DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR MICHAEL J. O'BRIEN
ASSOCIATE AREA COUNSEL (SB/SE)

FROM: Joseph W. Clark
Senior Technician Reviewer, Branch 2
(Collection, Bankruptcy and Summonses)

SUBJECT: Automated Discharge System

This memorandum responds to your request for advice dated November 2, 2000. This document may not be cited as precedent by taxpayers.

ISSUES:

1. Whether the Automated Discharge System (ADS) improperly determines that penalties are dischargeable where the debtor has filed previous bankruptcies.

2. Whether ADS properly discharges the estimated tax penalty under I.R.C. § 6654 when the taxpayer has been granted an extension of time to file the return.

CONCLUSION:

1. The ADS does not improperly discharges penalties in those cases where there have been multiple bankruptcy filings. The discharge of the penalty is not automatic. Rather, the computer system identifies and flags those situations where tolling may affect the discharge of penalties, and prompts the necessity for a manual review.

2. The ADS properly determines the dischargeability of the estimated tax penalty. The computer system processes the penalty as having arisen at the time the return is due, without regard to any extensions. The estimated tax penalty is discharged unless it falls under the exception provided for under Bankruptcy Code § 523(a)(7)(B) (i.e., if the return due date is within three years of the petition date).

FACTS:

In general, ADS automates processes involved in the disposition of bankruptcy cases after discharge. The program processes Chapters 7 and 13 discharges. ADS is intended to (1) identify or flag cases for further review; (2) forward certain cases for abatement; (3) select tax modules for abatement; and (4) input case closing actions to the Service's computer system (*Automated Discharge System, User's Guide*, IRS Publication, Catalog No. 85081X, p. 1-1).

In a Chapter 7 bankruptcy, Bankruptcy Code § 727(b) provides that the debtor is discharged from all debts that arose before the petition date, except as provided in section 523. Section 523(a)(7)(B) provides that a non-pecuniary loss tax penalty will be excepted from discharge if it is imposed with respect to a transaction or event that occurred within three years of the petition date. In re Roberts, 906 F.2d 1440 (10th Cir. 1990).

You indicated in your memorandum that ADS takes tolling into account in those cases where there have been multiple bankruptcy filings in order to determine the dischargeability of tax and interest. However, you expressed concern that ADS may not be taking tolling into account when determining the dischargeability of penalties. In other words, it appears that ADS may be discharging penalties where the due date of the return is more than three years from the date of the filing of the current bankruptcy, without regard to tolling caused by a previous bankruptcy.

The issue with regard to the discharge of penalties in a tolling situation was discussed with managers in the Office of Special Procedures, National Office. They explained the various proposed flowcharts created in connection with the operation of ADS, including the flowchart for discharge of penalties where there is a tolling situation caused by previous bankruptcies. The current flowchart/program in ADS provides that the tax is nondischargeable in those situations where, because of tolling, the bankruptcy petition is filed within the three-year period. With regard to penalties, the program identifies or flags the situation as needing further review. The computer system prompts the necessity for a manual review in order to determine whether any or all of the penalties are dischargeable under the circumstances.

Consequently, based on information provided by the Office of Special Procedures, it does not appear that ADS improperly discharges penalties in the situation where there have been multiple bankruptcy filings. It is anticipated that, because the system identifies and flags those situations where tolling may affect the discharge of penalties, the Service will have sufficient opportunity to examine the circumstances and determine whether the penalties are in fact dischargeable.

The second issue raised in your memorandum concerns dischargeability of the estimated tax penalty. The ADS program does not make any special distinctions between this penalty and other non-pecuniary loss penalties (such as the failure to file penalty or the failure to pay penalty). In other words, ADS processes the estimated tax penalty as having arisen at the time the return is due.

As previously stated, Bankruptcy Code § 523(a)(7)(B) provides that a non-pecuniary loss tax penalty will be excepted from discharge if it is imposed with respect to a transaction or event that occurred within three years of the petition date. In the context of penalties, the "transaction or event" that triggers the penalty has been determined to be the due date of the return or payment. See In re Leahey, 169 B.R. 96 (Bankr. D. N.J. 1994); In re Stoll, 132 B.R. 783 (Bankr. N.D. Ga. 1990); In re Frary, 117 B.R. 541 (Bankr. D. Alaska 1990).

Since ADS currently processes all non-pecuniary loss penalties, including the estimated tax penalty, as having arisen on the due date of the return (without regard to any extensions), the issue becomes whether the estimated tax penalty arises on the due date of the return, or some other date (such as the due date of the estimated tax payments). If it is concluded that the estimated tax penalty arises on the due date of the return, then ADS correctly processes the dischargeability of this penalty.

I.R.C. § 6654 provides for a penalty in the case of an underpayment of estimated tax by individuals. I.R.C. § 6654(b) provides that the penalty is computed on the amount of the underpayment for an installment of estimated tax, for the period of the underpayment. The period of the underpayment, as defined in I.R.C. § 6654(b)(2)(A), runs from the due date of the installment to the earlier of the 15th day of the 4th month after the close of the year or the date on which the underpayment is paid. Thus, an underpayment of estimated tax, upon which a penalty would be computed, can run until the 15th day of the 4th month following the close of the year (i.e., the due date of an individual's return, typically April 15th).

Payments of estimated taxes are prepayments of income tax for the year and are deemed paid on the due date of the return, determined without regard to an extension of time for filing. I.R.C. §§ 6315 and 6513(b)(2). The due date of a calendar-year individual's return is April 15th, and his income tax for the year is due on that date as well. I.R.C. §§ 6072(a) and 6151(a).

Thus, until April 15th, the due date of the taxpayer's return, estimated taxes paid are not considered taxes paid. Underpaid estimated taxes are still considered just that until April 15th. Until April 15th, the unpaid estimated taxes cannot be assessed and are not subject to underpayment interest. I.R.C. §§ 6201(b)(1) and 6601(h).

The estimated tax penalty arises only when the underpayment period for estimated taxes has concluded. On April 15th, the estimated taxes of an individual cease to be

prepayments of tax and become payments on account of his income tax for the year. The penalty for underpayment of estimated tax, which is dependent upon information determined by the return (e.g., tax shown on the return), is computed and assessed at that time, either by the taxpayer on his return or by the Service upon receipt of the return. It is an addition to tax which is assessed, collected and paid in the same manner as tax pursuant to I.R.C. § 6665(a).

Accordingly, the estimated tax penalty arises on the due date of the return for the year, without regard to any extension of time for filing the return. See In re Ripley, 926 F.2d 440 (5th Cir. 1991) (the estimated tax penalty does not become due and payable until the due date of the return, citing I.R.C. § 6513(b)(2)). Since the ADS program, in its present form, processes the estimated tax penalty as having arisen at the time the return is due and without any regard to extensions, for purposes of determining dischargeability, it appears that no modification is necessary with regard to that aspect of the program.

If you have any questions, please contact the attorney assigned to this case at (202) 622-3620.