A Collusion of Policy: Chapter 13 and Taxes

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A COLLISION OF POLICY: CHAPTER 13 AND TAXES

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I. INTRODUCTION

Fresh start! It is an emotional phrase that captures the turbulent sea of moral and legal tension inherent in the bankruptcy discharge. The phrase itself conjures up a host of images, running from "deserving debtor" to "deadbeat." This Article considers the fresh start policy through the most ambitious of all

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discharges—the Chapter 13 discharge—as it conflicts with the duty of citizens and residents of the United States to pay their lawful taxes. Part II analyzes the conflicting policies embodied in Chapter 13 of the Bankruptcy Code and the voluntary assessment system embodied in the Internal Revenue Code. The Chapter 13 process, with an emphasis on the discharge provision, is carefully explored with an eye toward highlighting the various statutory embodiments of the fresh start policy. Additionally, Part II considers the importance of equity in the United States voluntary compliance tax system. To the extent that the taxpaying public perceives that a person is shirking his responsibility to pay a lawful tax, it discredits the system and provides a convenient excuse for noncompliance.

Part III discusses those categories and types of tax claims that do not survive the Chapter 7 or 11 discharge. In particular, Part III focuses on those tax claims that survive the Chapter 7 and 11 discharge but fall to the Chapter 13 discharge. These tax claims include those related to fraudulent returns and to willful attempts to evade or defeat a tax. Part III also rejects the notion that a good faith requirement—in both the filing of the case and the proposal of the plan—may serve as an adequate gatekeeper in excluding fraudulent taxpayers from the bankruptcy process.

Part IV constructs a model of discharge designed to separate those debtors deserving of the full extent of the Chapter 13 discharge from those debtors that should forfeit that privilege. Part IV further analyzes the proposals of the Tax Advisory Committee to the National Bankruptcy Review Commission in an effort to clarify precisely what is at stake in this debate. In summary, the model would temper the Chapter 13 discharge specifically to prevent those debtors that have filed fraudulent returns or have engaged in a willful attempt to evade or defeat a tax from obtaining the Chapter 13 discharge. The historical roots of the discharge, the policy embodied in the robust Chapter 13 discharge, and a heightened standard of what constitutes a willful attempt to evade or defeat a tax provide the basis for this model.

II. CONFLICTING POLICIES

Part II of this Article explores the conflicting policies embodied in Chapter 13 of the Bankruptcy Code and the voluntary assessment system embodied in the Internal Revenue Code. This conflict presents difficult conceptual issues highlighted by the dischargeability of tax claims in a Chapter 13 bankruptcy

2. The Internal Revenue Code is codified in Title 26 of the United States Code.
4. See id. § 523(a)(1).
A. Chapter 13 Bankruptcy Relief

As its title states, the purpose of a Chapter 13 bankruptcy case is the adjustment of debts of individuals with regular income. The following subpart of this Article is a discussion of the Chapter 13 process and its requirements and is designed to provide context to the debate involving the dischargeability of taxes.

1. Debtor Eligibility

Section 109(e) of the Bankruptcy Code grants eligibility for the filing of a Chapter 13 reorganization case to any individual with regular income whose debts do not exceed $250,000 of noncontingent, liquidated, and unsecured liability, and $750,000 of noncontingent, liquidated, and secured liability. The definition of "regular income" is very broad and subject to a variety of interpretations. The regular income requirement is necessary as a means by which the Chapter 13 plan is funded.

The time for determining whether the debtor's liabilities satisfy the eligibility requirement is the date of filing the petition. Even if a debtor's liabilities exceed the dollar limitations set forth in § 109(e), decisions have indicated that a debtor's ineligibility for Chapter 13 relief does not deprive the bankruptcy court of jurisdiction to convert the debtor's Chapter 13 case to a case under Chapter 7. If it is not determined until after confirmation of a debtor's Chapter 13 plan that the debtor is not eligible for Chapter 13 relief because the debtor's liabilities exceed the eligibility dollar limits, authorities are split as to whether the Chapter 13 plan should be dismissed because the debtor lacks eligibility under Chapter 13. However, the preferred view is that the Chapter 13 case should not be dismissed at this stage of the proceeding because the likelihood of injury is minimal and any creditors who have an opportunity to object should do so at the appropriate time rather than waiting until the case has almost reached its conclusion.

The funding of the plan takes place by the debtor making payments to a

Chapter 13 trustee pursuant to the Chapter 13 plan. The Chapter 13 trustee, in turn, pays the creditors in accordance with the terms and conditions of the plan.\textsuperscript{12}

\textbf{2. Plan Structure}

If a debtor’s Chapter 13 plan “is not filed with the petition, it [must] be filed within 15 days” after the filing of the petition.\textsuperscript{13} Unless the court provides otherwise, a debtor must “commence making the payments proposed by a plan within 30 days after the plan is filed.”\textsuperscript{14}

The first element of a Chapter 13 plan is found in § 1302 of the Bankruptcy Code, which requires that the plan provide for the payment of money through a trustee. Also, a plan must provide for the payment of debts from the debtor’s disposable income as defined in § 1325(b)(2).\textsuperscript{15} The Bankruptcy Code includes certain mandatory provisions that a Chapter 13 plan must contain. These provisions include the following:

\begin{itemize}
  \item The plan must provide for the submission of all or a portion of the debtor’s future earnings to the trustee.\textsuperscript{16}
  \item The plan must provide for full payment to priority claimants under § 507 of the Bankruptcy Code, although such claims may be paid throughout the term of the plan.\textsuperscript{17}
  \item The plan must treat all creditors within a particular class in the same manner.\textsuperscript{18}
  \item The plan must not stretch out the payments for more than three years
\end{itemize}

\textsuperscript{12} The Chapter 13 trustee plays a role quite different from its Chapter 7 counterpart. Instead of being charged with the marshalling and liquidation of assets and the payment of proceeds from the assets to creditors, the Chapter 13 trustee is entrusted with the duty to pay creditors a portion of the debtor’s future earnings or income pursuant to the terms and conditions of a confirmed Chapter 13 plan. The United States trustee normally appoints one or more individuals to serve as standing trustees in cases filed under Chapter 13. See 11 U.S.C. § 1302(a). The trustee’s duties are set forth in § 1302(b) of the Bankruptcy Code and include such matters as presenting arguments to the court concerning the value of property subject to a lien and confirmation of the debtor’s Chapter 13 plan, advising and assisting the debtor in performance of the Chapter 13 plan, and “ensur[ing] that the debtor commences making timely payments” as required by the Chapter 13 plan. Id. § 1302(b)(5). Under normal circumstances, the debtor is required to send one check each month to the Chapter 13 trustee for all of the monthly payments due creditors under the Chapter 13 plan. The Chapter 13 trustee then divides the proceeds of the debtor’s monthly check and distributes the debtor’s monthly check to the creditors in accordance with the confirmed Chapter 13 plan.

\textsuperscript{13} Id. app. Bankr. R. 3015(b).
\textsuperscript{14} Id. § 1326(a)(1).
\textsuperscript{15} See id. § 1325(b)(2).
\textsuperscript{16} Id. § 1322(a)(1).
\textsuperscript{17} Id. § 1322(a)(2).
\textsuperscript{18} Id. § 1322(a)(3).
or, with the court's approval, a maximum of five years.\textsuperscript{19}

The debtor's Chapter 13 plan may also contain a number of permissive provisions, including modifying the rights of secured claimants (except on the debtor's principal residence), curing or waiving any defaults, providing for the assumption or rejection of executory contracts or unexpired leases, and including any provision not inconsistent with the Bankruptcy Code.\textsuperscript{20} Any permissive provision of a Chapter 13 plan is, of course, subject to objection by creditors, by the Chapter 13 trustee, and by the court.

3. \textit{Confirmation of Plan}

Confirmation of a Chapter 13 plan is governed by § 1325 of the Bankruptcy Code. It reads almost like an abbreviated list of plan confirmation requirements under § 1129 of the Bankruptcy Code for Chapter 11 reorganization cases.\textsuperscript{21} One of the important confirmation requirements of § 1325 is a financial condition test for the protection of unsecured creditors known as the "best interest of creditors test."\textsuperscript{22} This test requires a court to determine whether an unsecured creditor would receive less under a Chapter 13 plan than under a Chapter 7 liquidation, and if so, the plan should not be confirmed. Along with the financial condition test which protects unsecured creditors, the court may only confirm a Chapter 13 plan if the following conditions are met:

- The plan must comply with all the provisions of Chapter 13, as well as any other applicable provision of the Bankruptcy Code.\textsuperscript{23} For example, a Chapter 13 plan may not be confirmed if it does not provide for the full payment of priority tax claims as required by § 1322(a)(2).\textsuperscript{24}
- Any fees or charges required by law, or by the Chapter 13 plan, must be paid.\textsuperscript{25}
- The plan must be proposed in good faith and not by any means forbidden by law.\textsuperscript{26}

\textsuperscript{19} \textit{Id.} § 1322(d).
\textsuperscript{20} \textit{Id.} § 1322(b).
\textsuperscript{21} \textit{See id.} §§ 1325, 1129(a).
\textsuperscript{22} \textit{See id.} § 1325(a)(4).
\textsuperscript{23} \textit{Id.} § 1325(a)(1).
\textsuperscript{24} \textit{Id.} § 1322(a)(2); \textit{see also In re Schenk, 67 B.R. 137, 138-39 (Bankr. D. Mont. 1986)} (discussing the nexus between Chapter 13 and § 507) (quoting \textit{In re Healis, 49 B.R. 939, 940-41, 942 (Bankr. M.D. Pa. 1985)})
\textsuperscript{25} 11 U.S.C. § 1325(a)(2).
\textsuperscript{26} \textit{Id.} § 1325(a)(3); \textit{see also Lawrence Tractor Co. v. Gregory (In re Gregory), 705 F.2d 1118, 121 (9th Cir. 1983)} (concluding that good faith exists when the debtor acts equitably in proposing the plan regardless of whether the proposed payment is nominal or substantial).
• Secured claims must receive certain protection if the holder of such claims has not accepted the plan, including retention of the lien securing the claims or surrender of the collateral to the creditor.\textsuperscript{27}

• The Chapter 13 plan must be feasible; that is, the debtor must be able to make all payments under the plan and to comply with the plan.\textsuperscript{28}

If a Chapter 13 trustee or an unsecured creditor objects to confirmation of the debtor’s plan, the debtor must prove that the plan proposes either to pay the objecting creditor’s claim in full or that the plan provides that all of the debtor’s anticipated disposable income will be used to pay creditors.\textsuperscript{29} Only disposable income received during the three years following the first payment required by the plan must be used to pay the creditor.\textsuperscript{30} Disposable income means the debtor’s income reduced by necessary expenses either for the support of the debtor and the debtor’s dependents or for the continuation, preservation, or operation of the debtor’s business.\textsuperscript{31}

Like its Chapter 11 counterpart, the Chapter 13 debtor may modify the plan at any time before confirmation. However, the plan may not be modified in such manner that it no longer complies with § 1322 of the Bankruptcy Code, which regulates the contents of a plan of reorganization.\textsuperscript{32} Furthermore, § 1323 of the Bankruptcy Code provides that:

\begin{quote}
Any holder of a secured claim that has [previously] accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless the modification provides for a change in the rights of such holder from what such rights were under the plan before modification, and such holder changes such holder’s previous acceptance or rejection.\textsuperscript{33}
\end{quote}

Section 1327 of the Bankruptcy Code spells out the effect of the confirmation of a Chapter 13 plan. Initially, “[t]he provisions of a confirmed [Chapter 13] plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.”\textsuperscript{34} However, what happens if a Chapter 13 plan does not meet the Bankruptcy Code requirement relating to the full payment of priority tax claims under § 507(a)(8) and the Internal Revenue Service (“IRS”) has not made any objection? The only

\begin{itemize}
\item \textsuperscript{27} 11 U.S.C. § 1325(a)(5).
\item \textsuperscript{28} Id. § 1325(a)(6).
\item \textsuperscript{29} Id. § 1325(a)(1).
\item \textsuperscript{30} See id. § 1325(b)(1)(B).
\item \textsuperscript{31} Id. § 1325(b)(2).
\item \textsuperscript{32} Id. § 1323(a).
\item \textsuperscript{33} Id. § 1323(c).
\item \textsuperscript{34} Id. § 1327(a).
\end{itemize}
remedy for the IRS under these circumstances may be to request a modification of the plan, provided, however, the IRS has filed a claim in a timely manner or is otherwise treated by the plan. But several cases indicate that a creditor (including the IRS) may move to modify a plan only on a showing of a default by the debtor or that the circumstances have changed since confirmation.

Confirmation of a Chapter 13 plan also vests all of the property of the bankruptcy estate back in the debtor unless the plan or confirmation order provides otherwise. Thus, the automatic stay is terminated as to postconfirmation debts and property held by the debtor unless the plan provides that the debtor’s property remains property of the debtor’s estate. Hence, it is often in a debtor’s best interest to include a broad definition of property of the estate (including such things as postpetition earnings). A broad definition will serve to protect as much of the debtor’s property by the automatic stay as possible. Of course, the IRS and any other creditor should object to a broad definition of property of the estate unless a debtor can show good cause.

The property that vests in the debtor after confirmation under § 1327(b) of the Bankruptcy Code is also free and clear of any claim or interest of any creditor provided for by the plan. However, the phrase “claim or interest” does not include a valid lien, and thus, valid liens are not discharged by the confirmation of a Chapter 13 plan even if the plan treated the debt underlying such lien as unsecured. Further, removal of the automatic stay after confirmation of a Chapter 13 plan will allow the IRS, under certain circumstances, to collect postpetition tax liabilities of the debtor.


Once a Chapter 13 plan has been confirmed, there are seven procedural routes that may be available to an unsecured creditor to attack the plan: (1) appeal of the confirmation order; (2) motion to alter or amend the order, including a motion for reconsideration or for rehearing; (3) motion to dismiss the case; (4) motion to correct a clerical mistake; (5) adversary proceeding to revoke confirmation; (6) motion to set aside the confirmation on due process grounds; (7) motion to modify the Chapter 13 plan.


38. 11 U.S.C. § 1327(b); see also id. § 1306(b) (stating that “the debtor shall remain in possession of all property of the estate” except as otherwise provided).

39. See id. § 362(a).
40. Id. § 362(c)-(d).
41. Id. § 1327(c).
42. See Simmons v. Savell (In re Simmons), 765 F.2d 547, 557-59 (5th Cir. 1985).
4. Scope of Discharge

The Chapter 13 discharge is much broader in scope than either the Chapter 7 discharge or the Chapter 11 discharge. Under Chapter 7 or Chapter 11, when the debtor is an individual, a creditor that persuades the court to except its debt under § 523(a) of the Bankruptcy Code is not subject to any discharge order and may enforce its claim even after discharge or plan confirmation. This is not so, however, in a Chapter 13 case. Under § 1328(a) of the Bankruptcy Code, almost all debts provided for in the Chapter 13 plan are discharged on completion of performance of the plan, including many of those debts that are nondischargeable under § 523(a) in Chapter 7 and Chapter 11 cases. The only debts that are not discharged are those for alimony and support payments, certain educational loans, damages related to death or personal injury caused by the debtor’s operation of a motor vehicle while the debtor was intoxicated, and criminal restitution. Consequently, Chapter 13 may be a more useful tool for the debtor who has a substantial amount of debt which a court may find nondischargeable under § 523(a).

Unlike the more limited Chapter 11 discharge that arises at the time the plan is confirmed, the Chapter 13 discharge arises only after the debtor has completed full performance under the Chapter 13 plan. What happens, then, to the Chapter 13 right to discharge if the debtor is unable to complete performance under the plan? The answer to this question is found in § 1328(b) of the Bankruptcy Code: If a Chapter 13 debtor cannot perform under the plan for reasons beyond the debtor’s control, the debtor may still receive a “hardship” discharge as long as the debtor has performed sufficiently so that the creditors have received more under the Chapter 13 plan (even though only partially performed) than such creditors would have received under a Chapter 7 liquidation.

Even though a hardship discharge is available under the Bankruptcy Code, a Chapter 13 debtor that is given a hardship discharge pays a high price for obtaining it. If a hardship discharge is granted, the Chapter 13 debtor is not discharged from any debt of a kind specified in § 523(a) of the Bankruptcy Code which would otherwise have been discharged if the Chapter 13 plan had been fully performed.

Because the discharge covers “all debts provided for by the plan,” the critical issue is frequently the interpretation of the phrase “provided for by the plan.” In the tax area, the issue is the ability of the Chapter 13 debtor to discharge priority tax claims, even though such claims may have been

44. See 11 U.S.C. §§ 523(a), 1328(a).
45. See id.
46. See id. § 1328(b).
47. Id. § 1328(b).
48. Id. § 1328(a).
49. See id. § 507(a)(8).
“provided for” in the debtor’s plan, but not actually paid. Suppose, for example, that the debtor’s Chapter 13 plan provides that the debtor will “pay 100% of allowed claims to the IRS.” Suppose further that the IRS receives timely notice of the debtor’s Chapter 13 plan, but does not file its proof of claim in a timely manner, and is legitimately owed a designated amount of prepetition taxes that qualify as a priority unsecured claim under § 507(a)(8) of the Bankruptcy Code. On consummation of the debtor’s Chapter 13 plan, are the prepetition priority taxes owed to the IRS discharged?

Section 1322(a)(2) of the Bankruptcy Code states that a plan must provide for full payment in deferred cash payments of all priority claims. However, in the above example authority exists that supports the debtor’s position that the debtor will be discharged from the prepetition priority taxes owed to the IRS because the taxes were “provided for” under the debtor’s plan and (fortunately, for the debtor) the IRS failed to file its proof of claim in a timely manner.50

A plan for the adjustment of debts of an individual with regular income in a Chapter 13 bankruptcy case must give special treatment to priority claims. Under § 1322 of the Bankruptcy Code (which deals with the contents of a Chapter 13 plan), the plan must provide for the full payment of all claims entitled to priority under § 507.51 A variety of claims for federal taxes are given priority status under § 507. These priority tax claims include the following:

- Taxes incurred during the administration of the estate, trust fund taxes on wages or salaries earned and paid after the bankruptcy petition was filed, and quickie tax refunds;52
- Tax claims arising after the filing of an involuntary bankruptcy

50. See Leber v. Illinois Dep’t of Revenue (In re Leber), 134 B.R. 911, 915-16 (Bankr. N.D. Ill. 1991); Border v. IRS (In re Border), 116 B.R. 588, 595 (Bankr. S.D. Ohio 1990); Ledlin v. United States (In re Tomlan), 102 B.R. 790, 794-96 (E.D. Wash. 1989), aff’d per curiam, 907 F.2d 114 (9th Cir. 1990); see also Workman v. United States (In re Workman), 108 B.R. 826, 830 (Bankr. M.D. Ga. 1989) (holding that the penalty claim of the IRS against a Chapter 13 debtor was a “prepetition” claim and was barred because the IRS failed to file a timely proof of claim); Daniel v. United States (In re Daniel), 107 B.R. 798, 802-03 (Bankr. N.D. Ga. 1989) (holding that the tax claim of the IRS was “provided for” under the debtor’s Chapter 13 plan, and such claim was therefore discharged on completion of the plan) (citing Tomlan, 102 B.R. at 790).


petition but before a trustee is appointed or before the entry of an order for relief;\textsuperscript{53} 
- Certain employment taxes on prepetition wages;\textsuperscript{54}
- Unsecured tax claims of governmental units, including certain income and gross receipts taxes, trust fund taxes, prepetition employment taxes, excise taxes, customs duties, and tax penalties.\textsuperscript{55}

Section 1326 of the Bankruptcy Code provides that all claims given priority status by § 507(a)(1) must be paid either before or at the same time payment is made to all creditors under the Chapter 13 plan.\textsuperscript{56} Hence, federal taxes given a first priority status as administrative expenses must be paid (as required by § 1326) along with the payment of a trustee's fees and other administrative expenses. Section 1325(a)(4) sets forth the "best interest of creditor's test," providing that the value of property to be distributed under the plan to unsecured claimants must not be less than the amount that would be paid on each claim if the debtor’s estate were liquidated under Chapter 7. This provision raises two questions: If the liquidation of the debtor’s estate under Chapter 7 will result in full payment of all allowed unsecured claims, is the debtor then required to pay interest on such claims under a Chapter 13 plan which specifies a payout term of three to five years? Further, should the IRS also receive interest on its unsecured priority claim because § 1322(a)(2) requires the full payment of all prepetition priority tax claims under § 507(a)(8) in a Chapter 13 case?

Case authority suggests that when the liquidation of a debtor’s estate under Chapter 7 results in the full payment of all allowed unsecured claims, the Chapter 13 debtor cannot defer payment of such claims without including an appropriate interest payment to such creditors.\textsuperscript{57} Likewise, the IRS will contend that it is entitled to present value treatment, including interest, of any prepetition unsecured priority tax claims under § 507(a)(8) if such claims would have been fully paid in a Chapter 7 case, because § 1322(a)(2) of the Bankruptcy Code "provide[s] for the full payment, in deferred cash payments" of all priority tax claims in a Chapter 13 case. Of course, if the IRS receives only part of its priority tax claim in a Chapter 7 liquidation case, the IRS is not entitled to interest on any deferred payments in the Chapter 13 plan under present law.

After a debtor has made all payments required by the Chapter 13 plan, the bankruptcy court “grant[s] the debtor a discharge of all debts provided for by

\textsuperscript{53} Id. § 507(a)(2).
\textsuperscript{54} Id. § 507(a)(3).
\textsuperscript{55} Id. § 507(a)(8).
\textsuperscript{56} See id. § 1326(b)(2).
\textsuperscript{57} See Hardy v. Cinco Fed. Credit Union (In re Hardy), 755 F.2d 75, 78 (6th Cir. 1985).
the plan or disallowed under section 502,”

- The curing of any default and continuation of payments while a case is pending on any claim which has a final due date after the final day of the Chapter 13 plan,
- The debt owed to a spouse, former spouse, or child for alimony, maintenance, or support in connection with a separation agreement, divorce decree, or property settlement agreement,
- A debt owed for an educational loan which is insured or guaranteed by a governmental unit,
- A debt relating to death or personal injury caused by the debtor’s operation of a motor vehicle while the debtor was intoxicated from the use of alcohol or drugs, and
- A debt for restitution included in a sentence on the debtor’s conviction of a crime.

Section 1328(a) of the Bankruptcy Code does not exclude taxes from any discharge of debts that the bankruptcy court grants to a Chapter 13 debtor. However, all priority tax claims under § 507 must be paid in full as required by § 1322(a)(2). Nonetheless, certain nonpriority tax claims are only dischargeable in a Chapter 13 case. These claims include the various tax claims as set forth in § 523(a)(1) of the Bankruptcy Code concerning taxes relating to a late, unfiled, or fraudulent return and to those taxes related to a willful attempt to evade or defeat a tax.

Because the discharge covers “all debts provided for by the plan,” a critical issue is frequently the interpretation of the phrase “provided for by the plan,” as noted earlier. This issue arises in the tax area when determining the ability of a Chapter 13 debtor to discharge priority tax claims even though such claims may have been “provided for” in the debtor’s plan, but not actually paid.

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59. Id. §§ 1322(b)(5), 1328(a)(1).
60. Id. §§ 523(a)(5), 1328(a)(2).
61. Id. §§ 523(a)(8), 1328(a)(2).
62. Id. §§ 523(a)(9), 1328(a)(2).
63. Id. § 1328(a)(3).
64. Id. § 523(a)(1)(B)-(C).
65. Id. § 523(a)(1)(C).
66. The Advisory Committee proposed No. 441(a), entitled “Obligation of a Chapter 13 Debtor to Pay All Priority Taxes When a Proof of Claim for Such Taxes Is Not Filed.” TAX ADVISORY COMMITTEE REPORT, supra note 5, at 104. Those in support of this proposal stated:

Section 1322(a)(2) provides that all Chapter 13 plans provide for the payment of all claims entitled to priority under § 507. Courts, however, construe § 1322 to require only that a Chapter 13 plan provide for payment of allowed claims. A claim cannot be an allowed claim under Chapter 13 unless a proof of
Under present law, if a plan provides for payment of allowed priority claims and a proof of claim for priority taxes is not filed before the bar date, two consequences may occur: first, the IRS will not receive any distribution with respect to the claim, and second, because the plan "provided for" the tax claim, the claim will be discharged under § 1328.67

A discharge obtained by the debtor through fraud can be revoked, after notice and a hearing, provided the request for revocation is made within one year after the discharge is granted, and the requesting party did not know of the fraud until after the discharge was granted.68 If a debtor cannot perform under the plan for reasons beyond the debtor's control, the debtor may still receive a "hardship" discharge as long as the creditors have received more under the Chapter 13 plan (even though only partially performed) than those creditors would have received under a Chapter 7 liquidation.69 Even though a hardship discharge is available under the Bankruptcy Code, the Chapter 13 debtor pays a high price for obtaining it because the debtor is then not discharged from any of the following debts:

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claim is filed. . . . The current treatment of priority tax claims in Chapter 13 cases provides an unjustified benefit to many debtors who are delinquent in their taxes. Frequently, the debtor is a nonfiler; thus, the taxing authority may not know of the liability, much less the amount. Further, the debtor may be a responsible person of a corporation and thus be liable for trust fund tax recovery penalties. If the individual debtor's case makes no reference to the corporation, the taxing authority may not connect the individual debtor to the delinquent corporation until after the bar date. Finally, if the taxing authority mistakenly fails to file a proof of claim in time, the entire liability is discharged.

Id. (citations and footnote omitted).

Those arguing against the proposal observed:

The taxing authorities should have no greater rights in this respect than any other priority creditor. The two driving concerns—reasonable notice and filing return requirements—are adequately addressed by other proposals. Given adequate notice, a return filing requirement, and the 180-day bar date, the taxing authority should be required to file timely its proof of claim like any other holder of a priority claim.

Id. at 104-05.

By a vote of seven to two with one abstention, the Advisory Committee recommended that the Commission reject the proposal. Id. at 105.


68. 11 U.S.C. § 1328(e).

69. Id. § 1328(b).
Debts relating to the curing of any default and the continuation of payments while a case is pending on any kind of claim where the last payment is due after the final payment is due under the Chapter 13 plan; and

Any debt of a kind specified under § 523(a) of the Bankruptcy Code, which includes tax claims given a second priority as involuntary gap claims under § 507(a)(2); prepetition priority tax claims under § 507(a)(8); tax liabilities relating to a tax return which was either not filed, filed late, or filed after the bankruptcy petition; tax liabilities reported by fraudulent returns; and certain tax penalties.⁷⁰

B. Duty to Report and Pay Taxes

Tax revenues are one of the building blocks of society. These revenues help pay for the cost of government, military defense, roads, education, parks, and recreational areas; and the list can go on. These outlays are beneficial to all people whether or not they have paid a tax. Consequently, an incentive exists to avoid paying a tax, shifting the burden to others.⁷¹ Notwithstanding the incentive to “cheat,” the American tax system is one of voluntary compliance and assessment. Each year as we prepare and sign our Form 1040, we are voluntarily assessing an income tax against ourselves. Thus, every person is expected to account annually for their income and deductions, file the appropriate forms and schedules, and pay the tax owed.

To foster voluntary compliance, the federal government must impose taxes that are perceived as fair and equitable.⁷² Additionally, because of the incentive to cheat coupled with the voluntary compliance nature of the American tax system, the federal government must also penalize those individuals that do not play along. The Treasury Department, through the IRS, has the primary responsibility for tax compliance, collection, and enforcement. The IRS has at its disposal an array of tools to aid in the assessment, collection, and enforcement of taxes. One obvious tool is the criminal justice process. Typical federal tax crimes include (1) attempted evasion,⁷³ (2) willful failure to file or to pay,⁷⁴ (3) false statement,⁷⁵ (4) aiding and assisting,⁷⁶ (5) submitting a false document,⁷⁷ and (6) impeding or obstructing administration of the Internal

⁷⁰ Id. § 1328(c); see, e.g., In re Quick, 152 B.R. 902, 908 (Bankr. W.D. Va. 1992).
⁷⁴ Id. § 7203.
⁷⁵ Id. § 7206(1).
⁷⁶ Id. § 7206(2).
⁷⁷ Id. § 7207.
Revenue Code.\textsuperscript{78} An additional tool employed by the IRS is the imposition and collection of penalties and interest. Presently, four broad categories of penalties exist. These include information reporting penalties,\textsuperscript{79} accuracy penalties,\textsuperscript{80} preparer, promoter, and protestor penalties,\textsuperscript{81} and delinquency penalties.\textsuperscript{82} The IRS has the power to assess and collect not only the tax owed, but also the interest and penalties associated with the unpaid tax.

That a delinquent taxpayer may have sufficient funds to pay the tax, but insufficient assets to pay the additional penalties and interest is not unusual. Of course, finding a taxpayer that cannot pay any of the tax owed is not unusual either. Thus, it is not surprising that many of these taxpayers file for relief under the Bankruptcy Code. In fact, the IRS is the largest creditor in bankruptcy, filing well over 150,000 proofs of claim for delinquent federal taxes in bankruptcy each year.\textsuperscript{83} Some of these taxpayers have the best of intentions in seeking bankruptcy relief, including, in some instances, an attempt to reenter the voluntary tax compliance system. Others have the worst of intentions in seeking bankruptcy relief, including using the bankruptcy process in a continuing effort to evade the payment of taxes. Identifying members of each camp is not as simple as it may seem.

III. TAXES AND THE CHAPTER 13 DISCHARGE

Tax-driven Chapter 13 cases are no longer the exception, but the rule. In many Chapter 13 cases a debtor is delinquent in the payment of taxes. To be sure, many of those who seek Chapter 13 relief in an effort to address tax deficiencies are not abusing the system in any objective sense; nonetheless, many debtors do employ the Chapter 13 process as part of a pattern to evade or defeat a tax. Thus, that the IRS refers to the Chapter 13 process as a "fertile area for tax avoidance and . . . 'the tax shelter of the 90's'" should not be surprising.\textsuperscript{84} To an extent, this characterization is true, and to an extent, it is hyperbole.

This Part begins with a discussion of the present state of law regarding taxes and the Chapter 13 discharge. Specifically, it examines the development of the law as it relates to the treatment of fraudulent taxes and those taxes associated with a willful attempt to evade or defeat a tax. Both of these

\textsuperscript{78} Id. § 7212(a). For an introduction to these and related crimes in the tax context, see Patricia T. Morgan, Tax Procedure and Tax Fraud in a Nutshell 298-324 (1990).
\textsuperscript{79} I.R.C. §§ 6011, 6038, 6721-24.
\textsuperscript{80} Id. §§ 6662-65.
\textsuperscript{81} Id. §§ 6672-73, 6694-95, 6700-02, 7216, 7407.
\textsuperscript{82} Id. § 6656.
\textsuperscript{83} Letter from Internal Revenue Service to National Bankruptcy Review Commission 1 (Aug. 28, 1996) (on file with author).
\textsuperscript{84} Letter from Internal Revenue Service to National Bankruptcy Review Commission 2 (Aug. 28, 1996) (on file with author).
categories of taxes are nondischargeable in a Chapter 7 or Chapter 11 case, but may be discharged in a Chapter 13 case.\textsuperscript{85}

One of the safeguards embedded in Chapter 13 to prevent, among other things, tax abuse is a good faith requirement. Section 1325(a)(3) requires that a Chapter 13 plan be filed in good faith, and, despite the fact that there is no good faith requirement in § 1307(c), many courts have engrafted just such a requirement in Chapter 13 cases. This Part shows that although, in theory, the good faith safeguard may have meaning, in practice it is much too thin a wedge upon which to build a protective wall from abuse.

\textit{A. Fraudulent Taxes}

Although the federal income tax applies to all United States citizens and all residents of the United States, not every citizen or resident must file a tax return.\textsuperscript{86} Generally, filing requirements are triggered by the amount of income an individual taxpayer may receive without having to pay a tax.\textsuperscript{87} This amount is equal to the applicable standard deduction plus the personal exemption. Thus, an individual taxpayer must file a return if the individual has gross income in excess of the applicable standard deduction plus the personal exemption amount.

The failure to file a required return or the filing of a false return constitutes a federal tax crime.\textsuperscript{88} The federal government may also impose civil penalties and interest for the failure to file returns or the filing of fraudulent returns. The burden of proof is on the IRS to establish three elements with respect to a fraudulent return: (1) debtor’s knowledge of the falsehood of the return; (2) debtor’s intent to evade the taxes; and (3) an underpayment of taxes.\textsuperscript{89} Thus, it is not surprising that debts related to unfiled returns,\textsuperscript{90} certain late-filed returns,\textsuperscript{91} and fraudulent returns\textsuperscript{92} are excepted from both the Chapter 7 and

\textsuperscript{85. Compare 11 U.S.C. § 523(a)(1)(C) (1994) (prohibiting a debt to be discharged from a debtor that “made a fraudulent return or willfully attempted in any manner to evade or defeat such tax”) with id. § 1328(a) (instructing courts not to discharge debts in § 523(a)(1) situations).}
\textsuperscript{86. See I.R.C. §§ 6011-17.}
\textsuperscript{87. Id.}
\textsuperscript{88. See id. §§ 7203 (providing that willful failure to file or pay tax is a misdemeanor), 7206(1) (providing that filing a false statement is a felony).}
\textsuperscript{90. See 11 U.S.C. § 523(a)(1)(B)(i); Polly S. Higdon & Kenneth C. Weil, Priority and Dischargeability of Taxes 12-14 (May 1993)(unpublished article, on file with author).}
\textsuperscript{91. See 11 U.S.C. § 523(a)(1)(B)(ii); Higdon & Weil, supra note 90, at 12-14.}
\textsuperscript{92. See 11 U.S.C. § 523(a)(1)(C); Higdon & Weil, supra note 90, at 14-15. Fraud in this context generally means the failure to report income. See, e.g., Levinson v. United States, 969 F.2d 260, 261 (7th Cir. 1992); \textit{In re Brackin}, 148 B.R. at 958.}
Chapter 11 discharge. The problem is that these tax debts are not excepted from the Chapter 13 discharge. To be sure, the good faith requirement for confirmation of plans in Chapter 13 could be used as a gatekeeper; however, as discussed below, the requirement is ill-considered and too thin a wedge to build a wall against debtors who engaged in tax fraud. In the debate surrounding the proper scope of the Chapter 13 discharge, there was little serious controversy in amending §1328(a) to deny discharge of taxes related to a fraudulent return or a failure to file a return. The more difficult question is posed by §523(a)(1)(C), which excepts discharged debts related to a willful attempt to evade or defeat a tax from Chapters 7 and 11, but not Chapter 13.

B. Willful Attempt to Evade or Defeat a Tax

For the sake of argument, assume that most people do not want to provide a discharge of tax liabilities related to a debtor’s fraudulent activity. This is a reasonable policy position and is embodied in Chapter 7 and 11 cases. However, just what type of conduct constitutes a “willful[] attempt[] . . . to evade or defeat [a] tax” defies simplistic attempts to articulate. This definitional stage is where one of the most heated of bankruptcy-tax controversies begins.

Courts generally insist on a fact-intensive approach to fraudulent conduct, requiring a sifting of the facts and circumstances to determine whether the alleged conduct rises to a sufficient level of culpability to justify the denial of the discharge of the taxes. Thus, not all of the badges of fraud must be present for the court to conclude that the taxes should not be discharged. Furthermore, in the appropriate circumstances, the existence of but one badge may permit a court to stamp the conduct of the taxpayer as fraudulent. “Badges of fraud” include the substantial understatement of income, keeping and maintaining inadequate records, implausible or inconsistent explanations of behavior, attempting to conceal illegal activities, dealing in cash, failing to make estimated tax payments, backdating checks, filing false documents, and failing to file returns. Case law suggests that affirmative acts such as the concealment of assets to defeat tax collection efforts, signing a false return knowing the

94. See id. § 1328(a).
95. See id. § 1325(a)(3).
96. See generally id. § 523(a)(1)-(17) (enumerating exceptions to discharge).
97. Id. § 523(a)(1)(C).
100. See Jones v. United States (In re Jones), 116 B.R. 810, 814 (Bankr. D. Kan. 1990). Concealment should also include fraudulent omissions of assets from a collection information statement or other documents provided to the IRS in the collection process. Id.
return to be false, reducing income to avoid a tax levy but keeping cash flow constant by borrowing from the employer, transferring property into trust to frustrate tax collection efforts, filing false Form W-4 forms, or failing to file returns coupled with failing to report substantial amounts of income for several years may constitute indicia of fraud sufficient to render the conduct fraudulent.

Affirmative acts by the taxpayer to attempt willfully to evade or defeat a tax are the easy cases, if such a thing exists. More difficult are the cases in which the taxpayer has simply failed to pay a tax (with or without a lavish lifestyle) or has failed to file returns.

Two cases adequately capture the general debate regarding the willful attempt to defeat or evade taxes. The Eleventh Circuit Court of Appeals, in *Haas v. IRS (In re Haas)*, was in the difficult position of deciding whether a debtor’s mere failure to pay his tax liability should result in the nondischargeability of any tax liability. The court found the nonpayment of taxes not to be included within § 523(a)(1)(C) and that omissions do not satisfy § 523(a)(1)(C). Essentially, the Eleventh Circuit embraced a willfulness standard similar to the criminal tax standard. This standard requires the government to prove that “the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty.” The debtor must have committed an affirmative act in attempt to evade a tax liability, mere omissions are not enough to affect dischargeability.

In contrast, in *Toti v. United States (In re Toti)* the Sixth Circuit Court of Appeals found that the debtor’s failure to file returns was an omission which led to nondischargeability under § 523(a)(1)(C) and that attempts to avoid payment are included within § 523(a)(1)(C). The Fifth Circuit Court of

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106. 48 F.3d 1153 (11th Cir. 1995).  
107. Id. at 1156-57.  
112. 24 F.3d 806 (6th Cir. 1994).  
113. Id. at 809.
Appeals, in Bruner v. United States (In re Bruner), 114 endorsed the view of the Sixth Circuit, although it appeared to apply a standard closer to the Eleventh Circuit’s in Haas than to the Sixth Circuit’s in Toti. 115 Essentially, the Sixth Circuit, like a majority of courts, adopted the civil standard of willfulness. 116 Courts applying this standard generally equate “willful” with “voluntary, conscious, and intentional evasions of tax liabilities.” 117 Under the civil standard, the government is not required to prove an affirmative act on the part of the debtor in order to find that he “willfully attempted to evade or defeat” the tax. In other words, acts or omissions are considered willful under the civil standard. 118

Consistent with the majority of courts that have addressed the issue are the words of a distinguished commentator:

With respect to tax evasion, the discharge exception should apply both to acts of omission as well as acts of commission. Thus, the voluntary, conscious, and intentional failure to file required tax returns and pay taxes when the debtor had the wherewithal to do so is a willful attempt to evade or defeat the debtor’s tax liability within the meaning of Code § 523(a)(1)(C). Courts have overwhelmingly held that a willful attempt “in any manner” to “evade or defeat” a tax includes a willful attempt to evade or defeat payment on the tax. 119

In a note on the subject, Lynn M. Murtha elegantly captures the debate:

114. 55 F.3d 195 (5th Cir. 1995).
115. Id. at 197 n.4; see United States v. Sumpter (In re Sumpter), Nos. 94-1439, 94-1440, 1995 WL 501947, at *3 (6th Cir. Aug. 22, 1995).
117. Toti, 24 F.3d at 809. Some courts purport to apply the civil standard of willfulness by requiring the government to prove that: (1) the debtor had a duty to pay the tax; (2) the debtor knew of the duty to pay the tax; and (3) the debtor voluntarily and intentionally violated this duty. See, e.g., Bruner, 55 F.3d at 197 n.4; Laurin v. United States (In re Laurin), 161 B.R. 73, 75 (Bankr. D. Wyo. 1993); Commissioner v. Peterson (In re Peterson), 152 B.R. 329, 335 (D. Wyo. 1993). However, this standard is the criminal standard for willfulness set forth by the Supreme Court in Cheek v. United States, 498 U.S. 192, 201 (1991).
So, to juxtapose the two standards, the criminal standard of "willfulness" today requires an affirmative act by which the taxpayer voluntarily and intentionally violates a known legal duty. Under the civil standard, "willfulness" requires a voluntary, conscious, and intentional act or omission. Both standards require a voluntary and intentional act. Neither standard is satisfied by negligent acts, and neither standard requires a bad intent or evil motive except to the extent that under the criminal standard, the taxpayer must have the intent to violate a known legal duty. The two standards become even more similar when the examples of affirmative acts contemplated under *Spies* (the criminal standard) are compared to the "badges of fraud" relied upon by some courts adopting the civil standard. Thus, the primary difference between the two standards is the inclusion or exclusion of omissions as conduct constituting willfulness.  

Notwithstanding the cogent reasons given to justify inclusion of omissions within the ambit of tax evasion under § 523(a)(1)(C), *Haas* states the better view that the nonpayment of taxes was not intended to be included within § 523(a)(1)(C) and that omissions generally do not satisfy § 523(a)(1)(C). Debtors generally file for relief under the Bankruptcy Code because they cannot pay their lawful debts, including tax obligations. To fashion a nondischargeability provision from the very act that leads most folks into bankruptcy is quite peculiar. Therefore, § 523(a)(1)(C) should be reserved for instances in which the debtor has engaged in culpable behavior which warrants the nondischargeability of tax liabilities. In this respect the IRS should be treated like any other creditor, and the Bankruptcy Code policy requiring strict construction of exceptions to discharge should be given effect.

The debate over the contours of the tax evasion provision in § 523(a)(1)(C) will not end here. The more relevant inquiry to this Article, however, is why any interpretation of § 523(a)(1)(C) previously advanced would nonetheless fall to the Chapter 13 discharge.

C. Good Faith as a Gatekeeper

Although § 1307(c) of the Bankruptcy Code does not include the bad faith filing of a Chapter 13 plan as a statutory ground for dismissal of a Chapter 13 case, § 1325(a)(3) does provide that the Chapter 13 plan must be proposed in

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121. See *Haas* v. IRS (*In re Haas*), 48 F.3d 1153, 1156-57 (11th Cir. 1995).
good faith as a condition of confirmation of the plan.\textsuperscript{122} Unfortunately, even though courts are willing to dismiss cases in the event of an abuse of the bankruptcy process, the Bankruptcy Code does not define "good faith," no legislative history explains "good faith," and literally hundreds of decisions have produced inconsistent results in the conversion or dismissal of Chapter 13 cases for an alleged bad faith filing.\textsuperscript{123}

In reviewing these decisions, one must consider that the Bankruptcy Amendments and Federal Judgeship Act of 1984 ("BAFJA")\textsuperscript{124} amended portions of the Bankruptcy Code, thereby eliminating certain issues that courts confronted on a regular basis prior to 1984 to determine whether a Chapter 13 debtor had made a bad faith filing. For example, § 109(g)(2) of the Bankruptcy Code now specifically forbids a debtor, in certain circumstances, from refiling for bankruptcy relief within 180 days of a voluntary dismissal of a previous case.\textsuperscript{125} This addition to the Bankruptcy Code reduced the importance of court evaluation of repetitive bankruptcy filings as indicative of a lack of good faith. Additionally, § 1325(b)(b) of the Bankruptcy Code shows that a plan proposed in good faith does not require any specific amount or percentage of payments to unsecured creditors,\textsuperscript{126} whereas prior to BAFJA, courts analyzed whether a Chapter 13 plan proposed substantial or meaningful repayments to unsecured creditors in determining "good faith."\textsuperscript{127}

Unfortunately, clear instruction on how to attack successfully a Chapter 13 case on the basis of a bad faith filing does not exist; there are no charts that enlighten us. Rather, the cases define "good faith" based on a general feel for the case. As the Seventh Circuit has observed, ""[a] comprehensive definition of good faith is not practical."\textsuperscript{128} A recent case decided by the Seventh Circuit Court of Appeals is illustrative of the problem. In In re Smith\textsuperscript{129} a Chapter 13 debtor "fleeced senior citizens" in the state of Indiana by making repairs the debtor knew were unnecessary.\textsuperscript{130} As a result, the state obtained a judgment

\textsuperscript{122} 11 U.S.C. §§ 1307(c), 1325(a)(3) (1997); see also Bradley M. Elbein, The Hole in the Code: Good Faith and Morality in Chapter 13, 34 SAN DIEGO L. REV. 439, 448 n.45 (1997) (indicating that courts disagree as to whether there is an implied good faith finding in Chapter 13).
\textsuperscript{123} For an excellent article on this topic, see Elbein, supra note 122 at 450-56; see also In re Lilley, 185 B.R. 489, 493 (E.D. Pa. 1995) (recognizing that an action can be dismissed for breach of the implicit good faith requirement in Chapter 13), rev'd, 91 F.3d 491 (3d Cir. 1996).
\textsuperscript{125} 11 U.S.C. § 109(g)(2).
\textsuperscript{126} See, e.g., Ravenot v. Ringale (In re Ringale), 669 F.2d 426, 431 (7th Cir. 1982).
\textsuperscript{127} 11 U.S.C. § 1325(b).
\textsuperscript{128} Ringale, 669 F.2d at 431 (quoting Tenney v. Terry (In re Terry), 630 F.2d 634, 635 n.3 (8th Cir. 1980) (quoting 9 COLLIER ON BANKRUPTCY ¶ 9.20, at 319 (James Wm. Moore et al. eds., 14th ed. 1978))).
\textsuperscript{129} 848 F.2d 813 (7th Cir. 1988).
\textsuperscript{130} Id. at 814.
against the debtor under the Indiana Deceptive Consumer Sales Act in the approximate amount of $49,000, most of which was to be held in escrow for distribution to those senior citizens who had been fleeced by the debtor. The debtor filed a Chapter 13 petition and proposed a plan providing for a monthly payment of $115.41. The total payout to the state of Indiana was projected at two percent of the state’s claim at which point the debtor’s obligation to the state would be discharged.

The bankruptcy court found that the debtor’s plan was proposed in good faith, but expressly excluded evidence concerning how the debts arose, stating that “[a] debtor’s prepetition activities do not enter into the Court’s evaluation.” The district court affirmed, and the Seventh Circuit reversed and remanded with direction that the bankruptcy court review the “totality of the circumstances” and determine whether or not the debtor’s Chapter 13 plan was filed in good faith and whether it should be confirmed.

In essence, the Seventh Circuit found that the bankruptcy court erred in failing to consider the “totality of the circumstances” in which the debtor’s debts arose and that, but for the Chapter 13 filing, such debts would otherwise be nondischargeable. Further, the court directed the bankruptcy court to consider that the debtor “relied upon the favorable prospect of using bankruptcy law to avoid repaying his fraudulently won gains.”

In Smith the Seventh Circuit analyzed a number of other decisions which had struggled with the issue of the good faith filing requirement in Chapter 13 cases. Many of the cases that wrestle with the good faith issue articulate lists of various relevant factors in determining whether good faith exists. However, Professors Epstein, Nickles, and White, in their hornbook on bankruptcy law, suggest that a better approach is to consider those acts which might be regarded as amounting to bad faith, such as a small Chapter 13 payment, a term of less than three years, dishonesty, treating some creditors worse than others, gross modification of the rights of secured creditors, repetitious filings, and prebankruptcy behavior. These authors conclude that the real problem in deciding the “good faith” issue is Congress’s failure to

131. Id.
132. Id. at 814-15.
133. Id. at 815.
134. Id. at 815-16.
135. Id. at 816, 821-22.
136. Id. at 821.
137. Id.
138. See id. at 817-20.
139. See Education Assistance Corp. v. Zellner, 827 F.2d 1222, 1227 & n.6 (8th Cir. 1987); In re Chaffin, 816 F.2d 1070, 1073-74 (5th Cir. 1987); Neufeld v. Freeman, 794 F.2d 149, 152-53 (4th Cir. 1986); Kitchens v. Georgia R.R. Bank & Trust Co. (In re Kitchens), 702 F.2d 885, 888-89 (11th Cir. 1983) (per curiam); Ravenot v. Rimale (In re Rimale), 669 F.2d 426, 431-32 (7th Cir. 1982); In re Sutliff, 79 B.R. 151, 154 (Bankr. N.D.N.Y. 1987).
141. Id. § 9-14, at 704-07.
establish clear rules for courts to follow.

Some, like the Bankruptcy Appellate Panel in the Ninth Circuit, say Congress must have intended some difference between the low payout liquidation under which certain debts are not discharged in Chapter 7 and the same transaction in Chapter 13 where those debts are discharged. It is Congress’ failure to state its own mind clearly that has left the courts fumbling through these various factors and apparently contradicting what Congress directed while attempting to do what Congress intended.  

Courts have been particularly reluctant to allow a debtor to proceed in a Chapter 13—have found bad faith—where there is a pattern of tax evasion or avoidance culminating the filing of the bankruptcy. For example, in In re Marcellus, the Seven Circuit Court of Appeals affirmed a bankruptcy court decision that dismissed a Chapter 13 filing for bad faith and prohibited the debtor from filing a petition under Title 11 for two years. The court found that in a previous bankruptcy action the debtor had failed to pay overdue income taxes despite a court order to do so, had failed to file any income taxes since 1984, had no intention of filing any taxes, had engaged in a pattern of activity to frustrate the IRS’s collection activities, and had not proposed a feasible plan in the current bankruptcy. In reaching these conclusions, the court considered a number of factors that should be taken into consideration when making the determination as to whether a petition was filed in bad faith, including: the nature of the debt, the timing of the petition, how the debt arose, the debtor’s motives in filing the petition, how the debtor’s actions affected creditors, the debtor’s treatment of creditors both before and after the petition was filed, and whether the debtor has been forthcoming with the bankruptcy court and the creditors. With only some variations, courts use these factors in analyzing bad faith for both dismissal of a case and confirmation of a plan. Thus, while

142. Id. § 9-14, at 707.
143. See, e.g., In re Marcellus, No. 95-3451, 1997 WL 464100, at *1 (7th Cir. Aug. 4, 1997); Harker v. United States, No. 96-3620, 1997 WL 199507, at *1 (8th Cir. Apr. 7, 1997) (affirming the lower court’s dismissal of Chapter 13 filed “as a litigation tactic to avoid posting an appeal bond [that was otherwise necessary] to postpone assessment by the IRS”); Greatwood v. IRS (In re Greatwood), 120 F.3d 268 (9th Cir. 1997) (affirming dismissal of Chapter 13 for bad faith in failing to file tax returns and to propose a Chapter 13 plan that included payments to the IRS).
145. Id.
146. Id. at *2.
147. See, e.g., Kitchens v. Georgia R.R. Bank & Trust Co. (In re Kitchens), 702 F.2d 885 (11th Cir. 1983). The Eleventh Circuit articulates some of the factors to be considered in determining a debtor’s good faith. These factors include the following:

(1) the amount of the debtor’s income from all sources;
some courts follow the plain language of the statutes by not imposing a good faith requirement on the filing of a Chapter 13,\textsuperscript{148} a number of courts have simply combined the question of whether the plan should not be confirmed because it was propounded in bad faith with the question of whether the case should be dismissed because it was filed in bad faith.

For example, in \textit{In re Crayton}\textsuperscript{149} the Chapter 13 trustee objected to the confirmation of the debtor's Chapter 13 plan based on the debtor's failure to file tax returns before the filing of his Chapter 13 plan coupled with the failure for six months after filing the Chapter 13 plan to comply with federal law by filing the returns. The court conducted an analysis of good faith under § 1325(a)(3) and found that the debtor's failure to file tax returns constituted "unmistakable manifestations of bad faith" and ultimately dismissed the case based on this finding of bad faith.\textsuperscript{150}

Similarly, in \textit{In re Paulson}\textsuperscript{151} the court was faced with an objection to confirmation of the debtor's Chapter 13 plan filed by the IRS and with a motion to dismiss, filed by the Chapter 13 trustee. The \textit{Paulson} debtor had failed to file tax returns or had filed "protest" tax returns, claiming the protection of the Fifth Amendment, for eleven years.\textsuperscript{152} Ultimately, the IRS responded by levying upon the debtor's wages.\textsuperscript{153} The debtor reacted by filing

\begin{itemize}
  \item[(2)] the living expenses of the debtor and his dependents;
  \item[(3)] the amount of attorney's fees;
  \item[(4)] the probable or expected duration of the debtor's Chapter 13 plan;
  \item[(5)] the motivations of the debtor and his sincerity in seeking relief under the provisions of Chapter 13;
  \item[(6)] the debtor's degree of effort;
  \item[(7)] the debtor's ability to earn and the likelihood of fluctuation in his earnings;
  \item[(8)] special circumstances such as inordinate medical expense;
  \item[(9)] the frequency with which the debtor has sought relief under the Bankruptcy Reform Act and its predecessors;
  \item[(10)] the circumstances under which the debtor has contracted his debts and his demonstrated bona fides, or lack of same, in dealings with his creditors; [and]
  \item[(11)] the burden which the plan's administration would place on the trustee.
\end{itemize}

\textit{Id.} at 888-89. These factors have become known as the "totality of the circumstances" test, which has been adopted by a number of other courts. See, e.g., Handeen \textit{v.} LeMaire (\textit{In re LeMaire}), 898 F.2d 1346, 1348 (8th Cir. 1990); \textit{In re Smith}, 848 F.2d 813, 818 (7th Cir. 1988); Metro Employees Credit Union \textit{v.} Okoree-Baah (\textit{In re Okoree-Baah}), 836 F.2d 1030, 1032 (6th Cir. 1988); Neufeld \textit{v.} Freeman, 794 F.2d 149, 152 (4th Cir. 1986); \textit{In re Verdunn}, 160 B.R. 682, 688 (Bankr. M.D. Fla. 1993); \textit{In re March}, 83 B.R. 270, 273 (Bankr. E.D. Pa. 1988).

148. See, e.g., Pennsylvania \textit{v.} Flick (\textit{In re Flick}), 14 B.R. 912, 916 (Bankr. E.D. Pa. 1981) (finding no requirement that a Chapter 13 petition be filed in good faith, but only the requirement that the plan be proposed in good faith).


150. \textit{Id.} at 245.


152. \textit{Id.} at 497.

153. \textit{Id.}
a bankruptcy petition under Chapter 7 and receiving a Chapter 7 discharge which, pursuant to § 727, did not discharge the debtor’s tax liabilities. Therefore, the IRS levied on the debtor’s wages a second time after the Chapter 7 had been concluded. Thereafter, the debtor filed a Chapter 13 petition, which was dismissed on jurisdictional grounds and the levies continued. The debtor finally filed a Chapter 13 case in the proper jurisdiction to stop the IRS collection activities. The plan the IRS objected to proposed that the debtor pay only the priority tax claims over five years without interest. The remaining tax claims were to go unpaid.

The court began with an analysis of whether the plan had been proposed in good faith based on the “totality of the circumstances” surrounding the case. The court explained that where the debt to be discharged under the Chapter 13 could not be discharged under a Chapter 7, it would closely scrutinize the debtor’s motivation and any other relevant factors in considering whether good faith exists. The court found that because the debtor’s pre-petition “flouting of tax laws” was the sole source of his indebtedness, and because the debtor’s plan proposed to satisfy none of the liabilities, except those mandated by § 507, the debtor was attempting to manipulate unfairly the Bankruptcy Code. Therefore, the court sustained the IRS’s objection to confirmation and granted the Chapter 13 Trustee’s motion to dismiss the case.

In In re Love the Seventh Circuit Court of Appeals upheld a finding that the Chapter 13 petition was not filed in good faith, warranting dismissal of the case where the debtor’s tax protest activity resulted in the debtor’s primary source of indebtedness, and where the sole benefit and purpose for filing the Chapter 13 petition was to avoid federal tax liability. The court found “filing a Chapter 13 petition in order to thwart the payment of an otherwise nondischargeable income tax debt arising from the unlawful failure to pay income taxes [is] not one of the intended purposes of the bankruptcy provisions.”

Likewise, in In re Hazel the debtor was a tax protester who failed to file income tax returns for seven years and filed withholding forms with his employer which indicated a lower withholding rate than permitted by federal

154. Id.
155. Id.
156. Id.
157. Id. at 497-98.
158. Id. at 498.
159. Id.
160. Id.
161. Id.
162. Id. at 499-500.
163. Id. at 500.
164. 957 F.2d 1350 (7th Cir. 1992).
165. Id. at 1359.
law. His activities resulted in a $36,043 tax liability to the IRS.\textsuperscript{167} The court found that despite the debtor's abandonment of his tax protester status and acknowledged his obligation to pay taxes, the plan had been filed in bad faith, and, pursuant to § 1325(a)(3), the court dismissed the case.\textsuperscript{168}

In \textit{Schaffner v. IRS}\textsuperscript{169} the court found that the debtor's plan, which sought to discharge over eighty-five percent of the debtor's outstanding tax liability, could not have been proposed in good faith, given the debtor's past tax protestation activities and continued attempts to evade paying taxes. Again, the court denied confirmation of a plan and upheld the dismissal of the debtor's case.\textsuperscript{170}

Given the laundry list of cases where tax protesters have been denied the protections and benefits of the Chapter 13 filing, courts, for the most part, appear unwilling to lend assistance to those seeking to avoid the payment of taxes. Courts generally find this avoidance of taxes is an unfair manipulation of the Bankruptcy Code which they will not condone. Nonetheless, all of these courts seem to contemplate that in certain circumstances it might be appropriate to allow a case to continue, and even to confirm a plan as being proposed in good faith although confirmation would discharge a portion of the debtor's tax liability.

For example, in \textit{In re Verdunn}\textsuperscript{171} the debtor filed a voluntary petition for relief under Chapter 13 after pleading guilty to two criminal counts of false statements and perjury under section 7206(1) of Title 26 of the United States Code. In addition, the debtor had received an IRS notice of deficiency for underpayment of taxes due to fraud for the years 1982 to 1985. This underpayment was due to negligence, delinquency penalties, penalties for negligence for 1986, and interest claims for all of the years at issue.\textsuperscript{172} The debtor's proposed plan provided for payment only for twenty percent of the tax claims.\textsuperscript{173} Despite these facts, the court refused to be persuaded that "a debtor has a plan to defraud the Government where expenses and debts have been accurately stated, and there has been no showing of fraudulent misrepresentation in seeking relief under Chapter 13."\textsuperscript{174} The inquiry the court undertook was to determine whether the debtor sought to abuse the bankruptcy laws by employing them for a purpose for which they were not intended. Rather than finding the debtor was abusing the system, the court found that the debtor was simply exercising his right to use the system strategically.\textsuperscript{175} Thus, while the court had to address other issues prior to a final determination, it was

\textsuperscript{167} \textit{Id.} 68 B.R. at 288.

\textsuperscript{168} \textit{Id.} at 290.


\textsuperscript{170} \textit{Id.} at 65.

\textsuperscript{171} 160 B.R. 682 (Bankr. M.D. Fla. 1993).

\textsuperscript{172} \textit{Id.} at 684.

\textsuperscript{173} \textit{Id.} at 688.

\textsuperscript{174} \textit{Id.}

\textsuperscript{175} \textit{Id.}
“unwilling on a per se basis to find a lack of good faith merely where a debtor is seeking to discharge Tax Claims, albeit fraudulent, especially where the Bankruptcy Code gives certain dispensations.” This possibility illustrated in Verdunn—that under certain circumstances a tax protester could propose a Chapter 13 plan which discharges all or most of the debtor’s tax liabilities—highlights the deficiency with the good faith approach: the risk, and even the likelihood, that courts will disagree over what types of conduct constitute good faith.

For example, in In re Lilley the district court held that cause existed for the dismissal of a debtor’s Chapter 13 case based on the debtor’s prepetition tax fraud. However, the Third Circuit Court of Appeals reversed, holding that prepetition tax fraud cannot support a bad faith dismissal of a Chapter 13 petition. The district court also found that although the plan sought to discharge taxes previously found nondischargeable in a Chapter 7 case and that the plan proposed minimal payments to the IRS, these facts were insufficient to show that the plan was proposed in bad faith.

The need to debate precisely how, under Chapter 13, a court should dismiss a petition for relief because of fraudulent tax activity provides strong evidence that the good faith requirement cannot provide the assurance necessary to prevent abuse. Furthermore, the signal that the Bankruptcy Code sends by making fraudulent taxes presumptively dischargeable in a Chapter 13 case is a bad one. A more direct approach to sanctioning fraudulent tax behavior is in order.

IV. PROPOSED MODEL

This Part analyzes the proposals considered by the Tax Advisory Committee to the National Bankruptcy Review Commission relating to the Chapter 13 discharge and taxes. It builds upon one of the proposals rejected by both the Advisory Committee and the National Bankruptcy Review Commission (“NBRC”), arguing that the proposal provides the most sensible approach to reconciling the tension between tax liabilities and the Chapter 13 discharge.

A. National Bankruptcy Review Commission Proposals

The NBRC, through recommendations by the Tax Advisory Committee, has addressed the use of and perceived abuses of Chapter 13 to avoid tax

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176. *Id.*
178. *Id.* at 494.
179. *See Lilley*, 91 F.3d at 496.
liabilities. The several proposals considered by the Advisory Committee and by the Commission were highly controversial and often failed to achieve a consensus result. For example, Proposal No. 213 addressed the scope of the Chapter 13 discharge as it relates to tax claims. The first proposal was simply to retain the current Chapter 13 superdischarge. The second proposal, favored by the IRS, was to conform the discharge of Chapter 13 to that of Chapter 7, thus excepting most taxes from discharge. The third proposal, more modest than the IRS proposal, would circumscribe the discharge and deny it to those debtors who defrauded the government. This Article adopts this third proposal as the model of discharge. The first proposal sought the retention of the current superdischarge in Chapter 13. The arguments in favor of the superdischarge are well known and forceful. Chapter 13 provides a more robust discharge in return for at least as great a recovery for creditors as they would have received in a Chapter 7 case. The superdischarge breathes life into the fundamental bankruptcy policy of providing an individual debtor a fresh start. However, the arguments against a robust discharge weaken significantly where a debtor has engaged in tax fraud. Dishonest debtors do not deserve and should not receive a fresh start.

The second proposal sought to eliminate the superdischarge of priority taxes in a Chapter 13 case. This proposal aligned the Chapter 13 exceptions to discharge with those of Chapter 7 and of an individual under Chapter 11. The Bankruptcy Code now discharges a Chapter 13 debtor from taxes that are provided for by the plan or are disallowed under § 502. Several courts have held that priority taxes mentioned in the plan are “provided for” and can be discharged whether or not they are actually paid. Similarly, claims for priority taxes that have been disallowed in the bankruptcy proceeding under § 502 and that would not be dischargeable in a Chapter 7 or Chapter 11 case have been held to be dischargeable because they were mentioned in the Chapter 13 plan. The problem most often arises in those cases in which the IRS filed its claim in an untimely manner or where the IRS failed to file a claim at all. The IRS’s most serious concern occurs with derivative liabilities, such

181. See TAX ADVISORY COMMITTEE REPORT, supra note 5, at 56-59.
182. Id.
183. Id. at 56.
184. Id. at 56-57.
185. Id. at 57-58.
186. See id. at 56.
188. Id. § 1328(a).
189. See supra note 67 and accompanying text.
190. See supra notes 67-68 and accompanying text.
as the trust fund recovery penalty,193 under which the debt is prepetition but the
determination of liability does not occur until after the bar date. Additionally,
under present law a Chapter 13 debtor may obtain a discharge for taxes
fraudulently underreported or evaded more than three years from the petition
date.194 Certain tax penalties can also be discharged under Chapter 13, although
those same taxes and penalties would not be dischargeable for individuals in
a Chapter 7 or Chapter 11 case.

B. Proposed Model

The third proposal made by the Advisory Committee is the model
embraced by this Article. This proposal sought to amend § 1328(a) of the
Bankruptcy Code

to deny a discharge to those Chapter 13 debtors who have
filed fraudulent returns or who have engaged in an
affirmative act or acts in an attempt to willfully and
fraudulently evade a tax where the governmental unit proves
in accordance with applicable nonbankruptcy law the
fraudulent conduct in the bankruptcy case.195

Proponents of this third proposal recognized "that taxing authorities receive a
greater recovery in Chapter 13 cases than they do in Chapter 7 cases."196 In
fact, the Bankruptcy Code recognizes this consequence in Chapter 13 cases and
provides incentives for individual debtors to seek relief under Chapter 13.197
These incentives include relief from postpetition interest on unsecured tax
claims, an expanded scope of the automatic stay, and the broad discharge in
§ 1328(a).198 These incentives for filing under Chapter 13 as opposed to
Chapter 7 should be continued. Thus, a broader scope of discharge is justified
under Chapter 13, and the IRS proposal should be rejected.

At the same time, the Chapter 13 process should not provide a haven from
tax liabilities for taxpayers that have defrauded a governmental authority.
Although the requirement that any Chapter 13 plan must be proposed in good
faith may operate as a gate to prevent abuses of the bankruptcy process by tax
protestors and defrauders, courts are not in agreement on the meaning of good
faith in these circumstances and present law lacks clarity.199 Thus, a specific
amendment to § 1328(a) of the Bankruptcy Code is necessary to except tax

195. TAX ADVISORY COMMITTEE REPORT, supra note 5, at 57-58. As Chair of the
Advisory Committee, the author suggested the third proposal.
196. Id. at 57.
198. See id. §§ 1305, 1328(a).
199. See supra Part III.C.
claims involving fraudulent returns or conduct from Chapter 13 discharge where the government proves, in accordance with applicable nonbankruptcy law, the fraudulent conduct in the bankruptcy case.

The Commission also considered Proposal No. 602, which sought to clarify the exception to discharge in § 523(a)(1)(C) regarding a “willful[] attempt in any manner to evade or defeat [a] tax.” This proposal should be an essential element of a modification of the Chapter 13 discharge as detailed above. Essentially, in a bankruptcy case, this proposal requires a taxing authority to show an affirmative act of misconduct accompanied by the requisite intent. The term “willful” as used in § 523(a)(1)(C) would require that a finding of willful attempt to evade or to defeat a tax must be supported by an affirmative act as evidence of wrongful intention to avoid paying a lawful tax. Passive omissions such as failure to file or failure to pay should not be sufficient to support a finding of “willful” under § 523(a)(1)(C). Moreover, it would be incorrect to read the requirement of an “affirmative act” to mean only a de minimis act. The act must be practically and legally significant to the tax evasion. This proposal is consistent with the notion that the honest debtor is deserving of the bankruptcy discharge and reestablishment as a productive and taxpaying member of society.

Those opposed to the proposal argued that a legislative effort to define willful behavior under § 523(a)(1)(C) “will neither reduce nor streamline litigation . . .” According to the opponents, “[t]he inquiry must always be fact specific in each case.” Additionally, the requirement of proof of an affirmative act has been rejected by the majority of courts that have addressed the issue.

In the haste to draw battle lines, we should be careful to acknowledge that the two camps are not too far apart. In fact, a quick perusal of pending litigation in the area would suggest that the “unofficial” position, if there is such a thing, of the federal government is to litigate those cases where the debtor has engaged in affirmative acts of misconduct. To be sure, some exceptions exist, but those cases are exceptions. Both the private bar and the taxing authorities could benefit from some reasonable compromise and consensus.

200. By votes of eight to two and six to four, the Advisory Committee recommended the rejection of the second and third proposals, which state the IRS proposal and the proposal suggesting modest changes to the Chapter 13 discharge, respectively. However, the Advisory Committee failed to reach a majority on the first proposal, which would retain the Chapter 13 superdischarge in all respects. As to the first proposal, four members voted in favor, four voted against, and two abstained. When asked to state a preference for one of the proposals, four members favored the first, four members favored the third, and two members favored the second. See TAX ADVISORY COMMITTEE REPORT, supra note 5, at 58-59.

201. Id. at 116.

202. Id.

203. Id.

204. See, e.g., Dalton v. IRS, 77 F.3d 1297, 1300 (10th Cir. 1996); Bruner v. United States (In re Bruner), 55 F.3d 195, 199 (5th Cir. 1995).
V. CONCLUSION

More than 1.4 million Americans filed for relief under the Bankruptcy Code in 1998.205 Tennessee will witness over one bankruptcy filing for every fifty households; Georgia, one in every fifty-five households; Alabama, one in fifty-nine; Nevada, one in sixty-eight; California, one in seventy-three. Of these states, the top three also administer twice as many Chapter 13 cases as they do Chapter 7 cases.206

Virtually all individuals who file for relief under Chapters 7 or 13 seek the discharge. The bankruptcy discharge operates as a permanent injunction against the enforcement, by formal or informal means, of all dischargeable debts owed by the debtor.207 The discharge is at the heart of the fresh start policy promoted by the Bankruptcy Code. Although a relatively recent addition to bankruptcy law, the discharge has become firmly entrenched in the logic and lore of bankruptcy law and practice. Nevertheless, that lore also states that the discharge is reserved for the honest but unfortunate debtor. Many of the objections to the discharge in a Chapter 7 case square neatly with this maxim. For example, the discharge can be denied for hiding assets, failing to keep adequate financial records, debtor misconduct, and an inability to satisfactorily explain any losses or deficiencies of assets.208 Furthermore, those claims identified as nondischargeable under § 523(a) survive the Chapter 7 discharge. Section 523(a) claims include tax fraud, tax claims, breaches of fiduciary duties, and intentional torts.209 However, the superdischarge in a Chapter 13 case fails to square with the traditional notions of discharge reserved to the honest but unfortunate debtor. Under § 1328(a) almost all debts of the debtor are discharged, even willful misconduct claims are nondischargeable under § 523(a).210 To be sure, a Chapter 13 plan must be proposed in good faith, but good faith is too thin a wedge on which to build a policy to prevent abuse. Thus, the Chapter 13 debtor receives a windfall: The debtor may discharge debts that could not be discharged in a Chapter 7 or Chapter 11 case, debts that should not be dischargeable at all if honesty and discharge remain linked.

206. Id.
208. See id. §§ 727(a), 1141(d)(1)(C).
209. Id. § 523(a).
210. See id. §§ 523(a), 1328(a).