

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

OFFICE OF CHIEF COUNSEL

> Number: **200110007** Release Date: 3/9/2001 November 22, 2000

CC:PA:CBS:Br2 GL-808387-00 UILC: 67.00.00-00 9999.98-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SBSE), AREA 5 CC:SB:5:SLC

- FROM: Kathryn A. Zuba Chief, Branch 2 (Collection, Bankruptcy & Summonses)
- SUBJECT: Request for Legal Advice on Receivership

This responds to the request dated September 29, 2000, from your office for our advice regarding whether the Service should file a claim in the federal receivership proceeding United States v. X.

LEGEND:

X = Y=Date A = Date B = Date C = Date D = Date E = Date F = Date G =

BACKGROUND: A criminal indictment and forfeiture action was filed on Date A, by the United States against the taxpayer X and other parties based on charges that taxpayer and his associate defrauded clients of their stock brokerage firm by diverting and stealing approximately 35 to 45 million dollars of funds received from the clients. Pursuant to the forfeiture action, the United States claimed a right to possession of property belonging to the defendants, including real estate and bank accounts, pursuant to 18 U.S.C. § 982. Much of this property had already come into the possession of the United States through a prior criminal subpoena. The United States asserted its claim of forfeiture until the District Court issued an order on Date B, stating that the property will be delivered to the defrauded investors as restitution, but shall remain in the possession of the United States until a plan of restitution is agreed to by

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the parties. Because the administration of the property was burdensome to the United States, the United States Attorney asked the district court to appoint a receiver to administer the property. A receivership was appointed on Date C. The receiver has now liquidated most of the property and holds approximately 10 million dollars in bank accounts and real estate worth approximately 1.5 million dollars.

The taxpayer owes over Y dollars of federal income and gift taxes. The income taxes were assessed on Date D, and a Notice of Federal Tax Lien was filed in Date E. The gift taxes were assessed on Date F, and a Notice of Federal Tax Lien was filed in Date G.

You have concluded that the property in the receivership was subject to a constructive trust for the benefit of the defrauded investors as of the Date B, restitution order. Since this trust commenced prior to the tax assessment against the taxpayer, you do not believe that the Service can assert a claim for the taxes in the receivership proceeding because at the time the tax lien arose there was no property of the taxpayer for the lien to attach to .

<u>DISCUSSION</u>: If a person liable to pay any tax neglects to do so after demand, a lien arises in favor of the United States upon all property and rights to property belonging to such person. I.R.C. § 6321. The lien is effective from the time the assessment is made. I.R.C. §§ 6322. In this case the lien did not arise until after the court ordered that the property be delivered to the investors as restitution. Accordingly, at the time the lien arose the property was no longer property of the taxpayer and the lien could not attach to the property. See SEC v. Levine, 881 F.2d 1165, 1176 (2d Cir. 1989) (tax lien does not attach to property which was disgorged and turned over to the receiver prior to assessment). Thus, assuming that all the property administered by the receivership is property which was subject to the Date B restitution order, 1/ then the property is not subject to the tax lien and the Service cannot assert a priority based on the tax lien.

<u>1</u>/ Any property which was not subject to the Date B, restitution order may nonetheless be subject to a constructive trust with the defrauded investors as the beneficial owners, based on the principle that title was never acquired by the taxpayer. <u>See First National Bank of Cartersville v. United States</u>, 412 F. Supp. 422 (N.D. Ga. 1976) (tax lien does not attach to property purchased with embezzled funds). To establish a constructive trust on particular property, the beneficiary of the trust must trace the property to property improperly taken from the beneficiary. <u>TMG II v. United States</u>, 778 F. Supp. 37, 50 (D.D.C. 1991). The United States' criminal case against the defendants is premised on facts which would appear to establish a constructive trust with respect to the property at issue.

However even absent a lien, the Service could arguably claim a priority pursuant to the Federal Priority Statute, 31 U.S.C. § 3713(a). The United States is entitled to a priority over other claims when a person indebted to the Government is insolvent and either the debtor makes a voluntary assignment of property, the property of an absent debtor is attached or an "act of bankruptcy is committed." There is an "act of bankruptcy" within the meaning of the insolvency statute where the debtor's property is transferred to a fiduciary in a legal proceeding brought to liquidate the insolvent debtor's property and pay the debtor's debts. Bramwell v. United States, 269 U.S. 483 (1926). In general, the insolvency statute has been confined to proceedings for the benefit of all creditors such as insolvent decedent's estates, general assignments for the benefit of creditors and general receiverships. Plumb, Federal Tax Liens 196-97 (3d ed. 1972). If prior to insolvency another creditor of the debtor takes title or possession of the property, then the priority will not apply. United States v. Vermont, 377 U.S. 351 (1964); United States v. Gilbert Associates, Inc., 345 U.S. 361 (1953); Thelluson v. Smith, 15 U.S. 306 (1817).

In this case, an "act of bankruptcy" triggering the insolvency statute arguably occurred in Date B when the order of restitution established the United States as the fiduciary of the property on the behalf of the defrauded investors. Assuming that the taxpayer is insolvent, then the United States would have a priority to the property unless the taxpayer was divested of title or possession of the property at the time the insolvency proceeding commenced. This, of course, appears to be the case. The taxpayer and his associate were divested of possession of the property at least as early as the forfeiture action initiated in Date A. Thus, at least as early as Date A, the United States obtained possession of the property, and the insolvency statute would no longer have applied to any subsequently initiated proceedings. 2/

We also note that if, on the other hand, an insolvency proceeding for purposes of section 3713 was not commenced until the establishment of the receivership in Date C, it is clear that the taxpayer at that time had neither title nor possession of the property due to the Date B restitution order.

<u>2</u>/ We have considered whether the argument could be made that the transfer of the property to the United States in Date A based on the criminal forfeiture statutes was itself an attachment or act of bankruptcy triggering the federal priority. <u>See Jonathan's Landing, Inc. v. Townsend</u>, 960 F.2d 1538 (11th Cir. 1992) (treating levy by Service as an "act of bankruptcy" if debtor was insolvent at the time of seizure). However, if the Government were to make such an argument, it is likely that a court would hold that the section 3713 priority nonetheless does not apply because the taxpayer never held title to the property which the taxpayer held in a constructive trust on the behalf of the defrauded investors. See note 1, <u>supra</u>.

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We, therefore, conclude that the Service cannot claim a priority to the property in the receivership based on the tax lien or the federal priority statute. The United States seized the property pursuant to the criminal forfeiture statutes by Date A and the district court ordered that the property be delivered to the defrauded investors in Date B as restitution. The taxpayer, therefore, did not posess any property to which the tax lien or the federal priority could attach. We concur with your conclusion that the Service should not file a claim in the receivership proceeding.

Please contact this office at (202) 622-3620 if you have any questions or comments.