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

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MEMORANDUM FOR DELAWARE-MARYLAND DISTRICT COUNSEL

FROM: Lawrence H. Schattner
Chief, Branch 3 (General Litigation)

SUBJECT: GL-609413-98, WLI 2

This responds to your memorandum dated September 14, 1998, as supplemented by your memorandum dated January 28, 1999. This document is not to be cited as precedent.

ISSUES:

(1) Can or should the Service use administrative procedures to collect tax liabilities, for which Chapter 13 bankruptcy estate assets were sold under a modification of the automatic stay, where sale proceeds were erroneously refunded?

(2) What is/are the available remedy(ies) for recovery of the erroneous refund?

CONCLUSIONS:

(1) It would be possible for the Service to obtain a modification of the automatic stay to permit a levy against the identifiable asset of the erroneous refund for the tax liabilities for the tax years for which levy was made which are in excess of the intended application of the sale proceeds. However, in this case, this is not the preferred remedy.

(2) It is preferable in this case for the Service to recover the erroneous refund by an erroneous refund suit under I.R.C. § 7405, brought within the period of I.R.C. § 6532(b). Several cautions and a small amount credited are also discussed.

FACTS:

Tax liabilities were assessed against the debtor and his wife for six tax years. Notice of Federal Tax Lien was filed for each of those years. In March 1997, a levy was issued. Inadvertently, the tax year 1 liability was not included on the levy.

A month after the levy, the debtor filed a Chapter 13 bankruptcy. Proof of claim for liabilities secured by the liens was filed by the Service for the six tax years. 1/ A plan was confirmed July 1997and provided for payments over 60 months. The debtor made monthly payments from September 1997 through September 1998 but not thereafter. The case has not been dismissed.

The bankruptcy estate contained real estate encumbered by the Service's liens. In respect of this real estate, the court ordered:

> In consideration of the United States' Motion to Lift the Automatic Stay, and for the reasons at the hearing held on ... , it is this ... , by the United States Bankruptcy Court for the ... ,
>
> ORDERED that the automatic stay is modified to provide that after ... , the Internal Revenue Service may seize and sell the debtor's real property located [sic, in] the subdivision known as ... in ... , in accordance with the procedures specified under the Internal Revenue Code ... .

The order does not mention the liabilities to which the proceeds of sale are to be applied but refers to reasons given at the hearing. From this, we assume that the liens and outstanding liabilities for the six tax years, and the levy, were mentioned as reasons for modifying the automatic stay at the hearing.

The Service relied on the pre-bankruptcy levy in regard to the sale of the property. The property was sold in December 1997. The proceeds from the sale of the real estate were less than the outstanding liabilities.

In accordance with the Service's procedures governing application of involuntary payments, all of the proceeds from the sale were applied to the debtor's oldest tax liability first. It was intended that once the tax year 1 liability, a small amount, was paid, the excess proceeds would be credited to the tax years 2 and 3 liabilities,

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1/ All but the last of the six tax years are dischargeable periods. Tax liability for a seventh tax year was also assessed. However, since this liability was included on the proof of claim as unsecured, and since it is for a dischargeable period, it will not be further considered.

which would exhaust the proceeds. Such application would have left outstanding any remaining liability for year 3 and all of the liabilities for years 4-6.

Apparently due to freeze (nonpostable) coding on the accounts for tax years 2 -6, the excess funds did not offset to the tax years 2 and 3 liabilities. Instead, all of the proceeds remained credited to the tax year 1 account. Upon an erroneous release of a freeze code in the tax year 1 account, the excess funds held in the tax year 1 account appeared as an overpayment and were refunded in May 1998.

Because the taxes were joint liabilities, the refund check was issued in the joint names of the debtor and his wife. Thereafter, by two letters the debtor and his wife were advised that the refund was erroneous, that the check should not be cashed, and that the check should be returned to the Service. They, however, cashed the check and refused to return the check proceeds.

LAW AND ANALYSIS:

This advisory concerns sale proceeds which were erroneously credited or refunded, rather than applied to the liabilities regarding which the sale was conducted. The issues address whether administrative procedures can or should be used to collect against the erroneous refund for tax liabilities in respect of which the sale was conducted, and the preferred remedy for recovery of the erroneous refund.

Satisfaction Doctrine

The courts are in agreement that when a taxpayer tenders a payment on a tax assessment, the assessment is extinguished to the extent of the taxpayer's payment and, that an erroneous refund – whether rebate or nonrebate – does not revive a previously paid assessment. See, Bilzerian v. United States, 86 F.3d 1067, 1069 (11th Cir. 1996); Clark v. United States, 63 F.3d 83 (1st Cir. 1995); O'Bryant v. United States, 49 F.3d 340 (7th Cir. 1995); United States v. Wilkes, 946 F.2d 1143, 1150 (5th Cir. 1991). See also, Rodriguez v. United States, 629 F. Supp. 333 (N.D. IL 1986); United States v. Young, 79-2 USTC ¶ 9609 (D. DE 1979). The Service, thus, may not take administrative collection action on a previously paid tax assessment, even if the Service inadvertently refunds a portion of the taxpayer's payment back to the taxpayer. Stanley v. United States, 35 Fed. Cl. 493 (1996); Rodriguez, supra. Not every credit to the taxpayer's account, however, constitutes a payment in satisfaction of the original assessment. A payment and/or credit satisfies only the tax to which it is properly applied. A tax is generally not satisfied by the Service's error in applying the payment to the incorrect tax period. Clark, 63 F.3d at 89.

Application of proceeds of levy, including those from seizure sales, is governed by section 6342. Section 6342(a) provides:

> Any money realized by ... sale of seized property ... shall be applied as follows:
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> (1) ... [A]gainst the expenses of the [seizure and sale];
>
> (2) ... If the property seized and sold is subject to a tax imposed by any internal revenue law which has not been paid, ... against such tax liability;
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> (3) ... [A]gainst the liability in respect to which the levy was made or the sale was conducted.

See, also, Treas. Reg. § 301.6342-1. If the property is seized or sold in satisfaction of more than one tax liability, the proceeds must be applied to the oldest tax liability first (and within the oldest category, in the order of tax, penalty and interest), then to the liability for the next succeeding tax period, and so forth, until the funds are exhausted. See Rev. Rul. 79-284, 1979-2 C.B. 83; IRM 56(15)4; Rev. Proc. 84-58, 1984-2 C.B. 501, sec. 6.01. Any surplus proceeds remaining after application of subsection (a) shall be credited or refunded, permitting offset against other outstanding liabilities. Section 6342(b); IRM 5725.2. These provision reflect the involuntary, undesignatable nature of funds obtained by seizure and sale, and that section 6342(a),(b) provide for ordering application of a payment. 2/

In the case at hand, the Service seized and sold the debtor's real property pursuant to a court order modifying the automatic stay. The property was sold in order to partially satisfy the debtor's income tax liabilities for specific amounts for specific years. Had the Service followed section 6342(a),(b) and its own procedures governing application of such payments, the proceeds would have been applied first to tax year 2 liabilities, et seq., until exhausted. Because the proceeds were

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2/ In our view, section 6342 is an ordering provision not a satisfaction provision. The purpose of section 6342 is to provide for application of proceeds of levy in sequence to specified categories, and to provide for offset of the surplus in lieu of refund. But for these provisions, it is arguable that the category (1) items could not be paid at all from the levy proceeds, and that the category (2) items could only be paid if they had a lien priority. Our view that section 6342 is only an ordering provision, not a satisfaction provision, is supported by I.R.C. §§ 6331, 6401, 6402 and 7809(b)(3). Section 6331 provides authority to levy to collect unpaid tax without mention of expenses of sale; sections 6401 and 6402 address overpayments, and offset of overpayments, rather than surplus proceeds which have not become payments; and section 7809(b)(3) provides a special disposition account for surplus proceeds from levies.

not sufficient to fully satisfy the debtor's liabilities included in the levy, there would not have been surplus proceeds to refund to the debtor or the bankruptcy estate. 3/

The Service, however, inadvertently applied the proceeds to the tax year 1 tax liability, which was not included in the levy. While we do not believe that such an application is precluded by section 6342(a), it is clear that section 6342 does not contemplate a refund of any portion of the proceeds unless the taxes with respect to which the sale was conducted are fully satisfied. 4/ The question which needs to be answered, therefore, is whether the amount of the proceeds available for offset to the tax year 2, et seq., liabilities resulted in the satisfaction of these assessments despite the fact that this amount was erroneously refunded to the debtor. 5/

As stated above, the courts are in general agreement that a taxpayer's payment tendered in satisfaction of a tax assessment extinguishes the assessment to the extent of the payment. In Rodriguez, supra, for example, the Service had assessed deficiencies for three years. When the taxes went unpaid after notice and demand, the Service levied realty. On the last day before the sale, the taxpayer redeemed

the property by tendering three checks in full satisfaction of the liabilities for the three tax years. The checks, however, did not match the amounts due, on a check per year basis. In applying the funds, the Service applied the correct amount to year 3, too much to year 2, and not enough to year 1, resulting in a refund for year 2 and an underpayment for year 1. The Service issued a levy for the year 1 underpayment. Taxpayer sued for an injunction and collection damages, asserting that the tax year 1 assessment was fully paid and that the Service failed to make a

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3/ We are of the opinion that any surplus proceeds would have constituted property of the bankruptcy estate under B.C. § 541(a)(6).

4/ The Service could argue that the omission of the tax year 1 liability was inadvertent since the tax year 1 liability is included on the notice of lien and on the proof of claim, and presumably, the notice of lien and the proof of claim were included as reasons for the lifting of the stay at the hearing for the court to modify the stay.

5/ Whether the tax year 1 liability is satisfied depends on the position the Service takes with respect to the application of proceeds from the sale. If the Service takes the position that the application of the proceeds to the tax year 1 liability was permitted by the applicable statute and procedures, then the tax year 1 liability is satisfied and no longer available for collection. If the Service takes the position that the proceeds were applied to the tax year 1 liability in error, then the proceeds applied to the tax year 1 liability should be removed from the tax year 1 module and credited to the proper tax year module; thereupon, the tax year 1 assessment will be unpaid to the extent of the proceeds removed from the module. See, generally, Clark, supra.

new assessment and provide the required notice stream. The Service defended on the grounds that the tax year modules show an overpayment in year 2 and an underpayment in year 1, and, thus, the tax year 1 assessment was not fully paid and the Service was not required to make a new assessment. The district court, while agreeing that general principles of accord and satisfaction do not apply to the Service, held that as long as the Service was at one time in possession of funds that in total were sufficient to satisfy the assessments for tax years 1-3, the assessments are extinguished. Id. at 344. The court further stated that "[i]f the IRS misapplies the funds and generates a refund, the refund does not [revive] the old liability, but at most creates a potential for a new one." Id.; accord, United States v. Young, supra. Consequently, the court found that the tax year 1 liability was fully paid and the levy was void. 6/ The Rodriguez and Young opinions were cited favorably by the federal courts in Wilkes, O'Bryant, and Bilzerian. See, e.g., Wilkes, 946 F.2d at 1152 ("Rodriguez and Young establish the principle that as a taxpayer makes payment against a tax assessment, the assessment is extinguished in the amount paid and cannot be revived by the IRS' giving the taxpayer an unsolicited, erroneous refund.")

None of the above-cited cases address the impact of an involuntary payment upon the taxpayer's liability. However, we think the satisfaction principle espoused by those courts and acquiesced in by the Service would likely be controlling in the present situation, where the payment resulted from a seizure and sale of the debtor's bankruptcy estate property. Thus, it is unlikely that a court, whether bankruptcy or other federal court, would allow the Service to take collection action again with respect to so much of the same assessments as the Service intended that the proceeds should have been applied to. Accordingly, the Service should not take administrative collection action to collect on so much of these assessments as represent amounts to which the Service intended that the net proceeds be applied.

The Service, with permission of the bankruptcy court and its modification of the automatic stay, could use administrative procedures to collect from the identified asset of the erroneous refund in the usual manner so much of the assessments as exceed what would have been satisfied had the net proceeds of sale been applied as intended by the Service. The portions of the assessments which exceed the intended application of the net sale proceeds are a portion of the tax year 3, and all of the tax years 4-6, liabilities. However, this is not the preferred remedy: (1) the request for modification of the stay would be premised on identifying the asset of the erroneous refund, which may inhibit a subsequent erroneous refund suit and result in double counting the sale proceeds against assessments (once for the

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6/ We point out that Sanfellipo v. United States, 90-2 USTC ¶ 50,567 (N.D. Cal. 1990) (holding that the Service's application of an undesignated remittance to one account did not work a satisfaction of a second account which the taxpayer intended but failed to specify), was criticized in O'Bryant, supra.

original satisfaction and, against the remaining liabilities, for the subsequent levy); (2) most of the plan payments have not been made and, between satisfaction and this levy there may not be enough liability left against which to apply plan payments if the debtor resumes making payments; and (3) the debtor's wife is not in bankruptcy, which may limit the assistance the bankruptcy court can contribute to administrative collection against the identified asset if it has been put in an account in the wife's name. The preferred remedy, an erroneous refund suit, is discussed below.

Claim Under B.C. § 507(c):

Section 507(c) of the Bankruptcy Code provides that an erroneous refund has the same priority as a claim for the tax to which the refund relates. See Bleak v. United States, 817 F.2d 1368 (9th Cir. 1987). Thus, for proof of claim purposes involving erroneous refunds, the Service must determine the priority status of the underlying tax so that the claim for the erroneous refund or credit will be properly classified. In general, however, section 507 grants priority, with the exception of administrative claims, only to taxes incurred prior to the date of the bankruptcy petition. See, e.g., B.C. § 507(a)(8); see also Collier on Bankruptcy ¶ 507.06 (15th ed. 1995) ("[s]ection 507(c) speaks to erroneous refunds or credits given the debtor before the petition.") Furthermore, for section 507(c) to control, the Government must be a creditor of the bankruptcy estate pursuant to B.C. § 101(10). Accordingly, it is our position that an erroneous refund received by a Chapter 13 bankruptcy debtor after the petition date is a debt of the individual debtor and not of the bankruptcy estate; hence, section 507(c) is not available to the Service in the present case.

Erroneous Refund Suit Under I.R.C. § 7405:

Regardless of what other remedies are available to the Service to recover an erroneous refund, the Service may avail itself of an erroneous refund suit under I.R.C. § 7405. Before the Service proceeds against the debtor, however, the Service must consider the implications of the Bankruptcy Code upon its right to recover the refund.

The first issue which the Service must consider whenever it plans to take any action (whether administrative or judicial) with respect to the debtor or the debtor's property is the application of B.C. § 362. Section 362 operates to stay certain actions against the debtor and property of the bankruptcy estate while the stay is in effect. In relevant part, this section provides that the filing of a bankruptcy petition operates as a stay of:

> [T]he commencement or continuation ... of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this

> title, or to recover a claim against the debtor that arose before the commencement of the case under this title.

B.C. § 362(a)(1). It is clear, therefore, that where the Service is attempting to recover an erroneous refund issued to the debtor prior to the petition date, the Service may not proceed with the erroneous refund suit during the operation of the stay unless relief from the stay is first obtained. 7/ We think, however, that a colorable argument can be made that a section 362 stay does not operate to prohibit the Service from filing a civil suit to recover a post-petition nonrebate erroneous refund. 8/

As stated in the opening of the discussion, the courts have uniformly found that a tax assessment, once paid, is not revived by an erroneous refund. The liability arising out of an erroneous refund is independent and separate from the original tax assessment. See, e.g., O'Bryant, 49 F.3d at 347 (erroneous refunds and the tax liabilities are simply not of the same ilk). The Service may not rely on the original tax assessment to recover the erroneous refund.

While it is true that non-rebate erroneous refunds generally, albeit not always, "relate" to a specific tax liability, the remedies available to the Service to recover a non-rebate erroneous refund are vastly different from the remedies generally available to the Service to collect unpaid tax. The Service may not file a Notice of Federal Tax Lien for the amount of the erroneous refund. Likewise, the Service may not levy on the taxpayer's property. Furthermore, the debt for the erroneous refund does not arise until the taxpayer receives and negotiates a check for the amount erroneously refunded. O'Gilvie v. United States, 117 S. Ct. 452 (1996). Thus, it is our contention that a post-petition erroneous refund is not a "claim against the debtor which arose before the commencement of the [bankruptcy] case." Likewise, it is our contention that a suit for a post-petition erroneous refund is not a judicial action which "could have been commenced before commencement of the [bankruptcy] case."

We believe, nonetheless, that the Service should notify the bankruptcy court of the intent to commence an erroneous refund suit against the debtor. This will allow

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7/ B.C. § 108(c) extends the statute of limitations for a creditor if such creditor is stayed from commencing or continuing an action against the debtor under B.C. § 362.

8/ Where the Service may assess the amount erroneously refunded, as for a rebate under I.R.C. § 6211 or for an overstated income tax prepayment credit under I.R.C. § 6201(a)(3), the Service should assess and collect the tax using the remedies generally available to the Service to collect unpaid taxes rather than proceed in an erroneous refund suit. Accordingly, the ensuing discussion is limited to non-rebate, or non-assessable, erroneous refunds.

the bankruptcy court to determine whether it views an erroneous refund suit as a "collection" proceeding rather than a proceeding to obtain a judgement against the debtor. In addition the court may not agree with the Service's argument that a post-petition erroneous refund is a liability separate and independent from the underlying tax liability, and may not agree that the Service may not rely on the underlying assessment to recover the amounts erroneously refunded. Finally, the Service will be stayed from collecting on the judgement from assets used to fund the plan until the stay is lifted either by operation of the Bankruptcy Code or a court order. For these reasons, the Service should notify the court of its intent to commence an erroneous refund suit. 9/

A second issue which the Service must consider before initiating an erroneous refund suit against the debtor is whether the liability resulting from the erroneous refund is dischargeable in the debtor's bankruptcy. It is our position that an erroneous refund issued to and received by a Chapter 13 debtor post-petition, like any other liability incurred by the debtor post-petition, is non-dischargeable unless specifically "provided for by the plan" or disallowed under section 502." This position applies to the circumstances of the instant debtor and results in the erroneous refund not being discharged.

An erroneous refund suit must be commenced within the applicable period provided in I.R.C. § 6532(b). Here the applicable period is the two year period. The suit commencement period runs from the receipt of the refund, O'Gilvie v. United States, 117 S. Ct. 452, 458-459 (1996). Since, however, that date is normally not known to the Service, we suggest that the government conservatively file the suit on the basis of a calculation running from the earlier issuance date of the check. Sufficient time remains on the statute for recovery of the erroneous refund. As we indicate above, a modification of the automatic stay is required. We caution that if commencement of the filing of an erroneous refund suit is not stayed by section 108(c), see the discussion regarding section 507(c) and footnote 8, supra, then the running of the section 6532(b) period is not suspended by the debtor's bankruptcy. To be safe, we suggest that an erroneous refund suit be filed on the expectation that the section 6532(b) period is not suspended by the debtor's bankruptcy.

If you have any questions, please call 202-622-3630.

9/ We also think that notifying the bankruptcy court and the trustee of an erroneous refund circumstance may more likely result in a return of funds without a court intervention, and will prevent the circumstance of the government being found to have intentionally violated the stay.