

Treatment of Tax Claims in Consumer Bankruptcy Cases

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I. Consumer Bankruptcy - Chapter 7 and Chapter 13

- A. Core concept of bankruptcy - the automatic stay of Section 362 of the Bankruptcy Code. Upon filing, all collection activity must stop (unless and until the BK Court orders otherwise). Automatic stay applies to the IRS.
- B. Chapter 7 is designed to discharge debt and provide the debtor a “fresh start.”
 1. Typical Chapter 7 fact patterns cover a range of scenarios:
 - A. Unemployed individual with \$25,000 of credit card debt, \$10,000 of medical bills, \$7,500 vehicle repossession deficiency. Under Chapter 7, this individual can wipe out all of this debt and move on.
 - B. Downsized software executive whose income has decreased 30%. Client has 2 leased vehicles, a \$350,000 mortgage (behind 2 payments) and \$50,000 of credit card debt.
 1. Under Chapter 7, this individual may be able to walk away from everything, turn in the leased vehicles, walk away from the house and wipe out the credit cards.
 2. This individual may also choose to keep some of his secured debt and walk away from the rest.
 2. Things to be wary of in Chapter 7
 - A. Disposable income after surrendering secured items and discharging debts
 - B. Recent use of credit cards - credit card binge
 - C. Co-signers

- D. Secured debt vs. unsecured debt vs. priority debt
- E. Equity - property that is exempt from the bankruptcy estate is controlled by Georgia law - see copy of exemption statute

C. Chapter 13

1. Big picture: whereas Chapter 7 is designed to discharge debt, Chapter 13 is a Court supervised payment plan
2. Plan includes
 - mortgage arrearages (on-going mortgage payments paid direct)
 - secured claims
 - priority debts like taxes and child support
 - some percentage repayment to unsecured creditors
3. Plan must last 3 to 5 years. Payments to Chapter 13 trustee thru payroll deduction
 - A. Pay back unsecured debt to the extent of non-exempt equity
 - B. Jurisdictional limits - only individuals with “regular income” and secured debts of less than \$871,550 and unsecured debts of \$290,525.
 - C. Chapter 13 results in a “super discharge” which is broader than the discharge in Chapter 7
4. Typical fact patterns:
 - A. H & W earn \$100,000 per year They own a \$250,000 house with a \$150k first mortgage and a \$50k second mortgage.
 - three months behind on \$1,200/mo. first mortgage
 - two months behind on \$350/mo. second mortgage
 - two months behind to GMAC on car note - \$18,000 remaining bal
 - \$25,000 of credit card debt
 - \$7,500 in income tax debt from last year

Analysis:

Plan includes \$3,600 arrearage to 1st mortgage + \$700 to 2nd mortgage + \$18,000 car note + \$7,500 tax debt + \$25,000 credit

card = \$54,800

36 month plan = \$1,523

58 month plan = \$945

B. What suggests Chapter 13?

1. Mortgage arrearage
2. Behind on car note
3. Non-dischargeable tax debt
4. Disposable income - debtor must have stability to sustain a plan payment for 3 to 5 years
5. Non-exempt assets such that Ch. 7 is not feasible

II. Tax Claims in Chapter 7 and Chapter 13

A. Discharge of Tax debts in Chapter 7 and Chapter 13

1. Income tax debts can be discharged in Chapter 7 if all of the following conditions are met:

A. The tax return was filed timely and liability is for tax period more than 3 years from the date of the petition

1. Example: 1998 tax return is due 4/15/99. Debtor filed return 4/10/99. BK must be filed after 4/15/2002.

2. Example: 1998 tax return is due 4/15/99. Taxpayer got extension to 8/15/99. BK must be filed after 8/15/2002.

3. A substitute for return does not count as a valid tax return for discharge purposes (unless signed by taxpayer)

B. The tax return for the year in question was filed more than 2 years prior to the date of the bankruptcy petition

1. Example: 1995 tax liability is due 4/15/96. Debtor fails to file timely or get extension. He files 9/30/99. BK must be filed after 9/30/2001.

C. Tax must have been assessed (23-C date) more than 240 days prior to the bankruptcy filing

D. Tax returns for the year in question was not fraudulent

E. For the year in question, the taxpayer did not engage in a willful attempt to evade or defeat the tax

F. Interest follows the tax

G. Penalties are dischargeable if the tax is dischargeable or if the penalty "event" was more than 3 years prior to the BK filing.

H. Practice pointer: if dischargeable tax debt is substantial, debtor may wish to file a Complaint to Determine Dischargeability of Tax Debt (equivalent to a declaratory judgment action) to obtain Court Order from Bankruptcy Judge that specific tax obligations have been discharged.

2. Income tax debts may be discharged in with a Chapter 13 "super-discharge" as follows:

A. Old tax

1. Liability is for tax period more than 3 years from the date of the petition; and

A. Example: 1998 tax liability is due 4/15/99. BK must be filed after 4/15/2002.

B. Example: 1998 tax liability is due 4/15/99. Taxpayer got extension to 8/15/99. BK must be filed after 8/15/2002.

2. Tax was assessed more than 240 days prior to the date of the BK petition

B. Chapter 13 Loophole - crime pays

1. Tax is not yet assessed as of the date of the BK petition; and

2. The reason tax is still assessable is that taxpayer failed to file, attempted to evade tax or filed a fraudulent return (11 USC 523(a)(1)(b))

C. IRS fails to file a proof of claim

1. No tax lien has been filed; and
2. The IRS received proper notice; and
3. The IRS failed to file a timely proof of claim

D. Interest and penalties

1. Penalties are never priority
2. Pre-petition interest - follows the status of the underlying tax
3. Post petition interest - BK Code is silent; case law suggests that post petition interest is not payable by the trustee.

B. Traps to Avoid

1. Tax liens - where a tax lien has attached prior to BK filing, the tax debt is secured. No way to avoid lien in BK.
 - A. Arising from dischargeable tax - recent case law suggests that tax lien arising from a dischargeable tax debt may not apply to property acquired post petition - therefore debtor should clearly list all property *in detail* in BK petition.
 1. Practice pointer: after discharge of underlying tax debt, the IRS is often amenable to a very reasonable settlement of tax lien.
 - B. Arising from non-dischargeable tax - tax lien does apply to after acquired property
2. Previous bankruptcies toll the running of time periods

3. The running of time periods is tolled by the pendency of an OIC + 30 days
 - A. The pendency of an Installment Agreement does not toll the running of time periods.
 3. Filing BK within 240 days of assessment
 4. Fraud or willful attempt to evade or defeat the tax - no discharge in Ch. 7, but possible discharge in Ch. 13
 1. Area of BK Court litigation: What constitutes a willful attempt to evade the tax? Quitting a job? Closing a bank accounts to avoid the levy?
 5. Trust fund or sales tax liability are never dischargeable in BK
 6. Post petition interest on non-dischargeable tax claim survives Ch. 7 bankruptcy
 - A. Example: Debtor files Ch. 7 with enough assets to satisfy tax obligation. Trustee liquidates estate and pays IRS. Liquidation process takes 3 years. Interest accruing during 3 years is not payable by estate as a priority debt, but by (unhappy) debtor after discharge.
- C. Misc. issues
1. Section 505 of the Bankruptcy Code permits a debtor to challenge a tax liability that has not previously been sustained by a Court. This offers a debtor a pre-payment opportunity to challenge a tax determination even if the challenge would otherwise not be available (i.e. time has run to petition the U.S. Tax Court).