Treatment Of Local Government Debts In Bankruptcy

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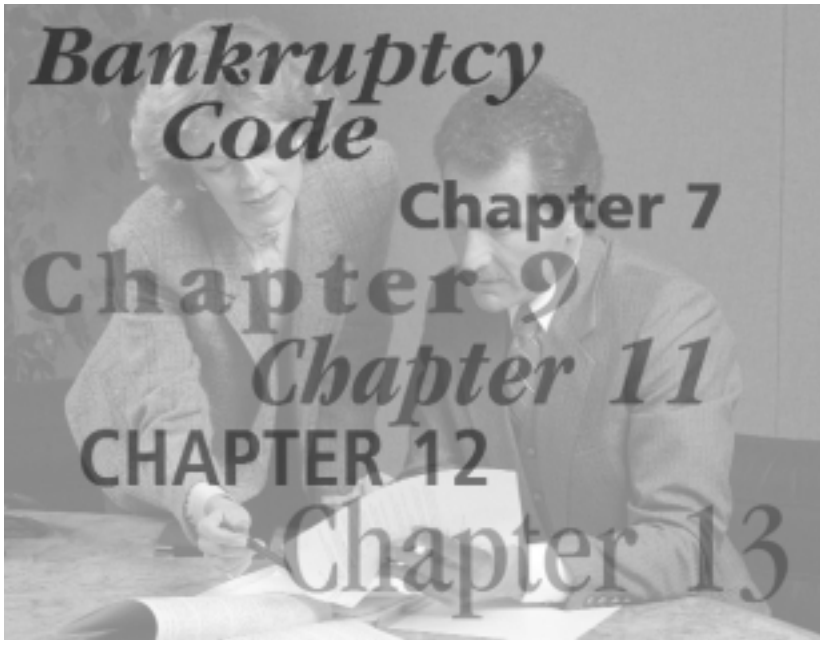

The Bankruptcy Reform Act of 1978 promised to breathe new financial life for the financially challenged by offering a fresh financial start. While the act did provide forgiveness of some tax debts, for the most part public policy dictated that tax debts eventually must be paid.[1]

Congress currently is considering legislation to limit which debtors qualify for bankruptcy and which debts can be discharged.[2] If the reforms pass in their present form, local debt collection will be much simpler.[3] Because this is an election year and bankruptcy filings last year declined, the prospects for enactment of the reform legislation remain uncertain. If and until passage of the proposed legislation, there are a myriad of factors that must be considered in determining the treatment of local government debts in bankruptcy.

Overview

There are five basic types of bankruptcies under the Bankruptcy Code: Chapters 7, 9, 11, 12, and 13. The treatment of local government debts in bankruptcy is contingent upon the type of assessment, the age of the debt, and the type of bankruptcy filing chosen by the debtor.

A Chapter 7 (known as a liquidation bankruptcy) is the most common type of bankruptcy filing. Chapter 7 is available to individuals and businesses. In Chapter 7, a debtor's liabilities far outweigh assets, and the court distributes available non-exempt assets to creditors. There are two kinds of Chapter 7 bankruptcies. In a Chapter 7 no asset bankruptcy, after exemptions, security interests, and administrative expenses, the debtor has nothing left that the court can distribute. Most tax claims will not be discharged and can be collected after the bankruptcy closes. Of course, if a Chapter 7 no asset case involves a business, there usually won't be anything left to collect. The other type of Chapter 7 is an **asset case**. The debtor's liabilities in this case outweigh assets, but here there are sufficient non-exempt assets for the court to distribute to creditors. Many creditors will receive a small percentage of their actual claim. Most tax claims will not be discharged and any balance can be collected after the bankruptcy closes.

Chapter 9 applies to municipalities that go broke. Of course, this would never happen in Virginia. In any event, Chapter 9 is beyond the scope of this article.

Chapter 11 is a business reorganization allowing companies, and some individuals, to postpone payments to creditors and earn operating revenue while obtaining necessary goods and services.[4] In a Chapter 11, a company will segregate creditors, and propose through a plan of reorganization how each class of creditor is to be paid. The plan may not pay all creditors in full. Payments legally may be extended over many years. Tax claims may be paid over time—not to exceed six years from the date of assessment.[5]

Chapter 12 offers special bankruptcy treatment for certain farmers. These cases are substantially similar to Chapter 13 reorganization. Few Chapter 12 cases have been filed in Virginia.

Chapter 13 is a reorganization available to individuals or sole proprietor businesses with up to $250,000 unsecured debt and $750,000 in secured debt. It is similar to a Chapter 11, offering repayment to creditors through a plan of reorganization. Because of the congressional intent to encourage wage-earning debtors to make the best effort to pay debts instead of resorting to a Chapter 7 liquidation, a failure to be included in the debtor's plan, after timely notice, usually results in a "super" discharge of all debts, including taxes, and a prohibition against future collection.[6] Plan payments may last up to 36 months, and they may be extended to 60 months for good cause.[7]

Notice of Bankruptcy

If a debtor has filed for bankruptcy, and has named a locality as a creditor, the court will send the locality a Notice of Bankruptcy. Because no formal notice is required before the automatic stay applies, a locality that receives informal notice from a debtor, or otherwise, should inquire to determine if a bankruptcy has been filed.[8]

Often localities will not receive timely notice of the debtor's bankruptcy. In Chapter 7 liquidation cases, debts omitted by the debtor in filing the schedules may be discharged under a "no harm, no foul" rule.[9] If an unscheduled debt was dischargeable under §523, or would not be paid even if scheduled, lack of notice makes no difference. In Chapter 11 or 13 reorganization cases, scheduling does make a difference. "An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections."[10]

The Automatic Stay

The automatic stay becomes effective when the debtor files his petition with the Bankruptcy Court pursuant to §362. Case law suggests that actual or constructive notice is required before the court will punish a violation of the stay.[11] The automatic stay ordinarily does not extend to non-debtor parties.[12] If the debtor only has an interest in property owned with a non-bankrupt co-debtor, the asset must be essential to the debtor's reorganization case for the estate to withstand a request for relief.[13] The Chapter 13 co-debtor's stay provisions in §1301 are inapplicable to tax liens because tax debts do not fall within the definition of a "consumer debt."[14]

The automatic stay acts as an injunction to prevent all active collection methods against property of the debtor's estate. §362. Unless state law transfers the full ownership of property seized by a creditor pre-petition, leaving the debtor no interest, the property remains protected by the stay.

Permitted Collection Actions

Audit and assessment of taxes, and notice to the debtor of such assessments and of other tax deficiencies, is allowed pursuant to §362(b)(9). The debtor will continue to receive bills after the bankruptcy filing. These notices are important to keep the debtor (and the court) aware of new and existing tax obligations. This information is especially important if the debtor has a reorganization payment plan.

The injunction of the automatic stay extends to the tax sale of real estate, including bill in equity (Va. Code §58.1-3965, et seq.) and escheat (Va. Code §55-168, et seq.) proceedings. However, if the tax foreclosure sale was conducted prior to the bankruptcy filing, but not confirmed by the state court, it should not be set aside. The automatic stay should be lifted so that the state court action can proceed.[15]

Statutory ad valorem tax liens for taxes that come due after the filing of the bankruptcy petition may also be created and perfected without violating the automatic stay pursuant to §362(b)(18). There is also a statutory lien available for post-petition utility services under Va. Code §15.2-2118.

Monies deducted from a debtor's Virginia income tax refund or lottery winnings under the state's debt set-off collections program (Va. Code §58.1-520, et seq.) may be retained without violating the automatic stay if the claim was filed pre-petition and the debtor did not timely contest the validity of the claim. The placement of the claim transfers to the locality the ownership interest in those funds that were withheld from the debtor pre-petition.[16] Although the funds may not be forwarded by the state until post-petition, the transfer does not create any new ownership interest.[17] The state merely is administratively transferring funds already belonging to the locality. This does not violate the automatic stay. The same rationale applies for pre-petition Va. Code §58.1-3952 wage and bank liens against cash or cash equivalents.[18] If the locality issued a lien before the debtor filed and the funds were earned or available pre-petition, the cash is converted to the locality's money at the time of the receipt of the attachment.[19]

Security agreements, such as bonds or letters of credit to ensure payment of cigarette taxes or completion of a plan of development, may be cashed upon default without violating the stay.[20] If the security is not honored, recourse is against the non-bankruptcy third party, and so is not subject to the stay.[21]

Tangible personal property obtained under a lien of *fieri facias* or seizure must be released to the debtor or trustee.[22]

Inadvertent Violations of the Stay

Sovereign immunity traditionally prevented the debtor from pursuing governmental entities for violations of the stay.[23] The 1994 amendments to the Bankruptcy Code in §106(a) retroactively removed the defense of sovereign immunity for bankruptcy-related causes of action (including willful violations of the stay and discharge).[24] In 1997 the Fourth Circuit Court of Appeals found §106 unconstitutional because it violates the Eleventh Amendment and thus §106 is not applicable to suits against the states and state agencies.[25] Virginia constitutional officers at the local level have been deemed agents of the Commonwealth and thus entitled to Eleventh Amendment immunity.[26] Even if immunity were not raised as a defense, unintentional or inadvertent violations of the stay—where an administrative error was made and where the locality promptly stops or reverses the action—are not likely to involve sanctions.[27]

Classification of Local Government Debts

There are four broad categories of debt in bankruptcy. First are administrative expenses, which should always be paid. These include attorney and accountant's fees, newly assessed taxes, and other expenses necessary to keep the debtor going. The second level, which also gets paid, often with interest, consists of secured debts, in which the creditor has filed and perfected a security interest in the property held by the debtor. The third level, which will get paid if there is enough money, are priority

claims, found in §507 and include recently incurred tax debts as discussed below. Unsecured claims are rarely paid, and then only as a percentage of the claim.

It is important to distinguish between pre-petition and post-petition claims. Pre-petition claims are debts that first come due before the filing date of the bankruptcy. Post-petition debts are any debts actually incurred by the trustee or debtor in possession while administering the estate. Debts incurred by the estate are administrative expenses under §503(b)(1)(B). In Chapter 11 and Chapter 13 reorganizations, taxes that become due after the debtor's plan is confirmed are no longer administrative expenses because the estate dissolves and the debtor controls the property.[28] The debtor in a reorganization should pay these taxes when they become due as required in 28 U.S.C. §§959 & 960 to avoid collection action.

Tax Claims

As a general rule, taxes due before filing are an eighth priority claim in §507(a)(8). There are a number of exceptions.

Real estate taxes and special assessments, such as sidewalk, curb and gutter assessments, which are treated under Virginia law as liens against the property, should be paid as secured claims because of the statutory lien.[29] As noted earlier, an exception to the automatic stay allows perfection of statutory liens under §362(b)(18). Secured tax liens survive discharge; and, in reorganization bankruptcies should be paid with interest (usually at the market rate).[30]

Personal property taxes are a priority debt if the taxes were due and payable without penalty not more than a year before the debtor filed for bankruptcy pursuant to §507(a)(8)(B). If property is specifically assessed, a statutory lien may apply, elevating the personal property debt to secured status pursuant to Va. Code §§58.1-3941 and 3942.[31]

A gross receipts tax, such as a business license tax, is a priority tax if the tax return was due not more than three years before the debtor filed for bankruptcy, or if the tax was assessed within 240 days of the bankruptcy filing under §507(a)(8)(A). If an extension of time to file is granted, the "last due" date is similarly extended under subparagraph "i" in that section. A debtor's previous bankruptcy filing should toll the running of the three year period for determining priority treatment under §507(a)(7)(A).[32]

Certain types of taxes, such as transient occupancy taxes, are collected and held in trust by the taxpayer until remitted to the treasurer. Because these taxes are not property of the taxpayer, the funds should not be part of the bankruptcy estate. The United States Supreme Court has found that "because the debtor does not own an equitable interest in the property he holds in trust for another, the interest is not 'property of the estate' nor is such an equitable interest 'property of the debtor' . . . ."[33]

Recordation/Stamp Taxes

In Chapter 11 cases, taxes paid by the debtor to record a security or instrument of transfer (such as a deed) under a plan of reorganization may be exempt under §1146(c). In NRV Homes, Inc. v. Clerks of the Circuit Court, 189 F.3d 442 (4th Cir. 1999) cert. filed 11/5/99, the Court of Appeals held the §1146(c) recordation tax exemption applies to post-confirmation transfers only. This decision also involved the issue of whether the state has Eleventh Amendment immunity against a suit brought by the debtor to obtain a refund of transfer and recordation taxes paid in a Chapter 11 bankruptcy proceeding. A petition for certiorari was filed on November 5, 1999.

Fees and Fines

Pre-petition fees owed to governmental units, such as permit fees, are generally treated as unsecured claims, and will be discharged at the end of the bankruptcy. However, criminal fines and other regulatory fees may be considered a "fine, penalty, or forfeiture" payable to a governmental unit and not dischargeable to individuals under §523(a)(7). Criminal restitution is also made nondischargeable under §523(a)(13).

Utility Services

Utility charges assessed by ordinance for services, such as water and sewer fees, become liens against the property under Va. Code §15.2-2118. Because such liens are created statutorily, there is no violation of the automatic stay under §362(b)(18). Although the utility debt may be discharged, the lien will not be discharged and will remain collectible in rem, but not as a debtor's personal obligation.[34] If the lien was not recorded in the clerk's office pre-petition as required in Va. Code §15.2-2120, the lien for pre-petition services may be lost since the trustee or debtor in possession is treated as a bona fide purchaser under §545(2). The automatic stay prevents shut-off of service for non-payment. However, a utility may terminate service if its demand for "adequate assurance" (a deposit) of the post-petition payments under §366(b) is not paid in 20 days.

Post-Petition Debts

Post-petition debts include taxes that are "incurred by the estate" after the debtor files for bankruptcy and are treated as administrative expenses in §503(b)(1)(B). Under 28 U.S.C. §959, "a trustee . . . including a debtor in possession, shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the state in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof." Therefore, the debtor or trustee must file tax returns and pay taxes as the taxes become due. The trustee or debtor in possession is subject to all applicable federal, state and local taxes.[35]

Administrative expense priority is available for taxes which are "incurred by the estate" after the bankruptcy petition date. The tax valuation date (January 1 in Virginia) is the day a tax is "incurred by the estate" for the purposes of §503(b)(1)(B). This means that if the debtor files for bankruptcy, any taxes due during that calendar year must be included on the proof of claim to be paid, even if the taxes are not yet due or even assessed.[36] Local governments have 180 days from the petition date to file a proof of claim in §502(b)(9). Therefore, tax bills should be avail-

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able for filing before the bar date passes. In Chapter 11 proceedings, ad valorem taxes assessed post-petition should be eligible for payment as an administrative expense claim.[37] In Chapter 13 cases, taxes that are assessed while the case is pending may be included in the debtor's plan of reorganization under §1305(a)(1).

Status of Local Government Debts at the Close of the Case

Chapter 7 no asset bankruptcies in the Eastern District close in about six months (unless the debtor voluntarily dismisses the case) and rarely go beyond a year. A reorganization bankruptcy normally lasts no more than five years from the date the plan is approved. Once a debtor has been discharged from bankruptcy, he may not file again for six years after the case is closed under §727(a)(8)&(9). When a bankruptcy case is dismissed, it is as though the debtor was never in bankruptcy. No debts are wiped out and the debtor is exposed to the full range of Virginia collection laws. A notice of discharge is sent to all listed creditors at the normal conclusion of the bankruptcy case. This informs creditors that the automatic stay is lifted, and all unsecured dischargeable debts are forgiven. Since a bankruptcy is a court action, the statute of limitations on filing suit for the collection of taxes and other debts is tolled under Va. Code §8.01-229(B).[38]

Individuals' priority tax claims are not dischargeable in bankruptcy under §523(a)(1). Except in a Chapter 13 case, priority taxes are nondischargeable even if a proof of claim was not filed.[39] Taxes for which a return was not filed, or where the return was filed late within two years of the filing of the petition, are nondischargeable under §523(a)(1)(B). Also, if a debtor willfully attempts to evade or defeat a tax, it may not be discharged under §523(a)(1)(C). "[A] debtor will be considered to have willfully attempted to evade a tax if he acted voluntarily, consciously, or intentionally or with reckless disregard for whether the tax has been paid. Regarding §523(a)(1)(C), a debtor acts with reckless disregard if he knew or should have known that the tax was due and did not pay the tax."[40] The taxing authority has the burden of proof, by the preponderance of the evidence, to show willful evasion. This may be done by circumstantial evidence.[41] The taxing authority is not required to file an action to determine dischargeability because the exceptions to discharge for taxes are set forth in §523(a)(1) and are not conditioned on a §523(c)(1) judicial finding of nondischargeability. A tax claim, however, will not survive discharge if specifically knocked out by the bankruptcy court or if not paid through the plan in a completed Chapter 13 reorganization.[42]

In Chapter 11 reorganization, the debtor remains under the protection of the bankruptcy court while making payments under the plan. Tax payments may last up to six years from the date of assessment under §1129(a)(9)(C). Taxes that arise after the plan is confirmed (and the debtor's estate ends) should be paid when due. It is not a violation of the automatic stay to collect post-confirmation debts.[43]

Discharge of Liens

Statutory liens are liens created by operation of law, such as the lien on real estate or the lien on personal property as created in Va. Code §§58.1-3340, 3941 & 3942. Although a tax debt may be discharged, extinguishing the debtor's personal obligation to pay; the tax lien survives the discharge in bankruptcy and continues in force, absent a lien avoidance proceeding within the bankruptcy.[44] The property to which the lien attached continues to be available for payment, after a bankruptcy discharge, in an in rem proceeding. Similarly, judicial liens do not have to be released or satisfied because a debtor files for bankruptcy.[45] Thus, only liens specifically discharged by the court should be released.

The statute of limitations is tolled with regard to any tax not discharged or otherwise rendered unenforceable during the time substantially all of the assets of the taxpayer are in bankruptcy or otherwise within the control of the court.[46] The statute of limitations for Virginia personal property taxes is five years and for real estate taxes is 20 years.[47]

Conclusion

While the Bankruptcy Code does prevent active collection of local government debts during the pendency of the proceeding, most tax debts survive bankruptcy and are still collectible after discharge, although collection may be limited to an in rem proceeding. The treatment of local debts in bankruptcy varies upon the type of debt involved, the age of the debt, and the chapter under which the bankruptcy is filed. It has long been recognized that "taxes are the life-blood of government, and their prompt and certain availability an imperious need."[48] After navigating the many difficult-to-find sections and cross sections of the Bankruptcy Code, it becomes clear that the Bankruptcy Act can provide a new financial start for debtors while concomitantly sustaining the life-blood of government and thus the provision of public services. ⚖

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Endnotes

1 The Bankruptcy Reform Act of 1978, Pub.L. No.95-598, effective October 1, 1979, repealed the existing Bankruptcy Act. This Act, as amended, together with the Federal Judgeship Act of 1984 (Pub.L. No. 98-352) and the Family Farmer Bankruptcy Act of 1986 (Pub.L. No.99-554, effective November 26, 1986, are codified in Title 11 of the United States Code (11 U.S.C. §101, et seq.) All references in this Article are to Title 11 unless otherwise indicated.

2 House Bill 833 was passed in May 1999. Senate Bill 625 is still under consideration.

3 Both House Bill 833 and Senate Bill 625 would give property taxes a higher priority status than under current bankruptcy law. In addition, the House Bill secures the state or local statutory interest rate for unpaid property tax penalties for debtors in all bankruptcy cases; the Senate Bill does so in most cases. Both bills fix the amount of time a debtor has to repay property taxes at six years beginning at the date of assessment and prohibits any "balloon" payments. The House Bill also allows a bankruptcy court to reverse a property valuation decision only when a bankruptcy debtor has a right to challenge such a decision under state law.

4 Toibb v. Radloff, 501 U.S. 157 (1991).

5 §1129(a)(9)(C).

6 In re McAloon, 44 B.R. 831 (Bankr. E.D. Va. 1984).

7 §1322(d).

8 In re LaTempa, 58 B.R. 538 (Bankr. W.D. Va. 1986). The Eastern District Bankruptcy Court will verify the case status on line at www.vaeb.uscourts.gov or by calling 1-800-326-5879. In the Western District of Virginia, this information is available through the PACER system for a fee. Directions for using this system can be found at www.vawb.uscourts.gov.

9 Karras v. Hansen, 165 B.R. 636 (N.D. Ill. 1994); see also, In re Banks Davis, 148 B.R. 810 (Bankr. E.D. Va. 1992), in which the Bankruptcy Court retained jurisdiction to determine dischargeability even after the close of a Chapter 7 case.

10 Colliers on Bankruptcy §1141.01(b), citing Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950). If notice is received after the bar date for filing a proof of claim, the confirmation of the plan of reorganization is not permitted unless priority taxes are scheduled to be paid in full so the full tax claim should be allowed pursuant to §1129(a)(9)(c) and §1322(a)(2).

11 See NationsBank v. Bush, 169 B.R. 34 (Bankr. W.D. Va. 1994).

12 See In re Sowers, 164 B.R. 256 (Bankr. E.D. Va. 1994).

13 A. H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir. 1986).

14 See In re Sovall, 209 B.R. 849 (Bankr. E.D. Va. 1997).

15 In re Washington, 232 B.R. 340 (Bankr. E.D. Va. 1999). See also, County of Chesterfield v. Tamojira, 197 B.R. 815 (Bankr. E.D. Va. 1995) where Bankruptcy Proc. Rule 9011(a) sanctions were warranted against a debtor and attorney for filing a Chapter 11 petition solely to delay a tax foreclosure sale of property.

16 United States v. National Bank of Commerce, 472 U.S. 713 (1985). Small v. Hennepin County, 18 B.R. 318 (Bankr. D. Minn. 1982).

17 In re Eisenbarger, 160 B.R. 542 (Bankr. E.D. Va. 1993).

18 In re Boutilier, 196 B.R. 323 (Bankr. W.D. Va. 1996); In re Oliver, 186 B.R. 403 (Bankr. E.D. Va. 1995).

19 Eisenbarger, at p. 546, n.17; Cross Elec. v. United States, 664 F.2d 1218 (4th Cir. 1981).

20 In re Page, 18 B.R. 713 (D.D.C. 1982).

21 Cf. Willis v. Celotex Corp., 978 F.2d 146 (4th Cir. 1992), cert. denied, 507 U.S. 1030 (1993). Although in this case the appeal bond was found not to be property of the estate, the court extended the automatic stay where the bond was essential to the debtor's Chapter 11 reorganization.

22 United States v. Whiting Pools, 462 U.S. 198 (1983).

23 See United States v. Nordic Village, 503 U.S. 30 (1992); Hoffman v. Connecticut, 492 U.S. 96 (1989).

24 Under 106(a)(3) the amount of attorney's fees is limited to the amount available under the Federal Equal Access to Justice Act.

25 In re Creative Goldsmiths [Schlossberg v. Maryland], 119 F.3d 1140, 1147 (4th Cir. 1997), cert. denied, 118 S. Ct. 1517 (1998); Seminole Tribe of Florida v. Florida, 517 U.S. 44 (1996).

26 See Hicks v. Phipps, 765 F.Supp. 1541 (W.D. Va. 1990) (Commissoner of Revenue entitled to Eleventh Amendment immunity); Blankinship v. Warren County, 918 F.Supp. 970 (W.D. Va. 1996) (Sheriff and Sheriff's Department performed classic government functions and are entitled to 11th amendment immunity. But see NRV Homes, Inc. v. Clerks of Circuit Court, 189 F.3d 442 (4th Cir. 1999), cert. filed 11/5/99.

27 In re Conti, 42 B.R. 122 (Bankr. E.D. Va. 1984).

28 In re Gyulafia, 65 B.R. 913 (Bankr. D. Kan. 1986).

29 See e.g., Va. Code §58.1-3340; In re Stanford, 826 F.2d 353 (5th Cir. 1987).

30 In re Trammel, 63 B.R. 878 (Bankr. E.D. Va. 1986) and United Carolina Bank v. Hall, 993 F.2d 1126 (4th Cir. 1993).

31 1982-83 Ops. Atty. Gen. 618. Chambers v. Higgins, 169 Va. 345, 193 S.E. 531 (1937).

32 In re Barton, 236 B.R. 613 (Bankr. W.D. Va. 1999) and Va. Code §58.1-3940(D).

33 Begier v. IRS, 496 U.S. 53, 59, 110 S. Ct. 2258 (1990).

34 See Trammel, supra at n.30, but see §545(2)(lien avoidance).

35 28 U.S.C. §960, In re Samuel Chapman, Inc., 394 F.2d 340 (2nd Cir. 1968).

36 In re Members Warehouse, 991 F.2d 116 (4th Cir. 1993).

37 Maryland National Bank v. Major of Baltimore, 723 F.2d 1138 (4th Cir. 1983).

38 See also Bowling v. IRS, 147 B.R. 383 (Bankr. E.D. Va. 1992) (statute of limitations suspended during prior bankruptcies).

39 §523(a)(1)(A). See Grynberg v. United States, 986 F.2d 367 (10th Cir.), cert. denied, 114 S. Ct. 57 (1993).

40 Irvine v. Comm'r., 163 B.R. 983 (Bankr. E.D. Pa. 1994). Despite the standard, courts often find the debtor did not willfully attempt to evade the taxes. In Irvine, the debtor embezzled money for gambling and the tax was discharged!

41 Griffith v. United States (In re Griffith), 161 B.R. 727 (Bankr. S.D. Fla. 1993).

42 Because §1328(a) overrides §523(a)(1)(A), even a priority tax will be discharged if notice was timely given and no proof of claim was filed.

43 Quillen v. United States, 160 B.R. 776 (W.D. Va. 1993).

44 Trammel, supra, at n.30.

45 Leasing Service Corp. v. Justice, 243 Va. 441, 416 S.E.2d 439 (1992).

46 Va. Code §58.1-3940(D); 1998 Va. Acts, c.648.

47 Va. Code §58.1-3940.

48 Bull v. United States, 295 U.S. 247, 259, 55 S. Ct. 695 (1935).