



## GENERAL LITIGATION BULLETIN

Department of the Treasury Internal Revenue Service

### Office of Chief Counsel

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### **OBJECTIONABLE** **CHAPTER 12 PLAN STRIPS TAX LIENS**

In July, 1990, the Service filed tax liens for 1987-89 taxes against taxpayers, who subsequently filed chapter 12 bankruptcy in January, 1992. In April, 1992, the debtors filed their chapter 12 plan, listing the Service's claim as unsecured priority in the amount of \$13,500. Without objection by the Service, the debtors' plan was confirmed in September, 1992. In October, 1992, the Service timely filed a proof of claim listing \$27,000 in secured taxes, \$1,500 in priority taxes, and \$400 in unsecured taxes for the 1987-89 & 1991 tax years. The debtors claimed their real property was fully encumbered by other creditors, but did not file an objection to the Service's proof of claim. In June, 1993, the debtors filed a motion to sell real property, proposing to pay the Service's "tax lien" of \$13,500. The Service did not object to the sale, and applied the proceeds to the 1987-88 tax years.

In April, 1995, the debtors filed a modified plan, which did not include any payment to or claim by the Service (presumably because the debtors considered the tax debt paid by the proceeds of the real estate sale). The plan also purported to release and extinguish any tax liens. The Service again did not object to the plan, which was confirmed by the court in June, 1995. The debtors bankruptcy case was closed as fully consummated in June, 1996.

In February, 1998, the debtors filed a motion to set aside the Service's tax liens. The bankruptcy court of **In re Black, 1998 Bankr. LEXIS 1665 (Bankr. D. Az. Dec. 17, 1998)** held that under B.C. § 1227(c), the confirmation of the debtors plan acts as *res judicata* of all matters dealt with by the plan. Therefore, the plan reduced the Service's claim to unsecured status, because the plan "provided for" the secured claim in that it determined there was no secured claim. No lien avoidance proceeding is needed in a reorganization, because the confirmation process serves that function. The Service's reliance on B.C. § 506(d) was misplaced, the court determined, because in a chapter 12 reorganization section 1222(b) controls, permitting rights of secured claimholders to be modified and so stripped of their liens.

The court distinguished the cases cited by the Service for the proposition that a plan is not a contested or adversary proceeding as is necessary to disallow a secured claim. The court found these cases turned on whether sufficient notice had been afforded to the secured creditor. Where, as here, the secured creditor had sufficient notice, but voluntarily

chose not to object, and where the debtor paid the claim as classified, the Service is precluded from challenging the plan in a subsequent proceeding. Because the Service is bound by the provisions of the debtors plan, the Service's tax lien is of no force or effect.

**BANKRUPTCY CODE CASES: Chapter 12 (Family Farmer): Effect of Confirmation: Provisions of Plan.**

1. **BANKRUPTCY CODE CASES: Automatic Stay: Collection, Assessment, or Recovery of Claims**  
**In re Innovation Instruments, Inc., 1998 Bankr. LEXIS 1626 (Bankr. N.D. Fla. Dec. 15, 1998)** - Exception to automatic stay in B.C. § 362(b)(9)(D) allowing assessment of taxes extends to the assessment of penalties and interest .
2. **BANKRUPTCY CODE CASES: Exceptions to Discharge (§ 523): No, Late or Fraudulent Returns**  
**In re Hindenlang, 1999 U.S. App. LEXIS 795 (6<sup>th</sup> Cir. Jan. 22, 1999)** - In 1990, Service prepared substitute returns because taxpayer failed to file in 1985-88. In 1993, the taxpayer filed Form 1040s for those years, but did not pay the deficiency. In 1996, the debtor filed chapter 7 bankruptcy, seeking to discharge the taxes under B.C. § 727(a). Reversing the lower courts, the Sixth Circuit applied the four-part test from Beard v. Commissioner, 82 T.C. 766 (1984) to determine that the debtor's filing did not constitute a "return." The debtor failed the fourth prong of the test, the court held, because he failed to respond to the Service's deficiency letters, the Service assessed the deficiency, and consequently the forms filed by the debtor served no tax purpose and were not an honest and reasonable attempt to satisfy the requirements of tax law.
3. **BANKRUPTCY CODE CASES: Exceptions to Discharge (§ 523)**  
**BANKRUPTCY CODE CASES: Statute of Limitations: On Collection After Assessment: Suspension under B.C. § 108(c)**  
**In re Simmons, 227 B.R. 338 (Bankr. N.D. Ga. 1998)** - Two year time period of B.C. § 523(a)(1)(B)(ii) is tolled during pendency of prior bankruptcy cases, under B.C. § 108(c).
4. **BANKRUPTCY CODE CASES: Liens: Order of Seniority**  
**In re TNT Farms, 226 B.R. 436 (Bankr. D. Id. 1998)** - Court determined order of priority to proceeds from sale of bankrupt debtor's crops: The bank lender received first priority under the cash collateral order due to its adequate protection liens (even though these liens were granted in an earlier, dismissed, case). Second priority went to the Service, even though the bank's line of credit lien predated the tax lien. Because the proceeds were derived from crops, which came into existence after both liens were filed, the court determined the case of I.R.S. v. McDermott, 507 U.S. 447 (1993), controls (where judgment lien and tax lien are perfected simultaneously in after-acquired property, Service has priority under I.R.C. § 6323(a)).

5. **BANKRUPTCY CODE CASES: Preference (§ 547)**  
**In re Arway, 227 B.R. 216 (Bankr. W.D. N.Y. 1998)** - The court reconciled the Second Circuit's decision of In re Riddervold (levy executed outside the 90 day preference period is a continuing, non-voidable levy as to monies paid within 90 days) with the Supreme Court's decision of Barnhill v. Johnson (transfer of check honored within 90 day preference period may be voidable). Applying the "predictive model" of vertical precedence to resolve the ambiguity, the bankruptcy court opined the Second Circuit, in light of Barnhill, would hold that wage garnishments deducted during the 90 day preference period prior to a bankruptcy filing are recoverable by the debtor under B.C. § 547 and § 522(h) & (i).
  
6. **BANKRUPTCY CODE CASES: Priorities (§ 507): Trust Fund Taxes**  
**In re Megafoods, Inc., 1998 U.S. App. LEXIS 31224 (9<sup>th</sup> Cir. Dec. 15, 1998)** - Debtor argued that because state trust fund taxes were commingled with general funds, no trust existed and funds are part of debtor's estate. The Ninth Circuit applied the "lowest intermediate balance" test, finding that because the debtor's daily combined cash balances never fell below the amount of the state's sales tax trust fund claims, a statutory trust was imposed. The court refused to distinguish this case from In re Al Copeland Enterprises, Inc., 133 B.R. 837 (W.D. Tex. 1991), aff'd 991 F.2d 233 (5<sup>th</sup> Cir. 1993), even though the debtor argued it did not make a voluntary payment of taxes.
  
7. **BANKRUPTCY CODE CASES: Priorities (§ 507): Trust Fund Taxes**  
**In re Mosbrucker, 227 B.R. 434 (B.A.P. 8<sup>th</sup> Cir. 1998)** - Trust fund recovery penalties under I.R.C. § 6672 are a priority tax claim under B.C. § 507(a)(8)(C), not dischargeable penalties under B.C. § 523(a)(7)(B).
  
8. **BANKRUPTCY CODE CASES: Proofs of Claim (§ 501): Informal**  
**In re Campbell, 83 A.F.T.R.2d ¶ 99-312 (B.A.P. 9<sup>th</sup> Cir., Dec. 22, 1998)** - Service failed to timely file proof of claim, but did object to confirmation of ch. 13 debtors' plan of reorganization. In its objection, the Service indicated that it had a claim against the debtors in an amount not yet determined because the debtors had not filed income tax returns. During the pendency of the bankruptcy, the Service continued to correspond with the debtors regarding their tax liability. The Bankruptcy Appellate Panel agreed that the Service's objection and subsequent correspondence were sufficient to establish an informal proof of claim. Since the Service's later filed proof of claim was for the same type of taxes, even though it included additional years, it was a proper amendment to the Service's informal proof of claim.
  
9. **BANKRUPTCY CODE CASES: Returns by Trustee, Debtor-in-Possession, or Debtor**  
**In re Fleming, 1998 Bankr. LEXIS 1701 (Bankr. M.D. Fla. Dec. 8, 1998)** - Bankruptcy judge is immune from suit or damages for requiring debtor to file tax returns (as required by local order) as a prerequisite to confirmation of debtor's

chapter 13 plan of reorganization.

10. **BANKRUPTCY CODE CASES: Statute of Limitations: Multiple Petitions**  
**In the Matter of Fontes, 228 B.R. 3 (Bankr. N.D. Ala. 1998)** - Debtor filed five bankruptcy petitions in eleven years, transferred assets without court approval, and failed to make plan payments. The court used its broad powers under B.C. § 105(a) to equitably toll the priority period statute of limitations under B.C. § 507(a)(8)(A)(i), so that the Service's taxes were not discharged.
11. **BANKRUPTCY CODE CASES: Statute of Limitations: On Collection After Assessment: Suspension under Bankruptcy Code (§ 108)**  
**In re Pagnac, 1998 Bankr. LEXIS 1632 (B.A.P. 8<sup>th</sup> Cir. Dec. 30, 1998)** - Provisions of B.C. § 108(c) and I.R.C. § 6503(b) suspend the three-year priority period of B.C. § 507(a)(8)(A)(i), even though taxes accrued prior to debtors first bankruptcy petition.
12. **COMPROMISE & SETTLEMENT: Mistake**  
**Buesing v. United States, 1999 U.S. Claims LEXIS 8 (Fed. Cl. Jan. 13, 1999)** - Taxpayer attempted to compromise tax liabilities, offering \$30,000 based in part on estimated value of residence owned by entireties, and also based in part on anticipated bankruptcy discharge of certain tax liabilities. A revenue officer responded, acknowledging the taxpayer's valuation and allegedly accepting the offer. Because the taxpayer alleged the requisite elements for either an express contract or an implied-in-fact contract, the court of claims denied the Government's Rule 12(b)(1) motion to dismiss. However, because it was unclear whether a unilateral mistake was made, the court denied the cross-motions for summary judgment.
13. **DAMAGES, SUITS FOR: Against District Director or Employee**  
**Haas, Jr. v. Schalow, 1998 U.S. App. LEXIS 32654 (7<sup>th</sup> Cir. Dec. 23, 1998)** - Taxpayer sued revenue officer and group manager in their individual capacities, claiming constitutional violations caused by seizure of his business property. The Seventh Circuit first refused the Service's sovereign immunity argument, finding no basis to substitute the United States where a constitutional violation is alleged. However, the court found no basis for a Bivens action where Congress has created an exclusive, comprehensive administrative scheme to resolve tax-related disputes, even though the statutes may not provide the relief the taxpayer desires.
14. **LEVY: Sale: Notice**  
**LIENS: Action to Quiet Title**  
**Kabakjian v. United States, 1998 U.S. Dist. LEXIS 20413 (E.D. Pa. Dec. 22, 1998)** - Taxpayers claimed sale of real estate was invalid under I.R.C. § 6335 because the Service provided notice of the seizure and sale by certified mail. The court found the taxpayers had actual notice of the sale, which was sufficient. In addition, the court held that a quiet title action was improper after the property had

been sold to a third party and the United States no longer had a lien against the property.

15. **LIENS: Priority Over Constructive Trust**  
**Blachy v. Butcher, 1998 U.S. Dist. LEXIS 20332 (W.D. Mich. Dec. 14, 1998)** - Debtors secretly reconveyed property to themselves, after which condominiums were built on the property. Court found facts sufficient to impose a constructive trust to avoid unjust enrichment by debtors. Because the debtors thus held only bare legal title as trustees, there was no property or rights to property to which the federal tax lien could attach. The imposition of the constructive trust thus stripped the Service's lien in favor of the interests of the condominium owners.
16. **PENALTIES: Failure to Collect, Withhold or Pay Over**  
**Bradshaw v. United States, 1998 U.S. Dist. LEXIS 20521 (D. Ut. Dec. 21, 1998)** - Service made "lump sum" assessment for responsible person penalties, but did not attach individual yearly statements to the summary assessment record. Although this invalidated the assessment, the taxpayer failed to timely raise a statute of limitations defense, so could not challenge the assessment.
17. **PENALTIES: Failure to Collect, Withhold or Pay Over: Responsible Officer**  
**In re DeMarco, Jr., 1999 Bankr. LEXIS 29 (Bankr. M.D. Fla. Jan. 6, 1999)** - Corporate vice-president and shareholder who signed checks and tax returns was not a responsible person under I.R.C. § 6672 because he did not possess the actual authority to control the company's financial affairs, and had no power to direct payment to particular creditors.
18. **PENALTIES: Failure to Collect, Withhold or Pay Over: Willfulness**  
**Howell v. United States, 1998 U.S. App. LEXIS 32529 (10<sup>th</sup> Cir. Dec. 29, 1998)** - The lower court held that because the government failed to provide the taxpayer with a copy of his assessment under Treas. Reg. § 301.6203-1, the trust fund recovery penalty assessment was invalid. The Tenth Circuit disagreed. However, the appeals court remanded to determine if the taxpayer could establish a reasonable cause exception to the issue of willfulness, by showing that he made reasonable efforts to protect the trust funds, but that his efforts were frustrated by circumstances outside of his control.
19. **PENALTIES: Failure to Collect, Withhold or Pay Over: Willfulness**  
**United States v. Valleau, 1998 U.S. App. LEXIS 31938 (6<sup>th</sup> Cir. Dec. 21, 1998)** - Taxpayers held liable for trust fund recovery penalty because they were officers and directors with exclusive authority to sign checks. The Sixth Circuit also held that choosing to pay other creditors rather than make tax payments constitutes willful failure to collect under I.R.C. § 6672.