

Discharge of Unfiled Taxes under the Bankruptcy Abuse Prevention and Protection Act of 2005 (BAPCPA). No More “Super” Discharge?

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The basic concept of a chapter 13 bankruptcy filing historically was to allow individual debtors to reorganize their finances. The policy of giving the debtor a chance to have a fresh start was foremost behind Congress’ intent to provide the debtor with a broad discharge of his/her debts incurred through false representation, fraud or recent consumer debt.¹ The term of art used in dealing with a discharge of this type of liabilities was called a “super” discharge.

History

As explained by **Thomas E. Ray**, in his 1994 analysis of the complex evolution of the “super” discharge provision of the Bankruptcy Code, the “original version of the Code did not have a liberal provision with respect to the discharge of the debts listed in §523 (a)”.² Only in 1978, did Congress recognize that based on the concept of a “fresh start”, the debtor should be allowed to discharge debts which were not “innocently” incurred.³ Subsequently, Congress’ policy turned away debtors. In 1984, Congress added §1325, a “disposable income” provision in which debtors needed to repay in order to get a confirmation of their chapter 13 plan.⁴ In 1990, Congress further amended the Code to disallow discharges of student loans, injuries arising from drunk driving and criminal-restitution payments.⁵

The development of the “super” discharge provision was always controversial. There was always a struggle between allowing the discharge of the debts mentioned in §523 of the Code and protecting innocent and honest debtors. It appears that the urge to protect honest citizens prevailed over intentionally incurred dishonest obligations.

Although Code §1325(a)(3) already had a good-faith requirement that protects the system from manipulative filings, Congress concluded that it needed to help the judge in determination of good faith with a strict provision that outlaws the discharge of

¹ See 11 USC §523(a)(2). Also see §523 (a)(1), §523(a)(3), §507(a)(8)(C).

² Thomas E. Ray, “Demise of the chapter 13 “super” discharge?” 13-5 ABIJ 16 (1994).

³ Id.

⁴ See Id.

⁵ See Id.

dishonest obligations.⁶ Congress finally outlawed a ‘super’ discharge provision with the adoption of BAPCPA.

This article will concentrate on the discussion of the dischargeability of income tax debts under the new law after briefly summarizing the general rules.

New Law for Handling Old Liabilities

Since BAPCPA went into effect on October 17, 2005, bankruptcy practitioners dealing with tax debt discharges have had to find new ways of dealing with their clients’ “unfiled old”⁷, late filed or “substantial old” tax liabilities.

According to the “old” law, debtors with income tax debts that were not completely dischargeable under chapter 7 were able to deal with them by filing chapter 13 bankruptcy. Some chapter 13 bankruptcies were filed solely to deal with unfiled income tax liabilities or for substantially old income tax liability.

Three Part Test for a Tax Liabilities Discharge under Chapter 7

Pursuant to 11USC § 523(a)(1) a tax debt discharge was allowed -and still is possible- if the tax debt satisfies a three part test. All three parts of the test have to be satisfied.

The first test is known as a “**three year rule**” meaning that the income taxes on the gross receipts had to be due three or more years before the filing date. The second part of the test is known as a “**two year rule**”, meaning that the debtor had to file the return at least 2 years before filing for bankruptcy. The third part of the test is called a “**240 day rule**”, meaning that taxing authorities must have assessed the tax at least 240 days prior to filing for bankruptcy with the addition of all the applicable stays.⁸ For these rules to apply, the tax return had to be filed by the debtor himself and not by the IRS after assessment.⁹

⁶ 11 U.S.C.S 1325(a) includes a requirement for the confirmation of the plan that the Plan has to be proposed in good faith. In determining good faith the Court needs to look at the totality of the circumstances test”. Circumstances taken into consideration are: percentage of the proposed payment, debtor’s financial situation, debtor’s honesty in representing facts and other relevant facts that go to the core of the understanding of whether there was an abuse of Chapter 13 in proposed plan. Of course each judge has his/her guidelines for determining the good faith in filing of the Plan. See also *In Re Elsie L. Herndon*, 218 B.R. 812; 1998 Bankr. LEXIS 310.

⁷ “Old” or “substantially old” taxes means here that the taxes are more than 3 years old from the date they are due, more than 2 years old from the date they were filed and 240 days old from the time they were assessed, with all the applicable stays. See §507(a)(8)(A)(ii).

⁸ The following activities on the Debtor’s account stay the running of a 240 day period: the number of days the Offer in Compromise (OIC) was pending, the number of days the prior Bankruptcy was pending after the tax return due date with the valued extensions plus 30 days for each applicable Offer in Compromise plus 6 months for each applicable Bankruptcy proceeding. As per BAPCPA the stay period in now for the duration of OIC plus 30 days, and for the duration of the prior Bankruptcy plus 90 days. See §507(a)(8)(A)(ii).

⁹ *In Re Gushue* 126 BR 202, also see *In re Nolan*, 1997 Bankr.Lexis 622, 79 A.F.T.R. 2d (RIA) 2670 (Bankr. E.D. Tenn.1997). The Bankruptcy Court ruled in favor of IRS stating that the Return prepared by the IRS is not a return for the bankruptcy purposes. Under new BAPCPA 2005 §523(a) tax returns filed under section 6020(a) of the Internal Revenue Code (IRC) are considered properly filed and returns filed

Chapter 13 Option for Debtors with Unfiled Taxes (Old Law)

An interesting technique that bankruptcy and tax practitioners were able to do is to discharge within the life of the chapter 13 Plan *unfiled taxes*. Under Code §1328(a), a discharge was granted to all debts properly provided for in the plan, with the exception of claims for which the last payment is due after the final payment under the plan as well as claims relating to alimony, maintenance and child support.¹⁰ Interpreting this section, if the debtor's plan properly provides for the payment of income taxes owing, the taxes were discharged, regardless of the age of the tax claims owing or other status, as long as the three-year rule as stated above is passed. In order for a discharge to apply the plan had to provide (1) for the full payment of taxes entitled to priority and 2) for payment of the value of all assets to which a filed federal tax lien has attached as of the filing date of the bankruptcy.¹¹

The bankrupt taxpayer who followed all the above-mentioned rules regarding the treatment of priority taxes in order to discharge taxes as a general unsecured claim paid as little as 10 cents on the dollar in chapter 13 to discharge such tax liabilities. Of course, in cases where a federal lien was filed, the plan had to provide for its repayment. All secured claims had to be repaid in full.¹²

Chapter 13 Option for Clients with the Intent to Evade or Defeat the Tax or Clients with the Recent Tax Debt (Old Law)

Section 1328(a) of the old Code allowed debtors to discharge their tax liabilities even for fraudulently filed tax returns or with an intent to evade or defeat such tax, as well as recent tax debts that could be included in the repayment plan. Chapter 13 in this sense was a very convenient harbor for those "irresponsible" tax "nonpayers" and "non filers". Indeed as Oct. 17, 2005, was approached, many debtors rushed to file their chapter 13s just for the sole purpose of dealing with the income tax debt on unfiled tax years in question or for taxes that might be deemed to be fraudulent.

BAPCPA Provisions and Practical Advice

Under the new law, a discharge of unfiled taxes, late taxes or fraudulently filed taxes is no longer available to debtor taxpayers. Section 1328 (a) specifically references §523 (exceptions to a discharge) and prohibits a discharge of any unfiled tax debt as well as debt for fraudulently filed returns.

under section 6020(b) of the IRC are not considered property filed. Section 6020(a) of the IRC states that "...if a person consents to a disclosure of all the information necessary for the preparation of the tax return, and the Secretary prepares such a return and the person signs such returns, it can be considered as a return of such person." Section 6020(b) of the IRC states "... if a person fails to prepare a return ... or prepared a fraudulent return...the Secretary should make a return from his/her own knowledge ...".

¹⁰ 11 USC § 1322(b)(5).

¹¹ 11 USC § 1322 (a)(2), 1325(a)(5), See also Arthur H. Boelter, "Represent Bankrupt Taxpayer", Tax Practice Series, West Group, Chapter 9-8.20, 04/2000.

¹² USC § 1225 (a)(5). See also *In Re Deutchman*, 192 F3d 457. Even after the plan was confirmed, the IRS secured interest was not extinguished, although the secured claim was not filed by the IRS.

A taxpayer with this problem today can address it by filing a chapter 7 bankruptcy and then, while it is pending, file an adversary proceeding against the taxing authorities. IRS officials want attorneys who deal with tax debt over \$100,000.00 to commence an adversary proceeding because for them, a presumption arises that the taxpayer had intent to evade or defeat the tax. Because of this presumption the IRS officials want debtors to argue their position in court and let the judge decide if the tax debt was incurred intentionally and whether or not it is dischargeable.

One practical problem that will arise is that, according to §1324 of BAPCPA, the confirmation hearing must be held within 45 days of the meeting of creditors. Section 1324 specifically reads that:

“the hearing on confirmation of the plan may be held not earlier than 20 days and not later than 45 days after the date of the meeting of creditors under §341(a), unless the court determines that it would be in the best interests of the creditors and the estate to hold such hearing at an earlier date and there is no objection to such earlier date.”

The problem with that provision is that with the adversary proceeding usually being usually lengthy, you never know when the chapter 13 trustee's patience will run out and he/she will bring a motion to dismiss the case. For example, in New York, it was always hard even without adversaries pending to get adjournments for over six months. (We are talking about situations when the attorney is working on the settlements of taxing authorities' claims, for example). Getting adjournments for the confirmation hearings for years would seem to be really problematic.

Another practical problem is that a chapter 13 with an adversary proceeding within will become very expensive for the client debtor. Many people might be better off filing an Offer in Compromise (OIC) with the taxing authorities instead of filing chapter 13.

To help a taxpayer with the tax liabilities under the new law, the attorney for the debtor needs to:

- a) urge a client to file his tax returns for the years in question;
- b) make sure that the tax owed is old enough to qualify for a discharge under the two year rule, the 240 day rule and of the three year rule, which always applied in chapter 13. Here, of course, if the client is filing his tax return after he came to a consultation with an attorney, the debtor will have to wait for at least two years to file any chapter 13 petition. The question that might arise is this: what if during these two years the taxing authorities assess the tax? Some good advice can be to enter into an installment agreement during these two years. If you do that, it will stop any assessment proceedings that the taxing authorities might take;
- (c) deal with the liabilities outside the bankruptcy court and file an OIC with taxing authorities.

Conclusion

The intent behind BAPCPA was to encourage debtors with disposable income to file for Chapter 13 in lieu of Chapter 7. With respect to debtors with tax liabilities, this might not be the result. A few examples will illustrate this (assume for all the examples no assets and some disposable income):

- 1) the debtor has \$90,000.00 of unsecured debt, \$50,000.00 of priority debt . Under the old law, the debtor was able to file chapter 13 and pay 100 percent of priority debt and 10 percent of unsecured debt. Under BAPCPA, the debtor can file chapter 7 and qualify under the means test because priority taxes are deducted over five years and then file an OIC with taxing authorities;
- 2) the debtor has \$100,000.00 of unfiled unsecured taxes and \$25,000.00 of priority taxes. Under old law, the debtor was able to file chapter 13 and pay 10 percent of unsecured debt and 100 percent of priority liabilities. Under BAPCPA, the debtor might disappear off the tax roll or file an OIC after filing the returns;
- 3) the debtor has \$225,000.00 of unsecured tax debt and \$0 priority debt. Under the old law, the debtor would file chapter 7 and commence an adversary proceeding. Under BAPCPA, the debtor might have to file chapter 13 if he/she fails the means test and file an adversary within the chapter 13. This means that the confirmation hearing might have to be adjourned for years and attorney for the debtor will have to make a fee application to be paid within a five-year plan. Another issue arises here if the debtor will have to show sufficient income to support the plan with huge legal fees in an adversary; more disposable income will lead to a higher settlement of adversary, which would lead to increased plan payments and more disposable income needed.