# IRS Pays $175,000 in Damages for Willfully Violating Bankruptcy Discharge By Making Collection Attempts Upon Discharged Debtor

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In a battle of competing statutes, the First Circuit Court of Appeals has held that the IRS's good faith belief that it had a right to collect debts discharged in bankruptcy because the debtor had filed a fraudulent return or willfully attempted to evade or defeat tax, was an insufficient basis to avoid damages against the United States for the IRS's willful violation of the debtor's bankruptcy discharge.

Under Section 7433(e) of the Internal Revenue Code, a bankruptcy debtor may petition the bankruptcy court to recover damages against the United States, where the IRS has willfully violated the automatic stay in bankruptcy or that debtor's bankruptcy discharge. In *Internal Revenue Service v. Murphy*, 65 Bankr.Ct.Dec. 195 (2018), the debtor had received a bankruptcy discharge in 2006. The IRS disregarded that discharge under the belief that Murphy's tax obligations were not discharged due to 11 U.S.C. § 523(a)(1)(C), which excepts from discharge any tax "if the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax."

The IRS failed to file an objection to the discharge of Murphy before or after entry of such order. Instead, the IRS spent three years trying to collect, even going so far as levying several insurance companies with which Murphy did business in February 2009. In August 2009, Murphy filed an adversary proceeding in the bankruptcy court seeking a declaration that his tax debts were indeed discharged. The IRS was represented by the U.S. Attorney's Office, which never submitted any evidence of Murphy's tax evasion, only allegations of same. In 2010, the bankruptcy court granted judgment in favor of Murphy and declared that Murphy's tax debts had been discharged. The IRS did not appeal the bankruptcy court's ruling.

In 2011, Murphy filed a complaint in the bankruptcy court against the IRS, alleging that under Section 7433(e) the IRS had violated the discharge by issuing levies in 2009. The IRS responded that it did not meet Section 7433(e)'s definition of willfully violating the discharge, because it had a good faith belief that Section 523(a)(1)(C)'s exception for debtors who made a fraudulent return or willfully attempted in any manner to evade or defeat such tax, applied to this debtor.

In December 2013, the bankruptcy court granted judgment in favor of Murphy, finding that Section 7433(e)'s term "willfully violates" has an established meaning in the context of violations of automatic stays and discharge orders issued in bankruptcy proceedings; that is, a willful violation occurs "when, with knowledge of the discharge, [a creditor] intends to take an action, and that action is determined to be an attempt to collect a discharged debt."

The IRS appealed the bankruptcy court decision to the Federal district court, which vacated the bankruptcy court decision on other grounds, but agreed with the bankruptcy court's definition as to when a willful violation occurs. On remand to the bankruptcy court, the IRS settled the matter in 2017, agreed that the debtor's taxes had been discharged, and agreed to pay Murphy $175,000 in damages if it lost an appeal on the issue of whether Section 523(a)(1)(C) provides a good faith exception to Section 7433(e). Given the settlement, the bankruptcy court entered final judgment against the United States, the district court affirmed, and the IRS appealed to the First Circuit Court of Appeals. And so, we come to today.

At the First Circuit, the IRS argued that it did not willfully violate Section 7433(e) because it had a good faith belief that a taxpayer violated Section 523(a)(1)(C). The IRS supported its position by arguing that prior to the enactment of Section 7433(e) in 1988, creditors could avail themselves of a good faith defense to allegations that they had willfully violated a discharge order. In addition, the IRS argued that it must be allowed to raise a good faith defense because Section 7433(e) is a waiver of sovereign immunity and must be construed narrowly.

The First Circuit disagreed. Noting that Congress did not define the phrase "willfully violates" with regard to Section 7433(e), the court applied its ordinary usage, and in context of the way the term "willfully" was used in Section 7433(e) and its references back to the automatic stay and discharge sections of the bankruptcy code. Following a deep historical analysis, **the court determined that a creditor willfully violated the automatic stay if it knew of the automatic stay and took an intentional action that violated the automatic stay. A good faith belief in a right to the property was not relevant to determining whether the creditor's violation was willful. The court found that when Congress enacted Section 7433(e), Congress intended that same standard to also apply to willful violation of a discharge order**. That is, the IRS willfully violates the automatic stay and bankruptcy discharge orders under Section 7433(e), where it has knowledge of the stay or discharge and takes an intentional act that violates same, like making collection efforts.

The First Circuit noted that the IRS could have filed an objection to discharge in the bankruptcy court, and could have filed an adversary proceeding prior to collection to obtain a determination that the debts were not discharged. The First Circuit cautioned that the IRS need not appear and object in every bankruptcy in order to have a taxpayer's debts excepted from discharge under Section 523(a)(1)(C). Rather, the IRS may wait until a bankruptcy discharge is invoked as a defense to IRS collection efforts, at which time the IRS may then prove its factual basis for the tax fraud exception to collection.