

CHAPTER 14

**TAX LAW FOR
LEGAL SERVICES AND
PRO BONO ATTORNEYS**

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About The Author

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1. INTRODUCTION

Tax law issues arise in most areas of a poverty law practice. This guide covers federal and state tax issues that a general legal aid attorney needs to know. It is not a guide for the legal aid or pro bono attorney who specializes in tax law.¹ This guide will help you identify and understand tax issues that affect low-income taxpayers.

The first part of this guide covers federal tax issues. The second part covers real estate taxes and tax sales. Citations to “I.R.C.” are to the Internal Revenue Code. Citations to “I.R.M.” are to the Internal Revenue Manual.²

2. FEDERAL TAXES—HOW TO SCREEN CASES

2.1 OVERVIEW OF FEDERAL TAX PROBLEMS

The Internal Revenue Service is a powerful creditor whose collection actions can affect an indigent’s economic welfare. Collections, failure to file tax returns, debt cancellation income, the Earned Income Credit, innocent spouse relief and identity theft are the most common tax problems faced by legal aid clients. Beginning in 2014, failure to comply with the Affordable Care Act may create many tax law problems for our clients.

The Internal Revenue Service administers the Earned Income Credit, the largest federal anti-poverty program. The Earned Income Credit is a tax refund for qualified low-income workers—even those who did not pay any income taxes or have children. An income tax return must be filed to obtain this tax refund.

The Earned Income Credit substantially increases the annual income of many legal aid clients. Denial of this tax refund can lead to huge tax debts and financial crisis for a taxpayer. Clients often lose their homes to eviction or foreclosure when they are denied the Earned Income Credit. Audits of an Earned Income Credit claim almost always occur when divorcing couples both claim the Earned Income Credit.

2.2 NOTICES FROM THE IRS — HOW TO ASSESS WHAT YOUR CLIENT FACES

Many low-income taxpayers do not fully understand the status of their tax liabilities, the notices or demands issued by the IRS. Your goal is to figure out what the taxpayer faces, their deadlines and options.³

2.3 NOTICES FROM THE IRS

The taxpayer should have a notice from the IRS. Each IRS notice can be identified by its CP number. This number should be in the upper right of the first page of the notice. You can find information on how to understand and respond to many IRS notices at “Understanding Your IRS Notice” in www.irs.gov/taxpros.⁴

¹ The tax specialist should consult *Effectively Representing Your Client Before the IRS* (ABA 5th ed. 2011).

² The Internal Revenue Service regularly revises and reorganizes the Internal Revenue Manual, which IRS staff generally follow in processing taxpayer cases. IRM citations may have changed since the revision of this Chapter. The Internal Revenue Manual can be found at www.irs.gov in the Tax Pros section as Reference Materials under Basic Tools for Tax Professionals.

³ In Louisiana, a federal tax controversy with the IRS may be referred to the Low-Income Taxpayer Clinic at Southeast Louisiana Legal Services (see www.slsls.org for more information). In addition, there is a Low-Income Taxpayer Clinic at Southern University Law Center (Baton Rouge) that may be able to help. Other states also have Low-Income Taxpayer Clinics.

⁴ The www.litctoolkit.com web page (password protected for LITCs) also has a list of IRS notices and letters that are commonly sent to taxpayers.

The common IRS notices are:

- Notice of proposed changes to tax return, CP-2000 Notice (30 days to reply).
- Penalty and interest notices (30 days to reply).
- An examination or audit notice (by correspondence or at office).

☞ **Practice Tip:** Deadlines to reply to IRS examination notices can generally be extended. Call the IRS for an extension to reply to a CP-2000 notice. (IRS phone numbers may be staffed until about 8 p.m. on week days). *However, deadlines to appeal or file suit should be strictly complied with.*

- Examination Report, Form 4549 or 886-A. (30 days to reply or appeal).
- The 30 day letter notifying taxpayer of right to appeal. Must appeal by protest letter within 30 days of date on letter. Taxpayer should not sign the Form 870 since it will waive right to petition Tax Court.
- Notice of tax deficiency or “the 90 day letter” (check the notice for last day to file Tax Court Petition—current law requires that the IRS specifically state the last day to file in Tax Court).
- Notice of determination on collection due process appeal (30 days to file petition with Tax Court)
- Notice and Demand for Payment, CP-14
- Notice of Federal Tax Lien (30 days to appeal by Form 12153)
- Final Notice Before Levy on Social Security Benefits, CP-91/298 (30 days to reply)
- Final Notice of Intent to Levy, CP-90/CP-297, (30 days to appeal by Form 12153, if bank account levy, 21 days before bank remits funds to IRS)
- Seizure (10 days to appeal by Form 9423; about 60 days to sale)
- Denial of Installment Agreement (30 days to appeal by Form 9423)
- Termination of Installment Agreement, CP-523 (30 days to appeal by Form 9423)

2.4 OTHER TAX DOCUMENTS

Some taxpayers may come to you with IRS Forms 1099. These forms report income to the IRS. Forms 1099 are generally issued by employers for compensation and by lenders or other creditors who have cancelled a taxpayer’s debt. The forms may also be issued by an opposing party in personal injury litigation for the portion of a settlement that may be income, e.g., lost wages or attorney fees.

If the Form 1099 is from an employer, there may be an issue as to whether the client is an employee or contractor. If the taxpayer is a contractor, he will be responsible for payment of Social Security taxes and estimated taxes.

If the Form 1099 is from a lender or creditor, the issue will be whether the debt cancellation can be excluded from income. Failure to report Form 1099 income on one’s tax return usually leads to an audit in which one must justify why the debt cancellation is not income.

2.5 ACCESS TO TAXPAYER INFORMATION

Have the client sign a Form 2848 (Power of Attorney) for the tax years in dispute. This will enable the designated attorney to get access to taxpayer information on file with the IRS. For Louisiana taxpayers, the Form 2848 must be faxed to the IRS Memphis CAF Unit at 855-214-7519. Low-Income Taxpayer Clinic attorneys may get quick electronic access to the taxpayer's income as reported by W-2 forms and Forms 1099, IRS account transcripts and tax return transcripts once the Form 2848 has been processed by the IRS.

2.6 COMMUNICATIONS WITH THE IRS ON NOTICES AND CORRESPONDENCE

A few tips for more effective communications with IRS employees:

1. Keep copies of any documents sent to the IRS
2. Reference or include the IRS notice or letter to which you are responding
3. Write the client's Social Security Number on each submitted document
4. Only use certified mail when necessary to protect a deadline, e.g., amended return, an election, or where there would be an adverse action if no taxpayer response
5. Generally, limit contents of a mailed submission to one tax year
6. When citing "law" to IRS employees, it is more effective to cite to the Internal Revenue Manual ("I.R.M.") or IRS Publications rather than case law

2.7 CRITICAL DEADLINES

Significant rights can be lost if certain deadlines in IRS notices are not met. You should identify all critical deadlines that affect taxpayer rights for IRS appeal, judicial review or avoidance of collection action.

3. IRS APPEALS

3.1 30 DAY NOTICES OF RIGHT TO ADMINISTRATIVE APPEAL

The IRS must issue a 30 day notice of right to appeal a proposed adjustment to the client's taxes, notices of federal tax liens, notices of intent to levy, denial or termination of installment agreement, or denial or termination of an Offer in Compromise. To obtain an appeal with the IRS Appeals Office, the taxpayer must file his appeal within 30 days of the notice. If this appeal deadline is not met, the taxpayer may face unnecessary levies. Also, the taxpayer's remedy may be limited to a Tax Court petition, which entails additional costs and delays beyond an appeal to the IRS Appeals Office.

For initial determinations of tax liability or innocent spouse relief, the taxpayer can still obtain successful Tax Court review under the "de novo review" standard. An appeal to the IRS Appeals office is not a requirement for Tax Court review.

However, for collection disputes, the failure to timely take an administrative appeal will, as a practical matter, preclude successful Tax Court review under the "abuse of discretion" standard and the general limitation of judicial review to issues raised at the appeal hearing.⁵

⁵ The "abuse of discretion" standard governs judicial review of collection due process appeal determinations on lien, levy, installment agreement or offer-in-compromise decisions unless tax liability or innocent spouse relief issues are involved. *Murphy v. Comm'r*, 125 T.C. 301, 307 (2005) *aff'd* 469 F.3d 27 (1st Cir. 2006). Absent special circumstances, the Tax Court will not consider new evidence in an "abuse of discretion" case that is not related to an issue raised in the appeal hearing. *Giamelli v. Comm'r*, 129 T.C. 107 (2007).

3.2 HOW DO I APPEAL TO AN IRS APPEALS OFFICER?

A protest letter or appeal letter should be filed within 30 days of the adverse action by the IRS. See IRS Publication 5 for information on how to appeal. Your letter should unequivocally state that you are appealing and request a conference with an Appeals Officer.

Appeals Officers are usually senior IRS employees. They are instructed to settle cases. 85% of appeals cases are settled. The Appeals Officers are aware of the law on common issues. They want to know the facts of your case. They are not supposed to develop the facts themselves.⁶ Rather, their role is to adjudicate facts and evaluate “hazards of litigation.” Procedures for appeals conferences are described in I.R.M. 8.6.

Convincing the Appeals Officer that there are hazards of litigation will enhance the probability of a favorable settlement. The Internal Revenue Manual states that settlements resolve each issue based on the probable result in litigation or involve mutual concessions of issues based upon the relative strength of the opposing positions when there is substantial uncertainty as to the outcome in litigation. I.R.M. 8.6.4.1. Appeals Officers have broad authority to settle cases. Their settlement authority is, however, restricted if there is a judicial or revenue ruling directly on point.

4. TAX COURT

4.1 TIME LIMITS FOR TAX COURT REVIEW

The Tax Court petition generally must be filed within 90 days of the mailing date of the Notice of Deficiency or the determination of innocent spouse relief.⁷ Review of these cases is *de novo*.⁸ Tax Court petitions to review collection due process appeal decisions must be filed within 30 days of the notice of determination.⁹ Review of collection due process appeals is for “abuse of discretion.”¹⁰

The IRS notice of deficiency must tell the taxpayer the last date to file a petition with the Tax Court. That date will be deemed to be timely (even if it is wrong). I.R.C. § 6213(a). Look for the date on the IRS notice of deficiency or determination.

The taxpayer may have additional time if she received the deficiency notice while a bankruptcy action was pending or if a bankruptcy was filed during the 90 day delay for filing a petition in Tax Court to contest the deficiency. In such cases, the time for filing the Tax Court petition is suspended until 60 days after the bankruptcy discharge.¹¹ A bankruptcy debtor is stayed from filing a Tax Court petition unless the bankruptcy stay is lifted by the bankruptcy court.¹² In such cases, the bankruptcy may control whether bankruptcy court or Tax Court decides the tax liability issue.

⁶ Appeal Officers are prohibited from *ex parte* communications with the auditors. Rev. Proc. 2000-43, 2000-43 IRB 404; *Adomowicz v. United States*, 531 F.3d 151 (2d Cir. 2008); *Robert v. United States*, 364 F.3d 989 (8th Cir. 2004); *Drake v. Comm'r*, 125 T.C. 201 (2005) (case remanded with order that a new, independent Appeals Officer be assigned to case).

⁷ I.R.C. §§ 6213, 6015(e). It is 90 days even if the taxpayer didn't receive her notice until many days after the notice date. A notice properly mailed to the taxpayer at her “last known address” is valid even if not received. *United States v. Ahrens*, 530 F.2d 781, 785 (8th Cir. 1976). For judicial review of a denial of innocent spouse relief or separate liability election, a taxpayer may file her petition at any time after 6 months of filing her election provided the 90 day period has not run. I.R.C. § 6015 (e)(1)(A).

⁸ *Porter v. Comm'r*, 132 T.C. 203 (2009) (extending *de novo* review to § 6015(f) equitable innocent spouse relief claims).

⁹ I.R.C. § 6330(d); *McCune v. Comm'r*, 115 T.C. 114 (2000).

¹⁰ *Murphy v. Comm'r*, 125 T.C. 301, 307 (2005) (abuse of discretion standard unless underlying tax liability is at issue).

¹¹ I.R.C. § 6213 (f)(1); *Zimmerman v. Comm'r*, 105 TC 220 (1995).

¹² 11 U.S.C. § 362(a)(8); *Halpern v. Comm'r*, 96 T.C. 895 (1991).

☞ **Practice Tip:** Be sure to ask a prospective Tax Court petition filer if he has a pending bankruptcy action.

The petition in a deficiency or innocent spouse relief case must be received within 90 days or mailed in a properly addressed envelope with an official U.S. Post Office postmark or by certain designated private delivery services¹³ within the 90 day limit. I.R.C. § 7502 (a). You must be able to prove a timely postmark. This means that you should use certified or registered mail and secure an official postmark if you are relying on a mailing date to meet the 90 day deadline. Make sure that the Post Office gave you a correct postmark date. Currently, the Tax Court does not allow electronic or fax filing of the initial Tax Court petition.

Don't use privately metered mail for the filing of Tax Court petitions. This delivery method only qualifies for the timely filed rule if the petition is actually received by the Tax Court within the normal delivery delay. If it is not received within that delay, it will be difficult to prove that the petition was timely mailed. See Reg. § 301.7502-1 (c)(1)(iii)(b).¹⁴

The filing fee is \$60, but may be waived for indigents.¹⁵ You must be admitted to the Tax Court before filing the petition or have a Tax Court member sign the petition and other initial pleadings. If you don't have a Tax Court member in your law firm, you can help the client file pro se if the filing deadline is imminent.

Caution: If the 90 day limit for Tax Court review is missed, the taxpayer's only judicial remedy is to pay the tax and sue for refund—usually in United States District Court. This is not a realistic option for most indigents.¹⁶ If the 90 day limit has been missed, you may want to try an audit reconsideration or an Offer-in-Compromise to eliminate the taxpayer's liability if there is "doubt as to liability." See Reg. § 301.7122.

4.2 HOW TO FILE A TAX COURT PETITION

Check the current rules at the Tax Court's webpage, www.ustaxcourt.gov, or 26 U.S.C.A. foll. § 7453. The initial filing requirements are an original of:

- Petition¹⁷
- Statement of Taxpayer Identification Number¹⁸
- Notice of Deficiency
- Designation of Place of Trial (Tax Court is held in most major cities, including New Orleans and Shreveport for about 1 to 2 weeks every year)
- Application for Waiver of Filing Fee and Affidavit (or check for \$60)¹⁹

¹³Federal Express and UPS. See www.ustaxcourt.gov. If you use these companies, make sure that you use the type of delivery recognized by the IRS. *Gibson v. Comm'r*, 264 Fed. Appx. 760 (10th Cir. 2008) (petition untimely because UPS store sent by US mail rather than approved UPS delivery service).

¹⁴Treasury Regulations are found in title 26 of the Code of Federal Regulations.

¹⁵I.R.C. § 7451; Tax Court Rules 20(b), 173(a)(2).

¹⁶Note, however, it may be meaningful in Earned Income Credit cases since the taxpayer often does not owe any tax. Rather, the IRS has denied her the EIC before ever paying it to the taxpayer. Also, consider audit reconsideration as a remedy. If the taxpayer's claim is disallowed in an audit reconsideration, he may appeal to an IRS appeals officer.

¹⁷Only the signed original has to be filed. Tax Court Rule 35(e).

¹⁸Tax Court Rule 20(b). The application form for waiver of filing fees may be found in the forms section of www.ustax-court.gov.

¹⁹Check Tax Court Rule 23. Motions and pleadings (other than petition) generally require 4 copies in addition to original.

Send the signed original to:

Clerk, U.S. Tax Court
400 Second St., NW
Washington, D.C. 20217

4.3 SHOULD THE CASE BE FILED UNDER SMALL TAX CASE OR REGULAR TAX CASE PROCEDURES?

The client must decide whether to elect to proceed in Tax Court under the Small Tax Case or Regular Tax Case procedures.

Election of the Small Tax procedure (available for cases under \$50,000 per year) waives the right to appeal the judge's decision. However, most tax cases are decided on factual issues where the right of appeal does not make much difference.

Trial may be sooner under the Small Tax Case procedures. Also, small tax cases are heard in more cities than regular tax cases are. In Louisiana, regular tax cases are only heard in New Orleans whereas small tax cases are heard both in New Orleans and Shreveport.

Interest does run on taxes while the case is pending in Tax Court. On the other hand, 90% of all cases are settled without a trial. Most cases are referred back to the IRS Appeals Officer for review and possible settlement.

4.4 HOW DO I DRAFT A TAX COURT PETITION?

The form and contents of the Petition in a regular case are specified in Tax Court Rules 34, 23 and Form 1 of Appendix I to the Tax Court Rules. For Small Tax Court cases, see Rules 173-79 and Form 2 of Appendix I.

On the Tax Court website, there is a Simplified Tax Court petition which can be used for both regular and small tax cases. Form 1 in the appendix of the Tax Court rules can be used and adapted for more complex deficiency cases.²⁰

The petition should clearly state every issue the taxpayer intends to litigate. Tax Court Rule 34 (b)(4). Tax Court review of collection due process appeals is limited to "abuse of discretion." Therefore, a petition to review a collection due process determination should specify each error committed by the IRS.²¹ The petition is an opportunity to provide the judge with a structured blueprint of your case. See Rule 41 if you need to amend the Petition to add issues.

⚠️ Caution: Affirmative defenses, such as an innocent spouse defense or the statute of limitations, should be pleaded in the Petition to avoid waiver.²²

If the taxpayer lives in a community property state and seeks § 66(c) innocent spouse relief, pleading this claim as an affirmative defense to a deficiency may be essential for Tax Court jurisdiction. ²³

²⁰Tax Court Rule 34(b).

²¹Tax Court Rule 331. By comparison, review of tax liability, innocent spouse relief and employment status is de novo.

²²The pleading rules for these de novo review cases are more liberal. See e.g., Tax Court Rules 31-32, 320-21.

²³*Charlton v. Comm'r*, T.C. Memo 1991-285; see also *Butler v. Comm'r*, 114 T.C. 276 (2000).

²³The Tax Court does not have jurisdiction to review an IRS denial of a "stand alone" request for equitable relief under I.R.C. § 66(c). *Bernal v. Comm'r*, 120 T.C. 102 (2003); see also *Christensen v. Comm'r*, 523 F.3d 957 (9th Cir. 2008). Thus, a taxpayer may only obtain Tax Court review of a § 66(c) claim by raising the issue in a collection due process appeal or as a defense to a 90 day notice of deficiency. *Felt v. Comm'r*, T.C. Memo 2009-245, n. 15 at 45.

4.5 WHAT IF IT IS THE LAST DAY TO FILE A TAX COURT PETITION?

Get the Tax Court petition filed to protect the taxpayer's rights.

If you don't have time to draft a detailed Tax Court petition, simply use Tax Court Form 2 (the Simplified Form). All the required forms are included in one fileable Adobe document at www.ustaxcourt.gov. The forms are designed for use by pro se litigants. Simply answer the questions on the form and check the appropriate boxes. This Simplified Petition form can be quickly completed by someone with no knowledge of Tax Court procedures or tax law.

The Tax Court petition can be amended later if necessary. There are few pleading traps in Tax Court procedure. But, you should plead any innocent spouse or statute of limitation claims as affirmative defenses in the petition.

4.6 WHAT HAPPENS IN A TAX COURT CASE AFTER THE PETITION IS FILED?

About 90% of the cases are settled without the necessity of a trial. If the taxpayer didn't appeal before, the Appeals Office will consider the case.²⁴ Cases are usually at the Appeals Office for about 6 months. You should participate in the Appeals Office conference. Most cases are settled with an IRS Appeals Officer. If settlement is not reached with the Appeals Officer, local IRS district counsel will also work to settle the case. If a settlement is reached with the Appeals Office or District Counsel, District Counsel will prepare a Stipulated Tax Court Decision for signature by all counsel and the judge.

4.7 HOW IS TAX COURT LITIGATION DIFFERENT FROM OTHER LITIGATION?

Significant differences are the mandatory duty to stipulate to the greatest extent possible and the requirement that the parties engage in informal discovery before initiating formal discovery. Also, evidentiary rules are relaxed for Small Tax cases.

The Pre-Trial Order requires you to prepare written stipulations and to exchange witness lists and documents at least 15 days before trial. Tax Court Rule 91 mandates that the parties stipulate to the fullest extent to which complete or qualified agreement can be fairly reached. This rule is mandatory, not aspirational. Failure to comply with stipulation, disclosure and consultation rules can result in dismissal of the petition for lack of prosecution.²⁵ **Work cooperatively with the IRS attorney and document your efforts to stipulate.**

Normally, discovery by the taxpayer is unnecessary. However, if you need discovery, you should proceed promptly with consultation and discovery given tight Tax Court deadlines. Under *Branerton Corp. v. Comm'r*, 61 T.C. 691 (1974), the parties should make reasonable informal efforts to obtain information voluntarily before seeking formal discovery. See also Tax Court Rule 70(a).

²⁴Rev. Proc. 87-24, 1987-22 I.R.B. 23.

²⁵*Raquet v. Comm'r*, T.C. Memo 1996-279.

5. REFUNDS

5.1 REFUND CLAIMS AND LAWSUITS

A refund claim is generally made by filing an original or amended tax return. The refund claim must be filed within 3 years of the April 15 due date of the original return. If the client is eligible for the Earned Income Credit, an original or amended tax return should be filed immediately for each of the last 3 years. If you are close to the 3 year time limit, be sure to get a proof of postmark or mailing or hand deliver the returns to an IRS office and get a receipt for the refund claims.

The denial of a refund claim may be appealed to an IRS appeals officer. The rules for a refund lawsuit in United States District Court are complex. A client who has been denied a refund claim should be immediately referred to a tax lawyer.

Generally, a refund suit is barred unless filed within 2 years after the date of mailing by certified or registered mail of a notice of disallowance of the claim by the IRS. I.R.C. § 6532(a). Absent a notice of disallowance, there is no time limitation for filing a refund lawsuit.²⁶ However, a taxpayer should not delay the filing of a lawsuit. Several courts have ruled that the 6 year limitation in 28 U.S.C. § 2401 applies as an outer limit.²⁷

Warning: The taxpayer may have signed a waiver of the notice of claim disallowance when the IRS originally denied the refund. Many low-income taxpayers do not know if they signed such a waiver or may forget to tell you. The 2 year period for a refund lawsuit begins running on the date the waiver is filed. If you are faced with a waiver, you should determine whether it is valid.²⁸

I.R.C. § 7422(a) and § 6511(a) allow the filing of a refund lawsuit within 2 years of the payment of taxes. This opens up potential rights to a refund lawsuit that are more than 3 years after the original tax return was due.

For example, when a taxpayer pays the last payment on an installment agreement with the IRS, his right to sue for a refund accrues and the 2 year time limitation begins running. I.R.C. §§ 7422(d), 6511(a). If the taxpayer finally pays off a 2003 tax obligation in 2012, she will then be able to sue for a refund of the 2003 "overpayment."²⁹

A taxpayer may win an Earned Income Credit for a recent tax year examination. The IRS will offset that refund against taxes owed for prior years, sometimes 5 to 10 years earlier. If that offset extinguishes the prior year tax liability, the taxpayer then has the right to sue for a refund. The date that the IRS applies the offset is considered the date of payment.³⁰

I.R.C. § 6513, which deems withholdings and credits to have been paid on the April 15th return deadline, does not apply to situations in which the refund claim arises from the application of an overpayment from one tax year to an outstanding tax liability for another tax year.³¹ In such situations, IRC § 7422(d) applies and the date of offset is considered the date of payment. Therefore, the taxpayer will have the right to seek refund for the amount of taxes paid within 2 years of the IRS offset.³²

²⁶ *Consolidated Edison Co. of NY v. United States*, 135 F. Supp. 881 (Ct. Cl. 1955); IRS CN Chief Counsel-2012-012, 2012 WL 2029785.

²⁷ *Finkelstein v. United States*, 943 F. Supp. 425 (D. N.J. 1997).

²⁸ See Reg. § 301.6532-1(c)(1)-(4); IRS National Office Service Center Advice, Assistant Chief Counsel Memorandum, No. 200202069 (Release date 1/11/2002).

²⁹ See e.g., *Dresser Industries v. United States*, 73 F. Supp.2d 682 (N.D. Tx. 1999) *aff'd* 238 F.3d 603 (5th Cir.2001).

³⁰ I.R.C. § 7422(d); *Favret v. United States*, 2003 WL 22888792, No. 03-2322 (E.D. La. 2003).

³¹ *Favret v. United States*, *supra*.

³² Payment of taxes by IRS offset can be determined from the offset notice or a transcript of the taxpayer's account.

The §§ 7422(a) and 6511(a) rules can open up many past years for litigation. For example, you win a 2011 Earned Income Credit. The IRS uses offset to apply the refund to a 2003 tax obligation. You sue for and win the 2003 refund, which is then applied to and pays off another tax year's deficiency and sets up the taxpayer for a refund lawsuit for another tax year.

5.2 MISSED THE TAX COURT DEADLINE? CAN'T PAY THE TAXES FOR A DISTRICT COURT REFUND LAWSUIT? WHAT CAN BE DONE?

Most refund claims for legal aid clients involve the Earned Income Credit. If you can win the Earned Income Credit for an "open" year, the taxpayer will receive a refund. The IRS will then seize the refund to pay the prior year tax deficiency. This payment, if the entire tax is paid, will give the taxpayer his "ticket" to District Court refund litigation.

However, the most practical remedy for a taxpayer, who has missed his Tax Court deadline, is audit reconsideration. Audit reconsideration is available to:

1. Reevaluate a prior audit where the taxpayer disagrees with the original determination by providing information that was not previously considered.³³
2. Contest a "Substitute for Return" determination by filing an original delinquent return; or
3. Contest the denial of a tax credit as a result of an examination.³⁴

See I.R.M. 4.13.1.2, 4.13.1.3, 4.13.1.7; IRS Pub. 3598.

To request an audit reconsideration, the taxpayer must have filed a tax return and the assessment remains unpaid or the IRS has reversed tax credits that the taxpayer disputes. I.R.M. 4.13.1.4. If the taxpayer has paid the tax, he should file a formal claim by using a Form 1040X.

The IRS does not have a form for audit reconsideration requests. Audit reconsideration may be requested by a Form 1040X or letter. Some IRS offices request both a Form 1040X and a cover letter for audit reconsideration. If the taxes have not been paid, a letter requesting audit reconsideration may be written. If a Form 1040X is used, state the request for audit reconsideration in the cover letter.

The letter requesting audit reconsideration should include:

1. Taxpayer's name, Social Security number, and tax year at issue.
2. Clear statement of issues and adjustments disputed.
3. Relief or action desired.
4. Document the history of the prior audit. (Attach original audit report, Form 4549).
5. Additional information not considered during the original audit. Your letter should identify the new information. (Attach new documentation. You should provide information on each disputed issue since the IRS considers your request issue by issue).

The request for audit reconsideration should be filed with the IRS Service Center where the taxpayer's return was filed. IRS Pub. 3598.

³³ This may also include new information or information that was not viewed in the proper light.

³⁴ Thus, audit reconsideration will often be available to review the correctness of an Earned Income Credit denial.

In a partially paid assessment, be careful not to miss the time limits for refund claims. The Taxpayer Advocate Service can help expedite an audit reconsideration. I.R.M. 4.13.1.5. If a case is accepted for audit reconsideration, and the taxpayer's request is disallowed in full or part, the taxpayer may request an appeal. I.R.M. 4.13.6.1.

6. COLLECTIONS—HOW TO DEAL WITH IRS COLLECTIONS

6.1 HOW LONG DOES THE IRS HAVE TO COLLECT TAXES?

The IRS has 10 years after a *timely* assessment to collect taxes. I.R.C. § 6502. An “assessment” is the timely recording of a taxpayer’s liability in accordance with IRS rules. I.R.C. § 6203. The taxpayer has a right to the IRS’s record of assessment. *Id.* Transcripts of a taxpayer’s records may be ordered by tax professionals from the Practitioner’s Priority Service, 866-860-4259. You should always order an account transcript to determine the expiration date for collections.³⁵

The 10 year limit on collections is referred to as the Collection Statute Expiration Date (CSED). The IRS Practitioner Priority Service (866-860-4259) will tell you the CSED. It is common for the IRS to miscalculate the collections statute of limitation. Therefore, do not rely on the IRS calculation of the collections statute of limitations. If the IRS collection employee won’t review and decide a collection statute of limitation defense, request a Taxpayer Assistance Order by a Form 911 from your Taxpayer Advocate Service office.

The limitation periods may be extended by deficiency notices, Tax Court proceedings, collection due process hearings, innocent spouse relief, installment agreements, Offers in Compromise, bankruptcy, Taxpayer Assistance Orders, wrongful levies or liens.³⁶ If the suspension action was taken by a separated spouse, determine whether that action also suspends the limitation period as to your client. Also, if your client lived in a federally declared disaster area, it is possible that the limitation periods may have been extended by the IRS under its I.R.C. § 7508 (A) authority. For example, in Hurricane Katrina, the IRS deadlines for collection were extended for one year.³⁷

⚠ Caution: If the 10 year statute of limitations is close to expiration, be careful about taking action which may extend the statute of limitations.

Generally, assessments must be made within 3 years. I.R.C. § 6501. If the taxpayer omitted more than 25% of his gross income from his return, the assessment period is extended to 6 years. I.R.C. § 6501(e)(1). The 3 or 6 year limit on assessment is referred to as the Assessment Statute Expiration Date (ASED). This period may be waived by the taxpayer. The assessment period does not begin if a tax return was fraudulent or not filed. I.R.C. § 6501(c). There is no statute of limitation for assessment and the subsequent filing of a non-fraudulent return does not avoid the unlimited statute of limitation for the original fraudulent

³⁵ See *Effectively Representing Your Client before the IRS* (ABA 5th ed. 2011), Ch. 17 (how to spot statute of limitation issues). The IRS account transcripts will use code 150 to designate the assessment date. See Transaction Codes, Pocket Guide, IRS Document 11734 (Rev. 5-2012), available at www.irs.gov.

³⁶ I.R.M. 5.1.19.3. Note that some cases may involve several actions that suspend the statute of limitations. See *e.g.* I.R.M. 5.1.19.3.6.3 for the IRS view on how to calculate the suspension periods that result from an innocent spouse claim made within a collection due process appeal.

³⁷ IRS Notice 2006-20 (extending limitation periods to August 28, 2006 for Katrina victims).

return.³⁸ However, even when the original failure to file is fraudulent, a subsequent return triggers the 3 year limit on assessment.³⁹ Substitute returns filed by the IRS under I.R.C. § 6020(b) do not start the assessment or collection periods. I.R.C. §§ 6020, 6501(b)(3).

6.2 WHAT ARE THE MOST COMMON IRS COLLECTION ACTIONS?

Levies, liens and offsets.

The IRS will file liens against real estate when a taxpayer owes \$10,000 or more in taxes.

Other IRS collection efforts focus primarily on levies of bank accounts, wages and federal payments, e.g., Social Security, tax refunds, etc. Current IRS policy discourages levies on principal homes and retirement plans even though they are not exempt from seizure. The IRS will seize and offset a taxpayer's tax refund to pay prior taxes owed to the IRS.

6.3 WHAT SHOULD I LOOK FOR AS DEFENSES TO A COLLECTION ACTION?

The taxpayer's general goals in a collection action are:

1. Is the lien or levy valid?
2. Can the levy be suspended or avoided?
3. What are the collection alternatives and how do you get them?

6.4 WHAT IS A "SUBSTITUTE FOR RETURN" AND WHAT CAN BE DONE ABOUT IT?

Your client may receive a notice from the IRS saying that he owes an unbelievable amount of taxes. What is going on? The taxpayer has failed to file a tax return. So, the IRS has filed a "Substitute for Return" (SFR) and assumed that he had certain income based on either W-2s or Forms 1099, or income reported on prior tax returns. In a "Substitute for Return", the IRS does not give the taxpayer any credit for exemptions, deductions, business expenses or tax credits. Generally, the alleged tax deficiencies can be substantially reduced if a correct original tax return is filed. Tax returns subsequent to a SFR should be filed with the IRS's Fresno office.⁴⁰

Correct original tax returns for the years in question should be filed. This is necessary to lower the tax deficiency and to start the statutes of limitations for assessment and collection running. For the purposes of starting the statute of limitations, a SFR under I.R.C. § 6020(b) is not considered a tax return.⁴¹ In a § 6020(b) substitute for return, the IRS will normally assess a deficiency after the taxpayer fails to respond to the 90 day "notice of deficiency" letter. An assessment after the expiration of the 90 day period to contest the deficiency in Tax Court will start the collection statute of limitations.⁴² On the other hand, a SFR under I.R.C. § 6020(a) may qualify as a "return" for the purposes of starting the statutes of limitations. Also, a SFR may stop the running of the delinquency period for additional penalties for failure to file and failure to pay amounts due on the return.⁴³

³⁸I.R.C. § 6501(c)(1)-(2); *Badaracco v. Comm'r*, 464 U.S. 386 (1984). A preparer's fraud can extend the statute of limitations. *Allen v. Comm'r*, 128 T.C. 37 (2007).

³⁹IRS Field Service Advice 200051040 (12/22/2000), I.R.C. § 6501(c)(3).

⁴⁰I.R.M. 4.4.9.5.13.

⁴¹I.R.C. § 6501(b)(3); Reg. § 301.6501(b)-1(c).

⁴²I.R.M. 5.1.19.3.15.

⁴³Rev. Rul. 76-562, 1976-2 C.B. 430.

Outside the 10th Circuit, a taxpayer may file a tax return despite an IRS deficiency assessment by a Substitute for Return. The SFR can't deny the taxpayer's right to contest the deficiency and the IRS's choice of filing status in a Tax Court proceeding.⁴⁴

Also, taxpayers who seek a discharge in a Ch. 7 bankruptcy must file a return. They can't rely on SFRs. In many circuits, a taxpayer is also barred from a bankruptcy discharge of taxes if his related tax return was filed late. Several courts have denied bankruptcy discharges where the related tax return was filed late despite the IRS's position that late filed tax returns don't always bar bankruptcy discharge.⁴⁵

6.5 WHAT CAN THE IRS SEIZE FROM A TAXPAYER IN A LEVY?

The IRS may seize property or income through the levy process once proper notice is given. A levy reaches every species of property owned by the taxpayer unless exempted by *federal* law.⁴⁶ Essentially, the IRS steps into the taxpayer's shoes and can reach the taxpayer's interest in the property. The IRS will use offset to seize tax refunds and apply them to prior tax debt. Homes and vested retirement accounts are not exempt from seizure. Unemployment benefits, worker's compensation, a modest amount of wages, furniture, household effects, and tools of a trade are exempt.⁴⁷

6.6 HOW CAN A LEVY BE RELEASED?

The grounds for release of a levy include:

- the liability is satisfied or becomes unenforceable
- the release will facilitate collection
- the taxpayer enters an installment agreement
- economic hardship
- the fair market value of the asset exceeds the liability and release will not hinder collection⁴⁸

6.7 WHAT IF AN IRS COLLECTION ACTION WILL CAUSE A SIGNIFICANT FINANCIAL HARDSHIP?

IRS seizure of income and assets may cause a taxpayer to either default on other debt, suffer eviction or foreclosure, or lose his business or the means to make a living. If this is the taxpayer's situation, you should act quickly to resolve the seizure or levy.

The Taxpayer Advocate (an IRS ombudsman) may issue Taxpayer Assistance Orders (TAO) to stop collection activity. A TAO may be issued if the taxpayer is suffering or about to suffer a significant hardship as a result of IRS action or inaction or for circumstances set forth in IRS regulations. I.R.C. § 7811(a).

TAOs are most commonly used where an actual or threatened seizure of a bank account, pension plan, car or wages will cause a taxpayer to lose his home (including eviction), car necessary for work, medical care, education, or leave him

⁴⁴*Milsap v. Comm'r*, 91 T.C. 58 (1988).

⁴⁵*Compare In re McCoy*, 666 F.3d 924 (5th Cir. 2012) with Chief Counsel Notice CC 2010-016 (Sept. 2, 2010).

⁴⁶*Drye v. United States*, 528 U.S. 49 (1999).

⁴⁷I.R.C. § 6334; Reg. § 301.6334-1.

⁴⁸I.R.C. § 6343(a); I.R.M. 5.11.2.2.1.

without enough money for basic necessities. A Form 911 is used to apply for a TAO. The Louisiana Taxpayer Advocate can be reached at 504- 558-3001 (Ph.) and 504-558-3348 (Fax). For more information on TAOs, see IRS Publication 1546, Internal Revenue Manual 13.1.7.2, and Reg. § 301.7811.

6.8 HOW DO I DEAL WITH A WAGE LEVY NOTICE?

The IRS uses a Form 668-W to levy wages. If the taxpayer has a levy notice, determine what stage he is at in the levy process. Generally, the taxpayer will receive 3 statutory notices before the actual levy, including the final Notices, which are CP-90/297 or CP-91/298:

- 10 day notice and demand for payment [I.R.C. § 6331(a)]
- Final notice before levy [I.R.C. § 6331(a)]
- Final Notice of intent to levy and CDP hearing opportunity at least 30 days before proposed levy [CP-90/297 or CP-91/298 Notices, I.R.C. §§ 6330(a), 6331(d)]

Generally, levy cannot be made on wages or property until the IRS has given the taxpayer a 30 day written notice of intent to levy required by I.R.C. § 6331 (d).

The primary ways to deal with a wage levy are:

1. **Claim the highest exemption possible.** Generally, the IRS will levy based on 1 exemption and single filing status. If a taxpayer is married or has children, he may claim a higher exemption amount and a more favorable filing status. The amount the taxpayer pays for support established by court order is exempt from levy. If the taxpayer or his spouse is at least 65 years old or blind, an additional standard deduction is available. Use Form 668-W. *See* IRS Pub. 1494.
2. **Ask for a reduction of the levy based on economic hardship.** If the levy will cause economic hardship, file for a reduced levy. The IRS will require the taxpayer to complete a Form 433-A on his income and expenses.
3. **File for “Currently Not Collectible” status.** Many legal aid clients can be placed in “Currently Not Collectible” status if collection would cause undue hardship by leaving them unable to meet necessary living expenses. The taxpayer will need to provide the IRS with the financial information required by Form 433-A or 433-F. The IRS must release a levy upon a determination of “Currently Not Collectible” status.⁴⁹
4. **File a collection due process appeal on Form 12153.** A collection due process appeal will generally stop the IRS from making a levy while the appeal is pending. Collection alternatives and other defenses can be pursued in a collection due process appeal.⁵⁰
5. **Ask for a brief suspension of the levy if the taxpayer can pay the liability.** The IRS has authority to suspend collection activity for up to 120 days for individuals to allow the taxpayer to gather the funds to pay the liability.⁵¹

⁴⁹I.R.C. § 6343(e).

⁵⁰The taxpayer has 30 days to appeal a levy to an IRS Appeals Officer. I.R.C. § 6330(b), Reg. § 301.6330-1(b)(1). If a taxpayer timely requests an appeal, the IRS may not levy while the appeal is pending. I.R.C. § 6330 (e). Use Form 12153 to appeal.

⁵¹I.R.M. 5.14.5.5.

6. Submit a proposal for an Installment Agreement or Offer-in-Compromise.

Levies are suspended while an Installment Agreement or Offer-in-Compromise is under consideration or in effect. The suspension of levy continues if denial of the Installment Agreement or Offer-in-Compromise is appealed to an IRS appeals officer.

6.9 CAN AN EMPLOYER FIRE FOR A WAGE LEVY?

If an employer fires an employee because of an IRS wage levy, he may have violated 15 U.S.C § 1674.⁵² This violation is punishable by a \$1,000 fine and up to 1 year in prison. The U.S. Department of Labor enforces employer violations of 15 U.S.C § 1674. The taxpayer does not have a private cause of action to enforce this law.⁵³ However, the Department of Labor may seek reinstatement and back pay for the employee.⁵⁴

6.10 HOW DO I HELP SOMEONE WITH A BANK ACCOUNT LEVY NOTICE?

A bank levy is a one-time levy that reaches the deposits at the time of the levy. I.R.C. § 6332(c) only requires banks to hold funds subject to levy for 21 days. So, a taxpayer or a joint account holder must act quickly to prevent the levy from being executed. The IRS may ask the bank to hold the funds longer than 21 days if another person claims ownership of the funds.⁵⁵

The IRS may seize a taxpayer's bank account even if it includes exempt wages or exempt Social Security benefits.⁵⁶ The IRS may even seize an account that the taxpayer does not own, but has the right to withdraw funds from. When this happens, the owners of the account must act quickly to convince the IRS that they own the funds, not the taxpayer. If the bank transfers the levied funds to the IRS, the non-liable account holder will need to use the wrongful levy procedures to recoup their funds from the IRS. A third party has 9 months to file for return of his money. A Form 4528 is used for administrative recoupment of a wrongful levy. Suit should be filed within the 9 month period if you can't secure the return of the funds within 9 months.⁵⁷

6.11 HOW DO I HELP A TAXPAYER WITH A SOCIAL SECURITY LEVY?

The IRS may issue a continuous levy which takes 15% of a taxpayer's Social Security check on a monthly basis.⁵⁸ The IRS has decided not to levy on SSI benefits even though the law allows this. Ask for release of the levy based on economic hardship or seek Currently Not Collectible status based on hardship.⁵⁹ The IRS will require Form 433-A collection information statement from the taxpayer and will conduct the analysis of hardship based on its financial standards. If the taxpayer's only income is Social Security, a collection information statement may

⁵² *Martin v. Hawkeye Int'l Trade, Inc.*, 782 F.Supp. 1320 (S.D. Ia. 1991).

⁵³ *Smith v. Cotton Bros. Bakery Co., Inc.*, 609 F.2d 738 (5th Cir. 1980) cert. denied 449 U.S. 821.

⁵⁴ *Martin v. Hawkeye Int'l Trade, Inc.*, 782 F.Supp. 1320 (S.D. Ia. 1991).

⁵⁵ I.R.M. 5.11.4.2.1.2.

⁵⁶ Reg. § 301.6334-2(b); I.R.M. 5.11.4.5.

⁵⁷ I.R.C. § 7426(a)(1); *EC Term of Years Trust v. United States*, 550 U.S. 429 (2007). There may be a due process exception to the 9 month rule in some circumstances. See *Scheafnocker v. Comm'r*, 642 F.3d 428 (3d Cir. 2011).

⁵⁸ I.R.C. § 6331(h).

⁵⁹ Reg. § 301.6343-1(b)(4); I.R.M. 5.11.2.2.1.4; 5.11.2.2.1.2 (example).

not be required for the hardship determination.⁶⁰ The IRS may not deny a release for hardship because the taxpayer has failed to file tax returns.⁶¹ You may need to enlist the help of the Taxpayer Advocate Service if the IRS refuses to release a levy on the ground of the taxpayer's failure to file returns. Social Security levies continue after an Offer in Compromise settlement.

6.12 THE IRS OFFSETS A TAX REFUND—WHAT ARE THE TAXPAYER'S RIGHTS?

Under I.R.C. § 6402, the IRS may offset tax refunds to satisfy unpaid federal taxes. In addition, a taxpayer's tax refund may be offset for child support, state taxes or past due federal debts.

If the refund was offset for federal taxes, the taxpayer may claim and sue for a refund if he disputes the tax. If the refund was offset for debts other than federal tax, the taxpayer must dispute the offset with the agency or creditor that initiated the offset.⁶² There is no right to sue the IRS for recovery of a refund erroneously paid to another agency.⁶³ The name, address and phone number of the other agency should be on the IRS notice of offset. If it is not, this agency information may be obtained from Treasury's Financial Management Services at 800-304-3107. What if the federal tax refund is later determined to be incorrect? The IRS does not have to recover the erroneous offset payment from the agency that received the offset payment.⁶⁴

6.13 HOW DO IRS LIENS WORK?

A federal tax lien is the IRS's legal claim to property as security or payment for a tax debt. The claim arises "automatically" under I.R.C. § 6321 and attaches to every interest in property and rights owned by a taxpayer without regard to its location. *Drye v. United States*, 528 U.S. 49 (1999). This statutory lien is often referred to as a "secret lien" because it arises even if not publicly recorded.⁶⁵ The lien attaches to after-acquired property (unless property acquired after bankruptcy where taxes discharged). Federal tax liens even attach to property exempt from seizure under state law. *Drye, supra*; *Medaris v. United States*, 884 F.2d 832 (5th Cir. 1989). Exemption from levy under federal law does not bar a lien on the exempt or non-exempt property. *Matter of Sils*, 82 F.3d 111 (5th Cir. 1990). The IRS may seek to enforce the lien against exempt property by a foreclosure lawsuit under I.R.C. § 7403, but this is unlikely.

If a taxpayer does not pay a bill, the IRS will generally send a Notice of Federal Tax Lien which demands payment within 10 days.⁶⁶ The Notice will threaten the filing of a tax lien in the public records office if the bill is not paid.⁶⁷ A tax lien is not self-enforcing. The IRS must administratively levy on property or income or bring a foreclosure suit under I.R.C. § 7403.

⁶⁰ I.R.M. 5.16.1.2.9.

⁶¹ *Vinattieri v. Comm'r*, 133 TC. 392 (2010); IRS Notice CC-2011-005, IRM 5.11.2.2.1 and 5.19.1.7.1.5.

⁶² If the offset refund exceeded the amount of child support owed, there is an administrative procedure for correcting the error. See *e.g.*, 31 C.F.R. § 285.3.

⁶³ I.R.C. § 6402(f).

⁶⁴ IRS National Office Field Service Advice Memorandum No. 199938004 (Sept. 24, 1999).

⁶⁵ IRS Chief Counsel Memorandum, 200634012 (June 23, 2006).

⁶⁶ IRS personnel are directed to file liens for tax debts that are \$10,000 or more and may file for lesser debts.

⁶⁷ Note that the filing of a lien on a taxpayer's home may trigger a technical default if the mortgage has a "no lien" clause.

6.14 DOES A LIEN ATTACH TO INHERITED PROPERTY?

Yes. Renunciation of an inheritance won't defeat the lien. It will still attach to the property despite Louisiana succession law that allows for renunciation that defeats creditors' claims.⁶⁸

6.15 CAN A NOTICE OF FEDERAL TAX LIEN BE APPEALED?

Yes. A taxpayer may appeal a Notice of Federal Tax Lien by filing a Form 12153 within 30 days. *See* Reg. § 301.6320-1. Grounds for appeal include:

- Whether the law or administrative procedures were followed⁶⁹
- Spousal defenses
- Challenges to appropriateness of collection actions
- Collection alternatives
- Tax assessed and lien filed while bankruptcy stay in effect
- Time to collect tax expired before lien filed
- Taxpayer did not have opportunity to dispute asserted liability
- Taxes fully paid before lien filed

An Offer in Compromise is a "collection alternative" which can be heard by the Appeals Officer. Practitioners report higher success rates on Offers that are raised in collection due process (CDP) appeals. Offers in Compromise raised in a CDP appeal can be judicially reviewed by the Tax Court.⁷⁰

Lien appeal decisions by the IRS Appeals Officer are reviewable under an abuse of discretion standard by the Tax Court. The petition for judicial review must be filed within 30 days.⁷¹

6.16 HOW CAN IRS LIENS BE REMOVED?

Liens may be released, withdrawn, discharged, subordinated or non-attached:

6.16.1 Release—I.R.C. § 6325(a)

A recorded lien can be released if the tax liability is satisfied or becomes legally unenforceable. I.R.C. § 6325. Since the 1980s, the IRS has used "self-releasing" liens which contain the date that the lien ends or is released. Surprisingly, taxpayers often don't know whether the lien has been satisfied or expired. The IRS lien staff will have information on the lien's payment status.

A lien becomes unenforceable upon expiration of the statute of limitations for collection unless the IRS brings timely suit and wins judgment.⁷² The IRS has 10 years after timely assessment to collect taxes. I.R.C. §§ 6502(a), 6322.

The IRS must issue a certificate of release within 30 days after the lien is paid or becomes legally unenforceable. See IRS publication 1450 for how to request a certificate of release.

⁶⁸ *Drye v. United States*, 528 U.S. 49 (1999).

⁶⁹ In a "CDP" appeal, check for compliance with all applicable I.R.M. procedures. *See* *Murphy v. Comm'r*, 125 T.C. 301, 307 (2005).

⁷⁰ A "stand alone" Offer in Compromise decision can't be judicially reviewed by the Tax Court.

⁷¹ I.R.C. §§ 6320 (c), 6330 (c)-(e). Joint Committee on Taxation, *Summary of the Conference Agreement on H.R. 2676*, 132 (June 24, 1998).

⁷² I.R.C. § 6322; *Markham v. Fay*, 74 F.3d 1347, 1353 (1st Cir. 1996).

6.16.2 Withdrawal—I.R.C. § 6323(j)

The IRS may withdraw a lien if the filing was premature or in violation of administrative procedures, or the liability is being paid through an installment agreement or an Offer in Compromise.⁷³ A “withdrawal” is as though the lien never existed. If these conditions are met, a Certificate of Release of Lien (Form 668Z) may be obtained from the IRS and filed in the public records office. If the lien was filed in error, the IRS Certificate of Release should so state to minimize damage to the taxpayer’s credit rating. I.R.C. § 6326 (b). Use Form 12227 to request a withdrawal of a lien. Inquiries about routine lien releases and current payoff amounts can be made to IRS customer service unit, 800-913-6050.

6.16.3 Discharge—I.R.C. § 6325(b)

A discharge may be sought by a taxpayer when he seeks to sell or dispose of a specific property. A certificate of discharge is commonly issued in these circumstances:

- taxpayer’s other property has value double of unpaid balance secured by lien;
- taxpayer pays the value of interest IRS has in property;
- agreement that proceeds of sale will be substituted for the property (while parties sort out priorities of their claims)

Use Form 14235 to discharge a lien on a specific asset.

6.16.4 Subordination—I.R.C. § 6325(d)

Liens may be subordinated to a lender or another creditor. Subordination is a process whereby the IRS allows a lender to move ahead of the IRS’s lien position. IRS Publication 784 sets forth the procedures for the subordination of federal tax liens to other creditors’ claims. To obtain a certificate of subordination, contact the IRS Advisory Group Manager for your area. The addresses can be found in IRS Publication 4235. The request for subordination is made on a Form 14134 to the Advisory Group Manager along with supporting documents.

6.16.5 Nonattachment—I.R.C. § 6325(e)

A certificate of non-attachment states that the lien does not attach to the property of a person. This procedure is used when your client is not the person who owes the taxes, but is being hurt by the lien because he has the same or similar name. See IRS Publication 1024.

6.17 WHEN CAN THE IRS TAKE A TAXPAYER’S HOME?

A taxpayer’s principal residence is exempt from seizure for tax debts less than \$5,000. The IRS must obtain a federal court order to sell a principal residence for tax debts greater than \$5,000. Possible defenses include (1) IRS non-compliance with the laws and procedures applicable to levy and (2) whether reasonable collection alternatives exist. There may be other defenses if the home is jointly owned and the other owner is not liable for the tax debt.⁷⁴

⁷³I.R.C. § 6323; IRS Publication 1468, *Guidelines for Notices of Federal Tax Liens and Centralized Lien Processing*.

⁷⁴The district courts have some discretion under I.R.C. § 7403 to deny a foreclosure sale where the IRS holds a lien on only part of the house. See *e.g.*, *United States v. Rodgers*, 461 U.S. 677 (1983); *United States v. Winsper*, 2010 WL 4638598 (W.D. Ky. 2010) (foreclosure denied due to harm to non-liable spouse); *United States v. Jensen*, 785 F. Supp. 922 (D. Utah 1992) (harm to terminally ill nondebtor outweighed delay to IRS); *United States v. Jones*, 877 F. Supp. 907 (D. N.J. 1995) (nondebtor wife kept house in return for ½ rent payments to IRS). See also *United States v. Craft*, 535 U.S. 274 (2002) (I.R.C. § 6321 federal tax lien attaches to taxpayer’s rights in “entireties property” even though state law exempts entireties property from creditors’ claims that are only against one spouse); IRS Chief Counsel Notice 2003-39 (IRS position on *Craft*).

A taxpayer does not have to move out of his house after a levy. The IRS will not evict a taxpayer after the sale. The buyer at the sale must bring a state court eviction lawsuit. The buyer does not have full title to the house. After the sale, the taxpayer has 180 days (not 6 months) to redeem his property by paying the full bid price plus interest at 20% per annum. I.R.C. § 6337. If the taxpayer plans to redeem, it may be possible to rent from the purchaser.

7. COLLECTION ALTERNATIVES

7.1 WHAT ARE A TAXPAYER'S OPTIONS WHEN FACED WITH IRS COLLECTION ACTIONS?

The primary collection alternatives for a taxpayer in collection are:

- Currently Not Collectible Status
- Installment Agreement
- Offer in Compromise
- Innocent Spouse Relief

See discussion in sections below.

7.2 CURRENTLY NOT COLLECTIBLE HARDSHIP-IMMEDIATE RELIEF FOR MANY LEGAL AID CLIENTS

Most legal aid clients will be candidates for “Currently Not Collectible” status. A taxpayer may be placed in “Currently Not Collectible” status if collection would cause undue hardship by leaving her unable to meet necessary living expenses.⁷⁵ A levy on wages must be immediately lifted if the taxpayer is placed in “Currently Not Collectible” status.⁷⁶ A taxpayer may receive CNC status even if there are unfiled tax returns.⁷⁷

CNC status suspends collection, but does not forgive or compromise the tax or release liens. Also, interest and penalties accrue during CNC status. The IRS will also offset future refunds to collect the tax debt. However, the 10 year statute of limitation for collection continues to run. CNC status does not toll the collection limitation period.

The financial analysis for CNC status focuses on 3 types of necessary living expenses: national standards, local standards and other expenses.⁷⁸ The individual taxpayer's financial information generally must be compiled on a Form 433-A.⁷⁹

National standards are automatically used for clothing, food, housekeeping, personal care and out of pocket health care expenses. If a taxpayer claims more than the national standards, she must substantiate and justify each separate expense of the total national standard.⁸⁰

For housing and transportation, taxpayers are allowed the local standard or the amount actually paid, whichever is less.⁸¹ On-line access to the national and local standards can be found at I.R.M. 5.15.1-2.

⁷⁵I.R.M. 5.16.1.1, 5.16.1.2.9.

⁷⁶I.R.C. § 6343(e); I.R.M. 5.16.1.2.9 (7).

⁷⁷*Vinatieri v. Comm'r*, 133 T.C. 392 (2009); I.R.M. 5.16.1.2.9; 8.22.7.7 (4).

⁷⁸I.R.M. 5.15.1.7.

⁷⁹I.R.M. 5.16.1.2.9.

⁸⁰I.R.M. 5.15.1.8.

⁸¹I.R.M. 5.15.1.9.

“Other expenses” may be considered if they meet the necessary expense test. The issue is whether they provide for the health and welfare of the taxpayer and/or his family or are for the production of income.⁸² Examples of “other expenses” found necessary by the IRS include taxes secured debt and court ordered payments.⁸³

7.3 INSTALLMENT AGREEMENTS

7.3.1 Overview

A taxpayer may make monthly payments through an installment agreement if he is not financially able to pay his tax debt immediately. The IRS generally will not take collection actions while an installment agreement is being considered, in effect, or on appeal.

The minimum monthly payment on an installment agreement is \$25. The time periods for the installment agreement vary. Generally, the installment agreement should not extend beyond the time remaining on the collection statute of limitation. Low income taxpayers who pay a small monthly payment may not be reducing their principal tax debt given the interest rates charged on the taxes owed. The fees for setting up installment agreements vary. Most low-income taxpayers will qualify for a \$43 set up fee. Use Form 13844 to apply for the reduced \$43 fee charged to low-income taxpayers.

If a taxpayer can pay the full amount owed within 120 days, he may want to apply for a 120 day suspension of collection activity to gather the funds.⁸⁴ In cases of financial hardship, a longer suspension of collection activity may be possible.⁸⁵ This procedure allows the taxpayer to avoid the fees for setting up an installment agreement.

Partial installment agreements are now authorized.⁸⁶ Taxpayers who request partial installment agreements will be asked to address how equity in assets can be used to pay off the tax debt.

Once the installment agreement is approved, the IRS and the taxpayer are bound by the agreement unless the taxpayer misses a payment, fails to file tax returns, provided inaccurate information during the negotiations or his financial condition changes. Denials or terminations of installment agreements may be appealed using Form 9423, and later reviewed in Tax Court under the abuse of discretion standard. The IRS will allow an installment agreement to be reinstated one time, but will require a reinstatement fee. If a taxpayer is in danger of default on an installment agreement, he should contact the IRS.

Taxpayers who owe less than \$50,000 may apply for an installment agreement (guaranteed or streamlined) by several methods: (1) apply online (2) call the phone number on the IRS notice or bill or (3) complete and mail a Form 9465, Installment Agreement Request. If a taxpayer owes more than \$50,000, he will have to complete a Form 433-F which requires certain financial information from the taxpayer.

The major types of installment agreements are (1) guaranteed, (2) streamlined and (3) regular, discussed below:

⁸²I.R.M. 5.15.1.10.

⁸³I.R.M. 5.15.1.10.

⁸⁴I.R.M. 5.14.5.5

⁸⁵I.R.C. § 6161(a)(1); Reg. § 1.6161-1(a).

⁸⁶I.R.C. § 6159; I.R.M. 5.14.2.1.

7.3.2 Guaranteed installment agreements

A taxpayer will qualify for a “guaranteed” installment agreement without a financial analysis if:

- he owes less than \$10,000;
- has been in tax compliance for the 5 prior years; and
- can fully pay the tax within 3 years

7.3.3 Streamlined installment agreements

An individual taxpayer may now apply for a streamlined installment agreement if the aggregate unpaid balance is less than \$50,000 and can be fully paid within 72 months.⁸⁷ Full compliance (i.e., filing of tax returns) is required for a streamlined installment agreement. A streamlined installment agreement can be granted without submission of a collection information statement to the IRS.

7.3.4 Regular installment agreements—financial analysis required

If a taxpayer does not qualify for a guaranteed or streamlined installment agreement, he will have to apply for a regular installment agreement. This procedure requires completion of (1) a Form 9465-FS and (2) a Form 433-F collection information statement. The Form 433-F is used to analyze the taxpayer’s ability to pay based on IRS collection financial standards. The IRS generally does not grant regular installment agreements if the taxpayer can fully pay the liability from assets and disposable income.

7.3.5 Options for paying installment agreements

Taxpayers may pay installment agreements by check or money order, direct debit from a checking account (Form 433-D), payroll deduction (Form 2159), Electronic Federal Tax Payment system, or credit card. A direct debit installment agreement may qualify a taxpayer for withdrawal of a lien after 3 months of probation.⁸⁸

7.4 OFFERS IN COMPROMISE

You have heard the TV ads about settling IRS debt for pennies on the dollars? These tax debt settlement firms are peddling help with filing “Offers in Compromise.” An Offer in Compromise can provide substantial relief to a qualified taxpayer. Indigent and disabled taxpayers, with no assets, can settle tax debt for very small amounts.

Tax lawyers at legal aid programs help taxpayers with Offer in Compromise applications for free. Some of the private firms scam taxpayers by taking fees as high as \$3,000 and then doing very little to get the Offer in Compromise approved by the IRS. They fail to provide the back-up documents and negotiation required for a successful Offer in Compromise. Some firms take fees from taxpayers who have no chance of getting an Offer in Compromise, e.g., a taxpayer with substantial retirement accounts or real estate holdings.

An Offer in Compromise may be submitted on the basis of (1) doubt as to collectibility, (2) doubt as to liability or (3) effective tax administration.⁸⁹ Most offers are submitted for doubt as to collectibility.

⁸⁷Memorandum SBSE 05-0112-013 (Jan. 20, 2012). See also I.R.M. 5.14.5 & 5.14.10 for I.R.M. implementation rules.

⁸⁸I.R.C. § 6323(f)(2)(B); Memorandum SBSE-05-0411-036 (April 7, 2011).

⁸⁹I.R.C. § 7122.

An Offer in Compromise is initiated by filing a Form 656 which requires information and supporting documentation from the taxpayer on his income, assets and expenses. The filing fee for an Offer is a non-refundable \$150. However, the fee may be waived for a taxpayer whose income is below 250% of poverty. Use Form 656A for waiver of the fee. A taxpayer must file all required tax returns in order for his Offer in Compromise to be considered.

The purpose of the Offer in Compromise program is to settle tax debts for the maximum amount that the taxpayer can pay out of his net current assets and future income potential. The amount of the offer is computed as the sum of (1) net realizable assets⁹⁰ and (2) gross income *minus* necessary living expenses. Even if the computed "offer" amount is zero, the taxpayer should still offer at least \$1. The Internal Revenue Manual has extensive rules on how the maximum collection potential is determined.⁹¹ After the filing of the Offer, an attorney will often need to advocate with the IRS for the proposed offer amount. The Internal Revenue Manual rules are useful in this advocacy since the IRS is supposed to follow them.⁹² IRS requests for additional information should be timely responded to.

Levy is suspended while an Offer-in-Compromise is pending or in effect. I.R.C. § 6331(k). The IRS is not required to release a prior levy upon the taxpayer's filing of an Offer in Compromise. However, it will usually release the levy if the taxpayer shows economic hardship. "Rejections" of Offers in Compromise may be appealed to the IRS Appeals Office. I.R.C. § 7122(e). Levy is suspended pending an appeal. I.R.C. § 6331(k). If the IRS "rejects" an Offer-in-Compromise, the taxpayer may be able to appeal the collection action under I.R.C. §§ 6320, 6330 or under the Collection Appeals Program. Rev. Proc. 2003-71.⁹³

Possible disadvantages to an Offer in Compromise include an extension of the 10 year statute of limitation by the pendency of the offer plus 1 year, forfeiture of certain tax refunds, filing of tax liens to protect the IRS's interests, adverse impact on bankruptcy options and reinstatement of the full debt, plus penalties and interest, if the taxpayer defaults on the offer.⁹⁴ Also, an Offer in Compromise will preclude a subsequent innocent spouse claim for a tax year covered by the Offer. I.R.M. 25.15.5.15.

The IRS may allow the taxpayer to pay off the debt in a lump sum payment or in installments over a period of time, not to exceed the time remaining on the statutory period for collection.⁹⁵ The taxpayer will be given a fixed monthly payment amount if an Offer in Compromise is accepted. Be sure to structure a realistic compromise that provides the taxpayer with adequate means for basic living expenses.

If an Offer in Compromise is accepted, a taxpayer must file tax returns and pay her taxes for the next 5 years. Non-compliance could result in a default and enforcement of the compromised taxes by the IRS. Be sure to advise your client of her duty to file and pay taxes per the Offer in Compromise agreement. Document your advice in writing.

⁹⁰"Net realizable assets" equals the Quick Sale Value of an asset (generally 80% of fair market value) minus the first encumbrance, fix-up costs, broker fees, etc.

⁹¹I.R.M. 5.8.5; 5.15.

⁹²*Fairlamb v. Comm'r*, T.C. Memo 2010-22.

⁹³Returns of offers for additional information are not "rejections."

⁹⁴The IRS will not process and Offer in Compromise for a taxpayer who is in bankruptcy. Rev. Proc. 2003-71, I.R.B. 2003-36.

⁹⁵I.R.M. 5.8.1.10.4.

If an Offer in Compromise is rejected, the taxpayer may appeal the rejection to an IRS Appeals Officer.⁹⁶ If the Offer in Compromise was submitted as part of a collection due process hearing, the rejection may be appealed to Tax Court under an abuse of discretion standard.⁹⁷

8. BANKRUPTCY

8.1 YOU SHOULD ORDER A TAX TRANSCRIPT FROM THE IRS IN ALL BANKRUPTCIES

Always order an account record or tax transcript from the IRS. This information will help you to determine what taxes are owed and whether they are dischargeable. Without accurate information on the assessment dates and tax return filing dates, you may file a bankruptcy before a tax becomes dischargeable and saddle the debtor with tax debt that he could have discharged. Also, a tax transcript or account record will enable you to verify that your client has filed all required tax returns.

8.2 ALL BANKRUPTCY DEBTORS MUST PROVIDE THE TRUSTEE WITH THEIR MOST RECENT TAX RETURN

At least 7 days before the first date set for the creditors meeting, the debtor must provide the trustee with a copy of the federal income tax return (or tax transcript) for the most recent year ending before the commencement of the case if a return was required for that year.⁹⁸ Also, creditors must be given a copy of the tax return or tax transcript if the creditor makes a timely request, which is defined as 15 days before the first date set for the creditors meeting.⁹⁹ If the debtor fails to file a required return or transcript, his bankruptcy may be dismissed.¹⁰⁰ An interested party may move for dismissal. If such a motion is filed, the debtor must show that his failure was due to circumstances beyond his control.

If a taxpayer has lost his return, he can usually get a copy from his tax preparer. Most low-income taxpayers use professional tax preparation services. Also, low-income tax clinic attorneys have immediate electronic access to IRS tax transcripts provided the client signs a Form 2848 authorizing the low-income tax clinic attorney to represent him in tax matters for the relevant years. If these options are not available, you should immediately file an IRS Form 4506-T to obtain a record of account, tax transcript or "account transcript."

8.3 POST-BANKRUPTCY TAX RETURNS MUST BE TIMELY FILED

For all bankruptcies, a debtor must file any tax return that becomes due after the commencement of the bankruptcy case or obtain an extension for filing the return before the due date. If the debtor fails to timely file required returns or extensions, a taxing authority may request that the court dismiss the bankruptcy or convert it to another chapter of the Bankruptcy Code. If the debtor does not file the required return or obtain an extension within 90 days after the taxing authority's request, the court must dismiss or convert the case. You should advise bankruptcy clients of their duties to file tax returns and insure that they comply.

⁹⁶ I.R.M. 5.8.7.6.5.

⁹⁷ See e.g., *Blosser v. Comm'r*, T.C. Memo 2007-323; *Samuel v. Comm'r*, T.C. Memo 2007-312.

⁹⁸ 11 U.S.C. § 521(e)(2)(a).

⁹⁹ 11 U.S.C. § 521(e)(2)(A)(ii); Bankruptcy Rule 4002 (b)(4).

¹⁰⁰ 11 U.S.C. § 521(e)(2)(B).

8.4 CHAPTER 13 DEBTORS MUST FILE ANY REQUIRED TAX RETURNS FOR THE LAST 4 YEARS

Chapter 13 debtors must file all required tax returns for tax periods ending within 4 years of the debtor's bankruptcy filing. Prior year tax return forms can be found at www.irs.gov. The required returns must be filed with the IRS before the first meeting of the creditors. A debtor may request that a trustee hold the creditors meeting open for an additional 120 days to enable the debtor to file the required returns. The failure to file the required returns will prevent confirmation of a Ch. 13 bankruptcy plan and will result in the dismissal of the Ch. 13 case or conversion to Ch. 7.

8.5 THE FILING OF A BANKRUPTCY-TIMING OF TAX REFUNDS-REPORT TO TRUSTEE

A tax refund attributable to pre-petition income is property of the bankruptcy estate.¹⁰¹

Generally, a trustee will pro-rate a tax refund by the days prior to the bankruptcy filing and treat the pro-rated part of a post-petition tax refund as a pre-petition asset available to satisfy pre-petition debts.¹⁰² For example, if the debtor filed his bankruptcy 73% of the way through the year, the trustee will claim 73% of the tax refund under the "pro rata by days" method. If the taxpayer is able to file earlier in a year, he will be able to protect more of a tax refund from the trustee and creditors.

A child tax credit differs from the earned income credit in several respects. The child tax credit has both refundable and non-refundable portions. The child tax credit may not accrue until the end of the tax year. Bankruptcy courts have held that the refundable portion of the child tax credit is property of the estate, but that the non-refundable portion is not.¹⁰³ One court has held that no part of the child tax credit is property of the bankruptcy estate since the earliest accrual date of a child tax credit is January 1 of the next year.¹⁰⁴

In Louisiana, and many other states, large portions of a low-income taxpayer's tax refund may be exempt from seizure.¹⁰⁵ For example, in Louisiana, the earned income credit is exempt from seizure. However, the child tax credit is not exempt in Louisiana.¹⁰⁶ Thus, in Louisiana, the issue will be how much of the child tax credit portion of the tax refund (generally about \$1,000) qualifies as pre-petition assets subject to turnover to the trustee.

Many bankruptcy courts have standing orders for debtors to turnover tax refunds to the trustee. Entitlement to the refunds can be litigated by motion should the trustee to decide to claim all or part of the refund.

¹⁰¹ *Kokoszka v. Belford*, 417 U.S. 642 (1974); *United States v. Michaels*, 840 F.2d 901 (11th Cir. 1988).

¹⁰² See e.g., *In re Meyers*, 616 F.3d 626 (7th Cir. 2010).

¹⁰³ *In re Law*, 336 B.R. 780 (8th Cir. B.A.P. 2006); *In re Matthews*, 380 B.R. 602 (Bankr. M.D. Fla. 2007); *In re Donnell*, 357 B.R. 386 (Bankr. W.D. Tx. 2006); see also *In re Zingale*, 451 B.R. 412 (6th Cir. B.A.P. 2011).

¹⁰⁴ See *In re Schwarz*, 314 B.R. 433 (Bankr. D. Neb. 2004); *contra In re Law*, 336 B.R. 780 (B.A.P. 8th Cir. 2006).

¹⁰⁵ La. R.S. 13: 3881(A)(6), Act 468 of 2004.

¹⁰⁶ *In re Legier*, 2004 WL 4945987 (Bankr. E.D. La. 2004) (child tax credit is not exempt).

8.6 HOW TO LITIGATE TAX ISSUES WITH THE IRS IN A BANKRUPTCY

If the debtor owes federal taxes, name the IRS as a creditor. Use the following address for your bankruptcy schedule: Internal Revenue Service, c/o Centralized Insolvency Operations, P.O. Box 7346, Philadelphia, PA 19101-7346. The telephone number for this IRS unit is 800-913-9358.

Be sure to claim the earned income credit portion of any tax refund claim as exempt if this credit is exempt under your state law.¹⁰⁷ List any pending tax refund claims as assets.

Priority tax debt should be listed on Schedule E unless secured by a lien.¹⁰⁸ Non-priority tax debt should be listed on Schedule F. Be careful to list dischargeable non-priority tax debt on Schedule F so as to avoid an admission of non-dischargeability.

An adversary proceeding is not required to discharge a tax debt. However, a debtor can only be certain that a tax has been discharged by filing an adversary proceeding and obtaining a judicial determination of the dischargeability of the debt. Before you file an adversary proceeding, call the IRS attorneys. They may be willing to abate the tax. Adversary proceedings and motions against the IRS should be served on the Attorney General, local United States attorney and the designated IRS office.¹⁰⁹

If you dispute a proof of claim by the IRS or its “secured” status, first try to resolve the matter with the IRS insolvency advisor. Resolution at this level could obviate the need for litigation of your issue.

A bankruptcy court may also have jurisdiction to determine a tax liability where the taxpayer has not fully paid the tax. For example, you may persuade the bankruptcy court to determine whether the taxpayer should have received an Earned Income Credit. This can be done by filing an 11 U.S.C. § 505 motion to determine tax liability.¹¹⁰ Tax refund claims may be heard by the bankruptcy court even where the taxpayer has not met the jurisdictional requirements for district court litigation, i.e., full payment of the tax deficiency, and has missed the deadlines for Tax Court review.

Ch. 13 bankruptcy debtors, unlike Ch. 7 debtors, have the right (or standing) to litigate any refund lawsuits in their own names.¹¹¹ The trustee will seek to recover tax refunds won by the Ch. 13 debtor as “disposable income” that must be included in the plan. However, there may be challenges to the trustee’s action depending on your jurisdiction and the facts of the debtor’s financial situation.¹¹²

8.7 TAXES THAT MAY BE DISCHARGED IN BANKRUPTCY

Certain income tax debts may be discharged in bankruptcy. A Chapter 7 or Chapter 13 bankruptcy may provide some tax debt relief. If most of the client’s debt is federal tax, an Offer in Compromise (IRS Form 656) may provide the client with better relief from his tax debt than a bankruptcy. In some cases, an Offer in Compromise may be the only option if the taxpayer filed his tax return after the IRS assessed the tax by a substitute for return.

¹⁰⁷ In Louisiana, the earned income credit is exempt from seizure under La. R.S. 13: 3881(A)(6).

¹⁰⁸ See 11 U.S.C. § 507. Secured debt is listed on Schedule D.

¹⁰⁹ Bankruptcy Rule 7004(d)(4).

¹¹⁰ Bankruptcy Rule 9014, *In re Luongo*, 259 F.3d 323 (5th Cir. 2001); *Matter of Taylor*, 132 F.3d 256 (5th Cir. 1998).

¹¹¹ See e.g., *Cable v. Ivy Tech State College*, 200 F.3d 467, 472-74 (7th Cir. 1999).

¹¹² See e.g., *In re Freeman*, 86 F.3d 478 (6th Cir. 1996).

In a bankruptcy, you should always evaluate whether any of the income tax debt can be discharged. The analysis should be done for each tax year. The rules for determining whether an income tax is dischargeable are very complex.¹¹³ Income taxes are only dischargeable if all of these tests are met:

- **The 11 U.S.C. § 523(a) timely filed return test—a new bar to discharge?**

In a 2010 Chief Counsel notice, the IRS held that a late filed tax return would not bar bankruptcy discharge of the related tax unless the return was filed after an assessment pursuant to § 6020(b) substitute for return.¹¹⁴ However, despite this favorable IRS notice, many courts have held that a late filed return [with the possible exception of a return filed pursuant to I.R.C. § 6020(a)] can never be a “return” for bankruptcy discharge purposes.¹¹⁵ The IRS notice had rejected the reasoning of several courts that found that a late filed return barred discharge. If you have this issue, you should check to see if the IRS has changed its 2010 position in light of recent court rulings that bar discharge.

- **The 3 year tax return due date test**

Tax return was due at least 3 years before bankruptcy filed.¹¹⁶ For example, if a 2007 tax return was due on April 15, 2008, the bankruptcy petition must be filed after April 15, 2011, for the 2007 income tax to be dischargeable.¹¹⁷

The 3 year look back period may be suspended by bankruptcy and collection due process appeals.¹¹⁸ Offers in compromise don’t suspend the 3 year period.¹¹⁹

- **The 2 year tax return filing date test**

Tax return must have been filed at least 2 years before the bankruptcy was filed. This test will exclude debtors with unfiled returns and certain late filed returns. For example, if a 2007 tax return was not filed until April 15, 2009, the bankruptcy could not be filed until after April 15, 2011, if the debtor seeks to discharge the 2007 income taxes. Note that the “filing date” in the IRS records may be weeks or even months after the debtor mailed the return to the IRS. The only way to know the IRS filing date is to obtain the tax transcript or account record from the IRS.

I.R.C. § 6020 (b) authorizes the IRS to prepare a “substitute for return” for a taxpayer who fails to make or file a return. A substitute for return filed by the IRS without the taxpayer’s participation and consent will not qualify as a tax return for the two year tax return filing date test.¹²⁰ Furthermore, the IRS maintains that a tax can’t be discharged if the taxpayer filed his tax

¹¹³ See National Consumer Law Center, *Consumer Bankruptcy Law and Practice* (9th ed. 2009), § 15.4.3.1; *Effectively Representing your Client Before the New IRS* (ABA 5th ed. 2011), Ch. 21; M. King, *Discharging Taxes in Consumer Bankruptcy Cases* (2012).

¹¹⁴ Chief Counsel Notice, CC 2010-016 (Sept. 2, 2010).

¹¹⁵ See e.g., *In re McCoy*, 666 F.3d 924 (5th Cir. 2012) (interpreting post-2005 language of 11 U.S.C. § 523(a)(1)(B)(i)).

¹¹⁶ For an example of the interplay between the look back periods, see *Severo v. Comm’r*, 129 T.C. 160 (2007), *aff’d* 586 F.3d 1213 (9th Cir. 2009).

¹¹⁷ See *In re Loving*, 2011 WL 3800042 (Bankr. S.D. Ala. 2011) (taxes not dischargeable because debtor filed on April 8, 3 years after she filed her tax return, but less than 3 years after due date of the return).

¹¹⁸ 11 U.S.C. § 507(a)(8).

¹¹⁹ Chief Counsel Advice 2004-04-049 (Jan. 5, 2004).

¹²⁰ Rev. Rul. 2005-59, I.R.B. 2005-37; I.R.M. 5.9.2.9.1.2.

return after the IRS assessed a tax deficiency when the taxpayer failed to respond to the 90 day deficiency letters based on the IRS's preparation of a "substitute for return."¹²¹

- **The assessment date test (at least 240 days before bankruptcy filed)**

For the assessment date test, the IRS must have assessed the tax against the tax debtor at least 240 days before the bankruptcy petition was filed. You can only determine the assessment date by reviewing the IRS tax transcript or account record.¹²² Generally, assessment is made within 3 years of the tax return's due date. You don't want to file a bankruptcy petition before 240 days (with extensions) has run from the assessment.

The 240 day assessment test may extended if the taxpayer filed a prior bankruptcy. The length of the bankruptcy plus 6 months must be added to the time periods.¹²³ Offers in Compromise, collection due process appeals and Taxpayer Assistance Orders may also toll or increase the time requirements.¹²⁴

- **No fraud or willful evasion**

A fraudulent return or a willful attempt to evade or defeat tax will deny the debtor the right to discharge the tax debt.¹²⁵ The IRS bears the burden of proof on fraud or evasion.¹²⁶

- **Timely notification test**

To discharge a tax, the debtor must notify the IRS of the bankruptcy in time for the IRS to file a timely proof of claim.¹²⁷

8.8 WHAT TAXES MUST BE PAID IN A CHAPTER 13 BANKRUPTCY?

In Ch. 13 bankruptcies, the plan must provide for priority and secured tax debts. Older taxes may be "non-priority" and therefore dischargeable. In some cases, you can prevent a tax debt from becoming "secured" by filing the bankruptcy before the IRS files its lien.

8.9 ARE THERE ANY TAX ADVANTAGES TO A CHAPTER 13 BANKRUPTCY?

For the most part, the 2005 bankruptcy legislation eliminated the so-called Chapter 13 "superdischarge" of taxes. However, Ch. 13 can still be used to discharge priority taxes paid with money from loans and credit cards, tax penalties and post-petition interest on certain taxes.

A Ch. 13 bankruptcy may secure a more favorable repayment plan for taxes than an installment agreement.

¹²¹ Chief Counsel Notice, CC 2010-016 (Sept. 2, 2010)(citing 11 U.S.C. § 523(a)(1)(B)(i)); *but see, In re Colsen*, 446 F.3d 836 (8th Cir. 2006)(under pre-2005 law, return filed after assessment pursuant to "substitute for return" may qualify as a tax return for bankruptcy discharge purposes).

¹²² *See Effectively Representing Your Client Before the IRS*, § 17.2 (ABA 5th ed. 2011)(information on how to ascertain assessment date).

¹²³ *Severo v. Comm'r*, 129 T.C. 160 (2007), *aff'd* 586 F.3d 1213 (9th Cir. 2009).

¹²⁴ I.R.C. § 507 (a)(8)(A)(ii); I.R.M. 5.9.13.19.3(2)(concept of tolling); *see also In re Emerson*, 224 B.R. 577 (Bankr. W.D. La. 1998)(appeal of rejected offer in compromise does not toll the 240 day period in I.R.C. § 507).

¹²⁵ *See e.g., Matter of Bruner*, 55 F.3d 195 (5th Cir. 1995).

¹²⁶ *Grogan v. Garner*, 498 U.S. 279 (1991).

¹²⁷ *United States v. Hatipoulos*, 118 F.3d 1240 (8th Cir. 1997).

8.10 EFFECT OF BANKRUPTCY ON LIENS

Discharge of a tax debt in bankruptcy will not extinguish a pre-petition lien.¹²⁸ It only extinguishes the personal liability. Generally, liens recorded before the bankruptcy will not be canceled.¹²⁹ If they survive, the IRS will be able to seize the lien asset. This puts debtors with homes and retirement plans at risk of future tax collection.¹³⁰ However, sometimes the IRS does not bother enforcing liens after a bankruptcy. A tax lien will not attach to property acquired after a bankruptcy if the underlying tax liability was discharged in the bankruptcy.¹³¹

8.11 BANKRUPTCY STAY OF TAX COLLECTIONS AND LITIGATION

A bankruptcy stay will apply to IRS *collection* actions. A Chapter 7 bankruptcy will even stay collection of nondischargeable taxes for a few months. The IRS can be sued for violating the 11 U.S.C. § 362 (a) stay or the 11 U.S.C. § 524 discharge injunction. Generally, collection activity in violation of the stay will be void.¹³² A § 362(a) bankruptcy stay will also stay the commencement or continuation of a Tax Court proceeding.¹³³

During a stay, the IRS may take these actions without violating the stay:

- set-off a pre-petition tax refund against pre-petition income tax debt
- intercept an income tax refund for payment of past due child support
- assess the tax
- issue a notice and demand for payment of an assessment
- issue a notice of deficiency while a stay is in effect.¹³⁴
- conduct an audit to determine a tax liability

8.12 EFFECT OF BANKRUPTCY ON COLLECTION STATUTE OF LIMITATIONS

The time period to collect taxes is extended by the filing of a bankruptcy that does not discharge all of the taxes. The balance on the 10 year statute of limitations is extended by the length of the bankruptcy plus 6 months. I.R.C. § 6503 (h).

9. FAMILY LAW AND TAX ISSUES

9.1 TAX COLLECTION REMEDIES AGAINST SPOUSES

If Louisiana spouses are jointly liable for federal taxes because they filed a joint tax return, the IRS may collect taxes from either spouse's separate property or any of their community property.¹³⁵

In some cases, only one spouse may owe the tax liability. This situation may arise when:

- one spouse incurred a pre-marital tax debt
- the spouses did not file a tax return

¹²⁸ *In the Matter of Orr*, 180 F.3d 656 (5th Cir. 1999); *In re Isom*, 901 F.2d 744 (9th Cir. 1990).

¹²⁹ Generally, a lien will be valid until the 10 year statute of limitations has run. I.R.C. §§ 6322, 6502(a).

¹³⁰ Generally, the IRS will not seek to levy retirement plans unless there has been "flagrant misconduct" by the debtor. I.R.M. 5.9.17.4.3; 5.11.6.2.

¹³¹ I.R.M. 5.17.2.5.6.

¹³² *Smith v. Comm'r*, 124 T.C. 36 (2005).

¹³³ 11 U.S.C. § 362(a)(8); *Prevo v. Comm'r*, 123 T.C. 326 (2004).

¹³⁴ 11 U.S.C. § 362(b)(9), *In re Luongo*, 259 F.3d 323 (5th Cir. 2001) (IRS right to offset); I.R.M. 5.9.2.5.

¹³⁵ I.R.M. 25.18.4.1.

- the spouses filed separate returns
- one spouse qualified for innocent spouse relief
- one spouse incurs self-employment tax liability

The IRS may collect a liable spouse's pre-marital tax debt from all of the liable spouse's separate property. Louisiana is a 100% community property state for tax collection purposes. In Louisiana, the IRS can collect a liable spouse's pre-marital or post-marital tax debt from 100% of the community property.¹³⁶ Generally, in Louisiana, the IRS is not limited to collection from the liable spouse's 50% share of community property. In community property states, the IRS may seize part of the non-liable spouse's wages to satisfy the liable spouse's separate tax debt if the wages are community property. Generally, this could not happen in states that are not community property states (unless state law allows seizure of the non-liable spouse's property).

Currently, a spouse's wages, even if the spouses are separated, are community property in Louisiana and may be levied against by the IRS for federal tax debt. However, a wage levy against a non-liable spouse's wage is not a "continuous levy" under I.R.C. § 6331(e). A separate levy must be issued for each pay check. A non-liable spouse may claim the exemptions for levied wages.¹³⁷

Jointly owned property can be seized by the IRS. However, the IRS must compensate the nondebtor for her share.¹³⁸ The district courts have some discretion under I.R.C. § 7403 to deny a foreclosure sale where the IRS holds a lien on only part of the house.¹³⁹

9.2 INJURED SPOUSE RELIEF–NON-LIABLE SPOUSE'S RIGHTS TO TAX REFUND

Under I.R.C. § 6402, the IRS may offset tax refunds to satisfy certain unpaid debts. Thus, a taxpayer's tax refund may not be paid to her if her spouse was delinquent on child support, state taxes or past due federal debts. Typically, the IRS seizes part or all of the tax refund to pay to the qualified creditor that invoked the § 6402 offset procedures.

In Louisiana, the IRS may seize or offset 100% of the spouses' tax refund to collect one spouse's unpaid federal tax debt.¹⁴⁰ However, the rights of other creditors to an offset of a non-liable spouse's tax refunds are more limited. These creditors may not offset against the non-liable spouse's share of community property.¹⁴¹ Note, however, that the State of Louisiana may offset against a state tax refund, that is community property, to satisfy one spouse's separate debt.¹⁴²

¹³⁶ Rev. Rul. 2004-72, I.R.B. 2004-30; I.R.M. 25.18.4.6. In states that are "50% community property" states, the IRS may be limited to collection against 50% of the community property.

¹³⁷ I.R.M. 25.18.4.3.

¹³⁸ *United States v. Rodgers*, 461 U.S. 677, 699 (1983); I.R.M. § 25.18.4.1.

¹³⁹ *United States v. Rodgers*, 461 U.S. 677 (1983); *United States v. Jensen*, 785 F. Supp. 922 (D. Utah 1992) (harm to terminally ill nondebtor outweighed delay to IRS); *United States v. Jones*, 877 F. Supp. 907 (D. N.J. 1995) (nondebtor wife kept house in return for ½ rent payments to IRS).

¹⁴⁰ See Rev. Rul. 2004-72, I.R.B. 2004-30.

¹⁴¹ I.R.M. 25.18.5.8.

¹⁴² La. Civ. Code art. 2345 (a spouse's separate obligation may be satisfied from community property during the community); *Price v. Secretary*, 664 So.2d 802 (La. App. 3 Cir. 1995), writ denied 669 So.2d 405 (La. 1996) (wife's wages garnished to satisfy husband's separate tax obligation). In Louisiana, child support that accrues during a second marriage is viewed as a community obligation. *Gill v. Gill*, 895 So.2d 807 (La. App. 2 Cir. 2005). The State of Louisiana will offset a community tax refund to collect child support owed by one spouse for children of a prior marriage, whether it accrues during the second marriage or is for arrearages that pre-date the second marriage.

If a joint return was filed and both spouses had income and tax payments on the return, the non-liable spouse may request her portion of the tax refund by filing a Form 8379. Residents of community property states may apply for injured spouse relief if they were not required to pay the past due amount that was offset by the IRS at the request of a qualified creditor. Overpayments are allocated according to state law in community property states.

9.3 MARITAL DISPUTES OVER TAX REFUNDS

Ownership of tax refunds is governed by state law.¹⁴³ In community property states, division of a tax refund may require an analysis of the community and separate nature of the underlying income earned. In Louisiana, the classification of property as community or separate is fixed at the time of acquisition.¹⁴⁴ By comparison, ownership of the stimulus refund payments may be owned 50-50 and not depend on the parties' respective incomes.¹⁴⁵

For most low-income taxpayers, the Earned Income Credit accounts for most of their tax refund. Federal law deems the Earned Income Credit tax refund to be the separate property of the spouse who was entitled to this tax refund—even in community property states.¹⁴⁶ Thus, the other spouse does not have a community property claim for any portion of the Earned Income Credit. Furthermore, one-time tax refunds are not "income" for the purposes of La. R.S. 9: 315 child support calculations.¹⁴⁷

9.4 TAX LIABILITY IN COMMUNITY PROPERTY STATES

9.4.1 Income Tax in Community Property States

What are a spouse's tax liabilities after separation, but before divorce?

If *separate* tax returns are filed by a married couple in a community property state, each spouse must report one-half of the community income.¹⁴⁸ The higher income spouse will want this community property law to apply, whereas the lower income spouse will want to argue that an exception to this rule exists. In a community property state, each spouse should be limited to 50% of any cancellation of debt income claimed by the IRS.¹⁴⁹

The Internal Revenue Code § 66 establishes 4 exceptions to the rule that a spouse has to report one-half of community income:

- (1) The spouses lived apart for the entire year, filed separate returns and did not transfer more than a *de minimis* amount of earned income between them.¹⁵⁰

¹⁴³ See e.g., Rev. Rul. 2004-72, I.R.B. 2004-30; Rev. Rul. 74-611, 1974-2 C.B. 399; see also *Gray v. United States*, 553 F.3d 410 (5th Cir. 2008) (analysis of interest in tax refund under Texas community property laws). Note that the allocation of tax refunds in non-community property may involve an analysis of the spouse's earnings, payments and separate tax liabilities. See e.g., I.R.M. 25.18.5.3; Rev. Rul. 80-7, 1980-1 C.B. 296; *In re Palmer*, 449 B.R. 621 (Bankr. D. Mont. 2011).

¹⁴⁴ *Robinson v. Robinson*, 778 So.2d 1105 (La. 2001).

¹⁴⁵ See e.g., *In re Thompson*, 396 B.R. 5 (Bankr. N.D. Ind. 2008).

¹⁴⁶ Rev. Rul. 87-52, 1987-1 C.B. 347.

¹⁴⁷ La. R.S. 9: 315 (C)(3)(a).

¹⁴⁸ *United States v. Mitchell*, 403 U.S. 190, 196-97 (1971); Reg. § 1.66-1.

¹⁴⁹ Cf. *Brickman v. Comm'r*, T.C. Memo 1998-340.

¹⁵⁰ I.R.C. § 66(a); Reg. § 1.66-2. I.R.C. § 66(a) relief is automatic if the requirements are met. For purposes of § 66 (a), any amount of income transferred for the benefit of the spouses' child is not treated as a transfer to the spouse. Reg. § 1.66-2(c).

- (2) The taxpayer was not notified by the other spouse of the nature and amount of the income before the due date (including extensions) for the filing of the taxpayer's return and the spouse acted as if solely entitled to the income.¹⁵¹ Only the IRS may invoke this exception which arises under § 66(b).¹⁵²
- (3) Traditional innocent spouse relief¹⁵³ from community property laws under I.R.C. § 66(c) for an item of community income if:
 - (a) the requesting spouse did not file a joint return for the tax year;
 - (b) the income item omitted from the gross income of the requesting spouse's income would be treated as the other spouse's income under I.R.C. § 879(a) (**Note:** the other spouse's wages or income from a trade and business he operated as a sole proprietor are the most common examples);
 - (c) the requesting spouse proves that she did not know of, and had no reason to know of, the item of community income; and
 - (d) taking into account all of the facts and circumstances, it is inequitable to include the item of community income in the requesting spouse's individual income.
- (4) Equitable relief under the "flush language" of I.R.C. § 66(c) for spouses who don't meet the requirements for traditional innocent spouse relief under I.R.C. § 66(c). *See* Rev. Proc. 2003-61, I.R.B. 2003-32; IRS Notice 2012-8.¹⁵⁴

Warning: The time limitation for requesting traditional innocent spouse relief under I.R.C. § 66 (c) is different from the time limitations for I.R.C. § 6015 innocent spouse relief or I.R.C. § 66 (c) equitable innocent spouse relief. Reg. § 1.66-1(j) states that traditional innocent spouse relief under I.R.C. § 66(c) must be requested no later than 6 months *before* the statute of limitation on assessment expires for the non-requesting spouse. By contrast, equitable innocent spouse relief under § 66(c) must be claimed within 2 years of the first collection activity against the electing spouse.¹⁵⁵

Some community property income may be excluded from a spouse's income by other laws. Examples include:

- pension distribution in a community property state is taxable to non-employee spouse even when the employee spouse received distribution and turned funds over to non-employee spouse for her property interest in pension as required by a state court judgment. *Powell v. Comm'r*, 101 T.C. 489 (1993); *see also Mitchell v. Comm'r*, 131 T.C. No. 15 (2008) (QDRO distribution taxable to non-employee spouse in community property state).¹⁵⁶

¹⁵¹ I.R.C. § 66 (b); Reg. § 1.66-3. The IRS may deny a spouse the federal income tax benefits of community property law on items of community income. Under the regulations, a spouse will not have acted as solely entitled if the income was "used or made available for the benefit of the marital community." Reg. § 1.66-3(a). It is not clear whether a small amount of funds paid for family support would bar the IRS from invoking I.R.C. § 66(b) against a taxpayer.

¹⁵² *Hardy v. Comm'r*, 181 F.3d 1002 (9th Cir. 1999).

¹⁵³ If a married couple filed a *joint* return, I.R.C. § 6015 would govern requests for innocent spouse relief. I.R.C. § 66(c) does not apply to *joint* filers.

¹⁵⁴ Note that the "absence of significant benefit" test is different for equitable relief under I.R.C. § 66(c), than for traditional relief under I.R.C. § 66(c)(4). *See Felt v. Comm'r*, T.C. Memo 2009-245. It is easier to meet the § 66(c) "absence of substantial benefit" test.

¹⁵⁵ Rev. Proc. 2003-61, 2003-2 C.B. 296. Note that "collection activity" has a technical definition. *See e.g., McGee v. Comm'r*, 123 T.C. 314 (2004).

¹⁵⁶ A different outcome may result when the employee spouse pays the non-employee spouse with his separate wages rather than the pension distribution. *Comm'r v. Dunkin*, 500 F.2d 1065 (9th Cir. 2007).

- the spouse who does not receive an IRA distribution is not taxed on her community property share of the IRA distribution.¹⁵⁷ Similarly, this spouse would not be liable for the I.R.C. § 72(t) additional tax on an IRA distribution.¹⁵⁸

9.4.2 Self-Employment Tax in Community Property States

Net self-employment income is community property income. Generally, community property rules will govern regular income tax liability and require the non-earning spouse to include one-half of the earning spouse's income in her separate tax return. However, even in a community property state, self-employment income will be allocated entirely to the self-employed spouse for the purposes of self-employment tax.¹⁵⁹ In other words, community property law is disregarded for the purposes of calculating self-employment taxes. This rule can provide significant tax relief for the non-earning spouse since self-employment tax is often about 60% of the tax liability faced by low-income taxpayers.

9.5 INNOCENT SPOUSE RELIEF

Innocent spouse relief cases are complex. Both federal and Louisiana law have provisions for relieving innocent spouses from tax deficiencies or understatements. You should be able to identify when a client may have a potential innocent spouse relief claim. Appropriate claims should be filed with both the IRS and the Louisiana Department of Revenue. Innocent spouse relief often arises in a domestic violence case. It is recommended that these cases be referred to a low-income tax clinic lawyer or other tax law specialist.

The IRS has a spousal tax relief eligibility explorer on its web page to assist with evaluating eligibility for innocent spouse relief. For a comprehensive discussion of § 6015 innocent spouse relief, see R. Nadler, *A Practitioner's Guide to Innocent Spouse Relief: Proven Strategies for Winning Section 6015 Tax Cases* (ABA 2011).

The Internal Revenue Code provides 3 forms of relief to innocent spouses: (1) innocent spouse relief, (2) separation of liability and (3) equitable relief. These 3 forms of relief are discussed below:

9.5.1 Innocent Spouse Relief— § 6015 (b)

§ 6015 (b) innocent spouse relief can't be used for an *underpayment*.¹⁶⁰ Generally, a taxpayer may be eligible for innocent spouse relief if she:

- did not know or have reason to know about the unreported income or erroneous items, and
- did not receive benefits from the unreported income or erroneous items.

If the requesting spouse knew or had reason to know of the understatement, innocent spouse relief is not available. Reg. § 1.6015-2(a)(3). The reason to know standard considers all the facts and circumstances (including the nature of the item, the requesting spouse's education and business background, and the extent of that spouse's participation) and inquires whether a reasonable person in similar circumstances would have known of the understatement. Reg. § 1.6015-2(c).

¹⁵⁷ *Bunny v. Comm'r*, 114 T.C. 259, 262 (2000).

¹⁵⁸ *Morris v. Comm'r*, T.C. Memo 2002-17.

¹⁵⁹ I.R.C. § 1402 (a)(5); Reg. § 1.1402 (a)(8); IRM § 25.18.2.2; *Charlton v. Comm'r*, 114 T.C. 333; *Davis v. Comm'r*, T.C. Memo 1989-46; *Gilliam v. Comm'r*, 60 Fed. Appx. 720 (10th Cir. 2003).

9.5.2 Separation of Liability—§ 6015(c)

A separate tax liability election under § 6015(c) is available for a taxpayer who, at the time of election, is no longer married to or has been living apart for at least 12 months from the person with whom the taxpayer originally filed a joint return.

The separate liability treatment may be elected by the taxpayer who qualifies for such treatment under I.R.C. § 6015(c). To get this relief, the taxpayer must prove that a portion of the understatement was attributable to her spouse. A taxpayer can't use § 6015(c) for an *underpayment* of tax liability.¹⁶¹ The determination of separate liability is made without regard to community property rights. Thus, the electing taxpayer is basically taxed on her own income as though she were filing a separate married return. If she did not have income, her tax liability will be zero.

Taxpayers are often successful under § 6015(c). Relief is easier to obtain under § 6015(c) than § 6105 (b) since the IRS must prove actual knowledge of an erroneous item, as distinguished from “reason to know”, to deny apportioned liability under § 6015(c).¹⁶²

9.5.3 Equitable Relief—§ 6015(f) and § 66(c)

Legal aid clients, particularly domestic violence victims, often qualify for equitable relief under § 6015(f) or § 66(c).¹⁶³

The IRS may relieve an individual of liability if relief is not available under the innocent spouse rule [6015(b)] or the separate liability election [6015(c)] if it would be inequitable to hold the individual liable for any unpaid tax or deficiency. I.R.C. § 6015(f). The IRS automatically considers a taxpayer for equitable relief if innocent spouse and separate liability relief are denied. Note, unlike I.R.C. § 6015(b) and (c), §§ 6015(f) and 66(c) permit equitable relief from an *underpayment* of income tax. §§ 6015(b) and (c) only permit relief from understatements or proposed deficiencies. Rev. Proc. 2003-61, § 4.04 may even allow refunds to the requesting spouse in some circumstances.¹⁶⁴

Even if relief is unavailable under § 6015(b) and (c), the IRS may relieve a spouse from liability under §§ 6015(f) and 66(c) if it would be inequitable to hold the spouse liable for any unpaid tax or liability. I.R.C. § 66 (c) provides equitable relief in community property states where a joint return was not filed. I.R.C. § 6015(f) applies if a joint return was filed (even in community property states).

On January 5, 2012, the IRS issued Notice 2012-8 which sets forth a proposed revision of Rev. Proc. 2003-61 which governs the evaluation of equitable innocent spouse relief. The IRS has stated that it will apply the factors in Notice 2012-8 until a new revenue procedure is adopted. However, until a new revenue procedure is adopted, Notice 2012-8 allows a taxpayer to elect for her case to be evaluated under Rev. Proc. 2003-61 if treatment under any of the Rev. Proc. 2003-61 factors would be more favorable to the taxpayer. Also, the Tax Court still applies Rev. Proc. 2003-

¹⁶⁰ *Hopkins v. Comm'r*, 121 T.C. 73, 88 (2003).

¹⁶¹ *Hopkins v. Comm'r*, 121 T.C. 73, 88 (2003).

¹⁶² Generally, the burden of proof is on the taxpayer for innocent spouse relief with the exception of the requirement that the IRS must prove actual knowledge to deny apportioned liability under § 6015(c); see e.g., *Culver v. Comm'r*, 116 T.C. 189 (2001).

¹⁶³ For a sample analysis of § 6015(f) equitable innocent spouse relief, see *Stephenson v. Comm'r*, T. C. Memo 2011-16.

¹⁶⁴ For a sample analysis of § 66(c) equitable innocent spouse relief, see *Bennett v. Comm'r*, T. C. Summ. Op. 2005-84.

¹⁶⁴ See also, *Washington v. Comm'r*, 120 T.C. 137, 152-54 (2003).

61, but is not bound by IRS guidelines.¹⁶⁵ IRS Chief Counsel has directed its attorneys to apply Notice 2012-8 and not to argue against relief based on the factors set forth in Rev. Proc. 2003-61.¹⁶⁶ Therefore, you should evaluate the taxpayer's case under both Notice 2012-8 and Rev. Proc. 2003-61 until a new revenue procedure is finally adopted. Pay particular attention to the new 2012 rules on abuse, financial control, economic hardship and the weighting of the factors.

The IRS revenue procedure for § 6015(f) and § 66 (c) equitable relief is Rev. Proc. 2003-61, 2003-2 C.B. 296, which is being revised by the IRS as announced in Notice 2012-8. An analysis of Rev. Proc. 2003-61 and the jurisprudence is set forth below. Under Rev. Proc. 2003-61, the requesting spouse must satisfy 7 threshold conditions for § 6015(f) relief. *See* Rev. Proc. 2003-61, § 4.01. Conditions 1 and 2 below don't apply for a § 66(c) equitable relief request. The threshold conditions are:

1. Filing a joint return
2. Relief denied under § 6015(b) and (c)
3. Application within 2 years of first collection activity ¹⁶⁷
4. No transfer of asset as part of fraudulent scheme
5. No transfer of disqualified assets
6. Requesting spouse did not file or fail to file with fraudulent intent
7. Item resulting in deficiency or underpayment is attributable to non-requesting spouse, unless:
 - Attribution is due to operation of community property laws
 - Item is only nominally owned by requesting spouse
 - Non-requesting spouse misappropriated funds and the requesting spouse had no knowledge or reason to know of the misappropriation, or
 - Abuse not amounting to duress led the requesting spouse not to challenge treatment of items. (For helpful discussion of the "abuse exception", *see Nihiser v. Comm'r*, T.C. Memo 2008-135; *Brown v. Comm'r*, T.C. Summ. Op. 2008-121).

If a case involves an *underpayment* on a joint return, the IRS will ordinarily grant § 6015(f) equitable relief if the taxpayer meets the 3 "safe harbor" conditions in § 4.02 of Rev. Proc. 2003-61, marital status, no knowledge of underpayment and economic hardship.¹⁶⁸ In some cases, the marital status factor may be met even if the spouses lived separately in the same house.¹⁶⁹ Equitable relief under § 4.02 is available to all joint return taxpayers with underpayments, including taxpayers in community property states.

A taxpayer may qualify for equitable relief under § 4.03 of Rev. Proc. 2003-61 if he filed a joint tax return, but does not qualify for "safe harbor" relief under § 4.02. Also, if partial relief is granted under § 4.02, a taxpayer may be eligible for total relief under § 4.03.¹⁷⁰

¹⁶⁵ *Sriram v. Comm'r*, T.C. Memo 2012-91, n.7.

¹⁶⁶ IRS CC-2012-004 (Jan. 5, 2012).

¹⁶⁷ However, the IRS has recently decided not to impose the 2 year time limit for § 6015(f) equitable relief claims. Notice 2011-70, 2011-32 I.R.B. 135. The IRS has not made a similar pronouncement that the Rev. Proc. 2003-61 time limits for § 66(c) equitable relief claims are invalid.

¹⁶⁸ *Gonce v. Comm'r*, T.C. Memo 2007-328.

¹⁶⁹ *Nihiser v. Comm'r*, T.C. Memo 2008-135

¹⁷⁰ *Cf. Bruen v. Comm'r*, T.C. Memo 2009-249.

Equitable relief is available under § 4.03 for the following taxpayers:

1. A “community property state” taxpayer who did not file a joint return, who requested relief under I.R.C. § 66(c) and met the applicable threshold conditions of § 4.01, i.e., conditions 3 to 7.
2. A spouse who filed a joint return, who met the § 4.01 threshold conditions, but did not qualify for “safe harbor” relief under § 4.02.

Under § 4.03, no single factor is determinative. All factors must be considered and weighed appropriately.¹⁷¹ The Tax Court now reviews IRS denials of § 6015 (f) equitable relief under a de novo standard of review and a de novo scope of review.¹⁷² The Tax Court regularly reverses IRS denials of equitable relief. If the Tax Court finds that the IRS abused its discretion in denying equitable innocent spouse relief, it must decide the appropriate relief and may not remand the case to the IRS.¹⁷³

9.6 LOUISIANA STATE TAX INNOCENT SPOUSE RELIEF

The primary laws for innocent spouse relief from state taxes are La. R.S. 47:101(B)(7) and 47:1584. These laws are similar to the IRS rules for innocent spouse relief and are retroactive to all tax years. If possible, file the innocent spouse claim with the State within two years of the first collection activity directed to the innocent spouse.¹⁷⁴ Guidelines for filing state innocent spouse relief claims are found in Louisiana Department of Revenue Technical Advisory Memorandum 99-003. Innocent spouses may also be relieved from suspension of driver’s licenses for failure to pay state taxes greater than \$1,000.¹⁷⁵

9.7 DEPENDENCY EXEMPTIONS

Dependency exemptions reduce taxable income. However, they generally have little impact on a low-income taxpayer’s tax liability or refund. The real money comes from the Earned Income Credit and child care credits. In some cases, a separated, but married spouse may need the dependency exemption to qualify for the head of household filing status and the Earned Income Credit.

If a parent’s dependent is not a “qualifying child”, check to see if the dependent qualifies as a “qualified relative.” Receipt of Social Security, food stamps and rental subsidies may affect an indigent taxpayer’s ability to claim a dependency exemption for a “qualifying relative” as distinguished from a “qualifying child.”

9.8 DIVORCED OR SEPARATED PARENTS AND DEPENDENCY EXEMPTIONS

In most cases, a child of divorced or separated parents is the “qualifying child” of the custodial parent. The “custodial parent” is the parent with whom the child lived for the greater part of the year.¹⁷⁶

However, under I.R.C. § 152(e), the child may be treated as the qualifying child of the non- custodial parent if:

¹⁷¹ *Rosenthal v. Commissioner*, T.C. Memo 2004-89.

¹⁷² *Porter v. Comm’r*, 132 T.C. 2003 (2009).

¹⁷³ *Friday v. Comm’r*, 124 T.C. 220, 222 (2005); *Nihsner v. Comm’r*, T.C. Memo 2008-135.

¹⁷⁴ La. R.S. 47:101 establishes a two year limit for assertion of innocent spouse relief. However, La. R.S. 47:1584 (B)(4) provides authority for the Secretary to grant innocent relief after the expiration of the two years.

¹⁷⁵ La. R.S. 47: 296.

¹⁷⁶ I.R.C. § 152(c)(1)(B).

1. The parents are divorced or legally separated, separated under a written separation agreement, or lived apart at all times during last 6 months of the year, and
2. The child received over half of his support from the parents, and
3. The child is in the custody of one or both of the parents for more than half the year, and
4. Either (a) the custodial parent signs a Form 8332 or a written declaration that conforms to the substance of Form 8332, that she will not claim the dependency exemption, and the non-custodial parent attaches the declaration to his return, or (b) a pre-1985 divorce or maintenance decree or separation agreement that applies to 2008, states that the non-custodial parent can claim the child as a dependent, and the non-custodial parent provides at least \$600 of the child's support during the year.

These rules also apply to parents who never married.

9.9 CAN A DIVORCE OR CUSTODY DECREE MEET THE REQUIREMENT OF A SIGNED FORM 8332?

Yes, if it is an unambiguous and unconditional release that is *actually* signed by the custodial parent herself.¹⁷⁷ The decree must state that the custodial parent will not claim the dependency exemption. *Armstrong v. Comm'r*, 139 T.C. No. 18 (2012). Ambiguity as to the tax years for release of the exemption can be fatal.

A divorce decree that has a contingent release of the dependency exemption can't conform to the substance of Form 8332.¹⁷⁸ For example, a decree that makes reallocation of the dependency exemption contingent on payment of child support won't be accepted by the IRS. Also, a divorce decree won't conform to the substance of Form 8332 unless it has the actual signature of the custodial parent.¹⁷⁹ The signature of the custodial parent's attorney on the consent judgment is insufficient to claim the dependency exemption.¹⁸⁰

9.10 MAY A FAMILY COURT REALLOCATE A DEPENDENCY EXEMPTION?

Generally, the custodial parent is entitled to the dependency exemption under I.R.C. § 152(e). Louisiana law states that there is a presumption that the domiciliary parent has the right to claim dependency exemption deductions and the earned income credit.¹⁸¹ However, Louisiana law also provides that a court may order a reallocation of the dependency exemption deduction upon proof:

1. that no child support arrearages are owed; and
2. that reallocation to the non-domiciliary parent will substantially benefit the non-domiciliary parent without significantly hurting the domiciliary.¹⁸²

Federal law also allows restrictions, e.g., timely payment of child support, to be placed on the reallocation of an exemption.¹⁸³ Under federal law, the parent who meets the relationship, age and residency tests should still get the Earned

¹⁷⁷ *Boltinghouse v. Comm'r*, T.C. Memo 2003-134.

¹⁷⁸ *Thomas v. Comm'r*, T.C. Memo 2010-11.

¹⁷⁹ *Clinton v. Comm'r*, T.C. Summ. Op. 2010-75.

¹⁸⁰ *Miller v. Comm'r*, 114 T.C. 184 (2000).

¹⁸¹ La. R.S. 9:315.18(A).

¹⁸² La. R.S. 9:315.18 (B)(1)(b); *State, Dept. of Social Services v. Mason*, 44 So.3d 744, 749 (La. App. 5 Cir. 2010).

¹⁸³ See e.g., *Flatt v. Comm'r*, T.C. Memo 1986-495.

Income Credit, and federal law deems this credit to be the taxpayer's separate property.¹⁸⁴ Note that Louisiana statutory law does not purport to authorize reallocation of the earned income credit.¹⁸⁵

9.11 DOMESTIC VIOLENCE AND TAX ISSUES

Many legal services clients are domestic violence victims. What are some of the tax issues and considerations for them?

1. Stop Filing Joint Returns

The economic advantages of a joint return will probably be outweighed by the economic disadvantages and the threat to your client's security. A joint return makes the victim jointly liable for taxes. She is unlikely to have access to the financial information necessary to sign a joint return.

If your client has been separated for the last 6 months of the year, she may be able to claim the favorable head of household tax rates and the Earned Income Credit. The additional tax refunds could help the victim's plan for financial independence.

Resolution of divorce and custody litigation before the end of a tax year may strengthen a victim's rights to head of household tax rates, the Earned Income Credit and dependency exemptions. A court decree allowing the victim use of the marital home may help her qualify for these tax benefits.

2. Assess a victim's needs for innocent spouse relief

Domestic violence victims often find themselves saddled with large tax debts due to their spouse's concealment of income (self-employment and gambling are easy to conceal), failure to file tax returns or pay taxes. We regularly see domestic violence victims assessed with \$30,000 to \$40,000 in tax debt for their spouse's income.

Ask a victim if she knows whether prior tax returns have been filed or whether she has received any notices from the IRS about their taxes. Abusers forge the victim's signature or may force the victim to sign a return without seeing it. After separation or relocation, a victim should file a Form 8822 with the IRS to receive deficiency notices relative to prior joint returns.

A victim may be able to avoid or minimize liability for a past tax return through either innocent spouse relief, separate liability limitation or equitable relief. Abuse and threats of violence are factors that may strengthen a Form 8857 application for innocent spouse or equitable relief.¹⁸⁶ A divorce decree requiring the other spouse to pay the tax helps a claim for equitable relief. Rev. Proc. 2003-61.

Innocent spouse relief may be applied for by filing a Form 8857. Unfortunately, due to a quirk in the law, judicial review of "stand alone" § 66(c) equitable relief determinations does not exist for spouses in community property states filing *separate* returns.¹⁸⁷ However, Tax Court review may be obtained if the innocent spouse claim is raised in a collection due process appeal or as an affirmative defense to a deficiency notice.¹⁸⁸ In addition, a

¹⁸⁴ Rev. Rul. 87-52, 1987-1 C.B. 347 (Earned income credit is separate property).

¹⁸⁵ Compare La. R.S. 9: 315.18 (B)(1)(b) with La. R.S. 9: 315.18(A).

¹⁸⁶ See *Kistner v. Comm'r*, 18 F.3d 1521 (11th Cir. 1994); Rev. Proc. 2003-61.

¹⁸⁷ See *Bernal v. Comm'r*, 120 T.C. 102 (2003), I.R.C. § 66 (c).

¹⁸⁸ *Felt v. Comm'r*, T.C. Memo 2009-245.

victim may ask for an appeal to the IRS Appeals Office¹⁸⁹ or for reconsideration for denied innocent spouse determinations.¹⁹⁰ The reconsideration option is available for victims who have missed their appeal deadlines and is similar to the audit reconsideration process.

The IRS protects domestic violence victims who apply for innocent spouse relief. A domestic violence victim who fears that filing a claim for innocent spouse relief would result in retaliation should write “Potential Domestic Abuse Case” at the top of the Form 8857. If the IRS has notice of domestic violence, it will not release to a current or former spouse information relative to a new name, employer phone number or other information that could endanger the safety of domestic violence victims. If in Tax Court, ask that records be sealed to prevent victim’s address from being released.

3. Threats or theft by batterer

A batterer may threaten to hurt a victim in order to get her to forgo a dependency exemption or other tax benefits. An abusive intimate partner may steal from a taxpayer’s account and said theft may support a theft loss deduction.¹⁹¹ Explore these issues with your client. If she has been threatened, advise her of any available civil or criminal remedies. If a spouse establishes that she signed a joint return under duress, the return is not a joint return.¹⁹²

10. CONSUMER DEBT AND TAX ISSUES

10.1 DEBT CANCELLATION INCOME

Generally, income from debt cancellation is includible in gross income. I.R.C. § 61(a)(12). Generally, the amount of income is the difference between the face value of the debt and the amount paid in satisfaction of the debt. Income is recognized in the year the debt cancellation occurs.¹⁹³ Debt cancellation often occurs in a foreclosure sale.¹⁹⁴

Cancellation of a large debt may result in taxability of Social Security benefits for a low income taxpayer or loss of Earned Income Credits.¹⁹⁵

Typically, debt cancellation income arises when a lender forgives debt or a government waives an overpayment. Examples of potential debt cancellation income are:

- reduction or forgiveness of personal credit card debt or loans¹⁹⁶
- personal vehicle repossession
- loan workout agreement or modification
- mortgage foreclosure, quit claim or reconveyance to creditor, short sale, abandonment¹⁹⁷

¹⁸⁹ See Rev. Proc. 2003-19, 2003-1 C.B. 371; IRM 25.15.12 (Appeal Procedures).

¹⁹⁰ I.R.M. 25.15.17.1.

¹⁹¹ *Herrington v. Comm’r*, T.C. Memo 2011-73.

¹⁹² Reg. §1.6013-4; Rev. Proc. 2003-61, 2003-2 C.B. 296, §2.03.

¹⁹³ *Rood v. Comm’r*, T.C. Memo 1996-248, *aff’d* 122 F.3d 1078 (11th Cir. 1997); *Jelle v. Comm’r* 116 T.C. 63 (2001).

¹⁹⁴ But, if local law provides a right to redeem a foreclosure sale, the sale is generally not final for tax purposes until the right to redeem expires. *Great Plains Gasification Associates v. Comm’r*, T.C. Memo 2006-276.

¹⁹⁵ *Jelle v. Comm’r*, 116 T.C. 63, 70-71 (2001); *Payne v. Comm’r*, T.C. Memo 2008-66, n.3.

¹⁹⁶ The Tax Court has ruled that a reduced payment in settlement of a credit card debt constitutes debt cancellation income. *Payne v. Comm’r*, T.C. Memo 2008-66 (purchase price adjustment exclusion denied); *Plotnitsky v. Comm’r*, T.C. Memo 2008-244 (gift exclusion denied). Because no exclusions applied in *Payne* and *Plotnitsky*, the write-off of the credit card debt was income to the taxpayer. See also, *Hill v. Comm’r*, T.C. Memo 2009-101 (debt cancellation income where credit card judgment and debt written off after Ch. 13 bankruptcy dismissed).

¹⁹⁷ *Frazier v. Comm’r* 111 T.C. 243 (1998).

- Truth-in-Lending rescissions¹⁹⁸
- government waiver of overpayment by government¹⁹⁹

Creditors defined as “applicable entities” by I.R.C. § 6050P(c)(2), are required to issue a Form 1099-C reporting debt cancellation income to the IRS when they reduce a debt by at least \$600. The duty to issue a Form 1099-C is triggered when there is a discharge of debt, which is deemed to occur when there has been an “identifiable event” as defined in Reg. § 1.6050P(b)(2)(I). The IRS will argue that a discharge of debt occurred when the “identifiable event” occurred. But, the IRS may be wrong. In some cases, the “identifiable event” may not constitute a discharge of the debt for determining (1) when debt cancellation income occurred, or (2) whether it actually occurred.

A Form 1099-C does not establish that a debt was discharged or the date of discharge. *Sims v. Comm’r*, T.C. Summ. Op. 2002-76. A Form 1099-C is not dispositive. If the taxpayer asserts a reasonable dispute with respect to reported income, I.R.C. § 6201(d) may shift the burden of production to the IRS, requiring it to produce reasonable and probative evidence in addition to the Form 1099-C.²⁰⁰ Unjustified reliance on Forms 1099-C by the IRS have led to attorney fee awards for taxpayers.²⁰¹

The issuance of Forms 1099-C has skyrocketed in recent years. In 2005, debt buyers were, for the first time, required to issue Forms 1099-C.²⁰² Most buyers of credit card debt have no idea or records as to what the original creditor’s pre-charge off amount was. This ignorance produces inaccurate Form 1099-C reports of debt cancellation income. Often, debt buyers don’t know where the debtors live. So, many taxpayers never receive the Forms 1099-C.

Many low income taxpayers don’t understand Forms 1099-C or their potential tax liability. It is difficult for a taxpayer to determine if he has debt cancellation income or rights to exclude such income from taxation. A taxpayer should review Form 1099-C (or Form 1099-A) for accuracy and request correction by the lender/creditor if inaccurate. If the debt was transferred to a debt buyer, it is likely that the discharged debt is wrong if reported by the debt buyer. IRS Publication 4681 explains how to read Forms 1099-A and C. If the taxpayer erroneously paid taxes on cancellation of debt income, he may be able to amend his tax return to claim a refund.

10.2 WAS THERE A DISCHARGED DEBT?

Debt cancellation income is income from the discharge of a debt. To evaluate the tax liability, first determine whether (1) there was a “debt” (2) whether cancellation of the “debt” creates an accession to wealth and (3) if and when the debt was “discharged.”

¹⁹⁸ *Schlifke v. Comm’r*, T.C. Memo 1991-19.

¹⁹⁹ See e.g. *Waterhouse v. Comm’r*, T.C. Memo 1994-467 (waiver of VA overpayment creates debt cancellation income). On the other hand, the IRS has privately ruled that the VA’s discharge of a veteran’s mortgage due to hardship was not taxable when the VA intended to reduce the veteran’s future benefits for the amount of the debt forgiveness. PLR 8839026 (June 29, 1988). Also, cancellation or waiver of an overpayment due to economic hardship should be excluded from income under the general welfare exclusion doctrine. See e.g., Rev. Rul. 78-46, 1978-1 C.B. 22.

²⁰⁰ *McCormick v. Comm’r*, T.C. Memo 2009-239; cf. *Portillo v. Comm’r*, 932 F.2d 1128 (5th Cir. 1991).

²⁰¹ See e.g., *Owens v. Comm’r*, 67 Fed. Appx. 253 (5th Cir. 2003).

²⁰² Unfortunately, debt buyers are now “applicable entities” and are required to report debt cancellation. See *Debt Buyers’ Association v. Snow*, 481 F. Supp.2d 1 (D.D.C. 2006).

If there is a dispute as to the debt, a compromise may not give rise to a discharge of a “debt.” Furthermore, a creditor may not need to report debts that are cancelled by operation of law.²⁰³ A settlement or “forgiveness” of a *disputed* or unenforceable debt does not result in income to the taxpayer. See *e.g.*, *Zarin v. Comm’r*, 916 F.2d 110, 115 (3d Cir. 1990). In *Zarin*, no taxable income resulted from the settlement since the amount of the discharged debt was void *ab initio* due to the underlying illegality or fraud. See also *Estate of Smith v. Comm’r*, 198 F.3d 515 (5th Cir. 1999) (unliquidated claim for contribution or restitution is not a “debt” that creates debt cancellation income). Refinancing of a debt may also provide an exception to debt cancellation income. See *Zappo v. Comm’r*, 81 T.C. 77, 85-86 (1983).

To win a *Zarin* argument, there must be evidence of a dispute of the amount or enforceability of the debt. A settlement alone does not prove that a good faith dispute existed. *McCormick v. Comm’r*, T.C. Memo 2009-239. The taxpayer has the burden of proof. *Rood v. Comm’r*, T.C. Memo 1996-248, *aff’d* 122 F.3d 1078 (11th Cir. 1997). If the taxpayer raises a reasonable dispute as to the amount of debt cancellation income on the Form 1099-C, the IRS must produce reasonable and probative information as to the amount of debt cancellation income, and can’t rely on the Form 1099-C. *McCormick*, *supra*.

To avoid tax consequences to the debtor, the settlement should include an agreement by the parties that the settlement agreement reflects settlement of disputed claims, does not represent a discharge of indebtedness for purposes of I.R.C. § 61(a)(12) and that the lender will not report the transaction as resulting in income to the debtor to any taxing authority. Lenders rarely agree to the last of these conditions, but that disagreement does not make the debt cancellation taxable income.

What are the tax consequences if the taxpayer successfully rescinds a transaction pursuant to the Truth-in-Lending Act or another consumer protection law? The IRS will argue that the difference between the loan principal and the amount paid by the taxpayer for rescission is debt cancellation income. See *Schlifke v. Comm’r*, T.C. Memo 1991-19. The taxpayer can argue that there was no debt cancellation income under *Zarin v. Comm’r*, *supra*, since the debt was disputed. This may be a successful argument, at least to the extent the taxpayer did not deduct interest in prior tax returns.

However, if the taxpayer took deductions for interest in prior tax years, the IRS will argue that recovery of the same is taxable income under the tax benefit rule. In *Schlifke v. Comm’r*, the Tax Court ruled that there was income from a rescission under the tax benefit rule to the extent that the taxpayer had taken deductions for interest on the rescinded mortgage.

10.3 WHEN IS A DEBT DISCHARGED?

A debt is discharged when it is clear that the debt will never have to be paid.²⁰⁴ Recourse debt is not discharged to the extent that there is a deficiency judgment or an unpaid deficiency that survives the foreclosure judgment.²⁰⁵ In some cases, the debt may not be discharged until the statute of limitations has

²⁰³ See *e.g.*, IRS Chief Counsel Adv. Mem. 201112008 (Mar. 11, 2011) (principal reduction in negotiated settlement of unfair lending practices case); IRS Priv. Ltr. Ruling 2008-02-012 (Jan. 11, 2008).

²⁰⁴ *Friedman v. Comm’r*, 216 F.3d 537 (6th Cir. 2000); *Cozzi v. Comm’r*, 88 T.C. 435 (1987).

²⁰⁵ See *e.g.*, *Aizawa v. Comm’r*, 99 T.C. 197 (1992) *aff’d* 29 F.3d 630 (9th Cir. 1994); *Webb v. Comm’r*, T.C. Memo 1995-486.

expired. See *Coburn v. Comm'r*, T.C. Memo 2005-283 (abandonment of collateral on recourse liability, alone, did not extinguish underlying liability). The applicable statute of limitations may be a complex issue.²⁰⁶ A creditor who sells credit card debt to a “debt buyer” may write off the debt and issue a Form 1099-C. However, in such cases, the debt is not discharged since the debt buyer owns the debt and often sues to enforce the debt.

10.4 EXCLUSION OF DEBT CANCELLATION INCOME FROM INCOME

10.4.1 Insolvency, bankruptcy, mortgage restructuring or foreclosure

The most common exclusions of “debt cancellation income” from income are the debt cancellation in (1) a bankruptcy, or (2) when the taxpayer is insolvent or (3) the debt is “qualified principal residence indebtedness.” I.R.C. § 108(a)(1)(A)-(B), (E).²⁰⁷ The bankruptcy exclusion may not apply if the taxpayer fails to obtain a bankruptcy discharge granted by the bankruptcy court or under a plan approved by the bankruptcy court.²⁰⁸ “Insolvent” means that the liabilities exceed the fair market value of the assets. I.R.C. § 108(d)(3). Income in excess of insolvency is includible in a partially insolvent taxpayer’s income. I.R.C. § 108(a)(3). The insolvency exclusion won’t apply to a discharged debt to which the § 108(a)(1)(E) exclusion for “qualified principal residence indebtedness” applies unless the taxpayer elects the § 108(a)(1)(B) insolvency exclusion. Cancellation of a debt that would have been deductible if paid, e.g., mortgage interest, is excluded from income. I.R.C. § 108(e)(2).

The Tax Court has held that exempt assets, e.g., a homestead exemption for the family home, must be included in determining whether a taxpayer is “insolvent.” *Carlson v. Comm'r*, 116 T.C. 87 (2001). Some consideration should be given to challenging *Carlson* since it has been criticized.

Another issue is whether a separated spouse’s assets must be included in the insolvency analysis. Prior to *Carlson*, the IRS had issued a private letter ruling that a spouse’s separate assets should not be considered in determining whether the other spouse is insolvent for the purposes of the § 108 exclusion.²⁰⁹

The Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142, allows the exclusion of debt cancellation income from mortgage restructuring or mortgage foreclosure on a taxpayer’s home for debts forgiven for the years, 2007-2013.²¹⁰ See I.R.C. § 108(a)(1)(E). The exclusion is limited to \$2 million (\$1 million if filing as married filing separate). The Act applies only to forgiveness or cancellation of debt to buy, build or substantially improve a “principal residence”, or to refinance debt incurred for these purposes. Refinanced home mortgage debt may include acquisition indebtedness and home equity debt. The home equity debt is not eligible for the qualified principal residence exclusion. I.R.C. § 108(h)(4). Lenders’ principal reductions pursuant to the National Mortgage Settlement may qualify for exclusion from income under I.R.C. § 108(a)(1)(E) if the debt was acquisition debt and the cancellation occurred before January 1, 2014 or any extended date of P.L. 110-142.

²⁰⁶ See e.g., *Portfolio Recovery Associates, LLC v. King*, 14 N.Y.3d 410 (N.Y. 2010).

²⁰⁷ The other § 108 exclusions, qualified farm debt, qualified real property business debt, deductible debt and certain student loans, do not commonly arise in low-income taxpayer cases.

²⁰⁸ See I.R.C. § 108(C)(2); *Hill v. Comm'r*, T.C. Memo 2009-101; *Schachner v. Comm'r*, T.C. Summ. Op. 2006-188 (debt was not discharged or dischargeable in this Ch. 13 bankruptcy).

²⁰⁹ PLR 8920019 (Feb. 14, 1989).

²¹⁰ Check to see if the Mortgage Forgiveness Debt Relief Act of 2007 is extended beyond 2013.

“Principal residence” in §108 has the same meaning as in “principal residence” in I.R.C. § 121. See I.R.C. § 108(h)(2) & (5). A § 108(a)(1)(E) exclusion does not apply in a bankruptcy discharge. I.R.C. § 108(a)(2)(A). The § 108(a)(1)(B) insolvency exclusion does not apply to discharged debt to which § 108(a)(1)(E) applies unless the taxpayer elects a §108(1)(B) insolvency exception. I.R.C. § 108(a)(2)(C). A Form 982 must be filed with the taxpayer’s return to claim the § 108(a)(1)(E) exclusion from income.

Income excluded under I.R.C. §§ 108(a)(1)(A)-(C) must be applied to reduce the debtor’s “tax attributes.” As a practical matter, this reduction of basis in an indigent taxpayer’s assets will have little or no effect on his ultimate tax liability. See J. Pierce, *Tax Consequences of Debt Forgiveness* (Spring 2010).

10.4.2 HAMP tax issues

The government’s Pay for Performance Success payments that reduce the principal balance on a home mortgage under the Home Affordable Mortgage Modification Program (HAMP) are not taxable. They are excluded from income under the general welfare exclusion in each year of payment.²¹¹ If the holder of the loan reduces the Principal Reduction Alternative Forebearance Amount by more than the government’s Principal Reduction Alternative investor incentive payments, the taxpayer may have cancellation of debt income from the lender’s reduction of principal. However, the exclusions for qualified principal residence indebtedness and insolvency may apply to allow the taxpayer to exclude the cancellation of debt income.

For the most recent IRS guidance on tax consequences for HAMP loan modifications, see Rev. Proc. 2013-16, I.R.B. 2013-7.

10.4.3 Other reductions in principal

A seller’s reduction in the price of the property does not give rise to cancellation of debt income.²¹² Instead, the buyer reduces his basis in the property. If a lender reduces the principal for an early payout or as part of a loan modification, the amount of cancelled debt is cancellation of debt income. However, if the debt is non-recourse and the owner retains the collateral, the owner does not have cancellation of debt income.

10.4.4 Foreclosures and tax consequences—how to calculate

A foreclosure is treated as a sale. Repossessions, quit claims, reconveyances, short sales or abandonments to the lender in lieu of foreclosure may also be treated as sales for tax purposes.²¹³

Income from a sale is computed as the difference between the amount realized and the taxpayer’s basis in the asset.²¹⁴ The amount realized by the debtor generally includes the liabilities from which the debtor is released because of the sale.²¹⁵ An exception exists for “recourse” debt.²¹⁶ Most low income taxpayers have recourse mortgage debt. Gain for “recourse” debt is bifurcated into (1) capital gain (or ordinary income) or loss from the sale and (2) ordinary income from debt

²¹¹ Rev. Rul. 2009-19, I.R.B. 2009-28.

²¹² I.R.C. § 108(e)(5).

²¹³ See *Coburn v. Comm’r*, T.C. Memo 2005-283.

²¹⁴ Reg. § 1-1001-2 (a)(1)-(2); *Frazier v. Comm’r*, 111 T.C. 243 (1998).

²¹⁵ Forgiveness of a non-recourse loan resulting from a foreclosure does not result in debt cancellation income. But, there may be gain or loss from the “sale.” Reg. § 1.1001-2(c).

²¹⁶ Recourse debt is a loan where the debtor is personally liable for the entire amount of the debt, not just the amount of the collateral. All other debt is non-recourse debt. But, it is arguable that recourse liability could be “non-recourse” in states that prohibit deficiency judgments. J. Pierce, *Tax Consequences of Debt Forgiveness*, 17-18 (Spring 2010).

cancellation. Here, the amount realized is the fair market value of the asset.²¹⁷ The difference between the fair market value and the house's basis will be a capital gain or a nondeductible loss. In addition, the debtor has ordinary income from the debt cancellation computed as the difference between the debt and the fair market value of the asset.²¹⁸

Bifurcated income from a foreclosure where the taxpayer had personal (or recourse) liability can be computed as follows:

Cancellation of debt income

1. Amount of debt immediately before the property transfer reduced by any amount for which taxpayer remains liable immediately after the property transfer _____
2. Fair market value of transferred property (generally the sale price at foreclosure absent contrary evidence) _____

Cancellation of debt income upon foreclosure

3. Subtract line 2 from line 1. If less than zero, enter zero (Income may be excludable under I.R.C. § 108 or other law) _____

Gain or loss from foreclosure

4. Enter smaller of line 1 or 2 from above _____
5. Enter any funds taxpayer received from foreclosure _____
6. Add line 4 and 5 _____
7. Adjusted basis of transferred property _____

Gain or loss from foreclosure.

8. Subtract line 7 from line 6 (Gain may be excludable under I.R.C. § 121, Mortgage Forgiveness Debt Relief Act, I.R.C. §108(a)(1)(e), or other law) _____

Income from cancellation of debt is reported as "Other Income" on the Form 1040 whereas gain from the foreclosure sale is generally reported as capital gains on Schedule D of Form 1040.

Under I.R.C. § 108, the taxpayer may exclude all or part of the debt cancellation income if he is insolvent when the foreclosure occurs.²¹⁹ The § 108 insolvency exclusion can only be used to exclude income from debt cancellation. The insolvency exclusion does not offset the capital gains portion of income from a sale. *Estate of Delman v. Comm'r*, 73 T.C. 15 (1980). Was the house the taxpayer's principal residence for 2 years in the 5 years prior to the sale?²²⁰ If yes, he may be able to elect the I.R.C. § 121 lifetime exclusion of \$250,000 (\$500,000 for joint filers) from the income treated as capital gains income *from a sale*. The I.R.C. § 121 exclusion can't be used to offset the portion of income that arises from debt cancellation.

For more information on tax consequences from foreclosures, see National Consumer Law Center, *Foreclosures* (4th ed. 2012), § 16.6.

²¹⁷ The sale price of property at a foreclosure sale is presumed to be its fair market value. This presumption can be rebutted by clear and convincing evidence. See *e.g.*, *Marcaccio v. Comm'r*, T.C. Memo 1995- 174; *Community Bank v. Comm'r*, 79 T.C. 789, 792 (1982) *aff'd* 819 F.2d 940 (9th Cir. 1987).

²¹⁸ Reg. § 1-1001-2 (a)(2); *Frazier v. Comm'r*, 111 T.C. 243 (1998).

²¹⁹ *Frazier v. Comm'r*, 111 T.C. 243 (1998).

²²⁰ Some circumstances, e.g., a loss of employment, may allow the taxpayer to qualify for the § 121 principal residence exclusion even he did not meet the 2 year/5 year rule. See Reg. 1.121-3(e)(2)(iii)(C).

10.4.5 Disaster relief legislation

Discharge of nonbusiness debt between August 24, 2005 and January 1, 2007 may be excluded from income for taxpayers whose primary homes were located in the Katrina disaster zone. See Katrina Emergency Tax Relief Act of 2005, P.L. 109-73, § 403. Exclusion of non-business debt may be available for disaster victims in Midwestern states. See Heartland Disaster Tax Relief Act of 2008, P.L. 110-343.

10.4.6 Gifts

Under I.R.C. § 102, a gratuitous release of a debt (something for nothing) may exclude debt cancellation from income. The issue is whether the creditor had a donative intent. See *Plotinsky v. Comm'r*, T.C. Memo 2008-244. Proving a § 102 exclusion is difficult in consumer or commercial debt cases.

10.5 ALLOCATION OF CANCELLATION OF DEBT INCOME AMONG CO-OBLIGORS

Often, there are co-obligors for discharged debt. Examples include: spouses, co-owners of real estate, a principal and a surety on a loan, and household recipients of public assistance overpayments. When the debt is discharged, the liable parties may no longer live together. What share of the cancellation of debt income is attributed to each of the liable parties?

In a community property state, each spouse should have 50% of the cancellation of debt income.²²¹ The discharge of a joint and several obligation by a creditor should not be treated as income to each co-obligor in the full amount of the discharged obligation.²²² Where there are co-obligors, you should argue for an appropriate reduction of the amount of cancellation of debt income attributable to your client.

10.6 HOW TO CLAIM THAT CANCELLATION OF DEBT INCOME SHOULD BE EXCLUDED

A Form 982 should be used to claim the insolvency, bankruptcy or Mortgage Forgiveness Debt Relief Act exclusions from income. IRS Publication 4681 can be helpful to a correct preparation of a Form 982.

10.7 IDENTITY THEFT

Identity theft is the theft of a person's identifying information to commit fraud or other offenses. Tax related identity theft is generally related to tax refunds, earned income credits or employment. The reporting of the identity thief's income to the victim's social security number can cause the victim to lose social security, public housing and other public assistance. Tax related identity theft may also cause the victim to have a host of consumer problems, e.g., damage to credit rating, denial of housing due to poor credit, suits by creditors for money the victim never borrowed, etc. For guidance on how to resolve tax related identity theft, see Ch. 22 of *Effectively Representing Your Client before the IRS* (ABA 5th ed. 2011).

Note that there is a difference in how the IRS processes identity theft and return preparer fraud. Identity theft involves a third party using a taxpayer's identity to obtain a refund. "Return preparer fraud" is when the taxpayer's preparer

²²¹*Brickman v. Comm'r*, T.C. Memo 1998-340.

²²²IRS Chief Counsel Advice 200023001 (June 9, 2000), 2000 WL 1997729; cf. *Kahle v. Comm'r*, T.C. Memo 1997-91.

uses a routing number to misappropriate the taxpayer's direct deposit refund. To facilitate resolution of your client's problem, be sure to file the proper form. Use Form 1409, *Identity Theft Affidavit*, for identity theft and Form 14157, *Complaint: Tax Return Preparer*, for return preparer fraud or embezzlement.

11 HOUSING LAW AND TAX ISSUES

11.1 RENTAL OR OTHER HOUSING ASSISTANCE

Rental subsidies are excluded from income under the general welfare exclusion doctrine. However, fraudulently obtained public assistance is taxable income. Therefore, a rental subsidy fraudulently obtained could be taxable income to a subsidized housing tenant. Subsidized housing tenants are required to authorize the public housing agency to access their tax return information from the IRS.

Other examples of housing assistance excluded from income by the general welfare exclusion doctrine are:

- Relocation payments to move from a damaged home²²³
- Temporary housing assistance for disaster victims²²⁴
- Replacement housing for people displaced from their homes²²⁵
- Assistance with the purchase of homes²²⁶
- Home improvement grants²²⁷
- Forgiveable loans²²⁸

11.2 LITIGATION RECOVERIES IN FEDERAL HOUSING CASES

Relocation payments under the Uniform Relocation Act are not considered income for federal tax purposes.²²⁹ Utility allowance refunds for federally subsidized tenants should not be taxable income since they are a recovery or refund of non-taxable public assistance that should have been granted to the tenant. Be sure to advise clients that the assistance is not taxable and that they need to timely respond to any IRS audit notices. Also, discuss the tax treatment of payments with the payors to avoid improper issuances of Forms 1099 to your clients and provide them with legal authority for the non-taxability of the payments. If the housing agency wrongly reports the litigation recovery as income to the IRS, contact your local Taxpayer Advocate for systemic relief to prevent IRS audits of your clients.

11.3 RETURN OF CAPITAL OR PROPERTY DAMAGE

Compensation for property damage or breach of contract by a home improvement contractor is not income unless it exceeds the basis in the property.²³⁰ No economic gain results from a recovery of basis in a capital asset.

²²³ Rev. Rul. 98-19, 1998-1 C.B. 840.

²²⁴ Rev. Rul. 2003-12, 2003-1 C.B. 285.

²²⁵ Rev. Rul. 74-205, 1974-1 C.B. 20

²²⁶ ILM 200910029, Doc. 2009-5050, TNT 43-23; *but see* LTR 201004005 (Oct. 21, 2009), Doc. 2010-221, 2010 TNT 20-24.

²²⁷ Rev. Rul. 76-395, 1976 C.B. 16.

²²⁸ Notice 2011-14, 2011-11 I.R.B. 544.

²²⁹ 42 U.S.C. § 4636.

²³⁰ Rev. Rul. 81-277, 1981-2 C.B. 14; *Daugherty v. Comm'r*, 78 T.C. 623 (1982); *see also* GCM PRENO 111606-07 (May 18, 2007) (addressing tax issues in Hurricane Katrina and Murphy Oil Spill Litigation).

I.R.C. § 1016(a)(1) provides that a proper adjustment shall be made for receipts and expenditures properly chargeable to the capital account of the damaged property. The homeowner should reduce his basis by the recovery and then increase it by the costs incurred for repairs or restoration.

Recovery of attorney fees may trigger income tax liability unless the recovery is excluded from income, deductible or chargeable to the capital account of an asset. A recovery of attorney fees for damage to a home should be tax neutral. Such attorney fees should be capitalized rather than deducted. Adjustments to the home's basis from recovery and payment of attorney fees should offset each other—resulting in no immediate or deferred recognition of income.

12. PUBLIC BENEFITS AND TAX ISSUES

12.1 WAIVER OF GOVERNMENT OVERPAYMENTS DUE TO ECONOMIC HARDSHIP

Cancellation or waiver of an overpayment of government assistance may constitute debt cancellation income.²³¹ However, waiver of an overpayment due to economic hardship should be excluded from income under the general welfare exclusion doctrine.²³²

12.2 UNEMPLOYMENT COMPENSATION

Unemployment compensation is subject to income tax, but not to FICA or self-employment tax.²³³ If there is no withholding on unemployment compensation, taxpayers may face under payments and penalties when they file their next tax return. To avoid these problems, a taxpayer can pay quarterly estimated tax payments or file a Form W-4V to have 10% of their unemployment compensation withheld for taxes.

12.3 SSI AND SOCIAL SECURITY BENEFITS

SSI benefits are not subject to income tax (except possibly in cases of fraud). However, lump sum Social Security benefits and ongoing Social Security benefits may be subject to income tax. After 1983, even Social Security disability benefits are subject to tax.²³⁴ Generally up to 50% of Social Security benefits are taxable to low-income taxpayers. Additional income from employment, retirement and gambling are common reasons for Social Security benefits becoming taxable. Cancellation of a large debt could make Social Security taxable in the year of cancellation if the debt cancellation income can't be excluded from income.

Social Security benefits are included in gross income for the tax year in which the benefits are received.²³⁵ The taxpayer may make an election to attribute a portion of the lump sum benefits to prior tax years. I.R.C. § 86(e). See IRS Publication 915 for a detailed explanation of the election and worksheets. This election should lower the tax impact of a lump sum Social Security benefit. The taxpayer's attorney fees for the disability appeal may be deducted from income to the same extent that Social Security is taxed. Rev. Rul. 87-102. This limited deduction is a Schedule A deduc-

²³¹ See e.g. *Waterhouse v. Comm'r*, T.C. Memo 1994-467 (waiver of VA overpayment creates debt cancellation income); see also IRS Chief Counsel Opinion CC: Pa. 01: RjGoldstein, PRESP-109087-12 (Mar. 9, 2012).

²³² See e.g., Rev. Rul. 78-46, 1978-1 C.B. 22.

²³³ I.R.C. § 85.

²³⁴ See *Payne v. Comm'r*, T.C. Summ. Op. 2011-59; *Reimels v. Comm'r*, 123 T.C. 245 (2004); *Maki v. Comm'r*, T.C. Memo 1996-209.

²³⁵ I.R.C. § 86(a)(1); *Green v. Comm'r*, T.C. Memo 2006-39 *aff'd* 262 Fed. Appx. 790 (9th Cir. 2007).

tion and subject to the 2% of adjusted gross income limit on certain itemized deductions. If the taxpayer uses all or part of a Social Security lump sum to reimburse his long term disability carrier, special tax relief may be available under I.R.C. § 1341. If the repayment to the LTD carrier is under \$3,000, the taxpayer gets a deduction on the current year's return. If the repayment is over \$3,000, the taxpayer chooses either the deduction or a tax credit for the excess tax paid in the prior year.

12.4 DISASTER ASSISTANCE

Generally, public disaster assistance will be excluded from income under I.R.C. § 139 or the general welfare exclusion doctrine.

Waiver of FEMA overpayments under the 2011 Disaster Assistance Recoupment Fairness Act will not create debt cancellation income. See IRS Chief Counsel Opinion CC:PA:01: RJGoldstein, PRESP-109087-12 (Mar. 9, 2012).

12.5 WELFARE AND OTHER PUBLIC ASSISTANCE

Under the general welfare exclusion doctrine, most welfare payments will be excluded from income.²³⁶ The criteria for exclusion under this doctrine are (1) payment from a government general welfare fund, (2) promotion of general welfare, i.e. payment is based on need, and (3) the payment is not made for services.²³⁷

Fraudulently obtained public assistance is taxable income. Cancellation of an overpayment of public assistance may create debt cancellation income unless excluded by the Internal Revenue Code or the general welfare exclusion doctrine.²³⁸

12.6 IMPACT OF EARNED INCOME CREDITS ON WELFARE

The Earned Income Credit (EIC) does not count as income for Medicaid, food stamps, SSI or federally subsidized housing. See I.R.C. § 32(l). States can set their own rules for how the EIC is treated for TANF eligibility. So far, no state has counted EIC refunds as income for TANF eligibility.

By federal law, states are prohibited from counting the EIC refund as an asset for Medicaid, SSI, food stamps or federally subsidized housing unless it is unspent by the end of the month after the month of receipt. A state may have rules that are more favorable than the minimum federal rule against counting EICs as assets.

12.7 LEVIES AGAINST SOCIAL SECURITY AND WELFARE BENEFITS

Immediately before a levy of Social Security benefits, the taxpayer should receive a CP-91 or CP 298, Final Notice Before Levy on Social Security Benefits. The CP 91/298 notices should have been preceded by a Notice of Intent to Levy and notice of the right to a collection due process (CDP) appeal. The taxpayer has 30 days to respond to the Final Notice and may still appeal through the Collection Appeal Program even though his rights to a collection due process (CDP) appeal have expired.²³⁹ Also, he may have a right to an "equivalent hearing" before an IRS appeals officer if he missed the 30 day period for requesting a collection due process (CDP) appeal, but is still within 1 year of the notice that advised him of his right to a CDP appeal.²⁴⁰

²³⁶ For a list of revenue rulings and court cases applying or denying exclusion under the general welfare exclusion doctrine, see I.R.M. 4.88.1, Exhibit 4.88.11-3.

²³⁷ See Robert W. Wood, *Updating General Welfare Exclusion Authorities*, 123 Tax Notes (TA) 1443 (June 22, 2009); *Bannon v. Comm'r*, 99 T.C. 59 (1992).

²³⁸ See e.g. *Waterhouse v. Comm'r*, T.C. Memo 1994-467 (waiver of VA overpayment creates debt cancellation income).

²³⁹ I.R.M. 5.11.7.2.4; 5.10.1.7.3; 8.24.1.2.

²⁴⁰ I.R.C. § 6330 (b). Unlike the CDP appeal, a decision in an "equivalent hearing" or Collection Appeal Program appeal may not be reviewed by a court.

Under the Federal Payment Levy Program, the IRS may continuously levy 15% of monthly Title II Social Security benefits and most welfare benefits other than SSI. The IRS no longer levies against Social Security benefits that are less than \$750 per month. Levies against Social Security benefits greater than \$750 can often be prevented or removed by applying for Currently Not Collectible status. It is important to respond promptly to a proposed notice of levy on Social Security benefits. Once the levy is imposed, it can take time to get the levy removed and wrongfully levied amounts refunded. If the IRS levies in excess of what is allowed by law, you have a time limit of 9 months in which to request a return of the excess amount.²⁴¹

Beginning February 2011, the IRS may exclude Social Security recipients with income less than 250% of poverty from the Federal Payment Levy Program if Social Security is their sole source of income.²⁴² However, low-income taxpayers still receive Social Security levies since the IRS has refused to apply the 250% poverty filter to non-filers. If a low-income Social Security recipient gets a levy notice, he may be a non-filer and need assistance with filing his delinquent returns.

13. EMPLOYMENT LAW

13.1 TAXATION OF SETTLEMENTS

Clients generally receive a Form 1099 (or a Form W-2) for the receipt of settlements and attorney fees in personal injury and employment law cases. Many clients say they were informed by their attorney that the settlement proceeds would be tax-free. Unfortunately, this information may be incorrect and subject a taxpayer to a large tax debt.

Settlement of employment law claims are taxable income unless the taxpayer proves an exclusion from income. Under I.R.C. § 104(a)(2), settlements or judgments on employment claims generally may be excluded if (1) the underlying cause of action is based upon tort or tort-type rights and (2) damages were received on account of personal physical injury or physical sickness.²⁴³

To determine the income and employment tax consequences of a settlement, one must break the settlement down into its various elements. The IRS Chief Counsel has issued a helpful memorandum on how the IRS analyzes settlements to determine tax liabilities.²⁴⁴

Generally, back pay and emotional distress damages are taxable income.²⁴⁵ Stomach aches and headaches may be viewed as symptoms of emotional distress rather than physical injury.²⁴⁶ Emotional distress incurred as a result of physical injury may be excluded.²⁴⁷ Exacerbation of a physical injury by a hostile and stressful work environment may be excludable.²⁴⁸ Payments for medical care to treat emotional distress may be excluded from income up to the amount of medical expenses relative to the emotional distress if not previously deducted under I.R.C. § 213.²⁴⁹

²⁴¹ I.R.C. § 6343 (b) and (d); I.R.M. 5.11.2.3.1 (8-24-10). See also, M. O'Connor, *The IRS's Authority to Garnish a Disabled Person's Social Security Benefits to Collect Unpaid Taxes*.

²⁴² I.R.M. 5.11.7.2.2.3.

²⁴³ *Espinoza v. Comm'r*, 636 F.3d 747 (5th Cir. 2011).

²⁴⁴ Office of Chief Counsel, *Income and Employment Tax Consequences and Proper Reporting of Employment Related Judgments and Settlements*, FILES 102495-07 (Oct. 22, 2008).

²⁴⁵ Back pay is subject to income and employment tax in year received. *Cleveland Indians Baseball Co. v. United States*, 532 U.S. 200 (2001). Emotional distress damages are taxable. *Espinoza v. Comm'r*, 636 F.3d 747 (5th Cir. 2011).

²⁴⁶ See e.g., *Gibson v. Comm'r*, T. C. Memo 2007-224.

²⁴⁷ House Committee Report, P.L. 104-188.

²⁴⁸ See e.g., *Domeny v. Comm'r*, T. C. Memo 2010-9.

²⁴⁹ *Wells v. Comm'r*, T.C. Memo 2010-5.

Legal fees in employment law actions should not be taxable since they can now be deducted as an adjustment to gross income.²⁵⁰ However, the deduction for legal fees should not exceed the taxable amount of the settlement. Also, if the entire settlement is excludable under I.R.C. § 104(a)(2), the taxpayer may not deduct his attorney fees.²⁵¹ The part of a settlement allocable to attorney fees does not constitute “wages” for the purposes of employment taxes.²⁵²

If the settlement agreement fails to specify that parts of the settlement were for physical injury or physical sickness, the client may be liable for income and employment taxes on the settlement. Legal fees, interest, physical injury and emotional distress damages are not subject to employment taxes. The IRS considers “front pay” to be wages. However, the 5th Circuit has held that “front pay” is not wages for the purposes of employment tax.²⁵³ To avoid employment taxes, a settlement should clearly indicate the amount for wages, the nature of the wages and the amount for other payments.²⁵⁴

The courts look first to the language of the settlement agreement to determine the purpose of the settlement payments. However, the settlement’s characterization or division of the settlement amounts does not bind the IRS or courts.²⁵⁵ The courts will look at the economic realities of the settlement. If the settlement lacks express language of purpose, the courts look beyond the agreement for other evidence of the payor’s intent as to the purpose for the settlement payments.²⁵⁶ The complaint and details surrounding the litigation may shed light on the purpose of the settlement.

The IRS now considers severance pay to a terminated employee as income subject to both income and employment taxes.²⁵⁷ However, it is unclear whether severance pay is subject to employment tax.²⁵⁸

13.2 EMPLOYEE OR INDEPENDENT CONTRACTOR?

Many employers take advantage of low-income workers by treating them as independent contractors rather than employees. How can improper classification as an independent contractor hurt an “employee?” Besides additional tax burdens and operating costs, an “employee” may lose the right to unionize, unemployment compensation, worker’s compensation and protections under many laws, e.g., National Labor Relations Act, Fair Labor Standards Act, Americans with Disabilities Act, Family Medical Leave Act, ERISA, Title VII of the Civil Rights Act, etc. Recently, employers have been hit with substantial fines for work models that misclassify employees as independent contractors.

You can file a Form SS-8 with the IRS to get a determination as to whether the taxpayer is an employee or independent contractor. For a detailed discussion of the tests for employee status, see *Effectively Representing Your Client Before the IRS* (ABA 5th ed. 2011), Ch. 20.

²⁵⁰ I.R.C. § 62 (a)(20) & (e).

²⁵¹ I.R.C. § 265 (a)(1).

²⁵² Rev. Rul. 80-364, 1980-2 C.B. 294.

²⁵³ *Dotson v. United States*, 87 F.3d 682, 689 (5th Cir. 1996).

²⁵⁴ Rev. Rul. 80-364, 1980-2 C.B. 294.

²⁵⁵ *Vincent v. Comm’r*, T. C. Memo 2005-95.

²⁵⁶ *Espinosa v. Comm’r*, 636 F.3d 747 (5th Cir. 2011).

²⁵⁷ Rev. Rul. 2004-110, 2004-2 C.B. 960.

²⁵⁸ *Compare In re Quality Stores*, 424 B.R. 237 (W.D. Mich. 2010) with *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008).

An IRS Form 4852 can be used to report employment income and pay payroll taxes if the employer won't issue a Form W-2. Once the employee has paid his payroll taxes, he should file for a correction of his wage earnings with the Social Security Administration. See 20 C.F.R. § 404.801 *et seq.* This should be done promptly since there is a time limit for correcting earnings records. 20 C.F.R. § 404.802.

In some states, there may be a tort claim against the employer for failure to correct an information return. See, e.g., *Clemens v. USV Pharmaceutical*, 838 F.2d 1389, 1395 (5th Cir. 1988) (tort action under Louisiana law). I.R.C. § 7434 creates a private cause of action against any person for fraudulent filing of information returns. § 7434 specifies damages as the minimum of \$5,000 or actual damages.

14. LEGAL FEES AS INCOME

In a private letter ruling, the IRS has ruled that statutory attorney fees paid directly to a legal aid or pro bono program are not taxable to the client since the client had no obligation to pay attorney fees.²⁵⁹ In class action lawsuits, a class member does not have to report the attorney fees as income.²⁶⁰

However, statutory attorney fees for other attorneys may trigger tax liability for the client. In *Commissioner v. Banks*, 543 U.S. 426 (2005), the Supreme Court held that attorney fees are included in the taxpayer's gross income even though she never receives the fees. Before *Banks*, the circuits were split on this issue. Thus, *Banks* exposed many taxpayers to significant new liabilities.²⁶¹ The attorney fees may be partially deducted (i.e., the amount in excess of 2% of adjusted gross income) on Schedule A of the Form 1040 if the taxpayer can itemize. For large attorney fee awards, the taxpayer may even suffer alternative minimum tax liability.

In the American Jobs Creation Act, Congress responded to *Banks* by amending the Internal Revenue Code to preclude taxation of attorney fees in most civil rights and employment law actions.²⁶² However, the AJCA only applies to fees and costs paid after October 22, 2004 with respect to any judgment or settlement after such date. In cases governed by the AJCA, the taxpayer takes an above the line deduction for attorney fees rather than a Schedule A deduction. It appears that attorney fees under consumer protection laws and in personal injury cases (contingency fees) are still taxable to the client unless there is a theory for exclusion.²⁶³

15. DISASTER TAX LAW

For a discussion of tax issues that arise in a disaster, see Ch. 24 of *Effectively Representing Your Client before the IRS*, (ABA 5th ed. 2011).

²⁵⁹ PLR 135328-09 (Jan. 5, 2010). Note that private letter rulings may not be used or cited as precedent unless otherwise authorized by Treasury Regulations. I.R.C. § 6110(k)(3). However, letter rulings provide some guidance as to how the IRS might view a tax law issue under the facts assumed in the letter ruling.

²⁶⁰ GCM PRENO-111606-07 (May 18, 2007).

²⁶¹ The 5th, 6th, 9th and 11th Circuits had held that attorney fees were not included in the client's gross income. *Banks* did not resolve the taxability of statutory attorney fees to a plaintiff who obtains equitable relief only.

²⁶² Pub. Law. 108-357, § 703, 118 Stat. 1546-48.

²⁶³ For example, the attorney is a legal aid, pro bono or class action attorney.

16. EARNED INCOME CREDIT

1. Overview

Generally, the Earned Income Credit (EIC) is a tax credit for workers who have earned income and adjusted gross income (AGI) below the applicable limits for the tax year in question. The Earned Income Credit is the largest anti-poverty program in the United States.

Those who qualify for the EIC pay less federal tax, no tax or even get a tax refund. Currently, the average EIC refund is about \$2,100. In 2012, the maximum EIC is \$5,891.

The EIC can result in a tax refund even if the worker paid no tax whatsoever. A taxpayer who did not apply for an EIC in any of the last 3 years may be eligible for EIC payments by filing amended returns for those years.

2. Eligibility Rules for Earned Income Credit

I.R.C. § 32 provides the statutory rules for the EIC. The easiest way to understand all the EIC rules is to consult IRS Publication 596, chapters 1 to 3. This IRS publication cogently summarizes the various EIC rules in 3 sets of rules:

- Rules for Everyone
- Rules If You Have a Qualifying Child
- Rules If You Do Not Have a Qualifying Child

Chapter 4 of IRS Publication 596 explains the income limits for the EIC. You can quickly assess your client's EIC eligibility by reference to Publication 596. If you are preparing a tax return, you should also consult Form 8867, *Paid Preparer EIC Checklist*.

That said, the basic rules for the EIC are the income limits, earned income, ineligibility of persons who legally must file as "married filing separately", and the relationship, age and residency tests for a qualifying child.

3. Income Limits

For each tax year, there will be AGI limits for the EIC by family size and filing status.

Historically, the AGI limits have increased each year. In 2012, the AGI limits will range from \$36,920 to \$50,720 for families with children.

4. Earned Income

Beginning in 2002, "earned income" includes wages, salaries, tips and other employee compensation, if includible in gross income²⁶⁴, plus net earnings from self-employment.²⁶⁵ Earned income may also include an employer's disability retirement plan benefits until the worker reaches minimum retirement age.

Earned income does not include pensions, annuities, unemployment compensation, social security, welfare, alimony, child support, inmate compensation, nontaxable workfare payments, scholarship or fellowship grants

²⁶⁴ Prior to 2002, earned income included nontaxable earned income, e.g. voluntary salary reductions, 401(k) contributions, mandatory contributions to a state or local retirement plan, etc.

²⁶⁵ Compensation paid by a third party for damages due to lost self-employment income will not constitute "earned income" for the purposes of the Earned Income Credit.

not reported on a Form W-2, or, in community property states, income earned by the spouse of a married taxpayer who is qualified to file as head of household. I.R.C. § 32(c)(2). Proof of “earned income”, e.g., W-2 or 1099 Forms, may be required.

5. Filing status cannot be “married filing separately”

Taxpayers who are married on December 31 of the tax year and who cannot file as “married filing jointly” face special problems. These taxpayers will not qualify for the EIC unless they meet the requirements for head of household filing status.²⁶⁶

Many EIC errors involve married taxpayers who could not legally file as single or head of household. If a taxpayer was married on December 31 of the tax year, review the taxpayer’s proof of separate residences and the 50% support test for head of household filing status.

If married taxpayers incorrectly filed as head of household or single, they may be able to file an amended tax return to get the allowable EIC for their income level. However, they are precluded from filing a joint return after a notice of deficiency has been issued and a Tax Court petition filed.²⁶⁷ Therefore, a joint return claiming an EIC should be filed before either spouse files a Tax Court petition if this is a feasible option.

If a married taxpayer did not live with her spouse at any time in the last 6 months of the year, she may be able to file as the head of household if she furnished more than half of the cost of maintaining the household. I.R.C. §§ 2(b)(1); 7703(b). Unmarried taxpayers do not have to be the head of household in order to get the EIC.

6. Relationship, Age and Residency Tests for Qualifying Child

Only taxpayers with a “qualifying child” get the large EICs. A “qualifying child” must meet 3 tests: relationship, age and residency. Beginning in the 2009 tax year, the definition of “qualifying child” will also require (1) that the child must be younger than the person claiming the child and (2) that the child has not filed a joint return.

A qualifying child is a child who is the taxpayer’s:

Relationship

1. Child, stepchild, adopted child, foster child²⁶⁸ or a descendant of any of them, or
2. Sibling, step-sibling, half-sibling or a descendant of any of them

Caveat: The definition of “eligible foster child” has changed several times since 1991. Make sure you have the right definition for the tax year in question. The history of the changes is set forth below:

²⁶⁶ I.R.C. § 32(d), *Mischel v. Comm’r*, T.C. Memo 1996-553.

²⁶⁷ See e.g., I.R.C. § 6013(b)(2); *Pelayo-Zabalza v. Comm’r*, T.C. Summ. Op. 2002-134; *Benitez v. Comm’r*, T.C. Summ. Op. 2002-12.

²⁶⁸ An eligible foster child is a child placed by an authorized placement agency, i.e., a court, state or local government agency or a tax exempt organization licensed by the state. *Hegwood v. Comm’r*, T.C. Summ. Op. 2002-156.

Tax Years	Definition
1991-99	A child that taxpayer cared for as her own and who lived with the taxpayer for whole year, except for certain temporary absences. I.R.C. §32(c)(3)(B)(iii); Conf. Rept. No. 106-478, p. 127
2000-01	Cousins and unrelated children eliminated as “eligible foster children” unless placed with taxpayer by an authorized placement agency. P.L.106-170, § 412, 113 Stat. 1917.
2002	Residency requirement decreased from 1 year to 6 months.
2005	Placement can also be by court order. Also eliminated the “cared for as own child” requirement.

Age

AND was at the end of the tax year:

1. Under the age of 19, or
2. Under the age of 24 and a “full-time” student, or
3. Permanently and totally disabled at any time during the year, regardless of age,

Residency

AND who lived with the taxpayer in the United States for more than half of the tax year.

7. Issues That Arise Under Qualifying Child Tests

A. Cared for as Her Own Child

The Working Families Tax Relief Act of 2004 eliminates the “cared for as own child” requirement for tax years beginning 2005. Before 2005, this was a commonly litigated issue.²⁶⁹

B. Residency Test

The majority of issues that arise under the “qualifying child” definition involve the residency test. Generally, the contested issues involve documentation of the child’s residency, and not legal issues.

The child must have lived with the taxpayer in the United States for more than half of the year.²⁷⁰ If a child was born or died in the tax year, she is considered to meet the residency test if she lived with the

²⁶⁹ A taxpayer, other than a parent, step-parent or grandparent, must prove that she treated the child as her own. *Domingo v. Comr.*, T. C. Memo 1998-442. A household resident who financially contributed to the household, but did not play a significant role in the child’s day-to-day life did not qualify for the EIC. *Mares v. Comr.*, T. C. Memo 2001-216; *Smith v. Comr.*, T. C. Memo 1997-544. However, even relatively little time acting as a parent may qualify. See e.g., *Barajas v. Comr.*, T. C. Summ. Op. 2002-59; see also, *Gilmore v. Comr.*, T. C. Summ. Op. 2004-38 (19 year old held to care for his nieces as his own children even where children’s mother and grandmother also lived in the house).

IRS Publication 596 alternatively refers to the statutory test, “cares for as her own child” as acting as a parent or sharing in parental responsibilities. Taxpayers may meet the relationship test for some children in the household, but not for others.

Publication 596 suggests that a parent’s child may also be an “eligible foster child” of the parent’s same sex relatives or friends who live with her. A taxpayer was held to care for his younger siblings as his own children even though their mother lived with them and also performed some parental duties. See e.g., *Barajas v. Comr.*, T.C. Summ. Op. 2002-59; see also *Gilmore v. Comr.*, T.C. Summ. Op. 2004-38.

²⁷⁰ Prior to 2002, an “eligible foster child” had to live with the taxpayer for the **whole** year in order to be a qualifying child for the taxpayer’s EIC claim.

taxpayer for the entire time she was alive in that year. Note that for the EIC, there is no “support” or “household maintenance” test if the taxpayer can properly file as single or married filing jointly.

A home is anywhere the taxpayer regularly lives and can include nontraditional homes such as homeless shelters. A taxpayer can meet the residency test even if the other parent has custody under a court decree and provided more than ½ the support. *Webb v. Comm’r*, T. C. Memo 1990-581.

Temporary absences can count toward the half year or whole year requirements if the taxpayer or child is away from home due to special circumstances such as:

- Illness
- School attendance²⁷¹
- Business or military service
- Vacation
- Detention in juvenile facility
- Kidnapping (if not committed by family member)
- Disaster displacement

Although not listed in IRS Publication 596, pre-conviction detention in a jail and custody agreements where the child is absent for less than 6 months may also count. *Cf.* Reg. § 1.2-2 (c)(1) (temporary absence pursuant to custody agreement is “special circumstance”); *Rowe v. Comm’r*, 128 T.C. 13 (2007). In *Rowe*, the taxpayer was eligible for the Earned Income Credit even though she was absent from the household for the last 7 months of the year due to her confinement in jail.

EIC legislative history indicates that determinations of an individual’s principal abode should be made under rules similar to those for the head of household filing status. H.R. Conf. Rept. 964, 101 Cong. 2d Sess. 1037 (1990).

Note: Tax preparation services often counsel a taxpayer not to claim her resident child if someone else has already filed for the EIC based on that child. The IRS will deny an electronic return where someone else has already filed for the EIC. The tax preparation service counsels the taxpayer to file an incorrect return so the taxpayer can get a quick refund through an electronic return. Then, the tax preparation service can make a hefty profit on a refund anticipation loan. In this situation, the proper procedure is to file a paper return which will prompt an IRS examination to determine which taxpayer is entitled to claim the child for the EIC, or file an electronic return without using a tax preparation service. This conduct by tax preparation services may necessitate an amended return, Form 1040X, which correctly reports the taxpayer’s qualifying children.

²⁷¹ If the child has a residence in her college’s city and does not intend to return, her college attendance cannot count as a “temporary absence.” *Schatz v. Comm’r*, T.C. Memo 1981-341.

C. AGI Tiebreaker

Sometimes, a child is the “qualifying child” of more than one person. However, only one taxpayer (or a married couple filing jointly) can claim the EIC for the child.

Beginning with 2002, the AGI tie breaker rules were changed substantially.²⁷² See I.R.C. § 32(c)(1)(C). The Working Families Tax Relief Act of 2004 retains the 2002 tiebreaker rules for tax years beginning 2005.

Under current law, if 2 eligible persons claim the EIC, the following tie breaker rules apply:

1. Parent wins over non-parent²⁷³
2. Where parents lived apart, but each lived with child for at least 6 months, parent who lived with child longer wins
3. Where child lived with each parent same amount of time, parent with higher AGI wins
4. If neither parent is eligible claimant, caretaker with highest AGI wins

These 2002 tiebreaker law changes present new planning opportunities for unwed parents who live together, but cannot file as “married.” If both unwed parents are the biological parents of a child, they can decide who claims the child for the EIC. If they have more than 1 child together, they can split their children. If both claim a child, the first tie breaker favors the parent who lived longer with the child. If residency is equal, the parent with the higher AGI wins.

8. IRS Audits of the EIC—What to Expect

The IRS audits many Earned Income Credit (EIC) returns due to the high error rates.²⁷⁴ Audits occur when more than 1 taxpayer claims a child for the EIC. Only 1 taxpayer may legally claim a child for the EIC.²⁷⁵ Correspondence audits are used to examine EIC claims.

Typically, an EIC disallowance will be accompanied by a disallowance of the head of household filing status, dependency exemptions and child tax credit.

To get an EIC for a child, the taxpayer must claim a child who meets certain residency, relationship and age tests.

In the past, income or filing status errors were responsible for about half of EIC erroneous payments. Qualifying child errors also accounted for many EIC errors. The vast majority of qualifying child errors occur because the residency test is not met.²⁷⁶

²⁷² Prior to 2002, only the “eligible individual” with the higher modified AGI could claim the EIC. I.R.C. § 32(c)(1)(C); *Jackson v. Comr.*, T.C. Memo 1996-54. Under the prior rules, relatives or friends with a higher modified AGI, but no earned income and therefore ineligible for the EIC, could defeat the parent’s EIC claim.

²⁷³ A parent should win over a “step-parent.”

²⁷⁴ The EIC rules are complex. This complexity leads to errors by both the IRS and taxpayers. In prior years, the estimated EIC error rate has been about 30%. *Compliance Estimate for Earned Income Tax Credit Claimed on 1999 Returns* (IRS, Feb. 28, 2002). The error rate remains high despite the fact that many low-income workers have their tax returns prepared by paid tax return preparers. The IRS error rate in its audits of EIC claimants is also high. You will find that some IRS auditors do not follow fairly basic EIC rules that are published on the IRS webpage.

²⁷⁵ Often, paid tax preparers erroneously tell taxpayers that they cannot file for the EIC because someone else already filed for their children. While it is true that the IRS won’t accept an electronic return, the taxpayer can file a paper return claiming the EIC for his child. The IRS will then review the tax returns of both taxpayers and determine which taxpayer, if any, is entitled to the EIC.

²⁷⁶ IRS FS-2003-14 (June 2003).

Common reasons for disallowance of the EIC are:

- The child's residency with taxpayer was not documented
- The child's relationship with taxpayer was not documented
- The taxpayer incorrectly filed as head of household, and legally could have only filed as married filing separately
- For tax years prior to 2002, the qualifying child was also the qualifying child of another person with a higher AGI
- The taxpayer's EIC was reduced or denied by the IRS for 1997 or a later year and a Form 8862 has not been filed
- The taxpayer was not a U.S. citizen or resident alien for the entire year
- Denial of self-employment income claimed

Documentation of the child's residency and relationship is essential to defending the taxpayer's EIC claim. Many indigent taxpayers find the IRS demands for documentation daunting and are unable to satisfy the IRS without a tax professional's assistance.

9. Documentation and Proof of Residency and Relationship

A. Tax Return Preparation or Review

In the past, low-income taxpayers and their paid tax preparers have not developed documentation to support EIC claims as part of the tax return preparation. If the tax return is selected for audit, the IRS will demand documentation. It can be more difficult to obtain such documentation when the audit occurs. Taxpayers throw out or lose documentation. Agencies, that may have documentation, go out of business, have a difficult time locating older records, or are unwilling to cooperate. Witnesses may move. Therefore, if you have the opportunity to prepare the return, you should advise the taxpayer to obtain and maintain documentation of residency, household and dependent support, as relevant to the return.

Remember to review the tax return with the taxpayer if the Earned Income Credit is being contested. Tax preparation services often counsel taxpayers to omit qualifying children, who live with them, if someone else has already incorrectly claimed the child for the Earned Income Credit.

B. How to Document and Prove an EIC Claim in an Audit or Appeal

Residency is commonly contested in an EIC audit. The key is to provide third party records that show the names, common addresses and dates of common addresses of the taxpayer and any qualifying children. Low-income people frequently change apartments. This can make the documentation quite burdensome. Nonetheless, the taxpayer can generally find some records to establish her own address, e.g., leases, rent receipts, subsidized housing records, utility bills, other bills, food stamp records, public assistance notices, medical records, driver licenses, pay stubs, etc.

On the other hand, it can be difficult to find third party records that establish the address of a child, particularly a young child. The IRS suggests school records, day care records, medical records and social serv-

ice agency or community based organization records to establish the children's addresses. Records submitted to the IRS should show a common residency of more than 6 months. For example, get a record in the beginning of the year and a record at least 6 months later that has the same address.

If these records do not exist, the taxpayer should try to get a letter on official letterhead from the child's school, medical provider, child care provider, or the taxpayer's clergy, employer, or landlord. If possible, the letter should state that the taxpayer and children lived at the same address for 6 months or more during the tax year in question. This can be difficult since these third parties may not know the exact duration of the common residency.

IRS examiners are less impressed by letters and affidavits from relatives, friends and neighbors. You should try to get another letter or some corroborating documents if the taxpayer must rely on letters from relatives, friends and neighbors. As a practical matter, relatives, friends, neighbors, school bus drivers, or lawyers handling divorce or custody matters are often more competent witnesses on the issue of common residency than the affiants preferred by IRS auditors. Fortunately, the IRS Appeals officers and the Tax Court, unlike the IRS examiners, can and do give weight to affidavits or testimony by such witnesses.

Tax Court judges can and do rule in favor of the taxpayer based primarily or exclusively on a taxpayer's credible testimony. Of course, testimony by other credible witnesses is also helpful. As a practical matter, the IRS generally will not have any witnesses on the EIC issues with the possible exception of a competing claimant. The Tax Court has even ruled in taxpayers' favor when the testimony as to the child's address is contrary to the address in school records. The taxpayer's credible testimony can be given more weight than "official" records.²⁷⁷

Never send original documents to the IRS. They routinely lose documents. You should write the taxpayer's Social Security number on each document that you send to the IRS.

If a married taxpayer needs head of household status to qualify for the EIC, she will need to document expenses for the household and dependents.

10. Defense of an EIC Claim—Know The Big Picture

There are several "big picture" principles that you should know for the defense of a typical EIC audit or disallowance.

For most low-income taxpayers, the disallowance of the EIC will account for most, if not all, of the tax adjustment or deficiency proposed by the IRS. Therefore, your primary goal is to protect the EIC. The child tax credit can also be large.

The taxpayer can get a large EIC even if she has 1 qualifying child. The IRS wrongly denies the entire EIC claim when it finds that a claimed child does not meet the residency, relationship and age tests. Claiming children who are not "qualifying children" can result in large tax liabilities.

²⁷⁷ See e.g., *Coats v. Comm'r.*, T.C. Memo 2003-78; *Sliwinski v. Comm'r.*, T.C. Summ. Op. 2003-49; *Gingrich v. Comm'r.*, T.C. Summ. Op. 2002-158.

Single and head of household filers get the same EIC. The amount of the EIC is based on the taxpayer's AGI. Therefore, the head of household filing status and dependency exemptions generally don't affect the amount of the EIC.

In 2011, even "married filing jointly" taxpayers would get the same EIC as a "single or head of household" taxpayer until their adjusted gross income (AGI) exceeds \$16,700. For higher income taxpayers, the "married filing jointly" status generally increases the EIC by less than \$1,000.

For many low-income taxpayers, the head of household filing rate does not lower their taxes. For example, a 2011 EIC taxpayer's tax refund or tax owed will be virtually the same for single or head of household for incomes below \$16,700. Loss of the head of household filing status (versus single filing status) would only lower the tax refund of an EIC taxpayer with an AGI of \$20,000 by a few hundred dollars. By comparison, the EIC provides a refund of about \$2,561 (single, 1 child) to \$5,751 (married filing jointly, 3 children) for 2011 taxpayers with \$20,000 AGI. The EIC is the same for taxpayers who file as single or head of household. The head of household status does not increase an EIC eligible taxpayer's EIC amount.

In summary, the head of household filing status can be irrelevant for income tax purposes. It may not be worth fighting over the head of household filing status or dependency exemptions if those items have little or no effect on the taxpayer's tax refund.²⁷⁸ Run a tax return for the taxpayer without the head of household filing status to see how much money is at issue.

An unwed or divorced taxpayer can qualify for the EIC since she can legally file as "single." It is amazing how many IRS agents and paid tax preparers do not know this. Instead, they take the position that a single taxpayer has to meet the head of household filing status to get the EIC. They are wrong.

The head of household status is, however, absolutely crucial for taxpayers who are married on December 31 of the tax year and who cannot file as "married filing jointly." These taxpayers will not qualify for pre-2005 EICs unless they meet the requirements for head of household filing status as to at least 1 child.²⁷⁹

For such low-income taxpayers, who are married on December 31, the major EIC audit issues are whether:

- their spouse lived with them during the last 6 months of the year²⁸⁰
- they paid more than half the cost of maintaining the household

For years before 2005, another major audit issue was whether such married taxpayers qualify for a dependency exemption as to at least 1 child.²⁸¹ Fortunately, most pre-2005 EIC claims do not depend on winning the head of household filing status and dependency exemption issues. A single or married filing jointly taxpayer does not have to meet the various support tests for head of household filing status or dependency exemptions to qualify for the EIC. After 2005, the dependency exemption is not a prerequisite for a married, but separated taxpayer to receive an EIC.

²⁷⁸ Each tax year stands on its own. A concession in one year does not bind the taxpayer in another year. *Pekar v. Comm'r.*, 113 T.C. 158, 166 (1999).

²⁷⁹ *Taylor v. Comm'r.*, T.C. Summ. Op. 2002-25.

²⁸⁰ Married, but separated taxpayer denied EIC because husband lived in household at some time during last 6 months of year. *Becker v. Comr.*, T.C. Memo 1995-177.

²⁸¹ Beginning with the 2005 tax year, the dependency exemption requirement has been eliminated by the Working Families Tax Relief Act of 2004.

Many low-income taxpayers receive money from third parties, e.g., Social Security, welfare or subsidized housing assistance. These funds do not count as support by the taxpayer.²⁸² Therefore, they may not qualify for the head of household filing status if their earned income is less than their income from third parties.

11. A Taxpayer May Be Eligible for an EIC Even If He Does Not Have a Qualifying Child

The IRS seems to deny any EIC when it finds that the taxpayer does not have a qualifying child. However, a taxpayer without a qualifying child may qualify for an EIC as to herself if her income is low enough. *Chandler v. Comm'r*, T.C. Summ. Op. 2002-74. The other EIC requirements for taxpayers without a qualifying child are:

- Taxpayer or spouse, if filing jointly, is at least 25 but under 65.
- Taxpayer is not dependent or qualifying child of another person.
- Taxpayer lived in the United States more than half of the year.

12. A Form 8862 Is Required for Taxpayers Who Have Been Denied an EIC

A taxpayer, whose EIC was reduced or denied by the IRS for 1997 or a later year, must file a Form 8862 with a subsequent return in order to claim the EIC. Reg. § 1.32-3.

13. IRS Disallowance Procedures For Fraud or Reckless Disregard of EIC Rules

If the EIC was denied for tax returns (beginning in 1997) and the IRS determines that the error was due to reckless or intentional disregard of the EIC rules, the taxpayer cannot claim the EIC for the next 2 years. If the error was due to fraud, the taxpayer cannot claim the EIC for 10 years. I.R.C. § 32(k). Such disallowance could cost the taxpayer several thousand dollars per year in tax refunds. IRS determinations of reckless disregard or fraud are reviewable through the Tax Court deficiency procedures. I.R.C. § 6213(g)(2). The EIC 10 year ban is often asserted with a civil fraud penalty.

14. Death and the EIC

A representative may file for the EIC refund if the decedent was eligible at the time of his death. If a child was born or died in the tax year, she is considered to meet the residency test if she lived with the taxpayer for the entire time she was alive in that year.

15. Earned Income Credits and Bankruptcy

State law determines whether an earned income credit is exempt from seizure by creditors.²⁸³ Some states exempt earned income credits; others don't. In Louisiana, the earned income credit is now exempt from seizure by creditors. La. R.S. 13:3881(A)(6). In states where the credit is not exempt, the timing of the tax return and bankruptcy can be critical to maximizing the amount of credit that the client may retain.

²⁸² See e.g., *Huynh v. Comr.*, T. C. Memo 2002-237 (HUD rental assistance); *Gulvin v. Comm'r*, 644 F.2d 2 (5th Cir. 1981) *aff'g* T. C. Memo 1980-111; *Lutter v. Comr.*, 514 F.2d 1095 (7th Cir. 1975); Rev. Rul. 74-543, 1974-2 C.B. 39; IRS Pub. 501.

²⁸³ See e.g., *In re Collins*, 170 F.3d 512 (5th Cir. 1999). *Collins* found that the Earned Income Credit was not exempt under Louisiana law. In 2004, the Louisiana legislature amended La. R.S. 13:3881 to exempt Earned Income Credits.

17. LOUISIANA REAL ESTATE (OR AD VALOREM) TAXES

17.1 INTRODUCTION

17.1.1 Screen homeowners for real estate tax issues

You can help preserve home ownership for low-income clients by a simple check-up of their real estate. Check for the following:

- is the homeowner listed as the homeowner in the assessor and conveyance records?
- is his address in the assessor records correct?
- has there been a tax sale, blight adjudication or other adverse government action?
- is he getting the correct homestead exemption?
- if permanently disabled, a disabled veteran with a 50% disability rating (or a surviving spouse, 45 or older or with minor children) or a senior citizen (65 or older or if a surviving spouse, 55 or older), does he have an special assessment level freeze?

17.1.2 Importance of updated ownership records

If the owner's name and correct address is not listed with the assessor, he won't get notices of tax sales, code enforcement and other adverse government actions. If the assessor's records list another person as the owner, there may have been a tax sale.

17.1.3 Homestead exemption

A Louisiana taxpayer is entitled to a \$75,000 homestead exemption from ad valorem taxes on his primary home which he lives in. For co-owned homesteads, the owners who occupy the homestead are entitled to a homestead exemption prorated for their ownership. Disabled veterans with a 100% service connected disability qualify (or their surviving spouses) for a \$150,000 homestead exemption in most parishes.

The homestead exemption should be timely applied for each year. If a homeowner has forgotten to file the homestead exemption application, the assessors will generally process retroactive homestead exemptions for the last 3 years.²⁸⁴ A homestead exemption may be granted to an heir without the opening of a judicial succession.²⁸⁵ However, if there is a will, an assessor may decline to grant a homestead exemption.

17.1.4 Special Assessment Level Freezes

Disabled persons and senior citizens (i.e., 65 or older) may be entitled to a special assessment level freeze which freezes the assessment on their home. These freezes should be applied for immediately when the owner becomes eligible. The freeze is limited to those with income below a certain level.²⁸⁶ Failure to timely

²⁸⁴ Under pre-2009 law, a taxpayer could obtain a judgment recognizing his homestead exemption retroactively for more than 3 years, or an assessor's determination. However, if taxes were erroneously paid on exempt property, the taxpayer's refund claims must be made within 3 years. *LaNasa v. City of New Orleans*, 855 So.2d 404 (La. App. 4 Cir. 2003) *writ denied* 861 So.2d 578 (La. 2003); La. Atty. Gen. Op. 07-0228 (Sept. 4, 2007); La. Atty. Gen. Op. 04-0221 (Sept. 23, 2004).

²⁸⁵ La. Atty. Gen. Op. 91-262 (Aug. 2, 1991) (an affidavit of heirship may suffice as proof of ownership).

²⁸⁶ For the 2012 year, the taxpayer must have an AGI of \$69,463 or less. This level is adjusted annually for inflation.

apply for the freeze will force the owner to wait another year for the freeze. A Social Security disability award letter is generally sufficient for a disability freeze. For senior citizen freezes, the assessor generally requires proof of annual income for the prior tax year. If the owner is employed, the assessor may ask for a copy of the owner's federal income tax return.

17.1.5 Partial payment of ad valorem taxes

Some parishes may allow partial payment of ad valorem taxes. Check your local parish's practice. If a parish does allow partial payment, it will still sell the property at the next tax sale if the taxes have not been fully paid.

17.2 TAX SALES

17.2.1 How clients with tax sale problems present

Ad valorem taxes are an *in rem* obligation of the land.²⁸⁷ So, a client will not be sued for real estate taxes. Rather, the property is sold at a tax sale subject to a right of redemption. A client may come to you whose property has been sold at a tax sale for failure to pay ad valorem taxes. In such cases, there will be a "tax deed" to the tax deed purchaser in pre-2009 sales or a "tax sale certificate" in post-2009 sales. Or if no person bid on the property, there will be a deed adjudicating the property to the city or parish.

A client may still be within the period to redeem the tax sale or adjudication sale. Or, he may face a post-sale notice of tax sale, a petition to quiet title, a motion proceeding or even a judgment confirming tax title.

A tax debtor may have the right to redeem a tax sale or annul a tax sale. In either case, the client ultimately will have to pay the tax purchaser or the tax collector the taxes and other amounts due under law.

Act 836 of 2012, codified at La. R.S. 47:2153 enacted a simple administrative procedure for co-owners, who did not receive notice of the tax sale, to seek cancellation of the tax sale from the Parish Tax Collector.

17.2.2 Overview of tax sale laws

Tax sales in Louisiana are authorized by the state Constitution, Article 7, section 25. Act 819 of 2008 comprehensively revised and restated the statutory law governing tax sales. These new laws are codified at La. R.S. 47: 2121 *et seq.*

Act 819 states "This Act shall become effective on January 1, 2009." The new laws presumably apply to tax sales after January 1, 2009. The law is still unsettled as to how the new laws, or which parts thereof, apply to tax sales before January 1, 2009.²⁸⁸

In addition to the statutes, there is considerable jurisprudence on the due process requirements for tax sales. *See e.g., Lewis v. Succession of Johnson*, 925 So.2d 1172 (La. 2006).

²⁸⁷ *State v. Liberto*, 181 So.2d 822, 825 (La. App. 4 Cir. 1966).

²⁸⁸ One court has applied the Act 819 judicial procedures for attacking a tax sale to a 2009 action to annul a 1993 tax sale. *In re Davis*, 59 So.3d 452 (La. App. 1 Cir. 2011).

17.3 REDEMPTIONS

17.3.1 The right to redeem tax sale property

There is a constitutional right to redeem property sold at a tax sale by paying the delinquent taxes, accrued taxes, interest and penalties within the prescribed time period. La. Const. art. 7, § 25 (B).

An action for redemption does not require proof of irregularity or defect in notice. It is merely a return of property to the tax debtor on demand upon payment of the back taxes. *Harris v. Estate of Fuller*, 532 So.2d 1367, 1368 (La. 1988). Louisiana law favors redemption of property sold at tax sales. *ACORN Community Land Association of Louisiana v. Zeno*, 936 So.2d 836 (La. App. 4 Cir. 2006).

17.3.2 The time to redeem

General rule: Property may be redeemed within 3 years of the recording of the tax deed in the public records. La. Const. Art. 7, § 25 (B)(1). *Hamilton v. Royal International Petroleum Corp.*, 934 So.2d 25 (La. 2006). A “tax sale certificate” is now considered a “tax deed” for redemption purposes. So, immediately check the recording date to determine how much time is left for redemption. In some parishes, there is significant delay between the tax sale and the recording of the tax deed.

While redemption must be initiated within the 3 year redemption period, there may be cases where it need not be completed within that time period. *Harris v. Guardian Funds, Inc.*, 425 So.2d 1322 (La. App. 4 Cir. 1983) (lawsuit to redeem filed within 3 years); *Becnel v. Woodland*, 628 So.2d 89, 91 (La. App. 5 Cir. 1993), *writ denied* 634 So.2d 374 (La. 1994) (oral request to redeem within 3 years is sufficient); *Mississippi Land Co. v. S & A Properties II, Inc.*, 817 So.2d 1200, 1204 (La. App. 3 Cir. 2002) (erroneous payment within 3 year redemption period held sufficient effort to redeem); *S.A. Mortgage Service, Co. v. Lemoine*, 800 So.2d 1015 (La. App. 5 Cir. 2001), *writ denied* 807 So.2d 851 (La. 2002) (redemption timely where insufficient amount paid because city gave tax debtor the wrong redemption amount).

Practice Tip: A tax debtor should preserve evidence to prove a timely redemption effort and act promptly to complete the redemption. The request for redemption should be in writing and sent by certified mail. The safest course of action in response to a refusal to grant redemption may be a timely suit against the tax collector or tax deed purchaser, as appropriate. Also, in a disputed or delayed redemption, a tax debtor should file an appropriate document in the public records to provide notice of his rights to third parties.

Orleans blighted property exception: In Orleans Parish, there may be a shorter period for redemption of blighted property sold at a tax sale. The Constitution provides that must be redeemed within 18 months. La. Const. art. 7 § 25(B)(2). The Court of Appeal has held that this 18 month redemptive period only applies when the tax sale occurred under the statutory authority for sales of blighted property. *Padilla v. Schwartz*, 11 So.3d 6 (La. App. 4 Cir. 2009).²⁸⁹ However, at least one Orleans district judge has ignored *Schwartz* and denied redemptions made after 18 months, but within 3 years, when the property has been adjudicated as “blighted.”

²⁸⁹ Note that under Act 819 of 2008, liens may be added to the tax bill to create a basis for a sale of the property pursuant to a tax sale. See R.S. 47: 2128.

Adjudication sales exception: If the property is not bought at the tax sale by a third party, it is adjudicated to the city or parish. In “adjudicated sales”, La. R.S. 47: 2246 (Rev. 2008) now provides that the property may be redeemed beyond the 3 year period until any of the following occurs:

- (1) later of 60 days or 6 months as applicable after the notice required by R.S.47: 2206 (notice of potential sale or donation), or the filing of the sale or donation transferring the property from the political division pursuant to R.S. 47: 2201 *et seq.*;
- (2) the granting of the order of possession pursuant to R.S. 47:2232 (suit by political subdivision to obtain possession of adjudicated property);
- (3) 60 days or 6 months as applicable after the notice required by R.S. 47:2236 (declaration of political subdivision by ordinance of its intent to acquire property).

The Comment to this Act 819 amendment notes that it codified pre-2009 practices.²⁹⁰

Interruption of redemption period? The 3 year (or 18 month) redemption period is preemptive and cannot be interrupted. La. R.S. 47:2241; *Harris v. Estate of Fuller*, 532 So.2d 1367 (La. 1988). Yet, a period of military service shall not be included in computing period of redemption of property sold at a tax sale. *Conroy v. Aniskoff*, 507 U.S. 511 (1993).

17.3.3 Options when redemption period expired?

- **Negotiate:** It pays to contact the tax sale purchaser even if the redemption period has passed. Many tax deed purchasers are investors (both small and large) who are not interested in owning the property, but seek the redemption interest and penalties as profit. Also, a petition to quiet tax title can be expensive and protracted, and the tax title property may not qualify for title insurance.²⁹¹ The tax sale purchaser may agree to allow you to redeem the property even after the official redemption period has passed.
- **Pursue annulment remedy:** If a co-owner did not receive sufficient notice prior to the tax sale, or there are other qualifying procedural defects, consider lawsuit to annul tax sale. See § 17.4, *infra*. An annulment suit may be possible even if there is a default judgment in a tax-title confirmation suit. *Chase Bank USA, N.A. v. Webeland, Inc.*, 98 So.3d 823 (La. 2012).

17.3.4 Who can redeem

It is now settled that any person may redeem.²⁹² However, the redemption is in the name of the tax debtor, and for his benefit.²⁹³

La. R.S. 13: 2575(C), as adopted by Act 209, § 2 of 2004, purports to revoke the constitutional right of redemption for Orleans property owners who have had their property sold at a tax sale for unpaid blight liens. R.S. 13: 2575 (C) is unconstitutional. If you have a redemption lawsuit for a tax sale involving blight liens, be sure to specially plead the unconstitutionality of R.S. 13: 2575 (C) and serve the pleadings and all hearing notices on the Attorney General.

²⁹⁰ For prior law, see *United Financial Group, Inc. v. Davis*, 481 So.2d 726, 728 (La. App. 1 Cir. 1985); La. Atty. Gen. Op. 05-0117 (April 20, 2005).

²⁹¹ In Orleans and St. Bernard Parishes, *Sutter v. Dane Investments, Inc.*, 985 So.2d 1263 (La. App. 4 Cir. 2008) makes it difficult to obtain title insurance on tax sale properties.

²⁹² La. R.S. 47:2242 (tax sale); 47: 2246 (adjudication sale); *Hebert v. Hollier*, 976 So.2d 1256 (La. 2007) (interpreting pre-2009 law).

²⁹³ La. R.S. 47:2242; *ACORN Community Land Association of Louisiana v. Zeno*, 936 So.2d 836 (La. App. 4 Cir. 2006).

17.3.5 How to redeem

Before Act 819 of 2008, there were administrative and judicial procedures for redemption of the property. Act 819 now provides that redemptions shall be made through the applicable tax collector. La. R.S. 47:2243. The Comment to § 2243 states that redemptions may no longer be made through or by negotiation with the tax deed purchaser. The Comment further states that this change eliminates potential abuse by tax deed purchasers who ask for “costs” as part of the redemption.

The basic redemption price is the delinquent tax, accrued taxes since the tax sale, a 5% penalty, costs, and interest at 1% per month. For each year of taxes paid by the tax deed purchaser, simply multiply the number of months between the tax purchaser’s payment and redeemer’s payment by 1% to get the cumulative interest owed.

R.S. 47:2244, as amended by Act 819, allows the tax collector to require the payment of all amounts accrued under other government liens at the time of the redemption payment. For properties with blight liens, grass cutting liens, etc., the requirement to pay these liens as part of the redemption could put the redemption beyond the tax debtor’s reach.²⁹⁴ (We have seen cases where the blight liens are significantly greater than the delinquent taxes, which may be very modest). The inclusion of liens as part of the redemption is within the political subdivision’s discretion.

Upon payment of the redemption costs, the tax collector shall issue a redemption certificate to the name of the tax debtor and file it in the appropriate conveyance records. R.S. 47: 2245.

If the tax collector improperly refuses redemption or asks for an incorrect amount, the redeemer will need to file suit for redemption of the property. If there was improper notice of the tax sale, the suit should also plead a claim for annulment.

The City of New Orleans continues to ask for penalties, interest and attorneys fees under City Ordinance 18,637 even though the ordinance was declared unconstitutional in *Fransen v. City of New Orleans*, 988 So.2d 225 (La. 2008).²⁹⁵ You should be able to get these items removed from the redemption price.

☞ **Practice Tip:** The new redemption procedures may present problems to tax debtors. Sometimes, it is easier and quicker to work with tax deed purchasers. Also, tax deed purchasers are often willing to allow “redemption” after the redemptive period has expired. In this case, you may need to also style the redemption as a quit claim deed.

Advocacy Alert: Prior to Act 819 of 2008, most tax assessors (or collectors) would deny the homestead exemption to the tax debtor on the theory that he no longer owned the property. Act 819 now clarifies that a tax sale does not transfer or terminate the tax debtor’s property interest in the tax sale property until the redemptive period has expired and he has lost his redemption or annulment rights. R.S. 47: 2121(B). Thus, the new law appears to provide a tax debtor with a claim for the homestead exemption during the redemptive period (particularly in adjudication sales where the property remains assessed in the tax debtor’s name). The

²⁹⁴ See R.S. 47:2121 (D)(5) for definition of “governmental liens” for purposes of tax sales and redemptions.

²⁹⁵ Check to see if the City has enacted a new ordinance in an attempt to circumvent *Fransen* for future years.

Attorney General has issued an opinion that the homestead exemption is lost when the home is sold in a tax sale, but continues when the home was sold in an adjudication sale. La. Atty. Gen. Op. 09-0161 (April 23, 2010). The Attorney General's non-binding opinion may be incorrect as to loss of homestead exemption in tax sales.

The tax deed purchaser's failure to pay taxes: Tax deed purchasers are required to pay the taxes for future years. They often fail to pay the taxes. The property can then be sold again at tax sale. Does the redemption period begin to run anew after each successive tax sale? One court has held that each successive tax deed purchaser has a right to redeem their inchoate title within 3 years after each respective tax sale and that the original redemption period does not begin to run anew. *Virtocom Financial v. Palo Verde*, 869 So.2d 194 (La. App. 5 Cir. 2004). The original tax debtor's redemption of the second tax sale may only inure to the benefit of the tax deed purchaser. However, his purchase of his own property at the second tax sale may make him the new tax deed purchaser subject to the original tax deed purchaser's right to redeem. A tax deed purchaser's failure to pay subsequent taxes may defeat his petition to quiet title or subject his petition to an exception until he has paid all the subsequent taxes as required by La. R.S. 47:2161.

17.4 SUIT TO ANNUL TAX AND ADJUDICATION SALES

17.4.1 Introduction:

If it is too late to redeem, a tax debtor's only legal remedy is a lawsuit to annul the tax or adjudication sale or to negotiate a settlement with the tax deed purchaser. The most common grounds for annulment are failure to give notice, a "redemption nullity", redemption or payment.²⁹⁶ If an action to annul is successful, the tax debtor must still pay the redemption amount to reclaim the property, unless the ground for nullity is that the taxes were paid and current at the time of the tax sale. Under the Constitution, interest for the taxes in a suit to annul is 10% per year rather than the 12% required for redemptions. *See also*, La. R.S. 47:2290 (A)(1)(c).

17.4.2 Constitutional due process

Historically, the government's failure to provide a pre-sale notice, as required by due process, renders the tax sale an absolute nullity.²⁹⁷ Act 819 of 2008 appears to state that a failure of notice is a relative nullity, i.e., one that can be cured. *See* R.S. 47:2286 and Comments-2008. However, courts appear to view a failure to give pre-sale notice as an absolute nullity.²⁹⁸

The most common due process violations are:

1. **Failure to give each co-owner a pre-sale notice.** *Lewis v. Succession of Johnson*, 925 So.2d 1172 (La. 2006). One co-owner may annul the tax sale in its entirety, not just the tax sale as to his fractional interest. *C & C Energy, LLC v. Cody Investments, LLC*, 41 So.3d 1134 (La. 2010).

²⁹⁶ *Commercial National Bank in Shreveport v. Dance*, 661 So.2d 551 (La. App. 2 Cir. 1995) (a tax sale is a nullity if the taxes were paid to time of tax sale).

²⁹⁷ *Lewis v. Succession of Johnson*, 925 So.2d 1172 (La. 2006); *Jamie Land Co., Inc. v. Jones*, 938 So.2d 738 (La. App. 1 Cir. 2006); *Richard v. Richard*, 892 So.2d 94, 97 (La. App. 5 Cir. 2004) writ denied 898 So.2d 94 (La. 2005); *Pardon v. Moore*, 908 So.2d 1253 (La. App. 2 Cir. 2005).

²⁹⁸ *Orleans Dist. Redevelopment Corp. v. Ocwen Loan Servicing LLC*, 83 So.3d 105 (La. App. 4 Cir. 2011) writ denied 85 So.3d 96 (La. 2012); *Quantum Resources Mgt. LLC v. Pirate Lake Oil Corp.*, 98 So.3d 394 (La. App. 5 Cir. 2012).

2. **Failure to send post-sale notice?** The Supreme Court has ruled that failure to send a post-sale notice does not void a tax sale.²⁹⁹ However, this ruling has been abrogated by Act 819 of 2008 and Act 836 of 2012, which require the tax collector to issue a post-sale notice of right of redemption and provide a statutory remedy for this “redemption nullity.”³⁰⁰
3. **Failure to send notice by regular mail to co-owners after certified mail is returned unclaimed.** *Lewis v. Succession of Johnson*, 925 So.2d 1172 (La. 2006); *Wilson v. Smith*, 2010 WL 4273091 (La. App. 1 Cir. 2010); *Jones v. Flowers*, 547 U.S. 220 (2006).

17.4.3 Time for suit to annul tax sale

Under pre-2009 law, there was no time limit for an action to annul other than time limits to respond to a petition to quiet title by filing a reconventional demand.³⁰¹ However, under post-2009 law, a tax debtor may receive a notice or a lawsuit that could trigger his time limits to redeem, sue or reconvene for annulment of the tax sale. Unsophisticated clients are less likely to respond to a letter from someone than a lawsuit.

Act 819 of 2008, codified at R.S. 47:2287, now provides for time limits for an action to annul based on a “redemption nullity.” A “redemption nullity” is defined a right to annul a tax sale under R.S. 47:2286 because the tax debtor was not duly notified at least 6 months before the redemptive period. Thus, Act 819 does the following: (1) creates a statutory remedy to annul for the tax collector’s failure to provide a post-sale notice³⁰² and (2) tries to cure the nullity of a failure of a pre-sale notice by providing for post-sale notices before the expiration of the redemption period.

Under the new R.S. 47:2287, the action for nullity must be brought within 6 months or 60 days after the person has been “duly notified.” Unfortunately, “duly notified” has been defined by R.S. 47:2121 (D)(4) to include a bewildering array of various notices by private persons and public officials, and includes certain post-sale notices. Under the statute, these notices which may meet the statutory definition of “duly notified” include:

R.S. 47: 2156	post-sale notice (within redemptive period)
R.S. 47: 2157	post-sale notice (after redemptive period)
R.S. 47: 2206	political subdivision’s notice of potential sale or donation
R.S. 47: 2236	political subdivision’s claim of ownership by ordinance
R.S. 47: 2275	notice pursuant to monition proceeding
R.S. 47: 2266	notice pursuant to petition to quiet title

²⁹⁹ *Hamilton v. Royal International Petroleum Corp.*, 934 So.2d 25 (La. 2006).

³⁰⁰ See La. R.S. 47:2286, 2122(10), 2122(4). Also the *Hamilton* case was wrongly decided. See *Stopping Short of Justice: Hamilton & Notice Requirement for the Redemption Period of Tax Sales*, 68 La. L. Rev. 263 (2007). Also, most states have held that tax sales that fail to comply with post-sale notice requirements are voidable. See e.g., *Johnson v. Ferguson*, 58 So.3d 711 (Miss. App. 2011).

³⁰¹ See e.g., *Pardon v. Moore*, 908 So.2d 1253, 1258-59 (La. App. 2 Cir. 2005); see also *Sutter v. Dane Investments, Inc.*, 985 So.2d 1263 (La. App. 4 Cir. 2008).

³⁰² La. R.S. 47: 2286, as amended, abrogates the holding in *Hamilton v. Royal International Petroleum Corp.*, *supra*.

You need to determine which time limit applies to the client's case. This may be tricky since a tax deed purchaser can trigger these time limits by sending a notice, rather than the old method of suing to quiet title. There may be future litigation issues for a tax deed purchaser's failure to notify all co-owners. *Cf. Lewis v. Succession of Johnson*, 925 So.2d 1172 (La. 2006) (pre-sale due process requirements).

1. For notices sent between the end of the redemptive period and 5 years after the recordation of the tax sale certificate, the tax debtor has 6 months to sue. The post-sale notice required in R.S. 47: 2156 can't count as the notice for this 6 month period.
2. For notices sent more than 5 years after the recordation of the tax sale certificate, the tax debtor has 60 days to sue.

If a client receives a petition to quiet title, he must sue or reconvene to annul the tax sale within either 6 months or 10 days. (Please be aware that the court citation may incorrectly state the delay period to sue). The shorter 10 day period applies if the petition has been filed after quieting of title by 5 years prescription. The longer 6 month period applies if the petition to quiet is filed after the redemptive period, but before the 5 year prescription. *See* La. R.S. 47:2266; La. Const. art. 7, § 25(D). One court of appeal has strictly enforced the 6 month time limit for filing a proceeding (lawsuit or reconventional demand) to annul the tax sale.³⁰³ However, the Supreme Court reversed upon a finding that there was no notice to the owner and that he should be allowed to raise a constitutional due process claim by an answer or an reconventional demand that was filed more than 6 months after the suit to quiet tax title.³⁰⁴ An owner served with a petition to quiet tax title should always file responsive pleadings that include a timely reconventional demand to annul the tax sale. You must file more than an answer to protect the owner's rights.

Note that the shorter 10 day period, if applicable to non-residents, is extremely unfair. It is also doubtful that service on a curator could ever result in actual notice (or due process notice) to a tax debtor within the 10 day period to sue for annulment. A 10 day limit appears unreasonable for both residents and non-residents in a petition to quiet title where a curator is appointed for the defendants.

Note: A suit to annul a default judgment quieting tax title may be brought if the original tax sale was null for a failure of notice. *Chase Bank USA, N.A. v Webe-land, Inc.*, 98 So.3d 823 (La. 2012).

Act 819 of 2008 also clarified the rules for monition proceedings by tax deed purchasers. *See* R.S. 47: 2271-75. Monition can now be brought after the expiration of the redemptive period. There is no need to wait 5 years from recordation of the deed or tax sale certificate.

17.4.4 Bankruptcy

A tax sale is also voidable if it was made while a bankruptcy stay was in effect. *Joshua Inv. Corp. v. Home Sales Consulting, Inc.*, 892 So.2d 151 (La. App. 2 Cir. 2005), *writ denied* 901 So.2d 1066 (La. 2005); *Bertini v. Britton*, 635 So.2d 712 (La. App. 1 Cir. 1994).

³⁰³ *Smitho v. Gulf South Shrimp, Inc.*, 77 So.3d 1012 (La. App. 1 Cir. 10/19/11), *rev'd* 94 So.3d 750 (La. 2012).

³⁰⁴ *Smitho v. Gulf South Shrimp, Inc.*, 94 So.3d 750 (La. 2012).

17.4.5 Judgments in nullity action

Act 819 of 2008 does clarify prior law by setting a 1 year period from the date of nullity judgment for a tax debtor to pay the “costs” owed to the tax deed purchaser. R.S. 47:2291. Nullity judgments don’t become effective until the “costs” have been paid. R.S. 47:2290. The prior law was unclear as to what a tax deed purchaser could do if a tax sale was annulled, but the “costs” never paid. R.S. 47:2291 also provides a litigation procedure to fix “costs” when the court has made a preliminary order to declare the tax sale a nullity. Act 275 of 2011, codified at R.S. 47: 2161, allows tax title purchasers of blighted property in New Orleans to seek reimbursement for the costs of improvements to bring the property into compliance with municipal code ordinances. However, the allowable costs are limited to \$1,500 per year for abandoned property and \$3,000 per year for blighted property. The owner’s failure to pay these improvement costs does not terminate or impair his right to redeem.

18. TAX LAW RESEARCH

See Ch. 25 of *Effectively Representing Your Client Before the IRS* (ABA 5th ed. 2011) for a comprehensive guide to tax law research.

IRS Web page, www.irs.gov

IRS web page has great resources for tax practitioners at www.irs.gov/taxpros.

Here, you can find:

- Tax forms and publications
- IRS contact information
- Internal Revenue Manual (www.irs.gov/irm)
- Weekly Internal Revenue Bulletin (new regulations, Revenue rulings, Revenue Procedures)
- Private letter rulings, technical assistance memoranda

Other Web pages

www.litctoolkit.com

Resources for Low-Income Taxpayer Clinics (password protected)

www.ustaxcourt.gov

Tax Court rules, forms and searchable opinions

www.abanet.org/tax/sites.html

American Bar Association, Section of Taxation’s tax links index

Treatises

Effectively Representing Your Client Before the IRS (ABA 5th ed. 2011)

M. King, *Discharging Taxes in Consumer Bankruptcy Cases* (2012).

R. Nadler, *A Practitioner’s Guide to Innocent Spouse Relief: Proven Strategies for Winning Section 6015 Tax Cases* (ABA 2011)

