By Elizabeth L. Gunn and Caleb Chaplain[1]

When Acting in Good Faith Isn't Enough: A Taxing Decision for IRS

Coordinating Editor
Elizabeth L. Gunn
Virginia Office of the Attorney General
Richmond, Va.

Caleb Chaplain
U.S. Bankruptcy Court (W.D. Va.); Harrisonburg

Elizabeth Gunn, an ABI "40 Under 40" honoree, is an assistant attorney general for the Commonwealth of Virginia and serves as the bankruptcy specialist for the Division of Child Support Enforcement. Caleb Chaplain is the career law clerk for Hon. Rebecca B. Connelly of the U.S. Bankruptcy Court for the Western District of Virginia. He previously clerked for Hon. Paul M. Black.

It is well settled that a bankruptcy court may hold a party in contempt for violating the discharge injunction imposed by § 524(a)(2) of the Bankruptcy Code. Certain limited defenses do exist to this general principle. Some courts have held that a creditor does not willfully violate the discharge injunction if the creditor holds a good-faith belief that the discharge injunction does not apply to his/her actions.[2] Conversely, a number of courts enforce a stricter application and find a violation of the discharge injunction, despite a creditor's subjective beliefs, if the creditor knew of the issuance of the discharge and intended to take the action in question.[3]

The Internal Revenue Service (IRS) is no stranger to the discharge injunction and violations thereof. Congress added subsection (e) to 26 U.S.C. § 7433 in 1998 to provide a means for a taxpayer to recover damages against the U.S. for violations of both the automatic stay and discharge injunction, including damages caused by the IRS.[4] In what appears to be the first circuit court decision on the topic, the U.S. Court of Appeals for the First Circuit recently rejected the IRS's access to a good-faith defense to a damages action filed pursuant to § 7433(e) in *Internal Revenue Service v. Murphy*.[5] At first blush, the holding arguably abolishes the IRS's ability to collect tax debt based on its own reasonable determination that a debt has been excepted from discharge without first having to seek a determination from the bankruptcy court. Such a result seemingly conflicts with Congress's structuring of the statutory exceptions to discharge.

Quite to the contrary, the First Circuit upheld the IRS's capacity to make dischargeability determinations and reinforced the obligation of critical examination based on evidence found during that process; that the IRS will be held accountable for improper collection serves not as an obstruction of efficiency, but as a reminder of the responsibility to "enforce the law with integrity and fairness to all."[6] Appropriately, while initially the opinion appears to be potentially too harsh to the IRS in the long term, *Murphy* might result in more due process for taxpayers/debtors who face debatable claims of fraudulent returns or willful attempts in order to evade or defeat tax liability.

Internal Revenue Service v. Murphy

In 2005, William Charles Murphy filed a chapter 7 petition in the U.S. Bankruptcy Court for the District of Maine. In the beginning, his bankruptcy proceedings were rather routine and unremarkable. On his schedules, Murphy listed income tax obligations owed to the IRS for nine tax years, which were by far the largest debts he sought to discharge, totaling more than $500,000. The IRS filed a notice of appearance, but no complaint objecting to the dischargeability of the tax debt. On Feb. 14, 2006, the court granted Murphy a standard § 727 discharge of his debts, then things really changed when the IRS began its post-discharge collection efforts.

The IRS believed, based on its internal investigations, that Murphy attempted to evade his taxes for the years for which he scheduled tax debt. Consequently, the IRS believed that Murphy's tax debt was excepted from his chapter 7 discharge by operation of § 523(a)(1)(C). Although the IRS did not inform the bankruptcy court of such a belief (*i.e.*, by filing a complaint objecting to dischargeability), "[f]rom February 2006 to February 2009, the IRS repeatedly informed Murphy that it did not view his tax obligations as discharged and that it planned to collect what it believed was owed."[7] This belief culminated in the February 2009 issuance of levies to collect the tax debt against insurance companies with which Murphy did business.

Following a minimal effort by the IRS in defense of the dischargeability action, the bankruptcy court granted Murphy's summary judgment declaring that

1 The opinions expressed herein are provided as a result of Ms. Gunn's own experiences and not as a representative of the Attorney General or the Division of Child Support Enforcement. She also serves as co-chair of ABI's Legislation Committee and co-authored ABI's *Consumer Bankruptcy: Fundamentals of Chapter 7 and Chapter 13 of the U.S. Bankruptcy Code, Fourth Addition* (now available for purchase at store.abi.org). In addition, the views expressed in this article are those of Mr. Chaplain and not of the U.S. Bankruptcy Court for the Western District of Virginia.

2 *See, e.g., Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438, 444 (9th Cir. 2018) ("Although the Creditors ... were ultimately incorrect, their good-faith belief, even if unreasonable, insulated them from a finding of contempt.").

3 *See, e.g., Bradley v. Fina (In re Fina)*, 550 Fed. App'x. 150, 154 (4th Cir. 2014) ("As the language of § 524(a)(2) makes clear, a violation occurs when the debtor is exposed to personal liability. The willfulness prong requires only that the acts taken in violation of the injunction be intentional. In other words, a good-faith mistake is generally not a valid defense."); *Howard Johnson Co. Inc. v. Khimani*, 892 F.2d 1512 (11th Cir. 1996) (noting that "the focus of the court's inquiry in civil contempt proceedings is not on the subjective beliefs or intent of the alleged contemnors in complying with the order, but whether in fact their conduct complied with the order at issue").

4 *See* Pub. L. No. 105-206, § 3102, 112 Stat. 685, 730-31 (1998).

5 *IRS v. Murphy*, 892 F.3d 29, 32 (1st Cir. 2018).

6 The IRS's mission is to "[p]rovide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all." *See* "The Agency, Its Mission and Statutory Authority," IRS, *available at* irs.gov/about-irs/the-agency-its-mission-and-statutory-authority (unless otherwise specified, all links in this article were last visited on July 24, 2018).

7 *Murphy* at 32.

the tax debt had been discharged.[8] Armed with a ruling that his tax debt was discharged, in February 2011 Murphy filed a complaint pursuant to 26 U.S.C. § 7433(e) against the IRS, asserting that it violated his discharge injunction by issuing levies against the insurance companies to collect on his discharged debt. The IRS defended that it acted in good faith, reliant on its own determination that Murphy had willfully attempted to evade paying his taxes and thus that the tax debt had been excepted from discharge. The bankruptcy court granted summary judgment in favor of Murphy's claim, the IRS appealed, and the district court vacated the bankruptcy court's decision.

Following a remand and pursuant to the terms of a settlement agreement,[9] the IRS appealed to the U.S. Court of Appeals for the First Circuit regarding the sole question of the meaning of "willfully violates" as used in § 7433(e). The IRS argued two points in the alternative.

First, the IRS asserted that "all creditors could raise a good-faith defense to allegations that they willfully violated an automatic stay or discharge order" prior to the enactment of § 7433(e) and thus that this defense should continue as an escape from liability for damages. Second, "because § 7433(e) is a waiver of sovereign immunity that must be construed narrowly," the good-faith defense should be available to the IRS — even if it is not available to other creditors.[10]

The First Circuit disagreed, simply holding "that an employee of the IRS 'willfully violates' a discharge order when the employee knows of the discharge order and takes an intentional action that violates the order."[11] The court derived this determination based on the "established meaning" of "willful violation" as interpreted by courts addressing violations of the automatic stay and the discharge injunction under §§ 362 and 524 of the Bankruptcy Code.[12] The holding appears to reaffirm the basic elements for a finding of a violation of the discharge injunction, while at the same time potentially abolishing the good-faith defense that the IRS relied upon, at least for actions in the First Circuit.

What Are Practical Considerations for the Tax Collector?

The First Circuit's decision might have unintended consequences beyond the facts of the *Murphy* case. The most apparent result is an exposure for damages on the IRS when it acts on its belief that a debt has been excepted from discharge, if a court ultimately determines that the debt was not excepted from discharge. Will this increased risk result in the need for a dischargeability adversary proceeding in every case with a tax debt, or only in those cases where the IRS is relying upon the § 523(a)(1)(C) exception to discharge? At a minimum, it appears to signal a need for the IRS to review its collection practices in bankruptcy and its internal standards of review.

The removal of an unlimited good-faith safety net forces the IRS to make more informed decisions as to the dischargeability of particular debts. The IRS must analyze the facts of any given case in order to determine the appropriate form of mitigation or collection under the circumstances. The IRS could seek to file for a determination from the bankruptcy court as to whether the debt will be or was discharged. As the IRS argued to the First Circuit, the *Murphy* holding might require the IRS to "'seek a pre-enforcement determination from the bankruptcy court about whether a tax debt has been discharged prior to initiating any post-discharge collection efforts,' which would be both impractical and inconsistent" with other Bankruptcy Code provisions.[13]

> ***Murphy* simply removes the good-faith defense to the imposition of damages for a willful violation of the discharge injunction. The benefits of this decision will more likely outweigh the perceived burden.**

While it remains true that the IRS does not need to seek this determination before seeking to collect, there might be cases in which the IRS determines that it makes more sense to obtain a determination before taking any further collection actions. Many debtors might agree that their tax debt will not be discharged or was not discharged. Those who have dabbled in tax evasion, on the other hand, are not as likely to consent.

The need to file a dischargeability action appears to be inherently inconsistent with § 523(a)'s clear provision that certain debts, including certain tax debts, are automatically excepted from the discharge without the need of the creditor to file a dischargeability action. Perhaps the most beneficial course of action might be for the IRS to collect and see what happens.[14] If the IRS holds a true good-faith belief that the debt has been excepted from discharge, it might still be able to collect without concern. The burden would then be on the debtor to raise the claim that the debt has been discharged.

Once the discharge injunction has been invoked, the impacted authority should cease collection efforts pending resolution from the bankruptcy court and mitigate any other potential damages. This might be the most cost-effective approach if the authority truly holds a good-faith belief that the debt has been excepted from discharge. A thorough analysis of the facts and the provision of evidence to support a finding of tax evasion should sway even the most skeptical of judges.

On the other hand, if the discharge injunction is never invoked, no resources have been wasted on a pre-collection complaint. If a debtor invokes the discharge injunction, the costs of prosecuting will be the same as filing a complaint

8 The IRS blames this result on the decline in the mental and physical health of the Assistant U.S. Attorney working on Murphy's bankruptcy case. *Id.* at 33. Nonetheless, the IRS did not appeal the ruling on the motion for summary judgment. *Id.*

9 Murphy and the IRS entered into a settlement agreement under which the IRS agreed to pay $175,000 in damages for the alleged violation of the discharge injunction if the IRS exhausted its appellate rights and lost on appeal. *Id.* at 33-34.

10 *Id.* at 34.

11 *Id.* at 32.

12 *Id.* at 35-39.

13 *Id.* at 41. The court dismissed this argument, stating that the IRS need not object in the bankruptcy court proceedings to have the debt excepted from discharge. *Id.* In her dissent, Hon. Sandra L. Lynch agreed that "[t]he opinion effectively requires the IRS to first go to court and prove its case that the taxes are owed before instituting any collection efforts." *Id.* at 48.

14 Arguably, a better option in *Murphy* would have been to aggressively respond to the debtor's dischargeability complaint and initially obtain the determination.

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pre-collection. A downside would occur if damages have resulted from the violation of the injunction. Similar to a complaint for violation of the automatic stay, the burden of proof is on the debtor to prove damages as a result of the violation. If the IRS immediately ceases any collection efforts pending resolution of an adversary proceeding, the damages should be minimized or even nominal.

Lesson Learned

While an initial reaction to *Murphy* by the IRS (and possibly other taxing authorities) might be one of apprehension and concern, the First Circuit teaches an important lesson — albeit forged under unique and somewhat frustrating circumstances. Murphy was not the typical honest-but-unfortunate chapter 7 debtor, and the facts surrounding the First Circuit's decision are uncommon at best.

The *Murphy* case serves as a cautionary tale for the IRS in relying on its own determinations of the § 523(a)(1)(C) exception to discharge. The IRS has wide administrative and legal authority to pursue the collection of debts, but this power should be exercised diligently and justly. By more closely scrutinizing the circumstances of each case and carefully choosing how to proceed, the IRS reduces its own risk of liability. More importantly, however, the IRS also furthers its mission statement of fairness in upholding the due-process rights of a debtor to have a third-party arbiter (whether the bankruptcy court or other appropriate tribunal) determine whether the IRS violated a debtor's discharge injunction.

Murphy simply removes the good-faith defense to the imposition of damages for a willful violation of the discharge injunction. The benefits of this decision will more likely outweigh the perceived burden. A discharge in bankruptcy guarantees debtors a fresh start free from certain debts. Should the IRS take actions that damage that fresh start, even if acting in good faith, debtors retain the right and ability to be made whole again. abi