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COLLECTION, BANKRUPTCY AND SUMMONSES BULLETIN

Department of the Treasury **Office of Chief Counsel** **Internal Revenue Service**

CASES

1. BANKRUPTCY CODE CASES: Chapter 13: Confirmation of Plan

In re Weiss, 251 B.R. 453 (Bankr. E.D.Pa. 2000) - Chapter 13 debtor, whose disposable income exceeded his debts, was required to pay post-petition interest on the Service's unsecured claim. Further, the court found that the debtor's proposed plan discriminated against the Service because it escrowed funds during the time an appeal of the Service's claim was pending, while making payment to other creditors. The court found this impermissible under B.C. §§ 1322(a)(3) and (b)(1) because it would permit a party to frustrate consummation of a plan merely by filing an appeal.

2. BANKRUPTCY CODE CASES: Exceptions to Discharge

In re Gillis, 251 B.R. 920 (Bankr. S.D. Ga. 2000) - Chapter 7 debtor erroneously reported taxes for 1989-91, transferred assets to corporations owned by family members, and failed to pay taxes. Although the government argued these other acts in support of its nondischargeability argument, the court stated it was unnecessary to consider them. Instead, the court found a single act of willful conduct (in this case, the debtor barricading his house against a levy) sufficient under the standard of In re Griffith, 206 F.3d 1389 (11th Cir. 2000), to make taxes nondischargeable under B.C. § 523(a)(1)(C).

3. BANKRUPTCY CODE CASES: Exceptions to Discharge: No, Late or Fraudulent Returns

Ralph v. United States, 2000 Bankr. LEXIS 1016 (Bankr. M.D. Fla. Aug. 17, 2000) - After Service issued deficiency notices and assessed taxes, debtor filed tax returns under Service non-filer initiative. The court found the taxes dischargeable under B.C. § 523(a)(1)(B)(i), choosing to follow the rationale of In re Nunez, 232 B.R. 778 (9th Cir. B.A.P. 1999) rather than that of In re Hindenlang, 164 F.3d 1029 (6th Cir. 1999). The court declined to adopt the per se rule urged by the Service (that taxes for which the Service prepared substitute returns could not be

discharged), finding this result inconsistent with Congressional intent. Rather, the proper test is whether the debtor acted in good faith at the time she filed her return.

4. BANKRUPTCY CODE CASES: Exceptions to Discharge: No, Late or Fraudulent Returns

In re Wright, 251 B.R. 326 (Bankr. W.D. Tex. July 11, 2000) - Criminal conviction for tax evasion sufficient to estop debtor from relitigating dischargeability of tax debts under B.C. § 523(a)(1)(C).

5. BANKRUPTCY CODE CASES: Liens: Determination of Secured Status

In re Dorholt, Inc., 2000 U.S. App. LEXIS 22182 (8th Cir. Aug. 29, 2000) - In this non-tax case, the Eighth Circuit considered whether a security interest perfected outside the ten day period of B.C. § 547(c)(1)(A) is automatically avoidable under B.C. § 547(b). The appellate court concluded that the use of the words "substantially contemporaneous" in section 547(c)(1)(A) meant Congress did not intend a specific time limit, but that the facts and circumstances of each case would determine whether a security interest was timely perfected. In this case, the court agreed that sixteen days was substantially contemporaneous.

6. BANKRUPTCY CODE CASES: Liens: Determination of Secured Status

In re Keyes, 2000 Bankr. LEXIS 1057 (Bankr. E.D.Va. Aug. 24, 2000) - ERISA-qualified retirement plan, which is excluded from debtor's Chapter 13 bankruptcy estate, cannot be used to secure the Service's lien for unpaid taxes. Because the retirement plan is exempt property, the Service's prepetition lien against the plan cannot be used to secure the tax claim for bankruptcy purposes.

7. BANKRUPTCY CODE CASES: Proofs of Claim

Adair v. Sherman, 2000 U.S. App. LEXIS 21951 (7th Cir. Aug. 25, 2000) - In this non-tax Chapter 13 bankruptcy case, the Seventh Circuit affirmed that a debtor who fails to object to a proof of claim prior to plan confirmation is precluded from objecting post-confirmation.

8. BANKRUPTCY CODE CASES: Property of the Estate

In re Stamm, 2000 U.S. App. LEXIS 21435 (5th Cir. Aug. 25, 2000) - In this non-tax case where debtors in a Chapter 13 bankruptcy made payments from their wages to the Chapter 13 trustee, but were unable to confirm a plan and instead converted to Chapter 7, the Fifth Circuit confirmed under B.C. § 548(f)(1) that those post-commencement pre-confirmation payments are not property of the Chapter 7 estate and must be returned to the debtors.

9. BANKRUPTCY CODE CASES: Property of the Estate: Distraint Prior to Bankruptcy
LIENS: Foreclosure

United States v. Bishop, 2000 U.S. Dist. LEXIS 14013 (W.D. Tex. Aug. 18, 2000) - Debtor filed for bankruptcy two hours prior to foreclosure sale. The United States protested the timing of the filing, but the district court was not swayed. It found that under state law the debtor retained an interest in the property until the sale, so that the property was property of the bankruptcy estate. The court refused to withdraw the reference to the bankruptcy court under B.C. § 157(d) or lift the automatic stay, finding the bankruptcy court a better forum to determine whether the debtor filed in bad faith.

10. BANKRUPTCY CODE CASES: Refunds: Bankruptcy Court Determination

Holywell Corporation & Subsidiaries v. United States, 2000 U.S. App. LEXIS 22310 (4th Cir. Aug. 31, 2000)*(unpublished)* - Debtor opposed a settlement of its tax liability by the Chapter 11 liquidating trustee, but lost on appeal. The debtor then filed for a tax refund. In an unpublished decision, the Fourth Circuit affirmed the lower court that the refund action was barred by res judicata. The appeals court found that a court-approved settlement receives the same res judicata effect as a final litigated judgment. Since the settlement agreement determined the proper amount of taxes to be paid, it is the same cause of action as a refund suit. Because the parties also were identical, all of the elements of res judicata are present.

11. INNOCENT SPOUSE

Cheshire v. Commissioner, 115 T.C. 15 (Aug. 30, 2000) - Taxpayer husband cashed out retirement account but understated the income on his joint return. His wife knew of the income and inquired about the reporting of the income, but was told that he consulted with an accountant in preparing the tax return. Following divorce, the wife claimed innocent spouse relief under I.R.S. § 6015(b)(1) & (c). The court concluded that as the wife had actual knowledge of the disputed item of income (receipt of the retirement funds) which led to the deficiency at the time she signed the joint return, innocent spouse relief did not apply. However, the court also found under section 6015(f) that it would be inequitable to impose an accuracy-related penalty under section 6662(a) where the wife erroneously but in good faith believed her then-husband that the return properly reported the item.

12. LIENS: Priority Over Security Interests

Bank of New Hampshire v. United States, 2000 U.S. Dist. LEXIS 10921 (D. N.H. July 25, 2000) - Bank perfected security interest in taxpayer's accounts receivables by filing financing statements, following which the Service assessed taxes. The taxpayer then used the proceeds of the accounts receivables to pay the taxes. The court found that because the voluntary tax payments were not fraudulent, but were in the ordinary course of the taxpayer's business, the bank's security interest did not attach to those proceeds. The court also found that the bank's claim for unjust enrichment under the Administrative Procedures Act was a claim for monetary relief, barred by the Act. The bank's claim of conversion was barred both by the Federal Tort Claims Act, 28 U.S.C. § 2680(c), and by not first pursuing

administrative remedies, under 28 U.S.C. § 2675. Finally, as to the bank's claim of an unconstitutional taking, the court lacked subject matter jurisdiction under either 28 U.S.C. § 1331 or § 1346(a)(1), or section 702 of the Administrative Procedures Act, since the United States had not waived its sovereign immunity.

13. LIENS: Priority Over Security Interests: Commercial Transactions Financing Agreements

Sampson Investments v. Sampson, 2000 U.S. Dist LEXIS 12565 (E.D. Wis. Aug. 22, 2000) - In February 1990, the taxpayer entered into a financing agreement with an investment company, pledging one-half of his interest in a partnership as security. In April 1990, the taxpayer obtained a separate bank loan by pledging as collateral all of his interest in the partnership. The security agreement with the bank also provided for the payment of taxes, although the earlier financing agreement with the investment company did not. Although missing the statutory five-year refiling deadline, the bank did refile the financing statement securing its loan in October, 1995, while the investment company did not refile until June 1997. In July 1999 the Service assessed 1997 taxes against the taxpayer, who interpled the funds. The investment company argued that it had a priority right to the funds because its security interest was filed before the taxes were assessed. However, the court agreed that the Service had priority to the funds. Because neither the investment company nor the bank refiled within the statutory period, the court looked to who refiled first (the bank). Since the security agreement with the bank authorized payment of the taxes, the court found that the tax claim had the same priority over the investment company as the bank.

14. PROPERTY SUBJECT TO COLLECTION

Christian v. United States, 86 AFTR2d ¶ 2000-5283 (11th Cir. Aug. 30, 2000) - Taxpayer had a margin account for the purchase of securities which the Service levied on. The Eleventh Circuit affirmed that, since the taxpayer had a "right to property" in his brokerage account, the levy was proper.

15. SUITS: Appellate Jurisdiction

In the Matter of Carlson, 2000 U.S. App. LEXIS 20166 (7th Cir. Aug. 15, 2000) - Taxpayer appealed dismissal of his bankruptcy case, and concurrently asked for stay of collection proceedings to prevent Service from selling his home. The Seventh Circuit found that it lacked appellate jurisdiction under the collateral order doctrine of Cohen v. Beneficial Loan Corp., 337 U.S. 541 (1946) (which sets out the three criteria to determine whether a collateral order is final enough to support appellate jurisdiction). Although the sale of the debtor's home may cause substantial grief, it is not an irreparable injury sufficient to justify use of the collateral order doctrine.

16. SUMMONSES: Fifth Amendment: Corporate Records

United States v. Kennedy, 2000 U.S. Dist. LEXIS 11719 (N.D. Ok. Aug. 3, 2000) - Representative of a trust cannot invoke a personal Fifth Amendment privilege based on his act of producing documents within the custody or control of the trust, even if those documents incriminate the representative.

The following material was released previously under I.R.C. § 6110. Portions may be redacted from the original advice.

CHIEF COUNSEL ADVICE

Offers in Compromise; Bankruptcy

July 21, 2000

GL-610467-99
UILC: 17.00.00-00

MEMORANDUM FOR DISTRICT COUNSEL, INDIANA

FROM: Kathryn A. Zuba
Chief, Branch 2 (General Litigation)

SUBJECT: Offers-in-Compromise - Effect of Bankruptcy on Processability

This memorandum contains our supplemental response to your memorandum dated January 10, 2000. You ask that we pre-review your memorandum to Acting Chief, Special Procedures Branch, Indiana District. This document is not to be cited as precedent.

Your memorandum raised issues regarding the processability of offers in compromise ("OICs") that have not been accepted or rejected as of the date of the filing of the taxpayer's bankruptcy petition. In our prior response dated March 27, 2000, we agreed with your conclusion that such OICs can be returned as nonprocessable. Your memorandum also concluded that while the Internal Revenue Service ("Service") may consider OICs submitted by debtors in bankruptcy as nonprocessable, a Bankruptcy Court may not agree in light of the issues raised in In re Mills, 240 B.R. 689 (Bankr. S.D. W.V. 1999), and In re Chapman, 1999 Bankr. LEXIS 1091 (S.D. W.V. June 23, 1999). The court in Mills and Chapman held that the Service's refusal to consider OICs from taxpayers in bankruptcy violated § 525(a) of the Bankruptcy Code. In our prior response we advised that we were in the process of developing our litigating position with regard to the issues raised in Mills and Chapman, and that we would respond to you on these issues in a detailed memorandum after our final position is reached. The following is our supplemental response. For the reasons that follow we conclude that the Service's policy not to process OICs from taxpayers in bankruptcy does not violate the Bankruptcy Code, and that the Service may not be compelled by a court to consider OICs from taxpayers in bankruptcy.

ISSUE

Does the Service 's policy not to process OICs from taxpayers in bankruptcy violate the anti-discrimination provision of the Bankruptcy Code?

CONCLUSION

No, the Service's policy not to process OICs from taxpayers in bankruptcy does not violate the anti-discrimination provision of the Bankruptcy Code.

BACKGROUND

The Offer in Compromise Handbook provides that when an offer is received it is first reviewed for processability. IRM 5.8.3.1. OICs from taxpayers in bankruptcy or who have not filed required tax returns will be returned as nonprocessable. Id. Deviation from the not processable criteria may not be made without written authorization from the National Office. IRM 5.8.3.3.1. The instructions to Form 656, Offer in Compromise, rev. Jan., 2000, also explain that taxpayers are not eligible for consideration of an OIC on the basis of doubt as to collectibility or effective tax administration if they have not filed all federal tax returns or are involved in an open bankruptcy proceeding.[1]

An offer will not be considered until the conclusion or termination of the bankruptcy proceeding. IRM 5.8.10.2.1(2). In Chapter 7 cases, an offer in compromise will normally not be considered until a discharge is granted. IRM 5.8.10.2.2(1). If a Chapter 7 discharge has been granted, but the case is still pending, the Service may consider an offer, but the amount acceptable for the offer should include the amount the Service reasonably expects to recover from the bankruptcy in addition to what can be collected from the taxpayer on non-discharged liabilities or from the estate outside the bankruptcy. IRM 5.8.10.2.2(2). While the Service will not consider an offer in compromise in a Chapter 11 case, the manual authorizes the occasional acceptance of a “compromising plan” in a Chapter 11 case when it is in the Service’s best interest to do so. IRM 5.9.9.4.2(6). The manual does not authorize the acceptance of a compromising plan in a Chapter 13 case.

Where a determination is made to return offer documents because the offer to compromise was nonprocessable, the return of the offer does not constitute a rejection of the offer and does not entitle the taxpayer to appeal the matter to Appeals pursuant to I.R.C. § 7122(d). Temp. Treas. Reg. 301.7122-1T(e)(5). The Offer in Compromise Handbook further

[1] It is our understanding that the Service’s policy not to consider OICs from taxpayers in bankruptcy does not prohibit compromise of the Service’s claim based upon doubt as to liability.

explains, "The Service will not consider an offer in compromise submitted by a taxpayer in bankruptcy. When a taxpayer files Bankruptcy, the Bankruptcy Code provides procedures resolving the Service's claim." IRM 5.8.10.2.1(1). See also IRM 5.9.4.7.

DISCUSSION

I. The Mills and Chapman Opinions

In re Mills, 240 B.R. 689 (Bankr. S.D. W.V. 1999), was a Chapter 13 case in which the Service had over $110,000 in tax claims, of which over $60,000 were entitled to priority status. These taxes arose from the debtors' unpaid employment taxes of a failed convenience style grocery store. After a number of plans were rejected, the debtors submitted a Form 656 OIC, and filed another plan proposing to pay the Service $6,500 as a lump sum to pay the priority claims in full at confirmation. The Service objected to the use of an OIC as a basis for satisfying its priority tax claim, and did not process the OIC. The debtors then commenced an adversary proceeding in the bankruptcy court alleging that the Service violated § 525(a) of the Bankruptcy Code by refusing to consider their OIC. The facts were substantially the same in In re Chapman, 1999 Bankr. LEXIS 1091 (S.D. W.V. June 23, 1999). The debtors were represented by the same attorney, and the case was litigated before the same judge.

The bankruptcy court's legal analysis was identical in Mills and Chapman. The court concluded that while the Service cannot be compelled to accept OICs, its failure to even consider them from taxpayers based solely on their bankruptcy status constitutes discrimination prohibited by Bankruptcy Code § 525(a). 240 B.R. at 698. Section 525(a) provides in pertinent part:

> [A] governmental unit may not deny . . . a license, permit, charter, franchise, *or other similar grant* to . . . a person that is or has been a debtor under this title . . . solely because such bankrupt or debtor is or has been a debtor under this title[.]

(emphasis added). The court relied on the following portion of the legislative history of § 525 to support its conclusion:

> In addition, the section is not exclusive. The enumeration of various forms of discrimination against former bankrupts is not intended to permit other forms of discrimination. The courts have been developing the Perez rule.[2]

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[2] Other portions of this legislative history show that when Congress wrote § 525, it "codified the result" of Perez v. Cambell, 402 U.S. 634 (1971), which held that a state law providing that a debtor's drivers license would not be renewed because a tort judgment resulting from an automobile accident remained unpaid, even though the debt

> This section permits further development to prohibit actions by governmental or quasi-governmental organizations that perform licensing functions, such as a State bar association or a medical society, or by other organizations that can seriously affect the debtor's livelihood or fresh start, such as exclusion from a union on the basis of discharge of a debt to the unions's credit union . . . This section is not so broad as a comparable section proposed by the Bankruptcy Commission . . . which would have extended the prohibition to any discrimination, even by private parties. Nevertheless, it is not limiting either, as noted. The courts will continue to mark the contours of the anti-discriminations provision in pursuit of sound bankruptcy policy.

H.R. Rep. No. 95-595 at 367 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6323 (1978) (citations omitted). The court concluded that "[t]he statute and legislative history, when read together, clearly indicate that Congress did not intend § 525 to be all-inclusive, but instead intended to prohibit bankruptcy-based discrimination that can seriously affect the debtor's livelihood or fresh start." 240 B.R. at 695.

The court agreed with the Service's contention that it could not be compelled to accept an OIC because such a decision is within the discretion of the Service. However, the court found that the use of the word "shall" in I.R.C. § 7122(c)(1) indicates that consideration of the OIC is not discretionary. Id. at 696, citing United States v. Garden State National Bank, 465 F. Supp. 437 (D.N.J.1979). The court also recognized that § 7122(d) provides for an administrative review of rejected offers. The court reasoned that by not considering OICs from taxpayers in bankruptcy, bankruptcy debtors are denied additional protections available to taxpayers who are not in bankruptcy. 240 B.R. at 696.

The court rejected the Service's argument that because the Bankruptcy Code specifically provides that its priority claims will be paid in full, its refusal to consider OICs in bankruptcy does not affect debtor's rights in bankruptcy. The court countered that if the taxes were compromised, a lesser amount would be required to be paid under the Chapter 13 plan. Id. at 697.

II. Does the Bankruptcy Code Require that the Service Consider Offers in Compromise from Taxpayers in Bankruptcy?

The first court of appeals case to address the scope of the "license, permit, charter, franchise, or other similar grant" in § 525(a) was In re Goldrich, 771 F.2d 28 (2nd Cir. 1985). In Goldrich, the debtor challenged the State of New York's refusal to guarantee debtor's student loans because debtor had obtained bankruptcy discharges of previous student loans. The court considered the legislative history, and concluded that § 525 does

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had been discharged in bankruptcy, violated the Supremacy Clause of the United States Constitution because it frustrated the fresh start policy of the Bankruptcy Code.

not promise protection against consideration of the prior bankruptcy in post-discharge credit arrangements. Id. at 30. The court reasoned:

> A credit guarantee is not a license, permit, charter or franchise; nor is it in any way similar to those grants. Had Congress intended to extend this section to cover loans or other forms of credit, it could have included some term that could have supported such an extension. We are reluctant to probe beyond the plain language of the statute. Although the exact scope of the items enumerated may be undefined, the fact that the list is composed solely of benefits conferred by the state that are unrelated to credit is unambiguous. Congress' failure to manifest any intention to include items of a distinctly different character is also unambiguous. In the absence of ambiguity, no further inquiry is required.
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> While Congress may have intended to allow expansion of the scope of protection described in section 525, it clearly also intended that such expansion would be limited to situations sufficiently similar to Perez to fall within the enumeration. The extension of credit is manifestly different from both examples given in the Senate Report: licensing and exclusion from a union. The fact that expansion must be permitted within the bounds of the statute's undefined terms may not be interpreted to require similar amplification outside of those bounds.

Id. at 30-31.

Two courts of appeals cases followed Goldrich, but with varying results. In In re Exquisito Services, Inc., 823 F.2d 151, 153-155 (5th Cir. 1987), the court ostensibly adopted the narrow approach articulated in Goldrich, reasoning that the application of § 525(a) should be limited to situations analogous to those enumerated in the statute, i.e., licenses, charters, franchises, and other similar grants. The court held that participation in a Small Business Administration Program under which minority businesses are given preferential treatment in selection for government contracts constituted a "franchise" as defined by Blacks' Law Dictionary. Thus, the court held that the Air Force's refusal to renew a SBA contract with a debtor because of its Chapter 11 status violated § 525(a).

In In re Watts, 876 F.2d 1090 (3rd Cir. 1989), the debtors challenged a provision of a state program that provided loans to homeowners in financial difficulty to prevent imminent mortgage foreclosure. Under the terms of the program, no loan payments would be made at any time the mortgagee was prohibited from instituting foreclosure proceedings against the mortgagor. Because the automatic stay prevented such foreclosure, loan payments were not provided to bankruptcy debtors during its duration. The court held that the loan simply is not a "license, permit, charter, franchise or other similar grant" per § 525(a). The court continued, "[I]t seems perfectly clear that the items enumerated are in the nature of indicia of authority from a governmental unit to the authorized person to pursue some

endeavor. Thus, a 'similar grant' should be given the same meaning." 876 F.2d at 1093.

While the narrow interpretation in these cases follows the language of the statute, Congress was not pleased with the result in Goldrich. In the Bankruptcy Reform Act of 1994, Congress overruled Goldrich through the addition of § 525(c). Section 525(c) provides that student loans or grants may not be denied based upon a debtor's past or present bankruptcy status. The language in the legislative history indicates that the provision was only intended to "clarify" the anti-discrimination provisions of the Bankruptcy Code to ensure that applicants for student loans are not denied those benefits due to a prior bankruptcy. It further remarked:

> This section overrules [Goldrich], which gave an unduly narrow interpretation to Code section 525. Like section 525 itself, this section is not intended to limit in any way other situations in which discrimination should be prohibited. Under this section, as under section 525 generally, a debtor should not be treated differently based solely on the fact that the debtor once owed a student loan which was not paid because it was discharged; the debtor should be treated the same as if the prior student loan had never existed.

140 Cong. Rec. H 10771 (Oct. 4, 1994).[3]

This legislative history arguably leaves unclear the scope of § 525. Though the language quoted above would indicate that the Goldrich court's reasoning was mistaken, and that § 525 should be interpreted more broadly, the very narrow remedy employed by Congress indicates otherwise. That is, had Congress truly envisioned a much broader scope of § 525, it could have expanded the scope of prohibited acts in § 525(a) rather than specifically adding § 525(c).

The only court of appeals opinion addressing § 525(a) since the 1994 amendments did not mention the legislative history. In re Toth, 136 F.3d 477 (6th Cir. 1998), cert. den. 524 U.S. 954 (1998). In Toth, the debtors challenged the state's policy of requiring at least three years to lapse after the date of a bankruptcy discharge before processing a loan application under a low income home improvement loan program of the United States administered by the state. The court refused the opportunity to construe § 525(a) broadly to further the fresh start policy of the Bankruptcy Code, and instead agreed with the analysis in Watts and Goldrich. 136 F.3d at 480. The court further explained:

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[3] This is taken from the section by section description of the Bankruptcy Reform Act of 1994, which was inserted into the record in floor statements attributed to the Speaker of the House pro tempore and makes up the entirety of the legislative history of the Act.

> The items enumerated in the statute – licenses, permits, charters, and franchises – are benefits conferred by government that are unrelated to the extension of credit. They reveal that the target of § 525(a) is government's role as a gatekeeper in determining who may pursue certain livelihoods. It is directed at governmental entities that might be inclined to discriminate against former bankruptcy debtors in a manner that frustrated the "fresh start" policy of the Bankruptcy Code, by denying them permission to pursue certain occupations or endeavors. The intent of Congress incorporated into the plain language of § 525(a) should not be transformed by employing an expansive understanding of the "fresh start" policy to insulate a debtor from all adverse consequences of a bankruptcy filing or discharge.

Id. Thus, the Toth court's limitation of the types of prohibited government action is perhaps the narrowest to date, limiting § 525 to situations where the government discriminates in its role as a gatekeeper in determining who may pursue certain livelihoods. Although the Toth court failed to address the legislative history relating to the passage of § 525(c), resort to the legislative history was not necessary considering the plain language of § 525(a).

An alternative view is reflected in a leading treatise's criticism of Toth, Watts, and Goldrich:

> While the conclusion that section 525 does not apply to extensions of credit may be generally correct, the courts did not adequately consider whether the state programs involved were in fact more in the nature of benefits conferred upon needy applicants, without regard to their credit worthiness, and therefore more similar to a franchise or similar grant, rather than an extension of credit.

4 Collier on Bankruptcy § 525.02[5], 525-16 (15th ed. 1999). Such an interpretation could be supported by a number of lower court decisions which have had little trouble finding government subsidy programs to be within the § 525 language. Courts have held that a public tenant may not be denied the continued right to live in his or her apartment, and thus denied the subsidy inherent in public housing, because of unpaid rent which is discharged or dischargeable, or because a bankruptcy has been filed, even if the bankruptcy had the effect of causing rejection of the preexisting lease. See In re Curry, 148 B.R. 966 (S.D.Fla. 1992); Gibbs v. Housing Auth. of City of New Haven, 76 B.R. 257 (D.Conn. 1983); In re Day, 208 B.R. 358 (Bankr. E.D.Pa. 1997); In re Szymecki, 87 B.R. 14 (Bankr. W.D.Pa. 1988). See also In re Rose, 23 B.R. 662 (Bankr. D. Conn. 1982) (state program offering mortgage assistance cannot deny benefits based upon the filing of bankruptcy or upon the automatic stay provided by a bankruptcy filing).

We disagree with the position espoused by Collier. The assertion that "benefits conferred on needy applicants" is somehow a like a "license, permit charter, franchise, or other

similar grant" is not tenable. As the Watts and Toth courts concluded, the targeted government actions concern government's role as a gatekeeper to pursue some occupation of endeavor. It is not so broad as to include benefit programs. Even so, we do not think even Collier's position is so broad as to encompass the Service's OIC program. The compromise of tax liabilities to reflect collection potential and enhance voluntary compliance with the Tax Code is not the type of "benefit conferred upon needy applicants" that even Collier envisioned.

We also disagree with the conclusion of the Mills and Chapman court that § 525(a) and its legislative history, when read together, indicate that Congress intended to prohibit bankruptcy-based discrimination by governmental units that can seriously affect the debtor's livelihood or fresh start. As the courts in Goldrich, Watts, and Toth have recognized, the plain language of § 525(a) reveals that Congress did not in fact prohibit all forms of discrimination that affect a debtor's fresh start. Congress only prohibited the discrimination with respect to a "license, permit, charter, franchise, or other similar grant," or employment. See also United States v. Ron Pair, 489 U.S. 235, 242 (1989) ("The plain language of legislation should be conclusive, except in the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters").

Consideration of an OIC is not similar to a "license, permit, charter, or franchise." Black's Law Dictionary (6th ed. 1991) defines "license" in pertinent part as "[a] permit, granted by an appropriate governmental body . . to pursue some occupation or to carry on some business subject to regulation under the police power. A license is not a contract between the state and licensee, but is a mere personal permit." A permit is "[i]n general, any document which grants a person a right to do something. A license or grant of authority to do such a thing." Id. A charter is "[a]n instrument emanating from sovereign power, in the nature of a grant, either to the whole nation, or to a class or portion of the people, to a corporation, or to a colony or dependency, assuring them of certain rights, liberties, or powers." Id. A franchise is "[a] special privilege to do certain things conferred by government on [an] individual or corporation, and which does not belong to citizens generally of common right; e.g., right to offer cable television service." In contrast, an accepted OIC is a contract to settle the taxpayer's tax liabilities. See, e.g., United States v. Feinberg, 372 F.2d 352 (3rd Cir. 1967); United States v. Lane, 303 F.2d 1 (5th Cir. 1962). When the government enters into a contract with the debtor in compromise of existing tax liabilities, it is not engaging in the type of regulatory conduct that is similar to a license, permit, charter, or franchise. Thus, § 525(a) does not apply. Toth, Watts.

Further, the legislative history cited by the Mills court does not in fact support the court's conclusion. The passage provided in pertinent part that "[t]his section permits further development [of case law] to prohibit actions by governmental or quasi-governmental organizations that perform licensing functions" (emphasis added). The passage then cites two examples of government units that perform licensing functions: a state bar association or a medical society, and a union. Thus, this portion of the legislative history only shows

that Congress intended courts to broadly prohibit other forms of discrimination by governmental units that do licensing functions, not to extend the prohibition to any function performed by governmental units.

When quoting the legislative history the court skipped over another portion of the legislative history which shows the intended effect of § 525:

> The effect of the section, and of the further interpretations of the Perez rule, is to strengthen the anti-affirmation policy found in section 524([c]). Discrimination based solely on nonpayment could encourage reaffirmations, contrary to expressed policy.

H.R. Rep. No. 95-595 at 367 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6323 (1978). Thus, Congress was primarily concerned that debtors would be forced to reaffirm discharged debts because of conditions made by licensing-type governmental units, though the statute clearly intended to prohibit other forms of discrimination by these entities.

The concern evidenced by the legislative history is quite distinguishable from the issue at hand. The governmental power at issue is not its right to regulate under the police power provided for under non-bankruptcy law, but is the power to collect taxes as provided in the Internal Revenue Code and the Bankruptcy Code itself.

When Congress wrote the Bankruptcy Code it engaged in a complex balancing of various interests. Interpreting B.C. § 525(a)[4] so as to require that the Service consider compromise of its claims, notwithstanding the provisions of the Bankruptcy Code that provide for full payment of priority and secured claims,[5] is inconsistent with the statutory scheme and has the effect of rewriting the Bankruptcy Code on a legislative level.[6] Courts may not reorganize the priorities established by Congress on a legislative level. United States v. Noland, 517 U.S. 535 (1996) (even where statute contemplated equitable

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[4] The same would be true had the court relied upon § 105. The court did not specifically address the issue under this section, having found that § 525 applied.

[5] A debtor would generally not need to compromise its tax liabilities with the Service if the Service did not have priority or secured claims in amounts that exceed the offer.

[6] Also, "it is a commonplace of statutory construction that the specific governs the general." Morales v. Trans World Airlines, Inc., 504 U.S. 374, 384-5 (1992), citing Crawford Fitting Co. v. J. T. Gibbons, Inc., 482 U.S. 437, 445 (1987). The rights granted under §§ 1322(a)(2) and 1325(a)(5) are more specific than the general (and inapplicable) prohibitions contained in § 525.

subordination of tax claims, bankruptcy court could not exercise the discretion in such a general way as to reorder the priorities established by Congress, because doing so would be impermissibly acting on legislative level). See also Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) ("[W]hatever equitable powers remain in the bankruptcy court must and can only be exercised within the confines of the Bankruptcy Code").

Because the plain language of the statute does not allow for a broad reading of the types of governmental actions that can be subject to scrutiny under § 525(a), we conclude that the Service's policy of not processing OICs from taxpayers in bankruptcy does not violate § 525. Further, we see no mechanism in the Bankruptcy Code whereby a court could order a governmental unit to consider compromise of its claim.

III. Does I.R.C. § 7122 Compel the Service to Consider OICs from Taxpayers in Bankruptcy?

Though the Mills court agreed with the Service's contention that it could not be compelled to accept an OIC because such a decision is within the discretion of the Service, the court found that the use of the word "shall" in I.R.C. § 7122(c) indicates that consideration of the OIC is not discretionary.[7] 240 B.R. at 696, citing United States v. Garden State National Bank, 465 F. Supp. 437 (D.N.J.1979), aff'd on other grounds 607 F.2d 61 (3rd Cir. 1979). The court also recognized that I.R.C. § 7122(d) provides for an administrative review of rejected offers. The court reasoned that by not considering OICs from taxpayers in bankruptcy, bankruptcy debtors are denied additional protections available to taxpayers who are not in bankruptcy. 240 B.R. at 696.

Section 7122 clearly states that the Secretary "may" compromise any civil or criminal tax case prior to referral to the Department of Justice, in accordance with applicable procedures. 26 U.S.C. § 7122(a), (c); 26 C.F.R. § 301.7122-1. See also Boules v. Commissioner, 810 F.2d 209 (D.C.Cir. 1987), cert. denied, 484 U.S. 896. The decision to accept or reject an OIC is discretionary and cannot be compelled. See In re Davison, 156 B.R. 600, 602 (Bankr. E.D. Ark. 1993) (courts are not authorized to make or compel settlement for the parties under any construction of § 7122); Carroll v. Internal Revenue Service, 14 A.F.T.R. 2d 5564 (E.D. N.Y. 1964). As the court in Carroll noted, "[t]he decision to accept or reject a compromise offer by its nature involved the discretion of administrative authority and cannot be compelled by any action for a mandatory injunction." To compel acceptance of, or, indeed, consideration of, a proposed compromise of a tax liability amounts to injunctive action with respect to the collection of a tax barred by IRC § 7421. See generally Enoch v. Williams Packing and Navigation Co., 370 U.S. 1 (1962).

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[7] Section 7122(c)(1) provides that the Service "shall" prescribe guidelines for OICs, "shall" make allowances for living expenses, and the Service "shall not" reject an OIC solely on the basis of the amount of the offer.

The only authority the court cited to support its contention that the Service must consider OICs was Garden State. Garden State was a summons enforcement case. The opinion contained language that the Service's refusal to consider compromises before a decision whether to refer the case to the Department of Justice for criminal prosecution was evidence that the summons was unenforceable as it was issued in bad faith. The court held that bad faith was not shown in that case because the taxpayer had not actually requested a conference to negotiate a compromise. However, the court also stated that the outcome might be different had there been a request for compromise met only by pro forma efforts by way of lip service to the negotiation process.

The Mills and Chapman court did not mention that the language in Garden State was dictum, and was rejected on review by the Court of Appeals, 607 F.2d at 66, 73. The Third Circuit stated, "[T]he refusal of the Service to enter into compromise negotiations, standing alone, does not amount to 'bad faith.'" Id. Indeed, the trial court itself later stated, "Garden State was by way of hope or expectation that since I.R.S. has complete jurisdiction to compromise and settle all aspects of a 'tax case', both civil and criminal, before referral to the Attorney General . . . the comment might induce both taxpayers and I.R.S. to undertake good faith negotiations for resolution of any disagreement without generating avoidable litigation." "Pseudonym Taxpayer" v. Miller, 497 F. Supp. 78 (D.N.J. 1980). The Garden State dicta was also rejected by the court in United States v. Smith, 1979 U.S. Dist. LEXIS 12471; 80-1 U.S. Tax Cas. (CCH) P91089; 45 A.F.T.R.2d (RIA) 1105 (S.D.N.Y. 1979). The Smith court accepted the Government's argument that Garden State is logically, practically, and legally unsound. The court also noted that the decision whether to discuss settlement and whether to issue a summons is a discretionary one that cannot be compelled by the court. Id., citing Leaonard v. Michell, 473 F.2d 709, 713 (2nd Cir. 1973) (mandamus cannot force a discretionary act).

CONCLUSION

For the foregoing reasons we conclude that the Service 's policy not to process OICs from taxpayers in bankruptcy is not prohibited by the Bankruptcy Code, and that a bankruptcy court cannot compel the Service to consider an OIC from a taxpayer in a bankruptcy case.

Bankruptcy; Trustee Liability

May 17, 2000

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UILC: 09.03.01-00
62.04.00-00

MEMORANDUM FOR NORTHERN CALIFORNIA DISTRICT COUNSEL (SAN FRANCISCO)

FROM: Kathryn A. Zuba
Chief, Branch 2 (General Litigation)

SUBJECT: Liability of Chapter 11 Trustee for Unpaid Excise Taxes

This responds to your request for advice dated December 20, 1999. This document is not to be cited as precedent.

ISSUE: Can a Chapter 11 trustee be held personally liable under I.R.C. § 6672 for failure to pay communication excise taxes collected by the estate?

CONCLUSION: Yes. The communication excise taxes collected from customers are subject to the statutory trust of I.R.C. § 7501. The Service can claim payment from the estate of the trust fund taxes ahead of other creditors pursuant to the rationale of Begier v. IRS, 496 U.S. 53 (1990). The Service can also assert section 6672 liability against the Chapter 11 trustee for any unpaid trust fund taxes if the elements of section 6672 are met.

BACKGROUND: A corporation filed a Chapter 11 petition in 1996. A Chapter 11 trustee was appointed and operated the corporation until the case was converted to Chapter 7 approximately four months after the Chapter 11 petition. The Chapter 11 trustee continued as the Chapter 7 trustee. During the period of Chapter 11 administration, the estate collected communication excise taxes from customers of the corporation pursuant to I.R.C. § § 4251 and 4291. Because these taxes are imposed on the customers and collected by the corporation, the amount of tax collected is subject to the statutory trust imposed by I.R.C. § 7501, and a failure to pay over the funds collected can subject a responsible person to the Trust Fund Recovery Penalty (TFRP) imposed by I.R.C. § 6672.

The trustee, who claims she was unaware of her duty to pay the excise tax, failed to make required deposits of the excise tax and did not file required excise tax returns on Form 720 during the administration of the Chapter 11 case. After the Service filed a timely claim for the excise taxes in the Chapter 7 case, the estate filed a return covering the entire Chapter 11 administrative period. The tax liability reported on the return is not in dispute.

The Chapter 7 trustee asserted that the estate had insufficient assets to pay all Chapter 11 administrative claimants in full after payment of Chapter 7 administrative expenses. The Chapter 7 trustee proposed to pay the tax claim pro rata with other Chapter 11 administrative claims. The Service in response proposed to assert the section 6672 TFRP against the Chapter 11 trustee. The trustee then filed an adversary proceeding in the bankruptcy case requesting a determination from the bankruptcy court that she is not personally liable under section 6672 because she acted within the scope of her authority as trustee, that she possesses immunity for acts within the scope of her authority as trustee, and that in any event her failure to pay taxes was not willful under section 6672. The adversary proceeding was subsequently mooted by the trustee's decision to pay the administrative claim in full ahead of other administrative expenses.

You state that a bankruptcy trustee's liability under section 6672 is a recurring issue and, therefore, request our advice as to whether as a general matter the Service can properly assert section 6672 liability against a trustee in cases similar to this case. Your primary concern is case authority which stands for the proposition that the section 7501 trust does not arise during a bankruptcy case because in bankruptcy only the priorities of the Bankruptcy Code control. United States v. Randall, 410 U.S. 513 (1971); In re Major Dynamics, Inc., 897 F.2d 433 (9th Cir. 1990). You conclude, however, that a person can be liable under section 6672 even in the absence of a statutory trust.

LAW AND ANALYSIS:

For the following reasons, we conclude that trust fund taxes are subject to the section 7501 statutory trust even in a bankruptcy case, since Randall and Major Dynamics are no longer controlling law.

The Supreme Court in Randall held that the priority provisions of the Bankruptcy Act supercede section 7501. In Randall, the debtor did not deposit withheld employment taxes into a special tax account during the pendency of a Bankruptcy Act Chapter XI proceeding, as required by court order. The bankruptcy estate was later liquidated. The Service sought to recover the delinquent trust fund tax liabilities accrued during the Chapter XI proceeding from the estate's general assets ahead of higher priority administrative expenses, based on the proposition that the funds were held in trust for the United States pursuant to section 7501. The Court held that the bankruptcy priority rules precluded such a recovery, stating that "the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and service created the assets." 401 U.S. 517.

In Major Dynamics, the former president of the debtor sought a declaration from the bankruptcy court that the Chapter 11 trustee breached a duty to pay over trust fund taxes incurred during the administration of the Chapter 11 estate. The taxes at issue were wages withheld from employees; the withheld funds were not segregated but were commingled in the debtor's operating account with other funds. The Service assessed the section 6672 penalty against the former president, who then sought the declaratory relief from the bankruptcy court. The court held that the funds were not subject to the section 7501 trust because "the withheld funds are subject to the system of priorities set out in the Bankruptcy Code and no Revenue Code section 7501 trust arises." 897 F.2d 436. Citing to Randall, the court also stated that a section 7501 trust cannot arise unless the withheld funds are either segregated or traceable.

Subsequent to the Supreme Court's decision in Begier, our position has been that both Randall and Major Dynamics are no longer controlling precedent. In Begier, the Court held that a voluntary prepetition payment of trust fund taxes, even if the Government cannot trace the funds paid to specific withheld or collected funds, cannot be avoided by the

trustee under B.C. § 547 because such funds are held in trust for the United States pursuant to section 7501 and, thus, are not property of the debtor. In reaching this conclusion, the Court, relying on the legislative history of the 1978 Bankruptcy Act, concluded that "[t]he strict rule of Randall ... did not survive the adoption of the new Bankruptcy Code." 496 U.S. 65. Instead, "[a]mong the changes Congress decided to make was a modification of the rule this Court had enunciated in Randall under the old Bankruptcy Act." 496 U.S. 63. The new rule, as modified, is that withheld or collected trust fund taxes are subject to the section 7501 statutory trust and are, accordingly, not property of the bankruptcy estate under B.C. § 541. 496 U.S. 65. Although the Court recognized that any funds the Service sought to obtain must be traced to actual collected or withheld funds, the Court cited legislative history indicating that where trust funds are not segregated, the Service should be able to rely on "reasonable assumptions" to trace such funds. 496 U.S. 67.

In In re Megafoods Stores, Inc., 163 F.3d 1063 (9th Cir. 1998), the Ninth Circuit followed Begier in affirming the bankruptcy court's award to the State of Texas of funds from the Chapter 11 debtor's general bank account in payment of the state's claims for sales taxes collected by the debtor prepetition. The court held that the sales taxes were held in trust for the state pursuant to state law and, therefore, were not property of the estate pursuant to the Supreme Court's reasoning in Begier. The court held that the state met its tracing burden by reliance on the "lowest intermediate balance rule, " i.e., the state showed that the bank accounts into which the trust funds were deposited never fell below the amount of the trust fund claims from the dates of collection to the date of bankruptcy. 163 F.3d 1068.

Our position, based on Begier and Megafoods Stores, is that the United States can assert that funds withheld or collected by the debtor before the date of the Chapter 11 petition, or by the estate prior to conversion from Chapter 11 to Chapter 7, represent section 7501 trust funds which should be turned over to the United States ahead of any other distributions, since such funds are held in trust for the United States and do not become property of the estate. Where the trust funds are not segregated in a separate account, the Service's case will be the strongest where it can establish that the amount on deposit in the debtor's or estate's general accounts never went below the trust fund claim pursuant to the "lowest intermediate balance rule."

Thus, trust fund taxes are in fact subject to the statutory trust even in the context of a bankruptcy case. What this means is that upon conversion to Chapter 7 the Service is not limited to accepting distribution after payment of Chapter 7 administrative claims, and pro-rata with other Chapter 11 claims, but can instead demand turnover of unpaid trust fund taxes to the Service ahead of other creditors on the ground that the funds are not property of the estate. This approach may be preferable in many cases to considering assertion of the TFRP against the Chapter 11 trustee.

However, insofar as payment cannot be obtained from the estate, we agree with your conclusion that the Chapter 11 trustee can be held personally liable for the trust fund taxes as a responsible person under section 6672, assuming that all the elements of section 6672 are met. The trustee must be a person responsible for the collection and payment of the tax, and the trustee must have willfully failed to pay over the tax. United States v. Landeau, 155 F.3d 93 (2d Cir. 1998); United States v. Jones, 33 F.3d 1137 (1994). Assertion of section 6672 liability is consistent with the case law indicating that bankruptcy trustees can be held personally liable for breaches of fiduciary duties to creditors. See, e.g., In re Cochise College Park, Inc., 703 F.2d 1339, 1357-58 (9th Cir. 1983); In re Markos Gurnee Partnership, 182 BR 211, 218 -220 (Bankr. N.D. Ill. 1995); Mosser v. Darrow, 341 U.S. 267 (1951). Additionally, the quasi-judicial immunity that trustees have does not extend to intentional or negligent violation of duties imposed by law. United States v. Hemmen, 51 F.3d 883, 891 (9th Cir. 1995) (Chapter 7 trustee can be held personally liable under I.R.C. § 6332(c)(1) for failure to honor Service levy on the allowed administrative expense claim of taxpayer). [8]

Some courts have held that a bankruptcy trustee can only be held personally liable for willful or deliberate actions. See, e.g., Sherr v. Winkler, 552 F.2d 1367, 1375-76 (10th Cir. 1977); In re Hutchinson, 5 F.3d 750, 753 (4th Cir. 1993). However, since the failure to pay over under section 6672(a) must be willful, in many cases where section 6672(a) liability can be imposed, the trustee's actions will meet the willful or deliberate standard for imposing personal liability.

While we conclude that a bankruptcy trustee can be held personally liable under section 6672, in order to avoid unnecessary litigation over the extent of the trustee's personal liability, the preferred course of action in most cases will be to request the estate to turn over collected or withheld trust fund taxes to the Service pursuant to the authority of Begier.

[8] However, if the trustee takes an action with the prior approval of the bankruptcy court, the trustee is immune from liability. See Mosser, 341 U.S. at 274-75.