An Overview of Taxation Issues in Bankruptcy

by Leonard C. Walczyk

In most cases, an individual or business in financial distress must resolve liabilities emanating from unpaid income, withholding, sales or real property taxes, in addition to all other claims included among a body of creditors. A debtor encountering financial difficulty may need to seek relief under the United States Bankruptcy Code if the collection pressure from creditors threatens a shut down of business operations or an involuntary liquidation of the debtor’s assets. Tax debt may be the primary cause of the debtor’s financial problems, or may be only a part of a larger financial debacle. In either case, the Bankruptcy Code offers avenues for dealing with and providing for tax claims, and may even operate to discharge certain tax claims altogether.

Upon the filing of a debtor’s bankruptcy petition, an automatic stay of creditor collection activity comes into effect against all of the debtor’s creditors, including taxing authorities. Actions such as imposing or perfecting a tax lien on a debtor’s assets, levying on property or seizing and selling property to satisfy a tax debt are prohibited by the automatic stay. However, the statutes of limitation for assessment and collection of federal tax liabilities stop running while the automatic stay is in place. Investigations, deficiency notices and assessments may also take place after the debtor’s bankruptcy filing, and are not subject to the automatic stay.

Once a bankruptcy petition is filed, the bankruptcy court becomes a potential forum for litigating tax controversies with taxing authorities. Under Section 505 of the Bankruptcy Code, the bankruptcy court may determine the amount or legality of any tax, fine or penalty relating to a tax, or any addition to a tax, whether or not previously assessed or paid. The bankruptcy court may not, however, determine the
amount or legality of a tax that has previously been decided by a proper court. A bankruptcy court is not required to decide a tax issue, and may abstain if the tax dispute would not otherwise affect a debtor’s prospects for a successful reorganization.

Some tax claims may be dischargeable in a bankruptcy case, while others are never dischargeable; and under certain circumstances, a tax claim may be paid through a bankruptcy proceeding without interest.

Kinds of Tax Claims

Tax claims arising prior to the debtor’s bankruptcy filing fall into three categories: secured, priority and unsecured. A secured tax claim can be fully secured or under secured. The extent of the secured status of the tax claim is determined by the value of the assets to which the tax lien attaches. A tax claim against the debtor that is fully secured is entitled to treatment as a secured claim, not as a priority claim. As a secured claim holder, the taxing authority will be entitled to present value of its claim, with post-petition interest on deferred payments under a Chapter 11 or 13 plan. If the tax claim is partially secured and partially unsecured, the unsecured portion will be a priority claim if it meets the requirements of Section 507(a)(S) of the Bankruptcy Code, and will thereby be entitled to be paid in full in deferred payments under a plan. If the unsecured portion falls outside the parameters for eligibility as a priority claim under Section 507(a)(S), it will not be excepted from discharge under Section 523(a)(l)(A).

A debtor is always liable for taxes that arise after the date of the bankruptcy filing. Such post-petition taxes are first-priority administrative claims of the bankruptcy estate under Bankruptcy Code Section 507(a)(I).

Taxes that are Dischargeable

The penultimate goal of any bankruptcy case from the debtor’s perspective, with the limited exception of corporate liquidations under Chapter 7 or 11, is the discharge of debt. The remedial purpose of the Bankruptcy Code is “to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy ‘a new opportunity in life [and] a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.’”

The dischargeability of income taxes is often misunderstood, and depends on a number of variables. An income tax for a pre-bankruptcy tax year is dischargeable if:

1. The return for that year was due more than three years prior to the debtor’s bankruptcy filing, taking into account any extensions for filing (the “three-year rule”), and

2. The tax was assessed more than 240 days prior to the bankruptcy filing, plus any periods during which an offer-in-compromise was pending, for tax periods more than three years prior to the bankruptcy filing, so long as tax returns for those periods were filed at least two years prior to the bankruptcy filing (the “two-year rule”).

The “three-year rule” is simply an age test, and the legislative history to Section 507 makes clear that it is the due date for the return, and not the date the return is filed, that is dispositive. However, if the tax return is filed late, an additional rule comes into play. The “two-year” rule denies a discharge of a tax debt for any tax year if the debtor files the return after its due date and the filing date falls within the two-year period immediately preceding the bankruptcy petition. Under this rule, the due date for filing the return is immaterial to the computation of the two-year period; the actual filing date is controlling.

If the tax is for a tax year within three years prior to the bankruptcy filing, or was assessed within 240 days of the bankruptcy filing, the tax is a priority claim and not dischargeable.

Taxes that are Never Dischargeable

There are certain categories of taxes that are never dischargeable under any circumstances. Trust fund taxes, those taxes collected by a third party that the third party is required to pay over to the taxing authority, are never dischargeable. The most common examples of trust fund taxes are employee withholding and FICA taxes required to be withheld by an employer, and state and local sales taxes required to be remitted by a vendor.

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Pursuant to Bankruptcy Code Section 523(a)(l)(C), any tax liability "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax" is non-dischargeable. The Third Circuit, in the case of In re Fegley," held that a debtor's intentional failure to file his federal income tax returns, together with his failure to pay taxes when he had resources to do so, satisfied the conduct element of the discharge exception for willful tax evasion. The Fegley court also held that the required mental state for discharge exception for willful tax evasion was satisfied by evidence showing that the debtor had a duty under tax law, knew he had that duty, and voluntarily and intentionally violated that duty, despite having the financial ability to discharge it. A debtor's failure to pay his taxes alone does not constitute willful tax evasion for discharge purposes. Instead, nonpayment of taxes is relevant evidence which the court would consider in totality of the debtor's conduct to determine whether or not the debtor willfully attempted to evade taxes.

However, claims grounded in prepetition tax fraud and willful tax evasion may be dischargeable under the broad "super-discharge" provisions of Chapter 13. The Bankruptcy Code allows the discharge, after completion of all payments due under a Chapter 13 plan, of all debts provided for by the plan or otherwise disallowed, except any debt for alimony, student loans, personal injury claims arising from the debtor's operation of a vehicle while intoxicated, or restitution included in a sentence on the debtor's conviction of a crime. The language of this provision clearly indicates that the exceptions it contains are exclusive — that is, that the courts are not to broaden the list of non-dischargeable debts in a Chapter 13 reorganization beyond those enumerated in the code. Section 523(a)(l)(C), which is not among the enumerated exceptions contained in Section 1328(a), refers to any debt "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." Sections 1328(a) and 523(a)(l)(C), read together, demonstrate Congress's intent that tax-related debts based upon willful evasion or fraud be dischargeable under Chapter 13.

Paying Taxes Through a Bankruptcy Plan

Payment of priority tax claims under a Chapter 11 plan must be made over a period not to exceed six years from the date of assessment of the tax of a value as of the effective date of the plan, equal to the allowed amount of the tax claim. In essence, interest accrues on the tax claim post-petition and through the life of the plan at the statutory rate.

Chapter 13 is an especially attractive way for a consumer debtor to manage tax claims and other priority claims because the post-petition interest that would be payable outside bankruptcy or in a Chapter 11 case is not required by Section 1322(a)(2). Priority tax claims can be paid off in deferred installments between three and five years through a Chapter 13 plan, retiring such claims without payment of interest. This is due to the omission from Section 1322(a)(Z) of language contained in Section 1129(a)(9). That language requires Chap-

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by allocating payments first to the trust fund portion of tax claims was a logical result.

The Supreme Court’s Energy Resources decision was not to mandate that such payments be made in that manner, but only to permit a bankruptcy court to exercise its discretion in allowing a debtor to do so.

An excellent planning opportunity exists regarding pre-petition payments of trust fund taxes. The Supreme Court in Begier v. Internal Revenue Service ruled that voluntary payments on delinquent trust fund taxes made from commingled funds by a Chapter 7 debtor within 90 days of the bankruptcy filing were not an avoidable preference which could be recovered by the bankruptcy trustee, as funds withheld from employees’ wages and ultimately paid to the IRS do not constitute a transfer of property of the debtor, but property of the employee. Begier’s focus is on voluntary pre-petition payments, and its rationale may not necessarily apply to property or money seized by levy within 90 days of the bankruptcy petition.

Trustee Succeeds to Tax Attributes of Debtor

A bankruptcy trustee steps into the debtor’s shoes, and may take advantage of any tax attributes that the debtor could have used. For instance, a trustee may sell a debtor’s residence and take advantage of a debtor’s rights under I.R.C. Section 121 to exclude any capital gains tax realized from such a sale. In 1997, Congress increased the capital gains exclusion to $500,000 for married taxpayers ($250,000 for singles) on the sale of a principal residence. After that change, trustees began successfully arguing that they could use this exclusion to the same extent as the debtor, since I.R.C. Section 1398 provides that the estate “shall be treated as the debtor would be with respect to the transfer of any asset, and “shall succeed...to the character the asset had in the hands of the debtor.” Supporting the bankruptcy estate’s claim to the Section 121 exclusion. The majority view is that the gain from the sale of a Chapter 7 debtor’s residence is excluded from gross income of the debtor’s bankruptcy estate, to the same extent that the gain would have been excluded from the gross income of the debtor.”

Moreover, a debtor’s otherwise irrevocable election to waive carry-back of net operating losses pursuant to I.R.C. Section 172(b)(3), and thereby relinquish the right to a tax refund, is a transfer of property that can be avoided by a bankruptcy trustee as a fraudulent transfer, so long as all other elements of a fraudulent transfer are proven.

Special Tax Issues in Bankruptcy

Certain provisions of the Internal Revenue Code address situations unique to bankruptcy. With respect to recognition of debt-forgiveness as income, I.R.C. Section 108(a)(1) provides that

\[\text{[gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayers if...the discharge occurs when the taxpayer is insolvent.}}\]

Instead of being included in gross income, the discharge of indebtedness is offset against various tax attributes of the debtor as set forth in I.R.C. Section 108(b)(2).

Upon the commencement of a Chapter 11 case in which the debtor is an individual, a separate bankruptcy estate is created for tax purposes. The estate computes its tax liability in the same manner as a married individual filing a separate return. The debtor may elect to split the tax year with the first part ending on the day before a petition is filed, and the second part commencing on the filing date. If the debtor fails to elect to split the tax year, the debtor is responsible for one tax year. When an election is made, two tax returns must be filed for the individual. Once the election is made, it is irrevocable.”

Short-year election is done so that the tax owed for the short year becomes a pre-petition liability, and thus becomes a liability of the bankruptcy estate. Otherwise, the tax for the entire year will be considered a post-petition liability. This is an analysis that must be done as soon as possible. Any short-year election may be made only on or before the due date for the filing of the return for the taxable year in which the bankruptcy case was commenced. Failure to make such an election may have the effect of having the entire tax liability for the tax year deemed to be a post-petition liability and will not constitute a claim against the estate entitled to administrative priority, but rather a post-petition tax claim against the debtor individually.”

The inequity of treating an S corporation differently from a C corporation or an individual debtor is evident in the Bankruptcy Code. If the bankrupt entity is a C corporation, the tax obligation arising from a sale is treated as a direct administrative expense of the estate under Bankruptcy Code Section 503(a)(10)(B), and must be paid from property of the corporate debtor’s bankruptcy estate prior to satisfying other creditor claims. Likewise, if the debtor is an individual, the tax burden from the sale of the property is also an administrative expense that must be paid out of the bankruptcy estate before satisfying the claims of creditors.

Because the shareholders of an S corporation have elected to follow a tax structure created by Congress for the purpose of applying a single tax instead of a two-tier tax, the Ninth Circuit bankruptcy appellate panel in In re Bakersfield Westar, Inc decided that a trustee can arbitrarily place the tax burden resulting from the future sale of bankruptcy assets or future
operation of the debtor’s business on third parties (i.e., shareholders of the S corporation who are not parties to the pending bankruptcy proceeding) without their consent. Commentators have described this holding as distorting the economics of bankruptcy proceedings by separating the tax burden on the property from the ownership of the property.\textsuperscript{16}

The U.S. Supreme Court has very recently resolved a split among the circuits, allowing shareholders of insolvent subchapter S corporations to adjust their basis upward by their share of excluded discharge of indebtedness income (because the IRC dictates that all S corporation income passes through to the corporation’s shareholders) and take deductions for the suspended losses under I.R.C. Section 1367(a)(1)(A).\textsuperscript{17}

As for partnerships, special care must also be taken regarding tax implications arising from a partner’s bankruptcy filing. Consider a scenario where a partner files a voluntary Chapter 7 bankruptcy petition, lists his share of the partnership’s secured debt on his bankruptcy petition, and obtains a discharge of his share of the partnership’s recourse secured debt. If the debtor’s partnership interest reverts back to him after the bankruptcy case is closed, the effect of the bankruptcy discharge creates a deemed partnership distribution to the debtor partner equivalent to the amount of his share of the partnership recourse debt discharged in the bankruptcy,” which could have disastrous tax consequences for the debtor partner. A deemed distribution resulting from a decrease in a partner’s share of partnership liabilities is treated as an advance or drawing of money under the relevant IRC provisions. The partner recognizes income pursuant to I.R.C. Section 731 to the extent that a deemed distribution exceeds his basis in the partnership. The forgiveness of debt provisions of I.R.C. Section 108 does not apply in this instance.

To avoid this situation, the debtor partner can reaffirm his liability for partnership debt by following the procedures set forth in the Bankruptcy Code for debt reaffirmation.

Real Estate Tax Claims in Bankruptcy

To fully understand the interplay of bankruptcy with New Jersey real estate tax assessment and lien laws, two cases must be studied. The first, In re Isley,\textsuperscript{18} confirms that valid, pre-petition municipal tax liens are secured claims entitled to post-petition interest at the statutory rate, and that taxes which accrue from January 1 of the following year in which the debtor filed the bankruptcy petition are accorded administrative priority.

The second case, In re Custom Distribution Services, Inc.,\textsuperscript{19} explains the scope of bankruptcy court jurisdiction in determining refunds of excess tax payments or offsets of excess taxes paid in other years against current tax liabilities, and that should a debtor fail to follow state tax appeal procedure, that debtor may be denied bankruptcy court jurisdiction for determination of the refund claim.

Conclusion

This article is at best a general overview, and many topics have not been included, or have been treated only superficially for the sake of brevity. Readers are urged to consult experienced bankruptcy counsel when confronted with tax issues in bankruptcy to avoid a minefield of traps for the unwary. \textsuperscript{20}

Endnotes

1. 11 U.S.C. Section 362(b)(9).
2. Grogan v. Garner, 498 U.S. 279, 286, 111 S. Ct. 654, 659, 112 L. Ed.2d 755, 764 (1991) (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 244, 54 S. Ct. 695, 699, 78 L. Ed. 1230, 1235 (1934)). However, this “fresh start” policy provided by the Bankruptcy Code applies only to the “honest but unfortunate debtor.” Id. at 286-87, 111 S. Ct. at 659, 112 L. Ed.2d at 765 (quoting Local Loan, 292 U.S. at 244, 54 S. Ct. at 699, 78 L. Ed. at 1235).
4. 118 F.3d 979 (3d Cir. 1997).
12. In re Féiler, 218 F.3d 948 (9th Cir. 2000).
15. 226 B.R. 227 (9th Cir. BAP 1998).
18. I.R.C. Section 752(b).
19. 104 B.R. 673 (Bankr. D.N.J. 1989); and, see 11 U.S.C. § 362(b)(18) added by amendment adopted October 22, 1994, which excepts “the creation or perfection of a statutory lien for an ad valorem property tax from the code’s ‘automatic stay’ provision”.
20. 224 F.3d 235 (3d Cir. 2000).

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