



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Alan C. Levine
Chief, Branch 1 (General Litigation)

SUBJECT: Secured Nonpecuniary Loss Penalties

This responds to your request for our prerule of your advice on the payment of nonpecuniary loss penalties in bankruptcy. This document is not to be cited as precedent.

ISSUES:

1. In a Chapter 7 case, when the Internal Revenue Service ("Service") files a Notice of Federal Tax Lien prepetition, are the penalties that accrue postpetition a secured claim if the tax lien is oversecured?
2. In what priority order should prepetition secured nonpecuniary loss penalties be paid in a Chapter 7 case?

CONCLUSIONS:

1. Nonpecuniary loss penalties that accrue postpetition are not secured claims.
2. Prepetition secured nonpecuniary loss penalties should be paid in a fourth priority distribution level in a Chapter 7 case. B.C. § 726(a)(4).

FACTS:

A debtor incurred nonpecuniary tax penalty accruals prior to the petition date in bankruptcy and after the petition date. The Service filed a Notice of Federal Tax Lien prior to the petition date. The value of the real estate in the bankruptcy estate exceeded the Service's prepetition lien claim for taxes, interest, and nonpecuniary loss penalty. To sell the real property, the Chapter 7 trustee requested a discharge

under I.R.C. § 6325(b)(3) of the federal tax lien that encumbered the property.¹ Section 6325(b)(3) allows property to be sold free of the federal tax lien, with the federal tax lien attaching to the proceeds in the same priority as it did to the underlying property. The Service granted the discharge. The Chapter 7 trustee did not avoid the nonpecuniary tax lien under section 724(a).

LAW AND ANALYSIS

(1) B.C. § 506(b) provides that a nonconsensual lienor, such as the Service, may recover interest when it is oversecured, but penalties and other charges can be recovered only by oversecured consensual lienors:

To the extent that an allowed secured claim is secured by property the value of which, ... , is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or other charges provided for under the agreement under which such claim arose.

In United States v. Ron Pair Enterprises, 489 U.S. 235, 241 (1989), the Supreme Court adopted a plain wording interpretation of section 506(b) and concluded that “in the absence of an agreement, postpetition interest is the only added recovery available [to a nonconsensual oversecured creditor].” Accord In re Brentwood Oupatient, Ltd., 43 F.3d 256 (6th Cir. 1994). In Brentwood, the Sixth Circuit, the controlling jurisdiction for your office, held that a nonconsensual oversecured lienholder cannot recover postpetition penalties. Brentwood, 43 F.3d at 263.

Applying the above law to your case, the Service can recover only interest from its oversecured claim. The Service cannot recover its postpetition nonpecuniary loss penalty because only a consensual lienholder can recover penalties when the lien is oversecured, and the Service is not a consensual lienholder.

(2) B.C. § 726(a)(4) describes the fourth payment level in a Chapter 7 distribution as follows:

in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim.

¹ Normally, a trustee may sell encumbered property free of any liens under B.C. #363(f). Apparently, the sale of real property in this case did not fall within the purview of section 363(f).

Emphasis added. Under the plain wording of subsection (a)(4), it makes no difference whether the prepetition nonpecuniary loss penalty is secured or unsecured. Accordingly, the Service's prepetition nonpecuniary loss penalty in your case will be paid at the fourth priority level under section 726(a)(4).

We note that if the secured nonpecuniary loss penalty is not paid in full by a distribution under section 726(a)(4), then the Service may enforce its nonpecuniary tax lien against the debtor's exempt property. When a debtor exempts property, he does not avoid the lien on the property. See B.C. § 522(c)(2)(A)(i) (a lien remains on the property if it is not avoided under section 724(a)). See also Farrey v. Sanderfoot, 500 U.S. 291, 296 (1991) (liens remain on exempt property).

If you have any further questions, please call me at 202-622-3610.

Cc: