

# **TAX CHANGES IN THE 2005 BANKRUPTCY CODE AMENDMENTS**

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1) **Tax Court Jurisdiction** – The automatic stay prevents the commencement or continuation of a Tax Court proceeding. In Halpern v. Commissioner, 96 T.C. 895 (1991), the court interpreted this provision very broadly to include postpetition tax periods that could not be claimed against the bankruptcy estate but were solely the debts of the postpetition individual debtor. B.C. § 362(a)(8) was amended to clarify the scope of the automatic stay. For individual debtors the changes to the stay mean that it now does not prevent the Tax Court from obtaining jurisdiction over the petitions of individual taxpayers for postpetition periods. For corporate debtors the stay operates to bar Tax Court jurisdiction for any taxable periods for which “the bankruptcy court may determine” the tax liability.

2) **Offset and statute of limitations** – The automatic stay provisions were changed in two ways that impact the collection of taxes. First, B.C. § 362(b)(26) now permits offset of prepetition income tax liabilities against prepetition income tax refunds while the stay is in effect. Notice that this exception to the stay is limited to income taxes. Second, B.C. § 362(c)(3) & (4) introduce severe limitations on the imposition of the automatic stay in general for individual debtors who have previously filed bankruptcy cases that were pending within one year of the date of filing of the current case. These limitations can cause the stay to terminate after 30 days or never to come into effect where there have been multiple filings within the past year. Of course, these provisions have exceptions permitting the debtor or a creditor to seek the imposition of the stay. The impact of these provisions on federal taxes is that they make it more difficult to calculate the statute of limitations on collection, which is suspended by I.R.C. § 6503(h) when the Service cannot take collection action by reason of a bankruptcy case. Since it is now more difficult to determine when the stay is in effect, it is corre-

spondingly more difficult to determine whether, and for how long, the statute of limitations on collection has been suspended. Sometimes this determination occurs many years after the bankruptcy case has ended.

3) ***Income taxes for individuals filing chapter 11*** – I.R.C. § 1398 creates a separate taxable estate for individual debtors filing chapter 7 or 11 cases. Individuals filing chapter 13 cases do not have a separate taxable estate created. New B.C. § 1115 creates in chapter 11 cases a rule providing that all postpetition property of the debtor, and all postpetition earnings from services, is property of the bankruptcy estate until the case is closed, dismissed, or converted. This raises questions concerning the extent to which income from postpetition services and income from postpetition property is taxed to the estate, rather than the debtor, and whether confirmation of the chapter 11 plan (and reversion of property in the debtor) has an impact on the taxation of the estate. The Service will publish guidance that attempts to address the uncertainty created by new section 1115 and its interaction with section 1398 of the Internal Revenue Code.

4) ***Discussion of federal tax consequences in chapter 11 disclosure statements*** – B.C. § 1125(a)(1) has been amended to require “a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interest in the case...” That change may cause bankruptcy lawyers to more regularly call tax lawyers in order to receive assistance in drafting the plan and disclosure statement.

5) ***Plan confirmation requirements for priority tax obligations*** – B.C. § 1129 has been amended in several ways that have an important impact on the plan provisions required in dealing with priority tax obligations. First, § 1129(a)(9)(C) now requires that the payments on these obligations be in “regular installments” and “in cash.” These changes were made to address recurring problems with plans that created balloon payments on the final day of deferral

and with plans that sought to pay the government with stock or other types of property. Second, § 1129(a)(9)(C)(i) adds the word “total” as a modifier to value to make it clearer that the taxes must be paid in full. Third, § 1129(a)(9)(C)(ii) changes the time period within which taxes must be paid from six years from the date of assessment to a period “not later than 5 years after the date of the order for relief....” Previously, it was possible that the date of confirmation would occur more than six years from the date of assessment making the priority taxes due in full at the time of confirmation. The new rule provides an incentive for early confirmation which is in sync with other changes to the code. Fourth, § 1129(a)(9)(C)(iii) clarifies (or not) the timing of the priority tax payments vis a vis payments to general unsecured claims. This provision is intended to address the concern that some plans front end loaded the payment of general unsecured claims leaving the taxing authorities to bear the risk of loss should the plan fail at a future point. It provides that the priority tax claims should be paid in a “manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a class of creditors under section 1122(b))” Fifth, § 1129(a)(9)(D) requires that claims that qualify as priority claims must be paid as other priority tax claims even if the government has filed a notice of federal tax lien before bankruptcy and filed a claim for the period as a secured claim. This change addresses the issue raised in some plans whereby the filing of a notice of federal tax lien prior to bankruptcy was used as a basis for deferring payment to a claim for 30 years or more meaning that the government was disadvantaged by the filing of the notice of federal tax lien since the claim would otherwise have been a priority claim payable within six years from assessment.

6) ***Tax Return Filing Requirements*** – Unfiled tax returns have been a large problem for the IRS and the IRS has objected in many bankruptcy cases to plans or other actions in an effort to obtain tax returns. Congress responded to this problem with five separate provisions. First, it created a general requirement that debtors provide to the trustee not later than 7 days before the first date set “for

the first meeting of creditors a copy of their federal income tax return required for the most recent tax year ending immediately before the commencement of the case and for which a Federal income tax return was filed.” B.C. § 521(e)(2)(A)(i). Second, it also allows any party in interest of the case of an individual filing a chapter 7, 11, or 13 to obtain a copy of each federal income tax return required to be filed while the bankruptcy case is pending as well as delinquent returns filed postpetition for the three years preceding the filing of the bankruptcy petition. B.C. § 521(f). Third, in chapter 13 cases Congress required debtors to file all returns due for the four years preceding the bankruptcy petition by the day before the first meeting of creditors. B.C. § 1308. Fourth, debtors must file tax returns that become due during the bankruptcy or face conversion or dismissal of the bankruptcy case. B.C. § 521(j). Fifth, debtors in Chapter 11 cases must timely file returns and pay taxes owed after the date of the bankruptcy petition or face conversion or dismissal of the case. B.C. § 1112(b)(4)(I). Sixth, an off-Bankruptcy Code provision, section 1228 of the BAPCPA, enforces § 521(f). Section 1228(a) directs the court not to grant a discharge in Chapter 7 cases of individuals unless requested tax documents have been provided to the court. Section 1228(b) directs the court not to confirm a plan in Chapter 11 and 13 cases of individuals unless requested tax documents have been filed with the court.

7) **Expanded basis for dismissal or conversion** – While it was previously possible for a taxing authority to request conversion or dismissal on the basis of a debtor’s failure to keep current on taxes while the bankruptcy case was pending this was not a basis for conversion or dismissal specifically enumerated in the code. Now, changes have created new provisions, 1112(b)(4)(I) and 1307(e) , which specifically enumerate the failure to keep current on taxes as a basis for dismissal. Both of the new sections tie in language providing that the court “shall” dismiss or convert the case. In chapter 11 cases the conversion or dismissal should occur “absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the

best interests of creditors and the estate....” In chapter 13 cases the court shall dismiss or convert a case “ to a case under chapter 7 of this title, whichever is in the best interest of the creditors and the estate.”

8) **Expanded priority rules** – The rules governing which tax claims receive priority status were expanded in several ways. The provision governing income taxes that provides for priority status when an assessment occurs within 240 days of the bankruptcy petition date was clarified to eliminate confusion concerning offers submitted during the 240 days after the assessment. B.C. § 507(a)(8)(A)(ii). The case of Young v. United States, 535 U.S. 43 (2002) was codified making clear that prior bankruptcy cases suspended the time frames set out in B.C. § 507(a)(8) and a new suspension for the time that Collection Due Process cases are pending was created. B.C. § 507(a)(8)(unnumbered paragraph after (G)). The suspension periods added do not include installment agreements which continue to be a basis for suspending collection without extending the time periods for a priority claim.

9) **Changes to discharge provisions** – Three changes to discharge provisions have direct implications for prepetition tax liabilities. First, the exceptions to discharge in B.C. § 523 were amended to provide a definition for the word “return” in § 523(a)(1)(B). The definition of return, which is found in an unnumbered paragraph after § 523(a)(19) means a document that satisfies the requirements of I.R.C. § 6020(a) but does not include a document created pursuant to I.R.C. § 6020(b). This change does not, however, resolve the issue which continues to be the subject of much litigation concerning the situation where a taxpayer files a Form 1040 after the IRS has prepared a return pursuant to I.R.C. § 6020(b) and assessed the liability. In that circumstance the IRS takes the position that the Form 1040 is not a return and, therefore, does not trigger the running of the two year period in B.C. § 523(a)(1)(B).

Second, the discharge provisions in chapter 11 found in B.C. § 1141 were changed in two ways. Individuals no longer receive a discharge at the time of

confirmation but now receive a discharge upon completion of all plan payments unless the debtor specifically applies for a “hardship” discharge. B.C. § 11141(d)(5). Corporate debtors can no longer discharge taxes with respect to which the debtor filed a fraudulent return or willfully attempted to evade or defeat the payment of tax. B.C. § 1141(d)(6).

Third, debtors in chapter 13 cases are now subject to certain of the exceptions to discharge found in B.C. § 523(a)(1). Chapter 13 debtors cannot discharge taxes which were required to be collected or withheld. Chapter 13 debtors also cannot discharge taxes where the returns have not been filed, the returns were filed late within two years of the bankruptcy petition or with respect to which the debtor made a fraudulent return or willfully attempted in any manner to defeat the tax. B.C. § 1328(a)(2).

10) ***Estate now protected party on postpetition returns*** – B.C. § 505(b) permits the trustee to request a prompt determination of taxes on a return of the estate. If the trustee makes this election, the IRS must notify the trustee within 60 days after such request that it intends to audit the return or the IRS is barred from making adjustments with respect to the return. Case law since 1978 determined that the IRS was barred from seeking additional amounts from the debtor and the trustee if it failed to act within 60 days but was permitted to claim additional liabilities against the estate. The new provision makes clear that if the IRS fails to act within 60 days it is also barred from seeking additional funds from the estate. The amendments to B.C. § 505(b) also make clear that the requests for prompt determination must be sent to the location designated by the IRS. Those amendments cleared up some conflicting case law in which some courts had allowed such requests to be sent to the service center despite the clear direction from the IRS that the requests were to be mailed to the local insolvency office. See Rev. Proc. 81-17.

11) **State tax changes** – There were many changes to the bankruptcy code that benefited state taxing authorities. Two of these changes deserve special note. First, there were three bankruptcy code sections that set up a scheme for certain income tax consequences for state taxes, B.C. §§ 346, 729, and 1146. When the bankruptcy code was passed in 1978 it was anticipated that these provisions would apply to federal taxes as well; however, when the Judiciary Committee notified the tax writing committees of these changes, they were rejected for federal tax purposes leading to the Bankruptcy Tax Act of 1980. These state provisions creating special rules for state income taxes are essentially eliminated and the federal provisions are adopted for application to the states. Second, the ability to litigate state and local tax issues has been limited to cases in which the state or local statute of limitations for such litigation is still open at the time the litigation is commenced. B.C. § 505(a)(2)(C). Many bankruptcy courts were allowing debtors to litigate concerning ad valorem tax assessments long after the statute of limitations had expired.

12) **Family Farmers (and Fisherman) receive special tax relief** – Two provisions in chapter 12 of the Bankruptcy Code provide unique relief for family farmers. First, these debtors can treat income taxes resulting from the sale of farm assets as general unsecured claims even though they would otherwise be entitled to priority status. B.C. § 1222(a)(2)(A). Second, with bankruptcy court permission, these debtors can litigate concerning their future federal tax liabilities based on their proposed plans. Previously, this provision permitted such litigation with respect to state and local taxes. It is now expanded to include federal taxes. B.C. § 1231(b).