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# USING BANKRUPTCY TO PROVIDE RELIEF FROM TAX DEBT





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# EXPLORE ALL OPTIONS

- Collection Statute End Date--IRC § 6502
- Offer in Compromise--IRC § 7122
- Installment Agreement--IRC § 6159
- Currently uncollectible status





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# THE BANKRUPTCY OPTION

- Chapter 7--liquidation
- Chapter 13--repayment plan
- Chapter 12--family farmers and fishers
- Chapter 11--repayment plan, larger cases

The names come from the chapters where the rules are found in Title 11 of the United States Code. This presentation focuses on federal income taxes in Chapter 7. In Chapter 13, the debt relief rules for taxes are similar to the Chapter 7 rules.





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# VOCABULARY

- Secured debt--payment protected by rights in property, *e.g.*, mortgage or statutory lien
- Unsecured debt--payment protected only by debtor's promise to pay
- Priority--ranking of creditor's claim for purposes of asset distribution
- Discharge--debtor's goal in bankruptcy, eliminate the debt





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# SECURED DEBT

- Bankruptcy does not eliminate, *i.e.*, discharge, secured debt
- IRS creates secured debt with a properly filed notice of federal tax lien (NFTL)
- Valid NFTL must identify taxpayer, tax year, assessment, and release date--Treas. Reg. § 301.6323-1(d)(2)
- Rules for proper place to file NFTL vary by state





# SECURED DEBT CONTINUED

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- Properly filed NFTL attaches to all property
- All means all; NFTL defeats exemptions (exemptions are debtor's rights to protect some property from creditors)
- Never assume NFTL is valid
- If NFTL is valid, effectiveness of bankruptcy is problematic; it will depend on the debtor's assets





# SECURED DEBT CONTINUED

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- If tax is otherwise dischargeable, NFTL cannot attach to any after-acquired property and should be released if debtor has little or no property
- If tax is otherwise nondischargeable, NFTL remains and continues to operate as if there were no bankruptcy filing





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# TWO CENTRAL THEMES

- Debtor wants a discharge; in a simple case, discharge entered within 3.5 months
- Creditor wants payment priority, *i.e.*, if possible, first-in-line to be paid; timing of distribution depends on trustee; if no assets, case can be closed within 6 weeks of filing
- The issues of discharge for the debtor and payment priority for creditors operate independently, except in the world of **unsecured** tax claims







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# PRIORITY & DISCHARGE

- The Bankruptcy Code's treatment of **unsecured** tax claims joins the two concepts of priority and discharge, 11 U.S.C. §§ 507(a)(8) and 523(a)(1)
- Some taxes are priority/nondischargeable
- Others are nonpriority/nondischargeable
- All the rest are nonpriority/dischargeable, which is the goal for a successful Chapter 7 filing





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# PRIORITY/NONDISCHARGEABLE

The first type of unsecured tax debt includes:

- Taxes on returns where the due date of the return, counting extensions, is within 3 years of the bankruptcy filing date
- Taxes assessed within 240 days of the filing date
- Trust fund taxes, no matter the age
- Taxes that have not been assessed but are still assessable





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# NONPRIORITY/NONDISCHARGEABLE

The second type of unsecured tax debt includes:

- Taxes on returns that have not been filed
- Taxes on returns filed late within 2 years of the filing date
- Taxes on fraudulent returns; or, taxes for years where the taxpayer willfully attempts in any manner to evade or defeat taxes that are due





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# BEWARE: TIME ADD-ONS

- Collection due process hearing extends 3-year rule and 240-day rule and adds 90 days
- Offer in compromise extends 240-day rule and adds 30 days
- Prior bankruptcy filing extends 3-year rule plus 90 days, 240-day rule plus 180 days (under literal reading of statute), and 2-year rule with no additional time
- Many traps for the unwary





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# NONPRIORITY/DISCHARGEABLE

- If neither priority/nondischargeable nor nonpriority/nondischargeable, then ...
- The unsecured tax falls into the catchall of nonpriority/dischargeable (yes!)
- Making bankruptcy work: avoid nondischargeable taxes, if possible, *e.g.*, let time elapse as classifications are time sensitive; sometimes the tax is nondischargeable and cannot be changed
- You must order account transcripts to learn the IRS's version of the story





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# PENALTIES AND INTEREST

- Interest follows the tax; if tax is nondischargeable, then, the interest on that tax is nondischargeable; if tax is dischargeable so is the interest
- Penalties, a 3-year rule: if less than 3-years old, penalties are nondischargeable; if more than 3-years old, penalties are discharged
- Successful Chapter 13 plan discharges all penalties and post petition interest on priority income taxes paid in plan; otherwise, discharge is similar to Chapter 7 discharge





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# CHAPTER 7 INDICATORS

- Older income tax debt
- Client has limited assets; or, no NFTL so that assets can be exempted
- No trust fund taxes
- Tax and business debt larger than credit card debt and house mortgage debt; allows debtor to avoid Bankruptcy Code test that kicks debtors out of Chapter 7
- Bankruptcy is designed for the honest debtor

