DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR ROCKY MOUNTAIN ASSOCIATE DISTRICT COUNSEL

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

SUBJECT:

This memorandum responds to your June 30, 1999, request for advice concerning the above referenced case. This document is not to be cited as precedent.

LEGEND:

Taxpayers

Corporate Debtor

ISSUES

(1) Whether the payments made by Corporate Debtor on Taxpayers' behalf which are subsequently avoided pursuant to a bankruptcy trustee's avoidance powers extinguished the Taxpayers' tax liabilities or tax assessments.

(2) Whether the Service was required to give Taxpayers due process before remitting avoidable payments to the bankruptcy trustee, when the payments were made by Corporate Debtor against Taxpayers' tax liabilities.

CONCLUSIONS

(1) No, the avoided payments did not extinguish the Taxpayers' tax liabilities or tax assessments.

(2) No, the Service was not required to give Taxpayers due process before remitting payments to the bankruptcy trustee, even though remittance will affect Taxpayers' tax liability.

DISCUSSION:

The facts you presented detail a situation where Corporate Debtor made payments of the Taxpayers' personal tax liabilities, then filed for Chapter 11 bankruptcy protection. The Taxpayers were insiders of Corporate Debtor. The case was subsequently converted to Chapter 7, and the bankruptcy trustee brought an adversary proceeding against the Service to avoid the payments. A settlement agreement was reached between the Service and the trustee, whereby a portion of the payments were remitted to the trustee. The settlement agreement was approved by the bankruptcy court after notice and opportunity for hearing.

The issue you raise is whether the payments made by Corporate Debtor on behalf of the Taxpayers extinguished the Taxpayers' tax liabilities or tax assessments even though a portion of the payments were remitted to the trustee as part of a settlement of a preference action against the Service. Your concern arises from a line of cases holding that payment extinguishes a tax assessment or tax liability. See, Bilzerian v. USA, 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). You conclude, however, that because the avoided payments were determined by the bankruptcy court to be property of the Corporate Debtor, they did not extinguish the assessments and that the Service should treat that amount as an erroneous credit to the account.

We agree that the avoided payments were determined by the bankruptcy court to be property of the Corporate Debtor and did not extinguish the tax assessments in this case. The trustee's avoidance action was brought under §§ 544, 547, 548, 549 and 550 of the Bankruptcy Code. Each of these provisions provide instances in which the trustee in a bankruptcy case may "avoid" transfers of property by the debtor. "Avoid" means to annul, cancel, make void, or destroy the efficacy of. See BLACK'S LAW DICTIONARY 136 (6th ed. 1990). See also, Farrey v. Sanderfoot, 500 U.S. 291, 296 (1991) (Court found that Congress intended the term "avoid" in Bankruptcy Code § 522(f) to be given its standard legal meaning to "annul" or "undue," citing Black's Law Dictionary); Matter of Merchant's Grain, Inc., 93 F.3d 1347, 1356 (7th Cir. 1996) (court followed Farrey, applying same standard legal meaning to the term "avoid" in Bankruptcy Code § 545). Thus, the payments at issue were annulled, canceled, voided, and without efficacy, to the extent of the bankruptcy court's order approving the settlement.

The line of cases holding that payment extinguishes a tax assessment or tax liability do not apply. In these cases the taxpayers paid their tax liabilities, then the Service erroneously refunded the payments back to the taxpayers. The Service attempted to use administrative collection procedures to collect the erroneously refunded payments. The Service argued that because the erroneous refunds left the tax liabilities unpaid, it could use administrative collection procedures based upon the original tax assessments. The courts rejected this argument, and the Service has changed its position accordingly. The reasoning of these cases was best articulated in O'Bryant, which held that there is a fundamental difference in character between the money the taxpayers originally owed and the money they owe as a result of the erroneous refund. 49 F.3d at 346. The court reasoned that the money owed as a result of the erroneous refund is not the money that the original assessment contemplated, but is owed because they were unjustly enriched by the Service's mistake. Id. Because this type of debt is not a tax debt, which was satisfied by the payment, it would not make sense to allow the Service to use tax collection procedures to collect it. Id. Thus, the court concluded that the Service was confined to the erroneous collection procedures available in the Tax Code. Id. at 347.

The O'Bryant line of cases is inapplicable to this case because the payments were not properly made and erroneously refunded, thereby creating a separate liability based upon the Taxpayers' unjust enrichment. It the present case, there has been no payment of the Taxpayers' tax liability. The payments were avoided, or annulled, as a result of the preference action and therefore had no efficacy. The present liability is still one for the underlying taxes. Further, the concern in the O'Bryant line of cases was that taxpayers should not be subject to administrative tax collection procedures when they had in fact fulfilled their obligations under the Tax Code. 49 F.3d at 346. The Taxpayers have not fulfilled their tax obligations in this case, where the payments were made by a separate entity, and were avoidable under the avoidance provisions of the Bankruptcy Code. See also, Clark, 63 F3d. at 88, following Wilkes, 946 F.2d at 1152 (only payments made by the taxpayer, and not by IRS error, extinguish assessments). Finally, it would be an absurd result if taxpayers could make avoidable payments, and thereby exchange tax liabilities for non-tax liabilities.

Taxpayers argue that the Service should reverse the assessed liabilities, and give them credit for the avoided payments because the Service did not give them any due process before agreeing to remit the funds to the bankruptcy trustee. They do not specify what type of due process they think would be necessary. This argument fails for two reasons. First, their agreement, if any, with Corporate Debtor to have it pay their tax liabilities was an agreement with the Corporate Debtor, not the Service. Their claim, if any, for breach of such an agreement, whether it be for breach of contract or promissory estoppel, would be against Corporate Debtor, not the Service. The Service had no obligation towards Taxpayers with regard to this agreement, because the Service was not a party to it. Second, Taxpayers had the opportunity to object to the settlement upon the notice and opportunity for hearing provided on the motion to compromise in the bankruptcy court.

If you have any further questions, please call the attorney assigned to this matter at (202) 622-3620.