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BANKRUPTCY AND THE IRS – ADVANCED LEVEL

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Howard is a frequent contributor to both law journals and the NAEA Journal on tax controversy issues. Howard also maintains a weekly IRS blog at howardlevyirslawyer.com/blog with posts and updates on solutions to IRS problems.

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I. When Bankruptcy Can Solve an IRS Problem.

A tax bankruptcy is all about “when” the taxes can be impacted by a bankruptcy filing. The tax returns that caused the liability have to be a little bit older to be eliminated in bankruptcy. Timing is everything.

a. Three Year Rule.

The bankruptcy must be filed more than three years after the return was due to be filed. Extensions are included in calculating the return due date.

Practice Example:

The tax due on a 2003 tax return that was due to be filed on April 15, 2004 would be eligible to be discharged in bankruptcy on April 15, 2007.

The tax due on a 2003 tax return that was due to be filed with extensions on October 15, 2004 would be eligible to be discharged in bankruptcy on October 15, 2007

Notes:

Obtain a power of attorney for your client and contact the IRS for transcripts of account, which will contain the return due dates, filing dates, and assessment dates.

b. Two Year Rule.

The bankruptcy also must be filed more than two years after the tax return was actually filed. This is in addition to the Three Year Rule. Your client must pass BOTH tests.

Practice Example:

A 2003 return was due to be filed on April 15, 2004 but was actually filed on June 1, 2007. The tax due on the return would be eligible for a bankruptcy discharge on June 1, 2009.

<u>Year</u>	<u>Due Date</u>	<u>3 Years</u>	<u>Filed Date</u>	<u>2 Years</u>
2003	04-15-04	04-15-07	06-01-07	<u>06-01-09</u>

Notes:

The bankruptcy must be filed three years after the return was due to be filed and two years after the return was actually filed. Bankruptcy filing dates are the latest of those two dates. In the above examples, the bankruptcy must be filed after June 1, 2009, the later of the due dates and the filing date. ALWAYS CALCULATE BOTH THE DUE DATE AND FILING DATE.

c. 240 Day Rule (Audit Scenarios).

The bankruptcy must be file more than 240 days after the tax was assessed on the IRS's books. This is rule usually comes into play in an audit situation where the returns have been filed, but the tax is later assessed from the audit.

Practice Example:

Your client, Steve Sprague, is self-employed, and had his 2004 and 2005 tax returns audited by the IRS. He filed the 2004 return on time (on April 15, 2005). He filed the 2005 return on October 15, 2006 with extension. The audit result was assessed by the IRS on August 1, 2008. He owes more than he can ever pay back to the IRS. You represented him in the audit, and now he asks for your magic in getting the monkey off his back.

Having the foresight to have attended the NTPI seminar on bankruptcy, you chart out the filing and assessment dates as follows:

<u>Year</u>	<u>Due Date</u>	<u>3 Years</u>	<u>Filed Date</u>	<u>2 Years</u>	<u>Assessment Date</u>	<u>240 Days</u>
2004	04-15-05	04-15-08	04-15-05	04-15-07	08-01-08	<u>04-01-09</u>
2005	10-15-06	<u>10-15-09</u>	10-15-06	10-15-08	08-01-08	04-01-09

Steve can eliminate the 2004 taxes anytime after April 1, 2009. The 2005 taxes would be eligible after October 15, 2009.

Practice Example:

What if Steve filed the 2005 return several months late on November 1, 2007?

<u>Year</u>	<u>Due Date</u>	<u>3 Years</u>	<u>Filed Date</u>	<u>2 Years</u>	<u>Assessment Date</u>	<u>240 Days</u>
2005	10-15-06	10-15-09	11-01-07	<u>11-01-09</u>	08-01-08	04-01-09

Notes:

The most straightforward way of making the calculations is to make a chart, with columns, to do the calculations, and then compare the dates to find the latest date. This makes the calculations easier.

d. Offer in compromise submissions within 240 days of assessment.

An offer in compromise submitted within 240 days of assessment (whether from an audit or a balance due return) extends the 240 day period for the time the offer is pending, plus 30 additional days.

Be careful in submitting an offer in compromise within 240 days of any assessment. If the OIC is unsuccessful, it can make “Plan B” options like bankruptcy more difficult.

Take the time left on the 240 day period, add in the time the offer was pending, then add 30 more days.

Practice Example:

Take our friend and client Steve Sprague from the example in (c), above. Steve got that first billing notice from the IRS and really wanted to plow into an offer compromise. You advise him on offers and the bankruptcy option. Steve wants to try an offer first, even though you advise him that only 20% of offers are accepted and the nonrefundable money he will have to pay to get it processed.

Tax is assessed by audit on August 1, 2008. The 240 day period is April 1, 2009.

Steve submits an offer in compromise on September 1, 2008 when there is 210 days left on the 240 day period.

Offer is rejected on September 1, 2009. Now the 210 days left starts running again, plus 30 days.

The offer extended the 240 day waiting period to May 1, 2010.

Notes:

1. This rule would be equally applicable to sending in an offer in compromise within 240 days of late filed returns that have just been assessed. If your client has a group of unfiled returns, and files them all at once, and then quickly submits an offer in compromise within 240 days of

the assessment of those returns, the time to bankruptcy will be extended by the pendency of the compromise.

2. An offer submission with 240 days of assessment does not affect the calculations regarding the return due date and the return filing date. It only tolls the 240 day period.

e. The taxes involved must be income taxes.

The taxes must involve an income tax liability.

Taxes for which a third party bears personal responsibility, like the trust fund portion of employment taxes or sales taxes, cannot be eliminated in a Chapter 7 bankruptcy. The non-trust fund portion of employment taxes can.

Practice Example:

Michael Powell is an old client with an old problem – he is a sole proprietor, operating a printing business that had trouble for a few years staying current on its employment taxes, Michael also had trouble with his personal estimated tax payments in the past, but he is current now. Here is what you find Michael owes from the IRS transcripts:

Income taxes: 2000, 2001, 2002, 2003, 2004 and 2005, all filed timely without extension.

Employment tax quarters: December, 2003; December, 2004; December, 2005 and December, 2006, all filed timely but not paid. Of the \$45,000 owed, you review the 941 returns and determine that \$25,000 is trust fund and \$20,000 is non-trust fund taxes.

Result:

Income taxes: All of Michael Powell’s income taxes can be eliminated in bankruptcy now except for 2005, for which Michael would have to wait until April 15, 2009. Chart mapping it out as follows:

<u>1040</u>	<u>Filed</u>	<u>Three years</u>	<u>Two Years</u>	<u>240 Days</u>	<u>BK Eligibility</u>
2000	4/15/01	4/15/04	4/15/03	N/A	4/15/04
2001	4/15/02	4/15/05	4/15/04	N/A	4/15/05
2002	4/15/03	4/15/06	4/15/05	N/A	4/15/06
2003	4/15/04	4/15/07	4/15/06	N/A	4/15/07
2004	4/15/05	4/15/08	4/15/07	N/A	4/15/08
2005	4/15/06	4/15/09	4/15/08	N/A	4/15/09

Employment taxes: The **non-trust fund portion** of Michael Powell's December, 2003 and December, 2004 employment taxes can be eliminated in bankruptcy now (by reference to the eligibility date). The **trust fund portion** of the December, 2003 and December, 2004 employment taxes cannot be eliminated. None of the December, 2005 and December, 2006 liabilities will be eliminated now. The non-trust fund portion of the December, 2005 and December, 2006 liabilities would be eliminated if the bankruptcy was filed after January 31, 2009 and January 31, 2010, respectively.

<u>941</u>	<u>Filed</u>	<u>Three years</u>	<u>Two Years</u>	<u>240 Days</u>	<u>BK Eligibility</u>
12/03	1/31/04	1/31/07	1/31/06	N/A	1/31/07
12/04	1/31/05	1/31/08	1/31/07	N/A	1/31/08
12/05	1/31/06	1/31/09	1/31/08	N/A	1/31/09
12/06	1/31/07	1/31/10	1/31/09	N/A	1/31/10

Notes:

1. Federal unemployment taxes (Form 940) are NOT trust fund taxes and qualify the same way as income taxes.
2. To calculate the trust fund taxes, reference Form 941 and add the entire income tax wage withholding on the return to 50% of the Social Security and Medicare withholdings.

f. Your client must have filed a return.

Your client must have **filed** a tax return. Substitute returns filed by the IRS are not counted as returns in most bankruptcy courts. Taxes from false or fraudulent returns also cannot be discharged in bankruptcy. The taxes on these types of returns would have to be repaid.

In all of the above examples, consider the taxes outside of the scope of being eliminated in a bankruptcy if the returns were IRC 6020(b) substitute returns.

g. Impact of IRS collection appeals (i.e., collection due process appeal) on the bankruptcy timing rules.

A timely filed collection due process appeal tolls all bankruptcy timing calculations across the board, including the rules that the bankruptcy must be filed 3 years after the return due date, 2 years after the return filing date and 240 days after assessment. Time is tolled during the time a collection appeal is pending, plus 90 additional days. Bankruptcy Code Section 507(a)(8)(G).

Notes:

If you are considering filing a collection due process appeal in response to a notice of intent to levy, **consider filing it late, but not more than one year after the date it was issued if bankruptcy is a possibility. Late filing by up to one year on a collection due process appeal still stops IRS collection action by their internal administrative rules but it should not extend the bankruptcy code timing rules as collection is stopped only administratively, not by law.** Your client will give up the right to go to Tax Court by filing late.

II. Chapter 7 Bankruptcy.

a. Background.

Chapter 7 is the most common form of bankruptcy. Debts are eliminated, but if there is any equity in assets, it will be lost. Chapter 7's are referred to as "liquidations" for this reason.

Most Chapter 7 cases are no asset/no equity cases, meaning nothing is lost but all debts are eliminated.

In addition to taxes, typical debts eliminated in a Chapter 7 are credit cards and medical bills. Some debts cannot be eliminated in a Chapter 7, like child support and student loans. **IRS debt is eliminated if it is eligible under the rules of Section I, above.**

The Chapter 7 filing fee is \$299.

A Chapter 7 can be filed once every eight years.

b. Information in Chapter 7 Bankruptcy Petition.

A Chapter 7 is started by the filing of a "petition" in US Bankruptcy Court. The petition will include:

- Itemization of all of your client's assets (with values)
- Listing of all the debts your client owes, including car and home loans
- Monthly household income

- Monthly household living expenses

c. Timeframe.

Most Chapter 7 bankruptcies take approximately 4-6 months to be completed.

The timeframe is as follows:

- Bankruptcy petition is filed
- Meeting of creditors is held 5-6 weeks later with bankruptcy trustee
- Approximately 60 days after the meeting of creditors, and provided no creditor objects to the bankruptcy on the basis of fraud, the bankruptcy court issues a discharge of the debts that are eligible to be eliminated

Notes:

Compare the timing of resolution by a Chapter 7 bankruptcy with an offer in compromise. Chapter 7 usually takes 4–6 months. Most offers take 6-12 months for initial investigation. If the initial investigation results in a recommendation to reject or a number your client disagrees with, an appeal can be filed. The appeal can take 6-12 months. If an agreement is ultimately reached, then payment of the offer can be made over as much as 24 months. That can be as much as 48 months for an offer to go through in certain circumstances. installment agreements⁷ to

d. Qualifications.

Chapter 7 cases are for clients who cannot afford to repay their debts. If a reasonable budget is taken, net cash flow after living expenses should be just about zero to qualify for a Chapter 7.

If there is cash flow to make repayments, the appropriate filing would be a Chapter 13.

There is no minimum or maximum amount of debt that must be owed to file a Chapter 7.

Individuals and businesses can both file for Chapter 7.

In most cases, a brief consultation must be completed with a certified credit counselor before filing for a Chapter 7.

e. **Automatic Stay.**

Upon the filing of a petition, bankruptcy law will impose an “automatic stay” on all collection activity against your client, including the filing of a levy or lien. This immediate hold on collection activity applies to virtually all activity by all creditors, including the IRS. The stay is in place until after the case is closed and discharge issued.

If there is an IRS levy or seizure pending, the bankruptcy will immediately cause it to be released without negotiation. Consider it absolute.

Notes:

1. Any creditor can request the bankruptcy court to grant it what is known as “Relief from the Automatic Stay.” This is usually used by banks to recover cars or houses that have payment arrearages and are being abandoned in the bankruptcy.
2. The IRS rarely pursues relief from stay.
3. The automatic stay does not apply to criminal proceedings, IRS audits, the issuance of a notice of deficiency (although it does stay Tax Court proceedings and the time to respond), demand for tax returns or the making of an assessment. Bankruptcy Code Section 362(b)(9).

f. **Reaffirmations – Keeping Property (Houses/Cars).**

Property that is secured by a debt will not be lost by your clients provided they are current on the monthly payments. This is usually cars and houses. This is called a reaffirmation. This agreement sets the clock back to before the bankruptcy was filed and restores your client and their bank to the prior status.

Your client should not lose a house or car provided they are current on the payments and the asset has no equity.

g. **Exemptions in Property.**

State and Federal laws provide for a fresh start after bankruptcy, meaning that your client’s property should be protected from creditors and the bankruptcy trustee. Bankruptcy law does not want your client to come out of bankruptcy homeless and without furniture.

Your client will keep all of his or her property after a Chapter 7 if there is no equity in the property after application of the exemption laws. This is usually the case.

Notes:

Typical bankruptcy exemptions would permit someone emerging from a Chapter 7 bankruptcy to keep all of their household goods, retirement plans, cash on hand and in a bank account up to \$800.00, up to \$1,000 of equity in a car, and up to \$5,000 of equity in a personal residence after deduction the fees and costs of sale (Ohio exemption law).

h. No Asset Cases.

Results in a Chapter 7 are best if your client has no equity in assets after application of state or federal exemptions, although that is not a qualification for filing.

If your client has a “no asset case,” then no property will be lost through the bankruptcy process. Most Chapter 7 bankruptcy cases involve no asset cases.

Notes:

1. A client has a “no asset” case when the value of his or her assets would result in no meaningful distribution to creditors, including the IRS. Asset value is arrived at after deducting bankruptcy exemptions that your client can claim in their property. Bankruptcy law allows most Chapter 7 filers to emerge from bankruptcy with all of their personal belongings.
2. In bankruptcy, equity is what is left over after deducting loans against property, less liquidation fees. **If your client has a car worth \$5,000, and has a loan against it for \$4,000, there would be equity, but it would be protected by the \$1,000 exemption provided by bankruptcy law, and the car would not be lost.**
3. **If a car is worth \$5,000 and the loan is \$5,000, there would be no equity and the car would not be lost. If there is no equity, then there is nothing to lose to creditors.**
4. **If a house is worth \$150,000 and has a \$140,000 loan against it, there would be no equity after application of an Ohio \$5,000 exemption and the costs of sale.** The house would be “abandoned” by the bankruptcy trustee and retained by your client.
5. In a “no asset” case, your client would keep everything and have the taxes eliminated if they are eligible.

i. **Asset Cases.**

“Asset” cases are those Chapter 7 filings in which there is equity in an asset after application of bankruptcy law exemptions.

If there is equity in an asset, then your client will be given a choice by a bankruptcy trustee of either:(1) negotiating a value to the equity, paying in that amount to the court and keeping the asset or (2) losing the asset and letting the bankruptcy court liquidate the asset. The bankruptcy court will disperse the equity to creditors by their priority under the bankruptcy code (IRS is usually a first priority).

Notes:

The value of the asset that could be lost should be compared to the value of the tax debt that would be eliminated in the Chapter 7. Eliminating a \$100,000 tax liability but paying in \$2,500 for the value of equity in a vehicle is still a pretty good deal.

j. **Tax Liens in a Chapter 7.**

Chapter 7 does not necessarily remove tax liens filed by the IRS. Chapter 7 eliminates tax debt, not tax liens.

If there is no lien filed by the IRS before the Chapter 7, the IRS has no post-bankruptcy rights to your client’s property.

The IRS cannot file any new tax liens after the tax has been discharged if the lien was not filed before the bankruptcy.

Release of the lien is discretionary by the IRS, although **no asset cases have strong arguments to have the lien released as it does not attach to after-acquired property if the taxes have been discharged.**

Notes:

The IRS will pursue a tax lien after a Chapter 7 discharge usually only on retirement plans. This is an asset that will not be lost to the bankruptcy trustee as it is exempt, but an IRS lien will attach to it and follow it after the bankruptcy. And retirement plans often have substantial funds in them. The IRS will have trouble reaching any funds post-

bankruptcy in a retirement account that your client cannot reach. See Internal Revenue Manual 5.11.6.2, Funds in Pension or Retirement Plans.

Many retirement plans do not give taxpayers present rights to the money, allowing access only at separation from service, retirement or death/disability. Review the terms of the plan – if your client is still employed, for example, and has no right to access the money, neither does the IRS.

k. Chapter 7 Case Study.

Your clients, Frank and Carole McDuff, owe the IRS income taxes for 2002 – 2005 from when Frank was a self-employed carpenter and Carole had insufficient withholding on early retirement plan distributions. A budget reveals that the McCourt's have minimal cash flow (after reasonable expenses) to consistently make monthly payments to repay the taxes.

The value of your client's property is small, with used desks, beds, tables, chairs, all of which is exempt from creditors and the bankruptcy court. Frank drives a 1996 Ford truck which he values at \$1,500 and Carole drives a 2002 Chevrolet, valued at \$5,500 with a \$5,000 loan. They rent an apartment. Your analysis reveals that there is no equity for IRS purposes, which usually translates into no equity for bankruptcy purposes.

The 2002 and 2003 returns were filed timely, but the 2004 and 2005 were filed late on April 15, 2008. The McDuff's are requesting your opinion on IRS solutions, and they are open to bankruptcy. You get IRS transcripts, and chart out the liabilities as follows:

<u>1040</u>	<u>Filed</u>	<u>Three years</u>	<u>Two Years</u>	<u>BK Eligibility</u>	<u>Tax Liens</u>
2002	4/15/03	4/15/06	4/15/05	4/15/05	Yes
2003	4/15/04	4/15/07	4/15/06	4/15/06	Yes
2004	4/15/08	4/15/08	4/15/10	4/15/10	No
2005	4/15/08	4/15/09	4/15/10	4/15/10	No

The McCourt's can file a Chapter 7 now and eliminate the 2002 and 2002 years, containing \$85,000, or wait until April 15, 2010 to file and eliminate the 2004 and 2005 as well (an additional (\$15,000)). You do a financial analysis of how your client would pay the 2004 -2005 back if you file the bankruptcy now.

1. What is the risk of collection action to wait longer and include more in the bankruptcy? How do you get them there? Is your client uncollectible? Installment agreement while they wait two years at what cost?

2. Does the lien have any real impact on your clients? Or do they just want relief from collections?

3. Is your client willing to take on the risk of IRS levy and do nothing to eliminate \$15,000 additional in taxes? They have not heard from the IRS in years.
4. What if your client had no loan against the Chevrolet and \$5,500 of equity?
5. Is an offer in compromise a better approach? Why or why not?

III. Chapter 13 Bankruptcy.

a. Background.

Chapter 13 is a repayment plan for individuals who have cash flow to permit some recovery to the IRS on their tax liabilities. No assets are lost in a Chapter 13. Your client will “buyback” equity in any assets with his or her monthly payments. Chapter 13 payment plans last between 36 and 60 months.

Chapter 13 also provides a mechanism for individuals to prevent foreclosures and repossessions. Arrearages on cars and houses can be repaid in a Chapter 13 so that the property is not lost to a creditor.

An important aspect to a Chapter 13 is that the amount repaid to the IRS can range from 1% to 100% of what is owed. The lowering of the amount actually repaid to creditors is commonly referred to as a “cramdown.”

In addition to taxes, debts like credit cards and medical bills can be repaid at substantially lower rates than what is actually owed. **Interest also stops running on most IRS claims, something that is nearly impossible to obtain directly with the IRS. Penalties also stop accruing after a Chapter 13 is filed.**

The amount repaid to the IRS in a Chapter 13 depends on how much your client can afford to repay and the classification of the taxes under bankruptcy law.

The Chapter 13 filing fee is \$279.

b. Timeframe.

A Chapter 13 bankruptcy will take between 36 and 60 months to complete,
depending on how much your client can pay and the amount of their monthly income.

The timeframe entails the filing of the bankruptcy petition, a meeting of creditors 4-6 weeks later, then confirmation by the court of the plan of repayment.

Notes:

Compare the timing of resolution by a Chapter 13 bankruptcy with an installment agreement. Many installment agreements go on forever, never paying anymore than continually accruing interest and penalties. Chapter 13 cases take 36-60 months. Comparison can be favorable to an offer in compromise as well. Most offers take 6-12 months for initial investigation. If the initial investigation results in a recommendation to reject or a number your client disagrees with, an appeal can be filed. The appeal can take 6-12 months. If an agreement is ultimately reached, then payment of the offer can be made over as much as 24 months. That can be as much as 48 months for an offer to go through in certain circumstances. installment agreements⁷ to

c. Qualifications.

Chapter 13 cases are for clients who can afford to repay their debts and have some cash flow to make monthly payments back on the debt.

There are debt limits to qualify for a Chapter 13. The secured debt cannot exceed \$922,975 and the unsecured debt cannot be more than \$307,675.

Individuals can file for Chapter 13, but corporations cannot.

A brief consultation must be completed with a certified credit counselor before filing for a Chapter 13.

d. Automatic Stay.

The automatic stay in a Chapter 13 works in the same manner as in a Chapter 7.

e. **Retaining Assets in a Chapter 13.**

All assets are kept in a Chapter 13 regardless of the amount of equity. The value of the equity simply needs to be repaid through the monthly payments to the bankruptcy trustee.

f. **Tax Liens in a Chapter 13.**

Since the value of a tax lien is repaid in a chapter 13, it will be released upon completion of the case. Tax liens can still be enforced by the IRS on property that is not part of the bankruptcy estate, primarily retirement plans.

g. **IRS Repayment in a Chapter 13 – Secured Claims.**

The value of any tax liens that the IRS has filed before commencement of the case must be repaid at 100%, plus continually accruing interest while the Chapter 13 is pending. This rule operates regardless of what type of tax is involved or how old the taxes are. This is referred to as a “secured claim.”

A claim is secured if the IRS has files a tax lien before your client files bankruptcy. The value of your client’s property that is subject to the lien must be repaid.¹ Your client must have enough cash flow to at least pay the value of the tax lien back to the IRS during the course of the Chapter 13.

Practice Example:

Your client, Sam Baker, files a Chapter 13. The IRS filed a tax lien before the bankruptcy was commenced. You review Sam’s assets, and determine that he has \$1,500 of household goods, a car with no equity, a house with no equity and \$400 of cash in the bank. Sam’s repayment on the tax lien in the Chapter 13 must total at least \$1,900 (\$1,500 + \$400), the value of his property subject to the lien.

If Sam’s house had \$2,500 of equity, then the amount that would have to be repaid would be \$4,400 (\$1,500 + \$400 + \$2,500). This is the minimum that would need to be paid from the value of property to satisfy the IRS tax lien. **If this is paid, when the Chapter 13 is completed, the lien will be released.**

Notes:

The IRS does not include the value of retirement plans in their calculations of lien values as a retirement plan is not considered an asset of the bankruptcy court and is therefore not subject to the lien in bankruptcy. The IRS will, however, consider the lien in force as the retirement plan after the bankruptcy if the value is not paid in the Chapter 13.

h. IRS Repayment in a Chapter 13 – Unsecured Claims.

There is also an unsecured part to most tax liens. The unsecured part is the amount of the taxes, interest and penalties owed on the lien that are in excess of the value of your client's property.

Practice Example:

For your client Sam Baker, assume he owed the IRS \$85,000, all of which is subject to a lien filed before the bankruptcy. The value of his property is \$4,400. The IRS secured claim is \$4,400 and the unsecured claim is \$81,600 (\$85,000 - \$4,400). Sam will have to pay back the \$4,400 secured part of the tax lien in the Chapter 13 with continually accruing interest. **The rest of the tax lien, the unsecured part, is then repaid either as an unsecured priority claim or is subject to cramdown as an unsecured general claim.**

i. IRS Repayment in a Chapter 13 – Unsecured Priority Claims.

Unsecured priority claims are (1) unsecured income taxes and non-trust fund taxes (i.e. Form 940) that are not yet old enough under the timing rules and (2) the unsecured trust fund portion of employment taxes and sales taxes. The tax and interest on these claims (up to the date of filing) is repaid 100%.

These “newer” income tax and non-trust fund tax claims must be fully repaid in a Chapter 13. They might be unsecured, but bankruptcy law treats them as a priority for repayment. The trust fund taxes are of such a nature that they will always be repaid at 100% in a Chapter 13.

Notes:

1. The penalties on unsecured priority claims have a lower classification. They are classified as unsecured general claims. They can be repaid much less than 100% as a cramdown. What is paid at 100% on priority claims is tax and interest up to the date of filing.
2. No interest runs on most priority claims while they are being paid in a Chapter 13.

j. IRS Repayment in a Chapter 13 - General Unsecured Claims.

Unsecured general claims are repaid with whatever cash flow your client has left after paying the secured part of a tax lien and the unsecured priority claims.

This is referred to as a “cramdown.”

Unsecured general claims are basically everything that is left: (1) unsecured income tax and non-trust fund claims that are “older” under the timing rules and (2) penalties on the unsecured priority claims.

No additional interest or penalties will accrue on most general unsecured claims during the bankruptcy.

The interest and penalties that already accrued before the bankruptcy was filed is subject to cramdown.

k. Summary Chart of IRS Claims in a Chapter 13.

Secured Claims: The value of your client’s property subject to an IRS lien. The value of the property is repaid at 100%. Interest is paid on the value of the collateral subject to the lien plus interest.

Unsecured Priority Claims: These are all unsecured claims, meaning there either is no tax lien or the amount owed under a tax lien is more than the value of your client’s property. Claims repaid at 100% are “newer” income taxes and non-trust fund taxes and any trust fund tax regardless of age. The 100% repayment applies to tax and interest accrued up to the date of the bankruptcy. Penalties on unsecured priority claims are paid as unsecured general claims.

Unsecured General Claims: “Older” income tax claims and non-trust fund taxes that are unsecured. Repayment rate is with remaining cash flow left after paying secured and unsecured priority claims (:cramdown”). Cramdown applies to tax, interest and penalties on these claims. There is also a cramdown on the penalties on unsecured priority claims.

I. Chapter 13 Case Studies.

Case Study #1

Your new client, Michael Florian, has consulted you for guidance in resolving his unpaid taxes. Mr. Florian is an over-the-road truck driver, earning on average \$55,000 per year. He is single with no dependents. When he first got into the trucking business in 2002, he was poorly advised and did not make his estimated tax payments for 2002, 2003 and 2004. In 2002, he took a large distribution from his retirement account to fund the start-up and did not have enough taxes withheld. He also got into some credit card debt during the start-up phase, and owes \$25,000 on a variety of credit cards. He also and has \$5,000 of unpaid medical bills that has accumulated.

You review his assets. He has a 1999 Freightliner worth \$9,000 that he owns free and clear. He also owns a house, which is valued at \$135,000. He has a bank loan on the house and owes \$134,000 on it. His other household goods are valued at \$1,952, for a total value of personal property of \$11,952.

His business is profitable now, and a review of his budget reveals \$550 extra money left over each month after all his expenses are paid. But that is not enough to satisfy the demands of the IRS and credit card companies simultaneously. In a Chapter 13, he would then be able to pay \$33,000 to all creditors over a 60 month plan. The total debt is \$124,355 (\$94,355 IRS claim, \$25,000 credit cards and \$5,000 medical bills).

He is now current on his taxes, but would like to put early mistakes behind him. You contact the IRS and find that the 2002 the taxes are “older,” but the 2003 and 2004 are not (all were filed on time). A tax lien is filed on the 2002 taxes.

	<u>Tax</u>	<u>Penalty</u>	<u>Interest</u>	<u>Total</u>
2002	\$ 51,534	\$15,769	\$ 9,367	\$76,670
2003	\$ 7,062	\$ 1,471	\$ 907	\$ 9,440
2004	<u>\$ 6,545</u>	<u>\$ 1,204</u>	<u>\$ 496</u>	<u>\$ 8,245</u>
	\$ 65,141	\$18,444	\$10,770	\$94,355

1. Where did the unsecured part of the tax lien filed on the 2002 taxes go on the IRS proof of claim? What if 2003/2004 had liens?
2. What claims have to be repaid at 100%?
3. Where will the credit cards/medical bills be classified and paid?
4. How much of a discount did your client get on his taxes, credit cards and medical bills?

Case Study #2

Your clients, Tom and Betsy Thomas, have a long history of IRS problems from Tom's self-employment income. Tom is a mechanic, and Betsy is a clerk at Wal-Mart. You get IRS transcripts, and find out they owe this:

	<u>Tax</u>	<u>Penalty</u>	<u>Interest</u>	<u>Total</u>
1997	\$ 5,795	\$ 8,125	\$10,042	\$ 23,962
1998	\$ 24,783	\$ 7,423	\$12,929	\$ 45,135
1999	\$ 16,826	\$ 6,584	\$ 6,796	\$ 30,206
2000	\$ 15,905	\$ 5,903	\$ 4,540	\$ 26,348
2001	\$ 17,509	\$ 6,005	\$ 3,467	\$ 26,981
2002	\$ 13,112	\$ 2,321	\$ 1,724	\$ 17,157
2003	\$ 8,059	\$ 2,027	\$ 657	\$ 10,743
2004	\$ 7,977	\$ 1,750	\$ 248	\$ 9,975
	\$109,966	\$40,138	\$40,403	\$190,507

You review of their cash flow reveals that they can afford \$750 per month to the IRS in an installment agreement. That, of course, would not even cover interest accruals and gets your clients nowhere. You inventory their assets and arrive at a value of \$6,500, consisting of a little equity in a work vehicle and household goods.

Your analysis of the IRS transcripts reveals that the 1997-2001 income taxes are all "older," while the 2002-2004 are not. All returns were filed on time. No tax liens have been filed despite the high balances owed. They can pay in \$750 per month over a five year Chapter 13 for a total of \$45,000.

1. What will the classification of the IRS claims be in a Chapter 13?
2. What discounts will your client get on interest and penalties?
3. What if the IRS had tax liens for all years owed that encumbered the \$6,500 value of your clients' assets?
4. What if the 1997 and 1998 taxes were for trust fund employment taxes rather than income taxes?
5. What would the result be if your clients had no cash flow and could file a Chapter 7?
6. How does this compare with an offer in compromise?

IV. IRS Collection Problems That are Best Resolved by Bankruptcy.

Here is a laundry list of some of the most common situations to look for where bankruptcy could make a difference for your client:

a. Alternative to installment agreements.

If you are considering an installment agreement for your client, consider the overall cost to the client of the agreement, and compare it making payments to the IRS through a Chapter 13 bankruptcy. Many installment agreements will never pay off an IRS liability, and all include continually running interest and penalties.

A Chapter 13 stops interest on unsecured claims and penalty accruals. What your client pays is what your client owes as of a date certain (the bankruptcy filing date). **A Chapter 13 can also shorten the repayment schedule of an IRS installment agreement by virtue of the bankruptcy cramdown provisions. The rate of repayment to the IRS in an installment agreement is 100%. It can be significantly less in a Chapter 13, as low as 5% or less.**

Additionally, a Chapter 13 can be used to force the IRS into a repayment plan that they otherwise refuse to give. If your client wants to pay \$350 monthly, but the IRS wants \$1,000, a Chapter 13 could resolve the dispute by taking a bankruptcy view of cash flow (along with the other benefits on interest and penalty accruals and cramdowns).

b. Alternative to penalty abatement.

Penalty abatement requests with the IRS are very subjective, with the “IRS reviewing the IRS” to determine if there is cause to abate an already assessed penalty. A penalty abatement request is made with the intent to then repay a lower amount (without the penalties) to the IRS. But keep in mind that a **Chapter 13 bankruptcy can reduce and cramdown older unsecured penalty claims to a low rate of recovery. And Chapter 7 bankruptcies can eliminate penalties in full, along with tax and interest.**

c. **Release IRS seizures or levy action.**

Bankruptcy stops the IRS. **The instant a Chapter 7 or Chapter 13 bankruptcy is filed, the IRS is barred from taking any collection against your client.** If the IRS has issued a wage levy, bank levy or seizure of real or personal property, it must be released once the bankruptcy is filed. There should be no negotiation to obtain the release once bankruptcy is filed. It is absolute.

d. **Intervention when the IRS is perceived as being unreasonable to your client.**

If you have a Revenue Officer and don't see eye-to-eye, or if Automated Collection Service is running your client around, bankruptcy can bring impartiality to the process. **IRS procedure defers to bankruptcy law, and claims that you are unable to negotiate with the IRS can be eliminated in a Chapter 7 or repaid in a Chapter 13.** You will also change the parties, as Revenue Officers and ACS employees usually do not handle bankruptcies on behalf of the IRS. Instead you will get the IRS Insolvency Unit and IRS District Counsel.

e. **Leverage in an offer in compromise.**

The Internal Revenue Manual, at Section 5.8.5.5, permits the IRS to consider the impact of a potential bankruptcy on the settlement of an offer in compromise. In other words, if a bankruptcy is a real option, and could eliminate everything that is owed to the IRS, but your client wants to avoid it if possible, tell the IRS that your client is considering bankruptcy, and show them what they would get if a bankruptcy was filed. If you are considering a Chapter 7, the IRM instructs the offer investigator to consider reducing the value of future income to reflect that a bankruptcy could eliminate the liability. The intangible value of avoiding the bankruptcy would be considered by the IRS as a cost of the compromise.

f. To simultaneously resolve both a tax problem and a credit card problem.

Clients with tax problems often have other financial problems, whether it is credit cards, medical bills, or unpaid bills from a business. **A Chapter 7 bankruptcy can eliminate all of these debts.** Your client may be making payments on the credit cards, and has no cash left over for the IRS. But the IRS wants the money your client is sending to credit cards. There isn't enough to satisfy everyone, and not enough to pay everyone off. **A Chapter 13 payment reorganizes this quagmire, and forces both the IRS and other creditors to split up the pot according to bankruptcy law and what your client can afford to pay.**

g. Alternative to an offer in compromise.

Consider that the IRS accepted 26% of compromises submitted in fiscal year ended 2007, and recent offer processing revisions that require nonrefundable down payments to be made as part of an offer submission, and bankruptcy becomes a viable alternative.

Also consider how long a bankruptcy takes, and how long an offer in compromise can take. A Chapter 7 bankruptcy takes 4-6 months, and a Chapter 13 takes 36-60 months. **Unlike offers, the outcomes and cost of a Chapter 7 and Chapter 13 should be predetermined before the bankruptcy is filed by quantifiable analysis.**

Depending on where the offer is worked, and the volume of IRS caseload, an offer in compromise can take 6-12 months to be investigated. If the investigation results in a rejection of the offer, an appeal can take another 6-12 months. If a settlement is ultimately reached, your client will be permitted up to 24 months to pay in the value to complete the compromise. And then your client must stay current on all taxes and filings for 60 months thereafter.

h. Stopping the accrual of interest and penalties.

A Chapter 7 eliminates interest and penalties along with the underlying tax liability. A Chapter 13 can stop the accrual of interest and penalties while repayment is made. This, alone, can result in significant savings.

i. Quick and efficient end to tax problem without negotiation.

Bankruptcy law governs if the taxes are eliminated, not IRS personalities or procedures. A Chapter 7 can end a tax problem within 4-6 months without any repayment. A Chapter 13 takes a little longer because payments are made to settle the liability, but it has benefits of cramdown, retaining equity in property and stopping interest and penalties.

j. Cramdown tax liabilities to lower rate of recovery.

A Chapter 7 is really a total cramdown – everything is eliminated if the taxes qualify for a bankruptcy discharge. **A Chapter 13 can change the rate of recovery by the IRS to 5% or lower by monthly repayment, depending on cash flow availability and the classification of the taxes.**

Bankruptcy can offer your clients alternatives and advantages in resolving IRS claims. It should be on every practitioner's list of potential remedies to discuss when that new client comes in the door. Understanding bankruptcy is not always easy, but it can be very rewarding for you and your client. It may not always be a client's first choice, but it is a choice, and a powerful one at that.
