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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR ASSISTANT DISTRICT COUNSEL, LOS ANGELES

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

SUBJECT: Chapter 13 Bankruptcies Involving Taxpayers with Accepted Offers

This memorandum responds to your General Litigation Transmittal Memorandum dated February 8, 2000 in which you ask that we post-review your memorandum of the same date to Chief, Special Procedures Branch, Los Angeles District. This document is not to be cited as precedent.

ISSUE

- (1) What kind of a claim should the Internal Revenue Service ("Service") file in a Chapter 13 bankruptcy case when the tax liabilities have been compromised in a pre-petition offer in compromise if the offer has not yet been fully paid?
- (2) Is the debtor prohibited from assuming without the Service's consent an accepted offer in compromise that has not been fully paid at the time the Chapter 13 petition was filed because the future compliance provision of the accepted offer makes the contract unassignable under applicable law?

CONCLUSION

- (1) When a taxpayer with an accepted but uncompleted offer in compromise files a Chapter 13 petition, the Service should file a protective claim for the entire underlying tax liabilities to protect the Service's interests in the event that the debtor fails to assume the accepted offer in the plan.
- (2) No, the debtor is not prohibited from assuming without the Service's consent an accepted offer in compromise that has not been fully paid at the time the Chapter 13 petition was filed.

DISCUSSION

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Your memorandum concludes that when a taxpayer with an accepted offer in compromise that has not yet been fully paid files a Chapter 13 case, the Service's proof of claim should reflect the full amount of the tax liability. We agree. In our Memorandum to Southern California District Counsel, Laguna Niguel dated February 8, 2000, we stated that the Service should file a protective claim for the entire unpaid underlying tax liability to protect the Service's interests in the event that the debtor fails to assume the accepted offer in the plan.

However, you also conclude that because the future tax compliance provision of the offer can only be fulfilled by the taxpayer, accepted offers are personal service contracts under Bankruptcy Code section 365(c)(1) that cannot be assumed. The effect of your conclusion is that a debtor with an accepted offer in compromise must either pay the full amount of the underlying priority and secured tax claims, or dismiss the Chapter 13 case.

You explain that Bankruptcy Code section 1322(b)(7) provides that a Chapter 13 plan may, "*subject to § 365 of this title*, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section" (emphasis added). Section 365(c)(1) provides in pertinent part:

The trustee may not assume or assign any personal service contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

- (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
- (B) such party does not consent to such assumption or assignment[.]

This provision follows the common law restriction against the assignment of personal service contracts. 3 Collier on Bankruptcy § 365.06[1][b], 365-56 (6th ed. rev. 1999). Personal service contracts are contracts for the services of a particular person when that person's services are unique and cannot equally be performed by another. Id.

The present version of the Offer in Compromise Form 656 (Rev. Jan. 2000), paragraph (d), provides that the taxpayer agrees to comply with all provisions of the Internal Revenue Code relating to the filing of returns and paying the required taxes for 5 years or until the offered amount is paid in full, whichever is longer. You conclude that this duty is personal to the taxpayer, and renders the contract

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unassignable under applicable law and therefore unassumable pursuant to sections 365(c)(1) and 1322(b)(7).

We have found no cases reaching the conclusion that a Chapter 13 debtor cannot assume and perform his own personal service contract. A related issue has arisen in Chapter 11 cases. In Chapter 11, Bankruptcy Code section 1107(a) grants debtors in possession the rights and powers of a trustee, but provides that these powers are “[s]ubject to the limitations on a trustee serving in a case under this chapter[.]” Even so, there is a split of authority as to whether a Chapter 11 debtor in possession can be prohibited from assuming a personal service contract under section 365(c)(1). Some courts hold that the language of the statute establishes a “hypothetical test” as to whether the contract could be assignable to a hypothetical non-debtor assignee. If not, the contract cannot be assumed by the debtor in possession. In re Catapult Entertainment, 165 F.3d 747 (9th Cir. 1999); In re West, 852 F.2d 79, 83 (3rd Cir. 1988). See also In re James Cable Partners, 27 F.3d 534, 537 (11th Cir. 1994). Other courts look to the legislative history, purposes, and construction of related statutory provisions and hold that a debtor in possession can assume an executory personal service contract of the debtor as long as the contract is not actually being assigned to a new entity. Institut Pasteur and Pasteur Sanofi Diagnostics, 104 F.3d. 489 (1st Cir. 1997), cert. denied 521 U.S. 1120 (1997); Texaco Inc. v. Louisiana Land and Expl. Co., 136 B.R. 658, 688-71 (M.D. La. 1992); In re GP Express Airlines, Inc., 200 B.R. 222, 231-33 (Bankr. D. Neb. 1996); In re Hatec Enters., Inc., 117 B.R. 865, 871-73 (Bankr. W.D. Tex. 1990), vacated on other grounds, 130 B.R. 929 (W.D. Tex. 1991); In re Cardinal Indus. Inc., 116 B.R. 964, 976-82 (Bankr. S.D. Ohio 1990). This is also the view of the leading treatise on bankruptcy. 3 Collier on Bankruptcy § 365.06[1][d], 365-58 (15th ed. 1999).

Your conclusion was based upon the “subject to section 365 of this title” language in § 1322(b)(7). You concluded that the restrictions imposed in section 365(c)(1) on the trustee’s ability to assume a contract under section 365(a) also apply to debtors assuming a contract in their plan under section 1322(b)(7).¹ We do not interpret the language in section 1322(b)(7) as if it reads “subject to the limitations imposed on the trustee in section 365.” Compare section 1322(b)(7) to Bankruptcy Code section 1304(b), which provides that a Chapter 13 debtor engaged in business may operate the business “subject to any limitations on a trustee under sections 363(c) and 364 of this title.” Compare also section 1107(a), discussed supra. Rather, the

¹ We should also note that a possible interpretation of the Code is that the debtor has the right to an executory contract under non-bankruptcy law, and does not lose that right upon filing bankruptcy. Seen in this light, section 1322(b)(7) only provides that the debtor may exercise this pre-existing right in the plan, and that this right is made subject to the trustee’s right to assume the contract under section 365(a) and other applicable provisions of section 365.

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inclusion of “subject to section 365” language in section 1322(b)(7) makes clear that applicable provisions in section 365 (those not expressly aimed at the trustee) apply. While many subsections of section 365 apply only to trustees (or debtors in possession under section 1107), other provisions are more broad, such as subsections 365(e) and (g).

Indeed, Bankruptcy Code section 365(e)(2)(A) would have no effect if the personal service contract limitation on trustees in section 365(c)(1) applied to debtors pursuant to section 1322(b)(7). Section 365(e) provides in pertinent part:

(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under the title or a custodian before such commencement.

(2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee² of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(ii) such party does not consent to such assumption or assignment[.]

Section 365(e)(2)(A) is the only provision other than section 365(c)(1) that addresses personal service contracts. Section 365(e)(2)(A), which has no language limiting it to the trustee as does section 365(c)(1), provides an exception for personal service contracts to the section 365(e)(1) rule which nullifies any

² Though the language in section 365(e)(2) is not identical to the language in section 365(c)(1) due to legislative oversight when section 365(c) was amended, it appears that there was no intention to distinguish substantively between the type of contracts being described. ³ Collier on Bankruptcy § 365.07[1], 365-67 (6th ed. rev. 1999).

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provision in an executory contract that allows the contract to be terminated if the debtor files bankruptcy or becomes insolvent. Thus, Congress chose to allow executory personal service contracts to be terminated by the non-debtor party if the contract provides for termination based on the financial condition of the debtor. There would be no reason for the 365(e)(2) exception for personal service contracts, however, if in all cases the non-debtor party could prevent the assumption of the contract under section 365(c)(1) simply because it is a personal service contract. Thus, section 365(e)(2) must apply to a class of cases not covered by 365(c)(1) to have effect. If section 365(c)(1) applied to the debtor as well as the trustee, there would be no class of cases in which the section 365(e)(2) exception would be necessary. Rather, as the plain language of section 365(c)(1) and section 1322(b)(7) indicate, the debtor's ability to assume or reject an executory contract in the plan is not limited by 365(c)(1), which applies only to the trustee. This gives effect to section 365(e)(2), which applies to the debtor. Thus, section 365(e)(2) has effect only if section 365(c)(1) does not apply to the debtor.

Accordingly, we do not recommend that the Service object to a Chapter 13 plan which provides for the payment of the Service's claims under an accepted offer in compromise on the basis that the offer cannot be assumed under section 365(c)(1).³ Rather, we reiterate our prior conclusion that the Service should file a protective claim for the unpaid underlying tax liabilities, and that the debtor can assume the accepted offer in the Chapter 13 plan.⁴

³ We should also note that if we were to take a contrary position, a bankruptcy court in a Chapter 13 case may be compelled to hold that the future compliance provision of the accepted offer in compromise is not a material term to the agreement in order to give the debtor the benefit of the contract. Adverse case law on this issue could hinder the Service any time it seeks to enforce the full amount of the tax liability upon default of the future compliance provision of a defaulted offer after the taxpayer has completed payments. Also, when the taxpayer has an accepted offer in compromise the Service has already expended administrative resources in researching and accepting the offer. Finally, there could be public policy concerns in cases where debtors file Chapter 13 to save their home from foreclosure and cannot present a feasible plan without the benefit of the accepted offer in compromise.

⁴ However, in a case in which the underlying tax claims could be discharged before the all terms of the accepted offer have been fulfilled, the Service could negotiate language in the plan providing that the underlying tax claims are nondischargeable in the event of default of the offer. The viability of the underlying tax liabilities is a basic assumption of the offer in compromise agreement, and the Service should not be bound to the offer agreement unless the underlying taxes are nondischargeable. See 2 Restatement of the Law Second (Contracts) sections 261, 261 comment(b), and 265 (1981). We also note that when the payments under an

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CONCLUSION

We conclude that when a taxpayer with an accepted but uncompleted offer in compromise files a Chapter 13 petition, the Service should file a protective claim for the full amount of the underlying tax liabilities. A note should be added to the proof of claim to reflect that it is being filed as a protective claim in the event that the debtor does not assume the accepted offer as an executory contract in the plan. The Service should then object to the Chapter 13 plan if it does not either, (1) expressly assume the accepted offer, or (2) provide for full payment of the Service's priority and secured tax claims, and any payment on its general unsecured claim that it may be entitled to in the case. In this way the Service will be honoring the accepted offer, while protecting its rights should the debtor chose not to assume the accepted offer. The debtor will have a choice, based on an evaluation of what is in the debtor's best interests, to either assume the accepted offer or be liable for the underlying tax liability.

If you have any questions, contact the attorney assigned to this matter at (202) 622-3620.

cc: Assistant Regional Counsel (GL), Western Region

assumed offer extend beyond the life of the plan, an argument could be made that the debtor has maintained payments on the underlying tax claims per section 1322(a)(5), rendering them nondischargeable per section 1328(a)(1).