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The treatment of unpaid federal income tax claims in bankruptcy

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Within the course of the bankruptcy process, the treatment of tax claims can be complex and challenging to navigate for debtors and their professionals.

A closer analysis of this topic provides insight into how taxes are treated within a bankruptcy, including when they are dischargeable, when they receive special treatment and other issues of which to be aware.

It is understood among bankruptcy professionals that unsecured debt arising before a bankruptcy case is filed will be eliminated when the debtor receives a discharge, and unsecured creditors can expect to receive nothing on their claims.

Most debts fall into one category or the other — they are either dischargeable or they are not — but income taxes occupy a gray area.

In fact, the presumption is that all pre-filing debt is dischargeable unless a statutory exception applies.

A category of debt that falls under a statutory exception is unpaid federal income taxes. Most debts fall into one category or the other — they are either dischargeable or they are not — but income taxes occupy a gray area.

They might be subject to discharge depending on the timing of the bankruptcy case.

Another feature of tax debt is the ability of an unsecured claim for unpaid taxes to be transformed to a secured claim with the Internal Revenue Service (IRS) recording a lien against the debtor's property, even property that would be exempt from the claims of other creditors.

While this analysis focuses on claims for unpaid federal income taxes, most of the discussion applies equally to both state and local unpaid income taxes.

SECURED TAX CLAIMS

A claim for unpaid taxes is secured if the IRS files a notice of federal tax lien in a county in which the debtor has real or personal property.

A notice filed in a county in which the debtor has property is valid as to all personal property belonging to the debtor wherever located. However, a lien against real property is valid only if the IRS records the notice in the county where the real property is located.

Most importantly, for bankruptcy purposes, the value of the IRS's lien is limited to the nonexempt value of the debtor's interest in the encumbered property, and the amount by which the claim exceeds the value of the property is unsecured.

UNSECURED TAX CLAIMS

Unsecured claims for the following taxes fall under a statutory exception to bankruptcy discharge:

- Unpaid taxes for which a tax return was originally due within three years of bankruptcy
- Taxes that were assessed within 240 days of bankruptcy
- Taxes that were assessable but were not assessed at the time of bankruptcy
- Income taxes for which a timely return was not filed
- Taxes for which the debtor made a fraudulent return or willfully attempted to evade or defeat payment of the tax

PRIORITY TAXES

Some unsecured tax claims are entitled to "priority." Priority in bankruptcy refers to the order of distribution to creditors when there are assets available from which to pay claims.

A priority designation is significant even if there are no assets to distribute to creditors because priority claims are not dischargeable. The entire claim must be paid in full during the bankruptcy case.

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That could easily render unfeasible an otherwise confirmable court-approved repayment plan.

Tax claims arising from current returns and recently assessed taxes are entitled to priority. Because priority is largely a matter of timing, priority taxes can become non-priority taxes with the passage of time.

Moreover, the IRS does not have an unlimited time to collect unpaid taxes and must do so within 10 years of assessment. Tax claims arising from late-filed or fraudulent returns are not entitled to priority even though they also may not be dischargeable.

Individuals can be assessed trust fund tax liabilities which are not forgivable. The trust fund recovery penalty covers all the unpaid trust fund tax, plus interest.

Trust fund taxes include the withholding and employment taxes that an employer withholds from an employee's paycheck.

When the employer fails to remit these tax payments, the officer who is responsible for processing those payments will be held personally responsible and assessed these trust fund taxes.

ASSESSMENT AND THE 240-DAY RULE

Assessment is the first step in the collection of federal income taxes. Taxes are assessed when the IRS signs a summary record of assessment. This determines the amount of the tax due. The IRS must make an assessment within three years after a return is filed.

The assessment date is important because income taxes assessed within 240 days of bankruptcy or that are still assessable at the time of filing are not dischargeable in a chapter 7 case and must be paid in full during a chapter 13 case.

TOLLING

A debtor who cannot afford to pay the full amount of taxes owed may apply for reduced payment through the IRS's "offer-in-compromise" program. However, the offer-in-compromise is a complex process and extremely difficult to obtain.

The period during which the IRS considers a debtor's offer-in-compromise tolls the running of the assessment period, which is extended by the number of days that an offer-in-compromise is pending or in effect plus 30 days.

Certain events that prevent the IRS from collecting unpaid taxes also toll the running of the 240-day time period.

For example, the 240-day period is suspended by a prior bankruptcy case if the IRS was prevented by the bankruptcy automatic stay from collecting the tax due, although the stay as it applies to the IRS is limited.

THREE-YEAR RULE

Priority taxes include unpaid income taxes for which a return was due within three years of bankruptcy. The three-year lookback period runs from the date a tax return was last due and not from the end of the tax year.

Consequently, even if the debtor files a return and pays the tax due well before bankruptcy, any required amendments to the return that were last due within the three-year period could result in the tax being a non-dischargeable priority claim.

> A priority designation is significant even if there are no assets to distribute to creditors because priority claims are not dischargeable. The entire claim must be paid in full during the bankruptcy case.

Also, any extensions of time to file would extend the due date for priority purposes.

Like the 240-day period, any period during which the IRS is prohibited from collecting the tax further tolls the three-year lookback.

This includes a prior bankruptcy stay, a non-bankruptcy stay, or an appeal of any collection action. An additional 90 days is added to the three-year period after the IRS is permitted to resume collection of the tax.

MISSING OR LATE RETURNS: TWO-YEAR RULE

Even if unpaid taxes are not entitled to priority, they will not be discharged, regardless of age, if the debtor never filed a tax return or filed a late tax return within two years of bankruptcy.

Because the IRS is not permitted to collect a tax until the tax has been assessed and a tax cannot be assessed until a return is filed, the IRS will file a substitute for return on behalf of a debtor who does not file a timely return.

Historically, the biggest controversies surrounding the two-year rule were what qualified as a "return" and whether the debtor could rely on a substitute return filed by the IRS to defeat the tax owed.

In 2005, Congress added a definition for the term "return" in a hanging paragraph of Bankruptcy Code Sec. 523(a).

As defined, a document is a return for discharge purposes if it satisfies the requirements of non-bankruptcy law, including "applicable filing requirements." The section then expressly excludes from the definition a substitute for return prepared by the IRS.

The criteria that a document must satisfy to qualify as a tax return were set out by the U.S. Tax Court in *Beard v.*

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Commissioner, 82 T.C. 766, 777 (1984), *aff'd sub nom*. *Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986).

Under the *Beard* test, a document is a tax return if:

(1) it purports to be a return;

(2) it is executed under penalty of perjury;

(3) it contains sufficient data to allow calculation of tax; and

(4) it represents an honest and reasonable attempt to satisfy the requirements of the tax law. *Justice v. United States (In re Justice)*, 817 F.3d 738, 740-41 (11th Cir. 2016).

RETURNS FILED AFTER ASSESSMENT

Some courts hold that a tax return filed by the debtor after an IRS assessment does not qualify as a tax return for purposes of the two-year rule because it does not satisfy the fourth *Beard* factor.

The IRS also takes the position that a return filed after assessment serves no purpose, and therefore it is not a tax return.

RETURNS FILED BEFORE ASSESSMENT

Most courts will count a late return that is filed before the IRS assessment. However, the First, Fifth, and Tenth Circuits say that "applicable filing requirements" include filing deadlines, perforce, returns that are filed late, even one day late, are not tax returns within the meaning of the Bankruptcy Code. *McCoy v. Miss. State Tax Comm'n (In re McCoy)*, 666 F.3d 924 (5th Cir. 2012).

Consequently, filing an untimely return in these circuits prevents discharge of the underlying tax debt.

The majority of courts reject the one-day-late rule in part because Bankruptcy Code Sec. 523 contemplates that some late-filed forms are "returns." The IRS also rejects the rule. *IRS Chief Counsel Notice CC-2010-016*, 2010 WL 3617597 (Sept. 10, 2010).

These courts consider whether the late filing represents an "honest and reasonable" attempt by the debtor to comply with the tax law, although the failure to file a timely return without a legitimate excuse or explanation probably evinces a lack of reasonable effort on the part of the debtor. *Justice*, 817 F.3d at 744.

Moreover, not every court finds the debtor's subjective intent relevant. *See, e.g., In re Colsen*, 446 F.3d 836, 840 (8th Cir. 2006).

EQUITABLE TOLLING

The running of the two-year period is probably suspended during the time the IRS is prevented from collecting unpaid taxes. Unlike tolling of the three-year look back period, there is no statutory provision in the Bankruptcy Code that tolls the two-year period.

However, courts invoke principles of equitable tolling to pause the clock during the time a bankruptcy case is pending. *Putnam v. IRS (In re Putnam)*, 503 B.R. 656, 666 (Bankr. E.D.N.C. 2014).

TAX FRAUD

A tax debt for which the debtor made a fraudulent return or willfully attempted to avoid liability is never dischargeable in bankruptcy.

To establish that a fraudulent return was made, the IRS must prove: (1) knowledge of the falsehood of the return; (2) an intent to evade the tax; and (3) underpayment of the tax. *In re Hopkins*, 133 B.R. 102, 106 (Bankr. N.D. Ohio 1991).

> Even if unpaid taxes are not entitled to priority, they will not be discharged, regardless of age, if the debtor never filed a tax return or filed a late tax return within two years of bankruptcy.

Willful evasion contains both a conduct requirement and a mental state requirement.

It requires the government to show that: (1) the debtor had a duty to file a return; (2) the debtor knew of the duty; and (3) the debtor willfully and intentionally violated that duty. *United States v. Fegeley (In re Fegeley)*, 118 F.3d 979, 984 (3d Cir. 1997).

Consequently, the debtor's failure to file a return or to pay a tax is not enough without more to preclude discharge. The debtor must act evasively and with bad intent.

CHAPTER 13 REPAYMENT

Unpaid taxes that are not dischargeable in a chapter 7 case also are not dischargeable in a chapter 13 case. However, the debtor may pay the taxes through a court-approved plan over a period during which the IRS must stop all collection efforts.

Priority taxes must be paid in full through the plan, unless the IRS agrees to accept less.

Full payment does not mean that the debtor must pay interest that accrues post-filing; however, because priority tax claims remain non-dischargeable, post-petition interest is non-dischargeable and the debtor remains liable for that interest after bankruptcy, even if the tax claim was paid in full.

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For non-priority taxes that are dischargeable, the debtor's plan must pay the IRS at least as much as the government would have received on its claim in a chapter 7 case.

Despite the special nature of secured claims, tax liens can be dealt with successfully in bankruptcy proceedings because they only need to be paid to the extent of the value of the debtor's property that secures the claim.

However, the debtor must pay post-petition interest on a fully secured tax claim, and unless the IRS agrees to a different treatment, periodic plan payments must be in equal monthly amounts.

Every creditor, including the IRS, who wants to participate in the debtor's bankruptcy case must file a proof of claim. The IRS may file a proof of claim even if taxes have not yet been assessed or are subject to a tax court proceeding.

The IRS also may file post-petition claims for taxes payable while the case is pending. Post-petition taxes must be paid in full if entitled to priority, and this will likely lead to the dismissal of the case unless the debtor is able to pay the claim within the remaining plan term.

A debtor has three choices when filing a tax return. The debtor can file a timely return, a late return, or never file a return. If timely filed, income taxes for a return that was due within three years of bankruptcy are not discharged in a chapter 7 case and must be paid in full in a chapter 13 case.

The same is true of taxes that were assessed within 240 days of the debtor's bankruptcy. Taxes for a return that was never filed, or that was filed within two years of bankruptcy, also are not discharged but full payment in chapter 13 is not required.

All time periods are subject to tolling during periods the IRS is prevented from pursuing the collection of unpaid taxes. Also not discharged are taxes with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade payment of the tax.

The rule can be summarized as follows: unpaid taxes are dischargeable if all of the following are true as of the bankruptcy filing date:

- A return was filed for the tax year in question;
- The return was filed more than two years ago;
- The return was due, counting extensions, more than three years ago;
- The tax was assessed more than 240 days ago; and
- There was no civil or criminal fraud nor did the debtor willfully evade or defeat payment of the tax.

CONCLUSION

Although bankruptcy is only one of many options available for dealing with unpaid taxes, it is an excellent tool for erasing a debtor's tax liability entirely, reducing it, or paying the obligation over time through a court-approved repayment plan.

Therefore, it is beneficial for professionals to have an in-depth understanding of the treatment of tax claims within bankruptcy to navigate the process and yield the best outcome possible for the debtor.

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