LESSON 5
CREDITORS, DEBTOR AND THE ESTATE
(Chapter 5, Bankruptcy Code)

CONTENTS

I. INTRODUCTION

Chapter 5 of the Bankruptcy Code, divided into three subchapters, addresses creditors and claims (sections 501-511), debtor's duties and benefits (sections 521-528), and the estate (sections 541-562).[1] Chief Counsel attorneys must have a basic understanding of the provisions of this Chapter to effectively represent the Service's interests.

II. DEBTOR'S DUTIES - 11 U.S.C. § 521

In general, section 521 sets forth a debtor's duties, such as the duty to file a list of creditors and, unless ordered otherwise, schedules and a statement of financial affairs. Several subsections of section 521 concern tax obligations.

Under section 521(e)(2)(A), added by the BAPCPA, a debtor must provide to the trustee, not later than seven days before the date first set for the first meeting of creditors under section 341, a copy of the federal income tax return (or at the election of the debtor, a transcript of such return) for the most recent tax year

[1] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the BAPCPA), effective as to cases filed on or after October 17, 2005, amended several Chapter 5 provisions.

ending immediately before the commencement of the case. At the same time as the return or transcript is provided to the trustee, a debtor must provide a copy of the tax return or transcript to a creditor that timely requested same. Under sections 521(e)(2)(B) and (C), if a debtor fails to provide the returns to either the trustee or a requesting creditor, the court must dismiss the case unless demonstrated that the failure is due to circumstances beyond the debtor's control.

Under section 521(f), also added by the BAPCPA, at the request of the court, the U.S. trustee, or any party in interest, an individual debtor in a Chapter 7, 11, or 13 case must file with the court, at the same time filed with the Service, copies of: (1) federal income tax returns for tax years ending while the bankruptcy case is pending; (2) any returns filed post-petition for tax years ending in the three-year period before the commencement of the case; and (3) any amendments to these returns. At the election of the debtor, the debtor may file a transcript of the return rather than a copy of the return.

Neither section 521(e)(2)(A) or (f) requires the debtor to provide filed copies of the required returns. The Service may receive requests from trustees or creditors for information to verify that the returns provided or filed pursuant to section 521(e)(2)(A) or (f) were actually filed with the Service. Any disclosure to the trustee must be in accord with the disclosure rules set forth in I.R.C. § 6103. For a detailed discussion regarding disclosure of return information in bankruptcy matters and guidance as to how and where to obtain information from the Service, refer to the Disclosure & Privacy Law Reference Guide, Chapter 6, on the Procedure & Administration intranet page, or Publication 908, Bankruptcy Tax Guide, available on www.irs.gov.

The BAPCPA also added section 521(j), which provides that if the debtor fails to file a tax return that becomes due after the date of the petition, or fails to properly obtain an extension of the due date for filing such return, the taxing authority may request that the court enter an order converting or dismissing the case. If the debtor does not file the return or obtain an extension within 90 days after the taxing authority files such request, the court shall convert or dismiss the case, whichever is in the best interests of the creditors and the estate.

The authorization given the Service under section 521(j) does not depend on whether the Service is a creditor or a party in interest in the case. Motions to convert or dismiss under this section would be considered a tax administration proceeding for disclosure purposes even if the Service has not filed a proof of claim and therefore the Service would be permitted to disclose the taxpayer's filing history to support its motion. Also note that under section 1112(b)(4)(I), failure to file post-petition returns and pay post-petition taxes constitute "cause" for conversion or dismissal of a Chapter 11 case.

III. PROPERTY OF THE ESTATE - 11 U.S.C. § 541

The filing of a petition in bankruptcy creates an estate, which consists of all property that will be subject to the bankruptcy court's jurisdiction. Whether or not certain property is part of the estate is significant, especially in liquidation cases, because only property of the estate is reduced to cash for distribution to creditors. Estate property is protected by the automatic stay of section 362(a) and a debtor may set aside certain property as exempt from claims under section 522.

A. Under section 541(a), property of the estate is comprised of the following property, wherever located and by whomever held.

1. All legal or equitable interests of the debtor in property as of the commencement of the case, except for property excluded from the estate under sections 541(b) and (c)(2). 11 U.S.C. § 541(a)(1).

2. All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is (i) under the sole, equal, or joint management and control of the debtor or (ii) liable for an allowable claim against the debtor, or for an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable. 11 U.S.C. § 541(a)(2).

3. Any property turned over to or recovered by the trustee. 11 U.S.C. § 541(a)(3).

4. Any interest in property preserved for the benefit of or ordered transferred to the estate. 11 U.S.C. § 541(a)(4).

5. Any interest in property that would have been property of the estate if such interest had been an interest of the debtor at the time the case was filed, and that the debtor acquires or becomes entitled to acquire within 180 days after the commencement of the case (i) by bequest, devise, or inheritance, (ii) as a result of a divorce decree or property settlement agreement or (iii) from the proceeds of a life insurance policy or death benefit plan. 11 U.S.C. § 541(a)(5).

6. Proceeds, product, offspring, rents or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after commencement of the case. 11 U.S.C. § 541(a)(6).

7. Any interest in property that the estate acquires after the commencement of the case. 11 U.S.C. § 541(a)(7).

Note: Sections 1115 and 1306 expand the definition of “property of the estate” as to individual Chapter 11 and 13 debtors.

B. Section 541(b)(1) through (9) list property excluded from the estate.

C. Section 541(c)(1) invalidates and makes unenforceable any provision in an agreement, transfer instrument or applicable nonbankruptcy law that attempts to limit or prevent property that would otherwise be included in the estate from becoming estate property (e.g., ipso facto clauses).

D. Section 541(c)(2) excludes from property of the estate a beneficial interest of the debtor in a trust that contains restrictions on transfer which are enforceable under "applicable nonbankruptcy law." “Spendthrift trusts” generally contain such restrictions enforceable under state laws; therefore, a debtor's beneficial interest in the trust that contains an anti-alienation provision is usually excluded from the bankruptcy estate. Property excluded from the estate cannot be claimed as exempt property; therefore, such property could remain subject to the Service’s assessment lien.

1. In Patterson v. Shumate, 504 U.S. 753 (1992), the Supreme Court concluded that a debtor's beneficial interest in an ERISA-qualified pension plan, subject to federal pension and tax law restrictions on assignment and alienation, is excluded from his bankruptcy estate.

2. Courts have developed different tests for determining whether a plan is an “ERISA-qualified pension plan” under Patterson and therefore excluded from the bankruptcy estate under section 541(c)(2). Any issue in bankruptcy involving a pension, profit-sharing, or other deferred compensation plan or employee benefit plan should be coordinated with TEGE and Branch 5, P&A. See infra Part XIV, Lesson 5, regarding the Service’s secured claim vis-à-vis the debtor’s interest in a pension plan excluded from the bankruptcy estate.

E. Section 541(d) provides that the estate can only succeed to the same property interests that the debtor possesses. In Begier v. Internal Revenue Service, 496 U.S. 53 (1990), the Supreme Court held that, under this provision, trust fund taxes withheld by the debtor are not property of the debtor or property of the estate, even if the withheld taxes are not held in a separate trust fund account but are commingled with the debtor's funds in a general account. The Begier case is discussed further in the text with respect to preferences.

IV. TURNOVER OF PROPERTY OF THE ESTATE - 11 U.S.C. § 542

Under section 542(a), any entity (other than a custodian) in possession of property that a trustee may use, sell or lease or that a debtor may exempt, must deliver to the trustee and account for the property or account for the value of such property, unless such property is of inconsequential value or benefit to the estate. Section 542(b) requires an entity that owes a debt to the debtor that is property of the estate, such as a tax refund, to turn over or pay such debt to the trustee (or debtor-in-possession), subject to any setoff rights under section 553. Kokoszka v. Belford, 417 U.S. 642 (1974). (A refund of income tax for a prepetition tax year is property of the bankruptcy estate even though the income tax return on which the refund was claimed was filed after the petition date.) Courts uniformly hold that where a tax year straddles the petition date, the portion of an income tax refund that is based on the prepetition income of a taxable year constitutes property of the bankruptcy estate. The refund is prorated between the prepetition and post-petition portions of the tax year. In re Barowsky, 946 F.2d 1516 (10th Cir. 1991). However, in Chapter 11, 12 and 13 cases, the debtor generally remains in possession of property of the estate. See sections 1107(a), 1203, and 1306(b).

In United States v. Whiting Pools, Inc., 462 U.S.198 (1983), the Supreme Court held that tangible property seized by the Service, prior to a bankruptcy petition being filed, was subject to the trustee's (or debtor-in-possession's) right to request turnover, as the debtor still retained some rights in the property, such as the right to redeem the property prior to sale. The holding in Whiting Pools has been expanded to include property which is not tangible, such as cash or cash equivalents, and does not require that the Service conduct a sale. When the Service has levied on cash or cash equivalents prior to the filing of the bankruptcy petition, but the funds have not been turned over as of the petition date, the funds are property of the estate and are subject to a turnover action. See, e.g., United States v. Challenge Air Int'l. Inc., 952 F.2d 384 (11^{th} Cir. 1992); Camacho v. United States, 190 B.R. 895 (D. Alaska 1995). If a request for turnover is made, the trustee (or debtor-in-possession) must provide the Service with adequate protection for its interest in the property. The Service could resist turnover by immediately filing a motion for relief from the automatic stay. See Litigation Guideline Memorandum GL-67, In re: Prebankruptcy Levies: Turnover, Adequate Protection, and the Automatic Stay. Note that adequate protection, contained in section 361, is discussed in this text in connection with Chapter 11 cases.

An adversary proceeding must be commenced to require any person, other than the debtor, to turn over property. Fed. R. Bankr. P. 7001(1).

V. PREFERENCES - 11 U.S.C. § 547

The Bankruptcy Code authorizes a trustee (or debtor-in-possession) to avoid certain prepetition transfers as "preferential."   When a transfer is avoided as a preference, the recovered property becomes part of the estate.

Under section 547(b), the trustee may avoid any transfer of an interest of the debtor in property:

1. to or for the benefit of a creditor;

2. for or on account of an antecedent debt owed by the debtor;

3. made while the debtor was insolvent;

4. made on or within 90 days before the petition date (date of transfer is not counted) or made between 90 days and one year before the petition date if the creditor was an insider; and

5. that enables the creditor to receive more than such creditor would have received if the case were a case under Chapter 7 case, the transfer had not been made and such creditor received payment of such debt to the extent provided by the provisions of title 11.

Note: The definition of “transfer” was amended under the BAPCPA and includes the creation of a lien or each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property. 11 U.S.C. §101(54). In determining whether a preference exists with respect to the Service, the trustee must also consider the subordination provisions under section 724(b), which allow certain priority creditors to be paid before payments are made to the Service from property subject to a federal tax lien.

For purposes of section 547(b), a transfer made by check is deemed to occur on the date the check is honored, and not the date of delivery to the payee. Barnhill v. Johnson, 503 U.S. 393 (1992).

Section 547(c) sets forth certain transfers that may not be avoided as preferences, including, but not limited to, the following:

1. transfers intended by the debtor and creditor to be a contemporaneous exchange for new value and is in fact a substantially contemporaneous exchange;

2. payment of debts incurred and paid in the ordinary course of business (e.g., current tax deposits and/or payments accompanying current tax returns); or

3. the fixing of a statutory lien that is not avoidable under section 545 (note that a tax lien is a statutory lien).

The payment of estimated tax payments and the withholding of income tax payments from wages is not a payment of an antecedent debt and, therefore, not avoidable as a preference. See In re Wieser, 86 B.R. 157 (Bankr. W.D. Ark. 1988). In Begier v. Internal Revenue Service, 496 U.S. 53 (1990), the Supreme Court held that the debtor's voluntary prepetition payment of its trust fund obligation to the Service was not subject to a preference action by the trustee as the property was not "property of the debtor," as I.R.C. § 7501(a) created a trust, even where the funds were not held in a separate account. The Court found the debtor's act of voluntarily paying its trust fund obligations would establish a nexus between the "amount" held in trust and the funds paid by the debtor, although no trust actually existed. However, the holding in Begier may not apply if the payments are not made directly to the Service by the debtor as the employer, such as where a payroll service is making the payment. See Wyle v. S & S Credit Co., 53 F.3d 285 (9th Cir. 1995), decision vac. appeal dism. as moot, 68 F.3d 337 (9th Cir. 1995).

Under section 547(f), the debtor is rebuttably presumed to have been insolvent within the 90 days immediately preceding the petition date. Section 547(g) allocates burdens of proof between the parties in preference litigation. The trustee has the burden of proving the elements of an avoidable transfer under section 547(b), e.g., that the transfer was made within 90 days and that the transferee received more by the transfer than it would have received in a Chapter 7 as of the date of the petition. The transferee has the burden of proving nonavoidability. Because a preference action is one to recover money or property from a person other than the debtor, the action is an adversary proceeding and must be brought by complaint. Fed. R. Bankr. P. 7001(1).

Note: Preferences should not be confused with fraudulent conveyances under section 548, which allow the trustee to recover certain transfers made within two years of the date of petition.

VI. POST-PETITION EFFECT OF TAX LIENS - 11 U.S.C. § 552

As a general rule, after-acquired property of the estate is not subject to any lien resulting from any security agreement entered into by the debtor before commencement of a bankruptcy case. An exception is made for proceeds, product, offspring, rents or profits generated by secured property if covered by the security agreement.

Since a tax lien is nonconsensual and does not arise by agreement, it is not subject to section 552. However, a negative inference should not be drawn from the fact that section 552(a) does not apply to federal tax liens. See In re Avis, 178 F.3d 718 (4th Cir. 1999). Without relying upon section 552, courts have held that after-acquired property is not subject to prepetition tax liens. See Brown Transport Truckload, Inc., 1990 U.S. Dist. LEXIS 16300 (N.D. Ga. 1990); In re Larson, 93-2 USTC ¶ 50,508, 72 AFTR2d 5564 (Bankr. D. N.D. 1993).

Field attorneys should consider this when negotiating for adequate protection for the Service and try to obtain language in an adequate protection or cash collateral agreement that the federal tax lien will continue to attach to after-acquired property to the extent that prepetition collateral subject to the lien is consumed.

VII. SETOFF - 11 U.S.C. § 553

Section 553(a) preserves the right of a creditor to set off a debt owing by such creditor to the debtor that arose before the commencement of the case against a claim of such creditor against the debtor that also arose before the petition date.

Section 553 preserves the right of setoff only if the debts are mutual; for example, a prepetition overpayment may be set off against a prepetition tax liability because the overpayment is owed to the debtor and the debtor is liable for the prepetition taxes. Mutual obligations are debts held by the same parties in the same right or capacity.

Whether a refund or claim arises prepetition or post-petition can also have an effect of whether setoff is appropriate. The Service's position is that a post-petition refund may generally be setoff against a post-petition liability since it is authorized under I.R.C. § 6402(a). The crediting of overpayments against underpayments under I.R.C. § 6402(a) constitutes a setoff within the meaning of the Bankruptcy Code.

The Service also takes the view that it can set off post-petition refunds against prepetition liabilities, but only if the debts are mutual, i.e., both the refund and the debt are owed to/by the taxpayer. For example, a post-petition refund may be setoff against nondischargeable debts of a Chapter 7 debtor because the refund is owed to the debtor, as opposed to the bankruptcy estate, and the debtor remains personally liable for the nondischargeable tax. Pursuant to section 553(a)(1), a setoff of a mutual prepetition debt is not allowed to the extent that the creditor's claim against the debtor is disallowed.

Although section 553 preserves the creditor's right to set off mutual prepetition debts, the automatic stay generally prohibits the exercise of the setoff right. See 11 U.S.C. § 362(a)(7). For cases filed on or after October 17, 2005, there is an exception to the automatic stay that allows the setoff of prepetition income tax liabilities against prepetition income tax refunds. 11 U.S.C. § 362(b)(26).

Section 362(b)(26) also provides that a governmental unit may hold a refund pending the resolution of an action to determine the amount or legality of a tax liability unless the court grants the taxing authority adequate protection. For setoffs not covered by section 362(b)(26), the government may rely upon the Supreme Court's decision in Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995), to retain the refund until the automatic stay can be lifted. However, it is unclear after Strumpf how long a creditor may maintain a temporary freeze without violating the automatic stay. In In re Holden, 258 B.R. 323 (D. Vt. 2000), the court held that the debtor's post-petition refund was property of the Chapter 13 estate and that freezing the refund without any attempt to seek relief from the stay was a violation of the automatic stay.

As stated in the discussion of section 506, an allowed claim of a creditor that is subject to setoff under section 553 is a secured claim to the extent of the amount subject to setoff. Insolvency should show the amount to be set off as a secured claim on the proof of claim, and should note the security consists of a refund subject to setoff. Many courts hold that when a creditor files a proof of claim but neglects to indicate the right to setoff on the form, the right is not negated. Other courts assert that failure to preserve setoff in a proof of claim is a waiver of that right. However, a creditor's right to setoff may be waived if it takes actions inconsistent with that right, such as by remitting the funds to the debtor.

VIII. EXEMPTIONS - 11 U.S.C. § 522

In order to promote a "fresh start," an individual debtor is allowed to claim a certain amount of property as exempt from the bankruptcy estate. The Bankruptcy Code allows an individual debtor to elect between either the exemptions provided under state law, if any, or the federal exemptions listed in section 522. Corporate debtors are not allowed exemptions. The election between state and federal exemptions is permitted unless the state of the debtor's residence specifically prohibits the election by law, in which instance the debtor is only allowed exemptions provided under state law. Most states have "opted out" of the federal exemptions. Currently, the states of Alabama, Arizona, California, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Mississippi, Missouri, Montana, Nebraska, Nevada, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming have enacted legislation prohibiting their residents from electing the federal exemptions. In those states that allow a choice between federal and state exemptions, and a husband and wife file a joint case or cases that are jointly administered, both spouses must close either federal or state exemptions. If a couple fails to agree on the election, it is presumed that they have elected, where possible, the federal exemptions. 11 U.S.C. § 522(b).

Under section 522(c), exempt property is not liable during or after the case for any debt that arose before the commencement of the case except for the types of debt listed in subsections (c)(1) through (4), which includes nondischargeable tax claims and customs duties (section 523(a)(1)) and debts secured by a lien that is not avoided or for which a notice of federal tax lien has been filed (section 522(c)(2)(B)). Thus, exempt property remains subject to a federal tax lien if a notice of federal tax lien was filed prepetition, or if nondischargeable under section 523(a)(1). However, because of the automatic stay, collection is prohibited when in effect.

The BAPCPA made several changes to section 522. One of the changes was to add subsection (p), which imposes a 1,215-day residency requirement for claiming a state or local law homestead exemption in excess of $146,450 (as periodically adjusted). Sections 522(b)(3)(C) and 522(d)(12) were added to explicitly exempt tax-exempt retirement funds. This exemption applies regardless of whether the debtor chooses state or federal exemptions. These subsections expand the types of retirement plans that could be exempt property to include retirement funds under I.R.C. §§ 401 (ERISA-qualified pension, profit-sharing and stock bonus plans), 403 (employee annuities), 408 (IRAs), 408A (Roth IRAs), 414, 457 (deferred compensation plans for tax exempt entities, including state and local governments) and 501(a).

Note: Retirement plans that contain anti-alienation language (spendthrift clauses) are excluded from the estate by section 541(c)(2). The legislative history to section 522 reflects Congress' intent to expand the protection of retirement assets.

Bankruptcy Rule 4003(a) requires that a debtor list the property claimed as exempt on his schedule of assets. A party in interest may file an objection to claimed exemptions within 30 days after the conclusion of the section 341 meeting or the filing of any amendment to the list or supplemental schedules. The court may grant further time to challenge the exemptions, provided a motion is filed within the original time period. Fed. R. Bankr. P. 4003(b). The validity of an exemption cannot be contested after the expiration of the deadline for challenging, regardless of whether there is a statutory basis for the exemption or whether the exemption was claimed in good faith. Taylor v. Freeland & Kronz, 503 U.S. 638 (1992); Schwab v. Reilly, 130 S. Ct. 2652, 177 L. Ed. 2d 234, 2010 U.S. LEXIS 4974 (June 17, 2010).

An objection to the debtor's claimed exemptions is a contested matter under Bankruptcy Rule 9014, and is brought by motion. In any hearing regarding the exemptions, the burden of proof is on the objecting party to prove that the exemptions are not properly claimed. Fed. R. Bankr. P. 4003(c).

Generally, the Service does not object to the debtor's claimed exemptions if a notice of federal tax lien has been filed. Since the federal tax lien cannot be avoided on exempt property, the Service may collect from this property after the automatic stay lifts, even if the taxes were discharged. However, if no notices of federal tax lien have been filed, Insolvency or the field attorney should review the claimed exemptions promptly to determine if the exemptions have been properly claimed.

IX. FILING AND ALLOWANCE OF PROOFS OF CLAIM - 11 U.S.C. §§ 501 AND 502

A “claim” in bankruptcy is a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured. It is also a right to an equitable remedy for breach of performance if the breach gives rise to a right to payment whether or not the equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured. 11 U.S.C. § 101(5).

Section 501 provides that a creditor may file a “proof of claim.” The filing of a proof of claim allows the creditor to participate in distributions from the estate, unless the claim is disallowed, and makes the creditor a party in interest for purposes of participating in various bankruptcy procedures.

If the creditor does not timely file a proof of claim, the debtor or trustee may file a proof of claim on behalf of the creditor. 11 U.S.C. § 501(c) and Fed. R. Bankr. P. 3004. In Chapter 11 cases, a proof of claim is deemed filed under section 501, and the creditor need not file a proof of claim, for any claim the debtor includes on the schedules, except for those scheduled as disputed, contingent or unliquidated. 11 U.S.C. § 1111(a). If the creditor actually files a claim in a Chapter 11 case, however, and the case is subsequently converted to Chapter 7, the claim will be deemed to have been filed in the Chapter 7 case and the creditor need not re-file. Fed. R. Bankr. P. 1019(3). Section 502(a) provides that a filed proof of claim is deemed allowed unless a party in interest objects. A proof of claim executed and filed in accordance with the Bankruptcy Rules constitutes prima facie evidence of the validity and amount of the claim. Fed. R. Bankr. P. 3001(f).

The Bankruptcy Code and Bankruptcy Rules set forth the following time requirements for filing a proof of claim:

1. In Chapter 7, 12, and 13 cases, proofs of claim are timely if filed not later than 90 days after the first date set for the section 341 meeting of creditors. Fed. R. Bankr. P. 3002(c).

2. Claims filed by governmental units are timely if filed not later than 180 days after the date of the order for relief. In a voluntary case, the date of the order for relief is the petition date. In a Chapter 13 case, a governmental unit has 60 days after the date on which a return was filed as required under section 1308 to file a claim with respect to such return. 11 U.S.C. § 502(b)(9); Fed. R. Bankr. P. 3002(c)(1).

3. For Chapter 7 priority claims filed after the bar date, the claim will still be entitled to priority distribution if filed before the earlier of the date that is 10 days after the mailing to creditors of the summary of the trustee's final report, or the date on which the trustee commences final distribution. 11 U.S.C. § 726(a)(1).

4. The Bankruptcy Rules do not provide a date for filing claims in Chapters 9 and 11. The Court usually orders that proofs of claim are to be filed by a specific date. This may be done by order in the specific case, by standing order or by local rule. Fed. R. Bankr. P. 3003(c)(3).

5. The periods above may be extended under Bankruptcy Rule 3002(c)(1) or 3003(c)(3), if the creditor files a motion before the expiration of the original bar date, for cause shown.

Forms and Procedures for Filing Proofs of Claim

Part III of the Bankruptcy Rules governs the form and procedural requirements for filing a proof of claim. In addition, many courts have local rules or have issued orders which must also be followed.

A proof of claim must be in writing, and must substantially conform to the appropriate Official Form. Fed. R. Bankr. P. 3001(a). Currently, the Official Form is Form B10. The Service files two types of forms to assert federal tax liabilities, the first being the Proof of Claim for Internal Revenue Taxes (Form 6338), which only lists prepetition tax liability. The first page of Form 6338 conforms to Official Form B10, showing the basis of the claim as being taxes, and giving the total amount of the claim, as well as the amounts for the secured and priority portions of the claim. The additional pages are unique to the Service, and set out details regarding the type of tax, tax periods, assessment and lien filing dates, and interest and penalty accruals. These are grouped together by classification as secured, priority or general unsecured liabilities. How liabilities are classified is discussed more fully below.

The second form used by the Service is the Request for Payment of Internal Revenue Taxes (Form 6338-A), which only lists post-petition tax liability (also known as administrative expenses), for those cases in which the bankruptcy estate incurs a tax liability.

Because the definition of a claim is so broad, the Service may have claims for taxes that are not yet fixed or agreed to. For example, the Service may be conducting an audit of the debtor's income tax return, or may be conducting an investigation for possible imposition of the trust fund recovery penalty, when the debtor files bankruptcy. Section 502(c) requires the estimation of the dollar amount of any claim that is disputed, contingent, or unliquidated, where the fixing or liquidation of such claim would unduly delay the administration of the case. Any estimate of a tax claim, therefore, should be as specific as possible regarding the type of tax, period, and amount. See In re Tanaka Bros. Farms, Inc., 36 F.3d 996 (10th Cir. 1994). The liability need not have been assessed to be included on the proof of claim. See In re White, 168 B.R. 825 (Bankr. D. Conn. 1994); In re Hatchett, 31 B.R. 833 (Bankr. E.D. Va. 1983); In re Saxe, 14 B.R. 161 (Bankr. S.D.N.Y. 1981). If no objection is made to these liabilities, they are deemed allowed even though the Service has not completed its audit or investigation.

When an amended proof of claim is filed, the previous proof of claim is not withdrawn, as the earlier form may protect the bar date and keep the claim from being objected to as untimely. Although this procedure is generally understood, many trustees or debtors bring "housekeeping" objections to claims to clarify the matter. The major difficulty in responding to those objections is that the trustees frequently refer to the claims/request by the numbers assigned the filed forms by the clerk's office, and the Service usually has no record of those numbers. It will be necessary to look at the claim file maintained by the clerk's office, although information in this file can be accessed from PACER, if the bankruptcy court is on the PACER system.

In order to be allowed, a proof of claim must be filed with the clerk in the district where the case is pending. Fed. R. Bankr. P. 3002(b), 5005(a). In the event that a proof of claim is not timely filed, the claimant may be able to argue that an "informal" claim was made before the bar date. Several Circuits have assigned five elements necessary for an informal proof of claim: (1) it must be in writing; (2) it must contain a demand by the creditor on the estate; (3) it must express an intent to hold the debtor liable for the debt; (4) it must be filed with the bankruptcy court; and (5) the facts of the case must make allowance equitable.

X. CLASSIFICATION OF PREPETITION CLAIMS – 11 U.S.C. §§ 506 and 507

Claims for prepetition taxes are classified as secured or unsecured. Unsecured claims are further classified as priority unsecured or general unsecured.

1. Secured - The Service has a secured claim with respect to assessed federal tax liabilities for which a Notice of Federal Tax Lien regarding the liability was properly filed prior to the filing of the petition or where the

Service has a right to setoff. The amount of the secured claim is limited to the value of collateral or the amount subject to setoff, with the remainder of the claim reduced to priority or general unsecured status. 11 U.S.C. § 506(a). The text discusses this in more detail in the section covering section 506.

Only the interest and penalty accruals calculated to the petition date are listed on a proof of claim, even when a claim for post-petition interest is asserted.

2. Priority unsecured - Section 507(a) sets forth the types of claims that are entitled to priority and the order of their priority. Priority unsecured claims include the federal tax liabilities described in section 507(a)(8), plus interest, but not penalties, computed to the petition date. Most courts have held that a priority tax claim includes the prepetition interest on the claim, even though the interest is not expressly provided for in section 507(a)(8). In re Garcia, 955 F.2d 16 (5th Cir. 1992); In re Stonecipher Distributors, Inc., 80 B.R. 949 (Bankr. W.D. Ark. 1987).

   For purposes of the priority provision, a tax on income for a particular period is generally considered incurred on the last day of the period. A tax on or measured by some event, such as the payment of wages or a transfer by reason of death or gift, or any excise tax on a sale or other transaction, is considered incurred on the date of the transaction or event.

Section 507(a)(8) gives a variety of tax liabilities eighth priority. The most relevant to the Service are:

a. Section 507(a)(8)(A) - For a tax on or measured by income or gross receipts for a taxable year ending on or before the petition date when:

   i. The return for the tax is last due, including any extensions, after three years before the date of the filing of the bankruptcy petition;

   ii. The tax was assessed within 240 days of the bankruptcy petition. The 240 days is exclusive of any time an offer in compromise with respect to that tax was pending, plus 30 days, and any time collection was stayed in a prior case, plus 90 days; or

   iii. The taxes were not assessed, but were assessable, under applicable law or by agreement, after the commencement of the bankruptcy case, so long as the taxes are not those specified as nondischargeable in 11 U.S.C. § 523(a)(1)(B) (returns not filed, or returns filed late but less than two years prior to the petition) or section 523(a)(1)(C) (fraudulent returns). In other words, if the statute of limitations on assessment is open only because no return was filed, or the return was fraudulent, the taxes will not qualify as priority under this provision. These exceptions are intended to prevent the government from having priority over other claims due to the debtor's bad acts.

Note: As to offers in compromise, section 507(a)(8)(A)(ii) was amended by the BAPCPA to clarify that suspension for the 240-day period does not require that the offer be made within 240 days of the assessment, but only that the offer in compromise is pending or in effect within 240 days before the petition date.

Note: As to tolling, before the BAPCPA, the Supreme Court held in Young v. United States, 535 U.S. 43 (2002), that the pendency of an earlier bankruptcy case equitably tolls the running of the three-year lookback period found in section 507(a)(8)(A)(i) and the case had been generally held applicable to section 507(a)(8)(A)(ii). In post-BAPCPA cases, the three-year period of section 507(a)(8)(A)(i) and the 240-day period of section 507(a)(8)(A)(ii) are tolled for the period of any prior bankruptcy, plus 90 days.

b. Section 507(a)(8)(C) - Taxes required to be collected or withheld and for which the debtor is liable in whatever capacity. This covers trust fund taxes, if the debtor is the employer, or the trust fund recovery penalty, if the debtor is a responsible person. These taxes are always priority, regardless of the age of the tax period.

c. Section 507(a)(8)(D) - Employment taxes on wages paid as a priority claim under section 507(a)(4), and wages paid before the petition for which a return was last due, including extensions, after three years before the filing of the bankruptcy petition. This covers the employer's share of the employment taxes.

d. Section 507(a)(8)(G) - Penalties related to the tax claims set out in section 507(a)(8), and in compensation for actual pecuniary loss. While the trust fund recovery penalty will fall under this section as well as being included under section 507(a)(8)(C), there may be other penalties contained in the Internal Revenue Code that may come under this category. There is no limitation on claims in this category due to the age of the tax year.

3. Unsecured general - Federal tax liabilities that cannot be classified as secured or priority.

a. Interest

i. Interest that accrued prepetition is set forth on the proof of claim in the same class as the tax liability which generated it. 11 U.S.C. § 502(b).

ii. Interest that accrues post-petition is not allowed as to priority or general claims because section 502(b)(2) provides a claim for unmatured interest is not allowable. Although unallowable in the bankruptcy case, the interest continues to accrue and may be collected outside the bankruptcy if it relates to a nondischargeable liability. However, the Supreme Court held in U.S. v. Ron Pair Enters., Inc., 489 U.S. 235 (1989), that the government is entitled to receive post-petition interest on its secured claim pursuant to section 506(b) if the claim is oversecured; that is, if the value of the assets subject to the federal tax lien exceeds the total amount of the liens which are attached to the assets.

b. Penalties (Non-pecuniary loss)

i. Prepetition penalties

For a secured claim, these are treated as secured and are payable as part of the secured tax claim set forth in the secured portion of the proof of claim, except in Chapter 7 cases. This is covered in the text discussing Chapter 7. If the tax claim is an unsecured priority claim, the penalty is not included in the priority claim but instead is listed separately and is treated as a general unsecured claim.

ii. Post-petition penalties

Post-petition penalties on prepetition tax liabilities do not accrue while the bankruptcy case is pending and therefore cannot be set forth on a proof of claim. I.R.C. § 6658. A bankruptcy case is pending until it is closed or dismissed. See Rev. Rul. 2005-9, 2005-6 I.R.B. 470.

Note: Whether a tax imposed by the Internal Revenue Code falls within one of the priority classifications is also dependent on the purpose of Congress in enacting the tax. In United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996), the Supreme Court held that designation as a tax is not determinative, and outlined the factors to be considered in determining whether an exaction is a tax or a penalty, with a penalty being considered to be a punishment for an unlawful act or omission. Accordingly, if an exaction under the Internal Revenue Code is determined to be a penalty, and is not in compensation for actual pecuniary loss, it will not fall within section 507(a)(8) and will be a general unsecured claim.

XI. POST-PETITION CLAIMS/ADMINISTRATIVE EXPENSES - 11 U.S.C. § 503

Under section § 503(a), a creditor files a request for payment, rather than a proof of claim, for administrative expenses. Administrative expenses are incurred by the estate after the filing of the bankruptcy petition. Section 507(a)(2) grants second priority treatment to unsecured administrative expenses allowed under section 503(b). Taxes, other than "of a kind" accorded an eighth priority under section 507(a)(8), and penalties related to such taxes incurred by the bankruptcy estate, are allowed as administrative expenses. Thus, the Service's request for payment of administrative expenses should include all post-petition taxes with interest and penalty accruals.

A. Administrative Expenses Under Section 503

Section 503(b) sets out the types of claims allowable as administrative expenses including, under subsections (b)(1)(B) and (C), “any” tax incurred by the estate, as well as any fine, penalty, or reduction in credit relating to such tax.

Interest on post-petition tax liabilities in a Chapter 11 case is also afforded status as an administrative expense. <u>United States v. Friendship College</u>, 737 F.2d 430 (4th Cir. 1984). Interest on post-petition tax claims in a Chapter 7 case also is afforded administrative expense status under section 726(a)(1). <u>United States v. Yellin (In re Weinstein)</u>, 272 F.3d 39 (1st. Cir. 2001).

Penalties and fines relating to post-petition taxes will also be an administrative expense, with some limitations. I.R.C. § 6658(a)(1) provides that the failure-to-pay penalty imposed by sections 6651, 6654, and 6655 will not accrue on taxes, other than a trust fund liability, if the tax was incurred by the estate and if the failure to pay occurred pursuant to an order of the bankruptcy court finding probable insufficiency of funds of the estate to pay administrative expenses.

Note: BAPCPA added section 503(b)(1)(D) to provide that a governmental unit shall not be required to file a request for payment of administrative expense taxes. Section 960(b) of title 28 was added to require that a tax shall be paid on or before the due date of the tax under applicable nonbankruptcy law unless the tax is a property tax secured by abandoned property or payment is excused under a specific provision of the Bankruptcy Code. Section 960(c) of title 28 was added to allow the payment of the taxes to be deferred until final distribution in Chapter 7 cases if the tax was not incurred by the Chapter 7 trustee (e.g., Chapter 11 administrative expense incurred before conversion to Chapter 7) or the court makes a finding, before the due date of the tax, that there will not be sufficient funds in the estate to pay all administrative expense claims in full. See IRM 5.9.13.11 stating that an administrative expense claim should nevertheless be filed because it puts the debtor and creditors on notice as to the amounts due.

Accordingly, for cases filed on or after October 17, 2005, administrative taxes are required to be paid on or before the due date and the Service is no longer under any obligation file requests for payment of such taxes. The Service should continue to monitor tax compliance closely in Chapter 11 cases and bring a motion to convert or dismiss under section 1112, or a motion for appointment of a trustee under section 1104, if post-petition taxes are not paid timely. The failure to timely file returns and pay taxes is now an express ground for conversion, dismissal, or appointment of a trustee, and the court's discretion to deny such motions is curtailed. See 11 U.S.C. §§ 1104(a)(3) and 1112(b)(4)(I). The Service should also beware of any order providing bar dates for administrative claims, which may be contained in a Chapter 11 plan or confirmation order.

XII. OBJECTIONS TO THE SERVICE'S PROOF OF CLAIM

Section 502 allows any party in interest to object to a claim. Section 502(b) lists several grounds for disallowing a claim in bankruptcy, although the list is not exhaustive. The most common objections with respect to the Service's proofs of claim are that the taxes are not owed or that the claim was tardily filed.

Bankruptcy Rule 3007 provides that an objection to the allowance of a claim must be in writing and filed with the court. A copy of the objection with notice of the hearing thereon is required to be mailed to the claimant, the debtor or the debtor-in-possession and the trustee at least 30 days prior to the hearing. Because an objection to claim is a contested matter, Bankruptcy Rule 9014(b) provides that the objection be served in the manner provided for service of a summons and complaint. Therefore, a copy of the objection must also be served on the Attorney General of the United States and the United States Attorney for the district when an agency of the United States is the creditor. See Fed. R. Bankr. P. 7004(b)(4) and (5).

Objections to claim are frequently ambiguous and uninformative. In general, however, upon receipt of an objection to claim, the field attorney should request Insolvency to forward a copy of the proof of claim and updated transcripts. If the basis for the objection goes to the secured status of the Service's claim, a request should be made for a copy of the notice of federal tax lien. If possible, Insolvency should also obtain the revenue officer's TDA file and the debtor's schedules from the bankruptcy case. The information contained in the TDA file and the values listed on the debtor's schedules will aid in determining how much collateral is available to secure the federal tax lien. An action to determine the extent, validity, or priority of a lien must be filed as an adversary proceeding. Fed. R. Bankr. P. 7001(2).

Debtors will often file objections to claim in an attempt to determine the substantive merits of their tax liability, as opposed to issues relating to the proof of claim, such as the classification of the liabilities or the timeliness of the claim. Technically, a determination of the debtor's prepetition tax liability should be brought as an action under section § 505(a), but many courts allow the determinations of tax liability to be made as an objection to claim. While a motion could be brought to dismiss the objection to claim or have it deemed to be an action to determine tax liability under section 505, the field attorney should ascertain what the local practice is, and whether, as a practical matter, it makes a difference as to which procedure is used. If the court uses the same procedure to handle section 505 determinations, the contested matter should proceed as filed.

XIII. DETERMINATION OF TAX LIABILITY - 11 U.S.C. § 505

Section 505 gives the bankruptcy court the authority to determine the prepetition tax liability. Under section 505(a)(1), the bankruptcy court is authorized to determine any unpaid liability of the debtor that has not been contested before or adjudicated by a judicial or administrative tribunal of competent jurisdiction prior to the commencement of the bankruptcy case. The bankruptcy court may not re-examine a tax liability that was previously adjudicated or determine the estate's right to a tax refund (before the earlier of 120 days after the trustee requests such refund from the Service or a determination is made by the Service). See 11 U.S.C. § 505(a)(2)(A); 11 U.S.C. § 505(a)(2)(B); See Rev. Proc. 2010-27, 2010-2 C.B. 183, modified by Ann. 2011-77, 2011-51 I.R.B. 874.

Debtors have used section 505(a)(1) seeking determinations with respect to related persons not in bankruptcy. For example, corporate debtors have attempted to bring an action to obtain a determination that corporate officers are not liable for the trust fund recovery penalty. The Service has argued that section 505(a) does not confer jurisdiction on a bankruptcy court to determine the tax liability of a nondebtor with success. See American Principals Leasing Corp. v. United States, 904 F.2d 477 (9th Cir. 1990); In re Brandt-Airflex Corp., 843 F.2d 90 (2d Cir. 1988); United States v. Huckabee Auto Co., 783 F.2d 1546 (11th Cir. 1986); contra Quattrone Accountants, Inc. v. I.R.S., 895 F.2d 921 (3rd Cir. 1990); In re Kaplan, 104 F.3d 589 (3rd Cir. 1997); In re Wolverine Radio Co., 930 F.2d 1132 (6th Cir. 1991).

The bankruptcy court has the discretion to determine the amount and legality of a debtor's prepetition tax under section 505(a). If the determination of the tax liability does not serve any purpose in administering the bankruptcy case, the field attorney should consider whether a request for the court to abstain from making the determination should be made. For example, if the debtor has filed a Chapter 7 case, and the trustee will not be making distributions as there are no nonexempt assets with equity for the trustee to administer, a debtor's request for a tax determination under section 505(a) will probably serve no bankruptcy purpose. In those situations, it may be more advantageous for the Service to have the determination made by the Tax Court or by a district court in a refund suit. See In re Fankhanel, 207 B.R. 292 (Bankr. M.D. Fla. 1997); In re Gossman, 206 B.R. 264 (Bankr. N.D. Ga. 1997); In re Williams, 190 B.R. 225 (Bankr. W.D. Pa. 1995). If there was a Tax Court case pending when the debtor filed bankruptcy, the field attorney should consider moving to lift the automatic stay to allow the Tax Court case to go forward, particularly if the tax issues are complex. In re Hunt, 95 B.R. 442 (Bankr. N.D. Tex. 1989).

Section 505(b) allows trustees to request a determination regarding any unpaid tax liability of the bankruptcy estate from the appropriate governmental unit, and provides that, unless the entity notifies the trustee within 60 days that the return has been selected for examination, "the trustee, the debtor, and any successor to the debtor are discharged from any liability for such tax" unless the return is fraudulent or contains a material misrepresentation. The BAPCPA amended section 505(b) to add “the estate” to the list of parties discharged under this provision. Accordingly, for cases filed on or after October 17, 2005, the Service will no longer be able to rely upon case law that allowed it to collect any additional tax due from the bankruptcy estate. See e.g. In re Goodrich, 215 B.R. 638 (Bankr. D. Mass. 1997); In re West Texas Marketing Corp., 54 F.3d 1194 (5th Cir. 1995). But see U.S. v. Bond, 486 B.R. 9 (E.D.N.Y. 2012) (affirming bankruptcy court’s ruling in pre-BAPCPA case that liquidating trustee had made proper request for determination of 2002 tax liability and that because IRS did not act timely to examine return, estate and liquidating trust were discharged of all tax liabilities not on 2002 return).

A bankruptcy discharge operates as an injunction against acts to collect the discharged debt as a personal liability of the debtor. See 11 U.S.C. § 524(a)(2) (“A discharge in a case under this title…operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor.”). But a discharge does not extinguish the liability itself and is not a finding that the discharged liability was improper. See Johnson v. Home State Bank, 501 U.S. 78, 84 (1991) (“a bankruptcy discharge extinguishes only one mode of enforcing a claim – namely, an action against the debtor *in personam* – while leaving intact another – namely, an action against the debtor *in rem*”); In re Edgeworth, 993 F.2d 51, 53 (5th Cir. 1993) (“A discharge in bankruptcy does not extinguish the debt itself, but merely releases the debtor from personal liability for the debt."); In re Conston, Inc, 181 B.R. 769, 773 (D. Del. 1995) (collecting cases).

Section 505(b)(1) requires the clerk of each district to maintain a list where the Federal, State, or local taxing authority responsible for collection of taxes within the district may designate an address for service of section 505(b) requests and describe where further information concerning additional requirements for filing such requests may be found. 11 U.S.C. § 505(b)(1)(A). Section 505(b)(1)(B) provides that if the taxing authority fails to designate an address, the request may be served at the address where the tax return or a protest is filed.

Section 505(b)(2) requires that requests for determination of unpaid liability of the estate be submitted to the taxing authority at the address and in the manner designated in section 505(b)(1). Rev. Proc. 2006-24, 2006-1 C.B. 943, modified by Ann. 2011-77, 2011-51 I.R.B. 874, sets forth the procedure for trustees to follow in making a request for a prompt determination under section 505(b).

Section 505(c) provides that once the court has made a determination under section 505(a), the determined amount may be assessed against the estate, the debtor or a successor to the debtor, notwithstanding the automatic stay of section 362.

Note: Because of I.R.C. § 6871, the Service does not need to follow normal deficiency procedures and may assess based on the court's determination.

XIV. DETERMINATION OF SECURED STATUS - 11 U.S.C. § 506

Under section 506(a), the claim of a creditor that is secured by the debtor's property is divided into secured and unsecured portions if the collateral is worth less than the face amount of the claim. Thus, there is a secured claim equal to the value of the collateral and an unsecured claim equal to the deficiency.

When the Service filed a notice of federal tax lien, all property of the debtor in which the estate has an interest subject to the lien must be valued in order to ascertain the lien's value. This includes property the debtor claims as exempt, and property exempt from levy under the Internal Revenue Code. Matter of Voelker, 42 F.3d 1050 (7th Cir. 1994); United States v. Barbier, 896 F.2d 377 (9th Cir. 1990); Risley v. United States, 184 B.R. 826 (N.D. Okla. 1995).

In computing the amount of the secured claim, the value of the property is not reduced by any hypothetical costs of sale or liquidation, where the debtor does not plan to sell or liquidate the property. Section 506(a) expressly states that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property. . . ." The Supreme Court held that, based on this language, bankruptcy courts should use the replacement value approach to determine the value of property that a debtor chooses to retain and continue to use. Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997). The replacement value test established by the Supreme Court in Rash was essentially codified under the BAPCPA by the addition of section 506(a)(2), which provides that in cases involving individual debtors in Chapters 7 and 13, claims secured by personal property are to be valued based on the “replacement value” of such property, as of the date of the filing of the petition, without deduction for costs of sale or marketing, as of the petition date. Replacement value is defined as the price a retail merchant would charge for like property considering the age and condition of the property at the time the value is determined.

Pursuant to section 506(a), an allowed claim of a creditor that is subject to setoff under section 553 is also a secured claim to the extent of the amount subject to setoff. Any amount of the claim in excess of the setoff amount will be an unsecured claim, although the unsecured portion of the claim may be a priority claim. The Service need not have a notice of federal tax lien filed to assert a secured claim based on a right to setoff. The most common setoff situations involve prepetition refunds that have not been issued to the debtor when the bankruptcy petition is filed. Section 553 is discussed more fully elsewhere in this text.

Note: In Patterson v. Shumate, 504 U.S. 753 (1992), the Supreme Court held that an interest in an ERISA qualified pension plan is excluded from the bankruptcy estate under section 541(c)(2). Since the value of a secured claim under section 506 is determined based on the estate's interest in the property, the question arises whether a secured claim can include the value of an ERISA qualified pension plan after Patterson. Under ERISA and federal tax law, anti-alienation provisions enforceable under ERISA against creditors generally are not enforceable against the Service. Thus, the Service argued that because pension plans' provisions are not enforceable under nonbankruptcy law against the Service within the meaning of section 541(c)(2), the debtor's rights in the pension plan becomes property of the estate for purposes of the Service's secured claim under section 506(a), but not for other creditors. In re Lyons, 148 B.R. 88 (Bankr. D.C. 1992). However, the Ninth Circuit, in United States Internal Revenue Service v. Snyder, 343 F.3d 1171 (9th Cir. 2003), rejected the reasoning of the Lyons court. In light of the Ninth Circuit’s decision in Snyder, the Service no longer relies upon the reasoning in Lyons. See United States Internal Revenue Service v. Snyder, AOD-2004-06 (Oct. 19, 2004). As such, if a pension plan is excluded from the bankruptcy estate under section 541(c)(2), it cannot be used to secure the Service’s claim under section 506(a).

Under section 506(b), to the extent that the secured creditor is fully secured, that is, the value of the collateral exceeds the amount of the debt, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided by the agreement under which the claim arose. Thus, the Service is entitled to receive post-petition interest on its allowed, nonconsensual oversecured tax claim. United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989). Taxing authorities have not been successful in claiming post-petition penalties with respect to an oversecured tax claim, where the penalties arise not by agreement, but by operation of law. In re Pointer, 952 F.2d 82 (5th Cir. 1992), cert. denied, 505 U.S. 1222 (1992); In re Parr Meadows Racing Ass'n., Inc., 880 F.2d 1540 (2d Cir. 1989), cert. denied, 493 U.S. 1058 (1990).

To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, the lien is void under section 506(d). Debtors use this provision to "strip down" a creditor's lien to the value of the property, so any increase in the value of the property after the valuation will inure to the benefit of the debtor and the general unsecured creditors, rather than to the creditor. The Supreme Court denied such relief in a Chapter 7 bankruptcy case, holding that sections 506(a) and 506(d) are not tied together, and section 506(d) does not allow for strip down where a creditor's claim is secured by a lien and has been allowed pursuant to section 502. Instead, the Court held that the function of section 506(d) is to void a lien whenever a claim secured by the lien has not been allowed, not to strip off the lien to the extent the claim is unsecured under section 506(a). Dewsnup v. Timm, 502 U.S. 410 (1992).

The Supreme Court concluded that a creditor's lien stays with the property which it secures, as was bargained for by the creditor and debtor. Thus, increases in the value of the property during a bankruptcy case accrue to the benefit of the lienholder, not to the benefit of the debtor or other unsecured creditors who were not part of the bargain. Anything less would result in a windfall to the debtor and unsecured creditors.

The Supreme Court's holding in Dewsnup has not been automatically applied in Chapter 11, 12 and 13 cases. Section 506(a) allows a secured claim to be bifurcated into a secured and unsecured claim, and in Chapter 11, 12 and 13 plans, the plan may modify the rights of holders of secured claims to provide only for payment of the secured portion of the bifurcated claim. 11 U.S.C. §§ 1222(b)(2), 1129(b)(2)(A)(i)(I), and 1322(b)(2). This has been a problem in Chapter 13 cases, where debtors may attempt to pay the value of the secured claim, have the lien released, and then dismiss the case or convert it to Chapter 7. The Service's position has been that the lien should not be released until the plan is completed and the debtor receives a discharge. Not all courts have agreed with this position. In re Campbell, 160 B.R.198 (Bankr. M.D. Fla. 1993), aff'd, 180 B.R. 686 (M.D. Fla. 1995).

This problem was addressed by the amendment to section 1325(a)(5)(B)(i) under the BAPCPA. The amendment specifies that the lien is to be retained until the earlier of the time the underlying debt is paid or the time a discharge is granted. The amendment also provides that if the case is dismissed or converted prior to completion of the plan, the lien is to be retained to the extent recognized by applicable nonbankruptcy law.

Section 1225(a)(5)(B)(i) was not similarly amended under the BAPCPA, so the issue of whether a Chapter 12 debtor may obtain the release of a lien after paying the value of the secured claim may still arise.

In Chapter 11 cases, be sure that the plan provides that any secured tax claim will retain its lien or it may be lost. See 11 U.S.C. § 1141(c); United States v. Standard State Bank, 905 F.2d 185 (8th Cir. 1990); see also In re Regional Building Systems, Inc., 254 F.3d 528 (4th Cir. 2001) (noting that every circuit court to have addressed the issue has held that a lien not expressly preserved by the plan or the order confirming the plan is extinguished by confirmation, and explaining why the treatment of liens in Chapter 13 cases is different from the treatment of liens in Chapter 11 cases).

Bankruptcy Rule 3012 provides that the court may determine the value of a claim secured by a lien on property on motion of any party in interest and after notice and a hearing. However, Bankruptcy Rule 7001 requires that a party file an adversary complaint when the validity, priority, or extent of a lien is at issue. The Advisory Committee Note to Bankruptcy Rule 3012 discusses the distinction.

XV. EXCEPTIONS TO DISCHARGE - 11 U.S.C. § 523(a)

A debtor's primary purpose is to obtain relief from indebtedness – that is, a fresh start. Section 523, however, provides that certain debts of an individual debtor are excepted from discharge. Those exceptions pertinent to the Service are listed below.

1. Section 523(a)(1)(A) – An individual debtor is not discharged from any debt for a tax of the kind specified in section 507(a)(8), whether a claim for such tax was filed or allowed.

2. Section 523(a)(1)(B) - An individual debtor is not discharged from any debt for a tax with respect to which a return, if required, was not filed or given or was filed or given late and after two years before the petition date.

   Note: Section 523(a) was amended by the BAPCPA to provide that "return" means a return that satisfies the requirements of nonbankruptcy law, including a return prepared under I.R.C. § 6020(a) or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but not including a return prepared under I.R.C. § 6020(b).

All bankruptcy cases involving application of the discharge exception under section 523(a)(1)(B)(i) to cases involving a return filed after assessment should be coordinated with Branch 5, Office of the Associate Chief Counsel (Procedure & Administration). See Chief Counsel Notice 2010-016.

3. Section 523(a)(1)(C) – An individual debtor is not discharged from any debt for a tax with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat the tax.

The assertion of section 523(a)(1)(C) can be used to prove that taxes are not dischargeable no matter how old the liabilities are. The basis for nondischargeability in this subsection can be found in two distinct situations: (1) where the debtor filed a fraudulent return; or (2) where the debtor willfully attempted to evade or defeat a tax.

The standard of proof in all dischargeability cases is the preponderance standard. Grogan v. Garner, 498 U.S. 279 (1991). Therefore, the government is not required to prove that a return is fraudulent by clear and convincing evidence (as required in Tax Court) because the preponderance standard must apply equally to all exceptions to discharge. United States v. Graham, 973 F.2d 1089 (3rd Cir. 1992). The existence of a fraudulent return must be found by the bankruptcy court to prove that the associated tax liability is not dischargeable. A finding by another court, e.g., the Tax Court, that a return is fraudulent will only be res judicata when it is the result of a judgment on the merits and not by a stipulation of the parties. Id.

Where the returns at issue are not fraudulent, the government may seek to prove that taxes are not dischargeable due to the debtor's "willful attempt to evade or defeat the tax." It is the government's position following the ruling of the Sixth Circuit in Toti v. United States, 24 F.3d 806 (6th Cir. 1994), that a debtor's "voluntary, conscious, and intentional" failure to file for an extended period and failure to pay taxes qualifies as a willful evasion of tax under section 523(a)(1)(C). Under the Toti rule, it is not necessary to prove that the debtor committed any other acts of evasion.

The Eleventh Circuit rejected the Toti argument and ruled that a debtor's intentional failure to pay taxes for which he properly filed tax returns and acknowledged were due, without more, did not constitute a willful attempt to evade or defeat taxes. In re Haas, 48 F.3d 1153 (11th Cir. 1994). Haas created a standard that requires the government to prove that the debtor willfully attempted to evade or defeat the assessment of the tax. The failure to pay, however egregious, was not a sufficient ground to find taxes nondischargeable. Id. at 1158-59. The Eleventh Circuit revisited Haas in In re Griffith, 206 F.3d 1389 (11th Cir.) (en banc), cert. denied, 531 U.S. 826 (2000), affirming Haas' primary holding (mere nonpayment is insufficient) but clarifying that section 523(a)(1)(C) renders nondischargeable tax debts where the debtor engaged in affirmative acts constituting a willful attempt to evade or defeat payment. See also In re Bruner, 55 F.3d 195, 200 (5th Cir.1995); In re Tudisco, 183 F.3d 133, 137 (2d Cir. 1999); In re Fegeley, 118 F.3d 979, 983 (3d Cir. 1997); In re Birkenstock, 87 F.3d 947, 951-52 (7th Cir. 1996); Dalton v. IRS, 77 F.3d 1297, 1301 (10th Cir. 1996).

4. Section 523(a)(7) – Penalties are dischargeable if related to nondischargeable tax or to taxes accruing more than three years before the petition date. See In re Hosack, 282 Fed. Appx. 309 (5th Cir. 2008); McKay v. United States, 957 F.2d 689 (9th Cir. 1992); In re Roberts, 906 F.2d 1440 (10th Cir. 1990); In re Burns, 887 F.2d 1541 (11th Cir. 1989). Thus, penalties imposed for those taxpayers who fail to file returns, file late, or file fraudulent returns or willfully attempt to avoid paying taxes are dischargeable if the failure to file, late filing, or fraudulent filing occurred more than three years before the filing of the bankruptcy petition.

Note: Corporate debts and partnership debts are not discharged in a liquidating bankruptcy, but will be discharged, in effect, in a reorganization case to the extent not provided for in the plan of reorganization. 11 U.S.C. § 1141(d). The BAPCPA added an exception to discharge for corporate debtors for taxes with respect to which the debtor filed a fraudulent return or willfully attempted in any manner to evade or to defeat the tax. 11 U.S.C. § 1141(d)(6).

Note: The Bankruptcy Reform Act of 1994 added section 523(a)(14) that provides that debts incurred to pay a tax to the United States that would be nondischargeable under section 523(a)(1) are similarly nondischargeable. This subsection prevents a debtor from borrowing funds from one source to pay otherwise nondischargeable tax debt and then seek to discharge the debt incurred to make the payment. The protection of nondischargeability is afforded to those who extend credit so that debtors can pay nondischargeable federal taxes.

Note: The BAPCPA added other exceptions to discharge, and amended some of the discharge provisions applicable to the particular chapters. These changes are discussed more fully in the lessons relating to the particular chapters.

The adversary proceeding rules apply to a determination of whether a debt is dischargeable. Fed. R. Bankr. P. 7001(6). Accordingly, the determination must be initiated by the filing of a complaint, and either the debtor or a creditor may file the complaint. Although the Bankruptcy Rules set out time limits for filing complaints to determine the dischargeability of a debt, these limits do not apply to tax debts, and a complaint may be filed at any time. 11 U.S.C. § 523(c)(1). In some cases, debtors have reopened bankruptcy cases to file complaints to determine the dischargeability of tax debts.