Consumer Track

Death and Taxes

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ERISA-qualified retirement plans and other plans which have anti-alienation/spendthrift provisions enforceable under applicable state law are not property of the estate, by operation of 11 U.S.C. §541(c)(2); Patterson v. Shumate, 504 U.S. 753, 112 S.Ct. 2242 (1992). However, liens for two (2) types of debts owed to the United States, if subject to properly filed notices of lien, will attach to a debtor's interests in such plans, despite their anti-alienation/spendthrift provisions: debts for federal taxes, and criminal monetary sentences (or at least with respect to this latter class, you can make an awfully good argument that the lien provided by 18 U.S.C. §3613(c) attaches to such plans). The issue becomes the extent to which, if any, the attachment of these liens to the plans gives rise to an allowed secured claim which must be provided for as such by a plan under 11 U.S.C. §1325(a)(5).

It's clear that these types of plans are subject to federal tax liens; Shanbaum v. U.S., 32 F.3d 180 (5th Cir. 1994) [cases cited in fn. 4, at page 183], and that the IRS may enforce the liens against the plans, levy against the plans, or pursue Federal Debt Collection Procedures Act garnishment against them; United States v. Sawaf, 74 F.3d 119 (6th Cir. 1996). However, the manner in which these statutory lien interests in such plans can or must be provided for in a Chapter 13 case is not so uniformly established. One could argue that because under the controlling precedent of Patterson v. Shumate, these plans are not property of the bankruptcy estate, they do not comprise part of the IRS' secured claim under 11 U.S.C. §506(a) and thus cannot be dealt with by a plan. Under this analysis, plans can be confirmed without complying with 11 U.S.C. §1325(a)(5) with respect to the IRS' lien interests in the plans; but then obviously, the Chapter 13 plans don't affect the liens in relation to the plans, and the liabilities subject to the liens which are not otherwise paid during the pendency of the Chapter 13 pass out

the rear of the Chapter 13 and attach themselves to the plan to gobble up whatever the taxpayer may have socked away to see her through retirement and old age. One could argue, alternatively and perhaps not very logically, that while such plans may not be property of the estate under section 541, they are "property in which the estate has an interest" as stated in 11 U.S.C. §506(a), and thus that the value of the debtor's interest in the plan on the date of the petition is subject to the IRS' secured claim, and thus must be paid under the plan in accordance with section 1325(a)(5).

There are divergent views on this issue. The first view is that the plans **are** property of the estate to the extent that the IRS can reach the debtor's rights in them, and thus must be subject to 11 U.S.C. §1325(a)(5): *In re Lyons*, 148 B.R. 88 (Bkrtcy. D.C., 1992); *In re Berry*, 268 B.R. 819 (Bkrtcy. E.D. Tenn., 2001); *In re Jones*, 206 B.R. 614 (Bkrtcy. D.D.C., 1997); *In re Perkins*, 134 B.R. 408 (Bkrtcy. E.D. Cal., 1991); *In re Fuller*, 204 B.R. 894 (Bkrtcy. W.D. Pa., 1997); *In re Jeffrey*, 261 B.R. 396 (Bkrtcy. W.D. Pa., 2001). The second line of cases holds that the interests of the IRS are not "allowed secured claims", and thus that although the liens attach to the debtor's interest in the plans, the plans need not provide for the IRS' claims against the plans pursuant to 11 U.S.C. §1325(a)(5): *United States v. Snyder*, 343 F.3d 1171 (9th Cir. 2003); *In re Richardson*, 307 B.R. 485 (Bkrtcy. Md., 2004); *In re Keyes*, 255 B.R. 819 (Bkrtcy. E.D. Va., 2000); *In re Robinson*, 301 B.R. 461 (Bkrtcy. E.D. Va., 2003). As noted in *Snyder*, the IRS has been schizophrenic in its positions.

Whatever the approach is with respect to tax debts subject to liens which attached prepetition to these plans, the same should seemingly apply to criminal monetary sentences of fines and restitution. 18 U.S.C. §3613(c) provides that the criminal sentence lien is a "lien in favor of the United States on all property and rights to property of the person fined as if the

liability of the person fined were a liability for a tax assessed under the Internal Revenue Code of 1986" (emphasis supplied). Ergo, the criminal monetary sentence attaches to the plans, and whatever a Chapter 13 debtor would have to do with a tax debt subject to liens on such a plan, he should have to do for his criminal sentence lien liabilities. Of course, lavish retirement plans, funded from years of criminal conduct, are the rule in Chapter 13s.

PRIMARY PROVISIONS OF BAPCPA AFFECTING TAX MATTERS IN CONSUMER CASES

1. 11 U.S.C. §1308.

This section is entirely a creation of BAPCPA. Section 1308(a) states requirements for filing of tax returns, and may be conceptualized as follows:

What returns: All tax returns required to be filed **by the debtor** under applicable nonbankruptcy law for all *taxable periods ending during the four year period ending on the date of the filing of the petition.* Note first that this provision requires the filing of returns the debtor was required to file, not returns necessary to determine the debtor's full tax liabilities. For example, if the debtor was a responsible person in a corporation which has unpaid Form 941 employment tax liabilities, the debtor will be liable for the Trust Fund Recovery tax for unpaid employee's FICA and withheld taxes, a liability which is both a priority claim under 11 U.S.C. §507(a)(8)(C) and a debt excepted from discharge by 11 U.S.C. §1328(a)(2), and thus a debt which must be determined. If that corporation hasn't filed the necessary Form 941 returns, §1308(a) does not require the debtor to do so, because the corporate entity, and not the debtor, is required to file those returns. Note next that the trigger is the close of a tax period, not when the tax return is due or when payment of the tax is due. For example, the tax period for a calendar year individual filer for a federal income tax return is a calendar year, so a tax period begins just after midnight on January 2007 and ends at midnight on December 31, 2007, even though the return isn't due until April 15/16 or later if an extension is filed, and the tax is due to be paid in full by that same date. Thus, if an individual files a Chapter 13 petition on March 31, 2008, the four year period extends back to March 31, 2004. The 2003 return isn't within the scope of §1308(a); the returns for 2004, 2005, 2006 and 2007 are. Note also that there is no exception for any type of tax return, be it federal, state, local, or for the planet Zoofarb. Note also the obvious– this provision is limited to debtors in Chapter 13 cases. Interestingly, for those debtors who didn't file returns who were caught by the IRS (or other taxing authority), and for whom "substitutes for returns" were prepared by the IRS [26 U.S.C. §6020(b)] or other taxing authority, or who entered into a written stipulation to a judgment or order of a nonbankruptcy court – the tax return filing requirement of §1308(a) is satisfied for the tax periods to which the substituted return or stipulation relates, without the debtor having to in addition file a return for that period; 11 U.S.C. §1308(c).

Where filed: The returns are to be filed "with (the) appropriate tax authorities". This means, it would seem, that the returns are to have been filed, or are to be filed, at the place for filing designated by the applicable authorities' tax laws. For example, a place for filing usually isn't slipping a return under the door of the local revenue office or handing it to a clerk at a counter somewhere.

When: "Not later than the day before the date on which the meeting of the creditors is first scheduled to be held under section 341(a)." Note, continuance of the first meeting of creditors doesn't alter this time requirement.

Section 1308(b)(1) provides a mechanism for an extension of time for compliance with

§1308(a). This mechanism is solely in the hands of the Chapter 13 Trustee. If returns required to be filed by §1308(a) haven't been filed by day before the first date set for the §341 meeting, the Trustee can "hold open that meeting for a reasonable period of time to allow the debtor an additional period of time to file any unfiled returns." However, there are limits to the Trustee's extension:

a. 120 days after the date first set for the §341 meeting, *for any return that is past due as of the date of the filing of the petition;* and

b. The later of (I) the date that is 120 days after the date first set for the §341 meeting, or (ii) the date on which the return is due under the last automatic extension of time for filing that return to which the debtor is entitled, and for which request is timely made, in accordance with applicable nonbankruptcy law, *for any return that is not past due as of the date of the filing of the petition.*.

So, if a debtor who files a petition on March 31, 2008 hasn't filed his 2004, 2005, 2006 and 2007 returns by the day before the date on which the meeting of the creditors is first scheduled to be held under section 341(a), and the §341 meeting is first scheduled to be held on May 5, 2008, the longest period of extension that the Trustee may grant is 120 days after May 5 for the 2004, 2005 and 2006 returns; and it's 120 days after May 5 for the 2007 return as well unless the debtor timely requests an automatic extension to which he is entitled which will extend that period beyond that 120 days.

Let's say the debtor can't get the required returns filed by the due date established by the Trustee, or that a particularly ogre-like Trustee won't extend the due date at all. Section 1308(b) addresses this circumstance by allowing the court – *after notice and a hearing, and order entered before the tolling (i.e., end) of any applicable period determined under §1308(b)(1)* – to extend "the filing period established by the trustee under [§1308(b)(1)]" for a period (I) of not more than 30 days for any return that is past due as of the date of the filing of the petition; or (ii) not to extend after the applicable extended due date for any return that is not past due as of the date of the filing of the petition.

If you want an extension from the court, you must file your motion sufficiently in advance of the Trustee's anointed due date to allow for notice of a hearing before the Court, the conducting of the hearing, and the entry of the Court's order before the expiration of the due date set by the Trustee. The effect of §1308(b) is to essentially place the ultimate due date for filing of returns subject to §1308(a) in the hands of the Chapter 13 Trustee; the court has very limited extension authority under §1308(b)(2).

2. 11 U.S.C. §521(e)(2)(A). This section requires the debtor in an individual Chapter 7 or Chapter 13 case to provide the case Trustee with a copy or transcript of the Federal income tax return for the most recent tax year ending before the date of the filing of the petition for which the debtor actually filed a return. The return copy/transcript is to be provided to the Trustee (and to creditors who take advantage of §521(e)(ii) by making a "timely request"– whatever "timely" means and by whatever mechanism it was envisioned a "request" would be made) not later than 7 days before the first date set for the §341 meeting. The penalty for failure to comply is a form

of Bankruptcy DEATH by nondiscretionary dismissal of the case ("the court *shall dismiss the case* [§521(e)(2)(B)]), unless the debtor "demonstrates that the failure to so comply is due to circumstances beyond the control of the debtor." One might contend that this is a provision without rational basis. First, many debtors haven't filed a federal income tax return for a number of years prior to the filing of the petition (about 15 years ago, a federal governmental study determined that probably more than 50% of bankruptcy debtors had not filed federal income tax returns for multiple years prior to their filing of bankruptcy), and what use is a tax return filed in 2003 for a debtor who files a case in 2008? Second, there is no law that requires a tax filer to retain a copy of a filed tax return, and in point of fact – as stupid as it might be, but many debtors are debtors for a reason like this – many debtors didn't. So now the debtor must get a copy of a filed return or a transcript from the IRS, the will-o'-the-wisp tax preparer she used, or a former spouse or girlfriend – which can be a long process, depending upon the responsiveness of the IRS in a particular area of the country, or the antipathy of the former girlfriend. Third, why would a Chapter 7 or Chapter 13 Trustee, charged as they are with administering cases for the benefit of creditors, want to seek dismissal of a case at its earliest juncture for this chimerical reason, before the prospects for benefit to creditors has been explored? As at least one bankruptcy court has concluded and has so advised Trustees– don't be bothering with dismissal on this basis, as it imposes a legally infeasible obligation on debtors, and you don't want to do it anyway until you know more about the case and its potential benefit to creditors.

3. Consequences of not complying with §1308(a).

a. Mandatory dismissal/conversion of the Chapter 13 case ("the court *shall dismiss*") under 11 U.S.C. §1307(e);

b. Alternative dismissal/conversion under 11 U.S.C. §1307(c) "for cause", especially under §1307(c)(1)– in at least one court's experience, taxing authorities prefer this ground to the nondiscretionary §1307(e) route, as their goal is to obtain the filing of tax returns, a goal toward which debtors can be leveraged with a bit more slack that §1307(e) allows;

c. Can't confirm a Chapter 13 plan (11 U.S.C. §1325(a)(9);

d. Referral to the United States Department of Justice for criminal prosecution *if the debtor has lied to the Trustee about having filed returns*. It is an observation that most debtors think that they may be prosecuted if they haven't filed returns, and thus many lie – that's the correct word – when asked at a §341 meeting about their filing of federal or other tax returns. The simple fact is that referrals by Trustees and courts to the United States Department of Justice for failure to file tax returns is ***extraordinarily*** rare, and the interest of the Internal Revenue Service in working up these cases is ever more rare, except in an Al Capone scenario (can't get him for rum running you know he's doing– get him for a tax crime). It is also an observation that when the IRS says someone didn't file a tax return based on their records, they didn't file a tax return. But if the debtor swears under oath that he/she/it filed tax returns – as at a §341 meeting – and the taxing authority – especially the IRS – files a proof of claim stating that by golly, the

debtor didn't file that there return ... that, my friend, may well generate a prosecution referral. The moral of the story is: it's much better for the debtor to fess up to unfiled returns than to lie about the filing of those returns.

4. 11 U.S.C. §521(f) and (g). Applicable to all Chapters. Requires the filing with the court of a copy of certain tax returns/ or a transcript with respect to prepetition and/or postpetition tax years under certain circumstances – you might want to read it.

5. 11 U.S.C. §521(j). Applicable to all Chapters. Provides that *a taxing authority* may request dismissal/conversion of a case if the debtor fails to file a tax return that becomes due after the commencement of the case or to properly obtain an extension of time to file the return. Subsection (j)(2) requires mandatory ("*the court shall"*) dismissal/conversion if the debtor fails to file such a return or obtain an extension within 90 days of the filing of the taxing authority's request.

6. 11 U.S.C. §1328(a)(2). This BAPCPA amendment significantly broadened the exception from discharge of tax liabilities in Chapter 13 cases, adding the types of tax liabilities designated in sections 507(a)(8)(C) ["trust fund" taxes], 523(a)(1)(B) and 523(a)(1)(C) [fraudulent return or willful attempt in any manner to evade or defeat tax liability]. Probably the most significant change is that made by adding §§523(a)(1)(B)(I) with respect to returns which were due but were unfiled as of the date of the petition, and §523(a)(1)(B)(ii) with respect to certain late filed returns. These amendments closed loopholes in Chapter 13 which allowed noncompliant taxpayers to many times avoid any tax liability for taxes which would not have been discharged in a Chapter 7. Note that the consequence of a nondischargeable tax liability is that interest, computed under the nonbankruptcy law applicable to the particular tax liability, continues to accrue on the liability despite the filing of bankruptcy. Moreover, under 11 U.S.C. 1322(b)(10), interest accruing after the petition date on nondischargeable debts may be paid under a Chapter 13 plan "only to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims", which probably means in the jumbled BAPCPA vernacular that interest can only be paid after all other allowed claims have been paid in full.

7. 11 U.S.C. §511. If interest or a present value discount factor is required to be paid on a tax claim (e.g., an allowed secured claim of a taxing authority by virtue of a tax lien) or on an administrative expense tax, the rate of interest is determined under applicable nonbankruptcy law. This means that the rate of interest charged generally to delinquent taxpayers is the rate of interest in a bankruptcy case. With respect to a confirmed plan, the rate is determined as of the calendar month in which the plan is confirmed.

8. 11 U.S.C. §507(a)(8), last paragraph. The statutory provision for tolling of the priority periods for taxes due to the taxing authority's inability to collect taxes for various reasons, particularly the pendency of a bankruptcy case by operation of the prepetition and postconfirmation stays. The effect is to add significant periods of time to the computation of priority periods under certain provisions of §507(a)(8). **When a debtor has previously been involved in a bankruptcy case and has tax liabilities which will be subject to a case to be filed, make sure to refer to this section to time the filing of the petition – it is not as**

uncommon as one might think for a petition to be filed a day or two before the lapse of the tolling period, turning what would have been a general unsecured claim, if filing had been delayed, into a priority claim and thus generating a separate legal malpractice claim. **COUNT**, **COUNT**, **COUNT!!**

9.11 U.S.C.§505(a)(2)(C). This section closed a device used by debtors to redetermine real property and other ad valorem (a tax determined by application of a tax rate to the value of the subject of taxation) tax liabilities as imposed by a taxing authority, in which the tax liability had not been timely challenged by the debtor under an available nonbankruptcy procedure. The court can no longer determine the tax under §505(a) "if the applicable period for contesting or redetermining that amount under any law (other than a bankruptcy law) has expired." Thus, if the debtor failed to timely contest the tax liability under an applicable nonbankruptcy review procedure, use of §505(a) is precluded.

Bankruptcy, Taxes, and Alternative Universes

In the palpable space/time continuum: (a) Most issues that relate to the priority of taxes are straightforward and are addressed by 11 U.S.C. §507(a)(8); (b) Most issues that relate to the exception of taxes from discharge are straightforward and are addressed by 11 U.S.C. §523(a)(1) and 11 U.S.C. §523(a)(7) [tax penalties]; (c) Most issues that relate to the allowed secured status of tax claims are addressed by the provisions of the Bankruptcy Code that apply to secured claims generally, keeping in mind that tax liens are statutory liens [11 U.S.C. §101(53)], and thus for example are not subject to certain provisions like 11 U.S.C. §522(f), and that 11 U.S.C. §724 provides special rules in Chapter 7 cases for subordination of claims secured by tax liens to certain other types of claims; and (d) Most issues of pure tax are determined by the rules provided by the Internal Revenue Code [Title 26 of the United States Code] and state tax codes.

Quantum mechanics theoretically posits the existence of alternative universes. In the interstices between palpable bankruptcy and non-bankruptcy universes lies a metaphysical realm in which theories about the nature of taxes in relation to the Bankruptcy Code collide. The resulting cosmic consequences may be illustrated by the following conundrums:

1. When is a tax return not a tax return? **[Compare: (a) *In re McCoy*, 666 F.3d 924 (5th Cir. 2012; (b) *Perkins v. Massachusetts Department of Revenue*, 2014 WL 896745 (D. Mass. 2014); (c) *Gonzalez v. Massachusetts Department of Revenue*, 2014 WL 888460 (1st Cir. BAP (Mass.) 2014)/ NOTE, 11 U.S.C. §1308(c)]**.

2. When is tenancy by the entireties property not tenancy by the entireties property? **[*United States v. Craft*, 122 S.Ct. 1414 (2002)]**.

3. When is first in time not first in right? **[26 U.S.C. §6321; 26 U.S.C. §6323, especially**

subsections (a) and (b)/ priority of recorded state tax liens vis-a-vis federal tax liens].

4. When is a spendthrift, anti-alienation provision in a retirement plan not a spendthrift, anti-alienation provision, and when is a tax claim secured by a retirement plan containing a spendthrift, anti-alienation provision not an allowed secured claim? **[Start with: 11 U.S.C.§541(b)(7) and *Patterson v. Shumate*, 112 S.Ct. 2242 (1992)/ <u>then compare:</u> (a) *In re Lyons*, 148 B.R. 88 (Bankr. Dist. of Columbia 1992), and *In re Snyder*, 343 F.3d 1171 (9th Cir. 2003)].**

5. When is an apparent tie in tax lien priorities not a tie? **[*United States v. McDermott*, 113 S.Ct. 1526 (1993)].**

6. When is TIP other than a commonly unreported source of taxable income? **<u>See</u>, *United States of America v. Specialty Cartage*, 115 B.R. 164 (Bankr. N.D. Ind. 1989), <u>aff'd</u> 113 B.R. 484 (N.D. Ind. 1990)].**

7. When are statutory tax liens, judicial liens and security interests identical, yet at the same time totally different, under 11 U.S.C. §506(b)? **[*United States v. Ron Pair Enterprises, Inc.,* 109 S.Ct. 1026 (1989)]**.

The universe is a vast, cold, dark place in which certain tax rules of the Internal Revenue Code and of state tax codes are drawn into, and at times subsumed by, the gravitational pull of the Bankruptcy Code. May you avoid the resulting black hole.

TAX CLAIMS IN CONSUMER CASES

1. 11 U.S.C. §1308. This section is entirely a creation of BAPCPA. Section 1308(a) states requirements for filing of tax returns. All tax returns required to be filed **by the debtor** under applicable nonbankruptcy law for all *taxable periods ending during the four year period ending on the date of the filing of the petition.* Note first that this provision requires the filing of returns the debtor was required to file, not returns necessary to determine the debtor's full tax liabilities. For example, if the debtor was a responsible person in a corporation which has unpaid Form 941 employment tax liabilities, the debtor will be liable for the Trust Fund Recovery tax for unpaid employee's FICA and withheld taxes, a liability which is both a priority claim under 11 U.S.C. §507(a)(8)© and a debt excepted from discharge by 11 U.S.C. §1328(a)(2), and thus a debt which must be determined. If that corporation hasn't filed the necessary Form 941 returns, §1308(a) does not require the debtor to do so, because the corporate entity, and not the debtor, is required to file those returns. Note next that the trigger is the close of a tax period, not when the tax return is due or when payment of the tax is due. For example, the tax period for a calendar year individual filer for a federal income tax return is a calendar year, so a tax period begins just after midnight on January 2007 and ends at midnight on December 31, 2007, even though the return isn't due until April 15/16 or later if an extension is filed, and the tax is due to be paid in full by that same date. Thus, if an individual files a Chapter 13 petition on March 31, 2008, the four year period extends back to March 31, 2004. The 2003 return isn't within the scope of §1308(a); the returns for 2004, 2005, 2006 and 2007 are. Note also that there is no exception for any type of tax return, be it federal, state, local, or for the planet Zoofarb. Note also the obvious– this provision is limited to debtors in Chapter 13 cases. Interestingly, for those debtors who didn't file returns who were caught by the IRS (or other taxing authority), and for whom "substitutes for returns" were prepared by the IRS [26 U.S.C. §6020(b)] or other taxing authority, or who entered into a written stipulation to a judgment or order of a nonbankruptcy court – the tax return filing requirement of §1308(a) is satisfied for the tax periods to which the substituted return or stipulation relates, without the debtor having to in addition file a return for that period; 11 U.S.C. §1308©.

2. 11 U.S.C. §1328(a)(2). This BAPCPA amendment significantly broadened the exception from discharge of tax liabilities in Chapter 13 cases, adding the types of tax liabilities designated in sections 507(a)(8)© ["trust fund" taxes], 523(a)(1)(B) and 523(a)(1)© [fraudulent return or willful attempt in any manner to evade or defeat tax liability]. Probably the most significant change is that made by adding §§523(a)(1)(B)(I) with respect to returns which were due but were unfiled as of the date of the petition, and §523(a)(1)(B)(ii) with respect to certain late filed returns. These amendments closed loopholes in Chapter 13 which allowed noncompliant taxpayers to many times avoid any tax liability for taxes which would not have been discharged in a Chapter 7. Note that the consequence of a nondischargeable tax liability is that interest, computed under the nonbankruptcy law applicable to the particular tax liability, continues to accrue on the liability despite the filing of bankruptcy. Moreover, under 11 U.S.C. 1322(b)(10), interest accruing after the petition date on nondischargeable debts may be paid under a Chapter 13 plan "only to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims", which probably means in the jumbled BAPCPA vernacular that interest can only be paid after all other allowed claims have

been paid in full. In terms of claims, the "UNASSESSED- NO RETURN" in an IRS claim translates into a nondischargeable tax liability WITHOUT REGARD TO the tax period's priority under 11 U.S.C. §507(a)(8).

3. 11 U.S.C. §511. If interest or a present value discount factor is required to be paid on a tax claim (e.g., an allowed secured claim of a taxing authority by virtue of a tax lien) or on an administrative expense tax, the rate of interest is determined under applicable nonbankruptcy law. This means that the rate of interest charged generally to delinquent taxpayers is the rate of interest in a bankruptcy case. With respect to a confirmed plan, the rate is determined as of the calendar month in which the plan is confirmed.

4. 11 U.S.C. §507(a)(8), last paragraph. The statutory provision for tolling of the priority periods for taxes due to the taxing authority's inability to collect taxes for various reasons, particularly the pendency of a bankruptcy case by operation of the prepetition and post-confirmation stays. The effect may be to add significant periods of time to the computation of priority periods under certain provisions of §507(a)(8), and the nondischargeable IRS tax penalties in Chapter 7 cases under 11 U.S.C. §523(a)(7). **When a debtor has previously been involved in a bankruptcy case and has tax liabilities which will be subject to a case to be filed, make sure to refer to this section to time the filing of the petition. Query: How is the tolling period actually computed, given the ambiguity in the statutory language?**

5.11 U.S.C.§505(a)(2)©. This section closed a device used by debtors to redetermine real property and other ad valorem (a tax determined by application of a tax rate to the value of the subject of taxation) tax liabilities as imposed by a taxing authority, in which the tax liability had not been timely challenged by the debtor under an available nonbankruptcy procedure. The court can no longer determine the tax under §505(a) "if the applicable period for contesting or redetermining that amount under any law (other than a bankruptcy law) has expired." Thus, if the debtor failed to timely contest the tax liability under an applicable nonbankruptcy review procedure, use of §505(a) is precluded.

6. Secured claims of taxing authorities. Tax liens that do not arise from judicial proceedings are statutory liens; 11 U.S.C. §545 applies to them; 11 U.S.C. §522(f) doesn't. The statutory lien of the IRS attaches to everything that walks, crawls, flies or swims in which a taxpayer/debtor has a property interest (determined in most instances under state law) – whether it's breathing or not. Most state's tax liens are as broad (Indiana's is). The levy exemptions applicable to IRS collections by levy are not applicable in most jurisdictions to determine the IRS' secured claim. The IRS lien will be primed by real property tax liens which are effective prior to the IRS' recording of the lien, and by mortgages and UCC Article 9 security interests which are perfected under applicable state law against a BFP before the recording of the lien. A few fun facts to know and tell re the IRS tax lien:

a. Ties go to the IRS with respect to liens perfected on the same date as the IRS lien is recorded; *United States v. McDermott*, 113 S.Ct. 1526 (1993).

b. A tax lien with respect to taxes owed only by one spouse attaches to that spouse's individual interest in property held as tenancy by the entireties, regardless of how state law treats

liens arising of other creditors under identical circumstances; *United States v. Craft*, 122 S.Ct. 1414 (2002) {decided with respect to Michigan law}. How one values the IRS' secured claim in this context isn't well settled.

c. The IRS will take the position that in the context of competing lien priority between the IRS tax lien and a state tax lien imposed by other than a judicial determination with an effective resulting judgment lien (e.g, in Indiana an Indiana Department of Revenue Lien arising from the recording of a tax warrant), when the IRS notice of lien has been effectively recorded, the **date of assessment** of the federal tax liability (not the date of recording of the IRS notice of lien) is the material date for determining the priority of its secured claim vis-a-vis that of the state lien

d. Federal tax liens (and probably state tax liens too) survive discharge of the tax subject to the lien in a Chapter 7 case, at least to the extent of the value of the property with respect to which the lien has priority on the date of the Chapter 7 petition.

7. Federal tax liens and retirement plans. In *Patterson v. Shumate*, 112 S.CT. 2242 (1992), the United States Supreme Court determined that these plans are excepted from property of a bankruptcy estate by operation of § 541(c)(2). Turning to 11 U.S.C. § 506(a)(1), in order to have an allowed secured claim, a creditor must be "secured by a lien on property in which the estate has an interest . . .". The federal tax lien provided by 26 U.S.C. § 6321 is a veracious, omnivorous creature: it attaches to everything that walks, crawls, flies or swims – whether edible or not – in which a taxpayer has a property interest as determined by state law. It is beyond question – under any jurisdiction you can chose – that courts have held or will hold that the Internal Revenue Service's tax lien attaches to a taxpayer's interest in retirement plans, whether or not they contain a spendthrift provision. The tax lien attaches to the actual interest of the taxpayer in the plan, and not just to future distributions to the taxpayer under the terms of the plan. Let's say that your debtor has stashed away money in a plan subject to the exclusion of § 541(c)(2), but that the IRS has enforceable tax liens with respect to tax liabilities of your client.[1]

The issue becomes of some significance in a circumstance in which the amount of a debtor's federal tax liabilities subject to federal tax liens exceeds the value of property of the estate, but the debtor has retirement plans or other plans which are subjected to the federal tax lien. To the extent the liabilities secured by the lien on the plan are not paid during the pendency of the bankruptcy case, those liabilities will shoot out the back of the case after discharge; penalties and interest on that portion of the tax liabilities will have continued to accrue throughout the pendency of the case; and when the debtor emerges from bankruptcy he/she/they will still have a federal tax lien on his/her retirement plan.

[1] Whether or not state taxing authorities take the position that their liens also attach to these plans, in the same manner as does the lien of the IRS, is something you'll have to figure out for yourself. The author has yet to have the Indiana Department of Revenue express a concrete opinion on this issue, and no case which has presented this issue has been presented to him.

The most obvious answer to the extent of the federal tax lien on property excepted under § 542(c)(2) is that the IRS has no allowed secured claim with respect to this property. That means that a debtor cannot provide for that claim under 11 U.S.C. § 1325(a)(5) in a Chapter 13 case at least, without consideration of discriminatory treatment of a creditor under 11 U.S.C. § 1322(a)(3).[2]

There is a split of authority on whether or not a tax liability in this circumstance constitutes an "allowed secured claim" under § 506(a), thereby making it subject to traditional treatment for allowed secured claims in a bankruptcy case. In *In re Lyons*, 148 B.R. 88 (Bankr. Dist. of Columbia 1992), the court determined that although for all other purposes and all other creditors, the debtor's interest in property subject to § 542(c)(2) was not property of the estate and would not generate an allowed secured claim with respect to any other creditor, that was not true for the IRS in the context of a federal tax lien attaching to such property. The court determined as a result that the debtor's Chapter 13 plan had to provide for treatment of the IRS' claim with respect to the plan pursuant to 11 U.S.C. § 1325(a)(5). A good analysis of the contrary view appears in *In re Snyder*, 343 F.3d 1171 (9th Cir. 2003). In Internal Revenue Service Chief Counsel Advice (IRS CCN CC-2004-033, 2004 WL 3210765 (2004)), the Office of the Chief Counsel of the Internal Revenue Service stated that the Internal Revenue Service would no longer argue that the value of its allowed secured claim in a bankruptcy case included the value of property subject to § 541(c)(2). In Internal Revenue Service Chief Counsel Advice (IRS CCA-200634012, 2006 WL 2460482 (2006)), the Internal Revenue Service stated its position as to the continued accrual of tax liabilities with respect to assets not considered to be property of a bankruptcy estate which were yet subject to a federal tax lien. In Internal Revenue Service Chief Counsel Advice (IRS CCA-200926001, 2009 WL 1817825 (2009)), the Internal Revenue Service announced its position with respect to availability of levy with respect to vested interests in ERISA-qualified plans.

What to do, what to do! One can attempt to negotiate a deal with the Internal Revenue Service in which the portion of the tax liabilities secured by the plan – otherwise not provided for as a secured claim – will be paid during the pendency of a bankruptcy case. One enterprising United States Attorney's Office in conjunction with the Internal Revenue Service cut deals by allowing the payment of this portion of the tax liability to accrue interest at a rate determined to be a combination of the penalties and interest which would accrue during the pendency of the bankruptcy case (usually around 12%), and to allow that payment to be made during the pendency of the bankruptcy case, thus resulting in a situation where the pension plan emerged totally free of the tax lien at the conclusion of the bankruptcy case. Absent a deal with the IRS, and absent a determination under the *Lyons* rationale, this situation can be a disaster. The extent to which the Internal Revenue Service actually levies on a vested interest in a plan prior to

[2] If the IRS truly has no allowed secured claim with respect to a portion of its tax liabilities, to the extent those tax liabilities are unsecured, the same treatment must be provided to the IRS as is provided to any other unsecured creditor. To the extent that the tax liabilities are priority claims under § 507(a)(8), then at least a portion of them can be paid as priority claims in the Chapter 13, but the residual amount of the secured claim will still shoot out the end of the case.

disbursement of benefits under the plan to the taxpayer is unknown, but they always can and one should assume that they will.

8. Post-petition tax liabilities. As we all know, sometimes debtors incur income tax or other tax liabilities for tax periods ending after the date of the petition. Sometimes they forget to file returns for those periods, which has a consequence if the taxing authority so chooses (11 U.S.C. §521(j), applicable to all Chapters, which allows a taxing authority to request dismissal/conversion of a case if the debtor fails to file a tax return which becomes due after the commencement of the case or to properly request an extension of time to file the return. Dismissal or conversion is mandatory if the debtor fails to file the return or obtain an extension within 90 days after the taxing authority files the request. Putting the foregoing a side, let's say that returns are filed, but the debtor has post-petition liabilities. 11 U.S.C. §1305(a)(1) provides a mechanism for the taxing authority to file a claim for such taxes (NOTE: only the taxing authority can file a 1305 claim– neither the debtor nor a trustee can file one). Taxing authorities sometimes shy away from using 1305 claims because of §1305(b) may preclude the accrual of interest and penalties on the claim if paid in full during the term of the plan. If nothing is done, the post-petition liability shoots out the back of the case as if the case had never been filed, with accruing interest and penalties in full bloom for the debtor to deal with after the case is closed. OOPS.

9. A valuable tool re ad valorem real property taxes, and an aside. In these troubled economic times, it is increasing unfortunately the case that homeowners are unable to pay real property taxes. If there's a mortgagee involved, many times the mortgagee will pay them and add the payment to the debtor's §1328(a)(1)/ §1322(b)(5) nondischargeable long term mortgage debt. But if there's no savior, the accrual of unpaid post-petition real property taxes leaves a debtor exposed to tax sales if the property of the Chapter 13 estate has vested in the debtor upon plan confirmation under 11 U.S.C. §1327(b); Section 362(a) does not preclude actions to impose or to enforce liens against *property of the debtor* with respect to **post-petition** debts – See, §§362(a)(3) and (4), which apply only to property of the estate. The tool? Provide in the plan, pursuant to §1327(b), that the property of the estate does not vest in the debtor upon confirmation. If there is then a failure to pay post-petition real property taxes, at least the taxing authority will be required to obtain relief from the stay to proceed with tax sale proceedings, a procedure which many may not undertake, and may allow for a negotiated repayment under the plan (recalling that only the taxing authority can file a 1305 claim for these taxes). The trade off is that disposition of pre-petition property during the pendency of the case will be subject to 11 U.S.C. §363 and must be done by court order. Be hereby notified that there is a Seventh Circuit case [*In re Heath*, 115 F3d 521, 524 (7th Circuit)] which opines in what is clearly *dicta* that non-revesting of property not "reasonably necessary to fulfill the plan" would be an abuse of the bankruptcy court's discretion... but it is dicta, and at least one court of which the author is aware includes in all confirmation orders that property of the Chapter 13 does **not** revest in the debtor upon confirmation.

The aside? 11 U.S.C. §502(b)(3), which allows for disallowance of claims for "a tax assessed

against property of the estate" if "such claim exceeds the value of the interest of the estate in such property". There won't be many properties which are underwater from the weight of a real property tax claim alone, but ..... maybe you'll have one.

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DISCHARGING INCOME TAX
THE BASIC RULES
CHAPTER 7

1. State, federal, and local taxes are all subject to the same rules. 11 USC 346

2. Priority Taxes Non Dischargeable – 11 USC 523 (A)(1)

   11 USC 507 (a)(8)

   To be dischargeable taxes must be on a return the greater of:

   a. Last legally due 3 years before the bankruptcy filing date if timely filed;

      Or

   b. 2 years before the bankruptcy filing date if the return was late filed (11 USC 523 (a)(i)(b)(ii).

      And

   c. 240 days after the date of Assessment of the taxes.

      (1) Add to the 240 days any time an offer in compromise was pending plus 30 days.

      (2) Add to the 240 days the time a stay of proceedings against collection was pending plus 90 days (includes stay due to Chapter 7, 11, 12, or 13 filings and stay occasioned by the Debtor disputing the tax).

   d. 507 (G) Adds time is postponed due to collection appeal or collection suspended due to prior case filing plus 90 days.

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3. The tax dischargability calculator will provide the discharge date.
4. To get the necessary dates, ask IRS for an Account Transcript for the years in question by calling the Practitioner Help Line, (888) 860-4259. Your client must be with you. If you do a lot of this work get qualified to request the information using Form 8221 (copy attached) (You need a CAF Certification to use this form). This will contain all the information needed to do the calculation.
5. Other considerations – 11 USC 523 (A)(1).
    a. No discharge if return not filed.
    b. No discharge of fraudulent return.

The attached work sheet provides the template for determining dischargability. Fill in the dates from the Account Transcript to get the correct discharge date.

Take note of any collection suspensions noted in the account transcript to apply 507(A)(8)(ii) and (iii) and 507 (G). These are infrequent but should be kept in mind.

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THE DELINQUENT FILED QUANDRY

A. The Problem.

In *Mallo,* 774 F_3 1313 (10th Cir CA 2014), the Court sua sponte imposed 1 day late rule – that a tax return filed 1 day late did not qualify as a tax return for purposes of dischargability.

IRC ¶6020 provides:

(a) Preparation of return by Secretary

If any person shall fail to make a return required by this title or by regulations prescribed thereunder, but shall consent to disclose all information necessary for the preparation thereof, then, and in that case, the Secretary may prepare such return, which, being signed by such person, may be received by the Secretary as the return of such person.

(b) Execution of return by Secretary

(1) Authority of Secretary to execute return

If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

(2) Status of returns

Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.

The 10th Circuit Court of Appeals took the phrase "at the time prescribed therefore" in 6020 (b) to **not** count any return filed 1 day late as a return (the 1 day rule). The First and Fifth

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Court of appeals supported this ruling, finding IRC ¶ 6072 created applicable time for filing income tax returns; and filings after that date were not "tax returns" for purposes of dischargability. See *McCoy vs. Miss. State Tax Comm.*, 666 F_{3rd} 924 (5th Circuit CCA 924) and *Fahey vs. Mass. Dept. of Revenue,* F_{3rd} 1 (First Circuit CCA).

This interpretation would nullify 11 USC 523 (1)(B)(ii) providing for discharge 2 years after a late filed return. The 9th BAP in *In Re Martin,* 14-1180 (BAP 9th Circuit)(December 17, 2015) found to the contrary and adopted the test set in *Beard vs. Commission* (82 TC 766 1984 affirmed 793 F_{2nd} 139 (6th Cir CCA 1986).

The Beard 4 part test for a "return" requires:

1. The document must purport to be a tax return;
2. The document must contain sufficient information to allow for the calculation of the correct amount of tax liability;
3. The Debtor must evidence "an honest and reasonable attempt to satisfy the requirements of the tax laws";
4. The taxpayer must have executed the document under penalties of perjury.

The BAP remanded the Bankruptcy Court for application of the "Beard" factors.

Taxes under Substitutes for Return under IRC 6020 (b) are not dischargeable.

As to tax returns filed after assessment on a Substitute for Return the 6th Circuit ruled in *In Re Hindenlang,* 164 F_{2nd} 1029 (6th Cir CCA 1999) that the "return" served no useful purpose

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since it only mirrored the SFR and found the taxes not dischargeable. Would the finding change if the filed return substantially changed the amount owing?

The IRS encourages filings by a taxpayer after a SFR has been filed by the Commissioner.

In *In Re Justice,* 15-10273 decided March 30, 2016 the 11th Circuit Court of Appeals declined to decide on the "one day rule", but held instead that taxes were non dischargeable where no returns were filed for 2000 to 2003, SFR were filed by the IRS in 2006 and returns were filed by the debtor in 2007 and bankruptcy filed in 2011.

The 11th Circuit, using the *Beard* test found the Debtor did not meet the 4th Branch of the test i.e. that there was no honest or reasonable effort to comply with the tax laws where returns were only filed four to seven years late and after the IRS did a SFR.

Would the decision have been different if the returns were filed before the SFR?

It should be noted that the commentators such as Ronald J. Mann of the Columbia Law School have noted that the IRS itself does not support the 1 day rule.

HOW TO CALCULATE DISCHARGEABILITY

Year	Date Due	Date Filed	Date Assessed	Amount	Longer of			Date Dischargeable
					3 yrs from due date	2 yrs from date filed	240 days from date assessed	

Form **8821**

(Rev. October 2012)

Department of the Treasury
Internal Revenue Service

Tax Information Authorization

▶ Information about Form 8821 and its instructions is at *www.irs.gov/form8821*.
▶ Do not sign this form unless all applicable lines have been completed.
▶ To request a copy or transcript of your tax return, use Form 4506, 4506-T, or 4506T-EZ.

OMB No. 1545-1165
For IRS Use Only
Received by:
Name
Telephone
Function
Date

1 Taxpayer information. Taxpayer must sign and date this form on line 7.

Taxpayer name and address (type or print)	Taxpayer identification number(s)	
	Daytime telephone number: 5136210912	Plan number (if applicable)

2 Appointee. If you wish to name more than one appointee, attach a list to this form.

Name and address	
Robert A. Goering Goering & Goering LLC 220 W 3rd Street Cincinnati OH 45202	CAF No. 3206-39059R PTIN Telephone No. 513-621-0912 Fax No. 513-621-6042 Check if new: Address ☐ Telephone No. ☐ Fax No. ☐

3 Tax matters. The appointee is authorized to inspect and/or receive confidential tax information for the tax matters listed on this line. Do not use Form 8821 to request copies of tax returns.

(a) Type of Tax (Income, Employment, Payroll, Excise, Estate, Gift, Civil Penalty, etc.) (see instructions)	(b) Tax Form Number (1040, 941, 720, etc.)	(c) Year(s) or Period(s) (see the instructions for line 3)	(d) Specific Tax Matters (see instr.)
Income	1040		not applicable

4 Specific use not recorded on Centralized Authorization File (CAF). If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions. If you check this box, skip lines 5 and 6 . . . . . ▶ ☐

5 Disclosure of tax information (you must check a box on line 5a or 5b unless the box on line 4 is checked):

a If you want copies of tax information, notices, and other written communications sent to the appointee on an ongoing basis, check this box . . . . . ▶ ☐

Note. Appointees will no longer receive forms, publications and other related materials with the notices.

b If you do not want any copies of notices or communications sent to your appointee, check this box . . . . . ▶ ☑

6 Retention/revocation of tax information authorizations. This tax information authorization automatically revokes all prior authorizations for the same tax matters you listed on line 3 above unless you checked the box on line 4. If you do not want to revoke a prior tax information authorization, you must attach a copy of any authorizations you want to remain in effect and check this box . . . . . ▶ ☐

To revoke this tax information authorization, see the instructions.

7 Signature of taxpayer. If signed by a corporate officer, partner, guardian, executor, receiver, administrator, trustee, or party other than the taxpayer, I certify that I have the authority to execute this form with respect to the tax matters and tax periods shown on line 3 above.

▶ **IF NOT SIGNED AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED.**

▶ **DO NOT SIGN THIS FORM IF IT IS BLANK OR INCOMPLETE.**

Signature | Date

Print Name | Title (if applicable)

Not applicable

☐☐☐☐☐ PIN number for electronic signature

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 11596P Form **8821** (Rev. 10-2012)

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TAX LIEN PRIORITY AND THE EFFECT ON REAL PROPERTY

The priority of a lien is generally governed by the non-bankruptcy rules promulgated by your state with respect to lien priority. In most instances, the priority of two liens depends on which was recorded first. In Michigan, case law has firmly established that the first in time to record takes priority. *See Mitchell v Trustees of US Mut Real Estate Inv Trust*, 144 Mich App 302, 375 NW2d 424 (1985) (first recorded mortgage takes priority); *Seiberling Tire & Rubber Co v State Bank of Fraser*, 78 Mich App 587, 261 NW2d 13 (1977) (pursuant to future advances provision in properly recorded first mortgage, advances made after subsequently recorded mortgage took priority over subsequently recorded mortgage)

The priority of tax liens is codified at both the federal and state level and is generally consistent with UCC Article 9. Generally, tax liens take precedence overall other interest in real or personal property that are recorded after the recording of the tax lien. *See* IRC 6323; MCL 205.29.

The general rule in Michigan and many other states is that the first secured party to file a financing statement covering the collateral or to otherwise perfect will have priority over competing security interests. It rewards the most diligent creditor in the race to the collateral. There are several exceptions to this general rule, that are not directly related to the discussion on treatment of taxes in bankruptcy. The exceptions are set forth in Article 9 of the UCC as well as the exceptions related to certain security interests arising under Articles 2, 2A, 4, and 5. *See generally* MCL 440.932.

Differences in Approach to Priority (State vs. Federal)

The federal and state tax lien statutes differ in their approaches to the priority of tax liens. The federal statute, IRC 6323, grants priority to mechanic's liens that, although recorded after the federal tax lien, relate back in time to work commenced before the tax lien was recorded. The federal statute provides, "The lien imposed by [IRC 6321, federal tax lien,] shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary." IRC 6323(a). Subsection (f) sets for the recording requirements for perfecting a federal tax lien. The federal structure provides for specific exceptions to the priority status of its tax liens.

The Michigan tax lien statute provides, "The lien imposed by this act shall take precedence over all other liens and encumbrances, except bona fide liens recorded before the date the lien under this act is recorded." MCL 205.29(2). On its face, there appears to be much more flexibility with respect to state tax liens since it requires a determination of what constitutes a "bona fide" lien.

Taxes administered under [The Revenue Act, MCL 205.1- 205.31], together with the interest and penalties on those taxes, shall be a lien in favor of the state against all property and rights of property, both real and personal, tangible and intangible, owned at the time the lien attaches, or

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afterwards acquired by any person liable for the tax, to secure the payment of the tax. The lien shall attach to the property from and after the date that any report or return on which the tax is levied is required to be filed with the department . . . . [MCL 205.29(l)].

The Michigan Department of Treasury has explained how it views the status of a tax lien between the time it attaches and the time it is properly recorded in its Revenue Administration Bulleting 1989-50. "At the time the tax lien attaches, it is an inchoate lien. It is fully effective and enforceable against the person liable for the tax, and against all who have actual knowledge of the tax lien. However, until the tax lien is properly recorded, it is subordinate to many other claims. See generally *United States v State of Michigan*, 346 F Supp 1277 (ED Mich, 1972), (application of the property tax rationale of U.S. Supreme Court in *United States v State of Alabama*, 313 US 274 (1941))."

At the moment a tax lien is properly recorded, it becomes a perfected lien. Once perfected, the tax lien take[s] precedence over all other liens and encumbrances, except **bona fide liens** recorded before the [tax lien] is recorded. However, bona fide liens recorded before the [tax lien] is recorded shall take precedence only to the extent of disbursements made under a financial arrangement before the forty-sixth day after the date of the tax lien recording, or before the person making the disbursements had actual notice of [the recordation of the tax lien] whichever is earlier. [MCL 205.29(2)(emphasis added)]. *Id.*

In other words, a lien recorded prior to recordation of the tax lien has precedence over the tax lien. However, if the prior lien secures future advances (such as disbursements made after the recordation of the tax lien), then the prior lien does not have precedence insofar as it secures disbursements made after the 45th day following recordation of the tax lien. In addition, the prior recorded lien does not take precedence over any advances (such as disbursements made by a secured party) made after that party has actual notice of the recordation of the tax lien. *Id.*

A properly recorded tax lien affects the rights of those who, after the tax lien is recorded, acquire property from, or through, a delinquent taxpayer. Specifically, a purchaser or succeeding purchaser of property acquired from a delinquent taxpayer after the lien is recorded is personally liable for the unpaid taxes due on the lien. However, a purchaser's liability is limited to the value of the property less any proceeds which are due holders of security interests that were acquired in the property before the tax lien was recorded. [MCL 205.29(3)]. *Id.*

Example 1:

On December 1, 1987, an assessment is made against A with respect to his delinquent tax liability. On January 2, 1988, A enters into a written agreement with B, whereby B agrees to lend A $10,000 in return for a security interest in certain property owned by A. On January 5, 1988 B records the document(s) evidencing his security interest in the appropriate public office.

On January 11, 1988 the Department of Treasury files its notice of state tax lien affecting the subject lands. On February 1, 1988, B without actual notice or knowledge of tax lien filing, disburses the loan to A. Because the disbursement was made before the 46th day after the tax lien was filed, and because the disbursement was made pursuant to a written agreement and before the state's notice of tax lien was filed, B's $10,000 security interest has priority over the

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tax lien.

Example 2:

Assume the same facts as in example (1), except that when B disburses the $10,000 to A on February 1, 1988, B has actual knowledge of the tax lien filing. Because B's disbursement was made with actual knowledge of tax lien filing, B's security interest does not have priority over the tax lien, even though the disbursement was made before the 46th day after the tax lien filing.

Examining Priority of Ad Valorem Real Property Taxes in Bankruptcy

11 USC 502(b)(3) states that a court, after a hearing on an objection to a claim, shall determine the amount of such claim and shall allow a claim in such amount, EXCEPT TO THE EXTENT THAT…. if such claim is for a tax assessed against property of the estate, such claim exceeds the value of the interest of the estate in such property.

Generally, 11 U.S.C. 505 authorizes the court to determine the amount or legality of any tax, fine or penalty related to a tax, or any addition to a tax regardless of whether it has been previously assessed, paid, or contested. There are several exceptions to this general rule which have been the subject of litigation surrounding the court's abstention under 305, 28 U.S.C. 1334 and FRBP 5011. One exception to the Court's authority that relates to the discussion here is that the Court MAY NOT determine the amount of legality of any amount arising in connection with an ad valorem tax on real or personal property of the estate, if the applicable period for contesting or redetermining that amount under applicable non-bankruptcy law has expired. *See* 11 U.S.C. 505(C). As such, knowing your State tax appeal calendar is critical to ensure your client receives the greatest value from his or her case.

For example, in Michigan, the tax year ends December 31st. By the 1st week of March, the tax assessments are mailed out and if you want to appeal the assessed value it must be done at the March Board of Review meeting. An appeal to the Board of Review is a prerequisite to an appeal to the Michigan Tax Tribunal. As a practical matter, appealing to the Board of Review can preserve the right to have the bankruptcy court determine the ad valorem tax liability owed by a debtor which would otherwise be unavailable had the appeal not been filed. Keeping track of the calendar in cases involving taxes is critical with respect to either taking actions to preserve the debtor's rights outside of bankruptcy and/or timing the filing of the case so that it is done prior to the expiration of the period for contesting or redetermining the debtor's tax liability under non-bankruptcy law.

Even if there is no basis for appealing the provisions of 11 U.S.C. 511 may be valuable for your client. Look closely at the non-bankruptcy laws setting the interest rates that are paid on ad valorem tax. In a recent opinion from the 6th Circuit B.A.P., the Court considered a question regarding the rate of interest to be paid on ad *valorem* real property taxes on property that was "oversecured" and thus subject to an interest rate under Section 506(d). *In Re Bratt*, Case #15-8009/8010 (6th Cir. B.A.P. 2016). In *Bratt,* the Chapter 13 Debtor proposed to pay 12% interest on the tax debt secured by the debtor's home. The interest rate was based on the Tennessee statute that provided for a penalty of .5% and interest rate of 12% per year. The State objected to confirmation of the debtor's plan based on a new sub-section of the Tenn. Code which provided,

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> "(d) For purposes of any claim in a bankruptcy proceeding pertaining to delinquent property taxes, the assessment of penalties determined pursuant to this section constitutes the assessment of interest."

This new sub-section essentially called for a 1.5% interest rate per month or the equivalent of 18% per year. The bankruptcy court agreed with the Debtor and confirmed the plan with an interest rate of 12%. The State of Tennessee appealed the bankruptcy Court's determination.

In its decision, the BAP relied on statutory construction with respect to the Tennessee law. Specifically, the Tennessee code agreed with the Chapter 13 Trustee's argument that the law directed specifically and exclusively to bankruptcy matters and, therefore, **is not a nonbankruptcy law**. *Id.* at 6. The BAP discussed the creation of "bankruptcy law" by a state; however, without reaching the constitutional argument, it held that the 6th Circuit decision in *Richardson v. Shafer*, 689, F. 3d 601 (6th Cir. 2012) could be fairly read as holding that a state promulgated bankruptcy-specific statute is, in fact, a bankruptcy law. *Bratt* at 7.

PRACTICE POINT - Given the BAP decision in *Bratt*, it is important to take a close look at the language of any State law that purports to be a nonbankruptcy law simply because it is a state law. The legislation may have actually created a bankruptcy law that would not be the basis for setting the interest rate on any ad valorem tax.

PRACTICE POINT - object to tax claims filed that purport to exceed the value of real and/or personal property that is property of the estate.

How does disallowance under Section 502 affect tax claims on ad valorem real property taxes and personal property taxes?

Ad Valorem real property tax treatment:
In Re 300 Wash St. LLC (E.D. N.Y. 2015) - the City's ad vallorem tax claim was disallowed to the extent that it exceeded the value of Debtor's real property. The Court opined that the 502(b)(3) protected the value of the property for the benefit of the estate and unsecured creditors and, as such, the ad valorem tax claim was disallowed to the extent it exceeded the property's value. To the extent that the tax claims were subject to 502(b)(3), the City did not have an allowed claim.

Ad Valorem personal property tax treatment:
In Re Intercoastal Contr., Inc. (E.D. N. Carolina 2015) - the county tax claim arising from pre-petition assessment on the debtor's equipment exceeded the value of the estate's interest in the equipment. The equipment sold for less that the total amount of the secured claims against it and the debtor had no equity in the equipment from the petition date until it was sold. As such, the claim was wholly disallowed since 100% of the claim was unsecured.

Under 506(d), to the extent that a tax lien is not an allowed secured claim (even under the expanded *Dewsnup* definition of a secured claim) its lien is void. As a result, the IRS lien in property of a Chapter 13 debtor is extinguished.

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A few questions for consideration – how do we interpret the language in Section 506 which states,"except to the extent that…" and its effect on the subsections that follow? Could it result in disallowance of the entire real property tax if it exceeds the value of the underlying property? If an ad valorem real property tax is disallowed only to the extent it exceeds the value of the underlying real property, does that result in an unsecured tax debt that can be reduced under 506(d). See *Dewsnup v. Timm, 502 U.S. 410 (1992)* (determining that if a claim has been allowed under 502 and is secured by a lien with recourse to the underlying collateral, it does not come within the scope of 506(d) "stripping down" provisions.)

THE IMPACT OF IRC SECTION 1398 ON THE DEBTOR AND THE ESTATE

The filing of a business chapter 11 or chapter 7, while creating a bankruptcy estate, does not create a new entity. The business continues under its existing employer identification number (EIN), method of accounting and tax year. Pursuant to 26 U.S.C. § 1399, the corporation is the same entity after the filing of the petition as it was pre-petition. Businesses continue to file all tax returns as they were required to prior to filing; however, regardless of how they did or did not file prior to the bankruptcy, returns during the administration of the case are required to be filed by the regular due date, or as allowed by a timely filed extension. The filing of an individual bankruptcy creates a bankruptcy estate that is required to obtain its own taxpayer identification number (TIN), separate and distinct from the individual's Social Security number (SSN). Joint filings require each spouse to obtain his or her own estate TIN. The debtor(s) will continue to file federal, state and local income tax returns under his or her SSN if required. Each debtor estate will file, for federal purposes, Page 1 of Federal Form 1041 (U.S. Income Tax Return for Estates and Trusts) as a transmittal cover sheet identifying the bankruptcy estate, which is attached to a pro forma federal Form 1040, and indicating whether there is tax due or an amount to be refunded. Form 1040 is prepared by the debtor as "married filing separately." For an individual chapter 11 debtor who has confirmed a reorganization plan, all earnings post-confirmation remain property of the estate and are reported on the estate's tax return until the final decree is entered. There is an exception whereby the income can be allocated between the SSN and TIN. The exception arises when the confirmed plan and/or the confirmation order contains an exact formula/procedure for such determination. The administrative costs of a bankruptcy estate are deductible against income of the estate for both business and individual debtors. For federal purposes, an individual debtor will deduct these expenses "above the line" on Page 1 of Form 1040 before arriving at adjusted gross income. Taxes for post-confirmation trusts will be determined by the nature of the trust created. *Building Blocks: Essential Tools for the Bankruptcy Practitioner (American Bankruptcy Institute Briefs)* (Kindle Locations 2633-2652). American Bankruptcy Institute. Kindle Edition.

It is this distinction between the individual and the bankruptcy estate of an individual (and its corresponding tax distinctions) that make IRC Section 1398 such a valuable provision of the Internal Revenue Code for individuals filing Chapter 7 or Chapter 11 bankruptcy cases.

IRC 1398 is only applicable to individual debtors who file for relief under Chapter 7 or Chapter 11 of the Bankruptcy Code. As discussed above, the bankruptcy estates of individuals under 26 USC 1399 are the only separately taxable entities. This only applies in individual Chapter 7 or 11 cases. This is not true for Chapter 12 or 13 cases or any cases in which the Debtor is not an individual. IRC sec. 1398(a)9, (b) and 1399.

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Congress created Section 1398 to further the purpose of bankruptcy – i.e. to provide a "fresh start" to the honest but unfortunate debtor. S. Rep. No. 1035, 96the Cong., 2d Sess. 24-25 (1980). This particular section aids in achieving the "fresh start" by allowing the debtor to include an up-to-date tax liability as an obligation of the debtor's estate.

Section 1398 provides a fairly clear methodology for determining income of the estate (as distinguished from the debtor) and treatment of deductions. *See* 26 USC 1398(e)(1) and (e)(3). Cancellation of debt income (CODI) is attributable to either the debtor or the estate based on IRC Section 61(a) unless it can be excluded under Section 108(a). The determination is generally made based on the date of the "taxable event" giving rise to the income (i.e. modification of principal, discharge of obligation, etc.). If the event occurs before the filing – it should usually be reported by the debtor.

Likewise, the estate also may benefit from the tax attributes of the debtor. *See* 26 USC 1398(g). Per sub-section (g), there are eight enumerated items that may be used by the estate; however, subsection (g)(8) provides a sort of "catch-all" provision that allows the estate to use any attribute that is "necessary or appropriate" to carry out the purpose of Section 1398.

Bankruptcy planning and the "Short Year" Election

IRC section 1398(d)(2) provides that a debtor may elect to split his or her taxable year into TWO taxable years. This option allows a debtor to end his or her first taxable year on the day before a bankruptcy case is filed. The second taxable year would begin on the bankruptcy filing date. This election allows the debtor to include any tax liability for the first short year as an allowed priority claim under 507(a)(8). This bankruptcy planning tool is only available to individuals (see IRC 1399) who are filing either a Chapter 7 or Chapter 11 case. By making this election, the debtor may essentially force his or her unsecured creditors to pay the short-year tax claims in full. Of course, the priority claim would survive the bankruptcy if there are insufficient assets to pay the short-year claims in full (see B.R. section 523(a)(1)). However, if the election is not made, any tax liability that is assessed for the year in which the bankruptcy case is filed cannot be treated as an allowed claim against the estate.

If a debtor makes the short-year election, the tax attributes as of the end of the first taxable year are transferred to the estate to be used by the estate to shelter income. Whereas, if the election is not made, the debtor's tax attributes as of the end of the full taxable year carryover. Tax attributes include net operating losses and carryovers, general business credit carryovers, alternative minimum tax credit carryovers, capital loss and foreign tax credit carryovers.

A short-year election is considered made if the complete tax return for the short period is filed timely. *See* Temp. Treas. Reg. section 7a.2(d) (1981); Treas. Reg. section 1.6081-1(b)(2).

PRACTICE POINT – if making the election, the debtor should be sure to identify the return as a "SECTION 1398 ELECTION" by writing it boldly at the top of a short-year return.

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The short-year election must be made by a debtor on or before the date for filing a return for the short-year. IRC section 1398(d)(2)(D). The returns must be filed before the 15th day of the fourth full month following the close of the taxable year. Once made, the election cannot be revoked.

Generally, making the election is a good option because it allows a debtor to shift some of his or her tax liability to the estate as an allowed priority claim, which furthers the ability of the debtor to truly obtain a fresh start.

There are a few practical pointers that one should be aware of when making this election:

1. Only individual debtors may benefit from IRC section 1398
2. An individual debtor filing a Chapter 13 case is NOT eligible to benefit from the section 1398 election.
3. Consider the tax attributes available to the debtor in light of the debtor's income when deciding whether to make the 1398 election. The debtor's income earned prior to the bankruptcy filing date will affect the decision to make the short-year election.
4. A spouse may join in the 1398 election, but only if a joint return is filed for the taxable year.
5. It may seem obvious, but if there are not any non-exempt assets, the 1398 election is not allowed.

If a debtor makes the election under 1398, the case must be an asset case. See IRC 1398(d)(2)(C). Any trustee administering the case could exercise its authority under 11 USC 505(b)(2) to request a prompt determination of any unpaid liability of the estate for any tax incurred during the administration of the estate. The debtor, estate, trustee and any successor to the debtor would be discharged if, within 60 days the taxing authorities did not respond and the remaining requirements have been met. In order to take advantage of this provision, the Trustee must file a tax return for the estate essentially requiring 3 returns to be filed: a) the pre-filing short year return, b) the debtor's estate return, and c) the debtor's return post-filing.

The filing of an individual bankruptcy creates a bankruptcy estate that is required to obtain its own taxpayer identification number (TIN), separate and distinct from the individual's Social Security number (SSN). Joint filings require each spouse to obtain his or her own estate TIN; however, if a spouse decides to make the 1398 election, the short-year return must be a joint return.

The debtor(s) will continue to file federal, state and local income tax returns under his or her SSN if required. Each debtor estate will file, for federal purposes, Page 1 of Federal Form 1041 (U.S. Income Tax Return for Estates and Trusts) as a transmittal cover sheet identifying the bankruptcy estate, which is attached to a pro forma federal Form 1040, and indicating whether there is tax due or an amount to be refunded. Form 1040 is prepared by the debtor as "married filing separately." For an individual chapter 11 debtor who has confirmed a reorganization plan, all earnings post-confirmation remain property of the estate and are reported on the estate's tax return until the final decree is entered. There is an exception whereby the income can be allocated between the SSN and TIN – i.e. when the confirmed plan and/or the confirmation order

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contains an exact formula/procedure for such determination. The administrative costs of a bankruptcy estate are deductible against income of the estate for both business and individual debtors. For federal purposes, an individual debtor will deduct these expenses "above the line" on Page 1 of Form 1040 before arriving at adjusted gross income.22 Taxes for post-confirmation trusts will be determined by the nature of the trust created. *Building Blocks* (American Bankruptcy Institute) at 2638-2652

Federal Income Tax Issues of Financially Troubled Companies

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I. Introduction

The federal income tax treatment of bankruptcies and out of court debt workouts is found primarily in Sections 108 and 1017 of the Internal Revenue Code ("IRC") and the associated Treasury Regulations ("Treas. Reg."), rulings and court cases. Although the basics of taxation of cancellation of debt income ("CODI") are well established, there are many important nuances which must be considered in all but the simplest of cases. This outline only covers the foundational basics of Sections 108 and 1017. A non-exclusive list of other considerations include: the application of rules that augment the provisions of Sections 108 and 1017 in the federal consolidated return context which are designed to preserve single entity treatment, choices and elections one makes to apply Section 382 relating to the limitation of the use of net operating loss carry forwards and other tax attributions after a bankruptcy or debt workout and rules related to the treatment of debt and modification of debt including the computation of tax deductible interest found in Sections 163 and 1271 through 1275 among others, and state income tax rules all of which are beyond the scope of this outline. The guiding principle of Sections 108 and 1017 is to bring the tax law into conformity with the purpose of the bankruptcy law to give a bankrupt a fresh start. Senate Report No. 960-1035 accompanying the Bankruptcy Tax Act of 1980 explained the purpose of the law

as "The rules of the bill concerning income tax treatment of debt discharge in bankruptcy are intended to accommodate bankruptcy policy and tax policy. To preserve the debtor's "fresh start" after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability. The bill provides that the debt discharge amount thus excluded from income is applied to reduce the taxpayer's net operating losses and certain other tax attributes, unless the taxpayer elects to apply the debt discharge amount first to reduce basis in depreciable assets." "To insure that the debt discharge amount eventually will result in ordinary income (and cannot be converted to capital gain), the bill provides that any gain on a subsequent disposition of the reduced-basis property will be subject to a "recapture" under rules similar to those now applicable with respect to depreciation recapture. Also, the bill contains rules relating to discharge of indebtedness as a capital contribution, acquisition of debt by a related party, discharge of partnership debt, and other income tax aspects of discharge of indebtedness."

II. Income from Discharge of Indebtedness vs Gain From Dealing in Property.

A. Gross Income Defined.

1. "Congress shall have power to lay and collect taxes on incomes, from whatever source derived…"

a. Under the Internal Revenue Code, gross income includes all income from whatever source derived, IRC Section 61(a) including:

i. Gains derived from dealings in property, Section 61(a)(3).

ii. Income from discharge of indebtedness, Section 61 (a)(12).

B. *United States v. Kirby Lumber Co.,* 284 U.S. 1.

1. Facts: A corporation repurchased its own bonds for an amount less than the issue price.
2. Analysis: Corporation made available assets previously offset by the obligation to repay the principal amount due on the bonds.
3. Holding: Corporation "realized within the year an accession to income" because it was no longer obligated to repay all of the amount borrowed. The corporation's assets that were burdened by the obligation to repay are now free of that obligation. Thus, taxable cancellation of debt income ("CODI") was realized.

C. Income from Discharge of Indebtedness.

1. Adjusted Issue Price.
    a. The Adjusted Issue Price of a debt instrument is the amount payable as computed applying relevant federal income tax rules, primarily Section 1271 through 1275.
    b. The Adjusted Issue Price of a debt may not be the same as the face amount of the debt. This is usually because there is an element of interest embedded in the face amount of the debt.
    c. The Adjusted Issue Price of a debt instrument is the relevant amount when computing the amount of income from discharge or cancellation of debt or when computing gain or loss from transactions dealing in property.

2. Not all income resulting from satisfaction of debt for less than its adjusted issue price can be excluded from taxable income under Section 108.
    a. Such income may be treated as gain from dealing in property under Section 61(a)(3).
    b. Section 61(a)(3) income cannot be excluded from taxable income under Section 108.
    c. Only Section 61(a)(12) income can be excluded from taxable income by Section 108.
    d. This distinction usually depends on:
        i. The nature of the transaction.
        ii. Whether the debt involved is recourse or non-recourse.
3. Definition of Types of Debt – Nonrecourse v. Recourse.
    a. Nonrecourse Debt – Lender's rights to collect on debt limited to specified assets of borrower.
        i. In determining gain or loss, the fair market value of the property is treated as not less than the adjusted issue price of the Nonrecourse Debt. Section 7701(g).
    b. Recourse Debt – Lender's rights to collect on debt are not limited to specified assets of borrower.
4. Nonrecourse Debt – Adjusted Issue Price exceeds fair market value of collateral.
    a. Transaction is Transfer, Sale or Foreclosure of Collateral.
        i. Treated as sale or exchange of Property.

ii. Gain or Loss = Adjusted Issue Price of the Nonrecourse Debt less Basis of Property.

iii. Any gain is Section 61(a)(3) gain from dealing in property. This gain cannot be excluded from taxable income under Section 108.

iv. Amount of Gain or Loss is not Limited by FMV of Property.

b. Transaction is Debt Reduction or Cash Settlement.

i. ("CODI") = Amount of Debt Discharged in excess of Payment (if any). This is Section 61(a)(12) income from discharge of indebtedness which may be excluded under Section 108 if other requirements are met.

ii. Compare *Fulton Gold Corp.* 31 B.T.A. 519

- Treated reduction in nonrecourse liability without property transfer as tax-free reduction in basis of the property.
- IRS does not follow Fulton Gold.

5. Nonrecourse Debt – FMV of Collateral exceeds Adjusted Issue Price of the debt.

a. Transaction is Transfer, Sale or Foreclosure of Collateral.

i. Sale of property that secures a nonrecourse liability is treated as sale or exchange of property.

ii. Sale of property discharges the nonrecourse liability.

- Amount of discharged nonrecourse liability treated as "Amount Realized" for purposes of determining Gain or Loss.
- Section 108 will not apply.

b. Transaction is Debt Reduction or Cash Settlement – Property was acquired subject to the nonrecourse debt.

i. CODI = Adjusted issue price of debt discharged in excess of payment.

- Not relevant whether the adjusted issue price of the FMV of collateral is greater or less than the nonrecourse debt.

ii. Section 108 applies if other requirements are met.

c. Transaction is Debt Reduction or Cash Settlement – Debt originally resulted in cash proceeds.

i. CODI = Adjusted issue price of debt discharged in excess of payment.

ii. Section 108 applies if other requirements are met.

6. Recourse Debt – Adjusted Issue Price of debt exceeds FMV of collateral.

a. Transaction is Transfer, Sale or Foreclosure of Collateral.

i. Treated as sale or exchange of Property.

- Gain or Loss = FMV of Property less tax basis of property.

- CODI (if any) = Amount by which the Adjusted Issue Price of the recourse debt exceeds the FMV of Property.
- Section 108 applies to the CODI amount if other requirements are met.

b. Transaction is Debt Reduction or Cash Settlement.

i. Cancellation of debt income under Section 61(a)(12) is the adjusted issue price of debt in excess of the payment, if any.

ii. Section 108 applies if other requirements are met.

7. Recourse debt when FMV of collateral exceeds adjusted issue price of debt.

a. Transaction is a transfer, sale or foreclosure of the collateral.

i. Treated as sale or exchange of property.

- Gain cannot be excluded from taxable income under Section 108.

b. Transaction is debt reduction or cash settlement.

i. Cancellation of debt income under Section 61(a)(12) is the adjusted issue price of the debt in excess of the payment, if any.

ii. Section 108 applies if other requirements are met.

III. Section 108 In General.

A. Definition of Indebtedness of Taxpayer.

1. "Indebtedness of the Taxpayers" means any indebtedness:

a. For which the taxpayer is liable, or

b. Subject to which the taxpayer holds property.

2. Sec. 108 excludes Discharge of "Indebtedness of the Taxpayer" from Gross Income for:

a. Title 11 case;

b. Insolvency of Taxpayer;

c. Qualified Farm Indebtedness;

d. Certain Qualified Real Property Business Indebtedness; or

e. Certain Qualified Principal Residence Indebtedness.

B. Discharge in a Title 11 Case.

1. Definition of Title 11 – "Title 11" means a case under Title 11 of US bankruptcy code but only if:

a. Taxpayer is under the jurisdiction of the court in such case, and

b. Discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

2. Amount of Exclusion – the entire amount of discharge of indebtedness is excluded from gross income.

3. Precedence over insolvency, qualified farm indebtedness, qualified real property business indebtedness, and qualified principal residence indebtedness (Sec. 108(a)(2)(A))

C. Discharge when the Taxpayer is Insolvent.

1. Definition of Insolvent- "Insolvent" means the excess of liabilities over the fair market value of assets.

2. Amount of Exclusion – the amount of discharge of indebtedness that is excluded from gross income is limited to the amount of insolvency.
3. Precedence over qualified farm indebtedness, qualified real property business indebtedness, and qualified principal residence indebtedness.
4. Determination of Insolvency – Insolvency is determined immediately before the discharge.
    a. Nonrecourse Debt – Discharged excess nonrecourse debt is taken into account in determining insolvency.
    b. Contingent Liabilities – Valuation vs. All-or-Nothing Approach.

IV. Tax Attribute Reduction – Section 108(b).

A. Order of Attribute Reduction.

1. Under Sec. 108(b)(2), debtor's tax attributes are reduced to the extent of the excluded CODI in the following order:
    a. Net Operating Losses ("NOLs") & NOL carryovers;
    b. General Business Credits;
    c. Minimum Tax Credits;
    d. Capital Loss & Capital Loss Carryovers;
    e. Tax Basis in Property;
    f. Passive Activity Loss and Credit Carryovers;
    g. Foreign Tax Credit Carryovers.
2. Attributes not specified under Sec. 108.

B. Amount of Reduction under Sec. 108(b)(3).

1. Attributes other than credits – Reduced on a dollar-for-dollar basis.

2. Credits – Reduced at a rate of 33 1/3 cents for each dollar of excluded CODI.
3. Amount of excluded CODI in excess of Debtor's attributes disappears (i.e., it does not reduce future attributes and is not included in income).
    a. *But see,* Treas. Reg. Sec. 1.1502-28 regarding reduction of consolidated attributes of the other members of a consolidated group.

C. Ordering rules under Sec. 108(b)(4).
1. Attribute Reduction made after determination of tax in taxable year of discharge.
2. NOL and Capital Loss Reduction – Current year loss reduced first and then carryover reduced in order of year.
3. Credits – Reduced in order in which carryovers are taken into account.

D. Election to reduce depreciable property first.
1. Election available to apply <u>any portion</u> of Attribute Reduction to "Tax Basis in Property" under Sec. 1017 before NOLs.
    a. Election made on Form 982.
    b. Amount of election cannot exceed "adjusted basis of the depreciable property".
        i. "Depreciable Property"
            - Includes Partnership Interest.
            - Includes Recapture upon sale.
2. Election is beneficial – Taxpayer anticipates that pre-change NOLs available in post-change years will exceed depreciation deductions.

3. Election is not beneficial – Pre-change NOLs that survive attribute reduction are significantly limited under Sec. 382.
    a. Ownership change may occur as a result of the restructuring, triggering the applicability of Sec. 382.
    b. However, debtor needs to consider special exceptions to the Sec. 382 annual limitation that are available in Title 11 bankruptcy cases.

E. Section 108(e)(2) – *Payment Liability Exception.*

1. CODI does not arise from discharge of a liability, if payment of the liability would have entitled taxpayer to a deduction.
2. Consider effect of:
    a. All Events Test under Sec. 461(h);
    b. Limits to deductions under Sec. 404.

V. Section 108(e)(4) – *Related Party Rule-General Rule.*

A. If "Related Party" to Debtor purchases debt of Debtor, Purchase treated as if the Debtor repurchased its own debt and CODI consequences may result.

1. Consider substitution of related party as holder.
2. Consolidated group – Special rules apply when holder and issuer become members of same consolidated group (See Treas. Reg. Sec. 1.1502-13(g)).

B. "Related Party" – A party is a "related party" if:

1. Related prior to debt acquisition,
2. Related on acquisition date, or
3. Related after acquisition date, and acquired DI in anticipation of becoming related.

C. Exception for security dealers that meet certain requirements.

D. Debtor is deemed to pay an amount equal to Related Party's basis in the Debt Instrument ("DI").

    1. Exception – Amount deemed paid will equal DI's FMV if:

        a. Acquired the DI > 6 months before becoming related,

        b. Did not purchase the DI (*e.g.,* took a carryover basis in DI), or

        c. Had a principal purpose of tax avoidance.

E. Debtor recognizes CODI if DI's Adjusted Issue Price > Amount Deemed Paid.

    1. Insolvency and bankruptcy exceptions may apply.

    2. OID if Issue Price > Stated Redemption Price at Maturity.

F. If holder sells DI to a third party for < the face amount, issuer does not have CODI because liability has not changed.

    1. Consider potential abuse where related party buys and holds DI. May allow issuer to defer recognition of CODI while DI outstanding.

G. Debtor recognizes CODI if DI's Adjusted Issue Price > Amount Deemed Paid.

    1. Insolvency and bankruptcy exceptions may apply.

    2. OID if Issue Price > Stated Redemption Price at Maturity.

H. If Related Holder sells DI to a third party.

    1. If Sale Price > Adjusted Basis, Holder will have gain.

    2. If Sales Price < Adjusted Basis, Holder may have to defer loss.

    3. If Sales Price < Face Amount, Issue does not have CODI because liability is unchanged.

        a. Consider potential abuse.

VI. Section 108(e)(5) – *Purchase-Price Adjustment.*

A. Reduction in purchase-money debt (*i.e.,* Debt issued by Purchaser of property issues to Seller, as (partial) payment for such property) is not treated as CODI

B. Treated as an adjustment to original purchase price.

1. Rule does not apply to Purchaser which is bankrupt or insolvent at time of debt reduction.

2. Original Purchaser and Seller must have continuously owned the property and debt from the time the debt arose out of the sale of the property.

VII. Section 108(e)(6) – *Contribution to Capital.*

A. If creditor-shareholder contributes debt to the debtor corporation, debtor corporation is treated as satisfying the debt for cash.

1. Amount debtor corporation is deemed to pay = shareholder's adjusted basis in the debt.

a. Thus, CODI income results if principal amount exceeds the deemed payment.

b. Application may require that debtor corporation is solvent afterwards.

c. Consider "adjusted basis" in foreign jurisdictions.

VIII. Section 108(e) – *Other Rules.*

A. Adjustment for Unamortized Premiums and Discounts.

B. Recapture of Gain on Sale of Stock.

C. Corporate Stock or Partnership Interest.

D. REIT Qualifications.

E. Issuance of Debt Instruments.

IX. Distribution to Shareholder Debtor.

A. Corporation's discharge of indebtedness issued by Shareholder (*i.e.,* corporation loaned money to shareholder) is treated as a distribution of property (Treas. Reg. Sec. 1.301-1(m)).

1. Unlike a COD, distribution results in ordinary income to Shareholder to extent of Corporation's earnings and profits.

2. However, see Rev. Rul. 2004-79 – to extent there is a difference between Adjusted Issue Price and Fair Market Value, CODI or an interest premium may result.

X. Basis Reduction – Section 1017.

A. If CODI is excluded under Sec. 108 and any portion reduces the Tax Basis in Property (including Elections under Sec. 108(b)(5)), then such portion reduces the basis of any property held by the taxpayer <u>at the beginning of the taxable year following the taxable year in which the discharge occurs.</u>

B. Reduction not treated as Disposition.

C. Basis reduction creates Sec. 1245 and 1250 recapture potential. May include stock basis in subsidiary, but see limitation under Treas. Reg. Sec. 1.1502-28(b)(4).

1. Consider planning opportunities such as purchasing property prior to year-end and sale-leaseback transactions.

D. Amount of Reduction – Floor Rule Limiting Amount of Basis Reduction – Section 1017(b)(2).

1. Limits basis reduction under Sec. 1017 to the excess of Aggregate basis immediately after the Debt Discharge, over Aggregate liability immediately after the Debt Discharge.
2. "Floor Rule" only applies in Title 11 cases and/or insolvency.
3. "Floor Rule" does not apply if the Sec. 108(b)(5) election is made to reduce depreciable property first.

E. Amount of Reduction – Depreciable Property Rule – Sec. 1017(b)(3).

1. Amount under Sec. 108(b)(5) (*i.e.,* Election to reduce depreciable property first) and (c)(1) only reduces "depreciable property".
2. "Depreciable Property" means property subject to depreciation.
    a. Special rule for Partnership Interests.
    b. Special rule for Affiliated Group.
    c. Election to treat certain Inventory as Depreciable Property.
    d. Special Rules for Qualified Real Property Business Indebtedness.

F. Order of Basis Reduction.

1. Under Treas. Reg. Sec. 1.1017-1(a), basis reduction applied in the following order:
    a. Real property used in trade or business or held for investment, other than real property under Sec. 1221(1) that secured discharged indebtedness;
    b. Personal property used in trade or business or held for investment, other than Inventory, A/R and Notes Receivable that secured discharged indebtedness;

c. Remaining property used in trade or business or held for investment, other Inventory, A/R, Notes Receivable, and Real Property under Sec. 1221(1);

d. Inventory, A/R, Notes Receivable, and Real Property under Sec. 1221(1);

e. Property not used in trade or business nor held for investment.

G. Other Rules – Treas. Reg. Sec. 1.1017-1.

1. Operating Rules.

2. Modification of ordering rules for basis reduction under Sec. 108(b)(5), and (c).

3. Definition of Depreciable Property.

4. Election to treat Sec. 1221(1) Real Property as depreciable.

5. Partnership Rules.

XI. Special Rules for S Corporations.

A. Sec. 108(a), (b), (c) and (g) applied at S corporation level.

B. Election to exclude debt-discharge income made by S corporation.

C. Loss or deduction disallowed under Sec. 1366(d)(1) treated as NOL.

XII. Rules for Partnerships.

A. Sec. 108(a), (b), (c), and (g) applied at partner level (Sec. 108(d)(6)(A)).

B. CODI is separate item and allocated to partners as follows: (i) mandatory special allocations, and (ii) profit sharing ratios.

1. Determination of whether CODI special allocations have "substantial economic effect" under Rev. Rul. 92-97.

C. Partner's Basis in Partnership is: (i) increased by share of CODI, and (ii) decreased by share of liability relief under Sec. 752 (Sec. 705(a)(1)(A), (a)(2), and 733).

1. Deficit Capital Account generally not loan (Rev. Rul. 73-301).

XIII. Rules for Disregarded Entities.

A. Sec. 108(a)(1)(A) only applies to debt of DRE or Grantor Trust if "Owner" is in Title 11.

B. Sec. 108(a)(1)(B) only applies to debt of DRE or Grantor Trust if "Owner" is insolvent.

C. For purposes of Sec. 108, "owner" is considered partner.

D. For purposes of Sec. 108, DRE includes qualified subchapter S subsidiaries and qualified REIT subsidiaries.