

## Coates' Canons Blog: Bankruptcy and Tax Collection

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I love a good flowchart. To me, nothing can simplify a complex process better than a well designed flowchart. Wouldn't it be wonderful if we had flowcharts to help us navigate some of life's more difficult decisions? Flowcharts would certainly be helpful when asking, "Which house should we buy?" Or, "Is that new job opportunity right for me?" Maybe even, "Should I have another shot of tequila?"

Sadly, I can't help with those sticky situations other than to share my observation that more tequila rarely produces positive consequences. But I *can* offer two flowcharts that should be helpful to tax collectors dealing with the increasingly common problem of taxpayer bankruptcies.

The economy may be improving, but bankruptcies show no sign of slowing. North Carolina bankruptcy filings increased by 50% in the third quarter of 2010 as compared to the same period two years earlier. More taxpayers filing for bankruptcy mean more delays in the collection of local taxes thanks to the automatic stay that arises immediately after a bankruptcy petition is filed. With few exceptions, the stay prohibits all collection actions for all obligations owed by the bankruptcy debtor, regardless of whether the obligation arose before or after the petition was filed.

The only silver lining in the process for local tax collectors is the preferential treatment given to local taxes by federal bankruptcy law. While a bankruptcy filing will almost certainly delay the collection of local taxes, many of those taxes either will be paid during the bankruptcy or will remain enforceable after the bankruptcy ends. But the process is complex and not easy to decipher.

Tax collectors facing bankruptcies need to answer two basic questions. First, they need to know whether their claims will be enforceable after discharge, the technical name for the successful completion of a bankruptcy proceeding. Some taxes will be enforceable using all available remedies, some will be enforceable only through foreclosure, while some—usually older unsecured taxes—won't be enforceable at all. Second, tax collectors need to determine whether they should file with

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the bankruptcy court a request for payment, known as a “proof of claim,” for the taxes owed by the debtor. Proofs of claim are not always necessary, but in some circumstances they are vital to protect the interests of the taxing unit.

To help with these decisions, I've created two flowcharts. Flowchart #1 illustrates which tax claims will be enforceable after discharge, while Flowchart #2 diagrams the proof-of-claim question. Both flowcharts are works in progress, meaning I would love your input on how to improve them. I owe a debt of thanks for this idea to Ben Pierce, assistant county attorney in Alamance County.

Here's a quick walk-through of each flowchart.

## **1. Will the Tax Claim Be Enforceable After Discharge?**

This question depends mainly on the type of claim involved. Claims are categorized based on when they were incurred, whether they are secured by a lien on real property, and when they were last payable without interest or penalty.

For bankruptcy purposes, property taxes on all property other than registered motor vehicles are incurred on the listing date, January 1 of each year. Property taxes on registered motor vehicles are incurred on the date an existing registration expires or a new registration is applied for. Other local taxes such as occupancy or privilege licenses are incurred on the first day the taxpayer conducts an activity that is subject to the tax.

Taxes that are incurred after the petition was filed are administrative claims that have the highest payment priority of all tax claims. Taxes that were incurred before the petition was filed and that are secured by a lien on real property generally will be enforceable through foreclosure after discharge. Taxes that were incurred before the petition was filed, are unsecured, and were payable without interest or penalty at any point in the twelve months before the petition was filed are eighth-priority claims that carry a good chance of repayment during or after bankruptcy. Finally, taxes that arose before the petition was filed, are unsecured, and accrued interest or penalties more than a year prior to the filing of the bankruptcy petition are non-priority claims that usually won't be paid during bankruptcy and won't be enforceable after discharge, either.

Clear as mud, right? Hopefully Flowchart #1 will simplify the categorization process.

You'll see that the enforceability of pre-petition eighth-priority claims varies with the type of bankruptcy involved. Tax collectors are most likely to face three types of bankruptcies, all of which are referred to using the name of the relevant chapter of federal bankruptcy law. Chapter 7 bankruptcies are liquidations in which a bankruptcy trustee appointed by the court sells (“liquidates”) the debtor's assets to satisfy creditors' claims. Chapter 11 bankruptcies are business reorganizations in which a business can continue operating while repaying some of its debts. Chapter 13 bankruptcies are reorganizations for individuals with regular income in which the individuals commit large portions of their earnings to repay some of their debts. The notice provided to creditors by the bankruptcy court will indicate which type of bankruptcy is involved.

Note that this flowchart is based on two important assumptions. The first is that the tax collector receives adequate notice of the bankruptcy proceeding to take the actions necessary to preserve the taxing unit's claims against the debtor. If the debtor fails to list the taxing unit as a creditor and the tax collector never receives notice of the proceeding, any taxes owed by the debtor generally will be enforceable after discharge. The second assumption is that the debtor receives a discharge, not a dismissal. A dismissal means the debtor did not complete the bankruptcy process successfully. If the court dismisses a bankruptcy petition, the tax collector can proceed with enforcement as if the petition had never been filed.

## **2. Should the Tax Collector File a Proof of Claim?**

This question depends mainly on the type of bankruptcy involved. For example, most Chapter 7 bankruptcies are “no-asset” cases in which the debtors have no assets that are not exempt from the liquidation process. In such cases, the court doesn't accept proofs of claims from creditors because there won't be any funds to pay any creditors. If non-exempt assets do exist, the trustee will give notice to the creditors and the tax collector should file a proof of claim.

In Chapter 13 bankruptcies, the type of claim held by the tax collector is also relevant to the proof-of-claim decision. After



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using flowchart #1, tax collectors will know the types of claims they hold. They can then use Flowchart #2 to decide whether it makes sense for them to file proofs of claim for the taxes owed by the debtor.

You'll see that in a Chapter 11 or Chapter 13 case, the tax collector needs to be wary of how the debtor or the trustee describes the outstanding taxes in the repayment plan and in any proofs of claims they file on behalf of the taxing unit. If the plan or proofs of claims inaccurately describe the amount or priority of the taxes owed by the debtor, the tax collector should file either an objection to the plan or an accurate proof of claims to correct the misstatements by the debtor or the trustee.

One word of caution: bankruptcy law contains countless complexities and exceptions that can't be summarized in a one-page flowchart. If you come across an unusual situation that doesn't seem to fit into the process described above, please be sure to give me or your attorney a call before moving forward. I also strongly recommend this excellent bulletin written by my colleague Shea Denning and bankruptcy law expert Robert E. Price, Jr.

[Image of "problem resolution" flow chart from [www.popular-pics.com](http://www.popular-pics.com) ]

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