Utah Bar, 2017 Spring Convention, St. George, Utah

Tax Issues in Bankruptcy, Gale K. Francis and Mark H. Howard

I. Organization of tax authorities and how it affects the bankruptcy process

A. United States and the Internal Revenue Service

1. Historical information. Litigation of tax issues in bankruptcy court comes under the jurisdiction of the United States Department of Justice. From approximately 1983 until December 31, 2015, the Department of Justice authorized the appointment of attorneys in the Office of Chief Counsel, Internal Revenue Service, as Special Assistant United States Attorneys to represent the IRS in United States Bankruptcy Court. The delegation of this authority was left to the local United States Attorney.

In Utah, IRS Chief Counsel attorneys actively participated as Special Assistant United States Attorneys from 1985 until December 31, 2015. Due to budget cuts at the Internal Revenue Service and, in turn, at the Office of Chief Counsel, IRS, the Office of Chief Counsel chose to end its participation in this Special Assistant U.S. Attorney program. This was the reason for the termination of the program on December 31, 2015. With this change the work of representing the IRS in bankruptcy court went back to the Offices of the United States Attorneys.

2. The Internal Revenue Service has manuals for almost everything it does. You can find the Internal Revenue Manual for bankruptcy at IRM 5.9. See https://www.irs.gov/irm/part5/index.html. The IRS has two different offices with responsibility for bankruptcy matters, a field operation (FI), consisting of more than 80 posts of duty geographically distributed throughout the country, and a single campus operation (CIO) in Philadelphia. See IRM 5.9.1.4, The Role of Insolvency (11-09-2015) which describes the roles of the two offices as follows:

1. The CIO performs most clerical duties for all bankruptcy chapters, including loading cases on the Automated Insolvency System (AIS). CIO works Chapter 7 No Asset cases. However, responsibilities in certain large dollar Chapter 7 No Asset cases are shared by CIO and FI. CIO monitors Chapter 13 cases for confirmation of the plan after the case is transferred from FI to the CIO, and processes Chapter 13 trustee payments. Upon closure of a Chapter 13 case by the bankruptcy court, the CIO makes any necessary account adjustments and closes the case on AIS. Generally, the CIO works Chapter 7 Asset business and individual cases transferred to them by FI after the initial case review has been completed, all proofs of claim have been acknowledged and there are no issues that require the case to remain in FI.
2. FI completes the initial case review in Chapter 13 cases and ensures that any required proofs of claim are completed and acknowledged. If there are no field issues, the case is generally transferred to CIO to monitor for confirmation. Similar to the Chapter 13 case, FI works Chapter 7 Asset cases and transfers most Chapter 7 Asset cases to the CIO once there are no issues that require the case to

remain in FI. This includes completing all proofs of claim, ensuring all proofs of claim are acknowledged, ensuring the Trust Fund Recovery Penalty (TFRP) investigation is completed (when required), etc. The Chapter 7 Asset case of a partnership is not transferred to CIO. The partnership case must remain in FI. FI takes all case actions in Chapter 11 and Chapter 12 cases, except for those actions taken at case closure by CIO. (See IRM 5.9.17.21.1, *MFT 31 Mirror Modules*, and IRM 5.9.17.23(1), *Addressing Prior Installment Agreements*, for additional information.) FI caseworkers review schedules and plans in Chapter 13, Chapter 11, and Chapter 12 cases, make referrals to Counsel in all chapters, appear in court as expert witnesses, attend § 341 meetings, participate in outreach efforts, and negotiate with debtors or their representatives. FI makes collection determinations and pursues collection from exempt, abandoned or excluded property in certain large dollar Chapter 7 No asset cases. Additionally, FI handles all aspects of receiverships, Chapter 9 and Chapter 15 cases.

CIO will refer more complicated matters to the local field office of the IRS to handle Because of the division in the work, you need contact information for both CIO and the local field office of the IRS.

Contact information for CIO is listed in IRM 5.9.1.4(2)(3) as: follows:

A toll-free number (1-800-973-0424) has been established at the CIO in Philadelphia to handle most Chapter 7 and Chapter 13 bankruptcy inquiries. (See IRM 5.9.19, Insolvency Disclosure and Telephone Procedures.)

Calls coming into an IRS Insolvency Unit or Field Operation will be worked until actions are completed for:

- Chapter 9, 11, and 12 cases;
- Chapter 7 Asset cases in Field Operation inventory;
- Chapter 13 cases currently assigned to a Field Operation group; and
- Complex cases identified in paragraph (3) of IRM 5.9.1.4 or non-complex cases identified in paragraph (4) of IRM 5.9.1.4.

Field Operations will generally refer all other cases to the CIO.

We provide the following as a list of potentially useful contacts for the local Insolvency Unit or Field Operation of the IRS:

Ken Walker, IRS Insolvency Chief, Salt Lake City, UT, Tel. No. 801-799-6717

Dawna Hill, IRS Insolvency Specialist, Salt Lake City, UT, Tel No. 801-799-6908

MaryAnne Proestakis, IRS Insolvency Specialist, Salt Lake City, UT, Tel No. 801-799-6910

3. Impact of local rules on debtors and the tax authorities

There are many instances where bankruptcy practitioners will need to give notice to the IRS. You should remember the requirements of the local rule on notice.

Local Rule 2002-1, Notice to Creditors and other Interest Parties (2014)

> (h) Notice to Certain Governmental Entities. In addition to all other notice requirements found in the Federal Rules of Bankruptcy Procedure, when notices are required to be sent to the Internal Revenue Service, the Utah State Tax Commission, the Utah Department of Workforce Services, or the Office of Recovery Services, notices should be mailed or delivered to addresses listed on the court's website, www.utb.uscourts.gov.

The Utah Bankruptcy Court website lists the IRS address as:

> Internal Revenue Service
> Centralized Insolvency Operation
> P.O. Box 7346
> Philadelphia, PA 19101-7346

However, you should not forget the requirements of Fed. R. Bankr. P. 7004 and 9014 and Fed. R. Civ. P. 4(i) dealing with the service of process on the United States and its agencies, corporations, officers or employees. In a contested matter or adversary proceeding, you should serve:

> The United States Attorney's office;
>
> The Attorney General of the United States in Washington, D.C.;
>
> And if the action challenges an order of a nonparty agency or officer of the United States, then a copy must be mailed by registered or certified mail to the agency or office;
>
> If any agency is involved, then a copy of the summons and complaint must be mailed by registered or certified mail to the agency.

The United States Attorney's Office address is now located at:

> 111 South Main Street
> Suite 1800
> Salt Lake City, Utah 84111-2176
> Phone: (801) 524-5682

See www.justice.gov/usao-ut/contact-us to verify the current address.

The general address for the Tax Division of the Department of Justice as found at https://www.justice.gov/tax/contact-division is:

Tax Division
U.S. Department of Justice
950 Pennsylvania Avenue, NW
Washington, D.C. 20530-0001

The Western Region of the Tax Division provides legal service for the Department of Justice in Utah. The Department of Justice, Tax Division, Western Region, has the following contact information.

Mailing address:	P.O. Box 683 Benjamin Franklin Station Washington, D.C. 20044
Courier address:	JCB Building, Room 7907 555 4th Street, N.W. Washington, D.C. 20001
Phone:	(202) 307-6413
Fax:	(202) 307-0054

You may need a contact at the United States Attorney's Office related to a bankruptcy case. The best contacts there at this time are:

Dan Price, telephone no. (801) 524-5682

Jared Bennett, telephone no. (801) 524-5682

Allison Moon, telephone no. (801) 524-5682

You may also need a contact at the Office of Chief Counsel for the Internal Revenue Service. At present, the main contact for bankruptcy issues in that office is Senior Attorney R. Craig Schneider, telephone no. (801) 799-6624

II. Tax liens and their impact in bankruptcy cases

A. Federal tax liens

For those new to the federal tax lien, the most difficult conceptual problem centers on the distinction between the federal tax lien (FTL) and the notice of federal tax lien (NFTL). The FTL exists whenever the Service assesses a tax, issues a Notice and Demand for payment of the tax and the taxpayer fails to pay the tax. The FTL does not depend upon notice to anyone other than the taxpayer. The NFTL, on the other hand, provides notice to the world that the FTL exists. Providing this notice carries importance when the NFTL competes against certain other creditors of the taxpayer but does not enhance the scope or power of the lien.

The Internal Revenue Service has a general statutory lien upon all property of a taxpayer once three events occur:

(1) assessment of federal taxes (e.g., filing a tax return, examination assessment, etc.);
(2) issuance of notice and demand for payment of the assessed taxes; and,
(3) failure to pay the taxes after notice and demand. See I.R.C. § 6321.

it is almost always true that an FTL exists whenever a taxpayer's account shows a balance due.

In order for the FTL to have priority as to certain third parties and to give the IRS secured status in bankruptcy, the IRS must perfect the FTL by filing a NFTL. See, I.R.C. § 6323(f). The NFTL gives notice to the world of the existence and the details of the taxpayer's outstanding federal tax obligations.

I.R.C. § 6323(f) provides that notices of federal tax liens shall be filed for both real and personal property in one office within the state in which the property is situated. UTAH CODE ANN. § 38-6-1 provides that notices of federal tax lien shall be filed in the office of the county recorder of the county in which any property subject to such lien is situated. For purposes of the federal tax lien, real property is located at its physical location. I.R.C. § 6323(f)(2)(A). For purposes of the federal tax lien, personal property is located at the residence or principal place of business of the taxpayer at the time the notice of tax lien is filed. I.R.C. § 6323(f)(2)(B). The federal law as embodied in I.R.C. § 6323 preempts state law as to the perfection of a federal tax lien. In re Williams, 16 B.R. 95, 96 (Bankr. E.D. Cal. 1981). Also see, United States v. National Bank of Commerce, 472 U.S. 713, 722 (1985); Drye v. United States, 528 U.S. 49, 58 (1999); United States v. Craft, 535 U.S. 274, 283 (2002).

There are many unusual aspects of how the federal tax lien works in the bankruptcy context. For example:

1. Preferences: Although the notice of federal tax lien of the Internal Revenue Service was filed within ninety days of the bankruptcy petition date, the filing of this statutory lien is not a preference. See, 11 U.S.C. § 547(c)(6). See, In re Carolina Resort Motels, Inc., 51 B.R. 447, 451 (Bankr. S.C. 1985); In re Borck, 81 B.R.142 (Bankr. S.D. Fla. 1987); In re Totten, 82 B.R. 402 (Bankr. W.D. Pa. 1988).

2. Homestead. Property claimed as homestead exemption remains subject to the FTL. See 11 U.S.C. § 522(c)(2)(B). See Forrest v. Internal Revenue Service (In re

Forrest), 98-1 U.S.T.C. ¶ 50,391 (10th Cir. BAP 1998)(11 U.S.C. § 522(c)(2)(B) prohibits the avoidance of a prepetition tax lien on property claimed exempt by the debtor, even if the lien would otherwise have been avoidable under 11 U.S.C. § 522(h))

3. Hypothetical BFP. Most courts have not allowed trustees to use the hypothetical bona fide purchaser status under 11 U.S.C. § 545(2) to avoid perfected federal tax liens under the provisions of I.R.C. § 6323. See In re Walter, 45 F.3d 1023 (6th Cir. 1995) (trustee had notice of the lien before taking possession of the vehicle; court refused to impute characteristics of the trustee, debtor or debtor-in-possession to the hypothetical bona fide purchaser); In re Janssen, 213 B.R. 558 (BAP 8th Cir. 1997) (trustee powers under section 545(2) as a hypothetical bona fide purchaser do not meet the requirements of I.R.C. § 6323); United States v. Battley (In re Berg), 188 B.R. 615 (BAP 9th Cir. 1995), aff'd 121 F.3d 535 (9th Cir. 1997) (I.R.C. § 6323 requires a higher standard than the "for value" given by section 545 and cannot be used by trustees to avoid federal tax liens).

4. Simultaneous attachment. When the NFTL and another lien attach simultaneously, the NFTL takes precedence. United States v. McDermott, 507 U.S. 447 (1993).

Like other secured creditors, the United States is entitled to adequate protection on its secured claims, even when those claims arise in bankruptcy as a result of federal tax liens. United States v. Whiting Pools, Inc., 462 U.S. 198, 209 (1983). Determinations of adequate protection involve questions of facts which an appellate court will review under the clearly erroneous standard. In re O'Conner, 808 F.2d 1393, 1397 (10th Cir. 1987). Once the creditor establishes its status as an undersecured creditor, the debtor has the burden to establish that the collateral is necessary to an effective reorganization. This requires a showing of a reasonable possibility of a successful reorganization within a reasonable time. Coones v. Mutual Life Insurance Company of New York (In re Coones), 168 B.R. 247, 259 (D. Wyo. 1994), aff'd without opinion 56 F.3d 77 (10th Cir. 1995).

There are many other possible issues involving federal tax liens, but inadequate time to address them.

III. Tax determinations while a case is pending in bankruptcy court

A. The bankruptcy court is authorized under Bankruptcy Code § 505(a)(l) to rule on the merits of any tax, any fine or penalty relating to a tax, and any addition to tax incurred by the debtor or the bankruptcy estate. This authority applies whether or not the tax, penalty, fine, or addition to tax has been previously assessed.

1. This provision is described in the legislative history as permitting a "determination by the bankruptcy court of any unpaid tax liability of the debtor." S. Rep. 989, 95th Cong., 2d Sess. 67, reprinted in USCCAN 5787, 5853.

2. Two policies underlie section 505.

a. First, it allows prompt resolution of a debtor's tax liability, where the liability has not been determined prior to the bankruptcy proceeding, so that the bankruptcy case can be efficiently administered. Stevens v. United States, 210 B.R. 200 (Bankr. M.D. Fla. 1997); In re D'Alessio, 181 B.R. 756 (S.D. N.Y. 1995). "Congress wanted to provide a forum for the quick resolution of disputed tax claims in order to avoid any delay in the conclusion of the administration of the estate." Stevens, supra, 210 B.R. at 202.

b. Second, section 505(a) protects creditors from the dissipation of the estate's assets which could result if the debtor failed to challenge a tax authority's claim. In re Vendell Healthcare, Inc., 222 B.R. 564 (Bankr. M.D. Tenn. 1998); In re Penking Trust, 196 B.R. 389 (Bankr. E.D. Tenn. 1996).

B. Bankruptcy court as an alternative tax forum.
Section 505(a) provides taxpayers in bankruptcy with an alternative prepayment forum to the Tax Court and is an exception to the Flora rule requiring full payment of the tax prior to non-Tax Court litigation.

1. The merits of the debtor's tax liability may be raised in two ways.

a. Most typically, the debtor or trustee may object to the Service's proof of claim pursuant to section 502.

b. Second, the debtor may seek a determination of tax liability in the absence of objecting to a claim pursuant to the authority of section 505(a). The debtor may seek to do this in order to resolve the merits of a nondischargeable tax for which the Service has not filed a proof of claim.

2. The jurisdiction of the bankruptcy court over the debtor's income tax liabilities is generally concurrent with that of the Tax Court. United States v. Wilson, 974 F.2d 514 (1992), cert. denied 507 U.S. 945 (1993). Because section 362(a)(8) stays the commencement or continuation of Tax Court proceedings involving the debtor, the bankruptcy court has the power to rule on the tax liability itself, or to

abstain from considering the tax liability and permit the Tax Court case to proceed either during the bankruptcy case or after the bankruptcy case is closed. See Wahlstrom v. Commissioner, 92 T.C. 703 (1989).

a. A final determination in one forum will be res judicata as to the tax liability in the other forum. Gould v. United States, 229 F.3d 1142, published at, 2000 WL 1233583, 86 AFTR2d ¶ 5958 (4th Cir. 2000), cert. denied, 531 U.S. 1193 (2001) (bankruptcy court approved settlement has res judicata effect in subsequent refund suit); Baker v. IRS (In re Baker), 74 F.3d 906 (9th Cir. 1996), cert. denied 517 U.S. 1192 (1996); In re Doerge, 181 B.R. 358 (Bankr. S.D. Ill. 1995); Freytag v. Commissioner, 110 TC 35 (1998).

b. After a res judicata determination of the merits of the tax liability of the debtor by the bankruptcy court, the Service may immediately make an assessment of a deficiency. I.R.C. § 6871(b)(2).

c. A final determination in Tax Court does not preclude the bankruptcy court from determining whether the tax liability is dischargeable under section 523, since dischargeability is a separate matter from the merits of the tax liability. In re Doerge, 181 B.R. 358 (Bankr. S.D. Ill. 1995).

IV. Discharge of taxes in bankruptcy

A debtor's entitlement to a discharge (barring further collection against debtor and resulting in a "fresh start") is governed by the specific provisions of the chapter under which the case is filed. Generally, the discharge provisions are sections 727, 1141, 1228 and 1328.

Although a debtor receives a discharge, particular debts may be excepted from discharge and deemed nondischargeable. Section 523(a) excepts certain debts from the discharge granted under section 727, 1141, 1228 or 1328. A discharge granted under these sections will not discharge a debtor who is an individual from the types of debt listed in section 523(a). There are 21 categories of debt excepted from discharge under section 523(a).

A. Collection after Abatement

1. Section 524(a)(2) provides that a discharge operates as an injunction against the commencement or continuation of an action, the employment of process, or any act to collect, recover or offset any discharged debt as a personal liability of the debtor, whether or not discharge of such debt is waived. The discharge does not extinguish the liabilities themselves and is not a finding that the discharged liabilities are improper. Johnson v. Home State Bank, 501 U.S. 78, 84 (1991)(mortgage liability discharged in Chapter 7 still a claim in subsequent chapter 13); see also In re Conston, 181 B.R. 769, 773 (D. Del. 1995)(priority tax claims could retain priority status in second Chapter 11 case).

2. Generally, the IRS adjusts (abates) tax accounts that are discharged except in cases with possible collection from exempt, excluded or abandoned property. Circumstances may cause the collection of discharged taxes to become feasible at a later time and so require the re-creation of a balance due on the taxpayer's account, as where the Service discovers property to which the tax lien remains attached, or new facts showing that the tax was excepted from discharge.

3. It is the Service's position that section 6404(c) abatements made after a bankruptcy discharge do not invalidate otherwise proper assessments, or extinguish otherwise proper liabilities, and that the abatement can be reversed if it is later discovered that the tax could be collected. Chief Counsel Notice 2001-014, 2001 WL 34771232.

4. In In re Range, 2002-2 USTC ¶ 50,662 (5th Cir. 2002), the debtors argued that because their tax liability was discharged in bankruptcy and subsequently abated, there was no tax liability remaining for the Service to collect. The Fifth Circuit rejected this argument, noting that the abatement of taxes executed outside the scope of statutory authority conferred by I.R.C. § 6404(a) is not effective. Accordingly, the court held that because the liability was nondischargeable under

section 523(a)(1)(C) and no valid authority existed for the Service to abate the taxes, the liability was not discharged and remained a valid debt subject to collection.

B. Effect of Discharge on Tax Liens

Because a discharge is an injunction against the collection of a discharged debt as a personal liability of the debtor, the Service may still enforce a tax lien to the extent the federal tax lien survived the bankruptcy case.

1. Courts have rejected the argument that I.R.C. § 6325(a)(1) requires the Service to release valid tax liens when the underlying tax debt was discharged. See In re Isom, 901 F.2d 744 (9th Cir. 1990) (while a discharge prevents the Service from taking any action to collect the debt as a personal liability of the debtor, the debtor's property remains liable for a debt secured by a valid tax lien); United States v. Uria, 180 B.R. 688 (S.D. Fla. 1995) (where there was evidence of equity to which the federal tax liens could attach, court determined that the liens were enforceable against the liened property and survived the discharge); In re Quillard, 150 B.R. 291, 295 (Bankr. D.R.I. 1993) (Service's lien creditor status as to debtors' IRAs remained unchanged as a result of the debtors' bankruptcy since a discharge does not affect valid prepetition bankruptcy liens); In re Dillard, 118 B.R. 89, 93 (Bankr. N.D. Ill. 1990) ("An obligation is in fact not 'unenforceable' after discharge if the secured creditor can still collect it by pursuing the liened property").

2. Case law establishes that, with respect to a discharged tax liability, the federal tax lien survives the discharge only to the extent of attaching to property held by the debtor as of the commencement of the bankruptcy case. See, e.g., United States v. Sanabria, 424 F.2d 1121 (7th Cir. 1970); In re Dishong, 188 B.R. 51 (Bankr. M.D. Fla. 1995); In re Olson, 154 B.R. 276, 282 (Bankr. D.N.D. 1993).

C. Effect of Discharge on Third Parties

1. Section 524(e) provides: Except as provided in subsection (a)(3) [dealing with certain claims against community property], discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.

2. The debtor's discharge from liability for federal taxes does not preclude the Service from attempting to collect taxes from a fraudulent transferee of the debtor. See Kathy B. Enterprises, Inc. v. United States, 779 F.2d 1413 (9th Cir. 1986).

D. Violation of Discharge Injunction

1. I.R.C. § 7433(e) allows a taxpayer to petition the bankruptcy court for damages as a result of the Service's willful violation of the discharge injunction. A violation that is not willful may become so if not corrected within a reasonable time. See In re Price,

42 F.3d 1068, 1071 (7th Cir. 1994) (the Service's failure to halt further collection activities after notice of the bankruptcy constituted a willful violation of the automatic stay).

2. Section 7433(e)(2)(A) provides that the section 7433(e) petition is the exclusive remedy for the recovery of damages for such actions, notwithstanding the bankruptcy court's contempt powers under section 105 of the Bankruptcy Code. Section 7433(b) provides that in any action under section 7433(e), the defendant shall be liable for actual, direct economic damages and costs of the action subject to certain limitations (one million dollars, or $100,000 in case of negligence).

Section 7433(d) provides that damages may not be awarded under section 7433(b) unless the court determines that the plaintiff exhausted administrative remedies with the Service. A debtor therefore has to exhaust administrative remedies with the Service before damages can be recovered for violations of the discharge injunction. See Treas. Reg. §. 301.7433-2 (civil cause of action for violation of section 362 or 524 of the Bankruptcy Code).

See also Treas. Reg. § 301.7430-8 (administrative costs incurred in damage actions for violations of section 362 or 524 of the Bankruptcy Code)

3. A petition for damages under section 7433(e) must be filed in Bankruptcy court within two years after the date the cause of action accrues. I.R.C. § 7433(d)(3); Treas. Reg. § 301.7433-2(g). The Seven Circuit held that when the Service made a number of attempts to collect a debt in violation of the discharge injunction, each discrete collection attempt being a separate violation. Kovacs v. United States, 614 F.3d 666, 676 (7th Cir. 2010).

4. Section 524(i) provides that a creditor that willfully fails to credit payments received under a confirmed plan is considered to have violated the discharge injunction under section 524(a)(2) if the creditor's action caused material injury to the debtor. Section 524(i) does not apply if the order confirming the plan is revoked, the plan is dismissed, or the creditor has not received payments in the manner required by the plan.

5. In re Lovato, 203 B.R. 747 (Bankr. D. Wyo. 1996), the Service violated the discharge injunction by freezing a post-bankruptcy refund to collect discharged debt.

V. Questions

NOTE: The materials in this outline are the responsibility of Mark H. Howard. However, I wish to give attribution for portions of the materials which I used from training materials available to attorneys for the Office of Chief Counsel for the Internal Revenue Service.