DISCHARGING INDIVIDUAL FEDERAL INCOME TAXES

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A.
RESEARCH RESOURCES

This is only a summary. The book *Discharging Taxes* by attorney Morgan King has a more comprehensive explanation. It is an invaluable resource, www.bankruptcybooks.com.

B.
STATUTE OF LIMITATIONS FOR COLLECTION

A bankruptcy may not be needed if the taxes are about to become uncollectable because of the statute of limitations. The IRS generally has 10 years from the date of assessment to collect taxes. 26 USC §6502. The 10 year period is tolled (extended - the clock stops running) if certain events occur. These events include but are not necessarily limited to: When the taxpayer agrees to a tolling such as in an installment payment agreement. §6502; while a tax court proceeding is pending plus 60 days; while a bankruptcy is pending plus 6 months. §6503; while the taxpayer is outside the U.S. for more than 6 months plus 6 months upon return to the U.S. §6503; for 60 days after the mailing of a §6212 notice of deficiency. §6503; while an offer in compromise is pending plus 1 year; while a Due Process appeal is pending.

C.
THE FIVE BASIC REQUIREMENTS

There are five basic requirements to discharge federal individual income taxes in a chapter 7 bankruptcy. Some of the requirements involve time periods which can be tolled as discussed later. If a time period is tolled, it is extended because the running of the time period is suspended. In other words, the clock stops running.

Your personal liability to pay taxes will be discharged in Chapter 7 if all five of the rules are met. If the taxes do not meet all five of the rules, then they will not be discharged in Chapter 7.

A tax transcript must be obtained from the IRS and carefully reviewed. There is no mechanism to obtain a pre-bankruptcy decision from the IRS regarding whether taxes can be discharged. A miscalculation of one day can prevent the taxes from being discharged.

1.
The Three Year Rule

The bankruptcy must be filed more than 3 years after the due date for filing the return. The due date is changed by extensions to file a return. For example, assume you owe taxes for tax year 2007. Normally the due date for the 2007 return is April 15, 2008 and the 3 year rule is satisfied if the bankruptcy is filed after April 15, 2011. If you obtained an extension for filing the 2007 return from April 15, 2008 to October 15, 2008, then the due date is October 15, 2008 and the 3 year rule is satisfied only if the Chapter 7 bankruptcy is filed after October 15, 2011, regardless of whether you filed the return before October 15, 2008. If the normal due date falls on a weekend or certain legal holidays, including District Of Columbia holidays, then the due date may be several days after the normal due date. The 3 years can be tolled as discussed later.

2.
The Two Year Rule

The bankruptcy must be filed more than 2 years after the date that you filed your tax return or you signed a substitute for return prepared by the IRS. This rule only applies to late filed returns. If a return is filed on time, then the three year rule, above, makes the 2 year rule irrelevant.

Bankruptcy Courts in the Northern and Southern Districts of Mississippi have ruled that a late filed return may never be discharged in bankruptcy because 2005 amendments to the bankruptcy laws define a return as a return that satisfies all applicable requirements of nonbankruptcy law, including filing requirements. The argument is that a late filed return does not satisfy all filing requirements and is not a return that starts the clock running for the two year rule. Under this argument, taxes from a late filed return may never be discharged unless it is a signed substitute for return pursuant to 26 USC §6020(a) as discussed below. The cases are *Creekmore v. Internal Revenue Service,* 401 B.R. 748, 751 (Bankr. N.D. Miss. 2008); *Weiland v. State of Miss.* (Bankr. N.D. Miss. May 11, 2011); *McCoy v. Miss. State Tax Comm.,* 3:09-cv-575 (Bankr. S.D. Miss. February 8, 2011).

The 5th Circuit Court Of Appeals upheld the *McCoy* ruling and agreed that a late filed return may never be discharged. *McCoy v. Miss. State Tax Comm., (5th Cir.* January 4, 2012, #11-60146). These rulings have been criticized because they make the two year

rule for a late filed return meaningless even though Congress left the two year rule in the law. In fact, prior to the 5th Circuit decision in *McCoy*, the IRS stated that it did not agree with this interpretation and the IRS would not argue for it even though the IRS was the prevailing party in *Creekmore*. As of January 2012 the IRS legal counsel in Phoenix said the IRS will still follow the 2 year rule and will not be taking the McCoy position that a late filed return may never be discharged. Of course the IRS could change its mind at any time. It is unknown what position will be taken by the State of Arizona regarding state taxes.

If you did not file a return, the taxes will not be discharged even though the IRS may have filed a "substitute for return" (SFR) pursuant to 26 USC §6020(b). Such an SFR is based on an estimate of your income and allows the IRS to assess taxes even though you failed to file a return. The IRS generally sends numerous warning letters before filing such an SFR. The SFR prepared by the IRS pursuant to 26 USC §6020(b) is normally without the consent or cooperation of the taxpayer, the taxpayer does not sign the SFR, and the SFR does not count as a filed return. Therefore the clock never starts running for the two year rule.

There is an unusual situation in which an SFR counts as a return. The 2005 changes in the Bankruptcy law provides that a return includes a return prepared by the IRS pursuant to 26 USC §6020(a), which is a type of SFR prepared by the IRS with the taxpayer's consent and signed by the taxpayer. The filing of the SFR prepared by the IRS pursuant to 26 USC §6020(a) and signed by the taxpayer starts the clock running for the two year rule. Apparently such an SFR counts as a return and starts the clock running even if filed late (after the due date for the return).

Some courts have ruled that if you file your return after the IRS has filed an unsigned SFR pursuant to 26 USC §6020(b), then your return is meaningless, the 2 year period never starts running, and you cannot discharge the taxes assessed by the SFR. This is the position of the IRS. In re Henne, 17 CBN 414 (Bankr. D. Ariz. 2007, Judge Hollowell); *In re Payne*, 16 CBN 113 (7th Cir. 2005) (might allow exception if circumstances beyond debtors control prevented filing.)

Other courts have ruled that a tax may be discharged even though the debtor filed the return after an assessment based on an unsigned SFR pursuant to 26 USC §6020(b) if the debtor acted in good faith. *Payne v. U.S.*, 14 CBN 291 (Bankr. N.D. Ill. 2004.); *In re Colsen*, 15 CBN (Bankr. 8th Cir. 2005.; In re Merrill, 17 CBN 584 (Bankr. D.N.N. 2007, IRS accepted debtor return as a substitute, apparently after IRS has previously filed its own substitute return

and made and assessment. IRS increased liability based on debtor's return.) Therefore it is uncertain whether taxes may discharged if the taxpayer filed a late return after the IRS filed an SFR pursuant to 26 USC §6020(b).

3.
The 240 Day Rule

The bankruptcy must be filed more than 240 days (approximately 8 months) after the taxes were assessed. Taxes are assessed when the IRS makes an entry on its records regarding the amount owing. This can be normally determined from reviewing your tax transcript. Additional assessments for more taxes can be made for a single tax year. Each assessment is subject its own 240 day rule. The 240 days can be tolled as discussed later.

4.
The No Tax Evasion Rule

Your taxes will not be discharged if you "willfully attempt in any manner to evade or defeat such tax." Most courts have said that simply failing to file a return on time is not willful evasion. However, several courts, including *U.S. v. Fretz*, 11th Circuit March 23, 2001, have ruled that intentionally failing to file returns is willful evasion. *In re Geiger* 18 CBN 873 (Bankr. C.D. Ill. 2008) found evasion when the taxes were not filed on time, were not paid and the taxpayer purchased luxury items while knowing he owed taxes.

5.
The No Fraudulent Return Rule

The last requirement is that you did not file a fraudulent return for the taxes.

D.
TOLLING
(EXTENDING THE THREE YEAR AND 240 DAY PERIODS)

The time periods discussed in the Three Year Rule and the 240 Day Rule can be "tolled" because of a previous bankruptcy, an offer in compromise or a request for a due process hearing or any other request for hearing and appeal which stops collections. If a time period is tolled, it is extended because the running of the time period is suspended. In other words, the clock stops running during the Three Year Rule time period or during the 240 Day Rule time

period when a tolling period overlaps the Three Year Rule time period or the 240 Day Rule time period, plus a specified number of days.

1.
A Previous Bankruptcy

The 3 year period is tolled by a previous bankruptcy for the time the automatic stay in the previous bankruptcy prohibited collection plus an additional 90 days or for the time one or more confirmed bankruptcy plans prohibited collection plus an additional 90 days. In other words, the time period is tolled during the time the protection in the prior bankruptcy overlaps the 3 year period, plus 90 days. See the "hanging paragraph" at the end of 11 USC 507(a)(8)(G). The law is unclear if there is a separate 90 day period for each prior bankruptcy when there is more than one prior bankruptcy.

The 2 year period apparently is not tolled by a previous bankruptcy.

The 240 day period is tolled by a previous bankruptcy in much the same manner as the three year period. See 507(A)(8)(ii)(II) which specifically refers to the 240 day period and refers to the automatic stay in a previous bankruptcy, plus 90 days. See somewhat duplicative but broader language in the hanging paragraph which refers to the time the automatic stay in the previous bankruptcy prohibited collection plus an additional 90 days and also refers to the time one or more confirmed bankruptcy plans prohibited collection plus an additional 90 days.

2.
An Offer In Compromise

The 3 year period probably is not tolled by an offer in compromise except when there is an appeal of a denial of an offer in compromise. The hanging paragraph at the end of 11 USC 507(a)(8)(G) refers to a period when the tax agency is prohibited from collection as a result of a request by the debtor "for a hearing and an appeal of any collection action taken or proposed against the debtor", plus 90 days. An offer in compromise does not include a request for a hearing except when there is an appeal. So an offer in compromise by itself probably is not a tolling event. However, an *appeal of a denial* of an offer in compromise perhaps tolls the 3 year period because such an appeal involves a request for a hearing. If so, then the time is tolled while the tax agency is prohibited from collection, plus 90 days. There remains an

issue of whether such an appeal is an appeal of "any collection action taken or proposed against the debtor."

The 2 year period apparently is not tolled by an offer in compromise.

The 240 day period is tolled by an offer in compromise for the time when the offer is pending or in effect during the 240 day period, plus 30 days. See 11 USC 507(a)(8)(A)(ii)(I) which specifically refers to the 240 day period and refers to an offer in compromise. However, the law is unclear if pursuant to the hanging paragraph at the end of 11 USC 507(a)(8)(G) an offer in compromise tolls the 240 day period for the time when the offer is pending, plus 90 days. The hanging paragraph refers to a period when the tax agency is prohibited from collection as a result of a request by the debtor "for a hearing and an appeal of any collection action taken or proposed against the debtor..." An offer in compromise does not include a request for a hearing except when there is an appeal. So an appeal of a denial of an offer in compromise perhaps tolls the 240 day period while the tax agency is prohibited from collection, plus 90 days.

3.
A Request For An IRS Due Process Hearing Or Any Other Request For A Hearing And Appeal Which Stops Collections

The 3 year period is tolled by a request for a an IRS Due Process Hearing or any other request for a hearing and appeal which stops collections, such as certain litigation. The hanging paragraph at the end of 11 USC 507(a)(8)(G) states that an applicable time period is "suspended" for any period when the tax agency is prohibited from collection as a result of a request by the debtor "for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days." The tax code at 26 USC 6330(e)(1) stops collections after a due process hearing is requested, plus 90 days after the final determination of the request for a due process hearing. As stated above, the bankruptcy code adds 90 days to the tolling. To be safe, one should assume that there really is a tolling of 180 days, which is 90 days after the final determination of the request for a due process hearing, plus 90 days under the bankruptcy code. The IRS has been using only one tolling period of 90 days, but this is not a written policy.

The 2 year period apparently is not tolled by a request for an IRS Due Process Hearing.

The 240 day period is tolled by a request for a an IRS Due Process Hearing or any other request for a hearing and appeal which stops collections. The hanging paragraph at the end of 11 USC 507(a)(8)(G) states that an applicable time period is "suspended" for any period when the tax agency is prohibited from collection as a result of a request by the debtor "for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days."

E.
DID THE IRS ACKNOWLEDGE THAT THE TAXES ARE DISCHARGED?

At one time the IRS had an informal procedure to acknowledge the discharge of taxes after a written request from the debtor's attorney. The IRS no longer uses the informal procedure.

The current procedure is to wait for the discharge from the bankruptcy court. The discharge does not list the specific taxes or other debts which are discharged or are not discharged. Wait 60 days after the discharge to give the IRS time to update its records. Then obtain transcripts to see if the IRS removed the assessment. The IRS transcripts should show a $0 Assessed Balance and use tax code 604, for Assessed Debit Balance Cleared. This means the IRS is acknowledging the discharge of the taxes. If the transcripts do not show this, then the debtor's attorney should contact the IRS. In Arizona that office is in Phoenix.

If the IRS will not remove the assessment, the debtor may file an adversary lawsuit in the Bankruptcy Court requesting the Bankruptcy Court to make a ruling.

The IRS at times sends a letter stating that the personal liability was discharged but that a lien survives the bankruptcy and that the debtor must contact the IRS about the lien. Liens are discussed below.

F.
CHAPTER 7 TRUSTEE PAYMENT OF TAXES

1.
Proof Of Claim

Less than 10% of chapter 7 cases result in payments to any creditors by the trustee. The chapter 7 trustee will only pay a creditor, including any taxes, if a proof of claim has been filed

by or for (on behalf of) that creditor. The trustee cannot pay a creditor simply because the creditor was listed in the bankruptcy. In Arizona the debtor's attorney may contact the IRS office in Phoenix to ask that a proof of claim be filed. If a creditor fails to file a proof of claim by the creditor's deadline, then there is an additional 30 day period for a debtor to file a proof of claim for the creditor. 11 USC §501; Bankruptcy Rule 3004. Tax agencies occasionally fail to file a proof of claim. A proof of claim should be filed for a tax agency if the Chapter 7 trustee has money available to pay some or all of the taxes that are not discharged and the tax agency fails to file a claim by the deadline. You want the trustee to pay some or all of these taxes so that you owe less. (The same is true for child support and spousal maintenance, which have a higher priority for payment than taxes and are not discharged.)

2.
Splitting A Tax Year In Chapters 7 And 11

The general rule is that the chapter 7 trustee cannot pay taxes that become due for the tax year in which the bankruptcy was filed. For example, if you file chapter 7 bankruptcy on July 1 of a year (one half through the tax year) and the following April it is determined that you owe income taxes for that year, the trustee will not pay any of those taxes, not even one half, unless you split the tax year as explained in the next paragraph. There is language in the bankruptcy code, 11 USC §507(a)(8)(A)(iii), that seems to say the trustee can pay such taxes. However, most courts, including *In re Allen*, Bkrtcy. D. Mass. December 11, 2006, No. 04-1266-JNF have ruled that the trustee cannot pay such taxes unless the debtor elected to split the tax year.

The IRS code, 26 USC §1398(d)(2)(A), allows a Chapter 7 or Chapter 11 debtor to split a tax year into two short tax years. One short tax year ends the day before the bankruptcy is filed. The other short tax year starts the day the bankruptcy is filed. If such an election is made by the debtor, then the tax liability for the first short tax year may be paid by the trustee as a priority claim.

The election by the debtor to split the tax year must be made on or before the due date for filing the return for the tax year in which the bankruptcy was filed. The election is irrevocable. However, the election does not apply if the bankruptcy is dismissed. The election may not be made if the debtor has no non-exempt assets.

3.
Category 1, Unsecured Priority Taxes And Not Discharged.

See the Chapter 13 explanation, below, for a definition of this category. These taxes may or may not be paid anything by the trustee in chapter 7. Your liability for these taxes is not discharged. You remain liable for any such taxes not paid by the trustee.

If the Chapter 7 trustee has money to distribute in the case, the trustee pays the trustee's fees and administrative expenses. Then the chapter 7 trustee pays unsecured priority creditors before paying unsecured non-priority creditors.

There are 9 classes of unsecured priority creditors. 11 USC §507. For example, class 1 is past due child support or past due spousal maintenance owed by the debtor. As another example, class 4 is certain unpaid wages owed by the debtor. Unsecured priority taxes owed by the debtor are class 7.

The chapter 7 trustee pays each unsecured priority class in order starting with class one, then class two, and so on. The trustee pays all the filed claims in a class, if there is money available, before paying the next class. The Chapter 7 trustee will only pay the principal and interest owed on unsecured priority taxes as of the day the bankruptcy was filed. After payment of all filed claims for unsecured priority claims, if the trustee has money available, then the trustee pays pro-rata to unsecured non-priority creditors, which includes credit cards, medical bills, dischargeable unsecured taxes and certain non-dischargead unsecured taxes.

As previously stated, the Chapter 7 trustee will only pay the principal and interest owing on unsecured priority taxes as of the day the bankruptcy was filed. The chapter 7 trustee will not pay any penalties, regardless of whether the penalties accrued before or after you file bankruptcy. The chapter 7 trustee will not pay any interest that accrues after you file bankruptcy. You remain liable for any unpaid amounts, whether interest, penalties or principle.

4.
Category 2, Unsecured Not Priority And Not Discharged

See the Chapter 13 explanation, below, for a definition of this category. It is possible that taxes are not priority and also are not discharged in chapter 7. The chapter 7 trustee cannot pay such taxes as priority. After payment of all claims filed for

unsecured priority claims, if the trustee has money available, then the trustee pays these non-priority non-discharged taxes pro-rata with other unsecured non-priority creditors, such as credit cards, medical bills, and discharged unsecured taxes (category 3, below). You remain liable for any unpaid amounts, whether interest, penalties or principal.

5.
Category 3, Unsecured Not Priority And Discharged

After payment of all claims filed for unsecured priority claims, if the trustee has money available, then the trustee pays these non-priority discharged taxes pro-rata with other unsecured non-priority creditors, such as credit cards, medical bills, and non-priority non-discharged unsecured taxes (category 2, above). You are not liable for any unpaid amounts, whether interest, penalties or principal.

G.
THE TAX AGENCY MAY SEIZE CERTAIN REFUNDS AS A SETOFF FOR PRIOR TAXES

A tax agency may seize a refund for a tax year that ended before you filed bankruptcy and apply it to a tax owing for a tax year that ended before you filed bankruptcy. This is an exception to the automatic stay. 11 USC §362 (b) (26). Example: You file bankruptcy on January 15, 2008 before you file your tax return for tax year 2007. You owe taxes for tax year 2001 which will be discharged in your bankruptcy because they meet discharge requirements. If you are entitled to a refund for the 2007 tax year, then the tax agency may, without requesting permission from the Bankruptcy Court, seize the refund as a setoff and apply it to the 2001 taxes.

H.
CHAPTER 7 LIABILITY FOR NON-DISCHARGED TAXES

1.
Collection Allowed After The Discharge Of Other Debts

Unfortunately, in a Chapter 7 bankruptcy, the tax agencies may resume collection activity from you on non-discharged taxes as soon as you receive your discharge of other debts, which is normally 4-6

months after you file chapter 7 bankruptcy. The tax agencies may collect from you even though the Chapter 7 trustee has or will have enough money in your bankruptcy case to pay some or all of the non-discharged taxes. The tax agencies do not need to wait to get paid by the trustee and often refuse to wait.

2.
No Priority Subrogation If The Taxpayer Pays Taxes That the Trustee Would Have Paid

If the tax agencies collect from you on non-discharged taxes after you file bankruptcy and before the chapter 7 trustee makes payments to creditors, you do not take over (subrogation/assignment) the tax agencies' priority claims in the bankruptcy. 11 USC 507(d). In other words, you do not step into the shoes of the tax agency. You do not get a priority distribution by the bankruptcy trustee for priority taxes you paid. At best you might have a non-priority claim for reimbursement, which is unlikely to be paid much, if anything. However, one court has ruled that the debtor does not get any subrogation at all because 11 USC 509(c) provides for subrogation for a person who "is liable with the debtor" on a claim and pays the claim. A debtor cannot be liable with himself. *In re Allen,* Bkrtcy. D. Mass. December 11, 2006, No. 04-1266-JNF. That is why it is usually to your benefit to try to liquidate your non-exempt property (and in some cases your exempt property) before filing bankruptcy and pay as much of the non-dischargeable taxes yourself before filing bankruptcy. Always consult with a bankruptcy attorney first.

3.
Interest and Penalties

To make matters worse, interest continue to accrue on non-discharged taxes after a Chapter 7 bankruptcy is filed. Normally penalties are not discharged if the taxes are not discharged. However, penalties are discharged even though the taxes are not discharged if the event which gave rise to the penalty, such as failure to file a return and failure to pay taxes, occurred more than three years before the bankruptcy was filed. 11 USC §523(a)(7)(B). If the Chapter 7 trustee has money to distribute, the Chapter 7 trustee will only pay the principal and interest owed on priority unsecured taxes the day the bankruptcy was filed. So even if the trustee pays on priority unsecured taxes, he will not pay any penalties, regardless of whether the penalties accrued before or after you file bankruptcy, and he will not pay any interest that
accrues after you file bankruptcy. (There may be a rare exception if the trustee has sufficient money to pay all creditors in full

with interest.) You remain liable for any unpaid amounts, whether interest, penalties or principal. In addition, the Chapter 7 trustee first pays the trustee's fees and administrative expenses, which leaves less to pay the taxes. Again, it is usually to your benefit to try to liquidate your non-exempt property (and in some cases your exempt property because many exemptions are not effective against tax agencies) before filing chapter 7 and pay as much of the non-dischargeable taxes yourself before filing bankruptcy. It is usually not in your best interest to assume the trustee will pay your non-discharged taxes.

4.
Normal Exemptions do Not Apply

The IRS may collect for a non-discharged tax from almost all income or anything you own, including social security and retirement benefits. IRS guidelines limit the percent of social security that may be garnished. State exemption laws, such as the homestead exemption, which apply to non-tax creditors may not be used against the IRS or the Arizona Department of Revenue to prevent property from being seized or sold or from a lien. The IRS tax code and the Arizona tax laws each contain a list of property which is exempt from collection from each respective agency. 26 USC 6334 and ARS 42-1204. Not much is exempt.

I.
TAX LIENS

1.
Chart

	Personal Liability For Taxes Discharged In Bankruptcy	**Personal Liability For Taxes Not Discharged In Bankruptcy**
NFTL recorded before bankruptcy.	Lien on any property at the time of bankruptcy survives bankruptcy. Lien for the discharged taxes cannot attach to new property owned in the future.	Lien on any property at the time of bankruptcy survives bankruptcy. Lien will attach to new property owned in the future.
NFTL not recorded before bankruptcy.	The section 6321 unrecorded lien at time of bankruptcy remains as a lien against property that never became part of the bankruptcy estate (if excluded by the debtor), such as 401k plan and probably trusts with spendthrift clauses. No lien for the discharged taxes may be asserted after bankruptcy against property that was included in (not excluded by the debtor) and exempted from the bankruptcy estate or that is acquired after filing bankruptcy.	No NFTL at time of bankruptcy. The section 6321 unrecorded lien exists when the bankruptcy is filed. The section 6321 unrecorded lien survives the bankruptcy against all property the debtor exempted from the bankruptcy estate and against property that was not in the bankruptcy estate and against new property owned in the future. A NFTL may be recorded after bankruptcy.

2.
General Rule

The general rule is that a recorded lien survives the bankruptcy. In some cases an unrecorded lien survives the bankruptcy concerning certain property.

3.
Notice of Federal Tax Lien And Unrecorded Lien

Some explanation is required. The IRS can record in the county recorders office a document labeled as “Notice of Federal Tax Lien” (NFTL). It is common to call this the lien. It is not the lien. It is notice to third parties that a lien is already in existence.

Under Title 26 of the United States Code, Section 6321 (26 USC 6321), the IRS has a lien on all of a taxpayer's property if the taxpayer fails to pay a tax after demand by the IRS. The lien is valid against the taxpayer even though a NFTL has not been recorded. The lien might not be valid against third party until the NFTL is recorded. 26 USC 6323.

4.
Bankruptcy Estate

When a debtor files bankruptcy, most property owned by the debtor becomes property of the bankruptcy estate. 11 USC 541. The debtor can remove certain property from the bankruptcy estate by claiming that property as exempt. 11 USC 522.

If a NFTL has been properly recorded before the bankruptcy was filed, then the lien remains on all property you own as of the day you file bankruptcy regardless of whether the property was in the bankruptcy estate and regardless of the fact that your personal liability for the taxes is discharged in bankruptcy. 11 USC 522 (c) (2) (B). The lien is not discharged.

If a NFTL has not been properly recorded before the bankruptcy was filed, and if the debtor's personal liability for the taxes is discharged, then the IRS does not have lien on any property which was included in the bankruptcy estate, including property the debtor removed from the bankruptcy estate by exempting the property.

5.
Property That Was Never In The Bankruptcy Estate (Excluded, Not Exempted)

Certain property normally never becomes property of the bankruptcy estate in the first place and therefore the debtor need not exempt it from the estate. Such property is "excluded" from the bankruptcy estate. 11 USC 541(b) contains a list of property that "the estate does not include." In addition, 11 USC 541 (c) 2 says that "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable under in a case under this title." For example, 401k plans normally are excluded from the bankruptcy estate because 401k plans have enforceable restrictions on transfers. *Patterson v. Shumate, 504 US 753 (1992*). As another example, many trusts and wills have enforceable "spendthrift" restrictions that prevent creditors from garnishing or attaching a person's interest in a trust.

Although exclusion of certain property would, by the terms of the §541, appear to be mandatory and outside the control of the debtor, that is not how the courts have interpreted the statute. In *Patterson v. Shumate, supra*, the U.S. Supreme Court said the debtor "may" exclude certain pension plans from the bankruptcy estate. The U.S. Tax Court has ruled that the *Patterson* interpretation means that a debtor is permitted, but not required, to exclude property from the bankruptcy estate if the property is eligible for exclusion. *Wadleigh v. Commissioner*, 134 T.C. No. 14, No. 10783-07L, June 15, 2010; *Gross v. Commissioner,* No. 26902-07L, August 5, 2010, Memorandum Opinion. In other words, the debtor may decide to include property in the estate even though it could be excluded.

This interpretation has created problems. The bankruptcy forms do not contain a place to list excluded property. Therefore it is common practice list excluded property in schedule A (real property) or Schedule B (personal property). Schedule C is where the debtor claims exemptions in property listed on Schedules A and B. It is a common and prudent practice in Schedule C to state that certain property is *excluded* from the bankruptcy estate, but to also state out of caution that the property is *exempted* in the event the property is somehow included in the bankruptcy estate. The U.S. Tax Court in *Wadleigh* and *Gross* ruled that by following this practice a debtor excludes the property, assuming the property is eligibility for exclusion under §541.

So what is the problem if property is excluded rather than exempted, since either way the trustee cannot take the property? It makes a big difference regarding certain taxes as explained below.

The unrecorded lien under USC 6321 survives the bankruptcy as to property the debtor excluded from the bankruptcy estate, such as 401k plans, certain education IRAs and certain trusts, even though the debtor's personal liability for the taxes was discharged and even though a NFTL was not recorded before bankruptcy. *Wadleigh* and *Gross*, *supra*. In such a situation, the IRS stands in the shoes of the taxpayer. In such a situation the IRS can garnish 401k distributions made after bankruptcy. The IRS cannot garnish or levy on the 401k if the taxpayer does not have the right to a distribution. The same is probably true regarding a trust. It is not clear how this applies to property that was in the bankruptcy estate and was not exempted but was abandoned by the trustee back to the debtor.

On the other hand, the unrecorded lien under USC 6321 for discharged taxes does not survive bankruptcy and may not be asserted after bankruptcy against property that was included in and exempted from the bankruptcy estate or that is acquired after

filing bankruptcy. Therefore if a debtor owes dischargeable taxes and no NFTL has been filed, then the debtor may decide to not exclude certain property from the bankruptcy estate. Instead, the debtor may specifically include the property in the bankruptcy estate and exempt it if an exemption is available.

6.
Liens On Personal Property.

A lien is valid and attaches to your personal property if, on the day the lien was recorded, you resided in the County where the lien was recorded. It does not matter where the personal property is located. It does not matter if you later moved and later acquired other personal property. The lien follows you.

7.
Liens On Real Property.

A lien is valid against third parties and attaches to your real property if the lien was recorded in the county recorders office of any county where your real property is located.

8.
Life Of A Lien.

A tax lien is generally valid for 10 years after the date the taxes were assessed, not 10 years after the lien was filed. The 10 years may be extended by certain events, such as a prior bankruptcy, an offer-in-compromise, being out of the country for at least 6 months, an application for a taxpayer assistance order, time in tax court proceedings, or a signed waiver of the statute of limitations. (The length of the extension of time is complicated and not described herein.) Liens are often filed several years after taxes are assessed.

9.
Liens On Retirement Accounts.

While the IRS has lien rights against social security and retirement accounts, it has some discretion in pursuing such lien rights. The IRS stands in the shoes of the taxpayer. The IRS cannot garnish or levy on a 401k if the taxpayer does not have the not pay post-petition interest, pre-petition penalties or post-right to a distribution. The IRS can garnish 401k distributions made after bankruptcy. The same is probably true regarding a trust. In addition, the IRS code provided theat the IRS may not enforce a lien against certain property.

J.
CHAPTER 13 DISCHARGE OF TAXES
AND
CHAPTER 13 TRUSTEE PAYMENT OF TAXES

In a Chapter 13 you may be able to get a tax lien released by paying the IRS, through the plan, the value of the property that the lien is against. This may be far less than the amount of the lien. There are three categories of unsecured individual income tax in Chapter 13.

1.
Category 1, Unsecured Priority, Paid Through The Plan

In a Chapter 13 you cannot discharge unsecured priority taxes. The plan must propose to pay priority taxes through a plan. The principal and interest owing on priority taxes as of the day of filing the bankruptcy petition are normally paid in full through the plan. The plan does not pay post-petition interest, pre-petition penalties or post-petition penalties. However, interest may continue to accrue during the plan, and at the end of the plan you may owe, on taxes for which the return was filed less than 2 years before the chapter 13 or for which you filed a fraudulent return or willfully attempted to evade or defeat such tax and the debtor may be liable for such accrued interest at the end of the chapter 13. Pursuant to 11 USC §1322(a)(2), §507 (a) (8), and §523 (a)(1)(B) & (C), priority taxes are taxes which meet ONE OR MORE of these 3 requirements:

1. The tax return, with any extensions, was due less than three years before filing bankruptcy, or

2. The taxes were assessed less than 240 days before filing bankruptcy, or

3. The taxes were not assessed before the bankruptcy was filed but were assessable under applicable law after the bankruptcy was filed, and ALL THREE of the following apply to this paragraph 3:

    (1) You filed the return more than 2 years before the bankruptcy was filed,
    and
    (2) You did not attempt to evade taxes,
    and
    (3) You did not file a fraudulent return.

2.
Category 2, Unsecured Not Priority, Not Discharged And Not Paid In Full Through The Plan

Taxes are not discharged and are not paid as priority taxes through the plan if BOTH of these apply:

1. The tax return, with any extensions, was due more than three years before filing bankruptcy,
and

2. The taxes were not assessed before the bankruptcy was filed but were assessable under applicable law after the bankruptcy was filed, and ONE OR MORE of the following apply to this paragraph 2:

   (1) The return was not filed, or

   (2) The return was filed less than 2 years before the bankruptcy was filed, or

   (3) You attempted to evade taxes, or

   (4) You filed a fraudulent return.

Such taxes probably will be paid only a few cents on the dollar in the Chapter 13 plan, the same as credit cards, but will not be discharged. This means you will continue to owe any unpaid amount after the completion of the Chapter 13 plan.

3.
Category 3, Unsecured Not Priority And Discharged

The rules for discharging taxes in Chapter 13 became the same as Chapter 7 for cases filed on or after October 17, 2005. See pages 1-3. If a tax meets the above 5 requirements for discharge in Chapter 7, then the tax will be discharged in Chapter 13. Such taxes probably will be paid only a few cents on the dollar in the Chapter 13 plan, the same as credit cards, and will be discharged

the same as credit cards. Upon completion of the plan you are discharged of any remaining liability.

K.
CHAPTER 13 LIABILITY FOR NON-DISCHARGED TAXES

The tax agencies may resume collection activity from you for non-discharged taxes as soon as you receive your discharge of other debts the same as after a Chapter 7 discharge, as explained above.