

## Dischargeable Debts

The bankruptcy discharge varies depending on the type of case a debtor files: chapter 7, 11, 12, or 13.

What is a Discharge?

A bankruptcy discharge releases the debtor from personal liability for certain specified types of debts. In other words, the debtor is no longer legally required to pay any debts that are discharged. The discharge is a permanent order prohibiting the creditors of the debtor from taking any form of collection action on discharged debts, including legal action and communications with the debtor, such as telephone calls, letters, and personal contacts.

Source: [www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/DischargeInBankruptcy.aspx](http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/DischargeInBankruptcy.aspx)

What debts are Exempt from Discharge?

Not all debts are discharged in a bankruptcy. The debts discharged vary under each chapter of the Bankruptcy Code. The Bankruptcy Code specifically excepts various categories of debts from the discharge granted to individual debtors. Therefore, the debtor must still repay those debts after bankruptcy.

The exemptions are located in Section 523(a) of the Bankruptcy Code. The Code Section will be provided in a separate handout, but as with most code sections, it contains parts and subparts, separately defined complex legal terms, and cross references to other code sections.

For our purposes, it is important to know that there are 19 categories of debt excepted from discharge under chapters 7, 11, and 12. A more limited list of exceptions applies to cases under chapter 13.

Generally speaking, the exceptions to discharge apply automatically if the language prescribed by section 523(a) applies.

The most common types of nondischargeable debts are:

- certain types of tax claims (which we will review in greater detail)
- debts not set forth by the debtor on the lists and schedules the debtor must file with the court
- debts for spousal or child support or alimony
- debts for willful and malicious injuries to person or property
- debts to governmental units for fines and penalties
- debts for most government funded or guaranteed educational loans or benefit overpayments,
- debts for personal injury caused by the debtor's operation of a motor vehicle while intoxicated
- debts owed to certain tax-advantaged retirement plans, and
- debts for certain condominium or cooperative housing fees.

The types of debts described in sections 523(a)(2), (4), and (6) (obligations affected by fraud or maliciousness) are not automatically excepted from discharge. Creditors must ask the court to determine that these debts are excepted from discharge. In the absence of an affirmative request by the creditor and the granting of the request by the court, the types of debts set out in sections 523(a)(2), (4), and (6) will be discharged.

A slightly broader discharge of debts is available to a debtor in a chapter 13 case than in a chapter 7 case.

Debts dischargeable in a chapter 13, but not in chapter 7, include debts for

- willful and malicious injury to property,
- debts incurred to pay non-dischargeable tax obligations, and
- debts arising from property settlements in divorce or separation proceedings.

Although a chapter 13 debtor generally receives a discharge only after completing all payments required by the court-approved (i.e., "confirmed") repayment plan, there are some limited circumstances under which the debtor may request the court to grant a "hardship discharge" even though the debtor has failed to complete plan payments. Such a discharge is available only to a debtor whose failure to complete plan payments is due to circumstances beyond the debtor's control. The scope of a chapter 13 "hardship discharge" is similar to that in a chapter 7 case with regard to the types of debts that are excepted from the discharge. A hardship discharge also is available in chapter 12 if the failure to complete plan payments is due to "circumstances for which the debtor should not justly be held accountable."

## 11 USC § 523 - Exceptions to discharge: Tax Obligations

(a) A discharge under section 727, 1141, 1228 (a), 1228 (b), or 1328 (b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507 (a)(3) or 507 (a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, or equivalent report or notice, if required—

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

### Section 507(a)(8) of the Bankruptcy Code: Non-Dischargeable Income Tax

Income taxes: (i) for tax years ending on or before the date of filing the bankruptcy petition, for which a return is due (including extensions) within 3 years of the filing of the bankruptcy petition; (ii) assessed within 240 days before the date of filing the petition; (iii) not assessed before the petition date, but were assessable as of the petition date, unless these taxes were still assessable solely because no return, a late return (within 2 years of the filing of the bankruptcy petition), or a fraudulent return was filed, withholding taxes for which a person is liable in any capacity, an employer's share of employment taxes on wages, salaries, or commissions (including vacation, severance, and sick leave pay) and excise taxes on transactions occurring before the date of filing the bankruptcy petition are all not dischargeable in bankruptcy.

### Five Rules to Discharge Tax Debts

If the income tax debt meets all five of these rules, then the tax debt is dischargeable in Chapter 7 and Chapter 13 bankruptcy petitions.

1. The due date for filing a tax return is at least three years ago.
2. The tax return was filed at least two years ago.
3. The tax assessment is at least 240 days old.
4. The tax return was not fraudulent.
5. The taxpayer is not guilty of tax evasion.

#### Return Due At Least Three Years Ago

The tax debt must be related to a tax return that was due at least three years before the taxpayer files for bankruptcy. The due date includes any extensions.

#### Return Filed At Least Two Years Ago

The tax debt must be related to a tax return that was filed at least two years before the taxpayer files for bankruptcy. The time is measured from the date the taxpayer actually filed the return.

#### Tax Assessment At Least 240 Days Old

The IRS must assess the tax at least 240 days before the taxpayer files for bankruptcy. The IRS assessment may arise from a self-reported balance due, an IRS final determination in an audit, or an IRS proposed assessment which has become final.

#### Tax Return was Not Fraudulent

The tax return cannot be fraudulent or frivolous.

#### Taxpayer Not Guilty of Tax Evasion

The taxpayer cannot be guilty of any intentional act of evading the tax laws

SOURCE: William Perez: Five Rules of Dischargeable Taxes

However, some of the taxes that would ordinarily be dischargeable because of their age may not be, if the Bankruptcy Court determines that the debtor has acted in "bad faith" with respect to their non-payment of taxes. Section 523 of the Bankruptcy Code (which governs exemptions to discharge) provides in Section 523(a)(1)(C) that:

"A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax."

However, Section 523 does not define what constitutes a "willful attempt to evade or defeat" a tax. To interpret this language, the Bankruptcy Court adopted the three-part test applicable under Section 6672 of the Internal Revenue Code, which imposes civil penalties on any taxpayer "who willfully attempts in any manner to evade or defeat any . . . tax or the payment thereof." Under that test, a willful attempt to evade or defeat a tax is established if the debtor (1) had a duty to pay the tax, (2) knew of that duty, and (3) voluntarily and intentionally violated the duty. Numerous courts have adopted this test as the standard for willful evasion under Section 523.

With respect to the attempt to avoid or evade taxes, the IRS takes the position that if a well-to-do individual (doctor, investment banker, or attorney) pays creditors other than the IRS, when they have available assets, this is "an attempt to avoid or evade taxes."