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Can Late-Filed Taxes Be Discharged in a Chapter 13 Bankruptcy?

by Robert P. Achenbach, Jr.*

Although bankruptcy is designed to provide a new start for debtors by discharging debts, the Bankruptcy Code also balances that purpose against the interests of the public in collecting taxes and the interests of unsecured creditors who receive less than their full claims.¹ If not properly informed and advised, debtors may proceed through bankruptcy with the expectation that all debts will be wiped away once they complete their plan payments, only to be surprised that some debts, especially late-filed federal taxes, survive the bankruptcy process. Although a recent bankruptcy case illustrates this danger, the case leaves open a very small crack opened by the U.S. Supreme Court that could allow late-filed taxes to be discharged in narrowly defined circumstances.

Nondischargeable Taxes in Chapter 13

Section 523² provides a list of debts not discharged in Chapter 7, 11, 12 and 13 bankruptcy, including taxes and custom duties: (1) that are entitled to a second or eighth priority among unsecured allowed claims; (2) for which a return or equivalent report or notice was not filed or given, or was filed or given after the report or notice was last due with extension less than two years before the date of filing; or (3) for which a fraudulent return was filed or taxes that the debtor tried to evade.

Section 523(a)(1)(B)(ii) states in relevant part:

“(a) A discharge . . . does not discharge an individual debtor from any debt— (1) for a tax or a customs duty— . . . (B) with respect to which a return, or equivalent report or notice, if required . . . (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.”

Section 1328 applies Section 523 to Chapter 13 cases. Section 1328(a)(2)2 provides, in relevant part:

“(a) . . . as soon as practicable after completion by the debtor of all payments under the plan, . . . the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title, except any debt— . . . (2) of the kind specified in section 507(a)(8)(C) or in paragraph (1)(B), (1)(C), (2), (3), (4), (5), (8), or (9) of section 523(a); . . .”³

In other words, nondischargeable taxes include taxes for which a return was filed late and filed less than two years before the bankruptcy filing. In addition, taxes which became due less than three years before the bankruptcy filing are priority claims and nondischargeable.⁴

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*United Student Aid Funds, Inc. v. Espinosa*⁵

In *Espinosa*, the debtor's Chapter 13 plan provided for payment of only the principal of the debtor's student loan and discharge of the interest. The lender failed to object to the confirmation of the plan and the debtor received a discharge of the interest claim. The Department of Education later attempted to collect the interest by arguing that the confirmation of the plan was void for failure of the Bankruptcy Court to make a determination of undue hardship of the debtor. The U.S. Supreme Court ruled that the confirmation plan could not be voided; thus, the otherwise nondischargeable student debt remained discharged under the confirmation order.

The Current Case

In the recent case of *In re Reuland*,⁶ the debtors, husband and wife, filed their 2002 through 2011 tax returns in early April 2012. On April 26, 2012, the debtors filed for Chapter 13, listing the taxes owed to the IRS and providing for payment of 100 percent of the secured claim taxes in the plan and 13 percent of the unsecured tax claims.⁷ The IRS filed a priority claim for the 2009 through 2012 taxes and an unsecured claim for the 2002 through 2008 taxes. The plan was confirmed without objection from the IRS.

During the plan, the priority tax claim was paid in full but only a small portion of the unsecured tax claim was paid. At the end of the plan, the debtors received their discharge, but the discharge order noted that not all claims were discharged, including taxes under Sections 507(a)(8)(C), 523(a)(1)(B) and 523(a)(1)(C).

After the case was closed, the IRS started the collection process to collect the remainder of the unpaid unsecured tax claim. The debtors filed the instant case to determine that the unpaid taxes were discharged in the bankruptcy case. The debtors argued that, although the unsecured tax claim was nondischargeable under the sections discussed above, the case of *United Student Aid Funds, Inc. v. Espinosa*⁸ held that the nondischargeable debt at issue was discharged because their plan provided for the debt and the creditor failed to object to or appeal the confirmation.

The Bankruptcy Court acknowledged that *Espinosa* provided an exception to the nondischargeability rules of Section 1328 but distinguished the current case from *Espinosa* in that the debtors in this case, unlike the debtor in *Espinosa*, did not expressly declare in the bankruptcy plan that the remainder of nonpriority debts unpaid at the end of the plan would be discharged.⁹ The Bankruptcy Court stated that without the express statement of discharge, the IRS had no chance to object to the plan provision providing for the discharge.¹⁰

In conclusion

The narrow exception to nondischargeability of debts under Section 1328 produced by *Espinosa* lives on after this case, to be litigated in some future case involving a plan which sneaks by the IRS counsel and is confirmed with language discharging all unpaid late-filed taxes. The Bankruptcy Court found sufficient differences in the facts and procedures in the present case to hold that the *Espinosa* exception did not apply, without attempting to disagree with the *Espinosa* holding or hold that the *Espinosa* exception could not be applied to tax debts under any facts. If the Bankruptcy Court had applied the exception in this case to discharge the unpaid late-filed tax claims, the balance between

the interests of the debtor, creditors and public treasury would be upset, possibly to the point of inspiring legislative action to remove the *Espinosa* exception.

ENDNOTES

¹ See Harl and Achenbach, *Agricultural Law* § 120.06 (2018) covering the discharge of debts in bankruptcy.

² All sections refer to the federal Bankruptcy Code.

³ Section 1328 also does not permit the discharge of priority taxes for late or fraudulently filed returns or claims from money, property, or services; an extension, renewal, or refinancing of credit obtained by false pretenses; debts not listed or scheduled; fraud or defalcation while acting in a fiduciary capacity; embezzlement or larceny; student loans; or for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft if the operation was unlawful because the debtor was intoxicated from using alcohol or another substance.

⁴ See Section 507(a)(8)(C).

⁵ 559 U.S. 260 (2010).

⁶ 2018-2 U.S. Tax Cas. (CCH) ¶ 50,468 (Bankr. N.D. Ill. 2018).

⁷ The debtors' plan language was "General unsecured claims (GUCs). All allowed nonpriority unsecured claims, not specially classified, including unsecured deficiency claims under 11 U.S.C. § 506(a), shall be paid, pro rata, ... to the extent possible from the payments set out in Section D, but not less than 13% of their allowed amount." [Emphasis in original]

⁸ 559 U.S. 260 (2010).

⁹ The *Espinosa* court also acknowledged the potential limit of its exception: "Sections 1328(a) and 523(a)(8) provide that student loan debt is dischargeable in a Chapter 13 proceeding if a court makes a finding of undue hardship. In contrast, other provisions in Chapter 13 provide that certain other debts are not dischargeable under any circumstances. See, e.g., §§ 523(a)(1)(B), (C) (specified tax debts); § 523(a)(5) (domestic support obligations); § 523(a)(9) (debts "caused by" the debtor's unlawful operation of a vehicle while intoxicated). We express no view on the conditions under which an order confirming the discharge of one of these types of debt could be set aside as void." 559 U.S. 260, at 273 n. 10 (2010).

¹⁰ In support of this holding, the court also cited *In re Moore*, 2013 WL 4017936 (Bankr. M.D. Ga. 2013); *In re Monahan*, 497 B.R. 642 (Bankr. 1st Cir. 2013).