Tax Talk

by Andrew Strelka

Bankruptcy Tax Litigators: The Unicorns of Federal Tax Litigation

Tax attorneys are a diverse bunch, ranging from adding machine addicted, soft-spoken accountant types to perfectly coifed stare-you-down litigators. Included in this array of heroes is a rare breed who attempts to master two codes, the Bankruptcy Code and the Internal Revenue Code. "When one travels the roads leading to the intersection of the Internal Revenue and Bankruptcy Codes, one may expect some curves."[1]

Who dares to travel such roads? Behold the mythological creatures known as bankruptcy tax litigators! This article provides a glimpse into the magical and challenging path these attorneys traverse and places some road signs for newer travelers.

Take a basic tax law class, and your professor undoubtedly will spend at least one class period discussing choice of forum. At the risk of offending tax professors nationwide, I will break down this critically important body of jurisprudence into three sentences:

- **Tax Court:** File a petition in the U.S. Tax Court to dispute a tax deficiency in the 90 days before it becomes assessed, thereby commencing litigation without first paying the tax and hitting the pause button on the Internal Revenue Service (IRS) collection machinery.
- **Court of Federal Claims:** Pay the disputed tax and sue for a refund in the U.S. Court of Federal Claims if nationwide jurisdiction and precedent from the U.S. Court of Appeals for the Federal Circuit are appealing.
- **District Court:** Pay the disputed tax and sue for a refund in a U.S. district court if you want a jury, think you might have some possible home-field advantage, and believe you have an innate ability to inspire and sway a group of strangers who just found out they're missing work for a tax case.

Consistently ignored as the Jan Brady of tax litigation fora are the U.S. Bankruptcy Courts. Like the Tax Court, a debtor litigating against the IRS in bankruptcy court does not have to pay the disputed tax first. While a jury is generally not an option, the litigation will largely follow the faster pace of bankruptcy courts and the debtor will receive a temporary reprieve from collection due to the automatic stay. Although it is hardly necessary for everyone to become a wizard of restructuring, all lawyers should at least be familiar with the primary ways federal tax disputes are handled in the bankruptcy world.

Before we delve into the exciting crossroads of Titles 11 and 26 (if you're a defense attorney and you're a still reading this article, you are now an honorary member of the Section on Taxation), an important word of caution: "Duking it out with the IRS" isn't exactly a box to be checked on a bankruptcy petition. Federal bankruptcy laws allow for reorganizations, restructuring of debts, and fresh starts. A debtor will have quite an uphill battle trying to convince a bankruptcy judge that the court should exercise its *discretionary* subject-matter jurisdiction to determine tax liabilities if the IRS is the only creditor in play (more on that later). Despite what certain late-night commercials claim, bankruptcy courts were not created for the sole purpose of "getting the IRS off your back." In fact, one of the most critical concepts for bankruptcy newbies to understand is that in many situations, federal tax liabilities cannot be discharged. Tax litigation in bankruptcy court often concerns more than just how much is owed.

Being a creditor in a bankruptcy case is like being the new kid entering the high school cafeteria on the first day of school. Where you sit relative to everyone else matters. In order to determine whether federal tax liabilities get to sit at the cool table (and get paid), tax liabilities in bankruptcy cases have other attributes apart from the amount. Two of the most important attributes to the debtor and the other creditors are whether the tax liabilities are secured in the debtor's property and whether bankruptcy law blesses the liabilities as "priority." Whether tax claims are secured or priority represents the lion's share of bankruptcy tax litigation because, generally speaking, secured tax claims and priority tax claims cannot be discharged and also receive preferential treatment over other creditors regarding payment. In other words, a million-dollar tax claim may not be worth the paper it's printed on if every other creditor gets paid first.

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A Quick Overview of Secured and Priority Tax Claims

Tax liabilities are secured in the debtor's property when the IRS has followed federal notice and due process requirements,[2] as well as state law recordation requirements, and recorded a Notice of Federal Tax Lien against the taxpayer/debtor. Of course, the debtor must have property for the lien to attach (a question of state law), and there may be competing interests for property equity from other creditors (known as lien priority, a question of federal law).[3] Secured claims are nondischargeable and paid out of the proceeds of the sale of the property or through a plan of reorganization.

Tax liabilities are conferred priority status through Section 507 of the Bankruptcy Code. That section includes a laundry list of ways certain tax liabilities are blessed as priority. For example, federal income tax liabilities generally can be conferred priority status in three ways: (1) the liabilities correspond to a tax year in which a tax return was due any time after the date three years before the petition date (the date the bankruptcy case commenced); (2) the liabilities were assessed within the 240-day window before the petition date; or (3) the liabilities have not yet been assessed but can be assessed after the commencement of the case (for example, a taxpayer who files a bankruptcy petition during the middle of an IRS audit).[4] Priority tax claims are also nondischargeable and are generally paid through a plan of reorganization. When the case is a mere liquidation of the debtor's assets, the priority claims are paid before general unsecured creditors.

So how does litigation get off the starting blocks? After the bankruptcy case commences, the IRS may file a proof of claim asserting that the debtor owes prepetition federal tax liabilities.[5] An IRS proof of claim is truly a thing of beauty. In an industry rife with voluminous administrative records and corporate tax returns so large they risk collapsing the gravitational field around them, the IRS proof of claim stands apart as a succinct snapshot of a taxpayer's federal tax liabilities. Tax type (income tax, employment tax, etc.), amount, tax period, date of assessment, and interest and penalties are all stated clearly on the proof of claim, along with whether or not any of the liabilities are secured or priority tax claims.

Once the claim is filed, it is allowed and the proof of claim constitutes *prima facie* evidence of its validity and amount.[6] To continue the high school cafeteria metaphor, by filing a proof of claim, the IRS has paid for its lunch, picked a specific table, and sat down. Everyone else will continue to eat their lunch, that is, until a party in interest objects and tells the IRS to go sit with the marching band.[7]

The procedural rules governing objections to the claim rely heavily on local rules and local practice. The objection must always be filed in writing and served upon the debtor,[8] the trustee, and the United States (meaning, the IRS, the U.S. attorney, and the U.S. attorney general).[9] Litigation moves quickly. After the objection is filed, some local rules set a 30-day deadline to respond while other courts will forego a response and simply schedule a hearing. Parties may also generally commence taking discovery without first conducting an initial discovery or scheduling conference.

The claims objection process has limitations, however. Certain requests for relief require the commencement of an adversary proceeding—a mini-lawsuit within a bankruptcy case. For example, adversary proceedings are technically required when requesting determinations on dischargeability or lien priority.[10] The quicker pace of bankruptcy courts still applies, and the rules require the government to answer a properly served complaint within 35 days, rather than the 60 days allowed in district courts.[11]

Finally, bankruptcy courts have broad, albeit discretionary, jurisdiction to determine the amount of unpaid tax liabilities, whether or not the liabilities have been assessed. Section 505 of the Bankruptcy Code allows a bankruptcy court to function similar to its pre-assessment cousin, the U.S. Tax Court. Like the district courts and Court of Federal Claims, some taxpayers may even request the refund of an alleged overpayment, provided that administrative remedies have been exhausted by filing an appropriate claim for refund.[12]

Tax liability determinations under § 505 are generally requested by filing a motion under Rule 9014. Some courts have held, however, that when a debtor fails to object to the claim of a taxing authority, the debtor is subsequently precluded from seeking relief by filing a § 505 motion.[13] Accordingly, some debtors combine requests for relief under § 505 with an objection to the IRS' claim.[14] Regardless of the form, two primary limitations apply.

First and foremost, bankruptcy courts may choose to abstain from adjudicating requests for determination of tax liabilities because § 505 confers permissive subject-matter jurisdiction, not mandatory.[15] A number of factors will be considered by the court, such as complexity, whether any bankruptcy issues predominate, whether the tax liabilities of nondebtors must be decided, potential prejudice to the parties, and judicial economy.[16] A debtor seeking relief under § 505 should be prepared to give clear reasons why the court should exercise its discretionary jurisdiction.

The second primary limitation of § 505 relief is that bankruptcy courts are prohibited from making tax liability determinations when such liabilities were previously contested and adjudicated before a judicial or administrative tribunal of competent jurisdiction before commencing the bankruptcy case. This issue arises when a taxpayer/debtor requests a § 505 determination from a bankruptcy court after receiving a final decision by the U.S. Tax Court for the tax years at issue. Such a request will be denied.[17]

While tax disputes generally boil down to the question of who owes what, bankruptcy tax attorneys must also be mindful of how it is owed and who else is sitting at the table. Whereas bankruptcy courts are hardly the forum of choice for most tax disputes, and not all tax attorneys need to strive to be bankruptcy tax unicorns, all tax attorneys should be familiar with the basic ins and outs of bankruptcy court litigation to effectively advise their clients. ⊙

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has had a volatile recent history involving issues of citizenship. After many years of struggle, it unilaterally declared independence in 2008, although not all countries have accepted its independence, most notably Serbia and Russia.

Indigenous People and Citizenship Rights

Citizenship status changes when one state is overtaken by another and a new state is established. Immigration Judges Mimi Tsankov and Lawrence Burman, in their personal capacities, and Greg Boos, who practices immigration law in British Columbia and Washington State, discussed indigenous people and citizenship rights. This panel explored the implications of dual nationality, self-government within a broader jurisdiction, and creation and denial of rights to indigenous populations, specifically Native Americans in the United States and Canada. They also explored the treatment of other indigenous populations like the Roma people in Europe. More than 10 million Roma live in the European Union and while they may have the same rights as other EU citizens, a large percentage live in extremely poor social-economic conditions.

Exclusive Citizenship Doctrines

The conference concluded with a discussion of exclusive citizenship doctrines. This panel was moderated by Margaret D. Stock, a recent recipient of the MacArthur Foundation Genius Grant who practices in Anchorage, Alaska. Her panelists included Paul Samartin, who practices U.S. immigration law in London; Hermie de Voer, who practices Dutch immigration law in the Netherlands; Stephen Coutts, a Ph.D. candidate at the European University Institute in Italy; and Maria Celebi from Instanbul.

This panel discussed issues that arise when a government prohibits dual citizenship. Demands for exclusivity of citizenship create conflicts, for example, when a person automatically acquires citizenship in a country that will not permit relinquishment. Sometimes people born in a territory are accorded citizenship but do not have the same level of representation as "full" citizens of a nation-state. While the U.S. recognizes multiple citizenships, it paradoxically discriminates against those who have multiple citizenships (e.g., military enlistment, security clearances), reflecting a schizophrenic mixture of openness toward multiple citizenships and suspicion as threatening to national security.

Other issues discussed included exclusive citizenship rules in the Netherlands and the United Kingdom as well as a program instituted in Turkey to allow its citizens to take up opportunities in other countries. Many Turks migrated to Northern EU countries that do not allow dual citizenship. Turkey has devised program that allows its citizens to renounce their Turkish citizenship to seek citizenship in a country for employment opportunities. If they return to Turkey, they may re-obtain almost all domestic rights.

Next Year's Citizenship Conference in Rome

One of the points made clear by this year's citizenship conference is that there is much more on this topic that can and should be analyzed and discussed. Hence, the third annual Citizenship in a Global Era conference will be held in Rome on Sept. 23, 2014. Citizenship is often reviewed from an immigration law perspective, but it is a far broader topic, going to questions of allegiance, civic responsibility, cultural identity, and body politic. To broaden the conference's reach, the chairs are working with the FBA International Law Section to expand its curriculum. There will be several networking opportunities again, including a dinner the evening before and a reception after the program, as well as a tour of the art collection at the U.S. Embassy in Rome. Mark your calendar for another memorable conference in a glorious Rome. ⊙

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Endnotes

[1]*See Smith v. United States, IRS* (*In re Smith*), 205 B.R. 226 (B.A.P. 9th Cir. 1997) (holding that a debtor contesting his federal tax liabilities was not entitled to a jury trial). Although *Smith* seems to foreclose the notion of jury trials in bankquptcy tax litigation, the issue has not been addressed by many courts.

[2]*See* 26 U.S.C. § 6320.

[3]A right to setoff is also treated as a secured claim. 11 U.S.C. § 506(a). In other words, one year's tax liability can be secured by another year's tax overpayment.

[4]11 U.S.C. § 507(a)(8)(A).

[5]Even when prepetition federal tax liabilities exist, the IRS may choose not to file a claim when there are no assets to pay the liabilities. Priority tax claims will still be excepted from discharge regardless of whether a claim has been filed. 11 U.S.C. § 523(a)(1)(A).

[6]11 U.S.C. § 502(a).

[7]Journalistic disclosure: The author of this piece was the president of his high school's marching band. Go Highlanders!

[8]In bankruptcy court, tax litigation may be initiated through the claims objection process by any "party in interest." 11 U.S.C. § 502(a). Depending on the facts or circumstances of the case, a third-party creditor may have standing to object to the IRS' tax claim. *See, e.g., In re Thomas Bros. Restaurant Corp. One*, 195 B.R. 918 (Bankr. C.D. Cal. 1996).

[9]Fed. R. Bankr. P. 3007, 7004, 9014.

[10]Fed. R. Bankr. P. 7001 contains a list of requests that must be made by adversary proceeding.

[11]Fed. R. Bankr. P. 7012.

[12]*See* 11 U.S.C. § 505(a)(2)(B); 26 C.F.R. §§ 301.6402-2, 301.6402-3.

[13]*See Holly's, Inc. v. City of Kentwood* (*In re Holly's, Inc.*), 172 B.R. 545, 565-66 (Bankr. W.D. Mich. 1994) (§ 505 motion filed after plan confirmation).

[14]*See, e.g., In re Johnson Sys.*, 432 B.R. 306 (Bankr. N.D. Ala. 2010); *In re Noronha*, 382 B.R. 363, 365 (Bankr. W.D. Ky. 2007).

[15]*See In re Gilliam,* 428 B.R. 656, 659-60 (Bankr. D.S.C. 2008).

[16]*Id.*

[17]*See In re Hilal,* 100 A.F.T.R.2d (RIA) 6283 (Bankr. S.D. Tex. 2007).