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BULLETIN NO. 483

COLLECTION, BANKRUPTCY AND SUMMONSES BULLETIN

Department of the Treasury | Office of Chief Counsel | Internal Revenue Service

First Circuit Weighs in on Equitable Tolling

Joining with the Third, Seventh, Eighth, Ninth, and Tenth Circuits, the First Circuit agreed with the Government that the three-year statutory priority period of B.C. § 507(a)(8)(A)(i) should be automatically tolled for those periods in which the debtor was in a prior bankruptcy. **Young v. United States, 2000 U.S. App. LEXIS 30156 (1st Cir. Dec. 1, 2000)**. Three other circuits (the Fifth, Sixth and Eleventh) have permitted equitable tolling on a case-by-case basis under B.C. § 105(a).

The debtors filed for Chapter 13 bankruptcy on May 1, 1996, owing 1992 taxes. This bankruptcy was voluntarily dismissed on March 13, 1997. On March 12, 1997, the debtors filed a no-asset Chapter 7 bankruptcy, and received a discharge on June 17, 1997. When the Service sought to collect on the 1992 taxes, the debtors moved to have the taxes discharged because the 1992 return was filed on October 15, 1993, more than three years before their Chapter 7 petition was filed. The Government countered by arguing that the three-year priority period should be tolled for the time the debtors spent in Chapter 13. Both the bankruptcy court and the district court agreed, and the debtors appealed.

Affirming, the First Circuit initially discussed discharge provisions under the old Bankruptcy Act, which included a 1966 amendment limiting previously nondischargeable priority taxes to a three year period. The court next considered the legislative history of B.C. § 507(a)(8)(A)(i), concluding that Congress had not meant to change the pre-Code priority structure. Although it is not explicit in the statute, the appellate court felt that Congress intended a tolling provision to protect the Government. Acknowledging that it could not re-write the Bankruptcy Code to make explicit this intent of Congress, the court sought to provide guidance when dealing with what it viewed to be a statute of limitations issue. In order to strike the right balance and preserve what Congress intended when it adopted the three-year lookback period in section 507(a)(8)(A)(i), the First Circuit decided that automatic tolling of the period best insured that the Service received the benefit of the full three-year collection period.

BANKRUPTCY CODE CASES: Priorities: Income Taxes

CASES

1. BANKRUPTCY CODE CASES: Exceptions to Discharge: No, Late or Fraudulent Returns

In re Weiss, 2000 U.S. Dist. LEXIS 16523 (E.D. Pa. Nov. 15, 2000) - Debtor failed to file returns for 1986-1991 until 1994, underpaying his taxes for those years. The bankruptcy court granted debtor a discharge of his 1986-87 taxes, but the district court reversed. The court found the debtor had a duty to file tax returns and admitted that he knew he had that duty. The debtor's claim that his ex-wife took his financial records in 1986 & 1987 did not excuse the debtor from not filing his returns for those years, because the debtor could have obtained duplicate financial information, or prepared the returns once the information was returned to him in 1989. The district court found the clear weight of the evidence supported it's finding that the debtor willfully evaded his tax liabilities, and so his taxes for 1986-91 were nondischargeable under B.C. § 523(a)(1)(C).

2. BANKRUPTCY CODE CASES: Liens: Determination of Secured Status

In re Hoekstra, 255 B.R. 285 (E.D.Va. 2000) - Service's lien against taxpayer's property was third in priority, but the property only had enough equity to pay the first two liens. When the taxpayers filed for Chapter 13 relief, then converted to Chapter 7, the bankruptcy court concluded that the Service's lien could be stripped from the property. Reversing, the district court held that under Dewsnup v. Timm, 502 U.S. 410 (1992), the lien was both allowed under B.C. § 502 and secured by the collateral. Because the federal tax lien is indivisible, and because it remained secured by the debtors' personal property, a component of the collateral retained value. The bankruptcy court thus erred in voiding the lien as unsecured.

3. BANKRUPTCY CODE CASES: Liens: Determination of Secured Status

United States v. Kogan (In re Herreras), 2000 U.S. Dist. LEXIS 17814 (C.D. Cal. Nov. 13, 2000) - Service had tax liens against attorney, who filed for Chapter 7 bankruptcy. The trustee objected to the Service's secured claim, arguing that the tax liens did not attach to the attorney's work-in-progress. The bankruptcy court agreed, guided by In re Connor, 27 F.3d 365 (9th Cir. 1994), where an unconditional pre-petition right to receive payments was held a sufficient property interest to which a tax lien could attach. Applying Connor, the bankruptcy court decided that a conditional pre-petition right, as represented by the work-in-progress, was not a property right. The district court reversed. Looking to California domestic law, the court found that work performed by a lawyer before a bankruptcy filing is considered valuable property. Since state law determines that property exists, the court held, federal law then establishes that property is subject to lien. Although the trustee argued that payment for the work in progress was conditional, such as with contingent fee cases, the court held that federal law broadly interprets the reach of the tax lien. Unlike a truly conditional interest, such as an intended bequest when the testator was still alive, the court found that in this case, the attorney would have been entitled to at least quantum meruit even if he did not complete the work-in-progress.

4. **BANKRUPTCY CODE CASES: Setoff: Sums Due From Other Federal Entities**
United States v. Fleet National Bank (In re Calore Express, Inc.), 86 AFTR2d ¶ 2000-5639 (D. Mass. Oct. 31, 2000) - Chapter 11 debtor borrowed money from bank in exchange for senior lien. The Service subsequently filed a proof of claim, which stated that there was no right of setoff. The debtor continued to borrow money, without objection by the Service, but accrued post-petition taxes, and the Service filed an administrative claim. The debtor objected, and the Service's response for the first time indicated a potential right of offset. The Government requested GSA freeze payments owed to the debtor. The debtor successfully objected to this as a violation of the stay, so the Government moved to lift the stay and setoff the GSA payments. The bankruptcy court denied the Government's motion, and on appeal, the district court affirmed under a clear error standard. The court determined that it had jurisdiction over the setoff issues even though the accounts receivable against which the setoffs were asserted were no longer property of the estate, because even though the assets were no longer subject to the automatic stay, the proposed setoff would impact the administration of the debtor's estate. Next, the court found, contrary to the Government's position, that the automatic stay applied to setoff of post-petition debts. Finally, because the Government repeatedly failed to assert its setoff rights, to the bank's detriment, the bankruptcy court was not clearly wrong in finding the Government waived its setoff rights.

5. **BOND FOR TAXES: Stay of Collection**
Peterson v. United States, 2000 U.S. Dist. LEXIS 17750 (D. Minn. Oct. 5, 2000) - Court refused taxpayer's request to grant stay of enforcement of judgment without posting of a supersedeas bond. The court determined that in this case, where the taxpayer only paid a good faith estimate of their tax liability, the bond requirement would not be waived.

6. **COLLECTION DUE PROCESS**
Loadholt Trust v. Commissioner, T.C. Memo 2000-349 (Nov. 13, 2000) - The companion case is Boone Trust v. Commissioner, T.C. Memo 2000-350. These were cases involving fraudulent trusts that had no income. They received an erroneous refund because the trusts filed income tax return Forms 1041 claiming prepayment credits that did not actually exist. The proposed levies at issue in those cases were not intended to obtain the recovery of any tax on income (under subtitle A of the Code); because there was no income, there was no income tax involved. Instead, the Service was attempting to recover a tax unique to section 6201(a)(3), not a subtitle A provision. Because the Tax Court does not have jurisdiction over a tax assessed under 6201(a)(3), the court did not have jurisdiction in the Boone and Loadholt cases.

7. **COLLECTION DUE PROCESS**
Pierson v. Commissioner, 115 T.C. No. 39 (Dec. 14, 2000) - Taxpayer did not challenge Notice of Deficiency, but did request hearing under I.R.C. § 6330 after receiving Notice of Intent to Levy. Taxpayer argued he had no income subject to

tax, and Appeals issued a Notice of Determination. Upon appeal to the Tax Court, taxpayer argued that he was not an official or employee of the United States, and so was not subject to income tax. The Tax Court found this position was frivolous and groundless, and considered imposition of sanctions and costs pursuant to I.R.C. § 6673. Although the Court ultimately declined to award a penalty, it issued "fair warning" that in future CDP appeal cases, a taxpayer whose position is frivolous or groundless or who institutes proceedings primarily for delay will be subject to sanctions under section 6673 in the future.

8. DAMAGES, SUITS FOR: Against U.S.: Unauthorized Collection (§ 7433)
Shwarz v. United States, 2000 U.S. App. LEXIS 31300 (9th Cir. Dec. 8, 2000) - After discussions regarding the terms of an Offer in Compromise broke down, the Service applied to the district court to execute a levy against the taxpayers' home and business. After the seizure, the taxpayers responded with a suit alleging unlawful disclosure under I.R.C. §§ 6103 & 7431 and 5 U.S.C. § 552a (Privacy Act), unlawful collection under I.R.C. § 7433, and a Bivens claim for constitutional violations by the revenue officers. The Ninth Circuit found the plain language and legislative history of section 7433 makes that section the exclusive remedy, thus barring the section 7431 action where the alleged disclosure occurred in connection with tax collection activity. The section 7433 action, in turn, was barred because the taxpayers only alleged that the Service violated IRM provisions and policy statements, not code provisions or regulations. The appellate court also found no constitutional violations or disclosures of tax information, and so dismissed the Bivens and Privacy Act claims.

9. DAMAGES, SUITS FOR: Against U.S.: Unauthorized Collection (§ 7433)
Western Center for Journalism v. Cederquist, 2000 U.S. App. LEXIS 33213 (9th Cir. Dec. 20, 2000) - Nonprofit organization claimed tax audit was politically motivated, so brought Bivens claim on First and Fourth amendment grounds against revenue agent and IRS commissioner on May 13, 1998. The district court dismissed the suit, finding no Bivens remedy available. The Ninth Circuit affirmed, but on different grounds. The court of appeals found that the applicable state statute of limitations was one year. Since a Bivens action accrues when the plaintiff knows or has reason to know of the injury, the statute of limitations began to run on October 22, 1996, when the plaintiff published an editorial accusing the Service of unconstitutional harassment. Thus, the suit was time-barred.

10. INNOCENT SPOUSE
In re Hinckley, 86 AFTR2d ¶ 2000-5614 (Bankr. M.D. Fla. Nov. 16, 2000) - Bankruptcy court grants innocent spouse relief under I.R.C. § 6015(c)(3)(C). Although the wife had knowledge of her husband's understatement of income, due to unusual circumstances including the husband's domineering personality and

mental instability following an accident, she was unable to resist his demands that she sign the erroneous returns.

11. INNOCENT SPOUSE

Miller v. Commissioner, 115 T.C. No. 40 (Dec. 21, 2000) - Service granted innocent spouse relief to wife in 1993, under former I.R.C. § 6013(e). In 1999, after Service began collection action against husband, he requested a Collection Due Process hearing to contest the relief previously granted to his wife. After an adverse Notice of Determination was issued, the husband filed with the Tax Court. The Court refused to apply the provisions of current I.R.C. § 6015 retroactively, and held that under former section 6013(e) the husband had no right to be notified of or participate in an award of innocent spouse tax relief given to his wife.

12. LEVY: Wrongful

LaBonte v. United States, 2000 U.S. App. LEXIS 31231 (7th Cir. Dec. 7, 2000) - Service levied on sale proceeds of property owned by taxpayer and her son, who claimed a 1/5 interest in the property. Some 20 months after the levy, discussions between the son and the Service broke down, and the son filed a wrongful levy action under I.R.C. § 7426. Affirming the district court, the 7th Circuit held the suit untimely filed. Because the suit was not filed within the nine-month statute of limitations, the son relied on a time extension under I.R.C. § 6532(c)(2), given for a proper request for the return of property. However, the letter relied on by the son did not meet the specific requirements of Treas. Reg. 301.6343-2(b). Further, the appellate court denied the son's request for equitable estoppel, finding no affirmative misconduct on the part of the Service due to the failure to advise the son of the statutory deadline.

13. PENALTIES: Failure to Collect, Withhold or Pay Over: Responsible Officer

In re Clifford, 255 B.R. 258 (D. Mass. Nov. 21, 2000) - Service alleged that taxpayer, vice president and 30% owner of the company who ran the daily business with the authority to hire and fire employees and pay creditors, was a responsible person liable for the Trust Fund Recovery Penalty. The district court disagreed, upholding the conclusion of the bankruptcy court under a clear error standard. The court found that the taxpayer did not have access to the corporate books and records, did not handle payroll, and was "kept in the dark" by the majority owner.

14. SUMMONSES: Issuance: Contents of Summons

United States v. Production Plated Plastics, Inc., 86 AFTR2d ¶ 2000-5655 (W.D. Mich. Nov. 6, 2000) - Taxpayer requested protective order, arguing the Government needed to show "extraordinary circumstances" to summons confidential documents held by trustee. The court found the "extraordinary circumstances" standard applicable only when the Government was a collateral litigant seeking duplicative discovery, not where a summons was properly issued pursuant to the standards set out by United States v. Powell, 379 U.S. 57 (1964). The court also discounted the taxpayer's argument that the documents had been provided to the trustee with an expectation of confidentiality, noting that the Service was limited to obtaining only those documents relevant to its investigation, and that further dissemination of the information was restricted by I.R.C. § 6103.

15. TRANSFEREES & FRAUDULENT CONVEYANCES: Fraud

United States v. Paradise, 86 AFTR2d ¶ 2000-5637 (E.D. Ill. Oct. 26, 2000) - Taxpayer, subject to Trust Fund Recovery Penalties, transferred real property into a trust. The court found the transfer fraudulent because the United States, though the taxpayer retained assets slightly in excess of the tax liability, effectively could not have collected from him. Thus the transfer impaired the Government's rights as a creditor, and the taxpayer was guilty of fraud in law.

CHIEF COUNSEL ADVICE

TOLLING OF PRIORITY PERIODS IN BANKRUPTCY

October 17, 2000

CC:PA:CBS:Br2
GL-610806-99
UILC: 09.32.00-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE), AREA 3 (NASHVILLE)

FROM: Kathryn A. Zuba
Chief, Branch 2 (Collection, Bankruptcy & Summonses)

SUBJECT: Determination of Priority in Bankruptcy Cases pursuant to Palmer v. United States, 219 F.3d 580 (6th Cir. 2000)

This responds to your request for advice dated September 22, 2000. This document is not to be cited as precedent.

ISSUE: In the Sixth Circuit, can the Service continue to claim taxes as priority on proofs of claim based on tolling of priority periods prior to a bankruptcy court determination pursuant to B.C. § 105?

CONCLUSION: Yes, taxes can be claimed as priority based on tolling so long as the Service determines that tolling is justified on a case-by-case basis.

BACKGROUND: Four circuit courts have agreed with the Government's position that the priority periods of B.C. § 507(a)(8)(A)(i),(ii) are automatically tolled while the Service could not collect during prior bankruptcy cases. Waugh v. IRS, 109 F.3d 489 (8th Cir.), cert. denied, 522 U.S. 823 (1997); In re Taylor, 81 F.3d 20 (3rd Cir. 1996); In re West, 5 F.3d 423 (1993); Montoya v. United States, 965 F.2d 554 (7th Cir. 1992). Three circuit courts, on the other hand, have declined to adopt this majority rule, and have instead held that tolling is permitted on a case-by-case basis where it is equitable to do so under B.C. § 105(a). Palmer v. United States, 219 F.3d 580 (6th Cir. 2000); In re Morgan, 182 F.3d 775

(11th Cir. 1999); Quenzer v. United States, 19 F.3d 163 (5th Cir. 1993). [1] In the most recent appellate case on this issue, the Sixth Circuit in Palmer held that priority periods are not automatically tolled during prior bankruptcy cases, but can be equitably tolled by the bankruptcy court pursuant to section 105(a) if the equities favor the Service based on the facts of a given case. The court affirmed the bankruptcy court's decision not to permit tolling where the Service failed to show that the debtor was guilty of any misconduct or manipulation of the bankruptcy system.

You have requested our advice on how to file proofs of claim in the Sixth Circuit in light of Palmer. The past procedure in the Tennessee districts was to list taxes as priority on proofs of claim based on the assumption that tolling during the pendency of the automatic stay in prior bankruptcy cases was automatic. You ask whether pursuant to Palmer, the Service should change its procedures and cease claiming taxes on proofs of claim as priority prior to obtaining a court determination as to tolling. You suggest a procedure where collection personnel in the Service must first refer a case to Counsel to file a motion with the court to determine priority. If the court rules in the Service's favor, then the Service can amend its claim to reclassify the taxes and seek appropriate modification of the Chapter 11 or 13 plan.

DISCUSSION: Our position is that as a general matter in the Sixth Circuit, [2] it is not necessary that the Service obtain a court determination as to tolling before claiming a tax as priority for purposes of filing a proof of claim. The general rule is that a claim is deemed allowed unless a party in interest objects. B.C. § 502(a). See also B.R. 3001(f) (properly filed proof of claim is "prima facie evidence of the validity and amount of the claim."). See generally In re Landmark Equity Corp., 973 F.2d 265, 269 (4th Cir. 1992). It is the debtor, trustee or other party-in-interest who has the responsibility to object to the classification of a tax on a proof of claim. Although pursuant to Palmer the Government is not entitled to automatic tolling, we nonetheless believe it is appropriate to require the debtor or other parties to object to a proof of claim to contest tolling in a particular case and bring the issue before the bankruptcy court.

We do not view this as any different than other situations where parties may contest the Service's proof of claim by, for example, disputing the valuation of the Service's secured claim or contesting the tax liability on the merits. The Service is not prohibited from asserting its position regarding the amount of the secured tax claim or the amount of the tax liability on the proof of claim, even where the Service's position is subject to dispute,

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[1] Although the Tenth Circuit relied under on 105(a) for tolling in United States v. Richards, 994 F.2d 763 (10th Cir. 1993), the court strongly suggested that such tolling occurs automatically as a matter of law.

[2] Since the standards in the circuits differ, this advice only applies to claims filed with bankruptcy courts in the Sixth Circuit.

such as where the value of the collateral may be uncertain or where tax returns have not been filed and the tax is not yet assessed. It is by an objection to the proof of claim that disputes over the proper amount and classification of claims are normally resolved. [3] We do not believe that this procedure is inconsistent with Palmer. Rule 3001(f) places the burden of coming forward with evidence to dispute a claim on the party who contests the claim. A debtor or trustee fulfills this burden by objecting to the claim on the ground that the facts do not justify tolling. Once the objection is made, the burden of production drops out, and the Service must establish that the facts justify tolling pursuant to section 105(a) as required by Palmer. See Raleigh v. Illinois Dept. of Revenue, 120 S. Ct. 1951, 1956 n.2 (2000); Landbank Equity Corp., supra.

We, accordingly, conclude that if the Service wishes to take the position that tolling should be applied in a particular case, it can do so by claiming a tax as priority. This will give the debtor, trustee or another creditor, if they disagree with the Service's classification, the opportunity to file an objection to the classification of the claim. If an objection is filed, and the parties cannot reach an agreement as to the proper classification, the bankruptcy court will then decide whether tolling is warranted pursuant to section 105(a). [4]

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[3] See, e.g., Simmons v. Ford Motor Credit Co., 224 BR 879 (Bankr. N.D. Ill. 1998), reconsideration denied, 237 BR 672 (Bankr. N.D. Ill. 1999), where the court rejected the debtor's claim for injunctive relief under B.C. § 105(a) against a lender of automobile loans to prohibit the lender from overvaluing its secured claim on proofs of claim. The court held that such valuation issues should be resolved through the objection to claim process. The court stated:

> Code § 502 and Bankruptcy Rule 3007 contemplate a process in which both debtor and creditor may be heard with respect to the amount and validity of a claim. The submission of a proof of claim is only one step in the claims allowance process, with unresolved issues ultimately determined at a evidentiary hearing.

224 BR at 884. Similarly, the Seventh Circuit in Adair v. Sherman, 2000 U.S. App. Lexis 21951 (7th Cir. Aug. 25, 2000), held that the district court properly dismissed a debtor's suit against a lender of an automobile loan brought under the Fair Debt Collection Practices Act (FDCPA). The debtor accused the lender of overvaluing its secured claim in the debtor's Chapter 13 case. The court held that the FDCPA claim was barred because the debtor should have objected to the valuation of the claim in the bankruptcy case prior to confirmation of the plan.

[4] But see In re Offshore Diving & Salvaging Inc., 242 BR 897 (Bankr. E.D. La. 1999), aff'd 1999 U.S. Dist. Lexis 16664 (E.D. La. 1999), in which the bankruptcy court noted that the correct way to request equitable tolling under section 105(a) is to file an adversary proceeding. As discussed infra, we believe this is the case only if the Service is contemplating collection action.

However, the Service must ensure that it is filing a correct claim in good faith pursuant to Bankruptcy Rule 9011. Pursuant to Rule 9011(b), the filing of a paper represents to the court

> that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, --
>
> (1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;
>
> (2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;
>
> (3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery....

B.R. 9011(b). Sanctions can be awarded for a violation of Rule 9011(b). B.R. 9011(c).

Pursuant to Rule 9011(b), the Service must make a reasonable inquiry prior to filing a proof of claim for taxes and must believe that the claim is well grounded in fact. In re Hamilton, 104 BR 525 (Bankr. M.D. Ga. 1989) (imposing sanctions against Service for overstating taxes on claim); In re McAllister, 123 BR 393 (Bankr. D. Or. 1991) (Oregon tax authority sanctioned for failing to make reasonable inquiry as to debtor's tax liability before filing claim). See also In re Lenior, 231 BR 662, 672 (Bankr. N.D. Ill. 1999) (the standard under Rule 9011 "to determine whether a party made a reasonable inquiry before filing a claim is the reasonableness of its conduct under the circumstances."); Adair v. Sherman, 2000 U.S. App. Lexis 21951, n. 8 (7th Cir. Aug. 25, 2000) ("Rule 9011(b) explicitly requires all filings with the court to present only facts which the party reasonably believes to have evidentiary support; debtors facing fraudulent proofs of claim could seek sanctions under that section.").

In order to comply with Rule 9011(b), we conclude that prior to listing a tax as priority on a proof of claim based on tolling, the Service should examine each case to identify one or more facts indicating that the equities favor the Government, such as evidence of misconduct by the debtor or abuse of the bankruptcy system. Under Palmer the mere fact that the debtor filed a prior bankruptcy case which was dismissed and that the Service could not collect the tax liability during the prior bankruptcy case may be insufficient to establish that tolling is justified. Courts have found that the following facts favor the Service under section 105(a): the debtor filed a bankruptcy petition shortly after the Service commenced collection efforts; the Service is the primary creditor of the debtor; the debtor filed a new bankruptcy case soon after dismissal of the prior bankruptcy case; the debtor filed more than two bankruptcy cases, with little time lapsing between cases; the debtor has a history of not filing timely tax returns or paying taxes on time; the debtor did not pay his or her obligations under the Chapter 11 or 13 plan in the prior case; and the taxpayer continued to pyramid unpaid tax liabilities during the pendency of the prior bankruptcy case. See In re Bair, 240 BR 247 (Bankr. W.D. Tex. 1999); In re Moss, 216 BR 556 (Bankr. E.D. Tex. 1997); In re Miller, 199 BR 631 (Bankr. S.D. Tex. 1996); In re Clark, 184 BR 728 (Bankr. N.D. Tex. 1995). [5] We believe that the precise factors relied upon to select cases for which tolling will be claimed should be developed by your office based on local case law and other relevant considerations.

Where the Service's claim of priority is based on tolling, a notation should be added to the claim stating that the tax is being claimed as priority based on tolling of the priority periods during a prior bankruptcy or bankruptcies. [6] This will ensure that other parties and the court are put on notice that the Service is relying on tolling in claiming a tax as priority, and will establish that the Service is filing the claim in good faith pursuant to Rule 9011(b). [7]

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[5] Although the court in Palmer emphasized the behavior of the taxpayer, courts have also examined the behavior of the Service in weighing the equities under section 105(a). In particular, courts have found that the fact that the Service engaged in normal collection activities during the periods when the automatic stay was not in effect weigh in favor of the Service. See Bair, supra. If, on the other hand, the Service did not take any collection activity during a lengthy period between bankruptcy cases while it had the opportunity to do so, this may weigh against the Service.

[6] Where the Service must rely on an additional six-month period pursuant to I.R.C. § 6503(b) or (h) to obtain priority, we also recommend that the notation on the proof of claim state that the additional six month period pursuant to section 6503(b) or (h) is being relied upon. [redacted] We leave it to your office, however, to decide under what circumstances relying on the additional six month period will be appropriate.

[7] You also ask whether pursuant to Palmer the Service has the obligation to review all proofs of claim filed in the last five years in open Chapter 13 cases to identify those cases where taxes were claimed as priority based on tolling. We conclude that the Service does not have this obligation. Prior to the Sixth Circuit's decision in Palmer, it was appropriate for the Service based on the case law in effect at that time to file claims with the presumption that tolling was automatic. Consistent with our discussion

To summarize, pursuant to Palmer the Service may continue to claim taxes as priority on proofs of claim based on tolling, but only after performing an investigation identifying the existence of facts that justify equitable tolling under section 105. Additionally, such claims should contain a notation stating that the Service is relying on tolling. We believe that this procedure complies with the Service's responsibilities under Rule 9011(b).

We finally note that our position has been that if pursuant to the law of the circuit tolling is not automatic but occurs on a case-by-case basis pursuant to section 105(a), then the Service should not take collection action based on the theory that a tax is nondischargeable due to tolling, without first obtaining a determination as to dischargeability from the bankruptcy court. Otherwise, the Service risks being subject to damages and attorney's fees for violating the injunction against collecting discharged taxes. See B.C. § 524(a)(2). Additionally, the fact that the Service took unilateral collection action may influence a court to rule against the Service in determining whether tolling is justified under section 105(a). In the Sixth Circuit, collection action should not be taken based on the assumption that priority periods will be tolled.

supra, we believe that it is the obligation of the debtor, trustee or other party-in-interest to object to the Service's claim, to seek reconsideration of a previously allowed or disallowed claim, or to seek modification of a plan.

BANKRUPTCY; EQUITABLE TOLLING

November 2, 2000

CC:PA:CBS:Br2
GL-121121-00
UILC: 09.32.00-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SBSE), AREA 4 (CLEVELAND)

FROM: Kathryn A. Zuba
Chief, Branch 2 (Collection, Bankruptcy & Summonses)

SUBJECT: Determination of Priority in Bankruptcy Cases pursuant to Palmer v. United States, 219 F.3d 580 (6th Cir. 2000)

This responds to your request dated October 12, 2000, requesting our review of your draft memorandum to the Cleveland Insolvency Group containing recommended guidelines for applying tolling to bankruptcy cases filed in the Northern District of Ohio in light of the Sixth Circuit's decision in Palmer v. United States, 219 F.3d 580 (6th Cir. 2000). Palmer held that priority periods are not tolled automatically during prior bankruptcy cases but are only tolled on a case-by-case basis pursuant to B.C. § 105(a). This document is not to be cited as precedent.

We concur with your draft memorandum insofar as it addresses the classification of taxes on proofs of claim. Our position is that under Palmer taxes can be claimed as priority on proofs of claim based on tolling so long as the Service determines that tolling is justified on a case-by-case basis, and the Service's reliance on tolling is indicated on the proof of claim. We believe that the precise factors relied upon to select cases for which tolling will be claimed should be developed by the local counsel offices based on local case law and other relevant considerations. Your draft memorandum is consistent with our position.

We make the following suggestions regarding your proposed guidelines for selecting tolling cases. Regarding number 1, "Debtor has filed two or more prior bankruptcy petitions," we believe that additional criteria establishing that debtor is abusing the bankruptcy system by filing multiple bankruptcy petitions within certain time periods will be helpful. For example, the two prior bankruptcy petitions were filed within the past X years, or only X months lapsed between each dismissal or refiling. We also suggest that you may want to consider an additional criteria for identifying tolling cases to include cases where a bankruptcy petition is filed shortly after the Service issues collection notices or commences collection action. We also suggest that it might be helpful to add to add a general catch-all criteria such as "other facts exist which establish that the debtor is using bankruptcy solely to evade his or her federal tax responsibilities."

We do not concur in your memorandum insofar as it suggests that the Service can collect a tax based on the administrative determination that the tax is nondischargeable due on tolling. Our position has been that if pursuant to the law of the circuit tolling is not automatic but occurs on a case-by-case basis pursuant to section 105(a), then the Service should not take collection action based on the administrative determination that a tax is nondischargeable due to tolling, without first obtaining a ruling as to dischargeability from the bankruptcy court. Otherwise, if the court disagrees with the Service, the Service risks being subject to damages and attorney's fees for violating the injunction against collecting discharged taxes. See B.C. § 524(a)(2). Additionally, the fact that the Service took unilateral collection action may influence a court to rule against the Service in determining whether tolling is justified under section 105(a). In the Sixth Circuit, collection action should not be taken based on the assumption that priority periods will be tolled.

COLLECTION DUE PROCESS; TRUST FUND RECOVERY PENALTY; DESTROYED ADMINISTRATIVE FILES

CC:PA:CBS:Br3
GL-603611-00
October 16, 2000
UIL: 6672.00-00 & 6330.00-00

MEMORANDUM FOR RONALD D. PINSKY, ASSOCIATE AREA COUNSEL (SBSE) – WASHINGTON, D.C. CC:SB:2:WAS:1

FROM: Lawrence H. Schattner
Chief, Branch 3 (Collection, Bankruptcy Summonses)

SUBJECT: Trust Fund Recovery Penalty (TFRP) – Different Service responses to destroyed files recommending the TFRP

This responds to your request of July 3, 2000, on the above subject. You requested general guidance on how the Appeals function should handle Collection Due Process (CDP) hearings and equivalent hearings challenging a trust fund recovery penalty (TFRP) assessment, pursuant to I.R.C. § 6672, when the Service has destroyed the administrative file that it created with respect to assertion of the TFRP. For the reasons described further below, it is not clear to us that different handling by the Service of the TFRP assessments at issue in your examples, involving the Customer Service, Collection, and Appeals functions, was not appropriate under the circumstances.

BACKGROUND

Your request for assistance attached a prior memorandum of May 13, 1999, now reproduced at 1999 IRS CCA LEXIS 172, which suggested that it would not be appropriate for the Customer Service function, as part of its project to clean up aged Non-Master File accounts (which include many TFRP assessments), to (1) investigate whether the Service's administrative file recommending assertion of the TFRP in each case had been destroyed, or (2) abate the unpaid portion of every TFRP assessment on the Service's books where the Service's TFRP file recommending assessment should have or has been destroyed, pursuant to the Service's ordinary document retention policy. The prior memorandum cited appropriate legal authority for the proposition that the Service need not be able to produce the original documentation for all of its actions in a taxpayer's case, that a certified copy of an IRS Form 4340 (Certificate of Assessments and Payments) constitutes prima facie proof that a timely and proper assessment was made. We stand by the above-described advice offered in the prior memorandum.

Consistent with the prior memorandum of May 13, 1999, and footnote 3 in particular from that memorandum, you note that your office has recently advised a Collection Offer-in-Compromise (OIC) manager in a particular Collection OIC case that the Service was not obliged to abate the unpaid portion of a TFRP assessment merely because the Service has now destroyed its original file recommending that the TFRP be asserted.

Next, you indicate that the Appeals function in your district also recently considered a taxpayer's old TFRP assessment in an "equivalent hearing" case under Temp. Treas. Reg. § 301.6330-1T:(i) (part of the Collection Due Process regulation), and the Service had also destroyed the TFRP recommendation file for this taxpayer before the taxpayer requested the equivalent hearing, as part of the Service's ordinary record retention policy. However, in the Appeals function case, you understand that the ultimate decision made by the Service was to abate the unpaid portion of the TFRP assessment and that a part of the basis for this decision was the destruction of the TFRP recommendation file.

Because the Service does ordinarily retain its TFRP recommendation files for a number of years after making a TFRP assessment, none of the examples discussed above involves a challenge to a TFRP assessment that could even arguably be covered by the burden of proof provisions of I.R.C. § 7491,[8] and this should remain true for many more years to come in any TFRP cases where the Service's TFRP recommendation files have been destroyed as part of the Service's record retention policy. Again, because the

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[8] Section 7491 applies only in court proceedings arising in connection with examinations that commenced after July 22, 1998, which would mean that TRFP assessments arising from investigations opened before July 22, 1998, should clearly be unaffected by the burden of proof provision added in 1998. For TFRP investigations begun after July 22, 1998, there is no case authority as yet on whether the TFRP may in substance be treated as a "tax" other than a "tax imposed by subtitle A or B" (and therefore not covered by section 7491(a)) or whether the TFRP may be considered a "penalty" covered by section 7491(c). See Sotelo v. United States, 436 U.S. 268, 275 (1978) (TFRP is not a "penalty" for purposes of Bankruptcy Act); Chief Counsel Notice N(35)000-164 ("Burden of Proof and Section 7491," Sept. 23, 1999) (also taking the position that the TFRP is not a "penalty" for purposes of section 7491(c)).

Service does ordinarily retain its TFRP recommendation files for a number of years after making a TFRP assessment, the Appeals function and the other examples discussed above also did not involve challenges to TFRP assessments where the taxpayer received the preliminary 60 day notices (for proposed TFRP assessments made after June 30, 1996) described in I.R.C. § 6672(b). However, we do discuss the 60 day notice requirement below because it is relevant to whether the Appeals function should, in future cases, consider the merits of a TFRP assessment in a CDP or equivalent hearing case brought under the Collection Due Process regulation. As more fully discussed below, in CDP or equivalent hearings where the file recommending assertion of the TFRP is unavailable, we do not expect the merits of the TFRP to be an appropriate issue in most cases because the taxpayer will have received notice from the Service of a prior opportunity to dispute the merits of the TFRP in an Appeals function hearing.

ISSUES & CONCLUSIONS

Issue 1: Is it appropriate for the Appeals function to consider the merits of a challenged TFRP assessment in a Collection Due Process (CDP) hearing or in an equivalent hearing under the Collection Due Process regulation (Temp. Treas. Reg. § 301.6330-1T)?

> Conclusion: It is appropriate for the Appeals function to consider the merits if the taxpayer has not had a previous opportunity to contest the liability. If a taxpayer received the 60 day preliminary notice of the Service's proposed TFRP assessment required by section 6672(b) (after June 30, 1996) or received another prior opportunity (pre- or post-assessment) for a conference with Appeals to dispute liability for the TFRP, then the existence or amount of the TFRP assessment may <u>not</u> be raised by a taxpayer in a CDP hearing or equivalent hearing under the Collection Due Process regulation. Similarly, if the taxpayer was a party in or otherwise participated meaningfully in a judicial proceeding in which the taxpayer's liability for the TFRP was at issue (e.g., a tax refund suit regarding the TFRP, a suit or counterclaim by the United States to reduce the TFRP to judgment, or the Service filed a proof of claim for the TFRP in the taxpayer's bankruptcy case), then the existence or amount of the TFRP assessment may not be raised by the taxpayer anew in a CDP hearing or equivalent hearing under the Collection Due Process regulation.

Issue 2: In a proper merits challenge of a TFRP assessment in a CDP hearing or in an equivalent hearing under the Collection Due Process regulation, is it appropriate for an Appeals officer to consider the Service's hazards of litigation on the merits?

> Conclusion: Yes. If a taxpayer is permitted to and does properly contest the existence or amount of a TFRP assessment in a CDP hearing, it is appropriate for the Appeals officer to consider the Service's hazards of litigation on these issues, including the destruction of the Service's file recommending the TFRP. Although

a taxpayer has no right to obtain judicial review of an adverse Appeals function determination resulting from an equivalent hearing under the Collection Due Process regulation, an Appeals officer should consider the same issues at an equivalent hearing that the Appeals officer would have considered in a timely requested CDP hearing, including consideration of the Service's hazards of litigation on the merits of the TFRP, where appropriate.

Issue 3: Is it appropriate for an Appeals officer to give substantial weight to an IRS Form 4340 (Certificate of Assessments and Payments) in considering various types of taxpayer challenges to a TFRP assessment?

Conclusion: Yes. In a CDP hearing or equivalent hearing under the Collection Due Process regulation, an Appeals officer may rely on an IRS Form 4340 as presumptive evidence that the TFRP has been validly assessed by the Service against a taxpayer and to otherwise verify the Service's compliance with the requirements of applicable law and administrative procedures, for purposes of I.R.C. § 6330(c)(1). Davis v. Commissioner, 115 T.C. No. 4 (July 31, 2000). The case law cited in Davis and in the prior memorandum illustrate many circumstances where the courts have given substantial weight to IRS Forms 4340 in considering taxpayer challenges to various tax liabilities, but the Service does not ordinarily rely solely on Forms 4340 to defend a permissible merits challenge by a taxpayer to a TFRP assessment.

Issue 4: When a taxpayer makes a permissible merits challenge of a TFRP assessment, is the destruction or missing status of the Service's administrative file regarding the TFRP recommendation against that taxpayer necessarily fatal to the Service's case?

Conclusion: No. The destruction of the Service's administrative file regarding a TFRP assessment (in merits challenge circumstances) may sometimes lead a court to consider whether the Service has only a "naked assessment" for the TFRP, which is not entitled to a presumption of validity. However, most courts will first allow the Service an opportunity to conduct discovery or otherwise develop or reconstruct probative evidence regarding the TFRP liability, such that the burden of proof remains on the taxpayer by the time of trial. The employer's Form 941 and other returns, Secretary of State records, bank signature cards, and the testimony of other employees or officers may often still be available to the Service as a more than adequate substitute for the destroyed or lost administrative file on various challenged elements of the TFRP liability.

Issue 5: When the Service's administrative file regarding a TFRP assessment has been destroyed and the merits of the TFRP assessment are being considered in the Appeals function, are there mandatory internal guidelines or tolerances as to how much time Appeals should give the Collection function to reconstruct or gather evidence supportive of the TFRP assessment or how many hours the Collection function should expend on this task of reconstructing or gathering evidence before concluding the effort is not likely to be cost effective or otherwise worthwhile?

> Conclusion: No. The Appeals function should generally attempt to conduct all CDP hearings or equivalent hearings under the Collection Due Process regulation as expeditiously as possible, but there are no time limits by law on how soon Appeals must hold the hearing or issue its Notice of Determination (for a CDP hearing) or its Decision Letter (for an equivalent hearing). If a TFRP case requires further factual development when the TFRP assessment is first proposed, the Appeals function may retain jurisdiction of the case but send it back to the Collection function for at least 45 days to take any necessary action, with extensions possible through mutual agreement of the two functions. See IRM 8.11.1.8.8:(3). In a CDP hearing or equivalent hearing context, where the Service is similarly stayed by law from levying (in the case of a CDP hearing) or where the Appeals function may ask the Collection function to stay its levy activity if it wants further time to reconstruct or develop the facts (in the case of an equivalent hearing), the Appeals function should also first afford the Collection function at least 45 days, subject to mutually agreed extensions, to attempt to reconstruct or develop facts that may support the TFRP assessment which was the subject of the destroyed or lost administrative file, if the taxpayer has brought a proper merits challenge to the liability. However, the local Collection function, after coordinating the matter appropriately within the new SBSE structure, may agree in advance with the local Appeals function that cases within certain tolerances (e.g., total dollar amounts, of a certain age, and/or with minimal known levy sources) are not cost effective for the Service to attempt to reconstruct or support after the administrative file has been destroyed.

DISCUSSION

Not less than 30 days before the day of the Service's first levy (after the effective date of I.R.C. § 6330) with respect to a particular tax and a particular tax period, the Service is required to give a taxpayer the notice described in I.R.C. § 6330(a)(3) (a CDP notice). Among other things, a CDP notice advises a taxpayer that the taxpayer may request a hearing (a CDP hearing) in the Service's Appeals function to consider the proposed levy and other related matters by making a written request to the office which issued the CDP notice within 30 days. I.R.C. § 6330(a)(3)(B). If the taxpayer makes a request for an Appeals function hearing with respect to a CDP notice more than 30 days after the CDP notice was issued, then the taxpayer may not obtain a CDP hearing, but may receive an equivalent hearing, pursuant to Temp. Treas. Reg. § 301.6330-1T:(i). In an equivalent hearing case with the Appeals function under the Collection Due Process regulation, the Appeals function considers the same issues that it would have considered in a CDP hearing case on the same matter, but the Service's collection limitation period is not suspended while an equivalent hearing case is in the Appeals function, the Service is not automatically stayed (but may choose to stay) its proposed levy activity while the equivalent hearing case is pending, and the taxpayer has no right to judicial review of an adverse decision by the Appeals function arising from an equivalent hearing. See Temp. Treas. Reg. §§ 301.6330-1T:(i)(2)Q&AI1-5.

Issue 1: Considering the Merits of TFRP Assessments in a CDP Hearing

In a CDP hearing, a taxpayer may be allowed to challenge the existence or amount of the underlying liability (the merits), but only if the taxpayer did not receive a statutory notice of deficiency for such tax liability (not applicable in TFRP cases) or "did not otherwise have an opportunity to dispute such liability." Further, a taxpayer may not raise an issue (including the merits) at a CDP hearing if the issue was raised and considered in any previous administrative or judicial proceeding in which the taxpayer participated meaningfully. I.R.C. §§ 6330(c)(2)(B) and (c)(4). The Collection Due Process regulation explains that "an opportunity to dispute such liability" includes a prior opportunity for an Appeals function conference either before or after assessment of the liability. One of the examples in the Collection Due Process regulation of this principle specifically concerns a TFRP assessment; it explains that when the Service offers the taxpayer an opportunity to request an Appeals function conference to dispute a TFRP liability and the taxpayer fails to take advantage of that opportunity, then the taxpayer is precluded from challenging the existence or amount of the TFRP at a subsequent CDP hearing (or equivalent hearing). See Temp. Treas. Reg. §§ 301.6330-1T:(e)(3)Q&AE8 and (e)(4)Ex.3.

For proposed TFRP assessments made after June 30, 1996, the Service has been required (except in jeopardy situations) to give the taxpayer a 60 day preliminary notice which generally informs the taxpayer of the proposed TFRP assessment and offers the taxpayer an opportunity to request an Appeals function conference within 60 days to dispute the proposed TFRP liability. The Service uses a Letter 1153(DO) to provide this 60 day notice of proposed TFRP assessments to taxpayers; the Service has generally decided to send the Letter 1153(DO) to a taxpayer by certified mail to the taxpayer's last known address.[9] I.R.C. § 6672(b); IRM 5.7.3.6:(3). The examples discussed in your memorandum requesting our assistance did not involve TFRP assessments made after June 30, 1996, but we believe it is useful here to discuss the 60 day preliminary notice requirements of section 6672(b) (effective after that date) because the Service's prior compliance with this provision should ordinarily satisfy the prior "opportunity to dispute" exception in section 6330(c)(2)(B) with regard to the merits of a TFRP assessment and thereby preclude consideration of the merits of the TFRP liability in a CDP hearing or

[9] Certified mailing of the 60 day notice, return receipt requested, is not required by law, but is the preferred mailing method selected by the Collection function for these notices, in part so that mailing and receipt of the 60 day notice may be more easily proven by the Service if these matters are ever later contested. The 60 day notice may also now be delivered in person to the taxpayer.

equivalent hearing conducted by the Appeals function for that taxpayer. This issue preclusion, in turn, should alleviate some of the complications that may otherwise be caused to the Service in old TFRP cases by the Service's document retention policy of destroying some of its older files recommending TFRP assessments before the collection limitation period for the TFRP has expired.

Prior to June 30, 1996, we understand that it was also the Service's general policy to offer taxpayers an opportunity either before or after assessment of the TFRP to obtain an Appeals function conference regarding the merits of their TFRP liability. However, since Appeals function conferences regarding proposed TFRP assessments were not a matter of right before the effective date of section 6672(b), it may generally be more difficult for the Service to show whether or not a particular taxpayer was offered an Appeals function conference to discuss a proposed or assessed TFRP if the TFRP recommendation file with respect to that taxpayer no longer exists. Nevertheless, if the Service can show that the taxpayer received notice of a prior opportunity to request an Appeals function conference on the TFRP liability, then the taxpayer would be precluded from challenging the merits of the TFRP liability in a CDP or equivalent hearing.

For TFRP assessments made after June 30, 1996, however, a taxpayer who was properly mailed a notice of his/her opportunity to request an Appeals function conference to consider the merits of a TFRP assessment by the Service may still be able to avoid preclusion of the underlying liability as an appropriate subject for a CDP hearing (or equivalent hearing) if the taxpayer shows that he/she did not receive the notice. See Temp. Treas. Reg. §§ 301.6330-1T:(e)(3)Q&AE2 and (e)(4)Ex.2 (discussing the consequences of a taxpayer's failure to receive a statutory notice of deficiency on the taxpayer's ability to contest the underlying liability in a CDP hearing). Regardless of whether the TFRP assessment was made prior to or after June 30, 1996, the Service and the courts are not obliged to accept, without question, a taxpayer's statement that he/she does not recall having received such notice. In the absence of clear evidence to the contrary, the Tax Court has found in a CDP hearing context that presumptions of official regularity and of delivery justify the conclusion that a notice by the Service was sent and that delivery was attempted by the Post Office at the address the Service used in its notice. In the same CDP hearing case, the Tax Court also held that a taxpayer may not defeat actual notice of an opportunity to contest a tax liability by refusing to accept delivery of mail from the Service. Sego v. Commissioner, 114 T.C. No. 37 (June 30, 2000).[10]

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[10] The Service may enhance the likelihood of showing that a taxpayer received a particular document by maintaining a centralized register of receipts for outgoing certified mail and by maintaining the register for 10 years, as the Service is now doing for CDP notices with respect to liens. See IRM 5.12.3.1.4:(5). Alternatively, for recent TFRP assessments, the Service may rely on information found in the Automated Trust Fund Recovery Penalty Program (ATFRPP). The ATFRPP now reportedly allows the Collection function to enter a textual history note on the date it receives a certified

In light of the foregoing discussion of the issue preclusion effect (for the merits of a tax liability) of a taxpayer having been given and received prior notice of an opportunity to contest the TFRP with the Service's Appeals function, it would be prudent for the Collection function to document prior notice and receipt before referring future CDP hearing or equivalent hearing cases to the Appeals function, and to note these facts in its transmittal to Appeals.[11] It may also be prudent for a revenue officer newly assigned to collect an older TFRP assessment to ask the taxpayer, before issuing a CDP notice, what types of prior notices the taxpayer has received from the Service regarding the TFRP liability and to document the taxpayer's response.

Issue 2: Weighing Litigation Hazards on TFRP Merits in Equivalent Hearing

If the merits of a TFRP liability (e.g., responsibility and willfulness) are properly at issue in a CDP hearing, the Appeals function may be required to weigh the taxpayer's and the Service's respective hazards of litigation in deciding whether to sustain, compromise, or concede the amount of the unpaid TFRP assessment. <u>See</u> H.R. Conf. Rep. No. 105-599, 105th Cong. 2d Sess. 266 (validity of tax liability reviewed <u>de novo</u>); <u>see also</u> IRM 5.1.9.3.8:(5). The destruction of the Service's file recommending assertion of the TFRP at issue against the taxpayer may affect the Service's hazards of litigation on the merits of the taxpayer's challenge to the TFRP liability, but the destruction of this TFRP file is not necessarily fatal to the Service's case, as discussed further below. In a CDP hearing context where the merits of the TFRP liability are properly at issue, the Appeals function gives the taxpayer a written Notice of Determination at the end of the hearing process which should address the TFRP merits issues and the other issues the taxpayer was allowed to and did raise. A Notice of Determination also advises the taxpayer of the taxpayer's right to seek judicial review of the Appeals function's determinations within 30 days, by filing a complaint in U.S. District Court in the case of a TFRP liability. <u>See</u> Temp. Treas. Reg. § 301.6330-1T:(e)(3)Q&AE7. In this manner, a taxpayer's CDP hearing challenge to an unpaid TFRP liability that is no longer supported by the Service's original file recommending assertion of the TFRP may be brought to court to consider the merits of the unpaid TFRP liability.

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mailing receipt of delivery (e.g., the customary green card) for a Letter 1153(DO), indicating that delivery of the 60 day notice of proposed TFRP assessment to the taxpayer by the Post Office has occurred. Since ATFRPP records for recent TFRP liabilities may not be readily available to the Appeals function in every city, it would be prudent for the Collection function to include any ATFRPP information which may exist with respect to delivery of the Letter 1153(DO) in the summary statement portion of the transmittal for a CDP or equivalent hearing case involving the TFRP liability to the Appeals function.

[11] A Form 3210 is the transmittal form used for this purpose, and the summary statement attached to it should contain information of this type that would assist the Appeals function in its determination. <u>See</u> IRM 5.1.9.3.6:(13) and 8.7.1.1.9.12:5.

The Service issues a Decision Letter, rather than a Notice of Determination, at the conclusion of an equivalent hearing process and the taxpayer has no right to judicial review of the Appeals function's resolution of the issues in a Decision Letter. Nevertheless, even though the equivalent hearing process in the Appeals function may not lead directly to a taxpayer's right to litigate the outcome in court, the Service has decided that it is appropriate for the Appeals function to consider the same issues that it would have considered at a CDP hearing on the same matter, including the hazards of litigation to the Service's position. See Temp. Treas. Reg. § 301.6330-1T:(i). This policy decision reflected in the regulation also makes good practical sense in the case of an unpaid TFRP liability. If the Service goes forward with its proposed levy action, the Service's levy activity may then easily result in the collection of enough of the TFRP liability (the trust fund taxes owed with respect to one employee for one quarter)[12] to entitle the taxpayer to make a request for a refund of the liability paid and to put the merits of the previously unpaid TFRP liability (with its attendant hazards of litigation) before a U.S. District Court for decision. Alternatively, a taxpayer denied an opportunity to discuss the parties' hazards of litigation with respect to the merits of a TFRP liability in an equivalent hearing by the Appeals function could file bankruptcy and obtain an opportunity to litigate his/her liability for the TFRP in the bankruptcy case, if the Service files a bankruptcy proof of claim for the unpaid TFRP liability.[13]

Issue 3: Reliance on Forms 4340 to Establish Elements of TFRP Liability

In a CDP hearing or equivalent hearing case, the Appeals function is required, prior to issuing a Notice of Determination or Notice of Decision, to obtain general verification from the Collection function that the requirements of applicable law or administrative procedure have been met by the Service, in addition to considering the issues properly raised by the taxpayer. I.R.C. § 6330(c)(1); Temp. Treas. Reg. §§ 301.6330-1T:(e)(1) and (e)(3)A-E1(i). In Davis v. Commissioner, 115 T.C. No. 4 (July 31, 2000), the Tax Court held that it was

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[12] See Steele v. United States, 280 F.2d 89 (8th Cir. 1960), wherein the United States confessed error and stipulated that the full payment rule for income tax refund actions, discussed in Flora v. United States, 357 U.S. 63 (1958), does not apply to assessments of divisible taxes such as the TFRP.

[13] These practical, alternative opportunities for a taxpayer to obtain judicial review with respect to the merits of an unpaid TFRP liability may also admittedly exist with respect to the merits of the liability in some of the issue preclusion circumstances (when the taxpayer receives prior notice of an opportunity for a prior Appeals function conference) discussed in relation to issue 1 above. Nevertheless, as a policy matter, it is not appropriate for the Appeals function to consider the Service's hazards of litigation on the merits in these issue preclusion circumstances. Otherwise, there would be no limit to the number of Appeals function conferences a taxpayer might seek on the same tax or issue, and taxpayers would not be appropriately encouraged to seek timely conferences with the Appeals function.

not an abuse of discretion for an Appeals function hearing officer in a CDP case to rely on an IRS Form 4340 (Certificate of Assessments and Payments) for purposes of complying with section 6330(c)(1). Indeed, as you have concluded and the prior memorandum you attached with your request for assistance suggests, it is highly appropriate and proper for an Appeals function hearing officer and for other Service employees to rely on a Form 4340, first, to satisfy the requirements of section 6330(c)(1) and, second, to overcome a variety of arguments a taxpayer may raise with respect to a TFRP assessment at a CDP or equivalent hearing pursuant to section 6330(c)(2), even when the Service's file recommending the TFRP assessment against the taxpayer has been destroyed. However, an IRS Form 4340 alone does not overcome all potentially proper challenges (e.g., a factually supported merits challenge to the underlying liability) that a taxpayer may raise to a TFRP assessment in a CDP or equivalent hearing case. Further, if there are material discrepancies between the information reflected on an IRS Form 4340 and other available evidence or if the IRS Form 4340 does not contain relevant entries that address the issues raised by the taxpayer, then an Appeals function hearing officer or a reviewing court may seek or receive further explanations from the interested parties rather than give conclusive weight to the information reflected on the Form 4340, even when the merits of the TFRP liability are not properly at issue.

In the Davis case, the taxpayer failed to allege that he did not receive a statutory notice of deficiency for the income tax deficiencies in issue, nor did he allege that he did not have a prior opportunity to contest the Service's deficiency determinations. Accordingly, the Tax Court opinion started with the conclusion that the taxpayer's underlying tax liability (the merits) was not properly before the court in this CDP review case. The procedural argument raised by the taxpayer in Davis was that the Appeals function hearing officer should not have relied on a Form 4340 in the CDP hearing to establish the date and amount of assessments made by the Service against him, that the hearing officer should instead have attempted to go behind the Form 4340 to verify from personal inspection of the original documents that IRS Forms 23C (Summary Records of Assessment) were actually signed by an IRS Service Center assessment officer on the dates and for the amounts shown in the Service's certified records. The Tax Court rejected this frivolous procedural argument, citing several prior circuit court decisions on the issue. The Tax Court correctly observed that IRS Forms 4340 provide presumptive evidence that a tax has been validly assessed under I.R.C. § 6203, and noted that the taxpayer did not demonstrate any irregularity in the assessment procedure.

The prior memorandum you referred to and the Davis opinion each cite a number of court decisions, decided outside the context of a CDP hearing, in which the Service and the courts have relied upon IRS Forms 4340 as presumptive proof of the regularity of various procedural matters, such as: (1) whether the Service properly made a record of the assessment, under section 6203; (2) whether the Service properly gave notice and demand for payment, under section 6303; (3) whether the Service's records reflect the actual assessment date of a tax, to measure the timeliness of a suit by the United States to reduce the tax to judgment before the collection limitation period expired under section 6502; or (4) whether the Service's records reflect the actual amount of a non-divisible tax assessment made by the Service, to evaluate the taxpayer's compliance with the Flora full payment rule so that the taxpayer could properly initiate a refund suit for the tax under section 7422.

Three circuit court cases involved quiet title challenges by taxpayers (pursuant to 28 U.S.C. § 2410) to the procedural regularity of the Service recording its assessments and/or the Service giving the taxpayer proper notice and demand for payment, under sections 6203 and 6303, respectively. Challenges to the merits of a federal tax liability are not permitted in a quiet title action. In each case, the circuit court relied upon IRS Forms 4340 as presumptive proof of the Service's proper compliance with sections 6203 and/or 6303, and the taxpayers failed to show any discrepancies between the Forms 4340 and any of the available evidence. See Geiselman v. United States, 961 F.2d 1 (1st Cir. 1992), cert. denied, 506 U.S. 891 (1992); Koff v. United States, 3 F.3d 1297 (9th Cir. 1993), cert. denied, 511 U.S. 1030 (1994); Gentry v. United States, 962 F.2d 555 (6th Cir. 1992).

Two other circuit court cases involved suits by the United States to reduce unpaid assessed taxes to judgment, the taxpayer raised non-merits objections to the assessed taxes, and the courts relied on the information reflected on IRS Forms 4340 to resolve the disputes in the Service's favor. In United States v. Chila, 871 F.2d 1015 (11th Cir. 1989), cert. denied, 493 U.S. 975 (1989), the taxpayer challenged whether the Service had properly recorded a TFRP assessment against him and whether the Service had made proper notice and demand for payment on the taxpayer, for purposes of sections 6203 and 6303. In United States v. Miller, 318 F.2d 637 (7th Cir. 1963), an heir to a decedent argued that an estate tax liability had been assessed by the Service earlier than the date shown on an IRS Form 4340, so as to make the suit by the United States to reduce the unpaid tax to judgment untimely (i.e., outside of the collection limitation period).

Two other circuit court cases involved tax refund suits brought by taxpayers, the taxpayers were not permitted to or did not contest the merits of the taxes in their appeals, and the courts again relied upon the information shown on Forms 4340 to resolve the disputes in the Service's favor. In Hefti v. Internal Revenue Service, 8 F.3d 1169 (7th Cir. 1993), the merits of the tax liabilities contested by the taxpayer could not be contested because the taxes had been previously determined in prior tax cases that were then res judicata, so the taxpayer's challenge was limited to a bare allegation the Service had failed to comply with section 6203 in making its assessments of the tax. In Rocovich v. United States, 933 F.2d 991 (Fed. Cir. 1991), the lower court dismissed the taxpayer's refund case for a federal estate tax because the taxpayer had not fully paid the tax before filing the suit, and the taxpayer alleged that the IRS Form 4340 overstated the amount of the estate tax assessment that the executor was required to pay in full in order to bring the refund action.

While the eight circuit court cases described above showcase procedural challenge circumstances where the Service has prevailed by offering certified Forms 4340 in evidence, other procedural challenges to the Service's actions have not been fully resolved by IRS Forms 4340 when the courts have found there was some evidence of material discrepancies or of data missing from the Forms 4340. In United States v. McCallum, 970 F.2d 66 (5th Cir. 1992), a suit by the United States to reduce unpaid income tax deficiency assessments to judgment, the court relied on certified Forms 4340 to defeat the taxpayer's allegation that the taxes were not properly recorded for purposes of section 6303, but the court remanded the case for proof that a statutory notice of deficiency had been properly mailed to the taxpayer by the Service and that the taxpayer defaulted before the deficiencies were assessed, because the taxpayer denied that he received a notice of deficiency and the IRS Forms 4340 did not address this procedural issue. In Huff v. United States, 10 F.3d 1440 (9th Cir. 1993), cert. denied, 512 U.S. 1219 (1994), the taxpayers filed a quiet title action challenging the procedural regularity of the Service's tax liens and the court accepted certified Forms 4340 as evidence the Service made proper notice and demand for payment for section 6303 purposes, but the Ninth Circuit found the Forms 4340 in the case were defective for purposes of section 6203 because the documents did not show a "23C date" that indicated when the IRS Forms 23C were signed. Earlier, in Farr v. United States, 990 F.2d 451 (9th Cir. 1993), cert. denied, 510 U.S. 1023 (1993), the Ninth Circuit also stated that while Forms 4340 are "proper evidence" of the propriety of the assessment procedures followed by the Service, the forms are not "necessarily conclusive evidence;" the Farr court suggested that the United States could rely on IRS Forms 4340 in a summary judgment proceeding to show that a notice of deficiency was mailed by the Service to the taxpayer's last known address, but that the taxpayer was first entitled to conduct discovery on the issue and that the taxpayer's case could not be dismissed at the outset for an alleged failure to state a claim on the basis of the information reflected on IRS Forms 4340.[14]

Finally, in a recent district court case where the United States was seeking to reduce an old TFRP assessment to judgment and the Service had destroyed a Form 941 return of the taxpayer's former employer, the court was unwilling to conclude that no material issue of fact remained for trial for one of the TFRP quarters at issue. A certified IRS Form 4340 showed that the TFRP assessment against the taxpayer for that quarter was made for an amount that was about $110,000.00 larger than the Service had asserted that the

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[14] See also Godfrey v. United States, 997 F.2d 335 (7th Cir. 1993). In Godfrey, the Service argued that it mailed the taxpayers a timely refund check, the taxpayers alleged that they did not receive the check, a new refund check was issued by the Service, and the taxpayers sued the Service for interest that was due them on the tax refund amount only if the Service failed to mail the taxpayers the original check on the date shown with the notation "Refund of Overpayment" on an IRS transcript other than a Form 4340. Without explanatory testimony, the Seventh Circuit was unwilling to interpret the transcript notation as meaning the refund check was mailed on that date.

corporate employer owed for that same quarter in an amended bankruptcy proof of claim that the Service filed a few months after the TFRP assessment was made. When the issue of the correct amount owed for this quarter is brought to trial, the court indicated that the initial burden of proving by a preponderance of the evidence that the TFRP assessment for this quarter was arbitrary and erroneous would lie with the taxpayer. United States v. Watson, 102 F. Supp. 2d 351 (S.D. Tex. 1999).

Issue 4: Defending TFRP Liability on the Merits When Files were Destroyed

In United States v. Janis, 428 U.S. 433 (1976), the Supreme Court was primarily concerned with whether the exclusionary rule (a criminal law deterrent to improper police conduct) should be applied to prohibit a federal agency (the Service) from using evidence that was improperly seized by California state police from a taxpayer's business in support of the federal agency's civil assessment (of the federal wagering tax) against the taxpayer. The Supreme Court ultimately decided that the exclusionary rule should not be extended to these circumstances, that the Service was not barred from using the evidence of gambling activity by the taxpayer that it received from the California state police in support of its civil, federal wagering tax assessments against the taxpayer. If the evidence improperly seized by the state police could not have been used by the Service, then it had conceded that it would not have had any admissible evidence (other than Forms 4340) to support its federal wagering tax assessments against the taxpayer. Moreover, if the Service had been barred from using the evidence improperly seized by the state police, any later efforts by the Service to reconstruct or supplement the same type of evidence on its own could have been construed as tainted fruits of the improper search, and also deemed inadmissible. Before it considered the historical policies behind the exclusionary rule and announced its decision on that issue, the Supreme Court first discussed (in dicta, Janis at 441-3) what the status of the Service's "naked assessments" would have been if the exclusionary rule had been applied, as follows:

> What we have is a "naked" assessment without any foundation whatsoever if what was seized by the Los Angeles police cannot be used in the formulation of the assessment. The determination of tax due then may be one "without rational foundation and excessive," and not properly subject to the usual rule with respect to the burden of proof in tax cases. ... There appears, indeed, to be some debate among the Federal Courts of Appeals, in different factual contexts, as to the effect upon the burden of proof in a tax case where there is positive evidence that an assessment is incorrect. ... However that may be, the debate does not extend to the situation where the assessment is shown to be naked and without any foundation. ... Certainly, proof that an assessment is utterly without foundation is proof that it is arbitrary and erroneous. ... We are willing to assume that if the District Court was correct in ruling that the evidence seized by the Los Angeles police may not be used in formulating the assessment (on which both the levy and the counterclaim were based), then the District Court was also correct in granting judgment for Janis in

> both aspects of the present suit. This assumption takes us, then, to the primary issue.

Seven years after Janis, the Sixth Circuit considered a federal income tax refund action where the Government conceded that it no longer had in its possession any reports, workpapers or other documents to support the notice of deficiency the Service had issued to the individual taxpayers a little over 10 years before the refund suit was commenced. Coleman v. United States, 704 F.2d 326 (6th Cir. 1983). In the Coleman case, the court also found that the taxpayers had delivered their relevant financial records to the Service in the course of the audit many years before, that the Service's notice of deficiency to the taxpayers was returned as unclaimed by the Post Office, that the taxpayers sought to learn the basis for the assessment from the Service relatively soon after they discovered the Service was trying to collect it, and that as early as three years after the assessment was made the Service admitted to the taxpayers that it could not locate the financial records the taxpayers had given them during the audit, nor could the Service locate it own files to explain the basis for its assessment. In these circumstances, the Sixth Circuit relied on the above-described dicta from Janis and held that the taxpayers had established that the Service's "naked assessments" were arbitrary and could not be enforced. However, the Sixth Circuit clarified (Coleman, at 329) that it was not saying that the Service, in another case involving missing original records, could not have preserved the presumption of correctness for its assessment by the use of non-original records:

> It should be noted that reversing the district court here does not strip the IRS of the ability to collect taxes in the absence of original records. ... Had such "secondhand" records been available in the matter sub judice, or any demonstrably reasonable methodology of estimation, it is likely that even the destruction of the Colemans' original returns would not have precluded reliance upon the assessment's presumption of correctness.

Seven years after Coleman, the Seventh Circuit considered the meaning of a "naked assessment" in a case involving a TFRP liability that the Service admitted before the second phase of a trial that it had miscalculated. United States v. Schroeder, 900 F.2d 1144 (7th Cir. 1990). In Schroeder, the Service originally miscalculated the TFRP owed by two responsible persons by failing to account for part of a prior payment by the employer that was applied to the trust fund taxes it owed; when the Service originally made the TFRP assessment, the total amount assessed was excessive by about 4.8%. As the collection limitation period for the TFRP approached, the Service believed that it had collected about 88.5% of the total TFRP, but it had in fact collected about 93.4% of the liability (not including a large interest accrual since assessment), due to its original calculation error. The United States then brought suit to reduce the unpaid portion of the TFRP liability and the unpaid accrued interest to judgment. Due to the Service's original miscalculation of the TFRP and considering the amounts collected and applied toward the total TFRP since assessment, the United States eventually admitted that it had sought judgment against the taxpayers for an unpaid TFRP amount that was overstated by about 58% (not including the large interest accruals). The Service's witness in the computation phase of the trial was also unable to provide the court with revised interest computations that accounted for the corrected TFRP amount. In these circumstances, the district court found the Service had an arbitrary, erroneous and invalid assessment for the TFRP and that the United States was liable to the taxpayers for attorney fees. The Seventh Circuit reversed, explaining (<u>Schroeder</u>, at 1148-9) as follows:

> When a court is faced with an incorrect but otherwise valid assessment the proper course is not to void the assessment, as did the district court, but to determine what, if anything, the taxpayer owes the government. See <u>Helvering v. Taylor</u>, 293 U.S. 507, 55 S. Ct. 287, 79 L. Ed. 623 (1935). This course should be followed, whenever a taxpayer's liability is capable of being determined by some approved method of calculation, even when the original assessment was arbitrarily computed and excessive in amount. ... The [district] court apparently believed this was a case like <u>Janis</u>, where the circumstances are such that the government's assessment is without effect. It is not. ... [A]n assessment excessive in amount, without more, is not void under <u>Janis</u>. For the assessment to be void, it must be more than incorrect, for the correctness of the amount assessed is quite irrelevant. It must be arbitrary in the sense that the calculation has no support and the true amount of tax owed is incapable of being ascertained. Thus, where records supporting an assessment are excluded from evidence, see <u>Janis</u>, <u>supra</u>, or are nonexistent, see <u>Coleman v. United States</u>, 704 F.2d 326 (6th Cir. 1983), so that the basis upon which an assessment is calculated is beyond the knowledge of the court, the assessment is "arbitrary and erroneous." It is beyond saving. Such an assessment, however, does not exist here. There are plenty of records, documents, and other "foundational" items upon which a correct determination of the defendants' liability may be made. Consequently, there was no need to void the assessment. There was at most a need to calculate the correct amount of tax due the government.

By the time that tax refund and other suits involving the merits of a TFRP assessment are sometimes brought to court by the taxpayers or the United States, it is not uncommon for the Service to have destroyed or lost some portion of its original records that might potentially be relevant to some aspect of the liability challenged by the taxpayers. In these circumstances, the United States is ordinarily able to show – through the original records it may still have (such as the employer's tax returns or files), documents obtained from neutral third parties (e.g., Secretary of State information, bank signature cards), or the testimony and other information obtained from witnesses related to the employer through discovery – that it has some foundation for its assessment and that the burden of proof should remain upon the taxpayer. In <u>Morales v. United States</u>, 805 F. Supp. 1062 (D.P.R. 1992), the taxpayers argued that the TFRP assessment against them was "naked" because the Service had apparently lost its file with respect to the employer who failed to pay the trust fund taxes at issue. Nevertheless, the district court in <u>Morales</u> found that the

United States presented considerable evidence in that case to show that the TFRP assessments were not lacking an evidentiary foundation, so the burden of proof remained on the taxpayers. In United States v. Tarlow, 98-1 U.S.T.C. ¶ 50,473 (E.D.N.Y. 1998), the taxpayers sought to dismiss a TFRP assessment as invalid and lacking a rational foundation because the Service had apparently destroyed its original administrative file recommending the TFRP assessment against the taxpayer and the Service's revenue officer who made the TFRP recommendation had since retired and could not be located. Since the taxpayers and/or the United States had apparently earlier made and retained copies of some of the pertinent records from the later destroyed TFRP file and the Service was going to provide the taxpayers either with a Certificate of Destruction or with an affidavit explaining the efforts it had made to locate the missing TFRP file, the district court concluded that it was not presented with a "naked assessment" case and it held that the presumption of correctness for the TFRP assessment remained.[15]

In another recent tax refund case involving a TFRP assessment and a missing administrative file of the Service with respect to the TFRP recommendation, Judge Francis Allegra of the U.S. Court of Federal Claims provided a thoughtful analysis of the meaning of the Janis and Coleman cases, and the possible effect of a "naked assessment" on the burden of proof in the taxpayer's case in chief (for refund of the paid portion of the TFRP assessment) and on the counterclaim of the United States (for the unpaid balance of the TFRP). See Cook v. United States, 46 Fed. Cl. 110 (Fed. Cl. 2000). In the Cook case, the court found that it could not determine whether the Service's loss of the TFRP recommendation file for the taxpayer gave rise to a "naked assessment" until the time of trial, when the United States would first be given an opportunity to show a foundation for the TFRP assessment. Judge Allegra noted, Cook at 114-5, that the Government's evidence to establish a foundation for a TFRP assessment need not include any documents or information that were originally in its possession when the TFRP assessment was made, as follows:

> As described in Janis and its progeny, however, an assessment is not "naked" simply because the administrative file supporting its entry is lost – what is critical, given the de novo nature of the proceedings before this court, is that admissible evidence exists to support the assessment. [citations omitted]. If such evidence exists, and is admitted by the court, it is irrelevant whether it is the same evidence that the Service relied upon in originally making its assessment. ... Indeed, consistent with the "no-look" doctrine, courts have repeatedly held that the government may support a tax assessment based on any admissible evidence, including that first disclosed in discovery, and conversely, need not rely solely, or at all, on the evidence reviewed administratively by the Service.

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[15] At the eventual trial of the Tarlow case, the Government was ultimately unsuccessful. See United States v. Tarlow, 99-1 U.S.T.C. ¶ 50,338 (E.D.N.Y. 1999).

Issue 5: Appeals/Collection Coordination re Missing TFRP Information

In a taxpayer's CDP hearing or equivalent hearing case, where the merits of an unpaid TFRP liability are properly at issue (because the issue was timely raised by the taxpayer, and consideration of the merits is not precluded), the Appeals function should be no less deferential than the courts have been in affording the Service an opportunity to reestablish an appropriate foundation for a TFRP liability where all or part of the Service's original file recommending the TFRP assessment has been destroyed. In keeping with the independent review mission of the Appeals function, however, it is not the responsibility of the Appeals function to attempt to reassemble or gather the information necessary to provide a foundation for a TFRP assessment when the Service's file recommending the TFRP has been destroyed. Instead, as with other Appeals function hearing matters where further factual development of a Collection function case is necessary to make a full and fair determination, the Appeals function should retain jurisdiction of the case but refer the matter back to the Collection function for an appropriate time period.[16] The Collection function may then determine, under the particular circumstances of the case, whether it would be a cost effective use of its resources in that case to attempt to gather foundational evidence to support the unpaid TFRP liability.[17]

An appropriate model of Appeals/Collection function coordination may be found where a taxpayer protests a proposed TFRP assessment to the Appeals function. When the Collection function issues 60 day preliminary notices of proposed TFRP assessments to taxpayers, pursuant to section 6672(b), the Service's original file recommending the TFRP should almost always be readily available for consideration by the Appeals function. If a taxpayer files a timely protest to such a 60 day notice, the Appeals function still may decide that it is appropriate to retain jurisdiction of a case but to hold its consideration in suspense while matters requiring further factual development are referred back to the Collection function. In these cases of timely protests from 60 day notices, the time allowed by the Appeals function to the Collection function for further factual development is ordinarily at least 45 days, with extensions possible by mutual agreement of the parties. See IRM

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[16] A Form 2209 or another locally acceptable form may be used for this purpose. See IRM 5.1.9.3.6:(12) and 8.7.1.1.9.12:4.

[17] Whether or not the Service has retained the TFRP recommendation file for older TFRP liabilities should be an issue of lessening importance in a CDP context in future years. First, most taxpayers who were issued 60 day notices of proposed TFRP assessments pursuant to section 6672(b) (after June 30, 1996) should find that consideration of the merits of the TFRP liability is precluded in a CDP hearing or equivalent hearing. Second, most taxpayers who are liable for a TFRP liability in future year cases should be receiving their one CDP hearing notice per period much earlier in the collection process, and therefore be precluded from receiving a CDP hearing or equivalent hearing for the same liability when collection activity is again contemplated closer to the expiration of the collection limitation period for the liability.

8.11.1.8.8:(3). While these 60 day notice TFRP cases are being further developed by the Collection function, the Service does not assess the TFRP and, therefore, the taxpayer should not be prejudiced by the delay.

While it is generally desirable for the Appeals function to conduct and conclude its CDP hearings and equivalent hearings as expeditiously as possible, there are no time limits by law or regulation on when the Appeals function must issue its Notice of Determination or Decision Letter in a case. See Temp. Treas. Reg. § 301-6330-1T:(e)(3)Q&AE8. Moreover, while a CDP hearing case is pending with the Appeals function, the proposed levy action by the Collection function that was the subject of the requested hearing is generally suspended. I.R.C. §§ 6330(e) and (f). When a taxpayer properly requests an equivalent hearing, the Service's proposed levy action is not automatically suspended, but the Appeals function may also request on a case-by-case basis that the Collection function suspend its proposed levy action in appropriate circumstances. See Temp. Treas. Reg. § 301-6330-1T:(i)(2)Q&AI-3. When the merits of a TFRP liability are properly at issue in a taxpayer's equivalent hearing request and the Collection function wants further time to reestablish the foundation for a TFRP liability because its original file recommending assertion of the TFRP has been destroyed, it would generally be appropriate (absent jeopardy circumstances) for the Collection function to agree to suspend its proposed levy action while an equivalent hearing case is pending with the Appeals function. Accordingly, while these CDP hearing or equivalent hearing TFRP cases with missing files are being further developed by the Collection function, the prejudice caused to the taxpayer by reasonable delays in the hearing process should be minimal.[18]

Therefore, as with 60 day notice cases involving the TFRP, it is appropriate for the Appeals function in a CDP hearing or equivalent hearing case to allow the Collection function no less than 45 days to decide whether to and to complete reconstruction of any necessary foundation evidence for a TFRP liability that is properly challenged by a taxpayer on the merits when the Service's original file recommending assertion of the TFRP has been destroyed. When the Collection function decides that it is cost effective for the Service to reconstruct the evidence supportive of the unpaid TFRP liability in these circumstance, but more than 45 days are required by the Collection function for this task, we believe the Appeals function should generally agree to reasonable extensions of the initial 45 day period. In some cases of this type, we expect the Collection function will decide that attempting to reconstruct the evidence is not a cost effective use of the Service's resources. The Collection function alone or the Collection and Appeals functions together may recommend advance selection tolerances to apply in these circumstances, with appropriate coordination and approval through the new SBSE structure. Such tolerances may be varied locally, with appropriate approval from the new SBSE structure, because workload and general deterrence considerations may differ in various parts of the country.

[18] During hearing process delays of this type, interest will admittedly continue to accrue on the assessed TFRP liabilities that are unpaid.

OFFER IN COMPROMISE - JOINT AND SEPARATE LIABILITIES

October 26, 2000

GL-809174-99
UILC: 17.00.00-00

MEMORANDUM FOR DISTRICT COUNSEL, PACIFIC-NORTHWEST DISTRICT SEATTLE

FROM: Kathryn A. Zuba
Chief, Branch 2 (Collection, Bankruptcy and Summonses)

SUBJECT: Offers-in-Compromise - Forms 656 and Conjunction Language

This memorandum responds to your memorandum electronically mailed July 28, 2000, asking questions about the number of offers that should be accepted from spouses who seek to compromise joint and separate liabilities. This document is not to be cited as precedent.

ISSUE

When spouses owe both joint and separate liabilities and submit separate offers at the same time, should the Service require that the offers include a clause stating that the offers are submitted in conjunction with each other, and that failure to pay the entire amount of both offers will result in a default of both offers?

CONCLUSION

When spouses owe both joint and separate liabilities and submit separate offers at the same time, the Service should not require that the offers include a clause stating that the offers are submitted in conjunction with each other, and that failure to pay the entire amount of both offers will result in a default of both offers.

DISCUSSION

In your memorandum you raise questions regarding offers in compromise from spouses who wish to compromise joint and separate tax liabilities. You state that in these situations it is sometimes necessary for the spouses to submit one, two, or three Form 656 offers in compromise. You noted manual provisions that specify how many forms should be filed. The IRM provides that if the taxpayer is solely responsible for one liability and jointly responsible for another, and both joint parties are submitting the offer, two offers must be submitted; one for the separate liability and one for the joint liability. IRM 5.8.1.5.c.[19] You stated that you understood such provisions to be general in nature, and are not intended to cover every taxpayer in every situation. You have advised the Service to require the number of Forms 656 as are appropriate in their judgment under the circumstances of each case and in light of the IRM. The Service has asked, for purposes of consistency and clarity, for more specific guidance in this regard. You ask us if such guidance is possible, and if so, what should that guidance be.

Similarly, you were concerned that when more than one offer is required, the amount offered on each Form 656 may not reflect the reasonable collection potential of the offeror(s), because the amount the couple offers to compromise all their liabilities is divided among the offers. This would be the case where the couple submits a joint offer for joint liabilities, and separate offer(s) for separate liabilities, as directed by IRM 5.8.1.5.c. You also state that in this situation there is a potential that taxpayers could selectively default on one offer (e.g., an old or small liability) and satisfy another (e.g., a new or large liability).[20] Thus, taxpayers could escape certain liabilities without paying the full amount the Service would otherwise require in a compromise.

To minimize this potential problem, and so that each offer reflects reasonable collection potential, your office has advised that the following language be added to each Form 656:

> This offer is submitted in conjunction with an offer submitted by [the other taxpayer] dated [date] in the amount of [$x]. The sum of these offers in [$y]. Failure to pay the entire amount of [$y] will result in a default of both offers.

Finally, you raised concerns arising from community property law. In some community property states, the income of one spouse may sometimes be used to satisfy the liabilities of the other. Also, in some community property states the entire amount of community property (rather than just the spouse's share) may be used to satisfy joint liabilities. Thus, were the couple to submit multiple offers, the sum of the acceptable amounts of the offers would exceed the amount the couple could pay.

We have advised the Service against the use of conjunction clauses. When such clauses are used, the Service makes one spouse's compromise dependant upon the other spouse's payment from separate assets and/or income. This is plainly inconsistent with section 3462(d)(2) of the IRS Restructuring and Reform Act of 1998. That section instructed the Service to notify taxpayers of their right to the continued benefits of a compromise when the other party to the compromise has breached the agreement.

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[19] See also IRM 5.8.3.3(6) and (8), directing the Service to seek corrected offers if a joint offer is submitted for both joint liability and separate liability.

[20] Similarly, one liability could be dischargeable in bankruptcy, and the other not.

Further, there is effectively no difference between two offers with conjunction clauses, and one joint offer that compromises both joint and separate liabilities. The Service does not usually require spouses to submit joint offers, even when only joint liabilities are at issue. See IRM 5.8.1.5.a (if there is a joint liability *and both parties wish to make the offer*, both names must be shown), IRM 5.8.1.7(1) (taxpayers who are jointly liable for the same tax liabilities *may submit* a joint offer) (emphasis added).

A better solution that could be used in cases where selective default could be a problem, IRM 5.8.1.5.c notwithstanding, would be to require separate offers from each spouse in compromise of all of his or her liabilities. Service procedures already allow a spouse to make a separate offer compromising both joint and separate liabilities when only that spouse is submitting an offer, and effectively require separate offers in situations where the Service has decided not to consider joint offers. See IRM 5.8.1.5.b, IRM 5.8.1.7(2).[21] When separate offers are made for separate liabilities, the Service determines each spouse's share in the value of jointly owned property. See IRM 5.8.5.3.6, IRM 5.8.5.3.9(3), and IRM 5.4.5.4. There is a presumption that the value of the spouse's interest in joint or tenancy by the entirety property is 50%, though the Service will use a different allocation if taxpayers can demonstrate otherwise. Id. When determining one spouse's income, the Service will generally not consider the other spouse's income except where state law allows, such as community property states. IRM 5.8.5.6. Household expenses are allocated based on the spouse's percentage of household income, unless the taxpayer can demonstrate a different allocation is appropriate. Id. This calculation could be used when spouses are making separate offers in compromise of joint and/or separate liabilities at the same time. Of course, the sum of the couple's separate offers should equal the total amount collectible from the couple.

When both spouses seek to compromise tax liabilities at the same time in community property states, the acceptable amount of each offer can be calculated in much the same way. The Service could start with the presumption that each is entitled to 50% of community property, but allow the taxpayers the opportunity to show that there should be some other division of assets and income under community property law and the facts of the case. For example, there could be a pre-nuptial agreement that changes the property rights of the spouses. The sum of the offers should again total the reasonable collection potential of the couple. The Service's rights under community property law are adequately protected in most cases. If one spouse defaults the Service can still, in its discretion,

[21] IRM 5.8.1.5.b. directs that if only one spouse is seeking to compromise both joint and separate liabilities, he or she should submit one offer. IRM 5.8.1.7(2) states that a joint offer will not be considered when taxpayers are no longer maintaining a marital relationship, one taxpayer is asserting that he or she is not liable for all or some portion of the tax liability, the taxpayers are attempting to allocate responsibility for portions of the tax or payment of the compromise amount, or the taxpayers have elected separate or proportionate liability subsequent to the filing of their joint return.

exercise its right to collect that spouse's taxes from the other spouse's assets and income under community property law. A provision could be added to the respective offers clarifying this point.

By accepting separate offers from each of the spouses that reflect the assets and income of each, neither spouse will get the benefit of a compromise of any tax liability until they have paid an amount the Service has determined to be collectible from that spouse. This would seem to us to resolve the problem of selective default.

We should also address your concern that when the Service considers two offers from the same taxpayer, as when there is one offer for joint liabilities and one offer for separate liabilities, neither offer reflects the reasonable collection potential of that spouse. Policy Statement P-5-100 states that the Service will accept an offer when it is unlikely that the tax liability can be collected in full, and the amount offered "reasonably reflects collection potential." If the Service were to consider the other spouse's income and share in community property in both offers, the sum of separate offers from the spouses in community property states would also exceed the couple's ability to pay. In these situations the same assets and income could be collected in satisfaction of liabilities underlying both offers, and, therefore, could be considered in each offer. However, the Service can only collect the same assets and income once. Thus, we think that where both the offers together reflect all the assets and income that can reasonably be collected from the taxpayers, each offer reasonably reflects collection potential.

BANKRUPTCY; AUTOMATIC STAY; REFUNDS

November 2, 2000

CC:PA:CBS:Br2
GL-604422-00
UILC: 09.08.01-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SBSE), AREA 3
CC:SB:3:NAS

FROM: Kathryn A. Zuba
Chief, Branch 2 (Collection, Bankruptcy & Summonses)

SUBJECT: Retention of Refunds in Chapter 13 Cases

This is in response to the request for advice dated July 28, 2000, from District Counsel, Kentucky-Tennessee District.

ISSUE: Whether the failure to pay a claimed refund for a prepetition tax period pending examination of the return for which the refund is claimed during a Chapter 13 case violates the automatic stay, B.C. § 362(a)?

CONCLUSION: The Service's failure to pay a refund for a prepetition tax period which is under examination and for which the Service has not yet determined there is an overpayment does not violate the automatic stay.

BACKGROUND: You have presented two hypothetical examples [22] which we will summarize as follows:

Example 1: Taxpayer filed a Chapter 13 case in January 2000. The Service filed a priority claim for $1,700 for 1998, and an unassessed priority claim for 1999 for $1,700. After the petition is filed, taxpayer submitted a claim for refund for $1,300 for 1999 as part of his 1999 return. The Service does not issue the refund because of problems identified in the return and instead selects the return for examination. A TC 420 code is input on taxpayer's account to prevent issuance of the refund pending the examination.
Pursuant to normal procedures, this examination may take more than a few months.

Example 2: Taxpayer filed a Chapter 13 case in January 2000. The Service filed a priority claim for $1,700 for 1996, and an unassessed priority claim for 1997 for $1,700.
Prior to the time the bankruptcy petition was filed, taxpayer submitted a claim for refund for 1997 for $1,300 which the Service did not issue because it selected the 1997 return for examination. Shortly after the bankruptcy petition is filed, the Service completes the examination for 1997 and two weeks after the bankruptcy petition the Service issues a thirty-day notice of deficiency for $1,700. The Service continues to retain the refund by use of the TC 420 code.

You state that pursuant to the authority of United States v. Norton, 717 F.2d 767 (3d Cir. 1983), and Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995), an indefinite retention of a refund may violate the automatic stay. You, thus, conclude that in Example 1, the Service must expedite the examination, since the retention of the claimed refund for the extended period that it normally takes to complete an examination may constitute a violation of the automatic stay. You request our assistance in establishing guidelines for how long Examination should have to complete an audit before being required to release a claimed refund to ensure that the automatic stay is not violated.

You conclude that in Example 2, after the notice of deficiency is issued the Service is not violating the automatic stay because it has completed the examination and has determined that no refund is due. You ask, however, whether the automatic stay is violated during the period from the filing of the bankruptcy petition to the date the thirty day notice is issued.

DISCUSSION: We conclude that the Service's decision not to immediately honor a claim for a refund based on a return the Service has selected for examination is not a violation of the automatic stay. Thus, the Service does not violate the automatic stay in both examples.

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[22] We will not separately address your third hypothetical since we do not believe it raises any issues which are not already raised by Examples 1 and 2.

Depending on the facts of the case, the following provisions of the automatic stay may arguably be implicated by the retention of a refund: section 362(a)(3) (prohibiting an act to obtain possession of property of the estate or to exercise control over property of the estate); section 362(a)(6) (prohibiting any act to collect or recover a prepetition claim against the debtor); and section 362(a)(7) (the setoff of any prepetition debt owing to the debtor against any claim against the debtor).

As a preliminary matter, we note that even after the Service determines that there is an overpayment and that a refund is due to the taxpayer, neither sections 362(a)(3) nor 362(a)(6) would be violated by the retention of such refund. The Supreme Court in Citizens Bank held that a bank's freeze of the debtor's bank account did not violate sections 362(a)(3) and (6) because the bank did not exercise dominion over property belonging to the debtor. The Court explained that a bank account is only a promise to pay from the bank to the depositor and, thus, the bank's temporary refusal to pay was not an exercise of control over debtor's property but merely a refusal to perform its promise. 516 U.S. 21. Based on the analysis in Citizens Bank, the retention of a tax refund will arguably never violate either sections 362(a)(3) or (6), because the Service is not exercising control over the taxpayer's claim to a refund and is not taking any act to collect or recover a claim against the debtor. Rather, the Service is merely withholding payment of the taxpayer's refund claim. See In re Mountaineer Coal Co., Inc., 247 BR 633 (Bankr. W.D. Va. 2000) (section 362(a)(3) not violated by failure to pay debt owed to the bankruptcy estate).

But even if the retention of a refund owed to the debtor can be considered a violation of sections 362(a)(3) or (6), there cannot be a violation of those provisions until the Service first determines that there is an overpayment. The Service is entitled to take all income, deductions, credits and other adjustments into account before determining the tax due for a particular taxable period for the income tax, and if based on such computations the taxpayer has not made an overpayment of tax under I.R.C. § 6402, the taxpayer is not entitled to a refund. See Lewis v. Reynolds, 284 U.S. 281, 283 (1932) ("An overpayment must appear before refund is authorized.") While the Service is performing the examination to determine whether there is an overpayment, it is not taking an act to obtain possession of property of the estate or to control property of the estate under section 362(a)(3), and is not taking an act to collect or recover a prepetition debt under section 362(a)(6), because it is merely in the process of making a determination as to the correct tax due to determine whether the taxpayer is in fact entitled to a refund under the Internal Revenue Code.

Additionally, the Service is not making a setoff (or a retention of a refund amounting to a setoff) under section 362(a)(7) under these circumstances because it is not seeking to set off a prepetition debt owed to the debtor against a claim against the debtor. Instead, the Service is computing the tax for one taxable period to determine whether or not it owes a prepetition debt (e.g., a refund), or has a prepetition claim, for that period. See Lewis v. Reynolds, supra.

[redacted]

We finally note that once the Service has completed the examination and determined that there is an overpayment for a prepetition taxable period, if the Service were to indefinitely retain such overpayment to preserve its right to set off the overpayment against a tax liability due for another tax period (such as the earlier tax years in both examples), then such retention could possibly violate section 362(a)(7) pursuant to Citizens Bank. In addition, there is case authority for the proposition that the Service cannot exercise setoff rights to collect a prepetition tax debt which is provided for in full in a confirmed Chapter 13 plan that is not in default. Norton, supra; United States v. Reynolds, 764 F.2d 1004 (4th Cir. 1985). Due to litigation hazards presented by this case authority, our position is that after confirmation of a Chapter 13 plan, if the Service does not wish to release a refund to preserve its setoff rights with respect to a tax liability provided for in the plan, the Service should either promptly file for relief from the stay, or, if the plan is in default and taxpayer will not cure the default, seek dismissal of the case. CCDM 34.10.2.6(2); IRM 5.9.4.3.1. Thus, in Example 1, if the Service ultimately determines that a refund is due, it should not retain the refund to preserve its setoff rights with respect to the earlier tax year after confirmation of the plan, assuming that the plan provides in full for the earlier tax liability and is not in default, without seeking relief from the stay.

OFFERS IN COMPROMISE; COLLECTION DUE PROCESS

December 15, 2000

CC:PA:CBS:Br1
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MEMORANDUM FOR SBSE ASSOCIATE AREA COUNSEL (ST. PAUL)

FROM: ALAN C. LEVINE
Chief, Branch 1 (Collection, Bankruptcy & Summonses)
CC:PA:CBS:Br1

SUBJECT: Processing of Offers in Compromise During Collection Due Process Proceedings

This responds to your November 2, 2000, memorandum requesting advice on the above-cited subject. This document is not to be cited as precedent.

The purpose of this memorandum is to provide further clarification of a position first set forth in a June 16, 2000, memorandum for your office on the above-cited topic. [23] The position taken in the June 16, 2000, memorandum was that once a Collection Due Process ("CDP") proceeding was pending in the Office of Appeals ("Appeals"), a Revenue Officer should not separately evaluate an offer in compromise submitted by a taxpayer. Rather, the offer should be referred to Appeals for consideration in conjunction with the CDP proceeding.

In a recent request for advice you have received from your local Territory Manager, it was suggested that this position was inconsistent with prior advice from the National Office indicating that a Revenue Officer should continue to work a collection case (including consideration of an offer) after the taxpayer has requested a CDP hearing, as long as the taxpayer is willing to attempt to reach a resolution with the Revenue Officer. If a satisfactory resolution is reached, the taxpayer may withdraw the CDP hearing request.

Our position is consistent with this advice. We concluded that a Revenue Officer should not be independently evaluating an offer submitted by a taxpayer whose CDP case is "pending" in Appeals. By "pending", we meant that the case file had been transferred to Appeals for Appeals to conduct the CDP hearing. After a taxpayer has requested a CDP hearing, but before the case has been transferred to Appeals, a Revenue Officer can and should attempt to work with a taxpayer to resolve his or her case. If a case can be resolved prior to Appeals consideration, it expedites the process for the taxpayer. If a taxpayer submits an offer to a Revenue Officer <u>after</u> the case file has been forwarded to Appeals for a CDP hearing, however, the offer should be referred to Appeals for consideration as a part of the CDP process.

Specific procedures for coordination of CDP cases with Appeals may be found in IRM 5.1.9.3.6, currently undergoing review by this office. These procedures provide that once a taxpayer submits a written request for a CDP hearing, the Revenue Officer should generally attempt to contact the taxpayer and resolve the issue. If the taxpayer is willing to cooperate, the Revenue Officer should attempt to reach a resolution within 45 days after receipt of the taxpayer's CDP request. If the issue is not resolved within 45 days, but the taxpayer is willing to continue to negotiate an agreement with the Revenue Officer, and a manager concurs that resolution is likely in the near term, the Revenue Officer may continue to attempt to resolve the case with the taxpayer for up to 90 days after receipt of the taxpayer's CDP request. If the issue is resolved, the taxpayer may withdraw in writing the request for a CDP hearing. If the issue is not resolved, or the issue is resolved but the taxpayer is unwilling to withdraw the CDP hearing request, the Revenue Officer should forward the case to Appeals.

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[23] The June 16, 2000, memorandum was subsequently modified by an August 24, 2000, memorandum for your office, with respect to an issue not relevant to the present discussion.

As a final note, communications between Revenue Officers and Appeals employees with respect to CDP cases will be subject to the new ex parte requirements, which were referenced in the June 16, 2000, memorandum. Section 1001(a) of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-296, 112 Stat. 685, requires the Internal Revenue Service ("Service") to develop a plan to prohibit ex parte communications between Appeals officers and other Service employees that appear to compromise the independence of Appeals officers. Guidance concerning the ex parte provisions, including their applicability in CDP proceedings, has now been finalized in Rev. Proc. 2000-43, 2000-43 I.R.B. 404.