Tackling Taxing Employment Issues in Bankruptcy

Presented by the Bankruptcy Taxation and Labor & Employment Committees

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CONCURRENT SESSION

2016

Tackling Taxing Employment Issues in Bankruptcy

Payroll Taxes Arising from Post-Petition Payment of Wage Claims, Tax Liens in Chapter 7 and Obtaining Prompt Determination of Tax

December 3, 2016

Jay D. Crom, CPA, CIRA, CFE

DEALING WITH POST-PETITION PAYROLL AND WAGE CLAIMS:

Post-Petition Payroll Taxes:

Bankruptcy Period Payroll gives rise to challenging tax claim issues. Federal, State and Local payroll tax rules are many and complex. Wages incurred after the petition date give rise to withholding and employer taxes and a requirement to timely file the related tax returns. For payroll taxes incurred by the Chapter 11 or Chapter 7 Estate, such taxes are due "on or before the due date of the tax under applicable nonbankruptcy law". A limited exception in a Chapter 7 case is available if the tax was either not incurred by the trustee or the bankruptcy court issues an order prior to the due date of the tax finding that the estate is probably administratively insolvent.

Failure to timely pay or file payroll tax returns will give rise to the same penalty and interest costs that non-bankrupt entities are subject to. Relying on Debtor personnel alone to timely comply with all payroll tax payment and reporting rules while in the midst of reorganization is risky. Because of the frequency and amounts involved, **it is highly desirable to use a payroll service**, including use of the payroll service to automatically make timely payroll tax deposits. Taxpayers with cash flow problems are often dropped from a payroll service's automatic payment process because the lack of funds creates an inability for the service to timely pay taxes and that gives rise to penalty exposure, problematic reliability of payment information and reporting challenges. Nevertheless, reestablishing the soup to nuts payroll service's processing of payroll through payment of taxes and filing of returns will make a Debtor's case run smoother and can serve to avoid costly penalties and interest.

If some Chapter 11 period payroll remains unpaid upon conversion to Chapter 7, the tax withholding and reporting arising from the later payment of those administrative wage claims will be required of the Trustee. In some cases, this occurs many years after the conversion. A Trustee needs access to the payroll tax records including detailed employee information and prior payroll tax returns in order to properly report any wage claim payments whether the claims arose pre- or post-petition.

Taxes Arising from Payment of Pre-Petition and GUC Wage Claims (11 U.S.C. §507(a)(4)):

Priority status is granted for up to $12,850 per employee in cases filed after April 1, 2016 for wage, salaries or commission earned by an individual (and some single employee corporations) within 180 days before the petition date. Payroll withholding and employer taxes arise from payment of all wage claims, not just priority claims. When wage claims are receiving a pro-rata distribution, it is challenging to compute the required withholding and employer taxes as there can be numerous 'moving parts' involved in the calculations. In a Chapter 7 case with wage claims, prior to the filing of the final account and proposed distribution, extensive analysis and computation work should be done to properly compute the taxes arising from payment of administrative, pre-petition priority and general unsecured claims (GUC) for wages. Preparing this tax analysis in advance should put the Trustee in a position to timely pay taxes and file payroll tax returns after the final hearing.

If a Chapter 7 Trustee is making distribution on priority claims prior to filing the final account, the notice of proposed distribution should include any tax payments that the Trustee intends to pay as a result of the wage distribution.

The withholding taxes are merely a portion of the wage claim distribution. If a $500 wage claim receives a $200 distribution, and if withholding on that $200 is $50, the entire $50 of withholding is paid over to the taxing authorities.

The priority of the employer taxes arising from the wage claim payment is a bit messier. Employer taxes incurred on post-petition wages are of the same priority as the triggering administrative wage claims. That is, a wage incurred during the 11 period but paid in the 7 period gives rise to employer payroll taxes with Chapter 11 priority. Employer taxes arising from post-petition payment of pre-petition wages create additional pre-petition priority tax claims under §507(a)(8)(D).

Note, these employer taxes will not receive any distribution if funds are insufficient to pay the higher priority wage claims in full. On the other hand, if non-priority wage claims are receiving pro rata distribution, the resulting employer taxes arising from the amount actually paid on such claims should be paid in full.

Interplay of Tax Liens and Priority Claims in Chapter 7 (11 U.S.C. §724 and 726:

In a Chapter 7 case, if perfected tax liens exist, §724(b) may allow priority wage claims to receive payment from the proceeds subject to such tax liens if no other source of payment exists. This provision allows funds, which would otherwise go to satisfy the tax lien, to be used to pay some priority claims. These claims include Chapter 7 administrative claims and certain other priority claims of a priority higher than §507(a)(8), including pre-petition priority wages and Chapter 11 wage claims. Further, Section §724(a) allows the penalty portion of tax liens,

including interest thereto, to be avoided and preserved for the benefit of the estate, and that penalty claim is relegated to subordinated status under §726(a)(4).

Interest on secured tax claims continues to accrue through the payment date and that will impact the amount available under Section 724. Generally, for unsecured tax claims, interest and penalty should cease to accrue upon the petition date in a Chapter 7 case, and for taxes incurred during Chapter 11, as of the conversion date (Mark Anthony Construction, Inc. (886 F.2d 1101)).

Chapter 11- Plan Requirements for priority tax payments (11 U.S.C. § 363(c), 1123, and 1129)

The deferred amounts must consist of "regular" installment payments in cash, must not extend beyond five years from the date of the order for relief (i.e., normally the petition date), and the taxing authority must be treated not less favorably than the most favored non-priority unsecured claimant other than a convenience class (the "most-favored-unsecured-creditor" requirement). These provisions will also apply with respect to secured tax claims. Note the payments must be completed in what could be significantly less than five years from the Plan Effective Date under these rules.

Personal Liability for Post-Petition Taxes:

While Trust fund tax exposure more often arises prior to bankruptcy, exposure to personal liability can arise after the petition date from Debtor operations. Many states, including California, impose personal liability for not only withholding taxes, but also for employer, sales and other taxes. The trigger for personal liability can vary for different tax types. It is not safe to assume there will be no personal liability for taxes incurred without verification of the applicable law.

A newly appointed trustee in an operating Chapter 11 may encounter immediately due payroll and delinquent payroll and other taxes with very little cash available to pay these obligations. This can lead to some very difficult decisions and any choice beyond immediate shut down could open up personal liability exposure.

Trust fund payroll taxes assessed against a responsible person are priority taxes even though the term 'penalty' is used to assess the third party tax against the Debtor. IRC §6672(a) imposes a penalty on any responsible person who willfully evades or fails to collect, pay or account for payroll taxes. The amount of the penalty is the tax evaded or not collected, accounted for or paid to the government. To be liable for the tax, a person must have possessed actual and significant authority over an enterprise's finances and decision making, including paying the taxes (a responsible person) and either knew the payments were not being made or recklessly disregarded whether they had been made.

The Ninth Circuit adopted the *Honey* test (footnote 14) and held that a company's funds weren't encumbered due to obligations imposed by the Bankruptcy Code. After filing for bankruptcy, the company continued to pay operating expenses, but failed to make quarterly excise tax payments. The taxpayer, the former CFO, argued that 11 U.S.C. §§ 503(b)(1) (which allows for the payment of certain administrative expenses) prioritizes operating expenses over post-petition taxes, but the court said this provision mandates equally the payment of operating expenses and taxes and thus the funds weren't encumbered. (Nakano, Raymond T. v. U.S., (2014, CA9) **113 AFTR 2d 2014-941**, **109 AFTR 2d 2012-642**, 2012-1 USTC ¶50138.)

Individual Chapter 11 Debtor's Wages and 11 U.S.C. §1115

An individual's bankruptcy estate is a separate taxable entity for income tax purposes in Chapters 7 and 11 under IRC §1398. IRC §1398 is not applicable to cases that are dismissed. The provisions of BAPCPA, Title 11 §1115(a)(2), bring an Individual Debtor's post-petition earnings into the estate during the Chapter 11 period. The allocation of W-2 earnings for the petition year and closing year are addressed in IRS Notice 2006-83. When a Trustee is appointed in an individual Chapter 11 case, the Trustee must obtain self-employment and W-2 earnings information from the Debtor and report the Debtor's earnings in tax returns and monthly operating reports.

Request for a Prompt Audit Determination (11 U.S.C. §505(b)(2); Rev. Proc. 2006-24)

Under Section §505(b) of the Bankruptcy Code, a trustee or debtor in possession may seek a prompt determination of the debtor's liability for administrative expense taxes. In order to invoke this procedure, the debtor submits a tax return and a request for determination of tax to the governmental unit charged with responsibility for collecting the tax in question (**See Exhibit A**). The IRS generally sends a reply to §505(b) requests (**See Exhibit B**). This process is valuable for all types of Federal, State and Local post-petition tax returns including income, payroll, sales, excise, gross receipts, minimum taxes and more.

If the governmental unit does not notify the debtor within 60 days that the return has been selected for examination, or complete such an examination within 180 days of the request, the debtor is generally discharged from liability for that tax. It has not always been clear to debtors seeking to invoke Section 505(b) what procedures should be followed in notifying the taxing authority. Under the Act, taxing authorities may register with the clerk of the bankruptcy court an address for service of requests and describe where further information concerning additional requirements may be found. If a taxing authority fails to do so, the trustee may serve the request at the address for filing a tax return or protest with the applicable taxing authority.

State of California
Employment Development Department
P.O. Box 826880
Sacramento, CA 94280-0001
Fax: (916) 464-2077

FOR THE PERSONAL ATTENTION OF THE SPECIAL PROCEDURES FUNCTION
(BANKRUPTCY SECTION).
DO NOT OPEN IN MAIL ROOM.

REQUEST FOR PROMPT DETERMINATION OF ANY UNPAID TAX LIABILITY
PURSUANT TO REV. PROC. 2006-24 AND U. S. BANKRUPTCY CODE 505(b)

Taxpayer: Loleta Cheese Company, Inc.
Chapter 11 Bankruptcy Filed on 11/19/14; Converted to Chapter 7 on 06/30/16
FEIN: 94-280[redacted]
U.S.B.C. Case No.: 14-11620

To the EDD Bankruptcy Unit,

Loleta Cheese Company requests prompt determination of any unpaid payroll tax liability for the final quarter ended June 30, 2016.

Attached hereto are copies of the final June 30, 2016 forms DE-9 & DE-9C, as filed. The returns were filed on 7/22/16.

Pursuant to the procedures for prompt determination of tax liability, I am herein requesting that you notify me within 60 days of either your acceptance of the above-named taxpayer's return or your intent to examine the estate's records.

I am the trustee in bankruptcy of this estate that is administered in the United States Bankruptcy Court, Northern District of California.

If you need any further information, please contact Bachecki, Crom & Co. LLP at (415) 398-3534.

I declare under penalties of perjury pursuant to the laws of the State of California that the foregoing is true and correct to the best of my knowledge, information and belief, and that this declaration is executed on 7/28/16, in Sebastopol, California.

[redacted]
Chapter 11 Trustee
P.O. Box 1761
Sebastopol, CA, 95473

Attachment: Final 06/30/16 Forms DE 9 & DE 9C

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SMALL BUSINESS/SELF-EMPLOYED DIVISION

Received
APR 26 2016

March 10, 2016

Ni-Fi Festivals, LLC
C/O [redacted] Trustee
P.O. Box 5350
Santa Rosa, CA 95402

[redacted] Trustee

Re: Request for Prompt Determination
EIN: 46-520[redacted]
Form: 940
Tax Period(s) Ending:
December 31, 2015

Dear Sir/Madam:

In response to your request, received February 25, 2016, for prompt determination of any unpaid tax liability on the tax period(s) shown above, this is to inform you that the tax return(s) has (have) not been selected for examination under the prompt audit procedures under section 505(b) of the Bankruptcy Code.

If you have any questions please contact [redacted] ID #10008[redacted] at (859)488-3734 (not a toll-free number). You may also address any response to this correspondence to:

Internal Revenue Service
ATTN: [redacted]
201 W. Rivercenter Blvd., Stop 5702A
Covington, KY 41011

Sincerely,

[redacted]
Internal Revenue Agent
SB/SE Employment Tax

ABI Winter Leadership Conference

Tackling Taxing Employment Issues in Bankruptcy

Treatment of employment tax claims in bankruptcy, and bankruptcy alternatives

By Dennis N. Brager, Esq.

I. Dischargeability of employment tax claims.

A. Employment taxes for which a return is last due, including extensions, after three years before the date of the filing of the petition 11 U.S.C. §507(a)(8)(D) may be discharged. See In *re Pierce*, 935 F.2d 709 (5th Cir. 1991). However, trust fund taxes, including the trust fund recovery penalty are priority taxes which are non-dischargeable. See 11 U.S.C. §507(a)(8)(C).

II. Installment Agreements. Pre and post-bankruptcy.

A. The IRS can agree to an in-business installment agreement. Installment agreements require the full payment of all taxes, penalties, and interest.

B. An installment agreement may extend over the entire life of the collection statute of limitations.

1. Generally the statute of limitations is 10 years from the date of the IRS' assessment of tax. IRC Section 6502. Several events can extend the 10 year collection statute including bankruptcy. IRC Section 6503. If a taxpayer files for bankruptcy then the collection statute is extended for the period during the taxpayer's assets are in the control or custody of the court, plus 6 months. IRC Section 6503(b).

C. Typically the IRS will allow up to 6 years (72 months) to pay off the outstanding liabilities.

D. In the context of employment taxes owed by a corporation the IRS may agree to refrain from assessing the TFRP as long as the taxpayer qualifies for an in business installment agreement, the statute of limitations on the assessment of the TFRP is extended as necessary. 5.7.4.8.1 (11-12-2015).

E. Taxpayers with amounts due of less than $50,000 may qualify for guaranteed, Streamlined, or In-business Express Agreements. These types of agreements do not require the taxpayer to submit a financial statement. IRM 5.14.5.1 (05-23-2014)

III. Offers in Compromise. Pre and post-bankruptcy. An offer in compromise (OIC) is an agreement between a taxpayer and the government that settles a tax liability for payment of less than the full amount owed. It is authorized by Internal Revenue Code (IRC) Section 7122. There are three different types: OIC Doubt as to Collectability (OICDATC), (b) OIC

Doubt as to Liability (OICDATL), (c) OIC to promote Effective Tax Administration. Treas. Reg. Section 301.7122-1. All references in this outline are to OICDATC.

A. The Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. An OIC is a legitimate alternative to declaring a case currently not collectible or a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government. Policy Statement P-5-100.Offers that are neither withdrawn, rejected, or accepted within 2 years of the date of receipt will be deemed accepted. IRC Section 7122(f).

B. OIC requests are submitted on Form 656, Offer in Compromise. The taxpayer must also file a financial statement on Form 433A (OIC). The IRS will not process an offer in compromise if the taxpayer is in bankruptcy. IRM 5.8.2.3.1 (07-28-2015). Generally the IRS will only accept an offer if it reflects the "reasonable collection potential" (RCP). Offers will not be accepted if the tax can be paid in full, or through an installment agreement within the remaining life of the statute of limitations on collection. (CSED).

C. There are two types of OICDATC. Lump sum offers. The amount of the offer must be paid in full in 5 or fewer payments within 5 or fewer months after the offer is accepted by the IRS. At the time the offer is submitted a down payment of 20% of the total amount of the offer must be submitted. Periodic payment offer. The first payment must be made with the Offer and the balance being paid within 24 months of the date the offer is accepted.

D. How is the RCP calculated? The amount collectible from the taxpayer's net realizable equity in assets, plus the amount collectible from the taxpayer's expected future income after payment of necessary living expenses. In the case of a lump sum offer the future income potential is calculated over a period of 12 months. In the case of a periodic payment offer the future income potential is calculated over a 24 month period. IRM 5.8.4.3.1 (April 30, 2015).

IV. Bankruptcy v. Offers in Compromise

A. Trust Fund liabilities can be eliminated in an OIC.

B. OICs do not come with a hit to the taxpayer's credit rating

C. OIC filings are not public record unless they are accepted

D. Taxpayer's do not have to "give up" their assets in an Offer in Compromise

E. Offers in Compromise can be funded with borrowed funds.

F. Assets are generally valued at only 80% of their fair market value in an OIC

G. IRS treats certain assets as "exempt" for OIC purposes, but NOT for bankruptcy purposes.

H. For taxpayers with significant consumer debt Chapter 7 may not be available.

I. Upon acceptance of an OIC, the IRS will release federal tax liens

V. Trust Fund Liabilities. Disputing employment taxes.

A. Section 505(a)(1) provides in relevant part that: [T]he court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction. 11 U.S.C. § 505(a)(1). Subsection (a)(2) limits that authority by providing that: The court may not so determine - (A) the amount or legality of a tax, fine, penalty, or addition to tax if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under this title. 11 U.S.C. § 505(a)(2)(A). In re *Johnston*, 484 B.R. 698 (2012) provides a review of authorities regarding the bankruptcy court's jurisdiction to hear tax claims:

1. Courts are divided on this question of whether § 505 is an independent grant of jurisdiction to bankruptcy judges to determine the legality and amounts of tax claims. Thus, in *Swain v. United States* (In re *Swain*), the court specifically held that § 505(a) is not an independent grant of jurisdiction to bankruptcy courts. 437 B.R. 549, 562 (Bankr.E.D.Mich.2010). See also *United States v. Zellers* (In re *CNS, Inc.*), 255 B.R. 198, 201 (N.D.Ohio 2000) (The subject matter jurisdiction of bankruptcy courts over tax proceedings is derived from the jurisdiction of the federal district courts under 28 U.S.C. § 1334....). The majority of bankruptcy courts have found jurisdiction for making the responsible person determination for the debtor in a no asset Chapter 7 case and have either made the determination or abstained from making the determination. Thus, Johnston relies on Kohl, to support this position. In *Donoff v. United States* (In re *Donoff*), 1999 Bankr.LEXIS 144 (Bankr. S.D.Ohio Feb. 5, 1999), the court held that it had jurisdiction over the responsible person determination, but abstained under § 1334(c) and § 505(a). See also *Beisel*; *Shapiro v. United States* (In re Shapiro), 188 B.R. 140 (Bankr.E.D.Pa.1995); *Starnes v. United States* (In re Starnes), 159 B.R. 748 (Bankr.W.D.N.C.1993); But see *In re Anderson*, 171 B.R. 549 (Bankr.W.D.Va.1994)(bankruptcy court declined to abstain from hearing responsible person determination); In re *D'Alessio*, 181 B.R. 756 (Bankr.S.D.N.Y.1995) (same); and In re *Wheeler*, 183 B.R. 265 (Bankr. W.D.Okla.1995) (same). Even if the bankruptcy court has jurisdiction, it is undisputed that the court has discretionary not to exercise its jurisdiction. See In re *Beisel*, 195 B.R. 378, 379 (Bankr.S.D.Ohio 1996) (Section 505(a)(1) allows but does not require the Bankruptcy Court to determine a debtor's tax liabilities.) and In re *Galvano*, 116 B.R. 367 (Bankr.E.D.N.Y. 1990) (authority under § 505 to determine tax liability is discretionary). It is also important to note the purposes of § 505: providing a forum for the speedy determination of the legality or amount of tax

claims, which if left to other proceedings, would delay the administration of the bankruptcy estate; and providing an opportunity for the trustee, on behalf of creditors, to contest the legality and amount of a tax claim when the debtor is unable or unwilling to do so and a dissipation of estate assets might otherwise occur. See *City Vending of Muskogee, Inc. v. Oklahoma Tax Comm.*, 898 F.2d 122, 124-25 (10th Cir.1990); *Beisel*, 195 B.R. at 379-80; Kohl, 397 B.R. at 845. 2. Review of Case Law on Bankruptcy Court Jurisdiction to Make Responsible Person Determine Tax Liability.

B. Internal Revenue Code Section 6672 imposes personal liability on a responsible person who willfully fails to collect or pay over employment taxes. For this purpose, employment taxes consist of the income taxes that was required to be withheld from an employee wages, as well as the portion of the Social Security taxes withheld from the employee wages. This is the so-called trust fund. It does not include the employer's share of the Social Security Taxes, nor does it include interest and penalties that have accrued on the trust fund. The personal liability is sometimes referred to as the trust fund recovery penalty (TFRP), or the 100% penalty. The penalty label is, however, inaccurate. It is not a true penalty, but merely a collection devise that the IRS may rely on.

C. An individual may be personally liable for trust fund taxes under Internal Revenue Code Section 6672 only if he is both a responsible person and has acted willfully. If either of these two elements are not present, there can be no personal liability for the unpaid taxes. *Davis v. United States*, 961 F.2d 867, 869 (9th Cir. 1992); *United States v. Bisbee*, 245 F 3d. 1001 (8th Cir. 1994).

D. Responsible Person. An individual is a responsible person for trust find purposes if that person has the power, duty and authority to exercise significant control over the disbursement of corporate funds. See *United States v. Chapman*, 2001 U.S. App. LEXIS 7709 (9th Cir. 2001). This includes the power, duty and authority to choose which creditors to pay. "Responsibility is a matter of status, duty and authority." *United States v. Sibbrel*, 2003 U.S. App. LEXIS 23908 (9th Cir. 2003); *Davis v. United States*, supra, 961 F.2d at 873. The crucial test is whether the person had the “effective power to pay the taxes owed.” *Purcell v. United States*, 1 F.3d 932, 937 (9th Cir. 1993) However, the fact that a taxpayer has check writing authority or is a corporate officer does not ipso facto mean that the taxpayer is a responsible person unless the taxpayer has the above referenced power, duty and authority. See *United States v. Bisbee*, supra.; *De Alto v. United States*, supra. In *Hutchinson v. U.S.*, 559 F. Supp 890 (N.D. Ohio 1982), the court, quoting *Feist v. U.S.*, 607 F.2d 954 (Ct. Cl. 1979), stated that " [i]n determining whether an individual [is] a responsible person, the proper analysis focuses on whether that person had and exercised authority as to what bills or creditors should or should not be paid, and when." See *Vinick v. Comr.*, 205 F.3d 1 (1st Cir. 2000) (absent a finding that treasurer/co-owner possessed actual, exercised authority over company's financial matters, including duty and power to determine which creditors to pay, as a matter of law, he could not be a responsible person).

E. Willfulness. In order to be held personally liable for unpaid trust fund taxes, not only

must the individual be a responsible person, but he must have also acted willfully. Willfulness is defined as a voluntary, conscious, and intentional act to prefer other creditors over the United States. See *United States v. Leuschner*, 336 F.2d 246 (9th Cir. 1964). Where there has been no notice to a responsible officer that taxes are due, there is no willfulness. *Gustin v. United States*, 876 F.2d 485 (5th Cir. 1989). Where an officer/shareholder relies on an employee to pay the taxes, and does not have knowledge that the taxes went unpaid, the officer/shareholder is not liable. *United States v. Leuschner*, 336 F.2d 246 (9th Cir. 1964). Even if the responsible officer is unaware of the payroll liability due to negligence the nonpayment is not willful. Id. See also *Calderone v. United States*, 799 F.2d 254 (6th Cir. 1986); *Morgan v. U.S.*, 937 F.2d 281 (5th Cir. 1991) (mere negligence does not establish willfulness).

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Classification of Employment Tax Claims in Bankruptcy Cases

by

Henry J. Riordan, Esq.[1/]

This paper addresses the classification of federal employment tax claims in bankruptcy cases commenced under the Bankruptcy Code (11 U.S.C.). Claims can be classified as postpetition administrative expenses or prepetition secured claims, unsecured priority claims, or general unsecured claims.

FEDERAL EMPLOYMENT TAXES:

Sections 3102(a) and 3402(a) of the Internal Revenue Code (26 U.S.C.) require an employer to deduct and withhold income and Federal Insurance Contributions Act ("FICA") taxes from the "wages" paid to its employees. An employer's liability is equal to the amount of the tax that should be withheld, along with an amount which matches the amount of the withheld FICA taxes. *See* 26 U.S.C. §§ 3101, 3102, 3111, 3402, and 3403.

Under 26 U.S.C. § 3301, Federal Unemployment Tax Act ("FUTA") taxes are imposed on every employer in the amount of a certain percent of the total "wages" paid by the employer during the calendar year. The employer's FUTA taxes must be determined by taking into account all of the wages and credits for the calendar year. 26 U.S.C. §§ 3301 and 3302.

Forms 941, Employer's Quarterly Federal Tax Return, for withheld income and FICA taxes are generally due to be filed with the IRS by the last day of the month following each quarterly tax period, *i.e.*, by April 30th, July 31st, October 31st, and January 31st. *See* 26 U.S.C. § 6151; Treas. Reg. §§ 31.6011(a)-1(a)(1), 31.6011(a)-4(a)(1), and 31.6071(a)-1(a)(1).

[1/] Henry J. Riordan is an Assistant Chief for the Civil Trial Section, Northern Region, at the United States Department of Justice, Tax Division. The views expressed are Mr. Riordan's, and do not represent the official position of the Tax Division, the Department of Justice, or any other Government agency.

Prepared By: Henry J. Riordan, Esq.
December 3, 2016
14528110.2

Forms 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, for FUTA taxes are generally due to be filed with the IRS by the last day of the month following each calendar year, *i.e.*, by January 31st. *See* 26 U.S.C. § 6151; Treas. Reg. §§ 31.6071(a)-1(c) and 31.6011(a)-3.

Under the Internal Revenue Code, employment taxes are normally incurred upon the payment of wages. As a result, taxes associated with wages earned prepetition from the debtor but paid postpetition by the bankruptcy trustee are technically incurred by the bankruptcy trustee. *See Otte v. United States*, 419 U.S. 43, 48-52 (1974); *see also* 26 U.S.C. § 3401(d)(1).

FICA taxes are capped by an annual wage base for each employee for each employer ($118,500 for 2016), and the same is true for FUTA taxes ($7,000 for 2016). *See generally* IRS Publication 908, Bankruptcy Tax Guide, and IRS Publication 15, (Circular E), Employer's Tax Guide; *see* 26 U.S.C. § 3121(a)(1) and Treas. Reg. § 31.3121(a)(1)-1(a)(3); *see also* 26 U.S.C. § 3306(b)(1) and Treas. Reg. § 31.3306(b)(1)-1(a)(3); *cf*. Rev. Proc. 2004-53, 2004-2 C.B. 320.

ADMINISTRATIVE EXPENSES (11 U.S.C. § 503):

If wages are earned prepetition from the debtor but paid postpetition by the bankruptcy trustee, the Bankruptcy Code reclassifies the employment tax claim from an administrative expense to an unsecured priority claim. As a result, it is important to keep track of whether wages were earned prepetition or postpetition. *See* 11 U.S.C. §§ 502(i) and 507(a)(8)(D).

Employment taxes, penalties, and interest associated with wages earned from the bankruptcy estate will be allowable as administrative expenses; the debts are "incurred by the estate." *See* 11 U.S.C. § 503(b)(1)(B). Administrative expenses include "any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph." *See* 11 U.S.C. § 503(b)(1)(C). Interest on administrative-expense taxes and penalties is also entitled to priority as an administrative expense. *See In re Flo-Lizer*, Inc., 916 F.2d 363, 366 (6th Cir.1990). Claims for penalties incurred by the bankruptcy estate cannot be categorically subordinated. *See United States v. Noland*, 517 U.S.

535, 543 (1996). Under 26 U.S.C. § 6658, a court may excuse the late payment of taxes under certain circumstances if there will likely be an insufficiency of funds, but the failure to pay trust fund taxes can never be excused.

SECURED CLAIMS (11 U.S.C. § 506(A)):

Secured claims are defined under 11 U.S.C. § 506(a)(1) as claims secured by liens or via right of offset. Due to the strong-arm powers of a trustee under 11 U.S.C. § 544, the IRS must have a notice of federal tax lien ("NFTL") filed in accordance with 26 U.S.C. § 6323(f) as a practical matter in order to be treated as a holder a secured claim–not just a statutory lien under 26 U.S.C. § 6321.

Under section 506(a), allowed claims are bifurcated into secured claims and unsecured claims depending upon the value of the collateral or offsetting claim. *See* 11 U.S.C. § 506(a). Property exempted from property of the estate under 11 U.S.C. § 522, but not property excluded from property of the estate under 11 U.S.C. § 541, is included in the collateral accounted for under section 506(a). *See In re Snyder*, 343 F.3d 1171, 1178-79 (9th Cir. 2003); *In re May*, 194 B.R. 853, 857 (D. S.D. 1996); *cf. In re Hannon*, 514 B.R. 69, 76 (Bankr. D. Ma. 2014).

The withheld income and employee's share of the FICA taxes (the trust fund portion of the Form 941 taxes) are not property of the estate, but belong to the United States. *See Begier v. IRS*, 496 U.S. 53, 59 (1990); *see also* 26 U.S.C. § 7501. No trust fund taxes are reported on a Form 940.

Prepetition penalties are allowable as part of an allowed secured claim, except in Chapter 7 cases; postpetition penalties on prepetition debts are not allowable. *See* 11 U.S.C. §§ 724(a) and 726(a)(4); *In re Brentwood Outpatient, Ltd.*, 43 F.3d 256, 263 (6th Cir. 1994). Prepetition interest is allowable as part of a secured claim; postpetition interest is allowable only on oversecured claims. *See* 11 U.S.C. §§ 506(b) and 511; *United States v. Ron Pair Enterprises*, 489 U.S. 235, 246-48 (1989).

UNSECURED PRIORITY CLAIMS (11 U.S.C. § 507(A)(8)) :

The income and FICA taxes withheld from the wages of employees and reported on a Form 941 are trust fund taxes; only the employer's share of the FICA taxes is not held in trust. As such, the bulk (roughly, 80%) of the taxes report on a Form 941 are trust fund taxes. *See* 26 U.S.C. §§ 3101, 3102, 3111, 3402, and 3403.

The trust fund portion of the employment taxes are afforded priority status under 11 U.S.C. § 507(a)(8)(C) if the wages were earned from the debtor and the wages were paid prepetition; if the wages were not paid prepetition, the trust fund portion of the taxes will be afforded priority status under 11 U.S.C. § 507(a)(8)(D) (or perhaps 11 U.S.C. § 503 if section 507(a)(8)(D) does not apply). Trust fund taxes carved out of priority wages paid under 11 U.S.C. § 507(a)(4) are also classified as claims under section 507(a)(4). Interest on priority taxes shares the same priority. *See In re Garcia*, 955 F.2d 16, 18 (5th Cir. 1992).

Under 11 U.S.C. § 507(a)(8)(C), trust fund taxes are classified as unsecured priority claims regardless of the age of the claim (**bold** added):

> "(C) a **tax** required to be **collected or withheld** and for which the debtor is liable in **whatever capacity**; …."

Under 11 U.S.C. § 507(a)(8)(D), employment taxes for returns (*i.e.*, Forms 941 and 940) due within 3 years of the petition date are classified as unsecured priority claims (**bold** added):

> "(D). an **employment tax** on a wage, salary, or commission of a kind specified in paragraph (4) of this subsection **earned from the debtor** before the date of the filing of the petition, **whether or not actually paid** before such date, for which a **return** is last **due**, under applicable law or under any **extension**, after **three years** before the date of the filing of the petition; …"

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TOLLING (THE FLUSH LANGUAGE OF 11 U.S.C. § 507(A)(8)):

Under the flush language of 11 U.S.C. § 507(a)(8), the unsecured priority periods set forth in section 507(a)(8) are tolled while the collection of the taxes is stayed, plus an additional 90 days. The flush language provides (**bold** added):

> "An otherwise applicable time period specified in this paragraph shall be **suspended** for any period during which a governmental unit is **prohibited** under applicable nonbankruptcy law from **collecting** a tax as a result of a **request by the debtor for a hearing** and an appeal of any collection action taken or proposed against the debtor, **plus 90 days**; plus any time during which the **stay of proceedings** was in effect in a **prior case** under this title or during which **collection was precluded** by the existence of 1 or more **confirmed plans** under this title, **plus 90 days**."

The legislative history of section 507 reflects that the request for a hearing referenced in the statute was a reference to a request for a collection due process hearing under 26 U.S.C. §§ 6320 and 6330.

The flush language of section 507(a)(8) is routinely applied to section 507(a)(8)(D), the three-year lookback period. Conceptually, section 507(a)(8)(D) affords the IRS a priority if it has not had at least three years (1,095 days) to collect a tax after the due date of the return. To calculate the three-year lookback mark, count backwards from the petition date until you reach 1,095 days on which there was no stay of collection activity, and then enlarge that extended period for an additional 90 days for each event that stays collection.

OTHER THINGS YOU SHOULD KNOW:

Generally, the IRS policy is to allow a taxpayer making a voluntary partial payment to designate the tax liability to which the payment should be applied. *See* Rev. Proc. 2002-26, 2002-1 C.B. 746; *cf.* IRM 1.2.14.1.3(10), Policy Statement 5-14; Rev. Proc. 2001-58, 2001-2 C.B. 579. A debtor, however, has no right to designate how involuntary payments are applied. *See United States v. Pepperman*, 976 F.2d 123, 127 (3rd Cir. 1992); *In re Ribs-*

R-Us, Inc., 828 F.2d 199, 201-04 (3d Cir. 1987); *cf. In re Bryan*, 407 B.R. 410 (10th Cir. BAP 2009); REST 2d CONTRACT §§ 258-60. In *United States v. Energy Resources Co., Inc.*, 495 U.S. 545 (1990), however, the Supreme Court ruled that a bankruptcy court could designate payments if such designation was necessary to the reorganization and all of the debts would be paid.

Under 26 U.S.C. § 6672, the IRS can assess a responsible person for the loss of trust fund taxes. A responsible person does not have to be an officer or employee of the corporation; the person must simply have significant control over the financial affairs of the business. *See, e.g., Caterino v. United States*, 794 F.2d 1, 5 (1st Cir. 1986). More than one person may be assessed, but the IRS only collects the trust funds once. *See, e.g., Gephart v. United States*, 818 F.2d 469, 473 (6th Cir. 1987). As a result, a claim under section 6672 is not treated as a claim for penalties for bankruptcy purposes. *See, e.g., In re Mosbrucker*, 227 B.R. 434, 437 (BAP 8th Cir. 1998).

If an individual debtor provides for the full payment of an allowed claim under a bankruptcy plan, any remaining interest due on that claim under the Internal Revenue Code may be collected from the individual if the claim is excepted from discharge. For individual debtors, the trust fund portion of employment tax claims, and interest thereon, is not dischargeable under any chapter of the Bankruptcy Code. *See* 11 U.S.C. § 727(b), 1141(d)(2), 1228(a)(2), and 1328(a)(2); *see also In re Monahan*, 497 B.R. 642, 649 (1st Cir. BAP 2014).

If a liquidating trust is created under a Chapter 11 plan in order to pay wage claims, the trust will become the employer upon the payment of the wages and the trust will be liable for the employment taxes even though the services were not performed for the trust. *See Guy v. Terex*, No. 91-3687, 1992 WL 88978 (6th Cir. Apr. 30, 1992).

Under the so-called "check the box" provisions of Treas. Reg. § 301.7701-3, owners of certain entities will be treated as an employer for purposes of employment taxes unless the owner elects otherwise. Treas. Reg. § 301.7701-3(b).

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If an entity pays the tax liabilities of its employees or owners, instead of paying the employee or owner and then having them pay their own tax liabilities, a trustee in bankruptcy may be able to set aside the transfers as fraudulent conveyances of that entity. *See In re Custom Contractors, LLC*, 745 F.3d 1342, 1349 (11th Cir. 2014).

Although 11 U.S.C. § 505(a) states that the bankruptcy court may determine any tax, section 505 in limited by 28 U.S.C. §§ 1334 and 157 to determinations of the tax liabilities of the debtor and the bankruptcy estate. *See In re CNS, Inc.*, 255 B.R. 198, 201-02 (USDC S.D. Ohio 2000); *cf. In re UAL Corp.*, 336 B.R. 370, 374 (Bankr. N.D. Ill. 2006).

CONCLUSION:

To test your knowledge of these rules and to assist you in learning them, some practical problems are attached. Written answers to the problems are provided.

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Practical Problems With Answers

These problems address the classification of federal employment tax claims in bankruptcy cases commenced under the Bankruptcy Code (11 U.S.C.). The answers to the problems are provided at the end of the document, but the learning experience will be better if you first try to answer the problems on your own:

Problem 1: Echo, Inc., filed a Form 941 for the fourth quarter of 2010 on April 15, 2011, reporting $100 in taxes due: $80 of the taxes were withheld income taxes and the employee's portion of the FICA taxes; $20 was for the employer's portion of the FICA taxes. The taxes were assessed on June 2, 2011. The corporation did not pay any part of the taxes. The corporation also failed to file its Form 940 for the calendar year 2010, and owes $50 in FUTA taxes for that year. Echo, Inc., commenced a Chapter 11 bankruptcy case on February 20, 2014.

What is the classification of the claim for employment taxes in Echo's Chapter 11 bankruptcy case?

Problem 2: Rick Grimes commenced a Chapter 7 bankruptcy case on January 15, 2014. Prior to the petition date, Rick's home security business failed, but he paid all of the wages of his employees. Rick filed his final Form 941 for the last quarter of 2013 on October 1, 2014. He reported $100 of withheld income and FICA taxes due, but paid nothing with the return. The taxes were assessed on December 20, 2014.

What is the classification of the claim for employment taxes in Rick's Chapter 7 bankruptcy case?

Problem 3: Glenn Rhee filed his Form 940 for the calendar year 2011 on November 11, 2012. The return reported $100 in taxes due. The IRS assessed the taxes on December 2, 2012. Glenn paid $100 when he filed the return. There is $10 in interest due on the taxes, plus a delinquency penalty under 26 U.S.C. § 6651(a)(1) in the amount of $25, all of which remains unpaid. Glenn commenced a Chapter 7 bankruptcy case on February 4, 2013.

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What is the classification of the claim for interest on the FUTA taxes and the penalties in Glenn's Chapter 7 bankruptcy case?

Problem 4: Tyreese was assessed $100 under 26 U.S.C. § 6672 in regard to the wages of the employees of Walkco, Inc., for the first quarter of 2006. On March 15, 2015, Tyreese commenced a Chapter 13 bankruptcy case. The debt remains unpaid.

What is the classification of the claim for penalties under 26 U.S.C. § 6672 in Tyreese's Chapter 13 bankruptcy case?

Problem 5: Deadbeatco, Inc., commenced a Chapter 11 bankruptcy case on June 30, 2012. The corporation failed to pay $1,000 in wages earned the week before the petition date. By order of the bankruptcy court, the wages are paid by the bankruptcy estate on July 10, 2012. The IRS had no notice of the motion to pay the wages. There was $100 in employment taxes incurred by the payment of the wages ($80 for the withheld income and the employee's portion of the FICA, and $20 for the employer's portion of the FICA). The bankruptcy court's order did not specifically address the payment of the employment taxes. The tax debts remains unpaid.

What is the classification of the claim for employment taxes in Deadbeatco's Chapter 11 bankruptcy case?

Problem 6: Beth Greene commenced a Chapter 11 bankruptcy case on Monday, November 10, 2015. Beth paid the wages of her employees on Friday, November 7, 2015. She was required to make Form 941 tax deposits for the wages by December 15, 2015. No tax deposits were made and 75% of the required deposit was for trust fund taxes. On January 15, 2016, the IRS assessed Beth for withheld income and FICA taxes which included $100 for taxes related to these wages, plus a failure to make tax deposit penalty under 26 U.S.C. § 6656 in the amount of $20. Beth thought that she was not supposed to pay any prepetition claims after she went into bankruptcy.

What is the classification of the claim for taxes and penalties in Greene's Chapter 11 bankruptcy case?

Problem 7: Peletier Group, Inc., commenced a Chapter 11 bankruptcy case on November 17, 2015. For the last quarter of 2015, the debtor in possession filed a Form 941 on January 30, 2016, but failed to pay the $100 in tax reported on the return. The IRS assessed $100 in Form 941 taxes on March 10, 2016, of which $50 related to wages earned prepetition and $50 related to wages earned postpetition. The corporation has several employees who earn over $150,000 annually.

What is the classification of the claim for employment taxes in Peletier's Chapter 11 bankruptcy case?

Problem 8: Michonne commenced a Chapter 11 bankruptcy case on July 1, 2015. For 2015, the debtor in possession filed her Form 940 on January 30, 2016, but failed to pay the $14,400 in tax reported on the return for the entire calendar year. The IRS assessed $14,400 in FUTA taxes on February 22, 2016, of which $7,200 related to wages earned prepetition and $7,200 related to wages earned postpetition. All of the employees are paid over $50,000 annually.

What is the classification of the claims for FUTA taxes in Michonne's Chapter 11 bankruptcy case?

Problem 9: Hershel Enterprises, Inc., commenced a Chapter 11 bankruptcy case on July 1, 2013. The case was converted to a Chapter 7 case on January 30, 2014. For the fourth quarter of 2013, the debtor in possession filed its Form 941 on January 15, 2014, but failed to pay the $100 in tax reported on the return. The IRS assessed $100 in withheld income and FICA taxes on May 4, 2014, plus $25 in failure to pay penalties under 26 U.S.C. § 6651. The Chapter 7 bankruptcy estate is administratively insolvent.

What is the classification of the claim for taxes and penalties in Hershel's Chapter 7 bankruptcy case?

Problem 10: Taxco, Inc., commenced a Chapter 11 bankruptcy case on July 1, 2013. Taxco was assessed $1,000 in penalties under 26 U.S.C. § 6721 for the postpetition failure to file Forms W-2 by their due date. The penalties remain unpaid. The bankruptcy estate is administratively insolvent and the debtor in

possession is considering converting the Chapter 11 bankruptcy case to a Chapter 7 bankruptcy case.

What is the classification of the claim for penalties in Taxco's Chapter 11 bankruptcy case?

Problem 11: Merle Dixon timely filed his Form 940 for the calendar year 2009. He reported $100 in taxes due, but failed to pay the tax reported on the return. The IRS assessed the taxes, plus $20 for failure to pay penalties. On January 1, 2013, Merle commenced a Chapter 11 bankruptcy case, but the case was dismissed on December 31, 2013. Merle commenced a Chapter 7 bankruptcy case on February 15, 2014.

What is the classification of the claim for FUTA taxes and penalties in Merle's Chapter 7 bankruptcy case?

Problem 12: Gabriel Stokes timely filed his Form 940 for the 2010 calendar year, reporting $100 in tax due. He did not pay the tax reported on the return. On June 2, 2011, the IRS assessed the tax. On February 1, 2013, the IRS issued a notice of intent to levy and, on October 1, 2013, Gabriel requested a CDP hearing. An IRS Appeals Officer is considering whether a levy would be economical. On October 1, 2015, Gabriel commenced a Chapter 13 bankruptcy case. As of the petition date, the CDP matter had not yet been resolved.

What is the classification of the claim for FUTA taxes in Gabriel's Chapter 13 bankruptcy case?

Problem 13: Dale Horvath timely filed his Form 941 for the third quarter of 2012, reporting $100 in tax due. The IRS assessed the tax on December 7, 2012. Dale failed to pay the tax. Dale was given notice of the tax debt and a demand for payment. A statutory lien for the debt arose under 26 U.S.C. § 6321 on the date of the assessment. No notice of federal tax lien ("NFTL") was filed. On March 3, 2014, Dale commenced a Chapter 13 bankruptcy case. On the petition date, Dale owned property with a fair market value of $50,000 and he has no creditors other than the IRS.

What is the classification of the claim for employment taxes in Dale's Chapter 13 bankruptcy case?

Problem 14: Andrea timely filed her Form 940 for the calendar year 2007. She reported $10,000 in taxes due, but failed to pay the taxes reported on the return. On June 1, 2008, the IRS assessed the taxes and $250 in failure to pay penalties. The IRS properly filed a NFTL on November 10, 2013. Andrea commenced a Chapter 13 bankruptcy case on February 13, 2014. On the petition date, Andrea owned a house worth $100,000, which is subject to a first mortgage in the amount of $98,000. She also owned a pension plan qualified under 26 U.S.C. § 401(k) in the amount of $5,000, plus tools in the amount of $2,000 which she exempted under 11 U.S.C. § 522.

What is the classification of the claim for employment taxes and penalties in Andrea's Chapter 13 bankruptcy case.

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ANSWERS TO PROBLEMS

Answer to Problem 1: $80 unsecured priority claim and $70 general unsecured claim. This problem applies 11 U.S.C. §§ 507(a)(8)(C) and (D). For purposes of section 507(a)(8)(D), the three-year lookback mark is February 20, 2011. The Form 941 was due on January 31, 2011, which is before the lookback mark. *See* Treas. Reg. § 31.6071(a)-1(a) (Form 941 due on or before last day of first month after quarterly period) (26 C.F.R.). The rule is tied to the due date of the tax return, not the actual date that the return is filed. Therefore, the Form 941 taxes are not entitled to priority under section 507(a)(8)(D). Under section 507(a)(8)(C), however, the trust-fund portion of the Form 941 taxes are entitled to priority regardless of the age of the taxes. Although Form 940 taxes are "unemployment" taxes, they can still qualify as "employment" taxes under section 507(a)(8)(D). The Form 940, however, was due on January 31, 2011, which is before the lookback mark. *See* Treas. Reg. § 31.6071(a)-1(c) (Form 940 due on or before last day of first month after calendar year). None of the Form 940 taxes are trust fund taxes. Therefore, the Form 940 taxes are not entitled to priority.

Answer to Problem 2: $100 unsecured priority claim. This problem applies 11 U.S.C. §§ 507(a)(8)(C) and (D). The three-year lookback mark of section 507(a)(8)(D) is January 15, 2011. The return was due on January 31, 2014, which is after the lookback mark. The fact that the return was filed or the taxes were assessed after the petition date is not relevant; it does not make the tax debt an administrative expense. The trust fund portion of the taxes would also fall within 11 U.S.C. § 507(a)(8)(C).

Answer to Problem 3: $10 unsecured priority claim and $25 general unsecured claim. This problem applies 11 U.S.C. § 507(a)(8)(D). Taxes and interest on taxes share the same priority. The three-year lookback mark of section 507(a)(8)(D) is February 4, 2010. The return was due on January 31, 2012, which is after the lookback mark. Although there are no unpaid taxes, the interest on any taxes paid remains a priority claim under the rule. Nonpecuniary loss penalties and interest thereon can never qualify as an unsecured priority claim.

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Answer to Problem 4: $100 unsecured priority claim. This problem applies 11 U.S.C. § 507(a)(8)(C). Under section 507(a)(8)(C), the trust fund taxes are entitled to priority regardless of the age of the taxes.

Answer to Problem 5: $100 unsecured priority claim. In "first day orders," bankruptcy courts frequently permit the payment of prepetition wages in Chapter 11 cases in order to retain employees. Employment taxes for the postpetition payment of prepetition wages are treated as prepetition tax debts if they otherwise qualify under 11 U.S.C. § 507(a)(8)(C) or (D). *See* 11 U.S.C. §§ 502(i), 503(b)(1)(B)(i), and 507(a)(8)(C) and (D); *cf.* 11 U.S.C. § 507(a)(4). Here, the wages were earned from the debtor just prior to the petition date but not paid by the debtor. Therefore, the taxes are unsecured priority claims under section 507(a)(8)(D). It's unclear whether section 507(a)(8)(C) also applies to the trust fund portion of the taxes because the debtor was never liable for the taxes. The trust fund portion of the taxes, however would also fall within 11 U.S.C. § 507(a)(4) to the extent that they are carved out of (withheld from) the wages.

Answer to Problem 6: $100 unsecured priority claim and $15 general unsecured claim. This problem applies 11 U.S.C. §§ 507(a)(8)(C) and (D), as well as 11 U.S.C. § 362 and 26 U.S.C. § 6656. The unsecured tax debts are for employment taxes earned from the debtor prior to the petition date. For purposes of section 507(a)(8)(D), the three-year lookback mark is November 10, 2012. The Form 941 return was due on January 31, 2016, which is after the lookback mark. *See* Treas. Reg. § 31.6071(a)-1(a) (Form 941 due on or before last day of first month after quarterly period). Therefore, the Form 941 taxes are entitled to priority under section 507(a)(8)(D). Under section 507(a)(8)(C), the trust fund portion of the Form 941 taxes are also entitled to priority. In addition, the debtor is most likely not liable for the deposit penalties insofar as the deposit relates to the employer's portion of the FICA ($5) because the deposit was not due until after the petition date and the automatic stay, 11 U.S.C. § 362, prevented the collection of the taxes. The trust fund taxes, however, are not property of the estate, but belong to the United States; there is no reason why those funds should not have been turned over to the IRS. *See Begier v. IRS*, 496 U.S. 53 (1990). The debtor might, however, be

able to make an argument that the failure to deposit the taxes was due to reasonable cause and not due to willful neglect.

Answer to Problem to 7: $50 administrative expense and $50 unsecured priority claim. This problem raises the issue of whether the bankruptcy estate is a separate employer for employment tax purposes and whether the withheld income and FICA taxes need to be apportioned for the quarter that the bankruptcy petition is filed. Although there is a new legal entity created by the commencement of the bankruptcy case, corporations generally file one Form 941 for the entire quarter and issue one Form W-2 to each employee for the year. For income tax purposes, no new entity is created. *See* 26 U.S.C. § 1399; 26 U.S.C. § 6012(b)(3). The law is unclear, however, as to whether the debtor in possession is a new employer for employment tax purposes. If the debtor in possession is a new employer, the bankruptcy estate is most likely not a "successor employer," within the meaning of 26 U.S.C. §§ 3121(a)(1) and 3306(b)(1), because it did not "acquire" the assets of the debtor. *See* 11 U.S.C. § 541(a). By treating the bankruptcy estate as the same employer, the corporation avoids a double FICA tax on wages above the wage base for the year ($118,500 for 2016), as well as a double FUTA tax on wages above its wage base ($7,000 for 2016). *See generally* IRS Publication 908, Bankruptcy Tax Guide, and IRS Publication 15, (Circular E), Employer's Tax Guide; *see* 26 U.S.C. § 3121(a)(1) and Treas. Reg. § 31.3121(a)(1)-1(a)(3) (26 C.F.R.); 26 U.S.C. § 3306(b)(1) and Treas. Reg. § 31.3306(b)(1)-1(a)(3) (26 C.F.R.); *cf*. Rev. Proc. 2004-53. Regardless, the taxes need to be apportioned for purposes of 11 U.S.C. § 507(a)(8)(C), 11 U.S.C. § 507(a)(8)(D), and 11 U.S.C. § 503 based upon whether the wages were earned prepetition or postpetition. Unlike income tax claims, the allowance of employment tax claims as either a prepetition claim or a postpetition claim is not governed by the date that the tax period ends.

Answer to Problem 8: $14,400 administrative expense and $14,400 unsecured priority claim. This problem raises the issue of whether the bankruptcy estate of an individual is a separate employer. Clearly, the tax claim must be apportioned and treated as either an unsecured priority claim under 11 U.S.C. § 507(a)(8)(D) or as an administrative expense under 11 U.S.C. § 503 based upon whether the wages were earned prepetition or

postpetition. Unlike income tax claims, the allowance of employment tax claims as either a prepetition claim or a postpetition claim is not governed by the date that the tax period ends. The more difficult part of the problem relates to whether the Chapter 11 bankruptcy estate of an individual is a new employer. For income tax purposes, the Chapter 11 bankruptcy estate of an individual is a separate taxpayer. *See* 26 U.S.C. § 1398; IRS Notice 2006-83, 2006-2 C.B. 596. For accounting purposes, it would make more sense to treat the employees as employees of the bankruptcy estate or else the payment of the wages of the employees would not be a deductible expense for income tax purposes. If the bankruptcy estate were a separate employer, however, the FUTA taxes would be doubled because the $7,000 wage base would apply separately to the prepetition wages and the postpetition wages. *See* Answer to Problem 7. The law is not clear.

Answer to Problem 9: $125 administrative expense. The withheld income and FICA taxes, and related penalties, are treated as an administrative expenses under 11 U.S.C. §§ 503(b)(1)(B) and (C) because the wages were earned from, and paid by, the bankruptcy estate. The penalties are allowable generally as an "administrative expense" under section 503(b) or specifically under subsection 503(b)(1)(C). Although a bankruptcy court can relieve a bankruptcy estate from certain failures to pay penalties under 26 U.S.C. § 6658, a court cannot do so retroactively and a court cannot in any event relieve an estate from the failure to deposit trust fund taxes. The penalties cannot be categorically subordinated. *See United States v. Noland*, 517 U.S. 535 (1996); *cf.* 11 U.S.C. § 726(b).

Answer to Problem 10: $1,000 administrative expense. This problem applies 11 U.S.C. § 503. Section 503 affords priority to "administrative expenses." Chapter 11 bankruptcy estates are liable for penalties under the Internal Revenue Code, just like any other taxpayer. *See* 28 U.S.C. § 960. A court cannot use 26 U.S.C. § 6658 retroactively. These penalties are not directly related to taxes, but the penalties should still qualify as administrative expense generally. Although section 503(b)(1)(C) specifically allows penalties relating to taxes, that provision does not limit section 503 to penalties related to taxes. *See* 11 U.S.C. §

102(3) ("including" is not limiting). It should be noted, however, that the law in this area is not fully settled, and some courts hold that if a penalty does not relate to a tax, it cannot be classified as an administrative expense.

Answer to Problem 11: $100 unsecured priority claim and $20 general unsecured claim. This problem applies 11 U.S.C. § 507(a)(8)(D) and the flush language at the end of section 507(a)(8). The three-year lookback mark of section 507(a)(8)(D) is February 15, 2011, but the automatic stay was in effect during the pendency of the prior bankruptcy case. The priority period was tolled while the stay was in effect (one year), plus 90 days. The tolling for one year brings the lookback mark to February 15, 2010. The return was due on January 31, 2010. When the additional 90 days of tolling are taken into account, the lookback mark is moved back to November of 2009, and the return was due after that date. The tax claim is therefore a priority claim under the rule. Nonpecuniary loss penalties and interest thereon can never qualify as an unsecured priority claim.

Answer to Problem 12: $100 unsecured priority claim. This problem applies 11 U.S.C. § 507(a)(8)(D) and the flush language at the end of section 507(a)(8). The three-year lookback mark of section 507(a)(8)(D) is October 1, 2012, but the IRS was stayed from collecting the tax for two years during the lookback period because the taxpayer requested a CDP hearing. The priority period was tolled while collection was stayed (two years), plus 90 days. The tolling for two years brings the lookback mark back to October 1, 2010. The return was due on January 31, 2011. Therefore, the tax claim is entitled to priority under the rule without having to use the additional 90 days of tolling.

Answer to Problem 13: $100 unsecured priority claim. Because a bankruptcy trustee has the status of a judgment lien creditor as of the petition date under 11 U.S.C. § 544, the estate has priority over a secret lien under 26 U.S.C. § 6321. The IRS will file its proof of claim as an unsecured claim when it has not filed a notice of federal tax lien in accordance with 26 U.S.C. § 6323(f). The tax claim is entitled to priority under 11 U.S.C. § 507(a)(8)(D) and, for the trust fund portion of the taxes, under 11 U.S.C. § 507(a)(8)(C).

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Answer to Problem 14: $4,000 secured claim and $ 6,250 general unsecured claim. This problem relates to what property is included in the valuation of collateral under 11 U.S.C. § 506(a). There is $2,000 in equity in the home and $2,000 in value for the tools which are exempted. Exempt property is used under section 506(a), but not excluded property. The balance due for the taxes and the nonpecuniary loss penalties are not entitled to priority under 11 U.S.C. § 507(a)(8).

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