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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR NORTHERN CALIFORNIA DISTRICT COUNSEL (SAN FRANCISCO)

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

SUBJECT: Liability of Chapter 11 Trustee for Unpaid Excise Taxes

This responds to your request for advice dated December 20, 1999. This document is not to be cited as precedent.

ISSUE: Can a Chapter 11 trustee be held personally liable under I.R.C. § 6672 for failure to pay communication excise taxes collected by the estate?

CONCLUSION: Yes. The communication excise taxes collected from customers are subject to the statutory trust of I.R.C. § 7501. The Service can claim payment from the estate of the trust fund taxes ahead of other creditors pursuant to the rationale of Begier v. IRS, 496 U.S. 53 (1990). The Service can also assert section 6672 liability against the Chapter 11 trustee for any unpaid trust fund taxes if the elements of section 6672 are met.

BACKGROUND: A corporation filed a Chapter 11 petition in 1996. A Chapter 11 trustee was appointed and operated the corporation until the case was converted to Chapter 7 approximately four months after the Chapter 11 petition. The Chapter 11 trustee continued as the Chapter 7 trustee. During the period of Chapter 11 administration, the estate collected communication excise taxes from customers of the corporation pursuant to I.R.C. §§ 4251 and 4291. Because these taxes are imposed on the customers and collected by the corporation, the amount of tax collected is subject to the statutory trust imposed by I.R.C. § 7501, and a failure to pay over the funds collected can subject a responsible person to the Trust Fund Recovery Penalty (TFRP) imposed by I.R.C. § 6672.

The trustee, who claims she was unaware of her duty to pay the excise tax, failed to make required deposits of the excise tax and did not file required excise tax returns on Form 720 during the administration of the Chapter 11 case. After the Service filed a timely claim for the excise taxes in the Chapter 7 case, the estate filed a return covering

the entire Chapter 11 administrative period. The tax liability reported on the return is not in dispute.

The Chapter 7 trustee asserted that the estate had insufficient assets to pay all Chapter 11 administrative claimants in full after payment of Chapter 7 administrative expenses. The Chapter 7 trustee proposed to pay the tax claim pro rata with other Chapter 11 administrative claims. The Service in response proposed to assert the section 6672 TFRP against the Chapter 11 trustee. The trustee then filed an adversary proceeding in the bankruptcy case requesting a determination from the bankruptcy court that she is not personally liable under section 6672 because she acted within the scope of her authority as trustee, that she possesses immunity for acts within the scope of her authority as trustee, and that in any event her failure to pay taxes was not willful under section 6672. The adversary proceeding was subsequently mooted by the trustee's decision to pay the administrative claim in full ahead of other administrative expenses.

You state that a bankruptcy trustee's liability under section 6672 is a recurring issue and, therefore, request our advice as to whether as a general matter the Service can properly assert section 6672 liability against a trustee in cases similar to this case. Your primary concern is case authority which stands for the proposition that the section 7501 trust does not arise during a bankruptcy case because in bankruptcy only the priorities of the Bankruptcy Code control. United States v. Randall, 410 U.S. 513 (1971); In re Major Dynamics, Inc., 897 F.2d 433 (9th Cir. 1990). You conclude, however, that a person can be liable under section 6672 even in the absence of a statutory trust.

LAW AND ANALYSIS:

For the following reasons, we conclude that trust fund taxes are subject to the section 7501 statutory trust even in a bankruptcy case, since Randall and Major Dynamics are no longer controlling law.

The Supreme Court in Randall held that the priority provisions of the Bankruptcy Act supercede section 7501. In Randall, the debtor did not deposit withheld employment taxes into a special tax account during the pendency of a Bankruptcy Act Chapter XI proceeding, as required by court order. The bankruptcy estate was later liquidated. The Service sought to recover the delinquent trust fund tax liabilities accrued during the Chapter XI proceeding from the estate's general assets ahead of higher priority administrative expenses, based on the proposition that the funds were held in trust for the United States pursuant to section 7501. The Court held that the bankruptcy priority rules precluded such a recovery, stating that "the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and service created the assets." 401 U.S. 517.

In Major Dynamics, the former president of the debtor sought a declaration from the bankruptcy court that the Chapter 11 trustee breached a duty to pay over trust fund taxes incurred during the administration of the Chapter 11 estate. The taxes at issue were wages withheld from employees; the withheld funds were not segregated but were commingled in the debtor's operating account with other funds. The Service assessed the section 6672 penalty against the former president, who then sought the declaratory relief from the bankruptcy court. The court held that the funds were not subject to the section 7501 trust because "the withheld funds are subject to the system of priorities set out in the Bankruptcy Code and no Revenue Code section 7501 trust arises." 897 F.2d 436. Citing to Randall, the court also stated that a section 7501 trust cannot arise unless the withheld funds are either segregated or traceable.

Subsequent to the Supreme Court's decision in Begier, our position has been that both Randall and Major Dynamics are no longer controlling precedent. In Begier, the Court held that a voluntary prepetition payment of trust fund taxes, even if the Government cannot trace the funds paid to specific withheld or collected funds, cannot be avoided by the trustee under B.C. § 547 because such funds are held in trust for the United States pursuant to section 7501 and, thus, are not property of the debtor. In reaching this conclusion, the Court, relying on the legislative history of the 1978 Bankruptcy Act, concluded that "[t]he strict rule of Randall ... did not survive the adoption of the new Bankruptcy Code." 496 U.S. 65. Instead, "[a]mong the changes Congress decided to make was a modification of the rule this Court had enunciated in Randall under the old Bankruptcy Act." 496 U.S. 63. The new rule, as modified, is that withheld or collected trust fund taxes are subject to the section 7501 statutory trust and are, accordingly, not property of the bankruptcy estate under B.C. § 541. 496 U.S. 65. Although the Court recognized that any funds the Service sought to obtain must be traced to actual collected or withheld funds, the Court cited legislative history indicating that where trust funds are not segregated, the Service should be able to rely on "reasonable assumptions" to trace such funds. 496 U.S. 67.

In In re Megafoods Stores, Inc., 163 F.3d 1063 (9th Cir. 1998), the Ninth Circuit followed Begier in affirming the bankruptcy court's award to the State of Texas of funds from the Chapter 11 debtor's general bank account in payment of the state's claims for sales taxes collected by the debtor prepetition. The court held that the sales taxes were held in trust for the state pursuant to state law and, therefore, were not property of the estate pursuant to the Supreme Court's reasoning in Begier. The court held that the state met its tracing burden by reliance on the "lowest intermediate balance rule," *i.e.*, the state showed that the bank accounts into which the trust funds were deposited never fell below the amount of the trust fund claims from the dates of collection to the date of bankruptcy. 163 F.3d 1068.

Our position, based on Begier and Megafoods Stores, is that the United States can assert that funds withheld or collected by the debtor before the date of the Chapter 11 petition, or by the estate prior to conversion from Chapter 11 to Chapter 7, represent section 7501 trust funds which should be turned over to the United States ahead of any

other distributions, since such funds are held in trust for the United States and do not become property of the estate. Where the trust funds are not segregated in a separate account, the Service's case will be the strongest where it can establish that the amount on deposit in the debtor's or estate's general accounts never went below the trust fund claim pursuant to the "lowest intermediate balance rule."

Thus, trust fund taxes are in fact subject to the statutory trust even in the context of a bankruptcy case. What this means is that upon conversion to Chapter 7 the Service is not limited to accepting distribution after payment of Chapter 7 administrative claims, and pro-rata with other Chapter 11 claims, but can instead demand turnover of unpaid trust fund taxes to the Service ahead of other creditors on the ground that the funds are not property of the estate. This approach may be preferable in many cases to considering assertion of the TFRP against the Chapter 11 trustee.

However, insofar as payment cannot be obtained from the estate, we agree with your conclusion that the Chapter 11 trustee can be held personally liable for the trust fund taxes as a responsible person under section 6672, assuming that all the elements of section 6672 are met. The trustee must be a person responsible for the collection and payment of the tax, and the trustee must have willfully failed to pay over the tax. United States v. Landeau, 155 F.3d 93 (2d Cir. 1998); United States v. Jones, 33 F.3d 1137 (1994). Assertion of section 6672 liability is consistent with the case law indicating that bankruptcy trustees can be held personally liable for breaches of fiduciary duties to creditors. See, e.g., In re Cochise College Park, Inc., 703 F.2d 1339, 1357-58 (9th Cir. 1983); In re Markos Gurnee Partnership, 182 BR 211, 218 -220 (Bankr. N.D. Ill. 1995); Mosser v. Darrow, 341 U.S. 267 (1951). Additionally, the quasi-judicial immunity that trustees have does not extend to intentional or negligent violation of duties imposed by law. United States v. Hemmen, 51 F.3d 883, 891 (9th Cir. 1995) (Chapter 7 trustee can be held personally liable under I.R.C. § 6332(c)(1) for failure to honor Service levy on the allowed administrative expense claim of taxpayer). ^{1/}

Some courts have held that a bankruptcy trustee can only be held personally liable for willful or deliberate actions. See, e.g., Sherr v. Winkler, 552 F.2d 1367, 1375-76 (10th Cir. 1977); In re Hutchinson, 5 F.3d 750, 753 (4th Cir. 1993). However, since the failure to pay over under section 6672(a) must be willful, in many cases where section 6672(a) liability can be imposed, the trustee's actions will meet the willful or deliberate standard for imposing personal liability.

While we conclude that a bankruptcy trustee can be held personally liable under section 6672, in order to avoid unnecessary litigation over the extent of the trustee's personal liability, the preferred course of action in most cases will be to request the estate to turn

^{1/} However, if the trustee takes an action with the prior approval of the bankruptcy court, the trustee is immune from liability. See Mosser, 341 U.S. at 274-75.

over collected or withheld trust fund taxes to the Service pursuant to the authority of Begier.

Please contact this office at (202) 622-3620 if you have any questions or comments concerning this memorandum.

cc: Assistant Regional Counsel (GL), Western Region