CONSUMER SESSION

Issues that "Tax" Consumer Debtors: Tax Year Election, Short Sales and 1099s, Dischargeability, IRS Claims and Best Practices for Dealing with the IRS

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ISSUES THAT "TAX" CONSUMER DEBTORS

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I. INTRODUCTION

"Taxes," as Justice Holmes informed us long ago, "are what we pay for civilized society."[1] It may surprise many that this price is extracted even from individuals in bankruptcy. Although the right to discharge in bankruptcy ensures an "honest but unfortunate debtor" a fresh start to begin anew his or her economic life, that right is tempered by the federal government's legitimate interest in protecting the public fisc by collecting taxes. The balance struck by the Bankruptcy Code[2] and Internal Revenue Code[3] between the competing interests of an individual debtor and the federal government insulates specific tax claims from the bankruptcy discharge. Under this compromise, only enumerated tax claims will survive a bankruptcy discharge in a chapter 11 case.[4]

Recognizing that nondischargeable tax liabilities are inconsistent with the fresh start policy, Congress further attempted to alleviate some harshness through enactment of the Bankruptcy Tax Act of 1980 (BTA).[5] Among other things, the BTA creates a separate taxable entity where an individual files for relief under either chapter 7 or 11 of the Bankruptcy Code[6] and enables an individual chapter 7 or 11 debtor to elect to shorten and end the taxable year, thus shifting at least part of the current year taxes to the estate as a BC section 507(a)(8) priority claim.[7] Nevertheless, certain tax claims designated as nondischargeable under BC section

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[1] *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927)(dissenting opinion).

[2] 11 U.S.C. § 101 et seq. In these materials, the Bankruptcy Code is also referred to as "BC."

[3] Title 26, United States Code. In these materials, the Internal Revenue Code is also referred to as "IRC."

[4] 11 U.S.C. § 523(a)(1)(identifying those tax claims that are nondischargeable by an individual debtor in a chapter 7 or 11 case).

[5] Pub. L. No. 96-589, 94 Stat. 3389 (1980)(codified at several sections of the IRC).

[6] See IRC § 1398. No separate entity for tax purposes is created where a partnership or corporation files for bankruptcy relief. IRC § 1399.

[7] See IRC § 1398(d)(2).

523(a)(1) (such as claims for taxes incurred within three years of the bankruptcy petition date) survive the discharge and, thus, significantly affect a debtor's fresh start.

The outline begins with a discussion of the tax issues generated by mortgage modifications and foreclosures, a common occurrence with individual taxpayers who happen to own homes either as their primary residence or as an investment or second home. The outline then turns to the separate entity rules for individuals who file for relief under chapter 7 or 11 of the Bankruptcy Code. Finally, the outline turns to the rules regarding the priority and dischargeability of tax claims, carefully distinguishing between the tax relief a debtor could expect in a chapter 7 or 11 case as opposed to a chapter 13 case. Of particular note is that the chapter 13 super-discharge will no longer work to discharge certain tax claims beyond the ambit of discharge one would expect in a chapter 7 case as in the past. Rather, once the 2005 Act went into effect, the chapter 13 discharge generally mirrors the chapter 7 discharge for tax purposes. Each nondischargeable tax claim will be addressed with particular attention to the recurring issues that one confronts in an individual debtor bankruptcy practice. The materials will conclude with several practice pointers that blend both substantive bankruptcy tax law with bankruptcy procedure.

The materials will introduce the reader to nine rules that every bankruptcy practitioner must know. These nine rules are:

1. Is there a claim? The taxing authority may have a claim based on gain and/or COD income, for example, where property owned by the taxpayer is foreclosed on and any deficiency released by the creditor. Generally, gross income includes gain from property and COD. IRC section 61(a).
2. Who is the taxpayer? For taxes, the debtor is the taxpayer except where IRC section 1398 applies and changes the general rule.
3. Not all taxes are nondischargeable.[8]

[8] *See* IRC §523(a).

4. Secured tax claims – even those securing nondischargeable tax claims – are recognized in bankruptcy and largely protected from various avoidance powers attack.
5. Looking back from the petition date, what returns were last due (including extensions) within the last three years? Personal taxes are dischargeable if the tax year in question is more than three years prior to the filing of the bankruptcy case unless some other provision applies.
6. Have any taxes been assessed within 240 days preceding the petition date? Personal taxes are dischargeable if the tax in question has been assessed more than 240 days prior to the filing of the bankruptcy case unless some other provision applies.
7. Are any returns still under audit or at audit risk (not including those that involve fraudulent returns, etc.), before the tax court, or under open assessment? Claims associated with such returns are both priority and nondischargeable.
8. Are there any late filed returns or years in which no return was filed? Personal taxes are dischargeable if the tax return for the year in question was filed at least more than two years prior to the bankruptcy filing.
9. Are there any taxes that arise from the filing of fraudulent returns or willful attempts to evade or defeat a tax (with no time limit)?

II. MORTGAGE FORECLOSURES

Foreclosure has been a hot topic and an often discussed matter over the last few years. Many attorneys, some of whom had never done a foreclosure previously, have become quite experienced and proficient with foreclosure actions and confirmation hearings. Discussed less often, and perhaps less understood, are the potential tax ramifications that may flow from a foreclosure or a short sale. This first part of this paper will provide a primer on the tax consequences, and a look at a few examples of the more likely scenarios. The second part then integrates the tax consequences of a mortgage foreclosure in a bankruptcy setting.

A few overarching legal principles must be understood before embarking on the examples set forth below. Two of these principles - that cancellation of debt generates income, and that of the exclusion of gain from the sale of a primary residence - have been around for some time and are likely to remain. The third legal principle, the exclusion of cancellation of debt income under certain circumstances, has been available only since 2007, and was recently extended by Section 202 of the American Taxpayer Relief Act of 2012 and is scheduled to end this coming December 31, 2013.[9]

A. CANCELLATION OF DEBT GENERATES TAXABLE INCOME.

As a general rule, cancellation or forgiveness of debt ("COD") for which the taxpayer is personally liable will result in taxable income to that taxpayer. Since virtually all home purchases using loans involve recourse indebtedness, the COD provisions will apply to home foreclosures and short sales.

The policy for the treatment of COD can easily be justified. The borrower with COD achieves in essence what is referred to as "wealth accession." He may have received a sum equal

[9] *See* http://i2.cdn.turner.com/cnn/2013/images/01/01/american.taxpayer.relief.act.pdf.

to the amount cancelled or forgiven by having their debt "paid" for them or on their behalf by another.

In theory, this COD policy for the most part places comparable taxpayers on equal an footing, and in fact, does not go quite far enough.

Compare two taxpayers – one of whom saves $100,000. In order to save this amount of money that taxpayer likely would have had to earn and pay taxes on $120,000 to $135,000 of income. This taxpayer utilizes the $100,000 as a 50% down payment on a home.

The second taxpayer does not have any savings, but desires to purchase a comparable priced home, borrowing the full $200,000. Since the second taxpayer is liable for the repayment of this debt, it is not viewed as income, but solely as an increase in their debt load.

A year after each has purchased their home catastrophe strikes, and each of their homes is foreclosed. The net proceeds for each is $100,000 at the foreclosure sale. At this point, neither have anything. Owner 1 has lost their home along with their initial $100,000 in equity. Owner 2 has lost their home, but had no initial equity in the home and the deficiency of $100,000 is forgiven or canceled. The net economic effect is Owner 2 has lost nothing. The forgiveness has put them on equal footing as Owner 1 – each receiving the "benefit" of losing $100,000 - but only Owner 1 was required to pay taxes on that $100,000.

Under these circumstances, Owner 2 would generally be required to recognize $100,000 in income and pay tax on that amount. Though this may come as a heavy burden, Owner 2 is still actually receiving more favorable treatment. Owner 2 merely recognizes the amount of debt forgiven – the $100,000 – and pays their marginal tax rate on that amount. Owner 1's lost $100,000 was tax paid monies, meaning Owner 1 likely had to pay taxes on an amount significantly more than $100,000

B. GAIN FROM SALE OF PRINCIPAL RESIDENCE EXCLUDED FROM INCOME UP TO $250,000

Under IRC section 121 a taxpayer is permitted to exclude from income any gain up to $250,000 ($500,000 for certain married taxpayers) resulting from a sale of their primary residence. Section 121 is satisfied if a taxpayer owns and resides in the primary residence aggregating at least two of five years preceding the sale or exchange.

This exclusion from income would have no effect on the above scenario, since neither taxpayer had gain. In fact, each indeed had an actual loss. Owner 2 did have income ($100,000), but no gain. However, there are some settings where this exclusion may be able to be utilized by a taxpayer that has received COD income from a loan modification that reduces a portion of the outstanding debt principal. (*See* example below).

C. THE MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007 EXCLUDES CERTAIN DEBT FORGIVENESS INCOME

The Mortgage Forgiveness Debt Relief Act ("MFDRA") applies only to forgiven or canceled mortgage debt on a primary residence, and not a second home. However, it can be quite substantial, since the law allows up to the maximum exemption amount of $2 million. (At the top marginal tax rate of 35% this could result in a tax savings of $700,000).

These are the basic principles to work through the three common scenarios set forth below.

1. Scenario 1 (Typical Foreclosure)

Foreclosure on home that has declined below the value of the balance of the purchase money mortgage AND acquisition cost:

Purchase price of Home: $400,000
Initial Loan Balance: $380,000 (LTV ratio of 95%)
Value at time of Foreclosure: $290,000
High Bid at Foreclosure: $200,000
Deficiency: $180,000

Lender elects not to, or denied the ability to pursue deficiency:

Recourse Debt (Property in Satisfaction of Debt):
Gain (Loss) = FMV – Basis
COD = Debt - FMV

Nonrecourse Debt (Property in Satisfaction of Debt):
Gain (Loss) = Debt – Basis
COD = $0

Amount of Debt Forgiven/COD: $180,000 (this constitutes $180,000 of income)
MFDRA exclusion: $180,000

Result: No additional tax due if forgiveness (not the foreclosure) occurs before expiration of the MFDRA. IF the MFDRA does not apply, either because this was an investment property, second home, or MFDRA had expired this debt forgiveness could result in a tax liability of up to $63,000. Note that in this Scenario, the FMV at the time of the foreclosure was $290,000, but the high bid was only $200,000. The COD is determined based on the FMV of the property, which is presumed to be the accepted bid price at the foreclosure sale absent fraud or collusion.

2. Scenario 2 (Cash Out)

Foreclosure of home that has increased in value of the acquisition cost but below the outstanding loan balance of the debt secured by the home. This scenario typically results from a cash out type refinancing. Here we must deal with the potential for a possibility of both gain and debt forgiveness.

Under the MFDRA, only that portion of the forgiven debt pertaining to the purchase (or improvement) of the primary residence qualifies for exclusion. Consequently, any debt attributable to the "cash out" will constitute income that does not qualify for the exclusion.

Purchase price of Home:	$400,000
Initial Loan Balance:	$380,000 (LTV ratio of 95%)

Subsequently, the home increases in value to $600,000, and the owner borrows an additional $200,000:

Balance after refinancing:	$600,000
Value at Time of Foreclosure /High Bid at Foreclosure:	$475,000
Deficiency:	$125,000
Gain:	$75,000

Lender elects not to, or denied the ability to, pursue deficiency:

COD	$125,000 (this constitutes $125,000 of income)
MFDRA exclusion	$0 (the amount forgiven is less than the non-purchase portion of the loan balance, $200,000)

In this scenario, the $75,000 is excluded as IRC section 121 gain, so no tax is due on that portion. The COD income of $125,000, however, does not qualify for exclusion under the MFDRA because of the "ordering rule." "If only a part of the loan is qualified principal residence indebtedness,[10] the exclusion applies only to the extent the amount canceled is more than the amount of the loan (immediately before the cancellation) that is not qualified principal residence indebtedness." Additionally, the COD does not qualify for the IRC section 121 exclusion, which is a capital gain exclusion. Income from debt forgiveness is ordinary income, not capital gain.

Result: Absent insolvency or in bankruptcy issues, a tax liability on $125,000 of income accrues.

[10] Qualified principal residence indebtedness includes only the debt used to buy, build, or improve a taxpayer's main home. IRC Section 163(h)(3)(B).

3. Scenario 3

Modification of Indebtedness involving Forgiveness of Debt; Ownership of Home Retained: A portion of the outstanding principal is forgiven in the loan renegotiation, and the home price partially or completely recovers later

Purchase price of Home:	$400,000
Initial Loan Balance:	$380,000 (LTV ratio of 95%)
Value time of Foreclosure:	$250,000

Modification reducing the principal balance to $250,000 and forgiving the remaining $130,000. Subsequent to the modification, five years pass, value of home rises to $430,000. Home sold for $430,000. When the forgiveness of the $130,000 occurred it constituted forgiveness of debt, but it was excluded under the MFDRA. However, the forgiveness required that the basis in the property be reduced. Thus, this is a rule of tax deferment and not outright exclusion.

Basis before modification:	$400,000
Less loan forgiveness:	($130,000)
Basis after:	$270,000
Sales proceeds:	$430,000
Less basis:	$270,000
Capital gain:	$160,000

Under this scenario, there is a larger degree of capital gain because of the COD. However, IRC section 121 would permit the exclusion of the entire gain. However, the taxpayer may not entirely avoid paying tax. In the event the gain at the time of the sale exceeds the amount of gain excluded by IRC section 121, a more likely occurrence with the reduction of the basis, the taxpayer may be liable for capital gains tax. Further, the COD has been converted from ordinary income into capital gain and the timing of the tax liability significantly deferred.

D. MOVEMENT TO BANKRUPTCY

As discussed, a material modification of a home mortgage, a short sell, or a foreclosure may give rise to either COD income, section 1001 gain, or both. Well-established principles guide the resolution of these issues outside of bankruptcy. In bankruptcy, matters become more complex: Who owes a tax, whether COD must be realized and recognized and by whom, whether gain is present, and, if a tax does exist, whether that tax is nondischargeable in a bankruptcy case are all questions that are top of mind. Parts III and IV address these issues.

III. SECTION 1398: THE SEPARATE ENTITY RULES

One of the most important provisions of the Bankruptcy Tax Act of 1980 (BTA) is Internal Revenue Code (IRC) section 1398. Essentially, section 1398 creates a separate entity for purposes of federal income taxes in cases where an individual debtor files for relief under chapter 7 or chapter 11 of the Bankruptcy Code. Following is a list of common questions and answers regarding the scope, purpose, and effect of section 1398.

A. WHEN DOES SECTION 1398 APPLY?

Section 1398 applies only when an individual debtor files for relief under chapter 7 or chapter 11 of the Bankruptcy Code. Thus, only the bankruptcy estate of an individual debtor in cases under chapter 7 or 11 is treated as a separate taxable entity. A separate taxable entity is not created in chapters 12 or 13 or in any case where the debtor is not an individual.[11]

B. WHAT IS THE PURPOSE OF SECTION 1398?

Section 1398 furthers the fresh start policy embodied in the Bankruptcy Code. The Committee Reports recognize that the purpose of bankruptcy is to provide for a debtor's ability to begin his or her economic life anew.[12] Congress recognized that any expenses incurred by the estate should not burden a debtor's fresh start. Consistent with this purpose is the fact that the income and losses of a separate taxable entity are computed separately from the individual debtor. Moreover, any estate tax liability is generally confined to the estate and its assets.

[11] IRC §§ 1398(a), (b), and 1399.

[12] S. Rep. No. 1035, 96th Cong., 2d Sess. 24-25 (1980); see generally Jack F. Williams, ***A Comment on the Tax Provisions of the National Bankruptcy Review Commission Report: The Good, The Bad, and The Ugly***, 5 Am. Bankr. Inst. L. Rev. 445-462 (1997)(symposium); Jack F. Williams, ***National Bankruptcy Review Commission Recommendations on Tax Policy: Individual Debtors, Discharge, and Priority of Claims***, 14 Bankr. Dev. J. 101-171 (1997); Jack F. Williams, ***The Federal Tax Consequences of Individual Debtor Chapter 11 Cases***, 46 S.C. L. Rev. 1203-1244 (1995)(symposium), reprinted in 47 Digest of Tax Articles 23-43 (1996); Jack F. Williams, ***Rethinking Bankruptcy and Tax Policy***, 3 Am. Bankr. Inst. L. Rev. 153-206 (1995)(symposium); see also Robert W. Van Amburgh, ***Tax Considerations For An Individual Debtor Contemplating Bankruptcy***, Annals Bankr. L. 93, 121-28.

Furthermore, by making the short-year election, a debtor may be able to shift at least part of his or her tax liability to the estate as a Bankruptcy Code (BC) section 507(a)(8) priority claim.[13]

C. HOW IS THE BANKRUPTCY ESTATE TAXED PURSUANT TO SECTION 1398?

Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual.[14] The estate is taxed at the same rate as a married individual filing separately.[15] The chapter 7 or 11 trustee is required to file any returns required by law and to pay any taxes due. The trustee must file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount.[16]

D. MUST A TRUSTEE FILE A FEDERAL TAX RETURN WHERE THE ESTATE HAS GENERATED NO INCOME?

Possibly. The estate may be liable for taxes generated by cancellation of indebtedness income or by sale and exchange (i.e., a foreclosure on property that is property of the estate).

E. HOW IS THE GROSS INCOME OF A BANKRUPTCY ESTATE DETERMINED?

The bankruptcy estate's gross income includes the gross income of the debtor to which the estate is entitled under §§ 541(a)(1) through (a)(7). Property of the estate includes all of the debtor's legal or equitable interest in property wherever located. Section 1398 does not permit double counting of income or losses by both the estate and the debtor. Thus, section 1398(e)(2) provides that a debtor's gross income for any taxable year does not include any item to the extent it is included in the estate's gross income.[17]

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[13] See IRC § 1398(d); see also 1A Collier on Bankruptcy & 9.05 (15th ed. L. King ed.).
[14] IRC § 1398(c)(1).
[15] IRC §§ 1398(c)(2) and (c)(3).
[16] See Van Amburgh.
[17] See generally 1A Collier on Bankruptcy at & 9.04[3].

F. How is Income Treated Where the Income Was Earned Prepetition, But the Income was Received Postpetition?

Section 1398(e)(1) provides that gross income of the estate does not include any amount received or accrued by the debtor before the commencement of the case. Thus, section 1398 was intended to override the assignment-of-income principles under tax law. An example may clarify the effect. Assume that a cash-basis individual who draws a weekly salary nonexempt under applicable state law earns one payment prior to the commencement of his or her chapter 7 case, but it is received by the estate after commencement. In that case, the estate and not the debtor would report the income.[18]

G. How is Cancellation of Indebtedness Income Treated Under the Separate Entity Rules?

Whether the debtor or the estate reports cancellation of indebtedness income will depend on when the taxable event occurs. If the taxable event, e.g., complete or partial discharge, modification of principal amount, etc, occurs before the commencement of the case, generally the debtor should recognize the income under section 61(a) unless it can be excluded under section 108(a). (There is a means by which to shift at least some of the tax consequences from the debtor to the estate through a section 1398 short-year election by the debtor). If the taxable event occurs after commencement of the case, then the estate should recognize the income under section 61(a) unless it can be excluded under section 108(a).

H. How are Deductions Treated Under the Separate Entity Rules?

Section 1398(e)(3) provides that the determination whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor and the debtor was

[18] See Van Amburgh at 123 (provides examples of cash-basis and accrual-basis debtors).

still engaged in the trade or business that the debtor was engaged in before the commencement of the case. It would appear that the same accounting method used for income should be used for deductions. Additionally, section 1398(e)(3) permits the estate to characterize some of its expenditures as trade or business expenses which can be used to offset current income of the estate. Furthermore, administrative expenses and any fees under chapter 123, Title 28, United States Code, are deductible by the estate to the extent not disallowed under another IRC section.[19] If the administrative expenses cannot be used in the current year then they may be carried back three years and carried forward seven years.[20]

I. ARE TRANSFERS OF ASSETS BETWEEN THE DEBTOR AND THE ESTATE TAXABLE EVENTS?

No. Transfers of assets from the debtor to the estate upon commencement of the case and from the estate to the debtor upon termination of the estate are not taxable events.[21]

J. DOES THE ESTATE SUCCEED TO THE DEBTOR'S TAX ATTRIBUTES?

Yes. The estate succeeds to certain enumerated tax attributes of the debtor upon commencement of the case.[22] Presently, these tax attributes include net-operating loss carryovers as determined under IRC section 172; excess charitable contribution carryovers as determined under IRC section 170(d)(1); the recovery of tax benefit items under IRC section 111; certain credit carryovers; capital loss carryovers determined under IRC section 1212; the basis, holding period, and character of property; the debtor's method of accounting; and other tax attributes of the debtor, to the extent provided in regulations carrying out the purposes of section

[19] IRC § 1398(h)(2).
[20] IRC § 398(h)(2)(C).
[21] IRC § 1398(f).
[22] See IRC § 1398(g).

1398.[23] The Service has issued regulations adding passive activity losses and credits to the list[24] and the section 121 exclusion of gain from the sale of a personal residence transferred to the estate.[25] Upon termination of the estate, any unused attributes are transferred back to the debtor.[26]

K. WHAT IS A "SHORT-YEAR" ELECTION? HOW IS THE ELECTION MADE?

Section 1398(d)(2) creates an election that a debtor may make to split his or her taxable year into two taxable years. This election is an important pre-bankruptcy planning tool that cannot be overlooked. The first taxable year-ends on the day before the day the bankruptcy case was commenced.[27] The second taxable year begins on the commencement date. Assume an individual debtor files for relief under chapter 7 on March 8 and shortly thereafter makes the IRC § 1398(d) election. As a consequence of the election, the debtor has two tax years. The first year spans from January 1 through March 7; the second year spans from March 8 through December 31. If the election is not made the debtor would have one taxable year spanning from January 1 through December 31. In other words, absent the election, the commencement of the case will not interrupt the debtor's taxable year.[28] The short-year election is considered made if the complete tax return for the short period is timely filed.[29] In our working example, the return

[23] See C. Richard McQueen and Jack F. Williams, Tax Aspects of Bankruptcy Law and Practice (2nd ed. 2002)(helpful explanation of the listed attributes).
[24] See Treas. Regs. §§ 1.1398-1 and 1.1398-2.
[25] See Treas. Reg. §1.1398-3.
[26] IRC § 1398(I).
[27] A bankruptcy case is commenced upon the filing of the petition under BC §§ 301, 302, 303, and 304.
[28] See IRC § 1398(d)(1). The debtor cannot make the short-year election if he or she has no assets other than exempt property. IRC § 1398(d)(2)(C).
[29] See Temp. Treas. Reg. § 7a.2(d) (1981); Treas. Reg. § 1.6081-1(b)(2).

for the short period ending March 7 should be filed by July 15. The debtor should conspicuously write "SECTION 1398 ELECTION" at the top of the return.[30]

L. WHEN MUST THE SHORT-YEAR ELECTION BE MADE BY A DEBTOR?

The short-year election must be made by the debtor on or before the date for filing his or her return for the short-taxable year.[31] IRC section 6072 requires that returns be made on or before the fifteenth day of the fourth month following the close of a fiscal year. A Treasury Regulation places a gloss on section 6072 in this context by requiring that the short-term return be filed on or before the fifteenth day of the fourth full month following the close of the taxable year.[32] Again, the election must be made on the return. Once made, the election is irrevocable.[33]

M. WHAT IS THE EFFECT OF MAKING THE SHORT-YEAR ELECTION?

The short-year election may be the most potent pre-bankruptcy planning tool because of its wide availability to individual debtors. The most significant effect of the election is that any tax liability for the first short-year becomes an allowed BC section 507(a)(8) priority claim against the estate. Thus, the debtor may essentially force his or her unsecured creditors to pay all or a portion of the first short-year tax claim. Of course, if there are insufficient assets to pay the short-year tax claims in full, they do survive the bankruptcy as a non-dischargeable claim under BC section 523(a)(1). If the debtor fails to make the election, then any tax liability for the complete year is not an allowable claim against the estate.[34] Moreover, if a debtor makes the election, then a debtor's tax attributes as of the end of the first taxable year are transferred to the

[30]Temp. Treas. Reg. § 7a.2(d) (1981). For an excellent discussion on requesting extensions to file the short-year return, see 1A Collier on Bankruptcy at & 9.05[b]. See generally James I. Shepard, The Trustee's Bankruptcy Tax Manual 157-58 (recent edition).
[31]IRC § 1398(d)(2)(D).
[32]Temp. Treas. Reg. § 7a. 2(d).
[33]IRC § 1398(d)(2)(D).
[34]See S. Rep. No. 1035, 96th Cong., 2d Sess. 26 (1980).

estate to be used by the estate to shelter income. If the election is not made, a debtor's tax attributes as of the end of the full taxable year carryover.

N. WHEN IS IT ADVISABLE FOR A DEBTOR TO MAKE THE SHORT-YEAR ELECTION? WHEN IS IT NOT?

There is no easy answer to the questions posed. Whether a debtor should make the IRC § 1398 election depends on the particular facts and circumstances at hand. As a general rule it appears that in most cases the election should be made.[35] By making the election, a debtor is able to shift at least some of the tax liability to the estate as an allowable BC section 507(a)(8) priority claim. However, if the claim is not satisfied it will be nondischargeable and survive the bankruptcy. There may be circumstances present to dissuade a debtor from making the election when substantial net operating losses are involved. For example, if the debtor will benefit more from (I) the use of a net operating loss carried forward from the first short year (if he makes the election) to directly or indirectly reduce nondischargeable tax liabilities than from (ii) the use of the net operating loss against projected income of the debtor after the filing of the petition, then the election should be made. Otherwise the election should not be made.[36]

Nondischargeable taxes are the antithesis of an individual's fresh start. Yet, the drafters of the Bankruptcy Code struck the synthesis in favor of the taxing authorities at least as to those tax claims identified in section 523(a)(1). Nevertheless, all is not lost for an individual debtor and his or her bankruptcy counsel in reducing possible tax consequences in contemplation of a bankruptcy filing. Although experience has shown that an individual debtor should most often make the short-year election, there are many instances where the election should not be made. Counsel must be aware of when a debtor should make the election and when a debtor should not.

[35]Van Amburgh at 144; see also Shepard at 150-57.
[36]Van Amburgh at 145; see also 1A Collier on Bankruptcy at & 9.05[3]; Shepard at 150-157.

Often times, there are no easy rules, no easy answers. Nevertheless, section 1398 with all its nuances and ramifications cannot be ignored before and during bankruptcy.

Example 1: THE MALPRACTICE TRAP

Example 1-1: A partnership applies for relief under chapter 7. May the partnership make a § 1398 election? *No. Only individual debtors may benefit from IRC § 1398. See IRC § 1399.*

Example 1-2: Elrod, a partner in the partnership identified above, seeks relief under chapter 13. May Elrod benefit from the § 1398 election. *No. An individual debtor must file for relief under chapter 7 or 11 only to benefit from § 1398.*

Example 1-3: Assume Debtor is a cash basis taxpayer with a calendar year tax year (January 1 – December 31). Debtor filed for chapter 7 bankruptcy relief on August 1, 20XX. In the seven months before the commencement of a bankruptcy case, Debtor had income giving rise to a tax of $25,000. *If Debtor fails to make the election, there is no interruption in her tax year. The tax would be due at the end of her tax year (31 December) and payable by the fifteenth day of the fourth month following the close of her tax year (15 April). The tax claim would not participate in the chapter 7 distribution in that it is a postpetition claim. However, it would not be discharged in the chapter 7 case. If the Debtor makes the election, she will have two tax years. The first short year runs from 1 January to 31 July. The second runs from August 1 to December 31. Now, the postpetition claim magically becomes a prepetition one due as of the end of the new short tax year. This is also a § 507(a)(8) priority claim that is nonetheless not subject to discharge as delineated in § 523(a).* ***Practice pointer: Make the election.***

Example 1-4: Same facts as above. However, in the previous tax years, Debtor had generated net operating losses (NOLs) that can be carried forward or back to other tax years. An NOL is a surplus deduction that tax law allows you to apply to other tax years. *If Debtor does not make the election, then these tax attributes will pass to the bankruptcy estate and can be used by the trustee to reduce the estate's tax liability. Any unused losses would then pass back to Debtor upon termination of the case. If Debtor makes the election, then she is entitled to use them herself.* ***Practice pointer: Make the election.***

Example 1-5: Same facts as above except that the NOLs arose in the seven months preceding the commencement of the case. Further assume that she had no income in the first seven months of the tax year and expects substantial income in

the last five months of the year. *Without the election, Debtor will be able to use the deductions against postpetition income. With the election, the bankruptcy trustee gets to use the losses and Debtor's income cannot be offset by the deductions.* ***Practice pointer: Do not make the election.***

IV. DISCHARGE OF TAXES

A. SCOPE OF DISCHARGE

An individual's most important bankruptcy objective is a discharge from his or her debts.[37] The discharge is at the heart of the fresh start policy promoted by the Bankruptcy Code and the BTA. The chapter 7 discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in prohibited conduct, usually constituting some type of fraud or bankruptcy crime.[38] The statute providing for discharge is liberally construed in favor of an individual debtor.[39] Thus, the objecting party has the burden of establishing a ground for the denial of a discharge.[40]

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[37] See generally Douglas G. Baird, The Elements of Bankruptcy 27-44 (1992) (discuss fresh start policy); David G. Epstein, Steve H. Nickles, & James J. White, 2 Bankruptcy § 7-16 (1993)(same).

[38] See 11 U.S.C. §§ 727(a)(1) through (a)(10).

[39] Accord *In re Adeeb*, 787 F.2d 1339 (9th Cir. 1986); *In re Johnson*, 98 BR 359 (Bankr. N.D. 1988); *In re Cutignola*, 87 BR 702 (Bankr. M.D. Fla. 1988); *In re Burke*, 83 BR 716 (Bankr. N.D. 1988); *In re Drenckhalm*, 77 BR 697 (Bankr. D. Minn. 1987); *In re Howard*, 55 BR 580 (Bankr. E.D.N.C. 1985).

[40] If a debtor has been denied a discharge in a bankruptcy case, so that all his or her debts remain outstanding, the debtor may not include the same obligations in a subsequent case to obtain a discharge. The denial of the discharge is *res judicata* as to the obligations existing at that time, which are forever nondischargeable. Although understood as part of the warp and wolf of bankruptcy law, the right to discharge was not a part of the early enactments of bankruptcy acts in the United States. The Supreme Court noted the comparative newness of the discharge and fresh-start policy in bankruptcy in *United States v. Kras*, 409 U.S. 414, 446-47 (1973). In fact, it was not until the enactment of the Bankruptcy Act of 1898 that the law provided an individual debtor with a right to discharge certain debts pursuant to the bankruptcy process. Moreover, contrary to conventional wisdom, there is no constitutional right to a discharge; discharge is a statutory privilege provided to the honest but unfortunate debtor who has not abused the bankruptcy process. See *In re Wheeler*, 101 BR 39 (Bankr. N.D. Ohio 1988). A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the personal liability of the debtor with respect to a prepetition debt. See 11 U.S.C. § 524(a). The discharge also operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, including telephone calls, letters, and personal contacts, to collect, recover, or offset any discharged debt. Id. In effect, the discharge is a total prohibition on debt collection efforts against a debtor. However, a discharge of the debtor does not discharge those liable on the debt along with the debtor, including guarantors, co-makers, or partners. 11 U.S.C.§ 524(e). Furthermore, under BC § 524, any attempt to reaffirm a discharged debt is void unless the provisions of the Bankruptcy Code delineating the requirements of reaffirmation are specifically followed. See 11 U.S.C. § 524(c). To ensure the effectiveness of the discharge, § 525(a) prohibits a governmental unit from denying, suspending, or refusing to renew a license or permit or deny employment solely because the person involved was discharged under the Bankruptcy Code, was insolvent before the bankruptcy case, or has not paid a dischargeable debt. Additionally, under § 525(b), no private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under the Code, or an individual associated with a debtor under the Code, solely because the debtor is or has been a debtor under the Code, was insolvent before the commencement of case under the Code, or has not paid a debt that is dischargeable under the Code. See generally D. Epstein, S. Nickles, & J. White at 7-40.

Under chapter 11, section 1141(d) governs the scope and limits of discharge. Pursuant to BC section 1141(d), the confirmation of a plan of reorganization discharges a debtor from any debt that arose before the confirmation of the plan. Unlike section 727(a), a partnership, corporation, or an individual may receive a section 1141(d) discharge.[41] The section 1141(d) discharge is broader than the section 727(a) discharge in that the latter discharges any debts that arose[42] before the *order for relief*,[43] while the former discharges any debts that arose before the *confirmation of the plan*.[44]

B. EXCEPTIONS OF DEBT FROM DISCHARGE

Notwithstanding the debtor's discharge under the Code, certain debts are excepted from discharge as a matter of public policy pursuant to section 523(a). These exceptions to discharge are strictly construed. An exception to discharge should be contrasted with an objection to discharge. If successful in an objection to discharge proceeding, the creditor's claim along with every other claim survives the bankruptcy case; that is, the debtor will not receive a discharge at all. It is significantly different with an exception to discharge proceeding under section 523(a). If successful in asserting section 523(a), the creditor's claim will not be discharged and will survive the bankruptcy case; that is, a section 523(a) claim may be enforced and ultimately satisfied even after the bankruptcy case. Thus, although the debtor receives a general discharge, the section 523(a) claims live on.

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[41] In *Toibb v. Radloff*, 111 S. Ct. 2197 (1991), the Supreme Court held that an individual may properly seek relief under chapter 11 of the Bankruptcy Code.

[42] It should come as no surprise that just when a debt arises has become a bone of contention. D. Epstein, S. Nickles, & J. White 7-16, at 312.

[43] The order for relief is entered automatically where a debtor files a voluntary petition in bankruptcy. See 11 U.S.C. § 301. In an involuntary case, the order for relief comes after the court is persuaded that the grounds for involuntary relief are met. See 11 U.S.C. § 303(h).

[44] For the requirements for chapter 11 plan confirmation, see 11 U.S.C. § 1129.

Section 523 of the Bankruptcy Code generally specifies which debts of an individual debtor are not discharged in a bankruptcy case under section 727 of chapter 7, section 1141 of chapter 11, or section 1328(a) and (b) of chapter 13 (the "super-discharge" and the "hardship" discharge). Included among these debts are certain taxes which are identified as nondischargeable.[45]

C. PRIORITY TAX CLAIMS

The first category of nondischargeable tax claims is set forth in section 523(a)(1)(A).[46] This category also happens to include the priority tax claims identified in section 507(a)(8). Thus, unlike the remaining two categories of nondischargeable tax claims, this particular category may participate in the distribution of estate assets under section 726 as a priority tax claim, in effect forcing the unsecured creditors of the estate to subsidize the tax obligation of the debtor. Therefore, it is incumbent on the debtor to ensure that such tax claim be filed by the taxing authority or to take the steps himself to file a claim on behalf of the taxing authority.

Under this section, a tax or customs duty specified in § 507(a)(3) as an involuntary gap claim[47] or § 507(a)(8)[48] is nondischargeable whether or not a claim for such tax was allowed by

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[45] In *In re Olsen*, 123 B.R. 312 (Bankr. N.D. Ill. 1991), the bankruptcy court held that a nondischargeable tax claim survives bankruptcy regardless of whether such claim was filed or allowed in the bankruptcy case.

[46] 11 USC § 523(a)(1), which reads as follows:

A discharge under section 727, 1141, 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, if required--

(i) was not filed; or

(ii) was filed after the date on which such return 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.

[47] 11 U.S.C § 523(a)(1)(A); 11 USC § 507(a)(3)(this section relates to the priority of involuntary gap claims).

[48] 11 U.S.C. § 523(a)(1)(A); 11 USC § 507(a)(8)(this section relates to the priority of allowed unsecured tax claims of governmental units)

the court or filed in the case.[49] These priority and nondischargeable tax claims include the following:

1. Involuntary gap claims under § 507(a)(3).[50]
2. Income or gross receipts taxes incurred (that is, measured by the last date by which a return could be filed without penalty) prepetition and within three years from the filing of the bankruptcy petition.[51] An easier approach in applying this rule is to go back three years from the petition date and look forward. Any subsequent return due date (including extensions) that can be "seen" as one looks "into the future" will mean that the taxes associated with that tax year are nondischargeable. Moreover, it is the first petition date and not any conversion date that constitutes the measuring date. Under § 507(a)(8), the three-year period is suspended if the automatic stay is in effect. Thus, a debtor cannot hide in a chapter 13 case for the purpose of "running out" the three year clock. Once the stay is no longer in effect, the clock begins to run again at the place at which it last stopped plus an additional ninety days. A practitioner should order the tax history (MFTRA-X) of her client to ascertain when returns were due, including extensions filed. One can request that information through calling the Tax Practitioner Hotline at 866-860-4259 or by ordering on-line through the E-Services for Tax Professionals Portal.

   Example 2:

   Taxpayer files a bankruptcy petition under chapter 7 May 1, 2012. Assume Taxpayer is a calendar year cash basis taxpayer. Thus, a tax return associated with taxes for Tax Year 20XX must be filed as of 15 April of 20XX + 1 (or 15 October 20XX + 1 if an extension is timely filed). What taxes would constitute priority claims under section 507(a)(8)(A)(i)?

[49] 11 USC § 523(a)(1)(A).

[50] The third priority as set forth in § 507(a)(3) of the Bankruptcy Code is "unsecured claims allowed under § 502(f) of this title." Under § 502(f), an involuntary gap claim is one which arises in the ordinary course of a debtor's business after the filing of an involuntary petition against the debtor but before either the appointment of a trustee or the entry of an order for relief. An involuntary gap claim is allowed "the same as if such claim had arisen before the date of the filing of the petition." The involuntary gap claim is the creature of the involuntary bankruptcy case. Recall that the filing of an involuntary petition against the debtor does not operate as an order for relief under the Bankruptcy Code. This priority speaks directly to the time delay made possible by segregating the order for relief from the filing of the petition.

[51] An eighth priority is allowed by § 507(a)(8)(A)(i) of the Bankruptcy Code for unsecured federal tax liens ("unsecured claims of governmental units") to the extent that such claims are for income or gross receipts taxes incurred before the filing of the bankruptcy petition for which the due date of the tax return (including any extension) occurred within three years before the date the bankruptcy petition was filed or for which the due date of the return (including any extensions) occurred after the filing of the petition. As indicated, the due date of the return, and not the date when the taxes are assessed, determines the priority.

Answer:

Year	Dischargeable	Prepetition Claim
2012	No	No
2011	Yes	Yes
2010	Yes	Yes
2009	Yes	Yes
2008	No (unless extension)	Yes (status?)

3. Income or gross receipts taxes assessed within 240 days from the filing of the bankruptcy petition.[52] This will require the practitioner to obtain evidence of the assessment date, if any. For federal taxes, one can obtain a proof of assessment by requesting a Form 23-C Assessment Certificate, the MFTRA-X tax history, the From 4340 Certificate of Assessments and Payments, or by looking for transaction codes 150, 290, or 300 (and a few others) from the Account Transcript.

4. Income or gross receipts taxes still assessable under applicable law at the time the bankruptcy petition is filed.[53] These taxes generally include those years that are still under audit risk, tax issues pending in the Tax Court, and taxes associated with a Form 872-A Consent to Extend Time for Assessment (open ended).

5. Recent property taxes assessed prepetition and last due without penalty within one year of the filing.[54]

6. Trust fund taxes incurred at any time, including the *employee's share* of payroll taxes that an employer is required to withhold and, in many states, sales tax.[55]

7. The *employer's share* of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition to the extent the return for such taxes was last due (including any extensions of time)

[52]Also included are income and gross receipts taxes assessed at any time within 240 days before the date the bankruptcy petition was filed. The 240-day period is extended for the period of time an offer of compromise is considered by the IRS after submission by the taxpayer, plus 30 days after such offer is rejected. Under this rule, the date on which the IRS assesses the tax, rather than the date of the return, determines the priority.

[53]Section 507(a)(8)(A)(iii) grants priority to income and gross receipts taxes not assessed before the filing of a bankruptcy petition, but which are still permitted to be assessed under applicable tax laws. Accordingly, a prepetition and unsecured federal tax lien will still receive an eighth priority under this section if the statute of limitations still allows an assessment of the tax liability after the bankruptcy petition is filed, even though such assessment was not made within the 240-day period (plus any extension) prior to the bankruptcy filing.

[54]An unsecured claim of a governmental unit for property taxes assessed before the bankruptcy petition was filed and last payable without penalty within one year before the filing of the petition is given an eighth priority.

[55]Taxes required to be collected or withheld and for which the debtor is liable in whatever capacity are given an eighth priority under § 507(a)(8)(C) of the Bankruptcy Code.

within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed.[56]

8. Excise taxes related to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition.[57]

9. Certain customs duty under § 507(a)(8)(F) of the Bankruptcy Code.[58]

D. MISCONDUCT TAX CLAIMS

The second category of nondischargeable tax claims is set forth in BC sections 523(a)(1)(B) and (C) and include the following taxes:

1. Tax liabilities relating to a tax return which was not filed.[59] There have been several cases that have struggled with what constitutes a "return" for these purposes. BAPCPA has now defined a return by reference to

[56]The employer's share of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition receives an eighth priority under § 507(a)(8)(D) of the Bankruptcy Code, to the extent the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed. Older tax claims of this nature are payable as nonpriority general claims. The employee's share of employment taxes on wages earned from a debtor and paid before the filing of a bankruptcy petition also receives an eighth priority as a trust fund tax liability without a three-year limitation.

[57]Unsecured claims for excise taxes are given an eighth priority under § 507(a)(8)(E) of the Bankruptcy Code. The excise taxes claimed must relate to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition. If a return is due, the three year period is extended if the due date for filing the return was extended. 11 U.S.C. § 507(a)(8)(E). If a return is not required, the tax claim must relate to a transaction which itself occurred within three years prior to the filing of the bankruptcy petition. For purposes of this priority, excise taxes covered include sales taxes, estate and gift taxes, gasoline and special fuel taxes, wagering taxes, and truck taxes.

[58]Unsecured claims for customs duty are given an eighth priority under § 507(a)(8)(F) of the Bankruptcy Code. According to the legislative history, this priority covers duties on imports entered for consumption within one year before the filing of the petition, but which are still unliquidated on the petition date; duties covered by an entry liquidated or unliquidated within one year before the petition date; and any duty on merchandise entered for consumption within four years before the petition but not liquidated as of the petition date, if the Secretary of the Treasury or his or her delegate certifies that duties were not liquidated because of possible assessment of antidumping or countervailing duties or fraud penalties.

[59]See, e.g., *In re Bergstrom*, 949 F.2nd 341 (10th Cir. 1991), where the United States Court of Appeals for the Tenth Circuit held that the term "filed return" was not broad enough to include a substitute return prepared by the IRS, absent the debtor's signature thereon; *In re Pruitt*, 107 B.R. 764 (Bankr. D. Wyo. 1989), where the bankruptcy court held that substitute tax returns filed by the Internal Revenue Service when the debtor failed to file such returns for several years did not preclude application of the Bankruptcy Code rendering tax debts nondischargeable for any tax debt with respect to which a return was required and not filed; *In re Brookman*, 114 B.R. 769 (Bankr. M.D. Fla. 1990), where the bankruptcy court held that the debt for unpaid income taxes was nondischargeable because the debtor failed to rebut prima facie evidence that the tax return for the applicable tax year was not filed; *In re Crawford*, 115 B.R. 381 (Bankr. N.D. Ga. 1990), where the bankruptcy court held that a tax obligation for which the debtor did not file a tax return is non-dischargeable even though the Internal Revenue Service filed the return on the debtor's behalf.

applicable nonbankruptcy law. Thus, for federal income tax purposes, a return includes a §6020(a) return where a taxpayer signs it, a written stipulation to a judgment, and a final order by a court of competent jurisdiction. However, a SFR or Substitute for Return prepared by the IRS, any return where the *jurat* has been altered or the return is unsigned, or any return filed in the wrong place do not constitute a return for these purposes. May a taxpayer file a return after the Service has prepared an SFR and meet the return requirement. Five circuits have concluded no but there is some emerging bankruptcy authority to the contrary.

2. Tax liabilities reported by a tax return filed late and filed within two years prior to the filing of the bankruptcy petition or filed after the bankruptcy petition;

3. Tax liabilities reported by a fraudulent return[60] or from an attempt by the debtor to willfully evade or avoid any tax.[61] Here, the courts have employed the civil and not criminal fraud standards. However, there are several approaches that do diverge in the hard cases. Generally, the government must prove some conduct on the p[art of the debtor and a requisite state of mind. To satisfy the conduct requirement, courts look to something more than the failure to pay the tax. For example, the recurrence of an understatement of income, inadequate records, asset transfers, false W-4's, no returns filed, barter transaction history, cash business history, and other forms of concealment may be sufficient to meet the conduct test. As for the state of mind requirement, the civil

[60]11 USC § 523(a)(1)(B); *see* 124 Cong. Rec. H11,113-14 (daily ed Sept 28, 1978); S 17,430-31 (daily ed Oct 6, 1978); *see also In re Graham*, 108 B.R. 498 (Bankr. E.D. Pa. 1989), where the bankruptcy court held that a prepetition tax court decision holding the debtor liable to the IRS for the debtor's underpayment of taxes, but which did not decide that the underpayment was fraudulent, did not preclude the debtor from disputing the government's claim that such tax liabilities were non-dischargeable for fraud; *In re Fernandez*, 112 B.R. 888 (Bankr. N.D. Ohio 1990), where the bankruptcy court held that the debtor's conduct concerning tax obligations was shown to be willful and evasive and thus, the tax obligations were deemed nondischargeable; *In re Kirk*, 114 B.R. 771 (Bankr. N.D. Fla. 1990), where the bankruptcy court held that the debtors' conduct demonstrated a purposeful attempt to evade income taxes and thus, the claim of the IRS for civil fraud penalties was allowed; *In re Carapella*, 115 B.R. 365 (N.D. Fla. 1990), where the district court held that the tax liability of a chapter 7 debtor for a fraudulent return filed by the debtor was nondischargeable; *In re Gilder*, 122 B.R. 593 (Bankr. M.D. Fla. 1990), where the bankruptcy court held that where the debtor submitted false withholding statements for the express purpose for eliminating the withholding of federal income taxes from wages, such conduct was a "willful attempt to evade or defeat tax" within the meaning of the exception to discharge; *In re Hopkins*, 133 B.R. 102 (Bankr. M.D. Ohio 1991), where the bankruptcy court held that the wife's signing of joint returns which she knew were in error constituted the making of a fraudulent return or willfully attempting to evade such tax and, thus, such tax debts were nondischargeable in the wife's bankruptcy case; *In re Peterson*, 132 B.R. 68 (Bankr. D. Wyo. 1991), where the bankruptcy court held that the debtor did not "willfully" attempt to evade tax by signing returns which the government admits were not fraudulent and then filing for relief under chapter 7 shortly after such taxes became eligible to be dischargeable; *In re Graham*, 973 F.2d 1089 (3d Cir. 1992), where the United States Court of Appeals for the Third Circuit held that a United States Tax Court judgment holding the debtors liable for income tax deficiencies resulting from fraudulent tax returns did not have claim preclusion or issue preclusion effect in determining whether the debtors' liability was nondischargeable; *In re Levinson*, 969 F.2d 260 (7th Cir. 1992), where the United States Court of Appeals for the Seventh Circuit held that the evidence was sufficient to support a determination that the debtor had filed fraudulent tax returns so as to render the tax debts nondischargeable.

[61]11 U.S.C. § 523(a)(1).

> standard usually mirroring the IRC §6672 responsible person standards for the imposition of trust fund liability are sufficient. Thus, an intentional, knowing, and voluntary act is all that is necessary. In a joint return situation, the state of mind of one spouse will not be imputed to the other spouse.

E. TAX PENALTIES

The third category of nondischargeable taxes is set forth in § 523(a)(7).[62] This section provides that tax penalties which are basically punitive in nature are nondischargeable only if the penalty is computed by reference to a related tax liability which is also nondischargeable. It appears that if the amount of the penalty is not computed by reference to a tax liability, the transaction or event giving rise to the penalty must occur during a three-year period ending on the date of the filing of the bankruptcy petition.[63]

F. TAX CLAIMS IN INDIVIDUAL DEBTOR CHAPTER 11 CASES

With respect to individual debtors in reorganization under chapter 11, section 1141(d)(2) of the Bankruptcy Code incorporates by reference the exceptions to discharge set forth in section 523 and discussed above.[64] Section 1141(d)(2) of the Bankruptcy Code provides that the confirmation of a chapter 11 plan does not discharge an individual debtor from any debt excepted from discharge under section 523.[65]

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[62] 11 USC § 523(a)(7), which reads as follows:

> (a) A discharge under Section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt--
>
> (7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty-
>
> (A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or
>
> (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

[63] 124 Cong Rec H11,113-14 (daily ed Sept 28, 1978); S 17,430-31 (daily ed Oct 6, 1978); see also Rev Rul 68-574, 1968-2 CB 595.

[64] 124 Cong. Rec. H11,113-14 (daily ed Sept 28, 1978); S. 17,430-31 (daily ed Oct 6, 1978).

[65] 11 USC §§ 1141(d)(2) and 523.

With respect to all debtors (i.e., including corporations and partnerships), the confirmation of a chapter 11 plan does not discharge the debtor from any debts (including taxes) if:

1. The plan provides for the liquidation of all or substantially all of the property of the estate
2. The debtor does not engage in business after consummation of the plan
3. The debtor would be denied a discharge under § 727(a) of the Bankruptcy Code if the case were a chapter 7 liquidation proceeding[66]

Thus, a debtor is not discharged from any debt (including federal taxes) by the confirmation of a plan if the plan is a liquidation plan and if the debtor would be denied a discharge in a chapter 7 liquidation proceeding pursuant to section 727(a) of the Bankruptcy Code.[67] Under section 727(a)(1), only an individual, and not a corporation or a partnership, may obtain a discharge.[68]

G. TAX CLAIMS IN CHAPTER 13 CASES

Prior to 2005, the chapter 13 discharge was sufficiently broad in scope that most tax claims could be discharged, even those under section 523(a). However, BAPCPA changed that result, conforming the chapter 13 discharge with that under chapter 7. Thus, after a debtor has made all payments required by the chapter 13 plan, the bankruptcy court grants to the debtor a discharge of all debts provided for by the plan or disallowed under section 502, except the following debts:

1. Debts with the final payment falling due after the final payment under the plan is due as set forth in section 1322(b)(5), that is, certain long-term debt;[69]

[66] Id. § 1141(d)(3).
[67] S Rep No 989, 95th Cong, 2d Sess 129 (1978).
[68] 11 U.S.C. § 727(a)(1).
[69] 11 U.S.C. § 1328(a)(1).

2. Debts in the form of trust fund taxes; nonfiler taxes; fraudulent taxes or taxes arising from a willful intent to evade; debts incurred under false pretenses; unlisted debt; debts from fraud, etc., when in a fiduciary capacity; domestic support obligations; certain student loans that do not pose an undue hardship to the debtor; debts for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft while intoxicated;
3. Debts for restitution included in a sentence on the debtor's conviction of a crime;[70] and
4. Debts for restitution or damages awarded in a civil action against the debtor as a result of willful or malicious injury by the debtors that caused personal injury to an individual or the death of an individual.

[70] 11 U.S.C. § 1328(a).

H. DISCHARGE PROCEDURES

An action to except a debt from discharge under section 523 is an adversary proceeding under Part VII of the Bankruptcy Rules. It is commenced by the service of a summons and complaint in accordance with Bankr. R. 4. The Federal Rules of Civil Procedure generally apply to adversary proceedings through Part VII of the Bankruptcy Rules, although several Bankruptcy Rules have non-FRCivP provisions.

The burden of proof to assert that the debt is non-dischargeable under section 523(a) falls squarely on the shoulders of the creditor asserting the exception and not necessarily the plaintiff for reasons soon to become apparent. Unlike many grounds for an exception to discharge that must be brought by the applicable bar date in a bankruptcy case, tax claims that may survive the discharge can be asserted against the individual debtor in personam well after the bar date has run or even past the closing of the bankruptcy case. Thus, it may be beneficial for the debtor to commence an adversary proceeding against the relevant taxing authority for a determination of whether the tax claim is dischargeable while the bankruptcy case is pending. If that be the case, the taxing authority still has the burden to prove that the tax claim is nondischargeable. Although there is some authority to allow re-opening of a bankruptcy case that has been closed under section 350, this is simply too thin a reed to rest such an important determination. Thus, a bankruptcy practitioner should carefully consider the tactical and strategic advantageous to the commencement of an adversary proceeding where the taxing authority has failed to do so.

V. CONCLUSION

Individuals seek bankruptcy relief because they want the benefits of discharge. However, not all claims are subject to discharge even where the debtor has conducted his or her affairs honestly and with integrity. The Bankruptcy Code mandates that certain tax claims survive the debtor's bankruptcy case. These tax claims may be grouped in two broad categories: (1) those claims that Congress has determined must be paid as a matter of public policy regardless of debtor culpability; and (2) those claims that arise from debtor misconduct. Notwithstanding the curtailment of the discharge of taxes, many taxes are subject to discharge in an individual debtor chapter 7, chapter 11, or chapter 13 case. Moreover, since enactment of BAPCPA in 2005, the advantages to a chapter 13 bankruptcy case largely no longer exist. This is quite odd when a primary objective of BAPCPA was the encouragement of debtors to seek relief under chapter 13 instead of chapter 7.

The cross-disciplinary practice of bankruptcy law and tax law brings with it a host of challenging substantive and procedural issues. This practice cuts across federal, state, and local bodies of law. It requires you do become comfortable with working with the Internal Revenue Service and its maze of formal and informal procedures. Daunting yes, but fabulously rewarding. A commitment to understanding this intersection of the law will make you a better bankruptcy practitioner and arm you with the tools necessary to address your client's needs in a robust manner.

Top 10 Things All Bankruptcy Attorneys Should Know About IRS Problems in Bankruptcy

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1. How did you get in this mess in the first place? Let's Fix That!

a. Lack of estimated tax payments?
b. Inadequate withholding at work?
c. Failed or failing business, unpaid payroll taxes?
d. Adverse audit?
e. Have you made changes to avoid repeating the problem?

2. Be A Patient Lawyer – Not All Problems Are Solved With Bankruptcy; And Not All Bankruptcies Need Be Filed "Today".

a. Start with a "game plan" meeting to review options, pros and cons of each option:
b. Let 10-year statute of limitations run (subject to tolling)
c. Look into Offer in Compromise (net equity plus 12 times disposable income)
d. Let income tax debts "age" before filing bankruptcy
e. Too many practitioners file chapter 13 with impossibly large priority claims, better to wait!

3. Know The Rules to Discharge Taxes!

a. Only applicable to unsecured tax debts (to be secured, FTL filed ***and*** equity)
b. Only applicable to ***income*** taxes (and gross receipts taxes)
c. Must have filed a "return" and SFRs (substitutes for returns under 26 USC §6020(b)) are not "returns" (see more #10 below)
d. 3 years from when return was "due" (including extensions to file)
e. 2 years from when the return was "filed" (meaning "delivered", not just "mailed")
f. 240 days from when the assessment was made (i.e. later audit assessments)

4. Know The "Tolling" Rules!

a. **Purpose: can't hide out in safe haven while the time periods lapse**
b. **Must give IRS adequate time to try to collect, so "toll" for anytime that IRS is prevented from taking collection action.**
c. **Looking for a tolling event that "overlaps" one or more of the 3 time periods.**
d. **If the tolling event *both starts and ends* before or after an applicable time period, ignore it.**
e. **If the tolling event *either* (i) starts before and ends after an applicable time period begins, or (ii) starts before an applicable time period ends and ends either before or after the applicable time period ends, the overlapping time is the tolling period (plus either 90 or 30 days – see below).**
f. **CDP – Collection Due Process Hearing (discuss impact of "timely" vs. "untimely")**
g. **The tolling period for CDP or BK is the time of the CDP or BK plus 91 days (if more than one BK or more than one CDP, add 91 once; if a CDP and a BK, add 91 twice)**
h. **The tolling period for OIC is the time of the OIC plus 31 days**
i. **The tolling provisions (i) apply to the 3-yr and 240-day rules, and (ii) are found in "flush language" of 11 USC §507(a)(8) (right after §507(a)(8)(G)) meant to codify the Young decision which applied equitable tolling.**
j. **No similar tolling provisions are found in 11 USC §523(a)(1)(B)(ii), which is the 2-yr rule.**
k. **IRS now takes the position that tolling due to BK or CDP applies to the 2-yr rule despite the codification only being found in §507 (its position is that Young still applies in §523).**
l. **www.TaxDischargeDeterminator.com**
All the practitioner needs to use the Tax Discharge Determinator program is copy of the Account Transcript; the program applies all rules including tolling, and gives the "answer" in the alternative with respect to tolling for the 2-yr rule.

5. Use Chapter 13 to pay "smaller" civil penalties and income taxes.

a. **The priority portion of the income tax (if too small to wait for them to become non-priority, or the need to file is too urgent to wait) and a civil penalty, can be paid over 60 months, without interest (if not fully secured), or with interest (if secured).**

6. Know the basic rules applicable to Forms 1099-C.

a. **Ordinary rule: it's ordinary taxable income unless an exception**
b. **COD is amount of debt in excess of sales price**
c. **Sales price over adjusted tax basis is gain (or loss if ATB is ≥ sales price)**

7. Know the Section 108 exclusions from income recognition.

a. **Discharge occurs in a bankruptcy case**
b. **Mortgage Debt Relief Act –**
    i. **Principal residence (at least 2 of last 5 years)**
    ii. **The forgiveness act must occur before 2014**
    iii. **The debt must have been used for acquisition or improvement**
    iv. **Cap ($2million joint return, $1million if MFS)**
c. **Discharge occurs when taxpayer is insolvent (FMV of "all" assets, exempt and non-exempt, less all debt, is extent of insolvency)**
d. **If income is excluded under Section 108, must reduce "tax attributes" accordingly**

8. Know Reduction of Tax Attributes.

a. **If COD is excluded under section 108 due to BK or insolvency, must reduce the taxpayer's "tax attributes"**
b. **If COD was excluded due to "principal residence" exception, the only tax attribute to be reduced is the basis of that principal residence (but not below zero)**
c. **"Tax Attributes" are (in the order they are to be reduced): Net Operating Loss (NOL); General Business Credits; Minimum Tax Credits; Capital Loss Carryovers; basis in property (and a few others). You can elect to reduce basis first.**

9. Dealing with Unpaid Payroll Taxes Owed by Corporations.

a. **Generally, Shareholders are not liable for debts of a corporation or LLC.**
b. **26 USC §6672 says those persons who were "responsible" for withholding, accounting for, and paying over employment taxes, and who "willfully" fails to do so, are themselves personally liable for the unpaid "trust fund" taxes of the employer. Termed Trust Fund Recovery Penalty or TFRP.**
c. **TFRP not needed for partners of general partnerships (liable anyway under state law).**

d. **Can apply to non-owners of corporations, LLCs and partnerships.**
e. **Almost strict liability for officers, directors, check signers, shareholders.**
f. **Trust fund taxes are those that were withheld from employees' paychecks (income taxes withheld and employees' share of social security and Medicare taxes withheld).**
g. **TFRP is not dischargeable; 10-yr statute of limitations**
h. **If entity has available assets, sell/collect/gather and make a "designated payment" of the funds to the trust fund taxes (after first paying legal fees, of course!); failure to do so is malpractice!**

10. Making Sense of SFR returns.

a. **If taxpayer doesn't file a tax return, there is no assessment and IRS cannot collect a tax. Therefore, it may behoove taxpayer not to file a return because IRS cannot collect what has not been assessed.**
b. **Congress therefore authorized IRS to make a "substitute" for the return if the taxpayer does not file one, which substitute for return ("SFR") is based on income reported by third party payers via forms 1099 and w-2.**
c. **When preparing SFR assessment, IRS does not know of deductions to which taxpayer is entitled (such as basis, children, filing status, etc.).**
d. **SFRs typically overstate correct liabilities as determined when taxpayer files actual return.**
e. **Host of BK courts have held that SFRs are not "returns", so are not dischargeable b/c one of the requirements for dischargeability is than actual return be filed.**
f. **Many taxpayers file an original return after being notified of the SFR assessment.**
g. **Some BK courts have held (erroneously in the opinion of the presenters) that the filing of an actual return after an SFR assessment is a "nullity" because it serves no purpose. Remains an unfiled return for discharge purposes.**
h. **Result? Tardy taxpayers with SFR assessments may have those tax debts treated the same in BK as if they had filed fraudulent returns or had willfully evaded the payment of the tax debts – is that what Congress intended? We think not.**
i. **IMPORTANT: just because Account Transcript says it is an SFR assessment does not mean it is automatically not dischargeable. If an actual return was filed and accepted before the SFR assessment was made, should be a dischargeable SFR.**