Tax and Bankruptcy: Just Like Peas and Carrots

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TABLE OF CONTENTS

PRACTICE POINTERS: SWEAT THE SMALL STUFF 1

DISCHARGEABILITY OF TAX CLAIMS 2

PRIORITY TAX CLAIMS 2

DISCHARGEABILITY OF TAXES IN CHAPTER 7 AND IN INDIVIDUAL CHAPTER 11 4

DISCHARGE OF INCOME TAXES UNDER CHAPTER 13 5

DISCHARGE OF TAXES UNDER CHAPTER 11 7

TOLLING OF PRIORITY AND DISCHARGEABILITY DEADLINES 8

LIENS 8

TAXPAYER'S AVOIDANCE POWERS IN BANKRUPTCY 9

TAX IMPLICATIONS OF TRANSFERS OF PROPERTY BEFORE, DURING AND AFTER A BANKRUPTCY 9

SHORT-YEAR TAX ELECTION IN CHAPTER 7 AND CHAPTER 11; THE PARALLEL UNIVERSE OF SECTION 1398 10

OFFER IN COMPROMISE PROGRAM 16

NET OPERATING LOSSES (NOLs) IN BANKRUPTCY 20

DISCHARGE OF INDEBTEDNESS/IRC § 108 ISSUES 21

IMPACT ON ASSETS, TAX BASIS AND TAX ATTRIBUTES 22

PRACTICE POINTERS: SWEAT THE SMALL STUFF

Whenever a taxpayer has Federal tax liabilities, counsel should always obtain a tax account transcript (sometimes referred to as a record of account) prior to the filing of a bankruptcy (presuming that time so allows). A tax account transcript is generated by the IRS and sets out not only the amount of liabilities on a year by year basis, but will also provide other salient information and dates that are necessary to determine the status of such tax liabilities. Under IRC § 6203, the taxpayer is entitled to this record. Similar information should be obtained regarding state income taxes.

Tax claims fall into one of the following categories:

1. **Secured** (this claim can consist of priority and/or non-priority tax liabilities).

2. **Unsecured**

   a. **Priority** under§ 507(a)(8).

      i. Pre-petition **interest** through the date a petition is filed is entitled to the same priority as the underlying tax claim.

      ii. Pre-petition pecuniary **penalties** through the date a petition is filed is entitled to the same priority as the underlying tax claim. See § 507(a)(8)(G).

   b. **General unsecured**

      Includes non-priority tax claims, non-pecuniary (punitive) tax **penalties** on priority and non-priority tax claims, and **interest** on non-priority tax claims. This class also consists of tax claims which are excepted from discharge under § 523 but which are not entitled to priority status under § 507(a)(8) (for example, a tax liability based upon a fraudulent or unfiled return).

It is thus possible to have the tax debt for a particular year consist of different classifications that fall within more than one category. For instance, a tax debt could consist of a priority claim for pre-petition principal tax and pre-petition interest on this principal, and also consist of an allowed general unsecured claim for pre-petition non-pecuniary (punitive) tax penalties. If a lien were filed, some or all of the liability might be treated as a secured claim.

2. DISCHARGEABILITY OF TAX CLAIMS

The Jurisdiction of the Bankruptcy Court.

Pursuant to § 505(a) of the Bankruptcy Code, bankruptcy courts have the jurisdiction in tax matters to essentially act as a tax court to determine the amount or legality of any tax, fine or penalty relating to a tax, or any addition to tax. The court may not make this determination in the event there were previously contested proceedings and an actual adjudication by a judicial or administrative tribunal. The bankruptcy court can thus function as a more convenient and friendly forum within which the debtor can have the propriety and/or the amount of a tax determined. Defenses to the liabilities can also be litigated. The bankruptcy court can determine the validity and the amount of a tax liability implicitly by determining an objection to a claim filed in the bankruptcy case. Claims in bankruptcy are generally determined under applicable non-bankruptcy law and the Bankruptcy Code and Rules set out the procedures for the allowance of such claims. There was previously a split among the circuit courts as to who carried the burden of proof to determine the allowance of a creditor's claim. Some circuit courts, including the Tenth Circuit, had held that irrespective of what non-bankruptcy law might provide, the burden rested with the creditor to prove its claim. See Martin, Burden of Persuasion: The Overlooked Defense to Tax Claims, 21 Cal. Bankr. J. No. 2 (1993). In Raleigh v. Illinois Dept. of Revenue, 53 U.S. 15, 120 S. Ct. 1951 (2000), the Supreme Court resolved the split and held that applicable non-bankruptcy law is followed to determine who has the burden of proof in determining a creditor's allowed claim. For instance, if under state law the taxpayer must carry the burden of proof to disallow an assessment, then this burden of proof applies in a bankruptcy filed by the taxpayer. The ruling applies with equal vigor to non-tax claims.

As a second facet of the bankruptcy court's jurisdiction, it can determine dischargeability of a tax claim under § 523.

3. PRIORITY TAX CLAIMS

To determine which tax claims can be discharged in bankruptcy proceedings, one must start with a determination as to which unsecured tax claims are entitled to priority claim status under § 507(a)(8) of the Bankruptcy Code. The reason that this determination is critical is that § 523(a)(l) incorporates by reference and renders non-dischargeable all claims under § 507(a)(8). With reference to income tax liability, § 507(a)(8) provides three independent bases of priority:

(1) If the bankruptcy petition is filed within three years of the due date of the tax return, the taxes are entitled to priority . . . . For this rule, the dispositive date is the due date of the return, and the date the return was actually filed is immaterial. § 507(a)(8)(A)(i).

(2) If the bankruptcy petition is filed within 240 days of the day of assessment of the tax (as extended during the period in which an offer in compromise was pending plus 30 days) the taxes are [priority]. See § 507(a)(8)(A)(ii). When an assessment of a tax is made is somewhat problematic. The term "assessment" is not defined

in the Bankruptcy Code and it generally refers to the determination by law by the taxing authority of the amount of the tax. Under IRC § 6203, a copy of the record of assessment is available to the taxpayer. Further, dates of assessment for liabilities are generally set out on a tax account transcript. **NOTE:** State tax liabilities may be assessed on different dates than the Federal tax liabilities.

(3) A tax is priority if it is not assessed but remains accessible after a bankruptcy petition if filed, unless the tax relates to either a non-filed tax return or a delinquent tax return filed within two years of the filing of the bankruptcy petition, or it relates to a fraudulent return. § 507(a)(8)(A)(iii).

These classification requirements apply with equal force to state and local taxes. Section 507 provides that other classes of tax liabilities are non-dischargeable as follows:

§ 507(a)(8)(B): Property tax assessed within one year from the date of filing without penalty.

§ 507(a)(8)(C): A tax required to be collected or withheld and for which the debtor is liable in whatever capacity (commonly referred to as "trust fund" or "fiduciary" taxes). This category includes not only employer's fiduciary taxes but also includes retail sales tax collected by the debtor. These liabilities are always entitled to priority status; thus, they are never dischargeable under § 523(a)(l) and must always be paid in full through a reorganization.

§ 507(a)(8)(D): Employment taxes (non-fiduciary).

§ 507(a)(8)(E): Excise tax.

§ 507(a)(8)(F): Customs duty.

§ 507(a)(8)(G): Non-punitive penalties related to priority tax claim and in compensation for actual pecuniary loss.

The analysis under § 507 as to which tax claims are entitled to priority status is also relevant to determine the order in which unsecured claims will be paid from an asset Chapter 7 bankruptcy estate. In order for priority tax claims to receive a distribution from a Chapter 7 asset estate, the Bankruptcy Code requires that all claims of a higher priority be paid in full. Further, in order for a plan to be confirmed under Chapters 11, 12, or 13, a plan must generally provide for payment in full priority tax claims.

5. DISCHARGEABILITY OF TAXES IN CHAPTER 7 AND IN INDIVIDUAL CHAPTER 11

Section 523(a)(l) of the Bankruptcy Code determines which income taxes are entitled to discharge under an individual's Chapters 7, 11, or 12 bankruptcy proceedings. These non-dischargeable tax claims are:

Priority taxes: § 523(a)(1)(A) excepts from discharge all priority taxes set out in § 507(a)(8) (see above analysis).

Unfiled or late filed return: § 523(a)(l)(B) excepts from discharge any tax for which a return was required and was not filed or for which a return was filed within two years from the date that the bankruptcy petition was filed. *NOTE: This exception to discharge also applies to Chapter 13 bankruptcies.*

An initial inquiry to determine whether a tax liability is excepted from discharge under § 523(a)(1)(B) is to determine whether a tax return has been filed by the debtor. If a return has never been filed, then the liability is excepted from discharge. For instance, if a return filed by the debtor does not comply with federal income tax requirements, there is not a return to trigger the two-year period of limitations under§ 523(a)(1)(B). This is also the case if a return is prepared for the debtor by the IRS under Internal Revenue Code § 6020(b). Even if the return filed by the IRS generates an assessment, this still does not trigger the running of the two-year limitation. In effect, the tax will have been assessed but will be rendered non-dischargeable under § 523(a)(1)(B) because two years would not have run from the date that the return was filed (because the return was not "filed" as contemplated under § 523(a)(l)(B). However, returns prepared by the IRS and signed by the taxpayer pursuant to Internal Revenue Code § 6020(a) are deemed returns such that the filing would cause the two-year statute of limitations to begin running. *NOTE: There is controversy regarding the dischargeability of taxes associated with a late-filed return that is filed post-assessment.* See Hon. Robert E. Berger, et al., McCoy: The Simmering Feud over Late-Filed Income Tax Returns, American Bankruptcy Institute Journal, June 2013, at 16.

An amended return arguably does not result in a new two-year statute of limitations from the date that it is filed. See Badaracco v. Commissioner, 104 Sup. Ct. 756 (1984).

Fraudulent return or tax evasion: § 523(a)(1)(C) excepts from discharge any tax attributable to a fraudulent return or for which the debtor willfully attempted in any manner to evade or defeat such tax. *NOTE: This exception to discharge also applies to Chapter 13 bankruptcies.*

Punitive (non-pecuniary) tax penalties: §523(a)(7) excepts from dischargeability certain non-pecuniary (*i.e.* punitive) tax penalties. However, such penalties that relate to transactions, which are, more than three years old are dischargeable even if the underlying taxes are not dischargeable. See, *e.g.*, McKay v. the United States, 957 F.2d 689 (9th Cir. 1992).

The issue is now well settled that the exceptions to discharge provisions and § 523(a)(l) and the priority provisions in § 507(a)(8) are applied alternatively; that is, they are not mutually exclusive. See In re Coleman American Moving Services, Inc., 20 B.R. 267 (Bankr. D. Kan.

1981). It is relevantly commented, "merely because a particular liability is not encompassed by a particular exception to discharge does not provide it safe harbor from another exception which squarely applies." See In re Etheridge, 91 B.R. 842 (Bankr. C.D. Ill. 1988). All of the various tests for dischargeability must be met separately in order for a tax liability to be discharged. It is possible for a tax liability under the Bankruptcy Code to be excepted from discharge and also to not constitute a priority tax claim.

6. DISCHARGE OF INCOME TAXES UNDER CHAPTER 13

Excerpt in Part from Kansas Bankruptcy Handbook, § 14.4.3, (Kansas Bar Assoc. 3rd Edition), Honorable Robert D. Berger, et al.

Many, but not all, taxes are dischargeable in a Chapter 13. The caveat is that § 1322(a)(2) provides that in order for a Chapter 13 plan to be confirmed, it must provide for payment in full of all priority tax claims.

> **PRACTICE TIP:** Note that in pre-BAPCPA cases, priority claims under § 507(a)(8(A)(iii) (*i.e.* taxes not assessed before, but assessable on the date the bankruptcy petition is filed) did not include those claims set out in § 523(a)(1)(B) (no return filed by the taxpayer) or § 523(a(1)(C) a fraudulent return or a willful evasion of a tax liability). Thus it was possible for a Chapter 13 individual debtor to discharge tax liability which would clearly be excepted from discharge in a Chapter 7 bankruptcy under § 523(a)(1). For post-BAPCA cases, this "super-discharge' is no longer available. § 1328(a)(2) now excepts from discharge those tax claims for unfiled tax returns, fraudulent returns, willful evasion, assessable but not assessed, and late filed returns, although the taxes still are not priority. Additionally, since taxes under §§ 523(a)(1)(B) and (C) and trust fund taxes under § 507(a)(8)(C) are non-dischargeable, a debtor is liable for post-petition interest. Worse, if the tax liabilities are not a priority, it is possible that the Chapter 13 plan may not provide for payment in full of the liability.

Failure of a Tax Authority to File a Proof of Claim. § 1322(a)(2) only requires that the Chapter 13 plan provide for payment in full of all priority claims, unless the holders of such claims consent to different treatment. § 1328(a)(2) does not except from discharge priority claims except trust fund taxes under § 507(a)(8)(C) and non-priority tax claims under §§ 523(a)(1)(B) and (C). In the event a debtor proposes to pay priority tax claims in full, and the entities to whom the obligations are owed fail to file proofs of claim, upon successful completion of the debtor's Chapter 13, plan, the priority tax claims (excluding trust fund claims under § 507(a)(8)(C) and claims under §§ 523(a)(1)(B) and (C)) are discharged without payment. See 8 Collier on Bankruptcy ¶ 1322.03 at 1322-13 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. 2012); In re Richards, 50 B.R. 339

(E.D. Tenn.1985) (IRS claim not allowed and need not be paid where it was not timely filed); In re Rothman, 76 B.R. 38 (Bankr. E.D. N.Y. 1987) (debtor discharged from taxes not included on a taxing authority's claim).

Payment of Post-Petition Penalties and Interest on Priority Tax Claims. Even though the debtor in a Chapter 13 bankruptcy must provide for payment of a priority tax claim in full, if the claim is otherwise *unsecured* and does not fall under § 507(a)(8)(C) or §§ 523(a)(1)(B) and (C), the debtor need not pay a post-petition interest and penalties on that claim. For claims that fall under § 507(a)(8)(C) (trust fund taxes) or §§ 523(a)(1)(B) or (C) (the two-year rule and fraudulent return or willful evasion, respectfully), interest most likely accrues post-petition and a debtor's discharge does not discharge the interest or the underlying tax debt. Note that § 1322(b)(10) allows for the payment of such interest through a plan, but only if all other allowed claims are paid in full through the plan.

Payment of Secured and Priority Tax Claims. In a Chapter 13 plan, the taxpayer can provide for payments on priority and secured tax claims over a period of up to five years (regardless of the date of assessment of the liability). Aside from the five-year limitation, secured tax claims are treated the same in a Chapter 13 plan as in a Chapter 11 plan. Interest is paid on the secured tax claim.

Unsecured non-pecuniary tax penalties do not constitute a priority claim under § 507. As such, these tax penalties should be treated as general unsecured claims, assuming that they are not secured by a tax lien in the debtor's property. In light of these considerations, it is essential to review tax claims filed by the taxing authorities to ensure that tax penalties have not been improperly classified as priority on a tax claim. If part of a taxing authority's proof of claim improperly classifies a liability as priority or as secured, the debtor has the right in a Chapter 13 bankruptcy to object to a proof of claim, a right which should be exercised. See In re Roberts, 120 B.R. 914 (E.D.N.Y. 1982); Chapter 13 debtor is a party in interest and has standing to object the IRS's proof of claim.

Failure of a tax authority to file a proof of claim. § 1322(a)(2) only requires that the Chapter 13 plan *provide* for payment in full of all priority claims, unless the holder of such claim consents to a different treatment. § 1328 does not except from discharge priority claims for which a proof of claim is not actually filed (and hence, the claim is not paid). In the event that a debtor proposes to pay priority tax claims in full and the entity to which the obligation is owed fails to file a proof of claim, upon successful completion of the debtor's Chapter 13 plan, the priority tax claim will be discharged without payment. See 8 Collier on Bankruptcy, ¶ 1322.03 at 1322-13 (16th ed., 2012); In re Richards, 50 B.R. 339 (Bankr. E.D. Tenn. 1989) (IRS claim not allowed and need not be paid where it was not timely filed); In re Rothman, 76 B.R. 38 (Bankr. E.D. N.Y. 1987) (debtor discharged from taxes not included on a taxing authority's claim). Although there is authority to the contrary to these holdings, the better interpretation of the applicable bankruptcy rule is that if a tax claim is not timely filed that the taxing authority does not receive a distribution

from the debtor's Chapter 13 plan and the liability will nevertheless be discharged. The Bankruptcy Reform Act of 1994 extended the IRS deadline to file proofs of claim to 180 days. For non-dischargeable tax claims, a proof of claim should be filed by the debtor (such as trust fund tax debts).

Payment of post-petition penalties and interest on priority tax claims. Even though the debtor in a Chapter 13 bankruptcy must provide for payment of a priority tax claim in full, if the claim is otherwise unsecured, the debtor need not pay post-petition interest and penalties on that claim. See In re Young, 61 B.R. 150 (Bankr. S.D. Ind. 1986) and In re Christian, 25 B.R. 438 (Bankr. N.D. N.M. 1982).

Payment of secured and priority tax claims. In a Chapter 13 plan, the taxpayer can provide for payments on priority and secured tax claims over a period of up to five years (regardless of the date of assessment of the liability). Aside from the five-year limitation, secured tax claims are treated the same in a Chapter 13 plan as in a Chapter 11 plan (see below).

7. DISCHARGE OF TAXES UNDER CHAPTER 11

Section 523 exceptions to discharge apply in a Chapter 11 filed by an individual debtor. By negative implication, these exceptions do not apply to partnerships and corporations in Chapter 11.

Unsecured priority tax claims under § 507 must be paid within five years of the date of the petition in a Chapter 11. See § 1129(a)(9)(C). In contrast to a Chapter 13 bankruptcy, priority tax claims which are paid over this period must receive post-petition interest on the claim.

Since the § 523 exceptions to discharge apply to an individual in a Chapter 11 in a similar fashion as they do in a Chapter 7, the above analysis with regard to Chapter 7 dischargeability of taxes applies with equal weight to Chapter 11 proceedings. Further, the failure of the IRS to file a proof of claim in a Chapter 7 or Chapter 11 case does not affect the dischargeability of the underlying tax debt. See In re Grynberg, 986 F.2d 367 (l0th Cir. 1993). For this reason, it may be advisable for the debtor to file a proof of claim on behalf of a taxing authority in such cases if assets are available to distribute in payment of such claim. A debtor is empowered under Bankruptcy Rule 3004 to file a proof of claim on behalf of a creditor, but the debtor must do so within 30 days of the creditor's filing deadline.

In the event that a tax claim is secured by a notice of federal tax lien filed by the IRS, or other appropriate statutory perfection by another taxing authority (such as a tax warrant in Kansas), then the tax claim will be treated as secured to the extent that there is equity in the debtor's property to which the lien attaches. In this instance, the tax claim will be treated as any other secured claim with the payment of post-petition interest. To the extent that the tax claim secures non-priority tax claims (such as non-pecuniary penalties), those non-pecuniary penalties would need to be paid by virtue of their secured status. The debtor can use § 506 of the Bankruptcy Code to bifurcate the claim of the IRS in a Chapter 13 or a Chapter 11 case. For example, if the IRS had filed tax liens for $100,000 in liability but the debtor only had $20,000 in equity in the property to which those liens attached, then $20,000 of the claim would be treated

as a secured claim, with the balance treated as an unsecured claim. The payment on the $80,000 balance would be determined either as a priority or as a general unsecured claim and paid as such through the plan. A federal tax lien will attach to all of the debtor's property, including exempt property such as the debtor's homestead. See U.S. v. Rogers, 103 S. Ct. 2132 (1983), in which the IRS was allowed to execute on a taxpayer's homestead even though it was protected by the Constitution of the state in which the taxpayer resided.

Upon successful completion of a plan of repayment, the secured claim of the IRS is satisfied and the IRS should release its lien.

8.

9. TOLLING OF PRIORITY AND DISCHARGEABILITY DEADLINES

The determination of whether an income tax liability is dischargeable in bankruptcy is often complex. Factors which affect the dischargeability of income taxes include the identity of the taxpayer, the chapter of the Bankruptcy Code under which the bankruptcy is filed and the date on which the bankruptcy is filed. Generally, in order for an income tax liability to be dischargeable in a Chapter 7 bankruptcy, at least three years must have expired since the due date of the tax return (including extensions), at least two years must have to expired since the tax return was filed by the taxpayer, and at least 240 days must have expired since the date the tax was assessed. See Bankruptcy Code § 523(a)(1) which incorporates by reference and renders non-dischargeable the priority tax claims set out in § 507(a)(8).

Although superficially simple, application of these rules is a complicated venture and one of the more vicious variants is the tolling of these deadlines because of prior bankruptcy proceedings by a taxpayer. See § 507(a)(8). Prior bankruptcies by the taxpayer may toll the running of the time limitations under § 507(a)(8) (priority tax classifications) and by extension § 523(a)(l) (dischargeability exceptions for taxes) of the Bankruptcy Code, which can affect the discharge of taxes in subsequent bankruptcies. In order to be confirmed, a Chapter 13 plan must provide for payment in full of priority tax claims. The tolling issue is thus relevant to all of the chapters under the Bankruptcy Code.

10. LIENS

Tax debtors may be classified as either general unsecured claims, as priority claims, or as secured claims. The general rule is that "if any person liable to pay any tax neglects or refuses to pay same after demand, the amount . . . shall be a lien in favor of the United States." See IRC § 6321. Therefore, an unperfected tax lien arises when a tax assessment is made and the liability remains unpaid. The tax on a return that is timely filed is usually assessed upon filing the return based upon the information in the return. To perfect its lien, the IRS files a Notice of Federal Tax Lien ("NFTL").

Section 6323(f) allows the states to designate the place for filing a notice of federal tax lien. Kansas adopted the Uniform Act in 1988 and provides at K.S.A. 79-2613 for the appropriate location for the IRS to file its lien in order for the IRS to be properly perfected as to a Kansas taxpayer. If the IRS does not file in the appropriate location for the particular taxpayer, it is arguable that the IRS is improperly perfected and that the lien may be avoided under the bankruptcy trustee's strong arm powers. The IRS takes the position that by filing a lien in the designated recording site for a taxpayer's residence, it has created a lien on the taxpayer's personal property anyplace in the country.

Even if the IRS lien secures taxes which are dischargeable in bankruptcy proceedings, the IRS is not required to release its liens. See In re Isom, 901 F.2d 744 (9th Cir. 1990). The lien will expire under its own terms 10 years from the date that it is filed. Further, the lien will not attach to the after-acquired property of the debtor. See Dischargeability of Claim for Taxes Under 1966 Amendment to§ 17(a)(l), the Bankruptcy Act as Effecting Government's Right to Enforce Tax Lien Against After-Acquired Property of Bankruptcy, 5 ALR Fed. 1004. However, the tax lien

remains in place as to the property that the debtor owns on the date that the bankruptcy petition is

filed, and if there is sufficient equity in that property, the IRS could satisfy its lien in such property post-discharge.

11. TAXPAYER'S AVOIDANCE POWERS IN BANKRUPTCY

In most instances, if a taxpayer files a Chapter 11 bankruptcy, he or she functions as a debtor in possession, to whom inures all of the trustee powers under the Bankruptcy Code. These powers can be quite beneficial to a taxpayer. For instance, unperfected tax liens can be avoided under the trustee's strong-arm powers. Further, if there is a pre-petition levy by the IRS, the IRS can be sued in an action for turnover and recovery of that property. Although the issue is not settled, there is also authority that a Chapter 13 debtor-in-possession also enjoys many of the trustee powers. Some courts have held that Chapter 13 debtors have full use of trustee's powers without limitation; this would include the avoidance powers under §§ 544, 545, 547, and 549. See, *e.g.*, In re Freeman, 72 B.R. 850 (Bankr. E.D. Va. 1987) and Epstein, BANKRUPTCY, West Publishing Co., 1992, § 6-2, p 502, wherein the authors state:

> [A] majority of courts have concluded that a Chapter 13 debtor is free, concurrently with the Chapter 13 trustee, to exercise the trustee's avoiding powers for the benefit of the estate. (String cite at fn 20 omitted).

Even a Chapter 7 debtor may exercise limited avoidance powers under §§ 522(g) and (h) of the Bankruptcy Code to recover exempt property.

Once a bankruptcy petition is filed, the debtor benefits immediately from the protection of § 362(a) (automatic stay) which stops all IRS collection efforts against the debtor, the debtor's property and property of the bankruptcy estate.

12. TAX IMPLICATIONS OF TRANSFERS OF PROPERTY BEFORE, DURING AND AFTER A BANKRUPTCY

If an individual taxpayer is in possession of a low-basis property, a Chapter 7 or a Chapter 11 bankruptcy petition may be used with some effect to avoid large tax liabilities upon the transfer (either by sale or foreclosure by a mortgagee) of the low-basis property.

Upon the filing of the bankruptcy petition, all of the debtor's property is transferred to the bankruptcy estate, although this is not a transfer subject to taxation. Further, the tax attributes of property are transferred along with the property. If the debtor is an individual debtor in a Chapter 7 or a Chapter 11, then a new taxable estate is created.

A Chapter 11 bankruptcy filing may be an effective solution. One possible strategy is to file a Chapter 11 bankruptcy, dispose of the low-basis property (thereby creating a tax liability to the Chapter 11 estate) and then to convert the case to a Chapter 7 bankruptcy proceeding before confirmation (thereby trapping the tax liability in the Chapter 7 estate as a prepetition claim). For

a detailed discussion of these planning considerations, see Pusateri, Small Business Bankruptcy Reorganizations, §§ 10.1 to 10.12 (Wiley 1994).

13. SHORT-YEAR TAX ELECTION IN CHAPTER 7 AND CHAPTER 11; THE PARALLEL UNIVERSE OF SECTION 1398

For purposes of explaining life as a Chapter 7 filer or Chapter 11 debtor-in-possession, consider that it is akin to a parallel universe where everything may appear the same, but, because the filing occurred, new rules of conduct must be followed. Indeed, for Federal income tax purposes, a separate entity is created for an individual or married couple when relief is sought under Chapter 7 or Chapter 11 of the Bankruptcy Code.[2] In Chapter 12 or Chapter 13 filings, a separate taxable entity is not created, nor in any case, where the debtor is **not** an individual.

Defining the Estate

The bankruptcy estate succeeds to the same tax attributes (*e.g.* deduction, net operating loss (carrybacks/carryforwards) that they debtor had been entitled prior to the bankruptcy filing. Specifically, the estate may inherit and take into account the following income attributes, of any, from the debtor:

(1) Net operating loss carryovers. The Net Operating Loss ("NOL") is the excess of allowable deductions over gross income, computed under the law in effect for the loss year.[3]

(2) Charitable contribution carryover.[4]

(3) Recovery of tax benefit items.[5]

(4) Carryovers of any credit the debtor would be required to take into account (but for the bankruptcy filing).

(5) Capital loss carryovers.[6]

(6) The debtor's basis, holding period and character of any asset acquired from the debtor (unless acquired by sale or exchange).

(7) The debtor's accounting method.

2 IRC §§ 1398(a), (b); See also S. Rep. No. 1035, 96th Cong., 2d Sess. 24-25 (1980) (Fresh start purpose).

3 IRC § 172; Treas. Reg. §§ 1.172-2 and 3 (Nearly every taxpayer is allowed to carryback a net operating loss (NOL) from a trade or business to apply as a deduction against prior income and to deduct from succeeding years' income any unabsorbed loss. NOL deductions are not available to partnerships and S corporations. However, the partners and shareholders of these entities, respectively, may use their distributive shares to calculate individual NOLs. Practically speaking, the useful life of NOL's are limited to carrying back to the two years preceding the loss year, and, then, forward to the 20 years following the loss year.)

4 IRC § 170(d)(1).

5 IRC § 111 (To the extent applicable for any amount to which this section applies).

6 IRC § 1212.

(8) All other tax attributes of the debtor provided by applicable regulation(s) unique to the particular debtor.

EXAMPLE: Assume a wage earner is not paid for work performed prior to the bankruptcy filing. In the bankruptcy context, if the debtor was paid nonexempt money after the bankruptcy commenced, the amount would be considered property of the estate, and reported by the estate for tax purposes, not the debtor.

Individual estates are allowed to opt out of the federal exemption scheme and determine what property is exempt for resident debtors. Upon conclusion, or dismissal, of the bankruptcy proceedings (and the estate), any unused attributes are transferred back to the debtor for tax purposes.[7]

The Bankruptcy Estate Tax Liability

The general rule is that the estate tax liability is limited to the scope of the estate and its assets. This means that upon the filing of bankruptcy, income and losses generated are those of a separate taxable entity, and computed separately from the individual debtor. So, the estate would compute its own taxable income just as an individual would do so. Practitioners who represent financially struggling taxpayers should consider whether there is a benefit of the short-year election. Though the mechanics and analysis to apply for consideration of whether an election is appropriate are detailed further *infra.*, for now, understand that the benefit that potentially exists for a debtor who timely makes an election is that a portion of the debtor's tax liability can be shifted to the estate (as a priority claim under § 507(a)(8)).[8]

Filing Applicable Returns and Paying Tax Liability

An individual debtor must continue to file his or her individual tax returns, and paying taxes on income that does not belong to the estate.[9] However, the filing of the estate's applicable tax returns, along with paying taxes due, is the responsibility of the (Chapter 7 or 11) Trustee.

Trustee and the Estate

The Chapter 7 Trustee has the responsibility to file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount. As a separate taxable entity, the Trustee (or debtor in possession in Chapter 11 proceedings) must obtain an employer identification number (EIN) for the estate . The EIN is what is used on the tax returns prepared and filed for the estate. The rate of taxation is the same married individual filing separately. To calculate the debtor's taxable income, the debtor's gross income for any taxable

7 IRC § 1398(I).

8 IRC § 1398(d).

9 IRC § 6012(a)(1).

year does not include any item to the extent it is included in the estate's gross income.[10] (Do not include amounts received or accrued by the debtor before the commencement of the case in the gross income of the estate.)[11]

Importantly, even when the estate appears to have generated no income, additional events may cause a reporting obligation to arise. For example, an obligation to file a tax return can still arise in circumstances of cancellation of indebtedness income, or a sale or exchange. In the context of cancellation of indebtedness income, it is a common scenario in Chapter 7 proceedings. If the taxable event (cancellation of indebtedness) occurs before the commencement of the case, the debtor would recognize the income[12], unless the exclusion under § 108 applies, as detailed *infra*.[13]

Given that administrative expenses are allowed as deductions by the bankruptcy estate, any administrative expenses which have been accrued, and properly deducted by the debtor before bankruptcy should not also be deducted by the estate when paid.[14] Administrative expenses incurred, but not deducted, in the current year may be carried back three years and carried forward seven years. However, be aware that the implementation of how the carryback and carry-forward tools are used, should be done in a certain order. First, calculation of the administrative costs for carryover purposes is done after a separate net operating loss carryover calculation is made.[15] Then, the administrative expense carryover is used after the net operating loss has been applied.

A Chapter 11 plan of reorganization generally vests all the property of the estate in the debtor, except as otherwise provided in the plan or order of confirmation. For most Chapter 11 cases, the debtor-in-possession remains in control without a trustee serving in the capacity as a Chapter 7 Trustee. However, the debtor-in-possession must perform all the functions and duties of a trustee.[16]

Individual Debtor/Taxpayer

For purposes of calculating the individual taxpayer's assets and income, a transfer (other than by sale or exchange) of an asset from the debtor to the bankruptcy estate is not treated as a disposition for income tax purposes. (In other words, gain or loss, recapture of deductions or credits, acceleration of income or deductions does not automatically occur when the petition for bankruptcy is filed.) To the extent that the taxpayer is a partner in a partnership or S Corporation shareholder, such interest(s) the individual owns when then bankruptcy petition are filed become property of the estate.[17] (The tax considerations the partnership, or S Corporation, respectively, should analyze when a partner or shareholder seeks Chapter 7 protection is a subject that is beyond the scope of the presentation. For now, it is important to know that there additional

10 IRC § 1398(e)(2).

11 IRC § 1398(e)(1).

12 IRC § 61(a).

13 IRC § 108.

14 11 U.S.C. § 503. Administrative expenses include wages, salaries and fees paid to attorneys and accountants for services performed subsequent to filing the bankruptcy petition.

15 IRC § 172 (b)(2).

16 11 U.S.C. § 1107(a), except for the duties found in 11 U.S.C. §§1106(a)(2), (3) and (4).

17 11 U.S.C. § 541.

concerns that a filing presents to a partnership or S Corporation, however.)

Upon termination of the bankruptcy, any transfer (other than by sale or exchange) of the estate's assets to the debtor is not treated as a disposition. In those circumstances where the Trustee/estate abandons property which makes its way back to the debtor, this is a nontaxable disposition of property. Yet, when the debtor receives the abandoned property from the estate, the debtor calculates the basis in the property. It should also be mentioned that carrying back a net operating loss occurring on a tax year ending after commencement of the bankruptcy to any pre-bankruptcy tax year is not permitted by the debtor.

The "Short-Year" Election[18]

Part of a pre-bankruptcy checklist must include reviewing whether the debtor benefits from making a short-year election. A timely short-year election made by the debtor can shift some, or all, of what would ordinarily be the taxpayer/debtor's tax burden to the bankruptcy estate. By making a proper election, the debtor splits the taxable year into two taxable years. It does not apply when the debtor has no assets other than exempt property, however.[19] Also, only individual debtors may make a short-year election.[20]

> Debtor files for bankruptcy protection under Chapter 7 on March 15. A timely election is made shortly thereafter resulting in two tax years. The first year covers January 1 through March 14, and, the second year covers March 15 through December 31. If no election had been made, the debtor's taxable year remains, as it would normally be, January 1 through December 31.

Mechanics[21]

The first taxable year-ends on the day before the day the bankruptcy case was commenced. The second taxable year begins on the commencement date. The short-year election must be made by the debtor on or before the date due for filing his or her Federal return for the short-taxable year. The short-year election is considered made if the complete tax return for the short period is timely filed.[22] Accordingly, on the debtor's tax return for the short year, the words "SECTION 1398 ELECTION" should be indicated at the top of the return.[23] On or before the fifteenth day of the fourth month following the close of a fiscal year, a return indicating the short-election must be filed, in other words, the fifteenth day of the fourth full month following the close of the taxable year.[24] The short-year election is irrevocable.[25] Where a debtor is married and files a joint tax return, separate elections are permissible as long as they are timely, and the return is considered filed jointly.

18 IRC § 1398(d)(2).

19 IRC § 1398(d)(2)(C).

20 IRC §§ 1398, 1399.

21 See Treas. Reg. §§ 1.1398-1, 2, and 3.

22 See Treas. Reg. § 1.6081-1(b)(2).

23 For additional examples, 1A Collier on Bankruptcy at § 9.05[b].

24 Temp. Treas. Reg. § 7a. 2(d); IRC § 6072.

25 IRC § 1398(d)(2)(D).

Tangible Benefits

By making a proper election, the tax liability for the first short-year is a priority claim under § 507(a)(8). If a debtor files a Chapter 7 bankruptcy petition in which there are assets for distribution to creditors, and the debtor makes a short-year election, then the income tax liability attributable to the earlier or pre-petition short year will constitute a priority tax claim under § 507 of the Bankruptcy Code. If this occurs, then it is possible for this tax liability for the pre-petition short year to be paid from assets of the debtor's bankruptcy estate (assuming that those assets are sufficient to pay some or all of that liability). The remainder would be a non-dischargeable administrative expense claim. In Chapter 11, there can be a significant difference in treatment required under the Bankruptcy Code. Without the election, the tax obligation is a post-petition administrative expense claim that would need to be paid in full when due or at the effective date of a plan. With the election, the pre-petition portion of the year can be paid over five years from the petition date as a priority claim.

Also, when a debtor makes a proper short-year election, the tax attributes of the debtor as of the end of the first taxable year are transferred to the estate. This is essentially a tool for the estate to shelter income. Otherwise, a debtor's tax attributes as of the end of the full taxable year will carryover when an election is not properly made.

Making an election requires careful analysis as to what will benefit the bankruptcy filer. A couple general rules of thumb to keep in mind are (i) when a debtor has taxable income for the short tax year ending the day before the bankruptcy petition is filed, it's likely an election could be beneficial for the debtor because the tax liability arising from the income, would become a claim against the estate; (ii) in contrast, when a loss for the first short year tax year has been generated, the debtor should carefully consider not making the election because the loss would be carried over to the bankruptcy estate. With no election, the loss becomes part of the debtor's return for the full year, and this could enable the debtor to use it to offset income earned later in the year. When a loss exists for the entire year, it would become a net operating loss carryover that is not acquired by the bankruptcy estate, so it is still available to the debtor.

Ultimately, the § 1398 election depends on (i) the likelihood that the bankruptcy estate can pay the short-year pre-petition tax liability; (ii) the individual's tax situation in the year of the bankruptcy filing. Put another way for those who represent individuals considering bankruptcy, the core examination for tax purposes is whether as a debtor, the client will have a better "fresh start" when the use of a short-year election results in carrying forward a net operating loss from the first short-year to reduce the nondischargeable tax debt. If the answer is in the affirmative, then, it is more likely than not after filing bankruptcy, the debtor should prepare to make a timely short-year 1398 election. If bankruptcy filing is to occur regardless of the tax consequences, a possible scenario where an election would not be made is if the net operating loss could be used against the filer's projected income after the filing of the petition. For illustration purposes of how to implement the general rules of thumb when analyzing a situation, consider the following:

EXAMPLE 1: Debtor's income totals $20,000 as of August 16, 2013. Debtor had generated net operating losses that can be carried forward or back to other tax years. Debtor files for Chapter 7 relief on August 17, 2013.Without the election, the tax owed is due on April 15, 2014 for the period January 1 through December 31. The NOL attributes will pass to the bankruptcy estate, and the trustee can use to reduce the estate's tax liability. Any unused losses would then pass back to Debtor upon termination of the bankruptcy case.

Applying the General Rule of Thumb: the debtor should consider making a proper election because the first year, January 1 through August 16, the post-petition tax claim would become a pre-petition obligation § 507(a)(8) priority claim due for payment at the end of the short-year tax return, so, if debtor makes a timely 1398 election, debtor would be entitled to use the net operating losses.

EXAMPLE 2: During the January 1 through August 16, Debtor has had little income. Net operating losses have arisen, however. Debtor files for Chapter 7 relief on August 17, 2013. Debtor expects to receive a total of $30,000 in payments over September through December. If Debtor does not make the election, the Chapter 7 Trustee can use the losses, even though Debtor's little income earned pre-bankruptcy is not going to be offset.

Applying the General Rule of Thumb, it appears that making an election would not be the best choice for the debtor. This illustrates how a person with little income and more losses in the portion of the tax year before the bankruptcy petition was filed, would be financially better off retaining the loss(es) for use in later years.

Sample Short-Year Election Form

Election by Taxpayer in Bankruptcy to Close Taxable Year

____

Taxpayer name

SS# _____________________________________

Form 1040 Filed _________________________________

Taxpayer hereby elects pursuant to IRC § 1398(d)(2) to close his taxable year as of the day before the commencement of his Chapter (7 or 11) bankruptcy case.

Taxpayer's Chapter (7 or 11) bankruptcy case was commenced on _____________________, on which date taxpayer's attorney, ______________________, caused to be filed on taxpayer's behalf, and with respect to taxpayer, a voluntary petition in bankruptcy pursuant to Chapter (7 or 11) of Title 11, United States Code. Taxpayer's Chapter (7 or 11) bankruptcy case is pending in the United States Bankruptcy Court for the _______ District of ______________, _____________ Division, Bankruptcy Case No.__________.

Taxpayer hereby elects to close his taxable year that commenced January 1, ___, as of ___, the day before the filing of taxpayer's Chapter (7 or 11) bankruptcy case.

14.

15. OFFER IN COMPROMISE PROGRAM

An Offer in Compromise is the IRS version of a settlement program. By filing an Offer in Compromise (IRS Form 656, Offer in Compromise (rev. May 2012)) with the IRS, the taxpayer is seeking an agreement from the IRS to pay less than the full amount of the tax liabilities owed. There is no one-size fits all approach, and significant financial information must be disclosed by the taxpayer. Wage earners complete IRS Form 433-A (OIC) Collection Information Statement for Wage Earners and Self-Employed Individuals (rev. May 2012), or Form 433-B (OIC), Collection Information Statement for Businesses (rev. May 2012).

Do not make the common mistake of approaching the OIC as if it is the "Let's Make a Deal" game show, or ordering your lunch at a fast-food drive thru line. Unlike the flexible ease certain "pennies on the dollar" advertisements[26] suggest, successfully achieving IRS acceptance of a reasonable OIC is a time-consuming process. It is also a detailed-oriented one. The IRS OIC examination officers follow very specific guidelines and criteria for analyzing whether an offer is ripe for IRS acceptance, including prerequisites a taxpayer must satisfy before the IRS will engage in an OIC application review.

Prerequisites

Before the IRS will consider an OIC (or any other resolution of a tax debt), the taxpayer must have (1) filed Forms 1040 for all required years, and (2) be in compliance with his or her current year income tax payment obligation. This means: (i) a self-employed individual must have made adequate estimated income tax payments for the current year to date (of the OIC), (ii) for wage earners, income tax withholding during the current year must be made; (iii) an offer to pay a lump sum must be accompanied by a payment of at least 20 % of the offer amount, in addition to a $150.00 OIC application fee. An offer of more than five periodic payments must be accompanied by the first proposed payment, and a $150.00 OIC application fee, and, during the time the offer is being considered, all proposed payments must be submitted;(iv) no pending bankruptcy. If you have a client who does not satisfy (i), (ii), (iii) and (iv) above, do not pursue the OIC. [27] The IRS will reject the OIC and keep the "deposit" payment.

Also, upon acceptance, the taxpayer will be required to file and pay all required taxes for five year. (When the IRS sends a letter of acceptance, the date in the upper right hand corner of the letter determines when the taxpayer's five-year period starts.) If the practitioner has a client who has been unable to comply with the applicable tax filing obligations, the five-year post-offer acceptance requirement may be a hurdle to OIC providing a realistic resolution to the client's tax problems.

Mechanics

There are three reasons the IRS will accept an amount less than the full liability due: "Doubt as to Liability"; "Doubt as to Collectability"; or, because the "Efficient Tax

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26 For a discussion of the debt settlement companies to avoid, see the free publication, "Tax Debt Settlement Hucksters Secrets Revealed: If You Owe The IRS, Read This Before You Pay Anyone to Help You Try To Settle" (free publication on iTunes, https://itunes.apple.com/us/book/tax-debt-settlement-hucksters/id531145315?mt=11).

27 For low income individuals, waiver of the fees may be sought.

Administration (ETA)" requires it.[28] "Doubt as to Liability" is only for people who do not believe that they owe the tax liability. Litigation hazards, calculation errors when the assessment was made are examples of when an OIC based on "Doubt as to Liability" may be pursued.

For "Doubt as to Collectability" or "ETA," the reasonable collection potential must be determined before extending an offer amount or period of time for payment. "Reasonable Collection Potential" is the term for calculation made by the IRS to determine whether the taxpayer liability will be settled for less than the total amount owed. If after utilizing the IRS "reasonable collection potential" formula it is determined that the liability can be paid in full as a lump sum, or a through an installment agreement, the IRS will reject an OIC application.

Reasonable collection potential occurs after the IRS verifies the taxpayer's income and assets for purposes of whether the taxpayer's offer satisfies IRS legal requirements. There is a set formula to determine the amount it is willing to accept, though the factors that go into formula are based on the National Standards for living standards. Be prepared that the "Allowable Living Expense" standards of the IRS commonly differ than what the taxpayer views as average expenditures for basic daily living necessities. IRS processing time varies once an application is filed. On average, expect a six-month processing wait, though the longest processing time has been approximately two years. (If more than two years have passed and the IRS has not responded, the offer is considered accepted.) Before submitting the IRS Form 433-A (Form 433-B Businesses) and Form 656, consult the National Standards for purposes of determining allowable expenses for housing, transportation, and related expenses.[29] By way of illustration, if an individual is paying $2,500 per month, but the standard only allows $1,636, then, the $1,636 figure is the number to be used when calculating the rent unless there are documented exceptional circumstances. A miscellaneous allowance factor can be used for credit card payments, bank fees and the like. Payments for student loans guaranteed by the federal government are allowed in the calculation, and payments for delinquent state and local taxes may be allowed based on a percentage basis of tax owed to the state when calculating the reasonable collection potential, and corresponding offer amount.

> **EXAMPLE:** Delinquent taxpayer files a separate Form 1040, and is living with a significant other who is not jointly liable for taxpayer's outstanding tax liability. Obviously, the IRS cannot seek collection from the person who shares the home, but, the IRS can seek disclosure of the total household income and expenses for the purpose of calculating the shared living expenses. Generally, this would be calculated based on the percentages of each person's respective incomes. Assume that the delinquent taxpayer had monthly income equal to 60% of total household income, then, the IRS would likely allocate 60% of the shared housing costs to the delinquent taxpayer's presumed share.

The precise amount to be offered and length of time is complicated. For illustration purposes only, to provide a very rough estimate of how the formula works, if the offer is to be

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28 For more information on this category, see the IRM, Part 5, 5 008 011, available online at http://www.irs.gov/irm/part5/irm_5-008-011.html.

29 There are various software programs available now providing OIC assistance. Caution should be used, as with all programs, because a computer program is only as good as the information put into it, and the updates made to it concerning inflationary changes and the like.

paid is 5 months or less, use the disposable income amount multiplied by 12. For illustration purposes only, to provide a very rough estimate of how the formula works if the offer is to be in 6-24 months, use the disposable income amount multiplied by 24. Concerning income-producing assets in a viable on-going business, the equity in those assets will not be considered when adding the value of total assets to disposable income. Generally speaking, ongoing, viable businesses are allowed their tools of the trade, up to $4,400 (though this amount is subject to change according to inflationary standards). Concerning dissipated assets, the IRS does not include them in calculating the OIC reasonable collection potential. (Historically, the IRS looked to them – even after the taxpayer had lost the assets – for purposes of an OIC.) Disclosure of a taxpayer's total household income and expenses is required.

For offers proposing to pay within five months or less, the IRS looks at one year of future income. For offers proposing to pay within 24 months of less, the IRS looks at two years of future income. All offers must be fully paid within 24 months of the date the offer is accepted.

It cannot be stressed enough that attorneys should carefully consider whether the client's factual circumstances realistically present an appropriate OIC eligibility situation. Be aware that when submitting an OIC to the IRS, attorneys must follow the ethical and professional responsibilities found in IRS Circular 230 rules for representing taxpayers before the IRS.[30] Before engaging in any IRS matter, it is wise to carefully read the Circular 230 responsibilities that are imposed on practitioners.

> **PRACTICE TIP:** Do not submit an OIC as a "starting point" for settlement discussions. Unless you have a reasonable basis to expect that there is the potential for the IRS acceptance of the OIC, submitting the OIC does more harm than good. This is because when the OIC is not accepted, the IRS keeps the deposit, though it will apply it to the taxpayer's tax liability. Also, the collection statute does not run while an OIC is pending, so, that adds to the time the IRS has to collect the debt (plus 30 days). Finally, when an OIC is submitted, financial information is disclosed which can also serve as a roadmap for the IRS on the taxpayer's assets for collection targets.

Appealing a Denied OIC

Though the IRS "Fresh Start Initiatives" publicized in 2012, and some of which were expanded in 2013, have helped ease some of the OIC restrictions, review of the IRS Data Book providing historical acceptance rates for the category of "Offers in Compromise/Tax Debt Settlements" best illustrates why the OIC is not a solution for all struggling taxpayers:

2008: 44,000 Offers in Compromise submitted - 11,000 accepted
2009: 52,000 Offers in Compromise submitted - 12,000 accepted
2010: 56,000 Offer in Compromise submitted - 14,000 accepted
2011: Numbers were not provided. Rather, Director of the IRS Collection Division Scott Reisher released a statement that 34% of all offers were accepted.

Should an OIC be rejected, the Internal Revenue Code provides for an administrative

30 Circular 230 is online at http://www.irs.gov/pub/irs-utl/pcir230.pdf.

appeal.[31] Collection activity may not occur while the appeal is pending.[32] When considering the merits of an appeal, be aware that pursuing an appeal may have tolling consequences, as further discussed below.

OIC Tolling Consequences

The 240-day period.[33] During the time period that an OIC was "in effect"[34] or pending overlaps the 240-day period, the running of the 240-day period is tolled, plus 30 days. Should an OIC be denied, and an appeal occur, the time period in which the appeal occurs is defined as "pending."

The Three-Year Period.[35] The OIC, without more, does not toll the three-year period. Ordinarily, the three-year period is computed from most recent date the tax return is **due** for the tax year (typically April 15 of the year following the taxable year).

Other Commonly Overlooked Tolling Situations That May Coincide with OIC Taxpayers

Collection actions – and challenges to them – take various forms. Financially struggling taxpayers have unique factual circumstances, but, common to many of them are activities that coincide with OIC's. Below are some activities to inquire about of the taxpayer/debtor because they could have effect of tolling the 240-day period, as well as the 3-year period. The IRS Account Transcripts[36] for a taxpayer's tax year(s) also detail the activity should the taxpayer/debtor not be a reliable source of information. (It should be mentioned that if the transcript shows the taxpayer made an installment agreement application, the installment agreement generally does not toll either the 240-day assessment nor the 3-year period.)[37]

Collection Due Process Hearing Request.[38] Essentially, a collection due process hearing is an appeal of a proposed collection effort. It often coincides with an OIC. A CDP tolls the 3-year period and the 240-day period.

Extension to File Return. Consult the transcripts for whether an extensions of time for filing returns was made. If so, an extension to file delays the start of the 3-year period.[39]

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31 I.R.C. § 7122.

32 I.R.C. § 6331(k); IRM § 8.23.1.2.

33 11 U.S.C. § 507(a)(8)(A)(ii) (During the time a pending or "in effect" OIC overlaps the 240-day period, the running of the 240-day period is tolled plus 30 days. Tax claim was assessed at least more than 240 days preceding the filing date of the bankruptcy. 11 U.S.C. § 507(a)(8)(A)(ii).

34 IRM § 5.8.1.9.4. "Periodic payment Offer" or "Deferred Periodic Payment Offer" means "in effect."

35 11 U.S.C. § 507(a)(8)(A)(i) (OIC is not listed as tolling the three- year period governed by this three-year rule).

36 Obtain Account Transcripts from the IRS via (i) Online: Password, Practitioner ID requires previous set-up with the IRS; (ii) IRS Priority Hotline: (866) 860-4259. Have an executed IRS Form 8821, Form 2848 Power of Attorney (including your CAF number) by the client ready to be faxed to the IRS, along with the client's taxpayer identification number(s); and, (iii) IRS agent/officer may also be able to provide expedited access.

37 11 U.S.C. § 507(a)(8)(G) (absent from code list of tolling events is installment agreement).

38 I.R.C. §§ 6220, 6330.

39 11 U.S.C. § 507(a)(8)(A)(i).

Tax Court, Appeals, "Closing" statements. Generally speaking, the IRS litigation process may delay assessment. Consequently, the start of the 240-day assessment period needs to be verified, especially if Tax Court litigation resulting in appeal(s), or a closing statement.

Additional Resources

www.irs.gov.com You can find the downloadable forms, instructions for completing the Forms the IRS requires be used in the OIC program, as well as free tutorials.

16.

17. NET OPERATING LOSSES (NOLs) IN BANKRUPTCY

The limitation on NOL carryforwards (IRC § 382(a)) does not apply to a change in the ownership of an old loss corporation if:

(1) the corporation was under the jurisdiction of a court in a Title 11 bankruptcy or similar case immediately before the change; and,

(2) those who were shareholders and creditors of the old loss corporation before the change own at least 50 % of the new loss corporation's stock by value and voting power after the change (IRC § 382(l)(5)(A)).

For purposes of (2) above, stock held by a creditor that was converted from indebtedness is considered in determining whether the 50% requirement is satisfied only if: (a) the creditor held the debt at least 18 months before the case was filed, or, (b) the debt arose in the ordinary course of the old loss corporation's trade or business (IRC § 382(l)(5)(E)).

For purposes of determining whether the reorganization of a bankrupt company qualified for IRC § 382(l)(5)(A) treatment, the beneficiaries of the trust, to which the company's common stock was transferred, rather than the trust, was considered to own the company's stock.

Stock options. For purposes of determining whether the stock ownership requirement of IRC § 382(l)(5)(A)(ii) is met at the time of an ownership change, stock of the loss corporation (or of a controlling corporation if also in bankruptcy) that is subject to an option is treated as acquired at that time, pursuant to an exercise of the option by its owner, if such deemed exercise would cause the pre-change shareholders and qualified creditors of the loss corporation to own less than the requisite amount of stock (Reg. § 1.382-9(e)(1)). An option that is owned by an individual or entity as the result of being a pre-change shareholder or qualified creditor that, if exercised, would result in the ownership of stock by a pre-change shareholder or qualified creditor is not treated as exercised under this rule.

Two special rules provide relief from the above (deemed exercised) general rule (Reg. § 1.382-9(e)(2)). First, a loss corporation may treat an option that lapses or is irrevocably forfeited as if it had never been issued. Second, stock acquired by a pre-change stockholder or qualified creditor pursuant to the exercise of an option received under the plan of reorganization may be considered by the loss corporation, provided that the option is exercised within three years of the date of the ownership change that arises from the reorganization. A loss corporation that subsequently satisfies the 50% stock ownership requirement under either of these special rules and qualifies for the bankruptcy exception allowing NOL carryforwards may file amended returns for the relevant tax years, provided that the statute of limitations has not expired.

The deemed exercise rule also applies to the right to receive stock as interest or dividends on post-petition debt or stock (Reg. § 1.382-9(e)(4)).

Application of the deemed exercise rule is suspended for options created by, or under, a plan of reorganization confirmed in a title 11 or similar case (pre-packaged plans and pre-negotiated plans), but only until the time that the plan becomes effective (Reg. § 1.382-9(o)).

Reduction for interest on debt converted to stock. If the bankruptcy exception applies, a corporation's pre-change losses, unused general business tax credits, and unused minimum tax credits that may be carried to a post-change year must be determined as if no deduction were allowable for interest on debt that was converted into stock pursuant to the bankruptcy or similar proceeding. This applies to interest paid or accrued during any tax year ending during the three-year period preceding the tax year of the ownership change, and the period of the tax year of the ownership change on or before the change date (IRC § 382(l)(5)(B)). For this purpose, the requirement under IRC § 108(e)(8) that a corporation's issuance of stock for debt be treated as a payment in money equal to the stock's fair market value does not apply to stock issued to reduce interest payments to creditors becoming shareholders under IRC § 382(l)(5)(B) (IRC § 382(1)(5)(C)).

Continuity-of-business requirement. The continuity-of-business requirement (IRC § 382(c), is inapplicable to an ownership change of a loss corporation that is subject to the bankruptcy exception of IRC § 382(l)(5) (Reg. § 1.382-9(m)(1)).

Effect of ownership change within two years. A second ownership change during the two-year period following the initial change will reduce the § 382 limitation to zero for any post-change year ending after the change date for the second ownership change (IRC § 382(l)(5)(D)). This eliminates the NOL carryforwards that arose before the first ownership change.

Election out. A new loss corporation may elect not to have the bankruptcy exception to the NOL carry forward rules apply (IRC § 382(l)(5)(H)). This irrevocable election must be made by the due date (including extensions) of the return of the loss corporation for the tax year including or ending with the change date (Reg. § 1.382-9(i)).

Informal workouts. If the bankruptcy exception does not apply to a reorganization in bankruptcy (*e.g.,* if the required change in stock ownership described above does not occur), the value of the old loss corporation is the value of the new loss corporation immediately after the ownership change. Thus, the exception does not apply to stock-for-debt exchanges in informal workouts.

18. DISCHARGE OF INDEBTEDNESS/IRC § 108 ISSUES

IRC § 108(a)(1) provides that "Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if:

(a) the discharge occurs in a Title 11 case;

(b) the discharge occurs when the taxpayer is insolvent;

(c) the indebtedness discharged is qualified farm indebtedness;

(d) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness; or,

(e) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2014.

American Taxpayer Relief Act of 2012. The exclusion from gross income for discharges of principal residence indebtedness is extended for one year to apply to indebtedness discharged before January 1, 2014

Defined in IRC § 108(d)(1), indebtedness of the taxpayer means any indebtedness (1) for which the taxpayer is liable, or (2) subject to which the taxpayer holds property. Pursuant to the broad definition of indebtedness, all of the debt obligations restructured and discharged (in whole or in part) enumerated in the facts above should qualify as indebtedness for purposes of the IRC § 108(a)(1). The Internal Revenue Code section does not treat or distinguish different types of indebtedness.

19. IMPACT ON ASSETS, TAX BASIS AND TAX ATTRIBUTES

A debtor who excludes discharge-of-indebtedness income under the bankruptcy exclusion, however, is required to reduce certain tax attributes as required by IRC § 108(b). Generally, the reduction in tax attributes shall be dollar for dollar excluded under IRC § 108(a) and the order of reduction is statutorily provided in the following order: (1) net operating losses, (2) general business credits, (3) minimum tax credits, (4) capital loss carryovers, (5) basis of property, (6) passive activity loss and credit carryovers, (7) foreign tax credit carryovers. If the excluded discharge of indebtedness income exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income as provided by Treasury Regulations § 1.108-7(a)(2).

The rules of IRC § 1017 apply when the basis of depreciable and non-depreciable property, depreciable property under the basis reduction election, or qualified real property business indebtedness (IRC § 108(c)(1), is reduced by any portion of the excluded amount of discharged debt. Under these rules, the basis reduction affects the property held by the taxpayer at the beginning of the tax year after the tax year in which the discharge of debt occurs (IRC § 1017(a); IRC § 1017(b); and Reg. § 1.1017-1(b)(2) provide the ordering rules applicable where the taxpayer owns multiple properties).

The fact that the basis reduction does not occur until the beginning of the tax year following the year of discharge means that any assets disposed of during the year of discharge are not subject to basis reduction. Likewise, basis reduction can be avoided by selling the property in the year of discharge and reinvesting those proceeds after the beginning of the year following the discharge. (Although repurchasing the same asset in the following year will probably be disregarded as a sham transaction.)