

How to Bankrupt Income Taxes § 507 & 523

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Understand timing & assessment to know how to bankrupt Income tax

- Assessments are based on returns filed under oath. Methods exist that stop the collection or modify a tax debt. The collection statutes have time limitations. However none of these Statutes of limitation ever start to run until a taxpayer files the return and unless a return is timely filed the time limitations may never run. Even if the IRS generates a return, seizes property or jails a non filer the statutes never run unless the return is filed! It is the duty of the taxpayer to know (prove) when these time periods expire and the IRS will not advise a taxpayer how to do it.

You must understand timing & assessment to: know how to bankrupt Income tax

- Taxes are not due earlier than April 15. (a tax may be due after April 15th due to extensions etc.).
- Taxes are not “due” for bankruptcy purposes until they are assessed under sections § 507 (3 year/ 240 day) or 523 (2 year rule). Taxes are not “assessed” until a taxpayer files a signed return under oath. Nothing substitutes for a properly signed return.
- If the taxpayer is audited and an IRS tax assessment is sent to the taxpayer then the period of time the taxpayer has to wait by at least 240 days after the assessment. 507(a) (8).

In Bankruptcy there are three types of Tax Debts Each type is handled differently:

- **Nonpriority/Dischargeable.** It is always the attorney's goal to convert tax debts to Nonpriority and dischargeable tax debts. A Discharged debt cannot be collected upon. Time eventually converts most proper signed and filed returns into Dischargeable debts.
- Although time converts most income tax debt from priority claims into dischargeable debts, **improper tactics** to hinder collection such as non-reporting, failure to keep business records, hiding assets, or underreporting income may make an income tax debt forever non-dischargeable.

In Bankruptcy there are three types of Tax Debts Each type is handled differently:

- **Priority/Nondischargeable income taxes.** Priority income tax debts must be paid in full during Chapter 13 (§ 1125) but a 13 will discharge any interest and penalties. Normally the taxpayer only has to wait for Priority income tax debts to become dischargeable. The discharge general rules are:
 - The income tax debt must become due 3 years before filing the bankruptcy 507(a) (8) (A) (i)
 - The return must be filed 2 years prior to filing 11 USC § 523 a 1 B ii.
 - At least 240 days have transpired since any new assessment increased the tax. 507(a) (8) (A) (ii)

In Bankruptcy there are three types of Tax Debts Each type is handled differently:

- **Nonpriority/Nondischargeable.** In many ways this is the worst type of tax debt. If it is included in a Chapter 13 the tax debt will only share in the amounts paid to unsecured creditors but the debt will remain at the end of the case. (523 Fraud attempt to evade and I.R.C. 6020 non file returns).

Priority debts are paid before secured and unsecured. The purpose of filing a bankruptcy is to discharge the debt and make it uncollectible. You must have a strategy for converting non dischargeable debt or bankruptcy will be an ineffective tool in dealing with this type of tax.

The goal is to pay or Discharge tax.

Methods of discharging tax debt:

- **Statute of Limitation** 10 years (plus extensions) after the return is properly filed § 6502 Collection Expiration Statute Date. Prior to expiration IRS increases collection activity. Tax liens are self limiting and expire upon 10 years I.R.C. 6325(a) I.R.C. § 7432. sets damages for failure to release liens See Griswold v US 1995 11th Cir 800-913-6050 national office. However 523 Fraudulent and non filed returns are generally forever collectible.
- **Filing Bankruptcy** can discharge income tax debt. But attorneys often miscalculate the time required and a client may be stuck income tax debt. Clients often fail to tell attorneys about a prior bankruptcy, assessments or filing extensions that increases the time limits.

Taxpayers will often use methods that make the matter worse:

- Out of fear and non planning the taxpayer will often devastate his own assets In order to avoid bankruptcy the Taxpayer will make the decision that was his worst option. These are common errors.
 - Taxpayer cashes in his retirement but now has to file bankruptcy anyway
 - Taxpayer mortgages his home to partially repay the tax debt and then lost his home to the mortgage company and has to file bankruptcy anyway.
 - Taxpayer fails to tell his attorney that he had a tax assessment 3 months prior to filing the bankruptcy that increased the time he has to wait before filing.

Methods the IRS proposes to handle a Tax Debt :

- **Offers in Compromise Form 656** It often takes over a year to obtain an OIC this increases the 240 day period you must wait prior to filing bankruptcy. In 2009 the IRS approved only 25% of the OIC's it approved in 2007 and they charge \$150 to deter frivolous offers meant to simply delay collection.
- Offers in compromise require that the offer equals the property that would have been lost by liquidation. The OIC offer should match what the IRS would have gotten if the IRS was a judgment creditor that liquidated the debtor. Normally a non liable Mom and Dad or a spouse is paying the debt in an OIC.
- The goal of the IRS is to get the Debtor into Compliance. To be effective the taxpayer must make no reporting or compliance mistakes for 5 years after an OIC.

Other Offer in Compromise Issues:

- **Methods that delay collection tend to add to the period of time you must wait to discharge the debt by Bankruptcy or the Statute of Limitation.**
- Filing an OIC adds to the 10 yr. statute of limitations and adds to the 240 day assessment calculation of time of when to file a bankruptcy. 507(a) (8) (A) (ii) (II) and 507 (a) 8. OIC's add the period of time of the OIC plus 30 days to calculating the 240 day period a person must wait to file bankruptcy after an assessment.
- Factors such as Doubt as to Collectability, Doubt as to Liability and effective tax administration can be plead to lower an OIC settlement amount.

Non OIC methods the IRS proposes to handle a Tax Debt :

- **Installment Agreement Form 9465** Disadvantages: the IRS always applies payments to the oldest tax liability first. This insures the amount repaid is maximized.
- Paying the IRS over time is your worst option. Repaying over time has a high failure rate and is the least likely method of working <5%. You often have an impossible budget that may demand that the taxpayer abandons his home. IRS allows only a minor mortgage expense.
- Many debtors are so frustrated that they file bankruptcy. The individual with substantial tax debt is rarely able to pay the debt in full and eventually files bankruptcy, does an OIC, or fails to repay.

More Methods of handling a Tax Debt that can effect Discharge:

- **Taxpayer Assistance Orders** These methods only tend to extend the amount of time it takes for taxes to be dischargeable. Form 911 like the offer in compromise merely informs the IRS of where your assets and income sources are. In this case the time is only suspended for the time you are in Taxpayer Assistance.
- **Collection Due Process Hearing** The taxpayer may request a hearing but this extends the statute of limitation or 3 and 2 year bankruptcy time periods until 90 days after the final determination of the due process review plus the time the process took.
- **Other self medications** For temp relief seek a Debtor can seek § 53 Uncollectible status but the IRS will normally file a lien. The IRS may ask a taxpayer to file form 900 which is an agreement to extend the time it takes to discharge (do not agree to this). Legal actions also stay the statute of limitations and the bankruptcy waiting period.

How different types of Bankruptcy can Discharge the Debt

- **Chapter 7** works best on dischargeable unsecured tax liabilities. In a Chapter 7 the taxpayer liability for dischargeable taxes is limited to what the taxpayers unsecured non exempt assets are worth. Bankruptcy exemptions generally allow more than what the IRS allows a taxpayer to keep. If property must be sold a Bankruptcy Trustee normally does a better job of it than a Commissioner because the Trustee is paid a commission for what property sells for and seeks the highest price. The Court commissioner has no interest whether the item sells for 1 cent or 1 million and is paid for his time spent.

How different types of Bankruptcy can Discharge the Debt

- **Chapter 13** is limited to moderate tax liabilities. 360,475 in unsecured debt & 1,081,400 in secured debt (adjusted for inflation 2010). 2005 BAPCA eliminated the Super discharge advantage a Chapter 13 case had in handling nondischargable non priority Income Tax Debts. Penalties and interest can still be discharged and handled the same as unsecured debt in a 13.
- If the tax debt is secured and cannot be repaid within 5 years then the plan (§ 1322) is basically unfeasible. If the taxpayer was unreasonable the IRS may not voluntarily modify “secured” claims

How different types of Bankruptcy can Discharge the Debt

- **Chapter 13** a secured tax (lien) arises by statute, it be valued but not modified or stripped under BC 522 (f) like a security interest or judgment lien in a 13. It can only be valued and must be repaid within 5 years (§ 1322).
- Income tax liens expire at the end of 10 years. Liens attach to real **and personal property**. BC Sec. 522(c)(2)(B). Property may be valued by motion. But it is difficult to the value you claim in your own schedules. Since secured debts must be repaid you can overpay if you overestimate the value of your property and have to repay the lien.

Modification of a Secured Tax Claim

- **Chapter 13** If the secured tax lien cannot be repaid within 5 years then the Chapter 13 plan is unfeasible (1322). The IRS may or may not adjust it's claim to make a plan become feasible.
- If a taxpayer was “unreasonable” during an OIC or in other dealings with the IRS it may punish the Debtor by refusing to modify it's claim.

How different types of Bankruptcy can Discharge the Debt

- **Chapter 11** The substantial benefit from Chapter 11 *for a corporation* is that all types of taxes except fraud are dischargeable even the current year. The Debtor runs his own case as the debtor in possession has the personal ability to avoid transfers, and has far greater powers but matching responsibilities such as reporting and reoccurring fees. Further the debt limits are eliminated.
- BC 1129 requires that IRS priority claims must be paid out in deferred cash payments over five years from the petition date. Plans are very flexible.

Chapter 11 cases with Priority tax claims require 5 year plans

- The practical problem for a Chapter 11 is few Debtors can afford it (often a 20,000 and up initial retainer). Most Debtors lack the sophistication to make the quarterly reports etc. §1129 requires IRS priority claims must be paid out in deferred cash payments over five years from the petition date. This provision includes any secured claim that would have been priority but for the IRS lien. Debtor is required to file a disclosure statement detailing “adequate information” including tax consequences. 1125 (a) (1)

How different types of Bankruptcy can Discharge the Debt

- **Chapter 26 and 20** a Debtor may need to file more than one bankruptcy to eliminate taxes.
- Although the Debtor is not allowed a second discharge unless years have transpired after the prior bankruptcy filing a second bankruptcy can be a tool to repay. Filing a second bankruptcy (chain filing) is simply filing a second case to completely manage debt. Chapter 7 +Chapter 13=Chapter 20. However a sudden change in the ability to repay that is not supported by facts may cause the second filing to be dismissed for not filing in good faith due to the means test.

The Benefits of Bankruptcy

- Can stay foreclosure proceedings
- Can decelerate loans and cure defaults
- Can Modify 2nd, vacation and commercial mortgages
- Venue for predatory mortgage and lending claims
- Avoid transfers in foreclosure, tax and rescue scams
- Trustee in bankruptcy as advocate
- Free up income by discharging unsecured debt
- Allow for payment of Priority debts such as Taxes and Child support at the expense of unsecured debt.

Documents necessary to the attorney to Discharge a Tax Debt

- Never trust what the client remembers. Always get the tax transcript and a copy of the return. When in doubt trust the IRS transcript.
 - Debtors don't lie but invariably are confused and have bad memories they are under stress
- If a Taxpayer does not file a return the IRS will file a *Substitute for Return* (sfr) 26 USC 6020(b) and collect based on a return filed "for" the Taxpayer. The filing of a SFR + final assessment normally makes discharge forever impossible. K Weil 104 J. of Tax 166 (2006). Filing after it becomes final does not cure the failure to file.
- Same for fraud and willful US v Fretz 244 F 3d 1323 (11th Cir 2001)

Example problems

The 3 basic rules to discharge

Nonpriority unsecured income tax

- **First** the Debtor must wait 3 years after the tax became due to file bankruptcy. Normally this means waiting 3 years after April 15th. To calculate take date the return was due and count 3 years forward.
- After April 15th 2010 you will not be able to discharge 2009, 2008 or 2007 but you can discharge a return that was properly filed on or before April 15th 2006. On what date in 2013 could you discharge your 2010 taxes 4/15 4/16 or 10/15? What day was 4-15-10
- Filing for an extension (October 15th), OIC or other procedure adds that additional period.

The 3 basic rules to discharge Nonpriority unsecured income tax

- Taxpayer says he timely filed a return in 2006 with no extensions, unpaid, with no offers in compromise, assessments or payment plans being offered. You file the bankruptcy April 30th 2010. Will you discharge the tax.
- Yes the OIC only effects the 240 and 10 year rules
- You find out later he filed on 4-15 in 2006 after asking for an extension. Now will you discharge the tax?
- No. The request for an extension extended the period of time three years to three years plus the time of the extension. (Three years after return was due 10/15)

The 3 basic rules to discharge Nonpriority unsecured income tax

- **Second** if the Debtor has an assessment the Debtor must wait 240 days before filing to discharge the debt.
- Again any Installment agreement, Due Process Appeal or Offer in Compromise will extend the 240 day period for the time of the agreement, OIC or Due Process was pending plus 30 days.
- Filing a bankruptcy (and not discharging the debt) will extend the period the amount of time the bankruptcy was active plus 180 days IRS § 6503(h) US v Hall 2002-1 USTC S.D. Ind 2002.

The 3 basic rules to discharge Nonpriority unsecured income tax

- **Third** The Debtor must have filed his return within 2 years before filing bankruptcy. 523 § (a) (1) (ii)
- If the Debtor does not properly and timely file a return there is never a discharge of the debt. The fact that the IRS did not pursue collections does not mean a debt was discharged. The IRS may not pursue collections due to its own error or the IRS may decide that collection would not be productive against a person with no assets. There are also decisions that the failure to file the return may cause a bankruptcy to be dismissed. (Failure to keep records). 11U.S.C. 727 (a)(3)

Failing to file a return

- A failure to file a return may mean that the Debtor failed to keep or preserve records which is a basis to deny a discharge and to dismiss a case. 11 U.S.C. 727 (a) (3) See *US v Walters* 94-2 USTC, 176 B.R. 835 876-877 Bankr. N.D. Ind 1994.
- The court uses a 4 part test to decide if a late filed return is a valid return. *Beard v Comm'r* 793 F.2d 139 6th Circuit 1986 If the IRS files a substitute for return it becomes substantially more difficult to argue that the return filed by the taxpayer is valid. *In Re Payne* 431 F 3d 1055 (7th Circuit 2005)

Filing an adversary proceeding may be necessary to insure discharge

- **In Re Payne 431 F 3d 1055 (7th Circuit 2005)** the taxpayer failed to file in 1986 the IRS filed a *substitute for return* in 1990 the taxpayer filed a return in 1992 and a bankruptcy in 1997 after waiting 5 more years. After the bankruptcy the IRS waited until 2001 to begin collections, claimed no statute of limitation applied and that there was no discharge of their debt. The court stated that filing a return after an SFR was not a reasonable effort to satisfy the filing requirement. In effect taxes filed after a SFR are becoming like Trust taxes forever collectible, & nondischargeable. But **See In Re Colsen 446 F 3d 836 (8th Cir. 2006)** which allowed the late filed return.

Taxes can not be discharged

- The Following Taxes cannot be discharged:
 - **Priority Nondischargeable taxes** normally arise from Recently Assessed or filed taxes, Certain property taxes and fines, Employer Trust fund liabilities § 1328(a)(2)[1/3 is normally not in trust], Excise taxes Custom taxes and Pecuniary loss penalties. In Chapter 13 these taxes must be paid in full or converted to a better status.
 - **Non Priority Non Dischargeable taxes** arise from late or nonfiled returns. Returns filed within 2 years of the petition, Fraudulent returns and willful attempts to evade the tax. *Always take steps to correct the status in these cases and move them to another status. **Always file the return** even if the debt will remain owing.*

Trust Taxes can not be discharged

- Failure to file a proof of claim does not defeat claim.
 - Under BAPCPA (Section 1328(a)(2)) taxes required to be collected or withheld and for which debtor is liable are non-dischargeable. To the extent the individual debtor is liable for employment taxes or for withholding and paying over employment taxes (the trust fund recovery penalty), no discharge will be granted for such taxes even if no POC identifying such taxes is filed.
- Instead the Debtor may want to file the claim and motion to set the claim amount. These taxes are generally only partially trust taxes to the extent the employee's funds were withheld or the extent the sales tax was withheld from the consumer

Tax liens are unaffected by 522 (f) motions to strip or avoid

- The IRS lien attaches to all real AND all personal property by statute IRC 6321 and relates to assessment IRC 6322. 522 (f) Motions can only value a judicial lien or security interest. IRS secured liens are not affected by exemptions
- Instead the IRS will often work with the tax attorney in a Chapter 13 and reduce the secured claim to what the lien is worth. See Publication 783 for release of tax liens.
- IRS will not agree to be paid outside the plan for prepetition debt because it violates the stay. It will not advise whether the tax is dischargeable. The IRS will also not mediate a claim generally after a bankruptcy is filed. File any OIC prior to filing a bk is possible.

Tax liens attach to both Real and personal property of the Debtor

- Income Tax liens if properly recorded attach to both the real and personal property of the Debtor.
- Tax liens must be correctly filed to be valid IRC 6322 and self expire after 10 years IRC 6325 (a)
- Tax liens attach to property held jointly but only to the extent of the property the taxpayer owns creating unique innocent spouse problems.
- Innocent spouse relief looks at the innocent parties education, involvement, lavish lifestyle during the tax period and any deceit on the part of the taxpayer to the spouse.

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