

Using the Bankruptcy Code to Take On the Tax Man

Part 3: Discussion of the Bankruptcy Reform Act; Dischargeability of taxes in a Chapter 13 Case

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Recently, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“Reform Act”), which contains several modifications to the tax provisions of the Bankruptcy Code. Accordingly, Part 3 will address these changes for Bankruptcy Code sections previously analyzed in Parts 1 and 2 of this article and will then continue the discussion of using the Bankruptcy Code, current and reformed, to take on the tax man by discharging taxes in Chapter 13.

I. Modifications to Bankruptcy Code Sections Cited in Parts 1 and 2 under the Reform Act

A. Part 1: Introduction/Dischargeability of Income Taxes for Individual Chapter 7 Debtors

Under the Reform Act, Section 507(a)(8)(A) (requirements for priority status) provides that unsecured tax claims will be entitled to priority status if (a) the return, including extensions, was due within three years of the bankruptcy filing and (b) the IRS assessed the tax less than 240 days before the filing, plus 30 days during which an offer in compromise was pending, and for any time during which a stay of proceedings against collection was in effect, plus 90 days.

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

11 U.S.C. § 507(a)(8)(B) under the Reform Act provides that property taxes will be dischargeable if the tax was *incurred* (striking assessed) more than one year before the filing pursuant to 11 U.S.C. § 507(a)(8)(B) and § 523(a)(1)(A).

II. Dischargeability of Taxes in Chapter 13

A Chapter 13 debtor is given a discharge after the debtor makes all payments under the plan, pursuant to 11 U.S.C. § 1328(a). This section sets forth exceptions to the discharge rule. 11 U.S.C. § 1328(a) does not list § 523(a)(1) as an exception to discharge. Therefore, it would appear that all taxes falling under § 523(a)(1) would be dischargeable. However, § 523(a)(1)(A) addresses the nondischargeability of priority taxes. Since the debtor must pay all priority taxes through the plan pursuant to 11 U.S.C. § 1322(a)(2) in order to obtain the benefit of the discharge, exceptions to discharge in a Chapter 13 case include taxes set forth in § 523(a)(1)(A), but do not currently include taxes set forth in § 523(a)(1)(B) and (C). Therefore, taxes related to unfiled or late filed returns are paid as an unsecured claim. These taxes are specifically excluded as a priority tax pursuant to 11 U.S.C. § 507(a)(8)(A)(iii). The same is true for treatment of false, fraudulent or tax evasion returns. These claims are unsecured claims, and are specifically

excluded as a priority claim pursuant to 11 U.S.C. § 507(a)(8)(A)(iii). Any unpaid portions of these claims are discharged. However, the Reform Act amends Section 1328(a)(2) to include unfiled or fraudulently filed returns as exceptions to discharge, consistent with the exceptions to discharge under Chapter 7. Therefore, the Chapter 13 debtor will still be liable for unpaid portions of the unsecured unfiled or fraudulently file tax claims after receipt of a discharge.

Secured tax claims filed by the IRS must be paid in full, equal to the value of the property encumbered by the lien. 11 U.S.C. § 1325(a)(5). The analysis of the claim must be two-fold: (1) what is the value of the property; and (2) to the extent that the claim is greater than the value of the property, whether that claim is a priority claim or an unsecured claim.

Property subject to a properly perfected IRS lien remains subject to the IRS lien even if the debtor receives a discharge in bankruptcy. However, the IRS is limited to enforcing the lien against the property in rem, after the bankruptcy is closed. In re Isom, 95 B.R. 148, 151 (9th Cir. BAP 1988). See also, 11 U.S.C. § 524(a)(2).

Pre-petition interest on a priority claim is in the nature of compensation to the tax authority for an actual pecuniary loss and therefore is a priority claim pursuant to § 507(a)(8)(G).

The Reform Act adds Section 511 to the Bankruptcy Code that provides if interest is required on a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law. In the case of interest paid under a confirmed plan, the rate of interest is determined as of the calendar month in which the plan was confirmed.

Post-confirmation interest is usually not entitled to priority status. Section 1322(a) (2) does not require the preservation of the present value of an unsecured claim, and therefore the tax authority is not entitled to interest. See, In re Hageman, 108 B.R. 1016 (Bankr. N.D. Iowa 1989); In re Kingsley, 86 B.R. 17 (Bankr. Conn. 1988). However, if the claim is secured, then the debtor may be required to pay post-confirmation interest as well.

Non-pecuniary loss penalties are not a priority claim because § 507(a) (8) (G) only deals with compensatory tax penalties. Unlike a Chapter 7 case, all such penalties are unsecured claims, regardless of whether it relates to a nondischargeable tax. See In re Holway, 237 B.R. 217, 219 (Bankr. M.D. Fla. 1999) (finding that the debtor does not pay post-petition penalties on unsecured priority claims). A secured claim can be modified pursuant to § 1322(b) (2), and therefore, if the tax penalty is secured, you may move to have it treated as an unsecured claim under this section.

Part 4 of this Article will discuss tax issues for business debtors.

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