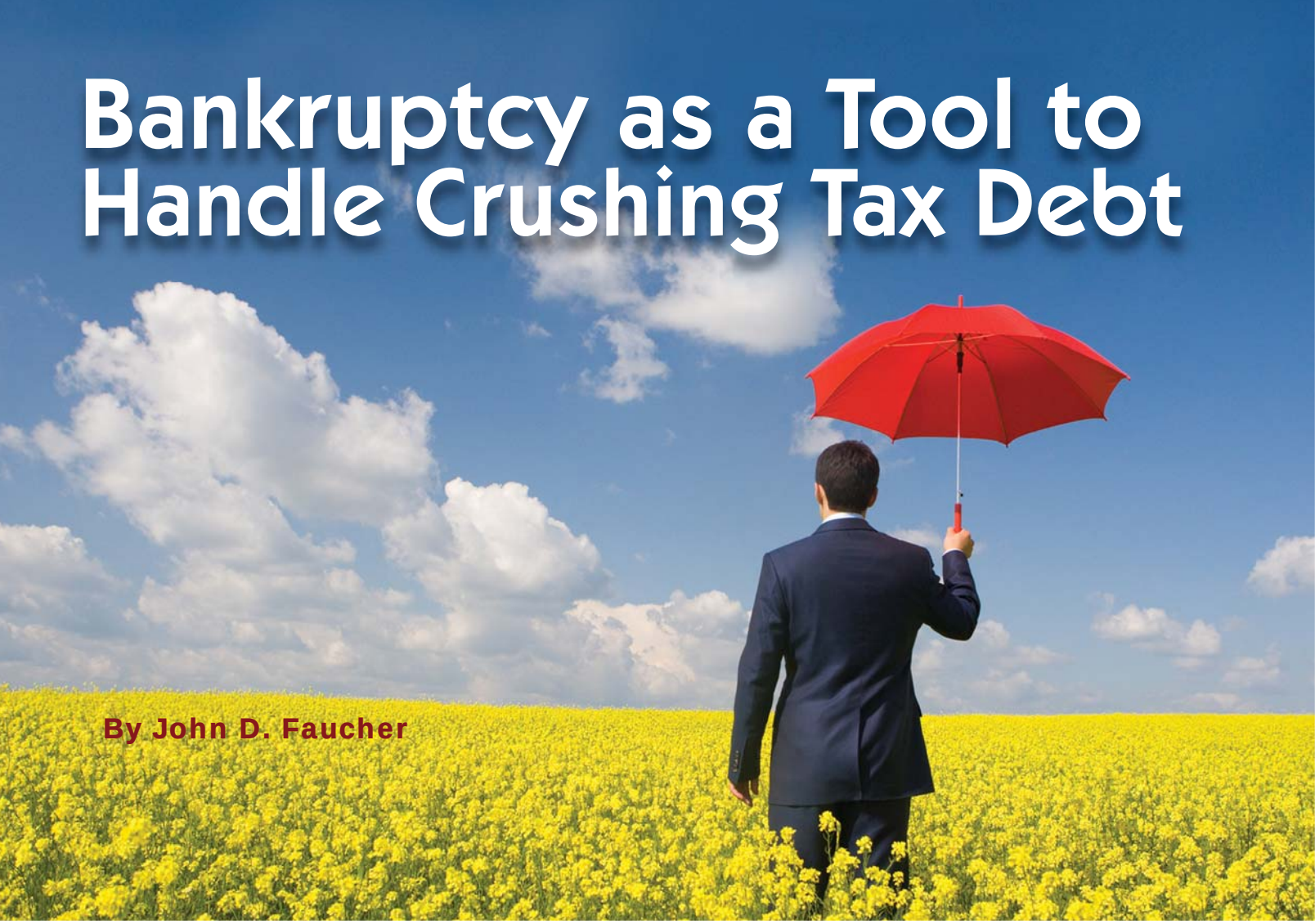
Bankruptcy as a Tool to Handle Crushing Tax Debt



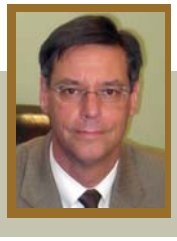
By John D. Faucher

MATT PLUMMER[1] WENT INTO business with two other partners, brokering flowers from fields in Santa Barbara and Ventura Counties to wholesalers in Los Angeles. Business went well for two years, then suddenly took a nosedive because of the recession and the business's failure to make effective decisions. The partnership split up, and Plummer found a job running a Von's florist shop, trying to forget about his failed business venture.

The IRS did not forget. It audited the partnership, and determined that the partnership had underreported income by $1 million in 2007, its last year of operation. When it looked at the partnership agreement provided by the tax matters partner, the IRS determined that Plummer, a one-third shareholder, was allocated 90 percent of the income (his former partners didn't try to change the IRS's mind, though this allocation was far from reality). Plummer's tax bill, announced via a statutory notice of deficiency,[2] amounted to $700,000 including penalties and interest. At the time of the audit, Plummer was making a yearly salary of $45,000.

Plummer went straight to a tax lawyer, Kimball Maher, to straighten things out. He had good reason to fight the IRS: the auditor had not considered costs of goods sold, and the revised partnership agreement actually gave Plummer a 10 percent share in the partnership's income. Maher advised that Plummer had a winner of a case: he was highly likely to prevail and have the IRS or the Tax Court agree that he owed no extra tax for 2007. However, this would only occur after a two-year litigation process that could cost up to $75,000, with an up-front retainer of $20,000 to start on the work. Plummer didn't have that kind of money.

Maher knew another avenue to deal with a delinquent tax bill: bankruptcy. Plummer would need



John D. Faucher practices law at the intersection of tax and bankruptcy: tax litigation, tax collection workouts, and bankruptcy. He spent 10 years as a docket attorney for the Internal Revenue Service. He can be reached at jdfaucherlaw@gmail.com.

to live with a crushing tax bill for a specified period, then could wipe it clean away with a bankruptcy discharge. If he did it right, the IRS would have to leave him alone.

The six tests for discharging taxes in bankruptcy lie in 11 U.S.C. §523(a)(1) and 11 U.S.C. §507(a)(8). The first three of these tests mostly challenge our arithmetical abilities: If the taxpayer wants to discharge an income tax, that tax must be from a return that was due more than three years before the bankruptcy petition date,[3] and was actually filed more than two years before the bankruptcy petition date.[4] The tax must also not have been assessed less than 240 days before the bankruptcy petition date.[5]

In addition to the three arithmetic rules above (the three-year, two-year, and 240-day rules), a tax must meet three other rules to be discharged in bankruptcy. The tax must not relate to a period where the taxpayer never filed a tax return,[6] nor to a tax return that was fraudulent.[7] Finally, the taxpayer must never have attempted to "evade or defeat" the tax.[8]

Plummer chose not to fight the IRS. He accepted the audit results by signing a "consent to assessment" form and sending it back to the IRS. A month later, Maher ordered an account transcript from the IRS to see when it received the consent, and therefore the date of the assessment.

Maher didn't forget that there was another tax authority to satisfy as well: the California Franchise Tax Board (FTB). Based on the audit results, Maher told Plummer to prepare an amended state return and mail it. Plummer dragged his feet, and before he was able to file his amended return, the FTB used the IRS's results to issue a Notice of Proposed Assessment showing $300,000 owing for the 2007 tax year.

The same 240-day rule applies to the FTB as to the IRS. However, when the FTB issues a Notice of Proposed Assessment, it does not give the taxpayer a chance to agree with it. The proposed assessment is not final until 60 days after the notice, and there is no way to speed up that process. Plummer had to wait 300 days, not 240, from the Notice of Proposed Assessment until he was able to file bankruptcy and discharge his $300,000 debt. Had he mailed in his amended return, he would have needed to wait only 240 days from the date the FTB received it.

So Maher got account transcripts from both the IRS and the FTB, and counted 240 days from the dates of final assessments to determine when to file the bankruptcy. In the meantime, the taxing authorities started their collection processes. Indeed, the whole point of the time limits on discharging taxes is to allow the tax authorities some time to use their tender mercies against the taxpayer.

Good practitioners know that bankruptcy is only one of many tools to use against the tax authorities. Until a taxpayer qualifies to discharge a tax, there are other ways to keep him financially alive.

The best tool for Plummer's situation was an installment agreement (like a truce between the tax authority and the taxpayer). The taxpayer agrees to make a regular monthly payment, and the tax authority agrees to not do anything else too painful, like levy wages. The monthly amount is based entirely on the taxpayer's income and ability to pay; there are guidelines to determine what expenses are allowed.

Maher called the IRS and told the revenue officer his strategy: he wanted an installment agreement. The collection officer (collectors are officers, auditors are revenue agents) agreed that there was little point in trying to collect much of this debt from Plummer; he took some financial information, and with four months left to go, put him in uncollectible status (known to IRS collection officers as status 53) rather than an installment agreement. The IRS was willing to

just walk away from this taxpayer, knowing it would never get a dime from Plummer.

Plummer was uncollectible because he had no extra income, and one reason he had no extra income was that the FTB was already taking that income. The FTB has a hard time competing with the IRS: it has much fewer resources to audit taxpayers and collect tax. However, whenever it gets a competitive advantage over the IRS, it won't let go. Here, the FTB's revenue officer started garnishing Plummer's wages almost immediately, taking 25 percent of his take-home pay. The revenue officer would not consider an installment agreement, even knowing that Plummer would file bankruptcy soon and that the garnishment would never pay more than tiny part of the $300,000 debt. The only installment agreement he would consider would be one that paid more than the garnishment was already collecting, even if FTB guidelines would have allowed a much lower payment.

The FTB takes such a hard line because it stands in a very different situation to the taxpayer than the IRS does. The IRS feeds money to the U.S. Treasury, the largest pot of money in the world. And money doesn't really mean the same thing to the Treasury that it means to any other entity: dollars returning to the Treasury is like water returning to the ocean, or electricity returning to ground. Because the government can always just print money, the Treasury doesn't really miss money that isn't paid to it.

The FTB, however, feeds the state treasury, and that entity needs real dollars. Its bank accounts have actual balances in them, and those accounts can become overdrawn. It is almost unthinkable that the U.S. Treasury would need to write an IOU for a practical, rather than a politically motivated, reason; California has needed to do so. The state needs tax dollars much more immediately than the federal government does.

Maher waited the requisite 240 days on both assessments, then filed Plummer's case. The case went smoothly: Plummer answered questions at his Meeting of Creditors; the trustee issued a no-asset report; no one sued him for nondischargeability of a debt; he took his financial management course. After the discharge was issued, Maher called the special procedures personnel at both tax authorities to find out whether Plummer's 2007 liability was discharged. The IRS agent agreed immediately that it was; the FTB did not make its determination until six months later, after sending a bill for the $300,000 liability and then saying, in effect, "never mind."

But there is no judicial determination that the 2007 taxes are discharged: there are merely notations on an account transcript, notations that the IRS or FTB can go back and administratively change if they later decide that Plummer's 2007 liability didn't actually meet all six dischargeability tests.

Few people can disagree about four of the tests: either the appropriate amount of time passed or it didn't. As for fraud, a tax return is presumed legitimate until a taxing authority proves it fraudulent, a proceeding that usually takes place outside the bankruptcy court and that almost no one involved with can ignore.[9]

There can be some initial ambiguity over whether a taxpayer actually filed a return. If the IRS starts an audit and the taxpayer has not filed a return for that year, it will request a return from the taxpayer. If the taxpayer doesn't provide one, the IRS will eventually prepare a substitute for return and assess the amount of tax it believes is owed.[10] The taxpayer then loses the opportunity to file his own return. Tax owed for that tax year is never dischargeable.[11] If the taxpayer is able to file a return in the audit that the IRS accepts, then the taxpayer has filed a return and the tax year is dischargeable.

The final test raises the most ambiguity: did the taxpayer attempt to evade or defeat such tax? Because it is in the same sentence with "fraudulent return," most people reading this section for the first time believe that it is reserved for people who have done really bad things. But evasion can turn out to be surprisingly easy to do: choosing to spend money on a vacation, for instance, at a time when you knew you owed tax can be evasion.[12]

If Plummer wanted a judicial determination about his taxes being discharged, he could have gotten it by filing an adversary proceeding—a complaint for declaratory relief—in the bankruptcy court. In California, the IRS is willing to stipulate to the first five dischargeability tests.[13] It is not willing to stipulate to the "evade or defeat" test, explicitly reserving its right to later challenge the dischargeability of the tax based on evidence it does not currently have.

That reservation of rights may not matter much in practice. The tax authority has the burden of proving the attempt to evade or defeat a tax. People file bankruptcy and get discharged because they genuinely have few resources. It is impractical for the government to spend much effort trying to collect taxes from someone who has admitted financial defeat and is rebuilding his or her life.

Generally, the IRS sees itself as a law enforcement agency. It relies on the cooperation of the vast majority of its citizens to self-report and pay their taxes. It is not interested in ruining people's lives so long as they make the attempt to comply with its requirements. So long as Plummer does not become a tax protestor, he can expect to have the IRS and FTB leave him alone, be free of his tax debt for the 2007 year, and look forward to being a productive member of our competitive economy.

[1] All names used in this article are fictitious.

[2] The statutory notice of deficiency, governed by 26 U.S.C. §6212, tells the taxpayer what amount of tax the IRS has determined is owed, and allows the taxpayer to file a petition with the Tax Court within 90 days if the taxpayer disagrees and wants to challenge the determination.

[3] 11 U.S.C. §§523(a)(1)(A), 507(a)(8)(A)(i).

[4] 11 U.S.C. §523(a)(1)(B)(ii).

[5] 11 U.S.C. §§523(a)(1)(A), 507(a)(8)(ii). An assessment (similar to a judgment in civil litigation) is a record of the tax owed. 26 U.S.C. §6203. Once the tax is assessed, the taxpayer can no longer challenge the amount of the debt, and the taxing authority can rely on it to collect the tax. Until the assessment, the tax liability is just a gleam in the government's eye. The IRS most commonly relies on self-reported tax returns to assess a tax liability. When a taxpayer mails a tax return to the IRS, the self-reported amount is assessed upon receipt of the return. Sometimes, as in Matt Plummer's case, the IRS assesses in a different manner: after an audit or a Tax Court case. At the end of Plummer's audit, the IRS proposed its $700,000 assessment, and gave him the opportunity to either agree with it (thereby starting the 240-day clock) or challenge it in Tax Court (with the 240-day clock starting at the end of the court proceedings).

[6] 11 U.S.C. §523(a)(1)(B)(i). This rule seems redundant in combination with the two-year rule of §523(a)(1)(B)(ii). After all, if a return wasn't filed at all, it would never satisfy the two-year test. In practice, this rule is used to weed out situations where the IRS assessed the tax before the taxpayer got around to filing his own return, as discussed below.

[7] 11 U.S.C. §523(a)(1)(C).

[8] 11 U.S.C. §523(a)(1)(C).

[9] Under 26 U.S.C. §6663, the government has the burden of proving fraud by clear and convincing evidence. That determination is usually made in Tax Court, but a bankruptcy court may hear a fraud case under 11 U.S.C. §505.

[10] 26 U.S.C. §6020(b).

[11] The Ninth Circuit established this rule in *In re Hatton*, 220 F.3d 1057 (2000). Since then, Congress amended Bankruptcy Code §523(a) with a definition of "return" that specifically excludes the substitute for return. Since then, no case has held that a tax assessed with a substitute for return is dischargeable; other circuits have read this amendment to deny dischargeability to all late-filed returns. See, e.g., *In re McCoy*, 666 F.3d 924 (5th Cir. 2012). The IRS itself does not take such a draconian view, as shown in Chief Counsel Notice 2010-016. However, the IRS does not litigate in bankruptcy courts; all U.S. Government appearances in bankruptcy courts are through the U.S. Attorney's Offices and the Department of Justice Tax Division, and these bureaucracies generally take a harsher line against debtor-taxpayers than the IRS.

[12] See, e.g., *Dalton v. IRS*, 77 F.3d 1297 (10th Cir. 1997); *In re Fegeley*, 118 F.3d 979 (3rd Cir. 1997); *In re Jacobs*, 490 F.3d 913 (11th Cir. 2007). The elements of evasion are simple: 1. The taxpayer had a tax-related duty (such as filing or paying); 2. The taxpayer knew of that duty; 3. The taxpayer voluntarily and intentionally violated that duty. *Fegeley* at 984. While the elements are simple and could trip up someone who is more incompetent than dishonest, the facts in the reported cases tend toward more shocking patterns. For instance, in *Jacobs*, the taxpayer lived for a decade in a golfing resort, invested $120,000 into his wife's jewelry store, paid $20,000 for his wife's cosmetic surgery, and drove a late-model Mercedes-Benz at the same time that he owed hundreds of thousands of dollars of past income tax.

[13] In other jurisdictions than California, the government will not stipulate in a case where it agrees with the taxpayer about the dischargeability of tax years. Rather, it will move to dismiss the cause of action because there is no current controversy. *In re Mlincek*, 350 B.R. 764 (Bankr. N.D. Ohio 2006).