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**Discharging Tax Liability in Bankruptcy**

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Discharging Tax Liability in Bankruptcy

Veryl Victoria Miles

Although few tax liabilities are dischargeable, those that are can be a great help to your client.

Imagine a typical client interview in a bankruptcy matter. After the preliminaries, you get down to the business of finding out exactly what got the client into debt. Was it an excessive use of credit cards? An extended period of unemployment caused by a layoff or even an incapac-

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Itating illness? Perhaps the client has assumed responsibility for an elderly or ailing parent, or for an adult child or grandchild who has encountered some kind of personal hardship—resulting in a financial catastrophe for all involved.

Whatever brought about the client's current state of indebtedness, you can usually expect to see one kind of debt listed along with the others: debt for unpaid taxes. This indebtedness may reflect unpaid income taxes, gross receipts taxes, property taxes, or even gift and estate taxes, to mention a few. Regardless of the nature of the unpaid tax, the client will want your answer to a basic question: "Is this tax debt dischargeable in bankruptcy?"

Unfortunately, the treatment of tax debts under the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C.) ("Code") (all section references are to the Code unless noted otherwise) requires that classic lawyer's answer: "It depends."

This article will examine what the answer depends on: The kinds of tax liabilities individual debtors are typically burdened with upon entering the bankruptcy process and the extent to which these prepetition debts are dischargeable or nondischargeable in bankruptcy. (The kinds of tax claims discussed in this article are unsecured tax claims. Accordingly, if a tax claim is secured by a lien against the debtor's property the following discussion would not be relevant.)

**What Kind of Bankruptcy Case is it?** Individual debtors usually seek relief either under chapter 7 or chapter 13 of the Code. These chapters provide different kinds of relief. They also treat tax debts differently.

**Chapter 7 Relief**

When a debtor seeks bankruptcy relief under chapter 7, the debtor expects to receive a discharge of personal liability from most prepetition debts. The debtor's prepetition non-exempt assets are liquidated by the trustee in bankruptcy and the proceeds are distributed among the prepetition creditors according to the asset distribution rules of the Code.

**Some Tax Debts**

**Nondischargeable in Chapter 7**

Chapter 7 specifies certain categories of tax debt that are nondischargeable. This means that the debtor will not be discharged from liability for any unpaid tax claims that fall within the categories of nondischargeable tax claims. Accordingly, the debtor will remain personally liable and accountable to the tax claimant for the full payment of the unpaid tax debts, notwithstanding a general bankruptcy discharge under chapter 7.
Chapter 13 Relief

The relief provided to the debtor who files a petition under chapter 13 includes a debtor's discharge of most prepetition indebtedness, and allows the debtor to retain all of his or her nonexempt assets in addition to exempt assets. However, to qualify for this relief under chapter 13, the debtor must propose a plan to repay certain prescribed amounts of all prepetition debts and postpetition administrative expenses over a period usually not exceeding 36 months, unless a longer period not to exceed 60 months has been approved by the bankruptcy court. Under the chapter 13 plan, the prepetition debts are to be paid from the debtor's future earnings, which usually results in a greater payment of the claims of creditors than might otherwise occur in a chapter 7 liquidation. Once the debtor has completed making all payments under the plan, the debtor will be entitled to a discharge of any unpaid portions of prepetition debts, with limited exceptions.

Chapter 13 Requires Full Payment of Priority Tax Claims

In the chapter 13 rehabilitation, the debtor's plan must provide for the full payment of those tax claims that are "priority claims," which is the most common type of tax claim present in bankruptcy cases and is one type of nondischargeable tax claim. The full payment of priority claims, including priority tax claims, is a requirement for the approval or confirmation of a chapter 13 plan by the bankruptcy court. Although a debtor's discharge in a chapter 13 case is broader than the discharge provided for under chapter 7, and technically allows for a discharge from tax claims, the requirement that the debtor provide for the full payment of priority tax claims in a chapter 13 plan has the same effect of holding a debtor accountable for such tax debts as experienced in the chapter 7 liquidation.

The Key Is Knowing the Difference

Thus, critical to one's understanding of the extent to which a tax debt is dischargeable under chapter 7 is knowing what kind of tax claim qualifies as a nondischargeable debt. In a chapter 13 rehabilitation it is just as important for the debtor who has outstanding tax claims to ascertain whether the outstanding tax claims qualify as priority claims and to understand that he or she will be required to pay these claims in full to qualify for the relief provided thereunder.

Nondischargeable Tax Claims

- Under the Code, certain types of debts are nondischargeable because, for public policy reasons, one should not be permitted to escape liability for them. Tax obligations are one of the types of indebtedness that
fall within the category of nondischargeable debts. The nondischargeability of tax obligations was present in our first federal bankruptcy law dating back to 1800, which made all debts owed to the government excepted from discharge, including unpaid taxes. Today, however, time limits are imposed on most of the tax obligations that are deemed nondischargeable at bankruptcy, with the exception of taxes with respect to which the debtor has failed to file a required tax return, or has engaged in fraudulent or evasive behavior.

Review Section 523(a)

The provision of the Code describing the types of debts that are nondischargeable in individual bankruptcy cases is section 523(a). Subsection (1) of this provision lists three categories of tax claims that are nondischargeable:

- Unsecured priority tax claims listed under section 507(a) of the Code. These are the most common nondischargeable tax debts;
- Tax claims for which the debtor was required but failed to file a tax return, or tax claims for which the tax return was filed late; and
- Tax claims for which the debtor was found to have filed a fraudulent return or to have willfully attempted to evade the tax obligation.

THe PRIORITY TAX CLAIM • The tax obligations that are nondischargeable under section 523(a)(1)(A) are the same tax claims that are listed as unsecured priority claims under sections 507(a)(2) and 507(a)(8) of the Code. Accordingly, one must refer to these sections to determine whether a client's tax indebtedness qualifies as a nondischargeable debt under section 523(a)(1)(A). The most common priority tax claims that are the subject of nondischargeability in consumer cases are those found under section 507(a)(8) (formerly known as section 507(a)(7), before amendment under the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106, 4132).

Claims Typically Arise in Involuntary Bankruptcies

The kinds of tax claims that fall within the scope of section 507(a)(2) usually arise in involuntary bankruptcy cases typically filed against business debtors under chapter 7 or chapter 11. In such cases, the debtor's creditors are the parties who have petitioned the bankruptcy court to place the debtor in bankruptcy pursuant to section 303(b). Section 507(a)(2) essentially grants priority status for any debts, including tax claims, that the debtor may have incurred after the petition was filed and before the bankruptcy court appoints a trustee or enters an order of relief granting
the petition for bankruptcy relief. Taxes incurred during the period between the filing of the petition and the decision to grant the order of relief enjoy a second-level priority claim status under section 507(a)(2) and also are nondischargeable under section 523(a)(1)(A). Again, the priority tax claim classified under section 507(a)(2) would only be applicable in involuntary cases.

**INCOME AND GROSS RECEIPTS TAXES**

Most priority tax claims fall within the categories listed under section 507(a)(8). There are seven different classifications of unsecured priority tax claims under this provision, some of which are more common in consumer bankruptcies than others. For the most part, the types of unsecured priority claims that are listed under section 507(a)(8) include a debtor's recent tax liabilities, and tax liabilities for which the debtor is responsible for collecting or withholding for another, such as trust fund taxes one must collect as an employer from employees to meet their social security and income tax obligations.

**Taxes Due on Recent Income**

The first category of priority tax claims under section 507(a)(8)(A)(i) encompasses income or gross receipts taxes for taxable years that:

- End on or before the filing of the bankruptcy petition; and
- For which a tax return was due (including extensions) any time after three years before the date of the filing of the bankruptcy petition.

Essentially, these types of tax claims are recent income and gross receipts taxes for which a debtor has filed timely tax returns but has yet to pay the amounts due. The reason for limiting the priority claim, and thus the nondischargeability of the claim, to tax claims for which tax returns were last due after the three years before the date of the petition is to prevent the tax authorities from excessive delay in the exercise of their collection rights as creditors against the delinquent taxpayer. See *Wood v. United States (In re Wood)*, 866 F.2d 1367 (11th Cir. 1989).

**When Was the Petition Filed?**

Assume for example that a debtor has filed a petition in bankruptcy on April 1, 1995. At the time the petition is filed there are outstanding income tax debts for the taxable years of 1991 through 1994 (the taxable year ends on December 31st of each year). The debtor has filed timely tax returns for each year, all of which were due on or before April 15th of the following year. In this case, the tax debts for each year (1991, 1992, 1993 and 1994) will be nondischargeable as priority claims under section 523(a)(1)(A). This is based on the fact that the taxable years for each year ended before
the filing of the bankruptcy petition, that is, December 31st of the taxable year; and the due date for the tax returns for each year was sometime after April 1, 1992 (the beginning of the three years before the date the bankruptcy petition was filed).

**Filing Date Is Critical**

If, however, the bankruptcy petition had been filed on or after April 16, 1995, the tax claim for 1991 would be a dischargeable tax claim because the tax return for that taxable year was due on April 15, 1992, which precedes April 16, 1992 (the beginning of the three years before the bankruptcy petition was filed). The other tax debts would remain nondischargeable because the due dates of those returns fall within the three-year rule of section 507(a)(8)(A)(i). The change in the date of the filing of the petition illustrates the importance of considering when to file the petition as a means of limiting the effect of the priority rule of this provision and the nondischargeability of the tax claim. See, e.g., *Fletchall v. State of Iowa (In re Fletchall)*, 1995 WL 453344 (N.D. Iowa 1994); *Williams v. Internal Revenue Service (In re Williams)*, 153 B.R. 74 (Bankr. S.D. Ala. 1992) aff'd, *U.S. v. Williams*, 156 B.R. 77 (S.D. Ala. 1993); *Gidley v. United States (In re Gidley)*, 151 B.R. 952 (M.D. Fla. 1992); *Bieber v. United States (In re Bieber)*, 151 B.R. 290 (Bankr. S.D. Ga. 1992).

**Recently Assessed and Assessable Income and Gross Receipts Taxes**

Section 507(a)(8)(A)(ii) qualifies income and gross receipts taxes as priority claims if they are assessed within 240 days of the filing of the petition (this 240-day period may be extended by any time plus 30 days during which a debtor makes an “offer to compromise” tax liability with the tax authority after an assessment has been made). Similarly, section 507(a)(8)-(A)(iii) qualifies income and gross receipts taxes as priority claims if they are assessable after the filing of the petition and are not the type of tax claims described in sections 523(a)(1)(B) or (C) (i.e., tax claims for which a return has not been filed, has been filed late, or tax claims for which a debtor has filed a fraudulent return or has attempted to evade tax liability).

**When Was the Tax Claim “Assessed”?**

The critical element in determining the priority status under the “240-day assessment rule” and the “postpetition assessment rule” of sections 507(a)(8)-(A)(ii) and (iii) is establishing when a tax claim is “assessed” or “assessable” and not the age of the tax. The “determination of the precise date of assessment should be accomplished by ref-
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Reference to the specific [federal, state or local] tax code and practices involved." King v. Franchise Tax Board of the State of Cal. (In re King), 961 F.2d 1423, 1427 (9th Cir. 1992); see also Hartman v. United States (In re Hartman), 110 B.R. 951, 955 (D.Kan. 1990). This requires an application of the particular assessment procedure of the relevant local, state, or federal tax law, which usually anticipates some formality of fixing tax liability. In re King, supra, at 1427. For example, under federal tax law the "assessment" might mean a certain amount of time after the notice of tax deficiency is issued, or a final determination by a tax court when a debtor has sought an appeal of an assessment. Id. at 1425 (citing Internal Revenue Code sections 6213 and 7481). Such a determination under the relevant tax law may even result in the assessment of taxable years well beyond the three year rule described under section 507(a)(8)(A)(i). S.Rep. No. 989, 95th Cong., 2d Sess. 70-71 (1978) reprinted in 1978 U.S.C.C.A.N. 5787, 5856-57.

Determining Priority Status of Recently Assessed Taxes

As an illustration, assume that a debtor does not file income tax returns for the taxable years of 1989, 1990, 1991, 1992, and 1993 until September 1994; thus, all of the returns for these years are filed late. The Internal Revenue Service then issues a final assessment of the debtor's tax liability for these taxable years in December 1994. The debtor files a petition in bankruptcy in February 1995. Under section 507(a)(8)(A)(ii), the tax liabilities for each of those years will be priority claims because the taxes were assessed within the 240 days before the date of the filing of the bankruptcy petition. The fact that the tax returns for 1989 and 1990 were due before the beginning of the three years before the bankruptcy petition was filed is irrelevant. Again, the age of the taxable year is not important when determining the priority status for tax debts for which returns have been filed late; it is the date of the assessment that is determinative. See In re Fletchall, supra, at 5; Greco v. United States, (In re Greco), 164 B.R. 686 (Bankr. M.D. Fla. 1994); Richcreek v. Internal Revenue Service, 1988 WL 81527 (S.D. Ind. 1988).

OUTSTANDING PROPERTY TAXES

In the case of outstanding property taxes, the priority status of such liabilities also is limited to recent property taxes. Section 507(a)(8)(B) provides that property taxes assessed before the filing of the bankruptcy petition and last payable without penalty anytime after one year before the filing of the petition are priority claims. Accordingly, the reach of this priority provision is limited to recent property taxes through the require-
ment that the tax be last payable without penalty after one year before the date of the bankruptcy petition. Thus, if taxes have been assessed against property at the time of the filing of the bankruptcy petition and a penalty was imposed against the outstanding taxes before the one-year period before the filing of the petition in bankruptcy, the tax claim will not be a priority claim under section 507(a)(8)(B) since it was payable with penalty after the one-year period before the petition was filed. See In re Becker, 169 B.R. 725, 730 (Bankr. D. Kan. 1994).

When Does the Property Tax Qualify as a Priority Claim?

If, however, the tax has been assessed at the time of filing and payable without a penalty after one year before the filing of the bankruptcy petition, the tax is a priority tax claim and nondischargeable under section 507(a)(8)(B). See In re Grivas, 123 B.R. 876, 880-81 (Bankr. S.D. Cal. 1991). When the tax has been assessed and was payable without penalty after one year before the filing of the bankruptcy petition, and an interest penalty is assessed within the one-year period before the filing of the petition, the tax will qualify as a priority tax under section 507(a)(8)(B) and so will the penalty. As will be discussed later, section 507(a)(8)(G) provides that pecuniary tax penalties will have the same priority status under section 507(a)(8) as the principal tax. See 3 William M. Collier, Collier on Bankruptcy, ¶507.04, 507-37 (Lawrence P. King, ed., 15th ed. 1994).

Accordingly, if a debtor files a petition in bankruptcy in September 1995, and has an outstanding property tax for the taxable year of 1994, which was payable without penalty on March 31, 1995, the tax would qualify as a priority claim under section 507(a)(8)(B) because it was payable without penalty after September 1994 (the beginning of the one year before the date of the filing of the petition). If prepetition interest penalties also accrued against the unpaid taxes after March 31, 1995, they would also qualify as a priority claim and have the same priority status as the principal taxes pursuant to section 507(a)(8)(G).

Special Priority Tax Claims

Other types of tax claims that have priority status, and thus are nondischargeable, include "trust fund" taxes, employment taxes, excise taxes, and customs duties.

Trust Fund Taxes

Trust fund taxes include those that a debtor is required to withhold from or to collect on behalf of another. §507(a)(8)(C). For example, if a client is an employer and is required to make withholdings from the earnings of employees to collect the employees'

Employment Taxes
Similarly, if the debtor as an employer is liable for outstanding prepetition wage and compensation claims owed to employees (like the kind described under section 507(a)(3) of the Code), and is required to make an employer’s contribution to employment taxes on the wages, or to an employee’s insurance fund like FICA, or to a state unemployment compensation fund, these claims will have priority status under section 507(a)(8)-(D). See State of Texas v. Pierce (In re Pierce), 935 F.2d 709 (5th Cir. 1991); In re Continental Minerals Corp., 132 B.R. 757 (Bankr. D. Nev. 1991); In re The Chief Freight Lines Company, 146 B.R. 291 (Bankr. N.D. Okl. 1992). However, the priority status of these employment tax claims is limited to taxable years for which a tax return for the employment taxes were first due any time after three years before the date the bankruptcy petition was filed. §507(a)(8)(D). The important distinction between the taxes described in section 507(a)(8)(D) and (C) is that the tax liability covered by section 508(a)(8)(D) is not one the debtor/employer is required to withhold from the employee’s salary but it is the debtor/employer’s share of such tax liability. S.Rep. No. 989, 95th Cong., 2d Sess. 71 (1978) reprinted in 1978 U.S.C.C.A.N. 5787, 5857. It is also important to note that this priority tax is limited to taxable years for which a return was due any time after three years of the date of the filing of the bankruptcy petition.

Excise Taxes
In the case of outstanding excise tax liabilities, such as “sales taxes, estate and gift taxes, gasoline and special fuel taxes, and wagering and truck taxes,” section 507(a)(8)(E) provides that these claims are priority claims. 124 Cong. Rec. S17406 (Senate), reprinted in 1978 U.S.C.C.A.N. 6505, 6567; 124 Cong. Rec. H11089 (House), reprinted in 1978 U.S.C.C.A.N. 6436, 6498. The excise tax is a priority claim only to the extent that the transaction upon which the tax is based occurred:
• Before the filing of the bankruptcy petition and the tax return to be filed for such tax was due anytime after three years before the date of the bankruptcy petition; or

• Within the three-year period before the filing of the bankruptcy petition in cases in which a return is not required. §507(a)(8)(E).

Customs Duties

Another liability that falls within the category of unsecured priority claims is a claim against a debtor for customs duties on imported merchandise. Generally, customs duties are priority claims to the extent that:

• The imported goods upon which the duty is based entered the country for consumption within the one year before the filing of the bankruptcy petition; or

• The imported goods have been "covered by an entry liquidated or re-liquidated within one year before the date of the filing of the petition." §507(a)(8)(F)(i) and (ii).

The term "liquidated" is meant to include all administrative determinations by the Secretary of Treasury of the "value and tariff rate of the item." S.Rep. No. 989, 95th Cong., 2d Sess. 73 (1978) reprinted in 1978 U.S.C.-C.A.N. 5787, 5859. When the liquidation of the imported goods has not been determined because of an investigation by the Secretary of Treasury, the customs duty will have a priority status against goods that entered the country for consumption within four years before the date of the petition in bankruptcy. The four-year rule applies to the cases in which the Secretary of Treasury certifies that the reason for the investigation was a need to assess antidumping duties or for fraud, or to obtain additional information needed to make an appraisal or classification of the merchandise. §507(a)(8)(F)(iii).

Pecuniary Tax Penalties and Tax Refunds

• The last of the priority tax claims includes pecuniary tax penalties. To the extent that a penalty has been assessed against any of the outstanding tax obligations that are listed under section 507(a)(8), the penalty will enjoy priority status if it compensates actual pecuniary loss. §507(a)(8)(G). If the penalty is punitive it does not fall within this category and would not enjoy the priority status of section 507(a)(8)(G), and would be a claim subordinate to general unsecured claims pursuant to section 726(a)(4).

An example of such a pecuniary penalty is prepetition interest assessed against unpaid taxes to the extent it compensates the government for loss of its use of the unpaid taxes. Although the interest is a penalty, it is not regarded as punitive but is for pecuniary loss. See Garcia v. United
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States (In re Garcia), 955 F.2d 16 (5th Cir. 1992). Although it is generally accepted that prepetition interest on nondischargeable tax debts will enjoy the same priority as the principal debt, the rationale to support this view varies between that found in Garcia, which relies on the language of 507(a)(8)(G), and the view expressed in In re Larson, 862 F.2d 112 (7th Cir. 1988), in which the court relied on the Code's broad definition of "claim" under sections 101(4) and 502.

Finally, if the government's claim against the debtor is for an erroneously paid tax refund, or a claim for having erroneously granted a tax credit, the claim will enjoy the same priority as the principal tax from which the claimed refund or tax credit is derived pursuant to section 507(c).

OTHER NONDISCHARGEABLE TAX CLAIMS

• Other nondischargeable tax claims include:

  • Tax claims for which no tax return has been filed as required;
  • Tax claims for which tax returns have been filed late;
  • Tax claims for which the debtor has filed fraudulent returns or has willfully attempted to evade the obligation; and
  • Punitive tax penalties.

Although these claims are nondischargeable, they are not priority claims and do not enjoy priority in the distribution of assets over general unsecured claims like the nondischargeable priority tax claims. The Code does not include this type of debt as a priority claim to protect a debtor's general unsecured creditors from having to bear the burden of the debtor's wrongful conduct. S.Rep. No. 1106, 95th Cong., 2d Sess. 22 n. 19 (1978) reprinted in App. 3 Collier on Bankruptcy, supra.

Failure To File

Under section 523(a)(1)(B)(i) tax obligations are nondischargeable when a required tax return has not been filed. This type of nondischargeable tax claim is not a priority claim. The public policy behind this rule in making such debts nondischargeable is to prevent a debtor from using bankruptcy relief as a means of avoiding his or her tax obligations.

What Constitutes a Filing?

Many of the cases litigated under this provision involved the question of what constitutes a "filing" of a return when the debtor failed to sign tax returns, or failed to file a return but a substitute filing was made by the taxing authority to assess the debtor's liability. The general rule in these cases has been that unsigned returns and substitute returns filed by tax author-

Late Filings

The other part of the provision, section 523(a)(1)(B)(ii), makes tax obligations for which a return has been filed late nondischargeable. That is, if a tax return has been filed by the debtor after the due date for filing the return, the tax obligation based on the return will be nondischargeable if the return was filed anytime after two years before the date of the filing of the bankruptcy petition. Accordingly, when determining the nondischargeability of a tax liability for the late filed return, look at the date the late return was filed and not "the taxable year in question"; that is, the date the returns were last due. S. Rep. No. 989, 95th Cong., 2d Sess. 78 (1978) reprinted in 1978 U.S.C.C.A.N. 5787, 5864.

For example, assume that a debtor filed a petition in bankruptcy on July 1, 1995 and had unpaid income taxes for the taxable years of 1991, 1990, and 1989, for which the income tax returns were filed late on September 1, 1993. The taxes would qualify as nondischargeable under section 523(a)(1)(B)(ii) because the late return was filed after the two-year period before the filing of the bankruptcy petition. On the other hand, if the income tax returns for 1991, 1990, and 1989 had been timely filed, that is filed on or before April 15 of 1992, 1991 and 1990, respectively, any unpaid taxes for those years would be dischargeable because the returns were due more than three years before the date of the filing of the petition. See §§523(a)(1)(A) and 507(a)(8)(A)(i). See Olson v. U.S. Internal Revenue Service (In re Olson), 154 B.R. 276 (Bankr. D. N.D. 1993).

Fraudulent Returns and Attempts To Evade Tax Obligation

The tax claim for which the debtor is found to have filed a fraudulent return or to have willfully attempted to evade the tax obligation requires little explanation for its inclusion as a nondischargeable debt pursuant to section 523(a)(1)(C). Such dishonest behavior appropriately should not be sanctioned by permitting a debtor to escape such liability at bankruptcy. It is important to remember that such indebtedness is nondischargeable without limit to the age of the tax liability.
What Constitutes Willfulness?
A debate exists in case law interpreting what conduct qualifies the debtor as having "willfully attempted in any manner to evade or defeat such tax." When the debtor has continuously and knowingly failed to file income tax returns in the past, did not pay any income taxes, and had earnings to pay such taxes, courts readily have found such conduct to be a willful attempt to evade such tax. See Bruner v. United States (In re Bruner), 55 F.3d 195 (5th Cir. 1995); Toti v. United States (In re Toti), 24 F.3d 806 (6th Cir. 1994), cert. denied, 115 S.Ct. 482 (1994). However, there is some division among the courts as to whether a debtor who has filed income tax returns but intentionally has not paid the taxes to pay other debts has engaged in conduct that constitutes a willful attempt to evade the tax obligations. See Haas v. Internal Revenue Service (In re Haas), 48 F.3d 1153 (11th Cir. 1995); see contra In re Bruner, 55 F.3d at 199-200. The question seems to rest on how broadly one interprets the language of the provision, and whether it means to include evading a tax obligation "in any manner" including an election not to pay taxes so to pay other obligations for which there are insufficient funds; or does it require more affirmative conduct evidencing evasion such as intentional actions by the debtor exhibiting a pattern of not filing returns when due, failure to report income, and having hidden income and assets.

Fines and Penalties
The final provision of section 523(a) that can also have an effect on the nondischargeability of tax claims is subsection (a)(7). This provision is devoted to claims that are fines and penalties, and payable to and for the benefit of a governmental unit, including tax penalties. Under section 523(a)(7), governmental fines and penalties that are not for actual compensation but are punitive will be nondischargeable claims. This status of nondischargeability does not include:

- A tax penalty charged against a tax claim that is dischargeable, and thus not falling within the category of nondischargeable tax claims listed under section 523(a)(1); or
- A tax penalty against a transaction that occurred before three years of the filing of the petition in bankruptcy.

Thus, if a tax penalty is punitive and charged against a principal tax claim that is dischargeable, the penalty also will be dischargeable. Similarly, if the tax penalty is against a nondischargeable tax it will be a nondischargeable penalty claim. See Burns v. United States (In re Burns), 887 F.2d 1541 (11 Cir. 1989); Amici v. United States (In re Amici), 177 B.R. 386 (Bankr. M.D. Fla. 1994); In re
Moreover, if the tax penalty is punitive but relates to a transaction that occurred more than three years before the filing of the bankruptcy petition, the penalty is dischargeable regardless of the nondischargeability status of the principal tax claim under section 523(a)(1). See In re Bergstrom, supra, at 341; In re Roberts, 906 F.2d 144 (10th Cir. 1990); In re Burns, supra, at 1541; see contra Cassidy v. Commissioner, 841 F.2d 477 (7th Cir. 1987) (the Seventh Circuit read the two exceptions to nondischargeability of a tax penalty in the conjunctive, thus finding a punitive tax penalty imposed more than three years before the filing of the petition against a nondischargeable tax claim to be nondischargeable as well).

**Punitive Penalty Against Priority Claim Is Not Priority**

It is important to note that the punitive tax penalty against a priority tax claim that is nondischargeable under section 523(a)(1)(A) will not qualify as a priority claim under section 507(a)(8)(G). However, the punitive tax penalty may qualify as a nondischargeable claim under section 523(a)(7) because of the fact that it is punitive and derived from a principal tax claim that is nondischargeable under section 523(a)(1). The significant distinction in having a nondischargeable tax penalty under section 523(a)(7) versus section 523(a)(1) is that although the punitive tax penalty is nondischargeable under section 523(a)(7), it does not enjoy priority status in the distribution of assets, and is in fact subordinate to general unsecured claims pursuant to section 726(a)(4).

**Debts Incurred to Pay Nondischargeable Taxes**

A new category of nondischargeable indebtedness was added to section 523(a) pursuant to the Bankruptcy Reform Act of 1994 that is directly related to nondischargeable tax debts. This category of nondischargeable indebtedness includes debts incurred by a debtor to pay any outstanding federal taxes that would have qualified as a nondischargeable tax debt under section 523(a)(1). §523(a)(14). The effect of this provision would make debts owed to lenders such as credit card companies nondischargeable if the debt "arise[s] out of the payment of [a nondischargeable] tax." S. Rep. No. 168, 103rd Cong., 1st Sess. 47-48 (1993).

**Determining What Constitutes a "Tax"**

One point to remember is that whether something is or is not a "tax" is a question of federal law. That is, just because a statute says a charge is a "tax" does not necessarily determine the question. The Supreme Court has stated "whether the present obligation is a
'tax' entitled to priority within the meaning of the [federal bankruptcy] statute is a federal question."

City of New York v. Feiring, 313 U.S. 283, 285 (1941). Accordingly, just because a tax statute says an obligation is a tax or specific tax such as an excise tax, the tax law may be useful to "ascertain whether its incidents are such as to constitute a tax within" the bankruptcy law but it is not determinative.

Id. In fact the Court described the priority tax claim as one intended to command priority as "pecuniary burdens laid upon individuals or their property, regardless of their consent, for the purpose of defraying the expenses of government or of undertakings authorized by it." Id.

Legislative History
Aids the Determination

Over the years there have been numerous cases in which the courts have been asked to determine whether a particular charge constituted a tax for purposes of bankruptcy priority, or whether they fall within particular categories listed under section 507(a)(8). In many of the cases, the courts have looked to the definition provided in City of New York v. Feiring, supra, and the legislative history of the bankruptcy laws to ascertain the status of such claims. Determinations regarding the status of a charge as a "tax," "trust fund tax," "excise tax," or "tax priority penalty" have been critical to debtors because of the effect on the debtor's ability to receive a discharge from such indebtedness in the following cases:

- In re Continental Mineral Corp., 132 B.R. 757 (the court considered whether a claim of the Nevada Employment Security Department qualified as an employment tax under section 507(a)(8)(D));
- In re Reichert, 138 B.R. 522 (the court determined whether federal unemployment taxes were trust fund taxes under 507(a)(8)(C) or employment taxes under section 507(a)(8)(D));
- In re The Chief Freight Lines Co., 146 B.R. 291 (the court determined that FICA tax penalties were "non-compensation of actual pecuniary loss" but were punitive and not entitled to priority under section 507(a)(8)(G));
- In re Groetken, 843 F.2d 1007 (the court held that Illinois Retailers Occupation Taxes did not constitute a "trust fund" tax under section 507(a)(8)(C), but was either a gross receipt tax or excise tax pursuant to section 507(a)(8)(A) or (E), the priority status for which is limited by the age of the taxable year); and
court held that where Congress deems a tax an excise tax under the Internal Revenue Code, it would not make an independent determination of that status).

**CONCLUSION** • If tax debts described in the bankruptcy petition appear to meet the description of nondischargeable tax claims under section 523(a)(1), they will automatically be deemed nondischargeable at bankruptcy. Accordingly, if a debtor questions the status of the debt as nondischargeable, he or she must petition for an adversary proceeding before the bankruptcy court for a hearing on dischargeability pursuant to Fed. R. Bankr. P 4007. A determination that the tax debt is a dischargeable debt will mean that:

- The claim will be treated as a general unsecured claim;
- The tax claimant will receive payment along with other general unsecured claimants to the extent there are any assets to be distributed to unsecured claimants; and

- The debtor will be discharged from personal liability for the tax claim once the discharge order is entered by the bankruptcy court.

The ability of the law to hold debtors liable for tax obligations at bankruptcy is significant because the nondischargeability provisions of section 523(a)(1) are very comprehensive and make the likelihood of avoiding such liability rather limited. For the client who wants to know if filing a petition in bankruptcy will provide relief from outstanding tax liabilities, the answer to this question may depend on several factors:

- The nature of the tax (is it an income tax, property tax, or excise tax?);
- The age of the debt; and
- Whether there was any negative conduct on the part of the debtor in assuming responsibility for the tax liability.

For the debtor with considerable outstanding tax liabilities, bankruptcy may not prove to be a sole or significant source of relief. Perhaps additional relief will have to be pursued in a workout agreement with the relevant tax authority.