

## Bankruptcy Taxation Committee

To monitor the activities of the Congressional committees and IRS on matters concerning bankruptcy tax legislation and regulations.



### The Basics of Discharging Taxes in Bankruptcy after BAPCPA

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BAPCPA dramatically altered the discharge of taxes in chapter 13 and chapter 11 when it killed the so-called “super discharge.” Tax debtors can no longer discharge tax debts in a chapter 13 case that they cannot discharge in chapter 7. Because chapter 7’s tax discharge provisions are now equally applicable to chapter 13 and chapter 11 cases, they may be of renewed interest to practitioners.

According to a leading commentator, the applicable chapter 7 provisions on discharge of taxes for individual debtors are “a wretched piece of draftsmanship” that “leads one on a wild goose chase” in the search for answers.<sup>2</sup> The statutes’ seemingly endless series of cross-references between the priority provisions in §507 and the dischargeability provisions in §523 unduly complicate the process of analyzing whether a particular tax debt may be discharged in bankruptcy.

Although BAPCPA clarified a few technical definitions, it did little to simplify the law regarding the discharge of tax debts. This article attempts to summarize the basic concepts involved in analyzing the dischargeability of tax debts.

#### Congress Eliminated the “Super Discharge”

Prior to BAPCPA, a debtor could obtain a discharge in a chapter 13 individual reorganization for tax debts in circumstances where tax returns were unfiled, late or even fraudulently filed. BAPCPA eliminates this so-called “super discharge.” The chapter 13 discharge for tax debts now parallels the discharge granted in chapter 7.<sup>3</sup> Likewise, Congress amended chapter 11 so that the discharge of tax debts for individuals parallels the chapter 7 discharge. Individual debtors all receive essentially the same discharge, no matter what type of bankruptcy case they file.

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<sup>2</sup> *Epstein, Nickles and White, Bankruptcy Practitioner Treatise Series*, (1992 ed.) Vol. 2, §7025, at p. 334.

<sup>3</sup> 11 U.S.C. §1328(a)(4); 11 U.S.C. §1141(d)(2).

## What Debts Can Be Discharged in a Chapter 7 Liquidation?

First, let's discuss some basic concepts:

a. *What constitutes a tax?* A tax is a financial burden imposed upon individuals or property to raise revenue for a government.<sup>4</sup> In contrast, a penalty is imposed as a punishment for the failure to pay a tax or file a return.<sup>5</sup> In some cases, this represents a distinction with a difference.

b. *When is a tax return deemed filed?* The law deems timely filed tax returns filed when the taxpayer mails the tax return.<sup>6</sup> On the other hand, applicable law deems late filed tax returns filed when they are received by the IRS.<sup>7</sup> In other words, the “mailbox rule” does not apply for late filed returns.

c. *What constitutes a “return?”* Under prior law, a seemingly existential debate existed as to what constituted a “return” for the purpose of discharging tax debts in bankruptcy. BAPCPA resolved this debate. The Bankruptcy Code now defines the term “return” to include returns that satisfy applicable nonbankruptcy law, including returns prepared pursuant to §6020(a) of the Internal Revenue Code, *i.e.*, a return prepared by the government and signed by the taxpayer,<sup>8</sup> or similar State or local law, a “return” does not include “a return prepared by the IRS but *not signed* by the taxpayer, under similar state or local law.”<sup>9</sup>

d. *When are taxes “assessed?”* The Internal Revenue Code charges the Secretary of the Treasury with making assessments.<sup>10</sup> Prior to making an assessment, the secretary is required to send the taxpayer a notice of deficiency.<sup>11</sup> If the taxpayer does not contest the deficiency, after a prescribed period of time, the secretary may assess a deficiency.<sup>12</sup> For federal income

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<sup>4</sup> *CF&I Fabricators of Utah Inc.*, 518 U.S. 213, 224, 116 S.Ct. 2106, 2113, 135 L.Ed.2d 506, 516-17 (1996) (*quoting New Jersey v. Anderson*, 203 U.S. 483, 492 (1906)).

<sup>5</sup> *CF&I Fabricators*, 518 U.S. 213, 224, 135 L.Ed.2d 506, 517 (*quoting United States v. LaFranca*, 282 U.S. 568, 572 (1931)) (alleged excise tax based on accumulated funding deficiencies has actually a penalty).

<sup>6</sup> 26 U.S.C. §7502.

<sup>7</sup> *Smith v. United States (In re Smith)*, 179 B.R. 66, 68 - 69 (Bankr. N.D. Ohio 1995), *aff'd*, 186 B.R. 411 (N.D. Ohio 1995), *aff'd*, 96 F.3d 800 (6th Cir. 1996).

<sup>8</sup> Section 6020(a) of the Internal Revenue Code provides:

(a) **Preparation of return by Secretary.** – If any person shall fail to make a return required by this title or by regulations prescribed thereunder, but shall consent to disclose all information necessary for the preparation thereof, then, and in that case, the Secretary may prepare such return, which, being signed by such person, may be received by the Secretary as the return of such person.

<sup>8</sup> 1 U.S.C. §507(a)(8)(A)(ii).

<sup>9</sup> 11 U.S.C. §523(a)(1).

<sup>10</sup> 26 U.S.C. §6201(a).

<sup>11</sup> 26 U.S.C. §6212(a).

<sup>12</sup> 26 U.S.C. §6213.

taxes, “[t]he date of the assessment is the date the summary record is signed by the assessment officer.”<sup>13</sup>

State law often contains similar assessment procedures.<sup>14</sup> The central question remains the point when state law fixes tax liability.

Keeping these definitions in mind, let us review the basic rules for the discharge of taxes. Most of these provisions except tax debts from discharge based on their proximity in time to the bankruptcy filing.

### **No Discharge for Income Taxes Where the Return Last Came Due within Three Years Prior to the Bankruptcy<sup>15</sup>**

The Bankruptcy Code does not permit the discharge of income taxes incurred in close proximity to the petition date. This three-year period runs when the return is due to be filed *after* all extension dates. If a return was actually filed more than three years before the bankruptcy but the last day to file under an extension was less than three years prior to bankruptcy, the tax will not be discharged.

For example, a tax return for the year 2001 would be due April 15, 2002. A client files a chapter 7 case on Oct. 1, 2005. If the return was filed by April 15, 2002, the tax would be discharged. On the other hand, if the return was due Oct. 15, 2002 but filed Oct. 5, 2005 because of extensions, the tax would not be discharged.

### **No Discharge for Income Taxes Where the Debtor: (1) Failed to File Returns or (2) Filed Returns Late within Two Years Prior to Bankruptcy**

Not surprisingly, Bankruptcy Code §523(a)(1)(B) excepts a tax debt from discharge where the tax return or equivalent report or notice was not filed or given. In addition, an income tax debt will be excepted from discharge where the tax return or equivalent report or notice was tardily filed or given within two years before the bankruptcy petition date. This analysis obviously depends on what constitutes “filing” and what constitutes a “return,” two concepts addressed above. Again, please note that late-filed returns are not deemed filed until the IRS receives them.<sup>16</sup>

### **No Discharge for Taxes Assessed within 240 Days Prior to Bankruptcy<sup>17</sup>**

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<sup>13</sup> 26 C.F.R. §301.6203-1; 26 U.S.C. §6203.

<sup>14</sup> See, e.g., *King v. Franchise Tax Bd. (In re King)*, 961 F.2d 1423 (9th Cir. 1992); *Louisiana Dep’t of Revenue & Taxation v. Lewis (In re Lewis)*, 199 F.3d 249, 43 C.B.C.2d 650 (5th Cir. 2000); *O’Connell v. Minnesota Dep’t of Revenue (In re O’Connell)*, 246 B.R. 332 (B.A.P. 8th Cir. 2000).

<sup>15</sup> 11 U.S.C. §523(a)(1)(A); 11 U.S.C. §507(a)(8).

<sup>16</sup> *Smith*, 96 F.3d 800.

<sup>17</sup> 11 U.S.C. §523(a)(1)(A); 11 U.S.C. §507(a)(8)(A)(ii).

The Bankruptcy Code generally excepts from discharge any tax, regardless of the period to which it relates, assessed within 240 days before the date of the bankruptcy filing. The 240-day period may be extended by any time during which an offer in compromise was pending. It will also be extended by any time period in which a prior bankruptcy case was pending. This 240-day rule applies most frequently to taxes for periods more than three years prior to bankruptcy, in circumstances where a return was selected for audit or for which an amended return reporting additional tax liability was filed.

### **No Discharge for Taxes Assessable under Applicable Law or Agreement after the Filing of the Bankruptcy Case<sup>18</sup>**

The Bankruptcy Code excepts from discharge taxes “not assessed before, but assessable, under applicable law or agreement,” after the commencement of the case. This exception to discharge most often applies to years for which tax audits remain ongoing when a chapter 7 petition is filed.

### **No Discharge for Certain Property Taxes Payable within One Year before Bankruptcy<sup>19</sup>**

The Bankruptcy Code prohibits discharge of property tax debts incurred before the commencement of the bankruptcy case and last payable without penalty within one year before the date of the filing of the bankruptcy petition.

### **No Discharge for Trust Fund Taxes<sup>20</sup>**

This includes withholding taxes and sales taxes that are required to be collected or withheld and for which the debtor is liable in any capacity. Trust fund tax obligations are excepted from discharge regardless of age. However, one should be aware there is a statute of limitations on the collection of IRS taxes, including trust fund taxes. This is generally 10 years from the date of assessment.

### **No Discharge for Excise Taxes Arising within Three Years before the Date of the Bankruptcy Petition<sup>21</sup>**

The courts have defined excise taxes to include certain sales taxes, estate taxes, gift taxes, gasoline and special fuel taxes, and wagering and truck taxes. Workers’ compensation premiums may also be viewed as excise taxes in some circuits.<sup>22</sup>

### **No Discharge for Employment Taxes on Certain Priority Wage Claims<sup>23</sup>**

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<sup>18</sup> 11 U.S.C. §523(a); 11 U.S.C. §507(a)(8)(A)(iii).

<sup>19</sup> 11 U.S.C. §523(a)(i); 11 U.S.C. §507(a)(8)(B).

<sup>20</sup> 11 U.S.C. §523(a)(1)(A); 11 U.S.C. §507(a)(8)(C).

<sup>21</sup> 11 U.S.C. §507(a)(8)(E).

<sup>22</sup> *Yoder v. Ohio Bureau of Workers Compensation (In re Suburban Motor Freight Inc.*, 998 E.2d 338 6th Cir. 1993).

<sup>23</sup> 11 U.S.C. §507(a)(8)(D).

This category includes employment taxes for pre-bankruptcy petition priority, wages, salary or commissions, whether or not actually paid pre-bankruptcy.

### **No Discharge for Tax Penalties on Priority Tax Claims That Represent Compensation for Actual Pecuniary Loss**

Penalties imposed by a taxing authority are not dischargeable to the extent that they are for actual pecuniary loss.

### **No Discharge for Fraudulent Tax Returns or for a “Willful Attempt in Any Manner to Evade or Defeat Taxes”**

Bankruptcy Code §523(a)(1)(C) excepts a debt from discharge where a debtor has “made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.” In *Toti v. United States (In re Toti)*, the Sixth Circuit Court of Appeals stated that “a plain reading of §523(a)(1)(C) includes both acts of commission and acts of omission.”<sup>24</sup> The *Toti* court held that a debtor’s “voluntary, conscious and intentional” failure to file his tax returns and pay his tax debts was a willful attempt to evade taxes.<sup>25</sup>

The mere failure to pay taxes has been found insufficient to except a tax debt from discharge.<sup>26</sup> However, nonpayment coupled with efforts to thwart collection may render a debt nondischargeable.<sup>27</sup>

### **In Determining Whether a Tax Obligation May be Discharged under the Framework Established by Congress, Practitioners Must be Aware of the Probability that the Time Periods in Which a Debtor is Nondischargeable May be Tolloed When the IRS Has Been Precluded From Taking Collection Action**

BAPCPA provides for tolling of the “reachback periods” for determining whether a tax is dischargeable. An otherwise applicable time period for dischargeability purposes may be extended. Congress provided for tolling based on any time period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection. Tolling applies for any period where applicable law prohibited collection, plus 90 days.

Congress also suspended the reachback periods for the discharge of taxes during any time when a taxpayer was a debtor in a prior bankruptcy case or where IRS collection efforts are precluded

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<sup>24</sup> *Toti v. United States (In re Toti)*, 24 F.3d 806, 809 (6th Cir. 6th Cir. 1994), *cert. denied*, 513 U.S. 987 (1994); *see also Meyers v. Internal Revenue Service (In re Meyers)*, 196 F.3d 622, 624-25 (6th Cir. 1999).

<sup>25</sup> *Toti*, 24 F.3d at 809. *But cf. United States v. Sumpter (In re Sumpter)*, 64 F.3d 663, unreported, 1995 WL 501947 at \*5-6 (6th Cir. 1995) (held that debtor/spouse’s conduct did not constitute willful attempt to evade taxes where she had limited education, deferred to debtor/husband on most issues concerning his business, and simply signed document fraudulently transferring property at debtor/husband’s direction)(citations omitted).

<sup>26</sup> *Dalton v. Internal Revenue Service*, 77 F.3d 1297, 1301 (10th Cir. 1996).

<sup>27</sup> *United States v. Fretz (In re Fretz)*, 244 F.3d 1323 (2nd Cir. 2004); *United States v. Fegeley (In re Fegeley)*, 118 F.3d 979 (3rd Cir. 1997).

by the existence of a plan of reorganization under the Bankruptcy Code, plus 90 days. In addition, a bankruptcy judge may find that facts presented to the court toll the reachback periods in certain circumstances.

### **Although this Provision is Not Referenced in the Bankruptcy Code, the “Innocent Spouse” Exception under the Internal Revenue Code May Provide Relief for a Debtor**

A limited number of debtors may escape liability for tax debts in the bankruptcy court by using the “innocent spouse” defense.<sup>28</sup>

### **Even if a Debtor’s Personal Liability on a Tax Claim is Discharged, the Debtor’s Property May Still be Subject to Tax Liens**

Tax liens may be enforceable *in rem* against the debtor’s property the same as any other secured claim.<sup>29</sup> Further, the state exemptions that apply in bankruptcy do not apply to the IRS.

### **Even Without the Super Discharge, Chapter 13 Bankruptcy Filings under BAPCPA Still Provide Benefits to Tax Debtors**

Chapter 13 still provides relief from collection efforts by taxing authorities. It also may prevent taxing authorities from adding penalties and interest to a tax debt. Moreover, it permits the taxpayer to repay the tax debt over time. A court-approved reorganization plan may provide for repayment of tax debts over a period of up to 60 months.

Chapter 13 debtors also obtain one minor advantage over chapter 7 debtors under the new law. They may still discharge a loan that they obtained in order to pay nondischargeable taxes. These debts are not dischargeable in chapter 7.

### **Chapter 11 reorganization may also benefit tax debtors who do not fit within the debt limitations of Chapter 13**

Because of statutory debt limitations in chapter 13, a debtor may be ineligible for such relief. Those debtors may be required to seek relief in a chapter 11 reorganization. The chapter 11 discharge of taxes parallels the discharge available in chapter 7 and chapter 13.

### **The New Law May Permit a Longer Repayment Period in a Chapter 11 Reorganization**

A chapter 11 plan of reorganization may provide for the repayment of tax obligations over a period of five years after the case *is filed*. In some cases, this may improve the debtor’s position over prior law. In the past, the law required debtors to pay taxes within six years *after they were*

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<sup>28</sup> See I.R.C. §6013(e)(1). *Compare In re Lesnick*, 202 B.R. 82 (Bankr. N.D. Ohio 1996) (held that mere knowledge of investment giving rise to liability was insufficient to defeat innocent spouse claim where debtor/spouse was financially unsophisticated, had limited role in family finances and debtor did not receive substantial benefit); *with Stevens v. Baas*, 197 B.R. 57, 59 (N.D. Ohio 1995) (held that exception did not apply based on debtor/spouse’s knowledge of underlying transactions and sophistication); *Graham v. United States (In re Graham)*, 199 B.R. 157, 159 (Bankr. N.D. Ohio 1996) (held that exception did not apply based on debtor/spouse’s knowledge of underlying transactions and sophistication).

<sup>29</sup> *In re Doerge*, 181 B.R. 358, 365 n.11 (Bankr. S.D. Ill. 1995).

*assessed.* Debtors may benefit significantly in circumstances where a taxing authority assessed a tax several years before the debtor filed the chapter 11 case. The new law further requires that a chapter 11 plan provide for repayment of tax debts on terms no less favorable than the repayment terms for the most favored class of nonpriority unsecured debt.

## **Conclusion**

While the impact of BAPCPA on tax debtors has not been widely publicized, Congress has made it more difficult to discharge tax debt. Because the discharge available to individuals in chapter 13 and chapter 11 parallels the chapter 7 discharge, now more than ever tax professionals must pay close attention to the technical requirements for discharging tax debts in bankruptcy.