In Supporting Bankruptcy Reform the IRS Aims to Shoot Itself in the Foot: Why Current Reform Proposals May Do the IRS More Harm Than Good

By
Morgan D. King

Morgan King explains why proposed bankruptcy reform may make things worse for the people most in favor of its provisions—the IRS and credit companies.

It seems that the first time a taxpayer fails to file a return, it is like the engine jumping track and dragging the whole train after it; the taxpayer often becomes, by sheer inertia, a "serial nonfiler."

For dieters, it's just plain lack of will power that causes one misstep to be followed by six months of sugary self-indulgence. But for taxpayers, the mechanism at work is probably less a matter of will power than it is a combination of fear, complacency and avoidance.

After the first return is skipped, fear sets in. The taxpayer is afraid if he files the next year's return the IRS will notice that no return was filed for the preceding year and will come crashing down on him. Then, after two consecutive nonfilings, the taxpayer notices a kind of eerie silence from the IRS. Nothing happens. What a relief!

When nothing happens, a combination of complacency and avoidance sets in. The taxpayer simply doesn't want to think about it, because if he or she thinks about it, the IRS will hear the thinking, wake up and start causing trouble. After all, it's good American common sense to let sleeping dogs lie. Isn't it?

Then, as time goes by, a kind of subtle worry begins nagging at the taxpayer. He begins to think his luck simply can't hold out forever. The subconscious inner ear begins to listen for the other shoe to drop.

This causes loss of sleep. After a few years, the taxpayer may be found in a kind of trance in the

Morgan D. King is an Attorney in Dublin, California, and specializes in bankruptcy and tax remedies.

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middle of the night ... eyes wide open, listening in the dark.

Eventually, the IRS's torture of utter silence eats at the taxpayer to such an extent the individual finally decides to come in from the cold and face the problem.

By then, in many cases, the problem has become virtually insurmountable; it may be feasible for the taxpayer to pay the initial tax liability, but the accumulated penalties and interest skyrocket the balance to a hopeless amount of money.

The IRS appears to be under the mistaken notion that by making all taxes where returns have not been filed nondischargeable, they will force taxpayers to pay the full liability through Chapter 13.

Chapter 13 Under Current Law

For such taxpayers, the existing law of Chapter 13 bankruptcy is often a life-saving remedy. Chapter 13 typically permits the taxpayer to erase all or a substantial portion of old income tax debt, and come current on more recent tax assessments with a three-to-five-year payment plan, supervised by the Bankruptcy Court. During the payment plan period, the taxpayer is shielded from levy or other tax collection activity. And, in most cases, interest stops.

But what about our serial nonfiler?

Under current law old income tax liabilities (liabilities for tax periods over three years old) are dischargeable (*i.e.,* capable of being erased without actual payment) in Chapter 13 even if the taxpayer failed to file tax returns for one or more of the tax periods in question.

This formula of forgiveness and court-protected repayment is an opportunity for the taxpayer to get back into "compliance." Getting delinquent taxpayers into compliance, that is, getting the taxpayer back into filing timely returns and keeping current with taxes, has been a key goal of the IRS.

Many taxpayers who cannot fund an offer-in-compromise for a variety of reasons are able to fund a Chapter 13, which erases the bulk of the tax and permits a feasible payment plan, based on the debtor's actual disposable income. The key to the program is budget feasibility, or in other words, a payment plan based on the realistic income and expense situation of the typical taxpayer.[1]

Thus, Chapter 13 advances an important goal of the Treasury: getting delinquent taxpayers back into the system with a realistic financial formula.

The program may be particularly helpful for the delinquent sole proprietor who has both income and payroll trust-fund tax liabilities; the income taxes can often by discharged, and the nondischargeable trust-fund taxes paid through the "plan."

Moreover, Chapter 13 does more than merely open the door for delinquent taxpayers to come in from the cold; it also generates substantial, actual tax revenue that otherwise would probably not be collected, or would be collected only with additional financial cost to the IRS in collection activity. According to the Administrative Office of the United States Trustees (the office that supervises Chapter 13 trustees and, ultimately, the administration of Chapter 13 plans), in 2002 Chapter 13 debtors nationally paid $195,651,255 into their plans for priority claims, the vast majority of which is priority tax liabilities.[2] And, in addition, debtors paid a substantial amount toward dischargeable income tax liabilities, as well, based on their budgets and ability to pay over the life of their plans.

Bankruptcy Reform Proposals

Unfortunately for the IRS, the double benefits offered by the current Chapter 13 program (generating tax revenue and bringing wayward taxpayers back into compliance) may be substantially impaired if legislation currently pending in Congress is adopted into law.

For half-a-dozen years, Congress has been on the verge of passing the so-called Bankruptcy Reform Bill, officially entitled the Bankruptcy Abuse Prevention and Consumer Protection Act.[3]

The bill would drastically alter the manner in which Chapter 13 currently treats delinquent tax debts and would impair both a taxpayer's opportunity to come back into compliance through the program, and very probably reduce the tax revenue generated to the government.

Ironically, the Treasury is apparently supporting the proposed changes. But those who practice daily in the "trenches" of Chapter 13—that is, the debtors' lawyers—know that the government is aiming to shoot itself in the foot.

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Here is why.

In some circumstances, delinquent income tax liabilities may be discharged entirely in Chapter 7 bankruptcy. Unlike Chapter 13, which is predicated on repayment of at least some debts, the premise in Chapter 7 is that the debtor entirely discharges his debts and obtains a relatively prompt "fresh start."

In order to be eligible for discharge of back taxes in Chapter 7, however, one requirement is that the taxpayer must have filed his or her tax returns for the tax years in question. And, the returns must have been filed at least more than two years before the filing of the bankruptcy.[4]

Thus, if the taxpayer has neglected to file the returns, or filed them only recently, a Chapter 7 discharge will leave the taxpayer personally liable for the full amount of the assessments, along with accrued interest.

In contrast, in Chapter 13, there is no requirement that the taxpayer must have filed his or her returns more than two years prior to the bankruptcy in order to make the taxes dischargeable. In fact, no taxpayer returns need be filed at all in order to be eligible for discharge of the tax.[5] At some point, the taxpayer will probably have to file the returns, if for no other reason than to establish how much of the total liability must be paid in the Chapter 13. But that is merely a practical matter of doing the arithmetic for the Chapter 13 plan.

The ability of a taxpayer to discharge, in Chapter 13, taxes that are not dischargeable in Chapter 7, is often called the Chapter 13 "superdischarge." The superdischarge throws a bankruptcy lifeline to taxpayers drowning in delinquent tax liabilities.

The proposed bankruptcy reform legislation, however, will, among other things, eliminate the Chapter 13 superdischarge for tax debts for which no returns have been filed.[6] As a consequence, even in Chapter 13, a taxpayer will be required to pay the entire tax assessment with accrued interest.[7]

As any experienced bankruptcy attorney can attest, a great many taxpayers come into the office with a mixed history of hits and misses on tax returns. It is not uncommon for an individual to have filed returns up to a point, and then for whatever reason, skipped a return, or perhaps two or three. Then the taxpayer may have filed one or two, and then skipped another one here and there.

Thus, in order to provide genuine relief from delinquent tax debts, only a Chapter 13 "superdischarge" will work.

The IRS appears to be under the mistaken notion that by making all taxes where returns have not been filed nondischargeable, they will force taxpayers to pay the full liability through Chapter 13. In reality, this provision of "bankruptcy reform" will only succeed in making it virtually impossible for most taxpayers to come back into the system through Chapter 13, for the simple reason that they won't be able to afford to make the payments.

Another entity that is supporting the reform legislation is the credit industry in general. They claim that bankruptcy reform will force more delinquent consumers into a payback program in Chapter 13 rather than a complete discharge of debt in Chapter 7. This will be done by operation of a provision of reform usually called "the means test." This provision will require that any consumer who has a certain level of disposable income (*i.e.,* the "means") must file Chapter 13, rather than Chapter 7. By this method the credit industry hopes to see more consumers pay back at least some of their debt through Chapter 13 than is currently seen.[8]

However, if elimination of the superdischarge for taxes is adopted, besides making it more difficult for a delinquent taxpayer to remain in Chapter 13 due to the onerous monthly payments that will be required, the payments that will be made will, in many cases, be consumed by the now-nondischargeable taxes. The result will be that even less revenue will be distributed to the credit card entities; for each additional dollar that must go to pay priority taxes, there is a dollar less available for credit card debt.

These difficulties that can so easily be identified by those who practice consumer bankruptcy every day appear to be beyond the comprehension of those who support bankruptcy reform. Those members of Congress who support the legislation appear to be uninformed about its true consequences, and frequently refuse to listen to the voices of experience and reason raised in alarm. This should not be too surprising, considering that the credit industry has expended tens of millions of dollars in lobbying fees and political contributions in an annual attempt to gain passage of the reform legislation. And along with the credit industry, the Treasury is preparing to shoot itself in the foot.[9]

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ENDNOTES

[1] The expense guidelines in bankruptcy court are typically more liberal and realistic than the IRS expense standards for offer-in-compromise.

[2] *See* The Chapter 13 Trustee 2002 Audited Annual Reports, at *www.BankruptcyMedia.com*. Under "Library," select "TOPICS/ARTICLES.

[3] The version now pending in the Senate is H.R. 975, introduced February 27, 2003, 108th Congress, 1st Sess. The full text may be found by going to *www.BankruptcyMedia.com*. Find "NEWS" and click on "Reform," then select "TEXTS/BILLS."

[4] 11 USC. §523(a)(1)(B).

[5] In Chapter 13, income taxes are dischargeable as long as the most recent due date of the tax return (as distinct from the actual filing date) is over three years old, and the taxes have been assessed for at least 240 days.

[6] Section 707 of the proposed Act amends 11 U.S.C. §1328(a) to make taxes for which no return was filed nondischargeable, as well as taxes associated with fraudulent tax returns or attempted tax evasion.

[7] But not, however, the penalties. Tax penalties are never "priority" claims in bankruptcy and thus are dischargeable to the same extent as ordinary debts like credit cards, even if the underlying tax is not dischargeable.

[8] Currently, the vast majority of consumer and small business bankruptcies filed in the United States are Chapter 7 liquidations, rather than Chapter 13 adjustments of debt. And, of those who file Chapter 13, most do not make it to the end of the plan. In 2002, there were 1,059,777 Chapter 7 filings, compared with 433,107 Chapter 13 filings. *See* Administrative Office of the U.S. Courts, at *www.BankruptcyMedia.com*. Under "Library," click on "TOPICS/ARTICLES."

[9] There is still some speculation about whether or not the reform bill will ever be enacted into law. It has come close four or five years in a row, but has never quite made it. There is a growing number of consumer, labor and professional organizations across the country that is taking strong positions in opposition to the bill.

Quick Reference for Calendar-Challenged Bankruptcy Lawyers (and other practitioners) in Tax Discharge Cases

Approximately 40 percent of all consumer and small business bankruptcy cases contain delinquent tax debts. And a good many of those tax liabilities, particularly personal income taxes, are dischargeable in bankruptcy.

But the rules for discharging taxes are a bit tricky. Some bankruptcy advisors are afraid of the whole subject and may simply tell their clients "I don't do taxes." In some of those cases, the debtor is left with nondischarged tax debts because the advisor either didn't know the rules, or knew the rules but not some of the traps for the unwary, or knew the rules and the traps, but did their calendar calculations incorrectly.

Why Are Calendar Calculations Critical to Discharging Taxes? Three of the rules that must be satisfied to discharge taxes are based on dates. In a nutshell, the five rules that must be satisfied are:

1. The most recent due date for filing the tax return for the delinquent tax year must be over three years old.
2. The debtor must have filed his or her tax return over two years ago.
3. The principal amount of the tax liability must have been assessed at least 240 days ago.
4. The filed tax return must have been nonfraudulent.
5. The taxpayer must be not guilty of attempted tax evasion.

In Chapter 13, one can dispense with rules 2, 4 and 5; the only rules that must be satisfied to make the income taxes dischargeable are the three-year rule regarding the due date of the return, and the 240-day assessment date.

In some circumstances, even the 240-day assessment rule need not be satisfied to discharge the tax in Chapter 13.

For Chapter 7 cases, the first challenge for the tax advisor is applying the three-time rules correctly. For the calendar-challenged, this sometimes requires a lot of time staring at the calendar and trying to count days, weeks and months more or less manually. This can lead to mistakes.

Tolling Events May Complicate the Calendar Analysis. Further complicating the problem is that there are two relatively common events that can toll, or extend, one or more of the time periods. These two events are (1) a taxpayer's prior bankruptcy that overlapped one or more of the time periods, and (2) a prior offer-in-compromise that the taxpayer made during the running of the 240-day assessment period.

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The reason for the tolling is that Congress and the courts recognize that the tax collector is entitled to a free hand at collecting the tax for at least the time specified by the rules, and it is not fair to the taxing entity to deduct from the collection period the time the tax collector was barred from collection because of the automatic stay, or a pending offer-in-compromise.[1]

Further complicating the calendar math is the rule, formerly followed in most jurisdictions, that in the case of a prior bankruptcy, the tolling period is the time of the overlap, plus an additional six months. However, based on a recent U.S. Supreme Court case holding that a prior bankruptcy tolls the time period but apparently does not allow for an additional six months,[2] the IRS has adopted a policy to abandon the six-month add-on in all future bankruptcy cases. Thus, the time period that is tolled is the time of the overlap only, without adding on another six months.

There is one more thing the taxpayer might have done which could catch the unwary bankruptcy advisor by surprise—that is change the usual date the return is due (*i.e.,* April 15) by filing one or more extensions, thus pushing the due date to August 15 or October 15.

In a case where the taxpayer has tax liabilities that are old enough to possibly be dischargeable, and especially where the taxpayer filed a previous overlapping bankruptcy, or filed an offer-in-compromise, or both, and also filed one or more extensions, trying to determine when all of the time periods will be satisfied can be mind-boggling to the nonmathematical lawyer.

Computerized Analysis Helps Avoid Mistakes. In this age of automated information processing, it was inevitable that someone would come along and offer an automated solution to the calendar problem. James Gold, of San Jose, California, was uniquely qualified to do so. He is both a bankruptcy lawyer and an engineer. He knows how to create software applications, and he is also an expert in connection with the tax discharge rules.

Gold has come out with a software application called the Tax Discharge Chronometer. Those who aren't sure what a chronometer is may think of it as the Tax Discharge Analyzer.

This program does not analyze whether the taxpayer engaged in tax evasion, or filed a fraudulent tax return. What it does do is unerringly calculate when each of the three time-sensitive rules will be satisfied on the calendar.

Data Is Entered. The program treats one tax year at a time. The user enters the applicable year, and then enters the most recent date the return was due to be filed including any extensions, the actual date the return was filed (assuming the taxpayer filed a return for the year in question) and the date the tax was assessed.[3] If a prior bankruptcy filed by the taxpayer may have been pending at the same time any of the three time periods were running, the user then enters the date the prior bankruptcy was filed as well as the final discharge date. Likewise, if an offer-in-compromise was made, the user enters the date the taxpayer submitted an offer-in-compromise to the taxing entity, as well as the date the offer was no longer pending due to the rejection or acceptance by the taxing entity, or withdrawal of the offer by the taxpayer.[4]

The user then presses the "calculate" button. The Gold program zips through the calendar and prints the dates the rules were, or will be, satisfied. It automatically factors in any tolling or extending events.

It does this calculation for both Chapter 7 and Chapter 13, because the results may differ. For example, if the taxpayer never filed his or her tax return for the year in question, the program will indicate that the liability is not dischargeable in Chapter 7, but is or will be dischargeable in Chapter 13 by a certain date, because the tax-return rule does not apply in Chapter 13 cases.[5]

Accounts for Weekends and Holidays. Gold has programmed into the application awareness mechanisms, meant to keep the unwary out of traps. For example, it automatically adds

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a day or two to account for a tax return due date falling on a weekend or a holiday, and also accounts for leap years. And, it takes into consideration other anomalies, such as the "Patriot's Day" celebrated by some of the states.

The results can then be printed out on hard copy, along with a statement of the amount of time the user was engaged with the program for billing purposes.

Obtaining the Data. The accuracy of the program is a function of how carefully the attorney enters the raw information, *i.e.,* the dates. Where does one obtain the dates and other information required for entry into the program? In the case of the IRS, this information is found on the taxpayer's transcripts.[6] For state tax information, typically the state taxing entity can provide account histories or other documents analogous to IRS transcripts.

This tool may be able to help the tax and bankruptcy advisor avoid malpractice as well as vastly reduce the amount of time required to conduct the calendar analysis.[7]

ENDNOTES

1 The IRS Restructuring and Reform Act of 1998 (P.L. 105-206) amended the Code to prohibit active tax collection while a *bona fide* offer-in-compromise is pending.

2 *C.P. Young*, SCt, 2002-1 USTC ¶50,257, 535 US 43, 122 SCt 1036.

3 Some years may have multiple assessments; the most recent assessment date should be entered in order to assure that all of the taxes for that year satisfy the 240-day rule.

4 To be precise, the first date for the offer is not the date the taxpayer mailed it, but rather the date the taxing entity accepted it for consideration. Some offers are sent back without being considered due to some glaring deficiency.

5 For a thorough explanation of how these rules work, *see* MORGAN D. KING, DISCHARGING TAXES IN BANKRUPTCY, (KingsPress 2000), available at *www.BankruptcyBooks.com.*

6 Typically, the relevant IRS transcripts are the MFTRA-X, the TXMOD and the IMF Specific transcripts. Other transcripts may provide other useful information.

7 For other information, contact Morgan King at KingsPress at (925) 829-6460, Pacific time.

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