DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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

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

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

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

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

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

BACKGROUND: Four circuit courts have agreed with the Government's position that the priority periods of B.C. § 507(a)(8)(A)(i),(ii) are automatically tolled while the Service could not collect during prior bankruptcy cases. Waugh v. IRS, 109 F.3d 489 (8th Cir.), cert. denied, 522 U.S. 823 (1997); In re Taylor, 81 F.3d 20 (3rd Cir. 1996); In re West, 5 F.3d 423 (1993); Montoya v. United States, 965 F.2d 554 (7th Cir. 1992). Three circuit courts, on the other hand, have declined to adopt this majority rule, and have instead held that tolling is permitted on a case-by-case basis where it is equitable to do so under B.C. § 105(a). Palmer v. United States, 219 F.3d 580 (6th Cir. 2000); In re Morgan, 182 F.3d 775 (11th Cir. 1999); Quenzer v. United States, 19 F.3d 163 (5th Cir. 1993). 1/ In the most recent appellate case on this issue, the Sixth Circuit in Palmer held that priority periods are not automatically tolled during prior bankruptcy cases, but can be equitably tolled by the bankruptcy court pursuant to section 105(a) if the equities favor the Service based on the facts of a given case. The court affirmed the bankruptcy

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

court's decision not to permit tolling where the Service failed to show that the debtor was guilty of any misconduct or manipulation of the bankruptcy system.

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

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

We do not view this as any different than other situations where parties may contest the Service's proof of claim by, for example, disputing the valuation of the Service's secured claim or contesting the tax liability on the merits. The Service is not prohibited from asserting its position regarding the amount of the secured tax claim or the amount of the tax liability on the proof of claim, even where the Service's position is subject to dispute, such as where the value of the collateral may be uncertain or where tax returns have not been filed and the tax is not yet assessed. It is by an objection to the proof of claim that disputes over the proper amount and classification of claims are normally resolved. 3/

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

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

We do not believe that this procedure is inconsistent with Palmer. Rule 3001(f) places the burden of coming forward with evidence to dispute a claim on the party who contests the claim. A debtor or trustee fulfills this burden by objecting to the claim on the ground that the facts do not justify tolling. Once the objection is made, the burden of production drops out, and the Service must establish that the facts justify tolling pursuant to section 105(a) as required by Palmer. See Raleigh v. Illinois Dept. of Revenue, 120 S. Ct. 1951, 1956 n.2 (2000); Landbank Equity Corp., supra.

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

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

> that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, --

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objection to claim process. The court stated:

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

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

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

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

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

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

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

(Bankr. S.D. Tex. 1996); In re Clark, 184 BR 728 (Bankr. N.D. Tex. 1995). 5/ We believe that the precise factors relied upon to select cases for which tolling will be claimed should be developed by your office based on local case law and other relevant considerations.

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

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

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

7/ You also ask whether pursuant to Palmer the Service has the obligation to review all proofs of claim filed in the last five years in open Chapter 13 cases to identify those cases where taxes were claimed as priority based on tolling. We conclude that the Service does not have this obligation. Prior to the Sixth Circuit's decision in Palmer, it was appropriate for the Service based on the case law in effect at that time to file claims with the presumption that tolling was automatic. Consistent with our discussion supra, we believe that it is the obligation of the debtor, trustee or other party-in-interest to object to the Service's claim, to seek reconsideration of a previously allowed or disallowed claim, or to seek modification of a plan.

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

We finally note that our position has been that if pursuant to the law of the circuit tolling is not automatic but occurs on a case-by-case basis pursuant to section 105(a), then the Service should not take collection action based on the theory that a tax is nondischargeable due to tolling, without first obtaining a determination as to dischargeability from the bankruptcy court. Otherwise, the Service risks being subject to damages and attorney's fees for violating the injunction against collecting discharged taxes. See B.C. § 524(a)(2). Additionally, the fact that the Service took unilateral collection action may influence a court to rule against the Service in determining whether tolling is justified under section 105(a). In the Sixth Circuit, collection action should not be taken based on the assumption that priority periods will be tolled. Please contact this office at (202) 622-3620 if you have any questions or comments concerning this memorandum.

cc: Deputy Division Counsel, Post-Filing (SB/SE) (Washington, D.C.)
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