

Using the Bankruptcy Code to Take On the Tax Man

Part 2: Dischargeability of Non-Income Taxes for Individual Chapter 7 Debtors

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Chapter 7 of the Bankruptcy Code may provide relief for individuals who owe non-income taxes and penalties assessed at the state and federal level. This Article includes a general discussion of the different types of non-income taxes and the dischargeability of each.

A. Dischargeability of Property Taxes

Property taxes will be dischargeable if the property tax was assessed before the filing and was last payable more than one year before the filing pursuant to 11 U.S.C. § 507(a)(8)(B) and § 523(a)(1)(A). Although personal liability is dischargeable, the ad valorem taxes attach to the real property and the property itself remains subject to the tax liability. Pursuant to 11 U.S.C. § 362(b)(18), a statutory lien for an ad valorem property tax that comes due after filing can be perfected without violating the automatic stay. In Florida, real property is assessed on January 1 of each taxable year. Fla. Stat. § 192.042. A lien for all taxes, penalties, and interest attaches to the property by statute on the date of assessment and continues until discharged by payment of the ad valorem tax. Fla. Stat. § 192.053.

B. Nondischargeability of State Sales Tax or Trust Fund Taxes Under 11 U.S.C. § 507(a)(8)(C)

Trust fund taxes are nondischargeable no matter how long ago the taxes were due, pursuant to 11 U.S.C. § 507(a)(8)(C) and § 523(a)(1)(A). Trust fund taxes are those that have been collected by the debtor from a third party, such as sales tax and income tax withholding, and are held in trust by the debtor for payment to the appropriate taxing authority. Accordingly, the funds are held in trust and are not property of the debtor or the bankruptcy estate. However, if the debtor has failed to collect or pay these taxes, then the taxing authority will have a priority tax claim pursuant to 11 U.S.C. § 507(a)(8)(C). This tax liability is a liability not only of a corporate debtor, but any responsible party. The debtor will only be liable for the trust fund taxes if he is found to be the “responsible person” pursuant to 26 U.S.C. § 6672(a).

C. Dischargeability of Employment Tax on Wages Earned from the Debtor

These payroll taxes are known as the non-trust fund taxes, because these are payroll taxes imposed on the debtor as the employer, such as federal unemployment taxes. These taxes will be dischargeable if they relate to a return last due, with extensions, more than three years before the filing of a bankruptcy. 11 U.S.C. § 507(a)(8)(D) and § 523(a)(1)(A).

D. Dischargeability of Tax Penalty

Tax penalties that are compensation for actual pecuniary loss and relate to nondischargeable priority taxes are also priority tax claims and therefore are nondischargeable. 11 U.S.C. § 507(a)(8)(G) and § 523(a)(1)(A). Pre-petition interest charged on tax debts is considered compensatory in nature and not punitive, and therefore is nondischargeable pursuant to 11 U.S.C. §507(a)(8)(G) and § 523(a)(1)(A). See In re Garcia, 955 F. 2d 16 (5th Cir. 1992); In re Hamrick, 259 B.R. 224 (Bankr. M.D. Ga. 2000). Interest on tax debt is dischargeable if the underlying tax indebtedness is dischargeable. See In re Burns, 887 F.2d 1541, 1544 (11th Cir. 1989).

Section 523(a)(7) provides that a tax penalty which is not compensation for actual pecuniary loss is nondischargeable if it relates: (1) to a tax of a kind not specified in subparagraph (1) of § 523(a); or if it was (2) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition. § 523(a)(7)(A) or (B). The majority rule is that subparagraphs (A) and (B) are read in the disjunctive. For instance, see In re Roberts, 906 F. 2d 1440 (10th Cir. 1990), where the court held that late filing penalties are dischargeable even though the underlying nondischargeable taxes related to unfiled returns. See also, In re Bergstrom, 949 F. 2d 341 (10th Cir. 1991) and In re Burns, 887 F. 2d 1541 (11th Cir. 1989) (finding civil fraud penalty is dischargeable).

Keep in mind that the general rule is that a tax penalty is not dischargeable if the underlying tax is not dischargeable; however, if the tax penalty is punitive and relates to a transaction or event that occurred more than three years prior to the bankruptcy filing, then this tax penalty should be dischargeable. The taxpayer's act or omission is what starts the running of the three-year period.

However, the 100% penalty tax, which is the penalty to the responsible person for failure to pay trust fund taxes, is not the type of penalty tax which is dischargeable, and as explained earlier, always remains a nondischargeable debt. 26 U.S.C. § 6672 imposes this penalty upon persons responsible for an employer's failure to withhold, collect, and remit income and payroll taxes. These types of taxes include employees' income taxes, Social Security, and Medicare taxes. This type of debt arguably falls under 11 U.S.C. § 523(a)(4), which states that debts incurred by fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny are nondischargeable.

E. Federal Tax Liens

The tax lien imposed by the IRS arises by operation of law on the date of tax assessment and attaches to all the taxpayer's property, including real and personal property, until the tax penalty and interest are paid. 26 U.S.C. §§ 6321, 6322. However, in order for a lien to be valid against judgment lien creditors, the lien must be filed according to federal law. A lien is not effective against real property unless filed in accordance with the filing laws of the state where the land is situated. 26 U.S.C. § 6323(a) and (f). In Florida, the lien must be filed in the county where the real property is located.

If a debtor files bankruptcy, the bankruptcy trustee can defeat a tax lien that is unfiled or improperly filed as of the bankruptcy filing date, because the bankruptcy trustee is deemed a judgment creditor as of the date of filing. 11 U.S.C. § 544(a). Since the trustee is unlikely to exercise its avoiding powers to avoid a tax lien that will allow the debtor to claim an interest in an asset for which the trustee has no interest, the debtor may exercise these avoiding powers pursuant to 11 U.S.C. § 522(h). In an individual Chapter 11 case, the debtor is a debtor in possession, pursuant to 11 U.S.C. § 1101, with all the rights, powers, and duties of a bankruptcy trustee, pursuant to 11 U.S.C. § 1107(a). Therefore, an individual in a Chapter 11 case can also exercise the avoiding powers available to a Chapter 7 trustee.

However, if the tax lien cannot be avoided, then the tax lien remains on the debtor's property post-petition, and the IRS has a right to foreclose its lien. See the court's ruling in In re Isom, 95 B.R. 148, 151 (9th Cir. BAP 1988), aff'd 901 F. 2d 744 (9th Cir. 1990), where the court specifically recognized that liens of the IRS not avoided in bankruptcy can be foreclosed upon by the IRS.

The IRS, who has a tax lien on the debtor's property, is a secured creditor as a result of the lien. Therefore, even if the underlying tax debt would otherwise be dischargeable, the lien survives and remains a lien on the debtor's property. The tax lien also remains a lien on exempt property which might otherwise be exempt as to other creditors. A lien on the debtor's exempt property can be avoided with respect to a tax lien, as provided in 11 U.S.C. § 522(c), if the notice of tax lien was not properly filed.

Part 3 of this Article will discuss the dischargeability of taxes in a Chapter 13 case and the analysis of whether to file a Chapter 7, 11 or 13 bankruptcy case.

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