CCH Tax Briefing:

BANKRUPTCY REFORM ACT—TAX PROVISIONS

Special Report

Updated April 20, 2005

Key Facts

- *Over 20 tax-specific provisions*
- *180-day effective date delay*
- *No more Chapter 13 superdischarge*
- *Individual/business bankruptcies affected*
- *Retirement savings/ education IRA exclusions*
- *Federal interest rate required*
- *Tax refund set-off in automatic stay*

Inside

Introduction 1

Discharge & Priorities 1

Retirement Accounts 3

Procedural Changes 3

Payment/Compliance 4

Effective Dates 5

Additional Coverage 6

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.

Practitioners will find all these changes 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.

Impact *The tax-related provisions of the new law predominantly favor the IRS and other taxing authorities, giving them increased priorities and additional protections. Taxpayers, however, have several new provisions in their favor. These include creditor protection for Individual Retirement Accounts (IRAs), as well as having a set and uniform rate of interest due on tax liabilities and quicker set-offs of refunds and liabilities.*

Impact *Proponents of bankruptcy reform like to point out that the new law contains the first "tax cut" of the year. They claim that the average consumer, who does not go into bankruptcy, is "taxed" an additional $400 every year in higher costs for goods and credit to pay for those who abuse the system.*

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 (see "Chapter Lexicon" in this Special Report for an explanation of Chapter 13 and other forms of bankruptcies). 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. §507(a) also will be nondischargeable. The playing field between Chapter 7 and Chapter 13 will be leveled.

Impact *Critics of elimination of superdischarge point out that the current rules allow courts to give "worthy" debtors, who may have engaged in past tax-related misconduct such as failing to file a return, the opportunity to start over. Eliminating the courts' discretion would be draconian, they claim. Proponents counter that the courts still have the inherent authority to protect taxpayers, particularly middle-income individuals, from overreaching by the IRS. Debtors unable to pay taxes that are nondischargeable under Chapter 13 will find that interest on tax liabilities would continue to accrue while dischargeable debts are paid.*

"Chapter" Lexicon

The different types of bankruptcies are referred to by the Chapter under which they are covered in the Bankruptcy Code (US Code Title 11):

- **Chapter 7** frequently is referred to as "straight bankruptcy." It is used primarily by individuals who want to free themselves of debt easily. In a Chapter 7 bankruptcy, the individual is allowed to keep certain exempt property, but all other assets are sold to repay creditors. All unsecured debt, with certain exceptions, is cancelled. Proponents of reform argued that Chapter 7 has been widely abused by individuals and that "means testing" will help to halt the number of Chapter 7 filings by requiring more people to file under Chapter 13.
- **Chapter 13** –often referred to as the "wage earner" chapter– enables individuals to propose and carry out a debt repayment plan under which creditors are paid over time. Historically, a broader discharge of debts has been available to filers under Chapter 13 than Chapter 7.
- **Chapter 11** is used mostly by businesses that want to keep operating and pay creditors under a plan of reorganization.
- **Chapter 12** is a special provision governing family farms with regular annual income. It operates similarly to Chapter 13.

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.

Impact Ad valorem *taxes generally are the province of state and local governments. However, this priority vis-à-vis federal tax liability now could become more of an IRS concern.*

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. §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,

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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.

RETIREMENT ACCOUNTS

The treatment of individual retirement accounts (IRAs), qualified retirement plans under ERISA, government and church plans and other retirement savings vehicles is complex –and controversial– in bankruptcy. The reform legislation clarifies and expands the rules governing exemption for retirement accounts. Retirement savings accounts, to the extent funds are in a tax-favored fund or account, will now be exempt from the bankruptcy estate. The legislation provides broad protection for retirement funds, including those exempt from tax under IRC sections 401, 403, 408, 408A, 414, 457, and 501(a). For IRA accounts, there is a $1 million limitation (as adjusted for inflation) on the protection, but this limitation excludes IRA accounts rolled over from qualified plans, which are protected without dollar limitation. Loans from retirement savings plans, typically from ERISA or thrift savings plans to the debtor, are excepted from discharge.

The Supreme Court in *Rousey v. Jacoway* (SCt. 2005-1 USTC ¶50,258) beat the new law by providing some pro-taxpayer relief. It held that traditional IRAs are beyond the reach of creditors. In that case, a married couple was required by their employer to take lump-sum distributions from their pension plans when they left the company for which they both worked. They opened two rollover IRAs, one in each of their names. The bankruptcy trustee tried to access the IRAs to pay the claims of creditors. The U.S. Court of Appeals for the Eighth Circuit found that the IRAs were savings accounts and were not protected from creditors. The couple appealed to the Supreme Court and the High Court reversed.

"Most tax provisions of the new bankruptcy reform law are effective 180 days after enactment."

Caution The Supreme Court's reasoning for protecting traditional IRAs does not make nearly as compelling a case for protecting Roth IRAs. There is no tax or penalty on Roth IRA withdrawals up to the amount of after-tax contributions and no required distribution rules apply. Even prior to the Supreme Court's decision, practitioners had questioned whether the same creditor protections under various state laws that applied to traditional IRAs also shielded Roth IRAs. Fortunately, Roth IRAs (Code Sec. 408A) are specifically included in the statutory language of the new law's general IRA protections. However, the general effective date of the bankruptcy bill is delayed until 180 days after enactment. Although traditional IRA rollovers are protected immediately because of the Supreme Court's *Rousey* decision, rollovers to Roth IRAs may not be protected until the 180 days after enactment have passed.

An exemption also is specifically allowed for education IRAs and Sec. 529 plans. Up to $5,000 in an education IRA will be eligible for exemption in the case of funds deposited between 720 and 365 days before the filing date. The education account protections do not extend to funds placed in the accounts within the year prior to the bankruptcy petition filing.

PROCEDURAL CHANGES

Stay of tax proceedings

The greatest immediate protection available to debtors is the broad automatic stay of certain actions by creditors once an individual or a business files a bankruptcy petition. The Bankruptcy Code mandates this stay in order to bring all collection and enforcement activities into one forum—the bankruptcy court. The rules are complicated and creditors may move the court to lift the stay under certain conditions. Willful violation of the stay may result in sanctions and damage awards.

Impact *Over the years, many cases have been litigated over which Tax Court actions are not enjoined from moving forward by a stay and what constitutes a violation of the stay by the IRS. The new law promises to reduce liti-*

gation on the issue but not eliminate it entirely.

The new law also changes the scope of the automatic stay that is applied for appeals of tax determinations by courts or administrative tribunals. The automatic stay in the Tax Court is limited to an individual debtor's prepetition taxes (taxes owed before entering bankruptcy). The bill clarifies that the automatic stay does not apply to an individual's postpetition taxes.

Reform also will impact the set-off of income tax refunds. Debtors sometimes have been burdened by additional interest and penalties accruing because of the manner in which the automatic stay operated to prevent set-off of a prepetition tax refund against a prepetition tax obligation. The new law allows set off without an express court order unless the set-off would not be permitted under applicable nonbankruptcy law because of a pending action to determine the amount or legality of the tax liability.

Disclosure of tax consequences

Reorganization plans under Chapter 11 will be required to include in their disclosure statements a discussion of the potential federal tax consequences of the plan to the debtor, any successors to the debtor and to a hypothetical investor. This hypothetical investor will be representative of the holders of claims and interests who will vote on the plan.

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.

Impact *The minimum rate is the same rate governing individual underpayments and overpayments to the IRS under normal circumstances. For the first quarter of 2005, the rate was 5 percent. For the second quarter of 2005, the rate is 6 percent.*

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. 6020(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

Bankruptcy Filing Stats (for fiscal year 2004)

Total Filings	
Chapter 7	1,153,969
Chapter 11	10,368
Chapter 12	238
Chapter 13	454,412
TOTAL	**1,618,987**

Total Business Filings	
Chapter 7	20,344
Chapter 11	9,436
Chapter 12	238
Chapter 13	4,799
TOTAL	**34,817**

Total Non-Business Filings	
Chapter 7	1,133,625
Chapter 11	932
Chapter 13	449,613
TOTAL	**1,584,170**

Source: Table F-2 U.S. Bankruptcy Court Business and Non-Business Bankruptcy Cases Commenced, by Chapter of the Bankruptcy Court During the Twelve-Month Period Ended Sept. 30, 2004

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claim provided for by 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.

In addition, government creditors will be excused from formally requesting payment of an administrative expense relating to a tax liability or penalty. Secured claimants entitled to interest, costs and fees include state tax claimants. Trustees also will be able to recover from property securing a claim for payment of all *ad valorem* taxes relating to the property.

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. The most striking example of these issues is the roll over of 401(k) plan distributions to traditional IRAs. They may begin immediately without further concern since the Supreme Court has settled that issue in advance of the legislative remedy.

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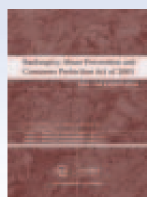

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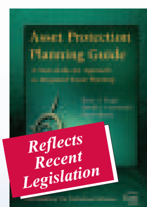

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