

Consumer Corner

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Is the ACA Penalty Entitled to Priority Treatment as a Tax Under the Bankruptcy Code?



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The Patient Protection and Affordable Care Act (ACA) was signed into law on March 23, 2010, and has remained a hot-button issue since its inception. Under the ACA, certain individuals are required to maintain “minimal essential [health insurance] coverage” throughout the year (the “individual mandate”).¹ A person subject to the individual mandate who fails to maintain the required insurance for one month or more is assessed a “shared responsibility payment.”² Although described by the statute as a “penalty,”³ the payment is collected by the Internal Revenue Service (IRS) along with one’s federal income tax return and shares many other features of a “tax.”⁴ Whether the payment is a “penalty” or a “tax” remains a hotly contested issue, and the answer differs depending on the type of analysis.

In the most notable decision on the issue to date, *NFIB v. Sebelius*, the U.S. Supreme Court held that the shared-responsibility payment is a tax for constitutional purposes,⁵ but is not a tax for purposes of the Anti-Injunction Act.⁶ In 2017, Congress amended the ACA, and while the individual mandate was retained, the shared-responsibility payment was set at \$0 by changing the statutory formula.⁷ This article addresses several federal court decisions that analyzed whether the shared-responsibility payment is a tax under the Bankruptcy Code and, if it is a tax, whether such payments qualify for priority treatment.

Interaction Between the ACA and the Bankruptcy Code

The interaction between the ACA and the Bankruptcy Code has been the subject of significant litigation over the past few years. Since at least 2018, the IRS has advocated for the priority status of shared-responsibility payments across the country. The results have been mixed, however. Some district and bankruptcy courts have held that the shared-responsibility payment is not entitled to pri-

ority, either because the payment (1) is a penalty, and not a tax, for bankruptcy purposes;⁸ or (2) is not either “an excise tax on a transaction” or “a tax on or measured by income,” as required for priority under § 507(a)(8).⁹ In contrast, at least two courts have held that the shared-responsibility payment is a tax that is entitled to priority as either an excise or an income tax.¹⁰ Two other courts have concluded that the shared-responsibility payment is a tax, but that it is entitled to priority only as an income tax and not as an excise tax.¹¹

Fifth Circuit Determines that Shared-Responsibility Payment Is Not Entitled to Priority as Excise Tax

The U.S. Court of Appeals for the Fifth Circuit has considered the issue of whether the shared-responsibility payment is entitled to priority treatment in bankruptcy. In *Matter of Chesteen*, an individual debtor filed for chapter 13 after his \$695 shared-responsibility payment for tax year 2016 came due.¹² The IRS subsequently filed a proof of claim seeking the shared-responsibility payment’s inclusion in the debtor’s repayment plan as a priority “excise tax on ... a transaction” pursuant to 11 U.S.C. § 507(a)(8)(E).¹³ The debtor objected, claiming that the shared-responsibility payment was a penalty — not a tax — and therefore not a debt for which the Bankruptcy Code required repayment.¹⁴

The U.S. Bankruptcy Court for the Eastern District of Louisiana agreed with the debtor that

1 26 U.S.C. § 5000A(a).

2 26 U.S.C. § 5000A(b)(1).

3 *Id.*

4 26 U.S.C. § 5000A(b)(1)–(2).

5 *NFIB v. Sebelius*, 567 U.S. 519, 570 (2012).

6 *Id.* at 546.

7 Pub. L. No. 115-97, § 11081, 131 Stat. 2054, 2092 (2017). Accordingly, litigation related to the shared-responsibility payment will likely diminish in the future.

8 *In re Albracht*, 617 B.R. 851, 854 (Bankr. E.D.N.C. 2020); *In re Bailey*, 2019 WL 2367180, at *5 (Bankr. E.D.N.C. May 24, 2019), *vacated as moot*, 2019 WL 7403930 (E.D.N.C. Nov. 22, 2019); *In re Parrish*, 583 B.R. 873, 881 (Bankr. E.D.N.C. 2018), *vacated as moot*, 2018 WL 6273577, at *3 (E.D.N.C. Nov. 30, 2018).

9 *IRS v. Alicea*, 634 B.R. 54, 64 (E.D.N.C. 2021) (payment not entitled to priority as excise or income tax), *appeal docketed*, No. 21-2220 (Oct. 22, 2021); *IRS v. Huenerberg*, 623 B.R. 841, 845 (E.D. Wis. 2020) (payment is not entitled to priority as excise tax); *In re Vallejo*, 2021 WL 5702699, at *3-7 (Bankr. D. Ariz. Nov. 23, 2021) (payment not entitled to priority as excise tax on transaction or income tax); *In re Jones*, 610 B.R. 663, 669 (Bankr. D. Mont. 2019) (payment not entitled to priority as excise tax on transaction, and IRS’s income tax argument “would likely fail”).

10 *In re Cousins*, 601 B.R. 609, 621 (Bankr. E.D. La. 2019); *In re Gabbidori*, 2020 WL 3566538, at *1 (Bankr. S.D. Fla. June 4, 2020).

11 *In re Miller*, 634 B.R. 641, 646 (Bankr. M.D. Ga. 2021) (concluding that payment is income tax, but not excise tax); *In re Juntoff*, 2022 WL 830901, at *12-13, *13, n.16 (B.A.P. 6th Cir. March 21, 2022) (holding that payment is tax measured by income without addressing whether it is excise tax).

12 *Matter of Chesteen*, 799 F. App’x 236, 238 (5th Cir. 2020).

13 *Id.* Section 507(a)(8)(E)(i) — an excise tax — was the only priority provision that the IRS advanced in bankruptcy court with respect to the shared-responsibility payment.

14 *Id.*

the purpose of the shared-responsibility payment was to deter citizens from living without health insurance, thus rendering it a penalty and not a tax for bankruptcy purposes.¹⁵ As such, the IRS's claim for the shared-responsibility payment was not entitled to priority.¹⁶ The bankruptcy court did not determine whether the shared-responsibility payment was entitled to priority as an "excise tax on a transaction."¹⁷ On appeal, the U.S. District Court for the Eastern District of Louisiana reversed the bankruptcy court's decision, holding that the shared-responsibility payment functions more like a tax than a penalty and is an excise tax entitled to priority status under the Code.¹⁸

In a nonprecedential opinion issued on Feb. 20, 2020, the Fifth Circuit reversed the district court's decision and concluded that the shared-responsibility payment is not entitled to priority as an excise tax because it is not assessed "on a transaction" as set forth under § 507(a)(8).¹⁹ Instead, the court held that the payment is the result of inactivity (*i.e.*, the failure to purchase health insurance).²⁰ Notably, the Fifth Circuit opted not to consider whether the shared-responsibility payment is a tax under the Code, or whether the Supreme Court's constitutionality analysis in *Sebelius* controls the issue.²¹ The court was also not willing to consider the IRS's newly asserted argument that § 507(a)(8)(A), which grants priority to "a tax on or measured by income," should apply.²² The court stressed that the IRS had failed to raise this issue in both the bankruptcy and district courts and had thus waived the issue.²³

Third Circuit Determines that Shared-Responsibility Payment Is a Tax Measured by Income and Entitled to Priority

The U.S. Court of Appeals for the Third Circuit is the latest appellate court to weigh in on the priority of the shared-responsibility payment under the Code. In *In re Szczyporski*, two individuals who had failed to maintain health insurance in 2018 filed a bankruptcy petition seeking chapter 13 relief.²⁴ In response, the IRS filed a proof of claim against the debtors' estate for nonpayment of a \$927 shared-responsibility payment that they argued was entitled to priority as either (1) "a tax on or measured by income," or (2) an "excise tax on a transaction."²⁵ The debtors objected to the IRS's claim, arguing that the shared-responsibility payment was not a tax, but was instead a penalty that was not entitled to priority status.

The U.S. Bankruptcy Court for the Eastern District of Pennsylvania held that (1) under the constitutionality analysis in *Sebelius*, the shared-responsibility payment is a tax — not a penalty — for bankruptcy purposes, and (2) the pay-

ment is entitled to priority under § 507(a)(8) as either an income or an excise tax.²⁶ On appeal, the U.S. District Court for the Eastern District of Pennsylvania affirmed the bankruptcy court's order finding that the shared-responsibility payment is entitled to priority, but only as an "income tax" under § 507(a)(8)(A).²⁷ The district court concluded the payment is not entitled to priority as an excise tax, since it is not a tax "on a transaction" as required by § 507(a)(8)(E).²⁸

On May 11, 2022, the Third Circuit issued a precedential decision on the matter. At the outset, the court held that the analysis in *Sebelius* was persuasive, but not controlling, since it involved constitutionality and not applicability under the Bankruptcy Code.²⁹ The court then analyzed the issue using the six factors set forth in *In re Lorber Industries of California Inc.*³⁰ These factors ask whether the responsibility payment is:

- (1) an involuntary pecuniary burden laid upon individuals or property;
- (2) imposed by, or under authority of the legislature;
- (3) for public purposes, including the purposes of defraying expenses of government or undertakings authorized by it;
- (4) under the police or taxing power of the state
- (5) universally applicable to similarly situated entities; and
- (6) whether granting priority status to the government will disadvantage private creditors with like claims.³¹

In applying these factors, and considering the Supreme Court's constitutional analysis in *Sebelius*, the court concluded that "[a]ll six of the *Lorber-Suburban* factors indicate that the payment is a tax."³² The court found that the payment is an involuntary burden on individuals who fail to maintain health insurance coverage, imposed by Congress pursuant to its taxing authority, and is universally applicable to all taxpayers.³³ The court also held that the granting of priority status would not disadvantage any private citizens with "like claims" because there are none.³⁴ The court also found it relevant that the payment is calculated using a taxpayer's income, is assessed and collected in the same manner as a tax and is enforced by the IRS.³⁵

The Third Circuit also found that the payment lacked the characteristics of a penalty. The court reasoned that the shared-responsibility payment does not impose a heavy financial burden, there is no *scienter* requirement for it to be applied, and there is no ability to enforce the payment through punitive means or criminal prosecution.³⁶ Accordingly, the Third Circuit held that the shared responsibility payment was a tax.

The court next considered whether the payment is entitled to priority under the Code. While the court acknowledged that the shared-responsibility payment is not a tax

26 *In re Szczyporski*, 617 B.R. 529, 531-32 (Bankr. E.D. Pa. 2020).

27 *In re Szczyporski*, 531 F. Supp. 3d 934, 936-43 (E.D. Pa. 2021).

28 *Id.* at 942.

29 *In re Szczyporski*, 34 F.4th at 186.

30 675 F.2d 1062, 1066 (9th Cir. 1982).

31 *In re United Healthcare Sys. Inc.*, 396 F.3d 247, 253 (3d Cir. 2005) (internal quotation marks omitted) (quoting *In re Lorber Indus. of Cal. Inc.*, 675 F.2d 1062, 1066 (9th Cir. 1982); *In re Suburban Motor Freight Inc.*, 36 F.3d 484, 488-89 (6th Cir. 1994)).

32 *Id.* at 187.

33 *Id.*

34 *Id.*

35 *Id.*

36 *Id.* at 188.

15 *In re Chesteen*, No. 17-11472, 2018 WL 878847, at *3 (Bankr. E.D. La. Feb. 9, 2018), *rev'd sub nom.*, *United States v. Chesteen*, No. 18-2077, 2019 WL 1499532, at *2-3 (E.D. La. Feb. 25, 2019).

16 *Id.*

17 *Id.* at *1-3.

18 *United States v. Chesteen*, No. CV 18-2077, 2019 WL 1499532, *1-3 (E.D. La. Feb. 25, 2019), *rev'd and remanded sub nom.*, *Matter of Chesteen*, 799 F. App'x 236 (5th Cir. 2020).

19 *In re Chesteen*, 799 F. App'x 236, 240-41 (5th Cir. 2020).

20 *Id.*

21 *Id.* at 239.

22 *Id.* at 241-43.

23 *Id.*

24 *In re Szczyporski*, 34 F.4th 179, 183, 186 (3d Cir. 2022).

25 *Id.*

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“on” an individual’s income, it noted that § 507(a)(8)(A) also grants priority to any taxes “measured by” a taxpayer’s income.³⁷ The court found that the shared-responsibility payment was measured by income under § 507(a)(8)(A), stating that “[w]hen the debtors incurred the obligation in 2018, its amount was ‘calculated as a percentage of household income, subject to a floor based on a specified dollar amount and a ceiling based on the average annual premium.’”³⁸ Thus, the court ultimately decreed that the shared-responsibility payment is entitled to priority as “a tax on or measured by income,” but is not entitled to priority as an excise tax.³⁹

³⁷ *Id.*; 11 U.S.C. § 507(a)(8)(A) (extends priority status to “a tax on or measured by income or gross receipts”).

³⁸ *Id.* (citing 11 U.S.C. § 507(a)(8)(A); *Sebelius*, 567 U.S. at 539; 26 U.S.C. § 5000A(c)).

³⁹ *Id.* at 187-88. The Third Circuit held that the payment was not entitled to priority as an excise tax “on a transaction,” as it was assessed based upon the failure to purchase health insurance. *Id.*

Conclusion

The decisions issued by the Fifth and Third Circuits provide guidance regarding the priority status of the ACA’s shared-responsibility payment. Due to its limited scope, *Chesteen* stands only for the proposition that the shared-responsibility payment is not entitled to priority as an excise tax. On the other hand, *Szczyporski* definitively concluded that (1) the shared-responsibility payment is a tax under the Bankruptcy Code, and (2) is entitled to bankruptcy priority as “a tax on or measured by income.”

Moreover, *Szczyporski* stands as a strong reminder that simply because a payment is considered a tax for constitutionality purposes, that is not dispositive as to whether it is a tax under the Code. While the ACA no longer imposes a shared-responsibility payment, practitioners would be well-served to maintain an awareness of the various factors that courts consider in determining the priority treatment of government claims. **abi**

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