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## Bankruptcy/Taxation

### Yes, Income Taxes are Dischargeable in Bankruptcy

By Robert V. Schaller

The Bankruptcy Code allows income taxes to be discharged as long as a taxpayer waits the appropriate amount of time before filing bankruptcy and is not a "bad boy" filer who committed fraud or evaded paying the tax.

Every lawyer should know bankruptcy basics to spot legal issues and determine where to direct prospective clients for appropriate help. Helping a prospect find the appropriate lawyer benefits the prospect and enhances the referring attorney's reputation as a trusted advisor.

#### Bankruptcy overview

A bankruptcy discharge is the cornerstone of the U.S. Bankruptcy Code<sup>1</sup> and affords honest but unfortunate taxpayers a fresh economic start in life, debt free and contractually free of most obligations.<sup>2</sup> The rehabilitative nature of a "fresh start" promotes the public policy of offering hope through economic redemption while minimizing criminal behavior resulting from despair.<sup>3</sup>

Historically, chapter 7 bankruptcy protection is the most frequent form of bankruptcy relief sought by taxpayers. This type of bankruptcy is colloquially referred to as "bankruptcy," "straight-bankruptcy," or "liquidation."

In chapter 7, individual taxpayers receive a discharge of all dischargeable debts.<sup>4</sup> But in return, all non-exempt assets owned by the taxpayer becomes property of the bankruptcy estate and are subject to seizure and sale by bankruptcy trustees to generate cash to pay taxing authorities and other creditors their statutory share. The vast majority of chapter 7 cases are "no asset" cases that result in no distribution to unsecured creditors; only a small percentage of cases result in the sale of assets and recovery of cash for distribution to creditors according to their statutory priorities.<sup>5</sup>

Chapter 13, on the other hand, is a debt-repayment plan that allows taxpayers to retain their assets and receive a discharge of all dischargeable debts<sup>6</sup> while repaying taxing authorities and other creditors over the applicable commitment period of three to five years.<sup>7</sup> Chapter 13 taxpayers typically pay unsecured creditors a dividend between 10 and 100 percent of the debt owed as of the commencement of the bankruptcy case, but can be as low as 1 percent for taxpayers with extremely tight budgets.



#### TAKEAWAYS

- Income taxes are generally dischargeable by filing for bankruptcy protection, but a taxpayer must satisfy certain requirements. For example, any income taxes relating to a tax year in which the tax return was due within three years of the bankruptcy filing are not dischargeable.
- Income tax debts are also not dischargeable for any tax year that the taxpayer failed to file a return. No return equals no discharge for the corresponding tax year.
- Taxpayers who file fraudulent returns are not able to discharge tax debts in bankruptcy. Similarly, taxpayers who willfully attempt to evade paying income tax obligations can't have their tax debts discharged.

## Debt dischargeability

The chapter 7 discharge is very broad and applies to individual taxpayers seeking chapter 7 protection.<sup>8</sup> The Bankruptcy Code discharges all claims against taxpayers that existed on the date they filed bankruptcy,<sup>9</sup> except claims that are specifically made nondischargeable.<sup>10</sup> The date the case was filed is crucial; claims arising after the filing date are not discharged in a chapter 7 case.<sup>11</sup>

Once a claim has been discharged, no steps can be taken to enforce the claim against the taxpayer.<sup>12</sup> The Bankruptcy Code permanently enjoins any attempt to enforce a discharged claim.<sup>13</sup> A creditor who attempts to enforce a discharged claim against a taxpayer could find itself back in court in a reopened chapter 7 case defending contempt of court charges for violating the bankruptcy discharge injunction.<sup>14</sup>



Chapter 13 taxpayers enjoy the "super discharge" provided in section 1328(a) that affords broader discharge rights than that granted to chapter 7 taxpayers.<sup>15</sup> These broader rights were designed to encourage eligible taxpayers to choose to pay unsecured creditors something under a chapter 13 plan, rather than nothing under a chapter 7 liquidation.<sup>16</sup> The law favors taxpayers proceeding under chapter 13 because the unsecured creditors would receive a larger distribution from those taxpayers than they would under a chapter 7 discharge.<sup>17</sup>

But not all income taxes are dischargeable. Certain tax obligations are excepted from discharge and survive the bankruptcy case unaffected by the bankruptcy discharge. The income tax discharge exceptions are set forth in three subsections of section 523(a)(1) of the Bankruptcy Code.<sup>18</sup> Section 523(a)(1)(A) excepts from discharge income tax debts afforded priority status pursuant to section 507(a)(8) of the Bankruptcy Code.<sup>19</sup> Next, section 523(a)(1)(B) excepts from discharge tax debts relating to a tax year in which a return was not filed and to certain late-filed returns. Finally, section 523(a)(1)(C) excepts from discharge tax debts relating to a fraudulent return or any attempt to evade or defeat the payment of taxes.

The section 523(a)(1) dischargeability exceptions apply equally to all governmental units and not just the IRS. Each tax year is considered separately for dischargeability purposes and a taxpayer can be discharged of tax obligations relating to a certain tax year and denied a discharge as to a different tax year. Each exception will be addressed.

## Exceptions to discharging taxes

**Section 523(a)(1)(A): 3-year due date rule and 240-day assessment rule.** Section 523(a)(1)(A) unconditionally excepts from discharge a certain subset of income taxes. However, it does not specifically identify this subset. Instead, it incorporates by reference the subset of priority income taxes identified in section 507(a)(8) relating to governmental units.

The first subset of section 507(a)(8) identifies the "three-year due date rule," which excepts from discharge any income taxes relating to a tax year in which the tax return was due within three years of the bankruptcy filing.<sup>20</sup> The look back period essentially functions as a statute of limitations.<sup>21</sup> The due date includes any filing extensions, including automatic extensions. For example, a taxpayer who requests an IRS extension to October 15th has a "due date" of October 15th even if that taxpayer files the return prior to the October 15th due date.

The second subset of section 507(a)(8) taxes identifies the "240-day assessment rule," which excepts from discharge any income taxes that were "assessed" by a taxing authority within 240 days of the bankruptcy filing, or are still assessable but not yet assessed. The assessment date can be difficult to calculate because it is an internal action taken by the taxing authority without notice to the taxpayer.

**Failure to file: 2-year filing date rule of section 523(a)(1)(B).** Income tax debts are not dischargeable for any tax year that the

taxpayer failed to file a return.<sup>22</sup> No return equals no discharge for the corresponding tax year.<sup>23</sup> Sometimes a taxing authority will file an estimated tax return on behalf of a taxpayer who fails to file a tax return.

A tax return filed by the taxpayer after the taxing authority filed a return on the taxpayer's behalf<sup>24</sup> is not deemed a "return" within the meaning of section 523(a)(1)(B) because it is redundant, serves no tax purpose, and is not an honest attempt to comply with the tax laws.<sup>25</sup> Similarly, a taxpayer's submission of non-traditional papers to the taxing authority (e.g., tax protester) is not deemed a "return" unless it (1) purports to be a "return," (2) is signed under penalty of perjury, (3) contains enough information to enable the taxpayer's tax liability to be calculated, and (4) evinces an honest and genuine endeavor to satisfy the tax law.<sup>26</sup>

Taxpayers who timely-file income tax returns can seek discharge if they wait the appropriate amount of time before filing bankruptcy. The section 523(a)(1)(B) "two-year filing date" rule excepts from discharge income taxes relating to tax returns filed within two years of the bankruptcy filing. Counsel must be cognizant that the "filing date" rule is independent of the "due date" rule. A common problem by inexperienced counsel is conflating "filing date" with "due date."

A growing controversy relates to the dischargeability of taxes that are filed after the tax return filing due date even though the taxpayer satisfies the section 523(a)(1)(A) "due date" rule and the section 523(a)(1)(B)(ii) "filing date" rule. While section 523(a)(1)(B)(ii) appears to only limit the discharge exception to tax returns filed within two years of the bankruptcy filing, several federal circuit courts have held that tax obligations relating to a return filed after the filing deadline can never be discharged no matter how long the taxpayer waits - even if the return was filed one day late.<sup>27</sup>

This interpretation is not universal and is hotly rejected by other courts.<sup>28</sup> The seventh circuit has not yet addressed this question since Congress amended section 523 in 2005.

**Section 523(a)(1)(C): 'Bad boy' exception for fraudulent returns.** Not surprisingly, the Bankruptcy Code provides a discharge exception in section 523(a)(1)(C) against taxpayers who file fraudulent tax returns. Taxpayers who are audited and caught filing fraudulent tax returns cannot obtain a discharge by amending the returns and then waiting the appropriate time period before filing bankruptcy.

Taxpayers who willfully attempt to evade paying income tax obligations do not fare any better. Section 523(a)(1)(C) excepts from discharge any debt with respect to which the taxpayer "willfully attempted in any manner to evade or defeat such tax."<sup>29</sup>

The seventh circuit addressed this exception in *In re Birkenstock* and held that section 523(a)(1)(C)'s exception comprises both a conduct requirement (that the taxpayer sought to evade or defeat his tax liability) and a mental state requirement (that the taxpayer did so willfully).<sup>30</sup>

The court found that a "willful" determination requires a taxpayer's attempt to avoid tax liability to be voluntary, conscious, and intentional. In other words, the taxpayer must both (1) know that the taxpayer has a tax duty under the law, and (2) voluntarily and intentionally attempts to violate that duty. The willfulness requirement prevents the application of the bankruptcy discharge exception to taxpayers who make inadvertent mistakes, reserving nondischargeability for those whose efforts to evade tax liability are knowing and deliberate.

The seventh circuit ruling in *In re Birkenstock* was set against a backdrop of an apparent willful tax evader who took affirmative steps to avoid paying taxes over multiple years. But what about less clear fact patterns?

For example, the IRS unsuccessfully asserted that a parent willfully evaded paying taxes by paying a child's college tuition.<sup>31</sup> But the IRS prevailed against a taxpayer who attempted to conceal income<sup>32</sup> and a different taxpayer who funneled money into a shell corporation titled in the name of the taxpayer's child.<sup>33</sup> The "willful" issue is obviously fact intensive.

Because direct proof of a debtor's willful attempt to evade tax obligations is usually unavailable, the intent to evade taxes is generally provable by circumstantial evidence and reasonable inferences drawn from the existence of certain fact patterns, otherwise called badges of fraud.<sup>34</sup> Badges of fraud include (1) significant understatements of income made repeatedly, (2) failure to file tax returns, (3) repeatedly filing returns late, (4) implausible or inconsistent behavior by the taxpayer, and (5) failure to cooperate with federal tax authorities.<sup>35</sup>

## Discharge injunction

Taxpayers who are fortunate enough to receive a discharge of the tax obligations are granted both a sword and a shield by the Bankruptcy Code. Section 524(a)(2) establishes a discharge injunction that operates as a permanent injunction against the commencement or continuation of an action, the employment of process, or an act to collect, recover, or offset any discharged debt as a personal liability of the taxpayer.<sup>36</sup> The purpose of the injunction is to ensure that once a debt is discharged, the taxpayer will not be pressured in any way to repay it.<sup>37</sup>

Taxing authorities ignore a bankruptcy discharge injunction at their peril. A violation of the discharge injunction may be redressed by a bankruptcy court under its civil contempt power contained in 11 U.S.C. § 105(a).<sup>38</sup> Flagrant disregard for the discharge injunction could result in sanctions that include damages, costs, attorneys' fees, and in some cases, punitive damages.

## Conclusion

Income taxes are dischargeable by filing bankruptcy, but a taxpayer must satisfy all parts of the section 523(a)(1) test.



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### ISBA RESOURCES >>

John T. Wagener & Kenneth D. Peters, *Bankruptcy and the Series LLC: Can Creditors Pierce the Veil?*, 102 Ill. B.J. 236 (May 2014), <http://www.isba.org/ibj/2014/05/bankruptcyandtheseriesllccancredito>.

Nancy Franks-Straus, *Tax Issues Facing the Individual Chapter 11 Debtor*, Commercial Banking, Collections, and Bankruptcy (July 2012), <http://www.isba.org/sections/commercial/newsletter/2012/07/taxissuesfacingtheindividualchapter>.

Helen W. Gunnarsson, *Bankruptcy Lawyers are "Debt Relief Agencies," High Court Rules*, 98 Ill. B.J. 342 (July 2010), <http://www.isba.org/ibj/2010/07/lawpulse/bankruptcylawyersaredebtreliefagencieshighcourtrules>.

1. 11 U.S.C. § 101 *et seq.*
2. See, e.g., *United States v. Sotelo*, [436 U.S. 268](#) (1978).
3. See *Village of San Jose v. McWilliams*, [284 F.3d 785](#), 790 (7th Cir. 2002).
4. 11 U.S.C. § 727(a).
5. Alane A. Becket & William A. McNeal, *Fundamentals of Chapter 7 and Chapter 13 of the U.S. Bankruptcy Code*, § I(B)(1), page 4 (3d Edition).
6. 11 U.S.C. § 1328(a).
7. *Id.* § 1325(b)(4).
8. *Id.* § 727(a).

9. *Id.* § 727(b); see *Matter of McFarland*, [84 F.3d 943](#) (7th Cir. 1996).
10. See, e.g., 11 U.S.C. §§ 523, 1328(a).
11. See, e.g., *Hawkins v. Franchise Tax Board of California*, [769 F.3d 662](#), 666 (9th Cir. 2014).
12. See Rosemary E. Williams, *Bankruptcy Practice Handbook*, § 5:95 (2d Edition).
13. 11 U.S.C. § 524(a).
14. Ginsberg & Martin on Bankruptcy, Vol. 1, § 12.12(A) (4th Edition).
15. 11 U.S.C. § 1328(a).
16. See Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *As We Forgive our Debtors* 265 (1999).
17. Becket & McNeal, *supra* note 5, at 109.
18. 11 U.S.C. § 523(a)(1).
19. *Id.* § 507(a)(8).
20. *Kolve v. Internal Revenue Service*, [459 B.R. 376](#) (Bankr. W.D. Wis. 2011).
21. *Young v. United States*, [535 U.S. 43](#), 46 (2002).
22. 11 U.S.C. § 523(a)(1)(B)(i).
23. See, e.g., *In re Payne*, [431 F.3d 1055](#) (7th Cir. 2005).
24. Under 26 U.S.C. § 6020(b), the IRS is authorized to prepare and file an income tax return on behalf of a taxpayer if that taxpayer fails to do so.
25. *In re Payne*, 431 F.3d at 1055.
26. *Zellerbach Paper Co. v. Helvering*, [293 U.S. 172](#), 180 (1934); *United States v. Moore*, [627 F.2d 830](#), 834-35 (7th Cir. 1980).
27. See, e.g., *McCoy v. Mississippi State Tax Commissioner (In re McCoy)*, [666 F.3d 924](#) (5th Cir. 2012).
28. See, e.g., *In re McBride*, [534 B.R. 326](#) (Bankr. S.D. Ohio 2015).
29. 11 U.S.C. § 523(a)(1)(C).
30. *In re Birkenstock*, [87 F.3d 947](#) (7th Cir. 1996).
31. *In re Looft*, [553 B.R. 910](#) (Bankr. N.D. Ga. 2015).
32. *Claxton v. United States (In re Claxton)*, [335 B.R. 680](#) (Bankr. N.D. Ill. 2006).
33. *In re Zuhone*, [88 F.3d 469](#) (7th Cir. 1996).
34. *In re Berzon*, [145 B.R. 247](#), 250 (Bankr. N.D. Ill. 1992).
35. *Claxton v. United States (In re Claxton)*, [335 B.R. 680](#) (Bankr. N.D. Ill. 2006).
36. 11 U.S.C. § 524(a)(2).
37. *In re Johnson*, [521 B.R. 912](#), 916 (Bankr. W.D. Ala. 2014).
38. See, e.g., *In re Bock*, [297 B.R. 22](#), 29 (Bankr. W.D. N.C. 2002).

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## Member Comments

