

ORIGINAL

In the

Supreme Court of the United States

X 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31 32 33 34 35 36 37 38 39 40 41 42 43 44 45 46 47 48 49 50 51 52 53 54 55 56 57 58 59 60 61 62 63 64 65 66 67 68 69 70 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99

UNITED STATES,

Petitioner,

VS

No. 76-1800

ONOFRE J. SOTELO AND NAOMI SOTELO,

Respondents.

X
2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31 32

Washington, D. C.
February 22, 1978

Pages 1 thru 46

Duplication or copying of this transcript by photographic, electrostatic or other facsimile means is prohibited under the order form agreement.

Hoover Reporting Co., Inc.

Official Reporters
Washington, D. C.

546-6666

IN THE SUPREME COURT OF THE UNITED STATES

-----:
UNITED STATES, :
:
Petitioner, :
v. :
: No. 76-1800
:
ONOFRE J. SOTELO AND NAOMI SOTELO, :
:
Respondents. :
-----:

Washington, D. C.,

Wednesday, February 22, 1978.

The above-entitled matter came on for argument at
10:59 o'clock a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice
JOHN PAUL STEVENS, Associate Justice

APPEARANCES:

STUART A. SMITH, ESQ., Office of the Solicitor
General, Department of Justice, Washington, D. C.;
on behalf of the Petitioner

BRUCE L. BALCH, ESQ., Katz, McAndrews, Durkee &
Tellegen, 200 Cleveland Building, P. O. Box 66,
Rock Island, Illinois 61201; on behalf of the
Respondents

C O N T E N T S

<u>ORAL ARGUMENT OF</u>	<u>PAGE</u>
Stuart A. Smith, Esq., on behalf of the Petitioner	3
Bruce L. Balch, Esq., on behalf of the Respondents	23
Stuart A. Smith, Esq., on behalf of the Petitioner--Rebuttal	45

- - -

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in 76-1800, United States v. Onofre J. and Naomi Sotelo.

Mr. Smith, you may proceed whenever you are ready.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.,

ON BEHALF OF THE PETITIONER

MR. SMITH: Mr. Chief Justice, and may it please the Court:

This federal income tax and bankruptcy case comes here on a writ of certiorari to the United States Court of Appeals for the Seventh Circuit. It presents the question of whether the statutory liability equal to unpaid taxes withheld from employees' wages, which is imposed by section 6672 of the Internal Revenue Code, upon persons who are required to collect and pay over such taxes but who willfully failed to do so is dischargeable under section 17 of the Bankruptcy Act.

We submit that this liability is not dischargeable and that the Court of Appeals erred in so holding.

The facts are relatively simple and undisputed. On June 26, 1973, Onofre J. Sotelo and Son, Masonry, Inc., a corporation, was adjudicated a bankrupt. The president of this corporation was respondent Onofre J. Sotelo, and the secretary of the corporation was his wife Naomi.

About ten days later, on July 5th, Onofre J. Sotelo and Naomi Sotelo were adjudicated bankrupts themselves and

their cases were thereafter consolidated in the Bankruptcy Court. Later that year, in November, the government filed a claim in the individual bankruptcy cases for unpaid withholding taxes amounting to \$40,000. This claim was later reduced to \$32,000. The claim was based upon section 6672 of the Internal Revenue Code, and which I have referred to as imposing a statutory liability on so-called responsible officers of a corporation who are required to collect withholding taxes and pay them over but who willfully failed to do so.

QUESTION: Mr. Smith, what section is it that requires the responsible officers to collect? I agree, that 6672 imposes a penalty upon those who are required to collect, but I am curious to know what section it is that requires them to collect.

MR. SMITH: Well, Mr. Justice Rehnquist, section 6671(b) defines a person as using the subchapter which includes an officer or employee of a corporation, and section 3402 of the Code, which we set forth at page 3a of the appendix of our brief, says "as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables prescribed by the Secretary." So the requirement is that these are statutory -- Onofre J. Sotelo was a person under the Code and the employer was the corporation and he acted on behalf of the corporation, and he was required to collect and

pay over these taxes as prescribed --

QUESTION: You say those two sections together not only require the employer to pay but makes one in Sotelo's position responsible for paying over them?

MR. SMITH: Yes, and that if he fails to pay, section 6672 --

QUESTION: I agree with that. Do you think your first proposition is crystal clear?

MR. SMITH: I think so, because he is acting on behalf of the employer. It says every employer making payment of wages, the corporations act through their officers and under section 6671(b) the term "person" includes an officer or employee of a corporation or a member or employee of a partnership, et cetera, et cetera. I think that is clear, Mr. Justice Rehnquist.

QUESTION: Perhaps it has already been covered in this colloquy, but is it not clear that the statute requires the employer to withhold the employee's portion from payment of social security taxes, for example, or withholding, and that if he fails to do it, the employer is responsible?

MR. SMITH: That's right. That's right. If he fails --

QUESTION: Congress has made the employer the tax collector, has he not?

MR. SMITH: Exactly. And if the employer, as in this

case, the typical situation where section 6672 liability arises, is where the employer is a corporation which goes bankrupt and it no longer has assets to pay and then Congress has determined that the collection agent, the responsible collection agent who made the decision to willfully prefer other creditors over the United States, he becomes personally liable for these taxes. In fact, in the Bankruptcy Court in this case, there was a trial as to whether Onofre J. Sotelo and/or Naomi Sotelo were responsible officers under section 6672, and the trial judge found that Onofre was a responsible officer but not Naomi Sotelo, and that is undisputed, that he is a responsible officer and that he has this liability.

The assets of the bankruptcy estate were insufficient to satisfy the government's tax claim. The government thereupon levied on a \$10,000 fund that had been set aside outside the bankruptcy estate as Onofre J. Sotelo's homestead exemption under Illinois law, and Onofre J. Sotelo objected to the levy on the grounds that the homestead exemption belonged to his wife Naomi and not himself. He also argued -- and that is the question before the Court -- that the section 6672 liability for unpaid withholding taxes was a dischargeable compensatory penalty rather than a tax and that his half of acquired property should be insulated from collection.

QUESTION: Strictly speaking, is the 6672 liability a tax liability or a liability for something equivalent to the

amount of the tax? The reason I ask, following up on Justice Rehnquist's question, is that section 3403 describes the person's liable for the tax and it only identifies the employer. The employer shall be liable for the payment of the tax required to be withheld, and so forth.

MR. SMITH: I think what that is is that section 3403 provides that the employer shall be liable for the payment of the tax in the first instance, but that section 6672 provides for backup liability when the employer doesn't pay the tax.

We have argued at length in our brief that --

QUESTION: The question I suppose is whether the backup liability is a strictly speaking tax liability.

MR. SMITH: I think it is a tax liability, although that is --

QUESTION: That is a penalty.

MR. SMITH: Congress used the term "penalty" but the authorities apart from the decision below in this case are unanimous in not only two circuits but all the district courts and they treat and describe this as a tax liability.

QUESTION: Had this question arisen prior to 1966 when section 17 was amended?

MR. SMITH: This question had arisen prior to 1966 in cases like the Sherwood case, which we cite in our brief, the Eastern District of New York case, and the court had held that this was a tax liability and not a penalty. But that is

an alternative. I want to emphasize that that is an alternative argument that we made. We think that our primary argument in this case is that this liability is not dischargeable under section 17(a)(1)(e) of the Bankruptcy Act which was added to section 17 in 1966.

But before I mention that, I just want to briefly summarize what the courts below --

QUESTION: Does the Code also say that the penalty shall be levied and assessed like taxes?

MR. SMITH: Like taxes, yes.

QUESTION: So they are to be treated as taxes?

MR. SMITH: They are treated like taxes.

QUESTION: This is 6671?

MR. SMITH: 6671(a). In fact, the Second Circuit, in *Botta v. Scanlon*, has held that they are subject to the Anti-Injunction Act.

QUESTION: Which defines taxes in a different way, doesn't it, than the Code?

MR. SMITH: The Anti-Injunction Act?

QUESTION: You can't carry over the Second Circuit holding *ao ipsi*, so to speak, to this case, can you?

MR. SMITH: Well, but I think it is persuasive, just as Mr. Justice White has said. These things are always treated as taxes and the Internal Revenue Service endeavors to make sure that these things are only collected once when the

corporation fails. They are only collected once from the officer. I don't think that there is any doubt that the way they are treated administratively and the way the courts have regarded them. They are always treated as taxes, notwithstanding the penalty.

QUESTION: Section 6671 says any reference in this title to tax imposed with this title shall be deemed also to refer to the penalties and liabilities.

MR. SMITH: Penalties and liabilities imposed by the subchapter, that's right. That's right. But I would submit -- and I don't want to belabor the point, because I think it is covered in our brief -- that despite the penalty denomination, these things are always treated as taxes and the courts apart from this Court have so held.

QUESTION: Mr. Smith, tell me the basis for your statement that the Internal Revenue Service collects only once as a matter of policy. Is there --

MR. SMITH: The basis of our statement for that is an opinion, a policy statement which we cite at page 30 of our brief, Policy Statement P-5-60.

QUESTION: Subject to change tomorrow.

MR. SMITH: What?

QUESTION: Subject to change tomorrow.

MR. SMITH: Well, quite frankly, I have been working in this area for quite a while and I have never heard of any

instance where the Internal Revenue Service has attempted to collect section 6672 liability more than once.

QUESTION: No, but you have heard of many instances where the Internal Revenue Service changes its mind.

MR. SMITH: Oh, absolutely, but I cannot -- it is hard for me to imagine changing its mind in this context when given the authorities which have held it is a tax rendered at the urging of the government.

In any event, the Bankruptcy Court held that the section 6672 liability was non-dischargeable under section 17 of the Bankruptcy Act, and the District Court affirmed. The Court of Appeals reversed. It held that section 17 a (1)(e), which is our primary argument before the Court today, was not applicable, and it also held that the liability was a penalty and not a tax.

I want to begin by referring the Court to section 17a(1)(e) because I think that its terms are explicit and cover this case. The pertinent language is set forth at pages 5a and going over to 6a of the Appendix to our brief. The beginning of section 17, the basic discharge provision, says, "A discharge in bankruptcy shall release a bankrupt from all of his provable debts whether allowable in full, in part, except as such" -- and then there is an exception for taxes. And then it goes on to say, "Provided, however, that a discharge in bankruptcy shall not release a bankrupt from any taxes" --

and then if the Court will turn over to page 6a and pick up at subsection (e) "which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over."

QUESTION: Tell me again your answer to the question of where you find the source of the requirement that the bankrupt who is an officer and not the taxpayer pay over?

MR. SMITH: Well, the bankrupt in the first instance is --

QUESTION: He was not liable for the taxes in the first instance.

MR. SMITH: In the first instance, of course, he wasn't liable, the corporation was liable, but the corporation did not pay them. He paid as the responsible officer, Onofre J. Sotelo paid net wages to his employees and benefited --

QUESTION: Well, to the corporation's employees?

MR. SMITH: Yes.

QUESTION: The corporation was the employer. They were not his employees.

MR. SMITH: Right, they were not his employees, they were the corporation's employees. But acting on behalf of the corporation, Onofre J. Sotelo paid net wages to his employees and did not --

QUESTION: They were not his employees.

MR. SMITH: -- and the corporation did not pay --

oh, I understand.

QUESTION: It is the basis of the Seventh Circuit's opinion.

MR. SMITH: I understand.

QUESTION: So it is something you can forget about.

MR. SMITH: Oh, I understand that. I am sorry if my nomenclature is --

QUESTION: Well, it is the basis of the Seventh Circuit Court of Appeal's opinion.

MR. SMITH: Yes, I know, the basis of the Seventh Circuit Court of Appeal's opinion, is that it is the corporation's liability --

QUESTION: That the corporation is the employer.

MR. SMITH: -- and not Onofre J. Sotelo's liability. But in our view, this ignores the very explicit legislative history going over, extending over eight years in which the Treasury kept telling the Congress -- and it is set forth in our brief in great detail -- that it resisted mightily the proposition that taxes and this section 6672 liability would be made dischargeable in bankruptcy. And the Treasury's major submission to the Congress --- and it was made to the Judiciary Committee and to the Ways and Means and Finance Committees --- was that there was an inequity in giving a responsible officer or a bankrupt a discharge ---

QUESTION: Mr. Smith, before you tell us about the

Treasury Department's objections to the 1966 legislation, why don't you tell us what the purpose of the 1966 amendment was?

MR. SMITH: The purpose of the 1966 amendment --

QUESTION: The entire amendment, I mean.

MR. SMITH: The entire amendment was as follows: It was to introduce a statute of limitations -- section 17a before 1966 --

QUESTION: Wasn't it to ameliorate the harsh rule against the individual that had to pay and has had a non-dischargeable tax obligation regardless of how old it was?

MR. SMITH: That was part of it. That was --

QUESTION: It was in order to protect the individual taxpayer.

MR. SMITH: That was part of it. Congress was interested in providing a statute of limitations for stale tax claims in bankruptcy, because before 1966 tax claims were not dischargeable and they were forever subject to collection.

QUESTION: And that was inequitable to individuals but not to corporations because corporations were --

MR. SMITH: Corporations --

QUESTION: -- and it was to provide protection to individuals, to bankrupt individuals.

MR. SMITH: Exactly, and that, Mr. Justice Stevens, that was introduced in section 17a(1) because it says "except such as taxes which became legally due and owing by the bankrupt

to the United States or any State or subdivision thereof within three years preceding bankruptcy."

But there was another purpose in adding section 17a-(1)(e). The Treasury Department was terribly concerned about mounting delinquencies in trust fund taxes, because it properly pointed out to the pertinent committees that there was an inequity in giving a bankrupt a discharge for failure to pay -- not to pay his own taxes but for failure to keep intact money which he had obtained from others as a trustee for the government.

In 1958, Congress felt that a criminal penalty would suffice, and they enacted section 7202 of the Code to provide for a criminal penalty for willfully failing to pay these trust fund taxes over. The point is --

QUESTION: To expressly identify the problem, the problem was they collected the money from third persons and converted such monies to their own use, wasn't that --

MR. SMITH: Exactly.

QUESTION: Well, that didn't happen here, did it?

MR. SMITH: Of course, it happened here because what happened here was that the employees were paid net wages and the corporation benefited from the fact that it did not pay the withholding taxes over.

QUESTION: It is not the corporation's liability that we are dealing with here.

MR. SMITH: Exactly, but then by operation of the statutory provisions in the Code, 6671(b) and 6672, this liability becomes Onofre J. Sotelo's liability, and the point is --

QUESTION: But did Onofre J. Sotelo convert these funds to his own personal use?

MR. SMITH: In the sense that he contributed them -- I mean that the funds were contributed or remained in the corporation which he ran --

QUESTION: Is that the normal use -- is that the normal way you think of a corporate officer converting corporate assets to his own use?

MR. SMITH: In the sense that his business was able to continue to use these funds would seem to me to be a --

QUESTION: His own use?

MR. SMITH: The corporation's own use.

QUESTION: Mr. Smith, you say that 6671(b) on page 4a of your brief, it is the provision you rely on that imposes liability upon a corporate officer to pay taxes that are owed by the corporation, and yet that, as I read it, simply says it includes an officer or employee of a corporation or a member or employee of a partnership who is under a duty to perform the act. In other words, it speaks the same way 6672 does. Both of them speak of people who are already under a duty. I still want to know where is Sotelo's original duty to pay taxes

on behalf of a corporation arise from?

MR. SMITH: His original duty to pay taxes on behalf of the corporation arises as the principal officer of the employer.

QUESTION: Well, what provision of the statute tells us that?

MR. SMITH: Well, 3402, if you turn back a page, and 3403, say that every employer making payment of wages, and then says the employer shall be liable. Now --

QUESTION: Well, the employer here is the corporation and it was not Sotelo.

MR. SMITH: Exactly, the corporations are legal entities, they have to operate through their principal -- through people.

QUESTION: Well, then you are not relying on any specific Code language?

MR. SMITH: No. I think --

QUESTION: You are relying on common law?

MR. SMITH: The case law is clear that in fixing 6672 liability they look to the person who was responsible, who --

QUESTION: Who would be responsible in a common law sense?

MR. SMITH: In a common law situation to make the decisions, and here that was Onofre. The Bankruptcy Court found that that was Onofre J. Sotelo, and there is no dispute about

that.

We submit that there was no dispute that he was a person required to collect, truthfully account for and pay over the withholding taxes, and he collected those taxes by paying net wages to his corporation's employees. And in our view he is a bankrupt who has collected or withheld taxes from others, as required by the laws of the United States, but who has not paid them over within section 17a(1)(e).

Now, I think that it is not without significance that the House report --

QUESTION: I don't suppose the government could just pick anybody at random in the corporation and put him -- impose this kind of liability on him?

MR. SMITH: I'm sorry, I didn't hear that.

QUESTION: The government just can't pick anybody in the corporation at random.

MR. SMITH: Oh, no.

QUESTION: They should identify and must identify the people, as the corporation is organized, has the duty of paying the taxes.

MR. SMITH: Exactly. Exactly. That has to be the person who makes the final decision, who says, well, we have a tax liability --

QUESTION: Why does it have to be the person who makes the final decision? Why can't it be the bookkeeper who

is charged with the duty to make the deductions and write out the checks?

MR. SMITH: Well, the bookkeeper exercises on trammelled authority--

QUESTION: What in the statute says it has got to be untrammelled authority?

MR. SMITH: Well, I mean I would suggest, Mr. Justice Stevens, that if the president of a corporation said to the bookkeeper don't pay the taxes this month, pay --

QUESTION: No, the bookkeeper's duty is to withhold and collect and pay over. That is all she does eight hours a day, seven days a week, and there is not enough money to go around.

MR. SMITH: I suppose as a technical matter she could be liable, but it would seem to me that she is being, her authority is being circumscribed and being taken away from her.

QUESTION: What in the statute tells us who has to have what authority? I still don't think you have quite answered Mr. Justice Rehnquist.

MR. SMITH: Well, I think that the case law indicates that it is --

QUESTION: Case law in this Court?

MR. SMITH: Well, there is no case law in this Court, but I mean the uniform Court of Appeals case law indicates that

it is the person in the corporation and indeed it could be more than one who makes the decision that the taxes are not going to be paid this time because the corporation doesn't have enough money or they don't have enough money at this time so they are going to postpone payment of the taxes, and we are going to willfully prefer other creditors, and that decision under section --

QUESTION: Well, what does willfully prefer other creditors have to do with it? Nothing in the statute says you are only liable if you willfully prefer other creditors. You are liable if you don't pay.

MR. SMITH: That's right. That's right.

QUESTION: Then why do we talk about willfully preferring other creditors?

MR. SMITH: Well, because normally that is the way the --

QUESTION: This is department policy, is it, or is it statutory --

MR. SMITH: No, no, because in the normal situation if you have got the money, you pay your taxes. I used that term because case law uses that term. You are right. If you have all the money in the world and you just decide you are not going to pay withholding taxes, of course, you are going to be personally liable, assuming that the corporation then goes bankrupt.

I do want to point out to the Court that it is not without significance that the current Congress -- I understand that the views of one Congress can't be attributed to another strictly, but that the current Congress regards as settled that section 17a(1)(e) renders the section 6672 liability non-dischargeable. There is a massive codification of the bankruptcy bill, which has just passed the House and which is being considered by the Senate, and at page 22 refers to a 1977 committee report which I would like to quote. It is very short.

It says: "The current Bankruptcy Act renders non-dischargeable all taxes which the bankrupt has collected or withheld from others but has not paid over. Thus, withholding taxes are accorded an unlimited priority under present law. The priority even includes the 100 percent 'penalty' imposed under the Internal Revenue Code. The present unlimited priority is justified by the notion that withholding taxes are held in trust."

In other words, the same rationale that the Treasury pressed Congress in the mid-1960's, that a bankrupt should not benefit from his failure to honor the statutory trust of these trust fund taxes.

QUESTION: But that wouldn't answer the question of whether Onofre Sotelo himself is subject to 6672 liability, would it?

MR. SMITH: It wouldn't answer the question, but that question was not in this case because it is assumed that --

QUESTION: "Assumed" is a good word for it.

MR. SMITH: It is given. I mean the lower courts have held, and Sotelo does not contend to the contrary, that he is subject to section 6672 liability. The question is whether it is dischargeable. I think the current Congress regards -- it is settled that section 17a(1)(e) was designed to not only reach as the corporate bankrupt, because, as we point out, Congress recognized that in liquidating bankruptcy, the corporation disappears. So it would have been rather futile to enact section 17a(1)(e) in order to preserve trust fund tax liabilities post-bankruptcy.

QUESTION: Why do you say a corporation "disappears" in a liquidating bankruptcy?

MR. SMITH: Well, my understanding is that a corporation that liquidates and goes out of existence in a liquidating bankruptcy and distributes all its assets constitutes itself under different ownership is a different entity.

QUESTION: Well, if it goes out of existence, it goes out of existence. But what if it doesn't?

MR. SMITH: Well, if it doesn't go out of existence, then --

QUESTION: I mean why does it do so inevitably?

MR. SMITH: It doesn't do so inevitably --

QUESTION: Well, that was your --

MR. SMITH: -- but it does so in many instances, and I think Congress recognizes that in --

QUESTION: In many instances bankrupts die, too.

MR. SMITH: Oh, absolutely. But what Congress was interested in was making sure of enhancing the Treasury's opportunity to collect these trust fund taxes from either the corporation, if it didn't disappear, or from the responsible officer because of his statutory liability which we submit does not disappear upon bankruptcy and is nondischargeable.

QUESTION: There is nothing in the bankruptcy law that prevents the Alpha Delta Realty Company, a bankrupt, after it has turned over all its assets, from getting a new board of directors and keeping right on as the Alpha Delta Realty Company, is there?

MR. SMITH: Oh, no, I don't mean to suggest that every corporation that undergoes bankruptcy disappears. But as we point out in our brief, Congress observed that although a corporate bankrupt theoretically is not discharged, the corporation normally ceases to exist upon bankruptcy and unsatisfied tax claims as well as all other unsatisfied claims are without further recourse even though the enterprise --

QUESTION: Well, didn't the United States file a claim in Sotelo's bankruptcy?

MR. SMITH: In the individual's bankruptcy?

QUESTION: Yes.

MR. SMITH: Yes.

QUESTION: And it was approved, it was allowed?

MR. SMITH: It was allowed.

QUESTION: It was allowed by the judge, not objected to. And the only question is dischargeability?

MR. SMITH: Exactly. Exactly. That is the only question before the Court.

QUESTION: Mr. Smith, am I not --- maybe it is a misapprehension, but wasn't \$7,900 of that claim not allowed by the bankruptcy judge?

MR. SMITH: That's right. That's right.

QUESTION: And what is the reason for that?

MR. SMITH: The record doesn't disclose it, but I assume that ---

QUESTION: But the amount that is at issue here is Sotelo's liability for, whatever his conduct was is not disputed?

MR. SMITH. Not disputed. I would like to save the remaining time, if I may.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Smith.

Mr. Balch.

ORAL ARGUMENT OF BRUCE L. BALCH, ESQ.,

ON BEHALF OF THE RESPONDENTS

MR. BALCH: Mr. Chief Justice, and may it please the

Court:

On behalf of the respondents, Onofre J. Sotelo and Naomi Sotelo, we submit that the section 6672 penalty is an obligation that is dischargeable in the personal bankruptcy of the individual against whom it is assessed. In reaching a conclusion on this issue --

QUESTION: Could I just ask you, is there any question about the validity of the claim in the bankruptcy?

MR. BALCH: There is no question, Your Honor. That was determined at the bankruptcy level and neither side appealed from it, neither side was happy with it because the government wanted more and Sotelo wanted less, but I believe we have to take it as a fact at this point.

QUESTION: But you don't now contest that Sotelo owes the money, owed the money to the --

MR. BALCH: I don't contest that, Your Honor. That was the very next thing I was going to say, that in reaching a decision on this case, it is important to distinguish between the concept of liability and the concept of dischargeability.

QUESTION: In any event, he owed the money and if there had been money to distribute in the estate at 50 cents on the dollar, 50 cents on the dollar would at least have gone to the United States?

MR. BALCH: Your Honor, I wish to make the point that this was an asset case, the government filed and proved a

claim in the personal bankruptcy, that claim was allowed for a substantial sum, the government obtained a dividend from the personal assets.

QUESTION: Thanks very much.

MR. BALCH: However, those assets were not sufficient to pay the claim in full and that is what brings us here.

QUESTION: All right.

QUESTION: You began with some discussion about section 6672 liability, but I am not sure you finished your sentence.

MR. BALCH: Thank you, Your Honor.

QUESTION: Would you give me that again?

MR. BALCH: I wanted to make the distinction between the liability under section 6672 and its dischargeability, and I am careful and I hope I don't slip, have a slip of the tongue somewhere in this discussion and, heaven forbid, call that a tax.

I call it an obligation. It is an obligation for a penalty, and we say that it is considerably different than the obligation for a tax. And the importance of that distinction becomes apparent when we go on to look at section 17a(1) of the Bankruptcy Act.

Now, a right to a discharge in bankruptcy is a rather sweeping privilege that Congress has extended to all bankrupts, and you start out with a general rule that a discharge in

bankruptcy shall release a bankrupt from all of his provable debts whether allowable in full or in part, except such as are -- and then there are some exceptions.

Now, we point out that the facts relate in this case, that at the government's instance, a claim was proved in the personal bankruptcy, it was allowed in part and therefore we squarely come within the general rule that this claim is a dischargeable claim and therefore releases the bankrupt from all of his provable debts, and so forth.

Now, if we are to say that one of the exceptions applies here, we say that the general rule of statutory construction is that one who asserts an exception to a recognized general rule has the burden of showing that you come within the exception, and we feel we have clearly shown we come within the general rules, so let's examine the exceptions and see if the government has met this burden of coming within one of them.

Now, the primary exception that the government relies upon in this case is the exception in 17a(1) which excepts taxes. So we are then met with the question what is the nature of the obligation under section 6672.

Well, the first place to look, I would suggest, is section 6672. What characterization did Congress itself put upon this obligation when they wrote section 6672? They say that certain people who are defined in that section -- and we

concede that Sotelo is one of them -- shall in addition to other penalties provided by law be liable to a penalty. Now, clearly they are talking penalty. They do not say that the individual is liable for the tax. This is not a tax on Mr. Sotelo. He did not file any returns. He didn't have a tax identification number in this capacity. The corporation was liable for the tax, and if the corporation --

QUESTION: There are provisions in the federal tax laws making certain parties secondarily liable for a tax, are there not?

MR. BALCH: That is correct, Your Honor, and I would say this is one of them.

QUESTION: Like -- you say this is not one of them -- like the donee for a gift tax is secondarily liable for the gift tax, at least that used to be the law.

MR. BALCH: Oh, transferee liability?

QUESTION: Transferee liability.

MR. BALCH: Yes, Your Honor.

QUESTION: That is secondary liability for the tax. But here your point is that this is not secondary liability for a tax but rather a penalty.

MR. BALCH: Thank you for correcting my slip of the tongue there, Your Honor.

QUESTION: Well, in other words, if Congress knows how to say secondary liability for a tax, it does know how to

say so, because it has said so in certain instances.

MR. BALCH: That is correct. They have made it very clear in other contexts that if they want the individual to be directly liable as a taxpayer --

QUESTION: Or secondarily liable for a tax.

MR. BALCH: Correct. They can say that. I don't think they said it in section 6672.

QUESTION: What do you think is the significance in the very context that you are just discussing of the language "shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded"? Doesn't this language equate the tax and the penalty?

MR. BALCH: That language, Your Honor, shows to the person enforcing this section how the amount of the penalty is calculated. But I don't think it changes --

QUESTION: Doesn't it make it all one?

MR. BALCH: What?

QUESTION: Doesn't it make it one and the same thing?

MR. BALCH: No, Your Honor. They could have just as well left out the words "a penalty equal to the" and that is one of the points we wish to make, that in construing the statute, if there are two possible ways to look at it, the preferred way is the way that gives meaning to each of the words that are in there. And if you construe it as simply saying a direct liability for the tax, you are rendering

meaningless the words "a penalty equal to the."

QUESTION: Can it not be read as saying that Congress intended that one way or another we are going to get this tax, we are going to get this tax which was in trust and held in trust and for these purposes we may call it a penalty?

MR. BALCH: Your Honor, that brings me back to my primary point at the very outset, and that was we must be careful to distinguish between liability and dischargeability. The point that Your Honor's question makes is that Congress wanted this person liable for this amount of money.

QUESTION: And non-dischargeable?

MR. BALCH: No, dischargeability is the issue to be decided today.

QUESTION: Yes, I know.

MR. BALCH: We are past the point of liability.

QUESTION: Yes. And doesn't this language -- isn't this language directed at dischargeability?

MR. BALCH: I would say, Your Honor, that if we can ascribe any motive at all to why they worded it in this rather peculiar fashion, I would say that it was put in there to show that there was some difference between the nature of this liability and the nature of a direct liability for the tax.

QUESTION: What about the provision of 6671(a) that says that except as otherwise provided, any reference in this title to a tax shall be deemed to include the penalties? Now,

if you concede that a liability for a penalty, if you look at the Code, it says you treat penalties like taxes. Now, you say that may be so for purposes of the Code but not for purposes of bankruptcy?

MR. BALCH: Your Honor has asked the question and then has answered it, because the section just cited refers in its operation to a particular title, and that is the whole problem with the approach of the government to this case and our approach. They are looking at this as a tax case, and it is a bankruptcy case.

QUESTION: I suppose in knowing what the bankruptcy law should consider a tax for purposes of dischargeability, it makes some sense to look to the Code to see what a tax is.

MR. BALCH: The Code in certain situations --

QUESTION: And the Code says that this penalty is a tax.

MR. BALCH: Well, we dispute that point, Your Honor.

QUESTION: Well, what else does that mean there in 6671? It says -- 6671(a) -- "The reference in this title to a tax shall be deemed also to refer to penalties."

MR. BALCH: That section 6671(a), Your Honor, is part of a procedural group of clauses which deal with the administrative matters as to how penalties are collected. What they are saying is that such things as levy and seizure and the forms and so forth, that you don't have to -- they don't have

to enact a whole separate body of material for the purpose of collecting a penalty. Now, the name of that subsection is "Penalty Assessed as Tax." Now, assessment is a highly technical tax word that refers to the matter of how liability is established for various things and how the government actually can get the money, but it doesn't go to the question of how you characterize things for the purpose of determining discharge in bankruptcy, which is in another section, and that section Your Honor just quoted refers to things like this subchapter and this title.

QUESTION: What if an individual is assessed a deficiency and then a civil penalty is also imposed under the Code, and there is no question about either the tax or the penalty, that it is valid, and the bank goes into bankruptcy, is the tax non-dischargeable but the penalty is? Is that what you are suggesting?

MR. BALCH: Well, Your Honor, the question of whether civil penalties are dischargeable, other types of civil penalties is not something that either side covered in this material and it is another area which frankly I have not prepared for, researched today.

QUESTION: All right.

MR. BALCH: That may go to the question of whether the ---

QUESTION: It might help you. It might help you.

MR. BALCH: Well, I appreciate that, Your Honor.

The question of other civil penalties would go then to whether or not they are provable or allowable at all, and then once you get over the hurdle of whether they are provable and allowable, then that gives rise to the matter of --

QUESTION: This one happens to have been provable and allowable and was allowed.

MR. BALCH: Yes, and we feel that that gives strength to our point that under section 17a of the Bankruptcy Act, once you have a claim that is proved and allowable, you presumptively have a right to discharge to it unless you can clearly show that it comes within one of the statutory exceptions of the Bankruptcy Act.

QUESTION: Well, do you suggest that, taken as a whole, this entire statutory scheme does not indicate intent by Congress that when an employer collects money from the employees by withholding it and then doesn't turn it over to the government, in the meantime having held it as a trustee, that Congress intended to make it as difficult as possible to have that be a dischargeable obligation?

MR. BALCH: I think Congress has made it a non-dischargeable obligation as to the employer-bankrupt corporation, but I don't think they have gone so far as to say that after they have taken all the corporate assets, gone on and taken all of the individual's personal assets, that they then

have hanging over his head for the rest of his life a non-dischargeable obligation that can be used to confiscate everything and anything that he ever will come to have in the future.

QUESTION: Well, realistically we know that this kind of a problem doesn't arise with General Motors or the du Pont Company, at any rate. It is more likely to arise with small businesses, is that not a realistic factor?

MR. BALCH: Well, Your Honor, I would respectfully suggest that we have had in this country some very substantial corporations that have gone bankrupt, and when they do, and if their payroll clerk or vice president for financial affairs finds himself on the wrong end of a personal liability for millions of dollars, that means he has lost everything he has ever worked for. But I don't think it means that he is in a condition of perpetual bondage to the government for the rest of his life for all of his after acquired earnings above the meager statutory exemption that the Code provides.

QUESTION: You don't think Congress viewed this as something in the nature of an embezzlement in the totality of the statute itself and its legislative history?

MR. BALCH: Well, Your Honor, there is a separate exception in the Bankruptcy Act for embezzlement. If the person had taken the money for his own personal use, you would have a different kind of a situation and a separate, independent

ground for objecting to discharge on it, and I believe Justice Stevens pursued that point with the Solicitor General as to whether he had taken it for his own use. I don't consider this type of financial difficulty a taking for the person's own use.

QUESTION: Well, what section of 17 did the government rely on, or does it?

MR. BALCH: I think they are relying on 17a(1) which excepts taxes.

QUESTION: And specifically 17a(1)(e), right?

MR. BALCH: There are two -- I don't want to make the government's argument for them, but I think that they have two theories. One is that it is an exception because it is a tax, and then there is a separate subparagraph within the tax exception that deals with withheld taxes.

QUESTION: Right.

QUESTION: Isn't one of the difficulties that the Seventh Circuit faced and we face here that you are basically dealing with the Internal Revenue Code, which is one federal set of statutes, and a Bankruptcy Code, which is another entire set of statutes?

MR. BALCH: That is exactly what it is, Your Honor. You have liability and dischargeability. The Code imposes liability. The Bankruptcy Act creates a relief of dischargeability, and that is the whole difficulty with the position of

the Internal Revenue Service in this matter. They are trying to transplant concepts from the Internal Revenue Code, which is a statute designed to impose liability and facilitate collection, as it ought to do, and they are trying to transplant those into the Bankruptcy Act. But each of these statutes was enacted for its own peculiar purposes and each has to be interpreted in light of its own function.

Now, the Internal Revenue Code, as a liability and collection matter, is interpreted in a certain way, but the Bankruptcy Act is amelioratory relief provisions which deal with the fair distribution of assets and the discharge of bankrupt debtors. And I don't consider it a conflict between the two, I think it is completely harmonious with our entire philosophy, that on one hand we want these things to be paid, but on the other hand, when you have taken all the corporate assets and all the personal assets, there comes a point where we say to the individual he is free to start over again, and I think we have reached that point here.

QUESTION: Is the claim that was filed and allowed by the United States in the record?

MR. BALCH: I believe it is, Your Honor, or at least it is referred to in the docket entry that is reproduced in the government's brief.

QUESTION: Did the trustee object to it?

MR. BALCH: I think there was a --

QUESTION: On amount? There was litigation on amount, I take it?

MR. BALCH: Yes, and there was also a contest as to the liability of Naomi Sotelo which the bankruptcy resolved in a finding that she was not liable.

QUESTION: Of course, as to the homestead exemption?

MR. BALCH: Well, that was an issue that was -- the homestead exemption was an issue at the bankruptcy judge level but not at this time in this Court.

QUESTION: I see.

MR. BALCH: Now, many lower courts have passed on this issue and they have concluded that it is non-dischargeable. But I would like to point out that when you see all these lower court opinions that have been collected in these briefs and where they come from, every one of them can be traced back to the case of Botta v. Scanlon. They are all spawned by Botta v. Scanlon.

QUESTION: And that was an Anti-Injunction Act case, wasn't it?

MR. BALCH: That is correct, Your Honor. Botta v. Scanlon was an attempt by some individuals to get an injunction against the government from collecting the 6672 penalty against them, and that involved construing the Anti-Injunction Act presently found in section 7421(a) of the Internal Revenue Code. Now, that statute prohibits injunctions against the

collection of tax, but there the Court referred to this section 6671(a) that has already been questioned by a number of the Justices, and that says that for the purpose of the Internal Revenue Code, penalties are collected like taxes. So the Botta court correctly holds, I will concede, the Botta court correctly held that for the purpose of the Anti-Injunction Act, a penalty is equivalent to a tax and therefore an individual cannot get an injunction against the collection of a 6672 penalty.

But the extension of the Botta doctrine to the bankruptcy context is completely beyond anything that was said in Botta; there is no equivalent to section 6671(a) in the Bankruptcy Act. That is purely an Internal Revenue Code concept; there is no equivalent in the Bankruptcy Act.

QUESTION: But it is the same Congress that enacted both, is it not, and we have to undertake to reconcile and make some sense out of it, isn't that our problem?

MR. BALCH: I would say that is your duty, Your Honor.

QUESTION: You mean the same Congress that has been sitting since 1789?

MR. BALCH: I don't think that section 6672 has been there for a long time. It has been reenacted repeatedly, as the Internal Revenue Code has been reenacted, and I think this one probably goes back to the 1954 Code.

QUESTION: But certainly the same Congress in a

literal sense, the 94th versus the 95th --

MR. BALCH: No, in that sense, I think it is a different Congress.

QUESTION: Was the United States accorded any priority in distribution?

MR. BALCH: I believe they were given priority.

QUESTION: The claim was?

MR. BALCH: I am not certain on that point.

QUESTION: If it was, it was only because of what, because it was a claim of the United States or because it was a tax claim?

MR. BALCH: I think in the circumstances involved that that wouldn't have mattered, because it would have gotten the personal assets either way.

QUESTION: They would have priority either way, you think?

MR. BALCH: Well, Your Honor, the question of priority of the claim once it is allowed is not an issue here, and I am not familiar with the priority that was accorded to it in --

QUESTION: Well, I am just wondering whether the claim was filed as a tax claim or whether it was allowed as a tax claim or what.

MR. BALCH: All I can say, Your Honor, is that it was proved and it was allowed and it did receive

a distribution, but as to the exact underlying theory of it, I don't know.

QUESTION: Thank you.

MR. BALCH: And I am not sure that it would matter at this point because we are now examining the nature of the statutory obligation which we hopefully can determine from the statute itself and the authorities that are --

QUESTION: Well, if it were allowed as or given priority as a tax claim and the bankrupt didn't object, that might be of some importance to the issue now before us.

MR. BALCH: Well, Your Honor, proper objection was made to its dischargeability, and I think that is --

QUESTION: Yes, but I am talking about it is a liability or particularly it is being given priority as a tax claim --

MR. BALCH: Well, from the point of view of the bankrupt --

QUESTION: -- and that the bankrupt conceded it as a tax claim.

MR. BALCH: From the point of view of the bankrupt, they would want -- the bankrupt would want the government to get as much money as possible out of the personal bankruptcy just to reduce this exposure, because he didn't know at the time whether --

QUESTION: If he did know, he was not going to be

dischargeable on this, he would --

MR. BALCH: Right, and that is a fact since he --

QUESTION: -- and the maximum amount paid --

MR. BALCH: Right. And since that is

QUESTION: -- to the detriment of the other creditors whose claims would be dischargeable.

MR. BALCH: Right.

QUESTION: Of course, the bankrupt -- we are talking about the bankrupt here and it may be that he and his trustee might not see eye to eye. So whatever the trustee, however the trustee might have viewed it, it wouldn't bind the bankrupt, I take it?

MR. BALCH: I don't see why it would, Your Honor. They are independent entities in the bankruptcy proceeding.

QUESTION: That's right.

QUESTION: If there is an inconsistency, as you -- at least I understand you to suggest -- between the Bankruptcy Act and the statutes we are concerned with, then do we look to the latest expression of Congress on the subject or some other expression?

MR. BALCH: Well, Your Honor, at the first level of your question, I don't view the two statutes as being inconsistent. I think that the Internal Revenue Code does its job for establishing liability, and I think that the Bankruptcy Act does its job --

QUESTION: Well, what about the last sentence of section 17, "And provided further that a discharge in bankruptcy shall not release or affect any tax lien"?

MR. BALCH: Any tax lien.

QUESTION: Yes.

MR. BALCH: The purpose of that --

QUESTION: All I am suggesting is that the people drafting the taxing statutes were not unaware of the Bankruptcy Act.

MR. BALCH: The section that says it won't affect the tax lien simply goes to the point that if the government claim has reached a lien step on a particular piece of property, and if that tax for which they have a lien is one of the class of taxes that can be discharged under section 17, that even though personal liability is discharged, that the government still retains its lien on that piece of property. That is all that that is there for, and I don't think that goes to the question of the discharge of personal liability, which is the matter that is before the Court.

QUESTION: The purpose of my question was to suggest that there was an awareness by Congress of the interaction between the Bankruptcy Act and the Revenue Code.

MR. BALCH: I would think that in their workings they were each, each of the committees that worked on this was aware of the fact that there was another statute, that the

bankruptcy people know there is a Revenue Code, and the Revenue Code people know there is a Bankruptcy Act. But as to how you harmonize them, I would say the words of the statute lead to the result that we request, regardless of the timing of the particular enactments.

Now, as a policy matter, I would like to conclude by pointing out that you have got a potential horrendous result here, that the liability that is non-dischargeable, as the government asserts, is totally unrelated to any assets that this individual has personally or ever could have. It is not like the other non-dischargeable taxes where there has been some relationship between the tax base, as it were, whether it is income, property, or otherwise, and the amount of the tax.

If, let's say, a person who is an officer of a very large corporation, his liability can be inflated by the fact that the enterprise has capital contributed to it from many, many shareholders and has no relationship to his own personal net worth or anything that he ever could acquire in the future.

QUESTION: In other words, the bookkeeper of a big contracting company which went bankrupt -- and they go bankrupt fairly frequently, and they are big companies -- and the bookkeeper would have this secondary liability, this penalty liability, and if she or he went bankrupt, that might be a million dollars and would be, if it is non-dischargeable, she would be in bondage for the rest of her life.

MR. BALCH: I am saying they take her house and her car, but that is as far as they go; that if she then gets another job as a bookkeeper with another company, she can make \$100 a week and keep it.

QUESTION: In this case, what percentage of the stock of the corporation did respondent own?

MR. BALCH: Your Honor, I came into the case after, long after the corporation was bankrupt and I don't have that.

QUESTION: Were there any stockholders other than the ---

MR. BALCH: I am sure he was a stockholder, and he may have been the sole shareholder, for all I know.

QUESTION: The record does not show?

MR. BALCH: I am not sure, Your Honor.

However, I would like to state that the percentage of the stock that he owns I would consider immaterial to the result that would be reached.

QUESTION: You were making the argument that there was no possible way in which the individual could benefit from withholding the tax. Now, it would depend on the corporation and what the corporation ---

MR. BALCH: I am only saying he didn't benefit in this case. I am not saying there is no possible way.

QUESTION: Does the record show that?

MR. BALCH: I don't believe so.

Now, we concede that under the Constitution, Congress has the power to compel the result that the government has argued for. They can decide what is dischargeable and what is not dischargeable, and if they want to explicitly say that this kind of a claim is non-dischargeable, that is within their power. But we don't think that statutory construction should be used to create a situation which amounts to peonage on this kind of liability.

Ours is a country where the private risk of capital is admired and encouraged. But when that capital has been risked and lost, we are also a country that says that you can make a fresh start, free and clear of these previous claims.

Now, we ask that this Court affirm the Seventh Circuit based on the reasoning contained in their opinion, that where they have made a clear distinction between the corporation as an employer and Mr. Sotelo personally as an employee-officer of that corporation, and we ask that this Court specifically hold that the penalty assessed against an individual under section 6672 is the kind of obligation that is discharged by the personal bankruptcy of that individual.

QUESTION: Isn't the concept of accountability for property held in trust approximately on the same parity with the broad doctrine you have just suggested about a fresh start?

MR. BALCH: I believe it applies only if the

individual, as an individual, is the trustee, and there is one of the other exceptions in the list of exceptions in section 17a of the Bankruptcy Act, is a defalcation by a person in a fiduciary capacity.

MR. CHIEF JUSTICE BURGER: Mr. Smith, do you have anything further?

ORAL ARGUMENT OF STUART A. SMITH, ESQ.,

ON BEHALF OF THE PETITIONER--REBUTTAL

MR. SMITH: A few points, Mr. Chief Justice.

I want to just focus briefly on some of the grounds of the Court of Appeals decision, apart from this corporation shareholder problem which we think the gap is filled by section 6671(b) and section 6672; in other words, Onofre J. Sotelo was a person required to truthfully collect, account for and pay over, and we think the statutory gap is filled and that his liability -- that he is a bankrupt within the meaning of section 17a(1)(e).

But the Court of Appeals also held within the context of our section 17a(1)(e) argument that it was not applicable because it refers to taxes, and this is a penalty. It kind of doubled back on its penalty tax rationale. And I think we have argued, and I think it has been explored at great length that we think that this is a tax and not a penalty.

But whether it is a tax or a penalty, for purposes of section 17a(1), these funds were undisputably taxes at the

time they were collected or withheld from others within the meaning of section 17a(10)(e). At that point they were taxes, they were trust fund taxes, and we think Congress meant that when you defalcate on that trust and that you don't pay over the ---

QUESTION: Isn't the issue there by whom they were withheld and collected?

MR. SMITH: I think that goes back to the point I made earlier, that they were withheld and collected by Onofre J. Sotelo on behalf of his corporation, and that he was a statutory person.

MR. CHIEF JUSTICE BURGER: Your time and the lunch hour are at the same time.

MR. SMITH: Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.
The case is submitted.

[Whereupon, at 12:00 noon, the matter in the above-entitled case was submitted.]

- - -

RECEIVED
SUPREME COURT U.S.
MARSHALS OFFICE

1978 MAR 2 AM 11 25