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JULY 2000 ***BULLETIN NO. 478***

COLLECTION, BANKRUPTCY AND SUMMONSES BULLETIN

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

COLLECT QUICKLY
Sixth Circuit Denies Equitable Tolling in Bankruptcy

Adding to a growing minority of circuits, the Court of Appeals for the Sixth Circuit denied priority status to federal taxes under the "plain language" of B.C. § 507(a)(8)(A)(i) and § 523(a)(1)(A), finding taxes assessed more than three years prior to the debtor's Chapter 7 bankruptcy filing to be dischargeable despite the debtor's intervening Chapter 13 case in **Palmer v. United States, 2000 U.S. App. LEXIS 16115 (6th Cir. July 14, 2000)**. The court also ruled that although tolling is within the bankruptcy court's power under B.C. § 105(a), tolling was not warranted in this case.

The debtor owed federal taxes, filing for Chapter 13 bankruptcy in February 1993. The case was voluntarily dismissed in June 1995, with the debtor having made minimal payments. Once the automatic stay was lifted, the Service assessed 1991 and 1992 taxes and filed Notices of Federal Tax Lien. The debtor then filed for Chapter 7 relief in August 1997. The Service filed proofs of claim for 1991-92, which the debtor objected to. The debtor argued that those taxes were dischargeable as being outside the three-year lookback period of B.C. § 507(a)(1)(A)(i). The bankruptcy court agreed, and further refused to toll the lookback period under section 105(a). According to the bankruptcy court, tolling under section 105 could occur only if the Service proved debtor misconduct. Since the Service failed to prove misconduct, the taxes were dischargeable.

The Bankruptcy Appellate Panel reversed, finding Congressional intent that the Service should have a full three years to collect unpaid taxes to control over the statutory language. On appeal, the Sixth Circuit quickly dismissed this approach. Finding the statutory language unambiguous, the court found no reason to look for legislative intent. The plain meaning of the statute, the court held, was that taxes are dischargeable if they arise from a tax return due more than three years prior to the filing of the Chapter 7 petition.

The Sixth Circuit also easily rejected the argument that B.C. § 108(c) permits tolling, finding that this section refers to applicable *nonbankrutpcy* law, which sections 507 and

523 clearly are not. The court found the appellate cases relying on section 108 unpersuasive. However, the court agreed that section 105(a) may be used by a bankruptcy court for equitable tolling. The Sixth Circuit expressly determined that section 105 was not applicable as a matter of law, but that its use would be at the discretion of the bankruptcy court. As to when a bankruptcy court should apply section 105(a), the court held only that because the debtor was not found guilty of misconduct or manipulation of the bankruptcy system, it would uphold the bankruptcy court's decision not to equitably toll the statute of limitations in this case.

BANKRUPTCY CODE CASES: Statute of Limitations: On Collection After Assessment: Suspension under Bankruptcy Code

CASES

1. **ASSESSMENTS: Abatement**
REFUNDS
WAIVERS: Assessment
Wechsler v. United States, 2000 U.S. Dist. LEXIS 7512 (S.D.N.Y. June 2, 2000) - Taxpayers were involved in two limited partnerships which the IRS audited. The tax matter partners (TMP) of the limited partnership were under criminal investigation and signed waivers to extend the statute of limitations as to the partnerships. The limited partners collectively argued that the waivers were invalid because they were signed while the TMPs were under criminal investigation. The Second Circuit agreed but remanded to the district court to consider the Service's alternative argument that a 6 year statute of limitations applied due to tax fraud. When the IRS continued to attempt to collect from taxpayers, the district court granted taxpayer's claim for abatement of an assessment and collection action pursuant to I.R.C. § 7486. Section 7486 states that when a bond has not been filed with the tax court and the tax court determines a deficiency that is later disallowed by a court of review, the disallowed amount must be credited or refunded to the taxpayer.

2. **ASSESSMENTS: Procedures**
United States v. Silkman, 2000 U.S. App. LEXIS 17253 (8th Cir. July 19, 2000) - Taxpayer challenged conviction for tax evasion because certificate of assessment was based on substitute returns. The Eighth Circuit held that unchallenged certificates of assessment were prima facie evidence of a deficiency where the taxpayer filed no return.

3. **BANKRUPTCY CODE CASES: Jurisdiction of Bankruptcy Court**
In re Donahue, 86 AFTR2d ¶ 2000-5057 (Bankr. D. Mass. May 19, 2000) - Debtor paid tax claims through confirmed Chapter 13 plan. When Service then sought to collect from his non-bankruptcy wife, debtor re-opened his Chapter 13 bankruptcy. The United States moved to dismiss, arguing that the bankruptcy court lacked subject matter jurisdiction to determine whether the wife had tax liability. The bankruptcy court ruled that, since a determination of whether the wife's joint liability was satisfied is a question arising under B.C. § 505(a), and consequently the court does have subject matter jurisdiction over the question.

4. **BANKRUPTCY CODE CASES: Jurisdiction of Bankruptcy Court**
INNOCENT SPOUSE
French v. United States, 2000 Bankr. LEXIS 536 (Bankr. N.D. Ohio April 27, 2000) - In a follow-up case to the one reported in the February 2000 GL Bulletin, the bankruptcy court ruled that it lacked subject matter jurisdiction to consider innocent spouse relief under I.R.C. § 6015(f). Under the plain language of the statute, relief under section 6015(f) is administrative, and is not subject to judicial review.

5. BANKRUPTCY CODE CASES: Statute of Limitations: On Collection After Assessment: Suspension under Bankruptcy Code

In re Schultz, 2000 Bankr. LEXIS 620 (Bankr. D.N.H. May 2, 2000) - Debtor challenged Service's proof of claim, arguing that taxes were outside the three-year lookback period of B.C. § 507(a)(1)(A)(i). The court held that the lookback period was tolled by the debtor's prior bankruptcy under B.C. § 108(c). Further, the court held that the three-year lookback period was tolled an additional six months I.R.C. § 6503(h)(2), based on West v. United States, 5 F.3d 423 (9th Cir. 1993).

6. COLLECTION DUE PROCESS

Johnson v. Commissioner, 2000 U.S. Dist. LEXIS 8320 (D. Or. May 24, 2000) - Taxpayer did not timely request collection due process (CDP) hearing, so was given an "equivalent" hearing under Reg. § 301.6330-1t(i). Reviewing the administrative denial of relief, the district court first held that the requirement that the request for a CDP hearing be in writing was consistent with I.R.C. § 6330 and legislative intent. Next, the court held that there was no provision for judicial review of the Service's determination in an equivalent hearing. Finally, the court refused to award relief under I.R.C. § 7433 because the Service was not required to suspend levy action during the pendency of an equivalent hearing.

7. INTERPLEADER

LIENS: Priority Over Security Interests

Allied Mutual Ins. Co. v. Midplains Waste Management, 2000 Neb. LEXIS 146, 259 Neb. 808 (Neb. June 23, 2000) - The court held that the United States' claims to interpled funds were superior to a holder of a security interest because the holder's financing statement was inadequate under Neb. UCC § 9-402. The court rejected the argument that the holder "substantially complied" with the statute because the financing statement did not provide the information necessary for a reasonably diligent researcher to be on notice of a security interest. The court also rejected the argument that the federal tax liens could not attach to the interpled funds because those funds were not "proceeds" under UCC § 9-306. The court found instead that, under federal law, tax liens attached to all property and rights to property of the taxpayer. Because the interplead funds were insurance proceeds paid as a result of the destruction of the taxpayer's property, those funds also were the taxpayer's property.

8. LEVY: Retirement Benefits

McIntyre v. United States, 2000 U.S. App. LEXIS 16012 (9th Cir. July 13, 2000) - The court held that a non-delinquent spouse did not have exclusive rights to one-half of the delinquent spouse's community property, so as to prevent levy of a pension fund. The court reaffirmed that a tax lien reaches all community property assets. The court also held that the Service's authority to levy a retirement account was not limited by ERISA's anti-alienation provision.

9. LEVY: Sale

Koby v. United States, 2000 U.S. Claims LEXIS 128 (Ct. Cl. June 21, 2000) - Purchaser of apartment complex filed suit after Service voided the sale and refunded his money (due to improper redemption notice to taxpayer) and after another party purchased the property (for a lesser amount) at the subsequent sale. The court found that the revenue officer who conducted the sale had actual authority to bind the Service, and so a tax sale contract existed. Because the taxpayer did not actually redeem the property, the court found the United States' failure to provide a deed to the first purchaser was a breach of the tax sale contract. The court reasoned that the Government's failure to provide proper redemption notice made the sale voidable at the option of the taxpayer, but not automatically void.

10. LEVY: Wrongful
LIEN: Place to File: Personal Property

Merisel of Americas, Inc., v. United States, 2000 U.S. Dist. LEXIS 3359 (D. R.I. Feb. 22, 2000) - Creditor sought assets of liquidating debtor; however, the Service had already seized the assets. Creditor sued the United States for several reasons, including fraud, and the magistrate recommended that the IRS was entitled to summary judgment. The court stated that the claim was untimely under I.R.C. § 7426(b) because creditor brought the action more than nine months after the seizure and rejected creditor's argument that the statute of limitations was tolled by bankruptcy and the alleged fraud. The court also decided that the United States perfected its lien under I.R.C. § 6323(a) by filing with the local recorder of deeds instead of the secretary of state.

11. LIENS: Priority over Attorneys

Centix-Landis Construction Co., Inc. v. United States, 86 AFTR2d ¶ 2000-5032 (E.D. La. May 9, 2000) - Attorney claimed priority to interpled funds over prior filed federal tax lien. The court found that the attorney was not entitled to superpriority under I.R.C. § 6323(b)(8) because there was no judgment or settlement in the case. The court declined to equate an interpleader complaint with a settlement, nor would the filing of such a complaint give rise to an equitable lien for attorney's fees.

12. LIENS: Priority over Divorced Spouse

Harless v. United States, 98 F.Supp.2d 1337 (S.D. Ala. 2000) - Taxpayer and wife were divorced in 1991, and the wife recorded the divorce judgment in July 1992. In August 1992, the Service assessed the taxpayer, recording a Notice of Federal Tax Lien in 1996. The Service argued that the divorce judgment was not properly perfected because it did not identify the property subject to lien nor the amount of the lien. The court disagreed, finding that the lien was properly recorded even though the wife, rather than the divorce court, created the lien. Further, the court found that the divorce judgement was for a sum certain, even though the payment terms were indefinite.

13. LIENS: Priority over Mortgages: Unrecorded

United States v. Fagin, 2000 U.S. Dist. LEXIS 7332 (W.D. Tex. May 4, 2000) - Court ruled that parent's loans to taxpayer, which predated Service's filing of tax liens, gave lien priority to parents. Taxpayer assumed mortgage when he purchased his house, using his parent's funds. In exchange, he signed notes to his parents, which were not recorded until after federal taxes were assessed. The court held that under Texas law, the parents had an equitable lien that was not required to be recorded. Additionally, the loans were not fraudulent transfers because the parents, by virtue of their loans, were equitably subrogated to the prior mortgageholder.

14. LIENS: Priority Over Security Interests

Wayne County Board of County Comm'rs v. Mendel, Inc., 2000 U.S. Dist. LEXIS 9706 (E.D. Ohio May 30, 2000) - Service and surety company both claimed funds from a construction project. The court held that the Service had priority because the taxpayer completed the project and thus was entitled to the funds, a right to which the tax lien could attach. The surety company was not entitled to equitable subrogation because its lien could not be choate before the subcontractors were entitled to payment, which did not occur until after the tax liens arose. Further, the surety company did not file a financing statement, and therefore was not entitled to superpriority under I.R.C. § 6323(c).

15. LIENS: Priority over Trusts or Receivers

United States v. Murray, 2000 U.S. App. LEXIS 15656 (1st Cir. July 6, 2000) - A husband and wife placed their residence in a trust naming themselves as two of the three trustees and as sole beneficiaries. One year later the couple divorced and the husband signed over his interest in the trust as part of the settlement agreement. The transfer deed was recorded two weeks after the IRS recorded a notice of tax lien against the husband's interest in the trust. The United States brought suit to enforce the lien and the court of appeals held that under state law the tax lien was valid as to the husband's interest in the trust and will attach to his interest once the trust expires. Relying on Drye v. United States, 120 S. Ct. 474 (1999), and its holding that labels like "vesting" and "nonvesting" under state law are not determinative, the court held that the husband's interest in income and corpus constitutes property and once the federal lien attached, his interest could not be terminated by the trustees.

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

In re Aboody, 250 B.R. 1 (Bankr. D. Mass. 2000) - Taxpayer was the treasurer of the family business, oversaw the bookkeeping staff, and paid bills. Nevertheless, the bankruptcy court, following Vinick v. Commissioner, 110 F.3d 168 (1st Cir. 1997), determined that the question of whether an individual was a responsible person under I.R.C. § 6672 was primarily a question of who decides whether or not to pay taxes. The court rejected the analysis of Roth v. United States, 779 F.2d 1567 (11th Cir. 1986) (emphasizing the individual's status, duty and authority to pay taxes), concluded that the taxpayer did not make management decisions, and so was not a responsible person.

17. PENALTIES: Failure to Collect, Withhold or Pay Over: Willfulness
Macagnone v. United States, 86 AFTR2d ¶ 2000-5076 (M.D. Fla. June 13, 2000)
- The district court affirmed the bankruptcy court's holding that the taxpayer was not liable for the Trust Fund Recovery Penalty under I.R.C. § 6672. Although the taxpayer formed the subject corporation, was its president and a shareholder, provided all of its initial capitalization, and provided 80% of the funds necessary to run the company before it filed for bankruptcy, the taxpayer testified that he was unaware that the employment taxes were not being paid. The court held that without notice of prior delinquencies, the taxpayer's failure to inquire whether taxes had been paid does not amount to a finding of willfulness.

The following material was released previously under I.R.C. § 6110. Portions may be redacted from the original advice.

CHIEF COUNSEL ADVICE

TRUST FUND RECOVERY PENALTY; REFUNDS

CC:EL:GL:Br2
TL-N-7246-99

April 20, 2000

UILN: 82.00.00-00
28.00.00-00

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL
KANSAS-MISSOURI DISTRICT, KANSAS CITY

FROM: Joseph W. Clark */s/ Joseph W. Clark*
Acting Chief, Branch 2 (General Litigation)

SUBJECT: Trust Fund Recovery Penalty - Erroneous Refund

This responds to your request for Significant Service Center Advice dated January 21, 2000. This advice is not binding and is not to be cited as precedent.

ISSUE

Whether an erroneous refund of the Trust Fund Recovery Penalty (TFRP) caused by the Service's error in cross-referencing a payment made by another responsible person can be recovered through administrative means.

CONCLUSION

No. The Service must rely on erroneous refund procedures to recover any erroneous refund issued to one responsible person as a result of an error in cross-referencing a payment made by another responsible person.

BACKGROUND

The hypothetical situation you asked us to address can be summarized as follows. A Trust Fund Recovery Penalty (TFRP or penalty) was assessed against two or more responsible persons for the same underling employment tax liability.[1] Although all responsible persons are liable for the full amount of the assessed penalty under the law, it is the Service's policy to collect the liability only once. Policy Statement P-5-60. When one responsible person makes a payment of the TFRP (or when a payment for the trust fund portion of the employment tax liability is received from the corporation), that payment is cross-referenced against the liability of all other responsible persons. See IRM 5.7.7.4; IRM 21.9.7.4.1.14. The payment is posted to the paying responsible person's account with a Transaction Code (TC) 670. The payment is cross-referenced against the other responsible persons' assessments with a Transaction Code 241, reference number 699 (TC 241 RN 699).[2]

When the amount collected from all responsible persons exceeds the amount of the assessed TFRP, including accruals, it is the Service's procedure to refund the excess to the responsible person whose payment caused the overpayment. See IRM 21.9.7.4.1.20. If the amount due from the other responsible person(s) is less than the payment received from the paying responsible person, the Service employee is instructed to input TC 241 RN 699 for the full amount of the payment and then to adjust the module by reversing the excess credit with TC 240 RN 699. IRM 5.7.7.4; IRM 21.9.7.4.1.14. In order to ensure that the excess credit is not erroneously refunded to the other responsible person(s), the module must be monitored until the excess credits are reversed and the module shows a zero balance.

This process can be illustrated by the following example. On April 15, 1998, the Service assesses TFRP against two responsible persons, A & B, in the amount of $9,000 and $10,000, respectively. On June 20, 1999, responsible person A makes a payment of $8,000. A few days later, on July 2, 1999, responsible person B pays $4,000. The payments are properly cross-referenced to the other responsible person's account. A proper refund of $2,000 is issued to responsible person B on August 16, 1999. See Example 1 below.

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[1] I.R.C. § 6672(a) makes "any person" having the responsibility to collect and pay over the employment taxes liable for the penalty. Transaction Code 240 is used to record the TFRP assessment.

[2] Although in the incoming memorandum you refer to this transaction as an abatement, TC 241 RN 699 is actually an adjustment code. See IRM 21.9.1.7.4.3. The reversal of the TC 241 RN 699, therefore, does not constitute a new assessment nor is it subject to the statute of limitation on assessments.

Example 1:

Responsible Person A		Responsible Person B	
TC 240 (4/15/98)	9,000	TC 240 (4/15/98)	10,000
TC 670 (6/20/99)	8,000 -	TC 241 RN 699 (6/20/99)	8,000 -
TC 241 RN 699 (7/2/99)	4,000 -	TC 670 (7/2/99)	4,000 -
TC 240 RN 699 (7/2/99)	3,000	TC 846 (8/16/99)	2,000

On occasion, however, the Service fails to timely adjust the other responsible person's account and the excess credits are erroneously refunded to that responsible person before the account is adjusted to reflect a zero balance. For example, let us assume that in the above described situation the Service did not timely adjust responsible person A's account to reflect a zero balance. As a result, in addition to issuing a $2,000 refund to responsible person B, the Service also issues a $3,000 erroneous refund to responsible person A. See Example 2 below. The question posed by the service center is whether the Service can collect the $3,000 refund administratively or whether it must follow erroneous refund procedures.

Example 2:

Responsible Person A		Responsible Person B	
TC 240 (4/15/98)	9,000	TC 240 (4/15/98)	10,000
TC 670 (6/20/99)	8,000 -	TC 241 RN 699 (6/20/99)	8,000 -
TC 241 RN 699 (7/2/99)	4,000 -	TC 670 (7/2/99)	4,000 -
TC 846 (8/7/99)	3,000	TC 846 (8/16/99)	2,000

LAW & ANALYSIS

While the Service could take a position that a TFRP assessment is satisfied only to the extent of payments made by a taxpayer against whom the penalty was assessed, and not by payments made by other responsible persons, this position would contravene the Service's established policy and procedures. Accordingly, we are of the opinion that when the Service issues an erroneous refund to a responsible person it must pursue recovery of the refund by following proper erroneous refund procedures.

Section 6672 of the Internal Revenue Code imposes personal liability in the amount of the unpaid trust fund taxes upon any person who is required to collect, account for, and pay over such taxes and who willfully fails to do so. I.R.C. § 6672(a). More than one person may be a "responsible person" under section 6672. Slodov v. United States, 436 U.S. 238, 246-50 (1978). Moreover, each person found liable under section 6672 can be held responsible for the total amount of withholdings not paid. There is nothing in the statute that prevents the Government from collecting and retaining from each responsible person the full amount of the penalty. USLife Title Insurance Company of Dallas v. Harbison, 784 F.2d 1238, 1243 (5th Cir. 1986).

While the Service is legally entitled to collect the full amount of the penalty from each responsible person, it has long been the Service's policy to collect the delinquent taxes only once. Policy Statement P-5-60. In accordance with this policy, any amount recovered from one of the assessed responsible persons is cross-referenced to reduce the amount due from the other responsible persons. IRM 21.9.1.7.4.3. See also Kelly v. Lethert, 362 F.2d 629 (8th Cir. 1966). To the extent that the Service collects more than 100% of the assessed penalty, its policy is to refund the excess to the appropriate responsible person. Policy Statement P-5-60; IRM 21.9.7.4.1.20.

With the Service's administrative policy in mind, the courts have been reluctant to allow the Service to recover more than the total amount of withholdings not paid. McCray v. United States, 910 F.2d 1289 (5th Cir. 1990); Brown v. United States, 591 F.2d 1136, 1143 (5th Cir. 1979) ("double recovery by the government is not necessary to fulfill section's 6672 primary purpose – protection of government revenue"). Although in one recent case a court allowed the Service to collect interest and penalties from one responsible person where the Service previously issued an erroneous refund to another responsible person, see Chene v. Chene, 236 B.R. 69 (M.D. Fla. 1999), the weight of the case law and the Service's policy and procedure support a contrary conclusion.

One issue on which courts are in agreement is that once a taxpayer tenders a payment on a tax assessment, the assessment is satisfied to the extent of the payment and an erroneous refund - whether rebate or nonrebate - does not revive a previously paid assessment. See Bilzerian v. United States, 86 F.3d 1067 (11th Cir. 1996); Clark v. United States, 63 F.3d 83 (1st Cir. 1995); O'Bryant v. United States, 49 F.3d 340 (7th Cir. 1995); United States v. Wilkes, 946 F.2d 1143 (5th Cir. 1991). Although generally a taxpayer is not entitled to a credit for another taxpayer's payment, it is the Service's policy and practice to credit one responsible person's account with another responsible person's payment. As such, one responsible person's payment may extinguish another responsible person's liability for the TFRP. See, e.g., McCray v. United States, 910 F.2d 1289 (5th Cir. 1990).

This proposition is more evident when we consider the following example. Let us assume that in addition to the two responsible persons in Example 1 above, the Service also makes an assessment for the same underlying employment tax liability against a third responsible person (C) in the amount of $10,000. Furthermore, let us assume that the erroneous refund is issued to responsible person C rather than to responsible person B, as in Example 2. Thus, the situation before the Service is as follows.

Example 3:

Responsible Person A

TC 240 (4/15/98)	9,000
TC 670 (6/20/99)	8,000 -
TC 241 RN 699 (7/2/99)	4,000 -
TC 240 RN 699 (7/2/99)	3,000

Responsible Person B

TC 240 (4/15/98)	10,000
TC 241 RN 699 (6/20/99)	8,000 -
TC 670 (7/2/99)	4,000 -
TC 846 (8/16/99)	2,000

Responsible Person C

TC 240 (4/15/98)	10,000
TC 241 RN 699 (6/20/99)	8,000 -
TC 241 RN 699 (7/2/99)	4,000 -
TC 846 (8/7/99)	2,000 (erroneous refund)

In order to recover the $2,000 erroneous refund administratively, the Service must establish that the TFRP remains unpaid despite the full payment received from responsible persons A and B. In order to do so, the Service can argue that the TFRP assessment made against C was not satisfied to the extent of the erroneous refund. The courts are not likely to find this argument persuasive, however. See, e.g., O'Bryant v. United States, 49 F.3d 340, 347 (7th Cir. 1995) (erroneous refunds and tax liabilities are simply not of the same ilk; an unsolicited erroneous refund must be handled on its own terms, not under the rubric of an assessed liability). The Service may also argue that since C has not made any payments against the TFRP assessed against him, the Service may collect the entire $10,000, plus accruals, from C. This position, however, is contrary to the Service's administrative policy to collect the TFRP only once. Under current procedures, any payments made or collected from responsible person C would be cross-referenced against the liabilities, if any, of A and B. This application could result in additional erroneous refunds being issued. Furthermore, the only reason the Service would argue that responsible person C in the example above is not entitled to receive a full or partial credit for the payments made by persons A & B is that the Service issued him an unsolicited erroneous refund. Again, this position contravenes the Service's policy and the case law regarding erroneous refunds.

Finally, the Service can argue that no responsible person is entitled to a credit for another responsible person's payment until the Service's right to retain the amount collected is established. See Policy Statement P-5-60. Pursuant to this argument, the Service arguably could collect $1,000 from responsible person A ($9,000 - $8,000), $6,000 from responsible person B ($10,000 - $4,000), and $10,000 from responsible person C.[3] Again, while legally sound, this position contravenes the Service's administrative policy and procedure. Moreover, however, it is not entirely clear whether the Service could apply any of the amounts collected to the liability resulting from the erroneous refund or whether such amounts would constitute overpayments under I.R.C. § 6401.

In conclusion, while the Service could craft an argument that a TFRP assessment is not satisfied for the purpose of collecting an erroneous refund by payments made by other responsible persons, this position would be contrary to the Service's current policy and procedures regarding collection of the TFRP. Accordingly, the Service must rely on erroneous refund procedures to recover any erroneous refund issued to one responsible person as a result of an error in cross-referencing a payment made by another responsible person. See IRM 21.4.5, *Erroneous Refunds*.[4]

HAZARDS & OTHER CONSIDERATION

In your incoming memorandum, you discuss the possibility of collection on the ground that the entry of the TC 241 RN 699 for the full amount of the payment constituted a clerical error which the Service can reverse at any time pursuant to the court's reasoning in Crompton-Richmond Co. v. United States, 311 F. Supp. 1184 (S.D.N.Y. 1970). We do not believe the doctrine of clerical error is applicable to the facts of this case for the following reasons.

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[3] In In re Chene, 82 AFTR.2d 6754 (Bank. M.D. Fla. 1988), *rev'd & remanded*, Chene v. Chene, 236 B.R. 69 (M.D. Fla. 1999), the Government took the position that an erroneous refund of the TFRP to the other responsible person did not affect the debtor's liability for the TFRP assessed against her. Thus, since the debtor did not full pay the assessment, including accruals, the Service argued and the district court agreed, the debtor continued to be liable for the any accrued interest and penalty. It is not clear whether the Service also attempted to collect the unpaid portion of the TFRP from the responsible person who received the erroneous refund.

[4] Please note that this conclusion does not alter our position that the TC 241 RN 699 credits are conditioned upon the Service's right to retain the payment. I.R.C. § 6511; Policy Statement P-5-60. Thus, when the Service issues a refund to a person determined not to be responsible, the Service may reverse the corresponding TC 241 RN 699 entries and continue to collect the TFRP against the remaining responsible person(s).

First and foremost, the entry of the TC 241 RN 699 in the full amount of the payment was neither erroneous nor clerical in nature. As stated above, it is the Service's policy and procedure to cross-reference the payment by entering a TC 241 RN 699 for the full amount of the payment and then adjust the account as appropriate to prevent the excess from refunding to the incorrect responsible person. The only error committed by the Service was its failure to reverse the TC 241 RN 699 in the appropriate amount to zero out the account. While this error may be considered 'clerical,' the Service may correct its errors only as long as the correction does not prejudice the taxpayer. Crompton-Richmond, supra. In the case at hand, the correction of the error would prejudice the taxpayer because, but for the Service's error, the TFRP assessed against the taxpayer would have been considered paid. While the taxpayer continues to be liable, the liability is one for an erroneous refund and not for a TFRP. Accordingly, it is our opinion that the Service cannot rely on the clerical error doctrine to collect the amount erroneously refunded as a tax in reliance on the TFRP assessment.

OFFER IN COMPROMISE; DEED; PROMISSORY NOTE; STATUTE OF LIMITATIONS

February 22, 2000

CC:EL:GL:Br2
GL-609406-99
UILC: 17.31.00-00

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Kathryn A. Zuba
Chief, Branch 2 (General Litigation)

SUBJECT:

This memorandum responds to your request for advice dated November 23, 1999. This document is not to be cited as precedent.

LEGEND

X
Y
Year 1
Year 6
Year 9
Date A
Date B
Amount 1
Amount 2
Amount 3

Amount 4
Amount 5

ISSUE

Whether the Service can, in lieu of taking enforced collection action, accept a promissory note and deed of trust in satisfaction of the taxpayers' tax liabilities, and whether the debts secured by such instruments can be collected notwithstanding the statute of limitations for collection in section 6502 of the Internal Revenue Code.

CONCLUSION

The Service can accept a promissory note and deed of trust and can take judicial action to collect on those instruments even after the expiration of the statute of limitations for collection of the taxes at issue. However, the Service's current collection procedures do not contemplate this kind of agreement. We recommend that a Service-wide policy be promulgated prior to utilizing this approach in individual cases.

BACKGROUND

The taxpayers are a married couple, ages X and Y years old, respectively. They have a history of timely filing all returns and of paying all taxes when due. However, in Year 1, taxpayers netted approximately $Amount 1 from the sale of a piece of real property. The proceeds of the sale were used to pay other debts, and an income tax liability of $Amount 2 went unpaid that year. With penalties and interest, that liability now exceeds $Amount 3.

In June of Year 6, the taxpayers were granted an installment agreement for payments of $Amount 4 per month. In February of Year 9, the case was referred back to Field Collection to obtain updated financial information. Since then, the Collection Division has concluded that an installment agreement is no longer an appropriate resolution of the case because full payment of the liability cannot be achieved. In the mean time, the taxpayers have continued to make timely payments under the existing installment agreement.

The taxpayers have twice submitted offers in compromise based on doubt as to collectibility.[5] Both offers were withdrawn because the taxpayers have been unable to

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[5] Both offers in compromise contained the standard language waiving and suspending the statute of limitations on collection for the period the offer was pending with the Service and for one additional year. See Form 656, (Rev. 2-1999), Item 8(e) & (n). The effect of these waivers was to extend the collection statute until Date A. However, the amendment of section 6502(a) by the IRS Restructuring and Reform Act of 1998 (RRA) limited the Service's authority to secure such waivers to situations in

raise the necessary funds to offer an amount equal to the equity in their home, approximately $Amount 5. According to the district, the taxpayers have been unable to borrow against that equity due to their age.

To avoid seizing the taxpayers' residence, the revenue officer proposed to the taxpayers an arrangement whereby the taxpayers would submit to the Service a promissory note secured by a deed of trust, essentially a mortgage, in favor of the United States. In the promissory note, the taxpayers promise to pay $Amount 4 per month until their liability is satisfied. The deed of trust conveys to the United States a security interest in the taxpayers' residence. As it is unlikely that the taxpayers would be able to pay their liability in full given the size of the liability and the age of the taxpayers, the practical effect of this arrangement would be monthly payments by the taxpayers until their deaths, followed by foreclosure and sale of the residence.

DISCUSSION

As you have you have previously advised the district, courts have long recognized that the Service may accept bonds, letters of credit, or mortgages as a means of securing the payment of taxes, and have upheld the Service's right to collect on such instruments as separate debts not subject to the administrative collection procedures set forth in the Internal Revenue Code. See Royal Indemnity Co. v. United States, 313 U.S. 289 (1941); Gulf States Steel Co. v. United States, 287 U.S. 32 (1932); United States v. John Barth Co., 268 U.S. 370 (1929). In these cases, the taxpayers submitted bonds to protect the Government's interests while requests for the abatement of taxes were considered. Each bond gave the United States the unilateral right to demand payment following a determination by the Commissioner of the correct tax due.

In each of these cases, the taxpayers unsuccessfully argued that the statute of limitations for taking administrative collection action, now codified at section 6502 of the Internal Revenue Code, was a defense to collection by the Government pursuant to the bonds issued by the taxpayers. The Court ruled that the bond created a new cause of action, one not subject to the period of limitations for taking administrative collection or bringing suit. See Royal Indemnity, 313 U.S. at 283; Gulf States, 287 U.S. at 39; Barth, 279 U.S. at 374.

The reasoning of these cases has been expanded to include the collection of debt instruments other than bonds. In Julicher v. Internal Revenue Service, 95-2 U.S.T.C.

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which the waiver is obtained at the same time as an installment agreement. RRA section 3461 also provided that waivers obtained prior to the enactment of RRA, but not in connection with an installment agreement, will expire on the later of the end of original ten year collection statute or December 31, 2002. Since the original collection statute in this case would have expired on Date B, the December 31, 2002, cut-off date applies in this case.

¶ 50,379 (USDC, E.D. Pa. 1995), the taxpayer's bank issued an irrevocable letter of credit in favor of the Service. When the Service attempted to collect, the taxpayer sought to enjoin payment because of the expiration of the ten year period provided by section 6502. The court, relying on Barth and Gulf States, held that the letter constituted a new debt in favor of the Government and not subject to the collection restraints of the Code.

The arrangement the district has proposed is most nearly analogous to that executed in United States v. Citizens Bank, 50 F. Supp. 2d 107 (D.R.I. 1999). In that case, the taxpayers, brothers whose business was faced with imminent seizure, executed a promissory note secured by a mortgage on their father's residence. In upholding the Government's right to collect on the note and mortgage, the court summed up the reasoning of these cases as follows:

> The principle to be derived from Barth and Julicher is that where the government suspends the collection of a tax at the request of a taxpayer, who in turn provides the government with security for later payment, the government is not thereafter bound by the statute of limitations applicable to the original obligation. Instead, the government may proceed against the security provided to it in consideration of its earlier forbearance.

Citizens Bank, 50 F. Supp. 2d at 111.[6]

The conclusion that these arrangements can be enforced notwithstanding the statute of limitations on collection contained in section 6502 is not changed by the recent amendment of that section. Section 3461 of the IRS Restructuring and Reform Act of 1998 amended section 6502 by narrowing the circumstances under which the Service could extend the collection statute by agreement. Prior to this amendment, taxpayers and the Service could agree to extend the collection period at any time. However, effective January 1, 2000, the Service and the taxpayer may only agree to extend the statute: 1) if the extension is executed by the taxpayer in exchange for the Service's release of a levy made prior to the expiration of the ten-year collection statute, or 2) if the extension is agreed to at the same time as the taxpayer and the Service enter into an installment agreement under section 6159. I.R.C. § 6502(a)(2).

While this amendment to section 6502 limited the ability of the Service to obtain waivers of the collection statute, it did nothing to alter the scope of activities to which this period of limitations applies. In the cases cited above, the courts did not find that the bond constituted a de facto waiver of protections of section 6502. Rather, they held that

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[6] It is significant that the mortgage in Citizens Bank gave the Service a security interest in property that was not already subject to the lien created by the failure to pay the tax liability. In the present case, the property which will secure the deed of trust is already subject to the Government's lien and is reachable by levy.

section 6502 was inapplicable to debt instruments submitted by taxpayers in lieu of administrative collection. Given that this limitations period is inapplicable, we conclude that changes to the section do not impact upon the Service's ability to collect on these kinds of instruments.[7]

A decision to accept a debt instrument designed to facilitate collection after the expiration of the collection statute raises significant policy concerns. Over the years, the Service has adopted several policies that limit action taken to extend collection beyond the ten-year statute of limitations. For example, the Code places no limitation on the length of an extension of the collection statute obtained in conjunction with an installment agreement. However, the Service has adopted a policy of limiting such extensions to just one per tax module and for no longer than five years beyond the end of the original ten year collection period. See IRM 5.14, Installment Agreement Handbook, Section 1.7(2). Note also that the Service could preserve the right to proceed against taxpayers in any case by reducing a claim to judgement prior to the expiration of the ten-year collection statute, but does not do so in all cases. Given that the Service does not always take these steps, even when there may be some future collection potential, we recommend that National Office Collection be consulted prior to taking this course of action. Whether the recent amendment of section 6502 can be read as a statement of Congressional intent that the Service normally collect liabilities within ten years, as you have suggested, is one issue to be considered.

As your memorandum noted, the arrangement proposed by the district will not result in full payment of the tax liability at issue. As such, it is essentially a compromise, subject to section 7122 of the Code and regulations issued pursuant to that section. The taxpayers are offering the sum of a stream of payments plus, at some future time, remaining equity in their personal residence. Should the Service determine that the amount offered is adequate to resolve the taxpayers' liability, the resulting compromise should be executed on a Form 656, Offer in Compromise, in accordance with all of the Service's compromise procedures. As currently written, Service procedures do not contemplate the acceptance of a promissory note and mortgage in compromise of tax liabilities. We suggest that this kind of departure from standard procedures be undertaken only with the approval of the appropriate National Office officials.

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[7] In Barth, the Court did describe the taxpayer's actions as a "waiver" of the statutory limitation period that would have otherwise applied. 279 U.S. at 735. However, it was only a waiver in that the taxpayers chose to postpone collection by executing a debt instrument subject to a different period of limitations. Id. The Court clearly stated that the predecessor section to 6502 "ha[d] no application to the situation following a claim of abatement and the giving of a bond." Id.

LAW, HAZARDS, AND OTHER CONSIDERATIONS

[REDACTED]

CONCLUSION

The proposed promissory note and deed of trust resolution of this case is permissible under the law, and would create a new debt, enforceable by its terms. However, the proposal represents a significant departure from Service policy with regard to collection in this kind of case. We will bring the issues raised by your request to the attention of Collection and ask that they consider whether agreements such as that proposed here would be helpful in resolving difficult cases.

LEVY; REFUNDS

TL-N-6616-99
UIL: 50.28.00-00
March 6, 2000

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL, KENTUCKY-TENNESSEE DISTRICT
ATTN:ACBrown

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

SUBJECT: Levy Payments Refund/Application

This responds to your request that we pre-review your significant Service Center advice for the general litigation issue. We have no opinion on your discussion of I.R.C. § 6511, which does not fall within the jurisdiction of our division. This document is not to be cited as precedent.

ISSUE:

When a levy payment creates an overpayment to a taxpayer's account (and there is not a balance due on any other period listed on the levy), may the overpayment be manually refunded, even though it has been over nine months since the date of the levy?

CONCLUSION:

When it has been more than nine months from the date of a levy, the overpayment may be returned under IR.C. § 6343(d) in limited situations. Specifically, money may be returned at any time within 9 months after the date of the levy. In addition, when a timely request for the return of money is filed in accordance with these regulations, or a determination to return an amount of money is made before the expiration of the 9-month period, the money may be returned within a reasonable period of time after the 9-month period if additional time is necessary for investigation or processing. This will ensure that if a timely request has been made, or the Service timely decides to return money on its own initiative, the Service will have sufficient time for necessary investigation or processing.

FACTS:

The hypothetical facts are that the Service makes a substitute for return for $10,000.00, and the assessment is fully paid by levy. Subsequently, the taxpayer files his return showing a tax liability of $8,000.00, but he does not file a timely refund claim.

LAW AND ANALYSIS:

Section 6343(d) provides that the Commissioner may return property if one of the following conditions exist: (1) the levy was premature or otherwise not in accordance with the administrative procedures of the IRS; (2) the taxpayer has entered into an agreement under section 6159 of the Code to satisfy the liability for which the levy was imposed by means of installment payments, unless the agreement provides otherwise; (3) the return of property will facilitate collection of the tax liability; and (4) the return of property would be in the best interest of the taxpayer, as determined by the Taxpayer Advocate, and in the best interest of the United States, as determined by the Commissioner.

Section 6343(d) also provides that the provisions of section 6343(b) shall apply to subsection (d), except that no interest shall be allowed. In regard to the return of money, section 6343(b) states that "Property may be returned at any time. An amount equal to the amount of money levied upon or received from such sale may be returned at any time before the expiration of 9 months from the date of such levy."

We generally agree with your draft memorandum, except for the discussion at page five regarding the period for returning money under section 6343(d):

> In conclusion, levied property may be returned to the party levied upon or the taxpayer, only if a claim is filed or the or the Service decides to return the property within nine months of the levy, unless the taxpayer can satisfy the refund period provided by I.R.C. § 6511. Further, by the express terms of I.R.C. § 6343(b) and (d)(4), a period longer than nine months is not allowed where the Service determines 'the return of the property would be in the best interests of the taxpayer (as determined by the Taxpayer Advocate),' now the National Taxpayer Advocate, and the Service under IR.C. § 6343(d).

The above discussion of the nine-month period is confusing, and we recommend that it be replaced by the following language:

> Property other than may be returned at any time pursuant to section 6343(d). Money may be returned any time within 9 months after the date of the levy. In addition, when a timely request for the return of money is filed in accordance with these regulations, or a determination to return an amount of money is made before the expiration of the 9-month period, the money may be returned within a reasonable period of time after the 9-month period if additional time is necessary for investigation or processing. This will ensure that if a timely request has been made, or the Service timely decides to return money on its own initiative, the Service will have sufficient time for necessary investigation or processing.

We think that our language clarifies the situations in which the money may be refunded after the expiration of the nine-month period.

BANKRUPTCY; TURNOVER OF PROPERTY; REFUNDS

CC:EL:GL:Br3
GL-502544-00
UILC: 09.13.01-00

May 12, 2000

MEMORANDUM FOR DISTRICT COUNSEL, MICHIGAN DISTRICT, DETROIT

FROM: Lawrence Schattner, Chief, Branch 3
(General Litigation)

SUBJECT: Bankruptcy Court Orders Requiring Turnover of Tax Refunds

This memorandum responds to your request for advice dated April 6, 2000, regarding the authority of the bankruptcy court to issue ex parte orders directing the Service to turn over the future tax refunds of chapter 13 debtors to the trustee.

ISSUES

Whether sovereign immunity is a viable defense to the enforcement of income deduction orders that are entered pursuant to section 1325(c) of the Bankruptcy Code against the Service with respect to debtors' future income tax refunds.

Whether chapter 13 debtors' future income tax refunds fall within the meaning of "income" in section 1325(c).

Whether the Assignment of Claims Act applies to bar the enforcement of an order directing the Service to pay debtors' future income tax refunds to the chapter 13 trustee.

CONCLUSIONS

[REDACTED]

FACTS

Years ago, the Michigan District adopted the practice of sending income tax refunds that were owed to chapter 13 debtors directly to the trustee. This practice was followed in cases where the Service filed a proof of claim and in "no-liability" cases where the Service did not file a proof of claim and was not otherwise a party to the bankruptcy case.

Due to the increased burden on the Michigan District to manually process income tax refunds that were sent directly to the chapter 13 trustees, the District decided to discontinue this practice. A letter was sent to the chapter 13 trustees in the district informing them that beginning on January 1, 2000, the Service would no longer be providing this service. Thereafter, the chapter 13 trustees filed ex parte applications with the court to obtain orders directing the Service to remit tax refunds directly to the trustees. Citing section 1325(c) for its authority, the bankruptcy court has entered at least 215 ex parte orders directing the Service to forward to the chapter 13 trustee "any and all monies due and payable to the debtor(s) ..., particularly any and all income tax monies due and otherwise payable to said debtors(s)."

LAW & ANALYSIS

Section 1325(c) of the Bankruptcy Code, 11 U.S.C., provides that after confirmation of a chapter 13 plan, "the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee." The definition of the term "entity" includes a governmental unit, and the definition of the term "governmental unit" includes the United States. See 11 U.S.C. §§ 101(15) and 101(27).

1. Sovereign Immunity as a Defense

Section 658(2) of the Bankruptcy Act preceded section 1325(c). Under section 658(2), the bankruptcy court was empowered to "issue such orders as may be requisite to effectuate the provisions of the plan, including orders directed to any employer of the debtor." Rule 13-213(b) facilitated this authorization by providing that the order of confirmation or a separate payment order was to specify the amount and manner in which payments were to be made by the debtor or to be obtained from the employer of the debtor. Thus, instead of having the debtor collect his entire wages and make the payment to the trustee, the Bankruptcy Act provisions authorized the court to direct the debtor's employer, where requisite, to deduct from the debtor's earnings the amount which the debtor is supposed to pay under the plan. 10 Collier on Bankruptcy, ¶ 29.08 (14th ed. 1978).

In United States v. Krakover, 377 F.2d 104 (10th Cir.), cert. denied, 389 U.S. 845 (1967), the court held that an order entered pursuant to section 658(2) which required the United States to pay part of the wages of one of its employees to the trustee was barred by sovereign immunity. Applying the rule that general language in the Bankruptcy Act cannot be construed as a waiver of sovereign immunity, the court rejected the trustee's argument that the reference to "any employer" in section 658(2) included the United States. Id. at 106. The court also noted that its ruling did not deprive federal employees of the benefits of chapter 13 because federal employees could be ordered to endorse and turn over their pay checks to the trustee. Id. at 107.
Under the Bankruptcy Reform Act of 1978, the class of persons eligible to file a petition under chapter 13 was expanded and no longer limited to wage earners. See In re Buren, 725 F.2d 1080, 1082 (6th Cir.), cert. denied, Hildebrand v. Social Sec. Admin., 469 U.S. 818 (1984) (discussion of legislative history). Section 1325(b), the successor statute to section 658(2) of the Bankruptcy Act and what is now section 1325(c), was also enacted as part of the Bankruptcy Reform Act of 1978. The legislative history to section 1325(b) indicates that Congress used the term "entity" in the statute because it intended income deduction orders to apply to governmental units. See Sen. Rep. No. 95-989, at 142 (1978), *reprinted in* 1978 U.S.C.C.A.N., 5787, 5928 ("Subsection (b) authorizes the court to order an entity, as defined by Section 101(15), to pay any income of the debtor to the trustee. Any governmental unit is an entity subject to such an order."). See also, In re Howell, 4 B.R. 102, 105 (Bankr. M.D. Tenn. 1980) (the language used in § 1325(b) of the Bankruptcy Code and the definitions of "entity" and "governmental unit" contained in § 101 clearly overrule the immunity analysis in Krakover); In re Hughes, 7 B.R. 791, 795 (Bankr. E.D. Tenn. 1980) (noting that the Senate committee report flatly states that "any" governmental unit is subject to an order under § 1325(b), court states that "[o]nly by obtuseness can the administration avoid the avoid the conclusion that § 1325(b) was meant to overrule United States v. Krakover.").

In holding that there was an explicit waiver of sovereign immunity, the courts in Howell and Hughes also relied upon the language contained in section 106(c) prior to its amendment under the Bankruptcy Reform Act of 1994 (the "BRA"). See In re Howell, 4 B.R. at 105-106; and In re Hughes, 7 B.R. at 796. Section 106(c) previously provided that sovereign immunity was waived in any situation in which the applicable bankruptcy statute contained the trigger words of "creditor," "entity," or "governmental unit." [redacted]

[redacted] Section 106(a) was amended to set forth a list of statutory provisions for which sovereign immunity is abrogated as to a governmental unit. Section 1325 is not included in this list. Further, the provision in section 106 that waived sovereign immunity when a statute contained certain trigger words, such as "entity," was not retained in the amended version of the statute. [redacted]

2. Whether "income" includes future income tax refunds

Under the Bankruptcy Code, any "individual with regular income" is eligible for chapter 13 relief. 11 U.S.C. § 109(e). Section 101(30) defines "individual with regular income" as an individual whose income is sufficiently stable and regular to enable such individual to make payments under a chapter 13 plan. Section 1325(b)(2) defines the term "disposable income" as income received by the debtor which is not reasonably necessary to be expended for the maintenance or support of the debtor. The term "income" is not defined in the Bankruptcy Code.

In Freeman v. Schulman, 86 F.3d 478 (6th Cir. 1996), the Sixth Circuit held that future income tax refunds can be considered "projected disposable income" under section 1325(b). In Freeman, the debtors received an income tax refund in an amount greater than expected and tried to amend their chapter 13 plan to exempt a portion of the refund. Id. at 479. Relying upon the particular facts in the case, the court determined that the refund qualified as "projected disposable income" because the debtor specifically provided that tax refunds should go to the plan and made no argument that the funds were needed for the maintenance and support of the debtor or her dependents. Id. at 481.

[redacted]

[redacted][8] [redacted]

[redacted] As noted above, the predecessor statute to section 1325(c) applied to “employers” of the debtor. Thus, the statute applied to wages received by debtors. When the Bankruptcy Reform Act expanded the eligibility of debtors to file chapter 13 so that relief was not limited to wage earners, it extended eligibility to any “individual with regular income.” Under section 101(30), an “individual with regular income” is defined as an “individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title.” [redacted]

While courts have recognized a variety of nontraditional sources of money as income under section 101(30), the income must be regular and stable enough to fund a plan. See In re Murphy, 226 B.R. 601, 605 (Bankr. M.D. Tenn. 1998), and cases cited therein. Similarly, the income against which courts have upheld income deduction orders under section 1325(c) is the regular and stable income that is used to fund chapter 13 plan payments. See, e.g., United States v. Devall, 704 F.2d 1513, 1515 (11th Cir. 1983) (debtors listed social security benefits as regular income in all of their chapter 13 plans); In re Howell, 138 B.R. 484 (W.D. Pa. 1992) (debtors entitled to monthly AFDC grants which were used to fund chapter 13 plans); In re Simmons, 94 B.R. 74 (Bankr. W.D. Pa. 1988) (debtor received monthly income from a teacher’s retirement system); Michigan Employment Sec. Comm’n.

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[8] In In re Anderson, 21 F.3d 355 (9th Cir. 1994), the Ninth Circuit held that the requirement that a chapter 13 plan provide for payment of all of the debtor’s “projected disposable income” to the trustee does not entitle the trustee to require that the debtor agree to pay all actual disposable income to the trustee. Relying upon Anderson, the court in In re Kuehn, 177 B.R. 671 (Bankr. D. Ariz. 1995), held that the trustee cannot require a blanket turnover of all tax refunds without a showing that such refunds are in fact projected in a certain amount. Thus, debtors may object to plan provisions which require them to commit all or a portion of their future tax refunds to the plan on the grounds that future tax refunds are not “projected disposable income.” [redacted]

v. Jenkins, 64 B.R. 195 (W.D. Mich. 1986) (debtor received unemployment benefits in lieu of wages); In re Williams, 13 B.R. 640 (E.D. Wash. 1981) (debtors' schedules listed as income monthly social security benefits). In all of these cases, the income deduction order was entered against a stream of regular payments that were used to fund the chapter 13 plan payments.

[redacted]

3. The applicability of the Assignment of Claims Act

In In re Cochran, 141 B.R. 270, 273 (M.D. Ga. 1992), the United States argued that the Assignment of Claims Act (the Act) bars a bankruptcy court from ordering the Service to send the debtor's tax refund to the trustee. The court rejected this argument on the grounds that section 1325(c) impliedly modified the Act to allow the assignment of tax refunds to the trustee via income deduction orders. Id. Although the issue was not raised in Cochran, there is also a question as to whether the Assignment of Claims Act even applies in a bankruptcy proceeding.

In a couple of cases, courts have determined that the Assignment of Claims Act does not apply where tax refunds were transferred to the trustee by operation of bankruptcy law or in accordance with a plan of arrangement. In Segal v. Rochelle, 382 U.S. 375 (1966), the Supreme Court held that a loss-carryback refund that was inchoate on the date of the petition was property that passed to the trustee under section 70a(5) of the Bankruptcy Act. In determining whether the refund constitutes property that could be transferred within the meaning of section 70a(5), the Court noted that the predecessor statute to the Assignment of Claims Act, 31 U.S.C. 22 203, does not prevent transfers by operation of law. Accordingly, the Court reasoned that the Assignment of Claims Act does not interfere with the vesting in the trustee of property coming within section 70a(5) because all transfers of property to the bankruptcy estate under section 70a(5) are explicitly by operation of law. Id. at 382, n. 7.

Similarly, in In re Kepp Elec. & Mfg. Co., 98 F. Supp. 51, 53 (D. Minn. 1951), the court held that a debtor's assignment of "any and all tax refunds which may be due or owing to the debtor from the United States government" was not within the purview of the Assignment of Claims Act, and that the assignment was therefore valid and effective to vest in a receiver any right of the debtor to the tax refunds. Because the tax refunds claimed by the debtor were transferred to the receiver pursuant to plan of arrangement under Chapter XI of the Bankruptcy Act that was approved and confirmed by the bankruptcy court, the court determined that the transfer constituted "an act of the law" and was not within the prohibition of the Assignment of Claims Act. Id. at 60-61.

Under section 1306(a) of the Bankruptcy Code, all property that the debtor acquires after the commencement of the case is property of the estate. Under section 1327, property of the estate vests in the debtor upon confirmation except as otherwise provided in the plan or the order confirming the plan. [redacted]

4. The ex parte nature of the orders

[redacted] Under Rule 9013, Fed. R. Bankr. P., a request for an order must be made by written motion and every written motion, other than one which may be considered ex parte, must be served by the moving party on those entities specified by the rules. The opportunities for legitimate ex parte applications are extremely limited. In re Intermagnetics America, Inc., 101 B.R. 191, 192 (C.D. Cal. 1989) (due to an increase in ex parte applications, court notes in some detail why they are "nearly always improper."). See also In re Dinova, 212 B.R. 437, 445 (2^{nd} Cir. BAP 1997) ("Even if notice is burdensome in a particular case, the American Judicial system is predicated on the adversary process and forbids *ex parte* communications on substantive matters by statute, rule, and code of ethics. Virtually every substantive motion in American jurisprudence must be on notice to affected parties.").

[redacted] Under Rule 7001(7), a proceeding to obtain an injunction or other equitable relief must be brought as an adversary proceeding, except when the chapter 13 plan provides for the relief. [redacted]

[redacted]

[redacted] Under Rule 9014, relief in a contested matter which is not otherwise governed by the Federal Rules of Bankruptcy Procedure is required to be made by motion, and reasonable notice and opportunity for hearing must be afforded the party against whom relief is sought. Other than Rule 7001, we are not aware of any other Bankruptcy Rule which could be construed as governing a request for an income deduction order. [redacted]

It should be noted that the bankruptcy court in In re Williams, 13 B.R. 640, 641 (Bankr. E.D. Wash. 1981), held that there is no notice or service requirement for income deduction orders issued pursuant to section 1325. In Williams, the court signed an order requiring the Social Security Administration to pay benefits directly to the trustee, which order was mailed by the trustee to the Social Security Administration's regional office. Id. Approximately five months later, the United States filed a Motion to Reconsider or in the Alternative for a Stay of Execution Pending Appeal. In addition to arguing that the order was void due to the anti-assignment provision under the Social Security Act, the United States argued that the order was void and unenforceable for lack of proper service. The bankruptcy court rejected both of these arguments.

With respect to service of the order, the bankruptcy court determined that the issuance of an order under section 1325 is not an adversary proceeding under Rule 13-701(a), the predecessor to Bankruptcy Rule 7001(a). In re Williams, 13 B.R. at 642. Further, the court determined that under Rules 13-203(a) and (b), the predecessors to Bankruptcy Rules 2002(a) and (b), there is no requirement for notice of orders issued under section 1325. Id. at 643. While stating that the Social Security Administration has the option of questioning the propriety of the court's order upon receipt, the bankruptcy court determined that notice is not afforded for reasons of obvious judicial and administrative efficiency. Id. Thus, the court held that the trustee acted properly by mailing a copy of the income deduction order to the Social Security Administration's regional office. Id.

[redacted]

[redacted]

CONCLUSIONS

[REDACTED]

BANKRUPTCY; OFFER IN COMPROMISE

GL-800565-00
UILC: 17.00.00-00
May 16, 2000

MEMORANDUM FOR ASSISTANT DISTRICT COUNSEL, LOS ANGELES

FROM: Kathryn A. Zuba
Chief, Branch 2 (General Litigation)

SUBJECT: Chapter 13 Bankruptcies Involving Taxpayers with Accepted Offers

This memorandum responds to your General Litigation Transmittal Memorandum dated February 8, 2000 in which you ask that we post-review your memorandum of the same date to Chief, Special Procedures Branch, Los Angeles District. This document is not to be cited as precedent.

ISSUE

(1) What kind of a claim should the Internal Revenue Service ("Service") file in a Chapter 13 bankruptcy case when the tax liabilities have been compromised in a pre-petition offer in compromise if the offer has not yet been fully paid?

(2) Is the debtor prohibited from assuming without the Service's consent an accepted offer in compromise that has not been fully paid at the time the Chapter 13 petition was filed because the future compliance provision of the accepted offer makes the contract unassignable under applicable law?

CONCLUSION

(1) When a taxpayer with an accepted but uncompleted offer in compromise files a Chapter 13 petition, the Service should file a protective claim for the entire underlying tax liabilities to protect the Service's interests in the event that the debtor fails to assume the accepted offer in the plan.

(2) No, the debtor is not prohibited from assuming without the Service's consent an accepted offer in compromise that has not been fully paid at the time the Chapter 13 petition was filed.

DISCUSSION

Your memorandum concludes that when a taxpayer with an accepted offer in compromise that has not yet been fully paid files a Chapter 13 case, the Service's proof of claim should reflect the full amount of the tax liability. We agree. In our Memorandum to Southern California District Counsel, Laguna Niguel dated February 8, 2000, we stated that the Service should file a protective claim for the entire unpaid underlying tax liability to protect the Service's interests in the event that the debtor fails to assume the accepted offer in the plan.

However, you also conclude that because the future tax compliance provision of the offer can only be fulfilled by the taxpayer, accepted offers are personal service contracts under Bankruptcy Code section 365(c)(1) that cannot be assumed. The effect of your conclusion is that a debtor with an accepted offer in compromise must either pay the full amount of the underlying priority and secured tax claims, or dismiss the Chapter 13 case.

You explain that Bankruptcy Code section 1322(b)(7) provides that a Chapter 13 plan may, "*subject to § 365 of this title*, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section" (emphasis added). Section 365(c)(1) provides in pertinent part:

> The trustee may not assume or assign any personal service contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if–
>
>> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>> (B) such party does not consent to such assumption or assignment[.]

This provision follows the common law restriction against the assignment of personal service contracts. 3 Collier on Bankruptcy § 365.06[1][b], 365-56 (6th ed. rev. 1999). Personal service contracts are contracts for the services of a particular person when that person's services are unique and cannot equally be performed by another. Id.

The present version of the Offer in Compromise Form 656 (Rev. Jan. 2000), paragraph (d), provides that the taxpayer agrees to comply with all provisions of the Internal Revenue Code relating to the filing of returns and paying the required taxes for 5 years or until the offered amount is paid in full, whichever is longer. You conclude that this duty is personal to the taxpayer, and renders the contract unassignable under applicable law and therefore unassumable pursuant to sections 365(c)(1) and 1322(b)(7).

We have found no cases reaching the conclusion that a Chapter 13 debtor cannot assume and perform his own personal service contract. A related issue has arisen in Chapter 11 cases. In Chapter 11, Bankruptcy Code section 1107(a) grants debtors in possession the rights and powers of a trustee, but provides that these powers are "[s]ubject to the limitations on a trustee serving in a case under this chapter[.]" Even so, there is a split of authority as to whether a Chapter 11 debtor in possession can be prohibited from assuming a personal service contract under section 365(c)(1). Some courts hold that the language of the statute establishes a "hypothetical test" as to whether the contract could be assignable to a hypothetical non-debtor assignee. If not, the contract cannot be assumed by the debtor in possession. In re Catapult Entertainment, 165 F.3d 747 (9th Cir. 1999); In re West, 852 F.2d 79, 83 (3rd Cir. 1988). See also In re James Cable Partners, 27 F.3d 534, 537 (11th Cir. 1994). Other courts look to the legislative history, purposes, and construction of related statutory provisions and hold that a debtor in possession can assume an executory personal service contract of the debtor as long as the contract is not actually being assigned to a new entity. Institut Pasteur and Pasteur Sanofi Diagnostics, 104 F.3d. 489 (1st Cir. 1997), cert. denied 521 U.S. 1120 (1997); Texaco Inc. v. Louisiana Land and Expl. Co., 136 B.R. 658, 688-71 (M.D. La. 1992); In re GP Express Airlines, Inc., 200 B.R. 222, 231-33 (Bankr. D. Neb. 1996); In re Hatec Enters., Inc., 117 B.R. 865, 871-73 (Bankr. W.D. Tex. 1990), vacated on other grounds, 130 B.R. 929 (W.D. Tex. 1991); In re Cardinal Indus. Inc, 116 B.R. 964, 976-82 (Bankr. S.D. Ohio 1990). This is also the view of the leading treatise on bankruptcy. 3 Collier on Bankruptcy § 365.06[1][d], 365-58 (15th ed. 1999).

Your conclusion was based upon the "subject to section 365 of this title" language in § 1322(b)(7). You concluded that the restrictions imposed in section 365(c)(1) on the trustee's ability to assume a contract under section 365(a) also apply to debtors assuming a contract in their plan under section 1322(b)(7).[9] We do not interpret the

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[9] We should also note that a possible interpretation of the Code is that the debtor has the right to an executory contract under non-bankruptcy law, and does not lose that right upon filing bankruptcy. Seen in this light, section 1322(b)(7) only provides that the debtor may exercise this pre-existing right in the plan, and that this right is made subject to the trustee's right to assume the contract under section 365(a) and other applicable provisions of section 365.

language in section 1322(b)(7) as if it reads "subject to the limitations imposed on the trustee in section 365." Compare section 1322(b)(7) to Bankruptcy Code section 1304(b), which provides that a Chapter 13 debtor engaged in business may operate the business "subject to any limitations on a trustee under sections 363(c) and 364 of this title." Compare also section 1107(a), discussed supra. Rather, the inclusion of "subject to section 365" language in section 1322(b)(7) makes clear that applicable provisions in section 365 (those not expressly aimed at the trustee) apply. While many subsections of section 365 apply only to trustees (or debtors in possession under section 1107), other provisions are more broad, such as subsections 365(e) and (g).

Indeed, Bankruptcy Code section 365(e)(2)(A) would have no effect if the personal service contract limitation on trustees in section 365(c)(1) applied to debtors pursuant to section 1322(b)(7). Section 365(e) provides in pertinent part:

> (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on–
>
> > (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> > (B) the commencement of a case under this title; or
> > (C) the appointment of or taking possession by a trustee in a case under the title or a custodian before such commencement.
>
> (2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if–
>
> > (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee[10] of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
> > (ii) such party does not consent to such assumption or assignment[.]

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[10] Though the language in section 365(e)(2) is not identical to the language in section 365(c)(1) due to legislative oversight when section 365(c) was amended, it appears that there was no intention to distinguish substantively between the type of contracts being described. 3 Collier on Bankruptcy § 365.07[1], 365-67 (6th ed. rev. 1999).

Section 365(e)(2)(A) is the only provision other than section 365(c)(1) that addresses personal service contracts. Section 365(e)(2)(A), which has no language limiting it to the trustee as does section 365(c)(1), provides an exception for personal service contracts to the section 365(e)(1) rule which nullifies any provision in an executory contract that allows the contract to be terminated if the debtor files bankruptcy or becomes insolvent. Thus, Congress chose to allow executory personal service contracts to be terminated by the non-debtor party if the contract provides for termination based on the financial condition of the debtor. There would be no reason for the 365(e)(2) exception for personal service contracts, however, if in all cases the non-debtor party could prevent the assumption of the contract under section 365(c)(1) simply because it is a personal service contract. Thus, section 365(e)(2) must apply to a class of cases not covered by 365(c)(1) to have effect. If section 365(c)(1) applied to the debtor as well as the trustee, there would be no class of cases in which the section 365(e)(2) exception would be necessary. Rather, as the plain language of section 365(c)(1) and section 1322(b)(7) indicate, the debtor's ability to assume or reject an executory contract in the plan is not limited by 365(c)(1), which applies only to the trustee. This gives effect to section 365(e)(2), which applies to the debtor. Thus, section 365(e)(2) has effect only if section 365(c)(1) does not apply to the debtor.

Accordingly, we do not recommend that the Service object to a Chapter 13 plan which provides for the payment of the Service's claims under an accepted offer in compromise on the basis that the offer cannot be assumed under section 365(c)(1).[11] Rather, we reiterate our prior conclusion that the Service should file a protective claim for the unpaid underlying tax liabilities, and that the debtor can assume the accepted offer in the Chapter 13 plan.[12]

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[11] We should also note that if we were to take a contrary position, a bankruptcy court in a Chapter 13 case may be compelled to hold that the future compliance provision of the accepted offer in compromise is not a material term to the agreement in order to give the debtor the benefit of the contract. Adverse case law on this issue could hinder the Service any time it seeks to enforce the full amount of the tax liability upon default of the future compliance provision of a defaulted offer after the taxpayer has completed payments. Also, when the taxpayer has an accepted offer in compromise the Service has already expended administrative resources in researching and accepting the offer. Finally, there could be public policy concerns in cases where debtors file Chapter 13 to save their home from foreclosure and cannot present a feasible plan without the benefit of the accepted offer in compromise.

[12] However, in a case in which the underlying tax claims could be discharged before the all terms of the accepted offer have been fulfilled, the Service could negotiate language in the plan providing that the underlying tax claims are nondischargeable in the event of default of the offer. The viability of the underlying tax liabilities is a basic assumption of the offer in compromise agreement, and the Service should not be bound to the offer agreement unless the underlying taxes are

CONCLUSION

We conclude that when a taxpayer with an accepted but uncompleted offer in compromise files a Chapter 13 petition, the Service should file a protective claim for the full amount of the underlying tax liabilities. A note should be added to the proof of claim to reflect that it is being filed as a protective claim in the event that the debtor does not assume the accepted offer as an executory contract in the plan. The Service should then object to the Chapter 13 plan if it does not either, (1) expressly assume the accepted offer, or (2) provide for full payment of the Service's priority and secured tax claims, and any payment on its general unsecured claim that it may be entitled to in the case. In this way the Service will be honoring the accepted offer, while protecting its rights should the debtor chose not to assume the accepted offer. The debtor will have a choice, based on an evaluation of what is in the debtor's best interests, to either assume the accepted offer or be liable for the underlying tax liability.

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nondischargeable. See 2 Restatement of the Law Second (Contracts) sections 261, 261 comment(b), and 265 (1981). We also note that when the payments under an assumed offer extend beyond the life of the plan, an argument could be made that the debtor has maintained payments on the underlying tax claims per section 1322(a)(5), rendering them nondischargeable per section 1328(a)(1).

LAST CHANCE LETTERS

April 27, 2000 CC:EL:GL:Br1
GL-607849-99
UILC 20.02.03-00

MEMORANDUM FOR VIRGINIA-WEST VIRGINIA DISTRICT COUNSEL

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

SUBJECT: Last Chance Letters

This responds to your memorandum dated August 26, 1999. This document is not to be cited as precedent.

ISSUES:

1. Whether sending a "Last Chance Letter" for a collection summons directly to a represented taxpayer/summoned party violates the prohibition on direct contact in I.R.C. § 6304(a)(2).

2. Whether sending a "Last Chance Letter" with respect to any summons (collection, examination or criminal) to a represented summoned party is an ethical violation of the Model Rules of Professional Conduct Rule 4.2 and various state bar rules of ethics.

3. Whether sending a "Last Chance Letter" to a non-taxpayer summoned party with respect to a non-criminal summons would be a third party contact under I.R.C. § 7602(c).

4. Whether a TDI summons, seeking information to complete a return, issued by a revenue officer would be considered in "connection with the collection of any unpaid tax" for purposes of I.R.C. § 6304(a).

CONCLUSIONS:

1. If the represented party has executed an unmodified Power of Attorney form (Form 2848), that party has consented to direct written communications. Accordingly, there is no section 6304(a)(2) violation.

2. Although there would be no section 6304(a)(2) violation, sending a "Last Chance Letter" to a party represented by an attorney may be an unethical ex parte contact. Such contacts should, therefore, be avoided by Chief Counsel attorneys.

3. If none of the three exceptions of I.R.C. § 7602(c)(3)(A)-(C) apply, then the Service's procedure for sending a "Last Chance Letter" to a summoned third party

is subject to the provisions of section 7602(c). Before sending a Last Chance Letter, the Service should ensure that the taxpayer has received reasonable notice. Also, the Service should record the contact on a Form 12175.

4. A summons served to determine whether a tax liability exists, i.e., before an assessment is recorded, is not an action taken "in connection with the collection of any unpaid tax."

FACTS:

In an earlier memorandum drafted by your office, you concluded that written communications may be sent by the Internal Revenue Service (the "Service") to taxpayers with authorized representatives, where such taxpayers and representatives have executed a Power of Attorney form (Form 2848), despite the restrictions upon communications found in I.R.C. § 6304(a)(2), discussed further below. Specifically, you concluded that the execution of the Form 2848 constitutes the taxpayer's consent to such direct communications. You further recommended, however, that the Form 2848 be modified to clarify that the taxpayer is consenting to receive collection communications. In particular, the Form 2848 does not presently provide the taxpayer with an option to elect not to receive such correspondence. These concerns will be more fully addressed below.

In the present memorandum, you raise several related questions that have arisen in your district pertaining to "Last Chance Letters", which are letters sent to summoned parties by District Counsel offices prior to seeking judicial enforcement of the summonses. First, you wish to clarify that sending a Last Chance Letter to a represented taxpayer who has executed a Form 2848 would not be a section 6304(a)(2) violation. Second, you conclude that sending a Last Chance Letter with respect to any summons (collection, examination, or criminal) to any summoned party represented by an attorney may be an ethical violation under Model Rules of Professional Conduct Rule 4.2 and various state bar rules of ethics. Third, you believe that sending a Last Chance Letter to a non-taxpayer summoned party with respect to a non-criminal summons would be a third party contact under I.R.C. § 7602(c).

In light of these conclusions, you have revised your Last Chance Letter procedures. Since you believe that it is standard practice in most District Counsel offices to send Last Chance Letters directly to summoned parties without consideration of the aforementioned issues, you also request that we review your new procedures and determine whether they are necessary under sections 6304(a)(2) and 7602(c) and Model Rule 4.2.

Your revised procedures provide that the District should inform District Counsel whether the summoned party is represented–i.e., the Power of Attorney form, Form 2848, is filed with the Service--in any case referred to District Counsel for a Last

Chance Letter. The nature of the representation should be indicated (attorney v. other recognized representative). The Last Chance Letter will then be sent to the representative, rather than to the summoned party, when the Service is aware of such representation. Third party contact procedures should be followed where the Last Chance Letter is sent to a non-taxpayer third party. The required notification must be given before such contact. Contacts should be tracked by completing Form 12175 and forwarding it to the Third Party Notice Coordinator.

Finally, you raise the additional issue of whether a TDI summons, issued by a revenue officer, seeking information from which to complete a return, would be considered in "connection with the collection of any unpaid tax" for purposes of I.R.C. § 6304(a). We have coordinated your advice request with the Office of Assistant Chief Counsel, General Legal Services, as that office has jurisdiction over the ethical questions raised in your second issue.

LAW AND ANALYSIS:

1. I.R.C. § 6304(a)(2)

We concur with the position taken in the earlier memorandum from your office. Where a taxpayer and his or her representative have executed a Power of Attorney form, Form 2848, sending a Last Chance Letter for a collection summons, or any other written collection communications, to that taxpayer does not violate section 6304(a)(2).

I.R.C. § 6304, Fair Tax Collection Practices, was added to the Internal Revenue Code (the "Code") pursuant to section 3466 of the Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 98"). Section 6304 makes certain provisions of the Fair Debt Collection Practices Act ("FDCPA") applicable to the Service, placing restrictions on certain communications with taxpayers and prohibiting abuse and harassment of taxpayers and third parties. In particular, section 6304(a) provides in relevant part that "without prior consent of the taxpayer ... the Secretary may not communicate with the taxpayer in connection with the collection of any unpaid tax ... (2) if the Secretary knows such person is represented by any person authorized to practice before the [IRS] ... unless such person fails to respond within a reasonable period of time ... or unless such person consents to direct communication with the taxpayer." (Emphasis added).

The counterpart section in the FDCPA, 15 U.S.C. § 1692c(a), contains comparable language. The FDCPA defines "communication" as "the conveying of information regarding a debt directly or indirectly to any person through any medium." 15 U.S.C. § 1692a(2). The stated purpose of the FDCPA is to "eliminate abusive debt collection practices by debt collectors ... ." 15 U.S.C. § 1692(e).

Thus, section 6304(a)(2) places restrictions upon communications, written or oral, with a represented taxpayer with respect to "the collection of any unpaid tax," unless (among other reasons) that taxpayer has consented to such communications. The legislative history in RRA 98 is silent as to the meaning of this specific provision and as to what constitutes the "prior consent of the taxpayer."

We agree with the position taken in the earlier memorandum from your office that the execution of a Power of Attorney form, Form 2848, constitutes "prior consent of the taxpayer" to direct receipt of written communications, including Last Chance Letters for a collection summons. By executing such form, the taxpayer's representative is also consenting to such direct contact.

In relevant portion, Form 2848, line 7 states "Original notices and other communications will be sent to you and a copy to the first representative listed on line 2 unless you check one or more of the boxes below." The form then provides the following options: a) original to POA and copy to taxpayer; b) more than one representative to be sent copies; and c) no copies to representative.

Thus, under each option, the taxpayer receives either the original or a copy of all written communications from the Service. By completing the Form 2848 and line 7, without alteration, we think that the taxpayer (and representative) are clearly authorizing receipt by the taxpayer of written communications, including written communications in connection with the collection of an unpaid tax.

Your office additionally suggested the possibility of revising the present Form 2848 to further clarify the taxpayer's informed consent. In particular, the Form 2848 does not provide the taxpayer with the option to not receive any written collection correspondence, whether originals or copies. In other words, you suggest that it would provide further support for the position that the execution of Form 2848 and line 7 constitutes a taxpayer's consent to receive direct written collection communications from the Service if the taxpayer is provided with the full range of options, including the option to elect to not be provided with any such communications.

While we agree that such a modification could be made to emphasize that the taxpayer is making an informed consent to receive written correspondence pertaining to the collection of his or her unpaid tax liability, we think that such a modification is unnecessary at this time. From a practice standpoint, we would have concerns about taxpayers being deprived of any opportunity to exercise control over their representatives, the potential harm which could arise where taxpayer representatives fail to respond or take appropriate action in response to Service collection matters, and making taxpayer use of the Form 2848 more complex. In other words, while providing the taxpayer with the option to refuse receipt of certain written correspondence would allow the Service to avoid even the appearance of a section 6304(a) violation, we are not aware of any circumstances under which it would be ultimately beneficial to a taxpayer to exercise such an option. To the contrary, the exercise of such an option may be detrimental to a taxpayer.

In addition, we do not consider the issuance of these types of written correspondence or notices to a taxpayer to be the type of action section 6304(a)(2) was intended to restrict. As previously discussed, the stated purpose of the FDCPA is to eliminate abusive debt collection practices. It is not an abusive practice to ensure that a taxpayer is kept aware of the imminent possibility (with respect to the Last Chance Letter) of judicial enforcement of a summons. We think that the purpose of section 6304(a)(2) was to prevent bypassing a taxpayer's representative for the purpose of harassing or abusing the taxpayer with respect to collection of the tax liability. [13]

In cases addressing the application of the FDCPA counterpart of section 6304(a), 15 U.S.C. § 1692c(a)(2), some courts have read the underlying purpose of the FDCPA as a threshold for determining whether there has been a violation of that provision. For example, in Pearce v. Rapid Check Collection, Inc., 738 F. Supp. 334 (D.S.D. 1990), the court considered a letter sent to the plaintiff threatening suit after the debt collection company was aware she was represented by an attorney. The court noted that there was a "technical" FDCPA violation but that "[u]nder the facts, however, such violation is characterized as de minimus. It is not the type of conduct which the intent and purpose of the Act proscribes." Id. at 338. In Bieber v. Associated Collection Services, Inc., 631 F. Supp. 1410 (D. Kan. 1986), the alleged FDCPA violation was a telephone inquiry by a debt company as to whether the plaintiffs had filed bankruptcy, after learning that the plaintiffs were represented by an attorney. The court noted that, while it would have been better practice to hang up and call the attorney, the one additional communication was not the type of communication prohibited by the FDCPA. "Although there are no cases on point, it seems c(a)(2) was designed to prevent repeated phone calls and letters directly to the debtor after the debt collector knows that person to be represented by an attorney." Id. at 1417. But see Langley v. Scanlon, et al., 1993 U.S. Dist. LEXIS 17278 (D. Del. 1993) (court rejected "threshold" argument and disagreed that statute required more than a single "innocuous written communication" for a violation).

We do not consider the issuance of written correspondence to a represented taxpayer, ensuring that the taxpayer is kept appraised of potential collection

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[13] We further note that the argument that this is not the type of action contemplated by section 6304(a)(2) allows section 6304(a)(2) to be read consistently with other Code provisions which require written collection notices be given to the "taxpayer"–i.e., sections 6320, 6330 and 6331.

actions, to be an abusive debt collection practice. Even if this were the type of action restricted by section 6304(a)(2), we think that the execution of a Power of Attorney form, Form 2848, constitutes the clear written consent of the taxpayer (and representative) to receive such correspondence. Accordingly, the issuance of a Last Chance Letter or other written collection correspondence to a taxpayer would not be a violation of the section 6304(a)(2) restrictions on direct communication. A proposed revision of the Form 2848, which contains no revisions pertaining to section 6304, has been recently circulated and is now in the final review stages. As previously discussed, we think it is unnecessary at this time to modify the Form 2848 with respect to section 6304. We do not foreclose the possibility that some modification may be reconsidered at a later date, however. If such a modification were to be made, the revised instructions and/or publications should contain information which would fully inform taxpayers of the possible consequences of having collection notices and communications sent only to their representatives.

2. <u>Ex Parte Contacts</u>

The second issue raised by your office is whether sending a Last Chance Letter with respect to any summons (collection, examination or criminal) to a represented summoned party is an ethical violation of the Model Rules of Professional Conduct Rule 4.2 and various state bar rules of ethics. As previously discussed, Last Chance Letters are sent by District Counsel offices prior to seeking judicial enforcement of summonses. As further discussed below, although such action would not be a section 6304(a)(2) violation, sending a Last Chance Letter to a represented party may be an unethical <u>ex</u> <u>parte</u> contact, which should be avoided by Chief Counsel attorneys.

Office of Chief Counsel attorneys are subject to the professional codes of the bars in which they are admitted to practice as well as to the American Bar Association Model Rules of Professional Conduct. CCDM (30)485(2)(a). Many states and Federal courts have adopted the Model Rules of Conduct. <u>ABA/BNA Lawyers' Manual on Professional Conduct</u> §§ 01:3 - 01:49; <u>Tannahill v. United States</u>, 25 Cl. Ct. 149 (1992).

American Bar Association Model Rule 4.2, Communication with Person Represented by Counsel, provides that "[i]n representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized by law to do so." Comment 3 to Model Rule 4.2 provides that it "applies to communications with any person, whether or not a party to a formal adjudicative proceeding, contract or negotiation, who is represented by counsel concerning the matter to which the communication relates." Comment 1 accompanying the model rule states that "parties to a matter may communicate directly with each other and a lawyer having independent justification or legal authorization for communicating with a represented person is permitted to do so." "Communications authorized by law include, for example, the right of a party to a controversy with a government agency to speak with government officials about the matter." Id. Comment 2 provides that "[c]ommunications authorized by law also include constitutionally permissible investigative activities of lawyers representing governmental entities, directly or through investigative agents, prior to the commencement of criminal or civil enforcement proceedings, when there is applicable judicial precedent that either has found the activity permissible under this Rule or has found this Rule inapplicable." While Model Rule 4.2 expressly applies to contacts by attorneys, Model Rule 5.3 prohibits lawyers from using nonlawyers to circumvent the Model Rules.

As noted above, there is an exclusion from Model Rule 4.2's direct contact prohibition where there is independent justification or legal authorization for the act–where the act is a "communication authorized by law." Thus it could be argued that, since the Service is authorized by IRC § 7602 to issue summonses in tax matters and enforcement in court proceedings is authorized by IRC § 7604, a Last Chance Letter is not subject to Model Rule 4.2 because there is independent justification or legal authorization. However, such an argument would be weak since these statutory provisions do not expressly authorize Government attorneys to handle such matters. While in a lengthy opinion on Model Rule 4.2, Formal Opinion 95-396 (July 28, 1995), the American Bar Association stated that government rules promulgated as regulations could constitute communications "authorized by law," we have been unable to find any regulations or other Service or Chief Counsel rules or procedures on Last Chance Letters.[14]

Attempts by the Department of Justice to allow ex parte contacts by its attorneys with represented persons have been unsuccessful. Courts have uniformly held that the regulations issued by the Department of Justice at 28 C.F.R. Part 77, and their predecessor (the so-called "Thornburgh memorandum" issued on June 8, 1989) did not supersede traditional court imposed bar rules such as Model Rule 4.2. United States v. Lopez, 765 F. Supp. 1433 (ND Cal. 1991), vacated, 989 F.2d 1032 (9th Cir.), amended and superseded, 4 F.3d 1455 (9th Cir. 1993); United States v. Talao, No. CR-97-0217-VRW (N. Dist. Cal. June 17, 1999); United States ex. rel. O'Keefe v. McDonnell Douglas Corp. 132 F.3d 1252 (8th Cir. 1998) (Department of Justice regulations did not make contacts "authorized by law"). Eventually, these efforts by the Department resulted in the enactment of 28 U.S.C. § 530B by Congress. Essentially, it makes Department of Justice attorneys, including non-Justice attorneys serving as Special Assistant United States Attorneys (SAUSAs), "subject to State laws and rules, and local Federal court rules, governing attorneys in each State where such attorney engages in that attorney's duties, to the same

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[14] ABA Formal Opinion 95-396, citing Chrysler v. Brown, 441 U.S. 281, 298 (1979), states that agency rules only qualify as "law" for purposes of Model Rule 4.2 if issued as a regulation in accordance with the procedural requirements imposed by Congress and are also rooted in a Congressional grant of authority.

extent and in the same manner as other attorneys in that State." Id.; CCDM Notice N(34)000-52 (April 15, 1999). While these regulations only apply to Department of Justice attorneys, the legislation is indicative of Congress's view that Government attorneys should be subject to the conduct rules of courts and state bars–particularly with respect to communications with represented persons.

In view of the Office of Chief Counsel policy that its attorneys will adhere to the Model Rules, the court decisions prohibiting ex parte contacts by government attorneys with represented persons in violation of court rules such as Model Rule 4.2, and the recent legislation requiring Government attorneys to adhere to the rules of courts and state bars, such contacts should be avoided by Chief Counsel attorneys.

In addition to the Model Code, you also requested our views on whether sending Last Chance Letters to a summoned party represented by an attorney would violate various state bar rules. Because of the large number of states it is impractical for this office to examine all jurisdictions. However, since most state codes are based on either the Model Rules or its predecessor, the ABA Model Code of Professional Responsibility, which contained a provision, DR 7-104(A)(1), substantially identical to Model Rule 4.2, most states would likely view direct contacts with represented parties to be improper.
Accordingly, we agree with your proposed procedures providing that the Last Chance Letter be sent directly to the representative, rather than to a represented taxpayer, to avoid an unethical ex parte contact.

3. Third Party Contacts

The next issue raised by your office is the applicability of the third party contact requirements to Last Chance Letters. In general, I.R.C. § 7602(c) requires the Service to give reasonable advance notice to a taxpayer before contacting third parties about the determination or collection of that taxpayer's liability. Procedurally, this is usually accomplished by sending a Form Letter 3164 to the taxpayer. Section 7602(c)(2) additionally requires the Service to maintain records of such contacts and provide them to the taxpayers periodically or upon request. This is usually done by recording the contacts on Forms 12175 and forwarding them to the third-party coordinator.

The advance notice requirement applies when the following elements are present. First, a Service officer or employee initiates a contact. Second, the contact is with a person other than the taxpayer. Third, the Service officer or employee identifies himself or herself. Fourth, the Service officer or employee identifies the taxpayer. Fifth, the contact is made with respect to the determination or collection of the taxpayer's liability. Sixth, none of three exceptions of section 7602(c)(3)(A)-(C) apply. The three exceptions include (1) third-party contacts authorized by the taxpayer, (2) instances in which notice of a third-party contact would jeopardize tax collection or might involve reprisal against any person, or (3) third-party contacts with respect to any pending criminal investigation.

When analyzed for the presence of the five elements, the scenario described in your memorandum involving Last Chance Letters sent to summoned parties clearly constitutes a third-party contact to which the advance notice and recordkeeping requirements of I.R.C. § 7602(c) apply. A Last Chance Letter sent to a summoned third party is a contact initiated by the Service, with a person other than the taxpayer, in which the Service's officer or employee identifies himself and identifies the taxpayer, and the contact is made with respect to the determination or collection of the taxpayer's liability. Also, in the fact pattern described in your memorandum, none of the three exceptions under section 7602(c)(3) apply. The inquiry was specifically limited to summonses not connected with a criminal investigation, and there are no indications that collection may be jeopardized, that any person may suffer reprisal, or that the taxpayer authorized the contact. Accordingly, we conclude that the advance notice and recordkeeping requirements of I.R.C. § 7602(c)(3) do not apply. Having reached these conclusions, we advise the following.

If neither a Form Letter 3164 nor a copy of the summons has been sent to the taxpayer, then the Service should send Form Letter 3164 to the taxpayer prior to sending a Last Chance Letter to a summoned third party. Of course, a previously sent Form Letter 3164 will meet the reasonable advance notice requirement. A copy of the summons sent to the taxpayer pursuant to section 7609 may also satisfy the notice requirement of section 7602(c). [15] However, the Service's procedure requires the Form Letter 3164 to be sent and that is clearly the preferred approach. Also, the Service should record the contact on Form 12175 and forward that form to the third-party coordinator. This process insures that the contact will be included in the periodic record of such contacts provided to the taxpayer as required by I.R.C. § 7602(c)(2). While the Service may have complied with the recordkeeping requirement of section 7602(c)(2) by sending the taxpayer a notice of the summons, which inherently constitutes a record of the contact, the better practice is also to record such contacts on a Form 12175.

Accordingly, we also concur with your office's proposed procedures requiring that third party contact requirements be followed with respect to Last Chance Letters sent to non-taxpayer summoned parties.

4. <u>TDI Summonses</u>

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[15] Although the copy of the summons sent to the taxpayer pursuant to section 7609 might satisfy the reasonable advance notification requirement of section 7602(c) for future contacts with the summoned party, it would not satisfy that requirement for contacts made with other third parties.

Finally, you have asked if a summons issued as a part of a tax delinquency investigation ("TDI summons") is considered an act of collection within the meaning of section 6304(a), which (as previously discussed) places restrictions on the circumstances in which the Service may communicate with a taxpayer "in connection with the collection of any unpaid tax." In concluding that it is not, we analogized to case law interpreting a similar provision in I.R.C. § 7433. Specifically, section 7433(a) provides a cause of action to taxpayers for damages if, <u>inter</u> <u>alia</u>, the Service recklessly, intentionally, or negligently violates the Code or the regulations "in connection with any collection of Federal Tax." This phrase is interpreted to encompass actions taken after the determination of a tax liability is completed. <u>See</u> <u>Miller v. United States</u>, 66 F.3d 220 (9th Cir. 1995), <u>cert.</u> <u>denied</u>, 517 U.S. 1103 (1996) (the Service's alleged erroneous jeopardy assessment could not be the basis of a section 7433 damages action because the act of assessing or determining a tax is not an act of collection). Based on this reasoning, we conclude that a summons issued to investigate a potential, but unassessed, liability is not an act of collection for purposes of section 6304(a).

COLLECTION DUE PROCESS, OFFERS IN COMPROMISE

CC:EL:GL:Br1
June 16, 2000 GL-700795-00
UILC 6330.00-00
ILM 200029009

MEMORANDUM FOR NORTH CENTRAL DISTRICT COUNSEL

FROM: Alan C. Levine
Chief, Branch 1 (General Litigation) CC:EL:GL:Br1

SUBJECT: Processing Offers-in-Compromise During or After Collection Due Process Proceedings

This responds to your March 27, 2000, memorandum requesting advice on the above-cited subject. This document is not to be cited as precedent.

You have requested our assistance in formulating procedures for the Collection Division for working offer-in-compromise cases during the time in which the Office of Appeals ("Appeals") has jurisdiction over a Collection Due Process ("CDP") proceeding. You have submitted proposed procedures for pre-review by this office.

The specific factual scenario is as follows: a taxpayer is involved in a CDP proceeding with Appeals. He or she submits an offer-in-compromise with respect to the tax years at issue in the CDP proceeding. The offer is submitted to the Collection Division, however, rather than to Appeals, either during the pendency of the proceeding or at some point after a determination has been made by Appeals, but where Appeals still retains jurisdiction over that determination. [16]

We agree with your proposed procedures to the extent that they acknowledge that, as Appeals has jurisdiction over the case for the time periods at issue, Appeals must be contacted and informed of the proposed offer and that the Collection Division may not unilaterally take any action with respect to the proposed offer. We think that your proposed procedures should be clarified, however, to the extent that they suggest that it may be appropriate for an offer to be processed by the Collection Division separately from the CDP proceeding.

Once a CDP proceeding is pending with Appeals, there should not be a separate evaluation of an offer-in-compromise by the Collection Division. If a taxpayer approaches a Revenue Officer with a proposed offer while a CDP proceeding is pending, the offer should be referred back to Appeals for consideration in conjunction with that proceeding. Pursuant to I.R.C. § 6330(c), a taxpayer should raise at a CDP hearing any issue relating to the unpaid tax or proposed levy. This includes any offers of collection alternatives such as offers-in-compromise. I.R.C. § 6330(c)(2)(A)(iii). The consideration of an offer-in-compromise, therefore, should be a part of Appeals' comprehensive review of the proposed collection action and its alternatives.

Similarly, if Appeals has issued its determination, but retains jurisdiction over that determination pursuant to section 6330(d)(2), a proposed offer made to a Revenue Officer should be referred to Appeals. Appeals may reconsider its original determination at that time.

We have the following specific comments on your proposed procedures. Number 2 states that the Collection Division may be able to "work the offer" while the CDP hearing is pending, if Appeals has no objections. We agree with numbers 2(a), 2(b) and 2(c). [17] Number 2(d), however, provides that either the taxpayer or Appeals

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[16] I.R.C. § 6330(d) provides that within 30 days of an Appeals determination in a CDP hearing, a taxpayer may seek judicial review of that determination. Pursuant to section 6330(d)(2), Appeals retains jurisdiction with respect to any determination made under section 6330, including any subsequent hearings requested by the person who requested the original hearing on issues regarding collection actions taken or proposed with respect to such determination, and (after the person has exhausted all administrative remedies) a change in circumstances with respect to such person which affects such determination.

[17] Number 2(a) provides that IDRS and AOIC controls cannot be established on the taxpayer's account during the CDP process because Appeals has jurisdiction over the case. Number 2(b) provides that payment of any deposits made with the offer cannot be posted on IDRS. Number 2(c) provides that any final determination

can request that the offer not be processed during the CDP period. An offer should not be evaluated by the Collection Division separately from the CDP context and consideration of the offer should not be postponed until after Appeals relinquishes jurisdiction over the matter. Appeals should consider the offer as a possible collection alternative as a part of the CDP process. The taxpayer cannot be allowed to make offers of some collection alternatives to Appeals and other collection alternatives to the Collection Division during the CDP process. All offers must be made to Appeals, either directly or referred by the Collection Division to Appeals.

In addition, number 3 indicates that where a proposed offer is submitted after a Notice of Final Determination has been sent, but Appeals still retains jurisdiction over that determination, the Revenue Officer should hold onto the file until Appeals no longer has jurisdiction. As previously discussed, however, if an offer is submitted during this time period, that offer should be referred to Appeals. Appeals may then wish to reconsider its prior determination, pursuant to section 6330(d)(2).

Finally, in drafting your procedures, we suggest that you keep in mind the <u>ex parte</u> procedures, which will impact communications between Appeals and other Internal Revenue Service ("Service") employees, including communications with Collection Division employees in conjunction with a CDP hearing. Pursuant to section 1001(a)(4) of the Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 98"), the Service is required to develop a plan to prohibit <u>ex parte</u> communications between Appeals and other Service employees that appear to compromise the independence of Appeals Officers. This prohibition will not take effect until a final Revenue Procedure describing these <u>ex parte</u> procedures is finalized. A proposed Revenue Procedure has been issued by Notice 99-50, 1999-40 I.R.B. 444 (October 4, 1999). A final Revenue Procedure is currently undergoing the review process. Accordingly, we suggest that your procedures make some reference to the future restrictions upon <u>ex parte</u> communications.

BANKRUPTCY; PREFERENCE; INVOLUNTARY PAYMENT; NONTRUST TAXES

February 29, 2000
CC:EL:GL:Br2
GL-801332-99
ILM 200029002
UILC: 09.31.00-00

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regarding acceptance, rejection, return, or withdrawal of the offer-in-compromise must be done after the proposed action is approved by Appeals. Collection cannot unilaterally do any of these things.

MEMORANDUM FOR DISTRICT COUNSEL, ROCKY MOUNTAIN DISTRICT

FROM: Mitchel S. Hyman
Senior Technician Reviewer, Branch 2 (General Litigation)

SUBJECT: Avoidance of Undesignated or Involuntary Payments Applied to Nontrust Tax Liabilities as Preferential Transfers

This memorandum responds to your request for advice dated December 2, 1999. This document is not to be cited as precedent.

ISSUES

1. Whether voluntary undesignated payments or involuntary levy payments applied to nontrust fund tax liabilities are protected from avoidance by a chapter 7 trustee by the holding in Begier v. Internal Revenue Service, 496 U.S. 53 (1990), that a voluntary prepetition payment of trust fund taxes is not payment of “property of the debtor.”

2. Whether the undesignated voluntary or involuntary payments could be re-applied to trust fund taxes so as to bring the payments within the protection of Begier.

CONCLUSIONS

1. Payments, whether voluntary or involuntary, of nontrust fund taxes within the preference period are “transfers of an interest of the debtor in property,” and may be avoided by the trustee if all of the elements of section 547(b) of the Bankruptcy Code are proven.

2. Funds previously applied to nontrust fund taxes should not be re-applied following the commencement of a bankruptcy case in an effort to bring the payments under the protection of Begier.

FACTS

The facts you provided are that two corporations incurred employment tax liabilities for withheld income and FICA taxes and for the employer’s portion of FICA taxes. Corporation A sent in a voluntary, undesignated partial payment which was less than the amount of the nontrust fund portion of the tax liability remaining unpaid at the time of the payment. In accordance with provisions of the Internal Revenue Manual (IRM) and applicable revenue procedures, this payment was applied to the non-trust fund portion of the corporation’s liabilities. See Rev. Rul. 79-284, 79-2 C.B. 83; Policy Statement P-5-60. After consulting with a tax advisor, Corporation A sent subsequent payments with explicit directions to the Service to apply the payments to the trust fund portion of the tax liability. These payments were applied as instructed.

The Service also levied upon the bank account of Corporation B. The proceeds of the levy were less than the full amount of the tax liability and less than the full amount of the nontrust fund liability due at the time of the involuntary payment. The funds were applied to the nontrust fund portion of the corporation's liabilities, as dictated by the IRM. As a result of the levy, the payroll checks of Corporation B were not honored.

Less than ninety days after the payments, Corporation A filed a Chapter 7 bankruptcy petition and Corporation B had an involuntary Chapter 7 case commenced against it by the employees whose payroll checks had been dishonored. In both cases the trustee asks to bring back into the bankruptcy estate the payments made to the Service as preferences under section 547 of the Bankruptcy Code (B.C.), so that distribution can be made to wage claimants entitled to priority over the Service's claims under section 507 of the Code.

You have asked us to consider the applicability of the Supreme Court's holding in Begier v. Internal Revenue Service, 496 U.S. 53 (1990) to these two cases. Specifically, you have asked: 1) whether the Service's application of involuntary or undesignated payments to nontrust fund liabilities takes those payments out of the protection of the holding of Begier that voluntary payment of trust fund taxes is not payment of property of the debtor; and 2) whether the Service's discretion to apply or re-apply undesignated or involuntary payments would permit the Service to re-apply the payments so as to bring them under the protection of the holding in Begier.

DISCUSSION

Section 547(b) of the Bankruptcy Code allows the trustee to avoid certain transfers made by the debtor prior to filing bankruptcy, and to bring the transferred property back into the bankruptcy estate. The section provides that:

> [T]he trustee may avoid any transfer of an interest of the debtor in property:
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made –
>
> (A) on or within 90 days before the filing of a petition; or
>
> (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if –

(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

B.C. § 547(b). The primary purpose of this provision is to promote equality of distribution among the various creditors of the debtor. See H.R. Rep. 95-595, at 177-78 (1977). The trustee's power to avoid preferential transfers made during the 90-day period prior to the bankruptcy filing precludes debtors from favoring one creditor over another by transferring property to creditors that would otherwise have been subject to distribution according to the priorities of the Bankruptcy Code.

The trustee bears the burden of showing that all of the elements of section 547(b) have been met. B.C. § 547(g). However, a threshold matter for determining the existence of an avoidable preference is a finding that the subject property is "an interest of the debtor in property."

In Begier, the Supreme Court adopted the Service's position that a voluntary, prepetition payment of trust fund taxes cannot be avoided under section 547(b), regardless of the source of such payments, because the funds paid were not property of the debtor but were instead held in trust for the United States under section 7501(a) of the Internal Revenue Code. The debtor, American International Airways, had made prepetition payments of air transportation excise taxes collected from customers, income taxes withheld from employee's wages, and FICA taxes withheld from employee's wages. The Internal Revenue Code provides that these collected and withheld taxes assume the status of trust funds, stating:

> Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States.

I.R.C. § 7501(a). Prior to payment, the debtor and the Service had agreed that the payments would be allocated to specific trust fund taxes. The payments were made from two different accounts, one a general operating account containing commingled trust and nontrust funds and one a segregated account, established pursuant to I.R.C. § 7512, used only for the deposit of withheld taxes. The bankruptcy court held that the funds from the segregated account had been held in trust for the United States and were not property of the debtor. However, the court allowed the trustee to avoid the payments from the general operating account because the Service could not trace the funds to actual withheld or collected taxes.

The Supreme Court rejected the bankruptcy court's reasoning and affirmed the Third Circuit's holding that the payment from the general account could not be avoided. The Court held that withheld employment taxes and collected excise taxes need not be placed in a segregated account to be subject to the trust imposed by section 7501(a). Rather, the trust is created pursuant to that section upon the payment of wages to employees or collection of taxes from customers. Begier, 496 U.S. at 61-62.

The Court further held that common-law tracing rules are not applicable to section 7501. This is because "(u)nlike a common-law trust, in which the settlor sets aside particular property as the trust res, section 7501 creates a trust in an abstract 'amount' – a dollar figure not tied to any particular assets – rather than in the actual dollars withheld." Id. at 62. On the other hand, "Congress expected that the IRS would have to show some connection between the section 7501 trust and the assets sought to be applied to the debtor's trust-fund tax obligations." Id. at 65-66. Relying on the legislative history of the Bankruptcy Code, the Court concluded that Congress expected the courts to apply "reasonable assumptions" to govern the tracing of trust funds, and that one such reasonable assumption is that "any voluntary payment of trust-fund taxes out of the debtor's assets is not a transfer of the debtor's property." Id. at 67

In his concurrence, Justice Scalia reasoned that the voluntary payment actually creates the trust by identifying the payment as the trust fund, but that the trust should be deemed to have been in existence from the time of the withholding or collection. Begier, 496 U.S. at 71 (Scalia, J., concurring).

Begier makes clear that a voluntary payment of trust fund taxes cannot be avoided by the bankruptcy trustee. Under the facts of that case, both the debtor and the Service, at the time of payment, were in agreement that the funds were trust fund taxes to be applied as such – thus, Begier involved a voluntary, designated payment. As you note, the degree to which Begier can be said to apply beyond those facts is the subject of disagreement among the courts. Your request asks us to consider the possible expansion of Begier in three directions: 1) to voluntary but undesignated payments, 2) to involuntary payments, and 3) to payments, whether voluntary or involuntary, which the Service initially applies to nontrust liabilities. Each of these variations on the facts of Begier should be considered in light of how they would effect the core finding of the Supreme Court in that case: that the transfer of funds was not a transfer of "property of the debtor."

Voluntary, Undesignated Payments

As you noted, no court has squarely faced the question of whether voluntary, undesignated payments which the Service applies to trust fund taxes are avoidable as preferences. However, we see nothing in such a scenario which would make the reasoning of Begier inapplicable. Begier held that Congress intended courts to apply “reasonable assumptions” when determining whether a payment could be traced to funds held in trust. The Court relied on the legislative history of the Bankruptcy Code, particularly a House report which stated:

> A payment of withholding taxes constitutes a payment of money held in trust under the Internal Revenue Code § 7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they have been if the debtor is able to make the payments.

H.R. Rep. 95-595, at 373 (1977). As we stated before, the Court concluded that it was not necessary for trust funds to be segregated from other funds to find that they had been “properly held for payment.” Rather, the nature or the floating trust is such that the ability to pay provides the nexus required to conclude that the funds were held in trust. It would be illogical to conclude that, although the funds were properly held for payment and the debtor was able to pay, lack of designation by the debtor as trust fund payments destroyed the presumption that the funds were subject to the 7501(a) trust.

Although the debtor and the Service in <u>Begier</u> had agreed that the payments were of trust fund taxes, the Court placed little reliance on this fact in holding that the funds were subject to the section 7501(a) trust or that common-law tracing rules did not apply. In the instant cases, as in <u>Begier</u>, if the funds were properly held for payment, the debtor was able to pay, and the payment was applied to trust fund taxes, the Service should argue that the funds were not property of the debtor and are thus not avoidable by the trustee.

<u>Involuntary Payments</u>

Similarly, if the same funds are taken from the debtor involuntarily, the funds could nevertheless have been held in trust for the Government. Relying on the same legislative history cited in <u>Begier</u>, the debtor “was able to make the payment” if the funds were available to be levied upon in the debtor’s account, and thus they were “properly held for payment” in trust for the Government. This reasoning was adopted by the court in <u>In re Nash Concrete Form Co.</u>, 159 BR 611, 613 (D. Mass. 1993), which held that the debtor’s objective ability to make the payments established the requisite nexus to conclude that the levied funds were trust funds.

If the funds were held in a segregated account, such as one established pursuant to I.R.C. § 7512(b), there is no question that the payments cannot be avoided, since they are directly traceable to withheld taxes. Your question, then, becomes exactly the one facing the Court in <u>Begier</u>: whether such segregation is necessary to establish that trust funds were remitted, and, if not, must the Service trace the levied funds back to the withheld taxes? We take the position that the same "reasonable assumptions" relied upon in determining that voluntary payments were made from trust funds would apply to determining the origin of involuntary payments as well.[18]

Application of Funds to Nontrust-fund Taxes

In the above discussion we have assumed, as was the case in Begier, that the payments, once received, were applied to trust fund liabilities. You have asked us to consider whether funds applied to nontrust liabilities might be beyond the avoidance powers of the trustee if the nexus required by Begier can be established. Furthermore, you argue that if application of the funds to nontrust fund taxes conclusively removes the payments from the protection of Begier, the Service could "cure" that deficiency by reapplying the funds to trust liabilities.

However, the issue here is not whether, in a non-bankruptcy setting, the payments previously applied to a particular liability could be reallocated to some other liability. We agree that the Service has broad authority to re-apply payments with the goal of maximizing collection. Rather, the issue is whether the funds, at the time of payment, represented an "interest of the debtor in property" which would be subject to the preference rules of section 547. This office takes the position that the Service cannot rely on Begier to assert that funds applied to nontrust fund liabilities were not avoidable under section 547. A court would be unlikely to accept the argument that such funds assumed trust fund status at the time of payment.

When the Service receives an involuntary or undesignated payment, it makes a choice to apply the payment in a manner which it believes best serves the interests of maximizing collection. As you noted in your memorandum, the courts have upheld the Service's right to make this choice, see Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983), and, in some circumstances, to revisit that decision when more information comes to light. See Davis v. United States, 961 F.2d 867, 878-79 (9th Cir. 1992), cert. denied, 506 U.S. 1050 (1993); Mattingly v. United States, 939 F.2d 816, 819-20 (9th Cir. 1991); Thomas v. United States, 98-2 USTC ¶ 50,622 (C.D. Ill. 1998). However, the choice between applying a payment to trust fund or nontrust liabilities is, in this context, a decision to designate the funds as either subject to the trust imposed by section 7501 or not. If the Government applies the payment to satisfy trust fund liabilities, it is making the implicit decision that those funds were held in trust for the Government and, applying the same reasoning which supported the holding of Begier, were not property of the taxpayer.

[18] We would not, however, argue that funds seized from some source other the debtor's accounts, such as an account debtor, were trust funds. See In re Hearing of Illinois, 110 BR 380 (Bankr. C.D. Ill. 1990) (rejecting Service's reliance on Begier where Service levied on account receivable to collect trust-fund taxes).

In the cases you have described, the subject payments have at no point been designated, either by the Service or the taxpayer, as trust fund payments. Although Begier established that the traditional common-law tracing rules do not apply to the section 7501 trust, there must be some nexus between the funds received in payment and the taxes withheld or collected. In a case in which the funds have never been identified as trust fund taxes at any point prior to the filing of the bankruptcy petition, we fail to see how the Service could argue that the requisite nexus has been established. In fact, the Service's designation of the funds at the time of payment as nontrust fund payments undercuts any argument that the funds were held in trust prior to remittance by the taxpayer.

You note that the debtor will not be harmed by the Service re-allocating the payments and not turning them over to the trustee. Those harmed would be the wage claimants whose claims have priority over the Service pursuant to section 507. However, potential harm to other creditors is the very concern for which section 547(b) was placed in the Bankruptcy Code, and courts are unlikely to view potential harm to a corporation which is about to be liquidated as a relevant consideration. Where it has been determined that property of the debtor has been transferred during the preference period, fairness to all creditors, rather than any concern over harm to the debtor, is the rational supporting return of the property to the estate.

CONCLUSION

In Begier v. Internal Revenue Service, 496 U.S. 53 (1990), the Supreme Court held that a voluntary prepetition payment of trust fund taxes is not payment of "property of the debtor," and is thus not avoidable by the trustee as preference. In the case of undesignated or involuntary payments, the same "reasonable assumptions" should be applied to determine whether the funds received were held in trust for the United States. Funds previously applied to nontrust fund taxes should not be re-applied following the commencement of a bankruptcy case in an attempt to bring the payments under the protection of Begier.