

**HARVARD-STYLE  
CASE STUDIES IN  
BANKRUPTCY  
ISSUES**

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## ADVANCED BANKRUPTCY AND TAX WORKSHOP

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### “Tax Problem Resolution”

Bankruptcy- an indispensable tool

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### Bankruptcy

Often the best choice to a solve tax problem.

- Certain taxes are dischargeable.
- Even if not dischargeable, pay over time often without interest.
- Even if tax is not dischargeable, penalties may be.
- Often result is far more favorable than OIC or installment agreement.

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## Bankruptcy

Often the best choice for "global" solution.

- Deals with state taxes.
- Addresses other debts.
- Options relating to unfavorable contracts.
- Benefits relating to COD income-§108.
- Stops all creditors in their tracks.

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## Bankruptcy

- Pendulum clearly has swung back.
- Increased tax enforcement.
- More frustrating to deal with.

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Knowledge of the benefits of bankruptcy distinguishes you from other "tax professionals".

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## BANKRUPTCY

### A QUICK OVERVIEW

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### CHAPTER 7 CASH LIQUIDATION

- Individual corporations
- Trustee appointed- sells non-exempt assets to pay creditors in order set by Congress.
- Quick and relatively cheap.
- Goal- "fresh start"- discharge of debt.

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### CHAPTER 7 (Continued)

#### Limitations

- Some debts excepted from discharge.
  - Including "priority" taxes.
- Means Test- May require conversion to Chapter 13.
  - Note: Means test applies to cases that are "primarily consumer debt".
  - Taxes are not considered consumer debt.

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### CHAPTER 13

- Individuals with "regular income".
- Keep assets.
- Pay creditors through plan-up to 5 years.
- Secured creditors paid in full-with interest.
- Priority creditors paid in full (often without interest).
- Unsecured/general creditors-often paid small percentage.

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### CHAPTER 13 (Continued)

- Unsecured creditors receive:
  1. Amount they would get in a Chapter 7.
  2. Excess disposable income.
- Debt limitations:
  1. Unsecured debt limit:
    - Unsecured- \$360,475
    - Secured- \$1,081,400

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### CHAPTER 11

- Individual or corporation.
- No debt limit.
- Keep assets, pay creditors through plan.
- Complex and expensive.

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### Terms Applicable to Bankruptcy

- Estate
- Automatic Stay-\$362
- Turnover
- Adequate protection
- Preference

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### Type of Pre-Petition Bankruptcy Claims

- Secured
- Priority- \$507
- General unsecured

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### BANKRUPTCY & TAX

The "Basics"



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### Types of Pre-Petition Tax Claims

- Secured
- Priority
- Unsecured

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### Secured Claims Negative Impact of NFTL

- Only if equity in assets
- If IRS is secured, dischargeable taxes & penalties will be secured 1<sup>st</sup>, before later priority taxes- can require payment of both.  
Ex. 2004-2006- (Dischargeable)-\$35k tax, \$15k pen.  
2007-2009- (Nondischargeable)- \$50k \$50k equity in liquid assets
- Solution- Designate! Designate! Designate!

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### Impact of NFTL on Exempt Assets

- Exemptions don't apply to IRS
- BUT-Exemptions apply in bankruptcy.
- Impact:  
Example 1 - Dischargeable (non-priority) tax = \$50k.  
IRA = \$50k. No NFTL. BK discharges \$50k- T.P. keeps IRA.

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### Example 2

Dischargeable (non-priority) tax = \$50k.

NFTL filed. Tax discharged, BUT lien stays on IRA- IRS can tax it.

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### **§507 Priority Claims...**

(8) Eight, 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 for a taxable year ending on or before the date of filing of the petition.

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(i): for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;

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(i): assessed within 240 days before the date of filing of the petition, exclusive of –  
(I) Anytime during which an offer in compromise with respect to that tax was pending or in effect during the 240-day period, plus 30 days; and  
(II) Anytime during which a stay of proceedings against collection was in effect in a prior case under this title during that 240-day period, plus 90 days.

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(iii): other than a tax of a kind specified in section 523(a)(1)(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;

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**TRUST FUND TAXES**  
(C) A tax required to be collected or withheld and for which the debtor is liable in whatever capacity.

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## RECAP

### Priority Tax Claims

[\$507(a)(8)(A) Income Tax]

- Return due w/in 3 yrs., plus extension
- Tax assessed w/in 240 days, if OIC time + 30
- Tax not assessed, but legally assessable
  - except- if unfiled return
    - late return w/in 2 yrs.
    - fraud
- Trust fund taxes

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## Tolling Provisions of §507(a)(8)

*An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a government unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.*

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## Exception to Discharge [§523(a)]

- Priority taxes
- Unfiled or late return w/in 2 years
- Fraud

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## RECAP

- Secured- Ch 7- IRS entitled to property or value.
  - Lien stays on exempt assets after BK.
  - Ch 13 & 11- Paid in full (including penalties) through plan + interest.
- Priority- Ch 7- Not discharged
  - Ch 13- Income tax pd. In full w/o interest.
  - FRP in full with interest
  - Penalties dischargeable.
  - Ch 11- Pd in full with interest.

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## CAVEATS:

1. "Equitable tolling"
2. Laws constantly changing.
3. Reliance on transcripts or client.

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## Updates

- 401(k) issue and assessment lien.
- SFR and late returns.
- Late returns- no SFR.

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### Other Key Points:

- Interest is part of the tax.
- Unsecured penalties are non-priority in a Chapter 13.
- 941 liabilities: non-TFRP, non-priority after 3 years.

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### \$108 Debt Forgiveness Income

Ex.: Fla. investment property  
Purchase Price = \$1 million  
Mtg. = \$800k  
Crash, -Foreclosure – Net \$400k  
COD income = \$400k

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Assets = \$15k bank account  
\$750k 401(k), \$60k IRA  
\$50k equity in residence  
Other debts = \$55k  
Insolvent? §108 exclusion?  
Effect of BK?

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**Bankruptcy Part 2**  
**Bankruptcy Problems**

For these problems, assume tax liability assessed on date return filed.

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**BK Problem 1**

Tax Yr. 2007, return filed on 4/15/2008, no fraud.

Priority?

Dischargeable?

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**BK Problem 2**

Tax yr. 2006, return filed 10/16/2007, on extension to 10/15/07.

Priority?

Dischargeable?

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**BK Problem 3**

Tax yr. 2006, return filed 10/16/2007, no extension.

Priority?

Dischargeable? As of When?

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**BK Problem 4**

Tax yr. 2006, filed, 1/2/2009.

Priority?

Dischargeable?

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**BK Problem 5**

Tax yr. 2005, audit and petition to U.S. Tax Court-Lost., Assessed 8/10/2010.

Priority?

Dischargeable?

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**BK Problem 6**

Tax yr. 2005, audit, signed extension of statute until 1/15/2011.

Priority?

Dischargeable?

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**BK Problem 7**

Tax yr. 2003, audited and tax assessed 4/10/2006, fraud penalty.

Priority?

Dischargeable?

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**BK Problem 8**

Tax yr. 2006, return filed, on extension 10/15/2007, OIC submitted 8/20/2009; pending until 10/11/2010.

Priority?

Dischargeable?

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**BK Problem 9**

Tax yr. 2006, return filed 10/15/2007, on extension  
CDP filed on 8/10/2010, appeal denied, levy  
action sustained on 10/01/2010.

Priority?

Dischargeable?

Same facts, but Equivalency Hearing instead of  
CDP.

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**BK Problem 10**

2005 return unfiled, 09/03/2008 SFR filed.

Priority?

Dischargeable?

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**BK Problem 11**

2005 SFR filed 07/10/2008, 10/10/2008 T.P.  
files tax return.

Priority?

Dischargeable?

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### BK Problem 12

2005 return filed 04/15/2008, NFTL filed 10/15/2008, no assets.

Priority?

Dischargeable?

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### BK Problem 13

941 return 3Q 2005 filed timely, TFRP assessed against T.P.

Priority?

Dischargeable?

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### Part 2- More Hypotheticals

#### # 1

- Client sells business in 2006. Substantial amount of money generated by sale, which creates large tax liability. Client requests all the money and loses it. Gets scared and doesn't file tax return. Sees commercial on tv that all his problems can magically be erased and his taxes wiped away. He pays this company \$50,000 to do an OIC. They then advise him he needs to file his outstanding return to do an OIC. They charge him an additional fee to prepare the return. They prepare a joint return, telling his spouse that she has to sign the return to resolve the problem. The return was submitted with no payment October 1, 2009. Then company did nothing. Client requests OIC immediately after receiving a Final Notice of Intent to Levy dated October 14, 2010. What are the options?

- **Key Points:**

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## #2

- Client is under audit for 2008, the return was timely filed 4/15/09. There was an 872 consent to extend the statute to assess until 12/31/13. RAR proposes a tax liability of \$100,000. You believe you may be able to contest part of the adjustment, potentially lowering it by \$10,000-\$15,000. Client can't pay either amount and inquires about filing bankruptcy.
  - Do you appeal? – Protest or petition Tax Court?
  - When will tax be dischargeable?
- Key Points:**

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## #3

IRS does SFR for 2004, liability \$40k, NPTL filed. 2005 and 2006 were settled for equity, \$60k, no NPTL filed. 2007 liability is \$20k. Client has \$50k in cash and stock and an IRA worth \$100k. Home with no equity. Lasted 15.5 yr monthly income, pursuant to 433 standards is \$750 a month.

a. How well does an offer in compromise work in this case?  
b. What if he filed a Chapter 7 right now? What if he waits?

What pre-bankruptcy strategy would help?

**Key Points:**

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## #4

Client owes \$60,000 2008 income taxes (\$20k of which is penalties). Also owes \$80,000 in credit card debt. Has no equity in any assets. Has net monthly income on 433-A of \$850 per month. Monthly credit card payments equal \$900 per month.

OIC? Chapter 7? Chapter 13?

**Key Points:**

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## #5

Client owes \$100,000 in credit card debt, filed Chapter 7 and received discharge 12/15/06. Owed income taxes for '03, '04, '05: \$80,000, \$50,000, and \$10,000 respectively. All returns were filed timely. Client received Final Notice of Intent to Levy on 10/15/10. OIC won't work.

What years are priority?

Can client file Chapter 7 and discharge any of the years? What about a Chapter 13?

Can client do a CDP and then file BK when the timing is right?

What would you do?

**Key Points:**

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## Part 3- Workshop Problems

Assume state Homestead Exemption equals \$50,000, \$100,000 jointly. IRAs and ERISA Qualified Plans are exempt.

**Problem #1**

H&W- income tax 2005 and 2006, \$210,000

Returns filed 06/05/2008- no NFTL.

Credit card debt = \$25,000

Assets- House FMV = \$250,000, Mfg. = \$150,000.

Car-leased.

Income-joint annual = \$96,000, net mo. (IRS standards) = \$1,200.

OIC = \$250,000 X 80% minus \$150,000.

IRA= \$65,000

+ \$1,200 X 48

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## Bankruptcy Analysis-Chapter 7

- No Means Test (debt not primarily consumer debt).
- Eliminate credit cards.
- IRA exempt, no NFTL, client keeps.
- Tax discharge
- Client pays 0.

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### Same Facts, but:

- TFRP assessed 02/10/2008, \$25,000.
- No equity in home, \$65,000 IRA, \$35,000 TFRP and NFTL filed for income tax.
- Equity in home + NFTL

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### Problem #2

Client owes income tax for 2006 (\$80k), 2007 (\$70k) and 2008 (\$50k).  
Returns timely filed.  
Credit card debt = \$30,000, paying \$600 per month.  
Assets: house FMV = \$200,000, mtg. = \$50,000 (\$100,000 Homestead Exemption)  
\$30,000 cash assets.  
Income-net income (433-A) = \$500 per month.  
OIC = \$200,000 (\$160,000) - \$50,000 mtg. = \$110,000 +  
\$30,000 cash = \$140,000.  
Income- \$500 X 48= \$24,000.  
Total OIC RCP = \$164,000 cash offer.

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### Problem 2 (continued)

Chapter 7- now  
2006 and 2007 (non-priority/dischargeable)  
2008 priority, nondischargeable, but would lose non-exempt assets, trustee would sell house for equity-\$110,000, and take cash-\$30,000.  
Even if delayed Chapter 7 until '08, if dischargeable, still would lose house and cash.  
Chapter 13 now- 2006 and 2007, general unsecured paid at "pennies" on the dollar.  
2008 priority, paid in full with no interest (not secured).

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### Problem #2 (continued)

Chapter 13 allows no accrual of interest or penalties and accrued penalties would also be paid at a small percentage on the dollar. Therefore, the amount owed for 2008 can be spread out and only the tax and interest accrued through the petition date would have to be paid in full.

Will keep all assets.

Required payments approximately \$500 per month for priority tax and trustee commission. Get rid of all debt for less than what client was making on credit cards alone.

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### Problem #2 (continued)

Chapter 13 later

Not worth waiting for '08 to be non-priority. Would just increase payments to unsecured creditor pool--due to Chapter 7 test and disposable income test.

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### Problem #3

Client assessed in 2006 \$175,000, \$100,000 tax and interest, \$75,000 fraud penalty. OIG won't work due to house FMV of \$200,000, mtg. of \$100,000.

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**ADVANCED TAX ISSUES IN BANKRUPTCY**

**ASTPS**

**LAS VEGAS SEMINAR**

**OCTOBER 21, 2010**

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## **INTRODUCTION**

As a result of the current economic climate, bankruptcy continues to be a prevalent option in addressing overwhelming debt. The major revisions to the bankruptcy laws made in 2005 have had less impact than contemplated on the number of filings. Bankruptcy continues to be the most powerful tool to provide a debtor with a “fresh start.” However, the congressional intent behind the bankruptcy laws which allows a debtor a “fresh start” or a troubled business the ability to reorganize is often hampered by statutorily created exceptions to discharge for specific debts. One of the most common and significant debts that falls under this category would be certain types of tax claims. Understanding the rules relating to the discharge of taxes through the bankruptcy process is critical for a tax practitioner and the focus of this outline.

### **I. BANKRUPTCY GENERALLY**

There are four types of bankruptcies that can be utilized by a debtor; the appropriateness of each depending on the circumstances. The choices consist of a chapter 7, 11, 12 and 13 and the attributes of each one can be summarized as follows

### **II. CHAPTER 7**

A chapter 7 can be filed by an individual, a partnership, a limited liability company or a corporation. It involves the liquidation of debtor's non-exempt assets, with the proceeds being distributed to creditors. The gathering of assets, the sale of the assets, and the payment of creditor's claims, are the responsibility of a chapter 7 trustee. Although a chapter 7 bankruptcy causes the dissolution of a partnership or corporation, obviously an individual continues to exist after bankruptcy. Therefore, the goal of an individual chapter 7 is to obtain a “fresh start,” even if it is at the risk of losing one's assets. This fresh start is possible because the Bankruptcy Code (herein after the Code) provides for the discharge of most pre-petition debts, whether or not they are paid in the liquidation. Certain debts, however, such as “priority taxes” (defined below) for public policy reasons are exempted from discharge by statute.

Often a chapter 7 can be virtually painless in that no assets are actually lost. This may be due to the fact that the debtor had no assets to liquidate or the assets were exempt. In order to help facilitate the “fresh start,” congress allowed for certain exemptions so the debtor was not left totally destitute. The Code sets forth federal exemptions but also provides that the states can opt out of these exemptions and allow for the utilization of that particular state's exemptions. However, as discussed more fully below, these exemptions do not apply to the IRS.

### **III. CHAPTER 11**

Unlike a chapter 7, a chapter 11 normally does not involve a liquidation. The goal of a chapter 11 is to reorganize the debtor and to come up with a plan to pay

creditors over time. The Code requires that the debtor provide a disclosure statement to creditors which sets forth financial information regarding the debtor and explains why the creditors should vote for the confirmation of the plan. The Code also sets forth specific requirements for the contents of the plan and what type of creditors have to be paid in full. Unsecured creditors normally only have to receive what they would receive in a chapter 7 liquidation, which is usually a small percentage of their claim. The plan must provide for creditor's treatment by breaking down creditors into different classes. The creditors are entitled to vote to accept or reject the plan. To be accepted, creditors who vote "yes" must hold at least 2/3 in amount and 1/2 in number of the claims of those who voted. If this is met and the plan meets all other statutory requirements, the plan will be confirmed. Even if a class votes against acceptance, the Court can still confirm the plan if it finds that it is fair and equitable. This is referred to as a "cram down." Once the plan is confirmed, all pre-petition creditors are bound by its terms. "Priority taxes" (defined below) and secured debt, including taxes and secured taxes, must be paid in full through the plan.

Although available to individuals, chapter 11 is usually utilized by corporations. This is primarily due to the fact that individuals, subject to certain debt limitations, can utilize a chapter 13, which is more advantageous due to its simplicity and broader discharge provisions. Chapter 11 differs from a chapter 7 or 13, in that there normally is no trustee in an 11 and the debtor continues to operate as a "debtor in possession" or "DIP." A trustee is appointed only in rare instances, usually when there is mismanagement or fraudulent conduct by the DIP. However, the United States Trustee, and in some cases a creditor's committee, provide some oversight of the debtor's activities.

On occasion, a chapter 11 will be used instead of a chapter 7 to liquidate a debtor. This will be done through a liquidating plan. This option allows the debtor to control the sale rather than a trustee, eliminates the trustee's commission, and often maximizing the return if the business can be sold as a going concern.

#### **IV. CHAPTER 13**

As in the case of a chapter 11, a chapter 13 allows the debtor to pay his or her creditors over time through a plan. Also, as in a chapter 11, priority taxes (defined below) and secured debt must be paid in full. The plan can go a maximum of 5 years, and must pay general unsecured creditors what they would have received in a chapter 7. There is also a requirement that if unsecured creditors are not being paid in full, the debtor must be fully using his or her disposable income to fund the plan. Often unsecured, non-priority creditors are paid a small percentage of their claim. Plan payments are made to a chapter 13 trustee, who then pays the creditors pursuant to the plan. Use of a chapter 13 is limited to individuals with regular income. Also a debtor can not qualify for a 13 if he or she has more than the unsecured debt or secured debt limits (adjusted for COLA). The current debt limits are \$360,475 for unsecured and \$1,081,400 for secured. If an individual meets the 13 debt limits, it is generally

preferable to a chapter 11 since it is much less costly.

## V. CHAPTER 12

Chapter 12 is somewhat a hybrid between chapter 11 and 13 and is only available to family farmers.

## VI. THE AUTOMATIC STAY

As with any creditor, bankruptcy can be a valuable tool in dealing with a state or federal tax liability. A major benefit applicable for all chapters is the automatic stay that goes into effect immediately upon the filing of the bankruptcy petition. Section 362 of the Code provides for the stay of all collection activity. Creditors, including the IRS, must immediately cease any collection action against the debtor. Even telephonic or written communication relating to collection is prohibited. Violations of the stay provisions may constitute contempt and damages can be awarded. The IRS Restructuring and Reform Act of 1998 provides for damages against the IRS up to \$1,000,000 for stay violations.

The automatic stay provides breathing space to a financially troubled debtor. If the IRS or any other creditor is threatening to seize assets, a bankruptcy petition will immediately stop any action. Moreover, if a creditor has seized an asset, but it has not yet been sold, and it is necessary for a successful reorganization, the debtor generally can force the return of the asset or release of the levy. If the asset involved is returned, the secured creditor may demand "adequate protection," which usually requires periodic payments to protect from depreciation of the property during the period the debtor is developing a plan. Since a chapter 13 plan is usually confirmed shortly after the petition is filed, adequate protection is not usually an issue. On the other hand, a chapter 11 often takes more than a year before a plan is confirmed. In such case, adequate protection becomes a significant issue.

## VII. ORDER OF PRIORITY & PAYMENT TO CREDITORS

The Code sets forth an order in which certain types of creditors will be paid. The type of creditors consists of secured creditors, administrative creditors, priority creditors and unsecured creditors. Secured creditors are creditors possessing a pre-petition lien on an asset or assets of the debtor. The IRS will be secured if a notice of federal tax lien was filed prior to the bankruptcy and the debtor had property to which the lien attached. It should be noted that the federal tax lien attaches to all property and rights to property belonging to the debtor. Generally, secured creditors must be paid the full value of the asset securing their claim or must be given the asset.

Administrative creditors are creditors whose claims came into existence after the bankruptcy filing. For example, attorney's fees, trustee's fees, and taxes arising

during the pendency of the bankruptcy but prior to plan confirmation are administrative claims. The Code provides for these claims to be paid as a first priority. The Code also provides for certain pre-petition claims to be paid in priority order ahead of general unsecured creditors. Tax claims are paid as an eighth priority. (See discussion of priority tax claims below.)

## **VIII. DISCHARGEABILITY**

In order to realize the goal of a “fresh start,” the key issue in relation to pre-petition debts is whether or not they are dischargeable. Secured creditors, as referenced above, have pre-petition liens on some asset of the debtor. If the lien is a consensual lien, such as a mortgage on real estate, the debtor will have to pay the lien or lose the asset in a chapter 7. In a chapter 13 or chapter 11, the debtor can retain the secured asset, but will have to make the required payments. Arrears, however, can be spread out through the terms of the plan. Nonconsensual liens, such as judgments, to the extent they impair exempt assets, can be avoided in the bankruptcy. The ability to do this, however, does not apply to statutory liens such as tax liens. The debtor can choose to give up the asset unencumbered by a secured creditor and discharge any obligation, assuming the type of debt would otherwise be dischargeable.

It should be noted, in reference to exemptions, that the primary exemptions (i.e. Homestead, IRA, 401(k)) do not apply to the IRS. The limited exemptions to IRS levy action are set forth in I.R.C. §6334 and are not generous.

Unsecured pre-bankruptcy claims are broken down into two categories, priority and general unsecured. Priority claims are nondischargeable and paid ahead of the general unsecured creditors in a chapter 7 liquidation. Priority claims must be paid in full through a chapter 13 or chapter 11 plan. Therefore, the questions as to whether or not a tax qualifies as a priority is critical in a bankruptcy context. If the liability is excepted from discharge as a priority tax, to the extent it is not paid out of the bankruptcy assets in a chapter 7, the liability will survive bankruptcy. As stated above, in a chapter 13 or chapter 11 full payment of priority claims will be required for confirmation of the bankruptcy plan.

Liabilities that do not qualify as secured or priority fall into the bottom class of creditors often referred to as general unsecured. The claims, to the extent they are not satisfied out of the distribution of the chapter 7 assets, are eliminated when the debtor receives a discharge. In a chapter 13 or chapter 11 general unsecured creditors are often paid a very small percentage on the dollar. In determining the amount to be paid, there are two tests. The first test requires any excess funds over the debtor’s allowed budget, after making required payments to secured and priority creditors, to be paid to the unsecured creditor pool. The second test requires payment of the amount equal to the excess equity in assets after subtracting what priority creditors would receive in a liquidation. Again, after applying the “disposable income” and

“liquidation” tests, general unsecured creditors usually do not receive significant payments through the plan.

## **IX. TAX ISSUES IN BANKRUPTCY**

### **I. Types of Pre-Petition Tax Claims**

As with other creditors, pre-petition tax claims will fall into one of three categories, secured, priority or general unsecured.

#### **A. Secured Tax Claims**

In order for the IRS to have a secured status in a bankruptcy, two requirements must be met:

1. There must be a pre-petition Notice of Federal Tax Lien filed (NFTL), and
2. There must be equity in property for the lien to attach.

#### ***Impact:***

As with other secured creditors, secured status for a tax claim requires the claim to be paid in full if the debtor maintains the assets the lien attaches to. This often causes old taxes and penalties to be paid in full where they otherwise could have been discharged. A filed lien can be devastating for a debtor.

**Example 1:** A taxpayer with exempt property- If the taxes in questions would not qualify as “priority” (explained below) and the debtor has an asset that would be exempt in bankruptcy (i.e. an IRA), even though the exemptions don’t apply against the IRS, the asset would be exempted from the bankruptcy estate. The taxes would then be discharged and the debtor would keep the exempt asset after bankruptcy.

But- same facts, except NFTL filed pre-BK. Although underlying tax is discharged, the lien would stay on the exempt asset. The IRS would then be able to take collection action against the asset, up to the value at the time of the petition, after the stay on collection was lifted.

**Example 2:** If NFTL is filed and the lien attaches to equity in an asset, older non-priority taxes and penalties would be secured first.

For example, if the date is October 15, 2010 and a debtor owed taxes for the years 2005 (\$25,000), 2006 (\$25,000) and 2007 (\$50,000) and the debtor had an asset worth \$50,000, even if the 2005 and 2006 were otherwise dischargeable, they would be treated as secured. The 2007 would not be dischargeable since it is a priority tax (see discussion below). Therefore, in a chapter 7 context, the \$50,000 would be applied towards the 2005 and 2006 years as a secured claim and the 2007 year would not be dischargeable, since it is a priority claim and would survive bankruptcy. In a chapter 13 context, the 2005 and 2006 would be fully paid as secured and the 2007 would be fully paid as priority. In both scenarios, the debtor would pay a total of \$100,000, rather than \$50,000 if no NFTL was filed.

**Solution:** Pre-Bankruptcy Strategy- Liquidate \$50,000 asset and pay it with a designation to the 2007 tax year, then file bankruptcy.

**Key Practice Point:** Whenever a voluntary payment is made to the IRS, the payment can be designated by indicating how the tax should be applied on the front and back of the check. Failure to designate will allow the IRS to apply the payment to the best interest of the government. The IRS will always apply to the oldest period first.

**Note:** This is also extremely important when dealing with a payroll tax liability. Since a payroll tax liability for a corporation is made up of a non-trust fund portion and a trust fund portion, the latter being a potential personal liability of an individual associated with the corporation, voluntary payments out of the corporation should always be designated to trust fund taxes.

## B. Priority Tax Claims

Bankruptcy Code §507(a)(8) provides for priority status in relation to certain taxes. Whether a tax qualifies as “priority” under this section is of critical importance to the debtor. It not only determines the order in which the taxes will be paid out of assets that are being distributed in a chapter 7, but more importantly to the debtor, priority taxes are not dischargeable in a chapter 7. **Moreover, a chapter 13 and chapter 11 plan cannot be confirmed without providing for full payment.**

Trust fund taxes are always granted priority status pursuant to §507(a)(8)(C). This not only includes taxes that were required to be withheld in relation to payroll taxes, but will also include state sales tax.

In relation to income tax, however, unlike the trust fund taxes mentioned above, timing may play a critical role in determining whether or not the taxes qualify as priority. Bankruptcy Code §507(a)(8)(A) sets forth the type of tax that qualifies as priority as follows:

A tax on or measured by income or gross receipts for a taxable year ending on or before the date of filing of the petition-

- (i) for which a return, if required, is last due, including extensions, after three years before the date of filing of the petition;
- (ii) assessed within 240 days before the day of filing of the petition exclusive of –
  - (I) anytime during which an offer in compromise with respect to that tax was pending or in effect during the 240 – day period, plus 30 days, and
  - (II) anytime during which a stay of proceedings against collection was in effect in a prior case under this title during that 240 day period, plus 90 days.
- (iii) Other than a tax of a kind specified in §523(a)(1)(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.

....An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable non-bankruptcy law from collecting a tax as a result of request of the debtor for *a hearing and an appeal* of any collection action taken or proposed against the debtor, plus 90 days, plus anytime during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by existence of one or more confirmed plans under this title, plus 90 days.

Specifically addressing dischargeability, §523(a) provides an exception to discharge for the following:

- 1. Priority taxes (explained above)

2. Taxes relating to delinquent returns filed within two years of bankruptcy.
3. Taxes relating to unfiled returns.
4. Fraud or willful attempt to evade or defeat a tax.

*Note:* The above provisions apply to both Federal and State taxes.

It is clear from the above cited statutory provisions, that in dealing with income taxes, mistiming a bankruptcy is a huge pitfall and potential for a malpractice action. The priority sections of 507 provide for bright line timing issues that an unwary practitioner could easily miss. §523 also provides for a timing issue in relation to a delinquent return.

*Note:* Interest is considered part of the tax. Therefore, if the tax qualifies as “priority”, so does the interest thereon. With regards to penalties for dischargeability in a chapter 7 or individual 11, pursuant to §523(a)(7), generally the three year rule applies. (chapter 13 allows for the dischargeability of penalties.)

### **C. General Unsecured**

Taxes and the interest thereon, as well as penalties, that do not qualify as secured or priority fall into the general unsecured category. These liabilities are dischargeable in a chapter 7 and can be paid in the same manner as other unsecured creditors in a chapter 13 and a chapter 11.

### **D. Review of Key Points to Dischargeability**

- Was the return, plus extensions, due within three years?
- Was the tax assessed within 240 days; was an OIC filed during that time period?
- If the tax is not assessed, is it still legally assessable?
- Was a prior bankruptcy filed?
- Was a Collection Due Process Appeal filed?
- Was the return filed?- SFRs don't count.

- If the return was delinquent, was it more than two years ago, and was an SFR previously filed?
- Was there fraud or willful attempt to evade tax?
- Was a Federal Tax Lien filed prior to bankruptcy, and if so, is there equity in any assets for it to attach?

**E. Miscellaneous Key Points**

- The interest on the tax is treated in the same manner as the tax is in bankruptcy. If the tax is priority, so is the interest.
- Dischargeable tax, interest and penalties will all be treated as secured if an NFTL is filed and there is equity for the liabilities to attach.
- A tax lien can actually be a benefit in a chapter 7, but not always. May help with Means Test or cause the trustee to abandon asset. On the other hand, attaches to exempt assets after bankruptcy.
- 20% reduction in OIC, not generally available in bankruptcy.
- Penalties can be discharged in chapter 7, three years after transaction they relate to. Immediately in chapter 13.
- IRS won't consider OIC when bankruptcy is pending.
- Dischargeability in bankruptcy can be considered in OIC evaluation.
- 941 liability asserted against individual (Sole Prop.). Non-trust fund portion, interest and penalties can be discharged after three years.

**X. §1398's IN A SPLIT YEAR ELECTION**

Upon the filing of an individual Chapter 7 or 11, a separate taxable estate is created under IRC §1398. §1398(d)(2) provides for the right to make an election to terminate the debtor's year when the case commences. The debtor may elect to treat the debtor's taxable year, which includes the

commencement date, as two taxable years, with the first year ending on the date before the commencement of the bankruptcy and the second year beginning on the bankruptcy filing date. An election under this section must be made on or before the 15<sup>th</sup> day of the fourth full month following the end of the first short year and should state on top of the return “§1398 Election”. The section further provides that the bankruptcy estate succeeds to all of the tax attributes of the debtor. At the end of the bankruptcy, the debtor succeeds to the tax attributes of the estate.

It is very important for practitioners to be aware of the right to make a 1398 election. The IRS will not sever an income tax year. Therefore, any tax liability that had accrued up to the date of filing the bankruptcy petition, even if the petition is filed December 31<sup>st</sup>, will be treated as a post-petition tax liability, since it will have been determined at the end of the year. Therefore, any income tax liability for the year of bankruptcy cannot be claimed against assets of the estate and will not be paid out of the bankruptcy proceeding. It will, however, be a liability facing a debtor after he receives his discharge. However, since §1398 allows a debtor to elect to split the tax years, the liability that has accrued during the first “short taxable year” will be considered a pre-petition priority tax claim and can be paid out of the bankruptcy assets. This will perhaps reduce the amount paid to unsecured non-priority creditors, however, they would be dischargeable in any event and the debtor would benefit from eliminating or reducing a nondischargeable tax. However, an election would not be desirable if the debtor would benefit from retaining the tax attributes of the year of bankruptcy. Under these circumstances, an election should not be made.

## **XI. §108 DISCHARGE OF INDEBTNESS**

IRC §61(a)(12) states that gross income includes income from the cancellation of indebtedness or C.O.D. income. However, §108(a) states that C.O.D. income is not taxable if it arises in a Title 11 case (bankruptcy). §108(a)(1)(B) states that a discharge of a debt that occurs when the taxpayer is insolvent is also excludable from gross income. Since lending institutions are now required to issue 1099's where debts were written off and/or settled, it is very common to have clients who receive proposed changes to their tax returns from the IRS based on debt forgiveness income. Being aware of the

§108 exclusions is often critical.

## **BANKRUPTCY PROBLEMS**

(For these problems, assume tax liability assessed on date return filed)

1. Tax year 2007, return filed on 4/15/2008, no fraud.  
Priority? Dischargeable?
2. Tax year 2006, return filed 10/16/2007, on extension to 10/15/2007.  
Priority? Dischargeable?
3. Tax year 2006, return filed 10/16/2007, no extension.  
Priority? Dischargeable? (As of When?)
4. Tax year 2006, return filed 1/2/2009.  
Priority? Dischargeable?
5. Tax year 2005, audit and petition to U.S. Tax Court-Lost., assessed 8/10/2010.  
Priority? Dischargeable?
6. Tax year 2005, audit, signed extension of statute until 01/15/2011.  
Priority? Dischargeable?
7. Tax year 2003, audited and tax assessed 4/10/2006, fraud penalty.  
Priority? Dischargeable?
8. Tax year 2006, return filed, on extension 10/15/2007, OIC submitted 8/20/2009, pending until 10/11/2010.  
Priority? Dischargeable?

9. Tax year 2006, return filed 10/15/2007, on extension, CDP filed on 8/10/2010, appeal denied, levy action sustained on 10/01/2010.  
Priority? Dischargeable?  
Same facts, but equivalency hearing instead of CDP.
10. 2005 return unfiled, 9/3/2008 SFR filed.  
Priority? Dischargeable?
11. 2005 SFR filed 7/10/2008, 10/10/2008 T.P. files tax return.  
Priority? Dischargeable?
12. 2005 return filed 4/15/2008, NFTL filed 10/15/2008, no assets.  
Priority? Dischargeable?
13. 941 return 3Q filed timely, TFRP assessed against T.P.  
Priority? Dischargeable?

## HYPOTHETICALS

1. Client sells business in 2006. Substantial amount of money generated by sale, which creates large tax liability. Client invests all the money and loses it. Gets scared and doesn't file tax return. Sees commercial on tv that all his problems can magically be erased and his taxes wiped away. He pays this company \$20,000 to do an OIC. They then advise him he needs to file his outstanding return to do an OIC. They charge him an additional fee to prepare the return. They prepare a joint return, telling his spouse that she has to sign the return to resolve the problem. The return was submitted with no payment October 1, 2009. Then company did nothing. Client comes to you immediately after receiving a Final Notice of Intent to Levy dated October 14, 2010. What are the options?

**Key Points:**

2. Client is under audit for 2008, the return was timely filed 4/15/09. There was an 872 consent to extend the statute to assess until 12/31/12. RAR proposes a tax liability of \$100,000. You believe you may be able to contest part of the adjustment, potentially lowering it by \$10,000-\$15,000. Client can't pay either amount and inquires about filing bankruptcy.

Do you appeal? – Protest or petition Tax Court?  
When will tax be dischargeable?

**Key Points:**

3. IRS does SFR for 2004, liability \$40k. 2005 and 2006 were timely filed, liability \$80k. 2007 liability is \$20k. A FTL is filed for all years. Client has an IRA worth \$100k. Home with no equity. Leased car. Client's net monthly income, pursuant to 433 standards, is \$750 a month.

- a. How well does an offer in compromise work in this case?
- b. What if he filed a chapter 7 right now?
- a. What pre-bankruptcy strategy would help?

**Key Points:**

4. Client owes \$60,000 2008 income taxes (\$20k of which are penalties). Also owes \$80,000 in credit card debt. Has no equity in any assets. Has net monthly income on 433-A of \$850 per month. Monthly credit card payments equal \$900 per month.

OIC? Chapter 7? Chapter 13?

**Key Points:**

6. Client owes \$100,000 in credit card debt, filed Chapter 7 and received discharge 12/15/06. Owed income taxes for '03, '04, '05; \$80,000, \$50,000 and \$10,000 respectively. All returns were filed timely. Client received Final Notice of Intent to Levy on 10/15/10. OIC won't work.

What years are priority?

Can clients file Chapter 7 and discharge any of the years? What about a Chapter 13?

Can clients do a CDP and then file BK when the timing is right?

What would you do?

**Key Points:**