

BANKRUPTCY BASICS AND TIPS
FOR COLLECTION OF PROPERTY TAXES
FROM TAXPAYERS IN BANKRUPTCY

by Roy F. Kiplinger
Kiplinger Law Firm, P.C.



ROY F. KIPLINGER
Attorney at Law
Licensed in Indiana & Ohio

927 S. Harrison Street
Fort Wayne, IN 46802
rfk@kiplingerlaw.com

P: (260) 407-7070
F: (260) 407-7137

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ROY F. KIPLINGER
Attorney at Law
Licensed in Indiana & Ohio

We pride ourselves in providing quality legal services and being responsive to our clients and their needs.

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Fort Wayne, IN 46802
rfk@kiplingerlaw.com

P: (260) 407-7070
F: (260) 407-7137



Admitted to Practice:

- Indiana
- Ohio

Undergraduate School:

- University of Michigan
- Bachelor of Arts with High Honors in History
- Graduated in 1987
- Rotary Foundation Scholar (1987-1988)

Law School:

- University of Michigan Law School
- Graduated in 1991

Biography:

Roy Kiplinger is a solo practitioner, with a practice concentrating on bankruptcy (creditors and debtors), creditors' rights, mortgage foreclosure, commercial law and general corporate law.

Professional Organizations:

- Indiana State Bar Association
- Ohio State Bar Association
- Allen County Bar Association
(Vice Chair, Bankruptcy & Creditors' Rights Section 2009 to present)

Community Involvement:

- Better Business Bureau of Northern Indiana
(Member, Board of Directors, 1996 to present; Chair, 2010 to present, Vice Chair, 2008 to 2010; Treasurer, 2004-2006)
- Volunteer Lawyer Program
- Covenant United Methodist Church
(Member, Staff Parish Relations Committee, 2006 to 2009; Member, Trustees Committee, 2003-2006)

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I. BANKRUPTCY BASICS AND TIPS FOR COLLECTION OF PROPERTY TAXES FROM TAXPAYERS IN BANKRUPTCY.¹

A. The Difference Between Pre-petition and Post-petition Taxes.

1. What are Pre-petition and Post-petition Taxes.

- a. Whether taxes are considered pre-petition or post-petition taxes can have a significant impact on their collectability. “**Pre-petition taxes**” are those which are assessed, or otherwise incurred, before the date of the filing of a taxpayer’s bankruptcy petition. “**Post-petition taxes**” are those which are assessed, or otherwise incurred, after the date of the filing of a taxpayer’s bankruptcy petition. It is the filing of a taxpayer’s bankruptcy petition which typically initiates a bankruptcy case. *See, e.g., Marion County Treasurer v. Blue Lustre Products, Inc. (In re: Blue Lustre Products, Inc.), 214 B.R. 188, 189-91 (S.D. Ind. 1997); In re 7003 Bissonnet, Inc., 153 B.R. 455, 457 (Bankr. S.D. Tex. 1992).* Consequently, in Indiana, real property and personal property taxes that are assessed against a taxpayer before the taxpayer’s bankruptcy petition is filed are considered pre-petition taxes, and real property and personal property taxes that are assessed against a taxpayer after the taxpayer’s bankruptcy petition is filed are considered post-petition taxes.
- b. Because of the way taxes are collected in Indiana, during the year following assessment, there is frequently confusion about whether taxes are pre-petition or post-petition taxes. Taxes which are assessed prior to a taxpayer’s bankruptcy filing, but which are not due until after the taxpayer’s bankruptcy filing may sometimes incorrectly be treated as post-petition taxes, even by bankruptcy attorneys involved in the case, when, in fact, such taxes are pre-petition taxes because they were assessed prior to the taxpayer’s bankruptcy filing. The date of assessment, in Indiana usually March 1 of any given year, is the relevant date for determining whether taxes are pre-petition or post-petition.

2. Payment of Pre-petition Taxes.

- a. Debtors in bankruptcy are generally not allowed to pay any of their pre-petition debts, including tax liabilities, without permission or authority from the Bankruptcy Court. Consequently, property

¹ All references in these materials to the “Bankruptcy Code” refer to Title 11 of the United States Code, Section 101 et seq.

taxes that were assessed prior to a taxpayer's bankruptcy filing will not usually be paid until the Bankruptcy Court has approved a plan of repayment in Chapter 11 or Chapter 13 or authorized a Trustee to pay claims in a Chapter 7. As a result, pre-petition property taxes that were current at the time of a taxpayer's bankruptcy filing may become delinquent during the course of the bankruptcy case. Nonetheless, the automatic stay in bankruptcy prohibits the assessment of a penalty on property taxes which become delinquent while a bankruptcy is pending. *See Bankruptcy Code §362(a) and (b).*

3. Timely Payment of Post-petition Taxes.

- a. Post-petition taxes should be paid by a taxpayer in bankruptcy in a timely manner as they become due. Post-petition taxes, like other ordinary course debts and obligations incurred by a taxpayer in bankruptcy during the bankruptcy case, are considered part of the costs of maintaining and administering the bankruptcy estate. Post-petition taxes are sometimes referred to as "*administrative taxes*" because they are considered an "administrative expense" of the bankruptcy estate and, if not secured, are entitled to the highest priority among unsecured debts of the taxpayer in bankruptcy.
- b. The general rule that post-petition taxes are to be timely paid is not set forth in a single provision of the Bankruptcy Code, but instead grows out of a number of provisions of the Bankruptcy Code and the interpretation of those provisions.
- c. The first provision of the Bankruptcy Code that is part of this general rule is contained in §362, which provides for the automatic stay that protects debtors in bankruptcy from the collection efforts of their creditors. Pursuant to §362(b)(9), there is an exception to the automatic stay that allows taxing authorities, among other things, to assess taxes as they normally would during a pending bankruptcy. In addition, §362(b)(18) provides a further exception to the automatic stay that allows statutory liens for post-petition property taxes to attach to the taxpayer's real property as they normally would outside of bankruptcy. Note, however, that this provision does not allow taxing authorities to conduct **collection** efforts such as tax sales, as they normally would. *See also Bankruptcy Code §505(c)*, which allows for the assessment of taxes, the amount of which are determined under the procedures of §505, notwithstanding the automatic stay of §362.

- d. The next provision of the Bankruptcy Code that is part of this general rule, and probably the most important provision, is §503, which concerns administrative expenses, the second highest priority unsecured claim under the Bankruptcy Code after certain domestic support obligations. Administrative expenses are costs incurred by the bankruptcy estate in administering the estate. For instance, a business in bankruptcy will have to pay its suppliers for post-petition orders and employees for post-petition wages or it will not be able to continue in business. Such costs are administrative expenses. Pursuant to §503(b)(1), most post-petition taxes are also considered administrative expenses.
- e. As an administrative expense, post-petition taxes must be paid in full under the terms of a Chapter 11 or Chapter 13 Plan. *See §1129(a)(9) and §1322(a)(2)*. Consequently, if a debtor under Chapter 11 or Chapter 13 does not pay its post-petition taxes as they become due, the debtor will have to pay such taxes in full through its Plan if such Plan is to be confirmed and the debtor to obtain a discharge, which is a principal goal of a bankruptcy filing.
- f. For individual Chapter 7 debtors, post-petition taxes are not dischargeable. A discharge under Chapter 7 only applies to debts that existed on the date of the petition filing. *See Bankruptcy Code §727(b)*. Consequently, if an individual Chapter 7 debtor does not pay its post-petition taxes when they are due, the taxing authority can seek collection of such taxes after the bankruptcy is concluded.
- g. The Bankruptcy Code also provides other enforcement mechanisms in addition to those already described. The most powerful of these is the ability to seek to have a non-paying debtor's bankruptcy case either dismissed or converted to a Chapter 7 bankruptcy. In Chapters 11 and 13, the debtor's ability to pay post-petition taxes when they become due is evidence of the debtor's ability to reorganize and/or complete its Plan. Where a debtor is not making its post-petition tax payments, this fact may constitute "cause" under §707, 1112 or 1307, as is appropriate in the particular case, for dismissal or conversion of the bankruptcy.

B. The Differences Between Secured Property Taxes and Priority Property Taxes.

- 1. Another area of some confusion when dealing with property taxes in a bankruptcy setting is whether the taxes should be treated as secured or priority and what this distinction can mean. In Indiana, real property taxes will almost always be treated as a secured claim in bankruptcy thanks to the first priority lien imposed on the assessed real property from the date

of assessment for the amount of real property taxes. *See I.C. §6-1.1-22-13*. Secured tax claims enjoy many benefits, including greater likelihood of payment, either directly by the debtor or the bankruptcy trustee, or indirectly by a mortgage or other lienholder. In addition, the Bankruptcy Code allows for creditors with secured claims, including secured tax claims, to receive payment for post-petition accruing costs and fees, including attorney's fees, allowed by state statute. *See Bankruptcy Code §506(c)*.

2. Personal property taxes, in Indiana, are not secured by an automatic first priority lien like real property taxes. Consequently, personal property taxes are generally unsecured in bankruptcy. However, certain personal property taxes qualify for status as a "priority" unsecured claim, which means that such priority tax claims must be paid ahead of lower priority and general unsecured claims. Personal property tax claims may qualify for the eighth priority. *See Bankruptcy Code §507(a)(8)*. In order to qualify for priority status, the personal property tax must have been: (1) assessed before the commencement of the bankruptcy case; and (2) be last payable without penalty after one (1) year before the date of the bankruptcy filing. *See Bankruptcy Code §507(a)(8)(B)*. Note that this priority status generally applies only to the actual tax and not any penalties or other fees. Some Courts, however, will allow a taxing authority's collection costs, including attorney fees, to be accorded priority status along with the actual tax. *See Bankruptcy Code §507(a)(8)(G)*. Pre-petition personal property taxes which do not qualify for this priority status will generally be treated as general unsecured claims and be paid on a pro-rata basis with all other general unsecured creditors.

C. Automatic Stay.

1. The automatic stay is a creation of the Bankruptcy Code which generally prohibits all efforts by a debtor's creditors to engage in direct collection efforts without first obtaining permission of the Bankruptcy Court. The automatic stay takes effect immediately upon the filing of a bankruptcy. *See Bankruptcy Code §362(a)*.
2. There are several exceptions to the automatic stay which apply to property tax collection efforts. The automatic stay does not prohibit a taxing authority from making a tax assessment; issuing a notice of taxes due and demand for payment of such taxes; issuing a notice of tax deficiency; issuing a demand for tax returns to be filed; or conducting an audit to determine tax liability. *See Bankruptcy Code §362(b)(9)*. In addition, a further exception to the automatic stay allows statutory liens, such as the lien securing real property taxes in Indiana, to attach to property of the debtor as they normally would outside of bankruptcy. *See Bankruptcy*

Code §362(b)(18). The automatic stay, however, does prevent taxing authorities from taking other action to collect taxes from a taxpayer in bankruptcy including conducting a tax sale of the taxpayer's real property with delinquent taxes, levying on the taxpayer's personal property or certifying to court delinquent taxes for collection.

D. Proofs of Claim.

1. Proofs of Claim are forms completed by a creditor and filed either with the Bankruptcy Court, or in some cases a claims agent, which provide evidence of the amount due from the debtor to the creditor as of the date of the bankruptcy filing. The form is a single page and asks for basic information about the creditor such as name and address, the basis for the debt, the amount due and whether any of the debt is secured or priority. When filing a proof of claim, it is always advisable to attach a copy of the relevant tax bill or bills or some other computer print-out or documentation providing details about the taxes that are due.
2. It is generally a good idea to file a proof of claim for pre-petition taxes in every Chapter 11 and Chapter 13 bankruptcy case and also in Chapter 7 cases in which you receive a notice from the Bankruptcy Court telling you there are assets available for distribution and that a proof of claim should be filed. The initial notice of bankruptcy will frequently state the deadline for filing a proof of claim, and governmental entities usually have somewhat more time to file their proofs of claim, although not always. Once the proof of claim is filed, it serves as, and will be considered, evidence of a valid claim against the bankruptcy estate, unless the debtor, the bankruptcy trustee or another interested party files an objection to the claim. *See Bankruptcy Code §502(a)*. However, if a timely proof of claim is not filed, you may not be able to receive any payments from the bankruptcy estate on the debtor's pre-petition tax debt, or payments received may be in the wrong amount, or the claim may not be accorded the correct status it is entitled to. In short, failing to timely file a proof of claim could result in receiving no payment on pre-petition tax claims or underpayment on such tax claims from the bankruptcy estate.

E. Dischargeability of Property Taxes in Bankruptcy.

1. Real Property Taxes.
 - a. Because real property taxes are secured from the date of assessment by an automatic first priority lien on the assessed real property, real property taxes are, in effect, virtually never discharged in bankruptcy. *See I.C. 6-1.1-22-13*. This is true regardless of the type of bankruptcy case (e.g., Chapter 7, Chapter

11, etc.). The first priority lien for the amount of taxes remains attached to the assessed real property and secures payment of the full amount of taxes. If the property is sold through the bankruptcy, the first priority lien for taxes attaches to the proceeds from the sale of the property and remains a first priority lien. If the property is abandoned from the bankruptcy estate to a mortgage lienholder for foreclosure, the lien remains attached to the real property, and the mortgage lienholder should pay the taxes from the proceeds of the foreclosure sale, if not before.

- b. Real property taxes may be discharged in a bankruptcy if the accumulated taxes assessed against the parcel of real property are more than the value of the real property itself. However, this circumstance rarely arises.
- c. Nonetheless, the County Treasurer must be vigilant in protecting the County's rights in bankruptcy, or otherwise nondischargeable real property taxes may be unnecessarily discharged in whole or in part. The Treasurer should timely file a proof of claim in all bankruptcy cases except for "no asset" Chapter 7 cases. The initial notice of bankruptcy will frequently state the deadline for filing a proof of claim, and governmental entities usually have somewhat more time to file their proofs of claim (although not always). In addition, all plans of reorganization under Chapter 11, Chapter 12 and Chapter 13 should be carefully scrutinized as soon as they are received to make sure that the proposed treatment of the County's tax claim accurately reflects the amount of taxes owed and the County's rights under the Bankruptcy Code. Do not assume that the debtor will accurately state the amount of taxes owed in the debtor's schedules or in the plan. I once reviewed a Chapter 11 plan of reorganization in which the debtor understated the amount of taxes owed by approximately \$60,000.00. If the Treasurer fails to file an objection to any plan by the deadline for doing so, the Treasurer will waive the right to object and will be bound by the plan's terms, even if legally entitled to more favorable terms. In addition, if the Treasurer fails to file a proof of claim by the deadline for doing so, the County may not be able to receive distributions under a plan, even if the plan provides for distributions.

2. Personal Property Taxes (including Mobile Homes).

- a. Unfortunately, the treatment of personal property taxes (including mobile home taxes) in bankruptcy is much more complex than the treatment of real property taxes. This is due primarily to the fact

that real property taxes are secured by an automatic first priority lien under Indiana law, where as personal property taxes are usually unsecured. If personal property taxes are secured, it is usually by a judgment lien resulting from a certified tax judgment. Such liens are not entitled to first priority automatically, as real property tax liens are. *See I.C. 6-1.1-23-1 and 2.* Nonetheless, personal property taxes are frequently entitled to priority which results in such taxes being paid before general unsecured claims. Personal property taxes are eighth on the list of priority claims under the Bankruptcy Code. *See Bankruptcy Code §507(a)(8)(B).*

b. The dischargeability of personal property taxes varies depending on the type of bankruptcy case. Accordingly, I will discuss the dischargeability of personal property taxes under each of the different types of bankruptcy.

(1) Chapter 7. The general rule under Chapter 7 is that any taxes entitled to priority under Bankruptcy Code Section 507(a)(8) are not dischargeable in a Chapter 7 bankruptcy. *See 11 U.S.C. §§523(a)(1) and 727(b).* Therefore, personal property taxes that were: (i) assessed before the date the bankruptcy was filed and (ii) last payable without penalty after one year before the date of the bankruptcy filing are not dischargeable.

As an illustration, consider a Chapter 7 bankruptcy filed on March 2, 2009. Personal property taxes for 2008 payable 2009 and 2009 payable 2010 will be nondischargeable: the taxes were assessed prior to the date of the bankruptcy filing (i.e., March 1, 2008 and March 1, 2009) and are last due and payable after March 2, 2008 (the date one year before the filing of the bankruptcy case). Personal property taxes for 2007 payable 2008 are also nondischargeable: the taxes were assessed prior to the date of the bankruptcy filing (i.e., March 1, 2007) and were last due and payable after March 2, 2008 (the date one year prior to the date of the bankruptcy filing). All taxes assessed in 2006 or earlier will be dischargeable.

If you alter the example somewhat and assume that the Chapter 7 bankruptcy was filed on February 28, 2009, personal property taxes for 2008 payable 2009 and 2007 payable 2008 would still be nondischargeable for the same reasons previously stated. Personal property taxes for 2009 payable 2010 would also still be nondischargeable but for a

different reason. Only those debts which arose prior to the date of the bankruptcy filing are dischargeable in Chapter 7. 11 U.S.C. §727(b). Since the personal property taxes for 2009 payable 2010 were not assessed until the day after the bankruptcy filing, those taxes would not be dischargeable in that case.

If you alter the example again and assume the Chapter 7 bankruptcy was filed on July 1, 2009, the personal property taxes for 2008 payable 2009 and 2009 payable 2010 are nondischargeable pursuant to Bankruptcy Code Sections 523(a)(1) and 727(b). However, in this example, only the November installment of the 2007 payable 2008 taxes is nondischargeable because the May installment was last payable without penalty on May 10, 2008, which is more than one year before the date of the bankruptcy filing.

With respect to personal property taxes that are discharged in bankruptcy, the County may still have some recourse for collection. If the delinquent taxes have been certified as a judgment, the County has a judgment lien securing payment of the delinquent taxes. This judgment lien attaches to all real property owned by the debtor in the assessing County. The bankruptcy discharge alone would not remove this judgment lien from the debtor's property, although there may be other steps the debtor could take in the bankruptcy case to have the judgment lien removed. If the judgment lien has not been removed during the course of the bankruptcy, after the bankruptcy has closed, the County may take action to foreclose its judgment lien. However, any liens ahead of the County's judgment lien for taxes would have to be paid first in full before the County's judgment lien could be paid. Consequently, as a practical matter, if there are numerous liens on the property ahead of the County's judgment lien for taxes, the County may not be able to collect the delinquent taxes through this route either.

- (2) Chapter 11. Personal property taxes entitled to priority under Bankruptcy Code Section 507(a)(8) are nondischargeable pursuant to Bankruptcy Code Sections 523(a)(1) and 1141(d)(2). Under Bankruptcy Code Section 1129(a)(9)(C), personal property taxes that are entitled to priority pursuant to Bankruptcy Code Section 507(a)(8) must be paid in full with interest through the debtor's

Chapter 11 plan of reorganization, unless the County agrees (or does not object) to different treatment. In order to determine whether particular personal property taxes are entitled to priority under Bankruptcy Code Section 507(a)(8), see the examples set forth under Chapter 7. Note that a discharge in Chapter 11 applies to debts that arose prior to the date of confirmation of the debtor's plan. 11 U.S.C. §1141(d).

All other personal property taxes not entitled to priority are treated as general unsecured claims and are paid on a pro-rata basis with other general unsecured claims. Non-priority personal property taxes may be discharged in Chapter 11. However, as described under Chapter 7, the County may have a judgment lien securing repayment of discharged personal property taxes. Please refer to the description of judgment liens under Chapter 7.

- (3) Chapter 12. The general rules for the dischargeability of personal property taxes in Chapter 12 cases are the same as the rules for dischargeability in Chapter 7 cases. Accordingly, personal property taxes entitled to priority under Bankruptcy Code Section 507(a)(8) are not dischargeable in Chapter 12 cases. *See 11 U.S.C. §§523(a)(1) and 1228.* Note that a discharge in Chapter 12 applies to debts "provided for by the plan." 11 U.S.C. §1228.
- (4) Chapter 13. Under Bankruptcy Code Section 1328(a), if the debtor completes all the payments required under his confirmed Chapter 13 plan, he is entitled to a full discharge, which would include all personal property tax debts. However, in order to confirm a Chapter 13 plan, the debtor must provide in his plan for the payment in full (deferred payments are permissible) of all personal property taxes entitled to priority under Bankruptcy Code Section 507(a)(8). *See 11 U.S.C. §1322(a)(2).* Consequently, if the County Treasurer is vigilant and timely files a proof of claim and, if necessary, timely objects to the provisions of any Chapter 13 plan which does not meet the requirements of Bankruptcy Code Section 1322, all personal property taxes entitled to priority will be paid in full, or the debtor will not receive a discharge for such tax debts. However, if the Treasurer fails to timely file a proof of claim or waives the right to object to any objectionable provision in a Chapter

13 plan, the County may not receive as much as it is entitled to, or it may receive nothing, and personal property taxes will be discharged. In addition, personal property taxes which are not entitled to priority under Bankruptcy Code Section 507(a)(8) are general unsecured claims and may be discharged whether paid in full or not.

Under Bankruptcy Code Section 1328(b), if a debtor does not complete the payments required under his Chapter 13 plan but nonetheless is entitled to and obtains a "hardship discharge," the same rule that applies to the dischargeability of personal property taxes in Chapter 7 cases will apply to personal property taxes in such Chapter 13 case. Accordingly, personal property taxes entitled to priority under Bankruptcy Code Section 507(a)(8) are not dischargeable, and other personal property taxes are dischargeable.

Note that a discharge in Chapter 13 applies to debts "provided for by the plan." 11 U.S.C. §1328.

As with personal property taxes in the other chapters of bankruptcy, personal property taxes that are dischargeable in Chapter 13 may, nonetheless, be secured by a judgment lien resulting from a certified tax judgment. To the extent that there is sufficient value in the debtor's real estate to pay such tax judgment liens, the County may collect the personal property taxes for which it has a judgment lien despite a bankruptcy discharge.