DISCHARGING TAXES IN BANKRUPTCY

__Disclaimer:__ Discharge of taxes in Bankruptcy is a complicated subject. The following is only the basics of the rules. There are many nuances and intricacies. Please understand that this document is not to be relied on as a substitute for doing research or verifying what the case law has determined.

This will provide an overview of the basics of Bankruptcy discharge of taxes. It will attempt to explain in as simple and understandable manner as possible what is required in order in order for taxes to be discharged in Bankruptcy. It is not intended to be a comprehensive discussion.

It is important to learn the principles of tax discharge in Bankruptcy if you represent clients with tax problems, either in Bankruptcy or administratively before the IRS. There are several reasons to learn Bankruptcy discharge.

First, it may be that you client will fare far better in a Bankruptcy than in some other type of relief from their tax liability.

Second, you will be better able to advise your client if you know the principles of Bankruptcy discharge of taxes.

Third, knowing the principles may help you avoid a mistake that could result in a negligence action against you.

A. REQUIREMENTS TO DISCHARGE TAXES IN Bankruptcy

1. The tax must be over three years old from when the return last came due. For example, the year 2010 tax return becomes due on April 15, 2011. On April 16, 2014 the tax meets the requirement of being over three years old from the date it first became due.

TRAP: You must ensure that your client did not file a __Request for Extension__ of time to file their return. If your client filed a __Request for Extension__, that would extend the due date for the return and the start of the three year period until October 15.

This is one of the major reasons why it is important to review a tax transcript before filing Bankruptcy on behalf of a client who has taxes that are between three and four years old. We have found that it is not wise to trust our clients when they tell us that they did not remember filing a Request for Extension. We have often found that clients who do not believe that they filed a Request for Extension did indeed file for an extension. We are talking about events that occurred three to four years previously and memories often fail. See Section Below “Obtaining Information from the IRS”.

2. Two years since the tax return was actually filed. It must be at least two years since the tax return was filed in order to meet this element of discharge. There are numerous lines of cases which address what constitutes a tax return and whether or not it was filed.

TRAP: If the Internal Revenue Service filed a Substitute for Return (SFR). This may **not** constitute the filing of a return and if not the taxes will probably not be discharged.

There is confusion at the present time as to whether a tax return filed by a debtor after the IRS files a SFR constitutes a return for purposes of discharge. There are cases going both ways. The IRS Chief Counsel issued an opinion that if a SFR was filed that the taxes are not subject to discharged. (See attached memo and BAP opinion) There is authority that holds that if a tax return is filed after an SFR, but before the SFR tax is assessed, that those taxes are subject to discharge. There is also authority that if there is a tax return filed after an SFR that shows more tax owed than assessed by the SFR, that the excess amount is discharged.

Very recently, a California Bankruptcy Judge decided a case which held that the mere fact that the IRS filed a Notice of Deficiency and assessed taxes is no bar to the discharge of the taxes where the Debtor filed his return and complied with the other requirements. See the attached opinion.

This subject is ripe for an opinion from the Ninth Circuit and later the Supreme Court, because of the contrary rulings amongst the Circuits. UPDATE: The IRS did file an appeal in the California case. It will be heard by the BAP.

Finally, if there is an agreed to SFR (rare) which is signed by the taxpayer, that agreed SFR constitutes a properly filed tax return.

3. Two hundred and forty days since the tax was assessed. When a taxpayer files a tax return the Internal Revenue Service usually assesses the tax within a relatively short time thereafter. This time period may be a few days or up to a couple of months. The tax does not become dischargeable in bankruptcy for two hundred and forty days after the tax has become assessed. Also, there may have been an examination of the return (audit) and additional tax may have been assessed, which starts a new 240 day period. The tax transcript will tell you this.

4. Late filed returns. There is a split of authority as to whether a return that is filed late constitutes a return for purpose of discharge. Fortunately the Ninth Circuit takes the position that even if a return is filed late, if the other elements for discharge are met, the tax will be discharged. This, of course, assumes that no Substitute for Return was filed. (see discussion supra and in the exhibits)

4. A review of the tax transcripts will show your clients history and what has happened. We have found that these tax transcripts are generally accurate and may generally be relied on. We always obtain tax transcripts when there are a significant amount of taxes involved. The transcript we order was previously called a MFTRA-X or more recently a Record of Account. There are also guides for the codes available online which will interpret the entries.

5. Tolling periods: There are several tolling periods which will extend the time periods for discharge of taxes. They include, generally, periods the taxing authority was prohibited from collecting the tax. The tolling periods are as follows:

3 year period

A. Time in Bankruptcy plus 90 days
B. Time in Appeal due to filing a Collection Due Process Appeal, plus 90 days.
C. Extension of time to file return.

240 Day period

A. Time in Bankruptcy plus 90 days
B. Time in Offer in Compromise plus 30 days.
C. Additional tax assessed, starts 240 day period over

Statute of Limitations

A. The Statute of limitations for collection is 10 years from the date of assessment.
B. This period is tolled if there was a Collection Due Process Appeal, and
C. Time in an Offer in Compromise.

C. TREATMENT OF TAXES IN CHAPTER 11

1. Taxes in Chapter 11 are treated very similar to treatment in Chapter 13, with certain exceptions.

2. With regard to priority taxes, the Debtor in Possession has 5 years from the date of filing to pay the Priority Taxes. This is an advantage over the prior law which allowed 6 years from the date of assessment.

3. Secured Taxes may be paid over a longer period of time. How long a time period is determined either through negotiations or by Court Order.

D. ASSESSABLE BUT NOT ASSESSED

1. 11 USC 507 (a) (8) (A) (iii) provides that if a tax is not assessed, but is assessable, it is a priority tax. This usually occurs when Debtor has taxes which are over 3 years old. If the taxpayer filed the return between 2 and 3 years before the Bankruptcy Petition, the tax remains assessable until the tax is over 3 years old. (The IRS has 3 years from when the tax was filed to assess the tax, with some exceptions). There may be a gap where the IRS can assess the tax and if so, the tax is assessable but not assessed. The assessed amount may be discharged, but the unassessed amount will not be discharged.

2. This situation will most often arise in a situation where the IRS conducts an examination of the taxpayer's returns.

3. Note that if there is a substantial under payment or fraud, the IRS has 6 years to assess the tax.

E. TAX CLAIMS IN BANKRUPTCY

The Internal Revenue Service in Chapter 11 and 13 cases will file a Proof of Claim breaking down their claim into Priority Claims, Secured Claims, and Unsecured General Claims.

1. Priority Taxes: Priority taxes are those taxes which do not meet the test for discharge. That is, they are:

Less than three years old, or;
Less than 240 days since assessment.
Payroll Taxes

Payroll taxes, discussed infra, are also priority taxes. Priority Taxes must be paid in full through a Chapter 11 or Chapter 13 and they survive a Chapter 7 discharge. Their treatment in Chapter 13, is favorable to the Debtor, however. The tax and interest which has accrued up to the date of filing must be paid through the Chapter 13 plan. Penalties are not treated as priority taxes, however. They are treated as General Unsecured Claims. (Note the rules for Penalties in Secured Claims, however)

Priority taxes are paid through Chapter 13 without interest. Only the actual tax plus the interest that accrued up to the date of filing must be paid through the plan. This is very favorable treatment.

2. Secured Tax Claim: If the IRS has filed a valid tax lien, the taxes subject to the lien may be treated as secured. In Chapter 11 or 13, the secured portion of the claim is only up to the value of the Debtors property. It should be noted that the security for the claim includes ALL of the Debtors property, without any deduction for the exemptions which the Debtor may otherwise claim.

This result means that there is a motivation in getting a Bankruptcy filed before a Tax Lien is filed. Be aware that the IRS may have filed Tax Liens for some periods, but not others. An early and careful review of the transcripts is necessary to decide when to file. A frequent occurrence arises in situations where you are waiting out one of the time periods to insure a particular tax becomes unsecured. The threat of a tax lien adds complications to the determination of when to file the Bankruptcy action.

3. Unsecured General Claims: This is the category that we try to fit as much of the tax as possible into. This category of tax is treated the same as any other general unsecured debt. That is, the IRS will receive its pro rata share of any dividend to unsecured creditors.

4. Penalties and Interest: Penalties and interest are subject to being discharged in Bankruptcy if the underlying tax is subject to discharge.

Interest: In a Chapter 7 case, if the tax is not dischargeable, any interest relating to the unpaid tax will also be non-dischargeable.

Penalties: If the tax is dischargeable, then the penalty is also subject to discharge.

In some cases, however, the penalties related to non-dischargeable taxes are likewise not dischargeable. However, in other cases, the penalty is dischargeable even if the underlying tax is not dischargeable.

Tax penalties are dischargeable in a Chapter 7 bankruptcy case if the events giving rise to the penalty occurred more than 3 years before the taxpayer files for bankruptcy, even if the related tax is not dischargeable.

Interest and Penalties in Chapter 13: The (priority) Proof of Claim will include all accrued interest through the filing date. Accrued penalties are not included in the priority POC. The plan will not pay post-petition interest on a priority claim. The penalties will be a general unsecured claim.

Please note that in Chapter 11, the DIP must pay interest on a priority claim (currently 3%)

5. Payroll Taxes: The general rule is that Payroll taxes are not subject to Bankruptcy Discharge. Nor, is the Trust Fund Recovery Penalty, assessed against the responsible party of a business. They are treated as priority taxes or secured if a tax lien has been filed. They must be paid through the Chapter 11 or Chapter 13 plan and are not subject to discharge in a Chapter 7.

6. Sales Tax: If the sales tax is a tax on the buyer, (it is in Idaho) it is treated as a trust fund tax, being held for the state which is not subject to discharge. In some states it is a tax on the seller and may be subject to discharge as it is not considered a trust fund tax.

7. Unsecured non priority non discharged tax in Chapter 13. Beware of the following. The tax is over 3 years old, but the return was filed less than 2 years before the filing of the Bankruptcy. Since the returns haven't been filed at least 2 years before filing Bankruptcy, they are not discharged. The IRS may file a proof of claim as an unsecured non priority tax. They will not be paid in full through the Chapter 13, but rather will receive a pro rata share of the dividend to unsecured creditors. However the tax is not discharged and after the Chapter 13, the debtor will still owe the tax. (See the attached Proof of Claim.)

F. Liens and Chapter 7

The rule in Chapter 7, where the taxes owed exceed the value of the Debtor's property, is that the lien may NOT be stripped down to the value of the debtors property. The lien survives Bankruptcy and even though the tax might have been discharged, the lien remains on the Debtor's property for its full amount, not just the value of the equity in the asset. This creates a trap for the unwary. If a lien is not released, it remains and attaches to all of the debtors property. The issue may arise years later. An example of how onerous this can be arises where a client has real property, there is a tax lien and a Bankruptcy is filed. In that situation, if the lien is not released and the property appreciates, the lien creditor (the IRS or State Tax Authority) gains the benefit of the appreciation in the property value.

This issue of liens is complicated when the Debtor has assets, particularly if the lien is for more than the value of the assets. To repeat, in Chapter 7, the lien is <u>not</u> stripped down to the value of the collateral. The lien remains, for its full amount on the debtor's assets until it is released. (*Dewsnup v. Timm* 112 S.Ct. 773.)

This creates a situation that can come back to haunt an attorney who files Bankruptcy for a client, then, months or even years later, the debtor discovers that there is a Tax Lien outstanding, usually when they try to sell real estate that was subject to the lien.

Our office has developed a methodology to deal with Tax Liens in Chapter 7. First, we always order an IRS transcript to determine what liens have been filed, their amount and their validity. Second, we advise the client of the liens and the implications. Third we analyze the value of the debtor's property. (Exemptions do not apply to tax liens). Then we develop a plan to deal with the lien.

In our District, the Bankruptcy Unit is who we deal with for liens after Chapter 7. They are well educated and reasonable to work with.

Depending on the particular situation, our strategy might include:

1. **Challenge the validity of an invalid Tax Lien.**

We have found that there are circumstances where a Tax Lien **avoidable** or **invalid**.

To avoid a lien, it must be improperly filed. Examples of an improperly filed lien are those where it is filed in the wrong county or is being asserted against after acquired real property, for taxes that were discharged. A more frequent occurrence is where the Tax Lien has been filed in the wrong name, such as a corporation rather than the debtor. In a case where the IRS had the first name spelled wrong, a Bankruptcy Court held the lien invalid. *In Re Reid 182 B.R. 443*

Other examples of an invalid lien are where the IRS failed to comply with state law or where they failed to refile after the 10 year life of the lien. It has also been held that a lien filed in violation of the automatic stay is invalid.

Local practice will determine whether a lien may be challenged by motion or must be challenged by adversary complaint.

2. **Requesting a Certificate of Release from the IRS.**

If the taxes have been discharged and the value of the debtor's assets is minimal we will just request that the IRS release the lien. The IRS will usually release its lien. If some of the tax has been discharged, but not all, then the IRS will usually not release the lien without some payment.

3. **Negotiate a release for an amount to be paid.**

We have found in our area that the IRS is usually willing to negotiate a favorable resolution of the amount it will settle for. The IRS simply doesn't want your client's furniture or old car. Even equity in a parcel of real estate may be negotiated for less than its real value.

4. **Advise client to wait out the Statute of Limitations.**

The tax lien is valid for 10 years from the date the taxes were assessed (not 10 years from the date the lien was filed). If that period is close to running we might advise the client to sit tight and wait out the period of time.

5. **Liquidate the assets and pay the funds to the IRS.**

If the IRS won't negotiate a reasonable settlement, then consider selling the assets and paying the proceeds to the IRS in settlement of the lien.

6. **File a Chapter 13 and pay the value of the assets.**

In Chapter 13, the debtor may strip the lien down to the value of the collateral and pay that amount over the life of the plan. We have found that the threat of a Chapter 13 may also give some negotiating leverage in settling the lien. Note, however that there can be no discharge if a prior bk discharge w/in 4 years.

7. **File an Offer in Compromise.**

If the amount of the tax lien is significant, and other alternatives do not work, consider filing an Offer in Compromise. For example, if your client owns a home worth $200,000 and has a lien secured by a mortgage of $160,000, in an OIC the house is presumed to have **no equity.** (The IRS uses 80% of real estate's value for OIC purposes!) An Offer in Compromise can be a powerful tool in resolving tax liens.

8. **Offers in Compromise while in Bankruptcy**

The IRS takes the position that they will not consider an Offer in Compromise while a debtor is in Bankruptcy. At least 2 Bankruptcy Judges have written opinions that have ordered the IRS to consider Chapter 13 Debtor's OIC's, notwithstanding the fact that they were in Bankruptcy. There is also a contrary opinion. It is unclear what our Bankruptcy Judges will do in this situation. Several years ago, I argued the issue before Judge Pappas. The case was dismissed for other reasons, however. Judge Pappas did seem receptive to the argument.

9. **What to do while waiting to file Bankruptcy for a client with tax problems**

Many times we have clients who come to us that need Bankruptcy, but for various reasons they can't file immediately. Perhaps they are waiting out one of the time periods so that their tax liability will be discharged. Or, they are waiting until a time period for filing BK has run. When this is combined with threatened action by the Tax Authorities, for example a levy, immediate action may be needed.
There are a number of ways to prevent levy action by the IRS and less with the Idaho State Tax Commission. Our office has used a variety of strategies to avoid our clients being levied on. Some of them are as follows:

- Collection Due Process Appeal
- Obtaining a Levy Release
- Setting up an Installment Agreement
- Getting the Client in Non Collectible Status
- Filing an Offer in Compromise
- Seeking a stay on collection
- The use of these strategies may allow a client to buy time or get a levy released.

Often, our clients just need some breathing room before filing Bankruptcy without their assets being levied.

H. OBTAINING INFORMATION FROM THE IRS

There are several items of information that we consider necessary to effectively represent a client with tax liability. These items may be obtained as follows.

1. Power of Attorney: We almost always obtain an IRS and Idaho State Tax Commission Power of Attorney. These will allow us to communicate with the IRS regarding our client's tax issues. Form 2848 Power of Attorney: This form is filled out and faxed to Practitioner's Priority Service.

2. If you decide to obtain a POA, you will need to obtain a CAF number

3. Form 8821 Authorization for release of information: This form is filled out with the person's name who will be obtaining the information from the IRS.

4. Practitioner's Priority Service: This is the section of the IRS where you can readily obtain requested information.
Their telephone number is: 1 866 860 4259

5. Have the client go to the IRS and ask for the transcript.

6. MFXTRA Transcript (Record of Account): This is the transcript which will show the following:

i. When and if returns have been filed
ii. If the IRS has issued a Substitute for Return (SFR)
iii. If an Offer in Compromise has been filed
iv. Whether there has been a prior Bankruptcy
v. How much Tax, Interest and Penalties are owed
vi. The Date of Assessment

7. W2/1099 Transcript: This is a transcript which shows year by year:

i. How much employment income has been reported against a taxpayer.
ii. How much 1099 income was reported.
iii. How much Mortgage interest was reported

iv. Pension plan distributions taken by the taxpayer

8. Form 4506T: This form will result in a tax return transcript which shows a summary of the taxpayer's tax return for a particular year.

The problem with the transcripts, particularly the Record of Account, is that they are not clear, oftentimes about whether a taxpayer filed a return or whether the IRS filed it for them. It takes a careful reading and some interpretation to determine whether the return was filed by the taxpayer or the IRS. There are some clues as to who filed the return, however:

If the code 1040 is in the upper left corner, rather than 1040A it is more likely a taxpayer filed return.

If the IRS files a return, the item listed as Exemptions are usually listed as one. If your client is married or has children they claim, this is a clue that a SFR was filed.

The filing status in a SFR is usually listed as single. If your client is married, this gives you an idea as to the fact that it is an IRS filed return.

In the area Tax Per Return, it will not be a zero.

And obviously if the words Substitute for Return appear it is an SFR.

Note that the fact that there is a Code 150 "Return filed- tax assessed" does not necessarily indicate that the taxpayer filed a return. It might refer to a SFR.

If the date that the return was filed is close to the due date, including extensions, it is almost certainly a taxpayer filed return.

A strong clue that a taxpayer filed a return after the IRS filed the SFR are the coded 971, 976 or 977, which are the codes for amended or duplicate returns, usually a taxpayer filed one.

If there is a code 599, with a closing code of 89, this means that there was an agreed SFR, which constitutes a valid return.

Also, note there is case law that holds that the mere testimony of a taxpayer is not enough to establish that the return was filed.