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Using the Bankruptcy Code to Take On the Tax Man

Part 1: Introduction/Dischargeability of Income Taxes for Individual Chapter 7 Debtors

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Individuals and businesses confronted with tax issues may find relief in the Bankruptcy Code. In some situations, taxes, including penalties, may be completely dischargeable. In others, the Bankruptcy Code provides the debtor the opportunity to repay taxes through a payment plan, without interest. The actual benefit of a bankruptcy depends on a number of factors including 1) the type of tax; 2) the age of the tax; 3) whether a tax returned was filed; and 4) the chapter of bankruptcy selected. Part 1A is the first of a five part article which discusses dischargeability of taxes, taxes within the different chapters of bankruptcy and strategies for litigating tax issues.

Overview of the Types of Tax Claims

Tax claims that arise before the debtor files bankruptcy usually fall into one of the following three categories: (1) unsecured; (2) secured; and (3) priority. Tax claims that arise after the bankruptcy filing date are first-priority administrative claims under 11 U.S.C. § 507(a)(1). Administrative claims are set forth in 11 U.S.C. § 503(b)(1)(B).

Generally, unsecured tax claims are not entitled to secured, administrative, or priority tax claim status. However, the unsecured tax claim may or may not fall under an exception to dischargeability as explained below.

Secured tax claims are secured by a lien on the debtor's property. 11 U.S.C. § 506(a). A fully secured tax claim is treated as a secured claim and non-priority claim. Therefore, the taxing authority that holds a secured claim is entitled to present value of its claim, with post-petition interest on deferred payments under a Chapter 11 or Chapter 13 plan. If the tax claim is partially secured and partially unsecured, then the unsecured portion is a priority claim if it meets the requirements of § 507(a)(8), and must be paid in full in deferred payments under a reorganization plan. If the unsecured portion does not meet § 507's requirements, then it is unsecured and dischargeable in a Chapter 13 case and also in a Chapter 7 case unless § 523 applies.

Priority tax claims are allowed unsecured claims given priority status pursuant to 11 U.S.C. § 507(a)(8). (Of course, to the extent a priority tax claim is secured, it is treated as secured and not as a priority claim—see preceding paragraph). All priority taxes under § 507(a)(8) are nondischargeable pursuant to § 523(a)(1)(A). In summary, they include: recent income taxes, recent property taxes, trust fund taxes, recent employment taxes on wages earned from the debtor as an employer, recent excise taxes, tax penalty compensation for actual pecuniary loss, and a penalty on a priority tax. As such, they survive a Chapter 7 filing and must be paid in full in a Chapter 13 filing.

Dischargeability of Taxes in an Individual's Chapter 7 Case

In a Chapter 7, the debtor is granted a discharge pursuant to 11 U.S.C. § 727 for all debts that arose before the date of the order for relief. However, § 727 further provides that a discharge is not provided for the debtor if the claim is excepted from dischargeability under § 523. The dischargeability of taxes are set forth in § 523(a)(1)(A), (B), (C); (a)(7); and (a)(14).

1. Dischargeability of Income Taxes

Income taxes are eighth priority claims if they meet the requirements of § 507(a)(8)(A).

Section 523(a)(1)(A) excepts taxes specified in § 507(a)(8) from an individual debtor's discharge regardless of whether a claim for said tax was filed or allowed. Dischargeability of taxes under § 523(a)(1)(A) are commonly referred to as taxes that are dischargeable under the 3-year rule and the 240-day rule. Income taxes will hold priority status under § 507(a)(8)(A) and be nondischargeable if: (1) the returns, including extensions, were due within three years of the filing of the bankruptcy petition ("three-year lookback period"); (2) the IRS assessed the tax less than 240 days before the filing; or (3) in an offer to compromise situation, the IRS assessments were made less than 270 days before filing plus the time of the related offer of compromise's pendency.

Section 523(a)(1)(B) excepts from discharge taxes for which a return was never filed, or taxes for which a return was filed after its due date and less than two years before the bankruptcy filing date (the 2-year rule).

Section 523(a)(1)(C) excepts from discharge taxes with respect to which the debtor made a fraudulent return or willfully attempted to evade or defeat the tax.

In sum, for an income tax to be dischargeable, the taxpayer must be able to satisfy all of the following six tests. First, the return for the unpaid tax must have been due, including extensions, more than three years before the bankruptcy filing date (after extensions). 11 U.S.C. § 507(a)(8)(A)(i). Second, if the taxpayer filed his or her return late and no extension was granted, then the additional 2-year rule applies. 11 U.S.C. § 523(a)(1)(B)(ii). The tax will not be dischargeable until the taxpayer waits the longer of more than three years from the tax return's due date, or more than two years from the date the late return was filed. Third, the taxpayer must have filed a return, or no discharge is available. 11 U.S.C. § 523(a)(1)(B)(i). Fourth, if the IRS made an assessment, then the 240-day rule applies and works in conjunction with the three-year lookback rule. Thus, the tax liability must have been assessed more than 240 days prior to the filing of the bankruptcy petition. 11 U.S.C. § 507(a)(8)(A)(ii). Or, in the case of an offer to compromise, no assessments must have been made within the 270 days before filing plus the time of the related offer of compromise's pendency. Fifth, the taxpayer must not have filed a fraudulent return or willfully evaded paying the tax. 11 U.S.C. § 523(a)(1)(C). Sixth, if the tax at issue remained assessable after the petition was filed and was not assessed before the filing date, then it cannot be discharged. 11 U.S.C. § 507(a)(8)(A)(iii). Therefore, if

an IRS audit or Tax Court case is pending when the debtor filed his or her petition, then no discharge is available for the tax that is ultimately assessed at the later date.

Part 2 of this Article will discuss the dischargeability of non-income taxes such as property, state sales, trust fund and employment taxes.