

Arizona Bankruptcy Essentials: Discharging Income Taxes

By Lawrence 'D' Pew, [Arizona Bankruptcy Lawyer](#)

By eliminating the “super discharge” in bankruptcy, the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)* significantly changed how taxes are discharged in bankruptcy. Why was the end of the super discharge important to bankruptcy petitioners?

Prior to 2005, the super discharge allowed individual Chapter 13 petitioners to discharge taxes even when the debtor failed to file tax returns, filed late tax returns, or filed fraudulent tax returns. Needless to say, this arrangement did not go over well with the federal government; Congress took action by eliminating the super discharge altogether with the BAPCPA. Since 2005, all individual debtors face the same tax discharge hurdles, whether they file Chapter 7, Chapter 11, or Chapter 13.

In 2012, long after BAPCPA went into effect, consumer debtors are still confused by tax discharge provisions in Chapter 7 (straight liquidation), Chapter 11 (reorganization), and Chapter 13 (individual repayment plan). This article will shed some light on what is possible regarding the discharge of taxes in bankruptcy. And when I say discharge, I mean wiped out in a Chapter 7 bankruptcy.

Rule of Five: When Are Taxes Dischargeable in Chapter 7?

We start with the general rule that taxes are not dischargeable in bankruptcy, but there is a huge exception to that rule. Taxes *are* dischargeable in a Chapter 7 bankruptcy when the individual debtor jumps through the requisite hoops. To determine tax dischargeability, the following five rules must be satisfied without exception:

- ***Rule 1 – Only Income Taxes Are Dischargeable in Bankruptcy.***

Only federal or state taxes on income are dischargeable in bankruptcy. Furthermore, a tax return must have been filed for every year that a tax discharge is sought. There is no exception to the rule that only taxpayers who filed required returns can seek a tax discharge in bankruptcy.

No tax return filed? No discharge.

Are employment taxes (payroll or 941) dischargeable? No.

Are trust fund recovery penalties dischargeable? No.

Are sales tax or fraud taxes dischargeable? No.

- ***Rule 2 – No Fraud or Willful Tax Evasion Can Be Involved.***

Only honest taxpayers can seek a discharge of taxes in bankruptcy. There is no discharge possible for a taxpayer who filed a fraudulent tax return or who willfully attempted to evade paying taxes. For example, the act of falsely under-reporting income

to avoid tax is sufficient fraud to eliminate the possibility of a bankruptcy discharge of that year's tax debt.

Are fraud-based taxes dischargeable? No.

Are attempts to willfully defraud the government rewarded with a tax discharge? No.

● **Rule 3 – Timing: Tax Debt Is “Stale” After Three Years.**

Only three-year-old tax debts (or older) are stale enough for a discharge in bankruptcy. The back tax debt may be discharged when the return giving rise to that debt was due at least three years before the bankruptcy petition was filed (and add to that any tax return filing extensions). Income taxes for 2009, for example, were due on April 15, 2010. IRC §§ 6072(a) and 6081(a). If there were no filing extensions, then the bankruptcy would be filed at least three years later on April 15, 2013, to seek discharge of the stale 2009 tax debt.

Was the tax due less than three years before the bankruptcy was filed? No discharge.

● **Rule 4 – Timing: Late Filers Must Always Wait Two Years.**

For a return that was filed late, two years must have passed between filing the late return and filing the bankruptcy petition. For example, income taxes for 2006 were due on April 15, 2007, but the taxpayer did not file a Form 1040 for 2006 until February 1, 2011. Therefore, February 1, 2011, is the important date to calendar and start counting from. To discharge the 2006 tax debt, the bankruptcy would have to be delayed until February 1, 2013, or two years after filing the late tax return.

Was the tax return associated with the tax debt filed less than two years before the bankruptcy? No discharge.

● **Rule 5 – Timing: Always Wait 240 Days After Any Tax Assessment.**

To discharge the tax debt, the debtor must wait to file bankruptcy at least 240 days after the IRS' or state's tax assessment. The rule is applicable when there is a late tax assessment, long after the taxpayer filed the requisite return. When the IRS conducts an audit and assesses an additional tax, for example, to discharge that additional assessment another 240 days must pass before the bankruptcy is filed. (This period may be extended with suspended collection activities, as when there is an offer in compromise or previous bankruptcy filing.)

Was the post-audit additional tax assessed within the eight months preceding bankruptcy? No discharge.

Income tax debts are completely dischargeable in a Chapter 7 when the rule of five is complied with. However, if any rule is not met, then the tax is non-dischargeable. Furthermore, the five Chapter 7 tax discharge rules also apply to Chapter 11 and Chapter 13 cases.

How Are Tax Debts Handled in Chapter 13 and Chapter 11?

Here are a few rules regarding the discharge of taxes and penalties in a Chapter 13 and Chapter 11 bankruptcy.

- ***Back Taxes as General Unsecured Debt.***

Whatever taxes are not discharged can be paid off without interest under a Chapter 13 repayment plan. Back taxes are treated as general unsecured debts in a Chapter 13 or Chapter 11 bankruptcy – that is, so long as the debtor completely satisfied the rule of five. This means that the taxes are treated the same as any other unsecured debt, such as a credit card or medical debt. The debtor's regular payment to the state or IRS is equal to other unsecured non-priority creditors. If the repayment plan is to pay each unsecured creditor 10% of the outstanding debt, for example, then the IRS and the state will only receive 10% of the tax owed. Also, it is possible to restructure the IRS or state tax debt over the 60-month period of the repayment plan in a Chapter 13.

- ***Tax Penalties as General Unsecured Debt.***

With Chapter 13, all of the debtor's unsecured tax penalties can be discharged upon completion of the repayment plan. Penalties are paid under the plan just as with any other general unsecured claims, and typically for a mere fraction of the original penalty. Additionally, no new penalties can accrue on prepetition taxes while the debtor is under the Chapter 13 plan.

- ***Government Fails to File a Proof of Claim.***

Although a rare occurrence, if the IRS or Arizona Department of Revenue fails to file a *proof of claim* in the bankruptcy as required of creditors, then the tax may be completely discharged.

Are Federal Tax Liens Dischargeable, Too?

Many people are confused by the rules of discharge regarding tax liens. What you need to understand is that a discharge of the tax liability does not extinguish the government's tax lien on assets. If the IRS properly recorded a federal tax lien on the debtor's property before the bankruptcy was filed, then that lien will survive the bankruptcy as a secured debt.

In Chapter 11 and Chapter 13 cases, secured debts are typically paid in full. Although the debtor's personal liability on the tax debt may be discharged, the lien outlives the bankruptcy (just as does a mortgage on real estate). In other words, there is no automatic removal of the government's lien. Instead, the tax lien is paid off when the property is sold. Importantly, when the debtor's personal liability on the tax debt is discharged in bankruptcy, but the tax lien remains, the lien will not impact other assets acquired by the individual after the bankruptcy discharge.

What Can Mesa Arizona's Pew Law Center Do for You?

Determining whether your back taxes are dischargeable, and timing your bankruptcy to assure compliance with the rule of five, is a balancing act with no room for error.

If you've read my book – ***Bankruptcy Secrets "They" Don't Want You to Know*** – then you are already familiar with the Pew Law Center's bankruptcy, tax relief and tax resolution practice. Many of our clients come to us owing \$20,000, \$30,000, even \$100,000 or more in taxes to the IRS. We contact the IRS, gather all the information regarding the taxes owed, what years are unpaid, and when the last tax return was filed. We conduct a comprehensive analysis and, if your back taxes meet specific qualifications, we first attempt to negotiate with the IRS to try and

get the tax reduced. When that is not possible, or we do not get the outcome that our client desires, we look to bankruptcy and a possible tax discharge.

Many times, filing bankruptcy is the best way to deal with a massive tax debt. If there are more recent taxes that cannot be discharged, and the IRS is preparing to levy a bank account or garnish wages, then bankruptcy can help in that instance, too. The automatic stay stops IRS collections! A Chapter 13, for example, stops the IRS from collecting against the debtor during the entire three- to five-year repayment plan.

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Lawrence 'D' Pew is an experienced tax, bankruptcy, and transactional attorney, and founder of the Pew Law Center, PLLC, a leading Arizona tax and bankruptcy law firm focused exclusively on debt relief. With offices in Mesa, the law firm serves Arizona residents in the greater Phoenix area, including Scottsdale, Mesa, Tempe, Gilbert and Chandler. As a client-oriented law firm with a mission to always exceed client expectations, the Pew Law Center has helped over 2,000 people file for bankruptcy and eliminate over \$100 Million in debt. Need more information? Call the Pew Law Center at (480) 745-1770.

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