

Bankruptcy News: IRS May No Longe Seize Tax Refunds for Benefit of Chapter 13 Trustee

There may be important changes on the horizon about this tool used by the Chapter 13 bankruptcy trustee. Read more...

Feb. 15, 2010 - [PRLog](#) -- As you probably know, there are two types of consumer bankruptcy cases available to you – a Chapter 7 which wipes out debt, and a Chapter 13 which creates a five year payment plan in which you pay back some or all of your debt with your "disposable income." When I prepare a Chapter 13 case, we work with you to create a liveable budget. The money "left over" after you pay for housing, food, transportation, insurance, utilities and other necessities must be sent to the Chapter 13 trustee, who then disburses these funds to your creditors based on a plan of reorganization that we submit to the court.

What happens if you need to file a Chapter 13, you have not yet filed your tax return for last year, but you know that a refund will be coming your way. The simple answer is that unless you are paying back your creditors at 100%, your Chapter 13 will demand that you turn over your tax refund check, and will use that money to pay your creditors. If you know that a refund is headed your way, make sure to tell your lawyer before you file – there are some steps you can take to preserve some or all of your tax refund money.

Your Chapter 13 trustee will also want future refunds paid to the trustee. This situation is easier to handle – you will want to adjust your payroll withholdings so that you do not have any refund coming. As far as the Chapter 13 trustee is concerned, your tax refund is kind of like a savings account that artificially reduces your net pay amount.

All of the Chapter 13 trustees in the Northern District of Georgia require debtors who are paying less than 100% to creditors to include in their Chapter 13 plans a provision that authorizes the IRS to intercept any refund payable during the years that your plan is in effect and send this money to the Chapter 13 trustee. And until now, the IRS has cooperated with the Chapter 13 trustees in redirecting refund money.

In January, 2010, however, a federal district court in Michigan has ruled that the Chapter 13 trustee does not have the power to compel the IRS to serve as its collection agent. In the case of *United States v. Carroll*, a judge in the Eastern District of Michigan ruled that there is no legal basis for the IRS to withhold money and deliver it to the trustee because Congress has not waived the IRS' "sovereign immunity" that would otherwise leave the IRS vulnerable to contempt actions and other enforcement actions by the trustee (in other words, if the IRS failed to withhold a debtor's refund, the trustee would not have the right to sue the IRS for damages or for remedial action). The Michigan judge issued an order forbidding the bankruptcy courts there from confirming any Chapter 13 plan that has the income tax refund seizure language.

I would not be surprised if bankruptcy courts elsewhere in the nation begin to follow the path set by the Michigan judge. We'll know soon enough, but I suspect that the trustees in the Northern District may discontinue their demand for an income tax provision involving the IRS in Chapter 13 plans.

I do not expect, however that Chapter 13 trustees here or elsewhere in the country will permit Chapter 13 debtors from keeping large tax refunds. I suspect that trustees will still demand provisions that obligate debtors to tender their tax refunds but they will expect the debtors to send in the money, rather than having it withheld by the IRS. I will continue to advise my clients to minimize their refunds to avoid the problem entirely.

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Needless to say, losing this automatic tax refund payment mechanism will make enforcement of tax refund plan provisions much more difficult. It will be interesting to what if anything Chapter 13 trustees do to address this potential administrative nightmare.

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