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## INSIGHT: Resolving Federal Tax Disputes in Bankruptcy



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Taxpayers often have limited control over the timing of bankruptcy filings and the resolution of their tax disputes with the Internal Revenue Service. The timing of these events are generally dictated by the schedules of others, including the creditors of the debtors, IRS employees, and the courts. As added complexity, a taxpayer's older and open tax years may be in very different procedural postures at the time of a bankruptcy filing. Some years may be under IRS examination, while others may not yet be opened for examination, in IRS Appeals, have refund claims pending, or be in litigation.

The bankruptcy code is designed to provide debtors with a fresh start, including protection from creditors and for the resolution of claims. This over-arching principle also applies to disputes with the IRS by providing considerable protections against IRS collection efforts, including an alternative forum to the Tax Court for pre-payment litigation of tax disputes. There are also many potential pitfalls as well, and taxpayers facing potential bankruptcy proceedings should plan ahead.

### How Does a Bankruptcy Affect the IRS?

When a tax liability (whether already assessed or potential) could render a taxpayer insolvent, a bankruptcy filing can forestall IRS action while providing the taxpayer with a forum to challenge the IRS's determination. For example, filing for bankruptcy protection creates an automatic stay preventing the IRS from pursuing collection proceedings such as liens and levies against the debtor or its property. 11 U.S.C. Section

362(a). The automatic stay also prevents the filing of suits against the debtor, and stays all pending litigation against the debtor, including U.S. Tax Court cases. Tax Court proceedings must come to an immediate halt once the bankruptcy petition is filed, and a debtor may not file a Tax Court petition while the automatic stay is in place. 11 U.S.C. Section 362(a)(8). The stay can only be lifted by order of the bankruptcy court, or at the end of the bankruptcy proceeding.

The bankruptcy code also places temporal limits on how long the IRS can take to examine a debtor's tax returns, at least for taxes incurred during the administration of the estate. If the debtor files a return and requests a prompt determination, the IRS has 60 days to provide notice that it intends to audit the return, and must complete any audit within 180 days unless the bankruptcy court finds good cause to allow an extension. 11 U.S.C. Section 505(b)(2)(A). If the IRS fails to meet these deadlines, "the estate, the trustee, the debtor, and any successor to the debtor are discharged from any liability for such tax" unless the return is fraudulent or contains a material misrepresentation. Taxpayers outside the bankruptcy context can only dream of being able to keep the IRS on a timetable, instead of the other way around.

The powers of the bankruptcy court over the IRS are not unlimited, and the IRS receives some special prerequisites in the bankruptcy code unavailable to other debtors. For example, certain unsecured tax claims are considered priority claims, placing them above ordinary unsecured creditors in the priority scheme. 11 U.S.C. Section 507(a)(8). Unavoidable tax liens filed before the bankruptcy petition are filed are considered secured and have even higher priority. 11 U.S.C. Section 506(a). The IRS has extended deadlines to file a proof of claim

for taxes and can still audit debtors and even assess tax liabilities, although it cannot pursue collection activities under the automatic stay. 11 U.S.C. Section 362(b)(9).

## Litigating Tax Disputes In Bankruptcy

Bankruptcy courts acquire jurisdiction over a debtor's tax liability after a bankruptcy petition is filed. "[B]ankruptcy courts have universally recognized their jurisdiction to consider tax issues brought by the debtor, limited only by their discretion to abstain." *IRS v. Luongo*. The bankruptcy court has special jurisdiction to "determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, [and] whether or not paid," so long as the tax issue was not contested and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the petition was filed. 11 U.S.C. Section 505(a)(1) & (a)(2)(A). In addition, the IRS often files proofs of claim for assessed (and often potential) tax liabilities of the debtor, which subjects the IRS to the jurisdiction of the bankruptcy court.

As noted above, a taxpayer is generally prohibited from filing a Tax Court petition while the automatic stay is in place and any pending Tax Court proceedings are stayed. So how does a taxpayer challenging an IRS determination get its day in court?

If Tax Court proceedings were pending at the time of the bankruptcy filing, then the bankruptcy court may either (1) lift the automatic stay and allow the Tax Court proceedings to continue, or (2) decide the issue itself. 11 U.S.C. Sections 362(d), 505(a). Alternatively, the bankruptcy court can lift the automatic stay and permit the debtor to proceed with filing a Tax Court petition. This is at the discretion of the bankruptcy court. But, in either case, the taxpayer has at least one forum available to litigate the disputed taxes prepayment. Taxpayers should carefully consider their specific tax issues and whether one of the forums may be more favorable for deciding those issues. The IRS is just one of many creditors in a bankruptcy proceeding, and every dollar the IRS keeps is a dollar not available to help reorganize the business or pay other creditors. This may give rise to unexpected alliances between the debtor, creditors, and other parties in interest.

The Bankruptcy Court's jurisdiction to hear cases comes from the District Court. 28 U.S.C. Section 157(a) and (b) and Section 1134. Accordingly, a party can seek to have a tax dispute pending before the bankruptcy court litigated in district court. 28 U.S.C. Section 157(d). This procedure, called "withdrawal of the reference," is within the discretion of the district judge, but is mandatory "if the court determines that resolution of the proceeding requires consideration of both Title 11 and other laws of the U.S. regulating organizations or activities affecting interstate commerce[.]". Withdrawing the reference on one issue in a bankruptcy proceeding does not stay the rest of the bankruptcy proceeding.

In bankruptcy tax litigation, the IRS is represented by trial attorneys from the U.S. Department of Justice's Tax Division. Many Tax Division trial attorneys litigate in bankruptcy courts against individuals and small businesses regularly. Experience with complex tax issues in the context of the reorganization or liquidation of a large corporation is less common. In addition to the bankruptcy code, the bankruptcy court has its own set of procedure rules set forth in the Federal Rules of

Bankruptcy Procedure. Each federal district also has its own local bankruptcy rules, and many Bankruptcy Judges have their own set of rules and procedures for appearing in their courts. Parties ignore these specialized bankruptcy procedures and rules at their peril.

## Pursuing Refund Claims

Tax refund claims may be an asset for a business filing for bankruptcy. If the debtor did not file a refund claim with the IRS before filing its bankruptcy petition, it must still do so in bankruptcy within the applicable statute of limitations. 11 U.S.C. Section 505(a)(2)(B). The debtor cannot file suit to recover the refund until the earlier of denial of the claim or 120 days have passed (as opposed to the six-month waiting period outside the bankruptcy process). However, that waiting period may not apply if the refund sought is a counterclaim against the IRS. *See, e.g.,*

*United States v. Kearns*. It should also be noted that in the Second Circuit, a liquidating trustee may not file a refund claim on behalf of the debtor, and the IRS may make the same argument against liquidating trustees in other circuits as well. *United States v. Bond*.

Once a claim is ripe, the debtor can request the bankruptcy court to adjudicate the claim by filing an adversary proceeding against the IRS. An adversary proceeding is a separate proceeding before the bankruptcy court adjudicating a specific claim among parties. The rules for adversary proceedings are included in Part VII of the Federal Rules of Bankruptcy Procedure, and are based largely on the Federal Rules of Civil Procedure, with the full scope of discovery of ordinary federal civil actions. It should be noted, however, local bankruptcy rules are not the same as, and may be very different from, the local rules of the district court.

Or, if the IRS files a proof of claim and thereby subjects itself to the jurisdiction of the bankruptcy court, the debtor can counterclaim for the amount of refund owed. 28 U.S.C. 157(b)(2)(C). The procedural rules for contested proceedings on a proof of claim do not include the full scope of Part VII of the Bankruptcy Rules, although the Bankruptcy Court may direct that any of the rules in Part VII shall apply, and the parties may find themselves with a truncated discovery schedule and an evidentiary hearing within a surprisingly short period of time.

In the alternative, the debtor can file a civil refund suit in district court or the Court of Federal Claims, outside the bankruptcy process. The case would proceed just like any other refund suit, without any interference from the bankruptcy court.

A debtor could also choose to list its refund claim in its schedules of assets and liabilities filed with the bankruptcy court, and expressly preserve and retain that claim in the reorganization or liquidation plan. This allows the taxpayer to pursue the claim later both administratively, and if necessary, in district court or claims court. Of course, the debtor must stay mindful of the statute of limitations for bringing suit.

Choosing whether and how to pursue a refund claim against the IRS is a crucial decision that depends on the facts of each case, the context of the bankruptcy proceeding, and many other factors.

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## Appeals From Bankruptcy Court Rulings

Decisions of the bankruptcy court are appealable to the federal district court, which sits as a one-judge appellate court. In the First, Sixth, Eighth, Ninth, and Tenth Circuits, if the parties agree, an appeal may instead be heard by the Bankruptcy Appellate Panel, which is a panel consisting of bankruptcy judges from the relevant circuit who were not involved in the underlying case. 28 U.S.C. 158(b). Both the district court and the BAP review legal issues de novo and factual findings for clear error, and there is no discovery or opportunity for an evidentiary hearing on appeal. Appellate decisions of either district court or the BAP are themselves appealable to the circuit court. This adds an extra step to the review process which can delay final resolution of the case.

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A taxpayer facing the prospect of filing a bankruptcy petition should keep in mind that in the bankruptcy world the IRS is just another creditor, albeit one with special privileges. Bankruptcy offers considerable flexibility in challenging IRS tax determinations. It also offers several alternatives for pursuing refund claims. There are also traps for the unwary, and serious strategic decisions to be made in deciding how to pursue a tax dispute in a bankruptcy context.

*This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.*

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