THIS OPINION IS NOT INTENDED
FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION



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| In re: | ) | Case No. 95-15662 |
| | ) | |
| CHARLES TRUAX and | ) | Chapter 13 |
| SHARON TRUAX, | ) | |
| | ) | Judge Pat E. Morgenstern-Clarren |
| Debtors. | ) | |
| | ) | **MEMORANDUM OF OPINION** |
| | ) | **SUSTAINING OBJECTION** |
| | ) | **TO CONFIRMATION AND** |
| | ) | **OVERRULING OBJECTION TO** |
| | ) | **IRS CLAIM** |

This case is before the Court on two related matters: (1) Objection of the United States of America, on behalf of the Internal Revenue Service, to confirmation of the Debtors' proposed plan (Docket 6), to which Debtors filed a Response, a Supplemental Response, and a Second Supplemental Response (Docket 14, 22, and 24); and (2) Debtors' Objection to Claim of the Internal Revenue Service (Docket 13), to which the Service responded. (Docket 20). Each party filed a final brief in support of its position. (Docket 26, 29). For the reasons stated below, the Internal Revenue Service's objection to confirmation is sustained, with Debtors' response overruled, and Debtors' Objection to the Internal Revenue Service claim is overruled, with the Service's response sustained.

## JURISDICTION

Jurisdiction exists under 28 U.S.C. § 1334 and General Order No. 84 entered on July 16, 1984 by the United States District Court for the Northern District of Ohio. This is a core proceeding under 28 U.S.C. §§ 157(b)(2)(B),(L) and (O).

## FACTS

The parties submitted this dispute on these stipulated facts:

1. Debtor Charles Buchanan Truax was a partner in Efron Investors II ("Efron II") during 1982.

2. Attached as Exhibit A[1] is a copy of Schedule K-1, Partner's Share of Income, Credits, Deductions, etc. - 1982, regarding Debtor's partnership interest in Efron II.

3. Efron II allegedly invested in a shopping center in Michigan and a partnership known as Dickinson Recycling Associates ("Dickinson").

4. Attached as Exhibit B is a copy of Schedule K-1, Partner's Share of Income, Credits, Deductions, etc. - 1982, regarding Efron II's partnership interest in Dickinson.

5. Dickinson allegedly was involved in a plastics recycling venture.

6. In April 1983, Charles Buchanan Truax and Sharon Marie Truax ("Debtors") filed a joint income tax return for their 1982 tax year.

7. On their 1982 income tax return, Debtors claimed a $32,527 loss from Debtor Charles Truax's investment in Efron II. They also claimed a regular investment tax credit of $10,313 and a business energy investment credit of $10,164 related to Efron II of which they used $3,868 on their 1982 return. Debtors also claimed a refund on their 1982 return in the amount of $16,216.

8. Attached as Exhibit C is a copy of Debtors' 1982 income tax return.

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[1] All documents referenced as "attached" are attached to the Joint Stipulation of Facts (Docket 33) and are incorporated by reference in this Statement of Facts. Debtors also submitted a Supplemental Factual Reply. (Docket 34). Neither party requested an evidentiary hearing following the latter submission.

9. In April 1983, Debtors filed Form 1045, Application for Tentative Refund, in which they carried back $16,609 of unused regular and business energy investment tax credit from their 1982 tax year to tax years 1979, 1980 and 1981, resulting in refunds in the latter three years totaling $16,609.

10. Attached as Exhibit D is a copy of Debtors' Form 1045, Application for Tentative Refund, signed by Debtors on April 11, 1983.

11. The Internal Revenue Service ("the Service") audited Dickinson's 1982 partnership return.

12. Attached as Exhibit E is a copy of a notice dated October 18, 1984, informing Efron II that the Service was beginning an examination of Dickinson's 1982 partnership return, Form 1065.

13. The Service determined that Dickinson was a tax shelter and, for various reasons, disallowed the expenses and investment tax credit claimed by it for tax year 1982.

14. Attached as Exhibit F is a copy of a letter dated May 2, 1988, informing Efron II of the Service's proposal to adjust Dickinson's partnership returns for 1982 through 1985, by disallowing the expenses and investment tax credit Dickinson had claimed.

15. Attached as Exhibit G is a copy of the Notice of Final Partnership Administrative Adjustment (FPAA) dated May 15, 1989, informing Efron II of adjustments made to Dickinson's 1982 partnership return and giving the tax matters partner 90 days to contest the proposed adjustments in court.

16. On June 12, 1989, a petition was filed by Sam Winer in the United States Tax Court, contesting the adjustments made to the Dickinson return. The case was docketed as

*Dickinson Recycling Associates, Sam Winer, Tax Matters Partner v. Commissioner of Internal Revenue*, Docket No. 13191-89.

17. Attached as Exhibit H is a copy of the Motion for Entry of Decision filed November 9, 1983, in the *Dickinson* case.

18. Attached as Exhibit I is a copy of Tax Court Rule 248(b).

19. On February 17, 1994, the United States Tax Court granted the Commissioner's Motion for Entry of Decision in the *Dickinson* case. See Exhibit H.

20. Attached as Exhibit J is a copy of the Decision entered in the *Dickinson* case on February 23, 1994.

21. The adjustments made by the Service to Dickinson's 1982 partnership return flowed through Efron II to Debtors, substantially reducing Debtor Charles Truax's distributive share of Efron II's partnership loss and investment tax credit and resulting in Debtors having a 1982 income tax deficiency in the amount of $15,257.

22. Attached as Exhibit K is a copy of an undated letter to Debtors regarding changes to their 1982 income tax return with enclosed Form 4549-A, Income Tax Examination Changes, dated December 14, 1994, and accompanying schedules dated December 14, 1994, setting forth Debtors' 1982 income tax deficiency. The form also explained that Debtors would be charged increased interest under I.R.C. § 6621(c) because the underpayment of tax was attributable to tax motivated transactions.

23. The 1982 income tax deficiency was assessed against Debtors on February 13, 1995, pursuant to the Tax Court decision entered in the *Dickinson* case on February 23, 1994.

24. Attached as Exhibit L is a copy of a notice dated February 13, 1995, billing Debtors for the 1982 income tax deficiency plus interest.

25. By letter dated February 9, 1995, the Service advised Debtors of changes made to their 1979 income tax return and the resulting income tax deficiency of $4,879. The tax deficiency resulted from the disallowance of the investment tax credit carryback Debtors had claimed on their 1982 return.

26. Attached as Exhibit M is a copy of the letter dated February 9, 1995, setting forth the changes to Debtors' 1979 income tax return.

27. Attached as Exhibit N is an undated copy of a letter informing Debtors of adjustments to their 1980 and 1981 income tax returns and enclosing Form 4549-A, Income Tax Examination Changes, setting forth Debtors' 1980 and 1981 tax deficiencies resulting from the disallowance of the investment tax credit carrybacks Debtors had claimed on their 1982 return. The form also explained that Debtors would be charged increased interest under I.R.C. § 6621(c) because the underpayments of tax were attributable to tax motivated transactions.

28. The income tax deficiencies for tax years 1979 through 1980 were assessed against Debtors on March 6, 1995.

29. Attached as Exhibit O is a copy of a notice dated March 6, 1995, billing Debtors for the 1979 income tax deficiency plus interest.

30. Attached as Exhibit P is a copy of a notice dated March 6, 1995, billing Debtors for the 1980 income tax deficiency plus interest.

31. Attached as Exhibit Q is a copy of a notice dated March 6, 1995, billing Debtors for the 1981 income tax deficiency plus interest.

32. On February 24, 1995, the Service mailed Debtors a notice of deficiency ("affected item notice"), informing Debtors of their liability for negligence and overvaluation penalties relating to their 1982 income tax return; the penalties resulted from the adjustments flowing from Dickinson through Efron II to Debtors' return. A copy of this notice is attached as Exhibit R.

33. On March 2, 1995, the Service mailed Debtors a notice of deficiency ("affected item notice"), informing Debtors of their liability for negligence and overvaluation penalties relating to their 1979 income tax return; the penalties resulted from the adjustments flowing from Dickinson through Efron II to Debtors' return. A copy of this notice is attached as Exhibit S.

34. On March 3, 1995, the Service mailed Debtors a notice of deficiency ("affected item notice"), informing Debtors of their liability for negligence and overvaluation penalties relating to their 1980 income tax return; the penalties resulted from the adjustments flowing from Dickinson through Efron II to Debtors' return. A copy of the notice is attached as Exhibit T.

35. On March 2, 1995, the Service mailed Debtors a notice of deficiency ("affected item notice"), informing Debtors of their liability for negligence and overvaluation penalties relating to their 1981 income tax return; the penalties resulted from the adjustments flowing from Dickinson through Efron II to Debtors' return. A copy of the notice is attached as Exhibit U.

36. The *Dickinson* Tax Court decision has not been appealed.

37. Debtors did not invest in Davenport Recycling Associates.

38. Debtors were and are not parties to the Tax Court proceedings concerning *Davenport Recycling Associates v. Commissioner of Internal Revenue*, Docket No. 12801-89.

39. Debtors submitted an offer in compromise dated May 11, 1995 to the Service regarding their Federal income tax liability for tax years 1979 through 1982. The offer was submitted on the grounds of doubt as to collectibility and doubt as to liability. Debtors subsequently submitted an amended offer in compromise dated July 15, 1995, regarding their Federal income tax liability for tax years 1979 through 1982 solely on the ground of doubt as to liability. By letter dated January 11, 1996, the Service rejected the amended offer, stating that there was no doubt as to liability given the Tax Court decision in the partnership case.

40. On December 21, 1995, Debtors filed a Chapter 13 petition.

41. The Service filed a proof of claim in Debtors' Chapter 13 case on February 8, 1996, setting forth $135,058.30 in priority claims and $53,310.37 in general unsecured claims. Attached as Exhibit V is a copy of the Service's proof of claim.

42. On February 9, 1996, the United States, on behalf of the Service, filed an objection to confirmation of Debtors' Chapter 13 plan.

43. On or about March 25, 1996, Debtors filed an Objection to the Service's proof of claim.

## ISSUES

The Objection to Plan and the Objection to claim raise the same two legal issues:[2]

A. Is the pre-petition interest on the Service's priority tax claim entitled to priority treatment?

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[2] While the Service initially also objected to confirmation on the ground that it is entitled to post-petition interest on the deferred payment of the priority tax claims, it later withdrew that portion of its objection. (Docket 26).

B. Is the interest under Internal Revenue Code § 6621(c) dischargeable as a penalty under 11 U.S.C. § 523 (a)(7)(A)?

## DISCUSSION

**A. Is the pre-petition interest on the Service's priority tax claim entitled to priority treatment?**

The Service contends that pre-petition interest on its priority tax claim is also entitled to priority treatment under 11 U.S.C. § 507(a)(8) and should be paid in full under 11 U.S.C. § 1322(a) (2). 11 U.S.C. § 507 (a) (8) provides in relevant part for priority treatment of :

> (8) . . . allowed unsecured claims of governmental units; only to the extent that such claims are for --
>
> (A) a tax on or measured by income or gross receipts [or] --
>
> * * * * *
>
> (G) a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss.

The majority view is that interest on a tax claim is accorded the same priority as the underlying claim, either because it falls within the definition of "penalty" or because it is considered a part of the taxing authority's underlying "claim". *In re Garcia,* 955 F.2d 16, 19 (5th Cir. 1992). ("Virtually every court that has considered the issue in dispute in this case has held that pre-petition interest shares equal priority with the underlying tax debt, although the various courts have based their decisions upon differing rationales"); *In re Larsen,* 862 F.2d 112, 119 (7th Cir. 1988) (". . . bankruptcy court decisions now unanimously agree that pre-petition interest is to be accorded the same priority as the underlying claim. We see no reason to depart from this unanimous authority").

Debtors concede that the majority view is that taken by the Service; they rely instead on the position directly espoused in only one case, *In re Razorback Ready-Mix Concrete,* 45 B.R. 917 (Bankr. E.D. Ark. 1984). Debtors acknowledge that the author of the *Razorback* opinion reversed himself on this issue ten years ago. *In re Stonecipher,* 80 B.R. 949 (Bankr. W.D. Ark. 1987). Nevertheless, they urge this Court to embrace the *Razorback* position in light of the United States Supreme Court's subsequent decision in *INS v. Cardoza-Fonseca,* 480 U.S. 421 (1987).

Debtors cite to the *Cardoza-Fonseca* case for the proposition that "if a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." (Response of Debtors to Internal Revenue Service's Objection to Confirmation of Chapter 13 Plan at ¶13). (Docket 14). To come within this doctrine, Debtors argue that 11 U.S.C. § 507(a)(8) is ambiguous because it grants priority to allowed, unsecured tax claims of governmental units, but it does not state that interest accruing on such claims is also entitled to priority. Debtors then turn to the legislative history to resolve the ambiguity. They point out that a Senate version of what ultimately became § 507 expressly stated that pre-petition interest on priority tax claims would also be entitled to priority treatment. As the final version of the statute omits this language, Debtors reason that Congress did not intend for this interest to enjoy priority status. (Response of Debtors ¶ 15). (Docket 14). Debtors do not contend that the *Cardoza-Fonseca* case established a new standard of statutory construction. And they do not address the fact that many courts have decided this issue contrary to Debtors' position even after the *Cardoza-Fonseca* decision.

On review of the statute, the legislative history, and the cases cited by the parties, the Court adopts the reasoning of the Fifth Circuit in *In re Garcia* that pre-petition interest that has accrued on a priority tax claim is a "penalty, to repay the government and the public, for the loss of use of the money they suffer while the delinquent taxpayer refuses to pay." 955 F.2d at 18. This conclusion is consistent with the legislative history which expressly indicates that Congress intended tax penalties to share equal priority with the underlying tax. *Id.* (quoting Representative Don Edwards introducing the bankruptcy bill in 1978). There is no contradictory statutory language or legislative history that would mandate a different result. *Id.* Consequently, pre-petition interest falls within the language of § 507(a)(8)(G) and is entitled to the same priority treatment as the underlying tax. 955 F.2d at 18. Debtors' argument is, therefore, unavailing.

**B. Is the pre-petition interest a penalty that is dischargeable under 11 U.S.C. § 523(a)(7)(A)?**

Debtors next argue that the interest rate of 120% provided for in Internal Revenue Code § 6621(c) is not a tax, but is instead a form of penalty that is dischargeable under 11 U.S.C. § 523(a)(7)(A) "Exceptions to discharge". They rely on two cases decided under Chapter 7 of the Bankruptcy Code in support. (Second Supplemental Response of Debtors ¶ 10). (Docket 24). Those cases are unpersuasive in this Chapter 13 case. In the Chapter 13 context, debtors are entitled to a discharge under 11 U.S.C. § 1328(a) after confirmation and upon completion of plan payments. Alternatively, they may qualify for a hardship discharge under 11 U.S.C. § 1328(b) after confirmation under certain prescribed circumstances. In either context, however, confirmation of a plan meeting the requirements of 11 U.S.C. § 1322(a)(2) is a prerequisite to

discharge. This argument regarding the dischargeability of the interest is without effect regardless of whether the interest claimed is a tax or a penalty because 11 U.S.C. § 1322(a)(2) requires priority treatment and payment in full with respect to the interest.

**CONCLUSION**

Pre-petition interest on the IRS' eighth priority tax claim is also entitled to eighth priority treatment. As Debtors' Plan does not provide for priority payment of the interest, the Plan does not meet the requirements of 11 U.S.C. § 1322(a)(2) and confirmation is, therefore, denied. Additionally, Debtors' objection to the IRS' claim for priority interest is overruled. A separate judgment will be entered in accordance with this Memorandum of Opinion. **This case will be placed back on the Chapter 13 hearing docket on May 20, 1997 at 8:30 a.m. for a status report from counsel.**

Date: 9 May 1997

Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

Served by mail on: Robert Balantzow, Esq.
Donza Poole, Esq.
Myron Wasserman, Esq.

By: Joyce L. Gordon, Secretary

Date: 5/9/97

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| In re: | ) | Case No. 95-15662 |
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| CHARLES TRUAX and | ) | Chapter 13 |
| SHARON TRUAX, | ) | |
| | ) | Judge Pat E. Morgenstern-Clarren |
| Debtors. | ) | |
| | ) | **JUDGMENT** |

For the reasons stated in the Memorandum of Opinion filed this same date,

IT IS, THEREFORE, ORDERED that the Objection of the Internal Revenue Service to confirmation of Debtors' Plan is sustained and confirmation of the plan is denied. IT IS FURTHER ORDERED that Debtors' Objection to the Claim of the Internal Revenue Service is overruled.

Date: 9 May 1997

Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

Served by mail on: Robert Balantzow, Esq.
Donza Poole, Esq.
Myron Wasserman, Esq.

By: Joyce L. Gordon, Secretary
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