

DISCHARGING PERSONAL FEDERAL INCOME TAXES

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STATUTE OF LIMITATIONS FOR COLLECTION

A bankruptcy may not be needed if the taxes are about to become uncollectable because of the statute of limitations. The IRS generally has 10 years from the date of assessment to collect taxes. 26 USC §6502. The 10 year period is tolled (suspended - the clock stops running) if certain events occur. These events include but are not necessarily limited to: When the taxpayer agrees to a tolling such as in an installment payment agreement. §6502; While a tax court proceeding is pending plus 60 days; While a bankruptcy is pending plus 6 months. §6503; While the taxpayer is outside the U.S. for more than 6 months plus 6 months upon return to the U.S. §6503; For 60 days after the mailing of a §6212 notice of deficiency. §6503; While an offer in compromise is pending plus 1 year; While a Due Process appeal is pending.

CHAPTER 7 DISCHARGE OF TAXES

There are five basic requirements to discharge federal individual income taxes in a chapter 7 bankruptcy. You must meet all five requirements. You must evaluate each tax year separately.

1. THE THREE YEAR RULE. The bankruptcy must be filed more than 3 years after the due date for filing the return. The due date is changed by extensions. For example, assume you owe taxes for tax year 2005. Normally the due date for the 2005 return is April 15, 2006, and the 3 year rule is satisfied if the bankruptcy is filed after April 15, 2009. If you obtained an extension for filing the 2005 return from April 15, 2006 to October 15, 2006, then the due date is October 15, 2006 and the 3 year rule is satisfied only if the chapter 7 bankruptcy is filed after October 15, 2009, regardless of whether you filed the return before October 15, 2006.

2. THE TWO YEAR RULE. The bankruptcy must be filed more than 2 years after the date that you actually filed your tax return. The 2 years may be extended because of a previous bankruptcy and other matters.

Bankruptcy Courts in the Northern and Southern Districts of Mississippi have ruled that a late filed return may never be discharged in bankruptcy because 2005 amendments to the bankruptcy laws define a return as a return that satisfies all applicable requirements of nonbankruptcy law, including filing requirements. *GREEKMORE V. INTERNAL REVENUE SERVICE*, 401 B.R. 748, 751 □BANKR. N.D. MISS. 2008□; *MCGOY V. MISS. STATE TAX COMM.*, 3:09-CV-575 □BANKR. S.D. MISS. FEBRUARY 8, 2011□; *WELAND V. STATE OF MISS.* □BANKR. N.D. MISS. MAY 11, 2011□. I do not agree with this ruling because it makes the two year rule meaningless even though Congress left the two year rule in the law. It remains to be seen if other courts agree with the Mississippi interpretation. The IRS has stated that it does not agree with this interpretation.

Most courts have ruled that if you did not file a return, the taxes will not be discharged in a chapter 7 bankruptcy, even though the IRS may have filed a "substitute

for return” (SFR). (However, see the next paragraph.) A “substitute for return” is based on an estimate of your income and allows the IRS to assess taxes even though you failed to file a return. Apparently only one court has ruled that an unsigned “substitute for return” qualifies as a filed return. *Ridgway v. U.S.*, No. 02-30358, Adv. No. 02-3092 (Bankr. D. Conn. 03/14/05).

The 2005 changes in the Bankruptcy law provides that a return includes an “equivalent report or notice” and provides that a return includes a substitute for return if it was prepared by the IRS and signed by the taxpayer. In this situation the filing of the signed Substitute For Return should start the clock running for the two year rule.

Some courts have ruled that if you file your return after the IRS has filed a “substitute for return”, then your return is meaningless, the 2 year period never starts running, and you cannot discharge the taxes. This is the position of the IRS. In re *Henne*, 17 CBN 414 (Bankr. D. Ariz. 2007, Judge Hollowell); *In re Payne*, 16 CBN 113 (7th Cir. 2005) (might allow exception if circumstances beyond debtors control prevented filing.) I disagree with this theory because the return you file may be more accurate and cause you to owe more taxes than a “substitute for return.”

Other courts have ruled that a tax may be discharged even though the debtor filed the tax returns after an assessment by the IRS, if the debtor acted in good faith. *Payne v. U.S.*, 14 CBN 291 (Bankr. N.D. Ill. 2004.); *In re Colsen*, 15 CBN (Bankr. 8th Cir. 2005.; *In re Merrill*, 17 CBN 584 (Bankr. D.N.N. 2007, IRS accepted debtor return as a substitute, apparently after IRS has previously filed its own substitute return and made and assessment. IRS increased tax liability based on return filed by debtor.)

3. THE 240 DAY RULE. The bankruptcy must be filed more than 240 days (approximately 8 months) after the taxes were assessed. The 240 day period may be extended by a prior bankruptcy or any offer-in-compromise. Taxes are assessed when the IRS makes an entry on its records regarding the amount owing. This can be normally determined from reviewing your tax transcript. Additional assessments for more taxes can be made for a single tax year. Each assessment is subject its own 240 day rule.

4. NO TAX EVASION RULE. Your taxes will not be discharged if you “willfully attempt in any manner to evade or defeat such tax.” Most courts have said that simply failing to file a return on time is not willful evasion. However, several courts, including *U.S. v. Fretz*, 11th Circuit March 23, 2001, have ruled that intentionally failing to file returns is willful evasion. *In re Geiger* 18 CBN 873 (Bankr. C.D. Ill. 2008) found evasion when the taxes were not filed on time, were not paid and the taxpayer purchased luxury items while knowing he owed taxes.

5. NO FRAUDULENT RETURN RULE. The last requirement is that you did not file a fraudulent return for the taxes.

Your personal liability to pay taxes will be discharged in Chapter 7 if all five of the above rules are met. If so, the IRS may not collect out of your future wages or seize property you obtain in the future. If the taxes do not meet all five of the above rules, then they will not be discharged in chapter 7.

CHAPTER 7 TRUSTEE PAYMENT OF TAXES

Proof Of Claim. Less than 10% of chapter 7 cases result in payments to any creditors by the trustee. The chapter 7 trustee will only pay a creditor, including any taxes, if a proof of claim has been filed by or for (on behalf of) that creditor. You can file a proof of claim for a creditor, including a tax agency, if the creditor fails to file a proof of claim by the deadline. Tax agencies occasionally fail to file a proof of claim. You would file a proof of claim for a tax agency if, as explained below, the Chapter 7 trustee has money available to pay some or all of taxes that are not discharged. You want the trustee to pay as much of such taxes as possible so that you owe less. (The same is true for child support and spousal maintenance, which have a higher priority for payment than taxes and are not discharged.)

Category 1, Unsecured Priority Taxes And Not Discharged. See the Chapter 13 explanation, below, for a definition of this category. These taxes may or may not be paid anything in by the trustee in chapter 7. Your liability for these taxes is not discharged. You remain liable for any such taxes not paid by the trustee.

If the Chapter 7 trustee has money to distribute in the case, the trustee pays the trustee's fees and administrative expenses. Then the chapter 7 trustee pays unsecured priority creditors before paying unsecured non-priority creditors. See attached explanation of *Unsecured Priority Claims*.

There are 9 classes of unsecured priority creditors. 11 USC §507. For example, class 1 is past due child support or past due spousal maintenance owed by the debtor. (Possibly the trustee's fees and administrative expenses are paid after payment of past due child support or past due spousal maintenance.) As another example, class 4 is certain unpaid wages owed by the debtor. Unsecured priority taxes owed by the debtor are class 7.

The chapter 7 trustee pays each unsecured priority class in order starting with class one, then class two, and so on. The trustee pays all the filed claims in a class, if there is money available, before paying the next class. The Chapter 7 trustee will only pay the principal and interest owed on unsecured priority taxes as of the day the bankruptcy was filed. After payment of all filed claims for unsecured priority claims, if the trustee has money available, then the trustee pays pro-rata to unsecured non-priority creditors, which includes credit cards, medical bills, dischargeable unsecured taxes and certain non-dischargeable unsecured taxes. See attached chart of *Distribution of Property & Money In Chapter 7 Liquidation*.

As previously stated, the Chapter 7 trustee will only pay the principal and interest owing on unsecured priority taxes as of the day the bankruptcy was filed. The chapter 7 trustee will not pay any penalties, regardless of whether the penalties accrued before or after you file bankruptcy. The chapter 7 trustee will not pay any interest that accrues after you file bankruptcy. You remain liable for any unpaid amounts, whether interest, penalties or principle.

Category 2, Unsecured Not Priority And Not Discharged. See the Chapter 13 explanation, below, for a definition of this category. It is possible that taxes are not priority and also are not discharged in chapter 7. The chapter 7 trustee cannot pay such

taxes as priority. After payment of all claims filed for unsecured priority claims, if the trustee has money available, then the trustee pays these non-priority non-discharged taxes pro-rata with other unsecured non-priority creditors, such as credit cards, medical bills, and discharged unsecured taxes (category 3, below). You remain liable for any unpaid amounts, whether interest, penalties or principal.

Category 3, Unsecured Not Priority And Discharged. After payment of all claims filed for unsecured priority claims, if the trustee has money available, then the trustee pays these non-priority discharged taxes pro-rata with other unsecured non-priority creditors, such as credit cards, medical bills, and non-priority non-discharged unsecured taxes (category 2, above). You are not liable for any unpaid amounts, whether interest, penalties or principal.

CHAPTER 7 LIABILITY FOR NON-DISCHARGED TAXES

Unfortunately, in a Chapter 7 bankruptcy, the tax agencies may resume collection activity from you on non-discharged taxes as soon as you receive your discharge of other debts, which is normally 4-6 months after you file chapter 7 bankruptcy. The tax agencies may collect from you even though the Chapter 7 trustee has or will have enough money in your bankruptcy case to pay some or all of the non-discharged taxes. The tax agencies do not need to wait to get paid by the trustee and often refuse to wait.

If the tax agencies collect from you on non-discharged taxes after you file bankruptcy and before the chapter 7 trustee makes payments to creditors, you do not take over (subrogation/assignment) the tax agencies' priority claims in the bankruptcy. 11 USC 507(d). In other words, you do not step into the shoes of the tax agency. You do not get a priority distribution by the bankruptcy trustee for priority taxes you paid. At best you might have a non-priority claim for reimbursement, which is unlikely to be paid much, if anything. However, one court has ruled that the debtor does not get any subrogation at all because 11 USC 509(c) provides for subrogation for a person who "is liable with the debtor" on a claim and pays the claim. A debtor cannot be liable with himself. *In re Allen*, Bkrcty. D. Mass. December 11, 2006, No. 04-1266-JNF. That is why it is usually to your benefit to try to liquidate your non-exempt property (and in some cases your exempt property) before filing bankruptcy and pay as much of the non-dischargeable taxes yourself before filing bankruptcy. Always consult with a bankruptcy attorney first.

To make matters worse, interest and penalties continue to run on non-discharged taxes after a Chapter 7 bankruptcy is filed. If the Chapter 7 trustee has money to distribute, the Chapter 7 trustee will only pay the principal and interest owed on priority unsecured taxes the day the bankruptcy was filed. So even if the trustee pays on priority unsecured taxes, he will not pay any penalties, regardless of whether the penalties accrued before or after you file bankruptcy, and he will not pay any interest that accrues after you file bankruptcy. (There may be a rare exception if the trustee has sufficient money to pay all creditors in full with interest.) You remain liable for any unpaid amounts, whether interest, penalties or principal. In addition, the Chapter 7 trustee first pays the trustee's fees and administrative expenses, which leaves less to pay the taxes.

Again, it is usually to your benefit to try to liquidate your non-exempt property (and in some cases your exempt property because many exemptions are not effective against tax agencies) before filing chapter 7 and pay as much of the non-dischargeable taxes

yourself before filing bankruptcy. It is usually not in your best interest to assume the trustee will pay your non-discharged taxes.

The IRS may collect for a non-discharged tax from almost all income or anything you own, including social security and retirement benefits. IRS guidelines limit the percent of social security that may be garnished. State exemption laws, such as the homestead exemption, which apply to non-tax creditors may not be used against the IRS or the Arizona Department of Revenue to prevent property from being seized or sold or from a lien. The IRS tax code and the Arizona tax laws each contain a list of property which is exempt from collection from each respective agency. Not much is exempt.

PROCEDURES TO HAVE THE IRS ACKNOWLEDGE DISCHARGE OF TAXES IN CHAPTER 7 BANKRUPTCY

After the bankruptcy court grants your chapter 7 bankruptcy discharge, we send a letter and an IRS power of attorney to the IRS requesting an informal decision that the taxes are discharged. We allow forty-five (45) days for a response from the IRS. The IRS should then send a letter indicating the taxes met discharge requirements and that the IRS removed the assessment from your tax transcripts. The IRS transcripts should show a \$0 Assessed Balance and use tax code 604, for Assessed Debit Balance Cleared.

Unfortunately the Bankruptcy Court Discharge Order does not list the specific taxes or other debts which are discharged or are not discharged. If you do not agree with the IRS response, or the IRS fails to respond after a second request, or if there is uncertainty, you may file a special lawsuit in the Bankruptcy Court requesting the Bankruptcy Court to make a ruling. This is expensive and not covered by the flat fee you pay me for the bankruptcy. It may also be possible to request an internal review within the IRS. Again, this is not covered by the flat fee you pay me for the Chapter 7 bankruptcy.

CHAPTER 13 DISCHARGE OF TAXES AND CHAPTER 13 TRUSTEE PAYMENT OF TAXES

In a Chapter 13 you may be able to get a tax lien released by paying the IRS, through the plan, the value of the property that the lien is against. This may be far less than the amount of the lien. There are three categories of unsecured individual income tax in Chapter 13.

Category 1, Unsecured Priority, Paid Through The Plan. In a Chapter 13 you cannot discharge unsecured priority taxes. The plan must propose to pay priority taxes through a plan. The principal and interest owing on priority taxes as of the day of filing the bankruptcy petition are normally paid in full through the plan. The plan does not pay post-petition interest, pre-petition penalties or post-petition penalties and, unlike chapter 7, the debtor is discharged from any liability on these upon completion of the plan. Pursuant to 11 USC §1322(a)(2), §507(a)(8), and §523(a)(1)(B)&©, priority taxes are taxes which meet ONE OR MORE of these 3 requirements:

1. The tax return, with any extensions, was due less than three years before filing

bankruptcy,
or

2. The taxes were assessed less than 240 days before filing bankruptcy,
or

3. The taxes were not assessed before the bankruptcy was filed but were assessable under applicable law after the bankruptcy was filed, and ALL THREE of the following apply to this paragraph 3:

(1) You filed the return more than 2 years before the bankruptcy was filed,

and

(2) You did not attempt to evade taxes,

and

(3) You did not file a fraudulent return.

Category 2, Unsecured Not Priority, Not Discharged And Not Paid In Full Through The Plan.

Taxes are not discharged and are not paid as priority taxes through the plan if BOTH of these apply:

1. The tax return, with any extensions, was due more than three years before filing bankruptcy,
and

2. The taxes were not assessed before the bankruptcy was filed but were assessable under applicable law after the bankruptcy was filed, and ONE OR MORE of the following apply to this paragraph 2:

(1) The return was not filed,

or

(2) The return was filed less than 2 years before the bankruptcy was filed,

or

(3) You attempted to evade taxes,

or

(4) You filed a fraudulent return.

Such taxes probably will be paid only a few cents on the dollar in the Chapter 13 plan, the same as credit cards, but will not be discharged. This means you will continue to owe any unpaid amount after the completion of the Chapter 13 plan.

Category 3, Unsecured Not Priority And Discharged. The rules for discharging taxes in Chapter 13 became the same as Chapter 7 for cases filed on or after October 17, 2005. See pages 1-3. If a tax meets the above 5 requirements for discharge in Chapter 7, then the tax will be discharged in Chapter 13. Such taxes probably will be paid only a few cents on the dollar in the Chapter 13 plan, the same as credit cards, and will be discharged the same as credit cards. Upon completion of the plan you are discharged of any remaining liability.

CHAPTER 13 LIABILITY FOR NON-DISCHARGED TAXES

The tax agencies may resume collection activity from you for non-discharged taxes as soon as you receive your discharge of other debts, which is normally 1-2 months after you complete all payments through your chapter 13 plan. The IRS may collect for that tax from almost all income or anything you own, including social security and retirement benefits. IRS guidelines limit the percent of social security that may be garnished. State exemption laws, such as the homestead exemption, may not be used against the IRS to prevent property from being seized or sold or from a lien. The IRS tax code and the Arizona tax laws each contain a list of property which is exempt from collection from each respective agency. Not much is exempt.

TAX LIENS

**General Rule: Recorded Lien Survives Bankruptcy.
In some cases an unrecorded lien survives bankruptcy concerning certain property.**

Some explanation is required. The IRS can record in the county recorders office a document labeled as "Notice of Federal Tax Lien" (NFTL). It is common to call this the lien. It is not the lien. It is notice to third parties that a lien is already in existence.

Under Title 26 of the United States Code, Section 6321 (11 USC 6321), the IRS has a lien on all of a taxpayer's property if the taxpayer fails to pay a tax after demand by the IRS. The lien is valid against the taxpayer even though a NFTL has not been recorded. The lien might not be valid against third party until the NFTL is recorded. 11 USC 6323.

When a debtor files bankruptcy, most property owned by the debtor becomes property of the bankruptcy estate. 11 USC 541. The debtor can remove certain property from the bankruptcy estate by claiming that property as exempt. 11 USC 522.

However, there is certain property that never becomes property of the bankruptcy estate in the first place and therefore the debtor cannot (and need not) exempt it from the estate. 11 USC 541c2 says that "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable under in a case under this title." For example, 401k plans never become property of the bankruptcy estate and technically do not need to be claimed as exempt from the bankruptcy estate because 401k plans have enforceable restrictions on transfers. As another example, many trusts and wills have enforceable "spendthrift" restrictions that prevent creditors from garnishing or attaching a person's interest in a trust.

If a NFTL has been properly recorded before the bankruptcy was filed, then the lien remains on all property you own as of the day you file bankruptcy regardless of whether the property was in the bankruptcy estate and regardless of the fact that your personal liability for the taxes is discharged in bankruptcy. 11 USC 522(c)(2)(B). The lien is not discharged.

If a NFTL was not been properly recorded before the bankruptcy was filed, and if

the debtor's personal liability for the taxes is discharged, then the IRS does not have lien on property which the debtor exempted from the bankruptcy estate.

The problem is that 401k plans and certain trusts are never in the bankruptcy estate and therefore are not exempted from the bankruptcy estate. This means that the unrecorded lien under 11 USC 6321 survives the bankruptcy as to 401k plans and certain trusts even though the debtor's personal liability for the taxes was discharged and even though a NFTL was not recorded. This was the ruling of the U.S. Tax Court in *Wadleigh v. Commissioner*, No. 10783-07L, June 15, 2010. In such a situation, the IRS can garnish 401k payments after bankruptcy. The same is probably true regarding a trust. It is not clear how this applies to property that was in the bankruptcy estate and was not exempted but was abandoned by the trustee back to the debtor.

	Personal Liability For Taxes Discharged In Bankruptcy	Personal Liability For Taxes Not Discharged In Bankruptcy
NFTL recorded before bankruptcy.	Lien on any property at the time of bankruptcy survives bankruptcy. Lien for the discharged taxes cannot attach to new property owned in the future.	Lien on any property at the time of bankruptcy survives bankruptcy. Lien will attach to new property owned in the future.
NFTL not recorded before bankruptcy.	The section 6321 unrecorded lien at time of bankruptcy remains as a lien against property that never became part of the bankruptcy estate, such as 401k plan and probably trusts with spendthrift clauses. No lien for the discharged taxes may be asserted after bankruptcy against property that was exempted from the bankruptcy estate or that is acquired after filing bankruptcy.	No NFTL at time of bankruptcy. The section 6321 unrecorded lien exists when the bankruptcy is filed. The section 6321 unrecorded lien survives the bankruptcy against all property the debtor exempted from the bankruptcy estate and against property that was not in the bankruptcy estate and against new property owned in the future. A NFTL may be recorded after bankruptcy.

Liens On Personal Property. A lien is valid and attaches to your personal property if, on the day the lien was recorded, you resided in the County where the lien was recorded. It does not matter where the personal property is located. It does not matter if you later moved and later acquired other personal property. The lien follows you.

Liens On Real Property. A lien is valid against third parties and attaches to your real property if the lien was recorded in the county recorders office of any county where your real property is located.

Life Of A Lien. A tax lien is generally valid for 10 years after the date the taxes

were assessed, not 10 years after the lien was filed. The 10 years may be extended by certain events, such as a prior bankruptcy, an offer-in-compromise, being out of the country for at least 6 months, an application for a taxpayer assistance order, time in tax court proceedings, or a signed waiver of the statute of limitations. (The length of the extension of time is complicated and not described herein.) Liens are often filed several years after taxes are assessed.

Liens On Retirement Accounts. While the IRS has lien rights against social security and retirement accounts, it has some discretion in pursuing such lien rights. In addition, the IRS code provides that the IRS may not enforce a lien against certain property.

SEIZING REFUNDS AS A SETOFF FOR PRIOR TAXES

A tax agency may seize a refund for a tax year that ended before you filed bankruptcy and apply it to a tax owing for a tax year that ended before you file bankruptcy. Example: You file bankruptcy on January 15, 2008 and you owe taxes for 2001 which will be discharged in your bankruptcy because they meet discharge requirements. If in 2008 you are entitled to a refund for the 2007 tax year, then the tax agency may, without requesting permission from the Bankruptcy Court, seize the refund as a setoff and apply it to the 2001 taxes.

SPLITTING A TAX YEAR

The general rule is that the bankruptcy trustee cannot pay taxes that become due for the tax year in which the bankruptcy was filed. For example, if you file chapter 7 bankruptcy on July 1 of a year (one half through the tax year) and the following April it is determined that you owe income taxes for that year, the trustee will not pay any of those taxes, not even one half. There is language in the bankruptcy code, 11 USC §507(a)(8)(A)(iii), that seems to say the trustee can pay such taxes. However, most courts, including *In re Allen*, Bkrcty. D. Mass. December 11, 2006, No. 04-1266-JNF have ruled that the trustee cannot pay such taxes unless the debtor elected to split the tax year.

The IRS code, 26 USC §1398(d)(2)(A), allows a debtor to split a tax year into two short tax years. If this is done for bankruptcy purposes, normally one short tax year ends the day before the bankruptcy is filed. The other short tax year starts the day the bankruptcy is filed. The election by the debtor to split the tax year must be made on or before the 15th day of the fourth full month following the day the bankruptcy was filed. If such an election is made by the debtor, then the tax liability for the first short tax year may be paid by the trustee as a priority claim.