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THE IRS, TAXES & BANKRUPTCY: CLAIMS & DISCHARGE OR NOT

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Notice & Service – The United States and state governmental units designate service addresses on a mailing register kept by the Clerk of Court. (*See* Federal & State Agencies – BR 5003(e) under the General Info tab on the USBC WDMI site.) Service may be made by first class mail postage prepaid as follows: "[u]pon the United States, by mailing a copy of the summons and complaint to the civil process clerk at the office of the United States Attorney for the district in which the action is brought and by mailing a copy of the summons and complaint to the Attorney General of the United States at Washington, District of Columbia, and in any action attacking the validity of an order of an officer or agency of the United States not made a party, by also mailing a copy of the summons and complaint to that officer or agency." Fed. R. Bankr. P. 7004(b)(4). *See* Fed. R. Bankr. P. 7004(b)(5) for service upon any officer or agency of the United States. Contested matters are served in the same manner as an adversary proceeding under Rule 7004. In short, Rules 9014(b) and 7004(b)(4) provide that motions brought in contested matters must be served by mailing a copy of the motion to the particular agency, the local United States Attorney's Office and the Attorney General of the United States. "Notice or knowledge of an Assistant United States Attorney cannot, as a general proposition, be imputed to the particular agency to which a debt is owing." *United States, Small Business Administration v. Bridges*, 894 F.2d 108, 112 (5th Cir.1990) (holding that notice or actual knowledge of one United States government agency will not be imputed to another agency).

Practice Pointers

- Where the IRS is a creditor, provide notice to the IRS at its designated addresses.
- Where another federal agency is a creditor, provide notice to the agency and the United States Attorney.

[1] This is not an official statement of the United States of America, United States Attorney's Office for the Western District of Michigan, United States Department of Justice, or Internal Revenue Service. The information contained herein is provided solely for informational purposes, it is not intended to be a complete overview of the subject matter, and it should not be construed as legal advice.

Acknowledgement: What Every Bankruptcy Practitioner Should Know About IRS, materials by Greg D. Stefan, retired Assistant United States Attorney, Eastern District of Virginia.

- Serve adversary proceedings on the agency (IRS if taxes are implicated), the United States Attorney, and the Attorney General.
- Serve contested matters (objections to claim, motions, plans, etc.) on the agency (IRS if taxes are implicated), the United States Attorney, and the Attorney General.
- Better Safe Than Sorry - Where the federal government is a creditor, list the IRS, U.S. Attorney, and Attorney General on the mailing matrix.
- Include both the U.S. Attorney and the Attorney General on your mailing matrix to ensure that service of a plan which significantly affects the interest of the United States (e.g., provides for the valuation of a secured claim, seeks an injunction, materially modifies terms of the form plan, etc.) is proper.

Secured Tax Claims – The IRS will assert two different types of secured claims in bankruptcy based upon (a) a federal tax lien, notice of which was properly filed and/or (b) a right of setoff. *See* Bankruptcy Code ("BC") 11 U.S.C. § 506(a)(1).

Federal Tax Lien. A statutory lien that arises automatically upon assessment of the underlying tax liability. 26 U.S.C. § 6321 (Internal Revenue Code or "IRC"). The lien arises on the date of assessment and attaches to all property and rights to property acquired by a taxpayer during the life of the lien. IRC §§ 6321, 6322. A tax lien encumbers both real and personal property. In *United States v. Craft*, 535 U.S. 273, 278 (2002), the United States Supreme Court determined that a federal tax against one spouse attached to the spouse's interest in property held as tenants by the entirety. The IRS is entitled to collect the value of the taxpayer spouse's interest (generally 50%) in the tenants by the entirety property. Joint and several tax liabilities assessed against a husband and wife (such as joint income tax liabilities and similar trust fund recovery penalties assessed pursuant to IRC § 6672) may be fully collected from tenants by the entirety property.

A tax lien continues "until the liability for the amount so assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time." IRC § 6322. Unless a tax liability is reduced to judgment, the IRS generally has 10 years from the date of assessment to collect it. IRC § 6502. However, the period for collection will be extended by certain events, such as the period during which the IRS is prohibited from collecting the tax liability because of a bankruptcy case, plus an additional six months. IRC § 6502(h)(2).

A federal tax lien does not have priority over any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until a notice of the federal tax lien has been filed. IRC § 6323(a). A bankruptcy trustee has the status of a bona fide purchaser for value. Therefore, a tax lien must be filed prior to the bankruptcy case for a tax lien to be valid in bankruptcy.

Section 6321 of the IRC provides for the imposition of a federal lien on "all property and rights to property" belonging to a delinquent taxpayer. Pursuant to Section 6322 of the IRC, such a tax lien arises automatically upon assessment and attaches to property owned or subsequently acquired by the taxpayer. *Glass City Bank v. United States*, 326 U.S. 265, 267-68 (1945). The scope of Section 6321 "is broad and reveals . . . that Congress meant to reach every interest in property that a taxpayer might have." *United States v. National Bank of Commerce*, 472 U.S. 713, 719-720 (1985). The priority of federal tax liens vis-a-vis other perfected liens generally is based upon the rule of "first in time is first in right." To compete successfully against a federal tax lien, a lien against a taxpayer's property must be "choate" when the tax lien arose. That is to say, the amount of the competing lien, the identity of the lienor, and the property subject to the lien must be specific and certain.

Practice Pointers

- The Trustee may avoid a federal tax lien if a notice of federal tax lien was not properly filed. 11 U.S.C. § 545(2).
- Exempt property remains subject to federal tax liens. 11 U.S.C. § 522(c)(2)(B).
- An ERISA qualified pension plan, being excluded from property of the estate, does not serve to secure an IRS claim in bankruptcy.
- The filing of a notice of federal tax lien is not avoidable as a preference. 11 U.S.C. § 547(c)(6).
- Chapter 7 debtors may not use 11 U.S.C. § 506(a) to avoid or strip down an under secured lien. *Dewsnup v. Timm*, 502 U.S. 410 (1991).
- Tax liens remain valid and attach to property acquired post-petition if the underlying tax is not discharged.
- The government is entitled to receive post-petition, pre-confirmation interest on its allowed, non-consensual, over-secured claim. *United States v. Ron Pair Ent., Inc.*, 489 U.S. 235 (1989).

Right of Setoff. In addition to being secured by tax liens, the IRS may be secured by the right of setoff. The IRS has both a common law and statutory right of setoff. *See* IRC § 6402 (statutory setoff right). Setoff is expressly authorized by 11 U.S.C. § 553. Section 553(a) allows a creditor to setoff a pre-petition claim owed by a debtor against a pre-petition debt owed by the creditor to the debtor. To be permitted to setoff under § 553, the debts must be mutual – that is owed by the same parties. There is mutuality between a tax liability and a tax overpayment. There also is mutuality between different federal agencies for setoff purposes.

A claim of exemption will generally trump a right of setoff. However, because of the reductions mandated by IRC § 6402, there is no property to exempt when a tax overpayment is reduced to pay other

debts owed for taxes or to other federal agencies. Every court that has considered the issue has held that setoffs effectuated under the Treasury Offset Program pursuant to IRC § 6402 have priority over a debtor's exemption rights with regard to a tax overpayment, because the debtor has no property to exempt in light of the reductions mandated by the IRC.

Practice Pointer

- The setoff of a pre-petition income tax refund against a pre-petition income tax liability does not violate the automatic stay. 11. U.S.C. § 362(b)(26). This exception only applies to income taxes.

Priority Tax Claims – The following federal government tax claims are entitled to 11 U.S.C. § 507(a)(8) priority status:

Three-Year Rule. Income taxes for which a return is last due, considering extensions, within 3 years of the date of the filing of the bankruptcy case. 11 U.S.C. § 507(a)(8)(A)(i). The operative date is the due date (as extended) for such return, not the actual filing date.

240 Day Rule. Income taxes assessed within 240 days of the petition date. 11 U.S.C. § 507(a)(8)(A)(ii). The 240-day period is extended in two situations. First, it is extended by the time that an offer in compromise was pending or in effect during the 240-day period, plus 30 days. Second, it is extended by the time a stay against collection proceedings was in effect during the 240-day period, plus 90 days.

Still Assessed Rule. If an income tax has not been assessed, but is still assessable, then it is entitled to priority status unless the statute of limitations is still open because of a late or unfiled return or the taxpayer's fraud. 11 U.S.C. § 507(a)(8)(A)(iii).

Withholding Taxes. A tax required to be collected or withheld and for which the debt is liable in whatever capacity is a priority tax claim. 11 U.S.C. § 507(a)(8)(C).

Employment Taxes – Three-Year Rule. Employment taxes for which a return is last due, considering extensions, within 3 years of the date of the filing of the bankruptcy case. 11 U.S.C. § 507(a)(8)(D). This category covers Form 940 and 941 taxes.

Excise Taxes. There are two types of excise taxes which are entitled to priority claim status: (1) excise taxes on pre-petition transactions for which a return is last due considering extensions within three years of the filing of the bankruptcy case, and (2) excise taxes for which a return is not required

and which relate to a transaction which occurred within three years of the filing of the bankruptcy case. 11 U.S.C. § 507(a)(8)(E).

Customs Duties. Certain customs duties are entitled to priority claims status. 11 U.S.C. § 507(a)(8)(F).

Compensatory Loss Penalties. A penalty related to a § 507(a)(8) claim that is compensation for actual pecuniary loss is entitled to priority claims status. 11 U.S.C. § 507(a)(8)(G).

Practice Pointers

- Amended § 507(a)(8) (hanging paragraph codifies and extends the Supreme Court's holding in *Young v. United States*, 535 U.S. 43 (2002) (serial bankruptcies toll tax priority time periods). Specifically, the time periods for determining whether a tax is a priority claim is tolled for the following time periods: 1) The time during which a collection due process request, hearing, and appeal prevented collection, plus 90 days; 2) The time during which the automatic stay was in effect or during which one or more confirmed plans prohibited collection, plus 90 days.
- Erroneous refunds have the same priority status as the tax to which they relate. 11 U.S.C. § 507(c).

Administrative Tax Claims – These are claims that arise during the pendency of the bankruptcy case. 11 U.S.C. § 507(a)(2). The claim is allowable under 11 U.S.C. § 503. Interest on administrative claims is an administrative expense. Penalties related to administrative taxes are also entitled to administrative priority. 11 U.S.C. § 503(b)(1)(C).

In Chapter 13, the IRS has the option of filing a claim under 11 U.S.C. § 1305(a)(1). The debtor does not have the option of filing a § 1305(a) claim on behalf of the IRS. The IRS makes its determination based upon the size of the claim, whether the IRS holds other pre-petition claims, the debtor's willingness to amend the plan to pay the §1305(a) claim, and the availability of other assets. If the IRS files a § 1305(a) claim, it is treated as a priority claim.

Discharge – The discharge of pre-petition debts which are not excepted from discharge by 11 U.S.C. § 523.

Chapter 7. Under Chapter 7, an individual receives a discharge for all pre-petition debts that are not excepted from discharge by 11 U.S.C. § 523. A debtor who is not an individual does not receive a discharge.

Chapter 11. Under 11 U.S.C. § 1141(d), an individual receives a discharge for all pre-petition debts which are not excepted from discharge by 11 U.S.C. § 523. A corporation or other entity that is not liquidating is eligible for a discharge.

Chapter 13 Hardship Discharge. Under 11 U.S.C. § 1328(b), a debtor who does not complete all payments under a plan is entitled to a hardship discharge if (1) the failure to complete the payments are due to circumstances for which the debtor should not be justly accountable, (2) the amount of property distributed under the plan equals or exceeds that which would have been distributed in a Chapter 7 case, and (3) modification of the plan is not practicable. If the requirements of § 1328(b) are met, a debtor receives a discharge of all debts except for those debts excepted from discharge by 11 U.S.C. § 523 or provided for in the plan pursuant to 11 U.S.C. § 1322(b)(5).

Chapter 13 Super Discharge. If the debtor completes his plan, 11 U.S.C. § 1328(a) provides that the debtor is discharged from all debts, except for certain excepted debts. The tax debts that are excepted from discharge include: 1) Obligations provided for under § 1322(b)(5). This exception would relate to pre-petition installment agreements that are assumed by the debtor. trust fund taxes, and tax liabilities which are based on a fraudulent tax return or which the debtor willfully attempted to evade or defeat.

11 U.S.C. § 523(a) - Tax Exceptions to Discharge.

1. Priority Tax Claims under 11 U.S.C. § 507(a)(8). 11 U.S.C. § 523(a)(1)(A).
2. Tax liabilities based upon unfiled tax returns. 11 U.S.C. § 523(a)(1)(B)(i). A return includes returns prepared under § 6020(a) of the IRC, but does not include returns prepared under § 6020(b) of the IRC.
3. Tax liabilities based upon tax returns that are filed late within two years of the date of the bankruptcy case. 11 U.S.C. § 523(a)(1)(B)(ii). When a case is converted, the original filing date, not the conversion date, is used in calculating the two-year period.
4. Tax liabilities which are based on a fraudulent tax return or which the debtor willfully attempted to evade or defeat. 11 U.S.C. § 523(a)(1)(C).
5. Penalties that relate to a nondischargeable tax and to a transaction that occurred within 3 years of the petition date. 11 U.S.C. § 523(a)(7).

Practice Pointers

- Pre-petition interest is nondischargeable if the underlying tax is nondischargeable.
- Post-petition interest and penalties on nondischargeable taxes, although not collectible during the bankruptcy case, may be collected from the debtor despite a discharge.

PRACTICE REFLECTIONS – THAT WAS THEN – THIS IS NOW

By Donna Justice[2]
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USAO – WDMI

1. When preparing a client for bankruptcy, you can obtain transcripts at www.irs.gov. Either search "transcripts" or use the URL: https://www.irs.gov/individuals/get-transcript. For pre-filing questions, call the IRS at (800) 829-1040. If the client is not already in bankruptcy, a Power of Attorney, on file at the IRS, is required to allow contact regarding the client-taxpayer.

2. If you contact the USAO regarding a case where we have not filed an appearance or pleading, we will send your email to IRS Insolvency and ask them to contact you, or to give us the information and authority to deal directly with you regarding the issue.

3. The Clerk of the Court maintains a list of federal agency addresses. (*See* https://www.miwb.uscourts.gov/federal-state-taxing-authorities-5003e-0). Discontinue using the IRS address on Evergreen in Grand Rapids. That IRS Insolvency office has been vacant since August 2018. Any returns sent there are being forwarded to the IRS Service Center, but no history is annotated on the system. Reminder that if the federal debt involves any agency other than the IRS, you must serve the USAO pursuant to Fed. R. Bankr. P. 2002(j).

4. Objections to claims must be served like an adversary proceeding. That includes serving the USAO, the Attorney General in Washington DC, and the federal agency. Fed. R. Bankr. P. 3007(a). The United States is entitled to 30 days to respond.

5. Contacts regarding levy/garnishment issues should include copies of the IRS levy or letter from Department of Treasury. For garnishments of wages, provide the employer's name, phone number, and fax number, if available.

6. If the client receives notices from the IRS, it is encouraged that they are read carefully and that the directions are followed explicitly.

7. The USAO has no power to change IRS policies and procedures, nor can we do anything to speed up the processes.

8. Currently, the IRS is not entertaining alternative treatment of its debts in Plans. Proposals for alternative treatment, however, should be made in writing to the USAO.

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9. The USAO does not render decisions regarding dischargeability. After discharge, wait two weeks before contacting the IRS – to allow time for the discharge to be input into their system. Call (800) 973-0424 for post-discharge issues.

10. If an objection to confirmation includes unfiled returns, contact the Insolvency Specialists who filed the proof of claim directly, as needed, and request W2's and other reportable information. In this District, the USAO generally does not file a motion to dismiss for unfiled returns under 11 U.S.C. § 1308.

11. Installment Agreements in place prior to filing bankruptcy will not be honored in the bankruptcy. The tax debt will need to be provided for in the Plan.

12. An Offer in Compromise, in good standing, by stipulation with the trustee, can be paid, along with other provisions, outside of the Plan.

13. When the IRS has a pre-petition claim on file, they are generally agreeable to adding a 11 U.S.C. § 1305 claim, for the first year only, as a post-petition liability. However, additional post-petition accruals may prompt an IRS referral to file a motion to dismiss the case.

14. If the IRS has not filed a proof of claim for pre-petition liabilities, they will not file one for post-petition liabilities. Voluntary payments can be made on post-petition liabilities from disposable income by making a check payable to the IRS with the SSN and tax year on the memo line. Payment should be sent to the IRS Service Center address for payments.

15. A taxpayer has three (3) years from the due date of the return to make a claim for a tax refund. *See* IRC § 6511(a) (statute of limitations).

16. *See* IRS People First Initiative – COVID-19: https://www.irs.gov/newsroom/irs-unveils-new-people-first-initiative-covid-19-effort-temporarily-adjusts-suspends-key-compliance-program (IRS temporarily adjusts, suspends key compliance programs).

17. USAO Contacts:

Gatekeeper - Donna.Justice@usdoj.gov – Direct: 616-808-2041
Kalamazoo - Nicole.Mazzocco@usdoj.gov
Grand Rapids; Lansing; Traverse City, & Marquette - Mike.Shiparski@usdoj.gov

MURKY DAYS AHEAD FOR REAL ESTATE, TITLE INSURANCE INDUSTRIES DURING COVID-19 ERA

By David A. Lerner
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It goes without saying that we are living in interesting times. Until recently, who even knew the words and phrases "coronavirus," "COVID-19," "social distancing" or "shelter in place" existed? Who knew that toilet paper would be such a hot commodity? A run on bottled water because we lack water in the United States? Hand sanitizer is now more expensive than French wine?

The pandemic has turned society and the business world upside down. Among the many businesses adversely affected are those in the real estate market. Transactions are delayed or cancelled. (The buyer of 44 Art Van stores in bankruptcy is "pausing"). Register of deeds offices are closed. Borrowers are being asked to sign affirmations that they will not refinance or enter into additional transactions relating to the property during this time.

It is anticipated that when the pandemic has subsided, and folks get back into the workplace from their shelters/workplaces at home, and the extent of the economic damage becomes clearer, there will be a surge in bankruptcy filings. Individuals may file Chapter 7 or 13 cases, businesses – Chapter 11 and small businesses – the new small bankruptcy section of Chapter 11.

The new federal CARE Act (stimulus bill) actually provides that the debt limit for small bankruptcies in Chapter 11 increased from 2.7 million to 7.5 million for one year. As such, nearly 90% of Chapter 11 cases will be eligible for the small bankruptcy provisions. This is significant given the new bankruptcy provisions streamline Chapter 11 in a much more debtor friendly way (contrary to the 2005 bankruptcy amendments that were creditor friendly). As such, we expect to see a surge in bankruptcy filings.

What does this mean for the title industry? Unfortunately, claims being made by bankruptcy trustees and debtors to avoid mortgages as preference recordings. We experienced this problem in the early 2000s when registers of deeds were swamped with refinance transactions that created a six- to nine-month backlog in recording.

The problem is the Bankruptcy Code preference provisions. The bankruptcy Code only allows 30 days to perfect an interest. So, a mortgage to be perfected and not be subject to a preference must be recorded with the register of deeds within 30 days of its execution. If not and if the debtor files

bankruptcy within 90 days of the recordation (or the mortgage is not even recorded at the time of bankruptcy), the bankruptcy trustee or debtor can file a lawsuit to avoid the mortgage and have the lender treated as unsecured.

As an example, Fred and Wilma refinance their house with Bedrock Bank on March 15. The register of deeds is closed, and the mortgage cannot be recorded. The register of deeds reopens May 4 and there is a month-and-half backlog in recordings. Fred and Wilma file bankruptcy June 10, having exhausted their stimulus checks, and Fred's unemployment checks just don't cover the bills and the lost revenue he had as an Uber driver in Bedrock. (Fred lost his job as a construction worker a while ago).

The mortgage is subject to being avoided as preference, given it was not perfected within the 30 days after it was executed. Fortunately, there is a case in Michigan which may help. In the case of In re Schmiel, the court was called upon to issue equitable relief because the mortgage could not be recorded given the backlog at the register of deeds. The court ruled that as long as the mortgage was in recordable form and was presented to the register of deeds within 30 days of execution, the mortgage would be deemed recorded.

In this environment, title companies may have to invoke equitable principles that the mortgages could not have been recorded, given the government shutdown. Back in the early 2000s, title agents used their recording logs to show when documents were submitted for recordation. Whether that will carry the day in the future remains to be seen.

Another issue that will undoubtedly arise is unscrupulous debtors refinancing their houses or taking out multiple mortgages on their house during the shutdown while the title companies cannot check the register of deeds. In the early 2000s, there were a number of debtors who gamed the system by taking out multiple mortgages with different lenders in rapid succession, knowing that the register of deeds was woefully behind in recording. When the fraud was exposed, suits were filed against the borrowers and adversary proceedings were filed in bankruptcy cases to have the debts not discharged.

In these troubled times when we are experiencing unprecedented events, title companies will need to be ever more vigilant in documenting attempts to record mortgages, guard against multiple mortgages on the same property, defend actions brought by trustees and debtors and pursue claims in bankruptcy by filing timely adversary proceedings. Bankruptcy counsel should be engaged early in the bankruptcy process given the shortened time periods in bankruptcy to defend and pursue claims.

EDITOR'S PICKS

Attorney Fees

In re Arnold, Case No. 19-54252 (Bankr. E.D. Mi 2020): this is Judge Shefferly opinion that limits the Supreme Court's holding in *Harris v. Viegelahn*, 575 U.S. 510, 135 S. Ct. 1829 (2015) and explains when the "no Chapter 13 provision sway" language from *Harris* is inapplicable. The third sentence eof §1326(a)(2) instructs the Trustee what to do with the payments made by the debtor: "if a plan is not confirmed…the trustee shall return any such payments…to the debtor, after deducting any unpaid claim allowed under section 503(b)." Judge Shefferly also states that the payment of administrative expenses was not at issue in *Harris*, and that the only question addressed was whether the Trustee should pay creditors pursuant to the confirmed plan after the payment of expenses of administration or return the remaining funds to the debtor. So, attorneys can get paid in an unconfirmed converted Chapter 13 case.

Setoff Rights of the IRS

Copley v. United States of America, Court of Appeals, 4th Circuit, 2020: In this case, Judge Keenan interpreted 11 U.S.C. §553 to mean that "no provision [in the Bankruptcy Code] 'affect[s]' a creditor's right to offset a mutual, prepetition debt with a bankruptcy debtor." She further explained that 11 U.S.C. §522(c) "must be read in conjunction with the unambiguous language of Section 553(a) . . . A contrary construction, permitting Section 522(c) to subordinate the government's offset rights, would violate that statutory directive." Section 6402(a) of the Internal Revenue Code permits the IRS to offset the tax refund, "notwithstanding the [debtors'] attempt to claim the property as exempt."