

# **Bankruptcy Tax Manual**

**Steven L. Walker**

LAW OFFICES OF STEVEN L. WALKER  
A PROFESSIONAL LAW CORPORATION

Silicon Valley Office  
2550 North First Street Suite 302  
San Jose, CA 95131  
Tel. (408) 295-5800

Los Angeles Office  
9350 Wilshire Blvd., Suite 203  
Beverly Hills, CA 90212  
Tel. (310) 348-8468

Firm's Website: [walk-law.com](http://walk-law.com)  
Email: [swalker@walk-law.com](mailto:swalker@walk-law.com)

Revision Date: May 13, 2022

## **Disclaimer**

The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice or as an opinion by the law firm to the reader. The reader is also cautioned that the material may not apply to, or be suitable for, the reader's specific circumstances or needs, and may require considerations of non-tax and other factors if any action is to be contemplated. The reader should contact his or her tax advisor before taking any action based on this information. The Law Offices of Steven L. Walker assumes no obligation to inform the reader of any changes in tax laws or other factors that could affect the information contained herein.

## Table of Contents

I.	Introduction .....	3
II.	Key Players.....	5
III.	Litigating Tax Liabilities in Bankruptcy Court.....	5
IV.	How to read an irs proof of claim .....	6
V.	The Federal Tax Lien .....	7
VI.	Nondischargeable Taxes in Chapters 7, 11 and 13 .....	10
VII.	Nondischargeable Debts Under 11 U.S.C. § 523(a)(1).....	11
VIII.	Eighth Priority Taxes under 11 U.S.C 507(a)(8).....	12
A.	Prepetition Income or Gross Receipts Taxes, 11 U.S.C 507(a)(8)(A) .....	12
1.	The Three-Year Rule .....	13
2.	The 240-Day Rule .....	16
3.	Tax Liabilities that are Assessable, but Not Yet Assessed.....	17
B.	California Property Taxes .....	21
C.	Trust Fund or Withholding Taxes.....	21
D.	Employment Taxes .....	22
IX.	Penalties.....	22
X.	Fraudulent, Unfiled, or Delinquent Returns.....	23
A.	Delinquent Returns .....	23
B.	Unfiled Returns .....	25
C.	Equivalent Report or Notice (Franchise Tax Board).....	25
D.	Fraudulent Return .....	25
E.	Willful Attempt to Evade or Defeat Tax.....	26
XI.	Sales and Use Taxes .....	26
XII.	Taxation of the Bankruptcy Estate .....	29
XIII.	Post-Bankruptcy Procedures .....	31
XIV.	Designated Payments in a Chapter 13 Case.....	31
XV.	Proper Service of Process .....	32

## I. INTRODUCTION

The intersection of tax law and bankruptcy is a complex and esoteric area of the law. Classes in this area are often taught too fast for most people to absorb, and many simply never get it. Helping people realize that they have a problem and then bringing in help is sometimes what works. I think issue spotting is as essential as problem-solving, and I have put together a checklist of some things to be aware of as we focus on bankruptcy tax.

First and foremost, every business owner needs at least the following essential ingredients to be successful: (1) a good accountant, (2) a reliable bookkeeper, (3) QuickBooks or other software, and (4) a payroll service provider such as ADP or Paychecks. Advising a client to have these four cornerstones in place can go a long way in helping a client either avoid a problem or help right the ship.

The following is a list of common tax issues faced by individuals and businesses under the microscope of the Internal Revenue Service or one of the California taxing authorities. When meeting with a client considering bankruptcy or who just needs help with restructuring debts, ask the client about these issues to better handle the situation. This list will help you spot the problems to address them later with tax counsel or an accountant.

### List of Common Tax Compliance Issues

- **Estimated Tax Payments.** Is the client timely making estimated taxes to the IRS and the Franchise Tax Board? Failing to pay estimated taxes is one of the most common reasons clients fall behind on their taxes. The accountant should calculate and provide this information to the client. The IRS will impose a late payment penalty of up to 25% for failing to pay the taxes by April 15. [26 U.S.C. 6651(a)(2)] Obtaining a valid extension of time to file does not extend the deadline to pay by April 15.
- **Unreported income, and false or unsubstantiated deductions.** The client is not filing honest tax returns, and typically has done this for a while and finally gets caught. The client either leaves off income from the return (income the client thinks that the IRS will not know about) or claims deductions for which there are no records.
- **Unfiled or delinquent returns.** Has the client filed all federal and state tax returns, and if not, what returns are unfiled? Generally, the IRS has a six-

year lookback period and will not allow the taxpayer to enter into an installment agreement or file an Offer in Compromise until all delinquent returns are filed. The FTB has similar rules. A taxpayer is not eligible for an installment agreement or an offer in compromise unless the taxpayer has (1) filed all tax returns he/she is legally required to file, (2) made all required estimated tax payments for the current year, and (3) made all required federal tax deposits for the current quarter if the taxpayer is a business owner. The IRS and FTB will not discuss the case if the taxpayer has not filed all legally required tax returns.

- **Payroll taxes.** Is the client current on payroll taxes with the IRS and EDD, and if not, which returns have you not filed and/or paid? The IRS and EDD may investigate the case and hold the responsible persons personally liable for the failure to collect and pay the taxes. [26 U.S.C. § 6672 and Cal. Unemp. Ins. Code § 1735] Failing to pay the payroll taxes places the client at risk for significant personal liability (taxes, interest, failure to deposit penalties up to 15%, failure to file penalties up to 25%, and failure to pay penalties up to 25%). In addition, the willful failure to collect or pay over tax is a felony if the client's ticket gets punched. [26 U.S.C. 7202]
- **Independent Contractors.** Does the client pay independent contractors, and if so, are they truly independent contractors or employees that the client improperly classified? Improper classification of workers can trigger an IRS or EDD employment tax audit.
- **Reasonable Compensation Cases.** Is the client using her S Corporation as a personal piggy bank and taking draws when the client should be paying herself wages? The IRS will examine the S Corporation's tax returns and impose reasonable compensation. The business will owe back Form 940 and Form 941 payroll taxes, in addition to substantial penalties (penalties for failure to file [26 U.S.C. § 6651(a)(1)], penalties for failure to pay [26 U.S.C. § 6651(a)(2)], and penalties for failure to make deposit [26 U.S.C. § 6656]). The penalties can be over \$200,000 for a two-year audit, even for a small S Corporation with one shareholder and one employee. The results can be devastating.
- **Form 1099s.** Has the client issued Form 1099s to all workers, or is the client simply making payments via wire transfers or Zelle and thinking that this is okay. The IRS will audit the business and impose penalties for failing to file Form 1099s or file correct forms. [26 U.S.C. §§ 6721, 6722] A

business owner must also withhold income taxes from payees who fail to furnish a TIN for payments subjected to Form 1099-MISC filing requirement and File and file a Form 945. The IRS will require the business owner to pay backup withholding [26 U.S.C. § 3406], late-filing penalties, and late payment penalties up to 25%. [26 U.S.C. §§ 6651(a)(1), (2)] No excuses for not filing Form 1099 if you don't have a TIN.

## II. KEY PLAYERS

There are three key players in a bankruptcy case, and bankruptcy counsel should be familiar with them and the role that they play.

- **IRS Field Insolvency** – Prepares and files all proof of claims, works on bankruptcy cases, reviews plans and schedules refers cases to U.S. Attorney's Office or IRS Area Counsel, makes collection determinations, and negotiates with debtors
- **U.S. Attorney's Office** – Represents the United States Government (IRS) in Bankruptcy Court.
- **IRS Area Counsel** – In-house counsel for the IRS.

## III. LITIGATING TAX LIABILITIES IN BANKRUPTCY COURT

The Bankruptcy court may determine the amount or legality of any tax, fine or penalty, whether or not the IRS has not assessed the taxes or the taxes were paid. [11 U.S.C. 505(a)(1)]

The court may **not** determine the amount of a tax, fine or penalty if such amount or legality was **contested before and adjudicated by a judicial or administrative tribunal** of competent jurisdiction before the commencement of the case under this title.” [11 U.S.C. 505(a)(2)]

So, if the Tax Court has already decided the issue, the debtor cannot re-litigate the case in Bankruptcy Court.

### Example 3-1. Tax Court Litigation

Taxpayer files a petition in U.S. Tax Court and the Court decides the issue. The debtor can not file bankruptcy and re-litigate the issue in bankruptcy court.

### **Example 3-2. Taxpayer Defaults on Notice of Deficiency**

The IRS issues a notice of deficiency, and the taxpayer failed to timely file a petition in Tax Court within 90 days and therefore defaulted on the notice. The taxpayer nevertheless can litigate the tax issue in Bankruptcy Court, and the taxpayer does not need a new notice of deficiency to litigate the case. The bankruptcy court has jurisdiction to hear the matter.

In summary, if the Tax Court has already decided the issue, a taxpayer can not re-litigate the case in bankruptcy court. Moreover, a taxpayer does not need a need a notice of deficiency or collection due process rights to bring the action in bankruptcy court. IRS files a claim and the debtor files an objection. The bankruptcy court has broad authority to hear the tax case. A bankruptcy court is simply another way for a debtor to resolve a tax dispute that the debtor was unable to do in an audit, before the U.S. Tax Court, or in a collection due process hearing. It is almost like a second or third bite at the apple.

## **IV. HOW TO READ AN IRS PROOF OF CLAIM**

The IRS enters the bankruptcy case and “frames” its case by filing a Proof of Claim for Internal Revenue Taxes, and annotated samples are attached at the end of this manual. It is important to know how to read and understand the IRS Proof of Claim, and below are a few key things to know.

### **Secured Claims**

- The “**Kind of Tax**” column tells you the kind of tax such as income taxes or payroll taxes. For example, “INCOME” refers to Form 1040 income taxes, and “WT-FICA” and “FUTA” refer to payroll taxes.
- The “**Date Tax Assessed**” column provides the date that the IRS assessed the taxes, and this date is important because it triggers the running of statute of limitations on collections, which is generally 10 years. [11 U.S.C. 6501] This column also states whether the debtor filed a return or the IRS prepared a substitute for return. IRS generally only can assess taxes if the debtor has filed a return, or the IRS has prepared an SFR.
- The “**Tax Due**” column lists the amount due, and it includes interest to the petition date.

- The “**Penalty to Petition Date**” includes the penalty and the interest attributable to the penalty up the petition date.
- The “**Notice of Tax Lien Filed**” column tells you the date the IRS filed a NFTL and the office location. You want to make sure that the IRS properly filed the NFTL, even though it’s listed on the IRS Proof of Claim.

### **Unsecured Priority Claims**

This column details the priority claims under 11 U.S.C. 507(a)(8), and below are a few key things to know about the IRS Proof of Claim.

- The “**Kind of Tax**” column list payroll taxes, which are unsecured priority claims under 11 U.S.C. 507(a)(8)(C). This indicates that the debtor likely has an entity and is not filing payroll tax returns (Form 940, 941) and/or filing the returns, but not paying the taxes.
- The “**Date Tax Assessed**” column tells you that the debtor did not file a tax return because it states, “NOT Filed.” The tax due is \$100.00 because the IRS does not know and can’t figure out the tax due. The \$100.00 is a place holder so that the IRS is not barred from making a claim.

## **V. THE FEDERAL TAX LIEN**

**Practice Tip:** If the IRS has filed a proof of claim, the debtor should determine whether the IRS properly filed a Notice of Federal Tax Lien (NFTL). Do not assume that the IRS properly filed the NFTL. If the IRS failed to file the NFTL properly, the IRS has an unsecured claim. In addition, determine whether the tax lien has expired because a lien generally only lasts ten years.

### **Secured Claims**

Under 11 U.S.C. § 506(a), the IRS has a secured claim when

- It has properly filed a prepetition Notice of Federal Tax Lien (NFTL), and there is equity in the debtor’s property to which the lien attaches; or
- It has a tax claim subject to set-off under 11 U.S.C. § 553. [IRM 5.17.8.14 (04-13-2020)]

The IRS claim is unsecured to the extent the debt exceeds the collateral's value.  
[11 U.S.C. 506(a)]

To determine the IRS's secured claim, the federal tax lien attaches to the debtor's property that became estate property as of the commencement of the case, including property exempted under 11 U.S.C. § 522. (See 11 U.S.C. § 522(c)(2)(B)); IRM 5.17.8.14 (04-13-2020)).

## Place of Filing

- 26 U.S.C. § 6323(f) and state law determine the correct place to file a NFTL.
- “For **real property**, the NFTL is filed in the one office designated by the state where the property is physically located. States generally provide that the one office for filing the NFTL for real property is the county recorder or clerk of the county in which the real property is located.” [IRM Section 5.17.2.3.2 (03-19-2018)]
- “Notices of liens upon **real property** for obligations payable to the United States and certificates and notices affecting the liens shall be filed for record in the office of the recorder of the county in which the real property subject to the liens is situated.” [Cal. C.C. P. 2101(b)]
- “As against personal property, the situs of both tangible and intangible property is the residence of the taxpayer at the time the notice of lien is filed. Again, most states generally provide that the one office for filing the NFTL for an individual's personal property is the county clerk's office in the county in which the individual resides.” [IRM Section 5.17.2.3.2 (03-19-2018)]
- Notices of federal liens upon **personal property**, whether tangible or intangible, for obligations payable to the United States and certificates and notices affecting the liens shall be filed as follows . . . “in the office of the recorder of the county where the person against whose interest the lien applies resides at the time of filing of the notice of lien. [Cal. C.C. P. 2101(c)(4)]
- “Notices of liens upon real property for obligations payable to the United States and certificates and notices affecting the liens shall be filed for record



in the office of the recorder of the county in which the real property subject to the liens is situated.”

## **Lien Rides Through Bankruptcy – in Rem**

The lien also attaches to property that the debtor acquires post-petition. [11 Collier on Bankruptcy P TX4.04 (16th 2022) (The IRS’s tax lien continues as an in rem claim against the debtor’s assets until an amount equal to the fair market value of the assets subject to lien is paid in full.)]

## **When and How the Lien Arises**

- “If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.” [26 U.S.C. § 6321]
- For federal tax law purposes, a “person” includes individuals, trusts, estates, partnerships, associations, companies, and corporations. [26 U.S.C. § 7701(a)(1)]
- The lien is effective from the date the Government assesses the tax. Thus, if the taxpayer neglects or refuses to pay the assessed tax, the lien is deemed to relate back to the assessment date. [26 U.S.C. § 6322]
- The Service is not required to file a Notice of Federal Tax Lien (NFTL) for the tax lien to attach.
- The Service may need to file a NFTL to have priority over the taxpayer’s other creditors. [IRM 5.17.2.2.1 (09-19-2018)]
- The act of filing protects the Government’s right of priority against certain third parties, typically a purchaser, holder of a security interest, mechanic’s lienor, or judgment lien creditor. [26 U.S.C. § 6323(a)]

## **Transfer of Property Subject to Lien**

- After the federal tax lien attaches to a property, it remains on that property until the lien has expired, is released, or the property has been discharged from the lien. [*United States v. Bess*, 357 U.S. 51, 57 (1958); IRM 5.17.2.2.3 (01-08-2016)]
- The transfer of property subsequent to attachment does not affect the lien. *Id.*

## **Duration of the Lien**

- The federal tax lien continues until the liability for the amount assessed is satisfied or becomes unenforceable by lapse of time, i.e., passing the collection statute expiration date (CSED). [26 U.S.C. § 6322]
- Generally, after assessment, the Service has ten years to collect the tax liability. [26 U.S.C. § 6502.
- However, some circumstances may extend or suspend the ten-year collection period. [IRM 5.17.2.2.2 (03-27-2012)]
- Most tax liens are self-releasing, meaning that unless notice of the lien is refiled by the due date, the NFTL shall, on the following date, operate as a certificate of release as defined in 26 U.S.C. § 6323(a).

## **VI. NONDISCHARGEABLE TAXES IN CHAPTERS 7, 11 AND 13**

### **Chapter 7**

A Chapter 7 discharge does not include certain debts that are nondischargeable under § 523. [B.C. § 727(b)]

### **Chapter 11**

A discharge under Chapter 11 “does not discharge a debtor who is an individual from any debt excepted from discharge under section 523 of this title.” [11 U.S.C. § 1141(d)(2)]

## Chapter 13

Section 1328 provides that a court shall grant a debtor a discharge of all debts provided for by the plan except a debt for **trust fund taxes** [§ 507(a)(8)(C)], **unfiled or late-filed returns** [§ 523(a)(1)(B)], and **fraudulent returns** [§ 523(a)(1)(C)].

Section 1322 provides that the plan shall provide for full payment, in deferred cash payments, of all claims entitled to priority under § 507. This means that you must determine whether the IRS has a priority claim, and if so, the plan must full pay the balance due.

## VII. NONDISCHARGEABLE DEBTS UNDER 11 U.S.C. § 523(A)(1)

### Overview

Section 523(a) sets forth the exceptions to a discharge in a Chapter, 7, Chapter 11, and a hardship discharge under Chapter 13. [11 U.S.C. § 523(a), § 1141(d)(2), § 1328(b)].

- **Eighth Priority Taxes.** For a tax of the kind specified in § 507(a)(8), whether or not the debtor filed a return or filed the return late. [11 U.S.C. § 523(a)(1)(A)]
- **Unfiled Tax Returns.** [11 § U.S.C. 523(a)(1)(B)(i)]
- **Late-Filed Returns.** For a tax with respect to which a return, or equivalent report or notice, if required was not filed, or was filed after the due date, and after two years before the date of the filing of the petition. [11 § U.S.C. 523(a)(1)(B)(ii)]
- **Fraudulent Returns.** For a tax with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat the tax. [11 U.S.C. § 523(a)(1)(C)]

## 11 U.S.C. § 523. Exceptions to Discharge

(a) A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

8<sup>th</sup>  
Priority  
Taxes

(A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

Unfiled  
Tax  
Return

(B) with respect to which a return, or equivalent report or notice, if required—

(i) was not filed or given; or

Delinquent  
Tax Return

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

Fraudulent  
Tax Return

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

### VIII. EIGHTH PRIORITY TAXES UNDER 11 U.S.C 507(A)(8)

#### A. Prepetition Income or Gross Receipts Taxes, 11 U.S.C 507(a)(8)(A)

Section 507(a)(8) provides that certain allowed unsecured claims of governmental units (e.g., IRS, Franchise Tax Board, California Department of Tax and Fee Administration) are entitled to eighth priority. These unsecured claims include the following:

- Prepetition priority income taxes or gross receipt taxes
- Property taxes
- Trust fund or withholding taxes
- Employment taxes
- Excise taxes
- Penalty related to a tax claim and in compensation for actual pecuniary loss

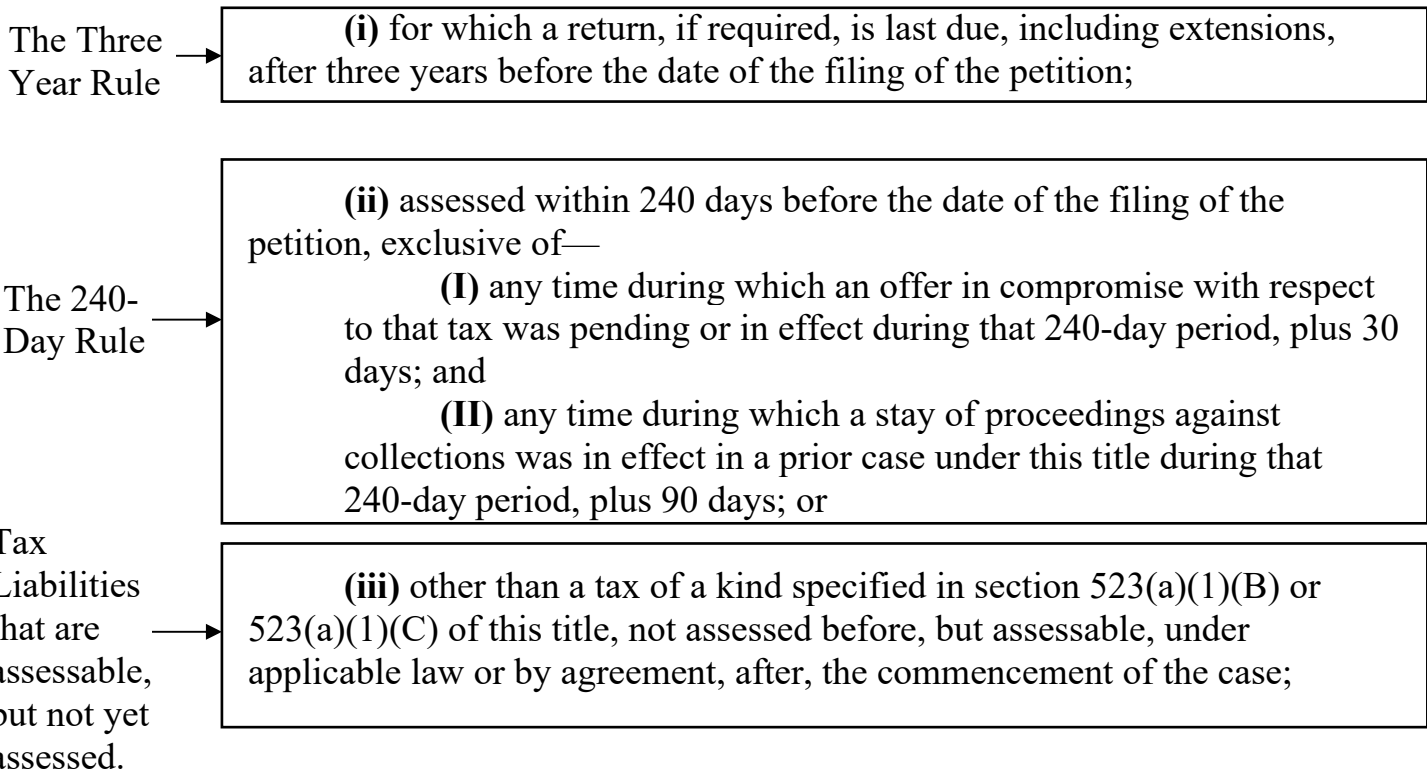
Priority claims generally are the first unsecured claims to be paid in a bankruptcy case following distribution to secured creditors.

## 11 U.S.C. § 507. Priorities

(a) The following expenses and claims have priority in the following order:

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—

(A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition—



### 1. The Three-Year Rule

The required tax return was last due (including extensions) within three years of the petition date [11 U.S.C. § 507(a)(8)(A)(i)]. To determine whether an unsecured tax claim qualifies under the three-year rule, ask the following questions:

- **What is the due date for filing the return?**
- **What is the three-year lookback period?**
- **Does the due date for the return fall within the lookback period?**

Did the debtor obtain a valid **extension of time** to file the return? If so, the due date for filing the return is October 15.

If the due date falls on a **weekend or holiday**, the due date moves forward to the next day.

The IRS extended the due date for filing returns during **COVID-19**.

### **Example 8.1 Priority Tax Under Three-Year Rule**

The debtor's tax return for the tax year ended 12/31/2019 is due on 4/15/2020. The debtor obtained a valid extension of time to file the return to 10/15/2020. The debtor filed his tax return on 08/01/2020, and the debtor filed a petition on 9/1/2020. Is the IRS' claim for tax liability for the tax year 2019 a priority tax?

3-Year lookback period: 9/1/2020 – 9/1/2017

The extended due date falls within the 3-year lookback period

Therefore, it's a priority tax.

### **Internal Revenue Service Filing Deadlines**

- 15<sup>th</sup> day following April for calendar year taxpayers
- 15<sup>th</sup> day of fourth month following the close of the year for fiscal year taxpayers. [26 U.S.C. § 6072(a)]

### **California Franchise Tax Board Filing Deadlines**

- 15<sup>th</sup> day following April for calendar year taxpayers
- 15<sup>th</sup> day of fourth month following the close of the year for fiscal year taxpayers. [Cal. Rev. & Tax Code § 18566]

### **Sales and Use Tax Returns Filing Deadlines**

- For quarterly reporting basis, returns are due by the last day of the month following each quarterly period. [Cal. Rev. & Tax Code 6451]

- Due dates for the other types of filers (monthly, yearly, or fiscal yearly), returns are due by the last day of the month following each designated period. [Cal. Rev & Tax Code § 6455]
- California Department of Tax and Fee Administration handles sales and use tax returns. The due dates are specified at: [cdtfa.ca.gov/taxes-and-fees/sales-use-tax-returns-filing-dates.htm](http://cdtfa.ca.gov/taxes-and-fees/sales-use-tax-returns-filing-dates.htm)

### **Extension of Time to File Tax Return**

- **Internal Revenue Service (Form 1040):** Automatic 6 -month extensions for individuals. [26 U.S.C. § 6081(a) and Treas. Reg. § 1.6081-4(a)]
- **Franchise Tax Board (Form 540):** Automatic extension until October 15<sup>th</sup>, if filed after April 15<sup>th</sup> and before October 15<sup>th</sup> for calendar year filers. Automatic extensions if filed within six months of original due date for fiscal year filers. [Cal. Rev. & Tax Code §18567, and Cal. Code Regs., tit. 18, §18567]
- **CA Sales & Use Taxes:** 30-day extension may be granted for good cause. [Cal. Rev. & Tax Code § 6459]

### **IRS Account Transcripts**

The IRS Account Transcript provides the due dates of the returns, date(s) of assessment, account balances, and other helpful information. The transcripts can be obtained online after submitting Forms 2848 and 8821 online.

<https://www.irs.gov/tax-professionals/submit-forms-2848-and-8821-online>

The Centralized Authorization File (CAF) Unit will process Forms received online on a first-in, first-out priority. Once the IRS processes the form, the IRS Account Transcript can be obtained online if you have established an account with the IRS.

<https://www.irs.gov/individuals/get-transcript>

Similar information can be obtained from the California Franchise Tax Board. Send a fax to the FTB Bankruptcy Section with Form 3520 (power of attorney) and request the information. See FTB Publication 933 C for contact information.

## 2. The 240-Day Rule

Even if the governmental unit passes the Three-Year Rule, the tax claim nevertheless may be classified as an eighth priority if the claim satisfies the 240-day rule.

Any income taxes and gross receipts taxes assessed within 240 days prior to the filing of a petition will be classified as eighth priority, nondischargeable tax liabilities in Chapter 7 and 11. [11 U.S.C. § 507(a)(8)(A)(ii)]

### Analysis

- Calculate the 240 Day lookback period from the petition's filing date, considering any tolling.
- During the 240-day lookback period, determine whether the governmental unit made any tax assessments.

### Tolling of the 240-Day Rule

If a taxpayer files an offer in compromise, the 240 days are extended by the time the offer was pending plus 30 days. [11 U.S.C. § 507(a)(8)(A)(ii)(I); *U.S. v. Klein (In re Klein)*, 189 B.R. 505 (C.D. Cal. 1995)]

If a stay against collection in a prior bankruptcy case was in effect, the 240-day period is extended by the time during which the stay was in effect plus 90 days. [11 U.S.C. § 507(a)(8)(A)(ii)(II)]

The 240-day period is also suspended under the hanging paragraph at the end of 507(a)(8). A request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days.

### Example. 240 Day Rule

IRS issued a notice of deficiency on January 1, 2018. The taxpayer failed to file a Tax Court petition timely within 90 days, and the IRS assessed the taxes on May 1, 2018. The debtor filed a chapter 13 petition filed June 1, 2019, and bankruptcy court dismissed the case 60 days later on July 31, 2019. The debtor then filed a Chapter 7 petition February 2, 2020. 240-day lookback period: February 2, 2020 to January 8, 2019 (Petition Date – 390 days (240 days + 90 days + 60 days)). No



priority status under § 507(a)(8)(A)(iii). An IRS claim could still be entitled to priority status if the three-year rule is met.

### **IRS Assessment Dates**

- **Liabilities Based on Returns** - When assessed under the Internal Revenue Code (i.e., when the summary record is signed by an assessment officer). [26 U.S.C. § 6203; 26 C.F.R. § 301.6203-1]
- **Liabilities of Deficiencies** - The amount determined by the Tax Court, which is final, shall be assessed. [26 C.F.R. § 301.6215-1]

### **FTB Assessment Dates**

- **Liabilities based on returns** - Generally, when liabilities are posted to the system. [*Schatz v. Franchise Tax Board*, 69 Cal. 4th 595, 603 (1999)]
- **Liabilities based on notices of proposed assessments** - When assessment becomes final. [*King v. Franchise Tax Board* (In re King), 961 F.2d 1423, 1426-27 (9th Cir. 1992); *Franchise Tax Board v. Bracey* (In re Bracey), 77 F.3d 294, 295 (9th Cir. 1996)]

### **California Sales and Use Tax**

- Liabilities for proposed assessments (determinations) are deemed “assessed” when the determination is final. [*In re King*, 961 F. 2d 1423 (9th Cir. 1992)]
- Sales and use tax determinations become final 30 days after a notice of determination is issued, absent the filing of a petition for redetermination. [Cal. Rev. & Tax. Code §6561]

### **3. Tax Liabilities that are Assessable, but Not Yet Assessed**

#### **In General**

The third rule under 11 U.S.C. 507(a)(8)(A) grants priority status to an unsecured governmental unit claim for taxes that were not assessed but are assessable (under applicable law or by agreement) after the filing of the petition, other than a tax liability for unfiled or late-filed returns, fraudulent returns, and tax evasion.

## 11 U.S.C. § 507(a)(8)(A)(iii)

(iii) other than a tax of a kind specified in section 523(a)(1)(B) [unfiled or late-filed returns] or 523(a)(1)(C) [fraudulent return or willful attempt to evade or defeat such tax] of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case ....

### Example

- IRS civil examinations and administrative appeals
- FTB audits, protests, and appeals before the California Office of Tax Appeals
- Trust fund recovery investigations by the IRS. [26 U.S.C. § 6672]
- Responsible person investigations for withholding taxes by the Employment Development Department. [Cal. Unemp. Ins. Code § 1735]
- Personal liability of corporate officers for sales and use taxes. [Cal. Rev. & Tax Code § 6829]

The key to determining whether the governmental unit can assess taxes after the debtor has filed bankruptcy is knowing the statute of limitations for assessing taxes. The rules are complex and detailed, but below are a few highlights:

### Statute of Limitations - IRS

- Generally, the IRS must assess the tax within **three years** after filing the return. [26 U.S.C. § 6501(a)]
- A **six-year limitation** period applies when a taxpayer omits more than 25 percent of gross income stated in the return. [26 U.S.C. § 6501(e)(1)]
- **No statute of limitations** applies if a taxpayer files a false return or engages in a willful attempt to evade tax, or files no return. [26 U.S.C. §§ 6501(c)(1)-(3)]
- There is a **suspension** of the statute of limitations during the pendency of IRS summons issued to a third-party (i.e., IRS issues John Doe summons to bank seeking names of all U.S. depositors). [26 U.S.C. § 7609(e)(1)(a)(ii)]

- There is an **extended limitations period** if certain international tax forms are omitted, such as the failure to file **Form 8938**. [26 U.S.C. § 6501(c)(8)]
- Suppose the taxpayer fails to include in gross income an amount relating to a specified foreign financial asset, and the amount omitted is greater than \$5,000. In that case, any tax owed for the taxable year can be assessed at any time within six years after the return is filed. [I.R.C § 6501(e)(1)(A)(i)]
- The limitations period does not apply in assessing **criminal restitution** under I.R.C. § 6201(a)(4). The IRS may assess and collect the amount of any criminal restitution ordered by a federal district court under 18 U.S.C. §3556 as if the restitution amount were such tax.
- The statute of limitations is suspended by issuing a **notice of deficiency**. [26 U.S.C. § § 6503(a)(1)]

### **Statute of Limitations - California Franchise Tax Board**

- **Four Years** - Except in the case of a **false or fraudulent return** and except as otherwise expressly provided in this part, every **notice of a proposed deficiency assessment** shall be mailed to the taxpayer within **four years** after the return was filed. [Cal. Rev. & Tax. Code § 19057]
- **Six Years** - If the taxpayer omits an amount properly includable therein from gross income, which is more than **25 percent** of the amount of gross income stated in the return, a notice of a proposed deficiency assessment may be mailed to the taxpayer within six years after the return was filed. [Cal. Rev. & Tax. Code § 19058]
- **No Statute of Limitations** - If any taxpayer **fails to file a return**, or files a **false or fraudulent return with the intent to evade the tax** for any taxable year, the Franchise Tax Board, **at any time**, may require a return or an amended return under penalties of perjury or may make an estimate of the net income, from any available information, and may propose to assess the amount of tax, interest, and penalties due. [Cal. Rev. & Tax Code § 19087.]

## **FTB Notification Responsibilities**

Taxpayers have notification responsibilities to California if the IRS examines a return and makes adjustments that increase the tax for any year. [Cal. Rev & Tax C § 18622(a)]

**Two Years** - If a taxpayer reports the change or correction within the six-month months after the final federal determination (or the IRS reports that change within six months), the FTB has **two years** from the date the FTB receives a report of the federal change to apply the federal change to a taxpayer's California income tax return. [Cal. Rev & Tax C § 19059(a)]

**No Statute of Limitations** - If a taxpayer fails to report a change made by the IRS, the FTB can mail a NPA resulting from the adjustment to the taxpayer at any time. [Cal. Rev & Tax C § 19060(a)]

**Four Years** - However, if the FTB receives the change or correction after six months, the FTB has a much longer time, four years, to issue a NPA to a taxpayer. [Cal. Rev & Tax C § 19060(b)]

Whatever you do at the federal level, you must also match and do at the state level.

The debtor's state tax liability was not dischargeable under § 523(a)(1)(B)(i) where the debtor failed to report IRS tax assessments to the California Franchise Tax board. [*Berkovich v. Cal. Franchise Tax Bd. (In re Berkovich)*, 619 B.R. 397 (B.A.P. 9th Cir. 2020)]

## **Statute of Limitations - California Sales and Use Tax**

- **Return Filed, three years** - For taxpayers filing returns, other than a return filed under Section 6452.1, on other than an annual basis, except in the case of fraud, intent to evade this part or authorized rules and regulations, or failure to make a return, every **notice of a deficiency** determination shall be mailed within **three years** after the last day of the calendar month following the quarterly period for which the amount is proposed to be determined or within three years after the return is filed, whichever period expires the later. [Cal. Rev. & Tax Code § 6487(a)]
- **Failure to File, eight years** - In the case of failure to make a return, every notice of determination shall be mailed within **eight years** after the last day

of the calendar month following the quarterly period for which the amount is proposed to be determined. [Cal. Rev. & Tax Code § 6487(a)]

- **Personal liability of corporate officer** - A notice of deficiency determination under this section shall be mailed within **three years** after the last day of the calendar month following the quarterly period in which the board obtains **actual knowledge** through its audit or compliance activities or by written communication by the business or its representative, of the termination, dissolution, or abandonment of the business of the corporation, partnership, limited partnership, limited liability partnership, or limited liability company, or, within **eight years** after the last day of the calendar month following the quarterly period in which the corporation, partnership, limited partnership, limited liability partnership, or limited liability company business was terminated, dissolved, or abandoned, whichever period expires earlier. If a business or its representative files a notice of termination, dissolution, or abandonment of its business with a state or local agency other than the board, this filing shall not constitute actual knowledge by the board under this section. [Cal. Rev. & Tax Code § 6829(f)]

## **B. California Property Taxes**

A property tax incurred before the commencement of the case and last payable without penalty after one year before the date of filing the petition. [11 U.S.C. § 507(a)(8)(B)]

## **C. Trust Fund or Withholding Taxes**

Trust fund taxes are income taxes, social security taxes, and Medicare taxes you withhold from an employee's wages as their employer. The income tax, employee share of social security tax, and the employee share of Medicare tax that you withhold from your employees' pay are part of their wages you pay to the Treasury instead of to your employees. The taxes are called trust fund taxes because they are held in trust until they are paid to the Treasury, and your employees trust that you will pay the withholding to the Treasury by making Federal Tax Deposits (FTD). [IRS website.]

- **Federal:** Civil trust fund penalties are not dischargeable. [26 U.S.C. § 6672(a); 11 U.S.C. 507(a)(8)(C)]
- **EDD:** Responsible person investigations for withholding taxes by the

Employment Development Department. [Cal. Unemp. Ins. Code § 1735;  
11 U.S.C. 5§ 07(a)(8)(C)]

- **Sales and Use Taxes:** Personal liability of corporate officers for sales and use taxes. [Cal. Rev. & Tax Code § 6829; 11 U.S.C. § 507(a)(8)(C)]

#### **D. Employment Taxes**

Employment taxes for which a return was last due **within three years** before filing a bankruptcy petition is an 8<sup>th</sup> priority tax. [11 U.S.C. § 507(a)(8)(D)]

Employee's shares of employment taxes (Social Security and Medicare taxes on debtor's wages)

### **IX. PENALTIES**

Tax penalties are dischargeable if the penalty relates to a tax liability that does not fall within the exception to discharge under § 523(a)(1) (gap taxes, 8<sup>th</sup> priority taxes, no tax return filed, delinquent tax return, fraudulent return, willful attempt to evade or defeat tax). [11 U.S.C. § 523(a)(7)(A)]

Tax penalties are also discharged if they relate to a tax year more than three years before filing the bankruptcy petition. [11 U.S.C. § 523(a)(7)(B)]

#### **11 U.S.C. § 523(a)(7)(B)**

(a) A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition;

## X. FRAUDULENT, UNFILED, OR DELINQUENT RETURNS

### A. Delinquent Returns

A late-filed return is a tax return filed after the due date and expiration of any extension of time to file the return, and the return is filed two years before the filing of a bankruptcy petition. [11 U.S.C. § 523(a)(1)(B)(ii)].

Treatment of late-filed returns can vary depending on where the debtor is located.

Return filed one day late→ not eligible for dischargeability.

- *McCoy v. Miss. State Tax Comm'n* (In re McCoy), 666 F.3d 924 (5th Cir. 2012)
- *Mallo v. IRS* (In re Mallo), 774 F.3d 1313 (10th Cir. 2014).
- *Fahey v. Mass. Dep't of Revenue* (In re Fahey), 779 F.3d 1 (1st Cir. 2015).
- *Justice v. United States* (In re Justice), 817 F.3d 738 (11th Cir. 2016).

### Default Rule

Return filed after the IRS assesses a Substitute for Return (SFR)→ the tax amount up to the SFR amount is not eligible for dischargeability; any excess of tax above the SFR amount could be dischargeable

*Smith v. United States IRS* (In re Smith), 2016 U.S. App. LEXIS 12859 (9th Cir. July 13, 2016)

“Here, Smith failed to make a tax filing until seven years after his return was due and three years after the IRS went to the trouble of calculating a deficiency and issuing an assessment. Under these circumstances, Smith’s “belated acceptance of responsibility” was not a reasonable attempt to comply with the tax code. Many of our sister circuits have held that post-assessment tax filings are not “honest and reasonable” attempts to comply and are therefore not “returns” at all.” *Id.* at 1097.

Return filed late, but before the IRS finalizes an SFR→ can be dischargeable

## What is a Substitute for Return (SFR)?

What is an SFR? How to know if one was filed on behalf of your client?

- If a debtor fails to timely file a return, the IRS can prepare a “substitute for return” (SFR) and assess the taxes typically based on information received from 3rd parties (i.e., wage and income transcripts).
- A tool that the IRS (and taxing agencies in general) have to deal with taxpayers who do not file required tax returns.
- Account transcripts will reflect an “SFR” indicator if a client has been selected for an SFR to be filed. Look to see if/when an actual return was filed. May need to submit a FOIA.

## Case Law

- *In re Smith*, 828 F.3d 1094 (9th Cir. 2016). In *Smith*, the Ninth Circuit reaffirmed and applied the four-factor test adapted by *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000). Under the *Hatton* test, a document qualifies as a tax return if it 1) purports to be a return; 2) is executed under penalty of perjury; 3) contains sufficient data to allow calculation of tax; and 4) represents “an honest and reasonable attempt to satisfy the requirements of the tax law.” *Id.* at 1060-61. See *Van Arsdale v. IRS* (In re Van Arsdale), 2017 Bankr. LEXIS 1388, at \*5-6 (Bankr. N.D. Cal. May 18, 2017).
- *United States v. Martin (In re Martin)*, 542 B.R. 479 (B.A.P. 9th Cir. 2015) (9<sup>th</sup> Circuit rejected IRS argument that a tax return filed after it files an SFR is never a return under § 523(a)(1)(B).)
- *Van Arsdale v. IRS* (In re Van Arsdale), 2017 Bankr. LEXIS 1388 (Bankr. N.D. Cal. May 18, 2017) (August 2005 filing of 2001 federal tax return was not an honest and reasonable attempt to satisfy his 2001 obligation).
- In *Beard*, the court determined that the wages earned by petitioner are taxable; the altered Treasury Form 1040 filed by petitioner did not constitute a return under 26 U.S.C. § 6011 (1982); and that petitioner, therefore, owed additional tax for willfully filing a late return in violation of 26 U.S.C. §§ 6651 (a)(1), 6653(a) (1982). *Beard v. Commissioner*, 793 F.2d 139, 139



(6th Cir. 1986)

### **B. Unfiled Returns**

A tax with respect to which a return, or equivalent report or notice, if required, was not filed or given, is nondischargeable in Chapters 7, 11, or 13. [11 U.S.C. § 523(a)(1)(B)(i)]

If there is an unfiled return and the debtor decides to late-file the return, see discussion above on delinquent returns.

### **C. Equivalent Report or Notice (Franchise Tax Board)**

Franchise Tax Board requires taxpayers to report changes or corrections made by the IR that increase the amount of tax owed to the FTB within six months of the final federal determination. [Cal. Rev. & Tax Code. §18622]

If a debtor fails to report the changes, the state taxes are not dischargeable. *See Berkovich v. Cal. Franchise Tax Bd. (In re Berkovich)*, 619 B.R. 397 (B.A.P. 9th Cir. 2020) (debtor failed to file a report with the FTB following IRS' assessment, and thus, debtor's state tax debts were exempted from discharge under § 523(a)(1)(B)).

### **D. Fraudulent Return**

Any tax with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax. [11 U.S.C. § 523(a)(1)(C)]

Look for civil fraud penalty under 26 U.S.C. § 6663.

The existence of fraud is to be determined by considering all the facts and circumstances. [*Stratton v. Commissioner*, 54 T.C. 255, 284 (1970)]

The Government bears the burden of proof and must show **clear and convincing evidence** of each element of fraud. [26 U.S.C. § 7454(a); Rule 142(b), Tax Court Rules of Practice and Procedure]

The IRS must show that the taxpayer intended to commit fraud, which has been described as an “**intentional wrongdoing** \* \* \* motivated by a **specific purpose** to evade a tax **known or believed** to be owing.” [Citations omitted] The elements to

be shown are (1) an underpayment of tax, and (2) that some part of this underpayment was due to fraud.” [*Hebrank v. Commissioner*, 81 T.C. 640, 642 (1983)]

Fraud is established by proving that a taxpayer intended to evade tax believed to be owing by conduct intended to conceal, mislead, or otherwise prevent tax collection. [*Clayton v. Commissioner*, 102 T.C. at 647; *Pittman v. Comm’r*, 100 F.3d at 1319]

### **E. Willful Attempt to Evade or Defeat Tax**

Declaring a tax debt non-dischargeable under 11 U.S.C.S. § 523(a)(1)(C) on the basis that the debtor willfully attempted in any manner to evade or defeat such tax required a showing of specific intent to evade the tax. [*Hawkins v. Franchise Tax Bd.*, 769 F.3d 662 (9th Cir. 2014)]

Willful attempts include declining to file tax returns, shifting assets to another person or a false bank account, shielding assets, and switching all financial dealings to cash. [*Id.* at 667-668]

“The primary, but not exclusive, theory of the IRS and FTB was that the Hawkinses’ maintenance of a rich lifestyle after their living expenses exceeded their income constituted a willful attempt to evade taxes.” [*Id.* 665-66. Remanded to reanalyze the case using the specific intent standard.

Fraudulent failure to file tax returns and pay taxes can be a basis for nondischargeability. [*Toti v. United States (In re Toti)*, 24 F.3d 806, 808 (6th Cir. 1994) (Debtor’s failure to file returns and to pay taxes were willful acts, and thus, he willfully attempted to evade or defeat his tax liability within the meaning of 523(a)(1)(C))]

## **XI. SALES AND USE TAXES**

An important issue to be aware of are unpaid sales and uses taxes, particular with a failing business. The California Department of Tax and Fee Administration can hold a personal personally liable for unpaid sales taxes in certain situations.

## **Personal liability**

Upon the termination, dissolution, or abandonment of a business, a person who is charged with the responsibility of for filing the returns or the payment of the tax, or who is under a duty to act, can be personally liable for any unpaid taxes, interest and penalties, if the person willfully fails to pay or causes to be paid any taxes due. [Cal. Rev. & Tax Code § 6829(a)]

### **Who Can Be Liable?**

An “officer, member, manager, partner, or other person” can be liable for taxes that became due during the period he or she had “control, supervision, responsibly, or duty to act” for the business. [Cal. Rev. & Tax Code § 6829(b)]

### **What California Must Prove**

Personal liability may be imposed only if the California Department of Tax and Fee Administration can establish one of two conditions:

- The business had included tax reimbursement in the selling price of, or added tax reimbursement to the selling price of, tangible personal property sold in the conduct of its business, or
- The business consumed tangible personal property and failed to pay the tax to the seller or has included use tax on the billing and collected the use tax or has issued a receipt for the use tax and failed to report and pay use tax. [Cal. Rev. & Tax Code Sect. § 6829(c)]

### **Willfulness**

For purposes of section 6829, “*willfully fails to pay or to cause to be paid*” means that the failure was the result of an intentional, conscious, and voluntary course of action. This is the same definition of willfulness for civil fraud under 26 U.S.C. § 6663.

### **Statute of Limitations**

The statute of limitations for issuing a notice of determination can be either three years or eight years, depending on when the Board obtains a

- **Three Years** - A notice of deficiency determination under this section shall be mailed within **three years** after the last day of the calendar month following the quarterly period in which the board obtains **actual knowledge**, through its audit or compliance activities, or by **written communication** by the business or its representative, of the termination, dissolution, or abandonment of the business, or
- **Eight Years** - Within eight years after the last day of the calendar month following the quarterly period in which the business was terminated, dissolved, or abandoned, whichever period expires earlier.

**Practice Tip:** A business owner should provide written communication of the termination, dissolution, or abandonment of the business so as to trigger the three-year statute of limitations; and otherwise, the Board has eight years to issue a notice of determination.

## **Sales and Use Tax Issues and Bankruptcy**

Sales and use tax issues can arise in bankruptcy.

If the Board holds an individual personally liable for unpaid sales and use taxes, the taxes are priority taxes. 11 U.S.C. § 507(a)(8)(C). See discussion above.

In addition, unpaid sales taxes also can be assessed long after they have not been paid. A debtor's tax liability for unpaid sales taxes was not discharged because the tax was not assessed but remained assessable under 11 U.S.C. § 507(a)(8)(A)(iii). See *In re Ilko*, 2009 Bankr. LEXIS 4541 (B.A.P. 9th Cir. Oct. 15, 2009).

“... because responsible person liability does not arise under Tax Code § 6829 until a corporation dissolves, terminates or abandons its business, the statute of limitations for issuing a notice of dual determination to a responsible person begins to run when the liability arises. Since debtor was not liable for the taxes until EAS ceased operations on March 31, 2003, which was after the July 3, 2001 commencement of his bankruptcy case, the Board asserts that the taxes were still assessable by law.” *Id.* at \*22-23 (B.A.P. 9th Cir. Oct. 15, 2009).

## XII. TAXATION OF THE BANKRUPTCY ESTATE

### In General

- Separate bankruptcy estate → chapters 7 and 11 [26 U.S.C. 1398]
- Trustee succeeds to the assets, liabilities, and tax attributes
- Trustee files Form 1041
- No separate taxable entity for chapter 13

### Example: Trustee Sells Personal Residence, Who Pays Tax?

Suppose that the trustee sells your client's principal residence in a chapter 7 case. Is the trustee allowed to consider 26 U.S.C. § 121 exclusion of gain from the sale or exchange of a debtor's principal residence?

The answer is yes. For purposes of the rules relating to a bankruptcy estate succeeding to a debtor's tax attributes, a bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate. Reg §1.1398-3(c). This rule applies to cases under chapter 7 or chapter 11 of the Bankruptcy Code, but only if the debtor is an individual. Reg § 1.1398-3(a). For purposes of Reg §1.1398-3, the Code Section 121 exclusion means the exclusion of gain from the sale or exchange of a debtor's principal residence. Reg §1.1398-3(b).

### Short-Period Election

If an election is made under section 1398, the debtor's tax year is divided into two short tax years:

- The **first short tax year** starts when the debtor's tax year would have started had the election not been made (Jan. 1 for most individuals) and ends the day before the bankruptcy petition is filed.
- The **second short tax year** begins the day the bankruptcy petition is filed and ends when the debtor's tax year would have ended had the election not been made (Dec. 31 for most individuals).

### **Example: Debtor Does Not Make a Short-Year Election**

Tom, a calendar year taxpayer, files a chapter 7 bankruptcy petition on March 15, 2016. Is Tom's tax year affected by the filing of the chapter 7 case? Does Tom file a Form 1040 for the entire year or only pick up income (and claim any deductions) up to the filing date of her chapter 7 case?

Assuming that Tom does not make a short-year election, his tax year is not affected by the filing of a chapter 7 case on March 15, 2016. Code Sec. 1398(d)(1). Tom files a Form 1040 for the entire year, but her return includes only income and deductions that accrued before the commencement of bankruptcy, as well as those accruing after bankruptcy that relate to property acquired after bankruptcy or exempt property. Code Sec. 1398(e)(2); *also see* Checkpoint EXP ¶13,984.05 Debtor's election of short tax year.

### **Example: Debtor Makes a Short-Year Election**

If Tom makes an election under Code Sec. 1398, when does the first short tax year begin and end? When does the second short year begin and end?

If the election is made, Tom's tax year is divided into two short tax years:

1. The first short tax year starts when Tom's tax year would have started had the election not been made (Jan. 1 for most individuals) and ends the day before the bankruptcy petition is filed.
2. The second short tax year begins the day the bankruptcy petition is filed and ends when Tom's tax year would have ended, had the election not been made (Dec. 31 for most individuals).

*See* Checkpoint EXP ¶13,984.05 Debtor's election of short tax year.

### **Effect on Bankruptcy**

- The short year is a pre-petition tax year and is part of the IRS Proof of Claim.
- The tax claim is classified as eighth priority claim because the taxes are not old enough to be discharged (the taxes fail the Three-Year

Rule). [11 U.S.C. 507(a)(8)(A)]

- In a Chapter 13, the taxes can be handled in a Chapter 13 plan, which is a key advantage in making the election.
- In a Chapter 7, the taxes would not be dischargeable because the taxes fail the three-year rule.
- The second period is a post-petition tax year and is not part of the IRS Proof of claim.

### **XIII. POST-BANKRUPTCY PROCEDURES**

What happens if the IRS takes collection action after the debtor receives a discharge?

- The debtor may contact the taxing agency, submit a copy of the discharge order, and request the agency to advise whether the bankruptcy court discharged the taxes.
- The debtor also can re-open the case and file an adversary proceeding, a complaint to determine discharge of tax liability. The bankruptcy court may enter an order determining that the tax liabilities are discharged. [Rule 4007]

### **XIV. DESIGNATED PAYMENTS IN A CHAPTER 13 CASE**

Practitioners think that they can designate how payments are applied. For example, paying the non-dischargeable taxes first.

Payments made through bankruptcy are considered involuntary payments, and so there is no designation of payments.

The IRS gets to designate Chapter 13 payments, and the IRS will apply the payments in the order that best serves the interests of the government, considering the Collection Statute Expiration Date. This will generally mean an application to the oldest tax, oldest penalty, and oldest interest, in that order until fully used. [IRM 5.1.2.6.4.1.]

## **XV. PROPER SERVICE OF PROCESS**

When there is an adversary proceeding, contested matter or objections, some practitioners think it's okay to just serve the IRS insolvency person or whomever their contact is.

But there are technical rules for serving the government.

You must serve the following parties:

- Internal Revenue Service,
- United States, the Attorney General in Washington, D.C., and
- United States Attorney in Los Angeles (or your local US attorney's office).

**Practice Tip.** Read the CDCA Local Bankruptcy Rule 2002-2(c)(2) and the Court Manual, Appendix D, which is found on Court's website.