Taxes and Bankruptcy: The Nuts and Bolts

The filing and subsequent discharge of either a Chapter 7 or a Chapter 13 bankruptcy may eliminate some types of personal income tax liability. There are, however, certain rigid restrictions which must be met in order to completely eliminate personal income tax liability through bankruptcy.

Some personal income taxes may be eliminated through the filing and subsequent discharge of a Chapter 7 bankruptcy. The following requirements must be met for the personal income tax liability to be eliminated in a Chapter 7:

- The tax return must have been filed on time
- The filing should not be fraudulent
- The tax return must have been filed over three years ago as of the bankruptcy filing date (e.g. IRS debts for the last three years generally, would not be dischargeable)
- Alternatively, in some cases, if the tax return was filed late, was not fraudulent and was filed over two years ago as of the date of the bankruptcy filing, the tax debt may be deemed dischargeable. For example, if you filed your 1986 tax returns in 1990, and in 1994 filed a Chapter 7 Bankruptcy, this tax debt would be dischargeable as long as it was not related to a fraudulent filing and the tax debt was assessed by the IRS over 240 days before the bankruptcy filing.

Even if all of the above requirements are met, personal income taxes can still sometimes be non-dischargeable in a Chapter 7 bankruptcy. This occurs when the IRS has placed a tax lien on the debtor's property. In this case, the tax liability must be paid in full, but the IRS may be forced to accept a payment plan or substantially eliminate penalties through the filing of a Chapter 13 bankruptcy.

In a Chapter 13 bankruptcy, the debtor makes payments to a bankruptcy trustee and the bankruptcy trustee in turn distributes a percentage of the payment to the creditors. A Chapter 13 plan is filed with the court which determines the amount distributed to each creditor by the trustee. A bankruptcy judge can force the IRS to accept extended payments on personal income tax liability through a Chapter 13 plan. This type of bankruptcy works well when the IRS has a tax lien on personal property and the debtor has enough income to pay back the IRS over a three to five year period. Tax penalties may be discharged in a Chapter 13 bankruptcy because they are lumped in with all the other unsecured creditors of the debtor, such as credit cards. These are generally only paid back through the bankruptcy at 10% or ten cents on the dollar.

Filing either a Chapter 7 or a Chapter 13 bankruptcy may be a useful tool for debtors to eliminate tax liability.