



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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MEMORANDUM FOR DISTRICT COUNSEL, ROCKY MOUNTAIN DISTRICT

FROM: Mitchel S. Hyman
Senior Technician Reviewer, Branch 2 (General Litigation)

SUBJECT: Avoidance of Undesignated or Involuntary Payments Applied
to Nontrust Tax Liabilities as Preferential Transfers

This memorandum responds to your request for advice dated December 2, 1999.
This document is not to be cited as precedent.

ISSUES

1. Whether voluntary undesignated payments or involuntary levy payments applied to nontrust fund tax liabilities are protected from avoidance by a chapter 7 trustee by the holding in Begier v. Internal Revenue Service, 496 U.S. 53 (1990), that a voluntary prepetition payment of trust fund taxes is not payment of "property of the debtor."
2. Whether the undesignated voluntary or involuntary payments could be re-applied to trust fund taxes so as to bring the payments within the protection of Begier.

CONCLUSIONS

1. Payments, whether voluntary or involuntary, of nontrust fund taxes within the preference period are "transfers of an interest of the debtor in property," and may be avoided by the trustee if all of the elements of section 547(b) of the Bankruptcy Code are proven.
2. Funds previously applied to nontrust fund taxes should not be re-applied following the commencement of a bankruptcy case in an effort to bring the payments under the protection of Begier.

FACTS

The facts you provided are that two corporations incurred employment tax liabilities for withheld income and FICA taxes and for the employer's portion of FICA taxes.

Corporation A sent in a voluntary, undesignated partial payment which was less than the amount of the nontrust fund portion of the tax liability remaining unpaid at the time of the payment. In accordance with provisions of the Internal Revenue Manual (IRM) and applicable revenue procedures, this payment was applied to the non-trust fund portion of the corporation's liabilities. See Rev. Rul. 79-284, 79-2 C.B. 83; Policy Statement P-5-60. After consulting with a tax advisor, Corporation A sent subsequent payments with explicit directions to the Service to apply the payments to the trust fund portion of the tax liability. These payments were applied as instructed.

The Service also levied upon the bank account of Corporation B. The proceeds of the levy were less than the full amount of the tax liability and less than the full amount of the nontrust fund liability due at the time of the involuntary payment. The funds were applied to the nontrust fund portion of the corporation's liabilities, as dictated by the IRM. As a result of the levy, the payroll checks of Corporation B were not honored.

Less than ninety days after the payments, Corporation A filed a Chapter 7 bankruptcy petition and Corporation B had an involuntary Chapter 7 case commenced against it by the employees whose payroll checks had been dishonored. In both cases the trustee asks to bring back into the bankruptcy estate the payments made to the Service as preferences under section 547 of the Bankruptcy Code (B.C.), so that distribution can be made to wage claimants entitled to priority over the Service's claims under section 507 of the Code.

You have asked us to consider the applicability of the Supreme Court's holding in Begier v. Internal Revenue Service, 496 U.S. 53 (1990) to these two cases. Specifically, you have asked: 1) whether the Service's application of involuntary or undesignated payments to nontrust fund liabilities takes those payments out of the protection of the holding of Begier that voluntary payment of trust fund taxes is not payment of property of the debtor; and 2) whether the Service's discretion to apply or re-apply undesignated or involuntary payments would permit the Service to re-apply the payments so as to bring them under the protection of the holding in Begier.

DISCUSSION

Section 547(b) of the Bankruptcy Code allows the trustee to avoid certain transfers made by the debtor prior to filing bankruptcy, and to bring the transferred property back into the bankruptcy estate. The section provides that:

[T]he trustee may avoid any transfer of an interest of the debtor in property:

- (1) to or for the benefit of a creditor;

- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made –
 - (A) on or within 90 days before the filing of a petition; or
 - (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if –
 - (A) the case were a case under chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

B.C. § 547(b). The primary purpose of this provision is to promote equality of distribution among the various creditors of the debtor. See H.R. Rep. 95-595, at 177-78 (1977). The trustee's power to avoid preferential transfers made during the 90-day period prior to the bankruptcy filing precludes debtors from favoring one creditor over another by transferring property to creditors that would otherwise have been subject to distribution according to the priorities of the Bankruptcy Code.

The trustee bears the burden of showing that all of the elements of section 547(b) have been met. B.C. § 547(g). However, a threshold matter for determining the existence of an avoidable preference is a finding that the subject property is "an interest of the debtor in property."

In Begier, the Supreme Court adopted the Service's position that a voluntary, prepetition payment of trust fund taxes cannot be avoided under section 547(b), regardless of the source of such payments, because the funds paid were not property of the debtor but were instead held in trust for the United States under section 7501(a) of the Internal Revenue Code. The debtor, American International Airways, had made prepetition payments of air transportation excise taxes collected from customers, income taxes withheld from employee's wages, and FICA taxes withheld from employee's wages. The Internal Revenue Code provides that these collected and withheld taxes assume the status of trust funds, stating:

Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States.

I.R.C. § 7501(a). Prior to payment, the debtor and the Service had agreed that the payments would be allocated to specific trust fund taxes. The payments were made from two different accounts, one a general operating account containing

commingled trust and nontrust funds and one a segregated account, established pursuant to I.R.C. § 7512, used only for the deposit of withheld taxes. The bankruptcy court held that the funds from the segregated account had been held in trust for the United States and were not property of the debtor. However, the court allowed the trustee to avoid the payments from the general operating account because the Service could not trace the funds to actual withheld or collected taxes.

The Supreme Court rejected the bankruptcy court's reasoning and affirmed the Third Circuit's holding that the payment from the general account could not be avoided. The Court held that withheld employment taxes and collected excise taxes need not be placed in a segregated account to be subject to the trust imposed by section 7501(a). Rather, the trust is created pursuant to that section upon the payment of wages to employees or collection of taxes from customers. Begier, 496 U.S. at 61-62.

The Court further held that common-law tracing rules are not applicable to section 7501. This is because "(u)nlike a common-law trust, in which the settlor sets aside particular property as the trust res, section 7501 creates a trust in an abstract 'amount' – a dollar figure not tied to any particular assets – rather than in the actual dollars withheld." Id. at 62. On the other hand, "Congress expected that the IRS would have to show some connection between the section 7501 trust and the assets sought to be applied to the debtor's trust-fund tax obligations." Id. at 65-66. Relying on the legislative history of the Bankruptcy Code, the Court concluded that Congress expected the courts to apply "reasonable assumptions" to govern the tracing of trust funds, and that one such reasonable assumption is that "any voluntary payment of trust-fund taxes out of the debtor's assets is not a transfer of the debtor's property." Id. at 67

In his concurrence, Justice Scalia reasoned that the voluntary payment actually creates the trust by identifying the payment as the trust fund, but that the trust should be deemed to have been in existence from the time of the withholding or collection. Begier, 496 U.S. at 71 (Scalia, J., concurring).

Begier makes clear that a voluntary payment of trust fund taxes cannot be avoided by the bankruptcy trustee. Under the facts of that case, both the debtor and the Service, at the time of payment, were in agreement that the funds were trust fund taxes to be applied as such – thus, Begier involved a voluntary, designated payment. As you note, the degree to which Begier can be said to apply beyond those facts is the subject of disagreement among the courts. Your request asks us to consider the possible expansion of Begier in three directions: 1) to voluntary but undesignated payments, 2) to involuntary payments, and 3) to payments, whether voluntary or involuntary, which the Service initially applies to nontrust liabilities. Each of these variations on the facts of Begier should be considered in light of how they would effect the core finding of the Supreme Court in that case: that the transfer of funds was not a transfer of "property of the debtor."

Voluntary, Undesignated Payments

As you noted, no court has squarely faced the question of whether voluntary, undesignated payments which the Service applies to trust fund taxes are avoidable as preferences. However, we see nothing in such a scenario which would make the reasoning of Begier inapplicable. Begier held that Congress intended courts to apply “reasonable assumptions” when determining whether a payment could be traced to funds held in trust. The Court relied on the legislative history of the Bankruptcy Code, particularly a House report which stated:

A payment of withholding taxes constitutes a payment of money held in trust under the Internal Revenue Code § 7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they have been if the debtor is able to make the payments.

H.R. Rep. 95-595, at 373 (1977). As we stated before, the Court concluded that it was not necessary for trust funds to be segregated from other funds to find that they had been “properly held for payment.” Rather, the nature of the floating trust is such that the ability to pay provides the nexus required to conclude that the funds were held in trust. It would be illogical to conclude that, although the funds were properly held for payment and the debtor was able to pay, lack of designation by the debtor as trust fund payments destroyed the presumption that the funds were subject to the 7501(a) trust.

Although the debtor and the Service in Begier had agreed that the payments were of trust fund taxes, the Court placed little reliance on this fact in holding that the funds were subject to the section 7501(a) trust or that common-law tracing rules did not apply. In the instant cases, as in Begier, if the funds were properly held for payment, the debtor was able to pay, and the payment was applied to trust fund taxes, the Service should argue that the funds were not property of the debtor and are thus not avoidable by the trustee.

Involuntary Payments

Similarly, if the same funds are taken from the debtor involuntarily, the funds could nevertheless have been held in trust for the Government. Relying on the same legislative history cited in Begier, the debtor “was able to make the payment” if the funds were available to be levied upon in the debtor’s account, and thus they were “properly held for payment” in trust for the Government. This reasoning was adopted by the court in In re Nash Concrete Form Co., 159 BR 611, 613 (D. Mass. 1993), which held that the debtor’s objective ability to make the payments established the requisite nexus to conclude that the levied funds were trust funds.

If the funds were held in a segregated account, such as one established pursuant to I.R.C. § 7512(b), there is no question that the payments cannot be avoided, since they are directly traceable to withheld taxes. Your question, then, becomes exactly the one facing the Court in Begier: whether such segregation is necessary to establish that trust funds were remitted, and, if not, must the Service trace the levied funds back to the withheld taxes? We take the position that the same “reasonable assumptions” relied upon in determining that voluntary payments were made from trust funds would apply to determining the origin of involuntary payments as well.¹

Application of Funds to Nontrust-fund Taxes

In the above discussion we have assumed, as was the case in Begier, that the payments, once received, were applied to trust fund liabilities. You have asked us to consider whether funds applied to nontrust liabilities might be beyond the avoidance powers of the trustee if the nexus required by Begier can be established. Furthermore, you argue that if application of the funds to nontrust fund taxes conclusively removes the payments from the protection of Begier, the Service could “cure” that deficiency by reapplying the funds to trust liabilities.

However, the issue here is not whether, in a non-bankruptcy setting, the payments previously applied to a particular liability could be reallocated to some other liability. We agree that the Service has broad authority to re-apply payments with the goal of maximizing collection. Rather, the issue is whether the funds, at the time of payment, represented an “interest of the debtor in property” which would be subject to the preference rules of section 547. This office takes the position that the Service cannot rely on Begier to assert that funds applied to nontrust fund liabilities were not avoidable under section 547. A court would be unlikely to accept the argument that such funds assumed trust fund status at the time of payment.

When the Service receives an involuntary or undesignated payment, it makes a choice to apply the payment in a manner which it believes best serves the interests of maximizing collection. As you noted in your memorandum, the courts have upheld the Service’s right to make this choice, see Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983), and, in some circumstances, to revisit that decision when more information comes to light. See Davis v. United States, 961 F.2d 867, 878-79 (9th Cir. 1992), cert. denied, 506 U.S. 1050 (1993); Mattingly v. United States, 939 F.2d 816, 819-20 (9th Cir. 1991); Thomas v. United States, 98-2 USTC ¶ 50,622 (C.D. Ill. 1998). However, the choice between applying a payment

¹ We would not, however, argue that funds seized from some source other the debtor’s accounts, such as an account debtor, were trust funds. See In re Hearing of Illinois, 110 BR 380 (Bankr. C.D. Ill. 1990) (rejecting Service’s reliance on Begier where Service levied on account receivable to collect trust-fund taxes).

to trust fund or nontrust liabilities is, in this context, a decision to designate the funds as either subject to the trust imposed by section 7501 or not. If the Government applies the payment to satisfy trust fund liabilities, it is making the implicit decision that those funds were held in trust for the Government and, applying the same reasoning which supported the holding of Begier, were not property of the taxpayer.

In the cases you have described, the subject payments have at no point been designated, either by the Service or the taxpayer, as trust fund payments. Although Begier established that the traditional common-law tracing rules do not apply to the section 7501 trust, there must be some nexus between the funds received in payment and the taxes withheld or collected. In a case in which the funds have never been identified as trust fund taxes at any point prior to the filing of the bankruptcy petition, we fail to see how the Service could argue that the requisite nexus has been established. In fact, the Service's designation of the funds at the time of payment as nontrust fund payments undercuts any argument that the funds were held in trust prior to remittance by the taxpayer.

You note that the debtor will not be harmed by the Service re-allocating the payments and not turning them over to the trustee. Those harmed would be the wage claimants whose claims have priority over the Service pursuant to section 507. However, potential harm to other creditors is the very concern for which section 547(b) was placed in the Bankruptcy Code, and courts are unlikely to view potential harm to a corporation which is about to be liquidated as a relevant consideration. Where it has been determined that property of the debtor has been transferred during the preference period, fairness to all creditors, rather than any concern over harm to the debtor, is the rational supporting return of the property to the estate.

CONCLUSION

In Begier v. Internal Revenue Service, 496 U.S. 53 (1990), the Supreme Court held that a voluntary prepetition payment of trust fund taxes is not payment of "property of the debtor," and is thus not avoidable by the trustee as preference. In the case of undesignated or involuntary payments, the same "reasonable assumptions" should be applied to determine whether the funds received were held in trust for the United States. Funds previously applied to nontrust fund taxes should not be re-applied following the commencement of a bankruptcy case in an attempt to bring the payments under the protection of Begier.

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

cc. Assistant Regional Counsel (GL), Western Region