

24th Annual DFW Area Chapter 13 Consumer Bankruptcy Seminar

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TO DISCHARGE PERSONAL LIABILITY FOR INCOME TAXES AND INTEREST IN CH 7 OR CH 13

- Tax Return must have been filed on time, or if late, more than two (2) years prior to filing bankruptcy (but see *In re McCoy*)
 - A bankruptcy case pending during the two-year period following the filing of the return, tolls the running of the period while the bankruptcy is pending
- Return must not have been fraudulent
- Debtor must not have willfully attempted to evade or defeat the tax

NOTE: CHANGE IN THE LAW

- The exception to discharge in chapter 13 for unfiled or late filed returns was added to the bankruptcy law in 2005
- Prior to the enactment of BAPCPA, there was no exception to discharge for taxes in chapter 13 cases

ADDITIONAL REQUIREMENTS TO DISCHARGE INCOME TAXES IN CHAPTER 7

- Tax return must have been due (including any extension) more than three (3) years prior to filing a chapter 7
- Tax assessed more than 240 days prior to filing the bankruptcy
 - If OIC is pending 240 day period is tolled
- Tax must not be assessable after the filing of the bankruptcy

THE 3-YEAR AND 240-DAY PERIODS ARE TOLLED DURING...

- Any period in which the taxing authority is prohibited under non-bankruptcy law from collecting the tax as a result of a request for a hearing and an appeal of collection against the taxpayer (PLUS 90 DAYS)
- Any time in which stay was in effect in a prior bankruptcy (PLUS 90 DAYS)

WHAT NON-BANKRUPTCY ACTIONS TOLL THE RUNNING OF THE PERIODS

- OIC, but only the 240-day rule, not the 3-year rule
- Request for a collection due process hearing pursuant to 26 U.S. Section 6330(a) [Form 12153]

WHAT NON-BANKRUPTCY ACTIONS DO NOT TOLL THE RUNNING OF THE PERIODS

- OIC, as to the three-year rule
- Installment Agreements

WHAT CONSTITUTES FILING A RETURN?

- DEFINITION:
 - A return that satisfies the requirements of applicable non-bankruptcy law (including applicable filing requirements)
- Courts are split on whether a late-filed return is not a return, but rule in 5th Circuit is late filed return is not a return, *In Re McCoy* 666 F.3d 924 (5th Circuit 2012)

WHAT CONSTITUTES FILING A RETURN? (Cont'd)

- INCLUDES:
 - Return prepared pursuant to Section 6020(a) of the IRC
 - Written stipulation to a judgment or a final order entered by non-bankruptcy tribunal
- DOESN'T INCLUDE:
 - A return made pursuant to Section 6020(b) of the IRC (i.e. Substitution for Return)

TAX PENALTY IN CHAPTER 7 DISCHARGED IF:

- The underlying tax is discharged

OR

- Imposed with respect to an event that occurred more than three (3) years prior to filing the bankruptcy

CHAPTER 13 TREATMENT OF UNSECURED INCOME TAX DEBT

- Except for fraudulent, unfiled, and late-filed (less than 2 years pre-bankruptcy) ALL income taxes are discharged in chapter 13.
- ALL tax penalties are discharged in chapter 13
- Taxes that are excepted from discharge under the 3-year, 240-day, or not-assessed-but-assessable rules are priority claims in chapter 13 and must be paid in full (without post-petition interest) in the chapter 13 plan

LINE 58 - ADDITIONAL TAX FOR RETIREMENT DISTRIBUTION A/K/A EARLY WITHDRAWAL PENALTY

- Liability is a penalty, not a tax. *In re Cespedes*, 393 B.R. 403 (Bankr. E.D.N.C. 2008)

- Film at 11:00

TAX LIENS (CHAPTER 7)

- Tax Liens survive Bankruptcy, meaning:
 - If tax is not discharged, lien remains attached to property owned when bankruptcy is filed AND continues to attach to property acquired post-petition
 - If tax is discharged, lien remains attached to property owned when bankruptcy is filed but does NOT attach to property acquired post-petition

TAX LIENS (CHAPTER 13)

- Unlike in chapter 7, in which tax liens are “pass through” the bankruptcy, in chapter 13, the amount of the secured tax claim must be paid as a component of the chapter 13 plan
- Amount of secured tax claim is equal to the amount of equity the debtor has in any property that is property of his bankruptcy estate
- Interest in spendthrift trusts and certain retirement accounts, including ERISA qualified 401-K plans and pension / profit sharing plans, are NOT property of the estate
- Secured tax claims are paid with interest at non-bankruptcy rate

TAX CLAIMS: EXAMPLE FACT PATTERN

- Debtor owes IRS \$41,100 in 2010 income taxes, interest and penalties, as follows:
 - \$30,000 tax
 - \$4,600 interest
 - \$6,500 penalty
- Debtor obtained extension to file return and filed return on October 1, 2011
- IRS filed FTL on July 1, 2012

TAX CLAIMS: EXAMPLE FACT PATTERN (Cont'd)

- Debtor owns the following:
 - \$3,000 Furnishings and personal effects
 - \$1,000 Bank Account
 - \$4,000 Equity in Vehicle
 - \$10,000 Equity in Residence
- He makes a request for a collection due process hearing on September 1, 2013, and withdraws it on November 1, 2013 (62 days)

Analysis

- Tax debt will not be discharged in chapter 7
 - Fails 3-year rule
 - Tax return due 04/15/11
 - Time from 10/15/11 to 10/27/14 is three years and 12 days
 - Subtracted from this period is 62 days of CDP request plus 90 days (152 days)
 - Must wait until March 17, 2015 to file.

Analysis (cont'd)

- Penalty will be discharged
 - Relates back to date return was due and no tolling, if any, is only the CDP period with no 90-day add-on
 - Tax debt will be a priority claim in chapter 13, which must be paid in full
 - Penalty will be a general, unsecured claim in chapter 13

Assume Bankruptcy Filed After 03/17/15

- Tax debt is dischargeable
- In chapter 7, tax lien will survive and remain attached to assets, but will not attach to later acquired assets.
- In chapter 13, amount of the secured tax claim is \$18,000
- Secured tax claim will be paid at 3.0% in sixty (60) monthly installments of \$323.43
- Balance of claim is general unsecured and will share pro rata on the dividend, if any, paid to general unsecured creditors

Early Withdrawal Penalty

FACT SITUATION: TREATMENT OF EARLY WITHDRAWAL PENALTY IN CHAPTER 13

- In January 2012, Henry Jones took a \$75,000.00 early withdrawal from his IRA account. No funds were withheld in connection with this withdrawal. When Henry filed his 2012 tax return, his income consisted of \$60,000.00 in wages on Line 7 of the 1040, and then \$75,000.00 IRA distribution on Line 15A. His income tax liability on Line 55 was \$16,187.50. In the “other taxes” section of the 1040, Henry listed taxes of \$7,500.00 (Line 58) representing the liability commonly called the “10% early withdrawal penalty.” His total liability on the 1040 was \$23,687.50. Henry had \$9,400.00 withheld from his 2012 wages from federal income taxes (Line 61). After applying this amount to Henry’s total liabilities, leaves him with \$14,287.50 of liability at Line 75.
- Henry’s only income in 2013 was wages, and when he filed his 2013 tax return, he was entitled to a refund of \$4,000.00. The IRS setoff this refund against his 2012 liability.

Fact Situation Cont'd

- When Henry consults with you, it appears that he can either file a no-asset Chapter 7, or a Chapter 13, with 0% to general unsecured creditors.
- When Henry consults with you, it appears that he can either file a no-asset Chapter 7, or a Chapter 13 in which the only claims to be paid would be your attorney's fees and prior tax debt.
- You obtain a transcript of his tax account, which shows the following:

<u>Total Liability:</u>	\$12,720.00
"Tax":	\$10,287.00
Interest:	\$ 983.00
Penalty:	\$ 1,450.00
- Whether you advise Henry to file Chapter 7 or Chapter 13 primarily depends on the treatment of the 2012 tax liability.

Here are the issues:

1. Is the \$7,500.00 liability (early withdrawal penalty) shown on Line 58 a tax or a penalty?
2. If it is a penalty, what difference does it make if the debtor files a Chapter 7?
3. If it is a penalty, what difference does it make if the debtor files a Chapter 13?
4. If it is treated as a non-priority tax penalty in Chapter 13, how much of the total liability of \$12,720.00 shown on the IRS transcript is tax, and how much of it is penalty?

Tax or Penalty?

- Per *In re Cassidy*, 983 F.2d 161 (10th Cir. 1992), and *In re Cespedes*, 395 B.R. 403 (Bankr. E.D.N.C. 2008):
 - the 10% “tax” on early withdrawals is a penalty.
- See also *United States v. Reorganized CF & Fabricators of Utah, Inc.*, 518 U.S. 213, 218, 116 S.Ct. 2106, 2110 (1996), footnote 3.

Effect in Chapter 7

- For purposes of discharge, it makes no difference if it is a tax or penalty.
- Pursuant to 11 U.S.C. §523(a)(7), a tax penalty owed to a governmental unit that is not in compensation for actual primary loss and that was imposed with respect to a transaction that occurred less than three years prior to filing the petition is not discharged.
- *See In re Mounier*, 232 B.R. 186 (Bank. S.D.Cal. 1998).

Effect in Chapter 13

- Tax penalties are not priority claims in Chapter 13.
- The exception to discharge imposed by §523(a)(7) does not apply in Chapter 13.
- Therefore, the early withdrawal penalty is a non-priority, dischargeable debt in Chapter 13.

Allocation of Pre-petition Payments And Additions to Liabilities

- The total liability on the 1040 is \$23,687.50, with \$16,187.50 representing income taxes and \$7,500.00 representing early withdrawal penalty. The current liability of \$12,720.00 reflects reductions in the original liabilities from payments and increases in the liability from interest and “normal” penalties. So, how are the payments that reduced the total liability allocated? There are several possible allocation schemes.

Scheme 1

- The IRS will argue that it can allocate the payments after the fact.
- If permitted to do so, it will allocate the payments to the penalty first.
- By doing so, it will render the issue moot because the only unpaid liability will be the income taxes, interest and “normal” penalties.

Scheme 2

- The second possibility is to apply the payments on a pro rata basis between the two debts.
- The income tax represents 68.34% of the total debt so \$9,157.26 ($.6834 \times \$13,400.00 = \$9,157.26$) would be allocated to the tax debt and the remainder to the withdrawal penalty.

Scheme 3

- A third option is apply the funds withheld from the wages (\$9,400.00) to the tax liability, and to apply the offset (\$4,000.00) against the remaining liability on a pro rata basis.
- This allocation is the most logical. It applies funds that were withheld to pay income taxes to the payment of income taxes, and applies undesignated funds (the refund) on to the two liabilities on a pro rata basis, since neither has a superior claim to the other.
- This is what the court did in *Cespedes*.

Trust Fund Taxes

- BAPCA made trust fund taxes non-dischargeable in chapter 13
- Or did it?

Section 1238(a)(2)

“... The Court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under Section 502 of the title, except any debt...

(2) of the kind specified in section 507(a)(6)(c) or in paragraph (1)(B)... of section 503(a)...”

Section 507(a)(8)(C)

“(a) The following expenses and claims have priority...

(8) Eighth, *allowed* unsecured claims of governmental units... for

- (C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity.”

Section 523(a)(1)(B)

- Excepts from discharge a tax with respect to which the return or report is not filed or filed late and less than 2 years before the petition date.

- The kind of debt specified in 507(a)(8)(C) is an allowed claim
- In the absence of a timely filed proof of claim the IRS does not have an allowable claim

- However,
 - The exceptions to discharge in Chapter 13 for unfiled or late filed returns or reports still apply when the IRS does not have an allowable claim

Case Law Support

- *In Re Weiss*, 2013 WL 6726502 (Bank. D.Kan. 2013), Judge Robert D. Berger

What to look for:

- Reports timely filed
- Civil Penalty not yet assessed
- Operations ongoing or recently closed

What to do:

- “Provide for” claim and give IRS notice:
 - Include provision in plan to pay all allowed priority claims
 - List “potential liability” for claims on Schedule E with business’s EIN
 - List business on SOFA with EIN
 - Perhaps include business names as d/b/a or f/d/b/a

Potential Pitfalls

- 10th Circuit precedent supports *Weiss. In Re Victor*, 121 F.3d 1383 (10th Cir. 1997) that a secured tax claim that otherwise meets criteria of 507(a)(8) is not excepted from discharge pursuant to 523(a)(1)(A) because only unsecured claims are of the kind specified in 507(a)(8)

Potential Pitfalls Cont'd

- Holding in *Victor* has been rejected by Ninth and Eleventh Circuits:
 - *In Re Miller*, 363 F.3d 999 (9th Cir. 2004)
 - *In Re Gust*, 197 F.3d 1112 (11th Cir. 1999)

Statutory Construction Argument

- §1328(a)(2) provides an exception to the general rule that claims disallowed pursuant to §502 are discharged
- §502(b)(9) disallows claims for which a proof of claim is not timely filed
- To construe the provision to discharge the trust fund tax debt because the IRS does not have an allowable claim due to its failure to file a timely claim would defeat the intent, if not the plain meaning, of the provision