduct. See K. Weil, *Resolving Your Client's Tax Liabilities* at ¶ 645 (2d ed. CCH 2006) for a survey of cases. Despite the enormous amount of litigation and the varying standards, common sense is the best rule of thumb. If the taxpayer's conduct was egregious, the tax

will not be dischargeable. Hiding assets, living an extravagant life style, and making lavish gifts are all indicators that the tax will not be dischargeable. Falling victim to a crooked tax shelter promoter or acknowledging the debt but taking basic steps to continue living in the face of an IRS collection assault are indicators that the tax will be dischargeable. Outcomes will also depend on the reasonableness of local IRS personnel and the views of the bankruptcy judge.

> **PRACTICE NOTE:** While mitigating behavior may not help when before a court, it may be very important in dealing with the IRS. IRS insolvency officers have enormous discretion to grant or deny a discharge. If an insolvency officer sees attempts to pay tax or correct past behavior, that officer may be more likely to grant a discharge.

CHAPTER 13 BASICS

I. Completing a Chapter 13 plan.

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

Secured claims. Pay all secured claims 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.

Administrative expenses. Pay all administrative expenses in full without interest. Included in this category are attorney's fees and trustee's fees.

Priority claims. Pay all priority claims in full without interest. 11 U.S.C. § 1322(a)(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. 11 U.S.C. § 1325(b)(1). In this author's opinion, the rule seems only to require a minimum payment to creditors, but, courts have held otherwise, finding this both a monetary and temporal requirement, *i.e.*, not only how much must be paid but also how long a Chapter 13 plan must last.

Disposable income is current monthly income less expenditures necessary for support. 11 U.S.C. § 1325(b)(2). The phrase "current monthly income" is a term of art that defines average prepetition income for a period of six months prior to filing. 11 U.S.C. § 101(10A). 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, reoccurring 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 IRS. 11 U.S.C. § 707(b)(2); and *see*, IRM 5.15.1 (Financial Analysis

Handbook) (May 1, 2004). For example, the debtor is allowed the following expenditures:

>Secured payments, including payments to cure and maintain;

>All priority debts, not just those inside 60 months;

>IRS standard and other necessary expenses, and clothing and food can be increased 5% with documentation;[1]

>Reasonable payments for dependents;

>Up to $1,500 for school expenses;

>Documented energy costs above the IRS standards; and

>Chapter 13 trustee's fee.

If the debtor's median income is below the applicable median, then the debtor is bound by reasonableness and not the IRS standards. 11 U.S.C. § 1325(b)(3).

Most courts are holding that a debtor must pay projected disposable income into the plan, not disposable income. The word projected 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. A minority of courts have held that the historical numbers from disposable income are used.

Liquidation Equivalent Distribution. Pay creditors more than they would have received if Chapter 7 had been elected. 11 U.S.C. § 1325(a)(4).

Good Faith. Act in good faith in proposing the Chapter 13 plan and in making the plan payments. 11 U.S.C. § 1325(a)(3). This good faith requirement places a watchful

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[1]Some courts are not familiar with IRS standard and necessary expenses. *Cf.*, IRM § 5.15.1.10.3 (court-ordered payments allowed as well as attorney's fees related to solving current liability) (May 1, 2004); *with*, *In re McDonald*, 361 B.R. 527, 530 (Bankr. D. Mont. 2007) (deduction for Chapter 13 attorney's fees would likely be denied).

eye over the debtor, and it can be used by governmental entities to block plan confirmation.

Miscellaneous. For a debtor to qualify for Chapter 13, the debtor's noncontingent, liquidated unsecured debts cannot exceed $336,900, as adjusted for inflation every three years, and the debtor's noncontingent, liquidated secured debts cannot exceed $1,010,650, as adjusted for inflation every three years. 11 U.S.C. § 109(e). The next inflation adjustment is April 1, 2010.

Under § 1308, a debtor must file tax returns for the four most recent tax years ending on or before the petition date. A plan cannot be confirmed unless these returns are filed.

A Chapter 13 filing does not create a separate taxable estate. Because the discharge is not granted until the plan is completed, the debtor retains the use of tax attributes throughout the life of the plan.

II. When a Chapter 13 filing may be advantageous.

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 11 U.S.C. § 523(a)(14), provided the original intent was to pay the card in full.

>It discharges certain types of hold harmless divorce obligations set forth in 11 U.S.C. § 523(a)(15).

>It discharges all types of tax penalties.

>Priority/nondischargeable tax obligations, other than trust fund taxes, can be paid without postpetition interest being incurred. The tradeoff is between 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 postpetition appreciation.

>As to a purchase money security interest incurred to purchase a motor vehicle within 910 days of filing or a purchase money security interest used to purchase any other asset within one year of filing, the debtor can

surrender the secured property and the secured creditor's claim will be satisfied, or, at worst, the secured creditor will hold an unsecured claim.

>Repayments of pension plan loans reduce the required payment to unsecured creditors. 11 U.S.C. § 1322(f).

>Because a separate taxable entity is not created, the debtor retains tax attributes until the plan is completed and the debt is discharged.

BAPCPA CHANGES TO CHAPTER 11

I. No discharge of fraudulent taxes in Chapter 11.

Under old law, no debt (tax or otherwise) was excepted from discharge for a corporate Chapter 11 debtor. Under amended § 1141(d)(6)(B), taxes and custom duties with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat are excepted from discharge. This imports into corporate Chapter 11s one of the most contentious battles in individual Chapter 7 cases. What acts constitute willful intent to evade or defeat tax? Furthermore, the new law leaves unclear whether the Tax Code burden of proof for fraud of "clear and convincing evidence" will be used or whether the burden of proof for fraud will be the more standard bankruptcy burden of "preponderance of the evidence."

II. Payment of taxes in Chapter 11 cases.

Under old law, secured tax claims could be paid over a time period selected by the debtor, as long as the taxing authority received interest. Priority tax claims had to be paid within six years of assessment. This led to the anomalous result of secured, priority claims, which intuitively ought to receive better treatment, often being paid over a longer period of time than priority claims. As to priority claims, the debtor was able to pay as the debtor so elected, as long as the claims were paid in full within six years of assessment. Thus, some courts allowed balloon payments.

Under amended § 1129(a)(9)(c) and new § 1129(a)(9)(D), priority claims under § 507(a)(8) must be paid within five years of the date the order for relief is entered. Five years from entry of the order of relief can mean a longer or shorter time period than under old law, depending on the age of the tax obligation. Payments must be "regular installment payments" in cash, but BAPCPA does not define "regular installment payments." Are regular installment payments monthly, quarterly, or annually? Do regular installment payments leave room for a balloon payment? Regardless, payments to priority claimants must be made at least as quickly as payments to unsecured, nonpriority creditors, other than payments to *de minimis* creditors, who are generally cashed out shortly after plan confirmation. As to secured claims, if the claim is one that would also be eligible for treatment as a priority unsecured claim, then payment on the claim is made as if it were a priority claim.

III. Standards for tax disclosure in Chapter 11 plans.

Before a Chapter 11 plan can be confirmed, a debtor must file a disclosure statement that contains "adequate information," so that an informed judgment can be made on accepting the Chapter 11 plan. § 1125(a) and (b). Under old law, the extent to which tax-related information needed to be disclosed to provide "adequate information" was unclear. Under amended § 1125(a)(1), the definition of "adequate information" is expanded so that a Chapter 11 plan must discuss the potential material federal tax consequences to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case. The word "discuss" is not defined, so guidance is not given as to the depth of discussion required. State jurisdictions are not included in new § 1125(a)(1) because it would be an administrative nightmare to discuss the state tax implications to hypothetical investors in more than 50 different jurisdictions.

IV. Chapter 11 tax years in year of filing no longer bifurcated.

Under old law, courts bifurcated the tax due on corporate tax years in the year of filing between prepetition (priority) and postpetition (administrative expense). *Towers v. United States (In re Pac.-Atl. Trading Co.)*, 64 F.3d 1292 (9th Cir. 1995). In reaching its holding, *In re Pac.-Atl. Trading Co.* relied on the fact that the phrase "for a taxable year ending on or before the date of the filing of the petition" could be found in § 507(a)(8)(A)(i) but not in § 507(a)(8)(A)(iii). Thus, tax owed in the year of filing fit the literal language of (iii). BAPCPA moved the phrase "for a taxable year ending on or before the date of the filing of the petition" out of § 507(a)(8)(A)(i) and into the flush language of § 507(a)(8)(A), thereby overruling *In re Pac.-Atl. Trading Co.* Thus, corporate tax years in the year of filing should no longer be bifurcated.

V. Earnings of individual Chapter 11 debtors belong to estate.

IRC § 1398 creates a separate taxable estate for individuals filing for relief under Chapter 11. Under new § 1115(a)(2), postpetition earnings from services performed by the debtor are property of the bankruptcy estate until the case is closed, dismissed, or converted. If the income belongs to the bankruptcy estate, then the tax is payable by the bankruptcy estate. In Notice 2006-83, the IRS provided guidance on how individual Chapter 11 debtors should report income under new § 1115(a)(2).

SECURED 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. 11 U.S.C. § 101(37). Once it arises, a lien sticks to property like glue. Until discharged, the lien attaches to property and remains attached regardless of ownership changes.

In legal language, liens are *in rem* obligations, *i.e.*, obligations against a thing. Bankruptcy discharges *in personam* or personal obligations like credit cards, where only the debtor's good word backs-up or "secures" the debt. Bankruptcy does not discharge *in rem* obligations, and it does not discharge a valid tax lien that is attached to the debtor's property. The advantage to filing for bankruptcy before the IRS properly files its notice of lien is that the bankruptcy will prevent the IRS from perfecting the lien, and the tax lien will not reach its full priming power. In other words, the tax debt remains an *in personam* obligation and potentially dischargeable in bankruptcy.

The federal tax lien arises automatically if, after demand, a person "neglects or refuses to pay the tax." I.R.C. § 6321. 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 IRS must make notice and demand on the taxpayer; and the taxpayer must fail to pay within 21 calendar days (10 business days if debt equals or exceeds $100,000). The lien relates back to the date of assessment. I.R.C. § 6322. On the "back-end," if not otherwise satisfied, tax liens self-release one month after the statute of limitation on collection runs. I.R.C. § 6325(a).

For a tax lien to reach its full priming or secured power, a valid notice of tax lien must be filed. I.R.C. § 6323(a). The notice of lien 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 IRS. That is, one filing allows the lien to attach against

both real and personal property. Other states, *e.g.*, California 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. See IRM Exhibit 5.12.2-4 (2/1/07) for a state-by-state list of places to file. Note, the bankruptcy discharge will prevent the lien from attaching to any property acquired after the bankruptcy filing.

A tax lien will not receive the special status of secured claim if it is not supported by a notice of lien filing. This results from 11 U.S.C. § 544(a), which deems the trustee a judgment creditor as of the filing date, and I.R.C. § 6323(a), which places a judgment creditor ahead of a tax lien not supported by notice. In Chapter 7, such unsecured tax claims, as well as undersecured claims and unliquidated tax claims where the lien has not yet arisen, are dealt with under the distribution rules of 11 U.S.C. § 726(a)(1), which provide that property of the estate shall first be distributed in the order specified in 11 U.S.C. § 507.

GLOSSARY

1. **Insolvency**: Inability of a person to pay obligations as they come due. (This definition notwithstanding, the Tax Code uses a balance sheet test for insolvency.[2])

2. **Bankruptcy**: Act of filing petition for relief from creditors under Title 11 of the United States Code (cited as 11 U.S.C. ____).

3. **Bankruptcy Court**: Federal court where the petition for relief is filed and the case is administered.

4. **Debtor**: Person who owes money, and except for involuntary cases, the person who files petition for relief.

5. **Prepetition**: Time period before the petition is filed.

6. **Postpetition**: Time period after the petition is filed.

7. **Bankruptcy Estate**: Assets of a debtor administered in bankruptcy; created automatically at commencement of case.

8. **Exempt Assets**: Portion of an individual's assets excluded from the bankruptcy estate. This exclusion helps provide the individual debtor with a fresh start.

9. **Creditor**: Person who holds a claim against the debtor.

10. **Automatic stay**: Prevents creditor from taking collection action upon filing of bankruptcy petition.

11. **Claim**: Potential right to payment from bankruptcy estate assets. Claim is a prepetition concept; postpetition, an entity files a request for payment of an administrative expense.

12. **Secured claim:** 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).

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[2] I.R.C. § 108(d)(3).

13. **Priority**: Ranking of creditor's claim for purposes of asset distribution. Bankruptcy does not work like a soup kitchen, 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, one's ranking is important. Secured creditors come first as to assets in which they have a security interest. Creditors holding certain administrative expenses and claims are next in line. The debtor comes last.

As an adverb that modifies tax, *i.e.*, priority tax claim, priority refers to the class of general unsecured tax claims that comes first.

14. **Discharge**: Goal of debtor in bankruptcy, *i.e.*, removal of legal obligation to pay creditors. If the legal obligation cannot be removed, a debt is nondischargeable.

15. **In rem and in personam obligations:** An *in rem* obligation is an obligation secured by a thing, *i.e.*, a secured claim. *In personam* obligations are secured only by a person's good word. Bankruptcy discharges *in personam* obligations. Bankruptcy does not discharge *in rem* obligations. This is why notices of tax lien can be death to a successful bankruptcy filing.

16. **Chapters 7, 11, 13, and 12**: Title 11 of the United States Code authorizes the filing of bankruptcy petitions for individuals under Chapters 7, 11, 13, or 12. Chapter 7 provides for the liquidation of the debtor's assets. Chapter 11 provides for a payment of creditors through a Chapter 11 plan of reorganization. Chapter 13 is known as the adjustment of debts of an individual with regular income, and it provides for the payment of creditors through a Chapter 13 plan. Chapter 12 is the adjustment of the debts of a family farmer or family fisher with regular annual income, and it provides for the payment of creditors through a Chapter 12 plan. Chapter 12 contains many special debtor-friendly rules not found in other chapters. For example, it allows debtors to convert potential priority/nondischargeable tax debt that arises from the sale of farm or fish assets used in the business into nonpriority/dischargeable tax debt.

17. **Trustee**: Person who administers the bankruptcy estate. The trustee conserves and manages the assets of the bankruptcy estate. In Chapter 11, the debtor can be the trustee, and that debtor is known as a debtor-in-possession.
In Chapter 13, the Bankruptcy Code provides for the appointment

of a standing trustee who administers Chapter 13 cases in that district.

The Bankruptcy Code also provides for the office of United States Trustee. In a perfect world, creditors would closely monitor the debtor to insure fair and efficient administration. In the real world, creditors often have an insufficient economic interest in the bankruptcy estate; therefore, they ignore the bankruptcy process altogether. The United States Trustee monitors the system to insure fair and efficient administration.