Six Tax Tips for Bankruptcy Practitioners

By Daniel P. Marsh and Neal Nusholtz

The world of the Internal Revenue Service (IRS) can be divided by a moment in time called an assessment.[1] After a tax is assessed the taxpayer can be sent a notice of demand for payment. Ten days thereafter, the IRS has the authority to seize all property belonging to a taxpayer.[2]

A tax can be assessed in a number of ways. The two most common are a filed tax return and a Statutory Notice of Deficiency.[3] Generally, the IRS has a limited period of time to send the taxpayer a Statutory Notice of Deficiency.[4] If the taxpayer does not answer the notice within 90 days, the taxpayer owes a tax.[5]

From the standpoint of whether the taxpayer owes or does not owe money, an assessment is like the goal line on a football field. Football players can argue all they want, the only thing that matters is whether they cross the goal line. Once the client crosses the line of an assessment, regardless of any of your arguments to the contrary, the client owes tax and is subject to the administrative power of the Internal Revenue Service to collect. Before the client crosses that line, regardless of potential liability, the client owes nothing. Whether taxes are dischargeable or not in bankruptcy can often depend on when they were assessed.

Tip No. 1: Obtain Transcripts from the IRS

A simple way to tell if there is an assessment is to see a bill from the IRS. Do not rely on the client to know whether or when there has been an assessment; obtain transcripts from the IRS to verify the debtor's tax information. The transcripts are broken down year by year, and the information is necessary for resolution of tax issues in a bankruptcy analysis.

Before meeting with the client, have the client call 1-800-829-1040 to request transcripts. Have the client choose option 2 for the first two choices after selecting the language and follow the prompts. Have the client request transcripts for the previous ten years' income tax returns. The return transcript will confirm the returns that have been filed. Returns filed within the last 6-8 weeks may not show up on a transcript. Tax Return Transcripts have most of the line items from the tax return and not reflect changes after the return is processed. A return transcript is only available for the current year and three prior years.

Tax Account Transcripts reflect changes made to the original return such as amendments and adjustments. Account Transcripts provide the following information:

- Amount of estimated payments
- Penalty paid/assessed
- Interest paid/assessed
- Interest paid to the taxpayer by the Service
- Balance due with accruals

Records of Account Transcripts are available for the current processing year and the three prior years.

The Account Transcript shows more details than a return transcript but will not reflect changes and installment agreement payments. (The Record of Account provides the detail necessary to determine classification and dischargeability of certain taxes.)

If the client arrives in the office without information about assessments, one can call the IRS during the initial interview, but transcripts requested over the phone may only be available for the previous five years while the remaining five years may be archived. In that case, be prepared to fill out a Form 4506-T (with a charge of $39.00 for each year, the form is available at www.irs.gov). The Form requires one to select the years and type of transcript wanted. It allows the transcripts to be sent to a third party or to the taxpayer. Transcripts that are not archived can be received by fax in a few minutes while on the phone with the IRS. The IRS employee on the phone will most likely request that the taxpayer stand by the fax machine while the fax is transmitted due to concerns about privacy and identify theft. Transcripts that are ordered with a 4506-T will be sent to the debtor's home or the address listed on the form; this probably should be your office.

If you or the client are uncomfortable having the client receive the transcripts, or the

transcripts are either too old or too lengthy to be faxed while you wait, transcripts may be obtained with an IRS Form 2848, Power of Attorney, signed by the taxpayer providing the attorney with the power to obtain the documents.[6] When filling out the form, be sure to fill in the box at Section 3 identified as "Tax matters" and at the caption "Year(s) or Period(s)" as ten years (for example 1996 through 2006). Where the form requests "Tax Form Number," fill in "transcripts for the years identified concerning the Account, Return and Income." Where the form requests "Tax years," insert "beginning 1996 through 2006."

Transcripts may also be obtained through a return preparer who qualifies for e-services (typically, a return preparer who files electronically with an Electronic Filing Number who has been registered for E-filing service). A return preparer will need a signed Power of Attorney (POA), the client's name, address, the period (including fiscal years), the adjusted gross income on the tax return for the most current year or for one prior year, and the individual client's date of birth (where applicable). Additionally, if an IRS lien is involved, the lien will also show dates of assessment.

The IRS will not provide information under a POA unless the attorney has a Centralized Authorization File number or "CAF number" on file with the IRS. (The attorney should obtain a CAF number if continued contact with the IRS is contemplated or necessary.) Attorneys may obtain tax information by calling the IRS Practitioners Hotline at 1-866-860-4259 and press prompt 4 ("transcripts request"). Over the phone, the debtor will need to verify their account and that the attorney is acting on their behalf. The IRS employee on the phone will ask if there is a signed Form 2848 available and, if so, to fax it while on the phone (in Michigan the fax is 901-546-4115). It may take 24-48 hours for the IRS to fax the transcripts and 7-15 days if mailed. When speaking with an IRS employee while making your request, it is also a good opportunity to inquire how a CAF number is obtained.

Tip No. 2: Determine What Type of Taxes Are Owed

Any unassessed tax that is no longer assessable by law or agreement is dischargeable.[7] The following taxes are not dischargeable in Chapter 7 or Chapter 11 Bankruptcy:[8]

1. Trust fund taxes owed to the IRS[9]
2. Employment Taxes[10]
3. Excise Taxes[11]
4. Unpaid Custom Duties[12]
5. Any tax, interest, assessments, and penalties that may be owed to the IRS--the so-called "catchall provision."[13]
6. Tax stated on returns found to be fraudulent and also where the taxpayer willfully attempted to evade the tax.[14]
7. Income taxes not assessed before the petition date but still permitted to be assessed.
8. Taxes filed by the IRS on the taxpayer's behalf (SFR on the IRS transcript)

The dischargeability of taxes from filed returns after the government has filed substitute returns is problematic and requires research and analysis.[15]

Tip No. 3: Determine the Time Requirements for Dischargeable Taxes

Review the IRS tax transcripts and determine the following four dates:

1. the taxpayer's return due date in the year of the delinquent tax;
2. the date the taxpayer's return was actually filed;
3. the date the IRS assessed the tax at issue; and
4. the number of days from those dates to the bankruptcy case filing date.

These dates assist in determining whether an income tax liability may be discharged in bankruptcy. Generally, income taxes are dischargeable for returns due more than three years prior to the filing date of the petition, on assessments from returns that have been filed at least two years before the petition filing data, and on assessments that are least 240 days old.[16] These periods do not count when there is a stay of collection in a prior bankruptcy (plus 90 days after the stay has ended) or when there is an Offer in Compromise (plus 30 days after the offer of compromise has been rejected).[17]

Certain events will "toll" or stop the running of the dischargeability periods. Some of those tolling events are as follows:

The IRS will not provide information under a POA unless the attorney has a Centralized Authorization File number or "CAF number" on file with the IRS.

1. An Offer in Compromise will toll the running of the 240-day assessment period if the Offer was made during the running of that 240-day period. The tolling will be for the period the Offer was pending plus 30 days after it is rejected).[18]

2. A prior bankruptcy tolls the running of both the three-year period and the 240-day assessment period for duration of the bankruptcy period in effect, plus 90 days after the bankruptcy is concluded.[19]

3. The three-year period is suspended if the debtor files an application for a taxpayer's assistance order.[20]

4. The three-year period is suspended if the debtor makes a request for a due process hearing regarding a levy action.[21]

5. The three-year period is suspended during pendency of an Offer in Compromise.[22]

Once these timing periods expire a "priority tax" that is not dischargeable under the bankruptcy statute becomes a dischargeable "non-priority tax."

If the bankruptcy estate does not have enough assets to pay the tax liability, the debtor's tax liability will be collected from the debtor.

Tip No. 4: Determine if IRC 1398 "Short Year" Election Is Appropriate

In General

Sometimes, a taxpayer will gain a benefit in bankruptcy from filing a "short year" tax return to divide pre-petition and post-petition tax liabilities. When a taxpayer files a return for a period ending on a day other than the very end of the calendar year (or their fiscal year), he or she should consider using a "short year."

The "short year" election must be examined for its impact on tax liability and with reference to assets that tax liability will be paid from. Under IRC 1398, an individual may elect to split the tax year in which the bankruptcy petition is filed into two short tax years of less than twelve months.[23] The first "short year" begins on January 1 (assuming a normal calendar year taxpayer) and ends the day before the petition is filed. The second such year begins on the date the petition is filed, called the "commencement date" (the commencement date is defined as the day on which the bankruptcy case begins),[24] and ends on December 31 of that year. Once the election is made, the debtor's federal income tax liability for the first short taxable year becomes an allowable claim against the bankruptcy estate as a claim arising before the bankruptcy filing.

The election determines the sources from which the tax liability will be initially collected. The tax liability for that first short taxable year is a pre-bankruptcy tax liability and is considered a claim arising before the bankruptcy filing and thus collectible from the bankruptcy estate. If the bankruptcy estate does not have enough assets to pay the tax liability, the debtor's tax liability will be collected from the debtor.[25] All post-petition tax liabilities will be collected from the debtor. In the event there are no available funds left in the bankruptcy estate after taxes are paid, debts to creditors with lower priority may be discharged without any payment. If an election is not made, creditors whose debts would have been discharged without any payment may receive distributions, while the remaining tax liability will become a personal liability of the debtor.

If the election is not made, the debtor's taxable year is not affected by filing the bankruptcy petition. Instead, any tax liability for the year in which a petition was filed will be treated as if it was due after December 31 of the year.[26] This means that in the year of filing the bankruptcy petition, all the taxes are treated as post-petition, and thus, no part of the debtor's tax liability is collectible from the bankruptcy estate. A debtor's own tax liability would be collectible directly from the debtor.[27]

Regardless of whether or not an election is made, if the estate cannot pay the tax, it becomes collectible from the individual debtor after the bankruptcy proceeding concludes.[28] In such a case, the tax liability is looming for the debtor after emerging from bankruptcy and to a great extent can undermine a fresh start.

The "short year" election is not for everyone,[29] and the decision to make such an election must be looked at carefully. The key is understanding how the bankruptcy estate succeeds, or transfers, to the debtor his or her tax attributes as of the first day of the debtor's taxable year in which the bankruptcy case is commenced.[30] This transfer is not considered a sale or exchange.[31]

An example of a tax attribute affected by the IRC 1398 election would be net operating losses (NOLs). NOLs are unused business

losses. They carry over from year to year and can be used to reduce taxable income in the years to which they are carried. If the IRC 1398 election is made, and the debtor has net operating loss (NOL) carryovers from prior years, the debtor can use them against income from the short tax year before the bankruptcy filing to reduce the taxes for the short year. If the election is not made, the NOL carries over to the bankruptcy estate on the day of the filing, and the debtor cannot use the NOL against income for the tax year during which the petition was filed. If the election is not made, a pre-bankruptcy NOL will be used against income of the bankruptcy estate. Tax attributes can be complex and, whether an IRC 1398 election is beneficial will not be immediately obvious, especially if business records are not up to date in the middle of the year.

Under IRC 1398(d)(2)(D), a debtor's election to close the taxable year must be made on or before the due date for filing the return for the short taxable year ending on the day before the commencement of the case and is irrevocable. There is no provision for extending the time for making the election. The regulations provide that the election is made by filing a return for the short taxable year ending on the day before the commencement date on or before the fifteenth day of the fourth full month following the end of that first short taxable year.[32]

Upon termination of the bankruptcy estate, any of the tax attributes that the estate received from the debtor that were not used by the estate go back to the debtor.[33] Any NOLs to which the debtor succeeds from the bankruptcy estate are reduced by the amount of discharged debt that was excluded from the debtor's income.[34] Analyzing this requires projecting income for the full calendar year when it may not be predictable and may involve returns that are open and subject to audit though an audit has not yet taken place, making it difficult to determine the amount of nondischargeable tax liabilities.

S Corporation or Partnership Considerations

If your client is an S corporation shareholder or conducts business in partnership form, then consider filing a petition after the close of the S corporation's or partnership's tax year. As indicated above, under IRC 1398, the estate succeeds to all legal and equitable interests and certain tax attributes of the debtor. This is because the filing of a petition is not considered a transfer under IRC 1398(f):

> A transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for purposes of any provision assigning tax consequences to a disposition, and the estate shall be treated as the debtor would be treated with respect to such asset.[35]

Income or losses of S corporations and partnerships are determined as of the last day of the corporation's or the partnership's taxable year (specifically, losses do not flow though to the member or shareholder until the end of the taxable year). An IRC 1398 election would cause the client, who is a partner or shareholder of a subchapter S corporation, to forfeit those losses on his or her personal return. Therefore, if the transfer of assets from the debtor to the bankruptcy estate took place before the end of the taxable year, the bankruptcy estate succeeds to those shares of an S corporation's or partnership's interests for the entire year. Accordingly, the bankruptcy estate is entitled to the entire loss generated by the partnership or S corporation during the year the petition was filed.

This is important if the S corporation or partnership has sustained losses during the year the petition for bankruptcy is filed. If the partner or S corporation shareholder filed for bankruptcy during the taxable year, those losses would pass through to the bankruptcy estate and cannot be used to claim corporate or partnership losses on personal returns. However, if the partner or S corporation shareholder filed for bankruptcy at the end of the S corporation or partnership's tax year, those corporate or partnership losses can be claimed on personal tax returns. If a petition is filed before the last day of the corporation's taxable year, the corporation's losses flow through to the estate. If a petition is filed on the day of the corporation's taxable year, the corporation's losses can be claimed on the personal tax return.

In the 2004 case, *Williams v Comm'r*,[36] the court held that when a debtor declared bankruptcy near the end of his tax year, 100 percent of the losses (several million dollars of NOLs) from the wholly owned S Corporation were transferred to the debtor's bankruptcy estate under IRC 1398. A pro rata allocation of each item of an S corporation's income or loss based on ownership percentages under

Upon termination of the bankruptcy estate, any of the tax attributes that the estate received from the debtor that were not used by the estate go back to the debtor.

IRC 1377(a)(1) that would allocate income and losses between the individual and the bankruptcy estate was not allowed. The tax court held that bankruptcy rules take precedence over the rules that otherwise apply for allocating losses of S corporations, and that IRC 1398 trumps IRC 1377.[37]

As a side note, beware that there are negative tax consequences of an S Corporation filing bankruptcy that do not accrue to a shareholder filing bankruptcy. One of the ways this can happen is when there will be post-petition income to the S Corporation while it is in bankruptcy. The S Corporation shareholders will not actually receive the income but will be required to report the gain on their return and pay the resulting tax obligation.[38] If the debtor were a C Corporation, the tax would be an obligation of the estate.[39]

If your client is a calendar year individual S Corporation shareholder and his or her wholly owned S corporation has losses, you should consider whether the shareholder should declare bankruptcy in January of the next year, the entity should declare bankruptcy at the close of the S corporation's tax year, or consider ways to terminate a Subchapter S election prior to a bankruptcy petition filing by the corporation.

The request for prompt determination should be made by the trustee before the bankruptcy proceeding ends.

Tip No. 5: The Trustee Should Consider Expedited Review of the Tax Return

During the administration of a bankruptcy estate, the bankruptcy trustee must file tax returns for the estate and the bankruptcy estate must pay the tax owed.[40] Typically, the government has three years to audit a return (6 years if more than 25 percent of gross income is underreported and forever if fraud is involved). This can create a problem for a bankruptcy estate because a tax debt from an audit could occur after the bankruptcy estate has been closed and not discharged. The bankruptcy trustee may request the IRS to determine unpaid tax liability of the estate for any tax incurred during the administration of the case. 11 USC 505(b)(2). This request is called "prompt determination" and is made by submitting a tax return for the tax and a request for prompt determination in accordance with the steps in Rev. Proc. 2006-24 and IRB 2006-22.[41]

To request a prompt determination of any unpaid tax liability, the bankruptcy trustee must file a signed written request, in duplicate, with the Centralized Insolvency Operation, PO Box 21126, Philadelphia, PA 19114 and marked, "Request for Prompt Determination." To be effective, the request must be filed with an exact copy of the return (or returns) for a completed taxable period filed by the trustee with the IRS and must contain the following information:

(1) a statement indicating that it is a request for prompt determination of tax liability, specifying the return type and tax period for each return for which the request is being filed;

(2) the name and location of the office where the original return was filed;

(3) the name of the debtor;

(4) the debtor's Social Security number, taxpayer identification number (TIN), or entity identification number (EIN);

(5) the type of bankruptcy estate;

(6) the bankruptcy case number; and

(7) the court where the bankruptcy is pending.

A request will be considered incomplete and returned to the trustee if it is filed with a copy of a document that does not qualify as a valid return. A return must be signed under penalties of perjury to qualify as a return. A document with the jurat stricken, deleted, or modified will not qualify.

The amount of the tax to be paid after an appropriate request is made is (1) the tax shown on the return, unless within 60 days after the request the IRS has provided notice that the return has been selected for examination or within 180 days after the request (or any additional time permitted by the bankruptcy court) the IRS has notified the trustee of any tax due; or (2) payment of the tax as finally determined by the bankruptcy court after the completion of the IRS examination. Unless the return is fraudulent or contains a material misrepresentation, the trustee, the debtor, and any successor to the debtor will be discharged from liability once there is payment of the tax.

The request for prompt determination should be made by the trustee before the bankruptcy proceeding ends. This will facilitate an early closing of the bankruptcy estate. Also, a prompt determination of tax liability will establish those tax liabilities that can be paid from the bankruptcy estate while there are still funds in the bankruptcy estate. In the event there are no available funds left in the bankruptcy estate after taxes are paid, debts to creditors with lower priority may be discharged without any payment. If a request

for prompt determination is not made and the tax liability is not paid out of the bankruptcy estate, those same creditors may receive distributions, while the remaining tax liability is now a personal liability of the debtor.

Tip No. 6: Consider an Offer in Compromise

The Internal Revenue Code provides that taxpayers may compromise any tax obligation by submitting an Offer in Compromise (OIC).[42] Only the IRS may process an OIC and only under the established regulations, rules, guidelines, and revenue procedures.[43] IRS policy is that OIC applications from taxpayers currently in bankruptcy are nonprocessable.[44]

The policy reflects the IRS' conclusion that processing OIC of taxpayers in bankruptcy is not in the government's best interest.[45] The OIC process permits the IRS to exercise its discretion to accept different treatment of priority claims than is provided for by the Bankruptcy Code. Under the Bankruptcy Code, a plan cannot be confirmed unless it provides for the full payment of priority tax claims, or the IRS agrees to different treatment. The Chief Counsel Notice (CC-2004-25) specifies factors that may be considered in determining whether it is in the government's best interest to accept less favorable treatment than is statutorily required under the Bankruptcy Code.[46]

The debtor taxpayer has a greater possibility to pay less under the OIC procedures than in the bankruptcy process and should consider OIC before filing for bankruptcy. If the debtor files a bankruptcy petition, the IRS will exercise its discretion and bow to the bankruptcy authority for reasonable collection potential as opposed to the OIC procedure and will concede to the bankruptcy forum chosen by the taxpayer.

Offers are accepted based on an ability to pay. Below is a table that illustrates submitted offers, rejection rates, percentages of tax liabilities compromised, and appeals for the years 2000-2005. The percentage of total tax liability accepted in compromise has increased from 12% in 2000 to 16% in 2005, indicating a growing possibility to compromise tax liability using OIC procedures.

Fiscal year	2000	2001	2002	2003	2004	2005
Offers received	109,818	118,893	122,405	126,466	103,106	73,301
Offers accepted*	31,609	37,071	27,692	18,340	14,636	14,526
End of year inventory	88,982	92,324	68,187	54,326	35,882	18,500
Amount of delinquent tax liability (in billions)	$2.43	$2.45	$2.25	$1.32	$1.32	$1.49
Amount of accepted offers (in billions)	$0.28	$0.31	$0.27	$0.19	$0.19	$0.24
Amount of tax liabilities written off as a result of OIC (in billions)	$2.15	$2.14	$1.98	$1.13	$1.13	$1.25
Percentage of total tax liability accepted in compromise	12%	13%	12%	14%	15%	16%
Number of offers rejected by OIC Program	13,071	18,568	22,287	35,721	30,874	27,409
Number of rejected offers appealed by taxpayers	3,976	6,819	8,129	15,376	15,888	10,224
Percentage of rejected offers appealed	30%	37%	36%	43%	51%	37%
Number of offers accepted by Appeals function	1,393	1,953	2,334	4,464	3,928	1,221
Percentage of Offers Accepted by Appeals function	35.04%	28.64%	28.71%	29.03%	24.72%	11.94%

*Acceptances are shown before any taxpayer appeals to the IRS Appeals function (Appeals).

Summary and Conclusion

These six topics are not exhaustive, but your authors believe they are the most common. First, IRS transcripts are important as they are typically the best evidence of taxes owed and prior actions taken and those transcripts provide accuracy when determining critical dates. Second, it is important to sort out which of the taxes are dischargeable. Third, the time requirements for those dischargeable taxes are important to determine which taxes will actually be discharged. Fourth, IRC 1398 should be considered to have tax debts for the short year paid put through the bankruptcy estate instead of surviving bankruptcy. Also, the "pass through" income or loss of partnerships and S Corporations should be considered at both the owner and identity level. Fifth, a request for prompt assessment should be considered by the trustee or urged by the debtor. Sixth, if tax liabilities are a driving force for the filing, consider an Offer in Compromise.

NOTES

1. IRC 6201.
2. IRC 6331.
3. IRC 6212.
4. IRC 6501.
5. IRC 6213.
6. SIGNIFICANT CAVEAT: When filling out Form 2848, the attorney affirmatively represents a number of things including that the attorney knows or his or her responsibility under Circular 230 (31 CFR 10.33–.37), and should consider reading it or hiring someone who has. See *Circular 230*, by George W. Gregory, George W. Gregory PLLC, Birmingham, presented at ICLE 15th Annual Drafting Estate Planning Documents Seminar, January 19, 2006.
7. 11 USC 507(a)(8)(A)(iii) and 523 (a)(1)(A).
8. The following taxes are not dischargeable in a Chapter 13: (i.e., they must be paid in full but still not priority; trust fund taxes (11 USC 507(a)(8)(c)), unfiled returns (11 USC 523(a)(1)(B)), late filed returns within 2 years of bankruptcy (11 USC 523(a)(1)(B)), fraudulent returns (11 USC 523(a)(1)(C)), evaded taxes (11 USC 523(a)(1)(C)).
9. 11 USC 523 (a)(1) and 507(a)(8)(C). A trust fund tax is money required to be withheld by the debtor as a "responsible person" from an employee's wages (income tax, social security, and Medicare taxes) by an employer and held in trust until paid to the Treasury. IRC 6672 and 3505.
10. 11 USC 507 (a)(8)(D). See also 11 USC 507(a)(4).
11. 11 USC 507(a)(8)(E).
12. 11 USC 507(a)(8)(F).
13. 11 USC 507(a)(8)(G).
14. 11 USC 523 (a)(1)(C).
15. In *Hindenlang v US* 164 F3d 1029 (6th Cir 1999), *cert. denied*, 528 US 810 (1999), a taxpayer filed returns that were identical to the substitute returns already filed by the government. The Sixth Circuit relied on a four-part test for the definition of a tax return found in *Beard v. Commissioner*, 82 TC 766 (1984), aff'd, 793 F2d 139 (6th Cir 1986):

    (1) it must purport to be a return;

    (2) it must be executed under penalty of perjury;

    (3) it must contain sufficient data to allow calculation of tax; and

    (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law.

    The Sixth Circuit held that returns generating an assessment identical to substitute returns served no valid tax purpose under the fourth test and that "a document purporting to be a tax return serves no purpose at all under the Internal Revenue Code, such a document cannot, as a matter of law, qualify as an honest and reasonable attempt to satisfy the requirements of the tax law." In *Hindenlang,* the Sixth Circuit seemed focused on the fact that where a filed return duplicates the assessment of the substitute return, it serves no valid purpose.

    A question could be raised whether a filed return that differs from a substitute return filed by the IRS will satisfy the valid purpose test under *Beard*. In *US v Payne*, 431 F.3d 1055 (7th Cir 2005) the Seventh Circuit, said that the valid purpose for filing a tax return is to "satisfy the taxpayer's obligations":

    > The legal test is not whether the filing of a purported return has some utility for the tax authorities, but whether it is a *reasonable* endeavor to satisfy the taxpayer's obligations, as it might be if the taxpayer had tried to file a timely return but had failed to do so because of an error by the Postal Service. There was nothing like that here.

    The language in *Payne* implies that filing when required to do so is important. It could mean that if the substitute return is inaccurate, that the filing of a tax return which is accurate, would satisfy the fourth test under *Beard.* In footnote 6 of *Hindenlang*, the government claimed that a return that increases the tax liability would serve a valid tax law purpose. The Sixth Circuit declined to rule on that question. In *In Re Izzo,* 287 BR 158, (USDC ED Mich SD 03/30/2006), the Bankruptcy Court addressed a situation where a taxpayer filed returns after substitute returns were filed. The tax liability on the filed returns was lower than the substitute returns (a likely occurrence given that taxpayer's have more information than the government when it comes to filing returns). The Bankruptcy Court in *Izzo* ruled that a valid tax purpose does not include the filing of an accurate return which differs from the substitute return:

    > Viewed in this light, the Court cannot accept Debtor's proposed distinction between this case and *In re Hindenlang*. The only material difference between the two cases, after all, is that the information ultimately provided by the debtor in *In re Hindenlang* was redundant of the IRS's own calculations, while the information eventually provided by Debtor here reflected tax liabilities that were lower than the IRS had previously computed through its SFRs. To say that the latter qualifies as an "honest and reasonable attempt" to satisfy the tax laws while the former does not would render the fourth prong of the *Beard* test devoid of all meaning or purpose.

    These cases create the following question. Language in *Hindenlang* implies a test that if the only purpose of filing a tax return is to have it dischargeable in bankruptcy, that filing will not support a valid tax purpose. Language in *Izzo* and *Payne* implies that a valid purpose disappears when the government has assessed a tax. One

has to wonder if the focus on the definition of an "honest filing of a return" as a measure of which taxes will or will not be discharged will result in the correct balance contemplated by Congress.

16. The Bankruptcy Code allows an individual to discharge an income tax when the taxpayer did not file a fraudulent tax return or engage in tax fraud (11 USC 523(a)(1)(C)), a tax return was actually filed for the delinquent tax liability (11 USC 523(a)(1)(B)), and if all of the following timing "rules" are met;

a) The 2-Year Filing Rule. The tax return was filed and, if late, more than two years prior to the bankruptcy petition (11 USC 523 (a)(1)(B))

b) The 3 -Year Look Back Rule. The due date for the return, including the due date after filed extensions, is more than three years before the bankruptcy filing (11 USC 507 (a)(8)(1)(A)(i) and 11 USC 523 (a)(1)(A)); and

c) The 240-Day Assessment Rule. The assessment date for the taxes must be greater than 240 days prior to the date the bankruptcy petition is filed (excluding any time an offer in compromise was outstanding, plus 30 days)(11 USC 507 (a)(8)(A)(ii)) and 11 USC 523 (a)(1)(A)).

17. 11 USC 507(a)(8)(A)(ii)(I) and (II).

18. 11 USC 507 (a) (8) (A)(ii)(I).

19. 11 USC 108 (c) and 507 (a)(8)(A)(ii)(I), and 26 USC 6503(b) and (h).

20. IRC 7811.

21. IRC 6330.

22. Chief Counsel Advice 200404049.

23. IRC 1398(d)(2). The rules of IRC 1398 only apply to Chapter 7 and Chapter 11 bankruptcy cases involving an individual. No separate estate for an individual debtor is created if he or she files for bankruptcy under Chapter 12 (adjustment of debts of a family farmer with regular income) or under Chapter 13 (adjustment of debts of an individual with regular income). Also, no separate taxable estate exists for partnerships or corporations, IRC 1399.

24. IRC 1398(d)(3).

25. 11 USC 523(a)(1).

26. IRC 1398(d)(2).

27. *Id*.

28. 11 USC 523(a).

29. IRC 1398(d)(2)(C). Debtors who have no assets other than property exempt under section 522 of the Bankruptcy Code cannot elect to terminate their taxable years.

30. IRC 1398(g). These attributes include: NOL's Capital loss carryovers, credit carryovers charitable contribution carryovers, recover exclusion under 111, debtor's basis, holding period, and character of any assets acquired from the debtor other than by sale or exchange, the debtor's accounting period, and passive and at-risk activity losses and credits and other tax attributes of the debtor to the extent provided in Regulations.

31. IRC 1398(f)(1).

32. See Treas Reg 301.9100-14T(d), which provides that to facilitate processing the taxpayer should write " 1398 ELECTION" at the top of the return. The regulations also state that the election may be made by attaching a statement of election to a timely application for an extension of time to file a return for the first short taxable year meeting the requirements of 6081.

33. IRC 1398(i).

34. IRC 108(a)(1) and 108(b). This is a complex area of tax accounting and an area fraught with different legal interpretations that are beyond the scope of this article. However, the practitioner should also look for debtor's tax attributes such as unused passive activity losses, 465 losses (deductions limited to amount at risk), investment interest deductions, suspended S corporation losses, and percentage depletion carryovers and seek compete professional counsel on whether they can succeed or transfer to the bankruptcy estate or remain with the individual in a 1398 election.

35. IRC 1398(f).

36. 123 TC 144 (2004).

37. *Id*.

38. In *Alphonse Mourad*, 121 TC 1 (2003), *aff'd,* 387 F3d 27 (1st Cir 2004), an individual S shareholder was liable for profits generated by an S corporation in bankruptcy.

39. See *Id* for Chapter 11 case and *In re Stadler Associates* 76 AFTR 2d 95-5619, decided June 13, 1995 for Chapter 7 case.

40. Or the debtor should urge the trustee to consider a prompt determination.

41. The bulletin can be found at: http://www.irs.gov/irb/2006-22_IRB/ar12.html.

42. See new rules for OIC at IR 2007-55; Fact Sheet 2007-16. Go to www.irs.gov, and click on Tax Stats under Information About. From the Tax Stats page, select SOI Bulletins under Products, Publications, and Papers. News Release IR-2007-55.

43. 28 USC § 7122. An OIC under 28 USC section 7122 "must be submitted according to the procedures, and in the form and manner, prescribed by the Secretary." 26 C.F.R. 301.7122-1(d)(1). An OIC under 28 USC 7122 is generally submitted on IRS Form 656. The IRS may refuse to process an OIC and return the OIC to the taxpayer if the IRS determines that "the offer was submitted solely to delay collection or was otherwise nonprocessable." 26 C.F.R. 301.7122-1(d)(2). What constitutes a nonprocessable offer is determined by IRS policy.

44. CC-2004-25, 2004 IRS Chief Counsel Notice LEXIS 18 (July 12, 2004). However, see *United States v Roland Harry Macher (In re Macher)*, 91 AFTR2d 2003-2654, 2003-2 USTC 50,537, (Bankr. WD Va), *aff'd*, 303 B.R. 798 (WD Va 2003) where the court found the IRS policy that refuses consideration of an offer-in-compromise from a Chapter 11 debtor conflicts with the general fresh start policies underlying the Bankruptcy Code and specifically the reorganization provisions of Chapter 11.

45. IRM 25.17.1.3 and 25.17.3.2. The Insolvency department of the IRS is responsible for protecting IRS interests in bankruptcy cases.

46. 11 USC 1129(a)(9)(C), 1222(a)(2), and 1322(a)(2). A plan cannot be confirmed under the Bankruptcy Code unless it provides for the full payment of priority tax claims, or the IRS agrees to different treatment. The Chief Counsel Notice (CC-2004-25) provides factors that may be considered in determining whether it is in the government's best interest to accept less-favorable treatment than is statutorily required under the Bankruptcy Code.

Daniel P. Marsh is an associate at George W. Gregory, PLLC, and practices in the areas of corporate tax, probate, estate planning, property transfer tax, business transactions, and business succession planning. He would like to give a special thanks to George W. Gregory for his support, input and guidance on this article.

Neal Nusholtz has a broad tax, estate and corporate practice. He has represented hundreds of taxpayers in disputes with the IRS. In 1999, Corp! *Magazine listed Mr. Nusholtz as one of the Top Ten Business attorneys in southeastern Michigan.*