

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

----- C.A. No. 99-4707
UNITED STATES OF AMERICA, : BKY. NO. 97-31204
 : ADV. NO. 99-0312
 v. :
 :
 CHARLES WEISS :

----- C.A. No. 99-5297
UNITED STATES OF AMERICA, : BKY. NO. 97-31204
 : ADV. NO. 99-0312
 v. :
 :
 CHARLES WEISS :

CONSOLIDATED

MEMORANDUM AND ORDER

Norma L. Shapiro, S.J.

November 15, 2000

The United States brought this appeal challenging a Bankruptcy Court ruling that the debtor Charles Weiss' 1986 and 1987 federal income tax liabilities were dischargeable. The debtor cross-appeals to challenge the ruling that his liabilities for 1988 through 1991 were nondischargeable. The Bankruptcy Court's opinion is reported at In re Charles Weiss, 237 B.R. 600 (E.D. Pa. Bankr. 1999). The debtor's unpaid tax liabilities for 1986 and 1987 should not have been discharged; the Bankruptcy Court will be reversed, in part, and affirmed, in part.

FACTS

On September 15, 1997, debtor filed for bankruptcy under Chapter 7 of the Bankruptcy Code. All dischargeable debts were discharged on April 16, 1998, and the action was closed on April

23, 1998.

On January 11, 1999, the IRS filed a motion to reopen the debtor's case and initiate an adversary proceeding to determine the dischargeability of the debtor's federal income tax liabilities. The motion to reopen was granted on March 23, 1999. A trial on the dischargeability issue was held on June 30, 1999; debtor was the only witness.

Debtor owed the balance of federal income taxes, underpaid during the years 1986 through 1991. He testified he has practiced as an attorney with the law firm of Timoney, Knox, Hasson & Weand (the "firm") continuously since 1973, and became an equity partner in 1985. His annual income during the relevant years was approximately \$140,000 to \$220,000.

Until 1986, debtor timely filed a federal income tax return each year. From 1986 through 1991, debtor did not file a federal income tax return, although he knew he had a duty to do so.

In 1986, debtor and his wife, from whom he was separated, began divorce proceedings, which became increasingly hostile. The mental and physical health of debtor's spouse was also deteriorating during this time. When he began preparing his federal income tax return in the spring of 1987, debtor discovered his wife had taken his financial records. His wife again took his records in the spring of 1988, before debtor had prepared a federal income tax return.

Debtor's wife died in 1989. He then recovered his financial records, but did not file late tax returns for 1986 and 1987. He also failed to file tax returns for the years 1988, 1989, 1990 and 1991.

For each year debtor failed to file, he requested an extension and remitted an estimated tax payment to the IRS, but failed to file his return within the extended time. Debtor testified that he believed the estimated payments covered his tax liabilities, so he did not owe the IRS money. In fact, each payment underestimated his actual tax liability by approximately \$18,000. During the six year period, debtor underestimated his tax liabilities by over \$110,000. Debtor testified that he did not discover that his estimates had been incorrect until September, 1994, when he finally filed tax returns for 1986 through 1991.

Debtor claimed he based his estimates for 1986 through 1991 on his 1985 return. He attributes the underestimations to the 1986 changes in the Tax Code and his failure to include the "self-employment tax" in his calculations. The Bankruptcy Court also found that the discrepancies occurred because the 1985 return was filed jointly with his first wife; his later returns should have been filed individually, until 1990 when they could have been filed jointly with his second wife.

When asked about why he continued to file for extensions but

did not complete the tax returns when due, debtor claimed it was "hard to catch up" after missing the 1986 and 1987 filings. He and his girlfriend, later his second wife, also contracted to have a house built in 1986. There were numerous time-consuming and expensive construction problems and delays. Debtor asserted that these problems impeded him from timely completing his annual returns.

During the years at issue, debtor made several substantial, non-tax expenditures: two loans, in 1987 and 1988, to his first wife totaling \$4,190; a loan in 1988 to a friend to start a business totaling \$12,500; in 1990, a wedding totaling between \$10,000 and \$20,000; and \$6,000 for the honeymoon. He also purchased at least two cars.

DISCUSSION

I. Standard of Review:

"Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witnesses." Bank. R. Proc. 8013. In reviewing a legal conclusion reached by a bankruptcy court, a district court exercises plenary review. See In re Siciliano, 13 F.3d 748, 750 (3d Cir. 1994).

II. Dischargeability of the Income Tax Obligation:

Section 523(a)(1)(C) of the Bankruptcy Code exempts from

discharge a tax liability "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." 11 U.S.C. § 523(a)(1)(C). The Bankruptcy Court found the income taxes owed by the debtor for 1986 and 1987 dischargeable, but the taxes owed for 1988 through 1991 nondischargeable.

The United States argues on appeal that the Bankruptcy Court erred in finding the taxes owed for 1986 and 1987 dischargeable. The government argues that the evidence clearly establishes the debtor willfully attempted to evade his federal income tax liabilities for those years. The government contends the judge erroneously failed to consider facts bearing on willfulness beyond the year in which each of the returns was due.

Debtor argues on cross-appeal that the Bankruptcy Court erred in finding his tax liabilities for the years 1988 through 1991 nondischargeable because the judge misunderstood the standard to be applied. He contends that the finding that he willfully attempted to evade those liabilities was against the clear weight of the evidence. Debtor also argues the tax liabilities in question should be discharged because they were due more than three years before the date his bankruptcy petition was filed.

A. The Standard of § 523(a)(1)(C):

The willfulness exception of § 523(a)(1)(C) consists of a

conduct element, an attempt to evade, and a mens rea requirement, i.e., doing so willfully. See In re Fegeley, 118 F.3d 979, 983 (3d Cir. 1997). Debtor asserts that more than a failure to file a return despite knowledge of the duty to file is required. "A debtor's failure to pay his taxes, alone, does not fall within the scope of [the] section[\'s] . . . exception to discharge in bankruptcy." Id. He is correct, and the additional element is willfulness. The debtor is incorrect to the extent he asserts that something more than willfulness is required.

The Fegeley court concluded, "we should consider . . . the totality of conduct to determine whether or not the debtor willfully attempted to evade or defeat taxes." Id. (emphasis added). The civil willfulness standard applies; a debtor has willfully attempted to evade his taxes if the attempted evasion was voluntary, conscious, and intentional. See id. at 984. To meet the requirements of § 523(a)(1)(C), the government must show:

- (1) the debtor had a duty to file income tax returns;
- (2) the debtor knew he had such a duty; and
- (3) the debtor voluntarily and intentionally violated that the duty.

See id. at 984. Despite the debtor's contentions, the Bankruptcy Court applied the correct standard.

B. The Application of the Standard of § 523(a)(1)(C):

The government bears the burden of proving each element of the test articulated in Fegeley by a preponderance of the evidence, see Fegeley, 118 F.3d at 982, and “[e]xceptions to discharge are to be strictly construed in favor of the Debtor.” Grogan v. Garner, 489 U.S. 279, 286 (1991). It is undisputed that debtor had a duty to file tax returns, and he admitted he knew of this duty.

1. Debtor’s 1986 and 1987 tax liabilities:

With regard to debtor’s 1986 and 1987 tax liabilities, the government claims the Bankruptcy Court erred in finding those liabilities dischargeable because the judge failed to consider evidence from 1988 and beyond, and improperly balanced the evidence of willfulness. The government is correct.

In justifying its conclusion of dischargeability the Bankruptcy Court stated, “[t]here was unrebutted testimony offered by the Debtor that his records for those years were unavailable, making his failure to file problematic and therefore not sufficiently intentional and involuntary.” In re Charles Weiss, 237 B.R. at 606. The Bankruptcy Court did not adequately consider whether the debtor’s continued non-payment became willful over time, and whether the information needed was available from another source.

A court may properly consider a debtor’s conduct after the return and payment were due to determine whether the evasion of

payment was willful. See In re Meyers, 216 B.R. 402, 405 (B.A.P. 6th Cir. 1998) (“[A] debtor's conduct over time may be evidence relevant to whether there was a willful attempt to evade or defeat a tax.”). The Bankruptcy Court appears to have examined only the evidence from the year in which the return was due in reaching its conclusion that the 1986 and 1987 liabilities were dischargeable. This was an error of law.

The debtor's income information was available to him despite the theft of his records. He had two sources of income - his law firm position and his investments. He could have requested records of that income from the two sources - his law firm and his investment broker - which obviously could have provided the necessary documentation. There is little evidence that debtor ever attempted to acquire duplicate records to ascertain his actual income tax liabilities.

Moreover, his financial records for the years at issue were returned to him by 1989 and the debtor has offered no tenable reason for not filing the overdue returns thereafter. The Bankruptcy Court recognized that “by 1988 the Debtor had access to his records and by 1989 the turmoil created by his first wife ceased.” In re Charles Weiss, 237 B.R. at 606. The clear weight of the evidence, once the evidence from the years after 1987 is considered, supports the finding that debtor's continued evasion of the balance of his federal income tax liabilities for 1986 and

1987 was willful. The Bankruptcy Court's finding that debtor's failure to file his 1986 and 1987 returns was not willful was clearly erroneous. The debtor's tax liabilities for 1986 and 1987 are nondischargeable; the Bankruptcy Court will be reversed.

2. Debtor's 1988 through 1992 tax liabilities:

With regard to the 1988 through 1991 tax returns, the court agrees with the Bankruptcy Court's finding that the debtor's evasion was willful. The "turmoil" created by construction problems do not justify debtor's behavior. Throughout the relevant period, he continued to work at a law firm without interruption and there is little evidence that any other obligation was disturbed by the construction problems. Debtor also claims that it was "hard to catch up" after not filing his 1986 and 1987 tax returns, but the connection between his inability to file a return for two previous years and his inability to file the return for the following years is not tenable.

Debtor's proclaimed belief that he had completely paid the taxes he owed is similarly unconvincing, as the Bankruptcy Court recognized. Debtor is a well-educated attorney and must have known that the changes in his marital and employment status would have a significant impact on his tax liabilities. He had to know that his estimates were inaccurate. Despite this knowledge, debtor continued to neglect his duties, failing to file returns

and underestimating payments.

The Bankruptcy Court found debtor would have had sufficient funds to satisfy tax liabilities if his returns had been filed in a timely manner. During the relevant years, he continued to fund the construction of a new home despite ever-rising costs, expended considerable sums on a wedding and honeymoon, loaned money to other people and purchased at least two cars. As the Bankruptcy Court noted, "[t]his is a case where the debtor chose to pay other creditors and, in lieu of payments on taxes, purchased a valuable home and numerous luxury items." In re Charles Weiss, 237 B.R. at 606. The Bankruptcy Court's finding that the debtor's evasion of payment from 1988 through 1991 was willful and the liabilities nondischargeable was not clearly erroneous and will be affirmed.

C. The Three Year Limit of § 507(a)(7)(A)(iii):

Debtor argues that the three year limitation for nondischargeability in § 507(a)(7)(A)(i) is applicable to § 523 by virtue of language in § 523(a)(1)(A) referencing the periods contained in § 507(a)(7) of the Code. The debtor contends that because the taxes claimed were due more than three years prior to the filing of the Petition, the taxes are not entitled to priority status and must be discharged.

Section 523(a)(1) of the Bankruptcy Code states:

(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 custom duty -
 - (A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(7) 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;

The debtor's reading of the §523(a)(1) is flawed because subparagraphs (A), (B) and (C) describe three separate grounds for nondischargeability. This reading of the statute is compelled by the "or" that separates the subsections and the inclusion of a time limit provision contained in subsection (B)(ii) that differs from the three year time limit of § 507(a)(7) referenced in subsection (A). The time limit provision of subsection (A) was not intended to govern all three provisions of § 523(a)(1).

If the tax fits into any one of the three subsections of § 523, it is nondischargeable. The three year limitation is only relevant if nondischargeability is predicated on subsection (A). Here, nondischargeability is based on subsection (C), and the number of years before the filing of the petition the tax was due is irrelevant. The debtor's tax liabilities for 1986 through 1991 are nondischargeable.

CONCLUSION

The Bankruptcy Court was clearly erroneous in holding that debtor did not willfully evade payment of his 1986 and 1987 tax liabilities. The clear weight of the evidence demonstrated that debtor's evasion of his federal income tax liabilities during those years was willful. The Bankruptcy Court was not clearly erroneous in finding that debtor willfully evaded his tax liabilities for the years 1988 through 1991. The sums owed to the IRS for the underpayment of taxes from 1986 through 1991 are nondischargeable under § 523(a)(1)(C). The Bankruptcy Court will be reversed, in part, and affirmed, in part.

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ORDER

AND NOW this 15th day of November, 2000, upon consideration of the Brief of Appellant United States of America (# 7), the Brief of Cross-Appellant Charles Weiss (# 8), the United States' Response thereto (# 9) and Weiss' Reply (# 10), it is **ORDERED** that the judgment of the Bankruptcy Court is **REVERSED, in part, and AFFIRMED, in part.**

1. The ruling of the Bankruptcy Court that debtor's 1986 and 1987 federal income tax liabilities are dischargeable is reversed; those liabilities are nondischargeable.

2. The ruling of the Bankruptcy Court that debtor's 1988 through 1991 federal income tax liabilities are nondischargeable is affirmed.

3. This action is **REMOVED** from **ADMINISTRATIVE SUSPENSE.**

4. This matter is **REMANDED** to the Bankruptcy Court for proceedings consistent with this Order.

S.J.