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Bankruptcy — Tax Discharge — Tax Priority

Taxpayer, a corporation, filed income tax returns for its fiscal years 1957, 1958, and 1959, which disclosed questions concerning deductions claimed and the treatment of various income items. The Internal Revenue Service had undertaken routine administrative adjustment procedures, but had given no notice of deficiency¹ nor made any assessment of taxes² for the years in question prior to the taxpayer's adjudication of bankruptcy in 1965. The United States claimed priority status for these taxes under section 64a(4) of the Bankruptcy Act,³ but the trustee in bankruptcy objected, contending that the taxes were dischargeable debts under section 17a(1) of the Bankruptcy Act,⁴ and, therefore, not entitled to priority status. The referee in bankruptcy and the district court sustained the objection and allowed discharge in bankruptcy of the tax liability. *Held, reversed and remanded*: The taxes are entitled to priority status and are not dischargeable in bankruptcy, even though they are over three years old, for two reasons: (1) they were not reported on a return made by the bankrupt; and (2) they were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt. *In re Indian Lake Estates, Inc.*, 428 F.2d 319 (5th Cir. 1970).

I. COMPELLING REASONS FOR 1966 AMENDMENTS TO THE BANKRUPTCY ACT

The fundamental policy of the Bankruptcy Act of 1938⁵ is twofold: first, it provides a means for the effective rehabilitation of the bankrupt; and second, it provides a means for the equitable distribution of the bankrupt's assets among his creditors.⁶ Generally, a debtor's basic objective in filing a voluntary petition in bankruptcy is to obtain a discharge from his provable debts⁷ in order to gain a new start free from obligations and responsibilities resulting from past business misfortunes.⁸ However, prior

¹ INT. REV. CODE of 1954, § 6212.

² *Id.* § 6201(a)(1).

³ Bankruptcy Act § 64a(4), 11 U.S.C.A. § 104(a)(4) (Supp. 1971), which reads in part: "The debts to have priority . . . and to be paid in full out of bankrupt estates . . . shall be . . . (4) taxes which become legally due and owing by the bankrupt to the United States . . . which are not released by a discharge in bankruptcy."

⁴ Bankruptcy Act § 17a, 11 U.S.C.A. § 35(a) (Supp. 1971), which reads in part:

(a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: *Provided however*, that a discharge in bankruptcy shall not release a bankrupt from any taxes . . .

(c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt.

⁵ Chandler Act §§ 1-404, ch. 575, 52 Stat. 840 (1938), as amended, 11 U.S.C. §§ 1869-1935 (1964).

⁶ S. REP. NO. 1158, 89th Cong., 2d Sess. 2 (1966), reported in U.S. CODE CONG. & AD. NEWS 2468 (1966).

⁷ *Dilworth v. Boothe*, 69 F.2d 621, 624 (5th Cir. 1934).

⁸ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

to the Bankruptcy Act of 1898,⁹ all debts and taxes due to the United States and to the states, although not specially excepted from discharge by statute, were held not dischargeable in bankruptcy.¹⁰ The Act of 1898, which specifically excepted taxes from discharge,¹¹ was interpreted to mean that any other debts not specifically excepted were dischargeable.¹² Taxes were denied dischargeability because it was not thought fitting that one should be able to avoid tax liability by going through bankruptcy.¹³ In addition, the Government was accorded priority status for payment of taxes in advance of payment to general unsecured creditors.¹⁴

As tax liability became more burdensome in modern times, the conflict between the desire to protect the public purse and creditors, and the need to aid the rehabilitation of the bankrupt became acute. Accumulation of back taxes, which was often unknown to creditors, frequently exhausted the assets of a bankrupt estate because of the priority status. Furthermore, an inequity arose when the bankrupt was an individual rather than a corporation. Corporations could go bankrupt without any surviving tax liability on their shareholders beyond that of their interest in the corporation, but individuals remained burdened with unsatisfied tax liabilities which adversely affected their rehabilitation.¹⁵ For these reasons section 17a(1) of the Bankruptcy Act of 1938¹⁶ was amended to limit, subject to exceptions, non-dischargeability of taxes to those taxes becoming "legally due and owing"¹⁷ within three years preceding bankruptcy.¹⁸ Thus, taxes accruing prior to three years before bankruptcy, subject to the exceptions, were made dischargeable in an attempt to mitigate the build-up of enormous tax debts on individuals over long periods.

II. EXCEPTION (C) TO DISCHARGE OF TAX LIABILITY

As noted above, there are exceptions to the dischargeability of tax debts

⁹ Act of July 1, 1898, ch. 541, 30 Stat. 544; see 1 W. COLLIER, *BANKRUPTCY* § 17.13 (14th ed. 1970) [hereinafter cited as COLLIER]; Plumb, *Federal Tax Liens and Priorities in Bankruptcy—Recent Developments*, 43 *REF. J.* 37 (1969).

¹⁰ See, e.g., *United States v. Herron*, 87 U.S. (20 Wall.) 251 (1873) (debt due United States); *State v. Shelton*, 47 Conn. 400 (1873) (debt due state); COLLIER § 17.13.

¹¹ Bankruptcy Act § 17a(1), ch. 541, 30 Stat. 544, 550 (1898), as amended, 11 U.S.C.A. § 35(a) (Supp. 1971).

¹² See COLLIER § 17.13 n.12.

¹³ *Bruning v. United States*, 376 U.S. 358, 361 (1964).

¹⁴ Chandler Act § 64a(4), ch. 575, 52 Stat. 840, 874 (1938), as amended, 11 U.S.C.A. § 104(a)(4) (Supp. 1971).

¹⁵ S. REP. NO. 1158, 89th Cong., 2d Sess. 2-3 (1966), reported in U.S. CODE CONG. & AD. NEWS 2468-69 (1966); Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 710 (1967) [hereinafter cited as Marsh]. Marsh states the inequity applied only to individuals in a business or profession and not to the wage earner on account of the withholding provisions of the IRC which make it doubtful that any unpaid taxes are of any real significance. *Id.* at 731. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 262 (1968).

¹⁶ Chandler Act § 17a(1), ch. 575, 52 Stat. 840, 851 (1938), as amended, 11 U.S.C.A. § 35(a)(1) (Supp. 1971).

¹⁷ The exact date to which the phrase refers has generated considerable controversy. COLLIER § 17.14[1] notes that it had no established meaning in federal tax law as of the time of the 1966 amendments. He maintains that several dates could logically be utilized, but that the simplest standard is the date when the tax return is due, which is the position the Government takes. See also Marsh 684-88, 694 n.35; Plumb, *supra* note 15, at 264.

¹⁸ Bankruptcy "with reference to time, shall mean the date the petition is filed." 11 U.S.C. § 1(13) (1964).

"legally due and owing" more than three years prior to bankruptcy. At least one writer¹⁹ has suggested that the most important exception of the 1966 amendment is exception (c),²⁰ which provides that taxes are not dischargeable "which were *not reported on a return* made by the bankrupt and which were not assessed prior to bankruptcy by reason of a *prohibition on assessment* pending the exhaustion of administrative or judicial remedies available to the bankrupt."²¹ The exception is relevant only to those taxes due more than three years prior to bankruptcy.

There are two conditions that must be met before exception (c) applies. The first is that the taxes were "not reported on a return"²² of the bankrupt, and the second is that those taxes were "not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt."²³ As to the first condition, a distinction exists between tax liability not reported based on information on the return, and information not reported which would give rise to tax liability.²⁴ Apparently, if the latter has occurred, the exception is inapplicable, although other exceptions may operate to deny dischargeability.²⁵ The second condition also requires interpretation. The key to its meaning is the phrase "prohibition on assessment," which refers to section 6213 (a) of the Internal Revenue Code.²⁶ Because of this section, assessment is prohibited: (1) until notice of deficiency (commonly called the ninety-day letter) is sent to the taxpayer, and a ninety-day period has lapsed if no petition is filed in the Tax Court; or (2) until decision of the Tax Court is final if a petition has been filed.²⁷ The "prohibition on assessment" does not mean a total prohibition since the possibility of jeopardy assessment under Internal Revenue Code section 6861 always exists. Thus, in essence, a total prohibition under Internal Revenue Code section 6213 (a) never exists. If total prohibition were a requirement of exception (c), it would be meaningless.²⁸

¹⁹ See Plumb, *supra* note 15, at 266; Plumb, *supra* note 9, at 43, 44.

²⁰ 11 U.S.C.A. § 35(a)(1)(c) (Supp. 1971); see note 4 *supra*.

²¹ *Id.* (emphasis added).

²² *Id.*

²³ *Id.*

²⁴ See *In re Cohen*, 68-1 U.S. Tax. Cas. ¶ 9250 (Ref. N.D. Ga. 1967); COLLIER ¶ 17.14[4].

²⁵ E.g., 11 U.S.C.A. § 35(a)(1)(d) (Supp. 1971) (fraudulent return).

²⁶ Marsh 692. This section stated in full is as follows:

Time for filing petition and restriction on assessment.—Within 90 days, or 150 days if the notice is addressed to a person outside the States of the Union and the District of Columbia, after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in section 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A or B [or chapter 42] and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. Notwithstanding the provisions of section 7421(a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court.

INT. REV. CODE of 1954, § 6213(a).

²⁷ Decision of the Tax Court is not final until the appellate process has been completed. INT. REV. CODE of 1954, § 7481. See, e.g., *Taylor v. Commissioner*, 258 F.2d 89 (2d Cir. 1958).

²⁸ Marsh 692 n.31.

One writer²⁹ contends the only taxes saved from discharge by exception (c) are those for which administrative remedies are "pending" at the date the petition of bankruptcy is filed. Others have rejected that theory in noting that exception (c) does not refer to "pending administrative remedies," but rather to "pending the exhaustion of administrative remedies."³⁰ Hence, any unassessed tax prohibited from assessment by Internal Revenue Code section 6213 (a) is not dischargeable, no matter how old the liability may be.³¹ The moment the prohibition on assessment has ceased—when ninety days have lapsed after notice of deficiency and no petition has been filed in Tax Court, or when a petition is filed in Tax Court and its decision has become final—the exception no longer applies. If the bankruptcy petition is filed before that moment, the tax liability is not dischargeable. However, if the bankruptcy petition is filed after that moment but before assessment is made and other necessary protection procedures³² are taken by the Government, the tax liability is dischargeable.³³

III. IN RE INDIAN LAKE ESTATES, INC.

In *In re Indian Lake Estates, Inc.*³⁴ the Fifth Circuit court of appeals thoroughly examined the legislative history of the 1966 amendment allowing dischargeability but could find no guidelines as to the meaning and purpose of exception (c). The court acknowledged the twofold purpose³⁵ for permitting dischargeability of tax liability, but stated that consideration of those purposes was meaningless in interpreting exception (c).³⁶ Although the taxpayer going bankrupt was a corporation, the decision would not have been different had the taxpayer been an individual where the equity of dischargeability is stronger. The meaning of exception (c) was too obvious for the court to decide otherwise. This was true even when considering what was in effect a "secret" tax lien on the taxpayer's property, about which creditors would likely have no knowledge and which would adversely affect any distribution of assets to them. The court faced a dilemma in applying exception (c), which was in direct conflict with the broad purposes of the statute. It appeared no other choice was available but that the plain meaning of exception (c) should prevail.

Indian Lake Estates involves a clear example of congressional recognition of an inequitable situation and an attempt to rectify the problem by amending existing law. The amendment, however, stopped short of the

²⁹ Lurvey, *Tax Discharge in Bankruptcy: How the New Rules Work; Difficulty in Tax Planning*, 28 J. TAX. 242 (1968).

³⁰ Marsh 692; Plumb, *supra* note 9, at 44.

³¹ However, this is not an absolute rule. If the deficiency arose from a non-fraudulent return and the Government has taken no steps to assess or collect it or to secure a waiver of limitations, INT. REV. CODE of 1954, § 6501 (a), proscribes assessment of such taxes when 3 years have lapsed from the time the return was filed.

³² Necessary procedure is outlined in S. REP. No. 999, 89th Cong., 2d Sess. 1-2 (1966), reported in U.S. CODE CONG. & AD. NEWS 2442-43 (1966); Marsh 693. Once prohibition on assessment has ceased, the Government has 60 days in which to make an assessment. INT. REV. CODE of 1954, § 6503 (a) (1).

³³ Plumb, *supra* note 9, at 44.

³⁴ 428 F.2d 319 (5th Cir. 1970).

³⁵ *Id.* at 322; see note 6 *supra*, and accompanying text.

³⁶ 428 F.2d at 323.

desired policy change as it included exception (c). The practical result is that pre-1966 law denying dischargeability has changed little. The court's interpretation is significant only in that it recognizes the opinions by various writers that the 1966 amendments to the Bankruptcy Act failed to effect a change in policy.

IV. CONCLUSION

If the prohibition of Internal Revenue Code section 6213(a) exists as specified within section 17a(1) of the Bankruptcy Act,³⁷ no federal income tax claims will be denied priority except: (1) taxes assessed prior to bankruptcy for which no lien notice has been filed; and (2) taxes against which the prohibition has expired but the petition of bankruptcy has been filed before assessment can be made. The first exception can be eliminated by the Internal Revenue Service sending a demand and filing a notice of tax lien simultaneously with assessment. The second can be eliminated by the Internal Revenue Service speeding up its assessment procedures upon termination of the prohibition.³⁸ Thus, the Government can preserve its priority status in virtually all cases. General unsecured creditors will not receive any more in bankruptcy liquidations than before, nor will the bankrupt be appreciably helped in his rehabilitation. Probably the only way to eliminate the ambiguities of section 17a(1) of the Bankruptcy Act³⁹ and more effectively implement the policies intended by Congress is by new amendments. W. T. Plumb, Jr., has offered a model amendment to that section, which he suggests would alleviate its ambiguities without altering the policy decisions of Congress. Exception (c) would be altered to read "that a discharge in bankruptcy shall not release a bankrupt from any taxes . . . which were not reported on a return made by the bankrupt and were not assessed prior to bankruptcy."⁴⁰ Omitted is the requirement that the failure to assess be "by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt."⁴¹ The suggestion would make dischargeability dependent not upon the prohibition of Internal Revenue Code section 6213(a), but only upon the assessment prior to bankruptcy. This is more nearly in accord with the policy reasons for enacting the 1966 amendments.

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³⁷ 11 U.S.C.A. § 35(a)(1)(c) (Supp. 1971).

³⁸ See Marsh 696-97.

³⁹ 11 U.S.C.A. § 35(a)(1) (Supp. 1971).

⁴⁰ Plumb, *supra* note 9, at 45-46.

⁴¹ *Id.* at 46 n.146.