A Brief Primer on Discharging Tax Debt Through Bankruptcy

By Leo Gabovich

It is not uncommon for people struggling with debt to consider their options for getting back on track. While determining the best course of action is not always simple, there are options available. In particular, income tax liabilities may be eligible for discharge under various chapters of the bankruptcy code. Individuals looking to file bankruptcy most commonly file under either Chapter 7 or Chapter 13 of the bankruptcy code.

Types of Bankruptcy

Chapter 7 bankruptcy is sometimes referred to as a "straight" bankruptcy because it allows for a full discharge of allowable debts. A bankruptcy trustee gathers and sells the debtor's non-exempt assets and the proceeds are used to pay creditors. The debtor is allowed to keep certain exempt property. If the debtor lacks sufficient non-exempt assets to cover their debts, they will no longer be responsible for the remaining balances on any allowable debts.

Chapter 13 bankruptcy involves a multiyear, court-approved payment plan to repay debts to the greatest extent possible. The plan requires the debtor to make payments to a trustee who then distributes money to the creditors. Chapter 13 bankruptcy is a good alternative for individuals who can repay some of their debts but need modified payment terms.

Rules for Tax Debt to Be Dischargeable in Bankruptcy

Tax debts are normally classified as "priority" debts in Chapter 7 and Chapter 13 bankruptcies. Priority debts need to be addressed and paid first when assets are liquidated in Chapter 7 and must be included and paid in full in a Chapter 13 payment plan. However, the bankruptcy code lays out specific criteria under which tax liabilities may become dischargeable in bankruptcy:

1. Three years must have elapsed from the due date for filing the tax return for the year in question.[1]
2. The tax return for the year in question must have been actually filed at least two years prior to the bankruptcy petition.[2]
3. At least 240 days must have passed since the date the liability was assessed.[3]
4. Finally, the return for the tax at issue must not have been fraudulent, nor can the taxpayer have been found guilty of attempting to evade or defeat the tax.[4] Any tax periods for which all of these conditions are met may be eligible for discharge.

Regarding the due date rule, this date includes any extensions. For example, if a taxpayer were looking to discharge a tax liability stemming from the 2014 tax year, normally the return would have been due in April 2015, and they would have to wait until at least April of 2018 until the liability could become eligible for discharge. However, if the taxpayer filed for an extension for their 2014 tax return, the due date would have been extended to October 2015 and, therefore, any resultant liabilities would not be dischargeable in bankruptcy until at least October 2018.

Regarding the filing rule, this time is measured from the date the return was actually filed. If a return is filed late, the 240 day period only begins to run on the date of actual filing. Furthermore, a return must be filed by the taxpayer in order for the 240 day period to begin to run. If the IRS has prepared "substitute returns" for the taxpayer for non-filed returns, tax liabilities stemming from those returns cannot be discharged in bankruptcy.[5]

Regarding the 240-day assessment rule, there are also situations which toll the period. If the liability was put in an Offer in Compromise status within the 240 days, the amount of time the liability was in Offer status plus 30 days is added to the calculation.[6] If there is a hold on collections, due to, for example, prior bankruptcy proceedings, the amount of time the liability is not collectible plus 90 days is added to the calculation.[7]

If the taxpayer enters an installment agreement and begins paying off the tax debt on a monthly basis, this will not toll the time for bankruptcy dischargeability under any of the rules. In fact, establishing an installment agreement is a valid strategy to buy the taxpayer the time necessary for the debt to become dischargeable while avoiding the filing of liens or imposition of levies.

Planning Considerations

When determining whether it would be advisable for a client to file for bankruptcy to discharge tax debt, a professional should make sure to fully understand the rules involved and the interplay between the Internal Revenue and Bankruptcy codes. Aside from ensuring that the liabilities have met the time requirements to be dischargeable, there are other important considerations.

Leo Gabovich, Esq., is a tax attorney at Tenenbaum Law, P.C. (www.litaxattorney.com), a tax law firm in Melville, N.Y., which focuses its practice on the resolution of IRS and New York State tax controversies. He can be reached at lgabovich@litaxattorney.com and at 631-465-5000.

Disclaimer: The information contained in this article does not constitute tax advice and is for informational purposes only.

For example, when considering an Offer in Compromise, the IRS will take into account the potential for some or all of the debt to be discharged in bankruptcy, which may lead to a better result for the taxpayer.[8] Therefore, a valid strategy is waiting until at least 240 days have lapsed since the assessment was issued and then filing for an Offer in Compromise, while continuing to weigh the benefits of filing bankruptcy. It is also important to consider which tax debts are and are not dischargeable in bankruptcy, thereby allowing the taxpayer to selectively pay down the liabilities which will not be discharged in bankruptcy, while still allowing for time to run on debts which will be dischargeable in the future. Additionally, only income taxes are dischargeable in bankruptcy—payroll taxes, the Trust Fund Recovery Penalty, and most state sales and excise taxes are not dischargeable.

Non-Bankruptcy Alternatives

While bankruptcy may be a useful tool for taxpayers to eliminate certain debts, it is not always the best course of action. There are some serious drawbacks to bankruptcy, including the forced liquidation of non-exempt assets and the mark left on your credit history, which can make future loans difficult to secure.

When back taxes make up a significant portion of a client's debts, they should consider whether applying for an Installment Agreement or an Offer in Compromise might be a better alternative to filing for bankruptcy. An Installment Agreement allows a taxpayer to pay down a liability over time. Under certain circumstances, the taxpayer may even qualify for a Partial Payment Installment Agreement, where the IRS will accept less than the full liability to be repaid over the term of the payment plan. Through an Offer in Compromise, a taxpayer may be able to satisfy their tax liabilities for a reduced amount based upon their financial circumstances; the offer process can require considerable time and documentation, but it may often be a better alternative. If your clients are considering their options for managing escalating tax debt, they should speak to a qualified tax advisor to determine their best course of action.

Endnotes

1. 11 U.S.C. § 507(a)(8)(A)(i).
2. 11 U.S.C. § 523(a)(1)(B).
3. 11 U.S.C. § 507(a)(8)(A)(ii).
4. 11 U.S.C. § 523(a)(1)(C).
5. 26 U.S. Code § 6020(b).
6. 11 U.S.C. § 507(a)(8)(A)(ii)(I).
7. 11 U.S.C. § 507(a)(8)(A)(ii)(II).
8. Internal Revenue Manual 5.8.10.2.2.

Reprinted with permission from: *The Senior Lawyer,* Summer/Fall 2019, Vol. 11, No. 1, published by the New York State Bar Association, One Elk Street, Albany, NY 12207.