The Tax Man and the Debtor:
Satisfying Both in Bankruptcy

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Tax Issues related to Bankruptcy – Filing and calculation related requirements - Not Discharge

1) Internal Revenue Code 1398

   a) Short year election (IRC 1398(d)(2)(A)) – creates two short years. One ending the day before the filing (pre-petition) and a second for the remainder of the calendar year (post-petition not a claim against the Bankruptcy Estate). *This a key point in many cases for bankruptcy professionals to consider!*

2) Tax computation of the Bankruptcy Estate

   a) Bankruptcy Estate is a separate taxable entity with tax filing requirement.
   b) Tax is calculated using married filing separate tables (IRC 1398(c).
   c) The Bankruptcy Estate is treated as if not in bankruptcy (Exclusion, divorce, etc.).
   d) Tax attributes as of first day of the year filed, unless making IRC 1398(d)(2)(A) election. Then the attributes are as of the day of the IRC 1398(d)(2)(A) filing, including the attribute impact through the filing of that short year return. The attributes that succeed to the Estate are:
      i) Net operating losses under IRC 172;
      ii) Charitable contributions carry-overs under IRC 170(d)(1);
      iii) Recovery of tax benefit items under IRC 111 (relating to bad debts, prior taxes and delinquency amounts);
      iv) Credit carry-overs and all other items which, but for the commencement of the case, would be required to be taken into account by the debtor with respect to any credit;
      v) Capital loss carry-over per IRC 1212;
      vi) Debtor's basis in, holding period for, and the character in the debtor's hand of any asset acquired (other than by sale or exchange) from the debtor;
      vii) Method of accounting;
      viii) Other tax attributes of debtor, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purpose of IRC 1398.

ix) Treasury Regulations 1.1398-1 provides that the bankruptcy estates succeeds to the unused passive activity losses and credits under section 469. Not really an attribute, but close enough.
x) Treasury Regulations 1.1398-2 provided that the bankruptcy estate succeeds to the unused losses from at-risk activities under section 465. However, the unused losses follow the property — if the property is abandoned, the estate does not get to use the losses. Also not really an attribute, but close enough.

e) The Bankruptcy Estate's tax liabilities are an administrative expense of the Estate. Watch the sale or other liquidation of property subject to liens – be sure the sale/liquidation of property will provide a net benefit to the Bankruptcy Estate. Be sure that sufficient funds will be available for payment of liens, taxes, fees and pre-petition claims. Taxes in both Chapter 7 and Chapter 11 are the same priority of all other administrative expenses, including professional fees.
f) Requirement for filing tax returns. The Bankruptcy Estate files Form 1041, U.S. Income Tax Return for Estates and Trusts, with the Internal Revenue Service. Form 1040, U.S. Individual Income Tax Return is attached to the Form 1041 as a supplementary schedule. For state and local purposes the appropriate fiduciary tax forms are to be used to report estate activity.

3) Tax computation of the Chapter 7 or 11 Debtor

a) Files individual (or joint) return whether Bankruptcy Estate does or not, depending on circumstances.
b) Cancelation of Debt Income
i) Taxable? Not in bankruptcy. If not taxable, reduction of tax attributes that succeed to the estate.
ii) Attributes that carry over to the Bankruptcy Estate come back to the Debtor at the close of the case, adjusted for impact of the case tax issues, and then are reduced in this order:
(1) Net operating losses under IRC 172;
(2) General business credits (ITC, R&D Credits, etc.);
(3) Minimum tax credits;
(4) Capital Loss Carryovers;
(5) Basis Reduction—limited to the aggregate bases of the property held by the taxpayer immediately after the discharge less the aggregate liabilities of the taxpayer immediately after the discharge. See 1017(b) (2)—this limitation does not apply to depreciable property reduction under 108(b) (5) (described below) the limitation for depreciable property is unlimited. ---Therefore if the taxpayer has limited non depreciable property attributes and wants to protect the taxpayer's depreciable property, don't make the election and although the taxpayer will lose all non depreciable property attributes under 108(b) (2) any excess COD income for the year should never be recognized. *But see* IRC Reg.1.108-7(a) (2). There is also a recapture rule that if basis is reduced under 1017 the recapture will result in ordinary income not capital gain to the extent of the COD. COD is ordinary income;

(6) Passive Activity Loss and Credit Carryovers; and
(7) Foreign Tax Credit Carryovers.

iii) Deducted or deductible expenses – If the debt forgiven would otherwise give rise to a tax deduction if paid, not COD income. Example, business expenses, etc.

4) Chapter 11 Post filing income/cash-flow. Under new rules, post-petition income is or might be property of the Bankruptcy Estate. This provides interesting issues, particularly if the Debtor is a wage earner.

   a) Budgeting - need to provide 13 week cash flows etc. considering post petition income and expenses, including personal living expenses. Budget, cash collateral analysis and agreements must contemplate all statutory issues and cash requirements, including providing for the income tax effect and sales taxes of transactions contemplated during the pendency of the case.
   b) Taxes need to be considered in budgeting. Is the source of income: wages, rent, business, sale of property, etc.?
   c) Monthly Operating Reports should include all Estate cash receipts and disbursements, including personal. Watch what the expenditures are for including, but not necessarily limited to: amount, type (too many cash withdrawals) and nature (embarrassing – private schools, donations, etc.).
   d) Nature of income will significantly complicate issues – wages, personal services, rent.

5) Abandonment of property

   a) Impact on estate. Not a taxable transaction. Some attributes might follow the property.
   b) Impact on debtor. Might be very burdensome to the Debtor depending on the type of property, basis and tax attributes associated with the proposed abandoned property. Really could impact the Debtor's "Fresh Start".
   c) COD income v. Capital Gain Income. Big distinction for the Debtor! The sale of low basis property subject to liens is the norm.

6) Converting to Chapter 7. Not a taxable event, but might be a planning opportunity. Watch timing of income and payment of deductible expenses.

7) Dismissing the case. Impact on discharge? Does it matter? No Bankruptcy Estate for tax purposes. Certain expenses will not be deductible that would have otherwise been deductible such as bankruptcy trustee commission and professional fees. Debtor will be responsible for income tax incurred, if any, related to the source of the funds to pay fees and claims. No 505(b) statutory time reduction or other relief. *BE SURE TO SERVE all applicable taxing authorities and be sure to have a well structured stipulation approved by the Bankruptcy Court.*

8) Chapter 13 Taxes – No separate Estate. Same as if not in bankruptcy.

Who Is Responsible Here?

A survey of federal and New England state law on personal liability for tax withholdings

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I. Introduction

When businesses face cash flow difficulties, the most tempting source of "financing" is often its tax withholdings. As state and federal tax payments are typically not due until quarter end, ever-optimistic business owners are tempted to raid tax withholdings with the expectation that their cash flow will improve before payment to the government is due. When optimism turns into reality, responsible business owners face personal liability for diverted withholdings.

This article examines the extent and existence of personal liability for business owners, employees and officers of companies that fail to satisfy their tax liabilities to the federal government and each of the New England state governments. In the interest of brevity, this article will first examine the applicable federal statute and case law, and highlight the distinguishing characteristics of the relevant statutes and case law in each of the New England states.[1]

II. FICA and Federal Income Tax Withholdings

Pursuant to 26 U.S.C. § 7501 all employee income tax and FICA withholdings are to be held in trust for the benefit of the United States government. Any individual responsible for diversion of such trust funds is personally responsible to the government to the extent such funds are diverted.

> (a) General rule.—Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to…pay over such tax,…shall, in addition to other penalties provided by law, be liable to a penalty equal to the amount of the tax evaded, or not collected, or not accounted for and paid over.

26 U.S.C. § 6672

Therefore, to be personally liable for the repayment of Federal income tax withholdings and FICA, an individual must have both the authority to control corporate expenditures and willfully fail to pay the taxes. *Thomsen v. United States*, 887 F.2d 12, 16 (1st Cir. 1989).

A. Responsible Person

> A responsible person within the meaning of section 6672 includes an officer or employee of a company who is under a duty to collect, account for, or pay over the withheld tax…

Id. at 16 (internal citations omitted).

As stated in *Mazo v. United States,* 591 F.2d 1151, 1155 (5th Cir. 1979), "responsibility is a matter of status, duty and authority, not knowledge." Courts must consider all three in assessing an individual's potential responsibility for the non-payment. The "status" analysis looks at an individual's position within the company, i.e. president, treasurer, manager, CEO, CFO, etc… The "responsibility" analysis looks at the division of responsibilities within

[1] Note that both federal law (26 U.S.C. § 7202) and many states provide for criminal penalties for failing to pay over payroll and other tax withholdings. A discussion of the criminal penalties is beyond the scope of this article, however, criminal prosecutions are extremely rare.

company, for example, who handles accounts payable, who hires and fires employees, who prepares the tax returns and ordinarily makes the tax payments. The "authority" analysis examines who had the power to dictate how funds are spent. "The determination of responsibility is a matter of status, duty, and authority, aimed at the ultimate determination of whether the person had the power to determine whether the taxes should be remitted or paid or had the final word as to what bills should or should not be paid and when." *Vinick v. Commissioner of Internal Revenue*, 110 F. 3d. 168, 171 (1st Cir. 1997)(citations omitted).

When applied to most small and closely held businesses, the three part test prescribed by *Mazo* is simple: the "buck" typically stops with the owner of the company, who oversees all aspects of its day to day operations, and is therefore "responsible" for the payment of the taxes. Where the application of the *Mazo* test becomes challenging is in larger companies where the "duty" to pay taxes falls on a lower-level employee, while the "authority" rests with higher-level officers who are further removed from the day to day operations of the company. The analysis of responsibility is fact intensive, and courts apply the *Mazo* test on a case-by-case basis, and there is no bright-line test as to either the corporate positions that a responsible and those that are not. Likewise, there is no bright-line test as to which corporate duties will give rise to individual responsibility, and which will not.

B. Willfulness

As 26 U.S.C. § 6672 is a civil remedy as opposed to a criminal remedy, willfulness involves "intentional, knowing and voluntary acts. It may also indicate a reckless disregard for obvious or known risk." *Monday v. United States*, 421 F. 2d 1210, 1215 (7th Cir. 1970). Therefore, for an individual's conduct to be deemed willful, he or she need not be shown to have acted intentionally, and with full knowledge of the diversion of the trust funds. Rather, an individual's conduct can be deemed willful as a result of recklessness or even gross negligence. *Thomsen* at 17. The range of fact patterns that have supported a finding of willfulness were surveyed by the United States District Court for the District of Massachusetts in *I.R.S. v. Blais*, 612 F. Supp. 700 (D. Mass. 1985) and include responsible individuals blindly relying on representations that taxes have been paid by individuals they knew to be unreliable, individuals that fail to investigate or correct mismanagement of corporate finances, and individuals who pay other liabilities of the company without first verifying that there are sufficient funds available to pay tax obligations. *Id.* at 710.

Significantly, the burden of proof is on the allegedly responsible individual to prove that his or her actions contributing to the non-payment of the tax obligations were not willful. *E.G. Anderson v. United States,* 571 F. 2d 162, 165 (8th Cir. 1977); *Liddon v. United* States, 448 F. 2d 509, 513-14 (5th Cir. 1971). In light of this burden and the broad range of conduct deemed to be willful by the courts, the standard has been described as tantamount to "strict liability" for any individual deemed "responsible" under the *Mazo* test.

C. Scope of Responsibility

Those deemed responsible under 26 U.S.C. § 6672 are jointly and severally liable for a penalty equal to 100% of the tax outstanding. They are not, however, responsible for any penalty that may have been assessed to the company.[2]

III. CONNECTICUT

Conn. Gen. Stat. § 12-736(a)[3] is remarkably similar to 26 U.S.C. § 6672. It provides:

> (a) Any person required to collect, truthfully account for and pay over the tax imposed under this chapter who willfully fails to collect such tax or truthfully account for and pay over such tax or who willfully attempts in any manner to evade or defeat the tax or the payment thereof, shall, in addition to other penalties provided by law, be liable for a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

There are no cases directly interpreting Conn. Gen. Stat. § 12-736(a). The only case discussing the statute is *State v. Cook,* Conn. Super. LEXIS 2286 (1993). In Cook, the Connecticut Superior Court held that it lacked jurisdiction to hold a corporate president criminally responsible for failing to "pay over" payroll tax withholdings. In reaching such conclusion, the Court examined Conn. Gen. Stat. § 12-736(a), remarked on its similarity to 26 U.S.C. § 6672, and explained that for its purposes, "the term 'person' includes a corporation and any officer or employee of any corporation, including a dissolved corporation, who, as such officer or employee, is under a duty to perform the act in respect of which the violation occurs." *Id.* at * 11. Connecticut courts would likely employ the same test in determining an individual's responsibility for failing to pay over tax withholdings.

On its face, the only distinction between the Connecticut statute and its federal counterpart is found at Conn. Gen. Stat. § 12-736(b), where it provides for a penalty "not to exceed one thousand dollars" for any individual who willfully fails to comply its requirements.

IV. MAINE

In Maine, responsible individuals are defined as "the individual who generally is responsible for the control or management of that person's funds or finances and, if different, the individual who is specifically responsible for the collection and paying over of those trust funds." 36 M.R.S. § 177(2). "Responsibility under [the Maine Statute] is imposed on all with the responsibility and authority to avoid the default, and responsibility is based on the function of the

[2] For this reason, it may be wise for an individual controlling a company to make payment on the trust fund liability out of his or her own funds so as to reduce the liability for the principal tax first, before having the company remit payment on the balance of penalties. Otherwise, the IRS will likely apply payments from the company first to penalties, then interest and finally to the underlying principal liability.

[3] Individuals obligated to pay over a company's sales and use tax withholdings in Connecticut face similar personal liability pursuant to Conn. Gen. Stat. § 12-414a. Again, there is a paucity of case law examining how one's personal responsibility is determined.

employee in the business, and not the level of the office held." *Prescott v. State Tax Assessor,* 721 A.2d 169 (1998).[4]

As such, Maine courts will look to not only the title of the individual in question, but also the individual's function within the company, under a similar rubric to that employed in interpreting 26 U.S.C. § 6672. *Id.* at 179.

Courts have considered several factors in determining whether an individual possessed the requisite control over a company's finances, such as (1) the person's official corporate capacity, i.e., officer or member of board of directors; (2) the derivation of substantial income from the company; (3) ownership of substantial amount of company stock; (4) the authority to sign checks on the company's behalf; (5) actual control over expenditures of company funds; and (6) actual payment of a company's taxes.

Id. at *8.

Once an individual is deemed responsible, there is no requirement under the Maine statute that the failure to pay the taxes be found to have been "willful" as required under 26 U.S.C. § 6672. Therefore, a responsible individual is liable regardless of his or her best intentions, just by the mere fact that the liability is unsatisfied.

Responsible individuals are responsible for all interest and penalties. 36 M.R.S. § 177(1).

V. MASSACHUSETTS

M.G.L. c. 62B, § 5[5] provides, in pertinent part, that

> [e]very employer who fails to withhold or pay to the commissioner any sums required by this chapter to be withheld or paid shall be personally and individually liable therefore to the commonwealth. The term "employer", as used in this paragraph…includes an officer or employee of a corporation, or a member or employee of a partnership or limited liability company, who as such officer, employee or member is under a duty to withhold and pay over taxes in accordance with this section and section 2.[6] Any sum withheld in accordance with section 2 shall be considered to be held in trust for the commonwealth.

[4] *Prescott* is unquestionably the lead case in Maine on the assessment of an individual's personal liability for the payment of a businesses' tax withholdings (including payroll, sales and uses taxes).
[5] M.G.L. c. 64H, § 16 and M.G.L. c. 64h, §2 use the same language to create personal liability for responsible individuals failing to pay over meal and sales taxes.
[6] Section 2 refers to payroll taxes. M.G.L. c. 62B § 5 establishes personal liability for the payment of sales, meals and use taxes in addition to payroll taxes.

Like the federal courts interpreting 26 U.S.C. § 6672, courts interpreting M.G.L. c. 62B, § 5 look to the division of responsibilities within the non-paying company as well as the alleged responsible individual's awareness of the failure to pay. *Adams v. Coveney*, 162 F. 3d 23 (D. Mass. 1998). In fact, Massachusetts courts have looked to cases interpreting 26 U.S.C. § 6672 for guidance in assessing an individual's personal responsibility. *Commissioner v. Brown*, 424 Mass. 42 (1997)(treasurer and minority shareholder that never actually wrote checks or paid bills held not responsible for failure of company to pay over Massachusetts payroll tax withholdings).

Additional guidance from decisions interpreting 26 U.S.C. § 6672 is incorporated directly into 830 CMR § 62C 31.1(2), as noted in *Brown*: "[t]he commissioner's regulations define a 'responsible person' as 'any person who is or was under a duty to pay over taxes imposed on a corporation' by G. L. c. 64H, and defines a 'duty to pay over taxes' as 'an obligation to remit taxes that arises from a person's position, function, or responsibility undertaken on behalf of a corporation.' *Id.* at 43-44.

Responsible individuals are liable to the Commonwealth for any interest accrued on the unpaid tax, however, penalties will not be levied against the individual. M.G.L. c. 62B, § 5[7].

VI. NEW HAMPSHIRE

New Hampshire employers do not have any payroll withholding obligations, and there is no state sales tax, therefore the individual responsibility for a company's failure to pay over New Hampshire taxes arises only in the context of meal and lodging taxes. Pursuant to RSA 78-A:7 and RSA 78-A:20, all taxes due from operators of restaurants or qualifying lodges must be collected from the patron and paid over to the state in a timely manner. "Operators" failing to pay over such taxes in a timely manner are personally liable for the tax and all penalties. An "'Operator means any person operating a hotel, charging for a taxable meal, or receiving gross rental receipts, whether as owner or proprietor or lessee, sublessee, mortgagee, licensee, or otherwise." RSA 78-A:3. [8]

VII. RHODE ISLAND

In Rhode Island, any amount of personal income tax actually deducted and withheld from an employee's wages must be held by the "Employer" in a special trust fund for the benefit of the state tax administrator. R.I. Gen. Laws § 44-30-76 provides that all employers are liable to the state for any funds held in trust. "Employer" is defined so as to include "an officer or employee of a corporation, including a dissolved corporation, or a member or employee of a

[7] If an employer in violation of the provisions of this chapter fails to withhold the tax in accordance with section two, and thereafter the tax against which such tax may be credited, pursuant to section nine, is paid, the tax so required to be withheld shall not be collected from the employer; but this paragraph shall in no case relieve the employer from liability for any penalties or addition to the tax otherwise applicable in respect of such failure to withhold. § 5.

[8] There are no New Hampshire cases interpreting the definition of "operator" under New Hampshire law.

partnership, if the officer, employee, or member **is under a duty to deduct and withhold Rhode Island personal income tax."** *Id.* at (a)(2).[9]

R.I. Gen. Laws § 44-30-76 (c) provides for strict criminal penalties and fines for diverting payroll withholdings:

> Any employer and any officer, agent, servant, or employee of any corporate employer responsible for either the collection or payment of the tax, who appropriates or converts the tax collected to his or her own use or to any use other than the payment of the tax to the extent that the money required to be collected is not available for payment on the due date as prescribed in this chapter, shall upon conviction for each offense be fined not more than one thousand dollars ($1,000), or be imprisoned for not exceeding one year, or by both such fine and imprisonment, the fine and the imprisonment to be in addition to any other penalty provided by this chapter.

There are no cases interpreting R.I. Gen. Laws § 44-30-76.

VIII. VERMONT

Vermont, like Rhode Island imposes a statutory trust over all payroll, sales, use, meal and lodging taxes for the benefit of the state, and if such funds are withheld by an entity, liability to the trust extends "to any officer or agent of the corporation or entity who as an officer or agent of the same is under a duty to withhold the tax and transmit it to the commissioner as required in this chapter." 32 V.S.A. § 5844 (§ 9279 for room and meal taxes, and § 9701(14) for sales and § 9703 for use taxes).

Unlike its federal counterpart, Vermont does not require both a duty to pay the taxes and a willful failure to do so, the failure in and of itself is sufficient to give rise to liability. *Rock v. Department of Taxes,* 170 Vt. 1, 9 (1999). While recognizing that the factors considered in assessing personal responsibility under 26 U.S.C. § 6172 are helpful to analyzing when an officer or agent of a company is properly responsible under 32 V.S.A. §§ 5844 and 9703, the Supreme Court of Vermont views such factors as only relevant to the extent they directly relate to an individual's control over the company's finances. *Id.* at 10. "The language varies slightly with each tax[10], but the practical effect is the same": the statutory duty is imposed personally on the corporate officer who, within the corporate structure, has a duty to collect and remit the

[9] R.I. Gen. Laws § 44-19-35 similarly provides that all sales taxes collected by a retailer are to be held in trust for the benefit of the state, and that such trust is enforceable against "any officer, agent, servant, or employee of any corporate retailer responsible for either the collection or payment, or both, of the tax…," amongst others.

[10] Meaning between the various statutes that impose a trust on income tax withholdings, sales and use taxes, and meal and lodging taxes.

taxes... In other words, an officer's corporate duty becomes a statutory. *Id.* at 5 (internal citations omitted).

Also distinguishing itself from the federal government, Vermont does hold responsible individuals personally liable for all accrued interest and penalties. Moreover, Vermont provides for imprisonment and criminal fines up to $10,000 for responsible individuals that "knowingly fail[] to file a return, fail[] to withhold a tax or fail[] to remit a tax…" 32 V.S.A. § 5844(c)(1).

The Dischargeability of Taxes in Individual Bankruptcy Cases

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INTRODUCTION

These materials highlight factors affecting an individual debtor's ability to discharge taxes in bankruptcy. Where possible, the materials rely on cases decided in the First and Second Circuit, in the last three to five years.

I. OVERVIEW

Determining whether tax debts may be discharged in bankruptcy requires an application of 11 USC § 523(a)(1), which states:

> **(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt--**
> **(1) for a tax or a customs duty--**
> **(A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;**
> **(B) with respect to which a return, or equivalent report or notice, if required--**
> **(i) was not filed or given; or**
> **(ii) 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; or**
> **(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax[.]**

A. Kind of Tax

Section 523(a)(1)(A) provides, in part, that a debtor is not discharged from any debt for a tax that is "of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed." As one court explains, section 507 "provides a structure for the payment of claims and expenses by setting out their priority."[1]

Section 507(a)(3) "refers to unsecured claims allowed under [section] 502(f), which concerns involuntary cases…."[ii] Section 507(a)(8) is an "extensive section dealing with unsecured prepetition tax claims for income taxes, property taxes, trust fund taxes, employment taxes, excise taxes, customs duties, and penalties related to these taxes."[iii]

1. Income Tax Debt

Section 507(a)(8)(A) refers to:

> **[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--**
> **(i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;**
> **(ii) assessed within 240 days before the date of the filing of the petition, exclusive of--**
> **(I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and**
> **(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days; or**
> **(iii) other than a tax of a kind specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case[.]**

Section 507(a)(8) concludes with the following tolling provision:

> **An otherwise applicable time period specified in this paragraph shall be suspended for any 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 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.**

a. Time requirements

A key challenge to assessing the dischargeability of income tax debt involves the time requirements set forth in 507(a)(8)(A)(i) and (ii). These time requirements are often called the "Three-Year Rule" and the "240-Day Test."[iv]

For income tax debt to be dischargeable:

- Under the Three-Year Rule, the tax return must have been due three years or more before the date of the bankruptcy filing.[v]
- Under the 240-Day Test, the IRS or the state taxing authority must have assessed the tax at least 240 days before the bankruptcy filing.[vi]

In *Abir v. United States* (*In re Abir*), the U.S. Bankruptcy Court for the Eastern District of New York was forced to tackle these requirements.[vii] The chronology of events in *Abir* is somewhat tedious, and the reader is cautioned to read the case carefully to appreciate the court's analysis. As an overview, *Abir* establishes that, pursuant to the tolling provision of section 507(a)(8) (quoted previously), the time requirements of 507(a)(8)(A)(i) and (ii) "shall exclude any time during which a stay of collection proceedings was in effect as a result of (a) a prior bankruptcy case filed within such period, or (b) any suspension arising under the Internal Revenue Code as a result of a request by the [d]ebtors for a hearing of any collection action taken or proposed against the debtors, plus 90 days."[viii] In *Abir*, as a result of the tolling provision, as applied to the chronology of events, the debtors were <u>not successful</u> in discharging federal income tax obligations arising from returns due more than three years from the bankruptcy filing and which had been assessed more than 240 days before the bankruptcy filing.[ix]

In *Maali v. United States* (*In re Maali*), the U.S. Bankruptcy Appellate Panel for the First Circuit clarified the assessment process as it relates to the 240-Day Test.[x] Although federal income taxes must normally be assessed within three years of the filing of a return, the IRS may not assess a deficiency before sending the taxpayer a notice of the deficiency.[xi] Once the IRS sends the notice of deficiency, the taxpayer has 90 days to petition the Tax Court for a redetermination of the deficiency.[xii] The IRS may not assess the deficiency until the 90-day

period expires, or, if the taxpayer files a petition with the Tax Court, until the decision of the Tax Court becomes final.[xiii]

To illustrate, in *Maali*, the debtor's federal income tax returns were deemed filed on April 15, 2003, and April 15, 2004. The IRS initially had until April 15, 2006, and April 15, 2007, to assess additional taxes. However, after the IRS sent notices of deficiency in 2005, the debtor challenged the deficiencies in Tax Court. The Tax Court's decision became final on August 2, 2007. The IRS made its assessments on August 6, 2007, and August 20, 2007, which were within 240 days of the date the debtor filed for bankruptcy (October 4, 2007). As a result, the debtor's income taxes were ruled non-dischargeable because they fell within the scope of section 507(a)(8)(A)(ii).[xiv]

b. Tax liens

Even when income tax debts are discharged in bankruptcy, liens arising from the failure to pay the debt are not affected by the discharge.[xv] In a Chapter 7 case, the U.S. Bankruptcy Court for the District of Massachusetts, Eastern Division, held that:

> [A] secured claim is comprised of "two components: the debtor's *in personam* liability on the obligation secured by the lien and the creditor's *in rem* rights to proceed against the collateral." This distinction is relevant in bankruptcy cases because a Chapter 7 "discharge extinguishes only 'the personal liability' of the debtor" and a secured creditor's *in rem* right to pursue the collateral attached to the claim "survives or passes through bankruptcy." "Indeed, the Supreme Court of the United States has expressly stated that '[o]rdinarily, liens and other secured interests survive bankruptcy.'" Accordingly, even if [the debtor's] *in personam* liability for the 1995-1996 Taxes was discharged, the [Massachusetts' Department of Revenue's] ability to enforce the Tax Liens *in rem* was unaffected by [the debtor's] discharge.[xvi]

The court noted, however, that neither the U.S. Supreme Court, nor the U.S. Court of Appeals for the First Circuit, had ruled on whether "a tax lien survives to attach to a debtor's

property that she acquires post-petition."[xvii] Other courts have held that "post-petition property acquired by a Chapter 7 debtor is not subject to a pre-petition tax lien."[xviii]

In *Tracey v. United States* (*In re Tracey*), Chapter 13 debtors argued that the IRS did not have a secured claim in their personal property because the IRS' notice of tax lien was not recorded in accordance with New Hampshire statute (N.H. RSA 454-B:2). The debtors argued that the IRS' claim should be deemed unsecured and dischargeable upon completion of the debtors' Chapter 13 plan. Although the IRS had complied with New Hampshire statute by filing the notice in the town where the debtors lived, the town clerk failed to record the notice in the town's UCC/lien file. Rejecting the debtors' theory, the U.S. Bankruptcy Appellate Panel for the First Circuit ruled that the IRS' act of filing the notice gave rise to a secured claim, pursuant to 26 U.S.C.S. § 6323(a), even if the notice was not recorded by the town clerk.[xix] The court noted that "26 U.S.C. § 6323 unambiguously refers to *filing* as the operative act, and not local statutory duties to file *and record*."[xx]

2. Property Taxes

Section 507(a)(8)(B) refers to:

> **[A] property tax incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition[.]**

There are few cases specifically applying this section. However, in 1997, the U.S. Bankruptcy Court for the District of Massachusetts was called on to determine whether a city tax imposed as a condition of registering an automobile or renewing a driver's license constituted a property tax (for which the debtor would have been discharged), or an excise tax (for which this debtor would not have been discharged).[xxi] The court concluded that the tax fell "within the uniformly adopted definition of what constitutes an excise tax set forth in Black's Law

Dictionary," which defined an excise tax, in part, as "[a] tax imposed on the performance of an act… or the enjoyment of a privilege."[xxii] The tax in this case was an excise tax because it "operate[d] as a tax on the privilege of operating an automobile."[xxiii]

3. Trust Fund Taxes

Section 507(a)(8)(C) refers to:

> **[A] tax required to be collected or withheld and for which the debtor is liable in whatever capacity[.]**

There are few cases recently addressing this section. The U.S. District Court for the District of Massachusetts has noted, however, that the section is "not limited to 'trust fund' taxes so-called," but "addresses itself to any tax which meets its functional definition," including taxes that retailers are required by law to collect from purchasers and turn over to taxing authorities.[xxiv]

4. Employment Taxes

Section 507(a)(8)(D) refers to:

> **[A]n employment tax on a wage, salary, or commission of a kind specified in paragraph (4) of this subsection earned from the debtor before the date of the filing of the petition, whether or not actually paid before such date, for which a return is last due, under applicable law or under any extension, after three years before the date of the filing of the petition[.]**

In 2009, the U.S. Bankruptcy Court for the District of New Hampshire considered the scope of this section.[xxv] Debtor was the president of a corporation that failed to pay unemployment contributions to the State of New Hampshire as required by New Hampshire law (N.H. RSA 282-A:69). Ruling that the contributions were state taxes and that the president had personal liability for the corporation's past-due contributions under New Hampshire law (N.H. RSA 282-A:143), the court went on to consider whether the past-due contributions constituted employment taxes under section 507(a)(8)(D).[xxvi] Focusing on the phrase "earned from the debtor," the court held that although the president was personally liable for the past-due contributions, the contributions arose from wages that were earned by employees of the

corporation, not from employees of the debtor. Accordingly, the past-due contributions were not employment taxes under section 507(a)(8)(D).[xxvii]

5. Excise Taxes

Section 507(a)(8)(E) refers to:

> [**A]n excise tax on--**
> **(i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or**
> **(ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition[.]**

In the same case (discussed immediately above), the Court found that the past-due unemployment contributions also constituted excise taxes under 507(a)(8)(E), relying on Black's Law Dictionary's definition of an excise tax, which includes a "tax imposed on the manufacture, sale, or use of goods… or an occupation or activity…."[xxviii]

6. Customs Duties

Section 507(a)(8)(F) refers to

> **[A] customs duty arising out of the importation of merchandise--**
> **(i) entered for consumption within one year before the date of the filing of the petition;**
> **(ii) covered by an entry liquidated or reliquidated within one year before the date of the filing of the petition; or**
> **(iii) entered for consumption within four years before the date of the filing of the petition but unliquidated on such date, if the Secretary of the Treasury certifies that failure to liquidate such entry was due to an investigation pending on such date into assessment of antidumping or countervailing duties or fraud, or if information needed for the proper appraisement or classification of such merchandise was not available to the appropriate customs officer before such date[.]**

One of the few, meaningful discussions of this section appears in an article published by The American Bankruptcy Law Journal in 1993.[xxix] Ironically, the author noted that there was a "dearth of case law" on this section, which he described as "not easily understood."[xxx] With little guidance from the courts (which remains the case, today), the author suggested that "the

key to the []section is understanding the words "consumption" and "liquidation."[xxxi] "Consumption," he reported, "concerns merchandise brought into the country… for sale or manufacture for sale in open commerce."[xxxii] "Liquidation" is a "term of art" that refers to "the final ascertainment or computation of import classification, duties, and value of goods which the importer declares upon entry into the United States."[xxxiii] "Reliquidation," which also appears in the section, "involves correcting an error in the original liquidation."[xxxiv]

B. Filing of a Return

Section 523(a)(1)(B) excepts from discharge tax debts for which a "return, or equivalent report or notice, if required," was not filed.[xxxv] Before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), the Bankruptcy Code did not define the term "return."[xxxvi] The BAPCPA added a definition of "return" to section 523(a) in an unnumbered paragraph, described by some courts as a "hanging" or a "dangling" paragraph. [xxxvii] The "hanging" or "dangling" paragraph defines a return as:

> **[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 or local law.**

1. IRC Section 6020(a) Returns vs. IRC Section 6020(b) Returns

Helpful discussions about the difference between 6020(a) and 6020(b) returns can be found in fairly recent decisions from the bankruptcy courts in Mississippi.[xxxviii] As a starting point, IRC section 6020(a) provides:

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.**

IRC section 6020(b) provides:

> **Execution of return by Secretary.-**
> **(1) Authority of Secretary to execute return.-If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.**
> **(2) Status of returns.-Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.**

Substitute returns prepared by the IRS under IRC section 6020(a) are based on the taxpayer's cooperation and, when signed by the taxpayer, constitute returns under section 523(a)(1)(B), even if they are untimely filed.[xxxix] By contrast, substitute returns prepared by the IRS under IRC section 6020(b) result from "little or no cooperation from the taxpayer."[xl] The definition of "return" in the "hanging" or "dangling" paragraph makes it "abundantly clear that a substitute return filed by the IRS pursuant to [IRC section] 6020(b) [] is not considered a 'return,' regardless of when it is filed."[xli]

In short, "a late filed [federal] income tax return, unless it was filed pursuant to [IRC section] 6020(a) [], can never qualify as a return for dischargeability purposes because it does not comply with the 'applicable filing requirements' set forth in the Internal Revenue Code."[xlii]

2. IRS Deficiency Assessments

Cases addressing section 523(a)(1)(B) often involve situations in which the debtor fails to file a return or equivalent report or notice to the state taxing authorities, as required by state law,

after the IRS has issued a final determination of deficiency assessment for additional federal income taxes due.

In 2007, the U.S. Bankruptcy Court for the District of Massachusetts ruled that the debtor, against whom the IRS had assessed a substantial deficiency, failed to prove that he filed a return or equivalent report or notice with the Massachusetts Department of Revenue ("MDOR") notifying the MDOR of the change in his tax liability as required by Massachusetts law (M.G.L. c. 62C, § 30).[xliii] The debtor "failed to submit any documents purporting to be a return or equivalent report or notice, let alone a document executed under the penalty of perjury."[xliv] Further, the debtor "failed to produce any document which contained information that would permit the MDOR to calculate the tax due," even though the IRS had provided the MDOR with that information.[xlv]

3. Filing Party

The U.S. Bankruptcy Court for the District of New Hampshire has held that section 523(a)(1)(B) is only concerned with whether returns were filed, not whether the debt originally accrued to the debtor.[xlvi] In that case, the debtor, a president of a corporation, was found to be personally liable for the corporation's past-due unemployment contributions.[xlvii] Although the corporation was obligated to file the quarterly returns, the corporation's failure to do so could be held against the debtor in assessing the dischargeability of the past-contributions.[xlviii]

C. Fraudulent Return or Evasion of the Tax

Section 523(a)(1)(C) excepts from discharge any debt for a tax "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax[.]" To satisfy this exception, the government bears the burden of proof by a preponderance of the evidence.[xlix] Exceptions to discharge are "construed strictly in favor of the debtor."[l]

Section 523(a)(1)(C) has two requirements: conduct and mental state.[li] "To satisfy the conduct requirement, the government must prove 'that the debtor engaged in affirmative acts to avoid payment or collection of the taxes.'"[lii] To satisfy the mental state requirement, the government must prove that the debtor "1) had a duty to pay taxes, 2) knew he had such a duty and 3) voluntarily and intentionally violated that duty."[liii]

Circumstantial evidence of intent includes "1) implausible or inconsistent explanations of behavior, 2) inadequate financial records, 3) transfers of assets that greatly reduce assets subject to IRS execution and 4) transfers made in the face of serious financial difficulties."[liv] Other evidence includes "[s]ignificant dealings in cash and maintaining an extravagant lifestyle…."[lv]

In *United States v. Beninati*, the debtors, husband and wife, failed to file federal income tax returns for the years 1985, 1986, and 1988, and owed the IRS well over $500,000 in federal income taxes. Ruling that the IRS had met its burden of proving that the debtors had willfully attempted to evade their federal income taxes, the U.S. District Court for the District of Massachusetts noted the following conduct by the debtors:

- Conveying their commercial property to their trust for $1.00, suggesting an attempt to conceal assets from the IRS;
- Spending extravagantly on luxury items such as expensive vacations, real estate purchases, and a boat;
- Submitting frivolous offers to compromise to the IRS for $0, $0.01, $1, and $100;
- Writing checks to themselves ranging from $2,000 to $10,000, claiming they preferred to make purchases in cash; and

- Filing federal income tax returns late on ten separate occasions between 1985 and 2005.[lvi]

In *Steinkrauss v. United States* (*In re Steinkrauss*), the debtors, also husband and wife, failed to file income taxes for eight years.[lvii] To refute the IRS' claim that they willfully attempted to evade their tax liability, the debtors advanced inconsistent theories: (1) that their failure to file income tax returns was the result of "mere procrastination," and (2) that they misunderstood the alternative minimum tax and self-employment tax and thought they owed no money. Ruling in favor of the IRS, the U.S. District Court for the District Court of Massachusetts, Eastern District, found that the debtors lacked credibility.[lviii] The court ruled that the debtors, who were "well-educated, intelligent and successful business people," had not attempted to conceal their assets, but did choose to "ignore their tax responsibilities."[lix] Under these circumstances, the IRS had met its burden of proving that the debtors had willfully attempted to evade their tax liability.[lx]

D. Jurisdictional Issues

An exception to discharge for tax debts, unlike other exceptions to discharge under section 523(1), "does not require any affirmative action on the part of the creditor to protect its debt from discharge."[lxi] "[T]he debtor is generally required to bring an action to determine the dischargeability of the debt… [a]nd, in the absence of such an action, the debt cannot be discharged."[lxii] The action may be brought by either the debtor or the creditor, even after the case is closed.[lxiii] In the case of state income taxes, state court has concurrent jurisdiction with the bankruptcy court to determine the dischargeability of tax debts.[lxiv] In a re-opened case, the bankruptcy court, however, may exercise its discretion to stay the state court action.[lxv]

CONCLUSION

As these materials demonstrate, there are many factors that affect an individual debtor's ability to discharge taxes in bankruptcy. These factors include, without limitation: (1) the kind of tax; (2) the age of the tax; (3) the timeliness of required returns; (4) the existence of tax liens; and (5) whether the debtor filed fraudulent returns or attempted to evade tax liability.

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[1] *Schroeder v. Johnson (In re Johnson)*, 2010 Bankr. LEXIS 3697 at *5 (Bankr. D. Neb. Oct. 19, 2010).

[ii] *Id.*

[iii] *Id.*

[iv] Brian Power, Note, *The Courts, Congress and Tax Debts: An Analysis of the Discharge of Tax Debts Before and After the Enactment of the Bankruptcy Abuse and Prevention Act of 2005*, 12 Fordham J. Corp. & Fin. L. 881, 885 (2007).

[v] 11 USC § 507(a)(8)(A)(i). See also, *Abir v. United States* (*In re Abir*), 2010 Bankr. LEXIS 377 at *7 -8 (Bankr. E.D.N.Y. 2010).

[vi] 11 USC § 507(a)(8)(A)(ii). See also, *Abir*, 2010 Bankr. LEXIS 377 at *12.

[vii] *Abir*, 2010 Bankr. LEXIS 377.

[viii] *Id.* at *8, 12.

[ix] *Id.*

[x] 432 B.R. 348 (B.A.P. 1st Cir. 2010).

[xi] *Id.* at 352.

[xii] *Id.*

[xiii] *Id.*

[xiv] *Maali* also held that there is no statutory "hardship" test for determining whether certain tax liabilities are excepted from discharge under section 523(a)(1). *Id.* at 353, citing *Carlin v. United States* (*In re Carlin*), 318 B.R. 556, 566 (Bankr. D. Kan. 2004).

[xv] See *Drake v. Mass. Dep't of Revenue* (*In re Drake*), 434 B.R. 11, 20 (Bankr. D. Mass. 2010).

[xvi] *Id.* (citations and quotations omitted).

[xvii] *Id.* at 23.

[xviii] *Id.*

[xix] *Tracey v. United States* (In re Tracey), 394 B.R. 635, 642 (B.A.P. 1st Cir. 2008).

[xx] *Id.* (emphasis in original).

[xxi] *In re Appugliese*, 210 B.R. 890 (Bankr. D. Mass. 1997).

[xxii] *Id.* at 895, 897.

[xxiii] *Id.* at 897.

[xxiv] *In re St. Hilaire*, 135 B.R. 186, 189 (D. Mass. 1991), aff'd, 1991 U.S. App. LEXIS 33668 (1st. Cir. 1991).
[xxv] *McAdam v. New Hampshire* (*In re McAdam*), 402 B.R. 473 (Bankr. D.N.H. 2009).
[xxvi] *Id.* at 477-8.

[xxvii] *Id.* at 480.

[xxviii] *Id.* at 481-2 9. See also, supra n. 22.

[xxix] Darrell Dunham & Alex Shimkus, *Tax Claims In Bankruptcy*, 67 Am. Bankr. L.J. 343 (1993).

[xxx] *Id.* at 372.

[xxxi] *Id.*

[xxxii] *Id.*

[xxxiii] *Id.*

[xxxiv] *Id.*

[xxxv] 11 USC 523(a)(1)(B)(i).

[xxxvi] *McCoy v. Miss. State Tax Comm'n* (*In re McCoy*), 2009 Bankr. LEXIS 2542 at *19 (Bankr. S.D. Miss. Aug. 31, 2009).

[xxxvii] *Id.* at *20; *In re Creekmore*, 401 B.R. 748, 750 (Bankr. N.D. Miss. 2008).

[xxxviii] *Id.*

[xxxix] *McCoy*, 2009 Bankr. LEXIS 2542 at *21.

[xl] *Id.*

[xli] *Creekmore*, 401 B.R. at 750.

[xlii] *Id.* at 751.

[xliii] *Shorton v. Massachusetts* (*In re Shorton*), 375 B.R. 26, 30 (Bankr. D. Mass. 2007).

[xliv] *Id.* at 32. Here, the court was indirectly referencing the 4-part test established by *United States v. Hindenlang* (*In re Hindenlang*), 164 F.3d 1029 (6th Cir. 1999), which provides that, "[t]o qualify as a return, '(1) [the document] must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law.'" *Shornton,* 375 B.R. at 31, citing *Hindelang*, 164 F.3d at 1033.

[xlv] *Shornton*, 375 B.R. at 32. Note that in March of 2011, the U.S. Court of Appeals for the Fourth Circuit held that the IRS' reporting to the State of Maryland the amount of the taxpayer's increased federal tax liability does not

satisfy the taxpayer's statutory obligation to report the information herself. *Maryland v. Ciotti* (*In re Ciotti*), 2011 U.S. App. LEXIS 4492 at *11 (4th Cir. Md. 2011).

[xlvi] Supra n. 25, at 479.

[xlvii] Supra n. 25, at 477.

[xlviii] Supra n. 25, at 479.

[xlix] *United States v. Beninati*, 438 B.R. 755, 758 (D. Mass. 2010) (citation omitted).

[l] *Id.* at 31.

[li] *Id.* (citations omitted).

[lii] *Id.* (quotation omitted).

[liii] *Id.* (citation omitted).

[liv] *Id.* (citation omitted).

[lv] *Id.*, citing *Hamm v. United States*, 356 B.R. 263, 286 (Bankr. S.D. Fla. 2006) (where debtors spent extravagantly and frequently withdrew large sums of money from their bank accounts in the face of significant tax liabilities); *United States v. Fegeley*, 118 F.3d 979, 984 (3d Cir. 1997) (where debtors made lavish expenditures while simultaneously failing to file tax returns or pay tax liabilities).

[lvi] *Id.* at 758-759.

[lvii] 313 B.R. 87 (Bankr. D. Mass. 2004).

[lviii] *Id.* at 98, 100.

[lix] *Id.* at 98-99.

[lx] *Id.* at 100.

[lxi] *In re Jackson*, 2006 Bankr. LEXIS 1201 (Bankr. D. Mass. June 6, 2006).
[lxii] *Id.* at *4.

[lxiii] *Id.*

[lxiv] *Id.* at *5-6. See also, supra n. 25, at 482.

[lxv] *Mass. Dept. of Revenue v. Crocker* (*In re Crocker*), 362 B.R. 49, 57 (B.A.P. 1st Cir. 2007).