

State of California

# County Tax Collectors' Reference Manual

Chapter 11000: Bankruptcy

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California State Controller's Office

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## INTRODUCTION

The County Tax Collectors Reference Manual is produced by the State Controller's Office (SCO), Local Government Programs and Services Division, Property Tax Standards Unit. This manual is designed to provide comprehensive reference material to assist county tax collectors in performing his or her duties in compliance with statutory requirements and promote uniformity throughout the state.

All statutory references cited are from the Revenue and Taxation Code, unless otherwise noted. Citations and references in this manual are current as of its publication date; however, care must be taken to ensure that none have been superseded by subsequent legislative action or court decisions.

The SCO forms referred to within this manual are samples that contain all of the required information pursuant to statute. The county tax collector's office may use the sample forms or create his or her own forms. Forms used should contain all information required by statute.

**NOTICE:** This publication is provided by the SCO as a general resource for California's county tax collectors. This publication is written primarily for use by county tax collectors and does not constitute legal advice. This publication has been reviewed by The Committee on County Tax Collecting Procedures and members of the California Association of County Treasurers and Tax Collectors.

## 11000-11001 General Overview

### **11000. BACKGROUND**

The Bankruptcy Abuse and Consumer Protection Act of 2005 (P. L. 109-8) was the first major revision of the bankruptcy laws since the Bankruptcy Reform Act of 1978 (P. L. 95-598). The result is a completely overhauled Title 11 of the U.S. Code.

The intent of Congress in making these changes to the Bankruptcy Code was to improve the law in a way that would restore personal responsibility. The majority of the changes made to the Bankruptcy Code impact consumer bankruptcy, but some Code changes affect corporations, farmers, and small businesses.

The Act also made vast and dramatic changes in the substantive bankruptcy laws. These changes include:

- 1) Means Testing;
- 2) Expanded Debtor Duties;
- 3) Priority Child Support;
- 4) Military Accommodations;
- 5) Automatic Stay Exceptions Expanded;
- 6) Credit Counseling;
- 7) Exemption Law Changes; and
- 8) Non-dischargeable Debts Expanded.

### **11001. AREAS AFFECTING UNSECURED TAX COLLECTION**

The five general areas of the Bankruptcy Abuse and Consumer Protection Act of 2005 (P.L. 109-8) that affect the collection of unsecured taxes are:

- 1) The automatic stay provisions of filing a petition in bankruptcy;
- 2) Pre-petition claims for eighth-priority treatment;
- 3) Post-petition administrative expense claims as second priority;
- 4) Claims as a general unsecured creditor; and
- 5) Collection of certain unsecured property taxes after an individual is discharged from bankruptcy.

## 11010-11011 Automatic Stay

### **11010. CONCEPT OVERVIEW**

The automatic stay is one of the fundamental debtor protections provided by bankruptcy law. It stops collection efforts, harassment, and foreclosure actions against the debtor. In addition, it permits an orderly liquidation procedure under which all creditors are treated equally.

The voluntary filing of a petition by the debtor in bankruptcy automatically stays any enforced collection action. This includes any court action up to and including the filing of an abstract of judgment when a judgment has been rendered by a court prior to the filing of the bankruptcy proceeding ([11 U.S.C. §362\(a\)\(4\) and \(5\)](#)).

A taxing authority may conduct an audit to determine the debtor's tax liability, may issue a notice of tax deficiency, may make an assessment, and may demand payment from the debtor in specific situations ([11 U.S.C. §362 \(b\)\(9\)\(A\), \(B\), and \(D\)](#)).

A taxing authority may create and/or record a tax lien to secure the payment of any property tax coming due after the date of the bankruptcy petition. The right to lien applies to both secured property tax ([Rev. and Tax Code §2187](#)) and unsecured property tax, which is secured by recording a certificate of delinquency ([Rev. and Tax Code §2191.3](#); [11 U.S.C. §362\(b\)\(18\)](#)).

### **11011. RELIEF FROM STAY**

The creditor with a prior lien on the debtor's property may file a motion with the court to obtain relief from the stay ([11 U.S.C. §362\(d\) & \(f\)](#)). This provision is mainly for secured, private creditors; its use by a tax collector is recommended only when a debtor files multiple bankruptcies or prior to the recordation of the Notice of Power to Sell Tax-Defaulted Property, authorizing the tax collector to offer for sale the property outside the bankruptcy.

For Chapter 7 cases and prior to the confirmation of a Chapter 11 or 13 reorganization plan, the main requirements are that the liens exceed the market value of the property and that the property is not necessary to an effective reorganization. After a Chapter 11 or 13 plan has been confirmed, the tax collector may obtain relief from an automatic stay if substantial payments required by the plan are not made (*In re Elmore* (Bankr. C.D. Cal. 1988) 94 B.R. 670; *In re Radney* (Bankr. M.D. Ga. 1987) 68 B.R. 444; also see *Matter of McMartin Industries* (Bankr. D. Neb.1986) 62 B.R. 718). Often, the filing of a motion for relief from stay results in an accommodation by the debtor or trustee.

## 11020-11027 Pre-Petition Claim for Priority Unsecured Taxes

### **11020. CONCEPT OVERVIEW**

Tax claims of any governmental entity that are assessed before bankruptcy and not secured by a tax lien are classified as eighth priority under [11 United States Code section 507\(a\)\(8\)](#), if the tax was assessed within the statutory time limitations of the Bankruptcy Code. Pre-petition priority taxes include:

- 1) Gross receipts taxes (including city payroll taxes measured as a percentage of payroll expense) for a taxable year ending on or before the date of the filing of the petition ([11 U.S.C. §507\(a\)\(8\)\(A\)](#)); and
- 2) Property taxes incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition ([11 U.S.C. §507\(a\)\(8\)\(B\)](#)).

In Chapter 11 cases, in the event that a debtor proposes to pay unsecured priority taxes under [11 United States Code section 507\(a\)\(8\)](#) within the five-year payment period, case law holds that the interest is allowed through the five-year payment period established under the plan in accordance with [11 United States Code section 1129\(a\)\(9\)\(C\)](#) so that what is received over a period of time will be equal to the present value of the priority tax claim. (See *In the Matter of Burgess Wholesale Mfg. Opticians, Inc.* (7<sup>th</sup> Cir. 1983) 721 F.2d 1146; *United States v. Southern States Motor Inns, Inc.* (11<sup>th</sup> Cir. 1983) 709, F.2d 647.)

**NOTE:** Real estate taxes are always secured by the tax lien and therefore are not included in this section. Unsecured taxes becoming delinquent after the petition is filed can be secured by a post-petition certificate of delinquency ([Revenue and Taxation Code section 2191.3](#)) and also filed as secured tax claims. The only reason for filing an unsecured personal property tax claim under this section would be the absence of property in the estate to which the lien would attach.

- 3) Taxes that the debtor is required to collect from others and remit to the taxing authority, e.g., transient occupancy taxes. No time limit applies ([11 U.S.C. § 507\(a\)\(8\)\(C\)](#)).

### **11021. FILING SCHEDULE**

Chapter 7 and Chapter 13 cases:

A governmental claim for pre-petition taxes is timely if it is filed not later than 180 days after the date of the order for relief ([Bankruptcy Rule 3002\(c\)](#)). A government agency may make a motion to extend the time before the 180-day period has expired.

Chapter 11 cases:

All pre-petition claims must be filed within the time established by the court upon due notice to all interested parties ([Bankruptcy Rule 3003\(c\)\(3\)](#)). This time can be extended by motion upon the showing of good cause.

### **11022. ASSESSMENT DATE**

Although the unsecured tax bill may have been issued after the filing of bankruptcy, if the lien date is prior to the date the petition in bankruptcy was filed, the unsecured tax bill is considered as assessed before the filing of the petition for purposes of filing a pre-petition claim for priority-six treatment.

### **11023. PAYMENT PRIORITY AMONG OTHER TAXING AUTHORITIES**

The Bankruptcy Code makes no provision for priority among different taxing agencies. The principal bankruptcy priorities come from the classification of the claim itself, e.g., secured versus unsecured, administrative expense versus pre-petition priority, rather than the identity of the governmental agency holding the claim.

However, as between competing secured claimants holding equally non-avoidable liens, the non-bankruptcy law in the state where the property is located applies. Thus, the senior priority status of the secured real property tax lien under [Revenue and Taxation Code section 2192.1](#) would be applied in California.

### **11024. DELINQUENCY PENALTIES**

True penalties, i.e., penalties assessed for punitive purposes, on pre-petition tax claims are not included in pre-petition tax classification (*In re Paar Meadows Racing Association* (2nd Cir., 1989) 880 F.2d 1540). The Bankruptcy Code makes the distinction between a tax penalty related to actual identifiable pecuniary loss suffered by the government because of the debtor's misfeasance, which is given priority status along with the underlying tax ([11 U.S.C. § 507\(a\)\(8\)\(G\)](#)), and penalties in excess of actual loss imposed to vilify and punish the debtor for fiscal misconduct. If the latter penalties are

imposed on pre-petition tax claims (both secured and unsecured), they are not afforded priority status but are classified fourth-priority status after general unsecured claims (*In re Paar Meadows Racing Association, supra*); also see *In re California Wholesale Electric* (Bankr. C.D. Cal. 1990) 121 B.R. 360 and *In re Brentwood Outpatient, Ltd.*, (6<sup>th</sup> Cir., 1994) 43 F.3d 256.

### **11025. INVOLUNTARY GAP**

If a lien date for property tax occurs between the filing of an involuntary petition in bankruptcy by a creditor and the subsequent confirmation of the bankruptcy of the debtor by the court, the tax is not entitled to treatment as a first-priority administrative expense. However, it is eligible for seventh-priority treatment if it met the requirements for property taxes. See [Manual section 11020](#).

Bankruptcy Code section 502(i) allows certain tax claims coming into existence during the period after an involuntary petition has been filed, but before an order adjudicating the debtor bankrupt, to be treated the same as pre-petition priority tax claims.

### **11026. SECURED CLAIMS FOR UNSECURED TAXES**

The Internal Revenue Service (IRS) is filing secured tax claims for pre-petition taxes where it has filed a lien or attachment. This gives the pre-petition tax claim the higher status of a secured claim. Where a lien has been filed for pre-petition unsecured taxes before the filing date, a tax collector should file a secured claim instead of a general unsecured claim. A copy of the lien should be attached to the bankruptcy claim to substantiate its secured status.

Any claim for secured taxes (excepting mobilehomes and possessory interests) should be filed as a secured claim, not as a priority tax claim.

### **11027. SECURED TAX CLAIMS**

Taxes secured by a lien are allowed in bankruptcy as secured claims (*United States v. Ron Pair Enterprises* (1989) 489 U.S. 235 [109 S. Ct. 1026]). Secured real property tax claims are entitled to interest, fees, costs and other charges pursuant to [11 United States Code section 506\(b\)](#) (See also [11 U.S.C. § 1129\(b\)\(2\)\(A\)](#) for Chapter 11 & [11 U.S.C. § 1325\(a\)\(5\)\(B\)\(ii\)](#) for Chapter 13.)

As a general rule, property of the bankruptcy estate that is encumbered by a tax lien is unaffected by the order of discharge, which is limited to the debtor's personal liability, and the lien survives the ensuing administration of the estate. An exception is when the lien is specifically voided, subordinated, or dealt with by a bankruptcy court order confirming a plan under the Bankruptcy Code for distributing property of the estate in a manner inconsistent with the tax lien ([11 U.S.C. §1141](#) (Chapter 11 cases), [11 U.S.C. §1327](#) (Chapter 13 cases)).

## **11030-11035 Post-Petition Claim for Taxes as an Administrative Expenses**

### **11030. CONCEPT OVERVIEW**

An actual necessary cost or expense of preserving a bankruptcy estate is entitled to the second priority of payment, as an administrative expense ([11 U.S.C. §503\(b\)\(1\)\(A\)](#)). Taxes, whether secured or unsecured, pertaining to tax periods occurring after the date of petition are given the same second priority as administrative expenses ([11 U.S.C. § 503\(b\)\(1\)\(B\)](#), [507\(a\)\(2\)](#)), *In re Mark Anthony*

*Construction, Inc.* (9th Cir. 1989) 886 F.2d 1101).

Also, Title 28 U.S.C. section 960, provides that any federal officer conducting a business is responsible for taxes, just as the business entity would be. This applies to trustees and debtors in possession managing an estate in bankruptcy cases.

Property taxes that accrued (as of the lien date) after the filing of a bankruptcy petition are generally the responsibility of the bankruptcy trustee or debtor in possession, whether the bankruptcy is in a Chapter 11 or 13 debtor-relief proceeding or in a liquidation of assets under Chapter 7.

Prior-year escape assessments whose lien date is before the filing of the petition are pre-petition claims, even though the bill was issued after the filing of the petition.

### **11031. FILING OF POST-PETITION CLAIMS**

Before a trustee or debtor in possession can terminate a bankruptcy case, all formal claims must be paid or objected to. If the claim is objected to, a hearing date is usually set for the court to rule on the claim and the objection. Therefore, if a formal claim is filed, the bankruptcy case is not terminated without notice or payment to the tax collector.

However, a county's failure to file a claim could result in distribution of the bankruptcy estate without payment, unless the debtor scheduled the tax obligation and filed a claim for the tax collector.

The time, form, and number of copies to be filed for administrative expense claims are contained in the local rules of the bankruptcy court and should be determined for each bankruptcy court division. Usually, one copy is sufficient.

If no time limit is specified, the tax collector is still subject to "laches" for any unreasonable delay in providing notice of the assessment. Some tax collectors routinely request the assessor to put the administrative expense unsecured tax bill in the name of the trustee, if one has been appointed, in addition to filing an administrative claim, as an aid in collecting administrative expense taxes.

**NOTE:** Although it is recommended that counties file an administrative expense claim, the bankruptcy code does not require a governmental unit to file one. ([11 U.S.C. § 503\(b\)\(1\)\(D\)](#))

### **11032. PAYMENT OF CLAIMS FOR POST-PETITION TAXES**

It is the practice of many debtors in possession under Chapter 11 proceedings and trustees under Chapter 7 liquidations to postpone payment of administrative expense taxes, even when a separate claim identifying the taxes as administrative claims has been filed. It is good practice to send a special demand letter to the debtor or trustee, explaining that the bill is an administrative expense and that the debtor or trustee is obligated to pay now.

A trustee or debtor in possession who is operating a business is obligated to observe all federal, state and local tax laws ([28 U.S.C. §960](#)). In the event of default, the taxing authority's only remedy is to file a motion for an order converting the case to Chapter 7 or dismissing the case. ([11 U.S.C. § 1112 \(b\)\(4\)\(I\)](#)) There is no motion to order the debtor in possession to pay administrative taxes.

If the estate is carrying on a business or has made regular administrative expense payments to suppliers, employees, etc., and refuses to pay administrative expense taxes, the tax collector can request the county legal counsel to file a motion in the bankruptcy court. Often, if legal counsel merely notifies the attorney for the debtor or trustee that the county intends to file such a motion, this is sufficient to produce a timely payment.

### **11033. PENALTIES IN POST-PETITION TAX CLAIMS**

Delinquency penalties are collectible with proper post-petition tax claims, because the debtor in possession or the trustee incurred the penalty by not making the payment in a timely manner. ([11 U.S.C. §503\(b\)\(1\)\(C\)](#)) Interest is also allowed for post-petition tax claims. (See also Historical and Statutory Notes of section 503; *In re Weinstein* (1<sup>st</sup> Cir. 2001) 272 F.3d 39; *Ingels v. Boteller* (9<sup>th</sup> Cir. 1938) 100 F.2d 915; *Nicholas v. U.S.* (1966) 384 U.S. 678 [86 S.Ct. 1674], *In re Mark Anthony Construction, Inc.* (9<sup>th</sup> Cir. 1989) 886 F.2d. 1101; *In re Pacific-Atlantic Trading Company* (9<sup>th</sup> Cir., 1995) 64 F.3d 1292; and *United States v. Noland* (1996) 517 U.S. 535 [134 L.Ed.2d 748].

However, penalties cannot be collected as unsecured taxes after a trustee has discontinued business operations and has commenced liquidation of the estate's assets.

### **11034. PRIORITY OF ADMINISTRATIVE EXPENSE BETWEEN CHAPTERS 7 & 11**

Where there are outstanding administrative expenses for a prior Chapter 11 proceeding and a subsequent Chapter 7 liquidation, the expenses of administering the Chapter 7 liquidation have precedence over the prior Chapter 11 administrative expenses. This potential loss of administrative expense taxes makes it good practice to pursue payment of a Chapter 11 administrative tax claim before the bankrupt's estate is converted to a Chapter 7 liquidation.

### **11035. LIMITATION OF ADMINISTRATIVE EXPENSE TREATMENT TO THE EQUITABLE VALUE OF THE ASSET TAXED**

Where the taxable asset is encumbered by prior liens or a secured creditor, the trustee may be able to avoid administrative expense tax claims that exceed the equitable value of the asset to the bankruptcy estate. In other words, the bankruptcy estate (i.e., trustee or debtor in possession) is liable only for taxes on the equitable value of the assessed asset. This usually involves the abandonment of an asset by the trustee to the secured creditor or lienholder. However, the debtor remains liable for the entire amount of taxes as a pre-petition claim in these cases (accord, *In re Carolina Triangle Limited Partnership* (9<sup>th</sup> Cir. B.A.P. 1994) 166 B.R. 411).

## 11040 General Unsecured Claims for Taxes

### **11040. CONCEPT OVERVIEW**

If more than one year has expired between the first delinquency date and the filing of a petition, unsecured taxes are entitled to treatment only as an unsecured credit.

Unless secured by a lien, property taxes that were assessed as delinquent for more than one year before petition are treated as general unsecured claims (*In re Electronic Theatre Restaurants* (Bankr. N.D. Ohio 1988) 85 B.R. 45).

## 11050-11053 Collection After Discharge

### 11050. CONCEPT OVERVIEW

Taxes that meet the requirements of [11 United States Code section 523\(a\)\(1\)](#) are non-dischargeable in bankruptcy and include:

- 1) Taxes determined to have priority status as defined in [11 United States Code section 507\(a\)\(8\)](#); i.e., pre-petition unsecured taxes;
- 2) Taxes determined to be post-petition administrative taxes within the meaning of [11 United States Code sections 507\(a\)\(2\)](#) and [503\(b\)\(1\)\(B\)](#);
- 3) Taxes assessed in the absence of a legally required tax return; and
- 4) Taxes assessed because of a fraudulent return or because the debtor acted willfully to evade the tax.

When an individual debtor receives a discharge in bankruptcy, the automatic stay against enforced collection action against the debtor is terminated for any non-dischargeable debts, if there are no assets in the estate to pay the taxes.

In these cases, the tax collector should rely on the bankruptcy estate to pay the priority taxes if there are sufficient funds. If there are no assets in the bankruptcy estate, collection enforcement procedures may be pursued against the individual. Payment cannot be obtained from both sources. Under the new bankruptcy code, discharged debtors have been able to exempt considerable assets. However, such debtors may be employed and subject to wage garnishment or may have a bank account subject to seizure. Collections should not be written off just because an individual has filed bankruptcy.

**NOTE:** Before using enforced collection procedures after a discharge in bankruptcy, the tax collector should ensure that the tax became delinquent within one year before the filing of the petition in bankruptcy (priority taxes under [11 United States Code section 507\(a\)\(8\)](#)), so it qualifies as a non-dischargeable debt. It is apparent that an aggressive collection effort is required for the first year after delinquency in order to reduce the amount of unrecoverable taxes due to a subsequent bankruptcy.

### 11051. STATUS OF UNSECURED TAX LIENS

Collections on unsecured tax liens filed before the filing of the bankruptcy petition are not precluded by a discharge in bankruptcy, even though the taxes were more than one year delinquent when the petition was filed (*Verran v. U.S. Treasury Department* (6<sup>th</sup> Cir. 1980) 623 F.2d 477). In other words, a discharge in bankruptcy does not release or affect a tax lien, and the lien should not be released just because the taxes were discharged in bankruptcy. See Sales Free and Clear of Liens, [Manual section 11052](#).

### 11052. SALES FREE AND CLEAR OF LIENS

Trustees often hold onto the real property and sell the property free and clear of liens under [11 United States Code section 363\(f\)](#). Upon the sale free and clear of the liens, the liens are transferred to and

attached to the proceeds of the sale. Most title companies require the secured taxes to be paid upon sale.

Pursuant to *Pearlstein v. Small Business Administration* (D.C. Cir. 1983) 719 F.2d 1169, the relative priority among valid liens is to be determined by non-bankruptcy law. In California, pursuant to [Revenue and Taxation Code section 2192.1](#), secured real property taxes have priority over all other liens on property, regardless of the time of their creation.

### **11053. OBJECTIONS TO SALES FREE AND CLEAR OF LIENS**

To sell property free and clear of liens, the debtor or trustee must have an interest in the property, or there must be unsecured administrative expense creditors. In addition, one of the five requirements of [11 United States Code section 363\(f\)](#) must be met. Lienholders must review the sale motion carefully to ascertain that their liens are treated properly. The failure to object to a sale free and clear of liens could result in non-payment of pre-petition secured taxes in special cases, depending on the trustee's and the court's view as to the priority of the secured taxes and the amount of administrative expenses.