

The Issue Checklist:

Discharging Unsecured Tax Debts for Individual Debtors

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The bankruptcy attorney is in familiar territory when working through a voluminous statutory code. After all, U.S.C. Title 11 comprises nine chapters and fills two books.² However, the size of the bankruptcy code pales in comparison to the mammoth size and complexity of the U.S. tax code.³ Even for seasoned attorneys, the prospect of a client with tax issues can be daunting. If you have a client who needs to discharge tax debts through bankruptcy, strict requirements must be met. Below is a brief discussion of the significant issues that could jeopardize your client's discharge of tax debts.

The First Step

When a client with tax debts is contemplating bankruptcy, special fact finding steps should be taken. In a perfect world, clients would be honest and accurate about their tax issues. In the real world, clients can be mistaken about details that are important to a bankruptcy discharge case. Because actions in a bankruptcy proceeding can affect the client's tax case, and vice versa, it is essential to ascertain the full extent of the client's tax situation prior to filing a petition for bankruptcy when tax debts are involved.

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² With the legislative history, comments, and related statutory provisions included in Collier's Pamphlet Edition.

³ Estimates of the exact length range from 4,000 to 70,000 pages. Andrew L. Grossman, *Is the Tax Code Really 70,000 Pages Long?*, Slate, Apr. 14, 2014.

http://www.slate.com/articles/news_and_politics/politics/2014/04/how_long_is_the_tax_code_it_is_far_shorter_than_70_000_pages.html (last accessed Oct. 2, 2018).

The best source of information about the client's tax situation is the client's account transcripts from the IRS.⁴ To obtain account transcripts, complete an IRS Form 2848 – Power of Attorney.⁵ Fax this to the appropriate CAF Unit for your area.⁶ Next, call the IRS and request your client's account transcripts.⁷ Be sure to order transcripts for “every year in which there is a liability.”⁸ Examining the account transcripts will reveal if the client failed to file returns, when returns or substitutes for returns were filed, if the IRS assessed penalties, and the date of those events. All of this information should be carefully considered before deciding when to file a bankruptcy petition.

Exceptions to Discharge

To discharge taxes, the client's situation must comply with several strict requirements. The discharge rules dictate when a tax debt becomes dischargeable. However, broad exceptions to dischargeability exist, that often render a tax debt not dischargeable. Notably, the exceptions to dischargeability are so frequently applicable in bankruptcy cases that discharging a tax debt is a rare feat. Because an exception might render a client's tax debt non-dischargeable from the

⁴ The following instructions are specific to federal taxes and the Internal Revenue Service; analogous steps will be required for state tax agencies.

⁵ The IRS will not speak to you without a POA on file and they typically do not accept other forms of POA, despite what their website says. When communicating with the IRS, always have a copy of the POA handy to email/fax to the IRS representative. Note that the IRS will not tell you when or why they have rejected a POA submission. Even small errors or omissions can result in the form being rejected, so do not leave any spaces blank (write N/A), ensure names and dates are correct, and list all relevant years and tax issues. It is not sufficient to be overly general; e.g. a POA form purportedly authorizing representation for “all years,” “all future periods,” or “for all purposes” will be rejected. If you have never worked through the IRS administrative system before, you need to be assigned a CAF#; to do this, write “Request CAF Number” in the box labeled CAF#.

⁶ Processing new POA forms can occasionally take weeks, so plan accordingly. However, you do not have to wait for the CAF Unit to file the POA into the file if you have one on hand to send to the IRS representative you are speaking with. A list of CAF Unit fax numbers and addresses can be found here: <https://www.irs.gov/businesses/small-businesses-self-employed/caf-unit-addresses-fax-numbers-and-state-mapping>.

⁷ The practitioner priority line can be reached at 866-860-4259. The account transcript is a record of all the filings, taxes assessed, liabilities, penalties, and administrative actions.

⁸ The IRS will allow you to order transcripts only for the years and matters listed on Form 2848, so it is essential that Form 2848 has a complete, specific listing of all the client's tax matters, including the type of tax or penalties, listed by name and year.

start, this article begins with the exceptions rather than the discharge rules. The three main exceptions to discharge are: non-income tax based debts, fraud, and willful tax evasion. Note also, as discussed below, even if a discharge of personal liability can be accomplished, property subject to a tax lien will still be encumbered.

Non-dischargeable Types of Tax

In a bankruptcy, the taxing authority may object to dischargeability on the grounds that the debt is based upon a non-dischargeable type of tax. An individual's state or federal income tax liabilities may be discharged if certain requirements are met. However, most other types of taxes are not dischargeable, including sales taxes,⁹ an employee's contribution to FICA,¹⁰ and unpaid child support obligations.¹¹

Fraud

When a client signs an IRS document, the client certifies under penalty of perjury that the document is true and correct as to every material matter.¹² To prevail on a fraud claim, the tax agency must demonstrate, by a preponderance of the evidence, (1) a knowing falsehood by the debtor; (2) an intent to evade taxes; and (3) an underpayment of tax.¹³ Certain circumstances, such as a single person claiming an exemption for disabled spouse, illustrate obvious fraud but in many cases the line between negligent inaccuracy and willful fraud is subtle. Carefully inspect

⁹ This varies by state.

¹⁰ 11 U.S.C. §§ 507(a)(7) & 523(a)(7).

¹¹ See *Duranceau v. Wallace*, 743 F.2d 709, 713 (9th Cir. 1984) (citing to *Nelson v. Regan*, 560 F. Supp. 1101, 1103 (D. Conn. 1983) (holding that tax refunds collected by tax intercept program to satisfy outstanding child support obligations are a non-dischargeable tax)); 26 U.S.C. § 6305.

¹² 26 U.S.C. § 7206(1)

¹³ *United States v. Schmidt*, 2016 WL 6516872, at *5 (E.D. Wash. Nov. 1, 2016).

the client's account transcripts to see if the IRS assessed a fraud related penalty, such as a civil fraud penalty.

Willful Evasion

The willful evasion exception applies when a debtor knew about a tax liability, but actively schemed to avoid paying. The elements of willful evasion are: (1) the debtor had a duty under the law; (2) the debtor knew of the duty; and (3) the debtor voluntarily and intentionally violated the duty.¹⁴ Examples of willful evasion include concealing an ownership interest in assets and structuring transactions to avoid reporting requirements.¹⁵ Some courts hold that the intent element applies only to the act itself, while other courts hold that the debtor must have acted voluntarily *and* with the specific intent to avoid the tax.¹⁶ The court will consider “badges of fraud” to determine if the client acted with the requisite fraudulent intent.¹⁷ The existence of these factors can raise a presumption of fraud against the client which can be difficult to defeat.

Requirements for Discharge of Unsecured Tax Debts

The main requirements for discharge are known as the 3-2-240 rules. These rules all impact the timing of *when* a bankruptcy petition should be filed. A tax debt can be discharged only by complying with all three rules simultaneously. Filing at the wrong time will render tax

¹⁴ *Hawkins v. Franchise Tax Bd. of California*, 769 F.3d 662, 669 (9th Cir. 2014) (citing to *In re Vaughn*, 765 F.3d 1174 (10th Cir. 2014)).

¹⁵ *Id.*

¹⁶ *Id.* Ninth Circuit case law draws a meaningful distinction between “I intentionally structured a transaction to avoid reporting requirements,” and “I intentionally structured a transaction to avoid reporting requirements with the intent to defeat taxation.” It is important to identify the relevant case law in your jurisdiction and understand what evidence your client will need to produce to successfully discharge tax liabilities. See *United States v. Schmidt*, 2016 WL 7230503, at *2 (E.D. Wash. Dec. 14, 2016) (citing to *Hawkins* and discussing willful evasion).

¹⁷ Such as: dramatically understating income, failing to maintain records, concealing assets, or dealing in cash. See *In re Bonner*, 13 F. App'x 517, 519 (9th Cir. 2001) (Note 9th Cir. Rule 36-3 on citation to unpublished opinions).

debts nondischargeable. Note that these discharge rules are self-effecting. That is, a nondischargeable tax debt is not affected by the failure to file a proof of claim.¹⁸

3-Year Rule

Under the 3-Year Rule, to discharge income taxes, the debt must come due pre-petition and the tax return must be due at least three years before filing the bankruptcy petition.¹⁹ To determine the exact date the tax return was last due, check the account transcripts. In simple cases, to determine the earliest date a bankruptcy petition can be filed to discharge the taxes, add three years from the date of the assessment. However, this date may change because the statute is tolled by certain events and provisions of the bankruptcy code add a set number of days to the period.²⁰

2-Year Rule

Under the 2-Year Rule, to discharge income taxes, the tax returns must have been filed at least two years before filing the bankruptcy petition if the tax return was filed late.²¹ Consequently, filing late tax returns pushes back the date on which the tax can be discharged. Further, failing to file on time can expose the client to criminal prosecution and eventually the IRS will file a Substitute for Return, potentially making the tax debt non-dischargeable.²² The 2-

¹⁸ 11 U.S.C. §§ 523(a)(1)(A); *see also*, *Colvin v. Commissioner*, T.C. Memo. 2010-235, 100 T.C.M. (CCH) 361, 363 (2010), *aff'd*, 460 F. App'x 349 (5th Cir. 2012) (“A nondischargeable tax debt is not affected by the failure to file a proof of claim.”).

¹⁹ 11 U.S.C. §§ 523(a)(1)(A), 507(a)(8)(A)(i).

²⁰ Collection due process hearings or the automatic stay of proceedings from a bankruptcy stop the clock and add a statutory “extender” of 90 days. *See* 11 U.S.C. § 507(a)(8)*. 8* is the paragraph at the bottom, after (a)(8)(G)).

²¹ 11 U.S.C. § 523(a)(1)(b)(ii). This period can also be tolled and extended. *See Young v. United States*, 535 U.S. 43, 49 (2002) (“It is hornbook law that limitations periods are customarily subject to equitable tolling.” (internal quotations omitted)); *see also*, *In re Brickley*, 70 B.R. 113 (B.A.P. 9th Cir. 1986) (“the Internal Revenue Code suspends the statute of limitations on a tax liability of a taxpayer from running while his assets are in the control or custody of a court and for 6 months thereafter...The amendment applies this rule in a Title 11 proceeding.”)

²² A discussion of the tax return filing process is beyond the scope of this article, but tax returns that are filed significantly after the due date may be treated as though they are not a “return” at all. The IRS cannot collect tax without assessing it first. To make an assessment where no return has yet been filed, the IRS will gather information

Year rule can be tolled by certain events. For example, the two year period is suspended as long as bankruptcy's automatic stay prevents the taxing authority from proceeding against the debtor and for six months after the stay is lifted.²³

240-Day Rule

Finally, the 240-Day Rule requires that the tax liability must have been assessed by the taxing authority 240 days prior to the bankruptcy petition,²⁴ or the taxing authority has not assessed the tax.²⁵ Carefully review the account transcripts to determine the assessment date. Once you have determined the trigger dates for each of these three rules, you will have a better idea of when the bankruptcy petition should be filed to maximize the value of your client's discharge.

Unresolved Issues

Even if you have successfully navigated all of the discharge rules and exceptions, your client may still have lingering tax problems. Below is a brief discussion of issues that could plague the client even after a successful discharge.

to assemble a Substitute for Return. Courts are split on what effect this has. In the 9th Circuit, see *In re Martin*, 542 B.R. 479, 480 (B.A.P. 9th Cir. 2015); see also, *In re Smith*, 828 F.3d 1094, 1097 (9th Cir. 2016). While the exact treatment of an SFR varies by jurisdiction, no court has held that a tax debt was dischargeable after the IRS filed an SFR.

²³ 11 U.S.C. § 523(a)(1)(B); 26 U.S.C. 6503.

²⁴ 11 U.S.C. § 507(a)(8)(A)(ii). Note that this period can be tolled and extended by submitting an offer in compromise to the tax agency or the stay of proceedings from bankruptcy. § 507(a)(8)(A)(ii)(I & II). The 90-day extender from § 507(a)(8*) also applies cumulatively.

²⁵ When taxes become assessable is beyond the scope of this article, but if the tax is not yet assessed, but still assessable, then the tax agency could make the assessment post-petition. In that case, the tax debt is nondischargeable because the tax debt did not come due pre-petition under the 3-year rule. If the tax was not assessed and it is no longer assessable, there is no "debt" to discharge in bankruptcy and any tax liability arising from an unlawful assessment could be resolved directly with the tax agency or through Tax Court.

Nondischarged Taxes

Tax discharge is not all or nothing. Taxes that were not eligible for discharge will remain after the client has received a discharge from the bankruptcy court. These remaining tax liabilities still need to be resolved with the taxing authority. Without a comprehensive plan, the client could end up in significant debt again a short way down the road.

Existing Liens

Secured tax debts are beyond the scope of this article, but note that discharging a tax debt does not release a tax lien that is already in place.²⁶ The discharge will extinguish the debtor's personal obligation to pay the debt, but the property subject to the lien will still be encumbered and cannot be sold without paying off that lien.²⁷

Prior Discharges and Post-Petition Taxes

Filing for bankruptcy or receiving a discharge order can change the way the IRS treats your client. Additionally, taxes assessed after the bankruptcy cannot be discharged. Because debtors cannot receive discharges more than once every eight years, this could leave a client in continued financial hardship. Some clients cannot afford to wait years before a discharge because of immediate financial pressure. However, some clients would be worse off if they filed for bankruptcy too soon because their post-discharge tax liabilities may exceed their future income. Tough choices like these make it difficult to choose the right time to file for bankruptcy. Emerging from bankruptcy with fresh tax debts will diminish the hard-fought victory of a tax discharge.

²⁶ 11 U.S.C. §524(a)(2).

²⁷ The in rem obligation is not affected by a discharge of the client's in personam debts. Likewise, the tax lien can be challenged in a legal proceeding separate from the bankruptcy.

Conclusion

Discharging taxes is a complicated process. Careful planning and early identification of the potential issues is essential to realizing the best possible results for your client. With careful planning and vigilant issue-spotting, you can help your client avoid or eliminate the burden of mounting tax debt.