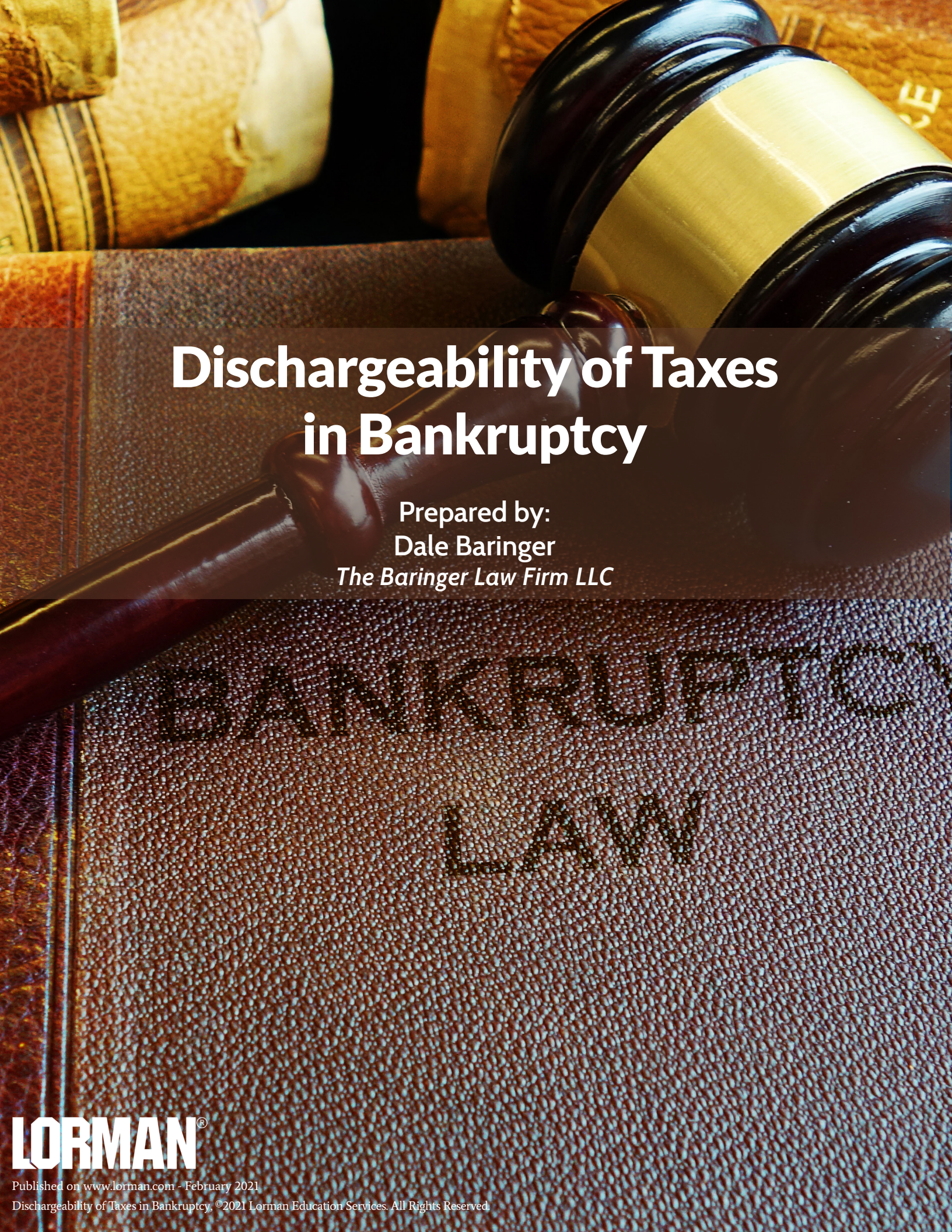


# Dischargeability of Taxes in Bankruptcy

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**Dischargeability of Taxes in Bankruptcy**

A. The Statutory Path to Dischargeability. The Bankruptcy Code provisions which relate to the dischargeability of taxes take one down a somewhat circuitous path in the search for the basic rules on dischargeability of taxes. What follows is the text of the applicable Bankruptcy Code provisions in the order in which statutory path leads the reader.

> 11 U.S.C. §523(a):
> A discharge under §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 §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 such 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;
>
> ...
>
> (14) incurred to pay a tax to the United States that would be nondischargeable pursuant to paragraph (1); ...

> 11 U.S.C. §507(a)(3) provides as follows:
>
> (a) The following expenses and claims have priority in the following order:
>
> ...
>
> (3) Third, unsecured claims allowed under §502(f) of this title.

> 11 U.S.C. §502(f) provides as follows:
>
> In an involuntary case, a claim arising in the ordinary course of the debtor's business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief shall be determined as of the date such claim arises, and shall be allowed under subsections (a), (b), or (c) of this Section or disallowed under Subsections (d) or (e) of this Section, the same as if such claim had arisen before the date of the filing of the petition.

> 11 U.S.C. §507(a)(8) reads as follows:
>
> (8) allowed unsecured claims of governmental units, only to the extent that such claims are for -
>
> (A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition -
>
> (i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;
>
> (ii) assessed within 240 days, before the date of the filing of the petition, exclusive of –

(I) any time during which an offer and compromise with respect to that tax that was pending or in effect during that 240-day period, plus 30 days; and

(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days; or

(iii) other than a tax of a kind specified in §523(a)(1)(B) or §523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case;

(B) a property tax incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition;

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

(D) an employment tax on a wage, salary, or commission of a kind specified in Paragraph (4) of this subsection, earned from the debtor before the date of the filing of the petition, whether or not actually paid before such date, for which a return is last due, under applicable law or under any extension, after three years before the date of the filing of the petition;

(E) an excise tax on -

(i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or

(ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition;

(F) a customs duty arising out of the importation of merchandise -

(i) entered for consumption within one year before the date of the filing of the petition;

(ii) covered by an entry liquidated or reliquidated within one year before the date of the filing of the petition; or (

(iii) entered for consumption within four years before the date of the filing of the petition but unliquidated on such date, if the Secretary of the Treasury certifies that failure to liquidate such entry was due to an investigation pending on such date into assessment of antidumping or countervailing duties or fraud, or if information needed for the proper appraisement or classification of such merchandise was not available to the appropriate customs officer before such date; or

(G) a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss."

An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.

B. A Simpler Path. Focusing on the more commonly encountered taxes, i.e. income and payroll taxes, what follows is an attempt at simplifying these seemingly complex rules. The dischargeability of unsecured federal income tax liabilities depends upon whether a federal tax return was filed and, if so, when it was filed, whether the taxes have been assessed or remain assessable, whether the debtor submitted an offer in compromise, and if so, when it was submitted, and whether the debtor had filed a fraudulent return or has willfully attempted to defeat or evade the tax.

1. Priority Tax Claims

(a) General Rule. In a Chapter 7 case, individuals with priority taxes will not obtain a discharge of taxes given a priority under §507 of the Bankruptcy Code. In a Chapter 11 case, priority taxes are required to be paid in full, within five years of the date of the order of relief under a voluntary or involuntary case, unless the taxing authority agrees to a different treatment. See 11 U.S.C. §1129(a)(9). Note that priority tax claims under 11 U.S.C. §507(a)(8) are only **unsecured claims**. [But as to dischargeability, see the discussion of **In re Gust** and **United States v. Victor** which follows] Certain non-priority tax claims are also non-dischargeable, such as §523(a)(1)(C) claims (fraudulent return/willful evasion tax claims) and secured tax claims in the 11th Circuit under **Gust**] Therefore, if there are tax claims of the type listed in §507(a)(8) that are secured by validly filed tax liens and there is value in property affected by the liens, the claims are secured to the extent of that value and are not priority claims, but may not be dischargeable under §523(a)(1)(A). If the tax is a type which falls within the priority provisions of §507(a)(3) or (8), it is not dischargeable under §727, 1141, 1228(a), or 1328(b), whether or not a claim is filed. Such a tax is dischargeable under a full payment discharge in §1328(a), such that if the government fails to file a proof of claim, the client may get a windfall. The problem is normally in getting there, since §1322(a)(2) requires that the plan provide for full payment, in deferred cash payments, of all claims entitled to priority under §507 unless the holder agrees otherwise, and §1325(a)(6) requires a determination of feasibility before the plan may be confirmed.

(b) Administrative Tax Claims. Note that 11 U.S.C. 507(a)(2), covering administrative expenses incurred post-petition to preserve the assets of the estate, includes taxes which accrue against the estate post-petition. These taxes are not dischargeable, however, in a chapter 7 case these taxes are not liabilities of the debtor but are liabilities only of the bankruptcy estate which is treated as a separate taxpayer under IRC §1398. In the Chapters 11 and 13 context, the plan will not be confirmed if it does not provide for full payment of such claims and the plan will not be confirmed unless it can be shown that such payments are feasible.

(c) The Gap Tax Claims. 11 U.S.C. §507(a)(3) deals with what is commonly known as "gap claims", which are those claims, and in this context, tax claims, which arise between the date of the filing of an involuntary petition for relief and the entry of an order for relief. These tax claims are not dischargeable.

(d) The Three-Year Rule. Where the bankruptcy petition is filed within three years of the due date of the tax return, including extensions, the taxes are priority taxes and not dischargeable. The date the return is actually filed is irrelevant to this rule.

**Example:** A files an extension for his 1997 federal income tax return extending the due date from April 15th to August 15th. Before August 15th, he files the second request for extension to October 15th. On

August 16th, however, he files his tax return. Taxes shown on that tax return are not dischargeable under this rule until at least three years after October 15th, 1998, i.e. the taxes would be dischargeable in a case filed on October 16, 2001, unless excepted from discharge under one of the other rules.

(e) The 240 Day Rule. Those taxes assessed within 240 days, before the date the petition is filed, will be exempt from discharge. The 240-day period is exclusive of any time in which an offer of compromise regarding those taxes is either in effect, or pending, plus 30 days, and any time during which a stay of proceedings against collections was in effect in a prior case under Title 11, plus 90 days. 11 U.S.C. §507(a)(8)(A)(ii). Note that there may be multiple assessments of tax and/or penalty and interest. This is particularly true where a deficiency has been determined and assessed. The 240-day period starts from the date of each of these assessments. There is no relation back to the date of the original assessment of the tax even though for tax purposes interest on the subsequent deficiency accrues from the due date of the return. In re Blank, 137 BR 671 (BC N.D. Ohio 1992; In re Frary, 117 BR 541 (D. Alaska 1990.

(f) The Taxes Assessable Rule. Where the tax remains assessable (i.e. under applicable statutes of limitations) **and** the tax is one **other than** a tax on a nonfiled return or a delinquent return filed within two years of the filing of the bankruptcy petition [covered by §523(a)(1)(B)], or relates to a fraudulent return, the tax is excepted from discharge. 11 U.S.C. §507(a)(8)(iii). Note that this would include taxes which could be assessed as of the petition date or thereafter if an audit of the taxpayer's return gave rise to a finding of a deficiency. Under IRC §6501(a), taxes may be assessed on a return up to three years after the date of the filing of the return. If no return is ever filed, the statute of limitations for making assessments never starts to run. Under IRC §6501(e) if there is an omission from gross income of more than 25% of the amount stated in the return, or the amount which is attributable to assets, with respect to information required to be reported under 26 USC § 6038D, is in excess of $5,000, the statute of limitations is six years for assessment of deficiencies. If the return is false or fraudulent, or there has been a willful attempt to defeat or evade the tax, there is no statute of limitations for assessment of deficiencies. IRC §6501(c). A substitute for return under IRC §6020(b) does not start the running of the statute of limitations.

(g) Premature Filing. If the debtor (should read "the debtor's lawyer") makes a mistake and files a Chapter 7 petition before the priority time provisions have run, he or she may not be permitted to voluntarily dismiss the case. In re Leach, 130 BR 855 (BAP9 1991).

(h) More on the Three-Year Rule. In a Chapter 11 case filed and then converted to Chapter 7, the "date of the filing of the petition" is most likely the date of the original Chapter 11 filing. In re Rassi, 140 BR 490 (BC C.D. Ill 1992); and In re Cross, 119 BR 652 (BC W.D. Wis. 1990). If the debtor files a Chapter 7, receives a discharge and then files a Chapter 11 or Chapter 13, he may not be successful in arguing that the priority periods have run based on the second petition date. See In re Wood, 78 BR 316 (BC M.D. Fla. 1987).

(i) Withholding Taxes. Taxes required to be collected or withheld and for which the debtor is liable in whatever capacity are never dischargeable regardless of when the assessment is made, or the return is filed. Section 507(a)(8) precludes discharge of trust fund taxes without regard to whether the claim is secured or unsecured. The focus is on the nature of the taxes, not the secured nature of the claim. In re Gust, 239 B.R. 630 (S.D. Ga. 1999). But see United

States v. Victor, 121 F3d 1383 (10th Cir. 1997). In Victor, the 10th Circuit conducted a statutory analysis of §523(a)(1)(A) and §507(a)(8) and recognized that there are inconsistencies with the interplay of the statutes. The Victor court acknowledged that §523(a)(1)(A) expressly provides that the taxes are not dischargeable whether or not a claim for such taxes was filed or allowed. The court also recognized that the introductory clause in §507(a)(8) only excepts *allowed* claims, which conflicts with §523(a)(1)(A). Nevertheless, the Victor court ignored this conflict and applied the "unsecured" introductory language of §507(a)(8) to §523(a)(1)(A) dischargeability. The Victor court thus ruled that the tax discharge exception and the statute governing priority of allowed unsecured tax claims authorizes the exception of tax debts and interest from dischargeability under the statute governing effect of confirmation under Chapter 11 only when a governmental entity holds an unsecured claim to the debt. The 11th Circuit, in Gust, found that: "[i]nstead of focusing on the type of 'tax', the Victor court focused on the type of 'claim'. This focus was in error." Therefore, the Gust court held that the debtor's trust fund recovery penalty was not discharged in a prior Chapter 7 case as a debt for "tax required to be collected or withheld," without regard to whether the claim was secured or unsecured. Under the 11 Circuit's analysis, secured or unsecured status of tax claims relates only to whether the claims are entitled to priority and is irrelevant to dischargeability.

An IRS claim for trust fund taxes retains its priority status in the second of serial corporate Chapter 11 filings. Matter of Official Committee of Unsecured Creditors of White Farm Equipment Co., 943 F2d 752 (7th Cir. 1991)

2. Non-filed or Late Filed Returns. §523(a)(1)(B) excepts from the discharge taxes for which no return has been filed. Determination of whether the debtor filed a return may not be clear. The IRC governs what constitutes a tax return. It requires that a tax return:

- be made on the proper form (IRC §6011);
- provide income, deduction, and credit data, and while IRC §6014 allows a taxpayer to have the IRS compute the tax, it is generally sufficient if the return contains sufficient data from which the tax computation can be made;
- use the proper accounting period and proper method of accounting (IRC §§ 441 & 442); and
- be signed by the taxpayer under penalty of perjury (IRC §§6061 & 6065(a)).

A document not on the prescribed form may, nonetheless, be a tax return. Germantown Trust Co. v. Comm., 309 U.S. 304, 84 L.Ed. 770, 60 S.Ct. 566 (1940).

(a) Substitute for Returns. IRC §6020(b) authorizes the IRS to prepare a "dummy" return where the taxpayer does not file a return. IRC §6020(b)(2) provides that such a return is treated as "prima facie good and sufficient for all legal purposes." These are the cases where the IRS computer computes taxes due and assesses a tax based upon information available from prior year's returns and from information reported to the IRS on W-2's, 1099's and other information returns filed with the IRS. Debtors' attempts to obtain discharges from tax debts for which the government prepared the returns have not been successful to this point. See Berostrom v. U.S., 949 F.2d 341 (10th Cir. 1991); Chapin v. U.S., 148 BR 304 (BC C.D. Ill 1992); United States v. D'Avanza, 132 BR 462 (M.D. Fla. 1991); In re Eastwood, 164 BR 989 (BC C.D. Ark. 1994); In re Lowrie, 162 BR 864 (BC D. Nev. 1994); In re Rank, 161 BR 406 (BC N.D. Ohio 1993); Rench v. U.S., 129 BR 649 (BC D. Kan. 1991); In re Crawford, 115 BR 381 (BC N.D. Ga 1990) Pruitt v. U.S., 107 BR 764 (BC D. Wyo. 1989); In re Hoffman, 76 BR 853 (BC S.D. Fla. 1987); In re Haywood, 62 BR 482 (BC N.D. Ill. 1986).

(b) Tax Court Cases on Substitute for Returns. In In re Gushue, 126 BR 202 (BC E.D. Pa. 1991), the taxpayer/debtor had not filed returns for 1975, 1976, 1977 and 1978. In October 1982, the IRS prepared substitute returns pursuant to IRC §6020(b), computing the income, deductions and tax on the net worth basis and mailed a notice of deficiency on November 5, 1982. The taxpayer/debtor filed a petition in the tax court in which ultimately a stipulated decision was entered on January 31, 1986. A Chapter 7 petition was then filed and an adversary proceeding brought to determine dischargeability of the taxes. Taxpayer argued that (1) the return prepared under §6020(b) constituted a return for purposes of the discharge rules, and (2) alternatively, the stipulated decision entered by the Tax Court operated under §6020(a) and Rev. Rul. 74-203, as a tax return for purposes of the discharge rules. Rev. Rul. 74-203 says: "Even though a document is not in the form prescribed for use as the appropriate return, it may constitute a return if it discloses the data from which the tax can be computed, is executed by the taxpayer, and is lodged with the Internal Revenue Service." The Bankruptcy Court held for the IRS reasoning that under In re Chastang, 116 B.R. 833 (Bankr. M.D. Fla. 1990), and other cases, a return prepared by the IRS under IRC §6020(b) is not a return for bankruptcy purposes and, further, the stipulated decision did not rise to the level of a return as the debtor did not cooperate and provide all the necessary information to the IRS.

3. Returns Filed Within Two Years of Petition. Where the debtor has filed a tax return beyond the due date of the return, including extensions, and files bankruptcy within two years of the actual filing date of the return, the taxes are excepted from the discharge. 11 U.S.C. §523(a)(1)(B)(ii).

(a) The Case of In re Doss. In re Doss, 42 BR 749 (BC E.D. Ark. 1984), dealt with the interplay of §§ 507(a)(8)(A)(iii) and 523(a)(1)(B)(ii). Here the taxpayer/debtors filed their 1976, 1977 and 1978 returns on November 30, 1979. Chapter 7 was filed on July 7, 1982. Taxes for 1976, 1977 and 1978 remained unassessed but were assessable. The court held that §507(a)(8)(A)(iii) must be read in conjunction with §523(a)(1)(B)(ii), and if a tax fits within §523(a)(1)(B) or (C), then §507(a)(8)(A)(iii) is not applicable and the taxes are dischargeable. There are cases to the contrary. See In re Torrente, 75 BR 193 (BC S.D. Fla. 1987); and In re Crist, 85 BR 807 (BC N.D. Iowa 1988).

4. Consideration of Chapter 13. Where no return has been filed and/or a substitute for return has been prepared by the IRS, Chapter 13 should be considered. If no federal tax lien is filed, the tax is more than three years old and assessed more than 240 days prior to the bankruptcy, it will be discharged under a successful plan. 11 U.S.C. §1328(a). As these taxes are not priority tax claims under §507, the plan is not required to provide for their payment in full, and they would be dischargeable as any other debts in the Chapter 13.

5. Fraudulent Returns and Willful Attempts to Evade or Defeat a Tax. Under 11 U.S.C. §523(a)(1)(C), the discharge of a tax is denied if there exists (1) fraud, or (2) a willful attempt to evade or defeat the tax.

(a) Fraud. IRC §§ 7201 and 7207 address attempts to evade or defeat a tax and fraudulent returns. Generally, it is probably not necessary that the IRS have previously raised the issue of fraud and prevailed in audit or a Tax Court proceeding in order to raise the issue relative to a bankruptcy filing, even if the tax case was settled without fraud. In re Bogart, ___ BR ___, (BC M.D. Fla. 1992; Levinson v. U.S., 969 F.2d 260 (7th Cir. 1992). In Levinson, the taxpayer/debtor and the IRS settled for tax years 1966-1969 with the taxpayer agreeing to pay the deficiency and the IRS agreeing not to assert civil fraud.

The taxpayer/debtor then filed bankruptcy and the Seventh Circuit affirmed a finding by the Bankruptcy Court of civil fraud and the tax was not dischargeable.

(b) Willful Attempt in Any Manner to Evade or Defeat a Tax. At least one case has held that a chronic failure to file and pay taxes is fraudulent under §523(a)(1)(C). Other cases have not reached the same result except in cases where deliberate acts of fraud, such as transfers of assets were involved. In re Zuhone, 88 F.3d 469 (7th Cir. 1996) [the transfer of ownership to daughters while retaining control of management and spending and other actions from which *mens rea* can be inferred]; In re Birkenstock, 87 F.3d 947 (7th Cir. 1997) [the mere nonpayment of taxes is not sufficient]; In re Fegely, 118 F3d 979 (3rd Cir. 1997) [failure to pay taxes when the taxpayer/debtor had the ability to do so was considered an overt act]; and others.

C. Interest on Tax Claims. How interest on tax claims is treated in bankruptcy depends on whether the claim is secured or unsecured, whether the proceeding is a Chapter 7, 11 or 13, and whether the interest is pre-petition or post-petition.

1. Pre-Petition Interest. Pre-petition interest may be either accrued or assessed. Periodically, the IRS system will assess interest that has accrued. Whether assessed or not, interest accrues at the statutory rate until it is paid.

- Pre-petition interest on unsecured priority tax claims is allowed and is payable in the same manner as the tax claim. Palmer Clay Products Co. V. Brown, 297 US 227, 56 S.Ct. 450 (1936); In re Lewis W. Shurtleff, Inc., 778 F.2d 1416 (9th Cir. 1985). If the priority tax claim is non-dischargeable, the pre-petition interest accrued on the tax claim is non-dischargeable also. Barash v. Public Finance Corp., 658 F2d 504 (7th Cir. 1981); In re Saco Local Development Corp., 30 BR 862 (Bankr. D Me 1983).

2. Post-Petition Interest on Priority Tax Claims.

Post-petition interest on unsecured priority tax claims is generally not allowed, whether the proceeding is a Chapter 7, 11, 12 or 13 because it represents unmatured interest not allowable under section 502.

In re Wakehill Farms, 123 BR 774 (BC N.D. Ohio 1990), held that the IRS was not entitled to post-petition interest on an unsecured priority tax claim that the debtor proposed to pay in deferred installments under a farm debt reorganization. The court rejected the IRS's contention that it was entitled to post-petition interest under 11 USC 1225(a)(4) based on no showing that the unsecured creditors would receive more in a Chapter 7 liquidation).

In re Mitchell, 210 BR 978 (BC N.D. Tex. 1997) held the IRS was not entitled to post-petition interest on an unsecured pre-petition tax claim in a Chapter 12.

However, In re Weinstein, 272 F.3d 39 (1st Cir. 2001) held that post-petition interest accruing on post-petition tax debt was part of the debt itself, which was entitled to a first priority as an administrative expense of a Chapter 7 estate. Also see In re Artisan Woodworkers, 204 F3d 888 (9th Cir. 2000) a consolidated appeal which held post-petition interest was nondischargeable and recoverable against debtors personally, aff'g In re Artisan Woodworkers, 225 BR 185 (BA P9 1998), a Chapter 11 case, and reversing In re Bossert, 230 BR 172 (ED Wash 1999), a Chapter 12 case. See also In re Goodrich, 215 B.R. 638 (BC D. Mass. 1997) which held that the IRS's entire claim for post-petition late filing penalties and interest was entitled to administrative expense status. In re Adcom, Inc., 74 BR 673 (BC D. Mass.1987) held that under the "best interest test" of section 1129 and the "equities of the case," the IRS was entitled to post-petition interest on its unsecured priority tax claim. In a Chapter 13 case, the plan is required to "provide for the full payment, in deferred cash

payments, of all claims entitled to priority under section 507" unless the holder of a particular claim agrees to a different treatment of the claim. See section 1322(a)(2). Courts have held that the distinction between this provision and 1129(a)(9), which requires that the deferred cash payments have "a value as of the effective date of the plan, equal to the allowed amount of such claim," means the deferred payments in a Chapter 13 plan on priority tax claims do not have to include post-petition or post-confirmation interest. See In re Stafford, 24 BR 840, 7 CBC2d 924 (BC D.Kan. 1982); In re Frost, 8 BCD 1377, 19 BR 804 (BC D.Kan 1982), rev'd in part 47 BR 961 (BC Kan 1985).

Post-petition interest on priority tax claims is not allowed to be collected from assets of the estate in a Chapter 7 case unless the estate is solvent.

3. Post-Petition Interest on Tax Claim Secured by Tax Lien . Under 11 USC 506(b), secured creditors are entitled to post-petition interest to the extent of the value of the collateral. In re Ron Pair Enterprises, 489 US 235, 109 S.Ct. 1026, 103 L.Ed. 290 (1989), the Supreme Court made clear that any creditor with a lien on property, whether consensual or nonconsensual, is entitled to the benefits of section 506(b) on an over secured claim. Thus, the IRS is entitled to such interest on its tax claims secured by tax liens.

4. Interest on Non-dischargeable Claims. Interest continues to run on non-dischargeable tax claims and is collectible out of the debtor's after acquired property. Bruning v. U.S., 376 US 358, 84 S.Ct. 906, 11 L.Ed. 2d 772 (1964); United States v. Friendship College, Inc., 737 F2d 430 (4th Cir. 1984); In re Peiffer, 126 BR 364 (BC N.D. Ala 1991); In re Hartman, 110 BR 951 (BC D.Kan 1990).D. Dischargeability of Penalties. Dischargeability and priority status of tax penalties depends upon whether the penalty is nonpecuniary or pecuniary in nature. Section 523(a)(7) provides that no discharge is granted from any debt:

> to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty–
>
> (A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or
>
> (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

Section 507(a)(8)(G) gives priority status to "a penalty related to a claim of a kind specified in this paragraph [a priority tax claim] and in compensation for actual pecuniary loss."

1. Pecuniary and Nonpecuniary Penalties. Nonpecuniary penalties are punitive in nature. They are not designed to compensate for loss. Pecuniary penalties are those which represent collection of the principal amount of the tax liability in the form of a penalty. The best example of a pecuniary penalty is the 100% Responsible Person penalty imposed upon those who are responsible for the failure of a tax paying entity to withhold and remit trust fund taxes. Some examples of nonpecuniary penalties would be the late filing penalty, the negligence penalty, late payment penalty, substantial understatement penalty, etc.

2. Discharge of Penalties Under Section 523(a)(7)(A). Penalties which are nonpecuniary in nature are dischargeable under 523(a)(7)(A) if they relate to a tax which is dischargeable, i.e., a "tax of a kind not specified in" section 523(a)(1).

3. Discharge of Penalties Under Section 523(a)(7)(B). This section deals with nonpecuniary penalties which are dischargeable if they are "imposed with respect to a transaction or event that occurred before three years before the date of filing of the petition." The IRS has argued that 523(a)(7) should be construed to mean that a penalty which is itself more than three years old can never be discharged unless the underlying tax is dischargeable. The issue has been decided adverse to the government in the 9th, 10th and 11th circuits. See In re Hillsborough Holdings Corp., 116 F3d 1391 (11th Cir. 1997); McKay v. U.S., 957 F.2d 689 (9th Cir. 1992); Roberts

v. U.S., 906 F.2d 1440 (10th Cir. 1990). See also In re Xenakis, 262 BR 339 (BC W.D. Pa. 2001) holding penalties dischargeable even though the tax was not, affd in part, rev'd in part, 2001 WL 1805844 (W.D. Pa. 2001) reversing and remanding as to issue of amount of excise taxes). In re Byrum, 139 BR 498 (BC CD Cal. 1992) holding that a civil fraud penalty for the year 1978 was discharged in a Chapter 7 case.

E. Conclusion. The distressed client who is in such state because of tax problems requires a special degree of attention to the dischargeability rules relating to tax claims. The statutory framework alone represents some of the more complex provisions of the Bankruptcy Code. Even more perplexing is the extent to which substantial mistakes may be made if the practitioner does not resort to significant case law behind the statutory provisions and this includes, in many instances, resort to general tax law. If the client comes to you for help in getting out from under his tax claims, don't oversimplify the analysis and advice.

1. There Can Be No Guarantees as to Dischargeability of Taxes. The financial condition of the taxpayer/debtor and the inability to pay substantial legal fees makes it difficult, if not impossible, to adequately investigate the facts to a degree that one can assure the client he faces no exposure under §523(a)(1)(C) to an assertion by the IRS that fraud has been involved or that the client has willfully attempted to evade or defeat at tax. Therefore, all advice to the client should be qualified with such a warning.

2. Take Care in Any Pre-bankruptcy Planning. It may be advisable to caution the client that even a modest amount of pre-bankruptcy planning can expose the client to problems under §523(a)(1)(C). Query: whether negotiating an installment plan and engaging in foot dragging in the process in order to allow the clock to run on the tax claims might be alleged as an overt act in a scheme to willfully attempt to defeat a tax?

3. Always Obtain an IRS Transcript. Under IRC §6203, a certified copy of the record of IRS assessments is available to the taxpayer or his representative. If there is any question at all as to whether an assessment was made or when it was made, it may be advisable to obtain this certified record. A certified copy of the assessments may not always be necessary, but always obtain a transcript from the IRS. This is a computer printout of all of the activity with respect to a taxpayer's tax returns for a given year. Request a tax module, "TXMOD" transcript for any year as to which tax liabilities are outstanding. This will present the full picture of activity that is of relevance. Upon obtaining the transcript, examine the following:

- Check the name and social security number to be certain the transcript is for your client.
- Be certain to obtain all tax years as to which taxes are outstanding.
- Check the amounts shown due for each year.
- Check the date the return was filed.
- Check the original assessment date.
- Check for subsequent audit assessments of tax.
- Review whether an offer in compromise has been submitted, and its disposition:
    - TC 480--Offer pending
    - TC 481--Offer rejected
    - TC 482--Offer withdrawn
- Check to see if an audit is in progress
- Check to see if return was prepared by Examination Division under IRC §6020(b)
- Check to see if Notices of Federal Tax liens have been filed.
- Check for subsequent assessments of interest and penalties and caution the taxpayer/debtor that even though the taxes shown on the return or assessed from audit may be dischargeable under the various rules, assessments of

additional interest and penalties on those prior assessments may not be dischargeable under the 240-day rule.