



Owe IRS, File Chapter 13 Bankruptcy, IRS Gets To Keep Tax Refund!

Many debtors and even many bankruptcy attorneys are surprised to find out that the IRS kept a tax refund to pay the debtor's tax debt notwithstanding the fact that the debtor filed chapter 13 bankruptcy. This situation typically arises for chapter 13 bankruptcies filed between February and May; reason being, most debtors have just filed, or are about to file, their prior year tax return; but if the debtor is going to receive a refund for that year and owes back-taxes, the filing of bankruptcy *does not* stop the IRS from keeping that refund.

There are 2 reasons why the IRS gets to keep the tax refund?

- [Internal Revenue Code 6321](#) provides the IRS with an automatic, statutory lien when a taxpayer owes a tax debt, the IRS has demanded payment, and the taxpayer has not paid. This tax lien is known as the silent or shadow tax lien. The IRS, in essence, has a security interest in the tax refund by virtue of its shadow lien.
- [Bankruptcy Code section 362\(b\)\(26\)](#) expressly allows the IRS to keep the tax refund if the debtor's bankruptcy case was filed after the end of the applicable tax period for which the refund (for individual income tax, the tax period ends December 31) and the refund is being used to pay prior year(s) taxes. This concept is known as a *right of set off*. This bankruptcy code section is saying that the Automatic Stay (which prevents most collection activities against the debtor) does not apply to the IRS's ability to take a refund to pay taxes owed for prior years. The bankruptcy Automatic Stay does not quash the IRS's right of set off.

For example, Don Debtor owes \$35,000 in back income tax for 2006, 2007, and 2008. Don files chapter 13 bankruptcy in February, 2011. Because of changes in his circumstances, Don will receive a \$5,000 tax refund for 2010. The chapter 13 bankruptcy was filed *after* the



end of the 2010 tax year. The combination of IRC 6321 and Bankruptcy Code 362(b)(26) allows the IRS to keep that \$5,000 refund and apply it toward Don's back-taxes even if Don files his tax return after he files chapter 13 bankruptcy. That is even the case even though the tax debt for 2006 and 2007 would be dischargeable in Don's bankruptcy.

So, IRC 6321 creates the IRS's right of set off, and Bankruptcy Code section 362(b)(26) allows the IRS to maintain that right notwithstanding that the taxpayer filed bankruptcy. But, you, as the taxpayer, are no worse off; if Don had not filed bankruptcy, the IRS would have kept the refund anyway.

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