

**Presented:**  
2013 Consumer Bankruptcy Practice

August 8-9, 2013  
Galveston, TX

**DETERMINING THE DISCHARGEABILITY  
OF UNSECURED INCOME TAX DEBTS  
Breaking the Code of the IRS Account Transcripts**

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## **A. Introduction**

This outline will cover three areas:

- (1) General elements of dischargeability for income taxes;
- (2) How to read IRS account transcripts to determine dischargeability of income tax liabilities; and
- (3) How to “catch” those taxes which will be unsecured but nondischargeable.

## **B. General Rules Regarding Dischargeability of Income Taxes**

Federal taxes, to some extent, are dischargeable. A detailed review of the rules regarding dischargeability is beyond the scope of this presentation, but the general rules for discharging income taxes are listed below:

Rule 1: 3 Year Rule – due date for the return must be more than 3 years prior to the petition date (11 U.S.C. §507(a)(8)(A)(i)).

The first rule requires that the due date of the return be more than 3 years prior to the petition date. Note that under this rule, the practitioner is determining when the return was actually due, including extensions, not when the return was actually filed. The practitioner should identify the tax year for which a discharge is sought, then count three years back from the proposed petition filing date to see if the return was due either within or beyond this time frame. If the return was due beyond this time frame, then the tax for that period passes this test and is not a priority tax under this subsection.

Rule 2: 240 day rule – The tax must have actually been assessed more than 240 days prior to the petition date. (11 U.S.C. § 507(a)(8)(A)(ii)).

If the tax year for which the debtor is seeking a discharge passes the 3-year rule, the practitioner must then determine whether the IRS assessed the tax more than 240 days prior to the petition date. This rule asks the bankruptcy practitioner to identify exactly when the tax for a particular tax year was actually assessed,<sup>1</sup> or posted on the IRS’ books. Typically, the income taxes resulting from a filed tax return are assessed (or put on IRS’ books) near the time the return is received by the IRS.

Be aware that there are times when, such as pursuant to a subsequent IRS audit or examination, the taxes are assessed against the taxpayer well after the return is filed. The IRS may conduct an audit of a particular tax year and assess

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<sup>1</sup> The assessment of a tax is essentially a bookkeeping notation, and is made when the Secretary or his delegate establishes an account against the taxpayer on the tax rolls. *In re Hosack*, 282 F. App'x. 309, 313 (5th Cir. 2008), citing *Laing v. United States*, 423 U.S. 161, 170 n. 13, 96 S.Ct. 473, 46 L.Ed.2d 416 (1976).

taxes for that year within 3 years from the date the return is filed.<sup>2</sup> Moreover, this period can be extended. Tax periods and returns that are subject to an IRS audit or examination deserve close scrutiny under this rule.

Rule 3: 2 Year rule - The return must have been actually filed more than 2 years prior to the petition date (11 U.S.C. §523(a)(1)(B)).

Under this rule, the bankruptcy practitioner should identify the date the Form 1040 was filed with the IRS and make sure that the bankruptcy petition is filed more than 2 years from the date of filing the return. If no return was filed by the debtor, then the tax for that year is not dischargeable.<sup>3</sup>

Rule 4 – No Fraud: Tax is not dischargeable if the debtor filed a fraudulent return (11 U.S.C. 523(a)(1)(C)).

Income taxes for a particular tax year are not dischargeable if the debtor has filed a fraudulent return for that tax year. As a practitioner, this may be very difficult to determine. Generally, the practitioner should review the debtor’s IRS transcripts (discussed below) and tax returns for any indications of fraud.

Rule 5 – No Tax Evasion: Taxes are not dischargeable for any year for which the debtor willfully attempted to defeat or evade the tax (11 U.S.C. 523(a)(1)(C)).

The debtor’s taxes are not dischargeable in bankruptcy when the debtor has willfully attempted to defeat or evade tax. The statutory phrase “willfully attempted to evade” means a voluntary, conscious, or intentional attempt to evade a tax, whether the evasion was through overt actions or omissions. Willfully attempting to evade taxes requires the misconduct and an intention to evade. The intention requirement requires that the taxpayer had a duty to pay a tax, knew of the duty, and intentionally and voluntarily evaded such duty.<sup>4</sup> The bankruptcy cases addressing this provision teach that the bankruptcy practitioner must determine whether the debtor fits the mold of the “honest debtor.”<sup>5</sup>

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<sup>2</sup> I.R.C. § 6501(a).

<sup>3</sup> See discussion below of dischargeability issues when IRS files a “substitute return” on behalf of the debtor.

<sup>4</sup> See e.g., *Matter of Bruner*, 55 F.3d 195, 200 (5th Cir. 1995).

<sup>5</sup> Determining factors include conduct such as (i) understatement of income for more than one year; (ii) implausible or inconsistent behavior; (iii) extensive dealings in cash; (iv) failure to cooperate with the IRS; (v) inadequate record keeping; (vi) transfer[s] of assets to a family member; (vii) transfer[s] of assets for inadequate consideration; (viii) transfer[s] that greatly reduce assets subject to IRS execution; (ix) transfers made in the face of

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First appeared as part of the conference materials for the 9<sup>th</sup> Annual Consumer Bankruptcy Practice session "Topic E: Bankruptcy Tax Issues"