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NOVEMBER 2001 ***BULLETIN NO. 494***

COLLECTION, BANKRUPTCY AND SUMMONSES BULLETIN

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

Service May Set Off Post-petition Refund Against Prepetition Liability

The United States Court of Appeals for the Sixth Circuit has held that where both a prepetition debt owed to the Service and a post-petition claim against the Service were held by the debtor, rather than the debtor-in-possession, the Service could set off the obligations against each other. In re Gordon Sel-Way, Inc., 2001 U.S. App. LEXIS 22938 (6th Cir., October 26, 2001).

Gordon Sel-Way, Inc. (Sel-Way), the debtor in this case, filed a Chapter 11 petition in July 1988. Sel-Way's plan was confirmed in July 1991. Sel-Way's prepetition debts included unpaid unemployment tax (FUTA) penalties owed to the Service. These debts were classified as general unsecured claims under the plan. In 1992, after the plan was confirmed, Sel-Way paid its outstanding unemployment taxes and thereby became entitled to FUTA refunds. When Sel-Way sought release of the refunds, the Service argued that it was entitled to offset the refunds against the liability for FUTA penalties. The bankruptcy court disallowed the setoff on the rationale that the Service's claim arose prepetition, whereas the debtor's arose post-petition. The district court reversed.

The Sixth Circuit upheld the district court's decision allowing the offset. The court noted that the customary prohibition against offsetting prepetition and post-petition obligations is based on two factors: lack of mutuality and the possibility that allowing the setoff will undermine the plan. Since a debtor and debtor-in-possession are separate legal entities, there is often no "mutuality" between a creditor's prepetition claim, which is against the debtor, and a post-petition claim against the creditor, which is held by the debtor-in-possession. Moreover, allowing setoffs in this scenario could undermine the plan, in that the setoff could enable creditors to circumvent the plan by, in effect, allowing them to collect ahead of creditors who would have been paid earlier under the plan.

The appellate court noted that neither of these outcomes would result from allowing the setoff sought in the present case. Initially, the prepetition claim was against the debtor itself, not the debtor-in-possession, and the post-petition claim, arising as it did after confirmation, was held by the debtor, not the debtor-in-possession; thus, no lack of mutuality existed in the case. Moreover, under the facts of the case, permitting the setoff actually supported the plan more effectively than would disallowing the setoff.

BANKRUPTCY CODE CASES: Setoff

CASES

1. **BANKRUPTCY CODE CASES: Chapter 7 (Liquidation): Distribution of property of the estate: Priority claims**
In re Anderson, No. 99-40093-7 (Bankr. D. Kansas, August 10, 2001) – In a case decided before Security State Bank v. IRS, No. 00-40866 (5th Cir., October 10, 2001)(see October 2001 CBS Bulletin, p.1), bankruptcy court held that for purposes of determining priority status of a claim pursuant to B.C. § 726(a)(1), trustee "commences distribution" when he files his initial version of a final report with the court.

2. **BANKRUPTCY CODE CASES: Exceptions to discharge**
In re Wilbert, 262 B.R. 571 (Bankr. N.D. Ga., March 20, 2001) – Where taxpayer not only did not pay taxes, but acknowledged his duty to do so and impeded the Service's collection efforts by writing letters accusing the agency of trampling on his constitutional rights and engaging in illegal behavior, harassment, slander, and "terroristic extortion," the court found that he willfully attempted to evade the payment of taxes, rendering his liability for the debts at issue excepted from discharge pursuant to B.C. § 523(a)(1)(C).

3. **BANKRUPTCY CODE CASES: Exceptions to discharge**
In re Krumhorn, 2001 U.S. Dist. LEXIS 15716 (N.D. Ill., September 28, 2001) – Where Tax Court's finding that taxpayer "willfully" attempted to evade his tax obligations was essential to its holding, bankruptcy court did not err in determining that taxpayer was collaterally estopped from litigating the issue of whether the liabilities at issue were nondischargeable pursuant to B.C. § 523(a)(1)(C).

4. **BANKRUPTCY CODE CASES: Exceptions to discharge: No, late, or fraudulent returns – "tainted taxes"**
In re Hetzler, 262 B.R. 47 (Bankr. D. N.J., March 12, 2001) – The taxpayer's late filing of Forms 1040 did not constitute the filing of "returns" which prevented the liabilities at issue from being excepted from discharge pursuant to B.C. § 523(a)(1)(B), since the filing of the Forms 1040, which mirrored the information contained in substitute returns previously prepared by the Service, did not reflect "an honest and reasonable attempt on the part of the taxpayer to satisfy the requirements of the tax law."

5. **BANKRUPTCY CODE CASES: Priorities: Income Taxes**
In re deJesus, No. BKY 94-32597 (Bankr. D. Minn., September 28, 2001) – Given that Service assessed liability 25 days before bankruptcy petition was filed, Service's claim was entitled to priority status pursuant to B.C. § 507(a)(8)(A)(ii). The fact that the assessment followed the taxpayer's voluntary filing of a tax return did not undermine the claim's entitlement to priority.

6. COLLECTION DUE PROCESS

Berkey v. IRS, 2001 U.S. Dist. LEXIS 16978 (E.D. Mich., September 20, 2001) – Where taxpayer did not allege either that he did not receive a Notice of Deficiency or that he did not have a prior opportunity to contest the Service's deficiency determinations, the district court reviewed Appeals' Notice of Determination with respect to an employment-tax liability under an abuse of discretion standard. Moreover, because the taxpayer did not establish that his challenge to the Service's determinations was improperly rejected, the Notice of Determination was upheld. In addition, the court held that the taxpayer's request for an installment agreement was properly denied.

7. COLLECTION DUE PROCESS

Geller v. United States, 2001 U.S. Dist. LEXIS 16977 (S.D. Ohio, September 25, 2001) – Tax Court, rather than district court, had jurisdiction over taxpayer's appeal of Notice of Determination with respect to income tax liabilities addressed therein. Accordingly, district court granted Service's motion for partial dismissal based on a lack of subject matter jurisdiction.

8. LIENS: Removal: Release: Reinstatement by revocation
LIMITATIONS: Assessment and collection: Suspension of running
ASSESSMENTS

United States v. Reid, 2000 U.S. Dist. LEXIS 5106 (S.D. Ga., March 21, 2000) – Service's revocation of erroneous release of tax liens pursuant to I.R.C. § 6325(f)(2) was timely where: 1) Service filed a collection lawsuit while the statute of limitations on collection was still open; 2) the filing of the lawsuit tolled the running of the statute of limitations on collection; and 3) the revocation was properly filed and notice thereof was mailed to the taxpayer within the limitations period as tolled by the filing of the lawsuit. Moreover, the fact that erroneous credits posted to the taxpayer's account balance brought the balance to zero did not eradicate the underlying assessment.

9. SUITS: By the U.S.: Foreclosure of tax lien

United States v. Nipper, 2001 U.S. Dist. LEXIS 17243 (N.D. Okla., September 20, 2001) – Where property has been sold following a suit to foreclose tax liens, the fact that a sale has occurred and has been confirmed does not prevent it from being set aside on grounds of fraud, accident, mistake, or some other cause. Moreover, a lesser standard applies when deciding whether a proposed sale should be confirmed by the court.

10. SUMMONSES: Defenses to compliance: Improper purpose

Mazurek v. United States, 2001 U.S. App. LEXIS 24025 (5th Cir., November 7, 2001) – District court properly ordered enforcement of summons issued to American bank at the request of a French government agency, despite the fact that taxpayer was simultaneously contesting his status as a French citizen during the relevant period. The "legitimate purpose" requirement imposed by United States v. Powell, 379 U.S. 48 (1964), requires only that the purpose of the Service in issuing the summons be legitimate, not that the actions of the French government in requesting the subject information also be legitimate; here, since Service was acting legitimately pursuant to the terms of a tax treaty, its purpose in issuing the summons was legitimate.

11. TRANSFEREES AND FRAUDULENT CONVEYANCES: Alter ego
Nominee

United States v. Taylor, 2001 U.S. Dist. LEXIS 17825 (D. Minn., October 24, 2001) – Service's challenge to a transfer effected by a state court's Qualified Domestic Relations Order (QDRO) was prohibited by the Rooker-Feldman doctrine, under which lower federal courts generally lack subject matter jurisdiction over challenges to state court judgments, since the Service could have participated in the state court litigation which led to issuance of the QDRO. Moreover, the Service's argument that the ex-spouse to whom a large portion of the taxpayer's interest in a retirement plan was transferred pursuant to the QDRO was actually an "alter ego" or "nominee" of the taxpayer and that, accordingly, the Service's liens should attach to the transferred interest was rejected on the grounds that the Government did not demonstrate that the taxpayer continued to exercise control over and enjoyed access to the funds at issue.

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

CHIEF COUNSEL ADVICE

BANKRUPTCY CODE CASES: Automatic Stay
PAYMENT: Installment payments

September 26, 2001

CC:PA:CBS:Br2
POSTN-145511-01

UILC: 61.03.00-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE), AREA 4, INDIANAPOLIS

FROM: Mitchel S. Hyman
Acting Senior Technician Reviewer, Branch 2
(Collection, Bankruptcy and Summonses)

SUBJECT: Annual Installment Agreement Statements in Bankruptcy

This Chief Counsel Advice responds to your memorandum dated August 27, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Whether the Internal Revenue Service ("Service") must send annual installment agreement statements ("statement") pursuant to the Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998") to taxpayers in bankruptcy.

2. Whether sending the statement to a taxpayer in bankruptcy violates the automatic stay.

CONCLUSIONS

1. The Service is not required to send annual installment agreement statements to taxpayers in bankruptcy because the installment agreement is not considered in effect while the bankruptcy case is pending.

2. Sending the statement to a taxpayer in bankruptcy would not violate the automatic stay.

FACTS

Section 3506 of RRA 1998 provides:

> The Secretary of Treasury or the Secretary's delegate shall, beginning not later than July 1, 2001, provide each taxpayer who has an installment agreement in effect under section 6159 of the Internal Revenue Code of 1986 an annual statement setting forth the initial balance at the beginning of the year, the payments made during the year, and the remaining balance as of the end of the year.

P.L. 105-206, 112 Stat. 685, 771-72 (1998) (emphasis added). The first of these statements were sent out a few months ago. Apparently, these statements were also sent to some taxpayers in bankruptcy.

According to your memorandum, such a statement, termed an annual installment agreement statement, was sent to a Chapter 13 debtor with a confirmed plan. Attached to the statement is a payment detail page showing what payments have been received and where they had been applied, as well as an installment agreement activity page showing what taxes are owed, including interest and penalties. The statement goes on to say:

> If you'd like to pay the full amount you owe, please call us . . . so we may give you a current payoff figure. Your future statements will be mailed to you annually, for as long as you have installment agreement activity.
>
> As always, we appreciate your timely payments.

Although the statement contains a large notification "**THIS IS NOT A BILL**" and "**THIS IS FOR YOUR INFORMATION**," the debtor's attorney expressed concern because the statement lists penalties and interest that have accrued post-petition. According to your memorandum, local Service personnel have received similar complaints from other debtors' attorneys.

LAW AND ANALYSIS

"In Effect" Requirement

RRA 1998 requires that annual statements be sent to taxpayers with installment agreements that are "in effect." P.L. 105-206 § 3506, 112 Stat. 685, 771-72 (1998). Neither RRA 1998 nor its legislative history define "in effect", however it seems that Congress was prompted by concern that taxpayers making payments pursuant to an installment agreement should be kept informed of how much they are paying and how much they still owe. See Senate Committee on Finance, S. Rep. No. 105-174, 105th Cong., 2nd Sess. (1998). In light of Congress' intent, "in effect" seems to refer to active installment agreements pursuant to which taxpayers are making payments on outstanding tax debts.

Generally, once a taxpayer enters bankruptcy his or her installment agreement is suspended. The taxpayer usually does not continue making payments pursuant to the installment agreement. In this case, the debtor is making payments through his confirmed Chapter 13 plan instead. Thus, even though the installment agreement is not terminated it should be regarded as suspended. Because the installment agreement is suspended and payments are not being made pursuant to the agreement, the installment agreement is not "in effect" for purposes of section 3506.[1]

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[1]Section 6159(b) of the Internal Revenue Code says "Except as otherwise provided in this subsection, any agreement entered into by the Secretary under subsection (a) shall remain in effect for the term or the agreement." This section deals with the termination of installment agreements, thus we understand "in effect" here to be referring only to the events that can lead to termination of agreements. "In effect" is not a term of art and is not defined in the Code. Thus, we emphasize that for purposes of RRA 1998 section 3506 an installment agreement is not in effect in bankruptcy.

The above analysis applies to pre-petition installment agreements. Nothing in this memorandum is meant to imply that notices should not be sent to taxpayers who enter into post-petition installment agreements. According to our analysis, those installment agreements would be considered “in effect” since the debtor continues to make payments pursuant to the agreement during the pending bankruptcy case.

The Automatic Stay

We conclude that sending an annual installment agreement statement does not violate the automatic stay. The automatic stay bars any act to collect pre-petition debts. B.C. § 362(a)(6). The purpose of the automatic stay is to prohibit attempts to compel a debtor to pay pre-petition debts outside of the bankruptcy process. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 340, 342 (1977). Specifically, section 362(a)(6) is designed to prevent creditors from harassing the debtor in attempts to collect on pre-petition debts. See 124 Cong. Rec. H11092 (daily ed. Sept. 28, 1978); S17409 (daily ed. Oct. 6, 1978) (remarks of Rep. Edwards and Sen. DeConcini).

The annual installment agreement statement is not an attempt to collect a pre-petition debt. As noted above, the statement contains conspicuous notification that it is not a bill and is for information purposes only. The notice is intended to help the taxpayer by keeping him informed of the status of his account. See Senate Committee on Finance, S. Rep. No. 105-174, 105th Cong., 2nd Sess. (1998). Similar notices have been held not to violate the automatic stay. For example, reaffirmation letters sent to debtors do not violate subsection (a)(6). Matter of Duke, 79 F.3d 43 (7th Cir. 1996); Brown v. Pennsylvania State Employees Credit Union, 851 F.2d 81 (3d Cir. 1988); Sears Roebuck and Co. v. Epperson, 189 B.R. 195 (E.D. Mo. 1995). The purpose of the automatic stay is not to prevent all communication with a debtor, but to protect the debtor “from the threat of immediate action by creditors, such as foreclosure or a lawsuit.” Brown, 851 F.2d at 86; see also Morgan Guaranty Trust Co. of New York, 804 F.2d 1487 (9th Cir. 1986), cert. denied 482 U.S. 929 (1987) (finding a creditor did not violate the stay by presenting the bank with a promissory note signed pre-petition after the debtor had filed for bankruptcy).

Thus, the stay is not violated by sending the annual statements. However, because pre-petition installment agreements are not considered “in effect” during the bankruptcy case, to avoid any litigation hazards, we recommend against sending the statements to taxpayers in bankruptcy.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

BANKRUPTCY CODE CASES: Chapter 11 (Reorganization): Effect of confirmation

UIL # 09.11.05-00 October 3, 2001

CC:PA:CBS:Br2
POSTS-152644-01

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
(SMALL BUSINESS / SELF-EMPLOYED) CC:SB:2:RCH

FROM: MITCHEL S. HYMAN
Acting Senior Technician Reviewer, Branch 2
(Collection, Bankruptcy & Summonses)

SUBJECT: Default of Chapter 11 Plan -- Your Request for Our Comments

This Chief Counsel Advice responds to your request for our review of a memorandum prepared by your office. [1] The memorandum, dated March 26, 2001, concludes, in reliance on Virginia state law, that upon a corporate taxpayer's default on making payments under a confirmed Chapter 11 plan, the Service is entitled to use administrative collection procedures to collect the amount for which the taxpayer is in default, but not the entire amount due under the plan. This position, which is based on law controlling in Virginia cases, is contrary to the position which has been expressed by this office. Accordingly, you asked for our comments on the position expressed in the March 26 memorandum.

ISSUE: Where a corporate Chapter 11 plan has been confirmed and the taxpayer-debtor fails to make one or more scheduled payments under the plan, is the Service entitled to collect the entire amount due under the plan or only the amount in default?

CONCLUSION: Upon a substantial default, where the debtor has ceased making any plan payments, the Service is entitled to employ administrative mechanisms for collection, and to use those mechanisms to collect the entire amount still due under the plan.

[1] This Chief Counsel Advice should not be cited as precedent.

LAW AND ANALYSIS: Section 1141 of the Bankruptcy Code states, in pertinent part:

> ... the provisions of a confirmed plan bind the debtor ... and any creditor, ... whether or not the claim or interest of such creditor ... is impaired under the plan and whether or not such creditor ... has accepted the plan.

B.C. § 1141(a).

This provision generally has been construed as replacing preexisting obligations on the debtor's part with whatever obligations are imposed by the plan, giving the plan a binding effect. See, e.g., In re Barton Industries, Inc., 159 B.R. 954 (Bankr. W.D. Okla. 1993). However, the Service's position is that it retains its ability to employ administrative collection mechanisms to collect a tax liability even after a given liability is dealt with in a confirmed Chapter 11 plan, at least upon the taxpayer-debtor's default. This position is supported by the analysis in In the Matter of Official Committee of Unsecured Creditors of White Farm Equipment, 943 F.2d 752 (7th Cir. 1991), cert. denied, 503 U.S. 919 (1992). In White Farm, a case involving serial Chapter 11 cases, the court held that even after confirmation, the priority tax liabilities at issue were not discharged and accordingly maintained their status as priority tax claims in a subsequent bankruptcy case. Pursuant to White Farm, where a tax is provided for by the plan, the tax retains its status as a tax liability.

This office's position that the Service may employ administrative collection mechanisms upon the debtor's default is also supported by cases holding that once a Chapter 11 plan is confirmed, a creditor aggrieved in some way may not seek redress through the bankruptcy court, but must instead pursue any available remedies without resort to the bankruptcy process. For example, in a local bankruptcy court decision cited in your memorandum, In re Jankins, 184 B.R. 488 (Bankr. E.D. Va. 1995), the taxpayer-debtor, an individual, defaulted on making payments under a confirmed Chapter 11 plan. The taxpayer-debtor and the Service differed as to what, if anything, was required to be paid under the terms of the plan. The bankruptcy court held that the plan required the taxpayer-debtor to pay post-confirmation interest on the Service's claim and that his failure to do so constituted a "material" default, but noted that the taxpayer-debtor had substantially complied with the plan terms. In denying the United States's motion to dismiss the case based on the taxpayer-debtor's default, essentially on the grounds that the Service failed to pursue its remedies in a timely fashion, the court characterized a confirmed Chapter 11 plan as "in the nature of a novation," and stated that where a debtor defaults on such a plan, "the creditor ... is not required to seek relief in the bankruptcy court but may pursue its normal remedies with respect to the restructured debt." 184 B.R. at 494. The court went on to specifically hold that the Service, "to the extent it has not received the payments promised by the plan, ... may enforce payment of the restructured liability through its own administrative processes." Id. [2] See also In re Seminole Motors, Inc., 1989 U.S. Dist. LEXIS 15634 (E.D. Okla. 1989)(obligations imposed by plan are enforceable in forum other than bankruptcy court).

Although it is clear that the Service can use its administrative remedies to collect plan liabilities after default, it has been less than clear whether the Service can only collect plan amounts as they come due. Our position is that where the debtor has defaulted on a series of plan payments and has ceased making any payments under the plan, and after notice of the default from the Service it is clear that the debtor will not attempt to cure the default and satisfy its plan obligations, it is appropriate for the Service to attempt to collect the full amount of the tax liability provided for by the plan. In such a case of substantial default, the debtor is in essence treating the plan as no longer in effect and has opted out of participation in the bankruptcy process. The Service should accordingly be permitted to use its full administrative collection authority to collect the plan amounts. Where the debtor, however, has only missed some payments and is still actively making some payments under the plan, we believe that since the debtor is still trying to participate in the bankruptcy process, the Service should limit any administrative collection to the plan payments then due.

Our position that the Service can collect the entire plan amount upon a substantial default is consistent with the fact that the statute of limitations on collection resumes running once default occurs. The running of the collection statute is clearly suspended during the period the automatic stay is in effect. I.R.C. § 6503(h). Moreover, the suspension continues during the post-confirmation period when a Chapter 11 plan is in effect and payments are being made under the plan, since prior to default the Service is bound by the plan and is, thus, prohibited from collecting. See, e.g., In re Montoya, 965 F.2d 554, 557 (7th Cir. 1992). However, upon substantial default, the Service can once again commence administrative collection. The collection statute is, accordingly, no longer suspended, and collection of the full amount of the plan liability may be necessary in order to ensure collection within the period of limitations.

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[2] In an individual case, some tax liabilities may be nondischargeable; there is no question that such liabilities may be collected by administrative means after default. See, e.g., In re Gurwitch, 794 F.2d 584, 585 (11th Cir. 1986); In re Amigoni, 109 B.R. 341, 345 (Bankr. N.D. Ill. 1989). The decision in Jankins does not indicate whether the liabilities at issue are nondischargeable. In any case, we interpret Jankins as standing for the broader proposition that the Service may use its administrative tax collection authority to collect any tax liability provided for by the plan after default. We also note, in this regard, that unless the plan provides otherwise, any tax liabilities not provided for by a corporate Chapter 11 plan are discharged under B.C. § 1141(d) and cannot be collected even after default.

Your view is that, assuming the Chapter 11 plan does not contain language explicitly allowing the Service to collect the full amount due under the plan if the debtor defaults, the Service may collect only the actual amount in default, at least in cases arising in Virginia. This position is based on controlling case law addressing remedies upon breach of an installment contract.

The controlling case which you cite as limiting the Service's ability to collect the entire plan amount upon default is City of Hampton, Virginia v. United States of America, 218 F.2d 401 (4th Cir. 1955), which holds that upon breach of an installment contract, a creditor with no remaining duties left to perform under the contract may recover only the installments due at the time the creditor institutes the action for breach. In accord, Parker v. Moitzfield, 733 F. Supp. 1023, 1025 (E.D. Va. 1990). These decisions may be representative of the general rule on this issue. See, e.g., Restatement (Second) of Contracts § 243 (1979). However, we do not view this rule as dispositive of the issue of the Service's remedies upon the taxpayer-debtor's default. These decisions contemplate the existence of contracts between consenting parties. A taxpayer is subject to a given tax liability not as a result of a consensual relationship, but because a federal statutory scheme exists which requires him to pay that liability. While a party to an installment contract is only obligated to pay each installment according to the contractual payment schedule, a delinquent taxpayer is obligated under the Internal Revenue Code to pay his or her taxes in full immediately or risk accrual of interest and penalties as well as administrative collection action. Even though the Chapter 11 plan modifies this statutory obligation to permit installment payments over an extended period of time, the underlying statutory obligation is one of immediate payment of the amount due. Accordingly, when the obligation to pay in installments under the plan is breached, thus permitting the Service to employ its normal administrative remedies available outside of bankruptcy, the Service should be able to collect the full amount as permitted under nonbankruptcy law. Given both the peculiarities of the bankruptcy process and the nature of the debtor-creditor relationship specific to taxpayers and the Service, we do not believe rules governing remedies upon breach of installment contracts should apply to situations where debtors who are also taxpayers have stopped making payments under confirmed plans in bankruptcy.

LITIGATING HAZARDS: [redacted]

[redacted]

[redacted]

In summary, our position is that the Service may legally use administrative collection mechanisms to collect the full amount due under a plan once the taxpayer-debtor defaults on making plan payments, in cases where the debtor has ceased making all payments under the plan and will no longer attempt to comply with the plan. We see no reason, based on the case law noted in your memorandum, why this remedy would not be available in Virginia as well as in other jurisdictions. [redacted]

Note: This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

COMPROMISE AND SETTLEMENT

July 5, 2001

CC:PA:CBS:Br2
GL-109616-01

UILC: 17.00.00-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE), AREA 7, SACRAMENTO

FROM: Lawrence H. Schattner
Chief, Branch 2 (Collection, Bankruptcy & Summonses)

SUBJECT: Offers in Compromise and Partnership Liabilities

This Chief Counsel Advice responds to your memorandum dated April 3, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE:

Where the Service compromised with one or more general partners for the employment tax liabilities of a partnership, can the Service later pursue collection of the unpaid balance of the liabilities from other general partners not party to the compromise agreement?

CONCLUSION:

Yes. Although it is the Service's policy to compromise the employment tax liabilities of a partnership at the partnership level only, it is possible for the Service, under certain circumstances, to compromise with one general partner while preserving its right to collect from other general partners or the assets of the partnership itself. In the cases you have presented, the Service has entered into binding compromises with one or more partners without extinguishing the liability of the partnership or prejudicing its rights to collect from other sources. In future cases, however, we recommend that compromises with individual partners not be entered into absent a change in the Service's policy or authorization from the Office of Compliance Policy in the Small Business/Self Employed Division's National Office.

BACKGROUND:

The Service's policy with regard to compromising the employment tax liabilities of partnerships is that the entire liability should be compromised at one time. The Offer in Compromise Handbook, IRM 5.8, provides:

> The amount that must be offered to compromise a partnership tax liability must include the maximum collection potential for the partnership and all general partners. Secure Collection Information Statements from the partnership and all partners before beginning your analysis.

IRM 5.8.1.12(1). Although it has long been recognized that individual partners are jointly and severally liable for the partnership unpaid employment taxes, the handbook contains no guidance on compromising an individual partner's derivative liability. The Service has concluded that because the employment tax liabilities are a single liability owed by the partnership itself, the Service can best maximize collection and protect its collection rights by compromising these liabilities at the partnership level only.

You have requested our advice regarding two cases in which the Service has, in fact, compromised employment taxes with one or more, but not all, of the individual general partners of partnerships. The compromises were made prior to revision of the Internal Revenue Manual to read as quoted above. At the time, the manual included a procedure for compromises with one partner while reserving the right to collect from other partners and/or from the assets of the partnership itself. In both cases, both the partners' offers and the Service's acceptances clearly indicate that the agreements related only to any personal liability on the part of the partners offering to compromise, and that those partners were not acting in their capacities as agents of the partnerships. Also in both cases, so called "co-obligor collateral agreements" were obtained from the partners. These collateral agreements clarify that while the parties intended the compromise to conclusively settle the Service's ability to collect from the partners named in the compromise, the compromises did not serve as releases from liability that would in any way prejudice the Service's right to collect from other parties liable in any capacity for the taxes at issue.

Your memorandum expresses concern over whether collection can be pursued against other partners not named in any of the compromises. That concern is in part based on prior advice from this office, in which we explained the reasoning behind the Service's current policy and expressed our opinion that the policy of compromising with all partners together is prudent in light of those considerations. We continue to believe that the Service's current policy has merit given the significant risks to which the Service would be exposed if a contrary policy were followed. We have nevertheless concluded that the Service can collect from other, non-compromising general partners in the two cases you have presented.

LAW & ANALYSIS:

Although the Code creates a single employment tax liability for which a partnership acting as employer is liable, the Service can collect the unpaid liability from individual general partners based on state laws making general partners liable for partnership debts. See Remington v. United States, 210 F.3d 281, 283 (5th Cir. 2000) ("The partnership is the primary obligor and its partners are jointly and severally liable on its debts."); Ballard v. United States, 17 F.3d 116, 119 (5th Cir. 1994); United States v. Hays, 877 F.2d 843, 844 n.3 (10th Cir. 1989); Tony Thornton Auction Service, Inc. v. United States, 791 F.2d 635, 637-38 (8th Cir. 1986); Calvey v. United States, 448 F.2d 177, 180 (6th Cir. 1971); Young v. Riddell, 283 F.2d 909, 910 (9th Cir. 1960); United States v. Underwood, 118 F.2d 760, 761 (5th Cir. 1941); United States v. West Productions, Ltd., 2001 TNT 78-74 (S.D.N.Y. March 30, 2001). California partnership law, consistent with the common law rule and the laws of most jurisdictions, states that general partners are jointly and severally liable for the debts and obligations of the partnership. See Cal. Corp. Code § 16306.

Section 7122 of the Internal Revenue Code grants the Secretary broad compromise authority. "The Secretary may exercise his discretion to compromise any civil or criminal liability arising under the internal revenue laws." Temp. Treas. Reg. § 301.7122-1T(a)(1). Further, the Service may, at its discretion, choose to compromise with only one of several parties responsible for the same tax liability. See id. at (d)(5) (providing that compromise conclusive settles the liability of "the taxpayer specified in the offer").

In the two cases at issue, the Service exercised its discretion to compromise with some partners and pursue different collection methods with others. Although a general partner may act as an agent for the partnership and form a binding agreement on the partnership's behalf, see, e.g., Cal. Corp. Code § 16301, the compromises made in these cases clearly stated that the partners were acting in their individual capacities and not as agents for their respective partnerships. Thus, the compromises had the effect of finally resolving the Service's rights to collect from the compromising partners and did not eliminate the underlying liability or the Service's right to pursue any other collection avenue provided by law.

Should the Service's ability to collect from other sources be challenged on the theory that these compromises have had some broader effect, we are confident that, under the particular facts presented, the Service would prevail. When interpreting or determining the effect of compromises under section 7122, courts have generally applied contract principles. See e.g., United States v. Feinberg, 372 F.2d 352 (3d Cir. 1967); United States v. Lane, 303 F.2d 1 (5th Cir. 1962). The goal in interpreting contracts and other legally operative documents is to arrive at a construction that gives effect to the parties' intent as expressed at the time the document was executed. See Corbin on Contracts VII (Rev. ed. 1998). The plain language of the document has long been the preferred source of authority regarding the parties intent, but extrinsic evidence of intent has also come to play a prominent role in modern principles of contract interpretation. See, e.g., Town v. Eisner, 245 U.S. 418, 425 (1918); Pacific

Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., 442 P.2d 641, 644 (Ca. 1968); John D. Calamari & Joseph M. Perillo, The Law of Contracts 166-67 (3rd ed. 1987).

In both of these cases, the language of the agreements and the extrinsic circumstances show a clear intent to resolve only collection from the individual partners offering to compromise. In the first case, the partner amended his offer prior to acceptance to state that it related only to his personal liability, including specific language stating that he was not acting as agent for the partnership. In the second case, similar limiting language was used in both compromises, referring to the liabilities as those of “former partners” of the by-then defunct partnership. Both compromises included the collateral agreement clarifying that the underlying partnership liability itself was not extinguished and could be collected from other sources. The Service’s recording of the compromises on its books–taking steps to maintain a separate accounting of the compromises and their effect so that it could continue to pursue collection from other partners–provides extrinsic evidence of the intended effect of the compromises. The very fact that the Service considered and accepted separate compromises from multiple partners in the same partnership is further evidence that no one of the compromises was intended to resolve the case with regard to any and all other partners.

For these reasons, we conclude that the compromises in these cases did not extinguish the liabilities of the partnerships or prejudice the Service’s ability to collect from other partners. Because we have concluded that collection against other partners was unaffected by these compromises, we have not addressed the specific collection actions being contemplated in the two cases. Whatever collection methods were available to the Service before the compromises remain viable options with respect to collection from any remaining partners.

We must note that our conclusions in no way override or modify the Service’s policy as expressed in the Internal Revenue Manual. We continue to believe that the policy has merit, and, in future cases, recommend that the policy be observed unless it is changed or a deviation is authorized by the Office of Compliance Policy, Small Business/Self Employed Division.

REDEMPTION

June 28, 2001

CC:PA:CBS:Br1
GL-126375-01

MEMORANDUM FOR ASSOCIATE AREA COUNSEL - LAGUNA NIGUEL
CC:SB:8:LN
Attn:WBDouglass

FROM: Alan C. Levine
Chief, Branch 1 (Collection, Bankruptcy & Summonses)
CC:PA:CBS

SUBJECT: Redemption of Property Sold at Foreclosure Sale

This Chief Counsel Advice responds to your EMAIL dated June 5, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Is there tension between the literal terms of I.R.C. § 7425(d)(1) and Treas. Reg. § 301.7425-4(a)(3) as to whether a Notice of Federal Tax Lien ("NFTL") must be properly filed more than 30 days before a nonjudicial such sale in order for the Internal Revenue Service ("Service") to have a right of redemption?

2. Whether a NFTL filed outside of the chain of title still meets the requirements of I.R.C. § 6323(f)(4)?

CONCLUSIONS

1. There is no tension between the literal terms of section 7425(d)(1) and section 301.7425-4(a)(3). Both provisions require that the tax lien be extinguished in order for the Service to have a right of redemption.

2. A NFTL that is filed outside of the chain of title does not meet the requirements of section 6323(f)(4).

FACTS

The pertinent facts are the following: On , the Service assessed tax liabilities against the wife. On , the husband and wife quitclaimed their personal residence to their daughter. On , the Service filed a NFTL reflecting the wife's tax liability; this NFTL was outside the chain of title of the grantor-grantee index because the property had been quitclaimed prior to the filing of the NFTL. In , the mortgage company, whose lien on the personal residence was senior to the federal tax lien, properly notified the Service that it would be conducting a nonjudicial sale, and subsequently sold the personal residence. The Service is now considering whether it can redeem the property.

LAW AND ANALYSIS

Tension between the statute and the regulation

We do not think there is any tension between the section 7425(d)(1) and section 301.7425-4(a)(3), as they both recognize that the Service may redeem only when its federal tax lien has been extinguished.

I.R.C. § 7425(b) divides the effect of nonjudicial sales into two categories. First, subsection (b)(1) provides the only situation in which the NFTL will not be extinguished: a senior nonjudicial sale of property will not extinguish the junior federal tax lien only if the NFTL was properly filed more than 30 days before such sale and the United States is not given proper notice of such sale. If the NFTL is not properly filed more than 30 before such sale or the United States is given proper notice of the sale, the federal tax lien will be extinguished. The rationale for the position taken in the regulations is fully explained in 1974 TM LEXIS 3, T.D. 7430.

Second, subsection (b)(2) addresses the converse situation, explaining the situations in which the federal tax lien will be extinguished by a nonjudicial sale. The most common situation is described in subsection (b)(2)(A) which provides that a tax lien will be extinguished if "notice of such lien or such title was not filed or recorded in the place provided by law for such filing more than 30 days before such sale."

Section 7425(d)(1) provides the Service with a right of redemption as follow: "In the case of real property to which subsection (b) applies to satisfy a lien prior to that of the United States, the Secretary may redeem such property within the period of 120 days from the date of such sale or the period allowable for redemption under local law, whichever is longer."

Treas. Reg. § 301.7425-4(a)(3) clarifies the effect of section 7425(d)(1):

> In the event a sale does not ultimately discharge the property from the tax lien

> (whether by reason of local law or the provisions of section 7425(b)), the provisions of this section do not apply because the tax lien will continue to attach to the property after the sale. In a case in which the Internal Revenue Service is not entitled to a notice of sale under section 7425(b) and § 301.7425-3, the United States does not have a right of redemption under section 7425(d). However, in such a case, if a tax lien has attached to the property at the time of the sale, the United States has the right of redemption, if any, which is afforded to any similar creditors under the local law of the place in which the property is situated.

At page five, your draft memorandum states that “the literal terms of I.R.C. § 7425(d)(1) appear to give the United States a right of redemption <u>whenever</u> there is a foreclosure of a lien senior to the federal tax lien.” (Emphasis added.) We disagree, as this statement suggests that the Service could redeem when a foreclosing senior lienor failed to give notice to the Service. (In such a situation, assuming that the Service had properly filed its NFTL more than 30 days prior to the sale, the Service would still have its tax lien, so it could not redeem the property.) In our opinion, the literal terms of section 7425(d)(1), which reference section 7425(b), limit the Service’s right of redemption to situations in which the tax lien has been extinguished. In other words, the definition of redemption presupposes that the junior lien has been extinguished.
See G. Nelson, <u>Real Estate Finance Law</u> § 7.2 (1993).

In any event, your memorandum correctly concluded that Treas. Reg. § 301.7425-4(a)(3) makes “clear that the right of redemption under I.R.C. § 7425(d)(1) is limited to situations in which (1) the foreclosure sale results in the extinguishment of the federal tax lien, and (2) <u>a notice of federal tax lien was properly filed more than thirty days prior to the foreclosure sale</u>.” (Emphasis added.)

<u>Chain of title</u>

Given that the Service’s right of redemption requires that a NFTL be properly filed, the next consideration is whether the Service’s NFTL in this case was properly filed when it was filed outside the chain of title.

I.R.C. § 6323(f)(4) provides the rules for filing the NFTL for real property:

> (A) [If] under the laws of the State in which the real property is located, a deed is not valid against a purchaser of the property who (at the time of the purchase) does not have actual notice or knowledge of the existence of such deed unless

> the fact of filing of such deed has been entered and recorded in a public index at the place of filing in such a manner that a reasonable inspection of the index will reveal the existence of the deed, and
>
> (B) there is maintained ... an adequate system for the public indexing of Federal tax liens,
>
> then the notice of lien referred to in subsection [6323(a)] shall not be treated as meeting the filling requirements under paragraph (1) unless the fact of filing is entered and recorded in the index referred to in subparagraph (B) in such a manner that a reasonable inspection of the index will reveal the existence of the lien.

In TKB International, INC. v. United States, 995 F.2d 1460 (9th Cir. 1993), the Ninth Circuit interpreted section 6323(f)(4) to conclude that the NFTLs that were filed outside of the chain of title did not meet the requirements of section 6323(f)(4), so the purchaser of the property prevailed under section 6323(a). In discussing the chain of title, the Ninth Circuit concluded that a purchaser had a duty to look beyond the grantor-grantee index when documents in the chain of title put the purchaser on notice. "We require that as to documents that are in the actual chain of title the searcher must at least look at such documents as may have current effect and must then act on the notice imparted." Id. at 1465. Looking to the chain of title, the Ninth Circuit concluded that there was nothing requiring further investigation by the purchaser: a deed from one corporation to another corporation, indicating the apparent payment of the full market value, did not indicate a fraudulent transfer.

At page 12, your draft memorandum argues that TKB may be interpreted to conclude that the Service's NFTL in the present case met the requirements of section 6323(f)(4). We disagree. You state "In the present case, we believe that anyone examining the quitclaim deed from the taxpayers to [their daughter], which indicated that the transfer was without consideration, would know that [the daughter] was not a purchaser under I.R.C. § 6323(a) and (h)(6)." [1] While this may be true, section 6323(f)(4) requires that the NFTL be filed in the chain of title to be effective in order to prime a subsequent purchaser. In this case, the NFTL was not filed in the chain of title. Also, TKB, in a corollary to section 6323(f)(4), provides that the actual purchaser must look at the documents in the chain of title and cannot ignore inquiry notice of a fraudulent conveyance. The TKB corollary, however, does not help the Service in this case, as a quitclaim deed from parents to a child should not be interpreted to suggest a fraudulent conveyance. Indeed, if the Service took the position that a transfer of

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[1] You cite the dicta in footnote 3 in TKB for the proposition that the purchaser's actual knowledge is relevant for determining the priority of the tax lien as against the purchaser. We disagree, as discussed infra, and think that the purchaser's knowledge is not a factor in determining priority under section 6323(a).

property from a parent to a child indicated a fraudulent conveyance, it would place an onerous burden on purchasers and undermine the certainty of deeds in the Ninth Circuit.

At page 13, your draft memorandum offers a second reason why the Service's NFTL meets the requirements of section 6323(f)(4). "Secondly, anyone examining the county records would also note that [the wife's] NFTL filed on June 16, 1996 recited that the tax liabilities at issue were assessed on April 22, 1996, prior to the date of the quitclaim deed. Therefore, anyone examining the county records would be on notice that an undivided one-half interest in the subject property was still encumbered by a federal tax lien in excess of $4,000,000.00." The problem with this theory is that it assumes that a purchaser has some duty to search outside of the chain of title. In this case, the Service filed its NFTL outside of the chain of title, and consequently, fails the requirements of section 6323(f)(4). Also, in Litigation Guideline Memorandum GL-1, we took the position that a purchaser primes an unrecorded or improperly recorded NFTL even if the purchaser had prior knowledge that the assessment lien encumbered the property. In other words, unlike section 6323(b)(1)(A) which considers whether the purchaser had actual notice or knowledge of the tax lien, the priority rule in section 6323(a) does not consider the actual notice or knowledge of the purchaser.

In conclusion, because the NFTL was not filed in the chain of title, we think that the NFTL was not properly filed before the nonjudicial sale of the property. Consequently, the Service has no right to redeem the property in this case.