

Bankruptcy Reform Did Not Eliminate a Taxpayer's Right to Discharge Delinquent Taxes

By Morgan D. King¹

Morgan King discusses whether bankruptcy reform will increase tax collections and the extent that individual and small business taxpayers may still discharge tax debt in chapter 13 bankruptcy.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),² became effective on October 17, 2005. It was enacted for the purpose of weeding out ostensibly undeserving debtors and forcing more debt-laden consumers to pay back a portion of their debts through chapter 13, rather than discharge them entirely in chapter 7.

The Treasury Department participated in the drafting of the Act. The objectives of the IRS suggestions for BAPCPA appear to have been intended to restrict the opportunities to discharge taxes in chapter 13, which had formerly been a way for delinquent taxpayers to discharge large portions of their tax debts, and pay the remainder through a bankruptcy-court repayment plan. Because pre-BAPCPA chapter 13 was fairly liberal in its opportunities for discharge, it was a good way for delinquent taxpayers and financially strapped entrepreneurs to re-enter the system as regular taxpayers.

Whether or not the amendments to the Bankruptcy Code prescribed by BAPCPA actually achieve the purposes of the IRS remains to be seen. Some consumer bankruptcy attorneys, including the author, believe the IRS has "shot itself in the foot" by making the changes, resulting in less, not more collection of delinquent taxes. The reason is that by making it more difficult to erase large delinquent tax debts in chapter 13, the reforms assure that many more tax-burdened consumers and entrepreneurs will prefer to keep run-

ning from the tax collector instead of resolving things through chapter 13, because for many it is no more feasible to pay the entire liability through chapter 13, than it is to pay it to the Government outside of bankruptcy. In other words, *impossible*.

This article will briefly explore these and other issues arising under BAPCPA in connection with tax liabilities in consumer and small business bankruptcies.

Looking at the overall impact BAPCPA makes on tax discharge we can begin by saying there is good news, and there is bad news.

Chapter 7 Discharge Left Intact

The good news is, BAPCPA did not appreciably eliminate or restrict the ability of a delinquent taxpayer to discharge old tax debts in a simple chapter 7 bankruptcy.

Prior to BAPCPA, a tax liability could be discharged in chapter 7 if it satisfied five rules.³ These rules are:

- The most recent due date for filing the return must be over three years old⁴;
- The tax had to have been assessed for at least 240 days⁵;
- The taxpayer must have filed his or her tax return at least more than two years prior to filing the bankruptcy⁶;
- The tax return in question must have been non-fraudulent⁷;
- The taxpayer must not have engaged in a willful attempt to evade or defeat the tax.⁸

If all of these rules were satisfied, the tax was discharged in the bankruptcy, and no taxing entity such as the IRS or

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a state taxing authority could make any further effort to levy or otherwise seize the debtor's property, or record a lien for the discharged taxes. If the taxing entity had filed a lien prior to the bankruptcy, the lien would survive, but only on the property the debtor owned as of the date of filing the bankruptcy petition; the lien was ineffective as to any property acquired by the debtor after the petition filing date.

BAPCPA did not change any of these rules for chapter 7. Accordingly, they remain in effect and offer

an opportunity for many taxpayers to rid themselves of impossibly large delinquent tax liabilities. And, in most cases, since the taxpayers have little equity in real or personal property at the time of the bankruptcy, any recorded tax liens impose relatively minor burdens following the discharge.

More Good News

But that is not the only good news. Another BAPCPA amendment broadens the definition of a *tax return*. Formerly, the Code simply required the debtor to have filed a "tax return" more than two years before filing the bankruptcy. However, a BAPCPA amendment changed that language to read a "return or equivalent report or notice."⁹ What did or did not constitute a tax return for purposes of discharge had generated a fair amount of bankruptcy court litigation prior to the Act, and even under the formerly straightforward term "tax return" courts had recognized a number of kinds of documents that were not the regular 1040 tax return, but were signed by the taxpayer, as satisfying the rule requiring filing of the return. Under the broader BAPCPA language, any "equivalent report or notice" would appear to spread the net even wider, and to include more non-Form 1040 documents within the definition of tax return for purposes of the 2-year rule. This can only make it easier for more debtors who never filed a 1040 to satisfy that rule.

BAPCPA also broadened the requirement that the return must have been "filed." Formerly, the Code simply required that the return had to have been filed more than two years prior to the bankruptcy. Under the BAPCPA, the Code now says "filed or given." Some taxpayers never get around to mailing their tax returns to the service center, as required by the Treasury Regulations to properly file a return. Rather, they simply hand it over the counter at

a local walk-in office of the IRS, or personally give it to an IRS employee during an audit or exam. In many a taxpayer's mind this act is the same thing as "filing" the return. However, more than one bankruptcy court had

ruled that unless the return had been filed with the appropriate service center, it was not filed within the meaning of the Bankruptcy Code, and therefore did not satisfy the return filing rule.

BAPCPA now includes, for purposes of satisfying the two-year rule, a return filed or *given*.¹⁰ Presumably,

this spreads the net wider to include returns handed to a revenue officer or given over the counter to an IRS office person. That, as well, makes it a little more likely a delinquent taxpayer may qualify for a tax discharge.

There is more good news, but it is good only in relative terms. BAPCPA imposes a complicated and problematic new requirement on debtors filing bankruptcy; as a general rule, they must now undergo what is called the "means test." The means test means, quite, simply, if the debtor has the ability to pay a substantial portion of his or her debts through a chapter 13, he or she must file chapter 13, and not a chapter 7. This is a substantial departure from pre-BAPCPA law that saw a great many consumers with measurable surplus income filing for chapter 7, instead of the court-approved chapter 13 payment plan.

The means test is, from the debtor's perspective, a lot of bad news. The good news in connection with tax discharge cases, tucked away in the verbiage of BAPCPA, is that a debtor whose debts are *primarily tax debts* is not subject to the means test¹¹. Thus, to some extent at least, having primarily tax debts lets a taxpayer avoid the messy obstacle of the means test.

There is yet another piece of good news that is, like the means test provision, good only relative to the overall bad news of BAPCPA. Under pre-reform law, a consumer in chapter 13 could typically reduce the balance owed on a motor vehicle or other personal property by doing what is called in Bankruptcy jargon, a *strip-down*, or a *cram-down*; in most cases a debtor filing for bankruptcy owes more than the value of the property for which the debt is owed. Thus, for example, it was (and still is) common for a consumer to owe more on a car installment contract than the car was worth. In chapter 13, the debtor could typically arrange to pay the current value of the car, but

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erase a substantial portion of the surplus debt (*i.e.*, the unsecured portion of the debt). This was called a strip-down or a cram-down.

These kinds of debts are referred to as *purchase-money-security-interests* (“PMSI”), because the money that is owed is used to make the original purchase of the item that is collateral for the debt. BAPCPA substantially restricted the right of a consumer to strip down such debts, by providing that if the motor vehicle was purchased for the debtor’s personal use within the 910 days preceding the bankruptcy filing, the chapter 13 plan must provide for payment of the full amount of the debt.

For delinquent taxpayers, the good news is that the new restriction on strip-down only applies to PMSI claims, and a tax lien is not a PMSI. Hence, if the underlying tax is dischargeable, a tax lien on a motor vehicle or other personal property may be stripped down to the value of the property, with the unsecured balance of the tax debt usually being substantially reduced, or discharged.

Chapter 13 Super-Discharge Eliminated

Balanced against the good news, is the bad news.

The main bad news, and this is really bad, is that BAPCPA eliminated what was called the *super-discharge* in chapter 13.

The super-discharge consisted of the fact that in order to discharge a tax in chapter 13, it was only necessary to satisfy two of the five rules applicable in Chapter 7, to wit; (1) the three-year rule (the most recent due date must be over three years old); and (2) the 240-day rule (the tax must have been assessed for at least 240 days prior to the bankruptcy).

This meant that many taxpayers who had not filed their tax returns at all, or filed some but not all, or filed them but filed them less than two years ago, could go into chapter 13 and in most cases erase most of the tax liability entirely, and pay the remaining portion over the life of the chapter 13 plan, which typically ran from 36 to 60 months. And, if the remaining portion of the tax was unsecured, it could be paid without any additional interest accruing after the petition was filed.

What BAPCPA did, essentially, is make all five of the rules for discharge in chapter 7 apply also in chapter 13 cases. In other words, the rules for discharge are now the same for both chapter 7 and chapter 13, and they both require that the returns have been filed more than two years ago, that the returns not

be fraudulent and that the taxpayer not be guilty of attempted tax evasion.

This removes one of the most powerful remedies for solving delinquent tax dilemmas and creating a pathway back into the system for tax-burdened individuals.

As explained above, the notion behind this is to force more debtors to pay more of their taxes. In the author’s opinion, however, while this may result in more revenue collected from a handful of taxpayers who may have gotten away with paying less before reform, a great many more will simply remain underground and continue to run and hide from the tax collector because paying the entire liability in chapter 13 is simply impossible. For those taxpayers, the government will collect less, and spend a lot more trying to collect it, than if they hadn’t messed with the Bankruptcy Code to begin with.

There is more bad news, as well, including the restriction on what is often called a *chapter 20*. There is, in fact, no such thing as a chapter 20 in the Bankruptcy Code. But in bankruptcy lawyers’ jargon, a chapter 20 is a *chapter 7*, followed quickly by a *chapter 13*.

Why would you do something like that?

One of the problems frequently encountered in considering chapter 13 as a potential remedy for a debt-burdened consumer is that such individuals are not eligible for chapter 13 if their total unsecured debt exceeds a certain limit, which as of April 1, 2007, is \$336,900.¹²

So, if you have a client who owes a total of, say, \$500,000 in unsecured debt, such an individual is not eligible for chapter 13. If, say, half of that is nondischargeable tax debt¹³ that you want to arrange for the client to pay off through a chapter 13 without additional interest (which could be a tremendous benefit even if the tax itself is not dischargeable), how do you do it if the client is not eligible?

You used to be able to do it by first putting your client through a chapter 7 to discharge all of the dischargeable debt, thus reducing his total unsecured debt to a figure under the chapter 13 debt limit, then putting him into a chapter 13 to deal with the nondischargeable tax debt. Another scenario, pre-BAPCPA, was to put the debtor first into chapter 7 to get the client within the debt limit, then put him into chapter 13 to handle the tax debts, where the tax debt was not dischargeable in chapter 7 because, for example, he or she had not satisfied the two-year tax-return rule, but was dischargeable pursuant to the now extinct *super-discharge* of chapter 13.

Under BAPCPA, as we have explained, taxes can never be dischargeable in chapter 13 that are not also dischargeable in chapter 7, so that reason for doing

a chapter 20 is gone. But BAPCPA presses its heel on chapter 20's neck in another way, as well.

Under BAPCPA, a consumer is not eligible for a discharge in a new chapter 13, if he or she obtained a discharge in a previous chapter 7 filed within four years of the new bankruptcy¹⁴. So, if you do step one in the chapter 20 process by filing a chapter 7, you've eliminated the possibility of getting a discharge in step 2, chapter 13, unless you wait for at least four years before filing. In most cases, that isn't much of a help to the taxpayer under threat of immediate levy. Thus, the chapter 20 is no longer a feasible strategy for this purpose.

It should be noted, however, that although the best benefit of the chapter 20 strategy has been eliminated, it has not been eliminated entirely; although following a chapter 7 renders the debtor ineligible to *obtain a discharge* in a chapter 13 filed soon after his chapter 7 discharge, he or she is still eligible to file and *be a debtor in chapter 13*; thus, many a taxpayer may still get the benefit of filing an immediate chapter 13 in order to have bankruptcy court protection, and a three-to-five year payment plan, through the plan. There won't be a final discharge, but there will still be the precious protection from IRS levy while the debt is paid off.

More bad news. We talked about how BAPCPA broadened the definition of a tax return to include an equivalent report or notice, and how this would benefit some taxpayers who never filed a 1040 for the tax period in question, but who did file or sign something that could be deemed an equivalent report or notice. Thus, under the Act it is easier for such taxpayers to satisfy the two-year rule.

But there is an unfortunate flip-side to this. Most states that have a personal income tax also have a rule that in the event a taxpayer is audited by the IRS and assessed an additional tax, he or she must inform the equivalent state tax collection entity, so that the state can do its "piggy-back" assessment and get more money out of the taxpayer; it follows that if the taxpayer owes more money to the Feds, he or she probably owes more money to the state.

State reporting rules vary as to how the taxpayer is supposed to inform the respective agency of the additional IRS assessment. In some states, the taxpayer is required to file a "return" reporting the additional tax. In those

states, the bankruptcy cases have held that such a return is the same thing as a return within the meaning of the Bankruptcy Code, and in order, therefore, to discharge that additional tax, the return must have been filed at

least more than two years previous to the bankruptcy. In such cases, although the additional IRS tax will be dischargeable once it has been assessed for at least 240 days, the additional state tax assessment will not be discharged unless the filing of the petition is held off for at least two years.

In some federal circuits, in those states that require, not a "return," but a "report," the report was deemed not to be a return; thus the debtor did not have to wait two more years before filing the bankruptcy in order to discharge the additional state tax, but merely 240 days from date of assessment.

BAPCPA's amendment, *or equivalent report or notice*, which now requires that the debtor have filed any required tax return or equivalent report or notice appears to include such state reports within the tax-return rule, so that now the taxpayer will have to wait at least two years after filing such report before that tax is dischargeable. Of course, the debtor could go ahead and file right away and still be eligible for discharge of the original tax based on the original tax return, assuming the five rules have been satisfied as to such original tax.

[I]n the most frequently seen situations, those involving delinquent personal income tax liabilities that are over three years old, bankruptcy remains a powerful remedy for the overburdened delinquent taxpayer.

The Sleeping Interest Trap

The last bit of bad news has to do with interest that accrues on tax claims following the filing of a bankruptcy petition.

Under pre-BAPCPA law, all taxes were technically dischargeable in chapter 13.¹⁵ The reason we often called priority taxes "nondischargeable" in chapter 13 is because even though dischargeable, the Code required that they be paid in full¹⁶; if the taxes had to be paid in full through the chapter 13 plan, one might as well call them nondischargeable.

Prior to BAPCPA this subtle distinction between a dischargeable priority tax that had to be paid in full, and a dischargeable nonpriority tax that could be reduced and only a small portion paid, was not important as far as the effect of the discharge was concerned; in either case, any remaining portion that was unpaid at time

of final discharge was discharged.

Under pre-reform law, interest continued to accrue on tax claims in chapter 13 after the petition was filed, but unless secured by a lien, such interest could not be paid through the plan. So, when the final discharge came through, there would be a substantial post-petition interest liability, but it would be discharged along with the tax. There were, in other words, no residual consequences in connection with accrued interest. We simply didn't have to worry about it.

That has changed under BAPCPA. Now, unpaid post-petition interest will in many cases accrue and will not be discharged upon final discharge in the chapter 13. Why is this so?

The rule in bankruptcy is that the interest follows the tax. In other words, if a tax is undischageable, so is the interest; if the tax is dischargeable, so is the interest.

BAPCPA amended the Code to provide that, in chapter 13 cases, certain taxes that were formerly dischargeable are now not dischargeable.¹⁷ These are, trust-fund taxes under 11 USC §507(a)(8)(C) (*i.e.*, payroll taxes), and any personal income taxes falling under one of the tax provisions of 11 USC §523(a)(1)(B) or (C), namely; taxes for which no return was filed, or was filed less than two years ago; taxes for which the tax return was fraudulent; or taxes in connection with which the taxpayer willfully attempted to defeat or evade the tax.

A tax falling within any of those categories, whether paid in full through a chapter 13 plan or not, will continue to accrue interest post-petition. That post-petition interest is nondischageable. Following the final discharge, it is highly likely that the debtor will soon receive a demand for payment from the taxing entity. Just when the debtor heaves a sigh of relief that his or her final discharge has come through and given him, ostensibly, a fresh start, he or she will be sadly jolted back to a new reality; it isn't over yet. This little time-bomb will rudely catch many a debtor, and his or her lawyer, napping. In truth, except for the situation described later, there is little the lawyer can do about it other than fully warn the client that it is coming¹⁸.

The Bankruptcy Code does provide that in chapter 13 the accruing post-petition interest may be paid through the plan, thus avoiding the post-discharge

bad news, but only if the plan is a 100-percent plan; in other words, only if the plan provides that all of the unsecured debt, including credit card, medical, rental and other similar debts, are paid in full. Since one of the major benefits of chapter 13 is the ability to discharge large portions of such debt, thus making it feasible based on the debtor's budget, it is relatively uncommon to have a 100-percent plan. Accordingly, in the vast majority of cases where there are nondischageable, unsecured taxes, the post-petition interest cannot be paid through the plan and will sit there, waiting ominously like a spider, for the final discharge to be entered before pouncing on the hapless debtor.

Even in the rare chapter 7 case where the accumulated pre-petition tax, interest and penalties are paid out of nonexempt property of the estate the general rule is that the accumulated post-petition interest cannot be paid out of the estate; hence in any case involving an appreciable delay in administering the chapter 7 estate and paying off the tax claims, there may be a substantial accumulated post-petition interest for which the debtor will still be liable after the chapter 7 discharge is entered.

Tolling Events Expanded

BAPCPA made some other changes to how tax claims are to be treated in connection with dischargeability, including some additions and changes to events that may toll, or extend, any of the three time periods that make up three of the five rules. Rather than go into those changes in depth, let it suffice that three common situations, namely, a prior bankruptcy, a prior offer-in-compromise and a prior request for due-process hearing, may extend one or more of the time periods, thus delaying the date when an income tax may become dischargeable.

Bankruptcy Reform has, indeed, made it more difficult to discharge income taxes in bankruptcy. Nevertheless, in the most frequently seen situations, those involving delinquent personal income tax liabilities that are over three years old, bankruptcy remains a powerful remedy for the overburdened delinquent taxpayer. As a possible way to solve such problems, bankruptcy should remain on the list of things to explore with the client.

ENDNOTES

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² Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8).

³ These five rules apply equally to state

ENDNOTES

income taxes and, in some jurisdictions, sales or excise taxes. The rules are not in the disjunctive; all five must be satisfied to discharge the tax.

⁴ 11 USC §507(a)(8)(A)(i). Unless indicated otherwise, any reference to a code section in this article refers to the U.S. Bankruptcy Code, *i.e.*, Title 11, United States Code.

⁵ 11 USC §507(a)(8)(A)(ii).

⁶ 11 USC §523(a)(1)(B).

⁷ 11 USC §523(a)(1)(C).

⁸ 11 USC §523(a)(1)(C).

⁹ 11 USC §523(a)(1)(B).

¹⁰ 11 USC §523(a)(1)(B)(i).

¹¹ To be precise, §707(b)(2), as amended, provides that an individual whose debts are primarily consumer debts is subject to the means test; ergo, one whose debts are not primarily consumer debts but rather tax liabilities, is not subject to it.

¹² This figure is adjusted upward automatically every three years to account for inflation.

¹³ With the balance consisting of a mix of credit card, delinquent rent, medical and other similar debts.

¹⁴ 11 USC §1328(f)(1).

¹⁵ All taxes were, technically, dischargeable in chapter 13 for the simple reason that under

11 USC §1328, the Bankruptcy Code did not include tax claims in its list of exceptions from discharge.

¹⁶ See 11 USC §1322(a)(2).

¹⁷ See 11 USC §1328(a)(2).

¹⁸ Note, however, that priority personal income taxes that do not also fall within 11 USC §523 are still technically dischargeable in chapter 13, even if they don't meet the two rules for discharge described earlier; accordingly, the accumulating post-petition interest will also be discharged. Thus, the lawyer need not worry about the post-discharge interest for priority income taxes.

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