Discharging Individual Taxes in Bankruptcy

University of Baltimore
School of Law
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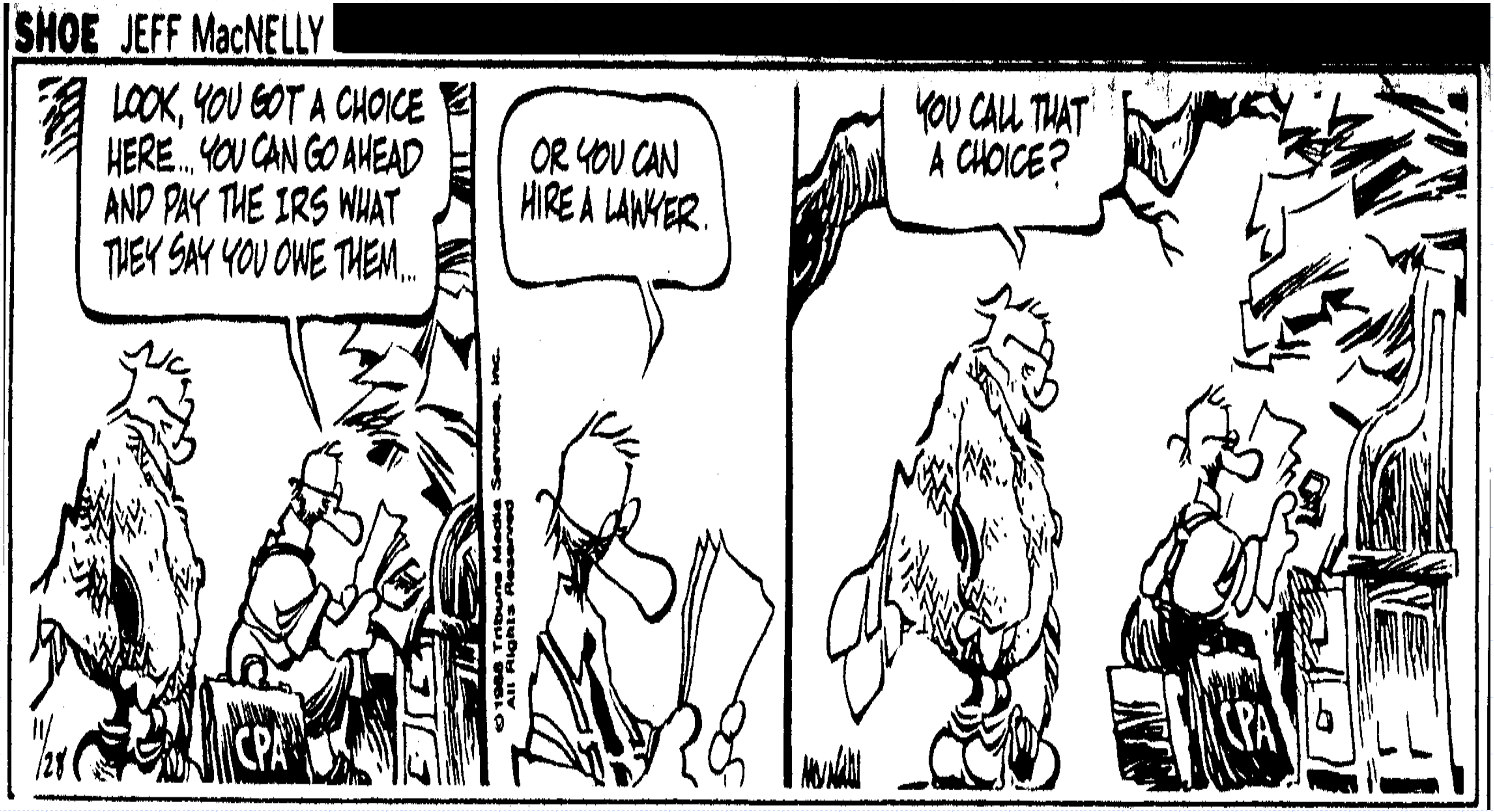
Russell J. Haynes, J.D.
www.haynestaxlaw.com

Using Bankruptcy to Deal With Tax Problems



Effect of Bankruptcy on IRS Collection Action

Automatic stay arises under BC §362(a).

All IRS collection action must cease, <u>except</u>:

- **Demanding delinquent (unfiled) tax returns.**
- **Auditing prepetition or postpetition returns.**
- **Issuing a statutory notice of deficiency ("SNOD").**
- **Assessing uncontested prepetition liabilities and taxes shown on filed tax returns (including Trust Fund Recovery Penalties under IRC §6672)**
- **Refiling a previous notice of federal tax lien.**
- **Issuing a summons to determine a tax liability.**

Effect of Bankruptcy on IRS Collection Action

Property levied on but not transferred to the IRS prepetition is property of the estate, and subject to a turnover action by trustee.

Tangible property seized prepetition, but not sold by IRS prepetition, is property of the estate, subject to turnover action by trustee.

When IRS has received payment prepetition, ownership has transferred to IRS, and the asset is not property of the estate (but may be subject to recovery as a preference).

Effect of Bankruptcy on IRS Collection Action

Some specific IRS collection actions are explicitly prohibited (See Saltzman ¶ 16.10 *et seq*):

- **Starting or continuing an administrative or judicial proceeding (including a CDP hearing).**
- **Issuing a levy or instituting a seizure.**
- **Verbally requesting payment or sending written notices demanding payment.**
- **Making a setoff against a postpetition refund to collect a prepetition tax.**
- **Filing, perfecting or enforcing a tax lien for prepetition tax periods (refiling is permitted)..**

Effect of Bankruptcy on IRS Collection Action

Violations of the BC §362 automatic stay or the BC §524 discharge permanent injunction by IRS:

IRC §7433(e)(1) permits action against the IRS for willful or negligent violations of the stay or the permanent injunction arising on discharge.

Taxpayer or injured third parties may recover up to $100,000 for IRS negligent violations, and up to $1,000,000 for reckless or willful violations.

[Game on!] Classifying Tax Debts

Three crucial determinations must be made to classify tax debts in bankruptcy:

- **secured vs. unsecured;**
- **priority vs. nonpriority; and**
- **exceptions to discharge.**

Secured vs. Unsecured

IRS can be:

- **A secured creditor, if a lien was filed; or**
- **An unsecured creditor, if no lien was filed; or**
- **Partially secured and partially unsecured, if a lien was filed but the tax exceeds taxpayer's equity in the property covered by the lien.** (This treatment is unaffected by the limited rule by the Court in the recent Bank of America case.)

Secured vs. Unsecured

A tax claim is unsecured if:

- **no notice of tax lien was filed;**
- **a tax lien was filed but the debtor has no equity in assets to which the lien may attach;**
- **a tax lien was filed but other creditors had recorded liens prior to the tax lien, consuming all available equity in the property.**

Priority vs. Nonpriority

BC §507(a)(8)(A) provides two rules that determine the priority status of a tax debt in bankruptcy:

1. The "3-Year Rule" of BC §507(a)(8)(A)(i); and
2. The "240-Day Rule" of BC §507(a)(8)(A)(ii).

Priority vs. Nonpriority

BC §507(a)(8)(A)(i) – <u>3 year rule</u>:

"Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for –

> **(A) A tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition –**
>
> > **(i) For which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;"**

<u>English translation</u>: Taxes are priority debts if the return <u>was due</u> (with extensions) less than <u>3 years</u> prior to the filing of the bankruptcy petition.

Priority vs. Nonpriority

BC §507(a)(8)(A)(ii) – 240 day rule:

"Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for –

(A) A tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition –

(ii) assessed within 240 days before the date of the filing of the petition, exclusive of —

(I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and

(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days;"

Priority vs. Nonpriority

240-Day Rule continued…

<u>English translation</u>: Taxes are priority debts if *assessment* was made less than 240 days prior to petition date

Self-assessment starts with filing a return; but the *filing date* is NOT the *assessment date*.

The 240-day period is extended by the time:

(1) an offer in compromise was pending, plus 30 days;

(2) a prior bankruptcy was open, plus 90 days.

Priority vs. Nonpriority

<u>BC §507(a), *flush language*</u>:

"An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days."

Priority vs. Nonpriority

Let's break it down a little…

"Applicable nonbankruptcy law."

- **Internal Revenue Code;**
- **Treasury Regulations; or**
- **State statute.**

Priority vs. Nonpriority

"… is prohibited […] from collecting a tax…"

Look to actions that prevent the IRS from taking enforced collection action:

1. **Collection Due Process Hearing ("CDPH")**
2. **Request for an installment agreement ("IA")**
3. **Request for an Offer in Compromise ("OIC")**

Which ones toll BC §507(a)(8)(A)(i)?

How about BC §507(a)(8)(A)(ii)?

Priority vs. Nonpriority

"…request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor…"

CDP Hearing?

Yes as to <u>both</u>, it's a request for a "hearing."

Request for an IA?

No, but an appeal of a decision to reject an IA request will toll <u>both</u>.

Request for an Offer in Compromise ("OIC")?

Not the 3-Year Rule, but an appeal of a decision to reject an IA request does. OIC tolls the 240-Day Rule per the statutory language (time pending + 30 days).

Priority vs. Nonpriority

Collection Due Process Hearings

The IRS is prevented from taking levy action while a timely request for CDPH is pending. IRC 6330(e).

"Timely" = filed within 30 days of the due process notice's issuance.

Late CDPHRs result in an "equivalent" hearing. TP still gets Appeals consideration of their case, but without the statutory stay on collection action and the resulting extension of the BC 507(a)(8) periods.

Understand the impact of your actions on behalf of your client!

Priority vs. Nonpriority

CDP Hearings: Stay on Collection – the Technical Explanation

Levy action is suspended while the periods of limitation listed in IRC 6330(e) are likewise suspended by the pending CDPH. IRC 6330(e); Reg. 301.6330-1(g)(2),Q & A G3.

The periods of limitation suspended are:

(1) IRC 6502 (collection after assessment);
(2) IRC 6531 (criminal prosecutions); and
(3) IRC 6532 (suits).

These three periods of limitation are suspended from the date the IRS receives the CDPH request "until the date the IRS receives the TP's written withdrawal of the request . . . or the determination resulting from the CDP hearing becomes final by expiration of the time for seeking judicial review or the exhaustion of any rights to appeals following judicial review." Reg. 301.6330-1(g).

Priority vs. Nonpriority

<u>CDP Hearings and the stay on collection</u>

Confusion over the "90-Day Extension" found in <u>IRC 6330(e)</u>.

The 90-day extension rule found in the second sentence of IRC 6330(e) is inapplicable in computing the BC 507(a) extension because it does not "suspend" the SOLs, it *extends* them.

The salient inquiry in computing the BC 507(a) extension is the amount of time the IRS is prevented from taking levy action because of a CDPH. Because no bar on levy action persists during the extra 90-days added by the second sentence of IRC 6330(e), there is no further tolling of the BC 507(a) periods.

Priority vs. Nonpriority

Dear God, please no more on CDP Hearings…

<u>CDP Hearings under IRC 6330 vs. CDP Hearings under IRC 6320</u>

The IRS is barred from taking collection action only for a CDPH filed under IRC §6330 (in response to a <u>levy</u> notice).

<u>Remember</u>: Only "the *levy* actions which are the subject of the requested hearing" are suspended. *IRC §6330(e), emphasis added*.

The rub is that there are TWO ways to get to Appeals on a CDPH request (see Form 12153):

(1) in response to a Final Notice of Intent to Levy (Letter 1058, CP-90); or

(2) in response to a filed Notice of Federal Tax Lien, i.e. a CDPH Request under IRC 6320.

Levy actions are <u>not</u> the subject of a CDP hearing filed under 6320. And while a CDPH under IRC 6320 is pending, the IRS may levy for taxes covered by the CDP Notice under §6320 and for other taxes and periods if the CDP requirements under §6330 for those taxes and periods have been satisfied. *Reg. §301.6320-1(g), question & answer G3*.

Therefore, NO EXTENSION of the BC 507(a) periods should be computed as a result of a CDPH filed in response to a NFTL due process notice. How can you tell the difference?

Priority vs. Nonpriority

Relation back: Interest and penalties are constantly *accrued* by the IRS computer, but *assessed* only periodically.

For purposes of the BC §507(a)(8)(A)(ii) 240-day rule, interest and penalties are deemed to relate back to the assessment date of the tax.

Thus, each incremental assessment of penalty or interest is not protected from discharge by a separate 240-day priority period.

Priority vs. Nonpriority

Let's PRACTICE!

Meet a couple of our poor, itinerant and recalcitrant miscreants…

Exceptions to Discharge

<u>The 2-Year rule</u> of BC §523(a)(1)(B):

"(a) A discharge under section 727, 1141, 1228 (a), 1228 (b), or 1328 (b) of this title does not discharge an individual debtor from any debt —

(1) for a tax or a customs duty —

(A) of the kind and for the periods specified in section 507 (a)(3) or 507 (a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, or equivalent report or notice, if required —

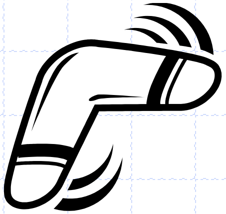
(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or…" (we'll come back to the "or…")

Exceptions to Discharge

English translation of BC §523(a)(1)(B):

Taxes are excepted from discharge if the return was filed less than 2 years prior to the filing of the petition (or was not filed at all).



Let’s return to our dischargeability analysis to complete the 2-Year Rule portion.

Exceptions to Discharge

- **Prior to BAPCPA, the 2-Year Rule applied in Chapter 7, but <u>not</u> in Chapter 13.**
- **Post-BAPCPA, it applies to both Chapter 7 and Chapter 13, with the result that taxes for years for which no tax returns were filed are now <u>nondischargeable</u> regardless of the type of bankruptcy used.**

Exceptions to Discharge

"Return" for discharge purposes: To constitute a tax return under BC §523, a document must

(1) contain enough information for the IRS to compute the tax liability, and

(2) must evidence an honest attempt to comply with the tax laws.

See *Beard v. Comm'r*, 82 T.C. 766 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

A frivolous return is not a "return" for this purpose. Tax protestors are constantly dreaming up new variants, and the taxes later assessed are not dischargeable if what was filed is deemed not to constitute a return for purposes of §523.

Exceptions to Discharge

Two years from "never" -- Substitute for Return Assessments ("SFRs").

IRC §6020(b) gives the IRS authority to compute and assess tax if a taxpayer fails to file, and can make the assessment without the TP's consent.

Prior to BAPCPA, many courts held that once a SFR was complete, a late filed "return" was not a "return" at all. If no return was filed, you can't satisfy the 2-Year Rule of §523(a)(1)(B), rendering a SFR nondischargeable in Chapter 7. See *In re Moroney*, 352 F.3d 902 (4th Cir. 2003).

Exceptions to Discharge

The BAPCPA added the BC's own definition of tax "return."

"... a return prepared pursuant to [§6020(a)]... or similar State or local law, or a written stipulation to a judgment or a final order entered by a non-bankruptcy tribunal, <u>but does not include a return made pursuant to §6020(b)</u> . . . or a similar State or local law." BC 523(a), *flush language (emphasis added).*

IRC 6020(b)(2) provides that a return made under 6020(b) "shall be prima facie good and sufficient for all legal purposes." BUT, Reg. §301.6020-1(b)(3) adds "except insofar as any Federal statute <u>expressly</u> provides otherwise" (emphasis added).

Exceptions to Discharge

So when is a SFR *really* a SFR? The IRS draws the line at whether a return has been filed when the tax is *assessed*. See Chief Counsel Notice 2010-016.

(1) **When the IRS starts a SFR but TP files the return before the SFR is complete and the IRS accepts it?**
(2) **When the IRS starts a SFR, finishes it, issues the SNOD, *then* TP files a return and IRS accepts it?**
(3) **When the IRS finishes the SFR, issues the SNOD, and makes the assessment?**
(4) **When the IRS finishes the SFR, issues the SNOD, TP files a Tax Court petition, and the tax is assessed pursuant to a written order of the Tax Court?** **(Remember the BC 523(a), flush language!)**

**** NOTE ALSO the language in CCN 2010-016 about additional tax (over the SFR amount) reported on a later return.**

Exceptions to Discharge

"True" SFR or not? The moral of the story:

Once a SNOD is issued, if the deficiency is such that your client won't be able to pay it and bankruptcy is the eventual outcome, file the Tax Court petition in order to preserve the debt's dischargeability.

In more recent years, the IRS has begun to show the issuance of a SNOD on account transcripts. But they are inconsistent in this practice. File a FOIA request and get Exam's files to see if a SNOD was issued.

Exceptions to Discharge

McCoy v. Mississippi State Tax Comm'r, **666 F.3 924 (5th Cir. 2012).**

"A state income tax return that is filed late under the applicable nonbankruptcy state law is not a 'return' for bankruptcy discharge purposes under 523(a)."

That's right: One day late and the resulting <u>state</u> income tax is NOT dischargeable.

Exceptions to Discharge

***McCoy* is not universal.**

The IRS rejected the McCoy rule and rationale (*before McCoy* came down in the 5th Cir.). See IRS Chief Counsel Notice 2010-016.

Currently, only two circuits have joined the 5th in adopting the *McCoy* Rule:

<u>1st Circuit</u>. See *In re Fahey*, 2015 WL 677033 (1st Cir. Feb. 18, 2015).

<u>10th Circuit</u>. See *In re Mallo*, 2014 WL 7360130 (10th Cir. Dec. 29, 2014) (involved *federal* taxes held not dischargeable due to late-filed returns even though IRS and debtor argued the same thing!).

Exceptions to Discharge

The Rationale of McCoy

BAPCPA amended BC 523 with the following language:

> **For purposes of this subsection, the term `return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements).**

The *McCoy* court considered the timeliness requirement to be an "applicable filing requirement."

Exceptions to Discharge

Do amended returns get their own 2-year clock for purposes of BC 523(a)(1)(B)?

Recall the statutory provision: "…with respect to which a return, or equivalent report or notice, if required…"

(1) **An amended federal tax return (1040X) is not a tax "return." There can only be one "return."**

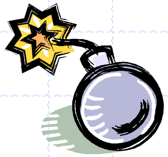
(2) **The IRC contains no provision defining or requiring an "amended" return.**

Hey, wait a second! Aren't you ignoring the "equivalent notice" part?

Yes, but so does the IRS. **Shhh, don't tell them.**

Exceptions to Discharge

Although the IRS has not pursued the argument that an amended "return" should get its own 2-year clock under BC 523(a), many states have.



***Ciotti v. Maryland*, 2011 U.S. App. LEXIS 4492 (4th Cir. Mar. 8, 2011)**

Md. Code Ann. §13-409(b) requires the filing of a "report of federal adjustment" within 90 days of the IRS making adjustments.

Exceptions to Discharge

In *Ciotti*,

- **TPs were audited by the IRS and hit with a deficiency.**
- **They didn't file the required Maryland amended return to conform their state taxes to the adjusted federal figures within the 90-day period required by Maryland law.**
- **Maryland (as they often do) got the information from the IRS and made the additional assessment themselves.**
- **TPs filed bankruptcy. Maryland objected to the discharge of the Maryland deficiency. . . and won.**

Exceptions to Discharge

<u>The 4th Circuit's holdings in *Ciotti*</u>:

(1) The Maryland report of federal adjustments was an "equivalent report or notice."

(2) The Maryland report was "required" by Maryland statute.

(3) When TPs failed to file the required report, the resulting assessment by Maryland was a SFR (called a "nonfiler assessment").

(4) When dealing with a completed SFR, the rule is "2 years from never is never." The 2-year clock thus never started and could not have expired before the bankruptcy petition was filed.

(5) Therefore, the Maryland tax was not subject to discharge.

Exceptions to Discharge

“Equitable Tolling” rears its ugly head.

Pre-BAPCPA, there were no annoying provisions in BC 507 or BC 523 to toll the three time periods for time the IRS was barred from taking collection action.

In *Young v. United States*, 535 U.S. 43, 49 (2002), SCOTUS held that “"[i]t is hornbook law that limitations periods are `customarily subject to equitable tolling.’" The Court ruled that the BC 507 periods were tolled during the time a TP was in a prior bankruptcy.

Exceptions to Discharge

Equitable Tolling continued…

BAPCPA incorporated the rule of *Young* into BC 507(a) by providing for extension of the time periods for the time a TP is in bankruptcy plus 90 days.

The general consensus among practitioners was that after BAPCPA incorporated the equitable tolling rule into the statutory construct, *Young* was mooted.

However, the IRS has recently begun arguing that the pre-BAPCPA concept of equitable tolling applies to toll the 2-Year Rule of BC 523(a), which extends the *Young* rule beyond its original context of BC 507.

Exceptions to Discharge

Equitable Tolling continued . . .

This is an evolving area of tax practice in bankruptcy. The IRS is expanding an old doctrine beyond its original reach in a new statutory environment that may be in direct conflict with the equitable principle in *Young*. Who should win?

Equity follows the law. The equitable principle should give way to the law if the two are in conflict. Stay tuned.

Interest on Tax Debts

Prepetition interest:

Interest follows the underlying tax.

So if the prepetition tax is discharged, the related interest will also be discharged.

But if the tax survives the discharge, so too does the pre-petition interest.

Penalties

BC §523(a)(7) <u>disjunctive</u> test for penalties: Penalties are dischargeable to the extent they –

(A) relate to a dischargeable tax claim, <u>OR</u>

(B) where the event giving rise to the penalty occurred more than three years prior to the filing of the bankruptcy petition.

See *In re Burns*, 887 F. 2d 1541 (11th Cir 1989); *In re Allen*, 272 B.R. 913 (E.D. Va 2002) (following majority rule); *but see In re Putnam*, 131 B.R. 52 (W.D. Va 1991).

Penalties

- **Pecuniary loss penalties, e.g. TFRP, are priority claims and not dischargeable. BC 507(a)(8)(G).**

- **But punitive penalties are not priority claims, even if the underlying tax is entitled to priority, and such penalties are dischargeable if they meet either prong of the disjunctive test of §523(a)(7).**

- **Punitive penalties include those for late filing, late payment, negligence and even civil fraud.**

Nondischargeable Taxes

The Bankruptcy Code also gives priority to "a tax required to be collected or withheld and for which the debtor is liable in any capacity," thereby making such taxes nondischargeable. BC §507(a)(8)(C). This includes:

- ***Withheld portion* of payroll taxes.**
- **Sales taxes collected from customers.**

Nondischargeable Taxes

What about the other part of the payroll taxes, i.e. the employer's share of payroll taxes?

While the withheld portions of the payroll tax are nondischargeable, the tax imposed on the employer (1/2 of FICA and Medicare) are dischargeable if the wages were paid and the return was due more than three years prior to the bankruptcy. See BC §507(a)(8)(D).

FUTA taxes are not "trust fund" taxes and are similarly dischargeable.

Nondischargeable Taxes

Chapter 7:

Nondischargeable taxes survive the discharge, and must be addressed later.

Chapter 13:

Priority taxes are paid, since to be confirmed a plan must provide for full payment of priority debts. Any nonpriority debts excepted from discharge survive and must be addressed later.

Exceptions to Discharge

Which brings us back to the "or…" of BC 523(a)(1)(C)…

Which excepts from discharge are "any taxes [. . .] with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax."

WATCH OUT for this argument. A criminal prosecution for a tax crime is a sufficient, but not a necessary condition for the IRS to raise the fraud exception.

Assertion of the civil fraud penalty in a deficiency case is sufficient to except the resulting tax from discharge (although the civil fraud penalty may itself be dischargeable).

Nondischargeable Taxes

Circuits are split on whether mere nonpayment, without more, constitutes a willful attempt to evade or defeat tax. See:

- ***Haas v. IRS*, 48 F.3d 1153 (11th Cir. 1995)**
- ***Toti v. U.S.*, 24 F.3d 806 (6th Cir. 1994)**
- ***Dalton v. IRS*, 77 F.3d 1297 (10th Cir. 1996)**
- ***Bryen v. U.S.*, 2011 TNT 215-16 (3rd Cir. 2011) (unpublished)**

But in general, much more is required before the IRS will even make this argument.

Nondischargeable Taxes

BC §523(a)(1)(C) doesn't require that the debtor be criminally prosecuted for fraud, but the TPs' behavior in the following cases was sufficient to bar the resulting tax liabilities from discharge under the fraud exception:

Meyers v. IRS **(6th Cir. 1999): Tax protestor did not file returns and claimed excessive withholding exemptions to reduce the amount of tax withheld.**

U.S. v. Schmidt **(4th Cir. 1991): Taxpayer assigned wages, yet maintained control over the funds.**

Bryen v. U.S., **2011 TNT 215-16 (3rd Cir. 2011) (unpublished): CPA who owed $19+ million continued to live "high on the hog" (lavish trips, expensive homes, etc.), made no payments to IRS, and dealt in cash to avoid creditors.**

Equitable Considerations

Pre-BAPCPA: Court could (and still can) deny discharge if the debtor is acting unjustly and could pay debts.

BAPCPA imposes a "means test" for debtors with "primarily consumer debt.“ Abuse can be found based on:

(1) presumption applicable in some cases; or

(2) general grounds, including finding of bad faith considering the totality of the facts.

Equitable Considerations

If debtor's income is above median income for the state, either the presumption or the general grounds standard can be raised by the Court, by the trustee, or by a creditor.

If debtor’s income is below the median income for the state, the presumption is inapplicable.

Check website of the U.S. Department of Justice, Office of the United States Trustee, for amounts.

Equitable Considerations

Under BC §707(b), the court has the ability to "dismiss a case filed by an individual debtor . . . whose debts are primarily consumer debts . . . if it finds that the granting of relief would be an abuse . . ."

The term "primarily" indicates that no means test is required if less than 50 percent of the total scheduled debt is consumer in nature.

Equitable Considerations

BC §101(8) provides some clarity here:

It defines "consumer debt" as "debt incurred by an individual primarily for a personal, family or household purpose."

Courts have also examined the legislative history of BC §101(8).11. And the drafters of the Code looked to consumer protection laws, such as the Truth in Lending Act, to define the term "consumer debt."

Equitable Considerations

These consumer-protection statutes reflect that when a borrower's motivation to secure credit is driven by profit, the debt will fall outside the meaning of consumer credit.

Likewise, courts have adopted the profit-motive test to determine whether a debt is a business debt that falls outside the definition of consumer debt for purposes of BC §101(8).14.

Equitable Considerations

The majority of courts considering the issue have held that income tax is not incurred as part of a consumption activity, but rather is "involuntarily imposed in the course of earning income," and therefore is not considered "consumer debt."

See: *In re Gault*, 136 B.R. 736, 738 (Bankr. E.D. Tenn. 1991).
In re Traub, 140 B.R. 286, 287 (Bankr. D.N.M. 1992).
In re Victoria, 389 B.R. 250, 252 (Bankr. M.D. Ala. 2008).

Equitable Considerations

The only appellate court to address the issue of whether income tax liabilities are consumer debts is the Sixth Circuit Court of Appeals in *In re Westberry*, 215 F.3d 589 (6th Cir. 2000).

In holding that an income tax debt was not a "consumer debt," it distinguished income tax debt from consumer debt in four ways:

Equitable Considerations

- **First, the income tax was not voluntarily incurred.**
- **Second, the tax was incurred for a public purpose rather than a personal, family or household purpose.**
- **Third, the tax debt resulted from profit earning activities rather than from consumption activities.**
- **Fourth, the taxation did not require or involve the extension of credit, which is a typical characteristic of consumer debt.**

Equitable Considerations

In contrast, the Fifth Circuit Court of Appeals in *In re Booth*, 858 B.R. 1051 (5th Cir. 1988), determined that a loan secured by the debtor's residence was not a consumer debt, and in *dicta* the court implied that the debt owed to the IRS was a consumer debt.

Similarly in *dicta*, a bankruptcy court in a Chapter 7 case categorized taxes owed to the IRS as consumer debt for purposes of § 707(b). *In re Bell*, 65 B.R. 575, 576 (Bankr. E.D. Mich. 1986).

Equitable Considerations

If the BAPCPA means test applies, it compares monthly income to "allowable" deductions.

Income is debtor's average income over the six full months prior to petition. (Even if only one spouse files bankruptcy, income for the means test includes income of nonpetitioning spouse.)

Equitable Considerations

Deductions for means test start with the IRS's "allowable" living expenses:

National standard for food, clothing, etc.;
Local transportation standard; and
County specific standard for housing and utilities.

(Bankruptcy attorneys must now understand the IRS's collection standards which are used in the means test, even in cases with no tax debts.)

Equitable Considerations

BAPCPA also permits "other necessary expenses," which in some cases exceed IRS allowances:

Health care costs;

Health and disability insurance;

Expenses for elderly, ill or disabled family member;

Up to $1,500 per year per child for public or private elementary or secondary school; and

Contributions to charity up to 15% of gross income.

Equitable Considerations

Because the BAPCPA means test is used to determine what debtor could pay on nonpriority unsecured debts, the computation also deducts contractually scheduled payments to secured creditors for five years after petition date.

For example, this may permit deduction of mortgage payments in excess of IRS housing allowance for purposes of the means test.

Equitable Considerations

Conversion of Chapter 7 case to Chapter 11 or Chapter 13 will permit the discharge, but at the price of making monthly payments.

Pre-BAPCPA, Chapter 13 plans usually required payments for 3 years. BAPCPA requires payments for 5 years if debtor's income is above the median income level for the state.

Chapter 7 vs. Chapter 13

Superdischarge provisions. Prior to BAPCPA, some taxes that were not dischargeable in Chapter 7 were dischargeable in Chapter 13:

- **SFR assessments.**
- **Taxes for years with unfiled returns or filed less than two years before petition date.**
- **Taxes arising due to fraud.**
- **Taxes assessable but not assessed.**

Unfortunately, these superdischarge features of Chapter 13 were eliminated by the BAPCPA.

Chapter 7 vs. Chapter 13

But even after the BAPCPA, Chapter 13 still has some advantages over Chapter 7:

- **Ability to pay priority taxes with monthly payments under the protection of the Court.**
- **No post-petition penalties, and no interest on unsecured, priority tax debts.**
- **Ability to discharge some debts even when Chapter 7 is unavailable due to means test.**

Chapter 7 vs. Chapter 13

Disadvantages of Chapter 13:

- **Who may be a debtor: Only someone with regular income; and with debts less than $383,175 unsecured, $1,149,525 secured.**
- **Monthly payments are required based on income and allowable living expenses.**
- **Must full pay priority debts for plan to be confirmed.**

Contesting Tax Debts

<u>U.S. District Court or Claims Court</u>.

- **Prerequisite is full payment. See *Flora v. U.S.*, 362 U.S. 145 (1960).**
- **Deals only with federal taxes.**

<u>U.S. Bankruptcy Court</u>.

- **Court has authority to determine <u>any</u> tax.**
- **Put taxes at issue by filing objection to IRS proof of claim, or an adversary proceeding to determine amount and dischargeability of tax.**

Contesting Tax Debts

Judicial opportunities to contest tax liabilities:

<u>U.S. Tax Court</u>.

- **No jurisdiction unless Petition filed within 90 days of Statutory Notice of Deficiency.**
- **Lacks jurisdiction over some kinds of taxes.**
- **Deals only with federal taxes.**

Contesting Tax Debts

Adversary proceeding is a lawsuit within a bankruptcy case, seeking affirmative relief.

This can include determining the validity, priority, or extent of a lien, and determining the amount and dischargeability of a debt.

After the Discharge

Tax problems often remain after bankruptcy:

- **Some taxes may survive the discharge (i.e. the "*in personam*" liability remains).**
- **Some taxes may have been secured by the pre-petition filing of tax liens (i.e. the "*in rem*" liability remains).**

Often, this is the critical variable that determines whether bankruptcy would provide any relief to a particular client.

After the Discharge

A valid federal tax lien survives a discharge.

If IRS has properly filed a prepetition NFTL, and the lien is still valid (i.e., it was refiled correctly, if applicable) – the lien survives the discharge.

IRS may collect discharged taxes from property that is exempt from the estate, excluded from the estate, or abandoned by the trustee.

After the Discharge

<u>IRS processing of case after discharge</u>:

Discharged modules are abated (driven to $0 balances) or reported as “currently not collectible” (TC 530, special CC).

Undischarged modules are reactivated (TC 521).

Discharge relieves taxpayer of personal liability. But tax may still be collected from property (including exempt property) encumbered by a pre-bankruptcy lien. SPf reviews collection potential and determines whether accounts should be abated. If there are no encumbered assets, taxes are abated and liens released.

After the Discharge

Possible solutions for taxes surviving discharge:

1. **Pay it (yeah, right).**
   - **Installment Agreements (IA, SLIA, FSIA)**
   - **Sale of property**
2. **Pay *part* of it.**
   - **PPIA**
   - **OIC**

After the Discharge

3. Don’t pay it at all.
   - Second bankruptcy. Chapter 7 can be followed by a Chapter 13 (after 4 years) or another Chapter 7 (after 8 years).
   - Wait out statute of limitations (10 years from date of assessment, extended by OIC, time in bankruptcy, CDPHs (under 6330 only), RTAOs, etc.).
4. Hybrid approaches.

Securing tax information

Complete information about taxes is essential.

Don't rely on client or client's accountant. The documents will be incomplete, recollections will be imperfect, and understanding of the relevant issues inadequate.

Get IRS Account Transcripts.

- **E-Services (Transcript Delivery System).**
- **IRS Practitioner Priority Service (866-860-4259).**
- **Local IRS Disclosure Office.**

Securing tax information

Transcripts show chronological history of events posted to the IRS Integrated Document Retrieval System (IDRS) – return due date, date filed, date assessed, SFRs, statutory notices of deficiency, payments, interest, penalties, appeals, collection waivers, innocent spouse claims, litigation holds, prior offers in compromise, etc.

Each tax period is tracked in a separate module.

<u>But remember</u>: The IRS screws up. Frequently. If the transcript is potentially ambiguous about a critical issue, obtain better information via a FOIA request.

Securing Tax Information

<u>Final reminder</u>: AVOID MALPRACTICE!

Account transcripts are meant to be “plain language” summaries of account activity. But as we’ve seen, entries on account transcripts can be misleading or blatantly wrong. If there is an outcome-determinative issue, especially involving a question of whether or not a SFR is a “true” SFR, file a FOIA request and get MFTRA-X transcripts to see the closing codes. Or, know when to lateral the case to an expert.