

TREATMENT OF TAX LIABILITIES AND LIENS IN BANKRUPTCY

Presented By
JOHN AKARD, JR., J.D., CPA

36th Annual Jay L. Westbrook
Bankruptcy Conference
Austin, Texas

November 17, 2017

I. Bankruptcy Overview

Effective October 1, 1979, the Bankruptcy Reform Act of 1978 (the “Bankruptcy Code”) amended and substantially revised the previous bankruptcy law. Effective October 17, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) further substantially revised the Bankruptcy Reform Act providing certain “anti-abuse” provisions and making it more difficult for consumers to qualify to file Chapter 7 liquidation cases. Bankruptcy relief is afforded to individual filers under Chapters 7 (liquidation), Chapter 13 (adjustment of debts), and Chapter 11 (reorganization), while businesses are generally relegated to Chapter 7 or Chapter 11 proceedings.

Individual debtors generally seek a discharge from dischargeable debts under a liquidation or plan approved by a court and businesses look to liquidate in whole or in part and become entitled to a discharge upon confirmation of a Chapter 11 Plan. An automatic stay of collection actions by creditors (including the IRS) is immediately entered in most cases upon the filing of a petition for relief with the Bankruptcy Court with only a few exceptions (collection of domestic support, paternity, child custody/visitation) and will remain in effect unless relief is granted from the stay by the court under certain circumstances. (11 U.S.C. §362).

A. Chapter 7 – Liquidation (11 U.S.C. §701 et. seq.)

Chapter 7 is available to individuals and businesses other than railroads, insurance companies, banks, credit unions, small business investment companies and similar organizations which are created and dissolved under separate Federal or State laws. (11 U.S.C. §109(b)). However, individuals with primarily consumer debts [more than 50% of their total debt is consumer debt (includes personal mortgage debt)] are subject to having their case dismissed (or converted to a Chapter 13 or 11 case with debtor’s consent) if granting the discharge is determined to be an abuse – not meeting the “Means Test” discussed hereafter. (11 U.S.C. §707(b)(1)).

Under Chapter 7, the debtor will turn over to the bankruptcy trustee all non-exempt property (under the governing law - either federal bankruptcy exemptions or state exemptions available only to individuals, not corporations, LLCs, partnerships or other business entities, are applied to exclude exempt property from the bankruptcy estate). A trustee will have the right to take possession of and sell the remaining property (the “bankruptcy estate”) that is not exempt and use the sale proceeds to pay creditors according to rules of priority. After the bankruptcy

estate has been applied, remaining unsecured debts, which are dischargeable are discharged and the court will enter an order of discharge in this regard (usually within six months after the filing). Non-dischargeable debts for an individual debtor include certain taxes (to be discussed later), debts obtained through false pretenses, misrepresentations or actual fraud or with false financial statements made with the intent to deceive a creditor and upon which the creditor relied, embezzlement, larceny, or debts arising from willful or malicious injury, claims resulting from death or personal injury caused by a debtor's DUI, criminal restitution obligations, domestic support and property settlement obligations, most student loans unless undue hardship is shown, and government fines and penalties. (11 U.S.C. §523(a)).

BAPCPA imposed two thresholds to overcome for a debtor to be eligible to continue in a Chapter 7 and not be subjected to a motion to dismiss by the bankruptcy or United States Trustee. These include:

(1) The Median Income Test [11 U.S.C. §707(b)(6) & (7)]. Under this test, a debtor (or in a joint case, the debtor and the debtor's spouse) must show annualized "current monthly income" from all sources, excluding social security and unemployment compensation, based on the six-month period prior to filing, is less the Median Annual Income for the debtor(s) for the number of persons in their household supported by such income for debtor(s) particular state, as reported by the U.S. Census Bureau. If the debtor(s) income is less than the Median Annual Income for his state and family size, the Chapter 7 bankruptcy petition will not be presumed to be an abuse. (As of November 1, 2017, the Median Annual Family Income for a one, two, three or four-person household in Texas is \$46,253, \$61,831, \$67,849 and \$76,933, respectively.)

(2) The Means Test (11 U.S.C. §707(b)(2)). An abuse of Chapter 7 is presumed if the debtor's "current monthly income," reduced by expenses hereinafter listed, multiplied by 60 months, exceeds the lesser of (as of November 1, 2017):

- (a) 25% of the debtor's non-priority unsecured debts, or \$7,770, whichever is greater; or
- (b) \$12,850.

In effect, if the debtor's gross monthly income in excess of allowed expenses is as little as \$214.16 per month, a Chapter 7 filing is presumed to be an abuse. On the other hand, a debtor is presumed eligible to file under Chapter 7 if his gross monthly income less allowed expenses are less than \$128.33.

The expenses allowed to be deducted from current monthly income to apply the means test include: [11 U.S.C. §707(b)(2)]

(a) Monthly expenses specified for allowable living expenses by the IRS (the National and Local Standards for debtor, dependents and spouse in the area of debtor's residence) for food, clothing, household supplies, personal care products and services and miscellaneous items;

(b) Mortgage/Rent and non-mortgage local housing and utilities per IRS Standards;

(c) Transportation expenses to include both operating costs and ownership costs for one or two automobiles in the family, or public transportation costs, per IRS Standards.

Notably, in Ransom v. FIA Card Services, N.A., (January 2011) 131 S.Ct. 716, the Supreme Court determined that without automobile purchase money loan or lease payments, a debtor cannot claim the IRS standard allowance of vehicle-ownership costs, only the operating cost allowance to include insurance, maintenance, fuel, etc.

(d) Other necessary expenses listed in the IRS Financial Analysis Handbook relating to support, health, and welfare of the family, and/or the production of income, including, federal, state and local taxes; accounting and legal fees; term life insurance payments; court-ordered payments; education for employment or for a physically or mentally challenged child; child care expenses; healthcare expenses not reimbursed by insurance; mandatory retirement contributions; union dues and uniform costs; cell phone, pagers, call waiting, caller identification, or internet services necessary for the health and welfare of family members, (www.irs.gov/irm/part5/ch15s01.html);

(e) Necessary health and disability insurance and health savings account expenses for the debtor, spouse and dependents;

(f) Actual expenses for care and support of an elderly, chronically ill, or disabled household member of debtor's immediate family including parents, grandparents, siblings, children and grandchildren of the debtor, the dependents of the debtor and the spouse of a debtor in a joint case and who cannot pay such expenses;

(g) Actual expenses for each dependent child under age 18, not exceeding \$1,925 per year, per child to attend private or public elementary or secondary school;

(h) An allowance for housing and utility costs in excess of IRS Standards if debtor can document actual expenses exceeding such standards;

(i) Monthly charitable contributions actually paid on a continuous basis;

(j) Monthly payments on secured debts due more than 60 months after the petition;

(k) Secured debts payable within 60 months after the petition date, divided by 60;

(l) Expenses for payment of all priority claims (including priority child support and alimony and priority tax debts) divided by 60.

**B. Chapter 13 – Adjustment of Debts of an Individual with Regular Income.
(11 U.S.C. § 1301 et seq.)**

Chapter 13 is designed for individuals with regular income who can pay all or a part of their debts in monthly installments over a 36 to 60-month period. Originally considered an alternative to Chapter 7 liquidation, it is now the necessary chapter for debtors seeking bankruptcy relief who cannot meet the Chapter 7 Median Income or Means Test.

To be eligible to file for Chapter 13 relief, an individual (and such individual's spouse) with regular income must have non-contingent, liquidated, unsecured debts less than \$394,725 (as of November 1, 2017) and non-contingent, liquidated, secured debts of less than \$1,184,200

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](http://utcle.org/elibrary)

Title search: Treatment of Tax Liabilities and Liens in Bankruptcy

Also available as part of the eCourse

[2017 Hot Topics in Consumer Bankruptcy](#)

First appeared as part of the conference materials for the
36th Annual Jay L. Westbrook Bankruptcy Conference session
"Tax Treatment"