

Dischargeability of Federal Taxes in Individual Cases
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I. General Principles

A. Section 523(a) Tax Exceptions to Discharge:

1. Priority Tax Debts described in Section 507(a)(8). 11 U.S.C. § 523(a)(1)(A).
2. Tax liabilities for which a required tax return was not filed. 11 U.S.C. § 523(a)(1)(B)(i). The term “return” means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). A “return” includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code, or a similar State or local law. 11 U.S.C. § 523(a) (hanging paragraph).
3. Tax liabilities based upon tax returns which are filed late within two years of the date of the bankruptcy case. 11 U.S.C. § 523(a)(1)(B)(ii). When a case is converted, the original filing date, not the conversion date, is used in calculating the two-year period. *In re Darden*, 202 B.R. 715 (Bankr. E.D. Va. 1996).
4. Tax liabilities which are based on a fraudulent tax return or which the debtor willfully attempted to evade or defeat. 11 U.S.C. § 523(a)(1)(C).
5. Penalties which relate to a nondischargeable tax and to a transaction that occurred within 3 years of the petition date. 11 U.S.C. § 523(a)(7).

B. Section 523 exceptions to discharge apply to the discharges granted to individuals in Chapters 7 (11 U.S.C. § 727), 11 (11 U.S.C. § 1141), 12 (11 U.S.C. § 1228(a), (b)) and pursuant to the Chapter 13 “hardship” discharge rule (11 U.S.C. § 1328(b)).

C. Under the Chapter 13 “super” discharge, all debts provided for in the plan are discharged, except the following tax claims are excepted from discharge:

1. 11 U.S.C. § 507(a)(8)(C) withholding taxes. These include form 941 withholding taxes and trust fund recovery assessments (otherwise known as 100% penalties) made pursuant to 26 U.S.C. § 6672.
2. 11 U.S.C. § 523(a)(1)(B) taxes related to unfiled or late filed returns.

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3. 11 U.S.C. § 523(a)(1)(C) taxes related to a fraudulent return or a willful attempt to evade or defeat a tax.
 4. What is discharged in a completed Chapter 13 case? The following tax liabilities are discharged if provided for in the plan and the plan is completed:
 - a. Priority tax liabilities.
 - b. Penalties.
- D. Tax Liens Generally Survive. Tax liens remain valid and attach to property acquired postpetition if the underlying tax is not discharged. *In re Dishong*, 188 B.R. 51 (Bankr. M.D. Fla. 1995); *In re Olsen*, 154 B.R. 276 (Bankr. N.D. Ohio 1993). A Chapter 7 discharge does not avoid a federal tax lien. While a Chapter 7 discharge removes a debtor's personal liability, the IRS may still take collection action against the debtor's pre-petition property. *In re Isom*, 901 F.2d 744 (9th Cir. 1990). In Chapter 13, a lien will be avoided if the underlying tax debt is provided for in the plan, the tax debt is dischargeable, the plan is completed, and a discharge is entered. 11 U.S.C. § 1325(a)(5)(B)(i). *But see In re Deutchman*, 192 F.3d 457, 461 (4th Cir. 1999) (a Chapter 13 plan which did not deal with or provide for federal tax lien did not extinguish the lien). In a Chapter 11 case, the lien can be extinguished if the property to which the lien is attached is dealt with in the plan and the plan does not specifically provide for the retention of the lien. *Universal Suppliers v. Regional Building Systems, Inc.*, 254 F.3d 528 (4th Cir. 2001).
- E. Prepetition interest is nondischargeable if the underlying tax is nondischargeable. *In re Treister*, 52 B.R. 735 (Bankr. S.D.N.Y. 1985).
- F. Postpetition interest and penalties on nondischargeable taxes, although not collectible during the bankruptcy case, may be collected from the debtor despite a discharge. *In re Hanna*, 872 F.2d 829 (8th Cir. 1989). *See also Bruning v. United States*, 376 U.S. 358 (1964) (postpetition interest on nondischargeable taxes).
- G. Post-Discharge Setoff. Discharged prepetition claims may be setoff against prepetition debts owed to the debtor after the discharge order is entered. *See e.g., In re Luongo*, 259 F.3d 323 (5th Cir. 2001); *In re Dominguez*, 67 B.R. 526 (N.D. Ohio 1986); *In re Conti*, 50 B.R. 142, 149 (Bankr. E.D. Va. 1985).

II. Unfiled and Late Filed Returns

A. Unfiled returns are excepted from discharge under 11 U.S.C. § 523(a)(1)(B)(i).

What is a return?

1. The Easy Answer. If the taxpayer timely files the appropriate IRS form (e.g., Form 1040 for income taxes) and makes an honest effort to complete it and report income, then a return is filed.
2. Bankruptcy Code definition of a return. A “return” includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code, or a similar State or local law. 11 U.S.C. § 523(a) (hanging paragraph).
 - a. A 26 U.S.C. § 6020(a) return is a return which is prepared by the IRS after the taxpayer discloses all information necessary to prepare the return and which is signed by the taxpayer.
 - b. 26 U.S.C. § 6020(b) states: “If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.” A 6020(b) return also is referred to as a substitute for return (SFR). It is not signed by the taxpayer. An SFR is never a filed return.
3. Tax law definition of return. For a document to be considered a “return,” under tax law, it must (1) purport to be a return; (2) be executed under penalty of perjury; (3) contain sufficient data to allow calculation of tax; and (4) represent an honest and reasonable attempt to satisfy the requirements of the tax laws. See *Beard v. Comm’r*, 82 T.C. 766 (1984), *aff’d*, 793 F.2d 139 (6th Cir. 1986). See also *In re Moroney*, 352 F.3d 902, 905 (4th Cir. 2003) (finding returns which were filed years after IRS made substitute for return assessments and which reduced tax liabilities, were not returns under the Bankruptcy Code).

B. Returns filed late within two years of the bankruptcy filing are excepted from discharge under 11 U.S.C. § 523(a)(1)(B)(ii).

1. Generally, the same definition of return applies, but there are two issues. First, can a return filed after the nonbankruptcy filing deadline even constitute a return

under bankruptcy law? Second, what, if any, portion of tax may be discharged if a return is filed after an SFR assessment is made?

2. IRS Chief Counsel Notice CC-2010-016 (Sept. 2, 2010) sets forth the IRS's position on late filed returns in bankruptcy. It reaches two conclusions:
 - a. IRS concludes that a Form 1040 is not disqualified as a "return" under section 523(a) solely because it was filed late.
 - b. IRS concludes that the portion of a tax that was assessed before a Form 1040 was filed is nondischargeable under Section 523(a)(1)(B)(i), but concludes that any additional tax reported may be eligible for discharge.

3. Sixth Circuit *Beard* Test (adopted Pre-BAPCPA): For a document to be considered a "return," under either the bankruptcy or the tax laws, it must (1) purport to be a return; (2) be executed under penalty of perjury; (3) contain sufficient data to allow calculation of tax; and (4) represent an honest and reasonable attempt to satisfy the requirements of the tax laws. A return which is filed after the IRS makes a substitute return assessment and which reduces the taxpayer's taxes is not a tax return for bankruptcy discharge purposes. *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). *See also In re Moroney*, 352 F.3d 902, 905 (4th Cir. 2003) (applying *Beard* test); *In re Justice*, 817 F.3d 738 (11th Cir. 2016) (applying *Beard* test in a BAPCPA case).

4. The one-day late rule. The First, Fifth, and Tenth Circuits hold that late-filed tax documents do not comply with applicable filing requirements and cannot be "returns." This approach has been termed the "one-day-late rule" because it prohibits discharge of a tax debt with respect to when a return was filed even one day late. In these "one-day-late" jurisdictions, there are only the narrow statutory exceptions to the "one-day-late rule," e.g., late-filed documents that qualify as returns under this interpretation are those filed in accordance with § 6020(a) of the Internal Revenue Code of 1986. *In re Fahey*, 779 F.3d 1, 4 (1st Cir. 2015) ("So the question is whether timely filing is a 'filing requirement' ... The answer is plainly yes."); *In re Mallo*, 774 F.3d 1313 (10th Cir. 2014); *In re McCoy*, 666 F.3d 924, 932 (5th Cir. 2012) ("Unless it is filed under a 'safe harbor' provision similar to § 6020(a), a state income tax return that is filed late under the applicable nonbankruptcy state law is not a 'return' for bankruptcy discharge purposes under § 523(a)."). IRS does not follow the one-day late rule in jurisdictions that have not adopted it.

III. Priority Tax Claims – Sections 507(a)(8) and 523(a)(1)(A)

The following federal government tax claims are entitled to priority claims status:

- A. Three Year Rule. Income taxes for which a return is last due, including extensions, after 3 years before the date of the filing of the bankruptcy case. 11 U.S.C. § 507(a)(8)(A)(i). The operative date is the due date (as extended) for such return, not the actual filing date.
- B. 240 Day Rule. Income taxes assessed within 240 days of the petition date. 11 U.S.C. § 507(a)(8)(A)(ii). The 240-day period is extended in two situations. First, it is extended by the time which an offer in compromise was pending or in effect during the 240-day period, plus 30 days. Second, it is extended by the time a stay against collection proceeding was in effect during the 240-day period, plus 90 days.
- C. Still Assessed Rule. 11 U.S.C. § 507(a)(8)(A)(iii). If an income tax has not been assessed, but is still assessable, then it is entitled to priority status unless the statute of limitations is still open because of a late or unfiled return or the taxpayer=s fraud. Congress did not want to penalize creditors for a debtor=s bad acts. However, the rule applies if the statute of limitations on assessment is open for some other reason, such as a consent to extend the statute executed by the debtor or pending Tax Court litigation.
- D. Withholding Taxes. A tax required to be collected or withheld and for which the debt is liable in whatever capacity is a priority tax claim. 11 U.S.C. § 507(a)(8)(C). Please note trust fund recovery penalties (otherwise known as 100% penalties) imposed pursuant to 26 U.S.C. § 6672 fall within this category.
- E. Employment Taxes - Three Year Rule. Employment taxes for which a return is last due, considering extensions, within 3 years of the date of the filing of the bankruptcy case. 11 U.S.C. § 507(a)(8)(D). This category covers Form 940 and 941 taxes.
- F. Excise Taxes. There are two types of excise taxes which are entitled to priority claim status: (1) excise taxes on prepetition transactions for which a return is last due considering extensions within three years of the filing of the bankruptcy case, and (2) Excise taxes for which a return is not required and which relate to a transaction which occurred within three years of the filing of the bankruptcy case. 11 U.S.C. § 507(a)(8)(E).
- G. Customs Duties. Certain customs duties are entitled to priority claims status. 11 U.S.C. § 507(a)(8)(F).
- H. Compensatory Loss Penalties. A penalty related to a Section 507(a)(8) claim which is compensation for actual pecuniary loss is entitled to priority claims status. 11 U.S.C. § 507(a)(8)(G). Please note trust fund recovery penalties (otherwise known as 100% penalties) imposed pursuant to 26 U.S.C. § 6672 fall within this category.

I. Other Important Points About Priority Tax Claims.

1. Interest which accrues on a prepetition tax claim is entitled to the same priority as the underlying tax claim. *In re Larson*, 862 F.2d 112, 119 (7th Cir. 1988); *In re Stonecipher Distributors, Inc.*, 80 B.R. 949 (Bankr. W.D. Ark. 1987).
2. Tolling. Amended section 507(a)(8) (hanging paragraph) tolls and extends the time periods for determining whether a tax is a priority claim is tolled for the following time periods:
 - a. the time during which a collection due process request, hearing, and appeal prevented collection, plus 90 days; plus
 - b. the time during which the automatic stay was in effect or during which one or more confirmed plans prohibited collection, plus 90 days.
3. Erroneous Refunds - have the same priority status as the tax to which they relate. 11 U.S.C. § 507(c).
4. Converted Cases. When a case is converted, the original filing date, not the conversion date, is used in calculating the priority periods. *In re Darden*, 202 B.R. 715 (Bankr. E.D. Va. 1996).