

**Add Section 6593.7 to the Revenue and Taxation Code to prohibit the accrual of interest on unpaid sales and use tax liabilities during the pendency of a Chapter 7 bankruptcy proceeding of a small business, as defined.**

**Source: Honorable Michelle Steel**

### **Existing Bankruptcy Law**

Under existing law, Article I, Section 8, of the United States Constitution authorizes Congress to enact “uniform Laws on the subject of Bankruptcies.” Under this grant of authority, Congress enacted the “Bankruptcy Code” in 1978. The Bankruptcy Code, which is codified as Title 11 of the United States Code, is the uniform federal law that governs all bankruptcy cases.

Several basic types of bankruptcy cases are provided for under the Bankruptcy Code, and the cases are traditionally given the names of the chapters that describe them. Chapter 7, for example, entitled “Liquidation,” contemplates an orderly, court-supervised procedure by which a trustee takes over the assets of the debtor’s estate, reduces them to cash, and makes distributions to creditors, subject to the debtor’s right to retain certain exempt property and the rights of secured creditors. Other common bankruptcy cases include those filed under Chapters 11, 12, and 13, which all involve repayment plans.

A bankruptcy discharge is an order issued by the court that prohibits creditors from personally seeking to collect certain debts from the debtor. Although a bankruptcy discharge releases the debtor from personal liability for certain debts, it does not prevent a secured creditor from seeking to enforce a valid lien against the debtor’s property. In a Chapter 7 bankruptcy case, a discharge is only available to individual debtors, not to partnerships or corporations. If an individual debtor is eligible to receive a discharge, then the court usually issues a discharge order four to six months after the commencement of the debtor’s case.

With respect to individuals in a Chapter 7 case, some debts are dischargeable, and others may be found to be “non-dischargeable” depending on particular circumstances. Sales tax debts, for example, are non-dischargeable in a Chapter 7 bankruptcy unless all of the following are met:

1. The tax return on which the tax debt arose must have been due at least three years before the filing for bankruptcy;
2. The tax return was filed at least two years before the filing for bankruptcy;
3. The taxes were assessed by the Board at least 240 days before filing; and
4. There was not a fraudulent tax return or a willful attempt to evade paying taxes.

A discharge of interest and penalty on taxes follows the tax liability on which it is computed. That is, if the underlying tax liability is dischargeable, so is the interest and penalty on that tax. On the other hand, if the underlying tax liability is non-

dischargeable, the interest or penalty accruing on that tax liability is likewise non-dischargeable.

### **Existing Sales and Use Tax Law**

Under existing law, persons who are late in payment of their tax obligations are required to pay a penalty of 10 percent of the tax, plus interest on those unpaid taxes from the date the tax was due to the date upon which they are paid. The law does not provide for a suspension of interest during the pendency of a bankruptcy proceeding. Therefore, under the law, if a taxpayer files a petition for bankruptcy, and the taxpayer has past due tax obligations, the interest on those unpaid tax obligations continues to accrue at the current rate of 11 percent until those taxes are either paid or discharged.

### **This Proposal**

This proposal would suspend the accrual of interest on past due tax obligations with respect to the period during which a taxpayer's Chapter 7 bankruptcy proceeding is pending if the taxpayer is a qualified small business.

This proposal was prompted by a case heard before the Board where a corporate officer of a small corporation was held personally liable for the debts of the closed out corporation under Section 6829. The corporate officer had entered into a payment plan with the Board to pay off the liability of the corporation. However, in the course of these installments, the corporation filed for bankruptcy under Chapter 7. As a result, even though the corporate officer was willing to continue making monthly payments under the installment payment plan, the officer was informed by the Board that it could not accept any further payments (once a petition for bankruptcy is filed, all the bankrupt's property vests with the trustee and the Board cannot legally collect any further amounts). Consequently, the interest continued to accrue on the unpaid tax at the annual rate of 11 percent, despite the fact that the officer was willing to pay, but legally prohibited from paying the tax with corporate funds while the bankruptcy proceeding was pending.

This proposal would therefore stop the accrual of interest on unpaid tax liabilities during the pendency of a bankruptcy Chapter 7 proceeding, provided the taxpayer is a "qualified small business" and the tax liabilities were due and payable prior to the date in which the petition for bankruptcy was filed. The proposal would define a "qualified small business" as any trade or business with average annual gross receipts of less than one million dollars.

*Section 6593.7 is added to the Revenue and Taxation Code to read:*

6593.7. (a) Notwithstanding any other provision of this part, no interest shall be imposed on a person's failure to make a timely payment of a qualified tax liability during the period in which the person's case is pending under Chapter 7, Title 11 of the United States Code if all of the following conditions are met:

(1) The person is a qualified small business.

(2) The person filed a petition for bankruptcy after the date the qualified tax liability was due as prescribed under this part (including an extension) for filing a return of the tax, and

(3) Pursuant to Sections 362, 521 and 727 of Title 11 of the United States Code, the person is prevented from paying the qualified tax liability.

(b) For purposes of this section, "qualified tax liability" means a tax liability that is due and payable to the state and that remains unpaid as of the date the person filed the petition for bankruptcy.

(c) For purposes of this section, "pending" means the period beginning from the first day of the month following the date the petition for bankruptcy is filed pursuant to section 301 or 302 of subchapter I of Chapter 3 of Title 11 of the United States Code and ending on the last day of the month in which the trustee has filed a final report and final account and has certified that the estate has been fully administered.

(d) For purposes of this section, a "qualified small business" means any trade or business that has average annual gross receipts, less returns and allowances, of less than one million dollars (\$1,000,000). A trade or business has average annual gross receipts of less than one million dollars (\$1,000,000) if, for the three-year calendar period ending immediately prior to the date the petition for bankruptcy was filed, the taxpayer's average annual gross receipts did not exceed \$1 million. If a trade or business has not been in existence for the three-year period, the average annual gross receipts shall be determined based on the average monthly gross receipts during the period the trade or business existed. If the average monthly gross receipts, less returns and allowances, during the period the trade or business existed is less than \$83,333, then the trade or business shall be regarded as a qualified small business.

(e) This section shall not apply when the person's bankruptcy case described in this section results in a dismissal. For purposes of the preceding sentence, a dismissal occurs when the case terminates without either the entry of a discharge or a denial of discharge.