OFFICE OF
CHIEF COUNSEL

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

June 5, 2001

Number: **200141011**
Release Date: 10/12/2001

CC:PA:CBS:RCGrosenick
GL-100935-01
UIL: 09.35.02-00
9999.98-00

MEMORANDUM FOR MARK H. HOWARD
ASSOCIATE AREA COUNSEL - SALT LAKE CITY
(CC:SB:5:SLC)

FROM: Joseph W. Clark
Senior Technician Reviewer, Branch 2 (CBS)

SUBJECT:

This Chief Counsel Advice responds to your request for assistance dated March 30, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Date A:
Date B:
Date C:
Date D:
Date E:
Date F:
Taxpayer:
Attorney:
Amount Z:
Amount Y:

ISSUES:

1. If an erroneous refund was generated by the abatement of dischargeable liabilities pursuant to a Chapter 7 discharge, but prior to a distribution by the trustee of funds that should have been applied to those dischargeable liabilities, is a reversal of the abatement permissible?

2. If so, whether a reversal of abatement would violate the discharge injunction?

3. Whether the filing of a suit to collect the erroneous refund violates the discharge injunction of B.C. § 524(a)(2)?

CONCLUSIONS:

1. The abatement of dischargeable liabilities may be reversed.

2. Reversal of the abatement does not violate the discharge injunction.

3. Filing suit to collect an erroneous refund generated from an abatement of dischargeable liabilities may violate the discharge injunction of B.C. § 524(a)(2).

FACTS:

On Date A, Taxpayer and his wife filed a Chapter 7 bankruptcy, receiving a discharge on Date B. On Date C, the Service received a Notice of Assets from the Chapter 7 Trustee, requesting that creditors file proofs of claim in the case. Responding to the discharge order, on Date D, the Service abated the assessments for Taxpayer for the taxable years 1988, 1989 and 1990, plus a frivolous filing penalty under I.R.C. § 6702 for the year 1989.

In response to the Notice of Assets, on Date E, the Service filed a proof of claim, which resulted in a distribution to the Service of $ Amount Z. Because the assessments for some of the periods had already been abated, the application of the $ Amount Z to Taxpayer's account resulted in an erroneous refund of $ Amount Y, which the Service was unable to intercept at the time the mistake was discovered. The refund check was negotiated on Date F, endorsed by "Taxpayer," and stating "Pay to the order of: Attorney." Attorney is thought to be Taxpayer's attorney.

LAW AND ANALYSIS:

1. The abatement of dischargeable liabilities may be reversed.

To understand the legal effect of an abatement, it is essential to first understand the legal effect of an assessment. Assessments do not create tax liabilities. Rather, assessments reflect the Service's judgment of what taxes are owed. Cohen v. Mayer, 199 F. Supp. 331, 332 (D.N.J. 1961) affirmed sub nom. Cohen v. Gross, 316 F.2d 521 (3rd Cir. 1963) ("assessment is a prescribed procedure for officially recording the fact and the amount of a taxpayer's administratively determined tax liability, with consequences somewhat similar to the reduction of a claim of judgment"). Taxpayers are liable for taxes, however, whether or not the Service assesses them. I.R.C. § 6501(a) (Service must either assess or bring proceedings in court without assessment within three years after the return is filed). See Ewing

v. U.S., 914 F.2d 499, 502-03 (4th Cir. 1990), cert. denied 500 U.S. 905 (1991) (rejecting taxpayer's argument that, prior to assessment, there can be no tax liability and therefore no "payment" of taxes).

Just as assessments do not create a tax liability, neither does the abatement of an assessment extinguish a liability. The authority to abate assessments is contained in section 6404, which provides, in relevant part:

> (a) **GENERAL RULE**.—The Secretary is authorized to abate the unpaid portion of the assessment of any tax or any liability in respect thereof, which---
>
> (1) is excessive in amount, or
> (2) is assessed after the expiration of the period of limitations properly applicable thereto, or
> (3) is erroneously or illegally assessed.
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> * * *
>
> (c) **SMALL TAX BALANCES**.—The Secretary is authorized to abate the unpaid portion of the assessment of any tax, or any liability in respect thereof, if the Secretary determines under uniform rules prescribed by the Secretary that the administration and collection costs involved would not warrant collection of the amount due.

The plain language of the statute authorizes the abatement of assessments, not liabilities. Section 6404(a) authorizes the Service to abate "the unpaid portion of the assessment of any tax or any liability in respect thereof." Likewise, section 6404(c) begins "The Secretary is authorized to abate the unpaid portion of the assessment of any tax, or any liability in respect thereof." These introductory clauses refer to abating the unpaid portion of the assessment of either "any tax" or any "liability in respect thereof." They do not refer to abating the liability.

Section 6404(c) authorizes the Service to abate the unpaid portion of any assessment when the Service decides "under uniform rules prescribed by the Secretary that the administration and collection costs involved would not warrant collection of the amount due." This abatement has nothing to do with a judgment about whether the assessment reflects the taxpayer's true liability; it only represents the Service's judgment that collecting the account is not cost-effective.[1] In effect the Service excuses its collector's obligation to account for the tax liability, but does not excuse the taxpayer's liability. See Crompton-Richmond v. U.S., 311

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[1] Treas. Reg. 301.6404-1(d) delegates to the Commissioner the authority to prescribe the uniform rules for making a section 6404(c) determination. As discussed infra, the Service has embodied the procedures for bankruptcy discharge determinations in the Bankruptcy Handbook, IRM 5.9.

F. Supp. 1184, 1186 (S.D.N.Y. 1970) (Service can revive an assessment abated under section 6404(c) because the abatement of an uncollectible tax does not cancel the tax). See also Carlin v. U.S., 100 F. Supp. 451, 454-55 (Ct. Cl. 1951) (IRS cannot relieve a taxpayer of tax liability merely because it is uncollectible, but can only abate it as a bookkeeping entry); Sugar Run Coal Mining v. U.S., 21 F. Supp. 10, 12 (E.D. Pa. 1937) (an abatement made because of a collectibility determination does not extinguish the liability).

Because the section 6404(c) abatement is made on the basis of collectibility and not because the liability was improperly assessed, money may still later be collected, so long as the collection limitations period is open. The Service may account for the collection by entering a debit to reverse the prior credit transaction.

2. Reversal of the abatement does not violate the discharge injunction.

A debtor who successfully completes the bankruptcy process is discharged from all pre-bankruptcy debts.[2] B.C. §§ 727, 944, 1141, 1228, 1328. The discharge order discharges the debtor from a personal obligation to pay and creates an injunction barring creditors from attempting to collect discharged debts from the debtor personally. B.C. § 524(a)(1), (2). The discharge does not destroy the pre-petition liability, however. Johnson v. Home State Bank, 501 U.S. 78, 84, 111 S. Ct. 2150 (1991) ("a bankruptcy discharge extinguishes only one mode of enforcing a claim -- namely, an action against the debtor in personam"); see also In re Conston, 181 B.R. 769, 773 (D. Del. 1995) (collecting cases). While the Service may continue to collect non-discharged taxes from all of the debtor's property or rights to property, it may collect discharged taxes only from pre-petition property to which a tax lien is still attached.

When the Service learns of a taxpayer's discharge from bankruptcy, the Insolvency function Tax Examiner or Bankruptcy Specialist evaluates the taxpayer's various tax liabilities to decide which have been discharged by the bankruptcy. See generally IRM 5.9.12.5 (describing procedures for evaluating and processing discharge). If the Insolvency employee decides that the costs of working the case do not warrant collection of the amounts involved, then the Insolvency employee must bring the balance due in each discharged tax liability module to zero by inputting adjusting credit Transaction Codes (TCs) to offset whatever debit TCs were used to account for the liabilities. Because the Service's accounting system is designed so that a prior transaction is never erased or extinguished or eliminated from the record, the

[2] Some debts may be excepted from discharge. B.C. § 523.

abatement always takes the form of a credit transaction entered to bring the balance due to zero.[3]

Adjustments made to account for bankruptcy discharges are abatements made pursuant to section 6404(c). A section 6404(c) adjustment is caused by the Service's decision that, despite section 6301's direction to collect taxes, it is not in the public interest to collect a particular liability because of the costs involved. Such abatements do not extinguish an otherwise valid tax liability, regardless of the reason for the abatement. While the bankruptcy discharge affects the Service's ability to collect the discharged liability, it does not extinguish either the underlying liability or those tax liens which have otherwise survived the bankruptcy. Since the underlying tax liability exists after bankruptcy discharge, it also exists after the assessments for the discharged taxes are abated. To account for the later collection, the section 6404(c) abatement may be reversed.

The discharge injunction of B.C. § 524(a)(2) prohibits the commencement or continuation of any act to collect, recover or offset any discharged debt from the debtor personally. Because the reversal of an abatement is, as explained above, not a collection action but merely a bookkeeping function, it is not a violation of the discharge injunction.

3. Filing suit to collect an erroneous refund generated from an abatement of dischargeable liabilities may violate the discharge injunction of B.C. § 524(a)(2).

The term "refund" within the phrase "erroneous refund" refers to any erroneous dispersal of money by the Service, whether or not that money has previously been paid in. See, e.g., United States v. Steel Furniture Co., 74 F.2d 744 (6th Cir. 1935) (erroneous payment of interest on a valid refund constitutes an erroneous refund for purposes of I.R.C. § 7405). An "erroneous" refund includes any receipt of money from the Service to which the recipient is not entitled, regardless of whether the recipient is the person whom the Service intended to received the refund or, whether the recipient is a taxpayer, or a third party. See, e.g., deRochemont v. United States, 23 Ct. Cl. 80 (Cl. Ct. 1991).

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[3] Although the Insolvency employee does make a collectibility determination, the freeze code TC 530 cannot be used because (1) that would shut down collection on every tax module of the entire account and (2) the eventual reversal of the TC 530 would cause collection to commence against all of the taxpayer's property. Only by abating specific tax assessments (the ones for discharged taxes) can the Insolvency employee continue to collect the nondischarged taxes and, if the opportunity arises, collect the discharged taxes out of the property to which the lien for those taxes still attaches.

A "nonrebate" erroneous refund occurs not as a result of a redetermination of the taxpayer's liability, but rather, as a result of a clerical or ministerial error. Nonrebate erroneous refunds can only be recovered through voluntary repayment, civil suit, or right of offset. The Service may not initiate any administrative collection action to recover a nonrebate erroneous refund, because there has been no assessment of that amount. Thus, the Service may not file a Notice of Federal Tax Lien, or issue a levy or notice of seizure for the amount erroneously refunded. The Service may, however, continue to administratively collect any unpaid portion of the original assessment, regardless of whether an erroneous refund was generated on the particular tax module in question. See United States v. Wilkes, 946 F.2d 1143, 1152 (5th Cir. 1991).

As previously noted, the discharge injunction of B.C. § 524(a)(2) prohibits the Service from collecting dischargeable debts from the debtor personally. However, the discharge injunction does not extend to debts which arise after the date of the order for relief. See B.C. § 727(b). The filing of an erroneous refund suit in this instance would be an action to collect a post-petition debt, and so not subject to the discharge injunction. This is because an erroneous refund creates a new debt. See Clark v. United States, 63 F.3d 83 (1st Cir. 1995); O'Bryant v. United States, 49 F.3d 340 (7th Cir. 1995). Thus, an erroneous refund issued and received by the debtors post-petition, like any other tax liability incurred by the debtor post-petition, is nondischargeable. See In re Ryan, 78 B.R. 175 (Bankr. E.D. Tenn. 1987) (debts which became payable by a Chapter 13 debtor post-petition are not discharged by the debtor's completion of plan); Bleak v. United States, 817 F.2d 1368 (9th Cir. 1987) (chapter 7 debtor's liability stemming from an erroneous refund nondischargeable under B.C. § 523(a)(1)(A)).[4] See also In re Campbell, 1990 Bankr. LEXIS 2922 (Bankr. D. Colo. 1990) (Service was entitled to return of an erroneous refund paid to a chapter 7 debtor post-petition).

Nor does the discharge injunction affect the ability of the Service to proceed against the debtor in rem. In re Wrenn, 40 F.3d 1162, 1164 (11th Cir. 1994). In United States v. Buckner, 2001 U.S. Dist. LEXIS 5861 (N.D. Ind. Apr. 10, 2001) adopting magistrate's recommendation 2001 U.S. Dist. LEXIS 5327 (Mar. 14, 2001), the Service levied on a retirement plan, but the debtor filed Chapter 7 bankruptcy before the fundholder replied to the levy. When the debtor's taxes were discharged under B.C. § 507(a)(8) and § 523(a)(1), the Service abated the corresponding assessments. The court held that the section 6404(c) abatements did not extinguish the debtor's liability and that the Service could reverse the abatements.

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[4] But cf. In re Jackson, 253 B.R. 570 (M.D. Ala. 2000) (Bleak decided under former version of section 507(c) that read erroneous refund would "be treated the same" as the tax; current version gives the claim the "same priority." Therefore, erroneous pre-petition refund not excepted from discharge under section 523(a)(1)(A)).

Because the Service never released its levy on the retirement plan, which remained outside the bankruptcy estate, the Service could collect the funds.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The discharge injunction of B.C. § 524(a)(2) prohibits the commencement or continuation of any act to collect, recover or offset any discharged debt. While the bankruptcy discharge affects the Service's ability to collect the discharged liability from the debtor personally, it does not extinguish either the underlying liability or those tax liens which have otherwise survived the bankruptcy. I.R.C. § 6404(c) permits the Service to abate a tax assessment to reflect an administrative determination that collection of a tax is economically unfeasible due to a bankruptcy discharge. Should collection become feasible within the statutory collection period, a section 6404(c) abatement may be reversed without violating the discharge injunction in bankruptcy. The Service then may proceed to collect by the filing of an erroneous refund suit. Because such a suit is an effort to collect a post-petition debt, it does not violate the discharge injunction.

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.

If you have any questions, please contact Richard Charles Grosenick at 202/622-3620.