

PRESENTED AT

**38th Annual Jay L. Westbrook
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PRIMER ON DISCHARGING IRS DEBT IN BANKRUPTCY

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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 below. (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 (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, 2019, the Median Annual Family Income for a one, two, three or four-person household in Texas is \$49,996, \$65,708, \$72,632 and \$84,724, 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 April 1, 2019):

- (a) 25% of the debtor's non-priority unsecured debts, or \$8,175, whichever is greater; or
- (b) \$13,650.

In effect, if the debtor's gross monthly income in excess of allowed expenses is as little as \$227.50 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 \$136.25.

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

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