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# GENERAL LITIGATION BULLETIN



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## WHAT IS REASONABLE?

### Bright-Line Test for Reasonable Cause Exception Rejected

The Third Circuit, in **East Wind Industries, Inc. v. United States**, 1999 U.S. App. LEXIS 29869 (3<sup>d</sup> Cir. Nov. 16, 1999), reversed the trial court in finding that financial hardship may constitute reasonable cause for the failure to pay taxes under I.R.C. § 6651 or to make deposits under I.R.C. § 6656.

East Wind Industries manufactured clothing and goods for the military. After 1976, in order to successfully bid on Defense Department contracts, East Wind found it necessary to provide bribes to government employees. If East Wind failed to pay the bribes, it either did not get the contract or had its goods rejected. In 1984, East Wind contacted government investigators, and assisted in exposing the widespread corruption. However, during this time East Wind suffered financially, filing for Chapter 11 bankruptcy in 1984 and, despite a damages award from the government, going out of business in 1988.

Because East Wind had used its limited cash flow to pay essential employees, payroll taxes were not always paid. East Wind used its damages award to pay off the tax debt, then sued for a refund. East Wind claimed that its failure to pay the taxes timely was due to reasonable cause, not willful neglect. The district court found, under **Brewery, Inc. v. United States**, 33 F.3d 589 (6<sup>th</sup> Cir. 1994), that financial difficulties alone can never constitute reasonable cause for abatement of penalties imposed by sections 6651 or 6656.

The appeals court explicitly rejected the bright line test of **Brewery**. Instead, the court adopted a “facts and circumstances” approach. In determining whether East Wind failed to pay taxes due to “willful neglect,” the court examined the facts of the case to see whether East Wind exhibited a conscious, intentional failure to pay or reckless indifference towards payment. Under Treas. Reg. § 301.6651-1(C)(1), the court interpreted this “reasonable cause” standard to mean whether the taxpayer exercised ordinary business care and prudence, given the type of tax owed, and given all of the facts and circumstances involved. The bright line test was inconsistent with this approach, held the court, because it essentially read out of the statute the “reasonable cause” exception.

The Government argued that with any tax, but especially with the trust fund taxes at issue here, the taxpayer's choice to pay other creditors instead of taxes should result in a finding of willful neglect. However, the court held the taxpayer's choice to pay creditors whose services were essential to maintaining and reworking its inventory, over payment of trust fund taxes, was not an intentional failure to pay, nor reckless indifference. The court felt the Government's position would negatively impact both the economy and ultimately tax collections in general by closing up businesses that owed taxes but otherwise were still operating.

## **PENALTIES: Assessment and Collection**

### ***FIRST IN TIME IS NOT FIRST IN RIGHT* Insolvency Act Trumps Prior State Tax Liens**

In **Straus v. United States, 1999 U.S. App. LEXIS 29990 (7<sup>th</sup> Cir. Nov. 17, 1999)**, the Seventh Circuit found in favor of the Federal Government in a lien dispute with the State of Illinois. The case concerned a liquidating business, which interpled its remaining assets subject to liens from both state and federal taxes. Although there was some dispute, the United States arguably filed only one of the first seven liens to attach to the corporation's assets, with Illinois filing the next six (which would deplete the remaining assets). Unable to prevail in a straight lien priority battle, the United States turned to the Insolvency Statute, 31 U.S.C. § 3713. The Insolvency Statute provides that any claim of the United States shall be paid first out of the assets of an insolvent debtor.

The Seventh Circuit, upholding the district court on appeal, initially noted the apparent absolute priority in the language of the statute. Despite this, the court said, the Supreme Court has recognized several exceptions to the Government's priority. Most recently, in **Estate of Romani, 523 U.S. 517 (1998)**, the Supreme Court held that the Insolvency Statute was superceded by the Tax Lien Act, I.R.C. § 6323(a).

However, the court of appeals rejected the state's argument that **Romani** signaled the high court's approval of the common law "first in time, first in right" rule of lien priority in insolvency cases. Because Illinois' liens did not qualify as priority liens under section 6323(a), it was irrelevant that they were perfected prior to the federal tax liens. Noting that cases prior to **Romani** similarly subordinated the Insolvency Statute only to later enacted, more specific federal statutes, the Seventh Circuit refused to expand **Romani** beyond the exceptions in section 6323.

## **LIENS: Priority over State and Local Taxes**

### **1. BANKRUPTCY CODE CASES: Chapter 13: Effect of Confirmation**

**In re Elstien, 238 B.R. 747 (Bankr. N.D. Ill. 1999)** - Debtor failed to disclose business taxes owed to both state and federal authorities, which put him over the Chapter 13 debt limit. Although his plan had been confirmed, and the time for challenging the plan had expired, the court found the debtor's false and misleading filings prejudiced the creditor's rights, and so the court dismissed his bankruptcy under B.C. § 1307(c). However, the court was very troubled by the fact that the Service was aware of the debtor's business debts, yet failed to file a proof of claim, object to confirmation, or take any action until a year after the time period for revocation of plan confirmation expired.

**2. BANKRUPTCY CODE CASES: Exceptions to Discharge (§ 523)**

**In re Blakeman, 84 AFTR2d ¶ 99-5457 (Bankr. N.D. Ohio Oct. 13, 1999)** - Court found taxes nondischargeable under B.C. § 523(a)(c)(1) because debtor willfully attempted to evade the tax. The debtor asserted the Government couldn't prove he had the means to pay his taxes but chose not to, but the debtor refused to testify about his income and expenses for the years in question. Based solely on circumstantial evidence (primarily the certificates of assessment), the court held it could draw adverse inferences from the debtor's assertion of his Fifth Amendment privilege. The court found under the "new era" of summary judgment, once the moving party establishes a prima-facie case, the nonmovant is obligated to provide concrete evidence establishing the existence of a genuine issue of material fact.

**3. BANKRUPTCY CODE CASES: Exceptions to Discharge (§ 523)**

**In re Meyers, 1999 U.S. App. LEXIS 29962 (6<sup>th</sup> Cir. Nov. 17, 1999)** - Lower court ruled that debtor's taxes were nondischargeable under B.C. § 523(a)(1)(C) because he willfully attempted to evade his tax liability. The debtor argued that his conduct was not willful because he voluntarily cooperated with the Service in an attempt to correct his past mistakes. Affirming, the court of appeals found under Toti v. United States, 87 F.3d 947 (6<sup>th</sup> Cir. 1996), that "voluntary, conscious and intentional acts are willful," and that the debtor's later conduct did not purge his earlier violation of a known legal duty.

**4. BANKRUPTCY CODE CASES: Returns by trustee, debtor in possession or debtor: Individual**

**McCullister v. United States, 84 AFTR2d ¶ 99-5527 (Bankr. W.D.N.Y. Nov. 1, 1999)** - Debtor claimed after Service prepared substitute returns that he offered to file actual returns but was told by a Service representative that it wasn't necessary, and consequently his taxes should be discharged in bankruptcy. Court rejected the absolute rule of In re Hindenlang, 164 F.3d 1029 (6<sup>th</sup> Cir. 1999) (as matter of law, once Service prepares substitute return those taxes cannot be discharged in bankruptcy) and adopted the four-prong facts and circumstances test of Beard v. Commissioner, 79 F.2d 139 (6<sup>th</sup> Cir. 1986). However, the court held that debtor did not make an honest and reasonable attempt to satisfy the requirements of the tax laws as his efforts were the minimum necessary to avoid collection, and so the taxes were nondischargeable.

5. **BANKRUPTCY CODE CASES: Setoff (§ 553): Sums Due from Other Federal Entities**  
**Internal Revenue Service v. Cherry Street Partners L.P., 84 AFTR2d ¶ 99-5525 (5<sup>th</sup> Cir. Nov. 3, 1999) (unpublished)**- The Fifth Circuit, in an unpublished, one-word decision, upheld the district court's decision (see GL Bulletin No. 463, April 1999) that the Government's right to setoff, as a defense to payment, prevails over a perfected security interest unless the Government had actual notice of the security interest before the setoff accrued. Further, the secured creditor has the burden to prove notice, and a UCC financing statement is not sufficient notice.
6. **BANKRUPTCY CODE CASES: Statute of Limitations: On Collection After Assessment: Suspension Under Bankruptcy Code**  
**In re Offshore Diving and Salvaging, Inc., 1999 U.S. Dist. LEXIS 16664 (E.D. La. Oct. 20, 1999)** - Debtor filed Chapter 11 bankruptcy in 1991, then filed a second Chapter 11 in 1995, which was converted to a Chapter 7 in 1996. The Service claimed priority in the second bankruptcy for 1990 & 1991 taxes, arguing that equitable tolling of the three-year "look back" period of B.C. § 507(a)(8)(D) was warranted under B.C. § 108 or § 105. The district court disagreed, holding that tolling is not permitted under § 108 by virtue of In re Quenzer, 19 F.3d 163 (5<sup>th</sup> Cir. 1993). Although the court found equitable tolling was allowed under § 105, under the facts of this case the district court concluded that the bankruptcy court did not abuse its discretion in refusing to find the equities favored the Service.
7. **COMPROMISE & SETTLEMENT: Liability Involved in Court Proceeding**  
**Tucek v. Commissioner, 1999 U.S. App. LEXIS 29189 (10<sup>th</sup> Cir. Nov. 2, 1999)** - Following an adverse court decision, partners filed suit in tax court to require Service to provide them the same favorable settlement offers given to other partners prior to the adverse decision. The Tenth Circuit, affirming the tax court, held that the Service had no statutory duty to inform all the partners of the offer, because the Service previously informed the Tax Matters Partner of the settlement offer.
8. **LEVY: Exempt Property**  
**Otter Bay Fisheries, Inc. v. Brown, 84 AFTR2d ¶ 99-5516 (W.D. Wash. Oct. 22, 1999)** - Maintenance, cure and unearned wages paid to a seaman as settlement for injuries are not exempt from tax levy as workmen's compensation.
9. **LEVY: Wrongful**  
**Kopec v. Kopec, 1999 U.S. Dist. LEXIS 16346 (E.D. N.Y. Oct. 18, 1999)** - Spouse claimed half-interest in taxpayer's pension, subsequently rolled-over into an IRA and levied on by the Service. Because she did not sign a spousal waiver, the court ruled that the spouse had a cause of action against the fiduciary of the IRA (the taxpayer) who improperly distributed the funds. However, the wrongful payment did not create an ownership interest to the funds in the spouse, and so the levy was valid.
10. **LIENS: Priority Over Divorced Spouse**

**Herzog v. United States, 1999 U.S. App. LEXIS 28154 (9<sup>th</sup> Cir. Oct. 29, 1999)** - Filed federal tax lien attached before marital settlement agreement awarded real property to divorced spouse, so Government entitled to half of the sale proceeds. The court held that even though the ex-spouse may qualify as a purchaser under gift tax laws, he was not a purchaser with priority over the federal tax lien under I.R.C. § 6323.

**11. LIENS: Priority Over Judgment Lien Creditor**

**Hensley v. Harbin, 1999 U.S. App. LEXIS 29335 (6<sup>th</sup> Cir. Nov. 9, 1999)** - Plaintiff obtained and filed judgment against defendant, but defendant appealed. While on appeal, the Service filed a Notice of Federal Tax Lien against the defendant. The Sixth Circuit determined that under federal common law (first in time = first in right), the Service took priority, because until the appeal was final, the amount of the judgment remained undetermined (and so the judgment lien remained inchoate). The Court rejected the plaintiff's argument that under state law, its judgment on appeal related back to the date of the original judgment. Instead, the court held, federal law governs priority.

**12. LIENS: Priority Over Judgment Lien Creditor**

**United States v. Kodama, 1999 U.S. Dist. LEXIS 4485 (N.D. Cal. March 29, 1999)** - Government is entitled to foreclose lien on houseboat even though there was no equity in the property at the time the debtors filed for bankruptcy. The court ruled the debtors could not strip away the lien just because a competing lien existed.

**13. PENALTIES: Failure to Collect, Withhold or Pay Over: Responsible Officer**

**Logal v. United States, 1999 U.S. App. LEXIS 30659 (5<sup>th</sup> Cir. Nov. 22, 1999)** - Taxpayer was the president, CEO, director and shareholder of a corporation, the only officer who received compensation from the business. Assessed with the Trust Fund Recovery Penalty, he argued that another director, who acted as the bookkeeper, diverted funds so that federal taxes were not paid. However, the Fifth Circuit, acknowledging that it takes a broad view of who is a responsible person under I.R.C. § 6672, found the taxpayer's position and responsibilities sufficient to support a jury's verdict. The court also found the taxpayer willful as a matter of law because he knew taxes were due and also knew that other creditors, including himself, were being paid rather than the Government. The court found unpersuasive the taxpayer's claim that the fraudulent conduct of the bookkeeper constituted reasonable cause for his failure to pay the employment taxes. The Fifth Circuit held that no such defense may be asserted by a responsible person who knew that the taxes were due, but made a conscious decision to pay creditors other than the Government.

**14. PENALTIES: Failure to Collect, Withhold or Pay Over: Responsible Officer**

**In re Wiley, 238 B.R. 895 (Bankr. M.D. Fla. 1999)** - Debtor, the Executive Vice President of Finance and Administration, supervised the accounting department of his company, arranged for financing, made cash decisions, and had bank account

signature authority. Based on these factors, the court found he was a responsible person subject to the Trust Fund Recovery Penalty, I.R.C. § 6672. The debtor unsuccessfully argued that he should not be found responsible because he was only following orders in not making payroll tax payments or because he delegated the actual payment to subordinates. The court found the debtor's apparently sincere efforts to remit payroll taxes insufficient. Instead, his preference of paying other creditors over making tax payments was willful as a matter of law.

15. **PENALTIES: Failure to Collect, Withhold or Pay Over: Responsible Officer**  
**Winter v. United States, 1999 U.S. App. LEXIS 29336 (2<sup>d</sup> Cir. Nov. 8, 1999)** - Company believed it overpaid taxes for a related entity, and requested a refund. Meanwhile, the Service assessed Trust Fund Recovery Penalties under I.R.C. § 6672 against the company's officers. The district court granted summary judgment in favor of the Government, but the Second Circuit reversed. The appellate court found there was a genuine issue of material fact as to whether the company was entitled to a tax credit. Moreover, the court held that if the taxpayers reasonably believed the company satisfied its tax obligations through the application of the tax credits, they would not be liable for "willfully" failing to remit the taxes. The court also examined each individual's status as a responsible person, and determined that section 6672 was not intended to apply to a person who lacks actual control over an employer's finances, even though that person has technical authority by virtue of title or ownership interest.
16. **SUITS: Removal**  
**Frese v. Smith, 1999 U.S. Dist. LEXIS 16819 (C.D. Ill. Oct. 15, 1999)** - United States properly intervened in and removed real property civil suit pursuant to I.R.C. § 7424. The court did not accept the taxpayer's argument that since the civil action was not one of the types listed in 28 U.S.C. § 2410(a), the United States could not remove the suit to federal court under section 1444. Rather, the court found, an action under I.R.C. § 7424 the Government is treated as if it had been a defendant to a section 2410(a) suit for purposes of sovereign immunity and removal.
17. **SUMMONSES: Intervention by Taxpayer: Right to Appear at Investigatory Interview**  
**United States v. Jones, 1999 U.S. Dist. LEXIS 16855 (D. S.C. Oct. 5, 1999)** - Court stayed a prior order denying taxpayer's request to have his attorney present during questioning of a third-party CPA recordkeeper. The court found that there was a likelihood of irreparable injury because the CPA, without presence of counsel, might divulge privileged information in response to the summons.