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GENERAL LITIGATION BULLETIN

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

INCRIMINATING EVIDENCE
Act of Production Triggers Fifth Amendment Protection

The constitutional privilege against self-incrimination protects the target of a grand jury investigation from being compelled to answer questions designed to elicit information about the existence of the sources of potentially incriminating evidence, held the Supreme Court in **United States v. Hubbell,** 2000 U.S. LEXIS 3768 (S. Ct. June 5, 2000). Further, the Court held, that constitutional privilege applies equally to the testimonial aspect of a response to a subpoena seeking discovery of those sources.

Hubbell was under investigation by the Independent Counsel regarding possible criminal actions of the Whitewater Development Corporation. In a plea agreement, Hubbell agreed to cooperate with the Independent Counsel regarding the Whitewater investigation. While he was in prison, Hubbell was served with a subpoena duces tecum requesting certain documents. Hubbell invoked his Fifth Amendment right against self incrimination. Following a grant of immunity, Hubbell produced documents that led to a grand jury indictment for tax fraud. The district court dismissed the indictment under 18 U.S.C. § 6002 because the subpoena which provided the incriminating information was issued for an unrelated purpose. The court of appeals remanded for a finding of how much of the information was otherwise available to the Government.

The Supreme Court granted certiorari to determine the scope of a grant of immunity relative to the subpoenaed production of documents. Acknowledging a person may be required to produce documents even though incriminating (such as tax returns), the Court also noted that the act of production may be incriminating (by admitting the records existed, for example). Thus, the protection offered by derivative-use immunity should be the same protection against incrimination as a plea of the Fifth Amendment. So, the Court found, the burden of proof is on the prosecution to show that the evidence it proposes to use is derived from a legitimate source wholly independent of the compelled testimony.

Here, Hubbell's production of the subpoenaed documents was the testimonial act that ultimately led to his indictment. Unlike Fisher v. United States, 425 U.S. 391 (1976), where the Government knew of the documents' existence and could independently authenticate them, here the Government could not show any prior knowledge of the existence or location of the records. Hubbell could not be compelled, absent a grant of immunity, to produce those documents. Thus, the immunity granted by the Independent Counsel must be as broad as the constitutional privilege itself. The district court was thus correct in dismissing the indictment.

SUMMONSES: Defenses to Compliance: Fifth Amendment

CASES

1. BANKRUPTCY CODE CASES: Automatic Stay (§ 362): Other Exceptions

In re Westberry, 2000 U.S. App. LEXIS 12202 (6th Cir. June 6, 2000) - Income taxes are not incurred for a personal, family or household purpose, and so are not consumer debts under B.C. § 1301. The Service is thus not precluded by the automatic stay from proceeding against a codebtor.

2. BANKRUPTCY CODE CASES: Chapter 13: Effect of Confirmation (§ 1327)

In re DeMarco, Jr., 2000 Bankr. LEXIS 628 (Bankr. M.D. Fla. May 5, 1000) - While Service appealed order denying its secured claim, debtor filed a Chapter 13 plan that provided for no payment and for a release of the tax lien. The court found that confirmation of the debtor's plan would deprive the Service of effective judicial relief should the Service prevail on appeal. Since the plan provisions would be binding under B.C. § 1327(a), the Service would lose its lien and so potentially render its appeal moot. Therefore, the court deferred confirmation pending resolution of the appeal.

3. BANKRUPTCY CODE CASES: Exceptions to Discharge (§ 523): Wilful Attempt to Evade or Defeat Taxes

United States v. Fretz, 248 B.R. 183 (N.D. Ala. 2000) - Debtor, an alcoholic, failed to file returns or pay taxes. While in recovery, he cooperated with the filing of past returns, but was unable to pay his tax debt (in excess of one million dollars), and so filed for bankruptcy. The district court, affirming the bankruptcy court, found no evidence the debtor concealed assets or lived beyond his means. Lacking any evidence of a wilful attempt to evade or defeat the payment of taxes, other than failure to pay, the court found the taxes dischargeable under B.C. § 523(a)(1)(C) and United States v. Haas, 48 F.3d 1153 (11th Cir. 1995).

4. BANKRUPTCY CODE CASES: NOL Carryovers

Gulley v. Commissioner, T.C. Memo 2000-190 (June 27, 2000) - Debtor was the sole general partner of a real estate venture which went bad in 1987. In July, 1991, the debtor filed Chapter 7 bankruptcy, filing a final partnership return claiming a million dollar Net Operating Loss. The Tax Court refused to accept any of the debtor's arguments that the NOL could be carried forward to a future year. This case offers guidance on what happens in the year of filing bankruptcy for individual debtors in a Chapter 7 or 11 case who had partnership interests when they filed for bankruptcy. Filing bankruptcy does not terminate the partnership. Instead, the partnership interest goes to the I.R.C. § 1398 estate in a transaction that is not a sale or exchange of the partnership interest, and any flowthrough partnership gain or loss for the year of the individual partner's filing belongs to the "partner" on the last day of the tax year, in this case the I.R.C. § 1398 bankruptcy estate.

5. BANKRUPTCY CODE CASES: Trustee's Avoidance of Transfers (§ 548)

In re Feiler, 1999 App. LEXIS 14630 (9th Cir. June 27, 2000) - Debtors filed tax returns, electing to carry forward a sizeable Net Operating Loss. The Chapter 7 trustee sought to avoid the election and so receive a refund for the estate. The Ninth Circuit held that an I.R.C. § 172(b)(3) NOL election is avoidable by a bankruptcy trustee when the other requirements of a fraudulent transfer under B.C. § 548 are established. Although the trustee succeeds to the tax attributes of the debtor; the trustee, in order to maximize recovery, may avoid transactions that would bind the debtor.

6. BANKRUPTCY CODE CASES: Turnover of Property to the Estate
LIENS: Priority Over Dower

United States v. Chalmers, 2000 U.S. Dist. LEXIS 4540 (W.D. Mich. March 27, 2000) - Bankruptcy trustee sought turnover of sale proceeds paid to United States in satisfaction of a tax lien, on the grounds that the proceeds were part of a dower interest. In dicta, the court considered that the property, which had been quitclaimed by the bankruptcy debtor wife and her husband to the husband (the only one who owed taxes) before being sold, may not have been property of the estate. However, because the Government conceded that point, the court held that even if the wife had a dower interest, it followed the property, not the proceeds. As dower is an inchoate right, it must be brought against the current owners of the property, not against the holder of the proceeds. Further, the bankruptcy court made no provision for the protection of the federal tax lien. Since the proceeds of sale were sufficient to provide the husband with an amount exceeding the dower amount, even if the court were to look to marshaling as an equitable remedy, the trustee would have to look to the husband's share first.

7. COLLECTION DUE PROCESS

Offiler v. United States, 114 T.C. 30 (June 19, 2000) - Taxpayer was assessed with 1994 and 1995 income taxes, and sent a Final Notice/Notice of Intent to Levy under I.R.C. § 6330 and § 6331 on February 1, 1999. On June 3, 1999, the taxpayer requested a collection due process hearing, which was denied in September as untimely. The Tax Court determined that it lacked jurisdiction under section 6330(d) to review the denial, because there was no determination by the Service. Without a determination, the Tax Court ruled, there can be no jurisdiction.

8. COLLECTION DUE PROCESS

Sego v. Commissioner, 114 T.C. 37 (June 30, 2000) - Tax Court sustained Service's administrative determination that collection was proper. The Court held that the taxpayers could not defeat the actual notice requirement of collection due process by refusing delivery of statutory notices of deficiency.

9. COMPROMISE & SETTLEMENT: Liability Involved in Court Proceedings

Hunt v. United States, 94 F. Supp. 2d 655 (D. Md. 2000) - Government and taxpayer reached settlement agreement in Tax Court case, but later disagreed

whether interest for a year not before Tax Court was included in settlement. The court found equitable estoppel to apply against the United States, because the taxpayer alleged he was misled by the Government into giving up a substantive right (rather than trying to avoid a required duty, for which estoppel would not apply). The court also found equitable estoppel by the statements of the Government's attorney and the revenue agent, both of which agreed that the taxpayer expected the settlement to include interest. The failure to then pay interest was affirmative misconduct, enabling equitable relief.

10. DAMAGES, SUITS FOR: Against District Director or Employee

Shreiber v. Mastrogiovanni, 2000 U.S. App. LEXIS 11974 (3d Cir. May 31, 2000) - The Third Circuit held that a damages suit cannot be brought against an IRS employee, under Bivens v. Six Unknown Federal Narcotics Agents, 403 U.S. 388 (1971), for alleged constitutional violations. The taxpayer brought suit against a revenue agent, alleging constitutional violations of due process, equal protection, civil rights, and religious discrimination. The appellate court agreed that there was no cause of action under I.R.C. § 7433 (for a violation of the I.R.C.), but that the absence of statutory relief for a constitutional violation did not authorize the courts to create a damages remedy against the employee responsible for the violation.

11. LEVY: Wrongful

Becton-Dickenson & Co. v. Wolckenhauer, 2000 U.S. App. LEXIS 12455 (3d Cir. June 6, 2000) - Taxpayer defrauded company, was convicted and ordered to make restitution on September 24, 1996. The Service levied on taxpayer's retirement fund on April 21, 1995. On November 7, 1996, the company sued the Service under I.R.C. § 7426 for wrongful levy, arguing that the nine-month limitations period in section 6532(c) should be equitably tolled since the company did not have an interest in the retirement fund until the restitution order was entered. The Third Circuit, relying on Congressional intent, held that the time limitation in section 6532(c) was a jurisdictional bar not subject to equitable tolling. The levy thus was proper.

12. LIENS: Foreclosure: Undivided Interest in Property
TRANSFEREES AND FRAUDULENT CONVEYANCES: Fraud

Hatchett v. United States, 2000 U.S. Dist. LEXIS 6802 (E.D. Mich. March 31, 2000) - Taxpayer purchased property with his wife as tenants by the entirety, then later filed for bankruptcy. Although the taxes were nondischargeable, and the property was abandoned by the bankruptcy trustee, the district court struck the Government's fraudulent conveyance defense on the grounds of standing, laches and res judicata, holding that the Bankruptcy Code gives the sole right to bring a fraudulent conveyance action to the trustee, and the Government is bound by that determination (or lack of) outside of bankruptcy. Relying on Craft v. United States, 140 F.3d 638 (6th Cir. 1998), the court then held that property held in tenancy by the entirety was not subject to the Government's tax liens against the taxpayer but not against his wife. Finally, although the judge previously sat on an attorney

disciplinary panel involving the taxpayer, she would not recuse herself from deciding this case.

13. REFUNDS: Requirement of Claim

Puckett v. Commissioner, 2000 U.S. App. LEXIS 9734 (5th Cir. April 12, 2000)(*unpublished*) - Debtors filed for Chapter 11 bankruptcy, their plan providing for payment of the outstanding federal taxes. After the plan was confirmed, they made a partial payment, then filed amended tax returns requesting a refund on the basis of a net operating loss. The Service denied the refund on res judicata grounds, and the debtors filed suit. Affirming the district court, the Fifth Circuit held that the four elements of res judicata were met: The parties in both the bankruptcy and refund actions were identical; the confirmation of the plan was a prior judgment rendered by a court of competent jurisdiction; the confirmation order was a final adjudication on the merits; and the bankruptcy proceeding and the refund claim involved the same cause of action. Further, the debtors were aware of, and could have brought their refund claims before the bankruptcy court. Their failure to do so precluded them from bringing a separate refund suit.

14. TRANSFEREES & FRAUDULENT CONVEYANCES: Uniform Fraudulent Transfer Act

Bresson v. Commissioner, 2000 U.S. App. LEXIS 11948 (9th Cir. May 31, 2000) - Taxpayer fraudulent transferred assets, and United States brought suit under California version of the Uniform Fraudulent Transfer Act. The Act provides that a claim is "extinguished" if not brought within four years of the transfer. Examining this provision, the Ninth Circuit contrasted two lines of cases. The first, typified by United States v. Summerlin, 310 U.S. 414 (1940), held that the United States is not subject to state statutes of limitation. The second, under Guarantee Trust Co. v. United States, 304 U.S. 126 (1938), holds that if a claim already is infirm when the United States obtains it (such as a contract right beyond the statute of limitations), Summerlin will not revive that claim. The Ninth Circuit further observed that under United States v. California, 507 U.S. 746 (1993), Summerlin applies when the right at issue is through a federal statute and the Government is proceeding in its sovereign capacity. Based on these principles, the Ninth Circuit concluded that neither statutes of limitation nor claim-extinguishment provisions apply to the United States.

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

CHIEF COUNSEL ADVICE

BANKRUPTCY; COLLECTIONS; LIMITATIONS; TRUST FUND RECOVERY PENALTY; DEFAULT ON PLAN PAYMENTS

CC:EL:GL:Br2
GL-607742-99
UIL 6503.09-00

February 22, 2000

MEMORANDUM FOR DISTRICT COUNSEL, NORTH FLORIDA CC:SER:NFL:JAX

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

SUBJECT: Taxpayer X – Suspension of Collection Limitation Period During Chapter 11 Bankruptcy Plan

LEGEND:
Taxpayer X
Company Y
Year 1
Date 1
Date 2
Date 3
Date 4
Date 5
Date 5A
Date 6
Date 7
Date 8
Date 9

This responds to your request for advice concerning the above taxpayer[1] and confirms the oral advice previously given to the referring attorney in your office. For the reasons described further below, we agree with your analysis that the ten year collection limitation period with respect to the trust fund recovery penalty (TFRP) assessed against the taxpayer on Date 3, was suspended from the assessment date until the taxpayer substantially defaulted on her payments of the TFRP under her Chapter 11 plan on or about Date 5, plus six months, pursuant to I.R.C. § 6503(h)(2). Accordingly, the Service's collection limitation period for the TFRP at issue is due to expire on or about Date 9, based upon the information provided to our office.

FACTUAL BACKGROUND

For the last three quarters of Year 1, Company Y. failed to pay over trust fund employment taxes due the Service. The Service determined that the taxpayer was a responsible person of the corporation within the meaning of I.R.C. § 6672 for each of these three quarters, but the Service did not assess the TFRP against the taxpayer before she and her former spouse filed a joint Chapter 11 bankruptcy petition on Date 1. While the automatic stay arising from the bankruptcy case was in effect, the Service was prohibited from assessing the TFRP against the taxpayer under bankruptcy law provisions operative for bankruptcy cases begun before October 22, 1994, and the Service's assessment limitation period for this TFRP was suspended pursuant to I.R.C. § 6503(h)(1). However, the Service filed a timely proof of claim for the taxpayer's TFRP liability in the taxpayer's bankruptcy case and the Service's claim for this TFRP liability was allowed in the bankruptcy proceeding.

On Date 2, the taxpayer's Chapter 11 plan was confirmed. The taxpayer's confirmed plan provided for full payment of the Service's proof of claim for the TFRP liabilities at issue (along with interest after the plan effective date), over a period of six years from the assessment date, with annual installments due commencing in Date 4. Soon after the automatic stay was lifted following confirmation and the effective date of the taxpayer's Chapter 11 plan, the Service timely assessed the TFRP liabilities owed by the taxpayer on Date 3.[2]

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[1] As discussed with your referring attorney, this memorandum does not concern the taxpayer's former spouse, who is not seeking any relief from Special Procedures. The taxpayer's former spouse filed a second solo bankruptcy case, after the joint bankruptcy case with respect to the taxpayer and the former spouse was completed, so the ultimate answers with respect to the taxpayer's former spouse would be different.

[2] In accordance with I.R.C. § 6601(e)(2)(A), the TFRP liability the Service assessed at that time did not include any pre-assessment interest, so there was no interest accruing on this tax debt between the date the taxpayer filed bankruptcy and the date the taxpayer's Chapter 11 plan became effective.

The taxpayer made the first payment of the TFRP liability due under her confirmed plan in Date 4. The taxpayer failed to make the payments of the TFRP liability due under her Chapter 11 plan in Date 5A and in later years. On November 5, 1990, the Service's general collection limitation period (not including any periods of suspension) for any taxes assessed before that date where the limitation period had not expired was extended by law from 6 years after the assessment date to 10 years after the assessment date.[3]

The bankruptcy court closed the taxpayer's Chapter 11 bankruptcy case on Date 7. In Date 8, the Service mailed the taxpayer a letter which observed that the taxpayer had defaulted on the TFRP liability payment installments due under her Chapter 11 plan and demanded that the taxpayer fully pay her surviving TFRP liability to the Service. The Service received no response from the taxpayer to this default notice and demand payment letter.

DISCUSSION

The statute of limitations on collecting a tax provided for by a confirmed Chapter 11 plan is usually extended automatically, via I.R.C § 6503(h)(2), while the taxpayer is current on Chapter 11 plan payments for the tax, up until the time the taxpayer is in substantial default on the plan payments for the tax, plus six months. While the automatic stay is the most commonly cited bankruptcy case "reason" why the Service may be prohibited from collecting a tax, within the meaning of I.R.C. § 6503(h), it is not the only bankruptcy case reason recognized by the courts and the Service for suspending the Service's limitation period for collecting a tax from a former bankruptcy debtor. See United States v. Wright, 57 F.3d 561 (7th Cir. 1995) (suspension while confirmed Chapter 11 plan was in effect, until default, plus six months); In re Montoya, 965 F.2d 554, 557 (7th Cir. 1992) (dicta regarding suspension not being limited to automatic stay circumstances, where a Chapter 11 plan was in effect before default and where the Service's claim had been disallowed and later was reinstated) ; United States v. McCarthy, 21 F.Supp.2d 888 (S.D. Ind. 1998) (suspension while a confirmed Chapter 11 plan was in effect until the default exceeded 30 days, plus six months); Nelson v. United States, 94-1 U.S.T.C. ¶ 50,206 (E.D. Mich. 1994) (suspension between the dates the taxpayer received a Chapter 7 discharge and the discharge was revoked, plus six months). If payment of a tax is provided for by a confirmed Chapter 11 plan and plan payments of the tax are not in default, then the Service is generally prohibited from attempting to collect the tax (outside of receiving payments provided for by the plan) from the debtor or the debtor's property, pursuant to the plan injunction arising pursuant to the terms of most Chapter 11 plans and B.C. §§ 1141(a) and (c).

[3] See I.R.C. § 6502(a)(1); Behren v. United States, 82 F.3d 1017 (11th Cir. 1996).

It is our office's position in the case of Chapter 11 corporate debtors with confirmed plans that the Service should not resort to use of its administrative remedies to collect a tax provided for by a confirmed plan until there is a default. The Seventh Circuit's decision in Wright, supra, approved the Service's position that the limitation period on collecting employment taxes from a partnership debtor remained (after the stay was lifted) suspended following confirmation of the partnership's Chapter 11 plan until the partnership defaulted on its plan payments, plus six months. See also United States v. Colvin, 203 B.R. 930 (N.D. Tex. 1996), following remand, 222 B.R. 799 (N.D. Tex. 1998) (considering equitable tolling of the 240-day period for priority income tax claim purposes during the time that a serial Chapter 11 corporate debtor was not in default on its first confirmed plan).

We similarly conclude that in individual debtor cases, the Service may generally rely on the section 6503(h)(2) suspension with respect to taxes provided for by the plan. On the other hand, the Service will not generally be able to rely upon a suspension with respect to taxes which are still owed by an individual debtor but which are not provided for by full payment under the debtor's plan. However, the TFRP taxes at issue in the present case were allowed in the bankruptcy proceeding and were required to be paid in full by the taxpayer's confirmed Chapter 11 plan, so the section 6503(h)(2) suspension applies in this case.

The Service's position regarding collection of non-dischargeable tax debts, like those at issue in the present case, from an individual debtor with a confirmed Chapter 11 plan is stated in IRM 5.9.9.5:(1), as follows:

> Confirmation of the plan binds the debtor and creditors to the terms of the plan. Although confirmation does not discharge an individual debtor from taxes excepted from discharge under B.C. § 523(a), the IRS will not attempt to collect nondischarged pre-petition taxes outside of the plan unless there is substantial default, the non-dischargeable tax is not fully provided for by the plan, or circumstances allowing collection through setoff arise.

Notwithstanding the survival of certain tax debts as non-dischargeable for an individual with a confirmed Chapter 11 plan, the collection limitation period is suspended for such debts, pursuant to I.R.C. § 6503(h)(2), as long as (1) the Service's claim for the debt is allowed, (2) the plan provides for full payment of the tax debt, and (3) the plan is not in substantial default (considering any period provided to the debtor in the plan for curing a default)[4], plus six months. This was

[4] The General Litigation User Guide to Chief Counsel's Macros, Document 9765 (9-96), recommends at page 1129-6 that Chapter 11 plans contain default language that allows the Service to collect tax debts provided for by a confirmed plan 14 days after the Service has made a written demand for the debtor to cure the default, if the default is not cured. We understand that the plan in this case did not contain a specific

the situation and result in United States v. McCarthy, supra. The Government also made an argument along these lines in Montoya, supra, but the Seventh Circuit did not address the argument because the Service's claim also was disallowed, before being reinstated, for a period long enough to achieve the Service's desired suspension of the priority claim calculation periods at issue in that case.

Although the Service may still use setoff opportunities in individual taxpayer cases to obtain payment of these non-dischargeable tax debts outside of the plan before the plan is in substantial default, this ability to continue to make setoffs has not stopped the Service from arguing nor the courts from finding that the Service is prohibited from "collecting" by reason of the bankruptcy case, for purposes of I.R.C. § 6502(h)(2). See Montoya, supra, at 558 (specifically addressing and dismissing the taxpayers' argument that the Service's ability to perform offsets after plan confirmation meant the Service was not barred from collecting the taxes owed).[5]

In light of our advice above – that the Service's collection limitation period with respect to the taxes at issue in this case was suspended from the post-confirmation assessment date until the taxpayer substantially defaulted on her tax payments due under her confirmed Chapter 11 plan, plus six months – you have asked us two further questions. First, when should the Service consider the taxpayer as being in "substantial default" under the facts of this case? Second, did the collection limitation period resume running for the taxpayer's total tax balance due under her Chapter 11 plan six months after the taxpayer first substantially defaulted or did the collection limitation period only resume running for those portions of the tax balance due under the plan as the taxpayer failed each January (plus six months) to make the particular annual installment payments due under the plan?

The taxpayer first missed a tax payment due under her confirmed Chapter 11 plan in Date 5A. For the sake of convenience and prudence, we assume in our analysis that the missed tax payment was required on the first of the month, so the taxpayer's first tax payment default occurred on Date 5. Some Chapter 11 plans

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default provision of this type for the taxes at issue.

[5] See also I.R.C. § 6330(e)(1), which suspends the collection limitation period while the Service is prohibited by the new collection due process procedures from using a "levy" to collect a tax debt, even though "setoff" to obtain payment of the same debt would not be prohibited while the collection due process procedures are pending. In some districts, local bankruptcy rules or general orders now allow the Service to make setoffs of prepetition tax debts against prepetition tax refunds while the automatic stay is still in effect, without the Service moving to lift the stay. In these districts, we conclude that the Service's ability to obtain setoff in this manner, while the automatic stay otherwise prevents the Service from attempting to collect the tax, does not remove the suspension of the collection limitation period, under I.R.C. § 6503(h)(2), for the tax left unpaid after the setoff is made.

contain specific remedial provisions in the event of a default, which limit a creditor's right to resume collecting a debt due after a default to the period after the creditor has given the debtor a notice of the default and a reasonable period of time thereafter to cure the default. We understand that the Chapter 11 plan in this case did not contain specific default notice provisions of this type. Even if a Chapter 11 plan contains no default provisions, IRM 5.9.9.6.3 recommends that the Service first immediately send the debtor in these circumstances a notice of default and that the Service next wait to see whether the debtor cures the default by the date mentioned in the notice of default letter, before the Service begins to consider its administrative collection options anew.

We understand that the notice of plan default letters in use in your district in Date 5A (when the taxpayer missed her first tax payment due under the plan) and the notice of default letter ultimately mailed to the taxpayer in this case in Date 8 (21 months after the first missed payment) provided a 15 day period for the taxpayer to cure a default. If the Service had mailed the taxpayer in this case a notice of default letter of this type reasonably soon after the Service should have first noticed the taxpayer's default, then we believe the Service would have a reasonably good case for arguing that the taxpayer should not have been considered in substantial default, for purposes of our suspension analysis under I.R.C. § 6503(h)(2), until after the debtor failed to cure her plan default by a reasonable cure date stated in the Service's notice of default letter. In McCarthy, supra, the court agreed that the Service's collection limitation period for the tax was suspended during the 30 day cure period (described in the plan), plus six months, following the taxpayer's missed plan tax payment.

In this case, the Service waited to send its notice of plan default letter to the taxpayer until 21 months after the taxpayer first missed the tax payment due under her plan and 8 months after the taxpayer's bankruptcy case was closed. In these circumstances, we recommend that the Service treat Date 5, as the date of the taxpayer's substantial default on the tax payments at issue due under her Chapter 11 plan.

Our office's position is that a debtor's substantial default under a Chapter 11 plan generally permits the Service to collect the entire amount due under the plan.[6]

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[6] We understand that there is no controlling case law precedent, no local bankruptcy rule, and no local general order of the court in your district which limits a creditor to collecting only its missed installment(s) when a debtor defaults on its payment obligations due under a Chapter 11 plan. We also understand that the terms of the Chapter 11 plan in this case did not limit the Service's administrative collection remedies upon default to only seeking to collect the missed installment payment(s). This also is not a case where the debtor missed a tax payment and then resumed making payments due under the plan.

Accordingly, we conclude that upon the date of substantial default in this case, plus six months, the period of limitation for collection began running for the entire amount due under the plan, and not just for the missed annual payments. Thus, the collection statute for the entire remaining TFRP due under the plan began running six months after approximately Date 5, on or about Date 6. Accordingly, the collection limitation period for the taxpayer's TFRP at issue is due to expire on or about Date 9, based upon the information you have provided to our office.

LEVY; SETTLEMENT PROCEEDS; ATTORNEYS' FEES

January 19, 2000

CC:EL:GL:BR1
GL-507286-99
UILC: 06.01.00-00

MEMORANDUM FOR DISTRICT COUNSEL, OHIO DISTRICT
CC:NER:OHI:CIN

FROM: Alan C. Levine, Chief Branch1 (General Litigation)

SUBJECT:

This is in response to your memorandum of November 12, 1999, in which you requested that we post-review the advice you issued to the District Director for the Ohio District concerning the above.

ISSUE(S):

1. Whether the obligation levied upon by the Internal Revenue Service (Service) constituted a "fixed and determinable" property right.

2. Whether attorney's fees as well as fees paid for accounting services and expert witnesses incurred in connection with legal services are entitled to priority over the federal tax lien pursuant to I.R.C. § 6323(b)(8).

CONCLUSION:

We have given thorough consideration to the advisory opinion you provided to the Special Procedures Function and agree with the position you have taken with respect to the first issue, namely, that the failure to honor the Service's levy was not justified. With respect to the second issue, i.e., whether the claim for attorney's fees as well as for accounting services and expert witness fees paid in connection with the legal services are entitled to priority over the federal tax lien, we believe that only the attorney's fees qualify for superpriority status under section 6323(b)(8).

FACTS:

(taxpayer), was assessed employment tax liabilities (Form 941 taxes) for the fourth quarter of and the second, third and fourth quarters of . Notice of federal tax lien was filed on either or . As of August 31, 1994, the outstanding balance on these liabilities amounted to $. contracted with a general contractor, to perform electrical subcontracting services for several public or quasi-public construction projects. More specifically, separately contracted with on approximately and to provide materials and labor on three construction sites.

As alleged by affidavits subsequently filed by under Ohio's Mechanic's Lien Law, Ohio Rev. Code. § 1311.01, et seq., and in the complaint thereafter filed in state court, physically completed work on the three projects on , and approximately , respectively. then claimed it was due approximately $, $ and $ on the three contracts.

was the surety for FDI on the construction projects. filed separate law suits against on and . These cases were settled by a single agreement on approximately .

The terms of the settlement called for payment to by of $. Of this amount, some $ went to lawyers for attorney's fees arising from the litigation. The remaining $ was distributed by or on behalf of to several third-party creditors, including $ paid to an accounting firm for services allegedly rendered in association with the litigation and $ paid for expert witness fees in the litigation. $ was paid to two creditors for goods or services not directly related to the litigation.

On , the Service issued a notice of levy to for tax liabilities. The levy was not honored.

We assume you have determined that the surety does not have priority or that laborers and materialmen have not argued that the taxpayer has no property rights in the proceeds by the failure to complete or failure to pay mechanic's liens. You have not advised what the surety is claiming so we have to assume you are of the view that their position is not well taken.

LAW AND ANALYSIS:

The basic question here is whether, at the time of the levy, was in possession of property belonging to . Pursuant to I.R.C. § 6321, the federal tax lien attaches to all property and rights to property of a delinquent taxpayer. The question of whether a state law right constitutes property or rights to property under section 6321 is a matter of federal law. United States v. National Bank of Commerce, 472 U.S. 713 (1985). When Congress broadly uses the term "property" as it does in section 6321 and section 6331, it aims to reach every species of right or interest protected by law and having an exchangeable value. Drye v. United States, 120 S.Ct. 474 (1999). According to the Supreme Court, the "Code's prescriptions are most sensibly read to look to state law for delineation of the taxpayer's rights or interests in the property the Government seeks to reach but to leave to federal law the determination of whether those rights or interests constitute 'property' or 'rights to property' under section 6321." id at 477.

Treas. Reg. § 301.6331-1(a)(1) provides in part as follows:

> Except as provided in § 301.6331-2(c) with regard to a levy on salary or wages, a levy extends only to property possessed and obligations which exist at the time of the levy. Obligations exist when the liability of the obligor is fixed and determinable although the right to receive payment thereof may be deferred until a later date.

The word "determinable" has been held to mean that the amount of liability is capable of being determined at some later time. Reiling v. United States, 77-1 U.S.T.C. ¶ 9269 (N.D. Ind. 1977). In United States v. Antonio, 91-2 U.S.T.C. ¶ 50,482 (D. Hawaii 1991), the court, in reviewing Treas. Reg. § 301.6331-1(a)(1), stated in footnote two, that it is the liability that must be fixed and determinable, not the amount of the liability. In Antonio, the defendant had done welding and sandblasting work for the taxpayer but there existed a dispute as to how much was owed to the taxpayer at the time of the levies. The court held that the defendant was entitled to set off against the amount owed the taxpayer for payments already made on the debt, for equipment purchased to complete work that was not completed by the taxpayer on a joint project, and for other expenses he incurred in connection with the project.

In United States v. Hemmen, 51 F.3d 883, 890 (9th Cir. 1995), the Service served a notice of levy upon a bankruptcy trustee against whom the taxpayer had filed a claim for administrative expenses. The court there, citing the above Treasury Regulation, held that a "determinable" tax obligation for tax levy purposes requires only that the sum be capable of precise measurement in the future, unlike the requirement that the extent of the obligation be determined. According to the Ninth Circuit, although the sum to be paid to the taxpayer on his claim against the trustee was uncertain at the time the notice of levy was served, "this uncertainty does not defeat the fact that the estate's obligation was 'determinable'. Unlike a requirement that the extent of an obligation be 'determined', the term 'determinable' requires

only that the sum be capable of precise measurement in the future." See also, United States v. Murray, 640 F. Supp. 889 (E.D. Tenn. 1989).

However, the government has not always been successful in its attempt to argue that its notice of levy attached to a "fixed and determinable" right of the taxpayer. Case law exists for that proposition. For example, in Tull v. United States, 69 F.3d 394, 398 (9th Cir. 1995) the government argued that the rights in question were fixed and determinable because the taxpayer's obligor had an "obligation to attempt to sell some as yet undetermined amount of property for an as yet undetermined price to as yet undetermined buyers." There, in ruling against the government, the court of appeals stated that it "did not see how the words 'fixed and determinable' could be given so unfixed and undetermined a meaning."

Other courts have reached similar conclusions. In In re Hawn, 149 B.R. 450 (Bankr. S.D.Tex. 1993), the court determined that the Service's levy would not reach amounts to be received in the future for sales of property that have not yet occurred. In Morey v. United States, 821 F. Supp.1438 (W.D. Okla. 1993), the court held that "for purposes of enforcing a levy, one must be able to fix and determine the value of the taxpayer's property interest on the date of levy in order for there to be property subject to levy in the hands of the obligor." Id, at 1442.

Although the issue is not completely free from doubt, we believe that the obligation of to appears to have been "fixed and determinable" at the time of the Service's levy notwithstanding that the settlement of lawsuit did not take place until , some four years after the notice of levy was served upon in . In essence, when physically completed the three work projects in the fall of , we assume that it was entitled, pursuant to its contract with , to payment. What the Service's levy attached to was contract right to payment, i.e., an account receivable. As stated in Antonio, supra, when the court in footnote two was interpreting Treas. Reg. 301.6331-1(a)(1), "As long as the events which gave rise to the obligation have occurred and the amount of the obligation is capable of being determined in the future, the obligation is fixed and determinable." In the instant situation, work had been completed prior to the service of the notice of levy although the amount of the liability was not determined until years later when the lawsuit against was settled. See, United States v. Long Island Drug Company, et al., 115 F.2d 983 (2d Cir. 1940) where the court stated that an indebtedness of a third party to a taxpayer is subject to levy, but not an indebtedness that is contingent upon the performance of future services. Although not entirely applicable to the situation confronting us here, we, nevertheless, also call your attention to Rev. Rul. 55-210, 1955-1 C.B.544. That ruling holds that where a taxpayer has an unqualified fixed right, under a trust or a contract, or through a chose in action, to receive periodic payments or distributions of property, a federal tax lien attaches to the taxpayer's entire right, and a notice of levy based on such a lien is effective to reach, in addition to payments or deductions then due, any subsequent payments or distributions that will become due thereunder. The

ruling also states that a notice of levy does not attach to a taxpayer's right to money that is contingent upon the performance of future services. See also, 1999 TNT 181-79, which discusses TAM 199924060 and Rev. Rul. 80-230, 1980-2 C.B. 169, (When liability becomes fixed and determinable for income tax purposes).

The second question presented by your memorandum is whether in addition to the $ fee that attorneys claim is entitled to priority over the federal tax lien, priority over the tax lien should also be awarded to the claim for accounting services and expert witness fees in the amounts of $ and $ respectively. The only basis for awarding priority to these two items would be if they could qualify for superpriority status pursuant to section 6323(b)(8).

I.R.C. § 6323(b)(8) provides a superpriority to certain attorneys' liens. (A superpriority means that the claimant primes the federal tax lien even when the federal tax lien was filed first. A superpriority is an exception to the rule that first in time is first in right.) Specifically, subsection (b)(8) provides a superpriority over the federal tax lien as follows:

> With respect to a judgment or other amount in settlement of a claim or of a cause of action, as against an attorney who, under local law, holds a lien upon or a contract enforceable against such judgment or amount, to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement, except that this paragraph shall not apply to any judgment or amount in settlement of a claim or a cause of action against the United States to the extent that the United States offsets such judgment or amount against any liability of the taxpayer to the United States.

After a levy, an attorney who holds a valid lien under local law may file an administrative request under section 6343(b) with the Service for his reasonable compensation in creating a fund of money through judgment or settlement. The attorney qualifies as a wrongful levy claimant because he has a senior lien, as provided for in section 6323(b)(8), on the judgment or settlement fund of money.

The words of the statute, section 6323(b)(8), are clear. They specifically refer to the attorney's reasonable compensation for obtaining the judgment or procuring the settlement. There is no reference in section 6323(b)(8) to a superpriority for expert witness fees or costs for accounting services. Were this a case where Buckeye were a "prevailing party" who requested an award for expert witness fees and costs for accounting services pursuant to section 7430(c)1(B)i and ii, a court might be inclined to grant its request but such is not the situation here.

In summary, based upon the foregoing discussion, we are of the opinion that

the levy in question captured the settlement proceeds except to the extent of the $ paid to attorneys for bringing about the settlement. That amount is entitled to superpriority status over the federal tax lien pursuant to section 6323(b) (8). As previously stated, the lawsuit settlement proceeds have already been distributed to attorneys as well as to several third party creditors.

RRA 98; LEVY; § 1203 EMPLOYEE TERMINATION; PERSONAL BELONGINGS

CC:EL:GL:Br1
April 4, 2000 GL-511409-98
UILC 50.05.00-00

MEMORANDUM FOR PENNSYLVANIA DISTRICT COUNSEL

FROM: Alan C. Levine
Chief, Branch 1 (General Litigation) CC:EL:GL:Br1

SUBJECT: Definition of “Personal Belongings” Under RRA § 1203(b)(1)

This responds to your memorandum requesting advice on the above-cited subject. This document is not to be cited as precedent.

ISSUE:

How are “personal belongings” defined for purposes of section 1203(b)(1) of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)? Does this definition include cars, bank accounts, retirement accounts and household goods?

CONCLUSION:

The term “personal belongings” may be commonly understood to include tangible personal property, such as cars and household goods. It does not include intangible property, such as bank accounts and retirement accounts.

FACTS:

This issue arose in connection with a document entitled “IRS Restructuring and Reform Act of 1998 (RRA ‘98) Conduct Provisions; Employee’s Guide September 1998" (Document 10848). On page 30 of this document, question 10 provides as follows:

> 10. How are “personal belongings” defined under 1203(b)(1)? Does this include cars, bank accounts, retirement accounts, and household goods?

A. Generally, yes. Seizure of any taxpayer assets would fall under one of the three categories (a taxpayer's home, personal belongings, or business assets) identified in 1203(b)(1).

LAW AND ANALYSIS:

The question refers to an interpretation of RRA § 1203, Termination of Employment for Misconduct. Section 1203 generally provides for potential termination of an Internal Revenue Service ("Service") employee upon a final determination that such employee committed one of ten enumerated acts or omissions. Specifically, section 1203(b)(1) lists as one of these acts or omissions the "willful failure to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets." "Personal belongings" is not defined within this provision, or in the legislative history.

Without further guidance on the specific intent of Congress in drafting this provision, we conclude that the term "personal belongings" must be defined in a manner consistent with its common meaning and usage. We think "personal belongings" are generally understood to include tangible items of personal property rather than intangible property rights such as bank accounts, accounts receivable, and retirement accounts.

This definition is also consistent with the concept of a "seizure". As discussed, section 1203(b)(1) refers to "seizures" of certain assets. The Service makes distinctions between property which is "seized" and property which is reached by levy. Generally, only tangible property may be seized and subsequently sold, pursuant to I.R.C. § 6335. Thus, this provision could be read not to apply to intangible assets because intangible assets cannot be "seized."

Under the broad construction of section 1203(b)(1) described in the response to question 10 above, a Service employee could be terminated for the unauthorized seizure of "any taxpayer assets." Under general principles of statutory construction, a statute should be construed to give meaning to each word. Under this proposed construction, however, there would be no reason to make specific reference to a taxpayer's home, personal belongings, and business assets. Rather, section 1203(b)(1) should just refer to seizures of all taxpayer assets or property.

Accordingly, in response to question 10 above, we would respond that the term "personal belongings" includes tangible personal property, such as household goods and cars, but does not include intangible personal property, such as bank accounts or retirement accounts. The response to question 10 will be revised accordingly. While Service employees would not be subject to termination for unauthorized seizures of property outside of the scope of section 1203(b)(1), Service employees should, of course, comply with all authorization requirements for

seizures and other collection actions to avoid the possibility of any disciplinary action or any challenges to the applicability of section 1203(b)(1).

OFFER IN COMPROMISE; BANKRUPTCY

February 8, 2000

GL-806225-99
UILC: 17.00.00-00

MEMORANDUM FOR SOUTHERN CALIFORNIA DISTRICT COUNSEL, LAGUNA NIGUEL

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

SUBJECT: Request for Field Service Advice Regarding Offer-in-Compromise in Bankruptcy

This memorandum responds to your memorandum dated August 3, 1999. This document is not to be cited as precedent.

ISSUES:

Your memorandum asks the following questions:

(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 ("OIC")?

(2) Is the answer to the aforesaid question any different if the bankruptcy is filed under Chapter 7 or 11?

(3) Should the language in the OIC Form 656 be changed to better protect the Service's interests?[7]

[7] You also ask whether the Service should reconsider its position that it will not consider OICs from taxpayers in bankruptcy in light of In re Mills, 240 B.R. 689 (Bankr. S.D. W.V. 1999), and In re Chapman, 1999 Bankr LEXIS 1091, 99-2 U.S. Tax Cas. (CCH) P50,690, 84 A.F.T.R.2d 5271 (S.D. W.V. June 23, 1999). Because this question is beyond the facts of the case at issue in this advisory, we will not address it in this memorandum. However, we are currently working with Collection and the Department of Justice on this matter and will inform you when we have reached a resolution.

CONCLUSIONS:

(1) When a taxpayer with an accepted but uncompleted OIC files a Chapter 13 petition, the Service has a tax claim for the entire underlying liability, unless the debtor assumes the OIC in the plan. The Service should therefore file a protective claim for the underlying tax liabilities to protect the Service's interests in the event that the debtor fails to assume the OIC in the plan.

(2) The answer is generally the same in Chapter 7 and Chapter 11 cases. In Chapter 7 cases the debtor cannot assume the OIC contract, so the Service's claim will not be a protective claim.

(3) We do not recommend any change to the language of Form 656.

BACKGROUND

Your request for advice asks for a post-review of a case in which debtors with accepted offers in compromise filed a Chapter 13 petition. Debtors were husband and wife. The husband had entered into a compromise for one tax year, but had not paid the principal due under the OIC agreement. The taxes compromised under this agreement are general unsecured claims in the bankruptcy case. Though the OIC was in default for nonpayment, the Service had not terminated the agreement as of the petition date.

The debtors had also jointly entered into another compromise for other tax years, and had paid the full amount of the principal due. They had not, however, paid interest on the compromised amount as provided for in the OIC form, though the amount of interest due was small. The taxes compromised under this agreement are entitled to secured claim status. The Service also had not terminated this agreement as of the petition date.

The Service filed a proof of claim with the bankruptcy court for the full amount of the unpaid tax liabilities, notwithstanding the accepted OICs. The amount of the Service's claim entitled to full payment in a Chapter 13 case as a secured claim greatly exceeded the amounts due under the OICs. The debtors filed an objection to the Service's claim, arguing that the tax liabilities had been compromised and paid (even though the husband's offer remained unpaid).

The objection to claim was resolved through a stipulation in the bankruptcy court whereby the debtors would pay an amount approximately equal to the unpaid principal and interest due under the OICs through their Chapter 13 plan as a priority tax claim. The stipulation required the debtors remain in compliance with the Internal Revenue Code as was required under the OIC agreements. The settlement also provided that any default on the payment or tax compliance provisions of the settlement agreement would result in reinstatement of the full

unpaid tax liability, including penalties and interest, which could be collected administratively without any further action to have the automatic stay lifted.

DISCUSSION:

I. What Kind of a Claim Should the Service File in a Chapter 13 Bankruptcy Case When the Tax Liabilities Have Been Compromised in a Pre-petition Offer in Compromise?

A. The Service's Claim in the Chapter 13 Bankruptcy Case and the Bankruptcy Code's Treatment of the Executory Contracts

In your memorandum, you state that a bankruptcy court will most likely conclude that an OIC agreement in full compliance as of the date a bankruptcy petition was filed is an executory contract. Therefore, you conclude, the IRS would have a general claim under the contract, as opposed to a priority tax claim, in the bankruptcy case, and the Service's proof of claim should reflect the balance of the compromised amount.

We agree that an uncompleted OIC is an executory contract. See Black's Law Dictionary (6th ed. 1991) ("In the context of Bankruptcy Code, [an executory contract] is a contract under which [the] obligation[s] of both bankrupt and the other party to contract are so far unperformed that failure of either to complete performance would constitute a material breach excusing performance of either"). See also, 3 Collier on Bankruptcy § 365.02, 365.02[1] (15th ed. 1999). When an OIC agreement has not been completed, performance remains due on both sides. The taxpayer has to comply with the payment and compliance provisions of the contract, after which the Service must remove any tax liens, abate the tax liability, and refrain from further collection.

However, the conclusion that the Service has a claim under a contract which has not been breached is problematic. Generally, a party to a contract under which the debtor's performance is prospective does not have a right to payment, and therefore a claim, until such time as the contract is repudiated or breached. We, instead, conclude that the Service has a tax claim entitled to general, priority or secured status, as the case may, for the full amount of the unpaid liabilities, rather than a general claim for the balance due under the contract.[8] A taxpayer's

[8] Your conclusion that the Service has a contract claim, as opposed to a tax claim, was based upon previous advice from this office. Memorandum to Director of Operations dated May 4, 1993. In that memo we advised that until such time as the OIC Form 656 is modified to provide that the filing of a petition in bankruptcy will result in the termination of the OIC, the Service should file a proof of claim for the amount due under the OIC, and also file a motion under Bankruptcy Rule 6006 for a determination

obligation to pay income taxes arises out of the Internal Revenue Code, not the OIC, and is therefore a tax liability.

Courts have repeatedly recognized an OIC as a contract. 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). In spite of this fact, courts have rejected arguments that the compromise amount is a new, contractual liability. For many years the Service argued that the amounts agreed upon in a compromise represented a contractual liability "in lieu of" the underlying taxes. These disputes about the nature of the unpaid liability arose when taxpayers who had compromised liabilities attempted to claim interest deductions for the amount paid which they believed had gone to pay the interest portion of the total debt. In I.T. 3852, 1947-1 C.B. 15, the Service took the position that no part of the payment made on a lump sum OIC could be considered a payment of income tax, penalties, or interest, but are payments made on a contract in lieu of the tax liability. In cases where the facts were in all material respects identical to the discussed in the ruling, courts generally accepted the ruling. See William C. Atwater & Co. v. Bowers, 5 F.Supp. 916, 918 (S.D.N.Y. 1934); Petit v. Commissioner, 8 T.C. 228, 236 (1947). However, where the Service sought to deny deductions based on the "substituted contractual obligation" theory in cases where payments exceeded the underlying principal tax, courts rejected the theory, finding that payments in compromise should be deductible to the extent of the deductibility of the liability to which they were applied. See, e.g., Finen v. Comissioner, 41 T.C. 557 (1964); Lustig v. United States, 138 F. Supp. 870, 873 (Ct. Cl. 1956). As the court in Lustig pointed out, and the Service later acknowledged, courts upholding the Service's position did so not because they adopted the Service's characterization of the liability as contractual, but because the amount of interest included in the payment had lost its identity. 138 F. Supp. at 873. See also Brink v. Commissioner, 39 T.C. 602 (1962); Automatic Sprinkler Co. of America v. Commissioner, 27 B.T.A. 160 (1932).

The substituted contract liability theory was finally rejected, for all types of cases, in Robbins Tire & Rubber Co. v. Commissioner, 52 T.C. 420 (1969) and 53 T.C. 275 (Supplemental Opinion) (1970), acq. 1973-3 C.B. 3, the case which led the Service to reconsider its prior position on the nature of compromised liabilities. In Robbins, the court held that because the agreement applied payments to the underlying tax liability, and other portions of the agreement plainly contemplated that the liability would survive, it could not be said that the parties to the contract contemplated the construction urged by the Service. Id. at 436-437. Because the payments were tax

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as to whether the OIC agreement is an executory contract. Although this specific language was not added to Form 656, other language was added that clarified that the Service will continue to have a tax claim in bankruptcy, and that the underlying tax liabilities will not be abated until the terms of the OIC have been completed. This language is discussed infra.

payments and the agreement was silent as to their application to specific liabilities, the court found that the normal IRS procedure for application of payments should be used to determine what portion of payments was applied to interest, and was therefore deductible. Id. at 437. In response to Robbins, the Service reconsidered and abandoned the substituted contractual liability theory. In Rev. Ruling 73-304, 1973-2 C.B. 42, the Service ruled that payments made on an OIC would be applied just as any other tax payment, unless the agreement provided otherwise. Thus, a deduction for interest would be permitted, to the extent allowed by I.R.C. § 163, for that portion of the compromise payment that was applied to interest.

The language in the present version of OIC Form 656 reflects that the taxpayer with an accepted OIC remains liable for the underlying tax, and that payments made on the OIC are tax payments. Form 656 (Rev. Feb. 1999), paragraph (j), provides that the taxpayer remains responsible for the full amount of the tax liability, and the Service will not remove the original amount of the tax liability from its records unless and until the taxpayer has met all the terms and conditions of the offer. Paragraph (k) of Form 656 provides that the tax being compromised remains a tax liability until the taxpayer meets all the terms and conditions of this offer, and if the taxpayer files bankruptcy before the terms and conditions of the offer are completed any claim the IRS files in bankruptcy proceedings will be a tax claim. The OIC forms used in the present case also contained such provisions. Thus, the underlying tax liability still existed when the taxpayers filed bankruptcy, and the Service was entitled to file a claim for the underlying tax liability.

While we conclude that it is clear that the an OIC does not convert the Service's claim from a tax claim to a contract claim, the more difficult issue to be resolved is whether the Service's claim in bankruptcy should be for the entire underlying unpaid tax liability or for unpaid amount under the OIC. Because the Service is entitled to collect the full amount of the unpaid underlying tax liabilities if the OIC is breached, we conclude that the proof of claim should list the full unpaid underlying tax liability.

The debtor, however, can choose to assume the OIC as an executory contract in the plan, in which case there will be no breach and the full tax liabilities will not be payable under the plan. The following is an explanation of the applicable executory contract provisions of the Bankruptcy Code. The bankruptcy trustee may accept an executory contract and render it a post-petition contract of the estate, or may reject it and render the contract breached. B.C. § 365(a), (g).[9] Debtors in Chapter 9, 11, 12, and 13 cases can also assume executory contracts in their plans, subject to

[9] We see no reason why a Chapter 13 trustee, rather than the debtor, would ever wish to assume an OIC contract. We also do not believe that a trustee could assume an OIC contract without the Service's consent. See footnote 8.

§ 365. B.C. §§ 1123(b)(2), 1222(b)(6), 1322(b)(7).[10] If the contract is rejected by the trustee, it is deemed to have been breached immediately before the date of the filing of the petition. B.C. § 365(g). The breach gives rise to a claim which is deemed to have arisen before the date of the filing of the petition. B.C. §§ 365(g), 502(g). In Chapter 13, debtors may also chose to cure any default and maintain any payments on secured or unsecured claims on which the last payments are due after the date on which the final payment under the plan is due. B.C. § 1322(b)(5). Such claims are nondischargeable. B.C. §§ 1328(a)(1).

Thus, if a debtor expressly assumes an OIC in the debtor's Chapter 13 plan, the OIC should be treated as not breached and the tax claim payable pursuant to the Service's proof of claim should be the amount due under the OIC. This is because having assumed the OIC as an executory contract, the debtor has agreed to pay in full the remaining obligation under the OIC, and the Service accordingly must honor the OIC by accepting such payment as satisfying the tax liability. If, however, the OIC is not expressly assumed in the plan, the OIC should be considered breached and the amount payable pursuant to the Service's proof of claim should be the full tax liability listed in the claim.[11]

Based on the foregoing, we conclude that in Chapter 13 cases where payments have not been completed under a pre-petition OIC, the Service should file a proof of claim reflecting the full amount of the unpaid 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 OIC 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 OIC, or (2) provide for full payment of the Service's priority and secured tax claims as provided for in Bankruptcy Code §§ 1322(a)(2) and 1325(a)(5), 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 OIC, while protecting its rights should the debtor chose not to assume the OIC. The debtor will have a choice, based on an evaluation of what is in the debtor's best interests, to either assume the OIC or be liable for the full underlying tax liability.

In the present, case, we conclude that the Service properly filed a proof of claim for the entire underlying unpaid tax liability, although consistent with our advice in this memorandum, we believe that such proofs of claim in the future should be labeled as "protective claims" should the OIC not be assumed in the plan. Pursuant to the

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[10] Section § 1107(a) also provides that a debtor in possession in a Chapter 11 case has the right of a trustee to assume or reject an executory contract.

[11] The Service should also be paid pursuant to the full tax liability listed on the proof of claim (as a pre-petition claim) if the OIC is assumed in the Chapter 13 plan, but the case is subsequently converted to Chapter 7. See B.C. § 348(c), § 365(d), § 502(g), and our explanation of the Service's claim in a Chapter 7 case infra.

stipulation in this case, the debtors effectively assumed both OICs by agreeing to pay the amounts remaining due under the OICs. This result is consistent with our conclusions in this memorandum.

B. What If the Taxpayer Is in Default on the Petition Date, but the Service Has Not Terminated the OIC?

Your memorandum also asks about situations where a taxpayer is in default under the terms of the OIC at the time the bankruptcy petition was filed, but the Service had not yet sent a default letter terminating the OIC.[12] We agree with your conclusion that the Service will continue to be bound by the OIC. Terminating the OIC once the bankruptcy case has commenced could be considered a violation the automatic stay, as it is an act to collect the pre-petition tax liability. See § 362(a). Further, the Bankruptcy Code provides that an executory contract in default can be assumed as long as the default is promptly cured. B.C § 365(b)(1).[13] This implies that the Service remains bound by the OIC for purposes of the bankruptcy case until it is rejected. Of course, if the OIC has been terminated before the bankruptcy case is commenced, there is no contract for the trustee or the debtor to assume.

C. What If All Payments Have Been Made Under the OIC, But the Debtor Is Still Subject to the Future Tax Compliance Provision on the Petition Date?

Our analysis has thus far assumed that the courts will find that uncompleted OICs are executory. Though we have found no case law on this point, we are confident in asserting the executory nature of uncompleted OICs when payments were not completed under the OIC. As we have said, performance remains due on both sides. The taxpayer must comply with all terms of the OIC, and thereafter the Service must abate the compromised tax liability. Payment of the agreed amount is clearly a material term that renders the contract executory. However, it is less clear whether courts would be willing to consider an OIC contract executory when a taxpayer has completed payments under the OIC, but remains responsible under the future tax compliance provisions of the OIC.

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[12] If an accepted OIC is to be defaulted, the Service prepares a default letter signed by the appropriate official declaring that the OIC is in default and terminated. I.R.M. 5.8.9.4(5) and Exhibit 5.8.9-4.

[13] Section 365 (b)(1) provides that if there has been a default in an executory contract, the trustee may not assume the contract unless the default is cured (or adequate assurance is provided that it promptly will be cured), and adequate assurance of future performance is provided. A debtor's assumption of an executory contract is also subject to the provisions of § 365. See B.C. §§ 1107(a), 1123(b)(2), 1222(b)(6), 1322(b)(7).

The present version of the OIC Form 656 (Rev. Feb. 1999), 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 (plus accrued interest) is paid in full, whichever is longer. The OIC agreements in the present case also contained such a provision. A court would have to decide whether this provision is a material term of the contract that renders the taxpayer's performance executory.

We believe that the future compliance provisions are material to the contract, rendering the contract executory even though all payments have been made. One of the primary purposes of the OIC program, and therefore the OIC contract, is to allow delinquent taxpayers who could not otherwise comply with the tax laws, to pay what they can afford to pay and come back into compliance with the federal tax system. Thus, a material part of the bargain for the Service is that the taxpayer remain in compliance with the Internal Revenue Code.

However, as a practical matter, we do not recommend filing a proof of claim in these cases, assuming the future tax compliance provisions have not been breached and the OIC terminated prior to bankruptcy. Such a proof of claim would be, in essence, a contingent claim which a bankruptcy court would probably estimate to be zero. If after confirmation the taxpayer fails to comply with the future compliance provision by failing to file post-petition tax returns or paying post-petition tax liabilities, the Service could use the normal remedies available to the Service during a Chapter 13 plan. That is, the Service could file a § 1305 claim for the post-petition liability, or seek conversion or dismissal of the bankruptcy case.

II. Is the Answer to the Aforesaid Question Any Different If the Bankruptcy Is Filed under Chapter 7 or 11?

Our advice as to the preparation of the proof of claim in a Chapter 13 case would be generally the same in a Chapter 11 case. In a Chapter 7 case, there is no mechanism whereby a debtor could assume an executory contract. See B.C. § 365. Recall that a debtor's ability to assume an executory in their plan was provided for by chapter specific provisions in the reorganization chapters. It is also unlikely that a Chapter 7 trustee could or would assume an OIC contract.[14] Thus,

[14] Notwithstanding § 365(a), we do not believe trustees can assume OIC contracts. We believe that the future compliance provision of the OIC contract renders the contract unassignable under contract law, because performance could only be accepted from the taxpayer. See 2 Restatement of the Law Second (Contracts) § 318, § 319 (1981). Such contracts cannot be assumed by the trustee under the Bankruptcy Code without the Service's consent. B.C. § 365(e)(1)(2)(A). We also do not believe that a bankruptcy trustee would want to assume an executory OIC contract, as there is no value to the estate in the right to assume the taxpayer's tax liabilities. While a

OIC contracts in Chapter 7 cases will typically be deemed to have been rejected on the 60th day after the order for relief. B.C. § 365(d)(1). Rejection will result in a breach of the OIC contract that is deemed to have occurred immediately before the filing of the petition. B.C. § 365(g). As in Chapter 13 cases, a claim for the unpaid tax liabilities resulting from the rejection and breach is treated as a pre-petition claim. B.C. § 502(g). Accordingly, the Service should file a proof of claim for the full amount of the unpaid underlying tax liabilities, and the claim should be treated in the bankruptcy case as if the OIC never existed. However, we see no reason why the Service should not still honor the OIC if the taxpayer has not otherwise defaulted. Any amounts collected pursuant to the proof of claim could be applied against the balance due under the OIC. This would protect the interests of both the Service and the debtor.

III. Should the Language in the OIC Form 656 Be Changed to Better Protect the Service's Interests?

Your memorandum also asks whether language should be included in the OIC contract Form 656 providing that the filing of bankruptcy case prior to fulfillment of all the terms of the contract would terminate the contract, and reinstate the full unpaid tax liability. You are concerned that absent such language, the Service could not file a proof of claim for the entire unpaid tax liability. However, any such language would not be enforceable pursuant to § 365(e)(1)(B), which provides that an executory contract cannot be terminated based upon a provision in the contract that is conditioned upon the commencement of a bankruptcy case. In any case, we believe such language is not necessary in light of our conclusion that the Service can file a proof of claim for the entire underlying tax liability.

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trustee may conceivably consider accepting an OIC contract and paying it to increase the payout to other creditors, we believe this runs counter to the trustee's duty to maximize the value of the estate for the benefit of all creditors. A possible exception could be a chapter 11 trustee seeking to reorganize the debtor.