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# Client Update

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## Rules of the Game – Tax Laws

Why is the tax code so complicated? Here is an explanation, plus some information on how the code is interpreted.

Congress writes the tax laws, which become part of the Internal Revenue Code (IRC) or tax code for short. The tax code is amended every year; presently, it is over 4,500 pages long.

Part of the problem is that many tax laws are passed for purposes other than raising money. A social goal using a tax law, for example, is Congress's attempt to alleviate the housing problem by giving tax breaks to those who invest in low-income housing. Similarly, an economic goal is found in allowing rapid tax write-offs to buyers of new business equipment to stimulate manufacturing. In addition, there are purely political reasons for tax laws. Many special interest groups, such as oil companies, horse breeders, broadcasters, insurance companies and even major league baseball clubs, have gotten tax laws passed that are designed to give them special treatment. These special provisions of the tax code outnumber the laws of general application.

**Interpreting the Tax Code** Congress has given the IRS the power, in the first instance, to interpret the tax code through a series of IRS regulations. These regulations are expanded versions of some, but not all, tax code provisions with illustrations of how the law is applied in different situations. The regulations are about four times the length of the tax code itself. The IRS also publishes revenue rulings, revenue

procedures and letter rulings, which provide guidance in much the same manner as the regulations. Not every provision of the tax code has a corresponding regulation.

There are thousands of situations where it is not clear exactly how the tax law should be applied. In these gray areas, disputes often arise between the IRS and the taxpayer. This is where the tax professionals earn their keep – by fitting the tax code most advantageously to a client's case. Or put another way, if the tax case is analogized to the fence around Farmer Brown's cabbage patch, the perimeter has gotten so long and twisty that a self-respecting rabbit may have a decent chance of finding enough room to wiggle through or under it.

The IRS is not the final word on interpreting the tax code. The federal court system, composed of the U.S. Tax Court, federal district courts, the U.S. Court of Federal Claims and U.S. bankruptcy courts, all have the power to decide, on a case-by-case basis, how Congress intended the tax laws to be applied. If more than \$50,000 is at stake, a taxpayer can appeal a Tax Court decision to a circuit court of appeal and in rare cases to the U.S. Supreme Court.

<http://taxes.yahoo.com/tips/updates/game.html>

## Beware the Tax Man, Even After Bankruptcy

Bankruptcy originally meant "broken bench." In common-law England, when a merchant or craftsman could not pay his debts, the custom in the community



was to break his workbench. This publicly established that the craftsman was “no longer in business.” Quite often, the creditors at that time would seek to perform the ceremony across the head of the debtor.

Now, bankruptcy laws are used as proactive shields not only to deflect creditors, but also to eliminate them in some cases.

Of course, you also have a very nasty black mark against your credit history. Most bankruptcy filings remain on your credit reports for seven to 10 years. For the first several years, you can forget about credit cards (unless they’re secured credit cards, in which the limit is backed by cash in an account with the lender), car loans and mortgages.

Then there is the Internal Revenue Service. You wiped out all of your other creditors (while in most cases getting to keep your home, which typically is exempt from bankruptcy proceedings,) but you still have a huge tax bill hanging over you. Under what circumstances will the government let you off the hook?

The rules are complex and sometimes courts in different jurisdictions interpret them differently.

All debts are divided into two categories – dischargeable and non-dischargeable. If the debt is dischargeable, you are no longer liable for it. Non-dischargeable debts cannot be cancelled in a bankruptcy.

How the rules are applied depends on the kind of bankruptcy you elect – either Chapter 7 or Chapter 13. These are the two most common types of bankruptcy filings available to individuals.

**Chapter 7** This is a liquidation bankruptcy where you give up all your non-exempt assets in exchange for a discharge of all your debts.

Under a Chapter 7 bankruptcy, income taxes for years ending on or before the date of filing the bankruptcy petition (including extensions) and within three years of the filing date cant’ be

discharged. However, income taxes owed for periods longer than three years can be eliminated. In addition, therein is where many people use the nation’s tax laws to their advantage.

Meanwhile, payroll taxes – Social Security and FICA – or employee withholdings that you owed cannot be discharged, even after three years.

So, if you work for a company in any capacity where you can be found to be a “responsible person,” make sure that payroll taxes and withholdings are sent to the IRS. These are dollars that have been withheld from your employees and, if you are a “responsible person,” the IRS can hold you personally liable for these business taxes.

If you are ever in a cash-flow position where you do not have the dollars to send what is due to the IRS, mark your check “trust fund portion only.” The IRS cannot hold you personally liable for the matching part of the Social Security and Medicare payments not sent in.

**Chapter 13** Under this form of bankruptcy, designed for wage earners “with regular income,” you agree to a plan to pay off your debts over a period of time, usually for pennies on the dollar.

Under this kind of bankruptcy, the court has the discretion to discharge taxes owed to the IRS without regard to the three-year rule, so long as you complete the payments under your Chapter 13 plan.

Even the IRS does not mess with the bankruptcy courts. When the courts say the tax is discharged or impose an automatic stay against collection, that’s it. It’s over. When the IRS did not follow the rules, the United States Bankruptcy Court for the Southern District of Florida in a decision rendered in December 1999 found the agency to be in contempt of court and fined it \$10 million.

<http://moneycentral.msn.com/content/banking/bankruptcyguide/p34109.asp>

