DISCHARGEABILITY OF INCOME TAX

I. INTRODUCTION

Contrary to popular belief, back due income taxes can be discharged in bankruptcy. The ability to discharge an IRS obligation was added to the Bankruptcy Code in 1966. This article will discuss the conditions on which the bankruptcy laws can be used to discharge taxes. Knowledge of these rules are essential to give proper advice with regard to such matters as: personal financial and business planning, filing tax returns, negotiated payment plans, offers and compromise, tax appeals, and filing bankruptcy.

The controlling sections of the Bankruptcy Code are 523(a)(1), which defines the tax exceptions to discharge in Chapter 7, §1328(a) which defines the tax exception to discharge in Chapter 13 and §507(a)(8) which defines which taxes are entitled to priority payment ahead of general unsecured creditors. All of these sections have undergone very substantial change by recent case law and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which went into effect October 18, 2005.

There are six major rules to determine dischargeability. The tax must pass <u>all of these rules</u>.

1) Have three years passed since the tax return was due? [the three year rule];

2) Have two years passed since the tax return was filed? [the two year rule];

3) Have 240 days passed since the taxes were assessed? [the 240 day rule];

4) Was the tax return fraudulent? [the fraudulent return rule];

5) Was there a willful attempt to evade or defeat the tax? [the willful evasion rule];

6) Does the tax arise from a duty to withhold? [the withholding rule].

The various rules can be summarized as follows. Withholding taxes can never be discharged. For income taxes, the law imposes a burden on other creditors by giving the government a priority claim for a three (3) year collection period, which means the IRS get available monies first. Taxes are nondischargeable during the priority collection period. Once the priority period is over, the law prevents bankruptcy discharge of income taxes where there is some form of fault, i.e., the failure to file a tax return, failure to file a tax return more than two (2) years prior to the bankruptcy, filing a fraudulent return or willfully evading the payment of taxes due.

II. CHAPTER 7 VS. CHAPTER 13.

Until recently, those who made payments through a Chapter 13 plan could discharge withholding taxes and income taxes notwithstanding 1) the total failure to file a return 2) filing a fraudulent return or 3) willful attempts to evade or defeat the tax. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) has made the discharge of taxes identical under either Chapter 7 or 13.

III. WITHHOLDING TAXES.

There is no longer any method to achieve a discharge in bankruptcy for the obligation to pay withholding taxes. As noted above, BAPCPA modified Section 1328(a)(2) to prevent the discharge their discharge in a Chapter 13. Therefore the only remaining solutions short of full payment would be the 10 year statute of limitations found in the tax code 26 USCS Section 6502 or an offer in compromise using the IRS form 656.

Chapter 13 may be useful to obtain relief from aggressive IRS collection efforts. Withholding taxes are at all times a priority claim in bankruptcy. Section 507(a)(8)(C). All reorganization plans under Chapter 13 must provide for "...the full payment, in deferred cash payments, of all claims entitled to priority under section 507..." Section 1322(a)(2). Therefore a plan can be devised to pay withholding taxes ahead of all general unsecured creditors.

IV. THE PRIORITY CLAIM PERIOD FOR INCOME TAXES.

This section discusses the rules which make income taxes nondischargeable during their priority period. As mentioned above, unless an income tax falls within this section, there must be some form of fault to be nondischargeable.

A. THE THREE YEAR RULE.

The rules of nondischargeability are found in Section 523 of the Bankruptcy Code. 523(a)(1)(A) makes clear that priority tax claims under 507(a)(8) are nondischargeable for the period of their priority status. The first requirement is subsection (i) which provide that income tax remains a priority claim "...for which a return, if required is last due, including extensions, after three years before the date of the filing of the petition..." (In English: was the return due more than three years before the bankruptcy filing?) The filing date is irrelevant. You must examine the date that the tax return was "due." More specifically, you must find out if any extensions were requested (even if the request was denied). Etheridge v. Illinois, 127 BR 421 (1989, DC Ill) Once you have located the last date due, calculate three years from that date. This is **THE THREE YEAR RULE**.

Until the case of Young v. U.S. 535 U.S.43, 122 S.Ct. 1036 (2002) there was some disagreement among the circuits whether this three year period was stayed by the existence of a previously filed bankruptcy. That case clearly stated that the three year lookback period was equitably tolled during any period that the IRS was prevented from collection by a prior bankruptcy stay.

BAPCPA codified the Young decision. In an unnumbered paragraph at the end of section 507(a)(8) the legislature added that all time periods for that section are extended by a prior bankruptcy stay, a nonbankruptcy stay or an appeal of any collection action. The code then adds an additional 90 days.

Note the absence of any extension of the time period by reason of any offer in compromise. It can be reasonably assumed that the legislature was aware of what it was doing by imposing a stay for other time periods but not an offer in compromise.

B. THE 240 DAY RULE.

Income taxes are also a priority claim for a period of 240 days after taxes are assessed. The bankruptcy does not define the word "assess." This is probably because the IRS and each of the 50 states may have a different method of assessing taxes. All of the federal income tax cases which have interpreted the word refer to Section 6203 of the Internal Revenue Code. "assessment shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the secretary." The regulations provide that assessment is made "by an assessment officer signing the summary record of assessment."

Many people mistake the filing of a tax return, a notice of deficiency or the decision of a tax court for the date of assessment. The IRS has a three year statute of limitation within which to assess after a return is filed. But the IRS cannot begin the collection process until after it has assessed. The regulations provide specific authority for the taxpayer to obtain a copy of the record of assessment. (26 CFR 301.6203-1) You should use Form 4506-T and request both the return and the "account transcript" to obtain the record of assessment.

Always distinguish between the assessment against a partnership, corporation and an individual. They are not the same events. Johnson v. Commissioner, 301 BR 707.

BAPCPA provided that the 240 day period is stayed during the period of an offer in compromise plus 30 days. Note the difference between this and the rule pertaining to the stay of the three year period. All time periods are also extended by a prior bankruptcy stay, a nonbankruptcy stay or an appeal of any collection action. The code then adds an additional 90 days.

V. FINDINGS OF FAULT

A. NEVER FILED A TAX RETURN

It is very clear in the Bankruptcy Code that the obligation to pay a tax cannot be discharged in bankruptcy if the debtor never filed the return. 523(a)(1)(B)(i) and §1328(a)(2). As the discussion in the next section will show, there is substantial debate in caselaw as to what constitutes a tax return.

B. THE TWO YEAR RULE

A tax obligation is nondischargeable if the bankruptcy was filed less than two years after a late filed return. 523(a)(1)(B)(ii) "The effect of the two year limitations period is to allow the taxing authorities a reasonable time to collect the tax or create a lien on assets of the debtor. That period should begin with the filing of the return that reports or should report the debts the taxing authority seeks to collect. Until that return is filed, the taxing authority cannot be expected to take action to assess or collect the tax." In re Greenstein, 95 BR 583 at 585. Judge Barliant (ND Ill. 1989) Essentially, the court is saying that it is the debtor's fault in failing to file a tax return and therefore the government cannot be expected to begin collecting until the return is filed.

There is substantial disagreement among the Federal appellate courts as to what constitutes a tax return. The issue is whether a document filed with the IRS is a return if it serves no purpose. When a debtor fails to file a return, the IRS assesses the tax on its own knowledge and commences collection. The IRS takes the position that a return filed after assessment serves no purpose and does not constitute a tax return.

Many appellate circuits accept the Beard Test, Beard v. Commissioner, 793 F2d 139 (6th Cir. 1986) to define what constitutes a tax return:

> (1) The document must purport to be a return, (2) the document must be executed under penalty of perjury, (3) contain sufficient data to allow calculation of the tax and (4) represent an honest and reasonable attempt to satisfy the requirements of the tax law.

This test was developed based upon a Supreme Court case of Germantown Trust Company, 308 US 304 (Sup. Ct. 1939). Germantown had filed a trust return. The government asserted that it should have filed a corporate return. However the statute of limitations had run on Germantown's obligations if the document constituted a return. The court stated:

> The respondent's contention is that where a fiduciary, in good faith, makes what it deems the appropriate return, which discloses all of the data from which the tax, treated as one imposed upon an association (classified as a corporation under the statute), can be computed, such a return is to be deemed no return. We think this view inadmissible.
>
> It cannot be said that the petitioner, whether treated as a corporation or not, made no return of the tax imposed by the statute. Its return may have been incomplete in that it failed to compute a tax, but this defect falls short of rendering it no return whatever.

The most extreme interpretation of the Beard Test comes from the Sixth Circuit. In re Hindenlang, 164 F3rd 1029 (6th Cir. 1999) which created a brightline test (i.e. no return filed after assessment of the tax by the IRS constitutes a return.) "We hold as a matter of law that a Form 1040 is not a return if it no longer serves any tax purpose or has any effect under the Internal Revenue Code." 164 F3d at 1034. The court went on to review all of the potential impacts of a filing after assessment and found none.

The Seventh Circuit recently decided the case of In re Payne, 431 F3d 1055 (7th Cir. 2005). There Justice Posner held "the legal test is not whether the filing of a purported return has some utility for the tax authorities, but whether it is a reasonable endeavor to satisfy the taxpayer's obligations, as it might be if the taxpayer had tried to file a timely return but had failed to do so because of an error by the Postal Service." 431 F3d at *7. The debtor had argued that the IRS requires the filing of a return in order to conduct an offer in compromise. The court seemed to criticize the debtor for filing the return to set up the eventual discharge of the obligation. (Posner's argument makes no sense to me at all. What does "reasonable" mean if you can't consider the purpose of the act. All he seems to be concerned with is the date of filing. How can the date of filing be critical when 523(a)(1)(B)(ii) specifically provides for the discharge of late filed returns! How can this section have any meaning if late filed returns are not returns?)

The dissent in Payne was written by Justice Easterbrook. He would have found the document to be a return because it served the purpose of compromise and it replaced the IRS estimates with facts. The dissent further criticizes the majority opinion, stating: "Timely filing and satisfaction of one's financial obligations are requirements distinct from the definition of a "return"; the majority, however, rolls them all together." 432 F3d *18. "Motive may effect the consequences of a return, but not the definition. (Amazingly after a well argued dissent, Justice Easterbrook offers dicta that BAPCPA now defines all late filed returns as non-returns.)

Colsen v. US (8th Cir. 2006), followed the reasoning of Justice Easterbrook's dissent. "We therefore hold that the honesty and genuineness of the filer's attempt to satisfy the tax laws should be determined from the face of the form itself, not from the filer's delinquency or the reasons for it."...."Our confidence in this result drives strength from the principle that "exceptions from discharge are to be strictly construed so as to give maximum effect to the policy of the bankruptcy code to provide debtors with a 'fresh start.'"

The question now is what effect BAPCPA has on this matter. In an unnumbered paragraph the legislature added the following to 523(a):

> For purposes of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law **(including applicable filing requirements)**. Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State of local law. (emphasis added)

This section puts to rest the argument that had been made for a "bankruptcy definition of return." It had been suggested in several cases that filing of a return after assessment put the IRS on notice that the clock was ticking on the ability to discharge the obligation in bankruptcy (THE TWO YEAR RULE). Several courts including the Payne decision rejected such a bankruptcy specific definition.

What is the meaning of the statute's words in parentheses: (including applicable filing requirements)? Does this means, as suggested by Justice Easterbrook, that all late filed returns are not returns for purposes of discharge? Is there nonbankruptcy law that states that a return filed late is not a return? Does the parentheses simply mean that the court may consider late filing as a factor among other factors in determining whether the document is a return? Prudent counsel must still advise that a client should file all late returns as soon as possible. Whether the obligation can then be discharged is certainly undecided.

C. THE FRAUDULENT RETURN RULE

The IRS carries the burden of proof that the debtor filed a fraudulent return. In re Frosch, 261 BR 181 (ED Pa, 2001) The elements of proof are: 1) Knowledge of falsehood of return, 2) intent to evade taxes and 3) underpayment of tax. In re Hopkins, 133 BR 102 (ND Ohio, 1991). It may be required that each of these elements existed at the time of the filing of the tax return. In re Riley, 202 BR 169 (MD Fla, 1996) In contrast many courts look to the "badges of fraud," which may or may not have occurred prior to the filing of the return. In re Koehl, 166 BR 74 (ED La, 1993). The courts often look to the debtor's sophistication, reliance upon an accountant, In re Rigney, 216 BR 65 (ND Ala, 1997), and reliance upon a spouse, In re Binkley, 242 BR 728 (MD Fla, 1999).

The filing of an amended return or subsequent disclosure of a fraud does not purge the fraud. In re Fliss, 339 BR 481 (ND Iowa, 2006).

We all know blatant fraud when we see it, such as, fictitious exemptions and nonexistent child care expenses or failure to report embezzled funds. The problem that will always be with us, is in the analysis of inadvertent mistakes which do not rise to the level of knowing and deliberate attempts to avoid taxes. In re Birkenstock, 87 F3d 947 (CA 7, Wisc. 1996).

D. THE WILLFUL ATTEMPT TO EVADE OR DEFEAT RULE.

The Bankruptcy Code allows discharge only to the honest and unfortunate individual. Dalton v. IRS, 77 F3d 1297 (10th Cir. 1996). This very same concept is found in the interpretation and application of 523(a)(1)(C) which prevents the discharge of a tax where the debtor"...willfully attempted in any manner to evade or defeat such tax." It would be very difficult to imagine or draft a broader or more powerful barrier to discharge.

The government carries the burden of proving both a conduct requirement (that the debtor sought in any manner to evade or defeat his tax liability) and a mental state requirement (that the debtor did so willfully). In re Birkenstock, 87 F3d 947 at 951 (7th Cir. 1996). To prove the mental state, the debtor's attempts to avoid his tax liability must be "voluntary, conscious, and intentional." He must know he has a duty to pay taxes and voluntarily and intentionally attempt to violate that duty. In re Birkenstock, 87 F3d at 952. The rule is not supposed to apply to inadvertent mistakes.

The cases exhibit very divergent results. From the debtor's point of view, the best case is In re O'Callaghan, 316 BR 550 (MD Fla. 2004) There the debtor had filed accurate returns, had communicated with the IRS and had paid all but the disputed obligations. The court held that the conduct of business in cash did not violate the act. The court held that "there is a 'venerable distinction between tax avoidance and tax evasion.' To the extent that a debtor employs legally permissible methods to avoid paying taxes, such conduct does not constitute improper tax evasion." If the standard for the evaluation of conduct were: "anything legally permissible" it would be very easy to advise a client. Most courts do not follow O'Callaghan.

At the opposite end of the spectrum are what could be called the "angel cases." No one but an angel could pass their standards. In re Mills, 337 BR 691 (D. Kan. 2005) In Mills the court implied that it would look at each and every household expenditure of the debtor to determine if, in its view, each was "reasonable and necessary in light of his available income..." id at 700. Although the non payment alone is not sufficient to violate the law, the court will determine on its own whether the debtor should have been able to pay the tax debt. Furthermore the court criticized the debtor for failing to accumulate assets!!! "Was debtor taking deliberate steps to avoid accumulating assets that could be seized to satisfy his liabilities, such as by renting instead of purchasing assets?" id at 702. Is failure to buy a house tax evasion? Another example is In re Claxton, 335 BR 680 (ND Ill. 2006). It may have been clear that Mr. Claxton did certain things that should have caused the denial of discharge of his taxes but how do you advise a client in the face of the following language: "By choosing to use personal income to pay corporate and personal expenses while failing to pay any corporate or personal tax obligations for many years, Claxton took affirmative steps to evade or defeat his taxes." Claxton at 692. The court is saying he paid the wrong bills. Is a corporation now forced to give the owner an extra paycheck and make sure that he uses it to pay his taxes? Many cases hold that mere nonpayment is not sufficient to constitute a willful attempted in any manner to evade or defeat a tax. But in light of Mills and Claxton the standard is: nonpayment coupled with inability to pay.

How do you advise a client what to do to avoid violation of the law? In light of the above cases, caution is imperative. The actions most likely to cause a finding of willful attempt in any manner to evade or defeat a tax are: many years of failing to pay taxes, failure to pay, creating a shell trust. In re Epstein, 303 BR 280 (EDNY, 2004); failing to file on time, a sophisticated debtor, concealing assets or income, In re Claxton, 335 BR 680 (ND Ill. 2006); non-payment, no quarterly returns, a vary lavish lifestyle, In re Landi, 289 BR 173 (MD Fla. 2002); non-payment, failing to file for 10 years and various badges of fraud, In re Crawley, 244 BR 121 (ND Ill. 2000); a single act of barring the IRS agents from entering into the house to inventory and seize personal property, In re Gillis, 251 BR 920 (SD Ga. 2000).

The analysis in caselaw is very similar to "fraud on creditor cases." The court will likely examine the debtor's conduct to distinguish between legitimate estate, business or personal planning from and conduct designed to avoid and evade the payment of taxes. Typically courts state: "this is not a case of tax or business planning designed to minimize taxes (or achieve some other lawful objective) with bankruptcy and unfunded tax liability occurring later." Dalton v. IRS, 77 F3d 1297 at 1304 (10th Cir. 1996) Often actions are taken for legitimate purposes but which also have the effect of avoiding the payment of taxes. Such conduct may well prevent the discharge of taxes in bankruptcy.

VI. CONCLUSION.

Withholding taxes can never be discharged now that BAPCPA prevents their discharge in a Chapter 13. The government has three (3) years after tax returns are due and 240 days after assessment (the priority collection period) during which taxes are nondischargeable. BAPCPA has clarified that a prior bankruptcy stays the running of these time limits. Once the priority period is over, the law prevents bankruptcy discharge of income taxes where there is some form of fault, i.e., 1) the failure to file a tax return, 2) failure to file a tax return more than two (2) years prior to the bankruptcy, 3) filing a fraudulent return or 4) willfully evading the payment of taxes due. There is no case law as of yet as to what constitutes a tax return under BAPCPA although dicta by the 7th circuit indicates that filing time limits may play a large part in the definition. Also remember that the two year period under BAPCPA is stayed by both prior bankruptcies and prior offers in compromise. Lastly the "angel cases" clearly imply that you have to be extraordinarily careful in order to avoid a denial of discharge for willfully evading taxes.

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