

# SELECTED BANKRUPTCY RELATED TAX PROBLEMS

by

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May 9, 2012

Render to Caesar the things that are Caesar's, and to God the things that are God's." Luke 20:25 (NAS)

There are many areas of dispute involving tax liability that come into play in the Bankruptcy Court. For example, litigation over tax priority, secured or unsecured status of tax claims, liability of nondebtor taxpayers, dischargeability of tax claims, and liability of a trustee for tax payment during the administration of a case are prime examples of areas which have been significantly litigated in recent years. Additional areas for litigation are: right to subrogate to a tax priority claim; determination of liability for tax obligations generated from abandonment of administered property; pursuit of third-party entities for debtor tax liabilities; and interest on tax claims.

The question of tax liability may be raised in numerous ways in a bankruptcy case. An expedited return may be filed by a debtor or trustee. A motion for determination of tax liability pursuant to 11 U.S.C. ' 505 may be filed. This section grants to the Bankruptcy Court the jurisdiction to determine tax liability of the debtor if such has not been previously adjudicated. The use of the Bankruptcy Court for this purpose is becoming more prevalent.

## I. BANKRUPTCY COURT JURISDICTION

- A. Power to Determine Tax Liability. The Bankruptcy Court under 11 USC ' 505 has the power to resolve any unpaid tax liability that has not

been contested before an administrative or judicial court of competent jurisdiction prior to the petition date. It also allows the prosecution of an appeal by the trustee (or the debtor-in-possession) within the time constraints of applicable law. This is abated for up to 120 days following a request for a tax refund to allow the tax authority to determine the estate's entitlement to such refund. There is nothing to prevent the IRS, a creditor, or a class of creditors from allocating tax liability by use of a motion pursuant to ' 505. Although there are no time periods for contesting income or sales taxes under this provision, BAPCPA limits the time period to contest ad valorem real and personal property taxes to the applicable non-bankruptcy period. 11 U.S.C. § 505(a)(2)(c).

- B. Automatic Stay. The automatic stay under 11 U.S.C. ' 362 enjoins the IRS from further attempts to collect, or recover a claim against the debtor and stays the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor. The IRS may be held in contempt for willfully violating the automatic stay. It also tolls the applicable statute of limitations for the time of the stay plus 30 days from notice of expiration of the stay. 11 U.S.C. ' 108(c)(2). The statute of limitations is tolled for the duration of the stay plus 6 months on all nondischargeable federal tax claims. I.R.C. ' 6503(b). The automatic stay, however, does not suspend the debtor's duties as a taxpayer. The debtor-in-possession must still withhold FICA and withholding taxes as well as FUTA taxes or face the consequences of a penalty. Ott v. U.S., 419 U.S. 43 (1974). The government is not stayed from offsetting tax refunds for pre-petition periods against pre-petition tax liabilities. 11 U.S.C. § 362(b)(26).
- C. Power to Enjoin Collection Against Nondebtors. 11 U.S.C. ' 105 is oftentimes used by debtors-

in-possession in chapter 11 proceedings to enjoin actions by creditors against nondebtor guarantors. Generally, this is only allowed when the continuation of that action would impair the ability of the debtor to reorganize. However, the Anti-Injunction Act, 26 U.S.C. ' 7421(a), prohibits injunctions of the IRS from collecting from nondebtors.

D. Power to Determine Tax Liability of Nondebtor.

Employers are required to deduct and withhold income taxes and FICA taxes. I.R.C. ' 3102(a) and 3402. These "trust fund taxes" are those taxes withheld by employers from employee's wages that are required to be held in trust pursuant to 26 U.S.C ' 7501. I.R.C. ' 6652 imposes personal liability upon "any person required to collect, truthfully account for, and pay over any tax Imposed by this Title who willfully fails to collect. . . shall, in addition to other penalties provided by law, be liable to a penalty to a total amount of the tax . . . not collected. . . and paid over. If the employer fails to remit the taxes, then the government may look to a responsible person for payment. The responsible person is deemed to be one who had the power, duty and control over the collection and remittance of trust fund taxes." Monday v. U.S., 421 F.2d 1210 (7th Cir. 1970).

I.R.C. ' 6672 liability of the responsible person is separate and distinct from the employer so that the IRS need not exhaust its collection efforts against the employer prior to assessing the ' 6672 penalty. Datlob v. U.S., 370 F.2d 655 (3rd Cir. 1966). Most courts have held that the Bankruptcy Court has no jurisdiction to adjudicate the tax liability of a nondebtor. U.S. v. Huckabee Auto Company, 783 F.2d 1546 (11th Cir. 1986).

E. Allocation of Payments Made by the Debtor to Trust Fund Taxes. Generally speaking, voluntary payments made by a taxpayer to the IRS can be allocated in any manner designated by the

taxpayer. Involuntary payments obtained by the IRS through collection or levy may be allocated by the IRS in any manner as the IRS sees fit. The IRS will apply it to nontrust fund taxes first in order to collect the full amount of the taxes. Until recently, most courts held that payments pursuant to a chapter 11 plan were not voluntary payments such that the IRS could apply them as they saw fit leaving the responsible persons liable for payments beyond those made by the debtor. However, the Supreme Court, in U.S. v. Energy Resources Company, Inc., 110 S. Ct. 2139 (1990), has held that the Bankruptcy Court may order the IRS to treat tax payments made by chapter 11 debtor corporations as trust fund payments where that designation is necessary for the success of the reorganization plan.

## II. PRE-FILING CONSIDERATIONS

- A. Are the Claims Dischargeable? The first consideration is whether the tax liability is dischargeable. It is an overly broad statement that one cannot discharge tax claims. One must look both to 11 U.S.C. ' 523(a)(1) and 11 U.S.C. ' 507(a)(7) to determine whether such claims are dischargeable.
1. Taxpayer Test
    - a. Chapter 7-Individuals
    - b. Chapter 11-Corporation and Partnerships
    - c. Chapter 13-Individuals
  2. Tax Return Due Date Test
  3. Tax Return Filing Date Test
  4. Assessment Date Test
  5. Tax Deficiency Assessment Test
  6. Fraudulent Return Test
  7. Timely Notification Test
  8. Type of Tax Debt Test
    - (i) Responsible for Collection
    - (ii) Excise Taxes
  9. Pre or Post Petition Taxes

- B. The Filing of Liens. Secured claims held by the IRS attach to the collateral as do other liens. A lien is created when the IRS makes an assessment. The lien attaches to all property of the taxpayer. I.R.C. ' 6321. A tax lien refers back to the date of assessment and continues until paid or until it becomes stale. This was recently extended to 10 years from 6 years. I.R.C. ' 6322, 6502. A tax claim will be unsecured unless a tax lien is recorded under I.R.C. ' 6323(f) and applicable state law. The trustee may invalidate any tax lien that has not been filed prior to the commencement of the bankruptcy with respect to property in I.R.C. ' 6323(b) and (c). 11 U.S.C. ' 544(a). However, the trustee may not avoid as a preference a lien filed within 90 days of the petition. ' 547(c)(6). Collateral subject to tax liens may be sold and the proceeds distributed in accordance with the priority provisions of the Bankruptcy Code 11 U.S.C. § 363. A valid tax lien is treated as a secured claim under Chapter 11. The order of payment for distribution on the sale of collateral for property subject to tax liens is: (1) perfected senior lien filed prior to the tax lien; (2) priority claims authorized by ' 507; (3) tax claims secured by tax liens; (4) junior lienholders; (5) tax claims to the extent they are not fully paid; (6) bankruptcy estate. 11 U.S.C. ' 724(b). An IRS would attach to entities interest to allow seizure and not just to the expectancy interest even if such interest would be subject to exemption under state law. U.S. v. Craft, 122 S. Ct. 1414 (2002).
- C. The Effect of Pre-Petition Seizure. If property has been seized by the IRS prior to the filing of the bankruptcy proceeding but prior to disposition of the property by the IRS (or any other creditor), the property is subject to turnover pursuant to 11 U.S.C. ' 542. U.S. v.

Whiting Pools. Inc., 103 S. Ct. 2302 (1983).

Property that has been seized is not excepted from preference actions under 11 U.S.C. ' 547(c)(6) but may be subject to other exceptions from preferential attack.

- D. The Effect of Debt Forgiveness Income. Section 108 of the Bankruptcy Tax Act of 1980 modified the prior law governing the federal income tax treatment of debt forgiveness. Discharge of both recourse and nonrecourse debts of a taxpayer are subject to the debt forgiveness provisions of ' 108. The provisions are quite complex and involve numerous changes of tax attributes. Generally speaking, the forgiveness of an indebtedness owing by a taxpayer gives rise to income for tax purposes except (i) when such discharge occurs within the confines of a Title 11 bankruptcy case, or (ii) where the debtor is insolvent, or to the extent that the debt forgiveness would then render him solvent with the solvency being defined as the fair value of the assets less liabilities. This determination is made on the basis of the taxpayer's assets and liabilities immediately before the forgive- ness with a very broad definition of assets.
- E. Capital Gains Possibilities in the Event of Foreclosure. A foreclosure sale is deemed to be a sale for the purposes of triggering capital gain treatment. As a result, the timing of the foreclosure may be imperative.
- F. Will the Bankruptcy Estate be a Separate Entity for Tax Purposes?
1. Individual debtors in a chapter 7 or chapter 11 case are separate entities for federal income tax purposes. I.R.C. ' 1398(a) and (c)(1). Except for family farmers, post-petition income is taxable to

the estate for federal, state and local income tax purposes. The tax liability is an administrative expense and the individual is not liable from his exempt or after-acquired assets. The return for such estate shall be filed by the trustee. I.R.C. ' 6012. The tax shall be paid by the trustee. I.R.C. ' 1398. There is no return required under chapter 7 unless the estate has net taxable income for the entire period. Certain tax planning should occur resulting in the debtor considering the possibility of electing to close the taxable year as of the day before the commencement of the case. I.R.C. ' 1398(d)(2). If the debtor has taxable income for the short period, this will give rise to a pre-petition liability and will be a liability of the estate, subject to nondischargeability rules of 11 U.S.C. ' 523 but would be subject to distribution from assets of the estate. A tax liability arising as a result of a return filed post-petition gives rise to a post-petition tax liability and not to a pre-petition liability even if the event giving rise to the tax liability occurred re-petition. In re Gonzalez, 112 B.R. 10 (Bky. E.D. Tex. 1990).

2. Estates for partnerships and corporations do not create separate taxable entities. I.R.C. ' 1399. As a result, the partnership remains a pass-through entity and each partner reports his distributive share of the partnership's post-petition income, deductions and credits.

G. Other Pre-Filing Considerations:

1. Does the debtor have N.O.L.=s ?
2. Have assessments been made against

- responsible parties for trust fund taxes?
3. Are offers in compromise pending or are they possible?
  4. Can you get blood out of a turnip?
  5. Are there recapture of tax credit problems?

### III. IRS CLAIMS

#### A. Chapter 7.

1. Pursuant to Bankruptcy Rule 3004 and ' 502(b)(9), the debtor has 30 days after the original 180-day claims bar date in which to file a claim on behalf of the IRS. If a claim is otherwise nondischargeable, it remains nondischargeable regardless whether the IRS files a claim. In the event that there are sufficient assets in an estate to pay a nondischargeable claim of the IRS, then it is in the interest of the debtor to see that a claim for the IRS is filed.
2. Interest on the nondischargeable claim continues to accrue against the debtor even though the priority claim of the Bankruptcy Court does not bear interest.

#### B. Chapter 11.

1. Priority claims of the IRS must be satisfied within 6 years of date of the assessment. 11 U.S.C. § 1129 (a) (9) (C).
2. Payments under the plan can be deemed to be voluntary payments and applied to the trust fund portion. U.S. v. Energy Resource Company, Inc., 110 S.Ct. 2139 (1990).
3. Taxes withheld but not paid and penalties and interest thereon incurred during the chapter 11 proceeding are deemed a first priority administrative expense. U.S. v. Friendship College, Inc., 737 F.2d 430 (4th Cir. 1984).



4. Post-confirmation taxes incurred by reorganized debtor are not administrative expenses in a subsequent chapter 7 proceeding. U.S. v. Redmond, 36 B.R. 932 (D.C. Kan. 1983); also, see In re Frank Meador Buick, Inc., 65 B.R. 200 (D. Virgo 1986).
5. The claim of the IRS generally does not bear interest until confirmation. However, at the time of confirmation, the claim will bear interest at the rate designated in 26 U.S.C. ' 6621.

C. Chapter 13.

1. Chapter 13 contains a "super discharge" that will discharge unfiled IRS claims. 11 U.S.C. S 1328.
2. The jurisdictional limit of a chapter 13 is presently \$360,475 unsecured and \$1,081,400 secured.
3. The failure of the IRS to file a claim for a duly- listed priority indebtedness may result in discharge of that indebtedness. In re Richards, 50 B.R. 339 (E.D. 1985); and In re Tomlin, 102 B.R. 790 (E.D. Wash. 1989).
4. Priority claims of the IRS will not bear interest or penalties post-petition and will be discharged upon completion of the plan payments. Compare 11 U.S.C. ' 1129(a)(9)(B) with ' 1325. Secured claims are entitled to interest. 11 U.S.C. S 506(b).
5. The plan must provide for payment to the IRS for priority claims. The plan may extend up to 5 years from filing date.

- D. Timely-Filed claims. When the IRS is not listed as a creditor, then it is allowed to file an untimely claim. In re Bares, 65 B.R. 407 (By. Mary. 1986). Generally speaking, the IRS

cannot amend timely filed claims to allege a different basis for claim. In re Miller, 118 B.R. 76 (E.D. Tenn. 1989). In chapter 7 proceedings all priority claims may be filed tardily up to the earlier of 10 days after the mailing of the summary of the trustee's final report or the date on which the trustee commences final distribution. 11 U.S.C. § 726(a)(1).

- E. Administrative Expense Claims. Administrative expense claims incurred in a chapter 11 must be filed by the bar date in a converted chapter 7 proceeding. In re Johnson, 901 F.2d 513 (6th Cir. 1990).
- F. Subrogation to priority status of tax claims is prohibited. 11 U.S.C. § 507(d).

#### IV. POST-PETITION TAX LIABILITY

- A. Liability for Post-Petition Taxes. As noted previously, the estate is liable for taxes generated post-petition. If a trustee disposes of property which gives rise to a tax penalty and/or a tax liability, then the estate is liable for those tax consequences. Matter of Kochell, 804 F.2d 84 (7th Cir. 1986) (the estate liable for penalty and taxes arising from early withdrawal of IRA). The estate is liable for taxes incurred post-petition. I.R.C. ' 346(b)(1). There is no tax effect resulting from transfers of property by the debtor to the estate or by the estate to the debtor. I.R.C. ' 1398(f), Code ' 346(g)(1). A trustee is required to file a return where there is net taxable income to the estate. 11 U.S.C. ' 728(b), and ' 346(c)(2). Administrative expenses are allowed as a deduction. In addition, the estate takes on the attributes of the debtor specified in I.R.C. ' 1398(g) which include:
  - 1. N.O.L. 's;
  - 2. charitable contributions carryover;

3. recovery of tax benefit items;
4. credit carryovers;
5. capital loss carryovers;
6. basis, holding period in character of assets;
7. method of accounting; and
8. others if provided by IRS and regulations.

During the case, the debtor may not use these attributes and the estate may carry back net operating losses realized during administration to obtain a refund of prepetition taxes paid by the debtor. I.R.C. ' 1398{j}{2}

- B. Abandonment of Property by the Trustee. If the trustee sells property of the estate and abandons or pays the proceeds to a secured creditor, then the estate is liable for the taxes incurred from the sale. In re Bentley, 916 F.2d 431 (8th Cir. 1990). The abandonment by the trustee without sale does not result in a liability to the debtor. A subsequent foreclosure or deed in lieu of foreclosure may give rise to gain to the debtor for post-petition liability. In re Olson, 121 B.R. 346 (N.D. Iowa 1990).
- C. Pre-Petition Wage Claims. 11 U.S.C. ' 507(a)(3) allows a priority wage claim for unpaid wages. This is limited to \$11,725.00 for wages earned within 90 days of the petition date. At the time that the trustee makes a disbursement on those claims, the trustee is required, to pay all employment taxes, FICA and FUTA, to the proper governmental agency. Ott v. U.S., 419 U.S. 43 (1974) and Laub Banking Company v. U.S., 642 F.2d 196 (6th Cir. 1981). Failure to do so will result in personal liability to the trustee.
- D. Sales Taxes. A bankruptcy estate no longer enjoys any immunity from taxation for sales tax as long as the tax does not discriminate against bankruptcy trustees. California State Board of Equalization v. Sierra Summitt, Inc., 109 S.Ct. 2228 (1989).