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ARE TAXES DISCHARGEABLE IN A CHAPTER 13 BANKRUPTCY?

By Victor Sy, CPA

Yes. Some are. Let's discuss taxes, penalties, and interest that are **not** dischargeable in a Chapter 13 filing. The Chief Counsel of the IRS examined which tax claims are nondischargeable in Chapter 13 bankruptcy cases filed on or after Oct. 17, 2005 (the effective date of the **Bankruptcy Abuse Prevention and Consumer Protection Act of 2005**). The Chief Counsel concluded that interest on nondischargeable tax claims is also nondischargeable.

Background. Chapter 13 provides a procedure for a payment plan for debts over a period of time. Before the effective date of the Bankruptcy Act, debtors received a super discharge if they completed all payments required under the plan. Any tax debts provided for under the plan would be discharged. The Bankruptcy Act modified this discharge so that certain tax debts that were excepted from discharge under old law are no longer discharged. After filing the Chapter 13 petition, the debtor files a Chapter 13 plan which proposes to pay creditors, including IRS, over a period of up to five years, typically in monthly installments.

Nondischargeable debts in a Chapter 13 Filing. The Bankruptcy Act substantially narrowed the scope of the Chapter 13 discharge by excepting from the discharge a number of tax debts. The Chief Counsel noted that exceptions **to discharge that are most likely to apply to tax debts in a Chapter 13** proceeding are:

- Debts for withheld taxes (trust funds withheld from employee wages),
- Taxes for which a return was not filed,
- Taxes for which a return was late-filed within two years of the bankruptcy case,
- Taxes for which the debtor filed a fraudulent return, and
- Taxes that the debtor attempted to **evade or defeat**.

Caution if Debtor fails to list Taxes in a Chapter Filing: Failure to include a creditor to whom a debt is owed in time to permit a proof of claim to be timely filed is not dischargeable (unless the creditor had notice or actual knowledge of the case in time to file a timely proof of claim). This exception applies where the debtor **fails to list IRS on its schedule of liabilities or otherwise notify IRS of the bankruptcy case**. However, if IRS learns of the bankruptcy proceeding in time to file a timely claim but failed to do so, this exception won't apply. In other words, there is no discharge if the creditor didn't have notice of the bankruptcy case in time to file a timely claim.

Prepetition interest. The Chief Counsel concluded that **if the tax debt is dischargeable** in Chapter 13, then the **associated prepetition and post petition interest is also dischargeable**. However, if the underlying tax liability isn't dischargeable, then the associated prepetition and post petition interest liability is also not dischargeable. Since The Bankruptcy Act created a number of tax debts that are now nondischargeable, debtors will owe post petition interest on the nondischargeable tax obligations.

Penalties. The Chief Counsel concluded that all **nonpecuniary tax penalties and the interest that accrues on them were dischargeable**. The Bankruptcy Act didn't alter the dischargeability of penalties. IRS also noted that penalties for failure to make timely payments of tax incurred by the debtor before the bankruptcy case do not accrue during the bankruptcy case.