

Committee Educational Session

Bankruptcy Taxation Overview of Significant Tax Issues for Chapter 7 and Chapter 11 Debtors and the Impact of Non-bankruptcy IRS Alternatives

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**TREATMENT OF POSTPETITION INCOME TAX
CLAIMS IN BANKRUPTCY CASES**

by
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This article addresses the ways in which recent changes to Chapter 12 of the Bankruptcy Code (11 U.S.C.) made by the Bankruptcy Abuse Prevention And Consumer Protection Act of 2005 force a close examination of whether postpetition income taxes are allowable as administrative expenses under 11 U.S.C. § 503 and, if so, whether they are paid through plans. These issues are particularly salient in light of a recent split between the Eighth and Ninth Circuit Courts of Appeals that will likely require resolution by either Congress or the Supreme Court.

As background, Chapter 12 of the Bankruptcy Code was recently amended by the Bankruptcy Abuse Prevention And Consumer Protection Act of 2005 (“BAPCPA”), Pub. L. 109-8, §§ 701-20, 119 Stat. 23 (2005). Contents of a Chapter 12 plan are governed by 11 U.S.C. § 1222 which generally requires a plan to “provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507.” *See* 11 U.S.C. § 1222(a)(2). BAPCPA added 11 U.S.C. § 1222(a)(2)(A) which created an exception to this requirement and eliminated the priority status of income tax claims arising from the sale of farm assets.

Under 11 U.S.C. § 1222(a)(2)(A), individual debtors sought confirmation of plans that treated taxes on the postpetition sales of farm assets as general unsecured claims. If Section 1222(a)(2)(A) applies to income tax claims arising from the postpetition sales of farm assets, Chapter 12 now offers a tremendous savings to debtors because it permits such claims to be categorized as general unsecured claims and ultimately discharged. The courts of appeals reached different conclusions as to whether the Bankruptcy Code permits the treatment of postpetition claims in this way. Despite this conflict, courts appear to agree that postpetition claims are normally paid outside of the plan

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pursuant to 11 U.S.C. § 1226(b)(1).

The issue of whether postpetition income tax claims are allowable as administrative expenses under 11 U.S.C. § 503 involves a fundamental issue involving all cases under all chapters of the Bankruptcy Code. Rules in the Internal Revenue Code state whether the bankruptcy estate is a separate taxpayer that incurs an income tax liability. *See* 26 U.S.C. §§ 1398 and 1399. However, the Eighth Circuit and Ninth Circuit recently applied different rules to determine whether a claim constitutes an administrative expense.

This issue--whether postpetition claims are governed by 11 U.S.C. § 1222(a)(2)--arises because the statute applies to “all claims entitled to priority under section 507,” including apparently administrative expenses. This is problematic because this interpretation of the statute conflicts with the overall structure of Chapter 12. Here, again, the courts of appeals have reached different conclusions with respect to the proper scope of Section 1222(a)(2). The issue of whether postpetition claims are governed by Section 1222(a)(2) is of great significance because the effect is the same for all types of postpetition claims, not just postpetition income tax claims, in Chapter 12 and 13 cases. This is because Chapter 12 was modeled after Chapter 13 and contains similar provisions with respect to the contents of plans, payments, effects of confirmation, and discharge. *See Pelofsky v. Wallace*, 102 F.3d 350, 351 n.2 (8th Cir. 1996); *compare* 11 U.S.C. §§ 1222, 1226, 1227, and 1228, *with* 11 U.S.C. §§ 1322, 1326, 1327, and 1328.

I. BAPCPA’S RELIEF FOR FAMILY FARMERS

Section 1222(a) of the Bankruptcy Code provides mandatory requirements for Chapter 12 plans. Section 1222(a)(2) generally demands that Chapter 12 plans fully pay, in deferred cash installments, all “claims entitled to priority under section 507.” *See* 11 U.S.C. § 1222(a). BAPCPA added an exception to this general rule for certain types of income tax claims: a “claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor’s farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority

under section 507.”^{2/} See 11 U.S.C. § 1222(a)(2)(A). In effect, this exception transforms priority claims into general unsecured claims.

Section 507 of the Bankruptcy Code includes postpetition “administrative expenses” allowed under 11 U.S.C. § 503(b), as well as prepetition “unsecured claims” allowed under 11 U.S.C. § 507(a)(8). Since administrative expenses are entitled to priority under Section 507, individual debtors propose plans, based upon Section 1222(a)(2)(A), that treat postpetition income tax claims as prepetition general unsecured claims. In light of the overall structure of the Bankruptcy Code, the Government objected to these plans, arguing that Chapter 12 plans may only provide for and bind holders of prepetition claims and, therefore, the relief provided in Section 1222(a)(2)(A) only applies to prepetition unsecured priority claims. In the alternative, the Government argued that claims for postpetition income taxes are not allowable as administrative expenses.

The Eighth and Ninth Circuits interpreted this issue and split. See *In re Hall*, 376 B.R. 741 (Bankr. D.Ariz. 2007), *rev'd and remanded*, 393 B.R. 857 (D.Ariz. 2008), *rev'd*, 617 F.3d 1161 (9th Cir. 2010), *pet. for certiorari filed*, No. 10-875, 79 USLW 3421 (Dec. 30, 2010); *In re Knudsen*, 356 B.R. 480 (Bankr. N.D.Iowa 2006), *aff'd in part, and rev'd in part and remanded*, 389 B.R. 643 (N.D.Iowa 2008), *aff'd*, 581 F.3d 696 (8th Cir. 2009). Two more appeals involving these issues are pending in the Tenth Circuit (see *In re Daves*, 382 B.R. 509 (Bankr. D.Kan. 2008), *aff'd*, 415 B.R. 815 (D.Kan. 2009), *appeal docketed*, No. 09-3129 (10th Cir.); *In re Ficken*, 430 B.R. 663 (Bankr. D.Colo. 2009), *aff'd*, 430 B.R. 663 (10th Cir. BAP 2010), *appeal docketed*, No. 10-1276 (10th Cir.)), as well as numerous bankruptcy and district courts. Petitioners filed a writ of certiorari with the Supreme Court (*Hall*, No. 10-875) to resolve the conflict between circuits and the Government has not opposed the petition. This article will examine the respective appellate court opinions and the relevant provisions of the Bankruptcy and Internal Revenue Codes.

^{2/} The definition of “farm asset” is widely disputed. Accordingly, it is beyond the scope of this article.

II. INCOME TAX CLAIMS AS ADMINISTRATIVE EXPENSES

A. Bankruptcy Claims Procedure.

If the bankruptcy estate of the debtor incurs a tax, the estate should generally pay the tax in the ordinary course of business. *See* 28 U.S.C. § 960(b); 11 U.S.C. § 363(c). Claims for taxes incurred by the estate are allowable as an administrative expense under 11 U.S.C. § 503(b) if the taxes are not paid. *See* 11 U.S.C. § 503(b). A request for payment is not necessary to allow the claim. *See* 11 U.S.C. § 503(b)(1)(D). Section 503 addresses this issue and provides that, after notice and a hearing, there shall be allowed “administrative expenses, other than claims allowed under [11 U.S.C. § 502(f)].” *See* 11 U.S.C. § 503 (b).

Section 503(b) enumerates certain types of claims that are allowable as administrative expenses. Administrative expenses include income taxes “incurred by the estate, ..., except a tax of a kind specified in [11 U.S.C. § 507(a)(8)].” *See* 11 U.S.C. § 503(b)(1)(B)(i). Administrative expenses may also include taxes that are not “incurred by the estate” because administrative expenses include the “actual, necessary costs and expenses of preserving the estate.” *See* 11 U.S.C. § 503(b)(1)(A); 11 U.S.C. § 102(3) (“includes” is defined to mean not limiting). As such, income taxes attributable to property of the estate, or reimbursements to the debtor for the same, may be an administrative expense irrespective of whether the tax is technically “incurred by the estate” under the Internal Revenue Code.^{3/}

Administrative expenses include “any fine, penalty, or reduction in credit relating to a tax of a kind specified in [11 U.S.C. § 503(b)(1)(B)].” *See* 11 U.S.C. § 503(b)(1)(C). Additionally, all other postpetition penalties incurred by the estate are entitled to priority as administrative expenses. *See In re N.P. Mining Co.*, 963 F.2d 1449, 1455 (11th Cir. 1992); *In re Flo-Lizer, Inc.*, 916 F.2d 363, 365 (6th Cir. 1990). Interest on postpetition taxes and penalties is also entitled to priority as an administrative expense. *In re Flo-Lizer*, 916 F.2d at 365-66.

^{3/} Capital gains are normally taxed to the entity that own or controls the property sold, and that income cannot be assigned to another entity. *See Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943); *Helwing v. Horst*, 311 U.S. 112, 116-17 (1940); *Howell Turpentine Co. v. Commissioner*, 162 F.2d 319, 322-24 (5th Cir. 1947).

B. The Bankruptcy Estate's Liability For Income Taxes.

The analysis of whether a federal income tax is incurred by the estate varies depending on both (a) the chapter of the Bankruptcy Code under which relief is granted and (b) the nature of the debtor. Commencing a bankruptcy case does not generally create a separate taxable entity for the estate (*see* 26 U.S.C. § 1399), except when an individual debtor files under Chapter 7 or Chapter 11 of the Bankruptcy Code (*see* 26 U.S.C. § 1398).^{4/} Because no separate taxable estate exists for an individual Chapter 12 or 13 debtor, the bankruptcy estate does not incur any income tax liability under the Internal Revenue Code.^{5/}

The Bankruptcy Code requires state income tax claims to be treated similarly to federal income tax claims. When 26 U.S.C. § 1398 creates a separate taxable estate for the bankruptcy estate and imposes a

^{4/} The legislative history of 26 U.S.C. §§ 1398 and 1399 indicates that in 1980 Congress intended these statutes to govern the allocation of income between a bankruptcy estate and the debtor:

“AT PRESENT, THERE ARE NO RULES IN THE INTERNAL REVENUE CODE SPECIFYING WHETHER THE BANKRUPTCY ESTATE CONSTITUTES A TAXABLE ENTITY APART FROM THE INDIVIDUAL DEBTOR; AND, IF SO, HOW TAX ATTRIBUTES ARE TO BE ALLOCATED BETWEEN THE ESTATE AND THE DEBTOR. THIS HAS RESULTED IN UNCERTAINTY AND LITIGATION CONCERNING THE FEDERAL INCOME TAX LIABILITY OF THE BANKRUPTCY ESTATE AND THE DEBTOR. THE PROVISIONS OF SECTION 3 OF THE BILL, ADDING NEW SECTIONS 1398 AND 1399 TO THE INTERNAL REVENUE CODE, PROVIDE THE FIRST COMPREHENSIVE STATUTORY TREATMENT OF THESE ISSUES.”

S. Rep. No. 96-1035, 96th Cong., 2nd Sess., at 24 (1980). *See also* Individual Chapter 11 Debtors, Notice 2006-83, 2006-40 I.R.B. 596, 2006-2 C.B. 596, 2006 WL 2663467.

^{5/} Although no separate taxable estate exists for a corporate debtor either, the estate incurs the tax nevertheless because the trustee of the estate must file the debtor's federal income tax returns and pay the tax. *See* 26 U.S.C. §§ 6012(b)(3) and 6151(a); *Holywell Corp. v. Smith*, 503 U.S. 47, 52 (1992). Partnerships are required to file information returns under the Internal Revenue Code, but they are not subject to federal income taxes; the income flows through to the partners. *See* 26 U.S.C. §§ 701 and 6031; *Central Valley AG Enterprises v. United States*, 531 F.3d 750, 755 (9th Cir. 2008).

federal income tax on the estate, a separate taxable estate is also created for purposes of any state and local law imposing a tax on or measured by income. *See* 11 U.S.C. § 346(a). Accordingly, any income is taxed to the estate instead of the debtor. *See* 11 U.S.C. § 346(a). Conversely, when Section 1398 does not create a separate taxable estate for the bankruptcy estate and instead imposes the federal income tax on the debtor only, such income is taxed to the debtor under a state or local law imposing a tax on or measured by income and may not be taxed to or claimed by the estate. *See* 11 U.S.C. § 346(b).^{6/} Indeed, BAPCPA amended Section 346 to ensure that federal and state income taxes were treated the same in bankruptcy cases. *See* H.R. Rep. No. 109-31, 109th Cong., 1st Sess., pt. 1, at 105.^{7/} Because Section 346 relies on the Internal Revenue Code to properly divide state and local tax liabilities between the estate and the debtor, the treatment of federal tax liabilities indicates that individual income taxes may not be appropriately taxed to a Chapter 12 or 13 estate.

C. Courts Of Appeals Disagree When The Bankruptcy Estate Is Liable For Income Taxes.

The Ninth Circuit recognized in *Hall* that there is no provision in Chapter 12 of the Bankruptcy Code “stating that a bankruptcy estate has

^{6/} The Bankruptcy Code also requires the trustee of the estate of a corporate debtor to file the debtor’s state income tax returns and pay the tax. *See* 11 U.S.C. § 346(b).

^{7/} Congress amended § 346 in 2005. *See* BAPCPA, Pub. L. 109-8, § 719(a)(1), 119 Stat. at 131-21. Section 346(b) now provides, with respect to state and local income taxes:

“Whenever the Internal Revenue Code of 1986 provides that no separate taxable estate shall be created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of an estate shall be taxed to or claimed by the debtor, such income, gain, loss, deductions, and credits shall be taxed to or claimed by the debtor under a State or local law imposing a tax on or measured by income and may not be taxed to or claimed by the estate.”

The legislative history indicates that this provision “conforms state and local tax administration to the Internal Revenue Code in the following areas: division of tax liabilities and responsibilities between the estate and the debtor ...” H.R. Rep. No. 109-31, 109th Cong., 1st Sess., pt. 1 (no pt. 2 issued), at 105.

the inherent ability to incur taxes.” *See Hall*, 617 F.3d at 1165. Since the Bankruptcy Code itself provides no definitive answer, the court consulted the Internal Revenue Code “because Congress has indicated repeatedly that it is aware of the taxable entity provisions in the Internal Revenue Code are relevant to the Bankruptcy Code.” *See Hall*, 617 F.3d at 1166. The court concluded that Sections 1398 and 1399 of the Internal Revenue Code provide that a Chapter 12 bankruptcy case of an individual debtor does not result in a separate taxable entity, which suggests that the estate cannot be taxed. The court explained:

“Since the chapter 12 estate is not a taxable entity, the chapter 12 estate cannot ‘incur’ a tax. We agree with those courts that have reached the same conclusion for the same reason with respect to chapter 13 estates, which are treated identically to chapter 12 estates by [26 U.S.C. §§ 1398 and 1399].”

Hall, 617 F.3d at 1163.

The Eighth Circuit reached the opposite result in *Knudsen*. The Eighth Circuit concluded that the estate incurs all postpetition tax liabilities under 11 U.S.C. § 503(b)(1)(B)(i). *See Knudsen*, 581 F.3d at 708-09. The court interpreted “incurred by the estate” in Section 503(b)(1)(B)(i) to mean “incurred postpetition.” *See Knudsen*, 581 F.3d at 708. The court then noted that “it is the IRC, *not the Bankruptcy Code*, that creates a ‘separate taxable entity’ upon the filing of petitions by individuals under Chapter 12 and 13.” *See Knudsen*, 581 F.3d at 709. The court determined that an estate exists in a Chapter 12 case until the case is closed, dismissed, or converted pursuant to 11 U.S.C. § 1207, although it is not a separate taxable entity (*see Knudsen*, 581 F.3d at 709), and that the postpetition sale of farm assets “certainly falls within the ambit of § 1207(a).” *See Knudsen*, 581 F.3d at 710. The court added:

“Finally, we also note that the majority of courts to have considered this precise issue have also reached the same result, rejecting the government’s argument that postpetition income taxes cannot be ‘incurred by the estate’ because a bankruptcy filing under Chapter 12 does not create a separate taxable entity under 26 U.S.C. § 1399 of the IRC.”

Knudsen, 581 F.3d at 710.

A real conflict exists between the circuits as to whether 26 U.S.C. §§ 1398 and 1399 determine if postpetition income taxes are allowable as administrative expenses under 11 U.S.C. § 503. There appears to be at least three possible rules to justify allowing such claims: (a) whether the estate is a separate taxable entity and incurs the tax under the Internal Revenue Code (*see Hall*); (b) whether the estate exists under 11 U.S.C. § 1207, regardless of whether the estate is a separate taxable entity under the Internal Revenue Code and regardless of whether the income is generated from property of the estate (*see Knudsen*); and (c) whether the income is generated from property of the estate (*see* 11 U.S.C. §§ 503(b)(1)(A) and/or (B)). The Supreme Court is highly likely to resolve this recurring question because the courts of appeals are sharply divided.

III. TREATMENT OF POSTPETITION CLAIMS

A. Contents Of Chapter 12 Plans.

Prior to BAPCPA’s enactment, 11 U.S.C. § 1222(a)(2) required debtors to submit a plan that provided for the full payment, in deferred cash installments, of all “claims entitled to priority under section 507.” Although the plan had to pay the full amount of the allowed claim, the estate did not need to pay interest on the deferred payments under this rule. *See* 11 U.S.C. § 502(b)(2); *In re Cousins*, 209 F.3d 38, 41 (1st Cir. 2000). BAPCPA carved out a new exception from the full-payment rule for claims owed to a governmental unit that arose from a sale or other disposition of any farm asset used in the debtor’s farming operation. After BAPCPA, Section 1222(a) provides in relevant part as follows:

- “(a) The plan shall—
- ...
- (2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507, unless –
- (A) the claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor’s farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge;”

11 U.S.C. § 1222(a). Under this provision, therefore, governmental claims that otherwise qualify for priority status under 11 U.S.C. § 507 are treated as general unsecured claims for purposes of their treatment under a plan if the government's claim stems from the sale of any farm asset used in the debtor's farming operation.

Individual debtors frequently propose plans that treat income tax claims arising from the postpetition sale of farm assets as administrative expenses under 11 U.S.C. § 503 and, pursuant to 11 U.S.C. § 1222(a)(2)(A), provide for the claim as a general unsecured claim that is discharged under 11 U.S.C. § 1228. The debtors maintain that, even if Chapter 12 plans generally do not encompass administrative expenses, BAPCPA extended the reach of Section 1222 to cover these types of postpetition tax claims.

The Government has objected to Chapter 12 plans that provide for postpetition tax claims under Section 1222(a)(2)(A) based upon the structure of the Bankruptcy Code. At its core, the objection is based on the fact that Chapter 12 plans only bind prepetition "creditors" (*see* 11 U.S.C. §§ 101(10) and 1227(a)), and not holders of postpetition claims. Although 11 U.S.C. § 106 waives sovereign immunity to the extent provided in Section 1227, that waiver does not extend to Section 1222. *See* 11 U.S.C. § 106(a)(1). The Government maintains that 11 U.S.C. § 1226(b) provides for the payment of postpetition claims outside of the plan. *See* 11 U.S.C. § 1226(b); *see also* 11 U.S.C. § 363(c). Each of the sections related to this structural argument will be examined below.

B. The Structural Argument.

Chapter 12 is structured to require plans to provide for the payment of prepetition creditors' claims. Section 1222(a)(2) of the Bankruptcy Code provides for the full payment, under a plan, of "claims entitled to priority under [11 U.S.C. § 507]." Section 507(a), in turn, accords priority status to both "expenses and claims." *See* 11 U.S.C. § 507(a) ("The following expenses and claims have priority in the following order:"). The term "expenses" in Section 507(a) refers to "administrative expenses allowed under section 503(b) of this title." *See* 11 U.S.C. § 507(a)(2). The other nine priority items listed in Section 507(a) are all described as "claims." *See* 11 U.S.C. § 507(a)(1), (3)-(10). Since Section 507(a) deals with "expenses and claims," but Section 1222(a)(2) refers only to "claims" entitled to priority under

Section 507, the plain language of Section 1222(a)(2) supports the notion that plans do not cover “expenses” entitled to priority under Section 507(a)(2).^{8/} See *In re Ames Dept. Stores, Inc.*, 582 F.3d 422, 428-29 (2d Cir. 2009) (Bankruptcy Code distinguishes between “claims” and “expenses”).

The position that Section 1222(a)(2) includes prepetition priority claims, but not postpetition administrative expenses, makes sense because those claims and expenses are not treated alike under the Bankruptcy Code. Administrative expenses enjoy a higher priority under 11 U.S.C. § 507. In addition, unlike prepetition unsecured priority claims, administrative expenses include postpetition penalties and interest. Compare 11 U.S.C. § 503 with 11 U.S.C. § 502(b)(2); see *United States v. Noland*, 517 U.S. 535, 541 (1996); *In re Cousins*, 209 F.3d at 40-41. If administrative expenses were includible in Section 1222(a)(2), payments could be deferred without interest or penalties, contrary to 11 U.S.C. § 503 and the mandate of 28 U.S.C. § 960(a). No one would conduct business with a debtor after the commencement of a case if postpetition claims would be impaired. See *In re Ybarra*, 424 F.3d 1018, 1026 (9th Cir. 2005) (“The purpose of administrative priority status is to encourage third parties to contract with the bankruptcy estate for the benefit of the estate as a whole.”); cf. 11 U.S.C. § 1129(a)(9)(A) (requiring full payment of allowed administrative expenses on the effective date of the plan).

The cornerstone of the structural argument is 11 U.S.C. § 1227(a). This section states: “Except as provided in [11 U.S.C. § 1228(a)], the provisions of a confirmed plan bind the debtor, each creditor, each equity security holder, and each general partner in the debtor,” Holders of postpetition claims are not “creditors,” as defined by the Bankruptcy Code. Section 101(10) of the Bankruptcy Code defines a “creditor” as an “entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;” As a result, a “creditor” is defined as a holder of a prepetition claim. See 11 U.S.C. § 101(10). Therefore, it would appear that holders of postpetition claims are not bound by Chapter 12 plans. Cf. *Holymwell*, 503 U.S. at 58-59

^{8/} Chapter 13 has an identical provision dealing with the contents of plans. See 11 U.S.C. § 1322(a)(2). There is no similar problem for Chapter 11 cases because 11 U.S.C. § 1129(a)(9) separately addresses each priority claim and clearly does not impair administrative expenses.

(“Even if § 1141(a) binds creditors of the corporate and individual debtors with respect to claims that arose before confirmation, we do not see how it can bind the United States or any other creditor with respect to post-confirmation claims.”)^{2/}

If plans provide for the payment of administrative expenses, unsecured priority claims would receive more favorable treatment than administrative expenses. Section 1228(a) generally discharges debts “provided for” by a Chapter 12 plan, except debts “of a kind specified in [11 U.S.C. § 523(a)].” Debts specified in Section 523(a) are of a prepetition kind and include unsecured priority claims. Section 1228(a) also discharges debts “allowed under section 503 of this title.” *See* 11 U.S.C. § 1228(a); *cf.* 11 U.S.C. § 1141(d)(2) (discharging the “debtor” from pre-confirmation debts, with exceptions); 11 U.S.C. § 1328 (no similar language). If administrative expenses could be satisfied under 11 U.S.C. § 1222(a)(2) without the payment of postpetition penalties and interest, it would produce a strange result: prepetition unsecured priority claims would be nondischargeable, but postpetition administrative expenses would be discharged. *See* 11 U.S.C. § 1228(a)(2). This would result from that fact that administrative expenses do not fall within the exception from discharge provided in 11 U.S.C. § 1228(a)(2). It is very likely that Section 1228(a) provides for the discharge of allowed administrative expenses because it assumes that the expenses will be fully paid with all penalties and interest, as required by 11 U.S.C. § 1226(b), as discussed below.

Section 1226(b) of the Bankruptcy Code does provide for the payment of postpetition claims outside of a plan. That section states that, “[b]efore or at the time of each payment to creditors under the plan, there shall be paid ... (1) any unpaid claim of the kind specified in [11 U.S.C. § 507(a)(2)];” Section 1226(b) requires all postpetition claims to be paid in full or all payments to creditors under the plan must cease. Section 507(a)(2) deals with administrative expenses allowable under 11 U.S.C. § 503(b). Elsewhere in the same statute, Congress uses

^{2/} Chapter 13 contains essentially an identical provision regarding the binding effect of plans. *See* 11 U.S.C. § 1327(a). For cases under Chapter 11, 11 U.S.C. § 1141 provides that the “provisions of a confirmed plan bind the debtor, ..., any entity acquiring property under the plan, and any creditor,” *See* 11 U.S.C. § 1141(a). As the Supreme Court confirmed in *Hobynwell*, Chapter 11 plans bind prepetition creditors only.

the phrase “any unpaid claim allowed under section 503(b).” 11 U.S.C. § 1226(a)(1). Thus, the “of the kind” language contained in Section 1226(b) appears to mean something more than claims allowed under Section 503(b).

Section 503(b)(1)(B)(i) of the Bankruptcy Code uses similar “of a kind” language to carve out from the definition of “administrative expenses” claims for taxes “of a kind specified in [11 U.S.C. § 507(a)(8)].” It creates a dichotomy between prepetition and postpetition claims using the “of a kind” language. Section 1226(b)(1), therefore, may be using the same type of language to create a similar dichotomy. A claim may be “of the kind” specified in Section 503(b), as the phrase is used in Section 1226(b)(1), if it is simply of a postpetition kind, *i.e.*, it does not have to be allowable under Section 503(b).

C. Courts Of Appeals Have Either Accepted Or Side-Stepped The Structural Argument.

The Ninth Circuit in *Hall* and the Eighth Circuit in *Knudsen* have reached opposite conclusions on whether 11 U.S.C. § 1222(a)(2)(A) applies to postpetition administrative expenses. The issue is of great importance to the administration of the Bankruptcy Code because it affects all creditors and debtors.

In *Hall*, the Ninth Circuit agreed with the structural argument and ruled that 11 U.S.C. § 1222 does not govern the payment of postpetition claims. The court stated:

“the tax is payable in full because it is incurred and owed by the debtor outside of the plan, as discussed in the text accompanying this footnote. It is of no matter that the debtors attempted to include the tax in their plan, because the Bankruptcy Code places limits on the liabilities a plan may address. Chapter 12 plans bind ‘each creditor,’ 11 U.S.C. § 1227, and a ‘creditor’ is defined, in relevant part, as ‘an entity that has a claim against the debtor that *arose at the time of or before the order for relief* concerning the debtor.’ 11 U.S.C. § 101(10)(A) (emphasis added).”

Hall, 617 F.3d at 1164.

In *Knudsen*, the Eighth Circuit reached the opposite result. As to

the argument that Chapter 12, read as a whole, required that Section 1222(a)(2)(A) to be interpreted as applying only to prepetition priority claims, the court held:

“nothing in the provision restricts its application to only those dispositions that occur *before* the debtor files his bankruptcy petition, nor does § 1222(a)(2)(A) apply to merely ‘creditors’ of the debtor, as it specifically refers to claims ‘owed to a governmental unit.’”

Knudsen, 581 F.3d at 706. Nevertheless, the court appeared to agree that postpetition claims are normally paid outside of the plan pursuant to Section 1226(b). The Eighth Circuit concluded that the “IRS’s reliance on [11 U.S.C. §§ 1226 and 1227] does not overcome the straightforward and specific language of § 1222(a)(2)(A)” and that Section 1222(a)(2)(A) was, in effect, an exception to the normal rule provided by Section 1226(b). *See Knudsen*, 581 F.3d at 706-08. The court also found that the Government implicitly waived its sovereign immunity as to Section 1222 because the obligations at issue are necessarily administrative expenses under 11 U.S.C. § 503 and the Government had waived sovereign immunity under 11 U.S.C. § 106 with respect to this section. *See Knudsen*, 581 F.3d at 708.

Both the Eighth and Ninth Circuits appeared to agree that Chapter 12 plans do not generally apply to postpetition claims. The courts differed, however, on whether 11 U.S.C. § 1222(a)(2) provides an exception to that rule. Although it is conceivable that, in the course of eliminating the priority for income tax claim arising from the sale of farm assets, Congress also meant to treat postpetition priority claims the same as prepetition priority claims, thereby binding holders of both types of claims as creditors under 11 U.S.C. § 1227. But the structure of Chapter 12 and the legislative history of BAPCPA does not support that interpretation. The courts are bending the statute to afford relief to farmers that is not provided in Section 1222(a)(2) itself. Since a conflict between the circuits exists on this fundamental issue, the dispute will linger until Congress clarifies the law or the Supreme Court steps into the dispute.

IV. CONCLUSION

The courts of appeals reached different conclusions with respect to the scope of 11 U.S.C. § 1222(a)(2)(A). More importantly, this dispute raised the fundamental question of when tax claims are allowable as administrative expenses under 11 U.S.C. § 503. This issue applies to all cases under all chapters of the Bankruptcy Code. The Internal Revenue Code alone may determine whether the bankruptcy estate incurred taxes for purposes of Section 503(b). Despite these conflicts, the courts appear to agree that postpetition claims are normally paid outside of the plan pursuant to 11 U.S.C. § 1226(b). Since Chapter 13 contains a similar provision (*see* 11 U.S.C. § 1326(b)), postpetition claims should also be paid outside of Chapter 13 plans.

Creditors should follow this dispute to gain a deeper understanding of how courts may adjudicate their claims in the context of bankruptcy. In the interim before Congress or the Supreme Court intervenes, creditors should carefully review all proposed plans and use 11 U.S.C. § 1226(b)(1) and its counterpart in Chapter 13 as tools to object to plans that provide for postpetition claims. Debtors should, of course, seek to apply Section 1222(a)(2)(A) whenever possible because of the tremendous tax savings.

DISCHARGEABILITY OF TAXES, TAX LIENS AND
THE IMPACT OF NON-BANKRUPTCY IRS ALTERNATIVES

by

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When a taxpayer contemplates filing for bankruptcy protection, the main goal is to resolve the tax issues. Whether or not this can be accomplished in the context of bankruptcy depends on several key issues. First, a determination must be made as to whether the taxes themselves meet the time periods set forth in the dischargeability rules in the bankruptcy code, as well as the other statutory preclusions to dischargeability. Then, a determination must be made as to whether the taxes may be non-dischargeable because the taxpayer has “evaded payment.” And, finally, the effect of any tax liens must be taken into consideration. This article will: outline the pre-requisites for dischargeability of taxes in bankruptcy; provide current caselaw with respect to the “evasion to pay” exception to discharge; review the effects of both the “secret tax lien” and the recorded federal tax lien on pre- and post-bankruptcy assets; provide some insight into recent state and local tax collection efforts in bankruptcy cases; and finally, give an overview of non-bankruptcy IRS alternative resolutions for tax liabilities. For each section, recent caselaw will be provided, if applicable.

I. DISCHARGING TAXES IN BANKRUPTCY

A. TIME PERIODS FOR DISCHARGE OF TAXES.

The “time-period” pre-requisites to dischargeability of taxes in bankruptcy are: the “3-year rule” that requires the tax return must be DUE (with extensions) more than 3 years before the bankruptcy, §507(a)(8)(A)(i); the “240 day rule” that requires the tax be ASSESSED at least 240 days before the bankruptcy, (the 240 days is extended anytime an offer in compromise is in effect during the 240 days, plus 30 days, and any time the IRS was precluded from collection during the 240 days, plus 90 days), §507(a)(8)(A)(ii); and, the “2-year rule” that requires late-filed return to be filed at least 2 years before bankruptcy, §523(a)(1)(B)(ii). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BACPA”), Publ. L. 109-8, 119 Stat. 23, §§701-20(2005) added a hanging paragraph in §507(a)(8) which extended all of the periods in §507(a)(8) anytime the IRS is precluded from collection as a result of the debtor requesting a hearing and an appeal of collection action, plus 90 days, and during any time the automatic stay was in effect during a prior bankruptcy plus 90 days, and during any time collection was precluded because of a confirmed plan, plus 90 days. §507(a)(8) hanging paragraph. Practitioners must be vigilant in analyzing each of the tax years to ensure that none of these periods have been extended due to the taxpayer exercising his due process rights prior to filing bankruptcy. These IRS procedures will be discussed in depth in Section IV herein.

B. OTHER PRE-REQUISITES FOR DISCHARGE OF TAXES.

In addition to meeting the time requirements, there are additional bars to discharging

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taxes which preclude discharge of: UNASSESSED taxes, §507(a)(8)(A)(iii); trust fund taxes, §507(a)(8)(C); taxes due from UNFILED returns, §523(a)(1)(B)(i)¹; and tax due to fraudulent returns, or unpaid as a result of evasion to pay, §523(a)(1)(C), as well as others that are not part of this discussion.

1. UNFILED RETURNS AND DISCHARGE OF TAXES.

The lack of any definition for “return” in either the Bankruptcy Code or the Internal Revenue Code has spawned a long debate as to whether a taxpayer, for whom the IRS has prepared a return under I.R.C. § 6020(b), can later file a return and have the taxes be discharged in bankruptcy, fulfilling the requirements of 11 U.S.C. § 523(a)(1)(B)(i). Some courts have found that returns filed by the debtor after an assessment by the IRS pursuant to I.R.C. 6020(b) are returns for purposes of dischargeability.² Other courts have found that returns filed by the taxpayer after the IRS has assessed the tax are not returns for purposes of dischargeability, because they serve no tax purpose.³ Yet other courts have used the failure to timely file returns as a basis to find the taxes to be non-dischargeable under the evasion provision.⁴

In trying to determine just what piece(s) of paper could be considered to be a return, there were other cases that decided whether an IRS Form 870 was a return,⁵ and whether various forms prepared in the course of an IRS examination constituted a return.⁶ In addition, courts struggled with whether a Tax Court stipulation was a return.⁷

In 2005, the Bankruptcy Code was amended to include a “hanging” paragraph after § 523(a)(19) which states,

“...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 § 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 § 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.”

This added language was probably meant to eliminate some of the questions that are apparent from the historical debate over late-filed returns. Congress did not eliminate the late filed return provision requiring at least 2 years to pass prior to the bankruptcy for the tax to be discharged.⁸ The language still does not eliminate the debate over whether a return filed by the taxpayer after a § 6020(b) assessment can be a return for purposes of dischargeability.

Notwithstanding the purpose of the amendment, Judge Easterbrook in his dissent in *In re Payne*, stated that the parenthetical, “(including applicable filing requirements)”, precludes discharge of any late-filed return, whether the assessment is due to the taxpayer’s return, or a § 6020(b) return.⁹ Subsequently, the IRS and the State of Mississippi have used Easterbrook’s *dicta* in the dissent, to convince at least three courts that the tax should be nondischargeable just because the return is late, thus, ignoring the 2-year provision of the Bankruptcy Code. In the first case, *Creekmore v. IRS*,¹⁰ the IRS filed § 6020(b) returns, after which the taxpayer filed late returns and the IRS reduced the tax liability based on the taxpayer’s submissions. The Court, citing Easterbrook’s dissent, held that under the new bankruptcy law, no late return can be discharged unless it is a § 6020(a) return. The court could have relied on the § 6020(b) language in the bankruptcy code, and followed the *Hindenlang* line of cases cited previously with respect to returns filed after an IRS assessment under § 6020(b), rather than limiting the dischargeability of all late returns to § 6020(a). So, for perhaps the wrong reasons, the decision can be

reconciled with the Code and caselaw.

There are two cases that take Easterbrook to heart and declare that any late return is nondischargeable. Both of these cases involved late returns filed by the taxpayer, with no prior assessments by the taxing authority.¹¹ Thus, there was no question whether they were returns for purposes of meeting the definition in the hanging paragraph. Specifically, the government argued that the timely filing of a return was required as part of the “applicable filing requirements” language. The *Links* court decided on summary judgement against a pro se taxpayer, that the 2005 amendment to the Bankruptcy Code overruled *Hindenlang*’s four part test for late returns. The court went on to say that the only late returns that could be discharged are those under the “safe harbor” of § 6020(a).¹² It appears as if the court believed that a taxpayer can voluntarily file a § 6020(a) return, without the IRS taking any action. Unfortunately, there is no such mechanism for a taxpayer.¹³

In September of 2010, the IRS issued Chief Counsel Notice CC-2010-016. This Notice recanted the IRS position in *Creekmore* and *Links*. So, where are we with respect to late-filed returns? As long as the IRS does not backtrack on the position stated in this Notice, we still have a 2 year rule as far as late filed returns; if the debtor files no return and tax is assessed pursuant to I.R.C. § 6020(b) (or other nonbankruptcy law), the tax is not discharged; if the IRS assesses the tax under § 6020(b) and the taxpayer files a subsequent return, the courts should look to the *Colsen* and *Hindenlang* lines of cases and tests to determine dischargeability; and, if the taxpayer is lucky enough to have a § 6020(a) assessment, or if the taxpayer waits and goes to Tax Court or even a federal district court and a judgment or stipulation is entered delineating the tax, even if no return is ever filed, the tax is dischargeable with respect to a “return”.¹⁴ One recent anomalous case found that because the IRS stipulated that they had “prepared substitute returns”, they were returns for purposes of dischargeability.¹⁵

2.. TRUST FUND TAXES ARE NOT DISCHARGED.

Trust fund taxes are those taxes which were withheld but not turned over to the IRS, or other taxing authority. Such taxes are not discharged in bankruptcy. Bankruptcy courts may abstain from making a determination as to the trust fund, non-dischargeable tax in a “no-asset” Chapter 7 case.¹⁶ The Service has taken the position that a single member LLC (for liabilities of the LLC prior to January 1, 2008) is a disregarded entity. Therefore all of the liabilities of the LLC can be pursued against the individual owner. For liabilities arising after January 1, 2008, the Service has decided to collect only the trust fund portion from the single member of the LLC. In the context of a bankruptcy proceeding, the proof of claim for the IRS would still be subject to the time period rules, and only the trust fund portion would be priority taxes, and thus non-dischargeable under §507(a)(8), even in the context of a single member LLC.

II. THE “EVASION TO PAY” EXCEPTION TO DISCHARGE

Section 523(a)(1)(C) excepts from discharge any debt “with respect to which the debtor....willfully attempted in any manner to evade or defeat such tax.” The government has the burden of proof, and must establish both a conduct requirement and a mental state requirement.¹⁷ To satisfy the conduct requirement, the government must prove that the debtor engaged in affirmative acts to avoid payment or collection of taxes, either through commission or omission.¹⁸ While non-payment of taxes alone is not sufficient, such acts or omissions can include failure to timely file returns,¹⁹ concealment of income or assets,²⁰ fraudulent transfers,²¹ and/or unnecessary expenditures.²²

This issue can be litigated in the bankruptcy court, both during and after the bankruptcy, in the District Court during a suit by the government to reduce a federal tax lien to judgment, and in the Tax Court pursuant to a timely filed petition following a Collection Due Process hearing.

Recent cases which exemplify these evasion criteria used by the courts involving adversary proceedings filed by the debtor include: an attorney-debtor transferred property to a nominee, took luxury vacations, had no personal checking account because he used his business account for personal expenses;²³ a debtor who depleted her IRA, bought a house with a pool, shopped at Saks, Nordstrom's, etc, dealt in cash and opened a new bank account;²⁴ real estate broker who filed late returns and failed to make any estimated payments for nine years, used cash, took extravagant vacations, and paid other creditors;²⁵ a Chapter 11 debtor, dot-com millionaire who bought KPMG tax shelters, had two expensive houses, a jet, four cars, including a \$70,000 Cadillac, and continued to live beyond his means after he knew there was a huge tax liability;²⁶ CPA-debtor who was a tax shelter promoter, took vacations all over the world, spent 1/4 of his income on recreation each month, used girlfriend's and business bank account for personal expenses, had two houses, and paid none of the tax;²⁷ The Service took a pro-active approach and filed an adversary to except the taxes from discharge where the debtor had filed multiple bankruptcies, lived an opulent lifestyle, filed multiple offers in compromise, put assets in his mother's name, and refused to testify under oath.²⁸

If no adversary is filed in the bankruptcy, the taxpayer can litigate dischargeability of the tax in a subsequent action by the government to reduce the tax lien to judgement and foreclose on property. Normally this occurs just prior to the expiration of the ten year collection statute and long after the bankruptcy discharge.²⁹ In both 2010 cases, the debtors had filed Chapter 7 bankruptcies, filed late returns, and used trusts, nominees, or other entities to hide their assets.³⁰

III. THE EFFECT OF THE "SECRET LIEN" AND THE RECORDED TAX LIEN ON PRE- AND POST-PETITION ASSETS

A tax lien arises at the time of assessment and continues until it is satisfied or becomes unenforceable by lapse of time.³¹ The lien attaches to all property and rights to property of the taxpayer.³² If the Debtor owns property prior to the bankruptcy and the IRS has filed a federal tax lien, or perfected their interest in the property, the tax lien survives the bankruptcy because it continues to attach to the debtor's property, including exempt and abandoned property.³³

Thus, after the bankruptcy, even if the tax is discharged, the IRS can seize this property, or demand payment of the value of the property. For example, the IRS could levy a pre-bankruptcy exempt IRA which was subject to a federal tax lien.³⁴ Similarly, the IRS could levy on an exempt personal injury recovery,³⁵ as well as abandoned property.³⁶ Furthermore, the IRS can re-file a lien post-bankruptcy prior to the expiration of the collection statute.³⁷ Even a nominee lien can be foreclosed on discharged taxes post-bankruptcy.³⁸ However, the tax lien does not attach to post-bankruptcy acquired property if the tax is discharged.³⁹ If the IRS levies a pension post-bankruptcy, the taxpayer must sue the IRS, not the pension plan to rectify any errors.⁴⁰

What if the tax has been assessed, but there is no federal tax lien filed? In two recent cases, the debtors elected to claim their pensions as "excluded property." In both instances, the courts found that the "secret lien" which arises on assessment attaches to the excluded property (which is never part of the bankruptcy estate). Thus, the pensions could be seized for discharged taxes post-bankruptcy.⁴¹

The IRS is entitled to offset pre-bankruptcy refunds against pre-bankruptcy taxes, even if the taxes are discharged.⁴² Tax refunds for the year that the bankruptcy is filed are pro-rated between pre- and post-bankruptcy liabilities.⁴³ However, the IRS cannot take post-bankruptcy refunds to apply to discharged taxes.⁴⁴ Notwithstanding the fact that the bankruptcy trustee pays the entire pre-bankruptcy IRS claim, the IRS can still collect the interest which accrues from the date of the petition until the date of payment from the debtor post-bankruptcy.⁴⁵

If the IRS tries to collect tax that has been discharged from post-bankruptcy property, the Service can be held in violation of the automatic stay and/or bankruptcy discharge injunction under §524. However, to be successful in obtaining damages against the IRS, the debtor normally has to exhaust their administrative remedies before a Court can award damages.⁴⁶

IV. STATE AND LOCAL TAX COLLECTION EFFORTS IN BANKRUPTCY

State taxing authorities, county taxing authorities and utilities across the country are active in the bankruptcy arena. Some of the recent developments in this area involve Chapter 11 plans, violations of the automatic stay, foreclosure of real property, timeliness of claims, determination of priorities, and outright dismissal of the bankruptcy. The following are examples of state and local efforts in bankruptcy.

The California Franchise Tax Board unsuccessfully tried to re-characterize a Chapter 11 Plan as the sale of partnership property, which would result in a tax on the partners.⁴⁷

Cook County, Illinois violated the automatic stay when they tried to collect interest on a real estate lien without objecting to the Chapter 13 Plan. The court found the additional interest to be discharged through the plan payments.⁴⁸

The State of Illinois was held in contempt for cancelling the right to do business when the debtor's tax was discharged in a Chapter 11.⁴⁹

Tioga County, New York foreclosed on real property for unpaid taxes and received a deed prior to bankruptcy, then auctioned the property after the bankruptcy petition. The court found that the debtor had no interest in the property at the time of the bankruptcy petition even though the property value was in excess of \$600,000 and the unpaid tax was less than \$30,000.⁵⁰

One Texas debtor unsuccessfully tried to claim that because he refunded sales tax to his customers, it was not a priority tax because it had not been "collected."⁵¹ Another Texas taxpayer successfully defeated a late-filed Chapter 11 administrative claim for ad valorem tax.⁵²

V. NON-BANKRUPTCY IRS ALTERNATIVE RESOLUTIONS FOR TAX

Generally, there are three basic choices with respect to resolving unpaid tax liabilities with the IRS. They are: convince the IRS that the taxpayer is currently uncollectible; enter into an installment agreement, or make an offer in compromise.

If the taxpayer decides to ignore the IRS and do nothing, The IRS can and may file federal tax liens, can and may levy bank accounts, wages, etc., can and may seize physical assets, including exempt property - house, ira, 401K. One of the downsides to this approach is that the taxpayer may relinquish some collection due process rights. Another downside is that ignoring the IRS sometimes causes them to take drastic measures to "get your attention".

Any of these choices can be proposed to the IRS in the context of a “collection due process” (“CDP”) proceeding. When the IRS issues a Final Notice of Intent to Levy, Notice of Right to Final Hearing (Form 1058), and/or a Notice of Filing Federal Tax Lien and Notice of Right to Hearing (Letter 3172), the taxpayer has 30 days to file a timely request for a hearing.⁵³ In addition, if the taxpayer has not had a prior opportunity to dispute the liability, the amount of tax and even the existence of tax after a bankruptcy, these issues can be raised during the CDP hearing.⁵⁴ The determination of the IRS at the hearing can be subject to review by the Tax Court, if the taxpayer disagrees with the outcome.⁵⁵ A timely request for a CDP hearing will trigger an extension of some of the bankruptcy dischargeability time periods.⁵⁶ If a request for a CDP hearing is not timely filed, an equivalent, non-appealable hearing can be held, in any event.

The appeals settlement officers who hear CDP cases usually are former revenue officers and must follow the same guidelines as a collection officer. However, they have resolution as their main focus. Each of the following collection alternatives can be proposed in a CDP hearing.

A. DETERMINATION OF CURRENTLY UNCOLLECTIBLE

If the taxpayer has no assets and no ability to pay, the IRS can determine the tax to be currently not collectible (CNC) (“53” the account)⁵⁷ This determination will usually require providing a Form 433a (or 433f) financial statement for individuals, and, if appropriate a Form 433b, financial statement for business, to the IRS with appropriate documentation. The IRS has 14 different reasons for determining an account to be CNC.⁵⁸ The dollar amount and type of case govern the extent of the investigation, which can include full credit report, vehicle registrations, real estate records, wage and income information, business licenses, open audits, passports.⁵⁹ The statute of limitations on collection dictates various IRS actions⁶⁰

The pre-requisites to request CNC are: current compliance with all filing requirements;⁶¹ liquidation of available assets; the IRS will usually request copies of recent tax returns; and, there can be no transfer of assets after the tax at issue became due. A “hardship” CNC⁶² exists if the taxpayer can’t pay reasonable basic living expenses. Usually this means there is no income or assets, or equity in assets to make payment without hardship. The IRS does not need to verify 433A and B financial statements if the tax is under certain amount and numbers appear reasonable. In addition, no 433 information is needed if: a) terminal illness or excessive medical bills; b) taxpayer is incarcerated; c) taxpayers only source of income is social security, welfare, unemployment; or, d) taxpayer is unemployed with no source of income.⁶³

Even though the IRS refrains from taking collection action while the taxpayer is deemed to be currently uncollectible, the interest and penalties continue to accrue and the Service will re-assess the ability to pay from time to time.

B. INSTALLMENT AGREEMENT

I.R.C. Section 6159 authorizes the IRS to enter into installment agreements. An Installment Agreement (“IA”) is a written agreement to satisfy tax liabilities in installment payments.⁶⁴ For an IA to be acceptable, the following requirements must be met: (a) the liability must be full-paid within the statute of limitations, except as described below in the “partial pay” IA;⁶⁵ (b) the taxpayer must be in full compliance during the term of the agreement;⁶⁶ (c) the taxpayer must provide updated financial information upon request;⁶⁷ and (d) the taxpayer must pay a \$52 fee⁶⁸ for IAs that include automatic bank debit form of payment, and \$105 for other IAs. In addition, the fee to re-instate a defaulted IA \$45.

Although the taxpayer is bound by the terms of the IA, the IRS can terminate or change the agreement if: (a) the taxpayer defaults in a payment;⁶⁹ (b) the taxpayer fails to file or pay a subsequent tax, including estimated tax payments;⁷⁰ (c) the taxpayer fails to provide requested updated financial information;⁷¹ (d) the IRS determines that the taxpayer provided incorrect information prior to the IA;⁷² (e) the IRS believes collection is in jeopardy;⁷³ or (f) the IRS determines that the taxpayer's financial position has changed.⁷⁴ It is much more difficult for a taxpayer to change the terms of the IA if his financial position deteriorates subsequent to the IA.

The IRS MUST enter into an installment agreement if certain criteria are met. Those criteria include: (a) the liability is not more than \$10,000; (b) the taxpayer has filed all returns due in the past 5 years; (c) the taxpayer has either paid all taxes due in the past five years on time, or was in an IA; (d) the IRS determines the taxpayer can't pay in full; (e) the taxpayer can pay in full within 3 years; and, (f) the taxpayer agrees to be in compliance during the 3 years.⁷⁵ If the IRS intends to terminate or alter an IA, they must provide the taxpayer 30 days written notice, unless a jeopardy exists.⁷⁶ Failure to provide notice might be subject to damages under I.R.C. Section 7433.⁷⁷

If a taxpayer has some ability to pay, but cannot full pay within the statute of limitations,⁷⁸ the IRS can grant a Partial Pay IA (PPIA).⁷⁹ Normally, the IRS will want whatever equity in available assets of the taxpayer as payment toward the liability.⁸⁰ In some cases, the taxpayer may keep this equity in assets. Those cases include: if there is minimal equity and no loan potential; if the property is tenants by the entirety and the spouse won't consent to a loan or sale; the asset is unmarketable; the assets will generate future income for the PPIA; economic hardship; or, any loan payment would exceed the taxpayer's disposable income and they wouldn't qualify for a loan.⁸¹ To qualify for a PPIA, the taxpayer must make a good faith effort to obtain financing and be unsuccessful.⁸²

Prior to entering into an IA, the IRS makes a determination as to the monthly amount that the taxpayer can afford to pay. To compute this monthly amount, the taxpayer's financial information is submitted to the IRS with Form 433F, 433A, and/or 433B. In some instances, this information can be provided by telephone and facsimile. The taxpayer's gross income and actual expenses are computed. Then, based on the gross income and number of dependents, the IRS allowable expenses are computed using the IRS National Standard Expenses (NSE) for food, clothing, misc., the Local Standard Expenses (LSE) for housing, and the allowable transportation expenses. Other actual allowable expenses include court ordered payments, taxes, insurance, etc. Although the IRS is supposed to use the NSE and LSE as a guide rather than as an absolute, there are few instances that actual expenses in excess of the IRS allowable standards are allowed. The monthly payment amount is the difference between the gross income and the allowable necessary expenses.

In certain circumstances, a taxpayer may qualify for a "Streamlined" IA, which expedites the processing of the IA. The Streamlined IA skips the requirements for financial analysis and managerial approval.⁸³ To qualify for a Streamlines IA, the following criteria must be met: the balance of the assessed amounts (not including accruals) must be \$25,000 or less; the amount must be paid in full within 5 years, or prior to the statute of limitations, whichever is earlier; and the taxpayer must be in full filing compliance prior to the IA.⁸⁴

The benefits and/or consequences of entering into an IA are: the taxpayer keeps his assets; the taxpayer pays the tax in full over time (except for the partial pay IA); the IRS will not pursue enforced collection;⁸⁵ the statute of limitations on collection is not extended during the time the IA is in effect;⁸⁶ the SOL is extended during the time the IA is "pending" (from the time the taxpayer formally requests an IA until it is accepted);⁸⁷ and a federal tax lien will usually be

filed unless there is justification to forego a lien.⁸⁸ The most significant disadvantages facing a taxpayer with respect to an IA are: the taxpayer must live on a small budget during the term of the IA; interest and penalties continue to accrue; and the taxpayer must stay in compliance or face enforced collection.

C. OFFER IN COMPROMISE

I.R.C. Section 7122 authorizes the Secretary of the Treasury to compromise tax liabilities for an amount that is less than the full amount owed. An Offer in Compromise is a written agreement entered into between the taxpayer and the Internal Revenue Service, (“IRS”), to satisfy unpaid tax liabilities for less than the full amount due.⁸⁹ The objectives outlined by the IRS in accepting OIC’s are: to collect the most amount, at the earliest time, with the least cost to the IRS; to reach resolution in the best interests of the IRS and the taxpayer; to provide the taxpayer with a fresh start toward voluntary compliance; and to collect money otherwise not available.⁹⁰

There are three types of OIC. First, there is an OIC that is based on doubt as to liability wherein the taxpayer does not really owe the tax. Examples include innocent spouse, incorrect deficiency, trust fund recovery penalty incorrectly assessed, or payments not properly applied.⁹¹ The second class of OIC is based on doubt as to collectability. The taxpayer in this second class cannot pay the full liability from assets and income, or there are special circumstances that allow the taxpayer to make a “hardship offer”, even though he may be able to pay.⁹² The final type of OIC is entitled “effective tax administration.” In this type of OIC, the taxpayer may be able to full pay the tax, but such payment would cause an economic hardship or there are special circumstances.⁹³

Each class of OIC is subject to its own requirements. The least rigorous is the first class, based on doubt as to liability. For this offer, the taxpayer must file a Form 656L, but there is no requirement for a financial statement (Form 433-A or 433-B). Included with the OIC must be proof to support the bases for doubt as to liability. In addition, the taxpayer must be in full compliance for all periods subsequent to those included in the OIC.⁹⁴ The OIC cannot be rejected under the compliance requirement just because the IRS may not be able to locate a return.⁹⁵

OIC’s based on doubt as to collectability are the most prevalent. To meet the initial requirements for this type of offer, the taxpayer must file Form 656 (Offer in Compromise), and fully completed financial statements, Forms 433-A and/or 433-B, with all attached documentation. The OIC must include all outstanding liabilities, including assessed and unassessed liabilities. It cannot include those taxes for which the collection statute (“SOL”) has already expired.⁹⁶ The amount offered must be equal to the quicksale value of the equity in the taxpayer’s assets⁹⁷ plus the present value of the monthly amount the IRS could collect (usually 48xIA monthly amount, unless there is a short SOL).⁹⁸ And, just as in the first type of OIC, the taxpayer must be in full compliance for all periods after those covered in the OIC. The taxpayer must remain in compliance for 5 years after OIC accepted.⁹⁹ In addition, the taxpayer must pay a \$150.00 processing fee, unless he or she can qualify as a low income taxpayer.¹⁰⁰

The final class of OIC is entitled “effective tax administration” offer (“ETA”). The filing requirements for this type of OIC are the same as those listed above for an OIC based on doubt as to collectability.¹⁰¹ The only difference is that there must be exceptional circumstances which result in a determination that collection of the full amount of tax due would either: (a) create a hardship; or (b) be detrimental to voluntary compliance. That is, in the former, even though the taxpayer has the money to full pay the tax, if the tax were collected, the taxpayer would not be

able to meet reasonable basic living expenses. With respect to the latter, collection would be so unfair and inequitable that other taxpayers would lose confidence in the system.¹⁰²

Notwithstanding the unwieldy amount of paper required to process a successful OIC, the odds of acceptance are weighted against the taxpayer from the get-go. The IRS will reject an OIC if: (1) all of the documents are not properly submitted; (2) the taxpayer fails to submit any additional requested documents; (3) the amount offered is less than what could be expected to be collected; or (4) there is a public policy reason to reject.¹⁰³ In addition, even though the IRS is supposed to use the National Standard Expenses (“NSE”) (food, clothing, and miscellaneous), and the Local Standard Expenses (“LSE”) (housing) as a guide, rather than an absolute maximum, there are very few instances in which any variance is allowed. According to the National Taxpayer Advocate’s Report for 2003, the IRS must justify acceptance of an OIC. On the other hand, rejection needs no support, merely a rejection letter.

TIPRA amended I.R.C. Section 7122 to require the submission of partial payments with offers in compromise. With respect to lump-sum offers in compromise,¹⁰⁴ TIPRA requires the taxpayer to submit with the application a partial payment of 20% of the offer amount.¹⁰⁵ For periodic payment offers,¹⁰⁶ the taxpayer is required to submit the first installment payment with the application and thereafter to comply with the taxpayer’s proposed payment schedule while the Service is considering the offer.¹⁰⁷

TIPRA provides that, if a taxpayer fails to submit the required initial payment with the offer, the Service may return the offer to the taxpayer as unprocessable.¹⁰⁸ In the case of a periodic payment offer, the Service may treat a taxpayer’s failure to comply with the proposed installment payment schedule while the offer is pending as a withdrawal of that offer.¹⁰⁹

None of the partial payments are refundable, but the taxpayer can designate their application. TIPRA authorizes the Secretary of the Treasury to issue regulations waiving the partial payment requirements.¹¹⁰ Low income taxpayers may qualify for waiver of these payments. Under TIPRA, an OIC is deemed “accepted” if it is not withdrawn, returned, or rejected with 24 months of IRS receipt. The 24 months does not include any time during which the liability at issue is the subject of a dispute in any judicial proceeding.¹¹¹

Once the OIC is accepted (unless it is a “doubt as to liability” OIC), if the taxpayer “defaults” during the five years following acceptance, the IRS will re-instate the tax, interest and penalties and re-commence enforced collection.

VI. CONCLUSION

When a debtor has tax issues, it is essential to make sure that bankruptcy will achieve the anticipated result. To do this, the taxes must be analyzed to determine if they meet the requisite time periods. The debtor’s facts and circumstances must be studied in detail to see if any of the discharge exceptions apply. The tax liens and debtors assets must be reviewed so that there are no surprises post-discharge. And finally, the taxpayer’s rights in pursuing a resolution with the IRS should be fully explored with the taxpayer prior to bankruptcy.

In a review of the 2010 bankruptcy discharge reported cases, there were instances where bankruptcy was filed: (1) prior to expiration of the three year rule;¹¹² and, (2) prior to expiration of the 240 day rule,¹¹³ Each of these instances could be attorney malpractice. In the *Brooks* case, the court re-opened the bankruptcy for the trustee to pursue the malpractice claim against the bankruptcy attorney as a pre-petition asset. In the *Kovacs* case, the bankruptcy attorney failed to

timely file a claim for damages for the stay violation. There are traps for the unwary where bankruptcy and tax law intercept which can and should be avoided.

1. *In re McKay, Jr.*, 430 B.R. 246 (Bankr. M.D. Fla. 2010). The court held that tax protestor "\$0" returns were not returns for purposes of bankruptcy.

2. *In re Colsen*, 446 F. 3d 836 (8th Cir. 2006); *Ralph v. US*, 258 B.R. 504 (Bankr. M.D. Fla. 2000); *Woods v. IRS and Indiana Dept. Of Rev.*, 285 B.R. 284 (Bankr. S.D. IN. 2002); *Izzo v. US*, 287 B.R. 158 (Bankr. E.D. Mich. 2002); *US v. Nunez*, 232 B.R. 778 (9th Cir. BAP 1999); *Savage v. IRS*, 218 B.R. 126 (10th Cir. BAP, 1998); *Sullivan v. US*, (200 B.R. 327 (Bankr. N.D. OH 1996); *In re Hatton*, 216 B.R. 278 (9th Cir. BAP 1997); *Crawley v. US*, 244 B.R. 121 (Bankr. N.D. IL, 2000) (the tax was still not discharged because the taxpayer failed the evasion provision.)

3. *US v. Hindenlang*, 164 F. 3d 1029 (6th Cir. 1999); *In re Payne*, 431 F. 3d 1055 (7th Cir., 2006); *Ruching v. US*, 273 B.R. 223 (D. AZ, 2001); *Miniuk v. US*, 297 B.R. 532 (N.D. Ill. 2003); *Moroney v. US*, 2002 U.S. Dist. LEXIS 22919 (E.D. VA, 2002)

4. *US v. Fretz*, 244 F. 3d 1323 (11th Cir. 2001); *Hassan v. US*, 301 B.R. 614 (Bankr. S.D. Fla. 2003); *Epstein v. IRS*, 303 B.R. 280 (Bankr. E.D. NY, 2004); *Semo v. US*, 188 B.R. 359 (Bankr. W.D. PA, 1995).

5. *Carapella v. US*, 84 B.R. 779 (Bankr. M.D. Fla. 1988).

6. *Berard v. US*, 181 B.R. 653 (Bankr. M.D. Fla. 1995); *Mathis v. US*, 249 B.R. 324 (S.D. Fla. 2000); *Lowrie v. US*, 162 B.R. 864 (Bankr. D. Nev. 1994).

7. *US v. Ashe*, 228 B.R. 457 (C.D. Cal. 1998); *Wright v. US*, 244 B.R. 451 (Bankr. N.D. Cal. 2000); *US v. Elmore*, 165 B.R. 35 (Bankr. S.D. Ind., 1994); *Gushue v. IRS*, 126 B.R. 202 (Bankr. E.D. Pa. 1991); *Schmitt v. US*, 140 B.R. 571 (Bankr. W.D. Okla. 1992); *Johnson v. US*, 236 B.R. 456 (Bankr. M.D. Fla. 1999).

8. See, 11 U.S.C. § 523(a)(1)(B)(ii).

9. *In re Payne*, 431 F. 3d 1055 at 1060 (7th Cir. 2005).

10. 401 BR 748 (Bankr. N.D. Miss 2008).

11. *McCoy v. Mississippi State Tax Commission*, 2009 Bankr. LEXIS 2542 (Bankr. S.D. Miss 2009) and *Links v. US*, 2009 Bankr. LEXIS 2921 (Bankr. N.D. OH 2009).

12. This ignores the additional language with respect to stipulations and judgments rising to the lever of a "return". 11 U.S.C. § 523(a)(1), hanging paragraph.

13. *Westcott v. IRS*, 335 Fed. Appx. 410 (5th Cir. 2009).

14. 11 U.S.C. § 523(a)(1), hanging paragraph.

15. *Ridgeway v. US*, 2009 Bankr. LEXIS 3264 (Bankr. Conn. 2009).

16. *Goins v. IRS*, 437 B.R. 372 (Bankr. E.D. Mo. 2010); *Rowland v. US*, 426 B.R. 874 (Bankr. NM, 2010); *US v. Paolo*, 619 F. 3d 100 (1st Cir. 2010); *In Swain v. US*, 437 B.R. 549 (Bankr. E.D. Mich. 2010), the court dismissed the adversary for lack of subject matter

jurisdiction.

17. *US v. Jacobs*, 490 F. 3d 913 (11th Cir. 2007).

18. *Id.*

19. *US v. Fretz*, 244 F. 3d 1323 (11th Cir. 2001).

20. *Jacobs*, 490 F. 3d at 925-927.

21. *Id.*

22. *Lynch v. US*, 299 B.R. 62 (Bankr. S.D. N.Y. 2003); *Stamper v. US*, 360 F. 3d 551 (6th Cir. 2004); *Wright v. IRS*, 191 B.R. 291 (S.D.N.Y. 1995).

23. *May v. US*, 106 A.F.T.R. 2d (RIA) 7292 (S.D. Ala. 2010).

24. *Barkley v. US*, 106 A.F.T.R.2d (RIA) 7020 (Bankr. N.D. Ga. 2010).

25. *Sheehan v. US*, 106 A.F.T.R. 2d (RIA)6946 (Bankr. N.D. Oh. 2010).

26. *Hawkins v. Franchise Tax Board and US*, 430 B.R. 225 (Bankr. N.D. CA 2010).

27. *Bryen v. US*, 433 B.R. 503 (Bankr. E.D. Pa. 2010).

28. *Acker v. US*, 106 A.F.T.R. 2d (RIA) 6495 (Bankr. E.D. Tx. 2010).

29. IRC §6502. The 10 year collection statute can be extended for various events:

a) taxpayer is outside the US for at least 6 months. IRC §6503(c); b) taxpayer is in bankruptcy. IRC §6503(h); and, c) anytime the IRS is precluded from levy. IRC §6503(i)(5) (during OIC, IRC §6503(k)(1), while an offer of an installment agreement is pending, IRC §6503(k)(2), during CDP proceeding. IRC §6503(i)(5), and during innocent spouse claim.)

30. *US v. Black*, 725 F. Supp.2d 1279 (E.D.Wash. 2010); *US v. Beninati*, 438 B.R., 755 (D.Mass. 2010).

31. I.R.C. §6322.

32. I.R.C. §6321.

33. IRC §§ 6321, 6322.

34. *Miles v. Commissioner*, 106 A.F.T.R.2d (RIA) 6563 (9th Cir. 2010). Similarly, Massachusetts Dept. of Revenue tax lien attached to a pension because the debtor was vested even though she had not elected to start receipt of the payments. *Drake v. Massachusetts DOR*, 434 B.R. 11 (Bankr. D. Mass. 2010).

35. *In re: Vanderhouwen*, 2010 Bankr. LEXIS 156 (Bankr. E.D. Wa. 2010).

36. *US v. Wilson et.al.*, 105 A.F.T.R. 2d. (RIA) 1719 (E.D. Ok. 2010).

37. *US v. Calvin*, 106 A.F.T.R.2d. (RIA) 5343 (M.D. Fla. 2010).

38. *US v. Boyd*, 106 A.F.T.R.2d. (RIA) 6098 (D. Mn. 2010).

29TH ANNUAL SPRING MEETING

39. *Indiana Bank and Trust Co. v. Hisrich and US*, 2010 U.S. Dist. LEXIS 18505 (S.D. IN. 2010).
40. *Lawrence v. General Motors Hourly-Rate Employees Pension Plan*, 2010 U.S. Dist. LEXIS 101070 (M.D. Fla. 2010).
41. *Wadleigh v. Commr.*, 134 T.C. 14 (2010); *Gross v. Commr.*, T.C. Memo 2010-176.
42. *Miller v. US*, 422 B.R. 168 (W.D.Wisc. 2010); *In re: Maines*, 106 A.F.T.R.2d. (RIA) 6870 (Bankr. N.J. 2010).
43. *Bryant v. Commr.*, 106 A.F.T.R.2d. (RIA) 6735 (6th Cir. 2010).
44. *Camangian v. US*, 2010 U.S. Dist. LEXIS 61132 (C.D. Ca. 2010).
45. *Washburn v. IRS*, 2010 bankr. OEXIS 4663 (Bankr. D. Ks. 2010).
46. *In re: Cooper*, 2011 Bankr. LEXIS 160 (Bankr. M.D. N.C. 2011); *Swensen v. US*, 438 B.R. 195 (Bankr. N.D. Ia. 2010). But see, *Logan v. US*, 105 A.F.T.R. 2d. (RIA) 1597 (Bankr. D. Az. 2010).
47. *In re: Wilshire Courtyard*, 437 B.R. 380 (Bankr. C.D. Ca. 2010).
48. *Malec v. Cook County, Clerk*, 2011 Bankr. LEXIS 15 (Bankr. N.D. Ill. 2011).
49. *In the Matter of: Adesta Communications, Inc.*, 2010 Bankr. LEXIS 2351 (Bankr. D. Ne. 2010).
50. *Martyak v. Tioga County*, 432 B.R. 25 (Bankr. N.D. NY 2010).
51. *Szostek v. Texas State Comptroller of Public Accounts*, 429 B.R. 552 (Bankr. W.D. Tx. 2010)
52. *In re: BH S&B Holdings LLC et.al.*, 435 B.R. 153 (Bankr. S.D. N.Y. 2010).
53. IRC §6330, and IRC §6320.
54. IRC §6330(c)(2)(B); *Becker v. Commr.*, TC Memo 2010-120; *Johnson v. Commr.*, TC Summ.Op 2010-69; *Mueller v. Commr.*, TC Memo 2010-10; *Barnes v. Commr.*, TC Memo 2010-30.
55. IRC §6330(d).
56. §507(a)(8) hanging paragraph.
57. I.R.M. ¶5.16.1; Policy Statement P-5-71.
58. I.R.M. ¶5.16.1.1(2).
59. I.R.M. ¶5.16.1.1(3)
60. I.R.M. ¶5.16.1.2
61. I.R.M. ¶5.16.1.1(6)

62. I.R.M. ¶5.16.1.2(9)
63. I.R.M. ¶5.16.1.2(3)
64. 26 CFR 301.6159-1(a).
65. I.R.C. Section 6159(a); IRM ¶ 5.14.1.7.
66. I.R.C. Section 6159(b)(4)(a)(B).
67. I.R.C. Section 6159(b)(4)(a)(C).
68. 26 CFR 300.1(b).
69. I.R.C. Section 6159(b)(4)(a)(A).
70. I.R.C. Section 6159(b)(4)(a)(B).
71. I.R.C. Section 6159(b)(4)(a)(C).
72. I.R.C. Section 6159(b)(2)(A).
73. I.R.C. Section 6159(b)(2)(B).
74. I.R.C. Section 6159(b)(3).
75. I.R.C. Section 6159(c).
76. I.R.C. Section 6159(b)(5)(A).
77. Grant v. United States, 92 AFTR 2d (RIA) 5600 (S.D. Fla. 2003).
78. The IRS has 10 years to collect the tax from the date of assessment, absent certain events that might extend the 10 years. I.R.C. Section 6502(a)(1).
79. I.R.M. ¶ 5.14.2.2.
80. I.R.M. ¶ 5.14.2.2(2).
81. I.R.M. ¶ 5.14.2.2.2(2).
82. I.R.M. ¶ 5.14.2.2.2(3).
83. I.R.M. ¶ 5.14.5.1.
84. I.R.M. ¶ 5.14.5.2(1).
85. I.R.C. Section 6331(k)(2).
86. I.R.C. Section 6331(k)(2) and (3).
87. I.R.C. Section 6331(k)(2) and (3).
88. I.R.C. Section 6323(j).

89. I.R.M. ¶ 5.8.1.1.1(1).

90. I.R.M. ¶ 5.8.1.1.4.

91. I.R.C. Section 7122(c)(3)(B).

92. I.R.M. ¶ 5.8.11.2; I.R.M. ¶ 5.8.1-1.

93. I.R.M. ¶ 5.8.11.2; I.R.M. ¶ 5.8.1-1.

94. Form 656.

95. I.R.C. Section 7122(c)(3)(B)(i).

96. I.R.M. ¶ 5.8.1.2; I.R.M. ¶ 5.8.1.7.3.

97. The Service has added another “asset” to this ability to pay which includes any assets that the Service has deemed the taxpayer “dissipated”. Which could make the amount required for the OIC to include assets the taxpayer no longer owns or to which he has access.

98. I.R.M. ¶ 5.8.5; I.R.M. ¶ 5.8.1.1.3(3); ¶ 5.8.1-1; Form 656.

99. Form 656.

100. 26 C.F.R. Part 300 (11/1/03). User fees made in conjunction with an offer in compromise will be treated as payments against tax, interest, and penalties to which the offer relates. I.R.C. Section 7122(c)(2)(B)

101. Form 656; 26 C.F.R. Part 300 (11/1/03).

102. I.R.M. ¶ 5.8.11.2.

103. Public policy is only supposed to be used to reject an OIC if acceptance is detrimental to the interest of the IRS, even though the amount offered is greater than the collectible amount. However, it is not to be used merely because public interest might be generated or the taxpayer was criminally prosecuted. I.R.M. ¶ 5.8.7.6.1.

104. Defined as any offer of payment made in five or fewer installments. I.R.C. Section 7122(c)(1)(a)(ii).

105. I.R.C. Section 7122(c)(1)(A)(i).

106. Defined as any offer of payment made in six or more installments.

107. I.R.C. Section 7122(c)(1)(B).

108. I.R.C. Section 7122(d)(3)(C).

109. I.R.C. Section 7122(c)(1)(B)(ii).

110. I.R.C. Section 7122(c)(2)(C).

111. I.R.C. Section 7122(f).

112. *Bisch v. IRS*, 437 B.R. 355 (Bankr. E.D. Mo. 2010); *In re Brooks*, 2010 Bankr. LEXIS 1473 (Bankr. E.D. Va. 2010).

113. *Bisch v. Missouri Department of Revenue*, 437 B.R. 359 (Bankr. E.D. Mo. 2010). But see, *Kovacs v. US*, 614 F. 3d. 666 (7th Cir. 2010), where the Court found that the IRS had violated the stay because they re-assessed the tax after a defaulted Offer in Compromise, which did not start the 240 days over again.