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GENERAL LITIGATION BULLETIN

Department of the Treasury *Internal Revenue Service*

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TAKE A LOOK
Court Orders Service to Consider Offers in Compromise in Bankruptcy

A bankruptcy court has found the Service's policy not to consider an offer in compromise submitted by a debtor in bankruptcy to be discriminatory and a violation of B.C. § 525. While the Service's decision whether or not to accept an offer in compromise ("OIC") remains discretionary, the bankruptcy court of **In re Chapman, 84 AFTR2d ¶ 99-5068 (Bankr. S. W.Va. June 23, 1999)** used its equitable power under B.C. § 105 to require the Service to at least consider the OIC.

The debtors filed chapter 13 bankruptcy, owing the Service nearly $139,000.00 in priority taxes. The debtors' plan of reorganization proposed to satisfy the Service's claim by means of an OIC in the amount of $10,000.00, and the debtors in fact submitted an OIC with a deposit to the Service. Under established policy, the Service did not consider the debtors' OIC, and timely objected to the debtors' plan. The debtors in turn asked that the court require the Service to review their OIC as though the debtors were not in bankruptcy.

The Service argued that, under I.R.C. § 7122, consideration of an OIC is discretionary. The Bankruptcy Code provides sufficient protections for debtors, and the Service's decision not to process an OIC while a debtor is in bankruptcy is not discriminatory because it applies to all debtors in bankruptcy. The Service also argued that as a priority tax debt is nondischargeable, and must be paid in full under the debtors' plan, refusal to consider an OIC has no effect on a debtor. Further, the consideration of an OIC might be considered a violation of the automatic stay.

The court found little merit to any of these arguments. Examining B.C. § 525(a) and its legislative history, the court found clear Congressional intent to prohibit discrimination that can seriously affect the debtor's livelihood or fresh start. The court then looked to I.R.C. § 7122(a), and found that although acceptance of an OIC is discretionary, nothing in that statute's language indicates that the Service can refuse to even consider an otherwise valid OIC. The court found the refusal to consider an OIC denies a bankruptcy debtor many of the protections, such as administrative appeal rights, that even a denied OIC taxpayer is offered.

The court also found that, although the Service's priority tax debt must be paid in full, a successful OIC would reduce the amount considered a priority debt, and thus clearly have an impact on the debtor's fresh start. As to the question of whether consideration of an OIC would be a stay violation, the court held that the debtors' choice to submit an OIC is a voluntary waiver of that defense, and should the Service have additional concerns, it could request that the stay be lifted.

BANKRUPTCY CODE CASES: Compromise or Settlement
COMPROMISE & SETTLEMENT: Bankruptcy

1. **ASSESSMENTS: Jeopardy Assessment: Judicial Review**
Arnold v. United States, 83 AFTR2d ¶ 99-981 (M.D. Fla. April 14, 1999) - Taxpayers challenged jeopardy assessments, which were upheld by the court. The court determined under I.R.C. § 7429 that the taxpayer's indictment for tax evasion, use of shell corporations and nominees to hide assets, lack of attachable assets, and history of filing false tax returns and financial statements established the jeopardy assessments were reasonable under the circumstances. The court dismissed the taxpayers' defense of disability, because it was a defense to ultimate liability, not the reasonableness of the assessment. The court also dismissed the taxpayer's claim that the acts cited to support the Government's case were too old. Because the section 7429 is a summary proceeding, the court may examine otherwise inadmissible evidence that the Service relied on in making its jeopardy assessments.

2. **BANKRUPTCY CODE CASES: Automatic Stay (§ 362): Creation, Perfection or Enforcement of Liens Against Property of Debtor or Estate**
In re Dinatale, 1999 Bankr. LEXIS 803 (Bankr. D. Md. July 1, 1999) - Debtor received discharge in no-asset Chapter 7 bankruptcy, then argued that the Service violated the discharge injunction by renewing pre-petition tax liens against the debtor's property. The court first overruled the Service's objection on statute of limitation grounds, holding a remedy exists under B.C. § 362(h) even after bankruptcy. The court then disagreed with the debtor's argument, finding that because the Service's liens passed through bankruptcy and could be enforced in rem, even against otherwise exempt property such as the debtor's pension plan, renewal of those liens was not a violation of the discharge injunction.

3. **BANKRUPTCY CODE CASES: Chapter 11 (Reorganization): Effect of Confirmation (§ 1141)**
REFUNDS: Jurisdictional Prerequisites
Puckett, Jr., v. United States, 1999 U.S. Dist. LEXIS 10638 (S.D. Tex. June 23, 1999) - Taxpayers' refund action is barred by res judicata because the bankruptcy court's order confirming the Amended Plan of Reorganization conclusively determined taxpayers' tax liability for the years at issue, taxpayers filed no objections, and taxpayers paid the taxes. The court here used the claim preclusion requirements from Agrilectric Power Partners, Ltd. v. General Elec. Co., 20 F.3d

663, 664-65 (5th Cir. 1994) to reach its conclusion, finding the taxpayers' reliance on In re Taylor, 132 F.3d 256 (5th Cir. 1998) unpersuasive as the Service did not file a claim or otherwise participate in the bankruptcy proceedings in Taylor. Finally, the court overruled the taxpayers' objection to the Government's F.R.C.P. Rule 12(b)6 motion as untimely filed after the Government filed its answer. Because the Government in its answer presented the defense of res judicata raised in the motion, thereby giving the taxpayers notice, the court would consider the motion as a Rule 12(c) motion for judgment on the pleadings.

4. **BANKRUPTCY CODE CASES: Chapter 12 (Family Farmer): Discharge (§ 1228)**
In re Cousins, 84 AFTR2d ¶ 99-5024 (D. N.H. June 22, 1999) - The district court affirmed the bankruptcy court's decision that debtors were not liable for post-petition interest on the Service's non-dischargeable priority tax claim, when interest was not provided for in the debtors' confirmed Chapter 12 plan. The Court found the Service's reliance on Bruning v. United States, 376 U.S. 358 (1964) unpersuasive as Bruning is effectively a Chapter 7 case, not applicable to a confirmed plan of reorganization.

5. **BANKRUPTCY CODE CASES: Exceptions to Discharge (§ 523): No, Late or Fraudulent Returns**
Tudisco v. United States, 1999 U.S. App. LEXIS 15073 (2nd Cir. July 7, 1999) - The Second Circuit affirmed the lower courts' findings that taxes were nondischargeable due to willful evasion, although as the debtor failed to file or pay taxes the court did not decide whether mere nonpayment would be sufficient alone for a finding of willful evasion. The appellate court also affirmed the lower courts' determination that the debtor's retirement funds, although exempt from the bankruptcy estate, were subject to the federal tax lien.

6. **BANKRUPTCY CODE CASES: Exceptions to Discharge: Pre-Petition Priority Taxes**
In re Grothues, 83 AFTR2d ¶ 99-959 (W.D. Tex. May 25, 1999) - Taxpayer pled guilty to tax evasion and agreed to pay back taxes owed by taxpayer's corporations. When taxpayer failed to make payments, the Service began collection, and the taxpayer filed joint chapter 11 bankruptcy with her spouse. The bankruptcy court determined the taxes were nondischargeable under the fraud exception of B.C. § 523(a)(1)(C), but the district court reversed. Because the Service asserted liability against the debtor as a nominee or alter ego of the corporations, the debtor had no direct liability for the taxes. Therefore, the Service, despite the fact it was attempting to enforce a money judgment, had only a equitable claim against the debtor. Because this equitable claim was not a tax claim, it could not be excepted from discharge under either section 523(a)(1)(C) or section 523(a)(1)(A).

7. **BANKRUPTCY CODE CASES: Proofs of Claim (§ 501): Amendment/Supplement**

In re Jones, 1999 Bankr. LEXIS 794 (Bankr. W.D. Mich. June 24, 1999) - Debtors filed Chapter 13 bankruptcy listing secured, priority and unsecured tax debts owed to the United States. After the debtors' plan was confirmed, and after the bar date, the trustee refused to pay the Service, so the Service filed its proof of claim. The debtors also filed a proof of claim on behalf of the Service, but only for the secured portion of the taxes (and in a lesser amount than claimed by the Service). The court held that as the Service had failed to protect its claim by timely filing or by requesting an extension of time under F.R.B.P. 3002, the Service could not now assert that its proof of claim merely amended the debtors' proof of claim. Consequently, apart from the amount listed on the debtors' proof of claim, the federal taxes were discharged.

8. **COMPROMISE & SETTLEMENT: Binding Effect**

Streck v. Commissioner, 1999 U.S. App. LEXIS 13623 (6th Cir. June 16, 1999) ***(unpublished)*** - The Sixth Circuit upheld the Service's disallowance of business expense deductions and innocent spouse relief. The taxpayers also claimed the Service was bound by an offer in compromise because it was signed by the revenue agent, who purportedly told them it had been accepted. The appeals court noted the agent did not have statutory authority to accept the offer, had signed only the portion of the offer which accepted a waiver of the statute of limitations, and that the Government could not be estopped by oral representations.

9. **DAMAGES, SUITS FOR: Against U.S.: Failure to Release Lien (§ 7432)**
DAMAGES, SUITS FOR: Against U.S.: Unauthorized Collection (§ 7433)
LEVY: Release of Levy

H.W. Reeder, D.O. P.C. v. United States, 1999 U.S. App. LEXIS 13601 (9th Cir. June 17, 1999) (*unpublished*) - Service levied upon and sold assets of taxpayer corporation. The Ninth Circuit first dismissed the claims of the corporation's owner as lacking standing. Next, the court found that although the corporation had been involuntarily terminated three years before, under Arizona law it retained the right to file suit as a part of winding up its affairs, and so had standing to sue the United States. Moving to the merits, the court held that the revenue officer did not exhibit reckless or intentional behavior in violation of I.R.C. § 6331(f) by selling property not belonging to the taxpayer, because she did not learn that most of the assets were leased until after the sale. The court next affirmed the district court's finding of no intentional or reckless disregard of the requirements of section 6343, though the revenue officer failed to release liens when paid in full, because there were no regulations in place and the revenue officer provided copies of payments to the taxpayer. Finally, because a levy is not a lien, there was no violation of section 7432.

10. **ERRONEOUS REFUNDS: Suits for**

Mildred Cotler Trust v. United States, 1999 U.S. App. LEXIS 15147 (2d Cir. July 9, 1999) - Taxpayer paid proposed tax assessments but not penalties. The Service then assessed, and the taxpayer challenged the deficiency. After reaching a

settlement, which was paid, the Service removed the freeze code on the account and assessed the agreed amount of taxes and interest. However, before the assessment was posted, the total amount paid was refunded to the taxpayer. When the taxpayer died, six years later, the Service filed a claim against the estate for the amount erroneously refunded. The district court ruled in favor of the Service, based on the assessment, but on appeal the Service agreed that an erroneous refund does not revive an assessment extinguished by payment (the current Service position). Instead, the Service tried to argue fraud. The Tenth Circuit, in reversing the district court, found no evidence of fraud (basically because the Government never argued it before the district court) and, although acknowledging the taxpayer's estate received a windfall, allowed the estate to keep the monies.

11. **LEVY: Erroneous: Property of Third Person**
Walwyn v. United States, 1999 U.S. Dist. LEXIS 8885 (E.D. N.Y. June 11, 1999) - Service sought to enforce tax liens on residential real estate in name of taxpayer Edward Charles. However, property actually had been purchased at a city tax sale by Charles' relatives, the Walwyns, using Charles as a straw purchaser to meet financing standards. Because Charles was owner in name only, and Walwyns had made all payments of mortgage and taxes, made substantial improvements, and were the sole occupants of the property, the court on equitable grounds enjoined the sale of the property and voided the Government's tax lien.

12. **LIENS: After-Acquired Property**
TRUSTS, COLLECTION FROM: Spend Thrift
Matter of Orr, 1999 U.S. App. LEXIS 15548 (5th Cir. July 12, 1999) - Taxpayer, beneficiary of spendthrift trust, filed bankruptcy, which discharged his personal liability for unpaid federal taxes. Under Texas law, a spendthrift trust beneficiary possesses an equitable ownership interest in the trust corpus, which is property or rights to property sufficient for a federal tax lien to attach. As a result, the Fifth Circuit held, the taxpayer's subsequent bankruptcy did not affect the validity of the federal tax liens, which were valid against future income distributions.

13. **LIENS: Priority over Mortgages**
United States v. Fletcher, 1999 Bankr. LEXIS 832 (Bankr. S.D. Ala. June 23, 1999) - While defending himself against tax assessments, taxpayer ran up legal expenses, for which his law firm filed a mortgage. After the Service subsequently filed Notices of Federal Tax Lien, the law firm argued it had priority even though it had notice of the Service's tax assessments. The court agreed, citing In re Haas, 31 F.3d 1081 (11th Cir. 1994). For the Service to have priority under I.R.C. § 6323(a), the court held, the Service must have recorded its lien prior to the filing of the competing security interest.

14. **LIENS: Priority over State and Local Taxes**
State of Minnesota v. United States, 1999 U.S. App. LEXIS 15056 (8th Cir. July 7, 1999) - Taxpayer owed state and federal taxes, filing its returns on June 2, 1992.

Federal taxes were assessed on August 3 & 10, and the state processed the taxpayer's returns on August 20. Notices of federal tax lien were filed in January, 1993. Although Minnesota law provides that a tax is a lien on property from the date of assessment (the date the return was filed), the court of appeals held that the state lien was not choate until it had been processed. The court determined that after filing the state Commissioner of the Revenue must examine the return and determine the taxpayer's liability, and cannot compute penalty or interest until after a return is processed. Therefore, the amount of the state liens was not determined, nor were the liens summarily enforceable, giving the federal lien priority.

15. **LIENS: Priority over State and Local Taxes**
PRIORITY: Insolvency (31 U.S.C. § 3713)
Estate of Walker v. Department of Revenue, 1999 Tenn. App. LEXIS 447 (Tenn. Ct. App. July 13, 1999) - The state appellate court found the federal estate taxes had absolute priority under the Insolvency Statute, 31 U.S.C. § 3713(a). The State of Tennessee unsuccessfully argued that its state inheritance tax was a debt of the estate, not a debt of the debtor as it arose after taxpayer's death.

16. **PENALTIES: Failure to Collect, Withhold or Pay Over: Responsible Officer**
Loew v. United States, 1999 U.S. Dist. LEXIS 10975 (W.D. Wash. June 25, 1999) - The court held that the taxpayer was a responsible person because, although he did not hold the corporate position responsible for the payment of taxes, he had authority to direct payment.

17. **PENALTIES: Failure to Collect, Withhold or Pay Over: Willfulness**
Macagnone v. United States, 1999 U.S. Dist. LEXIS 10770 (M.D. Fla. June 24, 1999) - Reversing the bankruptcy court's holding at 228 B.R. 784 (*see February, 1999 GL Bulletin*), the district court concluded that under Eleventh Circuit precedent, once a taxpayer is found to be a "responsible party," the burden of proof shifts to the taxpayer to disprove willfulness.

18. **SUITS: Against the U.S. or Employees: Declaratory Judgments**
Kinard v. Kinard, 83 AFTR2d ¶ 99-963 (D. S.C. June 7, 1999) - A personal representative brought suit to declare that she and decedent were common law wife and husband, and so claim marital deduction for the estate. The court found it lacked subject matter jurisdiction under the Declaratory Judgment Act, 28 U.S.C. § 2201(a), and the Anti-Injunction Act, 26 U.S.C. § 7421(a), because a declaration regarding the marital status of the personal representative and the decedent would be the same as an injunction against the Service's assessment against the estate's marital deduction claim. The court refused to judicially interfere with the Service's assessment process.