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**The Fundamentals of
Discharging Taxes
in Bankruptcy**

Charles F. Rosen—Moderator

James R. Kelley

Morgan D. King

CHECKLIST FOR DISCHARGEABILITY OF INCOME TAXES IN CHAPTER 7

The following rules apply equally to state as well as federal income taxes.

The tax is dischargeable if all of the following conditions exist:

- 1. THE THREE-YEAR RULE.** The tax year in question is over three years preceding the filing date of the bankruptcy. The three-year period is computed from most recent date the tax return is due for the tax year (typically April 15 of the year following the taxable year). An extension to file the return pushes the start time back. 11 U.S.C. § 507(a)(8)(A)(i).
- 2. THE TWO-YEAR RULE.** A tax return has been filed by the taxpayer for the tax year(s) in question at least more than two years preceding the filing date of the bankruptcy (however, even where no tax return was filed the tax may still be dischargeable in Chapter 13). 11 U.S.C. § 523(a)(1)(B).
- 3. THE 240-DAY RULE.** The tax claim was assessed at least more than 240 days preceding the filing date of the bankruptcy (plus any period of over-lapping time during which an offer in compromise was pending, plus 30 days). 11 U.S.C. § 507(a)(8)(A)(II).
- 4. NON-FRAUDULENT RETURN.** The tax return in question was non-fraudulent. 11 U.S.C. § 523(a)(1)(C).
- 5. NO WILLFUL TAX EVASION.** The taxpayer has not engaged in activity deemed willful attempts to defeat or evade the tax. 11 U.S.C. § 523(a)(1)(C).

A. CHAPTER 7

1. Personal income taxes

“In personam” liability is the liability of the taxpayer and his present and future income and property for the tax claim. If the tax is dischargeable, the debtor is relieved of *in personam* liability; all that remains are tax liens that may attach to present property only (“in rem” liability), not to after-acquired (postpetition) property or future income. To extinguish “**in personam**” liability - must meet all of the following five criteria:

a. **3-year rule** (tax return due date)

11 U.S.C. § 507(a)(8)(A)(i)

Period starts from most recent date tax return is due.

Extensions to file must be taken into consideration.

In re Gidley, 151 B.R. 952 (M.D.Fla. 1992)

In re Smith 109 B.R. 243 (Ky. 1989)

Note - what little case law there is holds that where the taxpayer fails to satisfy requirements for second extension (e.g. fails to file or pay tax by Oct. 15) the failure to qualify for the extension does not move the due date back to Aug. 15. *In re Brustman*, 217 B.R. 828 (Bkrcty.C.D.Cal. 1997); *Gidley v. United States*, 138 B.R. 298 (Bkrcty.M.D.Fla. 1992), *aff'd* 151 B.R. 952 (M.D.Fla. 1992).

Trap: state tax return due date may be extended automatically, even if taxpayer does not request it. Example, California - if state return is not filed on April 15 the due date is extended automatically, *and* the extended date goes to Oct. 15, not August 15.

Caution: some cases hold that where a state requires the filing of an amended tax return, a new three-year period is started commencing on the due date of the amended return. This argument was raised by states of Illinois and Georgia, but cases were disposed of on other grounds. *In re Greenstein*, 95 B.R. 583 (N.D.Ill. 1989); *In re Jones*, 158 B.R. 535 (N.D.Ga. 1993).

b. **2-year rule** (tax return filing date)

11 U.S.C. § 523(a)(1)(B)

U.S. v. D'Avanza 132 B.R. 462 (M.D.Fla. 1991)

The period begins on date debtor's tax return is filed

Do not confuse this with the due date (three-year rule)

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The two-year rule does not apply in chapter 13 cases. § 1328(a) does not except from chapter 13 discharge any tax listed under § 523 (tax return, fraud, evasion). *In re Daniel*, 170 B.R. 466 (Bkrcty.S.D.Ga. 1994)

1. What constitutes a return?

Substitute return by itself does not count; taxpayer must file it.
In re Bergstrom 949 F.2d 341 (10th Cir. 1991)

But an “agreed” SFR (IRC § 6020), may constitute a return; *In re Bergstrom*, 949 F.2d 341 (10th Cir. 1991). Or an SFR with a signed voluntary payment agreement may constitute a return for purposes of § 523 (a)(1)(B). *In re Hatton*, 216 B.R. 278 (9th Cir. BAP 1997); rev'd 220 F.3d 1057 (9th Cir. 2000).

Query: does a taxpayer-filed return, which is filed after the IRS files an SFR, constitute a “return” for purposes of the two-year rule?

Cases are undecided. Some draw a distinction between a taxpayer-filed return filed after SFR, but prior to actual IRS assessment of the tax, as opposed to return filed after SFR but before IRS assessment of tax.

e.g., taxpayer filed return filed after SFR is not a return, as it serves no valid purpose; *In re Rushing*, 273 B.R. 223 (Bkrcty.AZ 2001).

Other documents may constitute a constructive return for purposes of § 523:

- √ An agreed “audit” (Form 4549)
Berard v. U.S. 181 B.R. 653 (Bkrcty.M.D.Fla. 1995)
- √ A “schedule” signed by the taxpayer;
In re Ashe, 228 B.R. 457 (C.D.Cal. 1998).
- √ A Form 870 waiver of restrictions on assessment
Carapella v. U.S., 84 B.R. 779 (Fla. 1988)
- √ Schedules provided in court during litigation
In re Elmore, 165 B.R 35 (Bkrcty.S.D.Ind. 1994).
- √ A signed voluntary installment agreement with information upon which IRS could assess the tax
In re Hatton, 216 B.R. 278 (9th Cir. BAP 1997); but rev'd 220 F.3d 1057 (9th Cir. 2000).

See IRS Revenue Ruling 74-203 -

“Even though a document is not in the form prescribed for use as the appropriate return, it may constitute a return if it discloses the data from which the tax can be computed, is executed by the taxpayer, and is lodged with the Internal Revenue Service (see *Germantown Trust Co. v. Commissioner*, 309 U.S. 304 (1940), 1940-1 C.B. 178. In *United States v. Olgeirson*, 284 F. Supp. 655 (D. N. D. 1968), the District Court held that the signing of a Form 870 by a husband and wife, under

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circumstances similar to those described in this Revenue Ruling, made them jointly and severally liable.

The Form 870, although not containing the data from which the tax is computed, is accompanied by certain schedules, made available to the taxpayer, which contain the required data. Accordingly, the executed Form 870 with accompanying schedules is a return under section 6020(a) of the Code and a valid election to file a joint return under section 6013.

The above conclusion applies equally to a Form 1902-E, Report of Individual Income Tax Audit Changes, or Form 4549, Income Tax Audit Changes, when signed by a husband and wife.”

Note: This position again stated, as to signing of Form 870, in IRS memorandum of Feb. 7, 2001; Chief Counsel takes the position that signing of Form 870 waiver or like document, allowing the IRS to make an immediate assessment of the amount calculated on a substitute for return and waive right to contest the assessment, constitutes the signing of a return for discharge purposes. LTR 200113026.

Caveat; some states require a “report” or an “amended return” be filed with the state taxing entity, following a new IRS assessment. The courts are split on whether such a report or return is a “return” within the meaning of the Bankruptcy Code. If it is a return, the piggy-back state assessment may not be discharged for failure to satisfy the two-year rule. Held, a report is a return, *In re Blutter*, 177 B.R. 209 (Bkrcty S.D.N.Y. 1995); *Haywood v. State of Illinois*, 62 B.R. 482 (Bkrcty.N.D.Ill. 1986). Held, a report is not a return, *In re Jackson*, 184 F.3d 1046 (ith Cir. 1999).

2. What constitutes “filing”

IRC requires returns to be filed at the service centers. IRC § 6091.

Simply handing it to a revenue officer (for example, during an audit at the RO's request) may not be proper filing. *In re Savage*, 218 B.R. 126 (10th Cir. BAP 1998).

3. When is it filed?

Mailbox rule: return mailed early will be deemed filed on the due date; return filed late will be deemed filed when IRS received it. This may cause trouble if taxpayer mails return just after due date but IRS receives it several days later, within two years of the bankruptcy filing. Held, return mailed more than two years before bankruptcy, but which arrived at the IRS within two years of the bankruptcy, did not satisfy the two-year rule. *In re Harrison*, 226 B.R. 285 (D.Mass. 1997).

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c. 240-day rule (date of assessment)

11 U.S.C. § 507(a)(8)(A)(ii)
In re Leach 130 B.R. 855 (9th Cir. BAP 1991).

The period begins on date of assessment of tax

For IRS date of assessment is clear; the word “assessed” appears on IRS transcripts and is “assessed” within meaning of Bankruptcy Code

For state, it may not be clear. In California is the “posting” date or “effective” date. Assessment is date the claim is “final,” cannot be appealed administratively within the taxing agency. *In re King*, 122 B.R. 388 (9th Cir. BAP 1991). See also *In re Wernimont* 183 B.R. 181 (N.D. Iowa 1994) (discussion about when a state tax is deemed “assessed”).

“Self-assessment” as date of filing the return is not the date of assessment for purposes of the Bankruptcy Code. *Schatz v. Cal. Franchise Tax Board* (Third Appellate District, 1999).

A subsequent assessment of additional tax starts a new 240-day period as to the additional tax.

Caution: if there was a subsequent IRS assessment, it is probable that state had right to do piggy-back assessment as well; don't forget to look for that state assessment; that assessment must also satisfy the 240-day rule to be discharged.

Caution: the IRS typically assesses within a month or six weeks of receiving the return; some states, however, take much longer. Do not assume state assessment took place soon after the return was filed. See *In re Lewis*, 199 F.3d 249 (5th Cir. 2000).

d. No fraudulent tax return

11 U.S.C. § 523(a)(1)(C)
“Badges of fraud,”
In re Peterson 160 B.R. 385 (D.Wy 1993)

If transcript has a fraud penalty, probably prudent to file a complaint to determine discharge to resolve the question, or file Chapter 13, instead.

e. No willful attempt to evade tax

11 U.S.C. § 523(a)(1)(C)
In re Carapella 105 B.R. 86 (Fla. 1989)

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1. See checklist, *Potential Fraud And Willful Evasion Checklist*
2. Some cases hold that once willful evasion was committed, subsequent good conduct does not negate prior evasion. Held, subsequent attempts to make payments does not negate prior willfulness.
In re Meyers, 196 F.3d 622 (6th Cir. 1999).

3. Two rules fighting it out -

1. Affirmative misconduct necessary to prove attempt to evade (the criminal standard)
2. Mere omission is adequate to prove attempt to evade (the civil standard)

Caution: seemingly ordinary, common-sense things like moving one's bank account to stay one step ahead of a tax levy could be deemed evasion. See fraud & evasion checklist.

4. Two other rules fighting it out – courts are split on this issue:

1. To constitute evasion, must be evasion of assessment, not collection
2. Evasion of collection is also evasion within BK Code

5. Tax debts excepted from discharge due to § 523(a) are automatically non-dischargeable; e. tax.g., unlike other creditors, IRS or state taxing entity need not file a complaint to determine dischargeability based on fraud within 60 days of MOC.

Kelly v. Robinson, 107 S.Ct. 353 (1986).

Ergo, to adjudicate whether a tax has been discharged or not, debtor, not IRS, must take initiative to file adversary proceeding.

In re Borck, 81 B.R. 142 (Bkrtcy.SD FL 1987); In re Ekeke, 198 B.R. 315 (Bkrtcy.ED MO 1996); In re Mathews, 209 B.R. 218 fn 4 (6th Cir. BAP 1997). In re Ellsworth, 158 B.R. 856 (Bkrtcy.MD FL 1993).

6. Finding of fraud on part of one spouse is not necessarily applicable to other spouse. *In re Binkley, 242 B.R. 728 (DC MD FL 1999).*

2. DISCHARGEABILITY OF OTHER TAXES

a. Payroll and employer's taxes

- i. Withholding (“941”) trust-fund portion is not dischargeable in chapter 7.
11 U.S.C. § 507(a)(8)(C).

But note: typically about 25% to 33% of the 941 liability is not trust fund and is dischargeable if over 3 years old.

- ii. Employer's portion is dischargeable if over 3 yrs old.
11 U.S.C. § 507(a)(8)(D)
In re Pierce 935 F.2d 709 (5th Cir. 1991)

- iii. The entire “940” tax is dischargeable if over 3 years old.

b. Sales & excise taxes

- i. If tax is on the *purchaser*, a priority tax (trust fund tax) & not dischargeable.
- ii. If tax is on the *retailer*, then;
 - If excise tax, dischargeable if over 3 years old.
In re Raimon 172 B.R. 933 (9th Cir. BAP 1994) (California sales taxes)
 - If tax based on income, dischargeable same as personal income taxes.
- iii. Excise taxes incurred within three years prior to filing the bankruptcy are non-dischargeable excise taxes.
In re Appugliese 210 B.R. 890 (Bkrcty.D.Mass. 1997).

c. Interest

Majority rule is that interest “follows the tax.” That is, if the tax is dischargeable the interest is dischargeable; if the tax is not dischargeable the interest is nondischargeable as well.

Following rule: *Matter of Larson*, 862 F.2d 112 (1988); *In re Polston*, 239 B.R. 277 (Bkrcty.M.D.Pa. 1999).
Contrary: *In re Razerback Ready-Mix* 45 B.R. 917 (E.D.Ark. 1984)

d. Penalties

11 U.S.C. § 523(a)(8)(A) and (B)¹

a. Majority rule: penalties are dischargeable if -

¹(a) A discharge ... does not discharge an individual debtor from any debt ... (7) to the extent such debt is a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty - (A) relating to a tax of a kind not specified in paragraph (1) of this subsection, or (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.”

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i) the event giving rise to the penalty is over three years old (does not apply to “100% trust fund recovery penalty”)

or

ii) the tax is dischargeable.

In re Burns 887 F.2d 1541 (11th Cir. 1989)

McKay v. U.S. 957 F.2d 689 (9th Cir. 1992)

In re Polston, 239 B.R. 277 (Bkrcty.M.D.Pa. 1999)

Dischargeable penalties include, for example, late-filing, non-filing, negligent filing and underpayment penalties.

Held, federal tax penalties were not discharged in prior chapter 7 case because events triggering the penalties were within three years of filing of bankruptcy. *In re Brabham* 212 B.R. 999 (Bkrcty.M.D.Ala. 1997).

b. Minority rule: penalty dischargeable only if tax dischargeable

Cassidy v. Commr. of Internal Revenue 814 F.2d 477 (7th Cir. 1987)

c. Delinquent payroll withholding taxes, sometimes called a “trust fund recovery penalty,” are not penalties but taxes; *In re Campbell*, 242 B.R. 327 (W.D.Va. 1999) (refers to the withholding portion).

6. Credit card used to pay non-dischargeable tax

Held, credit card debt incurred to pay nondischargeable taxes shortly before filing bankruptcy was nondischargeable pursuant to 11 U.S.C. § 523(a)(14); *In re Gavin*, 248 B.R. 464 (Bkrcty.M.D.Fla. 2000).

B. CHAPTER 13:

1. Compare with chapter 7:

a. 11 U.S.C. § 523 (Exceptions to Disch) does not apply in ch 13 because § 1328 does not except from discharge any taxes under § 523 (unless it is a hardship discharge).

In re Fox 130 B.R. 571 (W.D. WA 1991)

Thus **no tax return is required** to discharge income tax in chapter 13; *In re Daniel*, 170 B.R. 466 (Bkrcty. S.D.Ga. 1994)

But note: Local practice may require filing of recent tax returns (typically required to be filed at or just after time of filing chapter 13) as a condition of confirmation of the plan.

b. 11 U.S.C. § 1322(a)(2) only requires that the plan provide for full payment of priority taxes as defined in § 507.

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Note: The requirement is that the plan “provide for” full payment; actual full payment is not required; if the taxing entity fails to file a timely proof of claim for an unsecured priority tax it is discharged even though not paid (see “loopholes” below).

c. Good discussion of how tax claims are to be treated in Chapter 13 plans – *In re Healis*, 49 B.R. 939 (Bkrcty.MD 1985).

2. Personal income taxes & sales taxes

a. Must satisfy only two rules to be dischargeable in Chapter 13:

1. 3-year rule applies (tax year is 3 years old)

2. 240-day rule applies (has been assessed at least 240 days)

c. 2-year rule does not apply (no need for tax return to be filed) because 2-year tax return rule is found in § 523(a)(1)(B) which does not apply in chapter 13.

d. Fraudulent tax or evasion rules do not apply. Same reason as above.

3. Other grounds for discharge in chapter 13

a. Tomlan rule (in chapter 13 if IRS or State misses claim deadline, unsecured tax is discharged even if a priority tax).

i. Bankruptcy Reform Act of 1994 added 11 U.S.C. § 502(b)(9) essentially codifying the rule in *Tomlan v. U.S.*, 102 B.R. 790 (E.D.Wash., 1989), 907 F.2d 114 (9th. Cir. 1990).

RULE: taxing entity must file proof of claim for any tax within 180 days of date of filing the bankruptcy, or claim is disallowed and discharged upon successful completion of the plan.

ii. When amendment of claim may be disallowed (IRS attempts to remedy failure to file timely claim by “amending” a timely filed claim for a different tax or different tax year.

- Different tax year
- Different type of tax
- Substantially different amount

Amended claim filed after 180 days for one kind of tax does not relate back to timely filed claim for another type of tax. *In re Osborne*, 159 B.R. 570 (C.D.Cal. 1993); *In re Friesenhahn*, 169 B.R. 615 (Bkrcty.W.D.Tex. 1994); *In re Appling*, 162 B.R. 43 (Bkrcty.M.D.Ga. 1993) (amended claim adding another tax year does not relate back to timely filed claim for a different year).

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- b. Not assessed but assessable & §523 offense committed
11 U.S.C. § 507(a)(8)(A)(iii)²

RULE: If tax satisfies the three-year rule, and taxpayer has violated one of the tax provisions of § 523 (e.g., didn't file a return), and tax is not yet assessed, it is not a priority and is therefore dischargeable in Chapter 13.

Muina v. United States 75 B.R. 192 (S.D.Fla 1987)

In re Daniel 170 B.R. 466 (Bkrcty.S.D.Geo. 1994)

In re Verdunn 160 B.R. 682 (Bkrcty.M.D.Fla. 1993)

In re Edwards 74 B.R. 661 (Bkrcty.N.D. Ohio 1987)

In re Zeig, 194 B.R. 469 (Bkrcty.D.Neb. 1996).

4. Penalties in chapter 13

- a. Ordinary punitive penalties are never priority (thus always dischargeable in 13 regardless of when triggering event happened)
11 U.S.C. § 523(a)(8)(A) and (B)
- b. Penalties are priority claims only if for actual pecuniary loss (e.g. payroll)
11 U.S.C. § 507(a)(8)(G)

5. No post-petition interest on unsecured taxes, including priority claims;

In re Boston & Maine Corp 719 F.2d 493 (1st.Cir. 1983)

Because chapter 12 was modeled after chapter 13, and not after chapter 11, IRS was not entitled to interest on its unsecured claims following chapter 12 discharge. *In re Mitchell*, 210 B.R. 978 (Bkrcty.N.D.Tex. 1997).

6. **Good discussion of treating IRS** secured, unsecured priority, and general unsecured claims in Chapter 13 cases;
In re Healis, 49 B.R. 939 (Bkrcty.MD PA 1985).

²The following ... claims have priority ... Seventh, 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

(iii) other than a tax of a kind specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed but assessable, under applicable law ...

TOLLING EVENTS

C. TOLLING EVENTS (“CLOCK STOPPERS”)

Events that may extend any of the three time periods for discharge:

1. Prior bankruptcy

a. Stops clock on 3-year and 2-year periods during the period of the overlap; might not stop clock on 240-day period because automatic stay does not prohibit assessment of tax.

Rationale: Tax entity is entitled to benefit of its full time period to collect the tax and should not suffer loss of time during period it is restrained from collection activity.

See recent Supreme Court ruling in *Young v. U.S.*, *S.Ct. 1036 (2002)* March 4, 2002; held, prior bankruptcy tolls the three-year period during the overlap period. Overrules cases saying prior bk may or may not toll based on equitable considerations: Supreme Court says it *always* tolls.

Does this rule apply to two-year rule? The 240-day rule?

Query - the Bankruptcy Reform Act of 1994 amended § 362 to permit assessments during the automatic stay; since tax collector is no longer prohibited by the stay from assessing, does a bankruptcy toll the 240-day period? It would seem that the justification for tolling is gone.

b. No longer add six months to tolling period.

Former rule - time in BK *plus six months*

In re Brickley, 70 B.R. 113 (9th Cir. BAP 1986) (plus 6 mo.)

Matter of Ross, 130 B.R. 312 (Bkrcty Neb. 1991);

U.S. v. Worthen, 137 B.R. 1016 (DC Ore. 1992);

In re Deitz, 116 B.R. 792 (Bkrcty D. Colo. 1990)

Matter of Stoll 132 B.R. 782 (N.D.Ga. 1990)

In re Tibaldo 187 B.R. 673 (Bkrcty.C.D.Cal. 1995)

In re Teeslink, 165 B.R. 708 (Bkrcty.S.D.Ga. 1994)

In re Zecco, 211 B.R. 109 (Bkrcty.D.Mass. 1997).

But in response to Supreme Court ruling in *Young*, the IRS has announced it will no longer take the position that an additional six months must be added to the tolling period. IRS Chief Counsel Memo May 9, 2002 # CC-2002-023. “In light of rationale in *Young*, the three-year lookback period of B.C. § 507(a)(8)(A)(i) should not be computed by including the additional six months, based on IRC § 6503(h).”

TOLLING EVENTS

2. Tax litigation (e.g. appeal of proposed assessment)

Pushes start of 240-day period back. After a stipulated judgment or court judgment, the assessment, and hence the 3-year period, starts upon the expiration of the appeal period.

3. Offer-in-compromise

- a. Tolls **240-day period** for assessment if made during the 240-day period. 11 U.S.C. § 507(a)(8)(A)(ii).
- b. But an offer initiated *prior to* start of 240-day period may be deemed not to stop the clock; *U.S. v. Aberl, 1996 U.S. App. LEXIS 3907 (6th Cir. 1996)*
- c. Is time during which rejection of OIC is being **appealed** still counted as “pending”?

No, says *In re Klein, 189 B.R. 505 (D.C.D.Cal. 1995)*; also *In re Aberl, 159 B.R. 792, 802 (Bkrcty.N.D.Ohio 1993)*.

Maybe yes, says *In re Hobbs, 1996 Bankr. LEXIS 698 (Bkrcty. N.D.Iowa 1996)*.

Yes, says *In re Genung 220 B.R. 505 (Bkrcty.ND NY 1998)*.

- d. Tolls only the tax for the year and tax entity for which the offer is made (e.g. an OIC as to federal taxes does not toll period for state taxes).

Query: When does an OIC commence pending for purposes of § 507? Time the offer is mailed? Received at IRS? Deemed a qualifying offer by IRS? *In re Callahan, 168 B.R. 272, 273 (Bkrcty.D.Mass. 1993)*.

IRM § 57(10)7.1 -

“The offer is considered pending from the date the delegated Service employee signs and dates the acceptance of the waiver of the statutory period of limitations on Form 656, until it is accepted, rejected or withdrawn.”

Query: When is offer no longer pending? When rejected? During time on appeal of rejection? During second offer? During counter-offer by IRS?

Held, time during appeal is not pending; *In re Klein, 189 B.R. 505 (D.C.D.Cal. 1995)*; *In re Aberl, 159 B.R. 792, 802 (Bkrcty.N.D.Ohio 1993)*.

Held, time on appeal is pending, *In re Genung 220 B.R. 505 (Bkrcty. N.D.N.Y. 1998)*; *In re Hobbs, 1996 Bankr. LEXIS 698 (Bkrcty.N.D.Iowa 1996)*;

IRM § 57(10)7.1 -

TOLLING EVENTS

“The compromise agreement on Form 656, Offer in Compromise, provides that the taxpayer agrees to the suspension of the *running of the statutory period of limitations* on both assessment and collection for the *period that the offer is pending*, or the period that any installment remains unpaid, and for one year thereafter. *This includes the period of time in which the offer is being considered by Appeals.*”

Caveat: Under the rule in Young v. U.S. (supra.), will the IRS argue that, since the consideration of an OIC prohibits collection, it should toll the other time periods as well?

Query: Does time in which OIC is pending toll the three-year period?

Argument for: the ruling in Young held that because a prior bankruptcy stay prohibits collection of tax during period of the stay it equitably tolls the three-year period, then since IRS collection of tax is prohibited by federal law from collecting tax during period OIC is being considered, it should operate to toll the 3-year period, as well.

IRS takes position that OIC does not toll 3-year period.
IRS Ltr Ruling 200404049, Ltr Rept. No. 1404, Jan 28, 2004.

4) Extension to file tax return (to Aug. 15 or Oct. 15)

- a. Delays start of 3-year period for tax year. 11 U.S.C. § 507(a)(8)(A)(i)
In re Bishop, 209 B.R. 578 (Bkrcty.N.D.Ga. 1997)
- b. Caveat; a state extension date to file return may not be same due date as IRS extension to file. May be a longer extension. For example, in California the mere failure to file return or pay tax on time triggers an automatic extension to Oct. 15, without a request by the taxpayer. Trap for the unwary.
- c. Caveat: An extension for IRS may trigger automatic extension of state tax.
- d. Query; if the second extension to file is disallowed by the IRS, does that mean the tax return due date goes back to the previous due date for purposes of starting the 3-year period?

No; debtor is stuck with the extended date despite his failing to qualify for the extension. *In re Hermann, 221 B.R. 944 (Bkrcty. N.D.Okla. 1998); In re Brustman, 217 B.R. 828 (Bkrcty.C.D.Cal. 1997).*

5) Taxpayer assistance order (IRC § 7811(d))

6) Non-tolling events:

- Time in voluntary installment plan?
- Time OIC is pending (as to the other time periods)?
- Time while a due process hearing is pending

FRAUD AND WILFULL EVASION CHECKLIST
POTENTIAL FRAUD AND WILLFUL EVASION CHECKLIST

YES NO

1. - Membership in a tax protest organization?
2. - Engaged in a pattern of unfiled returns? Why?
3. - Filed a fraudulent, frivolous, blank or incomplete return?
4. - Repeatedly understated income or overstated deductions on returns?
5. - A serial failure to pay taxes? Why?
6. - Concealed, gave away or traded away valuable assets, or transferred title? *In re Colish 90 AFTR2d 2002-7195, 2003-1 USTC 50119 (Bkrctcy. ED NY 2002).*
7. - Sold assets way below fair value? (especially to insiders such as family members, employers, business associates, etc.)
8. - Set up "abusive" trust or sham tax shelter and transferred assets to it? An abusive trust probably exists if debtor was facing tax debt at time of set-up, and he maintains control of, or benefit use of, assets of the trust.
 - Is he a beneficiary of family trust, business trust or other trust?
 - Did he set up the trust?
 - Did he transfer valuable assets to the trust?
 - Does he have unfettered control of trust assets?
 - Does he have benefit of use of trust assets?
 - Are his personal living expenses paid by the trust?
 - Does he not report trust payments as taxable income to himself?
 - Trust has no "economic reality"?
9. - Created a corporation and transferred assets to it?
10. - Changed bank or bank account frequently?
11. - Closed bank account and conducted business in cash only?
12. - Added another person's name to bank account to throw off a levy?
13. - Deposited income in another's bank account to avoid levy?
14. - Used a foreign bank account?
15. - Changed name? Changed spelling of name?
16. - Changed SSN?
17. - Had an altercation with a revenue officer?
18. - Engaged in money laundering?
19. - Withdrew cash from bank and hid it? See *In re Bernard, 96 F.3d 1279* (debtor simply withdrew \$64,000 from bank account in order to keep away from levy - held, fraudulent transfer and discharge denied!)
20. - Claimed incorrect number of exemptions on tax return?
21. - Purchased property in someone else's name?
22. - Refused to cooperate with a revenue officer, or deliberately obstructed audit or investigation
23. - Lost, concealed or destroyed financial documents?
24. - Maintained inadequate records?
25. - Concealed actual residence address or business address?
26. - Traded valuable assets for less valuable assets?

FRAUD AND WILFULL EVASION CHECKLIST

- 27. - Devising clever schemes such as divorcing his wife and directing all income to her and renting a room in her house, thus eliminating most income that could be traced to husband to satisfy husband's tax claims.
- 28. - Living a "lavish lifestyle" knowing that delinquent taxes had not been paid.

CLIENT SIGNATURE _____ **DATE** _____

USING TRANSCRIPTS
USING TRANSCRIPTS

1. Why use transcripts?

Transcripts are vital for verifying the dates when evaluating whether the time rules have been satisfied.

2. What information is contained in the transcripts?

a. Critical time/date information

- Date the tax was assessed
- Whether or not the client filed the tax return
- When was the client's return filed?
- Were any extensions to file the return made?
- The amount of the liability

b. Other important information

- Was a lien filed?
- Was there a previous bankruptcy?
- Was there a subsequent assessment of additional tax?
- Is there an open audit in progress?
- Has the statute of limitations expired?
- Is there evidence of a criminal investigation?
- If there was an SFR, did client file a subsequent tax return?
- Did client sign anything that might be a constructive return?
- Was an OIC made? Rejected? Still pending?
- Other useful information

3. What kind of transcripts should you get?

- a. IMFOLI
- b. MFTRA-X
- c. IMF Specific or TXMOD

4. Where do you get them?

- a. MFTRA-X from Priority Hotline **(866) 860-4259**
- b. IMFOLI, IMF Specific and TXMOD from disclosure office

5. How do you read them?

The ADP transaction code guide

6. Sources of help

- a. King's Discharging Taxes in Bankruptcy
- b. BankruptcyLibrary.com
- c. Experts (enrolled agents, etc.)

TAX LIENS AND LEVIES
WHAT YOU SHOULD KNOW ABOUT IRS TAX LIENS & LEVIES

1. IRS tax liens have a life-span of 10 years from date tax was assessed. (note, not date lien was filed). After this period the lien expires.

Comment - the only way this time period can be extended is for the IRS to go into federal district court and have the lien reduced to a judgment. Then, it may be executed pursuant to the respective state law procedures for execution of judgments. Note - in some states a judgment based on a tax lien may not be executed against personal property, or against certain personal property such as a pension or retirement plan.

2. Where the underlying taxes were discharged, a recorded tax lien survives the bankruptcy, but not as to after-acquired property. It remains valid only as to the property the debtor possessed as of date of filing the bankruptcy.
3. An IRS tax lien is valid against the debtor's real estate only if filed with the public records office in the county where the real estate is situated; it is valid against personal property if filed in the county where the debtor has residence. It is not uncommon for the lien to have been filed in the wrong county.
4. Recording a tax lien allows taxing entity to step into the shoes of the taxpayer. U.S. v. General Motors Corp., 929 F.2d 249 (6th Cir. 1991). This means if the taxpayer cannot access his retirement plan, neither can the taxing entity. For retirement plans which prohibit the employee from accessing the fund, the IRS lien may be executed by levy only when the plan goes into pay-status, at which point the levy may attach to the payments as they are made.
5. An unfiled federal tax lien for a discharged tax is invalid against the debtor's exempt property [11 U.S.C. § 522(c)] and may be avoided by the trustee as against property of the estate. Thus, arguably, an unfiled tax lien is valid only against non-exempt property that is property of the estate. Is there any such property? Possibly. Typically the only asset a debtor may have that is not property of the estate is an ERISA retirement plan; however, if it is not property of the estate it can not be "exempt" and accordingly may be subject to an unfiled federal tax lien.

"Exempt property is not liable for any debts of the debtor except alimony, security interests, nondischargeable tax debts and debts secured by a Notice of Federal Tax Lien." - IRM § [5.9] 4.1.2, IRS Bankruptcy Handbook.

And, a tax that is not secured by a filed tax lien is not treated as a secured claim in bankruptcy.

6. Federal tax liens may not be "stripped down" in a Chapter 7, but may be stripped down in Chapter 13.

TAX LIENS AND LEVIES

7. Where the underlying tax is discharged and the lien attaches only to personal property that is relatively low in value, the IRS will typically release the lien after the discharge, upon simple letter request by the debtor's attorney.
8. A tax lien filed within the 90 day period may not be avoided as a preference.
11 U.S.C. § 547(c)(6).
9. While an assessment made during the period of the automatic stay is valid, a lien filed during the period of the stay is invalid.
10. A tax lien based on an invalid assessment is also invalid.
11. Majority rule - where the IRS has served a notice of levy on a bank account or paycheck, it must be released once a bankruptcy has been filed, as long as the money hasn't actually left the bank or payroll department.

“All levies should be released immediately upon learning of the bankruptcy, and any funds levied upon but not paid over.” IRM § [5.9] 11.3

Held, taxpayer does not retain an interest in a levied bank account after service of the notice of levy, and after expiration of the 20-day waiting period. (case concerned state tax levy – rules may be different for IRS levy).

In re Valtenino's Restoration & Cleaning Service, 215 B.R. 153 (Bkrcty.ND IL 1997).

Held, a state tax notice of levy may allow the state to execute on the levy, even after a bankruptcy is filed, depending on the state levy statute. *In re Caldwell, 111 B.R. 836 (Bkrcty.C.D.Cal. 1990)* (State Board of Equalization sales tax levy on debtor's bank account).

12. The IRS habit of holding on to tax refunds after a chapter 13 has been filed, without first obtaining relief from stay, is a violation of the stay; IRS may move for relief from stay to conduct setoff, which is allowable.
13. Where debtor has an ERISA retirement plan, which is not property of the estate, and there is a filed tax lien, cases are divided over whether this should be treated as a secured, or unsecured claim in Chapter 13. But See important 9th Circuit ruling holding that tax lien on ERISA plan cannot be treated as secured in Chapter 13 - *U.S. v. Snyder, 343 F.3d 1171 (9th Cir. 2003)*
14. Majority rule: tax lien on other non-estate property is unsecured. Example; tax lien on individual does not attach to assets of his corporation.

DISCUSSION OF TAX LIENS IN CONSUMER BANKRUPTCY CASES

A. TAX LIENS IN BANKRUPTCY - OVERVIEW

1. What is a lien?
 - a. Tax assessed - IRC § 6201.
 - b. Demand for payment - IRC § 6303(a)
 - c. If unpaid, lien arises automatically - 6321
 - d. Lien is recorded (optional)

2. Lien and levy distinguished
Matter of King, 137 B.R. 43 (D.Neb. 1991)

Levy and seizure distinguished; levy goes after cash held by third party; seizure is directed at assets in hands of taxpayer.

3. Effect of a filed lien

Tax lien must be filed or recorded to be valid for most purposes, and rule of “first in time first in right” applies in determining validity of a senior creditor versus a junior IRS lien. *In re Carolinch Co. 210 B.R. 518 (Bkrcty.E.D.Pa. 1997)*.

- a. Allows taxing entity to step into shoes of taxpayer; IRS may levy against property to which debtor has access, but not property debtor can't access.

- √ IRA - levy is effective against the fund itself
- √ ERISA qualified pension - can reach only when goes into pay status

- b. Results in allowed secured claim for bankruptcy purposes, to extent of debtor's equity in property that is property of the estate. 11 U.S.C. § 506.

Case authority that lien on non-estate property may not be treated as secured claim in the bankruptcy. Example, ERISA qualified retirement plan.

4. Effect of unfiled tax lien - not a secured claim in bankruptcy, and not effective against exempt property [11 U.S.C. § 522(c)(1)(B)] but may survive outside of bankruptcy as to property that is not exempt (e.g. ERISA pension - not exempt because it is not property of the estate)

5. Lien may survive bankruptcy (but not always)

- a. For non-discharged tax, lien survives bankruptcy as to all of debtors present and future acquired property.

Matter of McCorkle 209 B.R. 773 (Bkrcty.M.D.Ga. 1997).

TAX LIENS AND LEVIES

In re Isom, 901 F.2d 744 (9th Cir. 1990)

- b. For discharged tax, lien survives bankruptcy as to property owned by debtor at time of bankruptcy only.
 - c. For discharged tax, lien does not survive as to after-acquired assets
In re Braund, 289 F. Supp. 604 (9th Cir. 1970)
In re Fuller, 134 B.R. 945 (9th Cir. BAP 1992).
In re Anderson, 149 B.R. 591 (9th Cir. BAP 1992).
 - d. Defective lien may not survive bankruptcy
 - c. Lien may expire. Life-span is 10 years from date of assessment. 26 U.S.C. § 6502.
6. Duration of lien

Federal tax lien statute of limitations is coterminous with statute of limitations for collection of an assessed tax; 10 years from date of assessment - not from date lien is filed. IRC § 6502. At end of the 10-year period IRS may convert the lien to a civil judgment and attempt to collect it according to the respective state laws for collection of civil judgments. This is rarely done. And, collection under a state's collection provisions may not be so easy.

7. How does it attach to property?

- a. Real property - recorded in county of location of property
- b. Personal property - recorded in county of taxpayer's residence
- c. State tax liens may be different (e.g. Cal. FTB).

8. What kind of property may be liened?

- a. Must be taxpayer's property

State law determines what is property.

i. Examples of taxpayer's property

ii. Examples of non-property

Held, the IRS lien was invalid against the debtor's postpetition disability payments because under Wisconsin law such payments are not property (no lump sum and no transferable or marketable value; disability payments are a form of compensation, not an asset that existed at time of filing bankruptcy); *In re Pansier, 1997 Bankr. LEXIS 554 (1997).*

Where debtor has an ERISA retirement plan, which is not property of the estate, and there is a filed tax lien, cases are divided over whether this should be treated as a secured, or unsecured claim in Chapter 13. But See important 9th Circuit

TAX LIENS AND LEVIES

ruling holding that tax lien on ERISA plan cannot be treated as secured in Chapter 13 - *U.S. v. Snyder, 343 F.3d 1171* (9th Cir. 2003).

- b. Outside of bankruptcy lien attaches to property of the estate, property that is not property of the estate, and to exempt property. For bankruptcy purposes, unfiled lien is not treated as secured.
9. Bankruptcy property exemptions are not effective against tax liens
U.S. v. Barbier, 896 F.2d 377 (9th Cir. 1990)
10. Property having no value
11. Priority of liens
- a. First in time is first in right
 - b. As against other entity liens
 - c. As against other liens by same entity

B. ATTACKING TAX LIENS IN BANKRUPTCY

1. In personam and in rem liability distinguished
2. To extinguish “in rem” liability - get rid of the tax lien
3. What doesn't work:

- a. Tax lien is not avoidable as a preference
11 U.S.C. § 547(c)(6)

In re Carolina Resort Motels, Inc. 51 B.R. 447 (Bkrtcy.D.So.Car. 1985) *In re Fandre*, 167 B.R. 837; *In re Souers*, 163 B.R. 346 (S.D.Iowa 1994); *In re Sheldon*, 1991 Bankr. LEXIS 1147; *In re Winchells, Inc.* 106 B.R. 384 (E.D.Pa. 1989); *In re Cleveland Graphic Reproductions, inc.* 78 B.R. 819 (N.D.Ohio 1987); *In re Carolina Resort Motels, Inc.* 51 B.R. 447 (Bkrtcy.D.S.Carolina 1985);

- b. Generally, a “properly filed” tax lien not avoidable.
11 U.S.C. § 522 (c)(2)(B)
- c. No tax lien stripping in chapter 7 (*Dewsnup*)
- d. Tax lien pierces exemptions (i.e., attaches to exempt property)

In re Bourque, 123 F.3d 705, 706 n. 2 (2nd Cir. 1997) (exempt insurance proceeds); *In re Sills*, 82 F.3d 111, 113 n. 3 (5th Cir. 1996) (exempt house); *In re Stangel*, 222 B.R. 289 (Bkrtcy.ND Tx 1998) (Chapter 13 case); *In re Mulligan*, 234 B.R. 229 (Bkrtcy.NH 1999).

- e. Still valid even though underlying tax is discharged
- f. Tax discharged, lien is valid only for existing assets
- g. Tax not discharged, lien valid for present and future assets

4. What might work:

The claim is unsecured if:

- a. No liens recorded with county recorder's office (unsecured tax claim)
 - i. Unrecorded, or “secret” tax lien not valid as to exempt property and is not a secured claim in bankruptcy.

Query? Must the debtor undertake a lien avoidance motion to nullify an unrecorded tax lien? Probably not. See § 522(c)(1)(B)

- b. Liens recorded, but no property to which it may attach

ASSESSMENT VALIDITY

- c. Liens recorded, but in wrong county [IRC § 6323(f)(2)(A)].
In re Barnett, 62 B.R. 638 (Bkrty.D.Maryland 1986).

- d. Lien based on invalid assessment

Example: tax was assessed during the period the debtor was in a prior bankruptcy; if the assessment was done before Oct. 22, 1994 (year Bankruptcy Reform Act of 1994 amended Code to permit assessments during period of automatic stay); the assessment is invalid, and any lien arising from that assessment would be invalid.

- e. Lien period has expired (10 years from assessment: IRC § 6502) (but may be converted to a civil judgment at end of 10-year period, which extends its life)

- f. Lien is legally defective (not avoidable, but may be declared invalid in adversary proceeding) (unsigned, incomplete, wrong name, etc.)

- g. Lien for discharged tax only good as to existing assets (i.e. the property the debtor possessed on date of filing the bankruptcy); future earned income, newly acquired assets are not subject to the lien; retirement, pension, etc. growth in value due to employment of the debtor is future acquired property and lien does not attach to it

- h. Lien may be junior to previously filed lien of other creditor or entity.

Example: Sometimes a state tax lien has been recorded prior to the IRS lien, and the state lien consumes all of the equity; the IRS lien is virtually a nullity in that situation (or vis-versa)

- i. Lien of taxing entity may be junior to previously filed lien of same entity.
Example: IRS lien for nondischargeable tax recorded before IRS lien for dischargeable tax. This would make the dischargeable tax unsecured. Thus, the lien doesn't hurt debtor, because it only protects a tax that is nondischargeable any way.

ASSESSMENT VALIDITY
CHECKLIST OF OPPORTUNITIES TO ATTACK TAX LIEN

YES NO

- Filed in wrong office - ¶ 6.7(f)(1)
- Incorrect or defective name on lien - ¶ 6.7(f)(2)
- Filed in wrong county - ¶ 6.7(f)(3)
- Other defect in filing process - ¶ 6.7(f)(4)
- Not refiled when required - ¶ 6.7(f)(5)
- Filed in violation of stay - ¶ 6.7(f)(7), 6.8(f)(8)
- Lien unrecorded - may not attach to exempt assets - ¶ 6.7(g)
- Statute of limitations is expired - ¶ 6.8(f)(1)
- Lien reduced to civil judgment - possibly not collectible under applicable state collection procedures - ¶ 6.8(f)(2), (3)
- Lien against wrong assets or wrong taxpayer - ¶ 6.8(f)(5)
- Underlying tax discharged - lien may not attach to debtor's after-acquired property - ¶ 6.8(f)(6)
- Lien based on invalid tax assessment - ¶ 6.8(f)(7)
See checklist.
- Unenforceable against nonlevyable property - ¶ 6.8(f)(9)
- Invalid against assets under IRC § 6323(b) - ¶ 6.8(f)(14) (?)
- Property has no equity and tax is discharged - ¶ 6.3(e)
- Property has no equity, may be stripped to zero value in Chapter 13 - ¶ 6.5(b)(3), 6.9(h)
- Statute will expire before pension plan goes into pay status, and underlying tax is dischargeable; lien is unenforceable against pension plan - ¶ 6.1(d)(5), 6.1(h)
- Lien on non-estate property may not be allowed secured claim in bankruptcy - ¶ 6.5(b)(4). Treated as unsecured claim in Chapter 13?
- Lien may be stripped down in chapter 13.

ASSESSMENT VALIDITY

- Lien may be ineffective against retirement plan - tax collector merely steps into shoes of taxpayer.
 - not vested
 - not in pay status
 - lien may expire before goes into pay status
 - may not include appreciation in value do to postpetition employment.

**ASSESSMENT VALIDITY
CHECKLIST - IS THE ASSESSMENT VALID?**

Where income taxes are being evaluated for bankruptcy, it ordinarily will be desirable to verify that a valid assessment has already been made with the clock ticking on the 240-day period, or has already expired. This is because to be dischargeable, a personal income tax must have been assessed at least more than 240-days prior to filing the bankruptcy. It would be a mistake to assume all of the discharge rules have been satisfied if based on an erroneous assumption that the assessment reported on the transcript is valid if in fact there is some legal defect making it null. In some cases, however, it will be hoped that a basis can be found to attack the validity of the assessment. For example, where the validity of a tax lien is being explored, it may be possible to attack the lien by attacking the underlying assessment upon which the lien is based; if the assessment is invalid, so is the lien.

Of course, the flip-side to this is that if the assessment is not valid, the 240-day period has not been satisfied and the tax is not dischargeable in chapter 7 and possibly in chapter 13, as well. But if more than three years have elapsed since the taxpayer filed his return, the IRS is barred from assessing additional taxes because of the three-year statute of limitations provided by IRC § 6501, so the assessment is a nullity and the taxpayer is permanently free of the tax.

Remember that in evaluating the validity of the assessment the amount of the assessment is not the issue, only the underlying basis for the taxpayer's liability.

YES NO

1. - Assessment was made during the period of the stay in a prior bankruptcy case, and predated Oct. 22, 1994 (effective date of the Bankruptcy Reform Act of 1994 which allowed tax assessments to be made during the stay period). If yes, the assessment is invalid.
2. - Legal basis for the taxpayer's personal liability for the tax is "arbitrary or capricious" (i.e., the wrong taxpayer was assessed)
3. - Legal basis for assessment of the tax is "arbitrary or capricious" (i.e., correct taxpayer, but no tax is actually owed, perhaps because taxpayer had no taxable income, etc.).
4. - Taxpayer has a legal defense (e.g. innocent spouse, etc.)
5. - Notice of assessment was not mailed, or was mailed but not to taxpayer's most recent address. IRC § 6303 provides that notice must be sent to the taxpayer's "last known address." Thus, if it can be shown that the IRS had a more current address but didn't use it, the assessment would probably be invalid.
6. - Assessment was made after the three-year statute of limitations on assessment provided by IRC § 6501 had expired.
7. - Assessment was a re-assessment of same tax assessed at an earlier time.
8. - Assessment procedure not followed according to statutory requirement (for example, Calif. Franchise Tax Board assessment was held invalid because FTB failed to examine taxpayer's return as required by statute).

ASSESSMENT VALIDITY

9. - IRS notice of assessment not sent within 60 days of assessment as required by IRC § 6303.