TAX ISSUES IN BANKRUPTCY - SECTION 523(a)

Section 523(a) of the Bankruptcy Code addresses, among other things, exceptions to an individual debtor's discharge from tax claims and obligations in a bankruptcy proceeding. This article will examine those provisions set forth in Section 523(a) which impact upon the dischargeability of an individual debtor's pre-petition tax liabilities.

I. Non-Dischargeable Priority Tax Claims

Section 523(a)(l)(A)-(C) of the Bankruptcy Code sets forth those provisions relating to an individual's discharge from taxes in a bankruptcy. In addition, Section 523(a)(14) excludes from discharge any debt incurred to pay a non-dischargeable federal tax claim.

Section 523 (a) (1) (A) refers to and renders non-dischargeable those taxes which are given priority under Section 507(a)(2) and (8) of the Bankruptcy Code. Therefore, in order for a debtor's tax liability to be discharged in bankruptcy, it must not be excepted from discharge under Section 523(a)(1)(B) or (C), or entitled to priority under Section 507(a)(2) or (8). Failure to correctly determine the dischargeability of a tax debt pre-petition may be prejudicial to a debtor, particularly if the tax debt would have become dischargeable in bankruptcy with the passage of time.

Taxes that are entitled to priority under Bankruptcy Code Sections 507(a)(2) ("gap period" taxes in an involuntary bankruptcy case) and 507(a)(8) are, by definition, non-dischargeable.

Section 507(a)(8)(A) of the Bankruptcy Code grants priority to three categories of income and gross receipts taxes:

(i) taxes for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, within three years before the date of filing of the petition;

(ii) taxes assessed within 240 days of the filing of the petition. This period is extended, however, for any period during this time that an offer and compromise is pending, plus 30 days; and

(iii) taxes not assessed before the petition date, but still assessable, under law or by

agreement, after the date of the filing of the petition.

Priority under the Bankruptcy Code for income or gross receipts taxes is granted for taxes for a taxable year ending before the date of the petition for which a return is last due, including extensions, within three years of the filing date of the petition. When a case has been converted from one Chapter to another, the date to consider for the "filing of the petition" under this provision is not the date of conversion, but rather the date the case was originally commenced.

The question of what constitutes the due date of a tax return is critical, particularly when an extension has been granted. In Wood v. United States, 866 F. 2d 1367 (11th Cir. 1989), the debtor extended the time to file his 1982 tax return until October 15, 1983. He actually filed his return on October 7, 1983. The debtor filed a Chapter 7 petition on October 10, 1986. Based on these facts, the Court ruled that the debtor's taxes were not dischargeable.

Priority under the Bankruptcy Code is also granted for taxes that are assessed within 240 days of the filing date of the petition. The 240-day period is extended for any time during which an offer in compromise is pending, plus 30 days. Because the IRS can assess a taxpayer numerous times in a given year, each assessment of tax must be independently determined as either dischargeable or non-dischargeable according to the 240-day rule.

Taxes are deemed to be "assessed" when the taxpayer's liability is recorded in the Office of the Secretary of the Treasury. The actual date of assessment is the date that the summary record of assessment is signed. The Third Circuit Court of Appeals has held that a proof of claim filed by the IRS does not qualify as a notice of assessment. See, Resyn Corp. v. United States (In Re Resyn Corp.), 945 F. 2d 1279 (3rd Cir. 1991).

Priority status is also provided for income or gross receipt taxes, which have not been assessed, but which are still assessable as a matter of law or by agreement after the date of the filing of a petition in bankruptcy. Taxpayers may extend the statute of limitations relative to an assessment by written agreement. An extension can be given either through a specific date or for an unlimited time. Thus, in the case of In re Crist, 85 B.R. 807 (Bankr. N.D. Iowa, 1988), a Bankruptcy Court determined that where

the debtor executed the requisite Form 872-A, and the time period was still open relative to assessment at the time that a bankruptcy petition was filed, the tax in question was assessable and subject to priority status.

If a debtor in bankruptcy fails to include in his income more than 25% of the gross income which should have been reported on his tax return, the statute of limitations for the assessment of the tax would be six years instead of three years. Furthermore, an amended return filed within 60 days of the last day of the applicable statute of limitation extends the statute of limitations for the assessment of any additional taxes for a period of 60 days from the date that the IRS receives the amended tax return.

Section 523 of the Bankruptcy Code sets forth specific exemptions to dischargeability for unfiled, late or fraudulent tax returns. Returns prepared by the IRS pursuant to I.R.C. Section 6020(b), which are not signed by the taxpayer, do not begin the running of the statute of limitations and therefore are not treated as returns for purposes of Section 523(a). Thus, a return must be signed in order for the statute of limitations to run as regards dischargeability of a tax claim.

Taxes reflected on a return which is filed after the due date and within two years of the filing of a bankruptcy petition are not dischargeable. Significantly, the "due date" is determined by taking extensions into account.

Taxes that are reported on fraudulent returns or returns filed by a taxpayer with intent to evade or defeat the tax, are non dischargeable under Section 523 of the Bankruptcy Code. It is the taxing authority which bears the burden of proving fraud in such a situation. Generally, the standard of proof for exceptions to dischargeability under Section 523 is the "preponderance of the evidence" standard.

II. **Other Tax Claims Which Are Deemed Non-Dischargeable in Bankruptcy**.

During a bankruptcy proceeding, the automatic stay which is imposed by Section 362(a) will impact the timing of those provisions pertaining to priorities and exceptions to discharge. By way of illustration, the three year rule set forth in Section 507(a)(8) is extended by the time that the automatic stay is in effect, plus six months. Taxes may also still be assessable where the taxpayer filed for bankruptcy relief before the running of the statute of limitations. This would have the effect of extending

the statute of limitations for at least the period of time that the automatic stay was in effect.

The automatic stay terminates at different times depending upon the applicable Chapter of the Bankruptcy Code. For example, the automatic stay terminates upon confirmation of a Chapter 11 plan. However, in a Chapter 13 case, the automatic stay continues until completion of payments under a confirmed plan, unless the case is closed, dismissed or converted to another Chapter.

It is critical to determine the extent to which a prospective debtor may or may not discharge tax liabilities in bankruptcy. Accordingly, an understanding of Section 523(a) as it relates to dischargeability of taxes is a must for the insolvency practitioner.