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THE EMPIRE STRIKES BACK! -- WILL THE FEDERATION SURVIVE?

or ... The I.R.S. vs. everybody

By: Donald B. Lawrence, Jr.*

The IRS is on a roll. At least in the Sixth Circuit, it is close to having blanket non-dischargeability as to all taxes. Terry Zabel has educated us about how tax protestors will find it very difficult to obtain a discharge of their tax liabilities.[1] While Mr. Zabel ostensibly addressed "Tax Protestors", the implications for the everyday taxpayer, who falls upon hard economic times and seeks a fresh start in bankruptcy, are ominous. The question arises, *"When are non-priority income taxes dischargeable in a Chapter 7 proceeding?"* This is a question that many bankruptcy practitioners are called upon to answer. Generally speaking, if a return was filed timely more than three years prior to the contemplated bankruptcy petition filing date or if a return was filed late but more than two years prior to the contemplated bankruptcy petition filing date, one might think that the non priority[2] income taxes

[1] "GOOD FAITH, WILLFULNESS AND NON-DISCHARGEABLE TAX LIABILITIES IN BANKRUPTCY", Terry Zabel, Volume 7, NO. 4, Bankruptcy Law Newsletter, Federal Bar Association, Western Michigan Chapter, January, 1995.

[2] Section 507 (a)(7) classifies three types of income or gross receipts taxes as priority taxes: (1) taxes for a taxable year ending on or before the filing of the bankruptcy petition for which the return, if required, is last due, including extensions, after three years before the filing of the petition; (2) a tax assessed within 240 days before the petition was filed, provided that the 240 period is extended for

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would be dischargeable. However, as pointed out by Mr. Zabel, in another bow to the "plain meaning" doctrine, enunciated by the Supreme Court in *United States v. Ron Pair Enters.*, 489 U.S. 235, 240 (1989), the Sixth Circuit has decided, in the case of *In re Toti*, 24 F3d 806 (6th Cir. 1994), that a plain reading of §523(a)(1)(C) includes both acts of commission and acts of omission. At issue was what standard should be used in deciding the meaning of "willfully" in §523(a)(1)(C) in order to decide what taxes would be within the exception to discharge of that section.

In summary of the facts, Debtor Toti had not filed or paid income taxes from 1974 through 1981 although he knew he was liable for the taxes and he had the wherewithal to pay his taxes during some of those years at least. After not filing his returns for 1974 and 1975, because he claimed to not have the funds to pay his taxes at the end of the years, he claimed to have failed to file returns in the subsequent years because of the penalties and interest accruing due to his failure to file in 1974 and 1975. In 1981, Toti was indicted on three felony counts, pursuant to I.R.C. §7201, of failing to file income tax returns, for the years 1974, 1975, and 1976. In exchange for a dismissal of two counts, relating to tax years 1974 and 1975, Toti pleaded guilty, was convicted and sentenced pursuant to I.R.C. §7203, on a misdemeanor, for willfully failing to file his 1976 return. As part of his sentence, Toti paid the full liability due for 1976 and filed all his delinquent returns. He filed timely returns for 1982 and 1983 but did not make either quarterly estimated payments or voluntary payments for those years. In 1985, he negotiated a plan for repayment with the IRS to address repayment of his tax liabilities for the period of 1977 through 1983. Although he initially followed the schedule of payments, he defaulted thereon more than two years prior the filing of his bankruptcy petition. On February 7, 1990, Toti filed a petition under Chapter 7 of the Bankruptcy Code. In an adversary proceeding brought by the Debtor against the IRS to determine the dischargeability of his tax liabilities, each party sought Summary Judgment. The government contended that Toti had willfully attempted to evade or defeat such taxes, thus making them non-dischargeable under §523(a)(1)(C). The bankruptcy court held the taxes were dischargeable because, applying the criminal standard to the §523(a)(1)(C) phrase "willfully attempted in any manner to evade or defeat such tax", the failure to file a tax return and pay a tax was merely an omission. It held that the Bankruptcy Code requires the commission of an act, so that Toti's omission did not fall within the willfulness standard. The government appealed to the district court. The district court reversed the bankruptcy court based upon the application of the wrong standard, i.e., the criminal standard as opposed to the standard used in other civil cases -- "voluntary, conscious, and intentional". It held that Toti willfully attempted to evade or defeat his tax liability within the meaning of §523(a)(1)(C). 149 B.R. 829 (E.D. Mich 1993) Toti appealed to the Sixth Circuit and the Sixth Circuit affirmed the District Court.

If one focuses on the factual background of this case, the holding makes sense. As the Sixth Circuit observed, the Debtor, Toti, had failed to file his tax returns for several years, was then indicted and convicted on a guilty plea of willfully

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any period of time plus 30 days during which a offer in compromise, made within the 240 day period, regarding such tax, was pending; (3) a tax, other than taxes specified in section 523(a)(1)(B) or 523(a)(1)(C), not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the bankruptcy case.

failing to file his 1976 federal income tax return. He then filed all of his delinquent returns and entered into a payment arrangement with the IRS. Unable to maintain the payments, he thereafter filed a Chapter 7 bankruptcy and, in a Summary Disposition in an adversary proceeding, he was granted a discharge of the taxes based on the felony standard for "willfully" requiring the commission of an act to evade or defeat his tax liability. The Bankruptcy Court reasoned that failing to file a return is merely an omission and, since §523(a)(1)(C) requires the commission of an act, the Debtor's omission did not fall within the willfulness standard.

In appeal to the District Court, the IRS was able to persuade the District Court that the Bankruptcy Court had applied the wrong standard. It applied the same standard used in other civil cases -- "voluntary, conscious, and intentional" -- to hold that the failure of the Debtor to file tax returns and to pay taxes were willful acts. In his appeal to the Sixth Circuit, the Debtor focused on the issue of the standard to be applied in determining the meaning of willfulness, arguing that the language of §523(a)(1)(C) closely parallels felony provision of I.R.C. §7201 which makes it a felony for a person willfully to attempt to evade or defeat any tax. He was convicted under the misdemeanor provision of I.R.C. §7203 which delineates the difference between the felony and misdemeanor provisions based on the distinction between acts of omission and acts of commission.

The Sixth Circuit[3] was not persuaded by Toti's analysis. Citing *Ron Pair*, the court apparently decided that the language of §523(a)(1)(C) was unambiguous, and, that an individual provision of the Bankruptcy Code should be interpreted according to its plain meaning. Going on from that premise, the Court observed that where statutory language is not expressly defined, that language should be given its common meaning. The District Court was noted by the Circuit Court to have equated the phrase "willfully attempted to evade" with the definition found in other civil tax cases -- voluntary, conscious, and intentional evasions of tax liabilities. The Circuit Court felt that this was the applicable standard to the Debtor whom it observed "had the wherewithal to file his return and pay his taxes, but he did not fulfill his obligation. It is undisputed that he did so voluntarily, consciously, and intentionally."

It is clear that neither the district court nor the Sixth Circuit found Mr. Toti to be a sympathetic character. The determination that he was not an honest Debtor entitled to a discharge establishes this point. He had pleaded guilty to a criminal offense based on very similar language to that used in §523(a)(1)(C). Sometimes, however, hard cases make bad law. Both the courts seem to have overlooked the significance of the language of §523(a)(1)(B)(ii) in considering their holdings to deny a discharge to Mr. Toti.

It is interesting to speculate on the circumstances under which a Debtor **would** be dischargeable from taxes under the literal language of the finding in the Toti case.[4] It

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[3]The Sixth Circuit opinion is written by the Honorable William H.. Timbers, Senior United States Circuit Judge for the Second Circuit, sitting by designation.

[4]Certainly, fittingly enough to a case which cites *Ron Pair*, there is the "coma" defense. A taxpayer who failed to file and pay his tax returns because he was in a coma might avail himself of a discharge of taxes notwithstanding the provisions of §523(a)(1)(C), provided that he had regained consciousness, filed his returns [to avoid the prohibition on discharge of §523(a)(1)(B)(i)] and the returns were filed more than two years prior to the date of the filing of the bankruptcy petition [to avoid the prohibition on discharge of §523(a)(1)(B)(ii)].

seems to preclude the dischargeability of taxes for a taxable year ending on or before the filing of the bankruptcy petition for which a tax return was filed after it became due but the tax return filing occurred more than two years before the filing of the bankruptcy petition. Let us consider the pertinent language of §523(a)(1), which reads:

§ 523. Exceptions to discharge

(a) A discharge under section 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 section 507(a)(2) 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, if required -

(i) was not filed; or

(ii) was filed after the date on which such return 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;

What is the meaning of §523(a)(1)(B)(ii) in the context of the decision of the Sixth Circuit in *Toti* decision? Or conversely, considering the existence and language of §523(a)(1)(B)(ii), what is the meaning of §523(a)(1)(C)? Clearly, if we focus on the first part of §523(a)(1)(C), i.e., "with respect to which the debtor made a fraudulent return", an affirmative act, the filing of a fraudulent return, is required. It is arguable that the fraud could be in the form of an omission, but, nonetheless, an affirmative act of filing the return which is fraudulent is required. Is the first part of §523(a)(1)(C), i.e., the filing of a fraudulent return, an enunciated "manner" as referenced in the second part of §523(a)(1)(C) which denies discharge of a tax "with respect to which the debtor ... willfully attempted in any manner to evade or defeat such tax"?

A often cited rule of statutory construction requires that the statute be construed as a whole so as to produce a harmonious whole. *In re Hall*, 151 BR 412 (Bankr. W.D. Mich 1993) (citing 2A N. Singer, Sutherland Statutory Construction §46.05 (1992)) The premise is that a statute should be read as a whole, reconciling all provisions with the section under immediate scrutiny, in such a fashion that no provision is rendered meaningless. Except for the fanciful "coma" exception posed above, under what circumstances can one construe the provisions of §523(a)(1)(C), as interpreted by the Court in *Toti*, to be different than the circumstances which might be described in §523(a)(1)(B)(i) or (ii)? As interpreted in *Toti*, does not the language of §523(a)(1)(B)(i) and (ii) become superfluous? In order to give the language of §523(a)(1)(B)(ii) meaning, when it provides for an additional exception to the general non-dischargeability of taxes as specified for taxes in respect to returns *filed after the date on which such return was last due, under applicable law or under any extension, and* BEFORE *two years before the date of the filing of the petition,*does not

the "willfully" language of § 523(a)(1)(C) have to be interpreted, as the Bankruptcy Court did, as requiring an affirmative act rather than just an omission? The language of §523(a)(1)(B)(ii) suggests that if a tax return was not filed on a timely basis but was filed more than two years prior to the filing of a bankruptcy petition, the tax liability may still be subject to discharge because it is not included within the exception to discharge. If as the IRS argued, the failure to file a timely return constitutes a "willful" act, i.e., by omission, and, if such a "willful" act results in a bar from discharge under the language of §523(a)(1)(C), does not the effect and meaning of §523(a)(1)(B)(ii) disappear?

In consideration of the *Ron Pair* decision, is the word "willfully" unambiguous in the context of §523(a)(1)(C)? Clearly, the word is interpreted by different standards depending on the context, i.e., civil vs criminal cases. Does the fact that §523(a)(1)(C) is a civil law provision mean that the civil law meaning of "willfully" is the meaning which must be applied. It was noted with approval by the Sixth Circuit in *Toti* that the District Court had stated "the purpose of the Bankruptcy Code is to allow the honest Debtor a fresh start" before making the statement that "Toti does not fall within the category of honest debtors." Does not the Court's analysis in terms of the honesty of the Debtor lead one to a consideration of the criminality of the behavior of the Debtor? If so, is not the criminal standard for "willfully" more appropriate.

For the foregoing reasons, it is argued that the decision of the Sixth Circuit in *Toti* is improvident. It may well be that the decision can be distinguished if, for example, there is no criminal conviction. Nonetheless, the standard enunciated by the court would presumably still snare a Debtor who had merely omitted to file tax returns.

At present, the Toti decision constitutes binding precedent on the Courts of both the Eastern and Western Districts of Michigan and will impose a substantial hurdle for a Debtor who has failed to timely file income tax returns to be able to later file such returns and then seek a discharge of that liability in a Chapter 7 case. It is likely that a Debtor under such circumstances, who does not want to litigate the issue on an extended basis, will be well advised to consider filing a Chapter 13 and treating such liability as a non priority unsecured claim.

RECENT BANKRUPTCY CENTER DECISIONS

6th Circuit and Supreme Court decisions are summarized by John Potter; Western District cases are summarized by Vickie Young; Eastern District cases are summarized by Jaye Bergamini.

In re James David Harden berg, Harden berg v Commonwealth of Virginia, 1994 FED App. 0406P (6th Cir.) File Name 94a0406p.06, Case No. 93-4183 (December 9, 1994). In 1985, Plaintiff/Debtor was convicted of drunk driving in Virginia. As punishment, the Virginia court imposed fines and costs and suspended Debtor's drivers license until they were paid. The state of Ohio also suspended Debtor's drivers license until he could provide a "letter of clearance" from Virginia to the Ohio Bureau of Motor Vehicles. Later, Debtor filed a Chapter 13 Petition and listed the Virginia Court as an unsecured creditor to be paid a 20% dividend on its claim. Despite the payment schedule set forth in the Chapter 13 Plan, Virginia refused to

provide the "Letter of Clearance" until Harden berg completed his Plan and received a discharge.

On January 6, 1989, Debtor filed an adversary proceeding against the state of Virginia, claiming it had violated the automatic stay under 11 U.S.C. §362(a)(6), by failing to reinstate his drives license and to issue the "letter of clearance". The bankruptcy court ruled that Virginia's actions were not automatically stayed, but the obligation to pay the fines and costs was a dischargeable debt upon successful completion of the Chapter 13 Plan. Since Debtor had completed his Plan and received a discharge, the injunction 11 U.S.C. §524 was effective. Virginia was now required to issue Debtor a drivers license and a "Letter of Clearance". The district court affirmed the bankruptcy court decision.

The Court of Appeals affirmed the lower court decision, station that pursuant to 11 U.S.C. §1328(a), criminal fines and costs were dischargeable debts. If this Court were to follow the dictum application to a Chapter 7 proceeding as stated in Kelly v Robinson, 479 U.S. 36 (1986), as being equally applicable in a Chapter 13 proceeding, it would render superfluous Congress' plain language of 11 U.S.C. §523(a)(7). As Justice Marshall noted in Pennsylvania Dept. of Public Welfare v Davenport, 495 U.S. 552, 562 (1990), which ruled that criminal restitution debts were dischargeable upon completion of a Chapter 13 Plan, there is a deep reluctance to render superfluous other provisions in the same enactment. The Court went on to note that the Bankruptcy Reform Act of 1994, amends 11 U.S.C. §1328(a)(3) to correct the result reached in Davenport.

In re Brentwood Outpatient, Bondholder Committee v Williamson County, Tennessee, 1994 FED App 0408P (6th Cir.) File Name 94a0408p.06, Case No. 93-5484/5609 (December 13, 1994).
In August of 1989, Debtor, Brentwood Outpatient, Ltd., a Nashville, Tennessee medical clinic filed a Chapter 11 Petition. Its assets included land and a building valued at $4 Million. This asset was financed by the issuance of bonds owned by Plaintiff, Bondholder Committee. Property taxes owed to Defendant, Williamson County, became due in October of 1989. Tennessee law provided that the taxes became delinquent on March 1, 1990, entitling the County to collect monthly interest, penalties, costs and lawyers fees. The taxes and any addition thereto were secured by a first priority lien on the property. That County asserted a claim which included interest, penalties, costs and attorneys' fees. The value of the property exceeded the claim, making the County's claim oversecured.

The Plan of Reorganization proposed by Plaintiff, Bondholder Committee, provided that the County's claim would be paid in full on the effective date of the Plan. After confirmation of the Plan, the taxes and interest were paid. However, Plaintiff objected to the payment of penalties, attorneys' fees and costs. The bankruptcy court allowed the payment of penalties but disallowed payment of costs and attorneys' fees. Also, the County's entitlement to penalties would fun up to the effective date of the Plan, and post petition interest would run up to the date of payment of the taxes. The district court affirmed this ruling. The county appealed seeking priority for its costs and fees and having penalties accrue up to the date of payment.

The Court of Appeals, citing United States v Ron Pair Enters., 489 U.S. 235 (1989), found that 11 U.S.C. §506(b) denied post petition nonconsensual additions to tax claims, regardless of whether such claims

are for federal or state taxes. Section 506(b) does control this case because it sets out the only exceptions to the general rule disallowing post petition additions. The Supreme Court has ruled decisively on the meaning of 506(b). The Court affirmed the bankruptcy court in allowing the County to recover post petition interest, but concluding Ron Pair requires disallowance of its claims for post petition fees and costs, since the claims arose by operation of law and not by agreement.

The Court of Appeals, however, reversed the lower courts conclusion that penalties were an allowable claim. No post petition additions to claims are allowable in Chapter 11 cases except as provided by 506(b). Accordingly, penalties which accrue post petition are not allowed to a nonconsensual oversecured claimant.

EDITOR'S NOTEBOOK

This is my first Newsletter as Editor and all comments are encouraged and welcomed. I am in need of articles for upcoming editions and anyone interested in writing an article should call me. There have been many new members to the Federal Bar Association from the Eastern District and these members are also encouraged to write an article.

I look forward to my term as Editor with enthusiasm and am hopeful that I can fill the shoes of my predecessors.

Mary K. Viegelahn Hamlin, Editor

STEERING COMMITTEE MINUTES

The Steering Committee met on January 27, 1995 at the Peninsular Club in Grand Rapids. The December seminar in Grand Rapids on the 1994 Amendments was a success. There were 137 in attendance. There was a January seminar in Traverse City on the 1994 Amendments which was well attended by the local attorneys. The 1995 seminar is currently scheduled for July 27, 28 and 29, 1995 and will be held at the Lake View Hotel on Mackinac Island. Anyone with a suggestion as to possible topics and speakers should contact Steve Rayman at (616) 345-5156. The keynote speaker for the 1995 seminar is Professor Karen Gross of New York Law School. She is a nationally known author and lecturer on Bankruptcy issues. Also in attendance as guest speakers will be Judge Waldron of Ohio, Judge Ginsberg of Illinois, Judge Martin of Wisconsin and our local Judges.

The next Steering Committee meeting will be held on February 17, 1995 and will be held at the Peninsular Club in Grand Rapids.

LOCAL BANKRUPTCY NOTICE

The Court Calendar which was published in the last edition of the Bankruptcy Law Newsletter has been extensively amended. Enclosed is a copy of the January 1 - June 30, 1995 Court Calendar.

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United states Bankruptcy Court for the Western District of Michigan (Lower Peninsula) during the period from January 1 through December 31, 1994. These figures are compared to those made during the same period one year ago and two years ago.

Bankruptcy Chapter	January 1 - December 31, 1994	Percent Increase (Decrease)	January 1 - December 31, 1993	Percent Increase (Decrease)	January 1 - December 31, 1992
Chapter 7	4156	(9.10%)	4563	(8.6%)	5281
Chapter 11	89	(7.4%)	121	(9.5%)	127
Chapter 12	21	(6.2%)	34	14.2%	24
Chapter 13	1611	(11.1%)	1457	(9.2%)	1592
Totals	5877	(9.5%)	6175	(8.8%)	7024

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COURT CALENDAR FOR 1995

	Monday	Tuesday	Wednesday	Thursday	Friday
JANUARY	2 Holiday	3	4 GL	5	6 GK
	9	10 GG	11 HG	12	13 HK ST
	16 Holiday	17	18 SK	19 GT	20 GT HL
	23 SG	24 GG HM	25 HM	26 GK	27
	30 Ct Admin Mtg.	31 HG	1	2 GL	3 HK
FEB	6 SK	7 GG	8	9 GK ST	10
	13 SG	14	15	16 GT	17 GT
	20 Holiday	21 GG SM	22 HG SM	23 GK SM	24 HK
	27	28 HL	1	2	3 GL
MARCH	6 SG	7 GG	8 HG	9 GK ST	10 HK ST
	13	14	15 SK	16	17 HL
	20	21 GG	22 HG	23	24 HK
	27 SG	28 HM GL	29 HM	30 GK	31 Court Admin Mtg
APRIL	3 SK HG	4 GG	5 HL	6 ST	7 HK
	10	11	12	13 GT SG	14 GT
	17 SM	18 GG SM	19 SM	20 GK	21
	24	25 HG	26	27 GL	28 HK
MAY	1 SK	2 GG	3	4 GK ST	5 HL ST
	8	9 HG	10 SG	11 GT	12 GT HK
	15	16 GG HM	17 HM	18 GK	19
	22 SK	23 HG	24 Ct Admin Mtg	25 GL	26 HK
	29 Holiday	30 GG	31	1	2
JUNE	5	6 HG GK	7	8 GT	9 GT HK
	12 SG	13	14	15 ST	16 HL
	19 SM	20 SM GG HG	21 SM	22 GK	23 HK
	26 GL SK	27	28	29	30

(LAST AMENDMENT -- JANUARY 1, 1995)

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