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# Income Tax Liabilities and Possible Bankruptcy Solutions

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## Income Tax Liabilities and Possible Bankruptcy Solutions

### Guide Information

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### Introduction

When an individual taxpayer becomes indebted to the Internal Revenue Service (hereafter referred to as the IRS), the taxpayer may pursue collection solutions provided under the taxation statutes in Title 26 of the United States Code. However, the taxpayer may have additional creditors or an undesired result from the options available through the tax code. In such an instance, the taxpayer may desire to file a petition for bankruptcy in order to deal with his financial problems as a whole or acquire additional opportunity to resolve his tax liabilities. When a taxpayer with tax liabilities files a petition for bankruptcy, the interrelationship between the Bankruptcy Law and Tax Law work together to determine the consequences to the tax liabilities.

This Web Research Guide is designed to provide the reader with a general understanding of the interrelation between Bankruptcy Law and Tax Law, and is NOT intended to be an exhaustive source of all the issues related to Bankruptcy effects on tax liabilities. The scope of this Guide is focused on the general types of tax liabilities that are dischargeable in bankruptcy.

### About the Author

[This website was created on November 15, 2005, as an assignment in Professor Nancy Johnson's Advanced Legal Research Class for the Fall 2005 semester. At that time, Brent Howard](#) was a three year law student at Georgia State University College of Law, and anticipating graduation in May 2006. He hopes to practice in either tax litigation or estate planning.

### Disclaimer

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## Primary Sources

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## AFFECTS OF BANKRUPTCY FILING ON IRS ASSESSMENT AND COLLECTION ACTIVITIES

## Statutes

### [26 U.S.C. §6501](#). Limitations on Assessment and Collection

Establishes a Statute of Limitations on the IRS to assess taxes within 3 years from the filing of the tax return. If the taxpayer omitted gross income in excess of 25% of the amount reported on the return, the IRS has 6 years to assess the tax. If the return was not filed, was false or a willful attempt to evade taxes, the IRS may assess taxes at anytime.

### [26 U.S.C. §6502](#). Collection After Assessment

Provides a 10 year Statute of Limitations on the IRS to collect taxes after they are assessed.

### [26 U.S.C. §6503](#). Suspension of Running of Period of Limitation

Suspends the statutory time to assess taxes under 26 U.S.C. §6501 for the duration of the proceeding plus 60 days. The statute also suspends the statutory time to collect taxes under 26 U.S.C. §6502 by the duration of the proceeding plus 6 months.

### [11 U.S.C. §362](#). Automatic Stay

Places an automatic stay on any creditor, and prevents any collections action against the debtor when the debtor files a bankruptcy petition.

### [11 U.S.C. §108](#). Extension of Time

Provides any creditor subject to a non-bankruptcy statute of limitations law the ability to pursue collection for 30 days after termination of the stay under 11 U.S.C. §362. However, subsection (c)(1) allows any suspension under the non-bankruptcy law. Thus, 26 U.S.C. 6503(b) applies, which adds 6 months plus the time the debtor's assets were in the control or custody of the Bankruptcy Court.

## Cases

*In re Montoya*, 965 F.2d 554 (7th Cir. 1992).

Court held that 11 U.S.C. 108 and 26 U.S.C. 6503 provide suspension of the Statute of Limitations when additional court proceeding prohibit collection after the automatic stay under 11 U.S.C. 326 had ended.

*In re Gore*, 182 B.R. 293 (Bankr.N.D.Ala.1995).

Court finding in favor of debtors held that a prior Chapter 13 bankruptcy did not suspend the Statute of Limitation on assessing taxes. Thus, the tax liabilities were dischargeable under the new bankruptcy filing.

*In re Brent*, 212 B.R. 311 (C.D.Ill. 1997).

Court denied debtors' claim that *In re Gore* should apply and cited *In re Montoya* in holding that a prior bankruptcy proceeding suspended the Statute of Limitations for assessing taxes.

## Administrative Regulations

27 CFR §70.225.

Suspension of running of period of limitation; assets of taxpayer in control or custody of court. Based on the Authority of 26 U.S.C. 6503. Provides that the period to collect assessed taxes is extended by the time of the proceeding plus 6 months when substantially all the taxpayer's assets are in the custody of a United States court.

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## ABILITY TO DISCHARGE TAX LIABILITIES EXISTING PRIOR TO BANKRUPTCY FILING

### Statutes

#### [11 U.S.C. §727](#). Discharge

Grants the Bankruptcy Court the right to discharge the debtor's debt under Chapter 7. Several exceptions to this right are listed, which includes exceptions provided in 11 U.S.C. §523.

#### [11 U.S.C. §523](#). Exceptions to Discharge

Tax Liabilities are NOT dischargeable if:

1. A kind specified in 11 U.S.C. §507(a)(2) and (a)(8);
2. If the taxes arose from a required return, which was not filed, or filed late within two years prior to the Bankruptcy filing.
3. If the taxes arose from a fraudulent return or willful attempt to evade or defeat the tax.

Additionally, §523(a)(7) makes penalties related to tax liabilities that occurred before three years prior to the Bankruptcy filing not dischargeable. Generally, this makes tax penalties not dischargeable when the underlining tax is not dischargeable. Except this provision does not apply to Chapter 13.

#### [11 U.S.C. §507](#). Priority

Sets Priority of Claims under Bankruptcy. Because of its reference in 11 U.S.C. § 523, sub sec (a)(8) represents unsecured tax claims that are not dischargeable, which are taxes arises from either:

1. A taxable year before the bankruptcy where the return was due within three years before the filing of the bankruptcy petition. The timing of the filing due includes extensions.
2. The tax was assessed within 240 days before the date of the filing of the bankruptcy petition. This time is extended for by any time an offer in compromise was pending plus 30 days.
3. Taxes that are assessable after the time the bankruptcy petition is filed. Unless specified in 11 U.S.C. §523(a)(1)(B) or (C).

#### [26 U.S.C. §6012](#). Persons Required to Make Returns of Income

Generally, any individual who's income exceeds the exempt amount.

[26 U.S.C. §6020](#). Returns Prepared for or Executed by Secretary

Allows the IRS to make a return for a taxpayer who fails to file. The return is good for the legal purposes of allowing the IRS to pursue collection action.

[26 U.S.C. §7502](#). Timely Mailing Treated as Timely Filing and Paying

For filing returns with the IRS, this code treats postage date as time of filing if the postage date is on or before the due date. If later than the due date, time of filing is the date received.

[26 U.S.C. §6501](#). Limitation on Assessment and Collection

If a return is received before the prescribed due date it is considered received on such date.

[26 U.S.C. §6203](#). Method of Assessment

The IRS may assess taxes automatically when a taxpayer files a return, by deficiency assessment based on an examination or by jeopardy assessment when there is a significant risk the IRS will not be able to collect if assessment is postponed.

## Cases

*In re Borck*, 81 B.R. 142 (Bkrcty.S.D.Fla.,1987).

Held that tax returns filed more than three years prior to bankruptcy filing were dischargeable. Taxes filed within three years of bankruptcy filing were NOT dischargeable. Pre-petition, tax lien and levy are enforceable.

*Tashjian v. I.R.S.*, D.Mass.2005, 325 B.R. 56 (D.Mass 2005)

An IRS waiver of right to collect interest from the bankruptcy estate did NOT preclude the IRS from collecting the interest from the individual debtor after the bankruptcy proceeding.

*Wetzel v. U.S.* , *I.R.S.*, 1997 WL 834810, (9th Cir.BAP Jul 15, 1997).

Held debtor has duty to prove that taxes under 11 U.S.C. 523 fail to qualify as an exception to discharge. Also, IRS substitute returns do not qualify as returns filed by or on behalf of the debtor in bankruptcy, and does not qualify as filing for purposes of making the tax liabilities dischargeable.

*In re Matthews*, 184 B.R. 594, (Bankr. S.D. Ala. 1995).

Automatic Stay can provide debtor recourse and protection for IRS collection action. Court found IRS in contempt of court for continuing to send levy notice and seizing two tax refunds.

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## ADVANTAGES TO CHAPTER 13 FOR DISCHARGEABLE TAX LIABILITIES

### Statutes

[11 U.S.C. 1328](#). Discharge

After completion by the debtor of all payments required under the Chapter 13 plan, the bankruptcy court grants a discharge of all debts under the plan. This statute allows the discharge of some tax debts under Chapter 13 that are not allowed under Chapter 7.

[11 U.S.C. 109](#). Who May be a Debtor

Subsection (e) allows a Chapter 13 filing only for an individual with regular income who meets certain limit requirements set under 11 U.S.C. 104 and the Judicial Conference of the United States .

### Cases

*Matter of Zieg*, 194 B.R. 469, 474, (Bankr.D.Neb. Jan 11, 1996).

Tax liability from willfully non reported income on tax return was dischargeable under Chapter 13 plan even though the plan did not pay the liability. Additionally the IRS could not claim the tax had priority under 11 U.S.C. §523 because that provision does not apply in Chapter 13.

*Matter of Ungar*, 104 B.R. 517 (Bankr.N.D.Ga. Sep 05, 1989).

Tax liabilities are not discharged under Chapter 13 if they are not part of the final Chapter 13 plan.

*In re Lovato*, 203 B.R. 747 (Bankr.D.Dyo. 1996).

IRS can not collect on tax liabilities discharged under Chapter 13 even if the IRS was unable to realize the property secured under a tax lien.

*In re Dixon* , 209 B.R. 535 (Bankr.W.D.Okla. Jun 10, 1997).

Tax liabilities for year prior to bankruptcy petition were dischargeable under Chapter 13 plan when filed on time, and IRS failed to provide proof of claim or secure liability.

*Matter of Miller*, 100 B.R. 898, (Bkrcty.N.C.Ohio, 1989).

Tax liabilities are dischargeable if included in the Chapter 13 plan even if no payments are provided under the plan. Additionally, nondischargeable taxes under 11 U.S.C. 523 do not apply to 11 U.S.C. 1328.

*In re Daniel*, 107 B.R. 798, 802 (Bankr.N.D.Ga. Oct 16, 1989).

Tax liabilities are dischargeable when provided for in the Chapter 13 plan even if no payment was received. Additionally, incorrect notification to address from collections notice did not affect discharge.

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## SECURED TAX LIABILITIES

### Statutes

[11 U.S.C. 522](#). Exemptions

This statute details property that is exempt from liability during and after the bankruptcy case. However, subsection (c)(2)(B) makes an exception for a properly filed tax lien.

### Cases

*U.S. v. Buckner*, 264 B.R. 908, (N.D.Ind. 2001)

IRS may pursue collection of debtor's property with a valid pre-petition tax levy even though taxes were discharged under Chapter 7. 11 U.S.C. §§ 524(a), 727. Even after IRS mistakenly abated the assessment after forgetting about the pre-petition tax levy.

*In re Miller*, 98 B.R. 110 (Bankr. N.D. Ga. 1989).

Automatic Stay under 11 U.S.C. § 362 prevents the IRS from acquiring proceeds from the sell of property under a lien while the proceeds are still in the custody of the bankruptcy court.

*In re Isom*, 901 F.2d 744 (9th Cir. 1990).

Holding that a discharge in bankruptcy only prevents the IRS from taking collection action against the debtors personally, but does NOT preclude the IRS from taking action in rem with a valid lien. Thus, a discharge in bankruptcy does not make the assessed tax unenforceable under 26 U.S.C. 6325(a)(1).

*In re Cohen*, 1999 WL 1424992, (Bankr.S.D.Fla. 1999).

Holding a tax lien is not enforceable when no pre-bankruptcy petition assets exist after the end of the bankruptcy proceeding.

### Administrative Publications

The IRS provides many publication detailing the affect of the code and regulations. These publications are available at [www.irs.gov](http://www.irs.gov). [Below is listed the IRS publication on Bankruptcy.](#)

[I.R.S., Bankruptcy Tax Guide, Publ 908 \(July 1996\).](#)

Provides an explanation of bankruptcies affects on tax liabilities with specific examples.

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## Secondary Sources

### Legal Encyclopedia

Legal encyclopedias are also a good starting point for research. They typically provide a basic understanding of a topic and provide the general statutes and cases that apply to the topic. Below are a few sections relevant to tax liabilities in bankruptcy.

35 Am. Jur. 2d *Federal Tax Enforcement* § 220.

Short summary of how and when the Statute of Limitations are suspended under 26 U.S.C. §6503 for the collection of assessed taxes.

33 Am. Jur. 2d *Federal Taxation Filing Returns and Paying Tax* § 1968.

Short summary on filing requirements and determination of filing date.

### Law Review Articles and Other Periodical Sources

American Law Reports and Law Review Articles are a good place to begin your research. They can provide a general understanding of your topic and provide you with the relevant statutes and cases to begin your research. Below are some A.L.R. and Law review citations relevant to tax liabilities in bankruptcy.

Donald T. Kramer, J.D., *Suspension of Running of Period of Limitation*, Under 26 U.S.C.A. § 6503, for Federal Tax Assessment or Collection. 160 A.L.R. Fed 1. (2000). Details how and when the Statute of Limitations are suspended under 26 U.S.C. §6503.

James E. Lockhart, J.D., *Debts Arising from Penalties as Exceptions to Bankruptcy Discharge Under § § 523(A)(7), (13) AND 1328(A) of Bankruptcy Code of 1978 (11 U.S.C.A. § 523(A)(7), (13), AND 1328(A))*, 150 A.L.R. Fed 159. (1998).

Discusses the rules and exceptions to discharge of penalties. The general rule is that penalties for nondischargeable taxes are nondischargeable.

James Lockhart, J.D., *Debts Arising from Tax Penalties as Exceptions to Bankruptcy Discharge Under § 523(A)(7)(A) AND (B) of Bankruptcy Code of 1978 (11 U.S.C.A. § 523(A))*, 157 A.L.R. Fed. 313 (1999).

Provides detailed information on when and how tax penalties are discharged in bankruptcy.

Andrew M. Campbell, J.D., *Exception from Discharge of Taxes Under § 523(a)(1) of Bankruptcy Code (11 U.S.C.A. § 523(A))*, 145 A.L.R. Fed. 1. (1998). Discusses exceptions to dischargeable taxes.

Kathleen Bicek Bezdichek, J.D., *Determination of Timely Filing of Tax Document Under Internal Revenue Code § 7502 (26 U.S.C.A. § 7502)*, 188 A.L.R. Fed. 1. (2003). Provide detailed discussion on the various factors that affecting the determination of timely filing.

Federal Tax Collection Procedure, Tax Management Portfolios, U.S. Income Series, Procedure and Administration (BNA) No. 638-2nd. (2005). Provides a comprehensive discussion on issues arising out of IRS collections, and covers issues related to bankruptcy filing.

Scott E. Vincent, *IRS Actions Violated Automatic Stay in Bankruptcy Case*, 61 J. Mo. B. 100 (2005). Short law review article giving a general understanding of when the IRS violates automatic stay under a bankruptcy case.

Rex B. Bushman, *Are Income Taxes Dischargeable in Bankruptcy?*, 1-JUN Utah B.J. 12 (1997). Provides a general understanding of how income tax liabilities can be discharged in bankruptcy, and provides the relevant statutes.

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## Websites and Internet Research

### Interest Groups

#### [Westlaw](#)

Westlaw is a paid subscription search service that provides detailed terms and connector searching and a comprehensive digest of legal issues. The use of the Key Numbers and Digest system allow you to browse the index and then narrow in on your topic. While, the terms and connectors feature allows you to develop very specific search criteria. A recommended search for tax liabilities in bankruptcy is TAX! /S LIABILITY! & DISCHAR! /P BANKRUPT!.

#### [LexisNexis](#)

LexisNexis is also a paid subscription search service that provides both terms searching as well as table of contents searches.

#### [BNA TAX Management](#)

BNA is a paid subscription service dedicated to financial information, and give comprehensive and detailed information in its Portfolios. Subscribing to the Tax Portfolio service gives the user focused searching ability for tax law. BNA Portfolios has a word searching tool, but works best through index search tool.

#### [CCH](#)

CCH is a paid subscription service for the tax practitioner. The service provide access to the IRS code, administrative regulations, publication and rulings as well as court holdings.

#### [Legal Information Institute](#)

Legal Information Institute is operated by Cornell University Law School as a free site for legal information. The site is a great source for access to the both the Federal and State Constitutions, several federal codes and many federal and state court opinions.

#### [GPO Access](#)

GPO Access is operated by the United States Government Printing Office. The site is free and offers a variety of government documents. It is most useful for view Code of Federal Regulations, and for searching for updated regulations.

#### [Thomas](#)

Thomas is operated by the Library of Congress. The site provides a great resource for legislative history, and following pending legislation. Searching is easiest with a bill number, but the site also allows several ways to browse including: by Senate or House, by specific committee or by legislative session.

#### [Georgia State University College of Law Tax Clinic Website](#)

This site is maintained by the GSU Tax Clinic, and is designed to provide law students with instruction on resolving federal tax controversies. The site provides instructions on IRS procedures, and how to use different procedures to help resolve tax controversies.

#### Popular On-Line Search Engines

Popular on-line search engines such as [Google](#) or [Yahoo](#) provide an excellent way to begin your research. The services are free and can provide an opportunity to become comfortable with a topic before using paid subscription services. Legal terms and topic are well suited for on-line search engines because they are unique enough to provide more specific results.

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## Conclusion

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Unfortunately the same issues that create outstanding tax liabilities also results in liabilities to other creditors. This fact means that tax liabilities and bankruptcy law are likely to always have some interrelationship. With the existence of this interrelationship, it is important for the tax practitioner to have an understanding of how bankruptcy can affect tax liabilities.

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