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President Signs Bankruptcy Reform Act— Tax Provisions Impact Priorities and Procedures

The biggest bankruptcy reform bill since 1978 was signed into law by President George W. Bush at a White House ceremony on April 20. The most prominent change made by the new law is the addition of “means testing.” Individuals with incomes above a certain threshold would be forced to file under Chapter 13 debt repayment rather than Chapter 7 bankruptcy. However, the tax consequences of the new law—while not in the limelight—are also significant. This Briefing highlights the impact of those changes.

The House of Representatives approved the final bankruptcy reform bill, the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* (S. 256), on April 14 by a vote of 302-126. Since the Senate already approved the bill on March 10, it went straight to the White House for President Bush’s signature.

On the tax front, the reform package makes some important changes in how tax obligations are treated. It does away with the so-called “superdischarge” in Chapter 13 plans. It also changes the priority of taxes during bankruptcy proceedings and the subordination and nondischargeability of certain types of taxes. Procedural changes, such as new notice requirements, also are put into place.

All of these changes are found in the Bankruptcy Code, however, and not in the Internal Revenue Code. Outside of the new law’s formal “tax title,” other changes, such as bankruptcy protection for all tax-favored retirement accounts, also make a significant impact on taxpayers.

Discharge & Priorities

“Discharge” is the most important word in the bankruptcy universe and alleged abuse has fueled support for reform. Discharge is the release of a debtor from personal liability for debts. However, not all debts are dischargeable. Attaining priority is also a matter of timing. Generally, tax debts incurred within three years of filing for bankruptcy are given priority status.

Superdischarge in Chapter 13

Under the prior scheme, some courts have allowed debtors, who have not filed tax returns, to discharge taxes under a Chapter 13 plan. Some courts have also allowed debtors to discharge taxes due within three years of the date of the bankruptcy petition or assessed within 240 days under a Chapter 13 plan. This option, not available to Chapter 7 filers, came about because of inconsistencies in the Bankruptcy Code. Failure to file a return or untimely filing generally makes a tax liability nondischargeable under Chapter 7. However, some bankruptcy courts have held that this rule does not apply in Chapter 13 filings.

The same conflict also has arisen concerning fraudulent returns. Tax debts from fraudulent returns, manifesting fraudulent activities, are nondischargeable in Chapter 7. However, some courts have allowed them to be discharged under a Chapter 13 plan. Again, the two Chapters have treated the same items inconsistently and debtors could avoid taxes, which would be granted priority status under Chapter 7, by filing under Chapter 13. These practices became known as “superdischarge.”

Under the reform measure, superdischarge is no longer allowed. Taxes resulting from failure to file a return, untimely filing of a return, or fraudulent filing of a return will not be dischargeable under a Chapter 13 plan. In addition, nonfraudulent tax claims entitled to priority under 11 U.S.C. Section 507(a) also will be nondischargeable. The playing field between Chapter 7 and Chapter 13 will be leveled.

Ad Valorem Tax Liens

The reform legislation gives more protection to ad valorem tax liens on a bankruptcy estate. Ad valorem taxes are assessed on the value of real or personal property of the estate. Under the measure, subordination of ad valorem tax liens will be limited. Subordination means the rearrangement of the priorities of creditors’ claims so that some claims have a lower priority than others.

Subordination of ad valorem tax liens will be allowable only to pay for administrative expenses under Chapter 7, and in the business context, to pay priority wage claims and priority claims for contributions to employee benefit plans. However, before the lien can be subordinated, the Chapter 7 trustee must exhaust unencumbered assets and recover costs and expenses under 11 U.S.C. Section 506. Subordination will not be allowed to pay administrative expenses under Chapter 11.

The reform package also puts a stop to the practice by bankruptcy courts of determining the amount of ad valorem liability late in the process. Some debtors were successfully petitioning the courts to determine these amounts, even when the time for contesting them had expired. Now, the amount cannot be determined by the bankruptcy court if the applicable period for contesting that amount under nonbankruptcy law has expired.

Late filing of priority tax claims

Tax claims that are filed late generally lose their priority status and, consequently, become more difficult to collect. In many cases, tax claims were filed before the bankruptcy trustee began distribution of the estate but were still deemed late by the courts. The new law protects the priority status of tax claims by providing that a priority tax claim may be filed within a larger window of time: before the trustee begins final distribution or 10 days following the mailing to creditors of the summary of the trustee's final report, whichever is earlier.

Tolling of priority tax claims

The reform package clarifies and expands the cut-off date for tax claims to attain priority status. The usual deadline set for the priority of income tax claims covers tax returns due within three years of the filing of the bankruptcy petition and tax assessments made within 240 days of filing the petition. The new law tolls and adds 30 days to the 240-day period for any offer in compromise pending or in effect during that 240-day period. It also tolls and adds another 90 days to the 240-day period and to the three-year period for any previous bankruptcy case pending during the three-year or 240-day period. Also to the IRS's benefit the new law tolls the priority, plus 90 days, while the taxpayer is requesting a hearing or appeal of any collection action under the collection due process provisions of the Internal Revenue Code.

Payment/Compliance

Interest rate

The new law simplifies the calculation of interest on tax claims (federal, state and local) by generally imposing a single and uniform interest rate for the computation of all taxes due. The minimum rate of interest is the rate determined under nonbankruptcy law. For federal tax purposes, the minimum rate is the federal short-term rate rounded to the nearest full percent plus three percentage points.

Tax Compliance

Taxpayers will be searching for and providing more paperwork to the courts under the reform package. Individuals seeking protection under Chapter 13 will be required to file all prepetition tax returns for the four-year period preceding the filing of the petition. If the returns are not filed by the date on which the meeting of creditors is first scheduled, the trustee can hold open the meeting for a reasonable period of time to allow the debtor to file any unfiled

returns. The additional period of time, however, may not be longer than 120 days after the date of the meeting of the creditors or, for returns that are not past due on the petition date, also beyond the date on which the return is due under the last automatic extension of time for filing. Nevertheless, the debtor may obtain from the court an extension of time beyond that set by the trustee if the debtor demonstrates by a preponderance of the evidence that the failure to file was attributable to circumstances beyond the debtor's control. Sanctions for failing to file the required returns include conversion of the Chapter 13 case to a case under Chapter 7 or even dismissal of the case.

Another provision of the reform package impacts the status of tax returns filed by the government on behalf of taxpayers. A return, which is filed by the IRS under Code Sec. 6020(a) on behalf of a taxpayer who has provided enough information to complete it, will constitute the filing of a return for discharge purposes. However, the rule will not apply to returns based on information obtained through testimony or otherwise under Code Sec. 602(b). The same rules apply to returns filed under state or local law.

The reform package also provides that a taxing authority may request that the bankruptcy court dismiss or convert a case if the debtor fails to file a postpetition tax return or obtains an extension. If the debtor fails to file or obtain an extension within 90 days, the court must convert or dismiss the case, whichever is in the best interest of creditors and the estate.

Periodic Payments

The reform measure provides tax claims with greater priority as to payment plans. Generally, payment of

priority tax claims under Chapter 11 must be made within five years after the date of the order for relief and must not be less favorable than the most-favored nonpriority unsecured claim provided for the plan. The reform legislation would prohibit balloon payments. The reform package also will require that tax payments be at least substantial and proportionate to all payments made to other creditors.

Payment of taxes

The payment of regular tax obligations by the bankruptcy trustee will become more likely with the addition of some new requirements. A trustee, and a Chapter 11 debtor in possession, will be required to pay postpetition tax obligations as they come due in the course of business. However, payment may be deferred in the case of Chapter 7 filings if the court determines that the estate has insufficient funds or if the tax was not incurred by the trustee. Certain secured and postpetition unsecured taxes, including property taxes, will be entitled to administrative expense priority.

Effective Dates

Most tax provisions in the new bankruptcy reform law are effective 180 days after enactment (measured from the April 20 date on which the President signed the bill), pushing the effective date to October 17, 2005. This creates a six month window to file for bankruptcy protection under the current bankruptcy rules. However, many provisions within the tax title provide a “clarification” of existing rules and, therefore, carry much weight as to how a court should interpret the law—both for and against taxpayers—before the 180-day period elapses. In addition, some issues are so pressing that at least partial resolution will be found in the courts before the new law becomes fully effective.