

NY County Lawyers Association
Consumer Bankruptcy Committee
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Dealing with the Taxing Authorities in Bankruptcy Matters

I. Tax Collection Fundamentals:
Non-Bankruptcy Alternatives

1) How does an assessment come into existence?¹

a. **Tax Return Filed.** When a tax return is filed showing a tax due, the IRS assesses that tax. [IRS §6201(a)].

b. **Deficiency Assessment.** A deficiency is defined under IRC §6211 as being the actual or correct tax over (or less) the tax shown on the return. It is important to remember that once the IRS sends an assertion that a deficiency is due (a statutory notice of deficiency) it is prohibited from making an assessment or collection of the tax until the correctness of that assertion is resolved. [IRS §6213]. The following are the normal events leading to a deficiency:²

1) The IRS selects the tax return for an audit.

2) The IRS sends a letter to the taxpayer in which the taxpayer has 30 days to protest through an appeal.³

3) A Notice of Deficiency is then sent to the taxpayer's last known address [§6212]. The taxpayer can either pay the tax and file a claim for refund to the District Court or file a petition to the Tax Court. If nothing is done within 90 days, the tax is ASSESSED.⁴

c. Assessment can now be made after Bankruptcy is filed. Before the 1994 Bankruptcy Reform Act, this was not the case.

1 An assessment is the recordation of the tax liability at the Service Center by the appropriately delegated IRS Officer.

2 See Flowchart attached.

3 See Enclosed.

4 The IRS generally has a 3 year rule for assessing. This is 3 years from due date of return, unless the return was false, fraudulent or substantial omissions.

d. Once there is an assessment there is a valid DEBT to the IRS. The taxpayer's only redress in non-jeopardy situations is a suit for restitution or refund after payment. Thus, the usual procedure for recovery of debts is reversed in the field of taxation, because payment precedes the defense and the burden of proof, which is normally on the claimant, is shifted to the taxpayer.

2) How does the IRS Collect its debt?

a) On the receipt of a return showing a balance due, the Service Center will make an assessment and place the return information on a computerized billing system. Thereafter, several computer printed and generated notices are sent to the taxpayer. The first notice

issued is a document titled "Request for Payment" or "Statement of Account", which informs the taxpayer that there is a balance due on the return, states the amount of tax, interest and penalties due, and requests payment within ten days.⁵

1. the tax shown thereon is paid within 10 days, then no additional interest will be charged. This notice is the one statutorily required for the creation of a valid Federal Tax Lien.
2. small individual income tax liabilities, the taxpayer will normally receive four subsequent notices before the IRS proceeds to take any administrative collection measures.
3. If the liability is not paid after the initial notice, then the taxpayer will receive a second notice, Notice 501, titled "Reminder of Balance Due", five weeks subsequent to the issuance of the first notice.
4. Thereafter the taxpayer will receive Notice 502, "Overdue Tax," five weeks after the issuance of Notice 501. Then the IRS will issue Notice 503, "Urgent Payment Required", five weeks after Notice 502.

b) Finally, the taxpayer will receive via certified mail Notice 504, "Notice of Intention of Levy," five weeks after issuance of Notice 503 if payment is not made after Notice 503. Notice 504 statutorily gives the Internal Revenue Service the right to initiate collection enforcement measures against the taxpayer 30 days subsequent to the date of the notice. Therefore, on smaller balance accounts, the total time from first notice to enforcement action is 25 weeks. For a business taxpayer, the total time is 15 weeks.

c) Early Intervention Program (Large Individual cases/Businesses) For large individual debt (over \$10,000), the IRS will omit notices 501 & 502 and instead, will generate notice 503 normally 5 weeks after the initial request for payment. Notice 504 will be generated 5 weeks after Notice 503.

For business taxpayers, the IRS will send out 2 notices over a 5 week period prior to initiating collection.

5 See Example of notice.

d) Automatic Collection Service - If the tax is still unpaid, it is shipped to the Automatic Collection Service (ACS). ACS is a computerized, less paper-intensive system linked to numerous CRT-telephone stations, which interface with Service Center computer operations. If ACS is unable to resolve the account or if the account requires personal contact, it will be referred to a field revenue officer. Since dealing with the ACS is almost inevitable, it is important to keep in mind some suggestions for dealing with them successfully:

1. Always get the name of the ACS account representative with whom you speak.
2. Request that they input into the terminal whatever information you want on the computer. (Keep in mind that another person will have the account on the next call.)
3. Follow up on any material conversation with a letter confirming the contents of the conversation. It takes two weeks for correspondence to be entered on to the computer system.
4. ACS can levy wages and bank accounts just like office collection so any information you volunteer may be used. ACS has access to the 1099 and W-2 files.
5. ACS is very stratified. Each piece of information is assigned to a different person. For

example, the person making the call will not be the person doing the research if you question the tax due.

6. ACS is looking for levy sources and will levy almost indiscriminately (four days after a call if a payment is promised immediately and doesn't arrive within four days).

7. ACS maintains a record of the taxpayer's bank account from checks sent in as partial payment. They can use this information to levy the bank account.

The ACS teams can perform the following to collect:

1. File a federal tax lien.
2. Approve installment agreements, if the tax is under \$10,000.
3. Levy assets.

e) Revenue Officers - If ACS is unsuccessful, the account can be handed over to a Revenue Officer. Revenue Officers have tremendous powers. They should never be taken lightly. Among the powers they can execute are:

1. Prepare and record Notices of Federal Tax Lien.
2. Levy on bank accounts and wages.
3. Seize and sell both real property and personal property.
4. Issue collection summons for tax returns and records to taxpayers and to third parties.
5. Refer cases to the Criminal Investigation Division.

f) IRS Lien (IRC §6321) The general rule is that "if any person liable to pay any tax neglects or refuses to pay same after demand, the amount... shall be a lien in favor of the United States." Therefore, a tax lien arises when three events have happened: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding its payment; and (3) the taxpayer has failed to pay the amount assessed within ten days after the notice and demand. Once these events have occurred, the tax lien which arises is enforceable against "all property and rights to property, whether real or personal, belonging to the taxpayer" as of the date the assessment was made. (IRC §§ 6321, 6322, 6331). As respect to other parties and creditors, the Lien Priority rules are as follows:

1. IRC §6323 - **Lien Priority** - The Federal Tax Lien (FTL), is NOT valid against purchasers, holders of a security interest, mechanic's lienors, and judgment lien creditors until a notice of lien has been filed.⁶ The tax lien becomes valid against these persons upon filing of notice of lien.⁷
2. IRC §6325 - **Discharge of Lien** - The IRS must release the tax lien not later than 30 days after it is paid or becomes legally unenforceable. The IRS may also release the lien if it accepts a bond or other collateral from the taxpayer. If the lien has been satisfied or has become unenforceable, a taxpayer should submit a Notice of Failure to Release Lien to the IRS SPF, lien section. If the IRS does not properly release the lien, a lawsuit may be initiated under IRC §7432.

g) IRC §6331 - Notice of Levy - Once there has been an assessment of a tax due, notice and demand, and failure to pay the tax within 30 days following the final demand, the Service has the authority to levy upon all property and rights to property (except certain property

exempt from levy under IRS §6334). The IRS is required to demand the taxes due and give notice of their intent to levy property if it is not paid.⁸ After 10 days of such notice and demand, the IRS can seize the property.⁹

6 See enclosed attachment.

7 However certain Superpriorities have priority over the IRS lien even though the IRS lien precedes them and notice has been properly filed (See IRC §6323(b)). These include:

- Security and motor vehicle sales.
- Retail purchasers, casual sales.
- Attorneys liens.
- Small repairs and improvement to residential property [mechanics liens].

8 See enclosed.

9 See enclosed copy of Public Auction Sale.

3) Relief from collections

a. Collection Appeals Program - This program gives the taxpayer the right to appeal lien, levy, and seizure actions, and the proposed termination of installment agreements. When a taxpayer is verbally told by a Collection employee that a lien, levy, seizure action, or termination of installment agreement has been taken, the taxpayer may appeal the action. Before Appeals consideration, the taxpayer must first discuss the problem with the IRS employee's manager. Once a seizure action has been made, the taxpayer has 10 business days from the date the Notice of Seizure is provided to the taxpayer or left at his/her usual place of abode or business to appeal the seizure action (IRM 5181.31(2)).

1) Issues excluded from Appeals Consideration include penalty appeals, trust fund recovery penalty, offers-in-compromise, jeopardy levies, closed examinations, actions under the control of a court of competent jurisdiction, cases under the control of the Criminal Investigation Division, and moral religious, or constitutional issues.

2) If a case is selected for appeal, it will be delivered to an Appeals Officer, who is expected to close the case within 5 business days.

b. Taxpayer Assistance Orders - A taxpayer had the right to apply for assistance if she or he is suffering or is about to suffer significant hardship as a result of the manner in which Internal Revenue laws are administered (IRC § 7811). Thus, taxpayers have the statutory right to appeal unreasonable decisions by collection officers. This is accomplished by requesting a Taxpayer Assistance Order¹⁰, which may require collection personnel to release property levied upon or to cease any action or refrain from any action with respect to the taxpayers (IRC §7811(b)).

c. Problem Resolution Program - The Problem Resolution is the first IRS program truly designated to assist taxpayers. Though incomplete in many respects, it can provide valuable help and assistance when properly utilized. The intent of Problem Resolution Program is: (1) to assure that the individual taxpayers have somewhere to turn when the systems fails and someone to assure that their rights are protected and that their problem is not lost or overlooked; (2) to enable the Service to identify and correct systemic problems.

4) Final Alternatives before Bankruptcy

a) **Installment Agreements** - Generally, when a return is filed, the taxpayer has the obligation to pay the tax. The IRS, in its best interest to collect whatever it can, will negotiate installment payment agreements¹¹. Remember, taxpayers have no absolute right to these agreements. IRC § 6159 asserts that:

- 1) The granting of an installment agreement is entirely within the discretion of the various district directors and their delegated personnel (a taxpayer has no right to an installment agreement).
- 2) Acceptance of an installment agreement does not affect a taxpayer's liability for penalties or interest.
- 3) The IRS can require that the agreement contain certain terms and conditions to protect the Government's interest.
- 4) The IRS may alter or modify or terminate the agreement if: (a) The taxpayer fails to provide accurate or complete financial information when requested; (b) The taxpayer's financial condition improves; (c) Collection of the tax is in jeopardy; (d) The taxpayer fails to pay any of the installment when due; or (e) The taxpayer fails to file or pay any other federal liability.
- 5) The IRS will give a taxpayer 30 days notice of its intent to alter, modify or terminate an installment agreement in all cases except where the tax is determined to be in jeopardy.
- 6) Directors have the authority to modify or terminate an agreement where the taxpayer's financial condition has deteriorated. (Reg §301.6159-1)

¹⁰ See enclosure.

¹¹ See Enclosed copy.

b) **Penalty and Interest Abatement** - There are occasions wherein a taxpayer would, but for penalties, be able to pay the tax and interest either in full or over a period of time. Penalties today are numerous and large. Some may be abated. The advantage to getting the penalties abated is that not only do the penalties themselves disappear, but so does the interest on those penalties.

c) **Offer in Compromise** - Many times, the IRS is willing to negotiate a tax debt, much like a private creditor, if it feels it can secure some funds with less hassle. Key parts to the IRS policy on offers in compromise¹² are:

- 1) An offer is an alternative to calling a case uncollectible or to a protracted Payment Agreement.
- 2) The goal is to collect what is potentially collectible at the earliest time and at the least cost.
- 3) The Service employee will discuss an offer as an alternative and assist in preparation of forms.
- 4) The taxpayer initiates the first specific proposal.
- 5) Success of the offer program depends upon the Service making prompt and reasonable decisions.

5) Information needed before filing.

- a. Obtain all IRS transcripts pertaining to the case.¹³
- b. Request copy's of any tax returns if not available. The IRS has files extending back indefinitely and almost anything can be accessed.¹⁴
- c. The Freedom of Information Act (FOIA) makes all information available to you for use in assisting your client.¹⁵ IRC §6110 provides for public disclosure of all IRS written determinations. The IRS must respond to FOIA requests within 10 working days of receipt. If the request is denied, in whole or in part, an appeal may be made in writing, within 35 days of the denial.

¹² See enclosed copies.

¹³ See Form 8821 attached. Alternatively, the representative can call the IRS at 800-829-1040 and ask for the accounts department.

¹⁴ See Form 4506 attached.

¹⁵ See sample letter to IRS attached.

II. Overview of Chapter 7 & Analysis of Taxes

1. *Chapter 7.* In chapter 7 debtors essentially freeze their assets and debts when they file for bankruptcy. Their assets become the bankruptcy estate. The debtor keeps assets within the exemption limits and turns the excess over to the trustee for sale and distribution to the creditors. In return for liquidating all non-exempt assets, the debtor is relieved of any future obligations to pay dischargeable, pre-bankruptcy debts, and all the debtor's subsequent earnings are free from the reach of prepetition creditors. Property subject to a valid security interest is either relinquished to the creditor or a mutually acceptable payment schedule is worked out.

2. Priority and Dischargeability of Unsecured Tax Claims

a. **Introduction.** Tax Liabilities Having Priority in a Bankruptcy Case. 11 USC § 507 deals with priorities. If a tax falls within the priorities set out in 507(a), it will not be discharged. The distribution scheme within bankruptcy is that the secured debts receive payment first followed by the unsecured debts in the order of priority set by section 507. The eighth priority is for unsecured taxes of governmental units.

b. Eighth Priority and Priority Rules.

i. *Eighth priority unsecured tax liabilities are nondischargeable.* Included are specific categories of tax liabilities such as income taxes, employment taxes, gross receipts taxes, excise taxes, property taxes assessed before commencement of case, and taxes required to be collected or withheld for which the debtor is liable in any capacity. Pecuniary and compensatory loss penalties and prepetition interest granted same priority as tax liability to which they relate.

ii. *Tests of eighth priority nondischargeability* consider the age of the tax liability as a factor. These dischargeability tests are "the three year rule" and "the 240 day rule".

iii. *Income and gross receipts taxes: the three year rule:* there is an eighth priority for prepetition income and gross receipts taxes that were due within the three year period before the petition date. The due date of the return, including any extensions, the key factor in application of rule: if there was an extension of time to file, that becomes the due

date.

iv. *EXAMPLE.* Assume petition date is January 1, 1990. The date three years prior to that date would be January 1, 1987. All tax liabilities for the taxable years for which the due date of the tax return, including extensions, was before January 1, 1987, are nonpriority, general unsecured claims, and are dischargeable. The 1986 tax year's liability due on April 15, 1987 would be classified as an eighth priority tax liability because its due date was within the three year period before the petition date.

v. *240 day rule:* where the bankruptcy petition is filed within 240 days of the assessment of the tax, or where the debtor submitted an offer in compromise within 240 days of the assessment, plus the period during which the offer in compromise was pending plus 30 days, the taxes are excepted from discharge.

vi. *Multiple Assessments.* Where there are multiple assessments for a taxable year's original and deficiency assessments, the date of the later deficiency assessment is the date from which the 240 day rule must be calculated.

vii. *Offers in Compromise.* The 240 day assessment period is suspended and thereby extended during the pendency of any prior Bankruptcy cases filed by the debtor. The 240 day period is also extended for any period (1) during which an offer in compromise is pending and for 30 days thereafter, or (2) during which a waiver of the statute of limitations on assessment is in effect. An offer in compromise can, however, be filed after the 240 day period has expired without affecting the priority classification or dischargeability of a tax liability. The filing of an offer in compromise before a tax is assessed does not toll the running of the 240 day period.

viii. *Using Priority Rules:* The bankruptcy petition should be filed more than three years from the due date of the tax return, more than two years after the return is filed and more than 240 days from the date of assessment. TIP: if taxes not yet assessed, expedite this, wait out the 240 day period, refrain from making an offer in compromise during 240 day period but instead enter into an installment agreement which won't affect later bankruptcy.

ix. *Review of Discharging Income Taxes.* For bankruptcy law purposes, federal income taxes fall into two categories--secured (NFTL) and unsecured (no NFTL). Unsecured federal income taxes can be discharged only if four conditions are true: (1) you neither filed a fraudulent return nor attempted to evade paying taxes; (2) the liability is for a tax return actually filed at least two years before you file for bankruptcy (the two year rule); (3) the tax return was due at least three years ago, including any time for extensions (the three year rule); (4) the taxes were assessed at least 240 days before bankruptcy filing (the 240 day rule). Certain actions extend the above time limits: (1) if you filed any bankruptcy in the past, the time the case was pending plus an additional six months is added to all three time requirements; (2) if you made an Offer in Compromise, the time your offer was pending plus an additional 30 days is added to the 240 day requirement; (3) if you requested a Taxpayer Assistance Order, the time your request was pending is added to all three time requirements.

x. *Certain property taxes.* Any property taxes payable without penalty within one year before the petition date are eighth priority unsecured tax claims. There is a limitation, in that the property tax must have been assessed within one year before the petition date.

xi. *Trust Fund Tax Liabilities.* This category includes the employee's withholding tax and the employee's social security. Trust fund tax liabilities asserted against an individual taxpayer are granted an eighth priority and are nondischargeable [ie the employee's portion of an employment tax liability is therefore nondischargeable no matter how old the liability is]. This includes the liability of a responsible officer under the Internal Revenue Code as

well as any state statutes that may impose a trust fund liability when that officer is the debtor. Important to identify any trust fund tax liabilities because of the unlimited time period during which those liabilities retain their priority and therefore nondischargeable status.

xii. *The 100% Penalty.* A person found liable as the "responsible person" for the 100% penalty cannot discharge the liability by filing bankruptcy under chapters 7, 11, or 13. The liability for trust fund taxes is entitled to an eighth priority. But Note that this priority status does not depend upon when the employment tax returns were due or filed, when the bankruptcy petition was filed, or when the 100% penalty was assessed against the responsible person. Thus a responsible person cannot file bankruptcy for relief from payment of the 100% penalty. At most, the automatic stay would immediately restrain the IRS from collection efforts. In chapter 13, if the debtor lists the 100% penalty, and the IRS neglects to file a claim, then the claim need not be paid and upon completion of the plan the tax (100% penalty) is discharged.

xiii. *Employment Taxes on Wages, Salaries or Commissions.* [when wages are paid there are income and social security taxes withheld from the wages as paid. These trust fund amounts constitute the subject of the 100% penalty if not paid. They are employees' taxes. Additionally, the employer is required to pay social security or FICA taxes on the wages so paid. These are not trust fund taxes because they are not withheld from the wages of employees. Additionally, unemployment taxes are known as FUTA (Federal Unemployment Tax Assessment).] Employment and unemployment taxes are subject to a three year rule similar to the one applicable to income taxes. Employment taxes reflected on tax returns due within three years preceding the petition date receive an eighth priority and will be nondischargeable in the case of an individual. The employer's employment tax liability may thus represent no more than a nonpriority general unsecured claim of the debtor/employer that is dischargeable if it falls outside the three year period.

xiv. *Excise Taxes.* Certain excise taxes are eighth priority and therefore nondischargeable in case of an individual [and must be paid if the tax return was last due including extensions within three years before the petition.. Courts have defined "excise taxes" to include estate and gift taxes, workers' compensation premiums, sales tax liabilities, occupation taxes, pension plan tax assessments, and uninsured motor vehicle assessments.

c. Other Dischargeability Rules: Section 523 Rules/ 2 year rule and fraud or evasion/ Fraudulent, Unfiled or Late Returns.

i. *Delinquent Tax Returns.* While a tax liability's priority status under section 507(a)(2) or (a)(8) operates to make the tax liability of an individual nondischargeable, there are other factors under section 523(a)(1) that may make a tax liability nondischargeable. The Two Year Rule: If an individual debtor files a tax return after its due date, including all proper extensions, that tax liability will be nondischargeable unless the delinquent tax return was actually filed more than two years before the filing of the petition [ie if he files petition within two years of actual filing date of the return, the taxes excepted from discharge]. Delinquent tax returns of individuals, even if filed more than two years prior to petition date, must also comply with the three year and 240 day rules before any tax liability reflected thereon will be dischargeable.

ii. *EXAMPLE.* Assume that a taxpayer files his delinquent 1985 return on January 1, 1991, and that the tax liability reflected thereon is assessed on February 1, 1991. Even though the

1985 tax liability may appear to be a nonpriority, dischargeable tax liability, it is in fact a nondischargeable tax liability if the petition was filed before January 1, 1993, two years from the date the tax return was filed with the IRS or state taxing authority. An individual's tax liability may therefore not have an eighth priority status under the three year and 240 day tests, but it may still be nondischargeable because it was not timely filed.

iii. *Fraudulent Tax Returns.* If a taxpayer files a fraudulent return, the tax liability attributable to that return will not be discharged, and will also not be granted any priority treatment in the scheme of distribution of assets from the estate. Whether or not a tax return is fraudulent is a question of fact.

iv. *Willful Attempts to Evade or Defeat a Tax.* Section 523(a)(1) includes an exception to discharge if a taxpayer "willfully attempted in any manner to evade or defeat such tax." What is the legal test for "willful" conduct? Court decisions reflect two views: debtor must commit a deliberate, affirmative act to evade or defeat and mere failure to pay tax is not cause for denial of discharge. But chronic failure to file and pay may satisfy the willful attempt to evade. The burden of proof to show tax fraud is on the government and the standard is at least equal to the civil standard "preponderance of the evidence."

v. *Civil fraud standard.* Courts have used a willfulness standard based on the civil fraud penalty of IRC section 6663, requiring proof of debtor's specific intent to evade a tax believed to be owing. Under this 6663 test, IRS must establish affirmative conduct intended to result in the evasion or concealment by which the government is harmed.

vi. *Priority of Fraudulent, Unfiled or Delinquent Return Tax Liabilities.* Even though fraudulent, delinquent and unfiled tax returns are nondischargeable, they are not granted any priority. Thus tax liabilities for tax returns not filed, delinquent returns filed within two years of the petition date, and fraudulent returns are not priority tax liabilities for claim distribution purposes.

vii. *Dischargeability of Loans to Pay Tax Liabilities.* Section 523(a)(13) specifically makes nondischargeable any debt incurred to pay a tax to the United States that would be nondischargeable pursuant to section 523(a)(1). The section should include any form of loan, be it bank loan, credit card advance or a credit card charge the proceeds of which are used to pay a tax liability owed to the United States. The section is limited by its terms, as it only applies to loans incurred to pay a tax owed to the IRS. Therefore, the nondischargeable provision of (a)(13) does not apply to loans the proceeds of which are used to pay a tax liability owed to a state, county, city, or other non-IRS governmental agency.

III. Lien Analysis

1.

Old Secured Debt. Debts are discharged, but liens are not. The discharged debtor has no personal liability on any debt, so unsecured debts are effectively vaporized. But a secured debt remains attached to its collateral and can be enforced against the collateral after bankruptcy, even though the debtor cannot be sued for any deficiency. If a ch 7 debtor has any secured debts, the property subject to the security interest will be taken back by the creditor unless the debtor redeems the collateral (pays the creditor the full loan or the full value of the collateral in cash, whichever is less) or enters a voluntary agreement with the creditor, informally or through a formal reaffirmation.

2. Secured Tax Claims and Priority of Tax Liens

a. **Introduction.** If the IRS has a filed Notice of Federal Tax Lien, the IRS's claims must be treated under the Bankruptcy Code as a secured claim. Debtor must first make sure the lien is properly recorded and therefore valid. Debtor must then value his assets and thereby determine the amount of the IRS's secured claim pursuant to section 506(a). If the value of the debtor's property is less than the amount reflected on the Notice of Federal Tax Lien, the excess tax claim may be an unsecured claim and may be subject to the priority and dischargeability rules. The unsecured portion may be dischargeable.

b. **Effect of Federal Tax Lien.** In general if the tax is a nonpriority tax otherwise dischargeable the lien will be enforceable only to the extent of assets to which it is attached as of the date of the filing of the bankruptcy petition. Thus, if the taxpayer/debtor files bankruptcy and has \$10,000 of assets not exempt from collection under IRC Section 6334, and not encumbered by liens prior to the FTL, the IRS would be able to collect the lesser of \$10,000 or the tax due if the assets are sold. Note an Alaska FTL would have no effect on real property located in Brooklyn, regardless of where bankruptcy filed.

c. **Tax Liens in General.** A tax lien in favor of the United States arises by operation of law if a person is unable to pay a tax liability after demand is made for payment. The general tax lien in IRC Section 6321 is referred to as a "secret lien" because it arises as a matter of law against the taxpayer without the necessity of filing a Notice of Federal Tax Lien. The lien attaches to "all property and rights to property, whether real or personal, belonging to such person", even if not seizable by IRS due to applicable exemptions from levy for certain property in IRC Section 6334. The "secret lien" is perfected without the filing of the Notice of Federal Tax Lien, but only as against the taxpayer. A Notice of Federal Tax Lien must be recorded before a tax lien will be effective against certain third parties. Tax liens arising from separate tax assessments than those asserted in a prior tax lien will not "relate back" to the first tax lien's filing date. Thus each tax lien must stand on its own merits unless it is an actual amendment of a previously filed lien.

I. *Notice of Federal Tax Lien.* When a bankruptcy petition is filed, the presence or absence of a recorded Notice of Federal Tax Lien controls how the IRS's claim is treated. If a NFTL is recorded, the IRS will be a secured creditor and the unsecured priority claim rules of section 507(a)(8) will be inapplicable to that secured claim. If, however, a NFTL is not recorded before the petition date, the IRS's claims will be unsecured, governed by the priority and dischargeability rules of section 507(a)(8). The "secret Lien" against a debtor will be discharged if the underlying tax liability is a nonpriority dischargeable tax liability. The "secret lien" will not be discharged if the underlying tax liability is nondischargeable.

d. **Recordation of the Tax Lien.** If the Notice of Federal Tax Lien was not filed in the correct location, the IRS's claim may be unsecured and potentially a nonpriority, dischargeable liability. To be valid, a NFTL must be recorded as provided for by IRC Section 6323(f). The physical location of real property is determinative; personal property, however, is "located" in the county of residence of the taxpayer, and in the case of a corporation/partnership "in the office of the secretary of state."

e. **Dischargeability of a Tax Lien.** A tax liability not made expressly nondischargeable in section 523(a) is dischargeable in a bankruptcy case. Although the underlying tax liability may be discharged, the tax lien itself will not be discharged if the IRS has recorded a NFTL against the debtor. In other words, secured tax claims, to the extent of the value of the collateral, survive

the bankruptcy discharge. Tax liens will also continue to encumber exempt assets beyond the termination of the bankruptcy case. [After termination of the bankruptcy proceeding, the debt is unenforceable. The lien may be foreclosed. However, this requires a proceeding in District Court. An administrative seizure or attempted sale by IRS personnel can be set aside.]

f. **EXAMPLE:** Assume Mr. Taxpayer owns his own home which has equity of \$100,000. He has a significant tax liability which is dischargeable. There is, however, a prepetition Federal Tax Lien filed which attaches to his residence. Result: The lien is undisturbed by the bankruptcy proceedings. As a consequence, if Mr. Taxpayer sells his residence before the statute of limitations on collection has run, the IRS will be entitled to part of the proceeds in an amount equal to the value of its lien on the date of the petition. Additionally, the IRS can foreclose its lien on the residence by a suit in District Court. The IRS cannot administratively seize the house or any other asset or levy upon wages to satisfy its lien as the tax debts are discharged. EX2: Suppose in EX1 there was an underlying mortgage of \$90,000 on Mr. Taxpayer's house and costs of sale would be \$10,000. Result: Mr. Taxpayer should bring an action under section 506 to have the lien declared valueless.

g. **After-Acquired Property.** A debtor is not prohibited from buying property out of the bankruptcy estate which is a separate entity. It has been held that the FTL did not attach to property acquired by debtors from the bankruptcy trustee at a private sale after the petition was filed. The Federal Tax Lien does not attach to after-acquired property of the debtor.

h. **Superpriorities.** There are some Superpriorities that the Tax Lien is subordinate to, even if filed first.¹⁶ The federal lien will also trump most state tax liens since it is perfected upon filing, whereas state liens are perfected normally upon execution.

i. **Attacking the lien.** The lien can be attacked by proving that notice was not sent within 60 days of the assessment. The IRS can refresh the 10 year collection period by going to District Court to secure a judgment. The homestead exemption does not defeat this lien.¹⁷ The lien survives bankruptcy, but the taxpayer can bring a Bankruptcy Code section 506 action to declare the lien valueless if there is no equity in the property.

j. **Levy.**

- i. No homestead exemption. But the district director must personally approve.
- ii. Cash surrender value of life insurance.
- iii. Bank Accounts - bank must turn over money within 21 days after receipt of notice of levy.
- iv. Pensions - IRS must wait until right to receive the benefits accrues to the taxpayer.
- v. IRA's - not subject to ERISA and thus can be levied but internal IRS policy is not to levy unless the taxpayer flagrantly disregards the IRS' request for payment.
- vi. Levy and notice of seizure must be served on the taxpayer. The taxpayer can redeem real property within 180 days after a sale.

IV. Discharge of Tax Penalties.

1. Introduction.

Penalties are not in harmony with the Code, because they prefer one creditor to the detriment of another. Penalties fall into two types - nonpecuniary and pecuniary and are distinguished in terms of their dischargeability. Nonpecuniary penalties are punitive in nature and are true penalties, not designed to compensate for any loss. Examples include the late filing penalty, negligence penalty, fraud penalty, over-, under-, valuation penalties, accuracy related penalty, and substantial understatement penalty. Pecuniary penalties are those which are in compensation for an actual pecuniary loss of the taxing authority. Example is the 100% penalty.

2. General Rule for the Treatment of Tax Penalties. [Pecuniary penalties are priority claims and are not dischargeable. Nonpecuniary penalties are dischargeable if they relate to a tax which is itself dischargeable, or if they are imposed with respect to a transaction or event that occurred before three years before the petition date.] Thus, a tax penalty is a nonpriority, dischargeable tax claim if the tax to which it relates is dischargeable or if the transaction or event that caused the penalty occurred more than three years before the filing of the petition. If the penalty itself is dischargeable, then interest on that penalty will also be dischargeable. However, if a penalty is secured by a perfected Federal Tax Lien it can be collected by the IRS in a bankruptcy proceeding up to the extent of the value of the secured property.

3. Timing of the Event or Transaction Causing the Accrual of the Tax Penalty. Most courts hold that tax penalties based upon acts that occurred more than three years before the petition date are dischargeable regardless of the dischargeability of the underlying tax liability.

V. Chapter 13 Fact Patterns

SCENARIO - Debtor is a bank VP of "Rich investors, "USA" and commits a crime by embezzling money from his Bank. This is uncovered by the authorities and Debtor is prosecuted. Attorney general reports the case to NYS Department of taxation and Finance. They send a deficiency notice to taxpayers who ignores the notice. NYS Assesses the taxpayers for \$100,000. The Tax year in issue was 1991. The assessment was on 7/31/98. Additionally, NYS places a lien on the house. The house is worth \$350,000. The Debtor has a 1st mortgage of \$250,000, a 2ND of \$50,000 and a \$40,000 judicial lien. Debtor is married and the house is owned Tenancy by the Entirety. Debtor filed a prior Chapter 7 on 8/31/98 for credit card debt and received a discharge on 12/15/98. What advice do we have for Debtor?

SCENARIO- same fact pattern, except the assessment is for \$375,000. What advice for this Debtor?

SCENARIO- same fact pattern, except Debtor voluntarily files an amended return on 1/1/98. What advice for this Debtor?

SCENARIO- same fact pattern, except Debtor never filed the 1991 return and NYS does not assess, but instead, makes a return for the Debtor and collects against this. What advice?

SCENARIO- same fact pattern, except Debtor on 10/31/98 files an Offer In Compromise with NYS. This offer was rejected on 12/31/98? Any difference if instead, Debtor enters into an installment agreement but has now defaulted on such agreement?

VI. Discharge of Tax Rules (Chapter 13)

1) Bankruptcy Code Analysis §1328(a)- Chapter 13 Super Discharge.

A successful Chapter 13 bankruptcy discharges all debts provided for in the plan except for:

- All debt provided for in 11 USC § 523(a)(5) such as alimony, maintenance or support to former spouse and child.
- Student loans (used to be an exception for 7 year old loans, but 1998 act eliminated that).
- Death or personal injury claims resulting from operation of a motor vehicle while intoxicated.

PRIORITY RULES §523(a)(1)(A) If an income tax of an individual debtor falls within the provisions of § 507 (a)(8), the tax is not dischargeable. These taxes are entitled to priority status, such that if the taxes fall within any one of these categories, the taxes are priority claims and excepted from discharge. The independent bases of priority are:

a. 3 year rule- § 507(a)(8)(A)(i) states that an income tax will be a priority tax and thus not dischargeable if it is: (1) for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition. The due date for a tax return, including any extension periods, is the key factor in the application of this three-year rule.¹⁸

EXAMPLE: Assume the Bankruptcy petition date is April 1, 1996. The date three years prior to that date would be April 1, 1993. All tax liabilities for taxable years for which the due date of the tax return, including extensions, was before April 1, 1993, are nonpriority, general unsecured claims, and are dischargeable. The 1992 tax year's liability due on April 15, 1993 would be nondischargeable as it should be a priority tax under § 507(a)(8)(A)(i).

b. 240 day assessment rule- Where the bankruptcy petition is filed within 240 days of the day of assessment of the tax, or, where the debtor submitted an offer-in-compromise within 240 days of the assessment, plus the period during which the offer-in-compromise was pending plus 30 days, the taxes are excepted from discharge (§ 507(a)(8)(A)(ii)). Note that submitting an Offer in Compromise tolls the 240 day period¹⁹ for the period that the offer was pending, plus 30 days.²⁰ If the taxing authority makes multiple assessments, the most recent assessment is the one that should be considered.

c. Other Priorities- These include property taxes assessed within 1 year, fiduciary taxes and excise taxes.

Debtors can use the priority rules to their advantage as the debtors have control over when the bankruptcy petition is filed, so that where possible, the bankruptcy petition should be filed more than three years from the due date of the tax return, and more than 240 days from the date of assessment. If the taxes have not yet been assessed, it is generally possible to expedite the case within the IRS system and cause an assessment to be made, and thereafter wait out the 240-day period. Obviously, debtors should be advised to refrain from submitting an offer-in-compromise during the 240 days after assessment. Instead, the debtor should consider entering into an installment agreement with the Service, which does not in any way prohibit the debtor from later filing bankruptcy.

¹⁸ Many cases have held that each bankruptcy proceeding suspends the 3 year period until 6 months after the Debtor's assets are no longer under court control.

¹⁹ Note that an offer submitted before assessment, does not have this tolling effect.

20 Thus the Debtor should refrain from submitting an offer in compromise if the intention is to file Bankruptcy. Instead, the Debtor can enter into installment agreements, which has no tolling effect and also usually results in the release of liens.

2) Chapter 13 Benefits

§523(a)(1)(B) rules against discharging tax debts for which no tax return was filed do not apply. So in a Chapter 13 case the only tax rules to consider are the Priority Tax rules. Thus Chapter 13 can be used for the following taxes that are non-dischargeable in a Chapter 7:

- Fraudulent filed returns or attempts to willfully evade or defeat the tax.
- Late file returns- 2 year rule is not applicable.
- Unfiled returns.

- Chapter 13 forces the IRS to enter into an installment agreement with the taxpayer.
- Tax penalties stop accruing the day you file for Chapter 13.
- Penalties on your tax debts are treated like any unsecured debt, such as credit cards.
- If the IRS has not filed a Notice of Federal Tax lien, interest stops accruing. If the IRS has filed a NFTL, interest accrues only on the amount of your tax debt equal to the value of your property. EXAMPLE: J owns property worth \$30,000 and owes the IRS \$90,000. The IRS has a NFTL. In J's chapter 13 case, interest accrues only on the \$30,000 secured portion of the tax debt.
- Each creditor must file a proof of claim by a certain date. If a creditor, even the IRS is tardy, it loses the right to make a claim on the debt in bankruptcy, and is barred forever from collecting outside bankruptcy. But you must complete all payments under the chapter 13 plan. If you don't, the tax debt will reappear, with interest and penalties added on for the time you were in bankruptcy. CAVEAT: exception for secured taxes: if the IRS recorded a NFTL, the amount of the tax debt secured by your property survives bankruptcy, whether or not the IRS files a claim.
- Filing under chapter 13, or any other type of bankruptcy, stops the IRS cold from taking drastic collection action such as seizure of your assets.
- A debtor's plan must provide for the full payment, in deferred cash payments, of all tax claims entitled to priority under section 507(a)(8) unless the IRS agrees to different treatment. Interest accruing on a tax liability after the effective date of the plan is not payable to the IRS in a chapter 13 case.

3) What is a Return?

Internal Revenue Code rules define a return as having to be: - On the Proper form. - Provide sufficient income and deduction data. - Be signed by the taxpayer. A return prepared by the IRS under IRC §6020(b) is not a return for discharge under Chapter 7, but can be discharged in Chapter 13 by following the 240 days rule.

VII. Employment Trust Fund Fact Pattern

Mr. Smith is the President of "XYG Internet Co.". He owns 25% of the stock. The company has not paid any of its 1997 trust fund taxes due to a cash flow problem incurred with its rapid expansion. Alice Jones is the Treasurer of the company. She signs all tax returns and sometimes signs checks. Dawn Jones is the VP of the company. She owns 75% of the stock which was originally supposed to be a silent investment. Lately, she has become more active in negotiating workouts and other contract matters, given that she is an Attorney.

IRS has sent collecting notices totaling \$70,000 at present, including interest and penalties. They have also assessed within the shortest period allowable and has most recently placed a lien on the property.

On 6/30/98 IRS placed liens on the premises and property and on 12/1/98 IRS sent Intent to Levy and Levy notice to Banks. IRS, in addition, has called in all 3 officers for an interview to determine "responsible party tax liabilities".

VIII. Trust fund rules (IRC §6672)

Who is a responsible party? *See IRC §6671(b)*

If the Corporation is in Chapter 11, will the IRS stop collection efforts against officers?²¹

Can the Corporation designate payments? The answer is yes, if the payment is voluntary, and the designation is in writing, including Bankruptcy plans.

If the IRS seizes money within the preference period can it be deemed a preference? Most cases, hold it is not a preference.

Bankruptcy plans fully pay taxes within 6 years. Is interest required?

If Chapter 11 fails, what are the personal Bankruptcy options for the officers?

21 Most recent decisions have held that the bankruptcy court cannot enjoin the IRS from collecting.

However, most IRS districts will withhold assessment if:

- The responsible person consents to the assessment.
- The responsible person agrees to extend the statute of limitations.
- The Corporation files a plan which provides for full payment.

The IRS handbook also states that they will withhold collection when the Corporation is adhering to approved bankruptcy plan or to an installment agreement.

IX. IRS Restructuring and Reform Act of 1998 (effective 1/18/99)

1) IRS must give written notice no later than 5 days after filing a notice of lien. The taxpayer then has a 30 day period to request a hearing with the IRS appeals.

2) IRS must provide written notice of an intent to levy at least 30 days before the action. The

taxpayer has a 30 day period to request an Appeals hearing.

1 An assessment is the recordation of the tax liability at the Service Center by the appropriately delegated IRS Officer.

2 See Flowchart attached.

3 See Enclosed.

4 The IRS generally has a 3 year rule for assessing. This is 3 years from due date of return, unless the return was false, fraudulent or substantial omissions.

5 See Example of notice.

6 See enclosed attachment.

7 However certain Superpriorities have priority over the IRS lien even though the IRS lien precedes them and notice has been properly filed (See IRC §6323(b)). These include:

- Security and motor vehicle sales.
- Retail purchasers, casual sales.
- Attorneys liens.
- Small repairs and improvement to residential property [mechanics liens].

8 See enclosed.

9 See enclosed copy of Public Auction Sale.

10 See enclosure.

11 See Enclosed copy.

12 See enclosed copies.

13 See Form 8821 attached. Alternatively, the representative can call the IRS at 800-829-1040 and ask for the accounts department.

14 See Form 4506 attached.

15 See sample letter to IRS attached.

16 Per IRC § 6323(b), these are: security sales; motor vehicle sales; attorney liens, etc.

17 However, a tax lien does not defeat a tenancy by the entirety or irrevocable trusts without Power of Appointment. It does defeat joint bank accounts.

18 Many cases have held that each bankruptcy proceeding suspends the 3 year period until 6 months after the Debtor's assets are no longer under court control.

19 Note that an offer submitted before assessment, does not have this tolling effect.

20 Thus the Debtor should refrain from submitting an offer in compromise if the intention is to file Bankruptcy. Instead, the Debtor can enter into installment agreements, which has no tolling effect and also usually results in the release of liens.

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