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Harold E. Wolfe Jr.

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# BANKRUPTCY AS AN ALTERNATIVE TO THE STATUTE OF LIMITATIONS FOR RELIEF FROM OVERDUE INCOME TAXES

by

HAROLD E. WOLFE, JR.\*

## INTRODUCTION

Recently, tax practitioners representing individual taxpayer clients in collection matters or abusive tax shelters have observed taxpayers with large overdue or proposed tax deficiencies which greatly exceed such taxpayer's or taxpayers' assets. A similar scenario may soon appear for those taxpayers who suffered substantial capital losses during the 1987 stock market crash since such capital losses may not be offset against earned income.

For the practitioner handling such cases before the Collections Division of the Internal Revenue Service (or with respect to abusive tax shelters or stock market capital losses, anticipating handling ultimate disposition of such cases before the Collections Division) an Offer in Compromise<sup>1</sup> may not be a viable alternative since such individual taxpayer may possess substantial future earnings potential derived from his or her entrepreneurial skills or business contacts. For this reason, the Internal Revenue Service may be unlikely to entertain an Offer in Compromise based upon doubt as to collectibility<sup>2</sup> since the Collections Division could initially proceed to collect the taxpayer's known assets pursuant to the levy, seizure and sale provisions contained in the Code.<sup>3</sup> Thereafter, the Collections Division may elect to periodically monitor the taxpayer's activities during the six year statute of limitations period on collection<sup>4</sup> to ascertain if the taxpayer has acquired assets subject to future levy<sup>5</sup> or is earning compensation which is subject to a continuing levy if subsequently made during the limitations period.<sup>6</sup>

After the Internal Revenue Service (the "Service") has levied, seized and sold<sup>7</sup> the taxpayer's known property pursuant to Section 6331 *et. seq.* of the Code,

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\* The author is a Florida Bar Board Certified Tax Attorney and Board Certified Estate Planning and Probate Attorney in private practice in West Palm Beach, Florida.

<sup>1</sup> Such Offer in Compromise would largely be based on doubt as to collectibility. *See*, Treas. Reg. § 301.7122-1(a)(2).

<sup>2</sup> Treas. Reg. § 301.7122-1(a)(2).

<sup>3</sup> I.R.C. § 6331(b); Treas. Reg. § 301.6331-1(a)(1).

<sup>4</sup> I.R.C. § 6502(a)(1); Treas. Reg. § 301.6502-1(a)(1).

<sup>5</sup> I.R.C. § 6331(b); Treas. Reg. § 301.6331-1(b).

<sup>6</sup> I.R.C. § 6331(e)(1); Treas. Reg. §§ 301.6331-2(c) and 301.6331-1(a)(4).

<sup>7</sup> I.R.C. § 6331 *et. seq.*; *See specifically* §§ 6331, 6332 and 6335.

the entrepreneurial taxpayer could nonetheless effectively "discharge" the uncollected income tax liability by simply allowing the six year statute of limitations on collections to lapse, provided that no extensions of the statute were made by subsequent agreement.<sup>8</sup> However, this may not be a viable alternative for the entrepreneurial type taxpayer for two reasons. Firstly, his or her business associates will probably avoid doing business with him or her during the remaining statute of limitations period if they envision that their business dealings or personal assets could possibly become "entangled" in the entrepreneurial taxpayer's then outstanding tax liability. Secondly, even though the entrepreneurial taxpayer may have the ability to derive substantial income from salary or other compensation, the accumulation of capital through such means often is not possible due to the Service's ability to levy upon salary and wages on a continuous garnishment basis.<sup>9</sup>

This article analyzes the situations in which a bankruptcy filing could be used as an alternative to the expiration of the statute of limitations on collections and sets forth various considerations that should be reviewed by the practitioner prior to a bankruptcy filing. Practitioners are cautioned that there are many collateral consequences resulting from a taxpayer's bankruptcy petition filing and each case must be analyzed carefully in light of the interplay of the Bankruptcy Code, the Internal Revenue Code and the sparse case law available in this area.

## DISCHARGE OF INCOME TAXES UNDER THE BANKRUPTCY CODE

### *General Rule*

In summary, under the Bankruptcy Code, an individual income tax liability arising prior to the bankruptcy petition filing may generally be discharged in bankruptcy<sup>10</sup> provided that all of the following conditions are met:

1. Such income taxes must not emanate from a taxable year ending on or before the bankruptcy petition filing date for which an income tax

<sup>8</sup> I.R.C. § 6502(a) and Treas. Reg. § 301.6502-1(a)(2).

<sup>9</sup> See *supra* note 6.

<sup>10</sup> See W. ELLIOT, FEDERAL TAX COLLECTIONS, LIENS AND LEVIES, ¶12.8[2][a] at 12-26 (Prentice Hall 1988). The actual bankruptcy discharge for any individual income tax liability arising prior to the bankruptcy petition filing will be made under § 1328 of the Bankruptcy Code in the case of an individual Chapter 13 petition, under § 727 in the case of a liquidation or Section 1141(d) in the case of a reorganization. Section 1328(c)(2) of the Bankruptcy Code discharges an individual debtor of all unsecured debts except any debt "of a kind specified in § 523(a)" of the Bankruptcy Code. In the case of a liquidation, an individual debtor is discharged from all debts that arose before the date of the order of relief under Chapter 7 "[e]xcept as provided in § 523" of the Bankruptcy Code. 11 U.S.C. § 727(b). Section 1141(d)(2) of the Bankruptcy Code also precludes a discharge of income taxes of a type specified in Section 523 with reference to a Chapter 11 case of an individual debtor. Each of the eleven types of income taxes specified in the main text is specifically excepted from discharge in bankruptcy under § 523(a) of the Bankruptcy Code.

The practitioner should further note that no forgiveness of indebtedness income arises to an individual taxpayer whose income tax liability is discharged in bankruptcy since § 108(a)(1)(A) of the

return was last due (including extensions) at any time within three years preceding the bankruptcy filing.<sup>11</sup> The return due date rather than the assessment date is used in measuring the aforesaid three year period.<sup>12</sup>

2. Such income liability must not have been assessed by the Internal Revenue Service within two hundred and forty (240) days of the bankruptcy filing.<sup>13</sup> If the Service receives an Offer in Compro-

Internal Revenue Code specifically provides that gross income does not include any amount of indebtedness of the taxpayer if "the discharge occurs in a title 11 case [a federal bankruptcy case brought under Title 11 of the United States Code]" I.R.C. §§ 108(a)(1)(A) and 108(d)(2). However, the practitioner should further note that there is a reduction of certain tax attributes under § 108(b) of the Internal Revenue Code when the taxpayer files a federal bankruptcy case; however, a discussion of the reduction of tax attributes of the insolvent individual debtor is beyond the scope of this article. *See also*, I.R.C. § 108(d)(8). For a good discussion of the reduction of such tax attributes, *See*, McQUEEN & CRESTOL, FEDERAL TAX ASPECTS OF BANKRUPTCY, § 2.12 *et. seq.*, (1987 Edition); *See also*, Section of this article entitled "Audit, Appeals, Tax Court Proceedings and Extension of the Statute of Limitations" and *supra* note 60.

<sup>11</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(A)(i) and 523(a)(1)(A); 124 Cong. Rec. H 11-112-113 (daily ed. Sept. 28, 1978); S 17,428 (daily ed. Oct. 6, 1978); The applicable Committee Reports to Pub.L. No. 95-598, 95th Cong., 2d Sess., 92 Stat. 2583 (1978) provide as follows:

Under the amendment, the following federal, state and local taxes are included within the sixth [now redesignated as seventh] priority:

First. Income and gross receipts taxes incurred before the date of the petition for which the last due date of the return, including all extensions of time granted to file the return, occurred within 3 years before the date on which the petition was filed, or after the petition date. Under this rule, the due date of the return, rather than the date on which the taxes were assessed, determines the priority.

*In re* Molina, 63 AFTR 2d 570 (S.D. Ohio 1988); *In re* Bradley, 36 B.R. 655 (Bkrcty. D. Md. 1984); *In re* Simms, 33 B.R. 792 (Bkrcty. N.D. Ga. 1983); *In re* Colson, 67 B.R. 30 (Bkrcty. M.D. Ga. 1986); *In re* Gerulis, 56 B.R. 283 (Bkrcty. D. Minn. 1985); *In re* Resnick, 52 B.R.90 (Bkrcty. D. Mass. 1985); *In re* Hoffman, 76 B.R. 853 (Bkrcty S.D. Fla. 1987); *cf.*, *In re* Carter, 74 B.R. 613 (Bkrcty. E.D. Pa. 1987).

<sup>12</sup> *See supra* note 11.

<sup>13</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(A)(ii) and 523(a)(1)(A); *In re* Kostoglou, 74 B.R. 202 (Bkrcty N.D. Ohio 1987); The applicable Committee Reports to Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2583 (1978) provide as follows:

Under the amendment, the following federal, state and local taxes are included in the sixth (now redesignated as seventh) priority:

Second. Income and gross receipts taxes assessed at any time within 240 days before the petition date. Under this rule, the date on which the governmental unit assesses the tax, rather than the due date of the return, determines the priority.

As noted above, the date when the Service assesses the tax, rather than the due date of the return, determines the priority, 124 Cong. Rec. H 11, 112-13 (daily ed. Sept. 28, 1978); S, 17,428-30 (daily ed. Oct. 6, 1978).

*See also*, W. ELLIOT, FEDERAL TAX COLLECTIONS, LIENS AND LEVIES, ¶12.8[2][i] at 12-30 (Prentice Hall 1988).

*cf.*, *In re* Whitehead, 61 B.R. 397 (Bkrcty. D. Ore. 1986).

mise,<sup>14</sup> the aforesaid two hundred and forty (240) day period is suspended for the Offer in Compromise's duration and will resume running only after the Offer in Compromise is withdrawn by the taxpayer or rejected by the Service.<sup>15</sup> The taxpayer's income tax liability will not be discharged in bankruptcy if the "... petition is filed during the balance of the 240 day period or during a minimum of thirty days after the offer is withdrawn or rejected."<sup>16</sup>

3. The taxpayer must not have extended the statute of limitations on assessment or collection with respect to such income tax liability.<sup>17</sup>
4. As to any assessed income tax liability for which discharge is sought, the taxpayer must not be currently engaged in litigation in the Tax Court with respect to such tax liability.<sup>18</sup>

<sup>14</sup> I.R.C. § 7122(a); Treas. Reg. § 301.7122-1(a).

<sup>15</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(A)(ii) and 523(a)(1)(A); Committee Reports Pub.L. No. 95-598, 95th Cong., 2d Sess., 92 Stat. 2583 (1978). The applicable language from the Committee Reports provides as follows:

If, following assessment of a tax, the *debtor submits an offer in compromise* to the governmental unit, the House amendment provides that *the 240-day period is to be suspended for the duration of the offer and will resume running after the offer is withdrawn or rejected by the governmental unit, but the tax liability will receive priority if the title 11 petition is filed during the balance of the 240-day period or during a minimum of 30 days after the offer is withdrawn or rejected.* This rule modifies a provision of the Senate amendment dealing specifically with offers in compromise. Under the modified rule, if, after the assessment, an offer in compromise is submitted by the debtor and is still pending (without having been accepted or rejected) at the date on which a title 11 petition is filed, the underlying liability will receive sixth [now designated seventh] priority. However, if an assessment of a tax liability is made but the tax is not collected within 240 days, the tax will not receive priority under Section 507(a)(6)(A)(i) [now redesignated as Section 507(a)(7)(A)(ii)] and the debtor cannot receive a priority for that tax by submitting an offer in compromise. (emphasis added)

<sup>16</sup> See *supra* note 15; S. REP. No. 989, 95th Cong., 2d Sess. 68-73 (18); cf. *Dail v. United States*, 635 F.2d 315 (4th Cir. 1980), *cert. denied*, 454 U.S. 838 (1981).

<sup>17</sup> Bankruptcy Code, 11 U.S.C. § 507(a)(7)(A)(iii); Committee Reports Pub.L. No.95-598, 95th Cong., 2d. Sess., 92 Stat. 2583 (1978); The applicable Committee Reports provide as follows:

Under the amendment, the following federal, state and local taxes are included in the sixth [now redesignated seventh] priority:

Third. Income and gross receipts *taxes not assessed before the petition date but still permitted, under otherwise applicable tax laws, to be assessed.* Thus, for example, a prepetition tax liability is to receive sixth [now redesignated seventh] priority under this rule if, *under the applicable statute of limitations, the tax liability can still be assessed by the tax authority.* (emphasis added)

See also, *In re Massoni*, 20 B.R. 416 (Bkrcty. D. Kan. 1982) where the debtor extended the statute of limitations on collection after filing of the bankruptcy petition and, accordingly, the court held that the Internal Revenue Service was still entitled to priority treatment with respect to such tax and such tax was therefore assessable by the Internal Revenue Service.

<sup>18</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(A)(iii) and 523(a)(1)(A); I.R.C. § 6503(a)(1); Committee Reports Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2583 (1978); The applicable Committee Reports

5. If the income tax liability has not been assessed by the Service as of the date of the taxpayer's bankruptcy petition filing, assessment of such income tax must not be otherwise permitted under applicable tax laws (e.g., statute of limitations period on assessment remains by operation of law).<sup>19</sup>
6. If any return for income taxes was filed late, the return from which the tax liability emanates must not have been filed within the two

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provide as follows:

Under the amendment, the following federal, state and local taxes are included in the sixth [now redesignated seventh] priority:

Third. Income and gross receipts taxes not assessed before the petition date but still permitted, under otherwise applicable tax laws, to be assessed. Thus, for example, a prepetition tax liability is to receive sixth [now redesignated seventh] priority under this rule if, under the applicable statute of limitations, the tax liability can still be assessed by the tax authority. The rule also covers situations referred to in Section 507(a)(6)(B)(ii) [now redesignated Section 507(a)(7)(A)(iii)] of the Senate Amendment where the assessment or collection of a tax was prohibited before the petition pending exhaustion of judicial or administrative remedies, except that the House amendment eliminates the 300-day limitation of the Senate bill. *So, for example, if before the petition a debtor was engaged in litigation in the Tax Court, during which the Internal Revenue Code [Title 26] bars the Internal Revenue Service from assessing or collecting the tax, and if the tax court decision is made in favor of the Service before the petition under title 11 is filed, thereby lifting the restrictions on assessment and collection, the tax liability will receive sixth [now redesignated seventh] priority even if the tax authority does not make an assessment within 300 days before the petition (provided, of course, that the statute of limitations on assessment has not expired by the petition date).* (emphasis added)

Additionally, the practitioner should be aware that if a statutory notice of deficiency is contested by the taxpayer in the Tax Court, the statute of limitations is suspended until the decision of the Tax Court becomes final plus a period of sixty (60) days after such final decision was rendered. I.R.C. § 6503(i)(1).

<sup>19</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(A)(iii) and 523(a)(1)(A); Committee Reports Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2583 (1978); *See also supra* note 18.

Additionally, where an individual taxpayer has filed a bankruptcy petition the practitioner should be aware that the statute of limitations is extended for nondischargeable income taxes for an additional sixty day period following expiration of the period where the Service was prohibited from collecting the tax pursuant to the automatic stay procedures under Section 362(a) of the Bankruptcy Code. I.R.C. § 6503(i)(1). Treas. Reg. § 301.6503(a)-1(a)(1). Under § 362(c)(2) of the Bankruptcy Code, the stay continues until the bankruptcy case is closed or dismissed, or the discharge is granted or denied. *See also, In re Berry*, 11 B.R. 886 (Bkrcty. W.D. Pa. 1981); *James R. Clark*, 90 T.C. 6 (1988). Therefore, under 11 U.S.C. § 507(a)(7)(A)(iii), even though the statute of limitations would have normally expired and the tax would be non-assessable on the date the Service issues a post-bankruptcy proceeding statutory notice of deficiency, the taxpayer should be fully aware of the aforesaid sixty day extension of the statute of limitations period under I.R.C. § 6503(i)(1) by virtue of the taxpayer's previous bankruptcy filing even though the normal statute of limitations period would have expired.

*In re Easton*, 59 B.R. 714 (Bkrcty. C.D. Ill. 1986); *In re Longley*, 66 B.R. 237 (Bkrcty. N.D. Ohio 1986); *In re OPM Leasing Servs, Inc.*, 68 B.R. 979 (Bkrcty. S.D. N.Y. 1987). *In re Edwards*, 74 B.R. 661 (Bkrcty. N.D. Ohio 1987); *In re Torrente*, 75 B.R. 193 (Bkrcty. S.D. Fla. 1987); *In re Franklin*, 78 B.R. 118

year period preceding the date of the bankruptcy petition.<sup>20</sup> The tax year for which the late filed return relates is immaterial.<sup>21</sup>

7. Such income taxes must not relate to a tax year for which an income tax return was not filed.<sup>22</sup>
8. Such income taxes must not relate to a fraudulent return or a return for which the taxpayer attempted in any manner to evade or defeat such income tax.<sup>23</sup>
9. Such income taxes must not relate to either payroll or withholding

(Bkrcty. E.D. Va. 1987); *cf.*, *In re Higgins*, 11 B.C.D. 7 (Iowa 1983). *cf. also*, *Estate of Walley*, 259 F.2d 579 (9th Cir. 1958).

<sup>20</sup> Bankruptcy Code, 11 U.S.C. § 523(a)(1)(B)(ii); Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2590 (1978); *See also*, 124 Cong. Rec. H 11, 113-14 (daily ed. Sept. 28, 1978); S 17,430-31 (daily ed. Oct. 6, 1978); The applicable language from the Committee Reports provides as follows:

The House amendment retains the basic categories of nondischargeable tax liabilities contained in both bills, but restricts the time limits on certain nondischargeable taxes. Under the amendment, nondischargeable taxes cover taxes entitled to priority under Section 507(a)(6) [now Section 507(a)(7)] of title 11 and, in the case of individual debtors under chapters 7, 11, or 13, tax liabilities with respect to which no required return had been filed or as to which a late return had been filed if the return became last due, including extensions, within 2 years before the date of the petition or became due after the petition or as to which the debtor made a fraudulent return, entry or invoice or fraudulently attempted to evade or defeat the tax. (emphasis added)

The above language is less than clear as to the two year period; however, 11 U.S.C. § 523(a)(1)(B)(ii) appears to actually clarify such language by providing: (B) With respect to which a return, if required -

(ii) Was filed after the date on which the return was last due, under applicable law or any extension, and after two (2) years before the date of the filing of the petition. (emphasis added)

<sup>21</sup> S. REP. No. 95-989 (Notes of the Committee on the Judiciary), Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2590 (1978); The applicable language from the Notes on the Committee of the Judiciary of this Senate Finance Committee Report referenced above (before amendment of the bill by the House of Representatives) provides as follows:

Also included in the nondishargeable debts are taxes for which the debtor had not filed a required return as of the petition date, or for which a return had been filed beyond its last permitted due date (§ 523(a)(1)(B)). For this purpose, the date of the tax year to which the return relates is immaterial. The late return rule applies, however, only to the late returns filed within three years before the petition was filed, and to late returns filed after the petition in title 11 was filed. For this purpose, the taxable year in question need not be one or more of the three years immediately preceding the filing of the petition. (emphasis added)

The reader should note that the Senate bill was amended by the House and therefore portions of the above-referenced Committee Reports are inapplicable since the statute was modified in Committee.

<sup>22</sup> Bankruptcy Code, 11 U.S.C. § 523(a)(1)(B)(i); *In re Haywood*, 62 B.R. 482 (Bkrcty. N.D. Ill. 1986); *See also, supra* note 20.

<sup>23</sup> Bankruptcy Code, 11 U.S.C. § 523(a)(1)(C); *See also* quoted language *supra* note 19; *In re Harris*, 59 B.R. 545, (Bkrcty. W.D. Va. 1986); *See, e.g.*, *A.K. Electric Corp. v. City of New York*, 495 F. 2d 1156 (2d. Cir. 1974); *In re Muina*, 75 B.R. 192 (Bkrcty. S.D. Fla. 1987).

taxes or the "100% penalty" imposed on a responsible "person" under Section 6672 for failure to withhold income taxes on the employees' share of social security taxes.<sup>24</sup>

10. In the case of an individual taxpayer who is an employer, such income taxes must not relate to the employer's share of employment taxes on wages, salaries or commissions for compensation up to a maximum of \$2,000 per individual employee which was earned during the ninety days before (i) the bankruptcy petition filing or (ii) the cessation of the debtor/taxpayer's business, as applicable, for which a return was last due, under applicable law or any

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<sup>24</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(C) and 523(a)(1)(A); Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2583 (1978); The applicable Committee Reports provide as follows:

Under the amendment the following federal, state and local taxes are included in the sixth [now redesignated seventh] priority:

Fifth. Taxes for which the debtor was required by law to withhold or collect from others and for which he is liable in any capacity, regardless of the age of the tax claims. This category covers the so-called "trust fund" taxes, that is, income taxes which an employer is required to withhold from the pay of his employees, and the employees' share of social security taxes.

In addition, this category includes the liability of a responsible officer under the Internal Revenue Code (sec. 6672 [section 6672 of Title 26, Internal Revenue Code]) for income taxes or for the employees' share of social security taxes which that officer was responsible for withholding from the wages of employees and paying to the Treasury, although he was not himself the employer. This priority will operate when a person found to be a responsible officer has himself filed in title 11, and the priority will cover the debtor's responsible officer liability regardless of the age of the tax year to which the tax relates. The United States Supreme Court has interpreted present law to require the same result will be reached under this rule. *United States v. Sotelo*, 436 U.S. 268 (1978) rehearing denied 438 U.S. 907 (1978).

This category also includes the liability under section 3505 of the Internal Revenue Code [section 3505 of Title 26, Internal Revenue Code] of a taxpayer who loans money for the payment of wages or other compensation.

*In re Murrell*, 57 B.R. 449 (Bkrcty. W.D. La. 1985); *In re Coleman*, 19 B.R. 529, 8 B.C.D. 1329, 6 C.B.C. 2d 623 (Bkrcty. D. Kansas 1982); *In re Myers*, 36 B.R. 576 (Bkrcty. D. Idaho 1984); *In re Turner*, 35 B.R. 811 (Bkrcty. D. N.D. 1983); *In re Madia*, 68 B.R. 11 (Bkrcty. D. N.J. 1986); *In re Clark*, 64 B.R. 437 (Bkrcty. M.D. Fla. 1986); *In re Shank*, 792 F.2d 829 (9th Cir. 1986); *In re Terrell*, 65 B.R. 365 (Bkrcty. N.D. Ala. 1986). However, if the Internal Revenue Service fails to prove that the debtor was a responsible "person" for purposes of § 6672 of the Internal Revenue Code, the trust fund taxes will not be given seventh priority in bankruptcy. *United States v. Kontaratos*, 36 B.R. 928 (Bkrcty. D. Me. 1984); *In re Brahm*, 52 B.R. 606 (Bkrcty. M.D. Fla. 1985); *Abramson v. United States*, 48 B.R. 809 (Bkrcty. E.D. N.Y. 1985); *In re Smith*, 68 B.R. 105 (Bkrcty. W.D. Mo. 1986). See also, W. ELLIOT, FEDERAL TAX COLLECTIONS, LIENS AND LEVIES, ¶12.8[d][iii] and 12.9[3][a][i] at pp. 12-30 and 12-35 (Prentice Hall 1988).

For the definition of a responsible "person" for purposes of imposition of the "100% penalty" under I.R.C. § 6672, reference should be made to I.R.C. § 6671(b) and *White v. United States*, 372 F.2d 513 (Ct. Cl. 1967).



extension, within three years of the filing date of the bankruptcy petition.<sup>25</sup>

11. Such income taxes must not constitute nonpunitive type tax penalties "in compensation for actual pecuniary loss" which are related to a nondischargeable tax liability of a type specified in Paragraphs 1, 2, 3, 4, 5, 9 or 10 above.<sup>26</sup> Further, such income taxes must not

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<sup>25</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(D), 507(a)(3) and 523(a)(1)(A); Committee Reports, Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2583 (1978); The applicable Committee Reports provide as follows:

Under the amendment the following federal, state and local taxes are included in the sixth [now redesignated seventh] priority:

Sixth. The employer's share of employment taxes on wages paid before the petition and on third-priority wages paid postpetition by the estate. The priority rules under the House amendment governing employment taxes can thus be summarized as follows: Claims for the employee's shares of employment taxes attributable to wages both earned and paid before the filing of the petition are to receive sixth [now redesignated seventh] priority. In the case of employee wages earned, but not paid, before the filing of the bankruptcy petition, claims for the employees' share of employment taxes receive third priority to the extent the wages themselves receive third priority. Claims which relate to wages earned before the petition, but not paid before the petition (and which are not entitled to the third priority under the rule set out above), will be paid as general claims. Since the related wages will receive no priority, the related employment taxes would also be paid as nonpriority general claims.

The employer's share of the employment taxes on wages earned and paid before the bankruptcy petition will receive sixth [now redesignated seventh] priority to the extent the return for these taxes was last due (including extensions of time) within 3 years before the filing of the petition, or was due after the petition was filed. Older tax claims of this nature will be payable as general claims. In the case of wages earned by employees before the petition, but actually paid by the trustee (as claims against the estate) after the title 11 case commenced, the employer's share of the employment taxes on third priority wages will be payable as sixth [now redesignated seventh] priority claims and the employer's taxes on prepetition wages which are treated only as general claims. In calculating the amounts payable as general wages claims, the trustee must pay the employer's share of employment taxes on such wages. The House amendment thus deletes the provision of the Senate amendment that certain employer taxes receive third priority and are to be paid immediately after payment if third priority wages and the employees' shares of employment taxes on those wages.

In the case of employment taxes relating to wages earned and paid after the petition, both the employees' shares and the employer's share will receive first priority as administration expenses of the estate.

*Cf.*, *Muntwyler v. United States*, 703 F.2d 1030, 1032 (7th Cir. 1983) as to application of voluntary payment to the Service of employment taxes; *In re Skjonsby Truck Line, Inc.*, 39 B.R. 971 (Bkrcty.D.N.D. 1984); *See also*, I.R.S. Policy Statement P-5-60 reprinted in Internal Revenue Manual (CCH) 1305-15.

<sup>26</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(G) and 523(a)(1)(A); *In re Reich*, 66 B.R. 554 (Bkrcty. D. Colo. 1986) [prepetition interest had priority as a penalty].

constitute penalties not in compensation for actual pecuniary loss (i.e., a “punitive” type penalty), including tax penalties, where such tax penalties were (i) basically punitive in nature and computed by reference to a related tax liability which is nondischargeable in bankruptcy or (ii) if the amount of the tax penalty is not computed by reference to a tax liability, such tax penalty must be imposed with respect to a transaction or event that occurred within the three year period ending on the filing date of the bankruptcy petition.<sup>27</sup>

Assuming that the taxpayer/debtor runs the gauntlet of the eleven above-referenced rules, then his or her prior income tax liability may generally be discharged in bankruptcy.

The two principal general rules are that (i) the taxpayer/debtor’s income tax liability arising prior to the bankruptcy petition filing must not emanate from an income tax return that was last due within three years preceding the bankruptcy filing and (ii) notwithstanding the aforesaid “three year rule,” the income tax liability must not have been assessed within 240 days of the bankruptcy filing.<sup>28</sup> However, several of the “ancillary” rules referenced above substantially modify these two principal rules and should be examined carefully by the practitioner prior to advising his or her client to file a bankruptcy petition in order to discharge an income tax liability.

#### *Audit Appeals, Tax Court Proceedings and Extensions of the Statute of Limitations*

Under Section 507(a)(7)(A)(iii) of the Bankruptcy Code, a creditor priority is preserved for income taxes “not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case.”<sup>29</sup> This Section and Section 523(a)(1)(A) of the Bankruptcy Code preserve the Service’s creditor

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<sup>27</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(G) and 523(a)(7); Committee Reports, Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2590 (1978). The applicable Committee Reports provide as follows:

The House amendment also adopts the Senate amendment provision limiting the nondischargeability of punitive tax penalties, that is, penalties other than those which represent collection of a principal amount of tax liability through the form of a “penalty.” Under the House amendment, tax penalties which are basically punitive in nature are to be nondischargeable only if the penalty is computed by reference to a related tax liability which is nondischargeable or, if the amount of the penalty is not computed by reference to a tax liability, the transaction or event giving rise to the penalty occurred during the 3-year period ending on the date of the petition.

*In re* New England Carpet Co., 26 B.R. 934 (Bkrtcy. D. Vt. 1983); *In re* Hernando Appliances, Inc., 41 B.R. 24 (Bkrtcy. N.D. Miss. 1983); *cf.*, *In re* Quality Sign Co., 51 B.R. 351 (Bkrtcy. S.D. Ind. 1985) and *In re* IML Freight, Inc., 65 B.R. 788 (Bkrtcy. D. Utah 1986).

<sup>28</sup> See *supra* notes 11, 12, 14 and 15.

<sup>29</sup> Bankruptcy Code, 11 U.S.C. § 523(a)(1)(A); See *supra* note 18.

priority status for and preclude the taxpayer/debtor's bankruptcy discharge of income taxes emanating from such situations where the statute of limitations on assessment has been extended (pursuant to a validly filed I.R.S. Form 872 or 872-A) and the Service has taken no direct action against the taxpayer pending resolution of a tax shelter case at the partnership level, the taxpayer is negotiating directly with the Service at the audit or appeals level pursuant to an extension of the statute of limitations on assessment, or the taxpayer is engaged in litigation with the Service in the Tax Court.<sup>30</sup>

If the entrepreneurial taxpayer or taxpayer involved in an abusive tax shelter has previously extended the statute of limitations on assessment and now desires to utilize the bankruptcy route to discharge his or her seemingly insurmountable tax liability, such taxpayer, at a minimum, must first force the Service to issue a statutory notice of deficiency, if possible. Issuance of a statutory notice of deficiency generally begins both the running of (i) the remaining period of the statute of limitations on assessment and (ii) the 240-day period preceding a bankruptcy filing where no income tax may be assessed if a discharge is sought for such income tax liability.<sup>31</sup> Even if the taxpayer has filed a valid Form 872-A (Special Consent to Extend the Time to Assess Tax) with the Service extending the statute of limitations, the taxpayer may nonetheless file a Form 872-T (Notice of Termination of Special

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<sup>30</sup> See *supra* note 18; cf. *In re Hoffman*, 76 B.R. 853 (Bkrcty. S.D. Fla. 1987); S. REP. 95-989 of the Notes of the Committee on the Judiciary, Pub.L. No. 95-598, 95th Cong., 2d. Sess. (1978) provides as follows:

In the case of certain Federal taxes, this [Section 507(a)(7)(A)(iii)] *preserves a priority for tax liabilities for more than three years before the filing of the petition where the debtor and the Internal Revenue Service were negotiating over the audit of the debtor's returns or were engaged in litigation in the Tax Court.* In such situations, the tax law prohibits the Service's right to assess a tax deficiency until 90 days after the Service sends the taxpayer a deficiency letter or, if the taxpayer files a petition in the Tax Court during that 90 day period, until the outcome of the litigation. (emphasis added)

<sup>31</sup> I.R.C. § 6501(c)(4); Treas. Reg. § 301.6501(c)-1(d); Edward P. Johnson, 68 T.C. 637 (1977); Irving S. Freedman, 86 T.C. M. (P-H) 257 (1986); Borg-Warner Corporation, 660 F.2d 324 (7th Cir. 1981); cf. Richard P. Valk, 84 T.C. M. (P-H) 622 (1984); I.R.S. Form 872-A (Revised June 1986) generally provides as follows:

The amount(s) of any Federal \_\_\_\_\_ (kind of tax) tax due on any return(s) made by or for the above taxpayer(s) for the period(s) ended \_\_\_\_\_ may be assessed on or before the 90th (ninetieth) day after: (a) the Internal Revenue Service office considering the case receives Form 872-T, Notice of Termination of Special Consent to Extend the Time to Assess Tax, from the taxpayer(s); or (b) the Internal Revenue Service mails Form 872-T to the taxpayer(s); or (c) the Internal Revenue Service mails a notice of deficiency for such period(s); except that if a notice of deficiency is sent to the taxpayer(s), the time for assessing the tax for the period(s) stated in the notice of deficiency will end 60 days after the period during which the making of an assessment is prohibited. A final adverse determination subject to declaratory judgment under sections 7428, 7476, or 7477 of the Internal Revenue Code will not terminate this agreement. (emphasis added)

Thus, assuming that a Tax Court petition is not filed which could trigger the Appeals Division of the Service's right to again review the case, the statute of limitations thus continues to run.

See also, Bankruptcy Code 11 U.S.C. § 507(a)(7)(A)(ii); see *supra* note 13.

Consent to Extend the Time to Assess Tax) with the Service's office then handling the audit or appeal, thus terminating the taxpayer's consent to extension of the statute of limitations on assessment.<sup>32</sup>

By these actions, the taxpayer necessarily positions himself or herself so that the Service must either issue a statutory notice of deficiency within ninety days or otherwise the statute of limitations on assessment will expire. If the Service properly issues a statutory notice of deficiency within ninety days, the taxpayer may then generally discharge in bankruptcy such income tax liability after expiration of the 240 day period following issuance of the statutory notice of deficiency.

The interplay between the Bankruptcy Code and the Internal Revenue Code can be seen in the recent case of *James R. Clark*.<sup>33</sup> In *Clark*, the taxpayer validly extended the statute of limitations on assessment for tax years 1974 and 1975 (until June 30, 1982) and for tax year 1978 (until June 15, 1982), presumably pursuant to an audit of the taxpayer's income tax returns. On March 8, 1982, the taxpayer filed a bankruptcy petition triggering the automatic bankruptcy stay of collection of income taxes by the Internal Revenue Service.<sup>34</sup> As of the date of the bankruptcy filing, the number of remaining days on the limitations period was 114 days for 1974 and 1975 and 99 days for 1978, respectively. Subsequently, a "Discharge of Debtor" was entered by the Bankruptcy Court on August 31, 1982, but such income taxes were not discharged in bankruptcy by virtue of § 507(a)(7)(A)(iii) of the Bankruptcy Code since assessment of the tax would not be precluded under the Internal Revenue Code due to extension of the statute of limitations.<sup>35</sup> Following entry of the discharge, the Bankruptcy Court mailed a copy of the discharge to all of the taxpayer's creditors, including the Internal Revenue Service, on April 11, 1983.

The Tax Court first noted that since such income taxes were not discharged in bankruptcy, the remaining period on the statute of limitations would be augmented

<sup>32</sup> See, *supra* note 31; Form 872-T applies to termination of the special consent to extend the statute of limitations with respect to Form 872-A. See also, Form 872-Q with respect to "S" corporations and Form 872-N with respect to partnerships. Edward P. Johnson, 68 T.C. 637 (1977); Irving S. Freedman, 86 T.C. M. (P-H) 257 (1986); Borg-Warner Corporation, 660 F.2d 324 (7th Cir. 1981); cf. Richard P. Valk, 84 T.C. M. (P-H) 622 (1984) [mailing of Form 872-T to Internal Revenue Service, Service Center rather than Office of District Director was ineffective in terminating Form 872-A agreement].

<sup>33</sup> 90 T.C. 6 (1988); Opinion issued January 21, 1988; [CCH Dec. 44,528]; See also, John Peter Galanis, 92 T.C. 4 (1989).

<sup>34</sup> Bankruptcy Code, 11 U.S.C. § 362(a); The automatic stay continues until the earliest of the time the case is closed or dismissed, or the discharge is granted or denied.

Bankruptcy Code, 11 U.S.C. § 362(c)(2); See also, *In re Berry*, 11 B.R. 886 (Bkrtcy. W.D. Pa. 1981), the Court noted also that as an exception to the stay, the Service may issue a notice of deficiency, even though the Service may not move to assess or collect the taxes. Bankruptcy Code, 11 U.S.C. § 362(b)(9).

<sup>35</sup> This is true since the statute of limitations remained open due to the taxpayer's filing of an extension of the statute, either pursuant to I.R.S. Form 872 or 872-A. The Court in *Clark* also noted that the automatic stay was lifted by the discharge granted by the Bankruptcy Court on August 31, 1982.

by the additional sixty day period granted the Service to assess the tax when an individual taxpayer files a bankruptcy petition under I.R.C. § 6503(i)(1)<sup>36</sup> for purposes of determining the exact date when the statute of limitations expired. The precise question before the Court was the date when the limitations period again began running pursuant to the bankruptcy proceedings, i.e., was it the date on which the taxpayer was granted a bankruptcy discharge or the date on which the Internal Revenue Service received notice of such discharge.<sup>37</sup>

The Tax Court determined that the statute of limitations on assessment again began running on the date the taxpayer was granted an actual bankruptcy discharge pursuant to entry of the "Discharge of Debtor" rather than the date the Service received notice of such discharge. Therefore, in *Clark*, the Tax Court ultimately held that since the Service issued its statutory notice of deficiency after expiration of the statute of limitations period on assessment as measured from the date the taxpayer was granted a bankruptcy discharge (as augmented by the sixty day period prescribed by § 6503(i)(1)), the Service was precluded from collecting such income taxes from the taxpayer since the statute of limitations period had expired.

#### *Statute of Limitations Open by Operation of Law*

Under the broad language of § 507(a)(7)(A)(iii) of the Bankruptcy Code, a taxpayer may not obtain discharge for prior income taxes due where the statute of limitations on assessment remains open by operation of law. This is true even if such income taxes emanate from a return that is last due within three years preceding the date the taxpayer would normally contemplate a bankruptcy petition filing. Thus, for example, a discharge of income taxes may not be obtained in such situations where the statute of limitations on assessment remains open due to a 25% omission of income,<sup>38</sup> or the taxpayer has been absent from the United States for a continuous period of at least six months.<sup>39</sup>

#### *Late Filed Returns, Fraudulent Returns and Failure to File Cases*

The practitioner advising a taxpayer who anticipates a bankruptcy filing for

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<sup>36</sup> See, *supra* note 19; See also, John Peter Galanis, 92 T.C. (1989).

<sup>37</sup> In *Clark*, the Court stated:

Under Section 6213(f), the running of the time for a debtor filing a petition in this Court is suspended while the debtor is prohibited from making such filing by reason of a Title 11 (individual bankruptcy) case. We have stated that the suspension period ends on the date that the discharge is granted and that, at that time, the debtor would be able to file a petition in this Court. See, *Thompson v. Commissioner*, 84 T.C. 645, 648 (1985). Furthermore, in *Olson v. Commissioner*, 86 T.C. 1314 (1986), we held that an automatic stay was lifted on the date the Bankruptcy Court entered an order of dismissal and did not remain in effect pending disposition of an appeal of that order.

<sup>38</sup> I.R.C. § 6501(e)(1)(A); Treas. Reg. § 301.6501(e)-1(a)(1).

<sup>39</sup> I.R.C. § 6503(c); Treas. Reg. § 301.6503(c)-1(b).

the purpose of discharging income taxes arising prior to the contemplated bankruptcy filing date must insure that (i) the taxpayer has timely filed all income tax returns and (ii) discharge is not sought for a fraudulent return or a return for which the taxpayer attempted to evade or defeat the tax. If this is not done, the taxpayer may find himself or herself in a position where a discharge of income taxes is granted for a particular year but the Service has now asserted a priority bankruptcy claim for a tax year for which the taxpayer did not file a return or filed a late return within two years preceding the bankruptcy filing.

Similarly, the practitioner must review all prior tax assessments to insure that the Service asserted neither civil fraud penalties<sup>40</sup> nor may assert that such income tax for which discharge is sought resulted from the taxpayer's attempt to evade or defeat the tax in any manner.<sup>41</sup> Finally, the practitioner must review all prior taxpayer returns to insure that all such income tax returns were timely filed, or if not timely filed, that all returns had been filed prior to the two year period preceding the date of the forthcoming bankruptcy petition.<sup>42</sup>

### *Payroll Taxes*

A bankruptcy discharge may not be sought for income taxes emanating from payroll or withholding taxes. Included in this category are so called "trust fund taxes" that an employer is required to withhold from employees' pay, the employees' share of social security taxes and the so called "100% penalty" imposed upon a responsible person under Section 6672 of the Internal Revenue Code for failure to withhold from the employees' wages their share of social security taxes.<sup>43</sup>

However, as hereinafter detailed, the astute practitioner in certain very limited situations may utilize a bankruptcy filing as a tactic to prevent his or her clients who are corporate officers and responsible persons from being saddled with the 100% penalty imposed under Section 6672. This is especially true where the Internal Revenue Service has issued a tax levy against corporate assets and proposes to sell such assets pursuant to the levy, seizure and sale provisions of the Code.

In *United States v. Whiting Pools, Inc.*,<sup>44</sup> the U.S. Supreme Court ruled that the Internal Revenue Service must surrender to the bankruptcy trustee all corporate property previously so seized by the Service (except property previously sold to a bona fide purchaser at a tax sale) and allow the corporate business sufficient time to

<sup>40</sup> I.R.C. § 6653(b); Treas. Reg. § 301.6653-1(b).

<sup>41</sup> Bankruptcy Code, 11 U.S.C. § 523(a)(1)(C); *See also, supra* notes 20 and 23; *cf., In re Harris*, 59 B.R. 545 (Bkrcty. W.D. Va. 1986).

<sup>42</sup> *See, supra* notes 20, 21 and 22; *In re Harris*, 59 B.R. 545 (Bkrcty. W.D. Va. 1986);

<sup>43</sup> *See, supra* note 25; *See also, for example, In re Farr*, 57 AFTR2d 1064 (Bkrcty. Tex. 1986); *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983); *See also, McQUEEN & CRESTOL, FEDERAL TAX ASPECTS OF BANKRUPTCY*, Supp. (1988) § 10.42 at S-102 (1987 Edition).

<sup>44</sup> 462 U.S. 198 (1983).

propose a plan of reorganization for satisfaction of debts.<sup>45</sup> Thus a corporate bankruptcy filing tactic in this instance may allow the corporate officers who are classed as responsible persons a limited amount of time within which to sell the corporate business or assets in bankruptcy with the bankruptcy trustee's consent or otherwise satisfy the outstanding payroll tax liability from operating income so that the corporate officers or other responsible persons do not become ultimately liable for the 100% penalty under I.R.C. § 6672.

In most instances, a corporate bankruptcy filing does not preclude the immediate imposition of the "100% penalty" under Section 6672 upon corporate officers who are classed as responsible persons by the Internal Revenue Service.<sup>46</sup> However, the Internal Revenue Service allows any person upon whom the 100% penalty is imposed certain appeal rights within the Service prior to formally attempting to levy against such alleged responsible person's assets.<sup>47</sup> If such appeal

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<sup>45</sup>United States v. Whiting Pools, Inc., 462 U.S. 198 (1983); The practitioner would be well advised to read the text of the *United States v. Whiting Pools, Inc.*, case since the case contains instructive language in this regard; *See also, In re Kenitra, Inc.*, 56 AFTR2d 6150 (Bkrcty. D. Ore. 1985); DiFlorio v. United States, 52 AFTR2d 5726 (D.C. N.Y. 1983); *In re Health Care of Fla., Inc.*, 51 AFTR2d 582 (Bkrcty. S.D. Fla. 1982); *cf., In re Carlton*, 49 AFTR2d 1190 (D. N.M. 1982); *United States v. Norton*, 717 F.2d 767 (3d Cir. 1983).

<sup>46</sup>I.R.S. Handbook, Section P-5-60 (as revised on May 30, 1984) provides:

The 100% penalty may be asserted against responsible officers and employees of the corporation, . . . , whenever such taxes cannot be immediately collected from the corporation itself. (emphasis added)

*See, e.g., Calderone v. United States*, 799 F.2d 254, 58 AFTR2d 5703 (6th Cir. 1986) which upheld an earlier version of I.R.S. Handbook, Section P-5-60. Further, a number of cases have specifically held that the I.R.S. need not pursue collection from the corporate employer prior to assessing the 100% penalty on a corporate responsible person under I.R.C. § 6672. *United States v. Huckabee Auto Co.*, 783 F.2d 1546, 57 AFTR2d 985 (11th Cir. 1986); *Datlof v. United States*, 370 F.2d 655 (3d Cir. 1966), *cert. denied*, 387 U.S. 906, (1967); *Hornsby v. Internal Revenue Service*, 588 F.2d 952, 954 (5th Cir. 1979); *Maguire v. United States*, 45 AFTR2d 1253 (W.D. N.Y. 1980); *Van Westerhuyzen v. U.S. Treasury Department*, 37 AFTR2d 301 (D. Minn. 1975); *Cambridge Machine Products Corp. v. U.S.*, 57 AFTR2d 574 (Bkrcty. D. Mass. 1985); *Calderone v. United States*, 799 F.2d 254, 58 AFTR2d 5703 (6th Cir. 1986); *See also, In re Condel, Inc.*, 63 AFTR 2d 301 (U.S. Bkrcty. App. Panel 9th Cir. 1988) [Bankruptcy Court improperly confirmed reorganization plan that enjoined I.R.S. from collecting 100% penalty from official responsible person of debtor corporation that failed to pay over trust fund taxes. However, as noted in note 48, some courts, notably the United States Eighth Circuit, have taken the view that the Internal Revenue Service may not proceed in collecting the 100% penalty directly against corporate responsible persons where irreparable harm would result to the bankrupt corporation's ability to reorganize itself and have, thus, issued an injunction prohibiting the Internal Revenue Service from collecting the 100% penalty from corporate officers despite the anti-injunction prohibition of Section 7421(a) of the Internal Revenue Code.

<sup>47</sup>These procedural rights are set forth in Rev. Proc. 84-78, 1984-2 C.B. 754. In a typical case, the Internal Revenue Service mails to the "alleged" corporate responsible party an I.R.S. Form 2751 (Proposed Assessment of the 100% Penalty) accompanied by Internal Revenue Service Form Letter #1153 (DO), proposing assessment of the 100% penalty against such corporate officer. In accordance with Rev. Proc. 84-78 and I.R.S. Form Letter #1153 (DO) the corporate responsible party would have thirty days to either respond with a defense, in writing, if the assessment is less than Two Thousand Five Hundred Dollars (\$2,500) or file a written protest with the Internal Revenue Service if the assessment is more than Two Thousand Five Hundred Dollars (\$2,500).

Usually, the taxpayer asserts in such written protest one of three defenses. First, the taxpayer may

rights are properly exercised by a corporate officer who is classed by the Service as a responsible person, such corporate officer may forestall immediate collection of the 100% penalty against him or her for a very short period of time (e.g., sixty days) which may be sufficient time for the corporation to secure a loan, accumulate operating income and/or sell the corporate business or assets in bankruptcy and thus satisfy the then outstanding payroll tax liability. However, this tactic should be utilized only where there appears to be a viable method of satisfying the payroll taxes at the corporate level.

assert that he was not a "responsible party," for instance in such situations where (i) the taxpayer performed only clerical acts at the direction of corporate officers, [United States v. Berg, 42 AFTR2d 5556 (S.D. Ohio 1978)], (ii) did not take an active interest in the corporate business so as to be aware of its finances and only signed checks without having authority to determine which creditors would be paid [Wilson v. United States, 35 AFTR2d 740 (N.D. Ga. 1975); Adams v. United States, 35 AFTR2d 1174 (W.D. Wisc. 1974); United States v. Carlin, 39 AFTR2d 392 (S.D. Texas 1976); Geiger v. United States, 583 F. Supp. 1166, 54 AFTR2d 5269 (D.C. Ariz. 1984)], or (iii) that even though such party is a corporate officer they are nonetheless not a responsible person since they do not have authority to pay the Internal Revenue Service ahead of other trade creditors due to their lack of control over corporate finances (even though they have check writing authority) [Cellura v. United States, 245 F. Supp. 379 (D.C. Ohio 1965); Meikle v. United States, 22 AFTR2d 5696 (D.C. Ill. 1968); Roth v. United States, 53 AFTR2d 1153 (D.C. Ala. 1984); Watson v. United States, 57 AFTR2d 393 (D.C. Ky. 1986)]. Second, the alleged corporate responsible party may defend the proposed assessment on the basis that his failure was not "willful" and therefore the Section 6672 100% penalty was improperly imposed. However, the Internal Revenue Service has interpreted the "willfulness" element to be present if money withheld from employees as employment taxes in lieu of being paid to the Internal Revenue Service is knowingly and intentionally used to pay operating expenses of a business, trade creditors, or for other purposes. Rev. Rul. 54-158, 1954-1 C.B. 247; *See also, e.g.,* Frazier v. United States, 304 F.2d 528 (5th Cir. 1962); High v. United States, 506 F.2d 755 (5th Cir. 1975); Flis v. United States, 35 AFTR2d 1425 (D.C. Fla. 1975). However, in some instances "reasonable causes" for not paying over such withheld payroll taxes to the Service have destroyed the "willfulness" element such as (i) a taxpayer relying on competent legal counsel's advice that he was not required to pay such tax, Gray Line Co. v. Granguist, 237 F.2d 390 (9th Cir. 1956), and (ii) a corporate president's failure to withhold and pay over tax during a period of illness when he was not in a position to act as to corporate finances or make any decision as to payment or preference of creditors. Sherwood v. United States, 246 F. Supp. 502 (D.C. N.Y. 1965) and 228 F. Supp. 247 (D.C. N.Y. 1964). Third, in some situations where assessment of the 100% penalty against corporate responsible persons would materially adversely effect the corporate debtor's ability to reorganize, a third ground for defending a proposed assessment of the Section 6672 penalty would be that the Internal Revenue Service is under a "due diligence" duty to first proceed to file a proof of claim with the Bankruptcy Court and then attempt to secure payment of the payroll taxes from the corporate debtor prior to assessment of the 100% penalty against individual corporate responsible persons. *See, cases cited in note.* However, as noted *infra*, and *supra* in notes 46 and 48, this appears to be a minority position and it is likely to be summarily rejected by the Internal Revenue Service and the alleged corporate responsible party may prevail only in a United States District of Bankruptcy Court that follows *Bostwick v. United States* (cited in note 48) and its progeny.

If the Internal Revenue Service thereafter rejects the taxpayer's written protest the taxpayer may thereafter stay collection proceedings of the 100% penalty in accordance with Section 6672(b) of the Internal Revenue Code by taking the following steps:

1. The taxpayer must pay an amount sufficient to initiate refund litigation (in the case of a penalty resulting from non-payment of employment or payroll taxes, this would be the withholding taxes attributable to one individual). I.R.C. § 6672(b)(1)(A);
2. The taxpayer must file a claim for refund for the amount so paid. I.R.C. § 6672(b)(1)(B); and
3. The taxpayer must furnish a bond in an amount equal to one and one-half (1 1/2) times



It should be noted that a substantial minority of courts, most notably the United States Eighth Circuit, have held that the Anti-Injunction Act set forth in Section 7421(a) of the Internal Revenue Code does not bar the Bankruptcy Court from restraining the Internal Revenue Service by injunction from collecting the 100% penalty against corporate responsible persons where collection of such penalty would have an adverse effect on the corporate debtor's reorganization efforts and irreparably harm the corporate bankruptcy estate if an injunction were not issued.<sup>48</sup> The theory behind this line of cases appears to be that since the Bankruptcy Courts are courts of equity and the general policy of the Bankruptcy Act as promulgated by Congress is to allow rehabilitation of a financially troubled business, the Bankruptcy Act will override the anti-injunction prohibition of Section 7421(a) of the Internal Revenue Code; therefore Bankruptcy Courts are empowered with the ability to enjoin the Internal Revenue Service from collecting the 100% penalty against corporate responsible persons if collection of such 100% penalty would have a

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the penalty assessed minus the payments made under item #1 above, in such form and with such sureties as the Treasury may by regulations prescribe. I.R.C. §§ 6672(b)(1)(C) and 6672(b)(3) [there are presently no prescribed regulations].

If the taxpayer complies with the three steps set forth above as prescribed in Section 6672(b) of the Internal Revenue Code, that section provides that no levy or proceeding in court for the collection of the remainder of the 100% penalty shall be made until final resolution of the case either pursuant to the claim for refund, or a suit in the United States District Court or Court of Claims if the claim for refund is denied, all in accordance with Section 6672(b)(2). It should also be noted that invocation of Section 6672(b) by the posting of such bond and complying with the steps set forth in #1-#3 above removes the proceeding from the anti-injunction prohibition of Section 7421. I.R.C. § 7421(a). Therefore, any court would be in a position to enjoin the Internal Revenue Service from collection of the 100% penalty against corporate responsible persons if the procedures set forth in Section 6672(b) of the Internal Revenue Code are followed. *See also*, McQueen & Crestol, *FEDERAL TAX ASPECTS OF BANKRUPTCY*, Supp. (1988) § 10.42 at S-102-104 for an additional discussion of this issue.

<sup>48</sup> *Bostwick v. United States*, 521 F.2d 741 (8th Cir. 1975) [note that some courts have distinguished the *Bostwick* holding on the basis that the Internal Revenue Service failed to file a proof of claim with the Bankruptcy Court]; *In re The Original Wild West Foods, Inc.*, 45 B.R. 202, 55 AFTR2d 1086 (Bkrcty. W.D. Tex. 1984); *J.K. Printing Services, Inc.*, 49 B.R. 798 (Bkrcty. W.D. Va. 1985); *In re Dair Systems Corp.*, 37 B.R. 690, 53 AFTR2d 1442 (Bkrcty. N.D. Ill. 1983); *In re Jon Co., Inc.*, 30 B.R. 831 (Bkrcty. D. Colo. 1983); *In re O.H. Lewis Co., Inc.*, 40 B.R. 531 (Bkrcty. D. N.H. 1984); *In re Otero Mills, Inc.*, 25 B.R. 1018 (D.C. N.M. 1982); *In re Major Dynamics, Inc.*, 14 B.R. 969 (Bkrcty. S.D. Cal. 1981); *In re H&R Ice Company, Inc.*, 24 B.R. 28 (Bkrcty. W.D. Mo. 1982); *In re Steel Products Inc.*, 47 B.R. 44 (Bkrcty. W.D. Wash. 1984). *The In re Jon Co., Inc.*, case *supra*, set forth the following four (4) elements which the debtor must approve for the injunction to issue:

1. Irreparable harm to the bankruptcy estate if the injunction does not issue;
2. A strong likelihood of success on the merits;
3. No harm or minimal harm to the other parties or party; and
4. A determination of what action better serves the public interest.

*See also, supra, In re Dair Systems Corp.*

*See also, South Carolina v. Regan*, 465 U.S. 367 (1984); *Bob Jones University v. Simon*, 416 U.S. 725, 736-737(1974).

detrimental effect on the corporate debtor's ability to reorganize resulting in irreparable harm to the corporate bankruptcy estate.<sup>49</sup> However, the majority of courts, notably the United States Third and Eleventh Circuits, have taken a strict-constructionist view of I.R.C. § 7421(a)'s prohibition against enjoining the Internal Revenue Service from collecting the 100% penalty against corporate responsible persons where the corporate debtor has declared bankruptcy, and have accordingly refused to issue an injunction prohibiting the Internal Revenue Service from collecting the 100% penalty against corporate responsible persons even if collection of the penalty would substantially impair the corporate debtor's ability to reorganize.<sup>50</sup>

### *Tax Penalties*

Tax penalties which are nonpunitive in nature and which are in compensation for actual pecuniary loss are nondischargeable in bankruptcy if related to a tax liability afforded seventh priority under § 507(a)(7) of the Bankruptcy Code.<sup>51</sup> Thus, if the tax penalty is in compensation for actual loss and related to a nondischargeable tax liability of a type set forth in Paragraphs 1, 2, 3, 4, 5, 9 or 10 of the *General Rule Section* of this article (the aforesaid paragraphs describe income taxes afforded seventh priority under § 507(a)(7) of the Bankruptcy Code), then such tax liability is nondischargeable in bankruptcy.

Tax penalties which are punitive in nature (i.e., "not in compensation for actual pecuniary loss"<sup>52</sup>) are generally dischargeable in bankruptcy if the penalty is computed with reference to a related tax liability which is dischargeable or, if not computed with reference to a related tax liability, the tax penalty was not imposed during the three year period preceding the bankruptcy filing.<sup>53</sup> This rule represents

<sup>49</sup> *Bostwick v. United States*, 521 F.2d 741, 36 AFTR2d 5533 (8th Cir. 1975); *In re Dairair Systems Corporation*, 37 B.R. 690, 57 AFTR2d 574 (Bkrcty. N.D. Ill. 1983); *In re Jon Co., Inc.*, 30 B.R. 831 (Bkrcty. D. Colo. 1983); *In re The Original Wild West Foods, Inc.*, 45 B.R. 202, 55 AFTR2d 1086 (Bkrcty. W.D. Tex. 1984). See also, *South Carolina v. Regan*, 465 U.S. 367 (1984); *Bob Jones University v. Simon*, 416 U.S. 725, 736-737 (1974).

<sup>50</sup> *Matter of Becker's Motor Transport, Inc.*, 632 F.2d 242 (3d Cir. 1980); *United States v. Huckabee Auto Co.*, 783 F.2d 1546, cert. denied 450 U.S. 916 (11th Cir. 1986) *aff'm.*, 46 B.R. 741 (Bkrcty. M.D. Ga.); *In re Matter of Driscoll's Towing Service, Inc.*, 56 AFTR2d 5753 (S.D. Fla. 1985); *In re Herbie K.'s, Inc.*, 57 AFTR2d 548 (Bkrcty. W.D. La. 1985); *In re Matter of ERC/Scheible, Inc.*, 57 AFTR2d 552 (Bkrcty. M.D. Fla. 1985); *In re A&B Heating & Air Condition, Inc.*, 57 AFTR2d 1054 (M.D. Fla. 1985); *In re Idaho Agriguiement, Inc.*, 57 AFTR2d 462 (Bkrcty. D. Idaho 1985); *In re: J.C. Williams & Peeptite Paving Co., Inc.*, 57 AFTR2d 969 (Bkrcty. S.D. Fla. 1985); *In re Arrow Transfer & Storage Co.*, 56 AFTR2d 5201 (E.D. Tenn. 1985); *Cambridge Machine Products Corp.*, 57 AFTR2d 574 (Bkrcty. D. Mass. 1985); *In re Pressimone*, 39 B.R. 240 (Bkrcty. N.D. N.Y. 1984); See also, *United States v. Rayson Sports, Inc.*, 44 B.R. 280, 54 AFTR2d 6434 (N.D. Ill. 1984); *In re County Wide Garden Center, Inc.*, 25 B.R. 203 (Bkrcty. S.D. N.Y. 1982).

<sup>51</sup> Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(G) and 523(a)(1)(A); *In re Reich*, 66 B.R. 554 (Bkrcty. D. Colo. 1986). See also, W. ELLIOT, FEDERAL TAX COLLECTIONS, LIENS AND LEVIES, ¶12.9[3][a] at 12-35 (Prentice Hall 1988).

<sup>52</sup> Bankruptcy Code, 11 U.S.C. § 523(a)(7).

<sup>53</sup> See, *supra* note 27, 11 U.S.C. § 523(a)(7); *In re New England Carpet Co.*, 26 B.R. 934 (Bkrcty. D. Vt. 1983); *In re Hernando Appliances, Inc.*, 41 B.R. 24 (Bkrcty. N.D. Miss. 1983); cf. *In re Quality Sign Co.*,

a statutory codification of the Service's earlier position set forth in Rev. Rul. 68-574.<sup>54</sup> The 100% penalty imposed on responsible persons under Section 6672 is never deemed a "penalty" dischargeable in bankruptcy under the above-referenced rule.<sup>55</sup>

However, it should be noted that merely because a tax penalty is punitive in nature and will be discharged in bankruptcy does not necessarily mean that the tax penalty will not be paid if the debtor's estate is liquidated under Chapter 7 of the Bankruptcy Code. Under § 726(a)(4) of the Bankruptcy Code, a tax penalty which is punitive in nature and is not in compensation for actual pecuniary loss is payable to the Internal Revenue Service upon liquidation of the debtor's estate to the extent that a surplus of assets, which would normally be returned to the debtor, remains at the close of the case.<sup>56</sup>

### COLLATERAL CONSEQUENCES OF A BANKRUPTCY FILING

Three primary collateral consequences emanate from a taxpayer's bankruptcy petition filing. First, the taxpayer's future credit will obviously be impaired. Second, for the entrepreneurial taxpayer involved in the venture capital market, a securities disclosure of the bankruptcy filing in any future prospectus or disclosure document possibly could be necessitated since the taxpayer's bankruptcy filing might be construed as a material factor of which an investor in any venture capital offering should be aware in determining whether or not to invest funds in the venture for purposes of the securities laws.<sup>57</sup>

Third, under § 6871(b) of the Code, the Service is given the immediate right to assess any tax deficiency which it determines due with respect to a taxpayer who has filed a bankruptcy petition (even though the taxpayer may have also filed a Tax Court petition with respect to that deficiency).<sup>58</sup> Therefore, the practitioner must

51 B.R. 351 (Bkrcty. S.D. Ind. 1985) and *In re* IML Freight, Inc., 65 B.R. 788 (Bkrcty. D. Utah 1986). See also, *In re* Carlton, 19 B.R. 73, 74-75 (D.N.M. 1982); W. ELLIOT, FEDERAL TAX COLLECTIONS, LIENS AND LEVIES, ¶12.9[3][b] at 12-36 (Prentice Hall 1988).

<sup>54</sup> 1968-2 C.B. 595; cf. Rev. Rul. 71-31, 1971-1 C.B. 409.

<sup>55</sup> *United States v. Sotelo*, 436 U.S. 268 (1978); *United States v. Murphy*, 381 F. Supp. 813 (D.C. Ala. 1974).

<sup>56</sup> Bankruptcy Code, 11 U.S.C. § 726(a)(4); *In re* Hernando Appliances, Inc., 41 B.R. 24 (Bkrcty. N.D. Miss. 1983); *In re* Quality Sign Co., 51 B.R. 351 (Bkrcty. S.D. Ind. 1985).

<sup>57</sup> Cf. *Michael I. Schorr* (1975), Release Number 34-11377, April 28, 6th S.E.C. Docket, No. 18, page 776; *S.E.C. v. Raymond Bliss, Inc.*, 4 S.E.C. Jud. Dec. 834 (D.C. Mass. 1946); *Maher v. Williston & Beane, Inc.*, Paragraph #93,457 CCH Dec. (S.D. N.Y. 1972); *S.E.C. v. Blatt*, Paragraph #95,281 CCH Dec. (S.D. Fla. 1975). Note that the Florida Department of Banking and Finance is currently contemplating adoption of an administrative regulation requiring disclosure of a prior bankruptcy filing under Florida's "Blue Sky" law, Chapter 517 of the Florida Statutes, at the time of publication of this article.

<sup>58</sup> Generally, the tax may be assessed either against the bankruptcy estate of an individual debtor or the debtor himself if such tax has become *res judicata* against the debtor pursuant to a Bankruptcy Court determination. I.R.C. § 6871(b). The applicable Committee Reports to Pub.L. No. 96-589 (1980) provide as follows:

Exceptions - The bill authorizes the Revenue Service to make an immediate assessment (1)

review with the taxpayer the taxpayer's other tax years for which an income tax liability discharge is not sought to ascertain any potential income tax deficiencies which could be asserted and assessed by the Service. This is especially true with respect to tax returns which were last due within three years preceding the bankruptcy filing, tax years for which the taxpayer has filed a Tax Court petition and tax years for which there could possibly be a twenty-five percent income omission. Otherwise, the taxpayer could find himself or herself saddled with wholly new tax liabilities despite the discharge in bankruptcy of income tax liabilities for which discharge is sought.<sup>59</sup> For the entrepreneurial taxpayer, these new tax liabilities, if imposed, could spell disaster since such taxpayer may find himself or herself largely in a position similar to that before the bankruptcy petition was filed and his or her business associates may again refuse to deal with the taxpayer until his or her "tax problems" are resolved.

Additionally, the practitioner should be aware that under the Bankruptcy Code no forgiveness of indebtedness income arises in an individual bankruptcy case. This is true since § 108(a)(1)(A) of the Internal Revenue Code specifically excludes from gross income any income which would normally arise from discharge of indebtedness resulting from such bankruptcy.<sup>60</sup>

### TAX LIENS

Merely because an underlying income tax liability may be discharged in bankruptcy does not prevent the Internal Revenue Service from collecting such outstanding tax liability against the taxpayer/ debtor's bankruptcy estate if (i) a properly filed notice of a perfected and enforceable tax lien has been recorded by the

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of tax imposed on the bankruptcy estate of an individual debtor, or (2) of tax imposed on a debtor if liability for such tax has become *res judicata* against the debtor pursuant to a bankruptcy court determination.

These two exceptions reflect bankruptcy situations in which there is no need to require the Revenue Service to follow the normal deficiency notice procedure. In the case of taxes imposed on the bankruptcy estate of an individual (i.e., where the estate is treated as a separate taxable entity), the estate's own tax liability is determined by the bankruptcy court and cannot be litigated in the Tax Court. In the case where an individual debtor's personal liability for nondischargeable tax claims has been litigated in the bankruptcy court, and under the doctrine of *res judicata* the debtor would be precluded from relitigating the issue in any court, no purpose would be served by requiring issuance of a deficiency notice prior to assessment. For the same reason, the bill permits immediate assessment of a corporate debtor's tax liabilities once the bankruptcy court has made a determination which is *res judicata*.

*See also*, Commissioner v. De Leve, 748 F.2d 465, 54 AFTR2d 6418 (8th Cir. 1984) and Charles N. Sharpe, Jr., 69 T.C. 19 (1977).

<sup>59</sup> Under the Bankruptcy Code, 11 U.S.C. § 522(c)(1), nondischargeable taxes may even be collected out of exempt property which would normally be exempt from creditor claims.

<sup>60</sup> I.R.C. §§ 108(a)(1)(A) and 108(d)(8); The practitioner should be aware, however, that there is a reduction in tax attributes with respect to an individual debtor under § 108(b) of the Internal Revenue Code; *See also*, *supra* note 10.

Service or (ii) with certain specified exceptions relating to "exempt assets," an unfiled tax lien was imposed against the taxpayer/debtor under § 6321 of the Internal Revenue Code and such unfiled tax lien generally became effective prior to the bankruptcy proceeding's commencement or prior to the time the debtor became insolvent.<sup>61</sup> Each of these two situations are discussed separately below.

<sup>61</sup> In the case of a Chapter 7 liquidation, secured tax claims are governed by Section 724(b) of the Bankruptcy Code. Secured tax liens on both real and personal property are subordinated to payment of claims having higher priority. Accordingly, the assets of a taxpayer's/debtor bankruptcy estate will be distributed first to pay claims having a higher priority than secured tax liens. Section 724(b) of the Bankruptcy Code sets forth the following distribution scheme with respect to unavoidable tax liens that secure an allowed claim for income taxes, as follows:

1. First, to lienholders senior to the tax lien.
2. Second, to administrative expenses, involuntary gap claimants, wage claims, employee benefit claims and consumer creditors that are granted priority [pursuant to 11 U.S.C. § 507(a)(1) through (5)], but only to the extent of the amount of the allowed tax claim that is secured by such tax lien. Thus, the priority claimants assume the same position as that of the tax collector and collect no more than the amount of the tax claim.
3. Third, to holders of the tax lien, to the extent that priority claimants did not use up the entire fund available for the payment of the tax claim.
4. Fourth, to junior lienholders.
5. Fifth, to the holder of the tax lien to the extent that the tax claim was not paid under #3, above [§ 724(b)(3)].
6. Finally, any remaining property passes to the bankruptcy estate and is distributed pursuant to the rules set forth in 11 U.S.C. § 726.

*See, e.g., In re Frank Meador Buick, Inc.*, 59 B.R. 787 (Bkrcty. W.D. Va. 1986); *cf., In re Granite Lumber Co.*, 63 B.R. 466 (Bkrcty. D. Mont. 1986).

In the case of an individual debtor petition under Chapter 13 of the Bankruptcy Code, § 1328(c) grants a discharge for "all unsecured debts" except for certain specified debts specifically set forth in that Section, including income taxes which are nondischargeable by reason of § 523(a) of the Bankruptcy Code. Therefore, by use of the language "unsecured debts," § 1328(c) of the Bankruptcy Code apparently would specifically allow the I.R.S. to collect a secured tax lien, to the extent of such security. *See, e.g., In re Bradley*, 36 B.R. 655 (Bkrcty. D. Md. 1984); *In re Richards*, 50 B.R. 339 (Bkrcty. E.D. Tenn. 1985); *In re Goodwin*, 58 B.R. 75 (Bkrcty. D. Me. 1986).

However, it should be noted that under § 6334 of the Internal Revenue Code, certain property is exempted from levy by the Internal Revenue Service. Such property includes the following:

1. Wearing apparel and school books for the taxpayer and his or her family.
2. Fuel, provisions, furniture, and personal effects which do not exceed \$1,500 in value, provided the taxpayer is the head of a family.
3. Books and tools of a trade, business, or profession up to \$1,000.
4. Unemployment benefits.
5. Certain annuity and pension payments.

Generally, if proper public notice of a tax lien has been filed the Service becomes a "secured creditor" for purposes of the Bankruptcy Code if the lien is perfected and enforceable at the time the taxpayer/debtor files a bankruptcy petition and, accordingly, such tax lien may not be avoided by the bankruptcy trustee even if the underlying income tax liability has been discharged.<sup>62</sup> Thus, the Service may

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6. Workers' compensation.
  7. Judgments for the support of minor children.
  8. Minimum wages, salary, and other income as determined under § 6334(d).

Presumably, these items also remain exempt from levy or any I.R.S. claims during the bankruptcy proceeding.

<sup>62</sup> Bankruptcy Code, 11 U.S.C. §§ 545(1), 545(2), 724(b)(2) and 1328(c)(2). Such Sections originally emanated from the Notes of the Committee on the Judiciary, S. REP. No. 95-989, Pub.L. No. 95-598, 95th Cong., 2d. Sess., 92 Stat. 2590 (1978) and was subsequently modified in Committee. The applicable S. REP. No. 95-989 provided as follows:

Liens that first become effective on the bankruptcy or insolvency of the debtor are voidable by the trustee. Liens that are not perfected or enforceable on the date of the petition against a bona fide purchaser are voidable.

Subsection (b) limits that trustee's power to avoid tax liens under Federal, state, or local law. *For example*, under § 6323 of the Internal Revenue Code [section 6323 of Title 26, Internal Revenue Code], once public notice of a tax lien has been filed, the Government is generally entitled to priority over subsequent lienholders.

However, certain purchasers who acquire an interest in certain specific kinds of personal property will take free of an existing filed tax lien attaching to such property. Among the specific kinds of personal property which a purchaser can acquire free of an existing tax lien (unless the buyer knows of the existence of the lien) are stocks and securities, motor vehicles, inventory, and certain household goods. Under the present Bankruptcy Act (§ 67(c)(1) [former section 107(c)(1) of this title]), the trustee may be viewed as a bona fide purchaser, so that he can take over any such designated items free of tax liens even if the tax authority has perfected its lien. However, the reasons for enabling a bona fide purchaser to take these kinds of assets free of an unfiled tax lien, that is, to encourage free movement of these assets in general commerce, do not apply to a trustee in a Title 11 case, who is not in the same position as an ordinary bona fide purchaser as to such property. The bill accordingly adds a new subsection (b) to sec. 545 providing, in effect, that a trustee in bankruptcy does not have the right under this section to take otherwise specially treated items of personal property free of a tax lien filed before the filing of the petition.

The Senate Finance Committee Report was modified in Committee. Those Committee modification statements are as follows:

Section 545 of the House amendment modifies similar provisions contained in that House bill and Senate amendment to make clear that a statutory lien may be avoided under section 545 only to the extent the lien violates the perfection standards of section 545. Thus a Federal tax lien is invalid under section 545(2) with respect to property specified in sections 6323(b) and (c) of the Internal Revenue Code of 1954 [sections 6323(b) and (c) of Title 26, Internal Revenue Code]. As a result of this modification, section 545(b) of the Senate amendment is deleted as unnecessary.

The House amendment retains the provision of section 545(2) of the House bill giving the

generally assert its secured creditor priority rights in bankruptcy against the bankruptcy trustee and debtor's bankruptcy estate with respect to any perfected tax lien and thus collect all or part of the then outstanding tax liability against the bankrupt estate's assets in which it has a perfected statutory lien interest even though the underlying tax liability is discharged in bankruptcy.

"Perfection" of a tax lien is governed under § 546(b) of the Bankruptcy Code and Section 6323(f) of the Internal Revenue Code. Any tax lien imposed by Section 6321 of the Internal Revenue Code<sup>63</sup> is not valid against any purchaser, holder of a security interest or mechanic's lien or judgment lien creditor until the Service files proper notice of such tax lien and under I.R.C. § 6323(b) is not valid against certain classes of "superpriority" lienholders.<sup>64</sup> Under § 6323(f) of the Internal Revenue Code, such notice must be filed (i) with respect to real property, where the property is physically situated, in accordance with the laws of the state of situs<sup>65</sup> and (ii) with respect to personal property within the office within the state where the taxpayer's residence is located at the time the notice of lien is filed.<sup>66</sup>

With respect to perfected and enforceable tax liens, the taxpayer/debtor may not prevent the Internal Revenue Service from collecting such outstanding tax liability against the taxpayer/debtor's bankruptcy estate, to the extent allowable under the Bankruptcy Code, after the Service has filed a proper proof of claim setting forth its secured status with the bankruptcy trustee even though the underlying tax liability is subsequently discharged in bankruptcy.<sup>67</sup> This is true even as to property

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trustee in a bankruptcy case the same power which a bona fide purchaser has to take over certain kinds of personal property despite the existence of a tax lien covering that property. The amendment thus retains present law, and deletes section 545(b) of the Senate amendment which would have no longer allowed the trustee to step into the shoes of a bona fide purchaser for this purpose.

<sup>63</sup> A tax lien on the taxpayer's real and personal property arises under Section 6321 of the Code where any person liable for a tax "neglects or refuses to pay the same after demand." The lien generally attaches to all property and all rights belonging to such person at any time during the period of the lien, including any property or rights to property acquired by such person after the lien arises. Treas. Reg. § 301.6321-1. After imposition of the lien, the lien generally continues until it is satisfied or becomes unenforceable by reason of lapse of time. I.R.C. § 6322. However, the lien is not generally enforceable against subsequent purchasers, holders and security interests, etc., until notice of such lien is filed in accordance with § 6323(f) of the Code.

<sup>64</sup> I.R.C. §§ 6323(a) and 6323(f).

<sup>65</sup> I.R.C. §§ 6323(f)(1)(A)(i) and 6323(f)(2)(A); Treas. Reg. §§ 301.6323(f)-1(a)(1)(i) and 301.6323(f)-1(b)(1); Treas. Reg. § 301.6323(f)-1(c) prescribes that such notice shall be filed on I.R.S. Form 668 (Notice of Federal Tax Lien Under the Internal Revenue Laws); *cf.*, Bankruptcy Code, 11 U.S.C. § 724(b) which sets rules as to priority of distribution among lienholders; *See also, supra* note 61.

<sup>66</sup> I.R.C. §§ 6323(f)(1)(A)(ii) and 6323(f)(2)(B); Treas. Reg. §§ 301.6323(f)-1(a) and 301.6323(f)-1(b)(2); Treas. Reg. § 301.6323(f)-1(c) prescribes that such notice shall be filed on I.R.S. Form 668, (Notice of Federal Tax Lien Under the Internal Revenue Laws). *See also, for example, In re R&T Roofing Structures and Commercial Framing, Inc.*, 54 AFTR2d 6388 (Bkrty. D. Nev. 1985); *In re Carolina Resort Motels, Inc.*, 56 AFTR2d 5830 (Bkrty. D. S.C. 1985); *cf.* Bankruptcy Code, 11 U.S.C. § 724(b) which sets forth rules as to priority of distribution among lienholders; *See also, supra* note 61.

<sup>67</sup> Bankruptcy Code, 11 U.S.C. § 501; Rev. Rul. 70-555, 1970-2 C.B. 296; *See also, In re McClure Co.*, 21 F.2d 538 (D.C. Ga. 1927); *Citizen's Bank of Lafourche v. Miller Link Lumber Co.*, 16 F.2d 163 (D.C. Tex. 1927); *Hammond v. Carthage Sulphite Pulp and Paper Co.*, 34 F.2d 155 (D.C. N.Y. 1928); *cf.*, United States v. Owens, 61 AFTR2d 865 (E.D. Pa. 1988). *See also, supra* note 61.

which is normally exempted from creditor claims (“exempt property”) under the Bankruptcy Code.<sup>68</sup> A valid perfected and enforceable tax lien also attaches to after acquired assets up to the date of the bankruptcy filing even though such underlying tax liability is subsequently discharged in bankruptcy.<sup>69</sup>

Generally, as to unfiled statutory tax liens, the Internal Revenue Service may collect its outstanding tax liability against a taxpayer/debtor’s bankruptcy estate, upon filing of a proper proof of claim, if an unfiled tax lien was imposed against the taxpayer under § 6321 of the Internal Revenue Code, provided that the trustee in bankruptcy may not avoid such statutory lien by virtue of §§ 545(1) and 545(2) of the Bankruptcy Code.<sup>70</sup> The two most important rules under the aforesaid Bankruptcy Code sections allowing the bankruptcy trustee to avoid the statutory tax lien are that the lien first became effective pursuant to § 6321 of the Internal Revenue Code (i) after the bankruptcy case was commenced or (ii) after the debtor became insolvent.<sup>71</sup> However, under the Bankruptcy Code a different rule apparently prevails as to attachment of an unfiled tax lien against any “exempt assets.”

Apparently, under the statutory language of the Bankruptcy Code, the Service may not collect an outstanding tax liability against certain assets exempt under § 522 of the Bankruptcy Code (“exempt assets”) unless the Service has a perfected and enforceable tax lien “notice of which is properly filed.”<sup>72</sup> Thus, if the underlying tax liability is subsequently discharged in bankruptcy the Service may not collect the outstanding tax liability against assets constituting “exempt assets” under § 522 of the Bankruptcy Code unless the Service has previously filed notice of its tax lien in accordance with § 6323(f) of the Internal Revenue Code.

Section 522(d) of the Bankruptcy Code sets forth certain federal “exempt assets” which are exempt from creditor claims, the most important of which are unmatured life insurance contracts owned by the debtor, benefits under pension and profit sharing plans and motor vehicles (up to \$1,200 in value).<sup>73</sup> Alternatively, the

<sup>68</sup> Bankruptcy Code, 11 U.S.C. § 522(c)(2)(B); *cf.*, *In re McCann*, 259 F. Supp. 632 (S.D. Cal. 1966).

<sup>69</sup> *In re Warren’s U-Joint Sales, Inc.*, 41 AFTR2d 946 (D.C. Tex. 1977); *In re Educational Equipment, Inc.*, 21 AFTR2d 1508 (C.D. Cal. 1968). It should also be noted that a perfected pre-bankruptcy tax lien attaches to assets in the bankruptcy estate acquired after adjudication if the underlying tax liability is not discharged in bankruptcy. *In re Wukelic*, 544 F.2d 285, 38 AFTR2d 6044 (6th Cir. 1976).

<sup>70</sup> *United States v. Turner*, 625 F.2d 328 (9th Cir. 1980); *United States v. McCann*, 259 F. Supp. 632 (S.D. Cal. 1966); *In re Bradley*, 36 B.R. 655 (Bkrcty. D. Md. 1984); *See also, supra* note 61.

<sup>71</sup> Bankruptcy Code, 11 U.S.C. §§ 545(1) and 545(2); *See also, supra* note 59; *See, for example, In re Davis*, 22 B.R. 523, 49 AFTR2d 1411 (Bkrcty. W.D. Pa. 1981).

<sup>72</sup> Bankruptcy Code, 11 U.S.C. § 522(c)(2)(B); *cf.* *United States v. Turner*, 625 F.2d 328 (9th Cir. 1980) and *United States v. McCann*, 259 F. Supp. 632 (S.D. Cal. 1966) [note that both of these cases were decided prior to the reorganization of the Bankruptcy Code in 1978 imposing the requirement that notice of the tax lien be “properly filed” under § 522(c)(2)(B) and neither case apparently involved a properly filed and recorded tax lien]. Note that the statutory language of Section 724(b) of the Bankruptcy Code uses the language “subject to a lien that is *not avoidable under this title* and that secures an allowed claim for a tax”, thus implying that § 522(c)(2)(B) would govern as to unsecured tax liens in a liquidation under Chapter 7. (emphasis added)

<sup>73</sup> Bankruptcy Code, 11 U.S.C. §§ 522(b), 522(b)(1) and 522(d).



taxpayer/debtor may elect to forego the federal "exempt assets" set forth in the preceding sentence and elect to claim as "exempt assets" under the Bankruptcy Code any property exempt under federal, state or local law from creditor claims, which under the laws of many states includes a taxpayer/debtor's personal residence or homestead (usually up to a certain value),<sup>74</sup> certain life insurance and annuity contracts and certain benefits under pension and profit sharing plans.<sup>75</sup> Thus, the property described in this paragraph constitutes "exempt assets" from which the Service may not collect its outstanding tax liability if such tax liability is subsequently discharged in bankruptcy unless the Service has previously filed proper notice of its tax lien under § 6323(f) of the Internal Revenue Code.

### CONCLUSION

A practitioner potentially advising a client to file bankruptcy to discharge an income tax liability would be well advised to review the various considerations set forth in this article in order to properly weigh the advantages and disadvantages of such bankruptcy filing to the client.

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<sup>74</sup> However, *See*, Fla. Stat. §§ 222.01 and 222.03 which generally allow an unlimited value with respect to a homestead claim.

<sup>75</sup> Bankruptcy Code, 11 U.S.C. §§ 522(b) and 522(b)(2).