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Tax

Maximizing Federal Income Tax Liability Discharge During Bankruptcy

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Briefly, a "priority debt" in the context of a bankruptcy Chapter 7 or 13 filing is: (1) paid first in a Chapter 7 once assets are liquidated, and (2) included and paid in full under a Chapter 13 payment plan. Generally, federal income tax debt is considered "priority debt" in all bankruptcy chapter filings. In other words, under this general rule, filing bankruptcy will not automatically eliminate tax debt. However, if nonpriority status of the tax debt can be established, then such tax debt may potentially be discharged in a Chapter 7. Discharging income tax debt is usually a complicated process, so before you try to eliminate such debt by filing bankruptcy, you should consult with an experienced attorney who understands the bankruptcy rules, and case law.

The Five Income Tax Dischargeability Rules

Discharging tax liability is canvassed by the following rules:

- 3-Year Rule
- 2-Year Rule
- 240-Day Rule
- No tax Fraud
- No willful evasion

For our purposes here, we will be discussing rules (1) through (3), often referred to as the "3-2-240 Rules." Additionally, we will consider the Beard Test, a bankruptcy trap for the 2-Year Rule—especially relevant in the Fourth Circuit. These considerations create a blueprint that can be implemented to maximize relief from tax liability, including penalties and interest. And if the discharge requirements are not met, all hope may

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not be lost—you may consider filing Chapter 13 to prevent collection efforts, avoid a tax lien, and ultimately receive more of the Chapter 13 plan payment than unsecured creditors.

3-Year Rule: dischargeable if taxes due at least three years before bankruptcy filing (including extensions)

Taxes based on income and gross receipts, filed during the year or within three years preceding the date the bankruptcy petition was filed, are considered a priority debt and are not dischargeable; however, if the taxes are placed outside of this window, they can be discharged as a non-priority debt. While this "lookback" date can be extended based upon a number of factors that include prior bankruptcies and collection due process hearings, taxes found outside of three years without extending events can be discharged in a bankruptcy case.

Examples:

Non-Dischargeable: A bankruptcy was filed on April 26, 2021. After requesting an extension, the taxpayer filed the 2017 tax return on October 14, 2018. The amount owed for 2017 taxes is $35,000. There are no other extending events. These taxes are considered priority debt and non-dischargeable in a Chapter 7. However, this debt may be paid in a Chapter 13 case that has a 5-year plan. A priority debt, such as taxes, will be given more of the plan payment than unsecured creditors. In fact, it is possible that taxes are fully paid and no plan payments ever go to unsecured creditors.

Dischargeable: A bankruptcy was filed on May 26, 2020. The 2015 taxes were filed by April 15, 2016. The amount owed is $75,000. There are no other extending events. These taxes are considered dischargeable in a Chapter 7.

2-Year Rule: dischargeable if the tax return was filed at least 2 years before the bankruptcy filing (watch for Beard trap discussed below)

The two-year rule is also a "lookback" process. Note that the Fourth Circuit has adopted the "post-assessment" approach in establishing late-filed returns. Contrary to the three-year rule evaluating the tax return due dates establishing priority status, the two-year rule often focuses on a late filed return and whether the return was filed within the two-year period prior to the date the petition was filed—satisfying the Internal Revenue Code's (IRC's) reliance on "honest and reasonable taxpayers."

The IRC §6020(b) allows for the IRS to create a return for an individual based on known information. Such return is commonly referred to as an SFR (Substitute for Return). If an SFR has been created, then under Beard the mechanical satisfaction of the two-year rule is not met and the taxes are non-dischargeable. In other words, the individual must have filed the tax return and the return must be valid. Validity is determined by the subjective Beard test. Fortunately, the IRS does not always get around to preparing SFRs, and good faith filings will often meet the Beard demands even if they were filed late.

Examples:

Non-Dischargeable: A bankruptcy case was filed on March 23, 2000. The tax returns for 1990 and 1992 were not filed. The IRS filed substitute returns for these tax years. Subsequently, the debtor filed the 1990 and 1992 tax returns postdated by four and six years, respectively. While the IRS accepted the postdated returns and abated $23,310, the adjusted tax due for the 1990 and 1992 tax years was non-dischargeable due to the late-filed returns lacking the "honest and

reasonable" element of the Beard test. Since the Beard test was not satisfied, the debtor's attempt to file will not be considered a "return" vacating the possibility of discharge for the tax liability in Chapter 7; however, these taxes are easily managed via a Chapter 13 five-year plan.

Dischargeable: A bankruptcy case is filed on June 20, 2020. The tax returns for tax years 2014, 2015, and 2016 were filed on April 15, 2018. No substituted returns were filed by the IRS. The tax owed is $87,000 for all three years. There are no other extending events in this case. The taxes were due to be file more than 3 years ago, no additional assessments took place with the 240 days of bankruptcy, and this bankruptcy filing was more than two years after the returns were filed. These taxes are dischargeable in a Chapter 7 bankruptcy case.

240-Day Rule: dischargeable if the tax was assessed by the IRS at least 240 days before bankruptcy filing

After an IRS assessment has been conducted, 240 days must have passed since the assessment was completed. These assessments might include audit adjustments and amended returns. The 240-day rule will be extended 30 days for an offer in compromise. An extension of 90 days will apply in cases of a stay in proceedings due to prior bankruptcy proceedings. Again, this can be a question of strategically choosing the appropriate bankruptcy method and filing the petition in order to adjust the taxes from a priority to a non-priority status.

Examples:

Non-Dischargeable: A bankruptcy case is filed on June 14, 2021. The taxes at issue are from tax year 2017. The return was filed on April 14, 2018. The taxpayer was chosen for audit on March 5, 2020. Due to COVID 19 delays, the final assessment was not entered until February 2, 2021. The assessment shows the amount due of $27,000. First, this case passes the 3-year rule because it was file more than 3 years earlier than the filing date. However, the assessment from the audit was less than 240 days ago so the tax will be non-dischargeable in a Chapter 7 bankruptcy filing. A Chapter 13 bankruptcy filing could more favorably deal with this issue in a 5-year payment plan with the IRS.

Dischargeable: A bankruptcy case was filed on May 15, 2020. The taxes in question were from tax years 2014 and 2015. The taxpayer filed the 2014 tax return on June 8, 2015 and the 2015 tax return on April 11, 2016. The 2014 tax return was late, but no substitute return was filed. An audit during 2014 and 2015 resulted in a $1,000,000 assessment. The assessment was entered on September 15, 2016 for both years. There were no other extending events. Both the 3-year and 240-day rule are satisfied. As a result, these taxes are dischargeable in a Chapter 7 bankruptcy filing.

Conclusion

Maneuvering through the mechanics of the "3-2-240 Rules" can create complicated questions of tax liability discharge through bankruptcy. Determining whether a tax is priority or nonpriority and then applying the "post-assessment approach" of the Fourth Circuit requires careful analysis. Once your specific case is evaluated, strategically determining the most effective bankruptcy method and petition filing date will allow you to maximize your new financial freedom. Expert advice and guidance from seasoned professionals can alleviate the difficult interpretations and support the timeliest petition achieving maximum relief.

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