

Navigating Personal Income Taxes in Bankruptcy

By: Dax B. Grantham, Esq.¹

Does your client owe personal income taxes to the IRS or Massachusetts DOR? If so, you are about to face one of the most complicated and misunderstood areas of Bankruptcy law. Through this article I will attempt to demystify the handling of personal income taxes in Consumer Chapter 7 and Chapter 13 Bankruptcies. First, this article will discuss the four basic rules of dischargeability, how the rules are applied and common events that toll the time periods in rules. Next this article will examine how personal income tax debt is handled in a Chapter 13 bankruptcy and in a Chapter 7 bankruptcy.

I. Part One: The Basics of Income Tax Dischargeability

To understand how personal income tax debt affects a debtor in bankruptcy, first it is important to understand the rules concerning the discharge of personal income taxes. Under the current Bankruptcy Code, determining dischargeability of income taxes is the same regardless of which chapter a debtor files.

a. Personal Income Tax Discharge Rules:

A personal income tax is only dischargeable if all four of the following conditions are met:

- (1) 3 Year Rule: The tax return was due more than 3 years prior to the bankruptcy filing²;
- (2) 2 Year Rule: The debtor's income tax return was actually filed more than 2 years prior to the date the debtor files his bankruptcy³;
- (3) 240 Day Rule: The income taxes were assessed by the IRS or Massachusetts DOR more than 240 days prior to the bankruptcy filing⁴; and

¹ Dax Grantham is the managing partner at Grantham Cencarik, PC, a Cambridge Law firm that concentrates a large portion of its practice to Consumer bankruptcy.

² 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(A)(i): A discharge under section 727, 1141, 1228 (a), 1228 (b), or 1328 (b) does not discharge an individual debtor from—a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition.

³ 11 U.S.C. §§ 523(a)(1)(B): A discharge does not discharge an individual debtor from—a tax with respect to which a return, was not filed or given; or was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition.

(4) The Fraud Rule: The debtor did not file a fraudulent return or willfully attempt to evade paying taxes.⁵

Remember, in order for an income tax to be dischargeable, a Bankruptcy debtor must meet **all** four of the above criteria.

b. Applying the Discharge Rules

As debtor's counsel, there are several nuisances that you must understand about applying each of the discharge rules:

Three-Year Rule

When does the Tax Return Become Due?

A tax return does not become due until April 15th, of the year immediately following the end of the tax year. For example, a 2005 tax return is due on April 15, 2006.

EXAMPLE: Tommy filed his 2000 tax returns on March 15, 2001 and owes \$5,000.00 for the 2000 tax year. The \$5,000.00 becomes dischargeable on April 16, 2004, which is three years from the date that the 2000 tax year became due.

The affect of extensions

The filing of an extension changes the due date and tolls the running of the three-year rule to the end of the extension date.⁶

EXAMPLE: Clare got an extension on April 14, 2000 and her 1999 income tax return became due on October 15, 2000. Clare filed her 1998 return on September 1, 1999 and owes \$10,000.00. The \$10,000.00 becomes dischargeable on October 16, 2003.

⁴ 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(A)(ii): A discharge does not discharge an individual debtor from—a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition assessed within 240 days before the date of the filing of the petition.

⁵ 11 U.S.C. § 523(a)(1)(C): A discharge does not discharge an individual debtor from—a tax with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

⁶ See 11 U.S.C. § 507(a)(8)(A)(i): a tax on income for a taxable year for which a return “is last due”...

It is important to remember is that it is the due date of tax return that controls - not the actual date the tax return is filed. The last due date for filing the tax return is the proper date for determining if the three-year rule has been satisfied. The date the taxpayer actually files the return is irrelevant.

Two-Year Rule

The two-year rule applies to tax returns that were filed late; without obtaining an extension. Although the three-year rule considers the age of the tax, the two-year rule only deals with the date the return was actually filed.

The Filing Date: Late filed income tax returns filed after the due date are considered filed on the date the taxing authority actually receives the return. If the taxpayer files the return before the due date, the two-year time period starts to run on the tax return due date, not the actual filing date. If the taxpayer files the return late (after the last due date), the two-year time period starts to run on the date that IRS or DOR actually receives the return.

EXAMPLE: Clare filed her 1999 income tax return on April 1, 2003 and it was received by the IRS on April 5, 2003. Clare owes \$10,000.00. The \$10,000.00 becomes dischargeable on April 6, 2005.

IRS Filed Returns: The Internal Revenue Code authorizes the IRS to file a substitute return for a taxpayer if the taxpayer fails file the return.⁷ If IRS prepares a return for the taxpayer, the taxpayer can consent to the return by signing it, or the IRS can file the return without the taxpayer's consent. If the taxpayer does not sign the IRS prepared return, the IRS return does not count as a filed tax return for purposes of the two-year filing rule. However, if the taxpayer signs the return, the IRS return will count as a filed return for purposes of the two-year filing rule.

240 Day Assessment Rule

A debtor cannot discharge an income tax through bankruptcy unless the taxing authority assesses the tax more than 240 days before the debtor files for bankruptcy.

⁷ See IRC § 6020(b)

Practice Tip: Don't leave it up to the client to determine when a return was "filed", or when the return was "due" or when a tax was assessed. Prudence requires that as debtor's counsel obtain official "tax transcripts" from the IRS. Only after thoroughly analyzing the transcripts should debtor's counsel determine how to deal with tax debts.

Tax Fraud and Willful Evasion

A tax debt is not dischargeable if the debtor files a fraudulent return. A return is fraudulent if the debtor intentionally fails to report income or makes misrepresentations on the return. Moreover, a debtor cannot discharge a tax if he willfully attempts to defeat or evade payment of the tax.

The following conduct would likely qualify as tax evasion: (1) the taxpayer has the ability to pay the tax but uses the funds for other purposes; or (2) the taxpayer evidences a pattern of failing to file returns, failing to pay taxes, or attempting to hide income and assets.

c. Events that Toll the Time Rules

There are certain events that may interrupt the running of the three-year, two-year, or the 240-day rules. Essentially, any event that prevents the taxing authority from collecting the tax serves to toll the running of the respective discharge time limits.

Offers in Compromise: An offer in compromise extends the 240-Day Rule by the number of days the offer in compromise is pending, plus an additional 30 days.⁸

Example: Tommy files his 1999 federal income tax return on April 15, 2000. The IRS commences an audit on November 1, 2004, and as a result of the audit, assesses \$10,000 of additional tax on April 14, 2005. Tommy has satisfied both the three-year and two-year filing rules, but the 240-day assessment rule will not be satisfied until after December 11, 2005; 240 days after IRS assessed the additional tax.

⁸ See 11 U.S.C. § 507(a)(8)(A)(ii)(I)

Prior Bankruptcies: The filing of a bankruptcy also tolls the 230-day rule. If a debtor files bankruptcy, the 240-day time period is extended by the number of days the bankruptcy is pending, plus an additional 90 days.⁹

Example: Tommy filed his 2001 taxes on time and the IRS assesses \$10,000 in additional taxes on April 14, 2005. Tommy files Chapter 13 bankruptcy on December 1, 2005. Both the three-year and two-year rules were satisfied, but not the 240 day rule. Tommy dismisses the case on December 31, 2005. Now, Tommy has to wait for the 240 days to run, plus the 30 days that the first bankruptcy was pending, plus an extra 90 days.

Request for a “Due Process” hearing: Both the three-year rule and the 240-day rules are tolled if a taxpayer makes a request for a due process hearing after a notice of assessment pursuant to IRC §§ 6320, 6330.¹⁰ The amount of time that the rules are tolled is equal to the full amount of time that the appeal was pending plus 90 days.

Example: Leo understated his 1999 income when he filed his taxes on April 15, 2000. On June 1, 2002, Leo receives a final notice of intent to levy for unpaid 1999 taxes. Leo files a request for a due process hearing and it is received by the IRS on June 30, 2002. Leo loses his due process hearing on December 30, 2002. The three-year rule is now extended by 6 months that the hearing was pending, plus 90 days.

<p>NOTE: <u>Tax installment plans</u> are not tolling events. A tax debtor can still make installment plan payments with the IRS and then file bankruptcy after the time limits have run.</p>
--

d. Handling Tax Penalties and Interest

⁹ See 11 U.S.C. § 507(a)(8)(A)(ii)(II)

¹⁰ See 11 U.S.C. § 507(a)(8): “An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable non-bankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.”

The general rule concerning interest and penalties is that if the underlying tax obligation is dischargeable, the interest and penalties thereon are also dischargeable. However, if the underlying obligation is non-dischargeable, so are all related interest and penalties.

II. Part Two: Chapter 13 Bankruptcy

A Chapter 13 bankruptcy presents unique circumstances when it comes to handling personal income tax debts. In a Chapter 13, in some cases, personal income taxes are treated as priority debts; meaning that they must be paid before any other debts.

a. The Priority/Discharge Rules

Like all priority debts, income taxes must be paid in full through the chapter 13 plan.¹¹ Therefore, there are three possible scenarios when it comes to personal income taxes:

i. Dischargeable-Not Priority

If a personal income tax satisfies the three-year rule, two-year rule, 240-day rule, and the fraud rule, then the tax is not treated as a priority debt on the Chapter 13 Plan and is dischargeable. In this case, the income tax is treated as a general unsecured debt on the Plan and will be discharged after the repayment period.¹²

ii. Not Dischargeable-Not Priority

As discussed earlier in this article, in order for an income tax debt to be discharged, it must satisfy all four of the discharge rules. However, when it comes to priority, only the three-year rule and the 240-day rule matter.¹³ Therefore, if the tax debt was due more than three years prior to filing, and was assessed more than 240 days prior to the filing of the petition then the debt is not considered priority; however, if the return was fraudulent, or was not filed within two years immediately preceding the bankruptcy, then the debt will not be dischargeable. In this case, the tax will be treated as a general unsecured debt during the repayment period but the remaining unpaid balance will be due and payable after the debtor receives their discharge.

iii. Not Dischargeable-Priority

¹¹ 11 U.S.C. § 1322(a)(2): The plan shall provide for the full payment, in deferred cash payments, of all claims entitled to priority under § 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim

¹² See U.S.C. §§ 523(a)(1)(A) and 507(a)(8)

¹³ See U.S.C. §§ 1328(a)(2) and 507 (a)(8)

If a debtor's income tax debt was incurred within three years of filing bankruptcy, and/or it was assessed within 240 days of the bankruptcy filing, then the tax debt is considered a priority debt and is not dischargeable.¹⁴ All priority claims must be paid in full through the Chapter 13 Plan.¹⁵ Typically, if the entire amount of the tax debt cannot be repaid in full, then the plan will not be feasible; thus resulting in a dismissal or conversion.

***Practice Tip:** In many cases a debtor may need to be in a chapter 13 in order to repay arrears on a secured debt; in this case conversion is not an option. Therefore it is imperative to contact the IRS or DOR in order to get their consent on a partial repayment through the plan. See 11 U.S.C. 1322(a)(2)(the plan shall repay all priority claims... “unless the holder of a particular claim agrees...”*

b. Taxes and Penalties

Another important consideration for chapter 13 debtors is the accrual of penalties and interest. The filing of a chapter 13 bankruptcy stops the IRS and the Massachusetts DOR from assessing additional penalties and stops the accrual of interest.¹⁶

c. The Everlasting Tax Lien

If the IRS or Massachusetts DOR has recorded a tax lien against a debtor's property for unpaid income taxes, that debt becomes secured debt and cannot be discharged; even if the tax would have otherwise qualified for discharge. However, if the amount of the lien exceeds the value of the property which the lien is attached, a debtor may seek relief from the Bankruptcy Judge and have the portion of the lien that exceeds the value of the property striped. The portion of the lien that is stripped then becomes unsecured and will become dischargeable pursuant to the tax discharge rules as outlined in this article.

¹⁴ See 11 U.S.C. §§ 507(a)(8) and 1328(a)(2)

¹⁵ See 11 U.S.C. § 1322(a)(2)

¹⁶ See *In re Quick*, 152 B.R. 909, 912 (Bankr. W.D. Vir. 1993)(penalty); *In re Hageman*, 108 B.R. 1016, 1019 (Bankr. N.D. Iowa 1989)(no interest on unsecured debt to IRS).

e. Unfiled Tax Returns

All debtors filing for Chapter 13 protection are required to file “all tax returns for all taxable periods ending during the 4-year period ending on the date of the filing of a petition.”¹⁷ If the tax returns were not filed by the date of the debtors’ 341 hearing, the Chapter 13 trustee may hold the meeting open for a reasonable period of time.¹⁸ In the event that the debtor does not file their income tax returns within the time period stated in § 1308, then the debtor’s chapter 13 case can be either dismissed or converted to a chapter 7.¹⁹ Therefore, it is imperative that a debtor be current on all income tax returns prior to filing their bankruptcy.

In the event that a debtor does not feel that they are required to file a tax return for any of the four years immediately preceding the bankruptcy, the debtor must be able to produce accurate records to substantiate their claim.²⁰ However, a little caution; the Massachusetts Bankruptcy Court has recently taken up the topic of unfiled tax returns and converted a Chapter 13 bankruptcy to a Chapter 7 because the debtor failed to file tax returns and failed to establish that she was not required to file returns.²¹

¹⁷ 11. U.S.C. § 1308(a)

¹⁸ 11. U.S.C. § 1308(b): The amount of time cannot exceed 120 days (if the return is late); or if the return is not yet due, then the later of 120 days or the date the return is actually due.

¹⁹ 11. U.S.C. § 13078(e): “Upon the failure of the debtor to file a tax return under section 1308, on request of a party in interest or the United States trustee and after notice and a hearing, the court shall dismiss a case or convert a case under this chapter to a case under chapter 7 of this title, whichever is in the best interest of the creditors and the estate.”

²⁰ See *United States v. Morse*, 497 F.2d 149, 151 (1st Cir. 1974)(all taxpayers have a duty to maintain sufficient accounting records for tax reporting purposes). Where a taxpayer fails to maintain and produce adequate records, the taxing authority is authorized to compute the taxpayer’s taxable income by any method that clearly reflects income. See 26 U.S.C. § 446(b); See *Macy’s East, Inc. v. Commissioner of Revenue*, 441 Mass. 797, 804 (2004)(Under Massachusetts law, the taxpayer has the burden of establishing an entitlement to an exemption for tax purposes)

²¹ See *In re Hayes*, 07-13967: The debtor claimed that she was not required to file a return. The DOR filed a proof of claim for the debtor, and the debtor objected to the proof of claim. The debtor did not provide any evidence that she was not required to file a return and failed to file a return by the deadline set by the Court. As a result, the Debtor’s chapter 13 was converted to a chapter 7.

Practice Tip: Even if the debtor is not required to file a tax return; it may serve the debtor's interest to file a return anyway. It is often easier and more cost effective than opposing a motion to dismiss that is filed by the IRS or DOR.

III. Part Three: Chapter 7 Bankruptcy

The standard discharge rules as discussed in the first section of this article apply to all Chapter 7 Bankruptcies. The only time that a debt is dischargeable is if the debtor is able to satisfy the three-year rule, two-year rule, 240-day rule and fraud rule as outlined in the first section of this article.²²

a. Asset Bankruptcy

If a debtor's income tax debt was incurred within three years of filing bankruptcy, and/or it was assessed within 240 days of the bankruptcy filing, then the tax debt is considered a priority debt.²³ If the bankruptcy estate has assets, upon liquidation of the asset, the income tax be paid in accordance and in order of the Priority Rules of § 507. Any unpaid portion of the tax the remains will survive bankruptcy and still be due by the debtor after discharge.²⁴

b. The Everlasting Lien

If the IRS of Massachusetts DOR has already recorded a lien on a debtor's property, then the IRS debt is secured. In this case the tax cannot be discharged; even if a debtor meets all of the conditions listed above.²⁵ However, that lien can only be assessed against the property that the lien is recorded. Any unsecured portion of the lien will be discharged only to the extent that the debt complies with the discharge rules.

²² See 11 U.S.C. § 523(a)(1)

²³ See 11. U.S.C. § 507(a)(8)(A)

²⁴ See 11 U.S.C. § 523(a)(1)

²⁵ See 11. U.S.C. §§ 724(b)

Example: Leo understated his 1999 income when he filed his tax return on April 15, 2000. On April 15, 2001, the IRS assessed an additional \$50,000.00 due against Leo. On June 1, 2002, the IRS levied vacant property owned by Leo. Leo files Chapter 7 on July 1, 2008. After the bankruptcy, the IRS sells Leo's property for \$30,000. The remaining portion of Leo's tax debt is discharged because the debt satisfies the 3-year rule, 2-year rule, 240-day rule and the fraud rule.

IV. Conclusion

The Bankruptcy rules are complex when it comes to dealing with income taxes. However, an understanding of the Rules as outlined in this article and a little prudence can go a long way in avoiding a potential malpractice claim and in successfully assisting a debtor obtain a discharge.