

Bankruptcy Filing and Federal Employment Taxes

I. What causes someone to file for bankruptcy?

Bad investments, too great an assumption of risk, circumstances beyond their control.

II. The options

- A. Individuals – Chapter 7, Chapter 11, Chapter 13
- B. Corporations & Partnerships – Chapter 7, Chapter 11
- C. Sole Proprietorships – Chapter 11, Chapter 13
- D. Voluntary filing versus involuntary filings:
 - 1. Debtor can voluntarily file a petition in bankruptcy under Chapters 7, 11 and 13 (11 U.S.C. §301).
 - 2. Creditors can file an involuntary petition to commence a bankruptcy proceeding under Chapters 7 and 11 (11 U.S.C. §303).

The Internal Revenue Manual recommends that the IRS not file an involuntary petition with other creditors (IRM 5.17.8.6). IRS should instead find other ways to collect tax debts owed.

- E. Converting claim from one chapter to another – Must satisfy requirements of chapter to which claim is being converted.

III. Discharging debt

- A. Tax debts excluded from discharge (11 U.S.C. §523).
 - 1. Certain taxes excluded from Chapter 7, Chapter 11 and Chapter 13 “hardship” discharges (11 U.S.C. §523(a)):
 - a. Employment taxes for which a return is last due, including extensions, after three years before the date of the filing of the petition (11 U.S.C. §507(a)(8)(D)):
 - i. On wages/salaries
 - ii. On certain sales commissions.
 - b. Income taxes for a taxable year that ends on or before the date the petition was filed (11 U.S.C. §507(a)(8)(A))
 - i. For which a return was last due within the three years before the date on which the bankruptcy petition was filed.

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- ii. That were assessed within 240 days before the date on which the bankruptcy petition was filed:
 - 1. Excluding the time during which an offer in compromise for such tax was pending, plus 30 days and
 - 2. Any time during a stay against collection had been effected under a prior case during such 240-day period, plus 90 days.
 - iii. Other than a property tax in §507(a)(8)(B) or other tax in §507(a)(8)(C) that was not previously assessed but was still assessable when the bankruptcy petition was filed
 - c. Tax required to be collected or withheld and for which the debtor is liable, regardless of capacity (11 U.S.C. §507(a)(8)(C)) – inclusive of the Trust Fund Recovery Penalty.
 - d. Penalties that are related to claims specified in 11 U.S.C. §507(a) and are compensation for actual pecuniary loss (11 U.S.C. §507(a)(8)(G)).
 - e. Taxes with respect to which a return was not filed or was filed late after two years before the bankruptcy petition was filed (11 U.S.C. §523(a)(1)(B)).
 - f. Taxes for which the debtor filed a fraudulent return or willfully tried to evade or defeat the tax (11 U.S.C. §523(a)(1)(C)).
2. Exclusions from a regular Chapter 13 discharge (11 U.S.C. §1328(a)):
- a. Tax required to be collected or withheld and for which the debtor is liable, regardless of capacity (11 U.S.C. §507(a)(8)(C)) – inclusive of the Trust Fund Recovery Penalty.
 - b. Taxes with respect to which a return was not filed or was filed late after two years before the bankruptcy petition was filed (11 U.S.C. §523(a)(1)(B)).
 - c. Taxes for which the debtor filed a fraudulent return or willfully tried to evade or defeat the tax (11 U.S.C. §523(a)(1)(C)).
- B. Under Chapter 7
- 1. Option available to individuals, not to entities and is usually granted by court within 60 – 90 days after the first date set for creditors to meet.
 - 2. Discharge may be revoked if it was obtained by fraud.
- C. Under Chapter 11

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1. Discharge occurs upon the confirmation of a plan of reorganization.
2. Amounts owed to creditors must be made pursuant to the reorganization plan. Generally, only those debts that existed at the time the plan was confirmed are discharged. Future debts are not included. (11 U.S.C. §1141(d)(1)).
3. If IRS has filed proofs of claims for administrative expenses, gap period taxes, priority taxes and secured taxes, then the plan of a non-individual must provide for full payment in cash (IRM 5.17.10.10.1)
4. No discharge of debts, including taxes, if:
 - a. Reorganization plan requires liquidation of all or substantially all of the estate's property,
 - b. The debtor does not continue with the business after the plan is consummated and
 - c. The debtor would not be entitled to a discharge under Chapter 7 if he had sought such a discharge (11 U.S.C. §1141(d)(3)).

D. Under Chapter 13

1. Regular discharge (11 U.S.C. §1328(a)) - Once all debts have been paid under the plan and debtor certifies as to such, the debtor's debts may be discharged, subject to certain exceptions.
2. Hardship discharge (11 U.S.C. §1328(b)) - Once the plan has been confirmed, a debtor who has not completed payments under the plan may obtain a discharge if:
 - a. His failure to completely pay is due to circumstances beyond his control,
 - b. The value of property distributed under the plan to each allowed unsecured creditor is not less than the amount that would have been paid had the debtor filed his petition under Chapter 7 and
 - c. The plan cannot be modified under §1329.

IV. Procedures

A. Priority claims

1. Unsecured claims that are given "priority" over other secured claims.
2. Certain tax claims have 8th priority (11 U.S.C. §507(a)(8)).

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- a. Trust Fund Recovery Penalty falls under the 8th priority (11 U.S.C §507(a)(8)(C)). While labeled a penalty, the United States Supreme Court declared the Trust Fund Recovery Penalty to be a tax (*United States v. Sotelo*, 436 U.S. 268 (1978)).

B. Penalties and Interest

1. Trust Fund Penalty is considered a pecuniary loss penalty (Saltzman, IRS Practice & Procedure, 16.12[3] and IRM 5.17.8.19). If it is not secured, it will be considered an unsecured priority (11 U.S.C. §507(a)(8)(G)).
2. Interest on a pre-petition tax claim is given the same priority as the tax claim itself (Saltzman, IRS Practice & Procedure, 16.12[2] and IRM 5.17.8.18). *If the interest is on a non-dischargeable tax claim, such interest will also be non-dischargeable (IRM 5.17.8.22(5)).*
3. Post-petition interest cannot be obtained on a pre-petition tax claim because it is considered to be unmatured interest, for which claims are not allowed under the Bankruptcy Code. (IRM 5.17.8.18, referencing 11 U.S.C. §502(b)(2)).
 - a. Exception – if the post-petition interest accrues on a non-dischargeable tax claim, then the post-petition interest is non-dischargeable and may be collected once the discharge is granted. (Saltzman, IRS Practice & Procedure, 16.12[2] and IRM 5.17.8.18).

C. Offers in Compromise

1. General Rule – IRS will not consider an offer in compromise while the taxpayer has a petition filed in bankruptcy (IRM 5.17.8.4).
 - a. Policy seeks to avoid conflict between an administrative decision and a legal decision (IRM 5.9.4.9).
 - b. Insolvency will instead look at the plan proposed in bankruptcy court (IRM 5.9.4.9).
2. Chapter 11 (IRM 5.9.4.9) - Only with respect to tax liabilities under a defaulted plan when the plan cannot be amended or the default cannot be fixed.

D. The Government's Players

1. Department of Justice – IRS' representative in Bankruptcy Court (IRM 5.9.1.2.2). Responsibility may be designated elsewhere (i.e., local US Attorney's office or Special Assistant US Attorney) (IRM 5.9.1.2.3).

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2. Insolvency – group within the IRS coordinates compliance with both tax and bankruptcy laws (IRM 5.9.1.3).

a. Centralized Insolvency Operation

- i. Performs most clerical duties.
- ii. Responsible for Chapter 7 “no asset” cases.
- iii. Chapter 13 cases.
 1. Supervises once the plan has been confirmed.
 2. Processes trustee payments.
 3. Once closed by the bankruptcy court, makes any necessary adjustments and closes the case internally.

b. Field Insolvency

- i. Responsible for Chapter 13 cases until confirmation of plan.
- ii. Chapter 11 cases
 1. Review the case and monitor its progress.
 2. Process payments.
 3. Close case.
- iii. Responsible for Chapter 7 asset cases.
- iv. Attends §341 meetings.
- v. Negotiates with debtors and their representatives.

E. Section 341 meeting

1. A meeting of the creditors, held by the U.S. Trustee who supervises the administration of the Chapter 11 case.
2. Affords creditors an opportunity to question the debtor under oath.
3. IRS may attend and question the debtor (IRM 5.17.10.5).

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4. In Chapter 7 cases, the creditors' committee is established during the Section 341 meeting (IRM 5.17.8.9). IRS may be a part of a Chapter 7 Creditors' Committee if it holds a general unsecured claim, but it usually refrains from participation.

F. Chapter 7

1. Within 20 – 40 days of filing the petition, the trustee will hold a §341 meeting of creditors.
2. "No asset" cases
 - a. Debtor's assets are either exempt or subject to valid liens.
 - b. Unsecured creditors do not receive any distributions, as there is nothing to liquidate.
3. "Asset" cases
 - a. Unsecured creditors must file their claims with the court within 90 days of the date the petition was filed. *Governmental entities have 180 days to file.*
 - b. Estate becomes the legal owner of debtor's property.
 - i. Trustee will sell any
 - a. Nonexempt property that is free and clear of liens, or
 - b. Exempt property that is worth more than the security interest or lien attached to it and any exemption that the debtor has.
 - ii. Each claim paid out of the estate must be distributed pursuant to 11 U.S.C. §726, with priority claims being paid first.

G. Chapter 11

1. Upon the filing of a voluntary or involuntary petition, a debtor automatically becomes a "debtor in possession."
2. Chapter 11 Plan Process
 - a. Timing of filing
 - i. Debtor has an exclusive right to file a plan of reorganization during the 120 days following the filing of the petition (11 U.S.C. §1121(b)).

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1. Small business debtors have a 180-day period during which they have an exclusive right.
 2. 120-day period may be extended, but total length of exclusivity period may not exceed 18 months (11 U.S.C. §1121(d)).
 - ii. Once the exclusivity period has ended, each creditor and the case trustee (if one is appointed) may file its own plan of reorganization.
- b. Debtor must file with the court:
- i. A written disclosure statement setting forth assets and liabilities and business affairs.
 1. IRS Insolvency group will closely review the disclosure statement (IRM 5.17.10.8.2).
 - a. Wants to insure correct characterization of its claim.
 - b. Will only object to a disclosure statement if:
 - i. The statement incorrectly sets forth the IRS' claim, or
 - ii. The statement is grossly deficient and
 - iii. IRS is going to object to the plan.
 - ii. A plan for reorganization
 1. Debtor may file a plan for reorganization with his petition or at anytime following the filing of the petition in both voluntary and involuntary cases (11 U.S.C. §1121(a)).
 2. Debtor will have the exclusive right to file a plan for reorganization for 120 days following the filing of the petition (11 U.S.C. §1121(b)).
- c. Creditors' Review of Plan (IRM 5.17.10.9.3)
- i. Creditors will vote to accept or reject a plan. IRS usually does not vote with respect to priority tax claims as they should not be classified by a plan under Chapter 11.
 - ii. IRS may vote with respect to its secured and unsecured claims

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1. If the IRS votes to reject a plan when the IRS has a secured claim, the IRS may thenⁱⁱ:
 - a. Continue to hold the lien that secures the claim,
 - b. Take deferred cash payments equal to the amount of the secured claim, or
 - c. Realize the equivalent of the claim.
2. If the IRS has an unsecured nonpriority tax claim, the plan must provide thatⁱⁱⁱ:
 - a. The IRS receive property whose present value is equal to the amount of the IRS' claim or
 - b. No property will be given to holders of claims that are junior to the IRS' claim.
- d. Plan Confirmation (IRM 5.17.10.9.4 and IRM 5.17.10.9.4.1)
 - i. Once the plan has been approved, a confirmation hearing is held.
 - ii. IRS will object to the confirmation of a plan if it feels its claims are not being treated properly .
 - iii. Once the plan is confirmed, it is binding on the debtor, creditors and other interested parties.
 - iv. If the debtor is a partnership or corporation, only the provisions for priority taxes must be set forth in the plan before confirmation can occur (Saltzman, IRS Practice & Procedure §16.16[1]).
3. Creditor's committee (11 U.S.C. §1102):
 - a. The creditors holding the 7 largest unsecured claims against the debtor will form the creditor's committee to confer with debtor in possession about case management; look into debtor's practices and business operation; and assist with creating the plan of reorganization.
 - b. IRS is not eligible to serve on the Creditors' Committee (IRM 5.17.10.4.2, referencing 11 U.S.C. §101(41)).
4. "Small business cases"

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- a. Court will determine whether a debtor is a “small business debtor” by applying a two-prong test: (11 U.S.C. §101(51D))
 - i. Debtor’s primary activity must be commercial or business and the total non-contingent liquidated secured and unsecured debts of such activity must be \$2,190,000 or less and
 - ii. Debtor cannot have been appointed to creditor’s committee.
- b. Debtor in possession must: (11 U.S.C. §308 & §1116)
 - i. File with the court the most recent balance sheet, cash-flow statement, most recent tax return and statement of operations,
 - ii. Consistently provide the court with profitability statements and expected cash receipts and disbursements,
 - iii. Report whether it is adhering to the rules and regulations as set forth in the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure and
 - iv. Inform the court as to whether it has filed its tax returns and paid its taxes.
- c. Subject to US Trustee’s oversight
- d. Circumstances under which a small business case will not be able to profit from an automatic stay: (IRM 5.17.10.7.2)
 - i. The debtor had another small business case already pending when the second petition was filed
 - ii. Within two years of the petition date, debtor’s previous small business case had been dismissed
 - iii. Within two years of the petition date, debtor’s plan in a previous small business case was confirmed or
 - iv. Debtor is a non-individual that has obtained a business or assets that meets the requirements above and debtor cannot show a good faith reason for purchasing the business or assets

H. Chapter 13

- 1. Once the petition is filed, a trustee is appointed to administer the case (11 U.S.C. §1302).

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2. Within 20 – 50 days after the petition is filed, the trustee will arrange for the creditors to meet
3. Unsecured creditors must file claims within 90 days after the first date set for the creditor’s meeting and for governmental agencies have 180 days from the date the petition is filed to file their claims.
4. Repayment plan
 - a. If not filed with the petition, must be filed within 15 days of the filing of the petition
 - i. Must provide for payments of fixed amounts to the trustee
 - ii. Must pay priority claims in full unless a priority creditor agrees otherwise (11 U.S.C. §1322(a)). Does not require that interest be paid (Saltzman, IRS Practice & Procedure §16.16[2], referencing *In re Bruce Martin Smith*, 77 AFTR2d 96-1844 (Bankr. MD Fla. 1996))
 - iii. Plan must provide for property to be distributed to unsecured creditors so that the unsecured creditors will get at least as much as they would had the petition been filed under Chapter 7 (11 U.S.C. §1325(a)(4))
 - iv. Plan must provide that the value of the property being distributed on account of a secured claim must be not less than the allowed amount of the claim (11 U.S.C. §1325(a)(5)(B)(ii))
 - b. Debtor must begin making plan payments within 30 days of filing the bankruptcy case, regardless of whether the plan has been approved (11 U.S.C. §1326(a)(1))
 - c. Once the plan is approved, funds are to be distributed by the trustee “as soon as practicable” (11 U.S.C. §1326(a)(2))
 - d. Depending on the monthly income of the debtor, the plan may provide for payments extending over a period of 3 or 5 years (11 U.S.C. §1322(d))
 - e. Debtor must obtain trustee’s consent to acquire new debt, as it could affect his ability to make payments under the plan
 - f. Payments may be made through payroll deductions.

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5. Case may be converted to a Chapter 7 case (11 U.S.C. §1307(a))
6. Protects co-debtors from collection attempts by creditors
7. Allows a debtor to reschedule and extend payments on his secured debts, excluding mortgage payments on a primary residence

V. Negotiations

- A. Anti-Injunction Act – any suit that is brought for the purpose of “restraining the assessment or collection of any tax” cannot stand in court, regardless of whether the person bringing the suit is the one against whom the tax was assessed.
 1. Enacted to protect the government’s tax collection abilities.
 2. *Marvel v. United States*, 548 F.2d 295 (10th Cir.) cert denied 431 U.S. 967 (1977). Court denied taxpayer’s attempt to enjoin the IRS from collecting taxes.
 3. *SEC v. Credit Bancorp*, 297 F.3d 127 (2d Cir. 2002). Court determined that the purpose of the suit was to prevent the collection of taxes, which is impermissible under the Anti-Injunction Act.
 4. *United States v. Macher*, 303 B.R. 798, 804 (W.D. Va 2003). The court order directing the IRS to consider a compromise did not violate the Anti-Injunction Act.

VI. After the Bankruptcy Proceedings Have Ended

A. Maintaining the plan

1. Designating payments under Chapter 11
 - a. Supreme Court held that the bankruptcy courts can approve Chapter 11 plans through which payments are allocated first to trust fund taxes if such designation is necessary for the plan to succeed (*U.S. v. Energy Resources*, 495 U.S. 545 (1990)).
 - i. Energy Resources does not extend so far as to allow bankruptcy courts to determine the tax liability of others who are not debtors.
 1. IRS feels that it has the authority to go after responsible persons, other than the debtor, for TFRP liability (IRM 5.17.10.9.5.2). *It will not pursue non-debtors for TFRP*

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liabilities if a Chapter 11 plan provides for full payment of priority taxes.

- ii. If the plan does not take care of the entire TFRP, the IRS may still hold the responsible party(ies) individually liable for the remainder.
2. Chapter 13 (Saltzman, IRS Practice and Procedure §16.16[2][f] and §16.16[2][i])
- a. When debtor cannot make payments
 - i. Trustee may try to modify the plan by lowering the amount of monthly payments or lengthening the plan's payment period
 - ii. Debtor can seek a hardship discharge from the bankruptcy court
 - iii. If neither modification nor hardship discharge is permitted, debtor can:
 - 1. Convert to Chapter 7, provided that no Chapter 7 discharge has been obtained within the last eight years and no Chapter 13 discharge has been obtained within the last six years, or
 - 2. Ask for a dismissal of the Chapter 13 case.
 - a. Debtor will still be obligated to pay his debts, minus any payments made under the repayment plan.
 - b. Creditors will be able to add interest that accrued during the Chapter 13 case to debtor's amount owed.
3. Binding on the IRS
- a. Chapter 11
 - i. Plans are generally binding on all creditors.
 - ii. May not be binding if they do not provide the IRS with as much as would otherwise be available under the Bankruptcy Code (IRM 5.17.10.10.2, referencing *In re DePaolo*, 45 F.3d 373 (10th Cir. 1995); *In re Taylor*, 132 F.3d 256 (5th Cir. 1998)).

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- iii. Where the plan calls for full payment of IRS' pre-confirmation claims, the IRS is unlikely to attempt to collect taxes (IRM 5.17.10.10.3).

B. Once the plan has concluded (remaining taxes owed)

1. If the taxes were discharged, the IRS is not permitted to collect the tax liability from the taxpayer personally (IRS Chief Counsel Notice (CC-2009-010) on Handling Collection Due Process Cases Under Sections 6320, 6330 (February 23, 2009) and 11 U.S.C. §524(a)).
2. Liens
 - a. If a Notice of Federal Tax Lien was filed prior to the filing of the bankruptcy petition, the lien will remain attached to property that was exempt or abandoned from the estate upon the conclusion of the bankruptcy process (IRS Chief Counsel Notice (CC-2009-010) on Handling Collection Due Process Cases Under Sections 6320, 6330 (February 23, 2009) and 11 U.S.C. §522(c)(2)(B)).
 - b. A lien for which a Notice of Federal Tax Lien was not filed prior to the filing of the bankruptcy petition will remain attached to property that was excluded from the bankruptcy estate (IRS Chief Counsel Notice (CC-2009-010) on Handling Collection Due Process Cases Under Sections 6320, 6330 (February 23, 2009)). The same rule does not apply to liens attached to *exempted* property.

VII. Statutes of Limitations and Stays – how does filing a petition with the Bankruptcy Court affect the statutes of limitations regarding tax proceedings?

A. Assessments

1. General Rule (26 U.S.C. §6501(a)) - An assessment must be made within three years of the date on which the taxpayer's return was filed.
2. When Bankruptcy Petition Filed (26 U.S.C. §6503(h)(1))
 - a. When a petition is filed in bankruptcy, the statute of limitations on assessment is suspended throughout the duration of the bankruptcy proceeding and continues for 60 days after the conclusion of the bankruptcy proceeding.

B. Collections

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1. General Rule (26 U.S.C. §6502(a)(1)) – Collection on a tax may be performed by levy or court proceeding so long as such action commences within 10 years of valid assessment.
2. When Bankruptcy Petition Filed (26 U.S.C. §6503(h)(2))
 - a. When a petition is filed in bankruptcy, the statute of limitations on collection is suspended throughout the duration of the bankruptcy proceeding and continues for six months after the conclusion of the bankruptcy proceeding.

C. Tax Court

1. When Bankruptcy Petition Filed (26 U.S.C. §6213(f))
 - a. When a petition is filed in bankruptcy, the statute of limitations for filing a petition in Tax Court is suspended throughout the duration of the bankruptcy proceeding and continues for 60 days after the conclusion of the bankruptcy proceeding.
2. Tax Court proceedings may not begin or continue when a petition is filed in bankruptcy (11 U.S.C. §362(a)(8))
 - a. Applies to corporate debtor's tax liability for a tax period that may be established by the bankruptcy court.
 - b. Applies to an individual debtor's tax liability for tax year(s) ending before the date of the order for relief in bankruptcy.

D. Trust Fund Recovery Penalty ("TFRP")

1. General Rule (26 U.S.C. §6672(b)(3))
 - a. Notice of a failure to collect and pay over tax must be mailed and delivered within the three year period set forth in §6501 for assessment of penalty.
 - b. A stay is imposed on collections of unpaid TFRP upon filing a bankruptcy petition (IRM 5.17.7.1.11).

E. Automatic Stay

1. Goes into effect immediately upon the filing of the bankruptcy petition (11 U.S.C. §362(a)).
 - a. Specifically prohibits:

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i. Assessment, collection or recovery with respect to any pre-petition claims against the debtor.

a. Exceptions (IRM 5.7.3.6):

1. When a responsible person files a petition in bankruptcy, the statute of limitations for assessing a TFRP will not be automatically extended
2. When a corporation is in bankruptcy court, the statute of limitations for assessing a TFRP against responsible persons will not be automatically extended.

b. Does not prohibit the IRS from taking a variety of actions, including, but not limited to: (IRM 5.17.8.10).

- i. Auditing a taxpayer in order to determine tax liability.
- ii. Issuing a notice of deficiency.
- iii. Demanding a tax return.

ⁱ Except stockbrokers and commodity brokers

ⁱⁱ (Saltzman, IRS Practice & Procedure §16.16[1])

ⁱⁱⁱ (Saltzman, IRS Practice & Procedure §16.16[1])