Bankruptcy is a popular remedy for unmanageable balances on credit cards, pulling houses out of foreclosure, and eliminating medical bills from illness. But bankruptcy is more than what is seen on TV; bankruptcy can also have a huge impact on tough IRS problems.

Bankruptcy can release IRS seizures and levies, stop the accrual of interest and penalties, improve and reduce the terms of IRS installment agreements, eliminate tax liabilities within months, reduce the value of an offer in compromise (OIC), solve the often inequitable use of IRS collection financial standards, and take the playing field away from revenue officers and Automated Collection Service (ACS) employees.

What follows are ten situations where bankruptcy can make a difference for your client.

#1 Immediate Release of IRS Seizures or Levy Action
Bankruptcy is a powerful way to put the brakes on an IRS jam. Bankruptcy stops the IRS collection machinery. The instant a bankruptcy is filed, the IRS is barred from taking any collection against your client. This is called a bankruptcy “stay,” and, unless modified by the bankruptcy court, continues uninterrupted while the bankruptcy is pending. Bankruptcy can bring a degree of evenness to difficult situations.

If the IRS has issued a wage levy, bank levy, or seizure of real or personal property, it must be released (wage and bank levy) or stopped (seizure of real or personal property) once a bankruptcy is filed. There should be no negotiation to obtain the release once bankruptcy is filed. It is absolute by operation of bankruptcy law.

When the IRS refuses to yield and your client is in a bind, bankruptcy law trumps IRS administrative action and forces levies and seizures to stop. Bankruptcy has your client’s back.

#2 A Payment Option That Reduces the Amount the IRS Has to Be Paid
In many IRS payment plans, the wheel just goes ‘round and ‘round, with the payments never enough to actually pay off the tax debt before the IRS collection timeframe expires (10 years/120 months).

The solution is in making payments through a Chapter 13 bankruptcy. A Chapter 13 is simply a debt repayment plan conducted by approval of a bankruptcy judge. It can repay tax debt, credit card debt, medical bills, and unpaid bills from a business.

If you have ever wondered how a house in foreclosure is saved in bankruptcy, it is usually by use of a Chapter 13, which stops the foreclosure and forces a bank to enter into a payment plan for the missed mortgage payments. Chapter 13 once again comes to the rescue: it can put the brakes on that spinning wheel.

Yes, Chapter 13 can do more than just stop interest and penalty accruals; it can actually reduce the amount the IRS gets paid in installment agreements.

Does your client owe $30,000 but can only afford $250/month—an amount that will not pay the liability before the collection timeframe expires? Chapter 13 can force the IRS to take a discount on what is owed and accept the $250/month as payment in full, even though it will only be paid over the course of the Chapter 13, which is thirty-six to sixty months. (The time it takes to complete a Chapter 13 payment plan—thirty-six to sixty months—often compares favorably with the time it takes to complete an IRS installment agreement.)

By Howard S. Levy, JD
Here’s why the IRS can be forced to take a haircut if paid through a Chapter 13: Chapter 13 laws have what is known as a “cramdown.” In bankruptcy speak, cramdown means that a creditor can be forced to receive less than the full amount of its bill. The bankruptcy code determines that a debt is subject to cramdown based on the priority, or level of importance, it is given. For example, credit cards and medical bills are given a low priority and importance in bankruptcy, in part based on their nature as used for household and family purposes; taxes are initially given a higher priority, which reduce over time to a lower priority.

In other words, the cramdown permits low-priority debts to be repaid at a fraction of what was originally owed. This can include the IRS. Taxes achieve a lower priority—matching them with credit cards and doctor bills—with the passage of time. “Nonpriority” is the technical term given to taxes when they are aged to achieve a low priority that is equal to credit cards. Credit cards and doctor bills are born as nonpriority debts; taxes take a little time to get there. In the bankruptcy world, taxes are like wine—they get better as they age. (See sidebar.)

The bankruptcy code determines that a debt is subject to cramdown based on the priority, or level of importance, it is given.

Once taxes meet the tests of time, they can be categorized as nonpriority debts and can be repaid like credit cards.

Here is an example:
Your client has $50,000 in credit card debt, $30,000 in IRS and state taxes, and $250/month of disposable cash flow.

At first glance, there is a problem—how can $250/month repay $80,000? Even at the sixty-month maximum time a Chapter 13 can last, that is only $15,000. But you do the analysis and find that the taxes have aged, and they have now changed from priority to nonpriority debts.

Here’s where Chapter 13 cramdown comes to the rescue. Since all the debts are nonpriority, the creditors have to accept payment of $250/month, equal to just under 20 percent of what is owed. This includes the IRS, which will get approximately $6,000 on its $30,000 claim. The rest of what is owed gets dismissed when the Chapter 13 bankruptcy concludes (remember, thirty-six to sixty months) by operation of the bankruptcy cramdown laws. The balance that is not paid by the monthly payments—taxes, credit cards, medical bills—is discharged by the bankruptcy court, with an entry then made by the IRS in its books after the bankruptcy, reducing the account balance to zero.

#3 A Payment Option That Shortens the IRS Collection Timeframe
Chapter 13 also shortens the length of repayment. To review, a Chapter 13 lasts between thirty-six to sixty months. The IRS has up to twice as long to collect: 10 years/120 months, approximately $6,000 on its $30,000 claim. The rest of what is owed gets dismissed when the Chapter 13 bankruptcy concludes (remember, thirty-six to sixty months) by operation of the bankruptcy cramdown laws. The balance that is not paid by the monthly payments—taxes, credit cards, medical bills—is discharged by the bankruptcy court, with an entry then made by the IRS in its books after the bankruptcy, reducing the account balance to zero.

#4 A Payment Option That Stops the Accrual of Interest and Penalties
Next to “Can I settle my debts with the IRS?,” the most popular question of a taxpayer in distress is, “How do I make the interest and penalties go away?”

The answer to the frustration caused by interest and penalty accruals is once again Chapter 13 bankruptcy. Chapter 13 (named after the thirteenth chapter in the bankruptcy code, which contains the laws governing this type of bankruptcy) can stop the accrual of IRS interest and penalties in payment plans, which can be a tremendous savings of not only money but time.

As a general rule, interest and penalty accruals will double the amount owed every five years, making success in paying off a tax debt difficult with many IRS-approved installment agreements.

By comparison, a Chapter 13 bankruptcy can stop interest and penalty accruals. That means the monthly payment goes to what was owed, not what will be owed.

#5 When There Is No Ability to Make Payment, an Option to IRS Uncollectible Status
If no ability to repay can be demonstrated to the IRS, the IRS can agree to temporarily forbear on collection-enforcement activity. “Uncollectible” is the technical term the IRS uses when it places an account in financial hardship status.

With ten years to collect the liability, the uncollectible status can linger on during that timeframe, or the IRS may review the account every two years, or request new financial disclosures on ability to pay if there are indicators that income is increasing. Uncollectible status is a temporary reprieve from IRS collections. The reprieve can be made permanent with Chapter 7 bankruptcy.
**Tax Liabilities: From Priority to Nonpriority Debts**

For taxes to achieve a low priority standing, there are a few questions that have to be asked, mainly focused on time. When you are looking at a potential bankruptcy situation, ask yourself the following initial qualifying questions:

1. Were the returns on which the liability is based due to be filed more than three years ago? (Extensions are included in calculating the return due date.) Example: A 2008 return, due to be filed on April 15, 2009, would pass this test after April 15, 2012 (three years after it’s due).

2. For late filers, were the returns actually filed more than two years ago? Example: A 2008 return, due to be filed on April 15, 2009, but not actually filed until April 15, 2010, would pass this test after April 15, 2012 (two years after filed).

3. In IRS audit situations, ask if the audit was completed and the amount owed assessed more than 240 days ago? (These rules are cumulative.)

4. Was a tax return actually filed? (IRS substitutes for return do not count in reducing the IRS’s priority in bankruptcy.)

5. Has anything happened that tolls the ticking of these timing rules? (For example, a timely filed collection due process appeal can toll the rules or an OIC submitted within 240 days after a tax was assessed.)

6. Are the taxes that are owed income and nontrust fund taxes? (Any type of trust fund tax—including the trust fund portion of withheld employment taxes—disqualifies taxes for nonpriority treatment; the taxes must be income or nontrust fund.)

Chapter 7 bankruptcy is the polar opposite of a Chapter 13 bankruptcy. Chapter 13 is for those with cash flow, and it imposes a repayment plan on the IRS. Chapter 7 is for those without cash flow, and it eliminates any nonpriority tax debt (taxes that have aged a little) without having to make any repayment of the liability.

Chapter 7 works best under the same circumstances that make an account uncollectible: no cash flow and assets that have no or minimal equity. The same bankruptcy schedules of income and expenses and assets and liabilities that are used for a Chapter 13 are used for a Chapter 7; but in a Chapter 7 there is no cash flow for a repayment plan. Because the taxes cannot be repaid, and if they have nonpriority status, they are eliminated by bankruptcy law without payment. And Chapter 7 usually lasts four to six months, making it quick, efficient, and a lot shorter than IRS uncollectible status.

#6 Leverage in an OIC

Sec. 5.8.10.2.2 of the Internal Revenue Manual (IRM) permits the IRS to consider the impact of a potential bankruptcy on the settlement value of an OIC. In other words, if bankruptcy is a real option and could eliminate everything that is owed to the IRS, but your client wants to avoid it if possible, tell the IRS that your client is considering bankruptcy, and show IRS what they would get if a bankruptcy was filed.

If your client is considering a Chapter 7, the IRM instructs the offer investigator to consider reducing the value of future income to reflect that a bankruptcy could eliminate the liability without any recovery. Bankruptcy can be used as leverage in reducing the value of an OIC.

#7 Alternative to an OIC

An OIC can be an effective tool to settle a tax liability in the right circumstances; but there are trade-offs involved. The acceptance rate—although on the rise in the last two years to 33 percent (2011) and 37 percent (2012)—is still low, especially in comparison to the more quantifiable results that bankruptcy offers. Bankruptcy results are based on bankruptcy law—whether seeking a better payment plan (Chapter 13) or to eliminate taxes without payment (Chapter 7). The analysis is objective; OIC results are more subjective as the results rest with the opinion and analysis of the offer examiner.

Before diving in with an OIC, consider how long a bankruptcy takes and how long an OIC can take. A Chapter 7 bankruptcy takes four to six months to eliminate a tax liability, and a Chapter 13 takes thirty-six to sixty months to repay it. This can compare favorably with the time it takes to get an OIC accepted and paid, all without wondering whether the IRS will say yes (bankruptcy forces the IRS to say yes).

Depending on where the offer is worked and the volume of IRS caseload, an OIC can take six to twelve months to be investigated. If the investigation results in a rejection of the offer, an appeal can take another six to twelve months. If a settlement is ultimately reached, your client will be permitted up to twenty-four months to pay in the value to complete the compromise. And then your client must stay current on all taxes and filings for sixty months thereafter. This is most certainly longer than a Chapter 7, and can rival a Chapter 13 in certain circumstances.

Most OICs also require a down payment when the offer is submitted; there is no such requirement in bankruptcy.

An OIC does, however, work to release tax liens. A successful Chapter 13 will also result in the release of tax liens. In Chapter 7, the IRS is not compelled to release the liens after the tax liability is eliminated, but usually will do so in cases where there are no assets of any significant value.

#8 Averting Application of IRS Financial Collection Standards

The IRS collection financial standards can have an onerous impact on IRS negotiations. IRS collection financial standards cap the amount...
of monthly living expenses the IRS will administratively allow in determining the ability to make monthly payments.

The most common offender of the IRS collection financial standards are housing and utility expenses, where actual expenses often exceed the IRS’s more puritan allowances. This creates phantom cash flow; the IRS disallows the part of the expense that exceeds its allowance and asks for that disallowed expense to be part of a monthly payment.

These standards are IRS administrative standards, and in most cases do not affect a bankruptcy court’s view of cash flow. By comparison, reasonable expenses, which are not allowed by the IRS, are often permitted in bankruptcy. Bankruptcy can change the expenses would be allowed. After all, absent bankruptcy—means testing, IRS standards are just that: internal IRS guidelines. They are not absolute bankruptcy guidelines to determine cash flow. Bankruptcy courts tend to use more of a “belt-tightening” approach, asking if the expenses are reasonable or excessive: Expect a $1,741 mortgage payment and $450 in housing and utilities to be reasonable in bankruptcy, and the $250 in cash flow—not $700—to be the amount of the repayment.

The result? In a Chapter 13, the taxpayer will have monthly payments of $250 on actual cash flow, not $700 on phantom income.

Let’s now apply the example to a Chapter 7, but presume that there was $5,000 in income and $5,000 in reasonable living expenses. There is no cash flow from which to make monthly payments, but the IRS requested $450/month after application of their collection financial standards to the housing and utility expenses.

The housing and utility expenses that exceeded IRS’s caps would likely be allowed in a Chapter 7, permitting a zero budget and qualifying the taxpayer to eliminate, rather than pay, any nonpriority taxes.

9 Intervention When IRS Is Perceived As Being Unreasonable to Your Client
If you have a revenue officer and don’t see eye-to-eye, or if ACS is running your client around, bankruptcy can bring impartiality to the process. IRS procedure defers to bankruptcy law, and claims that you are unable to negotiate with the IRS can be eliminated in a Chapter 7 or repaid in a Chapter 13. You will also change the parties, as revenue officers and ACS employees do not handle bankruptcies on behalf of the IRS. Bankruptcy changes the playing field.

10 To Simultaneously Resolve both a Tax Problem and a Credit Card Problem
Clients with tax problems often have other financial problems, whether it is state and local taxes, credit cards, medical bills, or unpaid bills from a business. A Chapter 7 bankruptcy can eliminate all these debts, while an OIC alleviates only one aspect of the financial distress. Bankruptcy works well in situations that involve more than tax problems.

What do you do when your client is making $600/month payments on credit cards, and the IRS demands that money be paid to it in an installment agreement, not to the credit cards? There isn’t enough to satisfy everyone, and not enough to pay everyone off.

The answer is again a Chapter 13, which reorganizes this quagmire and can take the $600 and permit it to be shared among all creditors. If all the debt is nonpriority, then all creditors share the $600 pro-rata in relation to the value of their claim—no fighting over the pot. If the IRS taxes are considered to be priority (that means they are more recent and have not yet aged), the bankruptcy court can order most of the $600 to go to the IRS and minimal amounts to the credit cards. The IRS now has a higher priority and claim to the money, and it will get the money before the lower priority claims. The lower nonpriority claims get the cramdown, and the IRS gets paid.

If you have a revenue officer and don’t see eye-to-eye, or if ACS is running your client around, bankruptcy can bring impartiality to the process.