Representing the Failing Company Where the IRS is "Knocking on the Door"

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I. General Considerations in Developing a Strategy for a Failing Company

A. As a company begins to approach a failing condition, management strategy should include a plan to deal with creditors when and if the time comes that the company will be unable to pay its obligations as they fall due. The plan should include a decision as to whether the company should seek concessions from creditors without resorting to proceedings under the Bankruptcy Code, or whether the makeup of its creditor and stockholder groups suggests that resort to the Bankruptcy Code may be necessary. As the troubles of the company become apparent to the creditors, they, too, should reach a decision on this point.

B. A company suffering cash flow problems typically becomes slow in paying its liabilities even before it reaches the point where it cannot pay its obligations as they become due. Management will keep current on those liabilities that as a practical matter cannot be delayed, such as wages, but will fall behind on other items that seem less pressing. In these circumstances, there is a temptation for management to fall behind in paying payroll taxes withheld from its employees. If this occurs, the company may eventually reach the point where it does not have enough cash to pay over the withheld amounts to the appropriate levels of government.

C. Penalties Can Be Severe

1. Code § 7501 states that all taxes collected or withheld are to be considered held in trust for the benefit of the United States.

2. Code § 7202 provides that a person who is required to collect and pay over taxes and who willfully fails to do so is guilty of a felony and can be fined up to $10,000 or imprisoned for up to five years, or both.
3. Under Code §7215, a person who fails to make withholding tax deposits may be guilty of a misdemeanor and fined not more than $5,000 or imprisoned for not more than one year or both.

4. Code §6672 provides a civil penalty—equal to 100 percent of the taxes withheld—on any person responsible for collecting the tax who willfully fails to collect it or trustfully account for and pay it over. The liability for employment taxes arises at the time of withholding, not at the time the withheld amount is due for payment. Consequently, a responsible person cannot avoid the penalty by resigning prior to the date the taxes are due. See, e.g., Brown v. United States, 591 F.2d 1136, 79-1 U.S.T.C. ¶ 9285 (5th Cir. 1979); Long v. Bacon, 239 F. Supp. 911, 65-1 U.S.T.C. ¶ 9289 (S.D. Iowa). A three-year statute of limitations on assessments applies for purposes of the Code §6672 penalty—Action on Decision CC-1996-006, July 15, 1996; see also §6672(b)(3), as added by the Taxpayer Bill of Rights 2 (referencing statute of limitations under Code §6501)—and, effective July 1, 1996, no Code §6672 penalty generally may be assessed unless the IRS first provides a notice of proposed assessment. Code §6672(b).

5. A penalty of up to 15 percent is imposed by Code §6656 for the failure to pay deposit taxes when due in an appropriate government depository. Interest will also be imposed on the underpayment.

II. Potential Creditor Liability for “Failing Company’s” Withholding Taxes

A. As a failing business moves from bad to worse, creditors may find themselves taking on major responsibilities relating to the control and management of the business. If this is done in the wrong way, the creditor will run the risk of having its claims subordinated to those of other creditors and of becoming subject to liability for unpaid withholding taxes of the debtor.

B. Where a lender, surety, or other person who is not the employer with respect to an employee or group of employees pays wages directly to the employee or group of employees, or to an agent on their behalf, it will have personal liability to the United States for the taxes (with interest) required to be withheld from such wages. Code §3505(a).

C. Code §6303(a) generally requires the Commissioner to give notice of an assessment, within 60 days after making it, to each person liable for the unpaid tax. However, in Jersey Shore State Bank v. United States, 87-1 U.S.T.C. ¶ 9131, 107 S. Ct. 782 (1987), the Supreme Court held that the IRS is not required by Code §6303(a) to give notice of an assessment for unpaid withholding taxes against an employer to a creditor potentially liable under Code §3505 for “a sum equal to” the unpaid tax. See Note, Jersey Shore State Bank v. United States: Lender Liability and Notice-When a Summons Is Enough, 7 Va. Tax Rev. 179 (1987); Note,
Taxation: Lender Liability Under I.R.C. § 3505(a), 39 Okla. L. Rev. 348 (1986) (pre-

D. Moreover, if the lender, surety, or other person supplies funds to or for
the account of the employer for the specific purpose of paying wages and has actual
notice or knowledge that the employer will not make timely payment or deposit of the
required withholding amounts, it will be personally liable for the withheld taxes
(together with interest), although in this instance its liability is limited to 25 percent of
the amount it supplied to the employer for this purpose. Code § 3505(b); see e.g.,
United States v. Park Cities Bank & Trust Company, 481 F.2d 738, 73-2 U.S.T.C.
¶ 9503 (5th Cir. 1973) (Code § 3505 penalty imposed on bank where bank approved
overdrafts, the proceeds of which were deposited in a payroll account from which the
employer failed to withhold); In re Brandt-Airflex Corp., 87-1 U.S.T.C. ¶ 9194, 69
B.R. 701 (Bankr. E.D.N.Y. 1987), rev’d on other grounds, 78 B.R. 10 (E.D.N.Y.
1987), aff’d 843 F.2d 90 (2d Cir. 1988) (held that lender was liable under Code
§ 3505(b) where the lender approved overdrafts for the payment of net wages but
“bounced” employer’s checks for the payment of withholding taxes).

E. A creditor’s liability under these provisions does not relieve the debtor
of its responsibility for any unpaid withholding taxes, except to the extent of amounts
actually paid by the creditor.

F. The IRS may institute collection proceedings against a creditor under
these provisions any time within ten years after assessment of the employer’s tax.
Treas. Reg. § 31.3505-1(d)(l). Because the employer’s tax must generally be
assessed within three years after the filing date of its employment tax return (which
is treated as occurring no earlier than April 15 of the succeeding calendar year to
which the return relates), this means that the collection proceeding against the
lender may be brought more than 13 years after the original liability for the tax arose.
See Code § 6501 (a) and (b)(2); O’Hare v. United States, 878 F.2d 953, 89-2
U.S.T.C. ¶ 9436 (6th Cir. 1989).

G. There is a conflict in the courts as to whether the lender’s collection
period is further extended automatically by any period for which the employer’s
statute of limitation on collection is tolled or extended, such as by the automatic stay
in bankruptcy or by the employer’s agreement to extend the statute of limitations. Compare *United States v. Harvis Construction Co.*, 857 F.2d 1360, 88-2 U.S.T.C. ¶ 9524 (9th Cir. 1988) (lender’s collection period not extended), with *United States v. Associates Commercial Corp.*, 721 F.2d 1094, 83-2 U.S.T.C. ¶ 9689 (7th Cir. 1983) (extended; viewed absence of any statement in the regulations to parallel suspensions as an oversight). See also *United States v. Olympic Savings and Loan Assn.*, 677 F. Supp. 1079 (W.D. Wash. 1988) (employer’s agreement to extend the statute of limitations on collection of employment withholding taxes also bound lender liable for such taxes under Code § 3505, even though the lender received no notice of the agreement).

H. Creditors should make special note of these provisions and be certain that, in the circumstances described therein, the withheld taxes are paid to the appropriate taxing authority. Even beyond these particular circumstances, however, creditors (and even prospective purchasers) who take over practical control of the failing company may find that they have become subject to the civil and criminal provisions, discussed above, that are applicable to responsible corporate officers, including the Code § 6672 100 percent civil penalty.

I. It should be noted that Code § 6672, which imposes a civil penalty on “responsible persons” of 100 percent of the taxes that should have been withheld, does not mention interest. It has been held that under Code § 6672 the “responsible person” has no liability for interest on the unpaid withholding taxes to the extent that it accrues between the date that the employer’s tax should have been paid and the date on which the IRS assesses the penalty against the “responsible person.” *United States v. Security Pacific Business Credit, Inc.* 956 F.2d 703 (7th Cir. 1992). On the contrary, Code § 3505, which applies to lenders, mentions interest for such period and makes the lenders to which it applies liable for such interest as well. Moreover, it has been held that the government can maximize its recovery by recovering the unpaid tax from a “responsible person” and recovering the interest on the unpaid tax from a lender under Code § 3505. *Id.* In *Security Pacific Business Credit*, the bank was found to be both a “responsible person” under Code § 6672 and a lender liable under Code § 3505(b). The IRS was allowed to recover the full amount of the unpaid tax from the bank under Code § 6672, and the interest on the unpaid tax from the date the tax was due under Code § 3505(b). The 25 percent limit contained in Code § 3505(b) applied in this case only to recovery of the unpaid interest.

III. **Pre-Petition Tax Planning**

A. **Timing of Petition Filing**

1. If the debtor owes back taxes, the filing of the bankruptcy petition in Chapter 11 can be timed so as to minimize the amount of taxes that receive priority treatment and, thus, maximize taxes subject to discharge. In determining whether a tax was incurred within three years before the
bankruptcy petition is filed, the due date of the return (including extensions) is the relevant date, not the assessment date.

Example: A calendar-year corporation with outstanding tax liabilities for 1991 through 1994 files for bankruptcy on February 16, 1995. The taxes for all prior taxable years, including 1991, receive eighth priority status and cannot be discharged. If, however, the debtor delays filing the bankruptcy petition for one month (i.e., until March 16, 1995), taxes relating to the 1991 tax year are outside the three-year period and can be discharged, assuming the corporation's 1991 return was filed on or before March 15, 1992.

2. A similar analysis applies to taxes that, for whatever reason, have been assessed within 240 days before the bankruptcy petition is filed. Such taxes, even though relating to tax years outside the three-year period, receive eighth priority status and cannot be discharged. Accordingly, a bankruptcy filing should be postponed until the 240 days after the date of assessment has expired.

3. Planning Point: Some individual debtors have tried to shift a tax liability to the bankruptcy estate by declaring bankruptcy prior to the foreclosure or other event that would generate taxable income. Bankruptcy trustees, however, have shown a willingness to abandon property where the tax liability exceeds the value of the property to the bankruptcy estate.

4. 11 U.S.C. § 554(a) provides that the trustee may abandon "any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." Indeed, a trustee may have a fiduciary duty to abandon property that would impose a tax burden on the estate.

5. The courts have upheld abandonment in these circumstances, stating that the impact on the debtor is not one of the factors to be considered by the court in authorizing abandonment. In re Johnston, No. 93-16497 (9th Cir. 1995) (Chapter 11 trustee authorized to abandon real property scheduled for foreclosure which would generate $2 million taxable gain for estate).

IV. Pre-Petition Trust Fund Taxes

A. General Comments

1. There are two broad categories of employment taxes: (1) the "trust fund" portion, consisting of withheld employee FICA and income taxes;
and (2) the non-trust fund portion, consisting of the employer's FICA taxes, FUTA taxes, and corporate income and excise taxes.

2. Any person responsible for the collection and payment of trust fund taxes who willfully fails to collect or truthfully account for and pay over such taxes may be held liable for such taxes in his individual capacity.

3. The trust fund portion of employment taxes is not dischargeable, regardless of the years to which such taxes relate. 11 U.S.C. § 523(a)(1) and § 507(a)(8)(C).

4. Unpaid trust fund taxes are common when dealing with a financially troubled business, and the potential individual liability of the debtor's various employees, officers, or controlling shareholders must be taken into account when planning for bankruptcy. The IRS generally applies partial payments first to the non-trust fund portion of employment taxes, thus maximizing its ability to recover unremitted trust fund taxes from the responsible officers.

5. The IRS' policy, however, permits taxpayers making "voluntary" payments to designate the tax liability to which the payments apply. Rev. Rul. 79-284, 1979-2 C.B. 83. The IRS policy is that tax payments pursuant to a bankruptcy reorganization are involuntary and are to be allocated at the direction of the IRS. See Holcomb v. U.S. 622 F.2d 937, 938 fn. 3 (7th Cir. 1980); IRS Policy Statement P-5-60 (2-9-93). As a result, to the extent possible, the debtor corporation ought to pay delinquent taxes before filing bankruptcy, and affirmatively designate these payments as trust fund taxes. This designation has the effect of: (1) reducing the exposure of the debtor's officers or other responsible persons for personal liability on the trust fund taxes; and (2) minimizing the possibility of the corporation or entity emerging from bankruptcy will burdened by nondischargeable trust fund taxes.

6. A pre-petition payment of trust fund taxes by the debtor, even from its general operating account, is not a recoverable preference item. See Begier v. U.S., 496 U.S. 53 (1990). After the bankruptcy petition is filed, a bankruptcy court can order the IRS to apply tax payments to the outstanding trust fund tax liability, if the court determines that the allocation is necessary for the success of a reorganization.

B. Favorable Forum

1. Another consideration in entering bankruptcy is whether the bankruptcy court is a more favorable forum than the Tax Court or other federal courts in which to litigate a tax dispute. The bankruptcy court has jurisdiction to decide tax claims brought against the debtor, whether pre-petition or post-petition, and whether or not previously assessed or paid,
provided that the claim has not been ruled on by a court or administrative tribunal before bankruptcy. 11 U.S.C. § 505(a) and § 505(a)(2)(A).

2. The bankruptcy court also may rule on refund claims, but only after the IRS has made its determination or 120 days after a refund request is filed with the IRS. 11 U.S.C. § 505(a)(2)(B).

3. With respect to pending Tax Court proceedings, the bankruptcy court may take jurisdiction over the proceeding, or it may lift the automatic stay and allow the Tax Court to hear the matter. 11 U.S.C. § 505(a) and § 362(d).

V. Trust Fund Taxes: Post-Petition

A. A debtor-in-possession has a continuing duty to collect, account for, and pay over all tax monies required to be collected or withheld (generally termed “trust fund” taxes) – whether collected or withheld prepetition or in respect of payments under a Chapter 11 plan. Otte v. United States, 419 U.S. 43, 74-2 U.S.T.C. ¶ 9822 (1974) (withhold FICA and income taxes); Laub Baking Co. v. United States, 642 F.2d 196, 81-1 U.S.T.C. ¶ 9333 (6th Cir. 1981) (pay FUTA); In re Armadillo Corp., 561 F.2d 1382, 77-2 U.S.T.C. ¶ 9659 (10th Cir. 1977). See also Howard, An Overview of the State and Federal Tax Responsibilities of Bankruptcy Trustees and Debtors, 93 Comm. L.J. 43, 56-58 (1988). Under Code § 7501, the amount of any tax collected or withheld is considered to be held “in trust for the United States,” hence the term “trust fund” tax. Such taxes include income and employment withholding taxes, backup withholding, and certain excise taxes.

B. Subject to a confirmed plan, however, a debtor-in-possession is prohibited from paying (without prior court approval) any trust fund taxes not remitted prior to the bankruptcy case. In many cases, this may prompt the IRS to seek alternative sources of payment. In particular, the IRS may seek to collect such taxes from any responsible officers or employees of the debtor. Court approval for the payment of such taxes should be easily obtained, however, where the trust fund taxes have been segregated prior to the commencement of the bankruptcy case and have not been expended.

C. Personal Liability for Unpaid Trust Fund Taxes

1. The penalties for failure to collect or pay over withholding and other trust fund taxes, or to file the requisite forms or maintain the requisite records, may subject the debtor corporation and any responsible person (including the trustee) to civil and criminal penalties. See e.g., Code § 6672 (100 percent of employment withholding tax imposed for “willful” failure or failure to “trustfully” account); Code § 7202 (five years imprisonment and/or $10,000; “willful” failure); Code § 7203 (one year imprisonment, $25,000
($100,000 for corporations "willful" failure); Code § 7215 (one year imprisonment and/or $5,000 imposed for failure to comply unless ("due to circumstances beyond his control," including lack of funds). Of these, Code § 6672, which imposes a civil penalty on "responsible persons" for 100 percent of any trust fund taxes that should have been paid over, is generally of greatest practical concern.

2. Liability may be imposed under Code § 6672 where the person's failure to collect or pay over the accrued taxes is "willful." For this purpose, willful generally includes acting with reckless disregard. Factually, this generally means that a person that knew (or had reason to know) of the unpaid trust fund taxes and, having the means (even if directed otherwise by his superiors), failed to ensure that the taxes were paid is a "responsible person" to which the Code § 6672 penalty applies. For a more detailed discussion of the Code § 6672 penalty, see Saltzman, IRS Practice and Procedure, ¶¶ 17.07-17.11 (1991); Sheppard, Tenth Circuit Writes Its Own Responsible Person Penalty, Tax Notes (September 8, 1997); Bedikian, The Pernicious Reach of 26 U.S.C. Section 6672, 13 Va. Tax Rev. 225 (1993); Seiffert & Hudson, IRS's New Approach to Determining "Responsible" Persons for the 100% Penalty, 79 J. Taxation 144 (1993); Hertz, Personal Liabilities of the Unsuspecting Executive for Penalties Under Section 6672 and Other Nightmares, 32 Inst. on Fed. Tax'n 1171 (1974). Accordingly, the penalty does not apply if, at the time the officer or employee otherwise became a responsible person, there were no funds with which to satisfy the tax obligation—all funds on hand being encumbered—and the funds thereafter generated are not directly traceable to collections of the tax. Slodov v. United States, 436 U.S. 238, 78-1 U.S.T.C. ¶ 9447 (Code § 6672 penalty not imposed as later acquired funds generated in carrying on the business, not from withholding tax collections); Michaud v. United States (Ct. Cl. 1997), reprinted at 97 TNT 233-11 (officers held not liable); see also Elmore v. United States 843 F.2d 1128, 88-1 U.S.T.C. ¶ 9267 (8th Cir. 1988) (finding reversible error in failing to issue jury instruction to such effect); Honey v. United States, 963 F.2d 1083, 92-1 U.S.T.C. ¶ 50,253 (8th Cir. 1992) (defining "encumbered" funds as only those funds that must be used to satisfy obligations that are superior in payment to the withheld taxes); cf. Bradshaw v. United States, 71 F.3d 1517, 96-1 U.S.T.C. ¶ 50,028 (10th Cir. 1995) (other originally negotiated credit facility), withdrawn and republished at 83 F.3d 1175, cert. denied, 117 S.Ct. 296 (1996).

3. The Tenth Circuit has recently held out some prospect of hope for the well-intentioned officer or employee that nevertheless is considered to have acted reckless under this standard, by recognizing a "reasonable cause" exception to Code § 6672 liability. Finley v. United States, 123 F.3d 1342, 97-2 U.S.T.C. ¶ 50,613 (10th Cir. 1997) (en banc). As fashioned by the Tenth Circuit, reasonable cause for nonpayment exists if (and only if) the responsible person made reasonable efforts to protect (or pay) the accrued
taxes but failed to ensure their payment due to circumstances outside his control. The factual situation before the Tenth Circuit, which was remanded for a new trial, involved an officer who upon discovering unpaid trust fund taxes gave specific directions to pay the taxes and, when he later learned that his directions were not followed, there were no unencumbered funds.

4. A creditor or other third party may also be held responsible for a debtor's withholding taxes — where, for example, the lender pays wages directly to the employee, supplies funds to or for the account of the employer for the specific purpose of paying wages (Code § 3505), or is otherwise deemed to have control over the disbursement of funds by the debtor corporation to pay wages (and is therefore considered a responsible person under Code § 6672). In appropriate circumstances, a lawyer may be a "responsible person" for purposes of Code § 6672. See, e.g., IRS v. Blais, 85-2 U.S.T.C. ¶ 9684 (D. Mass.) (lawyer acting under a power of attorney operated failing business); Brown v. United States, 464 F.2d 590, 72-2 U.S.T.C. ¶ 9568 (5th Cir. 1972), cert. denied, 410 U.S. 908 (1973) (attorney "nominal" president of client's corporation).

5. The civil penalties imposed by Code §§ 3505 and 6672, however, are only collection devices and are, therefore, not to be exacted where the tax itself is ultimately paid. See, e.g., § 3505(c); IRS Manual § 4784(1)(August 10, 1994), § (34)7(12):0:(2):d) (November 13, 1996) (Chief Counsel Directives Manual); see also United States v. Huckabee Auto Co., 783 F.2d 1546, 86-1 U.S.T.C. ¶ 9268 (11th Cir. 1986) (per curium); Emshwiller v. United States, 565 F.2d 1042, 77-2 U.S.T.C. ¶ 9744 (8th Cir. 1977).

D. Right of Contribution Among Responsible Persons

1. Congress, as part of the Taxpayer Bill of Rights 2, created a statutory right of contribution among responsible persons liable for the Code § 6672 penalty. IRC § 6672(d).

2. This new right is effective for penalties assessed and paid after July 30, 1996, and any action to recover against another responsible person must be brought in a separate proceeding from the IRS action for collection, and not as a third-party complaint.

3. The statute provides that the responsible person is entitled to recover the amount of the payment in excess of his proportionate share of the penalty. How is this amount determined? Must you litigate each of the other responsible person's responsibility or culpability? How much can you recover from any single person if there are multiple other responsible parties? Can you recover more than the other person's proportionate share?
4. Some assistance is provided by new Code § 6103(e)(9), which requires the IRS to disclose, upon written request, to any person it determined to be a responsible person, the name of any other persons it determined to be responsible persons, the nature of any collection activity against such persons and the amount collected.

E. Filing of Bankruptcy Petition Does Not Hinder Assessment/Collection of §§ 3505 and 6672 Penalties

1. With few exceptions, the filing of a bankruptcy petition by (or against) a debtor does not hinder the assessment or collection of the Code §§ 3505 and 6672 penalties by the IRS (although it may impede a suit for contribution). This is true even though a debtor-in-possession is precluded from paying over trust fund taxes collected or withheld prior to the bankruptcy case without first obtaining court approval. See 11 U.S.C. § 362(a).

2. Although upon the filing of the bankruptcy petition, the IRS is automatically stayed from collecting or recovering unpaid prepetition taxes, such stay applies only to the debtor corporation. It does not extend to the debtor’s officers. For this reason, the Eleventh Circuit and a number of lower courts have held either that the bankruptcy court lacks jurisdiction to enjoin the IRS from assessing or collecting the Code § 6672 penalty against its officers or that the debtor corporation lacks standing to seek the injunction. See, e.g., United States v. Huckabee Auto Co., supra note 130 (lacked jurisdiction); Success Tool and Mfg. Co. v. United States (In re Success Tool and Mfg. Co.), 86-2 U.S.T.C. ¶ 9563 (N.D. Ill) (same; “It is irrelevant that the collection of the penalty from (the principal officer and major shareholder) will affect the reorganization of the debtor”); United States v. A&B Heating and Air Conditioning, Inc., 57 B.R. 360, 86-2 U.S.T.C. ¶ 9520 (Bankr. M.D. Fla. 1986) (debtor corporation lacked standing; alternatively, held that Anti-Injunction Act barred injunction against IRS); United States v. Driscoll’s Towing Service, Inc. (In re Driscoll’s Towing Service, Inc.), 51 B.R. 990, 85-2 U.S.T.C. ¶ 9603 (S.D. Fla. 1985) (same); J.C. Williams and Peepite Paving Co. v. IRS, 86-1 U.S.T.C. ¶ 9393 (Bankr. S.D. Fla.) (same); United States v. Rayson Sports, Inc., 44 B.R. 280, 84-2 U.S.T.C. ¶ 9968 (N.D. Ill. 1984) (same); Dynamic Maintenance Service, Inc., No. 81-C-6640 (N.D. Ill. March 5, 1982) (Kocoras, J.).

3. More frequently, courts (including most federal appellate courts) have entertained the debtor corporation’s motion, but refused to invoke the broad equitable powers granted under Bankruptcy Code § 105(a) to override the Anti-Injunction Act.

4. The Anti-Injunction Act prohibits any “suit for the purpose of restraining the assessment or collection of any tax,” other than certain enumerated exceptions. See Code § 7421(a). See, e.g., In re LaSalle
Rolling Mills, Inc. v. Department of Treasury (In re LaSalle Rolling Mills, Inc.), 832 F.2d 390 (7th Cir. 1987) (would not enjoin IRS from assessing Code § 6672 penalty against two officer/shareholders of the debtor, who together owned 100 percent of the debtor, even though the complaint alleged that the debtor’s reorganization would be irreparably impaired both by (1) the expenditure of time that the officers would be required to devote to the proceedings with the IRS and (2) the depletion of their personal assets which had been used in part to fund the reorganization by serving as collateral for their guarantee of the debtor’s borrowings); A to Z Welding & Mfg. Co. v. United States, 803 F.2d 932, 87-1 U.S.T.C. ¶ 9109 (8th Cir. 1987) (per curium); American Bicycle Assn. v. United States (In re American Bicycle Assn.), 895 F.2d 1277, 90-1 U.S.T.C. ¶ 50,104 (9th Cir. 1990); In re Arrow Transfer and Storage Co., 50 B.R. 726 (E.D. Tenn. 1985), rev’g 85-1 U.S.T.C. ¶ 9145; Steel Products, Inc., 53 B.R. 999, 85-2 U.S.T.C. ¶ 9600 (D. Wash. 1985) (would not enjoin the IRS even though bankrupt corporation was in compliance with Chapter 11 plan which called for payment of tax over six years, and even though bankruptcy court perceived penalty as threat to a successful reorganization), rev’g 85-1 U.S.T.C. ¶ 9439 (Bankr. E.D. Mich.); Dore & Assocs. Contracting, Inc., v. United States (In re Dore & Assocs. Contracting, Inc.), 85-1 U.S.T.C. ¶ 9196 (Bankr. E.D. Mich.) (would not enjoin IRS even though officers would seek indemnification from debtor corporation, impairing ability of debtor to perform Chapter 11 plan, and Chapter 11 plan provided for payment of withholding taxes over six years); cf. In re Becker’s Motor Transportation, Inc., 632 F.2d 242, 246, 81-1 U.S.T.C. ¶ 9438 (3d Cir. 1981), cert. denied, 450 U.S. 916 (held that Anti-Injunction Act precluded injunction against IRS collection efforts against debtor under prior Bankruptcy Act); In re Heritage Village Church & Missionary Fellowship, Inc. 851 F.2d 104, 88-2 U.S.T.C. ¶ 9476 (4th Cir. 1988) (held that the Anti-Injunction Act prevented bankruptcy court from enjoining IRS revocation of debtor’s tax-exempt status; presumable, this court would also consider that the Anti-Injunction Act prevents it from enjoining the collection of tax against the debtor’s officers). See Bennett, The Bankruptcy Code and the Anti-Injunction Act: Collectability of Employment Tax Liabilities from Nondebtor “Responsible Persons,” 48 Tax Law 349 (1995).

5. In general, the IRS need not exhaust collection efforts against the debtor corporation (or any third-party guarantor or surety) before proceeding under Code § 6672. See, e.g., Calderone v. United States, 799 F.2d 254 (6th Cir. 1986) (restricted McCarty, infra, to its facts); Cooper v. United States, 539 F. Supp. 117, 82-1 U.S.T.C. ¶ 9296 (E.D. Va. 1982), aff’d without opinion, 705 F.2d 442 (4th Cir. 1983).

6. In this regard, IRS Manual HB57(16), § (10)35 (January 14, 1987) provided:
Where the corporation is in bankruptcy, it is not necessary that assessment of the 100-percent penalty against a responsible officer (not in bankruptcy) be delayed until the proceeding’s conclusion. The automatic stay does not apply to such an assessment and the statutory period for assessment of the 100-percent penalty against responsible persons is not extended by reason of a corporate bankruptcy. Therefore, prompt action should be taken so that a proper determination can be made before the statutory period for assessment of the 100-percent penalty assessment is about to expire, extensions of the period for assessment should be obtained from all parties against whom the assessment may be proposed.

7. Nevertheless, in 1993, the IRS discarded its prior bias which favored Code § 6672 penalty assessments in Chapter 11 cases. It is now the IRS’s general policy to refrain from making Code § 6672 penalty assessments in Chapter 11 cases, except in those cases where the delay would jeopardize ultimate collection. IRS Manual § 5638.6 (May 5, 1993). To this has since been added the statement that in Chapter 11 cases the assertion of the penalty “normally” will be withheld pending confirmation of a plan and as long as payments are current under the plan. IRS Manual HB 5.7, § 4.10(1) (July 31, 1998). However, the determination as to whether, and how actively, to proceed is generally within the discretion of the revenue officer assigned to the matter.

8. See, e.g., IRS Manual § 57(13)2.61:(8) (March 16, 1995) (listing factors to consider in determining whether to forebear, both before and after a plan). Previously, the IRS’s bias was toward assessment and collection except where there was “apparent certainty” that the taxes would be paid in full under a Chapter 11 plan. Moreover, where possible, field agents generally were encouraged to file tax liens prior to deferring collection efforts. See IRS Manual former § 57(13)2.61:(6) (November 17, 1992). This itself represented a significant hardening of the IRS’s position from a year earlier. See, e.g., IRS Manual § 5754.1(4) (May 29, 1991) (assessment may be withheld if “substantial likelihood” that the IRS will be paid in full).

9. Alternatively, in an appropriate case, the responsible person may himself file for bankruptcy and thereby automatically stay the collection of the penalty (although not the assessment). Moreover, as part of his bankruptcy plan, he may be able to permanently stay collection of the penalty, subject to a later motion for reconsideration if timely payments are not made under the debtor corporation's Chapter 11 plan.

10. See, e.g., United States v. Rowe, 90-1 U.S.T.C. ¶ 50,005 (N.D. Ga.), emphasizing that, “once it has proper jurisdiction of all parties in the case (apparently meaning the company, the officer, and the IRS), it may formulate its orders to manage the competing interest of the Bankruptcy Code
and the Internal Revenue Code “(for cases to the contrary, see supra note 111); In re Dobbins, 108 B.R. 638, 90-1 U.S.T.C. ¶ 50,011 (Bankr. W.D. Tenn. 1990) (considered the reasonable probability of payment by the company, the officer’s role in the company’s Chapter 11, and the potential adverse effect on the company’s reorganization of a further impairment of the officer’s financial condition were the officer to pay the penalty); see also Weiss, Bankruptcy Court Power to Enjoin the IRS from Collecting the Debtor’s Taxes from Its Officers: An Analysis of Recent Developments, 1986 Ann. Survey of Bankr. L. 233, 252-256 (also suggesting that, in appropriate circumstances, both bankruptcy cases might be consolidated).

F. IRS Collection Activity Methods on the Financially Troubled Taxpayer

The IRS has two principle tools for administratively collecting unpaid federal taxes, the lien and the levy. The basics of those tools is discussed below. Additionally, the taxpayer who owes taxes as a responsible officer will find that seeking refuge in bankruptcy will not discharge the debt for that particular tax unless the liability is fully satisfied.

G. The Federal Tax Lien

The federal tax lien is a statutory lien as that term is defined in section 101(53) of the Bankruptcy Code. The federal tax lien arises solely by force of statute.

The existence of the federal tax lien results from a series of steps in the process of collecting a federal tax liability. Those steps, described below, have rigid requirements prior to successful creation of this lien. In addition to detailing those steps, this paper will discuss the attachment of the lien to property and the competition between competing creditors when the federal tax lien exists.

H. Assessment

1. I.R.C. § 6201(a) - Authority of Secretary. The Secretary is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title, or accruing under any former internal revenue law, which have not been duly paid by stamp at the time and in the manner provided by law.

2. An assessment can take place for and of the following.
   a. Taxes shown on the return
   b. Unpaid taxes payable by stamp
c. Check or money order not duly paid

d. Erroneous income tax payment credit

e. Income tax of a child assessable against a parent.

3. Essential Factors of an Assessment

a. Identity of Taxpayer

b. Type of Liability

c. Tax Period (if applicable)

d. Amount of liability

4. The assessment usually results from the filing of a return. Usually, remittance accompanies the return or credits exist on the account to fully satisfy the account. In those circumstances where insufficient credits or remittance exist at the time of the assessment, the federal tax collection process begins with the assessment of the liability.

5. The assessment results when an assessment officer at a Service Center, a Campus using the newest IRS terminology, signs the assessment document. Almost all assessments occur on Mondays. A single assessment document may contain thousands of tax liabilities of individuals and entities.

6. When an assessment occurs and the account contains insufficient funds to satisfy the liability, the IRS simultaneously sends the taxpayer a notice and demand.

I. Notice and Demand

1. I.R.C. § 6303(a) - General rule. Where it is not otherwise provided by this title, the Secretary shall, as soon as practicable, and within 60 days, after the making of an assessment of a tax pursuant to section 6203, give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof. Such notice shall be left at the dwelling or usual place of business of such person, or shall be sent by mail to such person's last know address.
2. The demand portion of the letter requires payment within 10 days of the assessment date. This 10 day period represents the taxpayer's final chance to keep the federal tax lien from attaching to all property or rights to property in which the taxpayer has an interest.

J. **Neglect and Refusal**

1. This simply means that the taxpayer fails to satisfy the assessment. No affirmative act on the part of the taxpayer or the government need occur to meet this test.

2. I.R.C. § 6321 - If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

K. **The Assessment Lien**

1. Following the neglect and refusal to pay the tax in the notice and demand, the federal tax lien comes into existence without any further action. At this point the lien is known only to the taxpayer and the IRS. This is sometimes called the secret lien because no one else knows of its existence. As discussed below, the secret nature of the lien impacts its priority vis a vis other creditors.

2. I.R.C. § 6322 provides that the lien arises once the neglect and refusal to pay has occurred and relates back to the date of the assessment. The lien continues to exist until the underlying liability is satisfied or becomes unenforceable.

3. I.R.C. § 6502 provides that the period of limitations on collection of the liability runs 10 years from the date of the assessment. Certain actions, such as bankruptcy, extend the collection period and, therefore, the life of the lien which is coextensive with the collection period.

L. **Priority of the Federal Tax Lien**

1. The unfiled assessment lien is easily defeated in competition with certain other creditors. It will, however, defeat state tax liens, other unperfected liens and transferees of the taxpayer's property who take, after the lien arises, without adequate consideration in money or money's worth.
2. I.R.C. § 6323(a) lists four private creditors whose perfected liens will defeat the federal tax lien if perfected prior to the filing of the federal tax lien: (1) purchasers; (2) judgment lienholders; (3) holders of security interests; and (4) mechanics lienholders.

3. To protect its priority against these four creditors the IRS needs to file the federal tax lien in the appropriate location. The filed federal tax lien competes with other perfected liens on the basis of first in time. The timing of the assessment lien is also critical.

4. State and local taxes are not listed in I.R.C. § 6323(a). So, their competition with the federal tax lien focuses on the assessment lien rather than the filed lien. With the exception of real property taxes discussed below, state and local taxes also compete against the federal tax lien on a first in time basis. United States v. Vermont, 377 U.S. 351 (1964); United States v. City of New Britain, 347 U.S. 81 (1954). To succeed against the federal tax lien, the state tax lien must be choate meaning that it must identify the lienor, the property subject to the lien, the amount of the lien and be summarily enforceable. A more detailed discussion of this competition occurs below.

5. Certain transactions or creditors may defeat the federal tax lien even if they occur after the filing of the federal tax lien. I.R.C. § 6323(b). Congress carved out this list of 10 "superpriorities" to keep the federal tax lien from adversely impacting the normal flow of commerce. The items on this list were deemed necessary for that purpose. The items are (1) securities, including inter alia, cash; (2) motor vehicles; (3) personal property purchased at retail; (4) personal property of less than $1000 purchased at a casual sale; (5) personal property subject to a possessory lien; (6) real property taxes; (7) residential property subject to a mechanic's lien for repairs of not more than $5,000; (8) attorney's liens; (9) certain insurance contracts; and (10) deposit secured loans. The most important of these for this discussion is (6) real estate taxes. That provision permits real estate taxes to come ahead of the federal tax lien even though the real estate taxes arise long after the federal tax lien was perfected. This provision, adopted in 1966 after the Supreme Court's decision in City of New Britain, prevents circular priority problems that were prevalent prior to that time.

M. Perfecting the Federal Tax Lien

1. I.R.C. § 6323(f) details how the IRS must file its federal tax lien in order to protect the lien vis a vis other creditors. In general, the lien must be filed in the locality where real estate is located in order to defeat other liens with respect to real estate. For personal property the proper
location for filing the lien depends upon whether the taxpayer is an individual or an entity. For individuals the lien must be filed where the taxpayer resides at the time of the filing of the lien for the lien to remain viable. I.R.C. § 6323(g) provides that generally, the original filing of the lien is sufficient for the "ordinary" collection period on the assessment (10 years) plus one year and 30 days. Where the statute of limitations on collection is extended beyond the ordinary collection period, the lien must be re-filed to retain its validity.

2. The IRS may withdraw the filed federal tax lien under certain circumstances generally where a withdrawal would benefit the IRS or the lien filing was premature. I.R.C. § 6323(j).

3. The IRS will release the filed lien when the liability is satisfied or becomes legally unenforceable. I.R.C. § 6325(a).

4. The IRS may remove or "discharge" the filed lien from specific property under certain circumstances generally arising where the lien interest of the IRS is satisfied and the taxpayer divests any interest in the property. I.R.C. § 6325(b).

N. Collection Due Process

1. Beginning for liens filed after January 18, 1999, the IRS must send a taxpayer a notice within five business days after the first filing of the federal tax lien for a tax period giving the taxpayer the opportunity to meet with an appeals officer to discuss other methods of collection than the filing of the federal tax lien. I.R.C. § 6320. (See extended discussion below in section — of this outline.)

2. If the IRS agrees to pursue collection by means other than through the filing of the federal tax lien, the lien will be withdrawn.

3. If the IRS does not agree to withdraw the lien the taxpayer has the ability to go to court to try to convince the court that the lien should be withdrawn.

O. Simultaneously Attaching Liens

1. At times the lien of the IRS and that of a competing creditor attach to property simultaneously. This usually happens when a judgment lien creditor or a state tax lien compete with the federal tax lien because all of these liens attach to after acquired property.

2. The position of the IRS is that it has priority when liens attach simultaneously. United States v. McDermott, 507 U.S. 447 (1993). While
McDermott dealt with competition between a judgment lien creditor and the federal tax lien, the IRS also argues for the same result when competing against state tax liens. Woods v. United States, 46 F.3d 21 (6th Cir. 1995).

P. Non-Bankruptcy Insolvency Cases

1. For many years the IRS took the position that liabilities owed to it had priority in non-bankruptcy insolvency cases such as insolvent decedent's estates or receiverships notwithstanding the "regular" priority of its lien with the competing creditor. In reaching this conclusion, the IRS relied upon 31 U.S.C. 3713.

2. The Supreme Court ruled that the general federal non-bankruptcy insolvency priority scheme set out in 31 U.S.C. 3713 was superceded by the specific provisions in the Internal Revenue Code concerning the collection of federal taxes. United States v. Estate of Romani, 523 U.S. 517 (1998).

Q. The Levy Process

Nature and General Purpose

1. A levy is an administrative means of collecting taxes by seizure of the taxpayer's property to satisfy his delinquent taxes. It is a summary, extrajudicial remedy of self-help for the purpose of compelling payment of the tax debt. United States v. Eiland, 223 F.2d 118 (4th Cir. 1955). A levy is analogous to, but something more than, an attachment, garnishment, or other similar creditor's remedy.

2. I.R.C. § 6331(a) provides the authority for the Revenue Officer, as a delegate of the Secretary, to collect delinquent taxes by levy.

R. Conditions Precedent

The person show property is seized must:

1. Be liable for the tax (an assessment and notice and demand have been made), but no judgment need be rendered by a court Eiland, supra at 121; and

2. Neglect or refuse to pay the tax within 10 days after notice and demand; and
3. Have been given 30 day written notice of the IRS's intention to levy after July 1, 1989. See I.R.C. § 6331(d)(2). Have been given 30 day written notice of the right to a Collection Due Process hearing with IRS Appeals. See I.R.C. § 6330.

S. The Pre Levy Notice

The pre levy notice must set forth, in simple and non-technical terms:

1. The amount of the unpaid tax;
2. Notification of the right to a hearing;
3. A statement that the IRS intends to levy;
4. A description of the taxpayer's rights with respect to the levy action.

T. The pre-levy notice must be given in person, left at their home or sent certified mail to their last known address. The 6331(d) notice may be combined with the 6330 notice; however, the 6330 notice requires that any certified mail be sent return receipt requested.

U. If notifying the taxpayer of the impending levy would jeopardize the IRS' ability to successfully levy, then the notices described above need not be sent prior to the levy. Similarly, a waiver of prior notification exists where the subject of the levy is a state tax refund. The CDP process itself is described in section — of this paper.

V. The effect of the levy varies depending on the type of property it seeks. For wages and salary the levy is continuing, without further action, until the liability is satisfied. For other property, the levy results in a seizure of all property or rights to property in possession of the person upon whom the levy was served in the possession of that person at the time of service. If the taxpayer or third party upon whom the levy was served acquires property subsequently, the IRS must issue another levy to reach it.

W. There are numerous items of property and rights to property belonging to taxpayers that are exempt from levy. I.R.C. § 6334. These include, among other things, wearing apparel, personal effects, tools of a trade, and a portion of the taxpayer's wages.

X. A third party receiving a levy from the IRS is held harmless if the property is surrendered. I.R.C. § 6332(e). If the third party refuses to honor the levy the third party becomes personally liable for the unpaid tax up to the
value of the property not surrendered. I.R.C. § 6332(c). The IRS can bring a
suit to enforce the levy and may, if the failure lacked reasonable cause, hold
the third party liable not only for the value of the property but also for a 50% penalty. I.R.C. § 6332(d)(2).

Y. Once a seizure has occurred the IRS must notify the taxpayer as soon
as practicable. I.R.C. § 6335(a). The IRS is considered to be in lawful
custody of the property and has broad powers over the property. If a third
party claims ownership, making the levy wrongful, that person may request
the IRS to hand over the property and if the request is not honored, may sue
the IRS for wrongful levy within nine months of the seizure. I.R.C. § 7426.

Z. The Effect of Bankruptcy on Tax Collection

Effect of Tax Lien in Bankruptcy

1. If the IRS has properly filed its lien and if the lien attaches to equity
in the taxpayer's property, then the IRS will have a secured claim in the
bankruptcy case.

2. If the IRS has a secured claim, then it must be paid in full in a
Chapter 11 or 13 case during the life of the taxpayer's plan. If the claim is
oversecured, meaning there is more equity to which the lien attaches than
outstanding tax liability, then the IRS is entitled to interest on its secured
claim.

3. Depending on the nature of the property securing the IRS lien, the
IRS may also be entitled to adequate protection payments throughout the
period in which the bankruptcy is pending in order to protect its secured
status. When the lien has attached to cash or cash equivalents, the taxpayer
cannot use those funds without the prior permission of the bankruptcy court.

2. Effect of Bankruptcy on Levy

1. Unless it receives the bankruptcy court's permission to sell the
property, the IRS must release property it has seized but not sold at the time

2. The IRS may not levy to collect prepetition debts while the
automatic stay is in effect.

3. The taxpayer must provide adequate protection to the IRS for its
secured claim.

3. Trust Fund Recovery Penalty in Bankruptcy
1. The liability for any tax that has been collected and is held in trust for the United States receives priority status no matter what causes the taxpayer to be liable for such a debt. B.C. 507(a)(8)(C). So, a responsible officer who goes into bankruptcy will find that his liability for the trust fund tax either must be paid in full during the bankruptcy case or it will not be discharged. B.C. 523(a)(1)(A)(i); 1129(a)(9)(C); 1325(a)(1)(A).

2. A corporation heading into bankruptcy can write the IRS a check on the eve of bankruptcy (within the preference period) to satisfy unpaid trust fund taxes and the payment will not be treated as a preference. Begier v. Internal Revenue Service, 496 U.S. 53 (1990). Rather, the payment will be treated as a payment of monies held in trust. This gives responsible officers a tool to use in planning for bankruptcy as they seek to minimize their own personal liability.

3. Once in bankruptcy a corporation may seek to designate how its payments will be applied in order to protect its responsible officers. The Supreme Court has said that the bankruptcy judges have discretion to determine whether such a designation is in the best interest of the bankruptcy estate. United States v. Energy Resources Co. Inc., 495 U.S. 545 (1990). The IRS almost always contests these types of plan provisions; however, the IRS will usually withhold collection from responsible officers in situations where the corporation is keeping current on its taxes while in bankruptcy, making its plan payments timely, not seeking to designate payments in the plan, and extending the assessment statute of limitations on the trust fund recovery penalty where necessary.

4. Attempts to enjoin the IRS from collecting the trust fund recovery penalty from responsible officers while the corporation is in bankruptcy have generally failed.

VI. Collection Due Process Hearings: How Do They Work?

A. Prerequisites: Notice of Intent to Levy and CDP Notice

1. Before seizing the taxpayer's property, the IRS must mail or deliver a written statement notifying the taxpayer of its intent to levy and describing the statutory and administrative procedures relating to levy and sale and the alternatives that may be available to the taxpayer to prevent a levy (the Notice of Intent to Levy, Form 668-A). I.R.C. § 6331(d). The IRS must provide the Notice of Intent to Levy at least 30 days prior to levying on the taxpayer's property. Id.
2. Effective for activities after December 31, 2000, the IRS Reform Act requires supervisor approval before the IRS can issue a levy notice and before it can levy on or seize the taxpayer’s property. IRS Reform Act § 3421. In the case of a jeopardy assessment, the Code permits the IRS to levy and seize a delinquent taxpayer’s property immediately after making notice and demand with no prior notice required. I.R.C. § 6331(a).

3. The IRS Reform Act created a new, separate pre-levy notice procedure, described in Code section 6330, which is similar to the procedure in section 6520 relating to notification after a Notice of Federal Tax Lien has been filed. The required contents of the notice are virtually the same as those for a Notice of Intent to Levy and must be provided within the same 30-day period before a levy takes place. I.R.C. § 6330(a). In addition, the section 6330 Notice must inform the taxpayer of his right to protest a proposed levy with the Appeals Office, also referred to as a CDP Hearing. A delinquent taxpayer in a jeopardy case is not entitled to a CDP Notice prior to levy, but still has a right to request a due process hearing within a reasonable amount of time after the levy occurs. I.R.C. § 6330(f)(1). Similarly, section 6330 does not require that the taxpayer be granted a pre-levy CDP Hearing before issuing a levy to collect a state tax refund owing the taxpayer. As in a jeopardy case, a post-levy hearing is all that is required. Temp. Treas. Reg. § 301.6330-1T(a)(2).

B. Further Administrative Remedies: Taxpayer Assistance Orders and the CDP Hearing

1. The Code contains a number of administrative remedies available to a taxpayer who is being threatened with enforced collection action. Pursuant to Congressional mandate, the IRS recently expanded the procedures permitting an early referral of a collection issue to the Appeals Division (before a lien is filed) (the “Collection Appeals Program” or CAP). I.R.C. § 7123. Issues that may be considered by Appeals as part of this CAP process include Notices of Federal Tax Lien, Notices of Intent to Levy, Notices of Seizure, and denials of installment agreements. Revenue Procedure 99-28, 1999 I.R.B. 109 see also Publication 1660, "Collection Appeal Rights." Code section 7811 also permits the Office of Taxpayer Advocate to stop IRS collection activity as part of a Taxpayer Assistance Order (“TAO”), if to do otherwise would result in significant hardship for the taxpayer. A taxpayer might utilize a TAO to prevent or stop a wage garnishment or to prevent seizure of a particular asset. See Treas. Reg. § 301.7811-1(c); see generally Treas. Reg. § 301.7811-1 for procedures relating to a request for a TAO.

2. Effective for collection activities initiated on or after January 19, 1999, the taxpayer is afforded an additional opportunity to suspend collection activities in order to request a hearing with the Appeals Division. The Code
requires the taxpayer to be notified of his right to request a CDP (Collection Due Process) Hearing in two separate instances: after the IRS files a Notice of Federal Tax Lien with respect to his property, I.R.C. § 6320, and before the IRS levies on the property. I.R.C. §§ 6320(a); 6330(a). To conserve resources, the two hearings may be consolidated. I.R.C. § 6320(b)(4). The types of issues that may be reviewed as part of a CAP appeal are generally broader than those that may be considered as part of a CDP Hearing. However, only the CDP procedure permits direct judicial review of the Appeals Office’s determination.

3. Although the types of issues that may be considered as part of a CDP Hearing are somewhat more limited as compared to those that may be raised in an early referral hearing, the scope of the CDP Hearing is still significant. At the hearing, an Appeals Officer who has not previously been involved in the taxpayer’s case must first verify that the Code procedures relating to the creation of the federal tax lien or proposed levy have been satisfied (for example, whether the IRS properly issued the Notice and Demand for Payment or the Notice of Intent to Levy). In addition, the taxpayer may raise any issue relevant to the lien or levy action, including innocent spouse claims, collection alternatives such as offers in compromise and installment arrangements, and suggestions as to which of the taxpayer’s assets should be levied upon to satisfy the outstanding liability. I.R.C. § 6330(c); see also Temp. Treas. Reg. §§ 301.6320-1T and 301.6330-1T for details relating to the notice requirement and conduct of the CDP hearing. As a general matter, however, the taxpayer cannot use the CDP Hearing to challenge the existence or amount of the underlying tax liability, except in a case where the taxpayer did not receive a statutory notice of deficiency or has not otherwise been given the opportunity to contest the existence of the liability. See Temp. Treas. Reg. § 301.6330-1T(e).

4. The results of the CDP Hearing appear in a Notice of Determination prepared by the Appeals Officer, which is sent to the taxpayer. Temp. Treas. Reg. § 301.6330-1T(e)(3) A-E7. The Notice of Determination must confirm that all procedural requirements were met in the taxpayer’s case and decide the merits of any issues raised by the taxpayer during the hearing. If the parties reach an agreement concerning any relief or other action to be taken, the Notice of Determination will set forth the terms of that agreement. Id. A taxpayer who receives an adverse ruling has 30 days to appeal the findings in the Notice of Determination to the Tax Court. I.R.C. § 6330(d). If the Tax Court does not have jurisdiction over the type of liability contested (employment taxes, for instance), then an appeal lies to the United States District Court. The court will review the Appeals Officer’s determination as to the appropriateness of the collection activity using an abuse of discretion standard. Temp. Treas. Reg. § 301.6330-1T(f).
5. Although the CDP Hearing procedure is still developing, it holds the prospect of a meaningful opportunity for the taxpayer to resolve most of his concerns relating to the lien and levy process, and to further negotiate with the IRS over the how collection efforts will proceed. Save for the fact that the statute of limitations on collection is tolled during the hearing period, there appear to be no strategic drawbacks associated with the process. See I.R.C. § 6330(e). Unless the taxpayer protests the appropriateness of the lien or levy, the CDP hearing will likely focus on whether alternative collection methods are appropriate under the circumstances.

6. Requests for CDP Hearings have exploded since the new law came into effect, creating significant backlogs at the Appeals level. An IRS official estimated that the IRS had 8,000 requests for such hearings in fiscal year 2000, and anticipates as many as 23,000 requests in 2001.

7. Requests by taxpayers for Tax Court review of adverse notices of determination resulting from CDP hearings are also piling up. Tax Court Chief Judge Thomas Wells, speaking at the ABA Section of Taxation Meeting in October of 2000, told the audience that approximately 200 cases contesting CDP hearing results had already been filed with the Tax Court. Subsequently, Congress added Code section 7463(f), which permits a taxpayer to appeal the results of a CDP hearing to the Tax Court using its small tax case procedures. Section 313(f), Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (effective December 21, 2000). On the one hand, using small tax case procedures in CDP cases may well alleviate some of the pressure on the Tax Court's docket. Because small tax cases carry no precedential value, however, the drafters of section 7463(f) requested that "the Tax Court will give careful consideration to . . . . a motion by the Commissioner of Internal Revenue to remove the small case designation (as authorized by Rules 172 and 173 of the Tax Court Rules) when the orderly conduct of the work of the Court or the administration of the tax laws would be better served by a regular trial of the case," H.R. Conf. Rep. No. 106-1033.

8. Interim Tax Court Rules 330 through 334 provide procedural guidance to taxpayers appealing the Appeals Officer's findings in the Notice of Determination. The IRS updated its Internal Revenue Manual in August 2000 to provide instructions to agents concerning CDP hearings. See I.R.M. 5.11.1, et. seq.

9. During the past year, a number of cases were decided that clarify permissible CDP Hearing procedures at the Appeals level. In Davis v. Commissioner, 115 T.C. 35 (2000), the Tax Court addressed the issue of whether an Appeals Officer failed to afford the taxpayer an adequate CDP hearing as envisioned by Congress in section 6330 when the Appeals Officer declined the taxpayer's requests to examine witnesses under oath during the hearing and to subpoena documents. The Tax Court stated that the "nature
of the administrative Appeals process does not include the taking of testimony under oath or the compulsory attendance of witnesses." The court also noted that hearings "at the Appeals level have historically been conducted in an informal setting" and that neither the language of section 6330 nor the legislative history indicated that Congress intended to change this format.

10. *Mesa Oil Inc. v. United States*, 86 A.F.T.R. 2d (RIA) 7312 (D. Colo. 2000) focuses on what type of record is required for judicial review of a CDP hearing. *Mesa Oil, Inc.*, a corporation engaged in processing used oil for industrial use, was delinquent in paying its payroll taxes for several quarters. In an attempt to collect the unpaid taxes, the Service filed a notice of federal tax lien and issued to *Mesa Oil* a Notice of Federal Tax Lien Filing and Your Right to a Hearing under IRC 6320. The Service also issued to *Mesa Oil* a Notice of Intent to Levy and Your Right to a Hearing. *Mesa Oil* requested and was given a CDP hearing by the IRS Office of Appeals on the filing of the notice of federal tax lien. Appeals issued *Mesa Oil* a notice of determination sustaining the lien filing, from which, pursuant to section 6330(d), *Mesa Oil* appealed to the district court. The district court held the administrative record to be inadequate for judicial review under section 6330(d)(1)(B), because "no record of the hearing was kept, no record of the evidence or arguments presented at that hearing was made, and no analysis of the evidence or arguments was presented in the determination." The district court ordered that the record on remand "may be made" either through audiotape, videotape or stenographic transcription.

11. The IRS nonacquiesced to the *Mesa Oil* decision. In its AOD, the IRS stated: We do not believe that sections 6320 and 6330 require a CDP hearing to be recorded verbatim. Congress did not intend CDP hearings to be conducted in a manner different from proceedings with Appeals instituted prior to the passage of the IRS Restructuring and Reform Act of 1998. *Davis v. Commissioner*, 115 T.C. 35, 41 (2000) ("The references in section 6330 to a hearing by Appeals indicate that Congress contemplated the type of informal administrative Appeals hearing that has been historically conducted by Appeals and prescribed by section 601.106(c), Statement of Procedural Rules"); see H.R. Conf. Rep. No. 105-599, pp. 290-291. The fundamental purpose of proceedings with Appeals is to provide an informal setting in which taxpayers and appeals officers can resolve tax issues. To maintain a productive informal forum for the resolution of tax issues, these procedures do not include a verbatim recording requirement and should not now include such a requirement for CDP hearings. To the extent the district court in this case intended to hold that CDP hearings must be recorded by videotape, audiotape or stenographic transcription, we disagree. CDP hearings should be carefully documented by appeals officers in determination letters and case memoranda which, with any documents provided by the taxpayers or otherwise obtained by the appeals officers, will constitute the record for review by the court.
12. *In Katz v. Commissioner*, 115 T.C. 329 (2000), the Tax Court granted the IRS's motion for summary judgment over the taxpayer's numerous challenges, one of which was that he never received (or had the opportunity for) an adequate CDP Hearing under section 6320. In response to a Notice of Federal Tax Lien filed by the IRS, the taxpayer requested an CDP Hearing with the Appeals Office pursuant to section 6320(b) in order to contest the entire amount listed in the lien filing. The Appeals Officer notified the taxpayer of the time for the hearing and the location, which was the IRS Appeals Office in Sunrise, Florida. The taxpayer refused to appear on the ground that the scheduled location was inconvenient to the taxpayer and his witnesses and requested that the hearing take place in West Palm Beach, about 100 miles from the Appeals Office. The Appeals Office called the taxpayer to explain that Appeals hearings were not available in West Palm Beach, but rather were conducted at the Appeals Office. During the same call, the Appeals Officer discussed the substantive issues surrounding the lien filing with the taxpayer. Two days later, the Appeals Officer issued to the taxpayer a written notice of determination under 6330, denying all relief. The taxpayer subsequently petitioned the Tax Court for review of the determination under section 6330.

13. Noting that neither the statute nor legislative history addressed the appropriate location for a CDP Hearing or whether it can occur over the telephone, the Tax Court relied on procedural regulations relating to the time and place of an IRS examination to guide its decision. "The Treasury Regulations in the examination context consider the distances taxpayers will have to travel to submit information to the IRS and attempt to provide taxpayers with venues at IRS offices near their homes. At the same time, the Treasury regulations recognize the limited resources of the IRS." Because the taxpayer could not explain why commuting 100 miles would constitute an undue burden, the Tax Court rejected his complaint. The court went on to note:

Because of petitioner's insistence of an Appeals hearing in West Palm Beach, Florida, the Appeals Officer attempted to accommodate petitioner by offering to discuss his case over the telephone. From the record, we conclude that petitioner and the Appeals Officer did in fact discuss his case over the telephone and that the Appeals Officer heard and considered petitioner's arguments. We thus further conclude that, through the communications between petitioner and the Appeals Officer in the instant case, petitioner received an Appeals hearing as provided for in section 6320(b).

*Id.* at 332.
14. Code section 6330(b)(3) specifies that the CDP Hearing must be conducted by an impartial Appeals Officer.

VII. Collection Due Process Guidelines: Views of the Collection Due Process Hearing by the IRS Appeals Division. What is a Collection Due Process “CDP” hearing?

RRA '98 granted appeal rights to taxpayers who want a review of specific collection actions. These rights differ from the Collection Appeal process (CAP) that was already in place at that time.

CDP Expands the Taxpayer Rights to Resolve Collection Disputes

1. The taxpayer has judicial rights under a CDP determination, but not under a CAP decision.

2. Appeals officers have broader authority in resolving a CDP case than they do in resolving a CAP.

3. A taxpayer may have the right to challenge an underlying liability during a CDP hearing but not during a CAP.

When does a taxpayer have the right to request a Collection Due Process hearing with Appeals?

The right to request a CDP hearing begins with one of two collection actions that occur after January 18, 1999:

1. The IRS files a Notice of Federal Tax Lien. The taxpayer is notified of the filing and his or her right to a Hearing by use of Letter 3172

2. The IRS issues a final notice of intent to levy. The taxpayer is notified of the intent and his or her right to a Hearing by use of Letter 1058 or 11

If the taxpayer requests a CDP hearing and one of the two above events have not occurred after January 18, 1999, the taxpayer's request will be returned to them. However, Appeals may still consider the taxpayer's complaint as a CAP or as an informal claim.

Timing is important

1. For a hearing regarding a NFTL, the request must be made within 37 calendar days of the date the lien was filed. The deadline date is shown on Letter 3172.
2. For a hearing regarding the final intent to levy notice, the request must be made within **30 calendar days** of the date of the levy notice (Letter 1058).

**Written Request Required – Form 12153 Recommended**

To avoid delay or “late” requests, it's important to send the request to the office that initiated the lien or levy – refer to the letter sent to the taxpayer L3172 (lien) or L1058 (levy).

The date of the postmark is used to determine the date of the request.

**Did your Client File the Request too Late?**

The taxpayer will still be entitled to an Equivalent Hearing. During the Equivalent Hearing, the taxpayer gets the same consideration as in a CDP hearing. However, the taxpayer does not have the right to judicial review.

The Equivalent Hearing is not granted by statute; it's provided for in the Regulations.

**What about Enforcement Action and Collection Statutes of Limitation?**

If the request for a hearing was filed timely (CDP), enforcement action must be suspended during the appeal (except in limited situations). The Collection Statute of Limitations is also suspended.

If the request for a hearing was not filed timely (Equivalent Hearing), enforcement action may continue (but usually it does not). The Collection Statute of Limitations is not suspended.

**Where is the hearing to be held?**

We often hold CDP or Equivalent Hearings by phone, but face to face conferences are always available if the taxpayer prefers; these are held at the closest Appeals Office.

The Appeals Officer must have had no prior involvement with the unpaid liability, although this can be waived by the taxpayer.

**What can be discussed during the hearing?**

- The taxpayer can challenge the underlying liability if they have had no prior opportunity to do so.

- Innocent Spouse issues can be raised.
- The taxpayer can argue that the filed lien or proposed levy is unfair, overly intrusive, or creates a hardship.

- The taxpayer can propose alternatives that would be less intrusive but still allow the government to collect the full amount if the taxpayer can afford to pay; alternatives for lesser amounts can be considered if the taxpayer cannot afford to pay.

Alternatives that most Taxpayers want us to Consider

- an installment agreement or

- an offer in compromise

The taxpayer must be in compliance with filing and deposit requirements to qualify for these alternatives.

We may request current, updated financial information

What happens after the hearing?

- We'll process any necessary adjustments to the taxpayer's account after a liability issue is resolved.

- For agreed CDP cases, we'll ask the taxpayer to sign a waiver of judicial rights

- In Equivalent Hearings, the taxpayer will receive a "Decision Letter" outlining the final decision of Appeals, whether the case is agreed or unagreed.

If no agreement is reached in a CDP case, or if the taxpayer will not sign the waiver, Appeals will issue a "Determination Letter" that addresses:

1. Whether the IRS has verified that legal and procedural requirements were followed.

2. Any issues raised by the taxpayer.

3. Whether the collection action balances the government's need to collect with the taxpayer's concerns of intrusiveness.

4. The taxpayer's right to petition the Court.
Judicial Review

- The taxpayer has 30 days to petition the court.
- The court with jurisdiction depends on the type of tax – for example, the Tax Court has jurisdiction over income tax cases.
- The standard of judicial review is “Abuse of Discretion” – this means the Court looks to see if Appeals determination was logical given the facts in evidence at the time.
- Cases we’ve “lost” have been remanded to Appeals for additional consideration.

When are Cases are Returned for Collection?

- If the taxpayer withdraws his request for a Hearing
- Equivalent Hearing – when Decision Letter is issued
- Agreed CDP cases – when waiver accepted
- Unagreed CDP cases – when no petition is filed or when judicial review is complete.

Retained Jurisdiction:

The taxpayer can return to Appeals if the Appeals determination is not carried out, or if the taxpayer has a change in circumstances.

However, the taxpayer must exhaust all regular administrative remedies first.

Suggestions for Avoiding Problems

- Don't file Form 12153 prematurely – consider a CAP to address collection issues or an informal claim to address liability issues.
- Don't send the request for a CDP Hearing to the Appeals Office.
- Encourage your client to submit requested financial information promptly.
- Remind your client that all required returns must be filed before installment agreements or offers will be considered.
• Be aware that an approved Installment agreement or a determination of currently not collectible status for the account often means that a Notice of Federal Tax Lien will be filed (or will remain if already in place).

Need Assistance?

• The Customer Service Officer can provide assistance with CDP or CAP issues.

• Once the case is assigned to Appeals, the Appeals Officer will assist you with any questions you might have.

How Appeals is Meeting our Commitment to Quality

CDP cases have presented us with a challenge because they differ significantly from traditional Appeals work. As with all our work, however, Appeals is committed to delivering quality dispute resolution service. These are our strategies for keeping that commitment:

• We’ve given training to our Appeals Officers — in class and on the job

• We’re hiring more Settlement Officers — currently in process

• We have two national program consultants who address questions or problems that arise. They publish a monthly newsletter with pertinent information.

• We’ve completed two major review projects and CDP cases will now be reviewed as part of our quality measurement process.

• We participate in cross-functional conferences on the national and area level.
Comparison of CAP, CDP, and Equivalent Hearing

<table>
<thead>
<tr>
<th></th>
<th>CAP</th>
<th>CDP</th>
<th>Equivalent Hearing</th>
</tr>
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<tbody>
<tr>
<td><strong>Prerequisites</strong></td>
<td>Proposed of actual lien/levy/IA actions</td>
<td>Notice re lien (L3172) or levy (L1058 or LT11) issued</td>
<td>Notice re lien (L3172) or levy (L1058 or LT11) issued</td>
</tr>
<tr>
<td><strong>Issues the TP may raise</strong></td>
<td>Only the lien/levy/IA action proposed/taken</td>
<td>Any relevant issue including: Appropriateness of levy etc. Legal/procedural sufficiency Challenge to liability Spousal defenses other ways to resolve the case</td>
<td>Any relevant issues including: Appropriateness of levy etc. Legal/procedural sufficiency Challenge to liability Spousal defenses Other ways to resolve the case</td>
</tr>
<tr>
<td><strong>Reviewed by Appeals for</strong></td>
<td>Legal and procedural compliance of an issue Appropriateness of an action and TP’s proposed resolution</td>
<td>Legal/procedural compliance Appropriateness by the TP Is the collection action more intrusive than necessary</td>
<td>Legal/procedural compliance Appropriateness of action Issues raise by the TP Is the collection action more intrusive than necessary</td>
</tr>
<tr>
<td><strong>When to appeal</strong></td>
<td>Any time before/after lien/levy Before seizure or w/ 10 days of F2433 When proposed IA rejected When IA is proposed or terminated</td>
<td>Date of Filing + 5 business days + 30 days Within 30 days of L1058</td>
<td>After date of filing + 5 business days + 30 days after L1058</td>
</tr>
<tr>
<td><strong>GM conference required</strong></td>
<td>Yes</td>
<td>No conference required but file routed through manager</td>
<td>No conference required but file routed through manager</td>
</tr>
<tr>
<td><strong>Form for appeal</strong></td>
<td>F9423</td>
<td>Form 12153 or similar info</td>
<td>Form 12153 or similar info</td>
</tr>
<tr>
<td><strong>RO sends to Appeals</strong></td>
<td>W/I 2 bus. Days after mgr. has F9423</td>
<td>After attempts to clarify/resolve issues</td>
<td>After attempts to clarify/resolve issues</td>
</tr>
<tr>
<td><strong>Does to appeals</strong></td>
<td>File copy or needed documents</td>
<td>Entire file &amp; supporting docs</td>
<td>Entire file &amp; supporting docs</td>
</tr>
<tr>
<td><strong>Appeals priority</strong></td>
<td>Close within 5 days</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td><strong>Conference held</strong></td>
<td>Within 2 days of receipt</td>
<td>As soon as possible</td>
<td>As soon as possible</td>
</tr>
<tr>
<td><strong>Enforcement</strong></td>
<td>Generally withheld</td>
<td>Almost always withheld</td>
<td>Generally withheld</td>
</tr>
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</table>
Provided the TP did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute the liability. The issue may not be raised if the issue was considered at a previous hearing under section 6320 or 6330 OR in any other previous administrative or judicial proceeding AND the person participated meaningfully in the hearing or proceeding. If resolved and withdrawal F12256 is secured from the taxpayer, appeals does not need to get the file.

D. Do the IRS Reform Act Revisions Make the Offer in Compromise Program More Viable for the Financially Stressed Taxpayer?

1. Historically, the IRS would compromise tax liability on only two grounds: doubt as to the existence of the liability and doubt as to its collectibility. The 1998 IRS Reform Act authorized the IRS to compromise tax liabilities based on new, additional criteria, including considerations of equity and economic hardship. See I.R.C. § 7122(c); H.R. Conf. Rep. No. 105-599, at 289 (1998).

2. The 1998 legislation required the IRS to publish schedules of estimated national and local living costs that are used to ensure that taxpayers entering into compromise agreements will be left with sufficient resources to provide for basic living expenses. These financial standards are also used to determine whether the taxpayer is entitled to enter into a compromise agreement in the first instance. The IRS has posted these standards on its website. Section 7122 also prohibits the IRS from rejecting an offer from a low-income taxpayer based solely on the amount of the offer. I.R.C. § 7122(c).

3. Given that a taxpayer has other avenues available to negotiate with the IRS over the extent of his tax liability, compromises on the basis of doubt as to liability are far rarer than those for doubt as to collectibility. Particularly when the taxpayer has exhausted the pre-assessment administrative appeals procedure, the taxpayer's ability to obtain a compromise on the basis of doubt as to liability is slim. In a case where a deficiency assessment was made with little or no action by the taxpayer to defend against it, however, a representative may be able to compromise a previously-assessed liability by raising the possibility that the taxpayer might prevail in a refund action following payment.

4. More often, the IRS accepts an offer in compromise when doubt exists as to the taxpayer's ability to pay the assessed tax. In evaluating offers on this basis, the IRS conducts a thorough examination of the taxpayer's assets, liabilities and earnings potential. As with an installment agreement, the taxpayer must submit financial statements on Form 433-A or B, setting forth a full and complete description of the taxpayer's financial condition. I.R.M. [5.8]1.4. To determine whether the amount offered by the taxpayer should be accepted, the revenue officer looks primarily at two factors: (1) The taxpayer's future ability to pay, determined based on the difference between
expected monthly income and necessary expenses; and (2) the net value of all assets owned by the taxpayer.

5. Although other factors may be considered, the IRS normally requires the taxpayer to offer an amount equal to the present value of the taxpayer’s ability to pay over a four-year period plus the net realizable value of the taxpayer’s assets.

1. The net realizable value of the taxpayer’s assets is normally their “quick sale” value, generally defined as 80% of the current fair market value of the assets. I.R.M. [5.8]5.3.1.

2. Using a quick sale value takes into account the hardship caused when the taxpayer must sell an asset in a short period of time.

3. Because of the unique nature of certain assets (such as going concern value and retirement plans) the IRS has established guidelines to be used in determining whether these types of assets should be considered when calculating the minimum offer required. See generally I.R.M. [5.8] Chs. 4 & 5. As noted above, the IRS uses national and local estimates of living expenses to determine the taxpayer’s future ability to pay.

4. As a result of the IRS Reform Act, taxpayers are directed to use a four-year value test for cash offers and a five-year value test for offers to be paid over time. I.R.M. [5.8]5.7. The IRS allows the taxpayer three different payment options: (1) a cash offer, payable within 90 days; (2) a short-term deferred payment offer, payable over a two-year period; and (3) a deferred payment offer, payable over the number of years remaining in the statute of limitations on collection. I.R.M. [5.8]1.5.4.

E. Taking Congress up on its invitation/mandate to expand the offer in compromise program to include equity and hardship cases, the IRS issued temporary regulations in July of 1999 that spell out in more detail the circumstances that would justify an offer based on these new criteria. See Temp. Treas. Reg. § 301.7122-1T(b)(4). Under these temporary regulations, taxpayers may be eligible for a compromise if collection of the entire tax liability would create economic hardship, or exceptional circumstances exist that would cause collection of the entire tax liability to be detrimental to voluntary compliance. Id.

F. The temporary section 7122 regulations outline several examples applying these new standards. Temp. Treas. Reg. § 301.7122-1T(b)(4)(iv)(D). Economic hardship might exist, for instance, if a taxpayer (or his dependent) faces a long-term illness, medical condition or disability and it is foreseeable that the taxpayer’s financial resources would be exhausted as a result. Economic hardship can also
cover cases where the sale or liquidation of assets to pay a tax bill would prevent the taxpayer from meeting basic living expenses. An example might include a retiree with a retirement fund large enough to pay the tax bill, but use of the funds for this purpose might deprive the retiree of basic support and maintenance in the future. The IRS's willingness to grant a compromise based on exceptional circumstances requires an extraordinary event beyond the taxpayer's control. An example might include a taxpayer who was hospitalized for several years, during which time the taxpayer could not manage his financial affairs and was unable to file tax returns. Temp. Treas. Reg. § 301.7122-1T(b)(4)(iv)(E). Whether based on hardship or extraordinary circumstances, the taxpayer seeking the offer must have a history of timely paying his taxes and filing his returns. Moreover, the IRS warns that the expanded offer in compromise program is tailored for taxpayers involved in very severe circumstances, not those with temporary financial problems. See I.R.M. Chapter 5.8.11.

G. Practitioners were generally critical of the temporary section 7122 regulations, claiming that few taxpayers would likely qualify for relief. As a basis for these criticisms, refer to the following two Office of Chief Counsel Advice opinions.

H. In Chief Counsel Advice 200043006, the taxpayer's limited partners in a partnership that was audited under TEFRA proceedings, received a final partnership administrative adjustment denying certain deductions. After the tax matters partner unsuccessfully petitioned the Tax Court arguing that the deductions were legitimate, the taxpayers proposed a compromise based on promotion of effective tax administration. Relying on the Temporary section 7122 compromise regulations, the taxpayers argued that collection in excess of their offer would cause them economic hardship. The Chief Counsel's Office concluded that full collection would not create a hardship as contemplated by the regulations. Economic hardship is defined as an inability to pay reasonable basic living expenses, considering the taxpayer's age, employment status, dependents, and cost of living. It does not take into account maintenance of an affluent standard of living. The CCA noted that the taxpayers had assets that could be easily liquidated to pay the liability and that the liability represented only 25% of their equity in those assets. By comparison, their offer represented less than 2% of that equity.

I. In Chief Counsel Advice 200043046, the Office of Chief Counsel advised that a taxpayer's claim for relief based on the "voluntary compliance" criterion be rejected. The taxpayer, president of Company A, received a 30-day letter asserting deficiencies against him as transferee. The taxpayer argued that the liability resulted from erroneous advice from his tax advisers who had conspired, without his knowledge, to delay assessment of the tax and interest. The taxpayer made an offer in compromise, which the district counsel recommended accepting because of the IRS's delay in providing him a liability figure and his lack of involvement in the acts that resulted in the underlying liability. Although the taxpayer was fully able to pay the assessed liability, he argued that collection would be detrimental to voluntary compliance of taxpayers. The Chief Counsel's Office concluded that Congress did
not intend the IRS to adopt a standard where, in effect, the government would act as insurer or relieve taxpayers of risks relating to business and financial transactions. Compromises based on acts of third parties that are beyond the control of the IRS depart from what was contemplated in expanding the compromise rules, despite the taxpayer's noninvolvement in the acts that delayed assessment. "Compromise... in this case would create an incentive for not inquiring into the consequences of a transaction by relieving those without direct knowledge of interest accruals."

J. Processing the Offer in Compromise

1. Once a taxpayer submits an offer in compromise, collection action is normally postponed while the IRS processes the offer. I.R.M. [5.8]3.8; see also I.R.C. § 6331(k); Policy Statement P-5-100. An offer generally is processed by an IRS revenue officer who will initially review the offer for completeness and may contact the taxpayer's representative for the purpose of soliciting additional information or explanations required to evaluate the offer. See I.R.M. [5.8]3.3. Once an offer in compromise is accepted, the settlement will not be reopened unless the IRS discovers that the taxpayer falsified or concealed assets or there was a mutual mistake of fact between the parties. Temp. Treas. Reg. § 301.7122-1T(d)(5). If the taxpayer fails to carry out his obligations under the compromise agreement, the IRS can rescind the agreement and proceed to reassess and collect the originally determined liability, reduced by any payments previously made.

2. If the revenue officer rejects the taxpayer's offer, an internal review procedure takes place, after which the taxpayer is granted the right to appeal the rejection with the IRS Appeals Division. See I.R.M. (5.8) Ch.7; Temp. Treas. Reg. § 301.7122-1T(e). If the liability sought to be compromised is $2,500 or less, an oral or short written appeal is sufficient to trigger the appeal rights. For liabilities in excess of $2,500, the taxpayer must file a written protest. I.R.M. 57(10). The Appeals Office may also be asked to consider the availability of an offer in compromise as part of a CDP Hearing. If the taxpayer's office is rejected, the decision is subject to judicial review by the Tax Court. I.R.C. § 6330(d).

3. If an accepted offer is payable in installments, the taxpayer will be required to agree to toll the statute of limitations on collection for the period the offer remains in force. Temp. Treas. Reg. § 301.7122-1T(h). The taxpayer also waives the right to seek a refund for any overpayments to which he would otherwise be entitled to during the period covered by the offer. I.R.M. [5.8]1.5.4.3.

4. The expanded offer in compromise program has led to a backlog in the IRS's ability to process offers in a timely manner. To reduce this backlog, the IRS has established an on-line offer in compromise program, which permits taxpayers to request a compromise electronically in cases where the total amount in issue is $50,000 or less. The taxpayer makes the request by using special on-line forms (656-P Offer in Compromise; 433-OIC Financial Statement). The on-line program may be accessed through the IRS's website at www.irs.gov/ind_info/index/html.
VIII. **Offers in Compromise Reference Guide**

**What authorizes an Offer In Compromise?**

Authorization for the Government to settle liabilities through an Offer In Compromise (OIC or offer) has been in existence since 1831. Legal authority for compromising a tax liability and accepting Offers in Compromise is found in Section 7122 of the Internal revenue Code (IRC) and Section 301.7122-IT of the Treasury Regulations.

Section 7122(a), IRC provides that the Secretary *may* compromise any civil or criminal case arising under the Internal Revenue laws prior to reference to the Department of Justice for prosecution or defense.

Within the Appeals organization, authority to accept OICs has been redelegated down to the Chief Appeals, Assistant Chiefs, Team Chiefs and Team Managers.

Section 7122(b), IRC provides that certain accepted offers will be open to public inspection and requires a review of offers that compromise a total liability of $50,000 or more, including accruals. Counsel performs this review.

The Revenue and Restructuring Act of 1998 (RRA’98) added subsections (c) and (d) to Section 7122, IRC. Section 7122(c), IRC, codifies the use of standardized expense guidelines such as the National Standard Expenses but allows these guidelines to be exceeded when necessary to provide a taxpayer basic living expenses. Section 7122(d), IRC, mandates the review of offers where there is a proposed rejection of the offer and allows for the appeal of any offer rejection to Appeals.

**What Can Be Compromised**

1. **Taxes** – Generally, a submitted OIC will cover the entire tax liability for a stated period, including penalties and interest.

2. **Penalties** – An OIC may be submitted to compromise a disputed penalty provided that the underlying tax, interest and any undisputed penalties have been paid.

3. **Forfeitures** – OICs can be submitted when a party in interest offers to forfeit some, but not all, of the seized property to the Government.
Types of Offers

Section 301.7122-IT provides the criteria for accepting an OIC. An offer can be submitted based on any or all or any combination of these criteria for making an offer. However, an offer can only be accepted based upon one of these criteria. The criteria are:

1. **Doubt as to Liability** – The Examination function within Compliance generally investigates doubt as to liability offers. There are exceptions to this general rule. For example, the Collection function investigates offers involving Trust Fund Recovery Penalties (TFRP).

   a. There is no basis for compromise on doubt as to liability when the liability is certain. For example, where the liability was resolved by a Tax Court decision or with a Closing Agreement.

   b. There must be a bona fide dispute as to a question of fact or law with respect to the merits of the liability.

   c. The compromise must be justified based upon a degree of doubt such as litigating hazards.

   d. Section 3466 of RRA'98 amended Section 7122, IRC, to provide that taxpayers do not have to submit financial statements when the offer is based on doubt as to liability and provides that no doubt as to liability offer will be rejected solely because the Secretary is unable to locate the taxpayer’s return or return information.

2. **Doubt as to Collectibility** – The vast majority of the offers involve circumstances in which collection is in doubt. Typically, these offers are investigated by the Collection function within Compliance. The key issue is whether the taxpayer is offering to pay an amount equal to, or more than, the amount the Service could otherwise collect. Policy Statement P-5-100 provides that the Service will accept an offer if the amount offered reasonably reflects collection potential.

   a. Collectibility determinations are based on the potential collection from a taxpayer’s assets, including net worth and present and future income. See Section 57(10)(10) of the Internal Revenue Manual (IRM).

   b. Consideration is to be given to all the priorities granted to the Government by statutes.
c. An acceptable offer should reflect the taxpayer’s maximum capacity to pay based upon his equity in assets and his present and future income potential.

d. Completed financial statements must accompany a doubt as to collectibility offer. Form 433A is used for individuals and Form 433B is used for business entities.

3. Effective Tax Administration (ETA) – The Congressional Committee Report for RRA’98 suggested that the IRS take into account equity, hardship and public policy where an offer would promote effective tax administration. Thus, Temporary Regulation 301-7122-1T(b)(4) provides for the acceptance of ETA offers.

   a. The offer must not qualify for acceptance based on either doubt as to liability or doubt as to collectibility.

   b. Collection of the full liability would create an economic hardship or would be detrimental to voluntary compliance.

   c. Regulation 301-7122-1T(b)(4)(B) provides that factors indicating economic hardship include:

      - Taxpayer is incapable of earning a living because of long-term illness, medical conditions or disability and it is reasonably foreseeable that the taxpayer’s financial resources will be exhausted providing care and support.

      - Liquidation of assets would render the taxpayer unable to meet basic living expenses.

      - Taxpayer is unable to borrow and liquidation of assets would have sufficient adverse consequences such that enforced collection is unlikely.

   d. Regulation 301-7122-1T(b)(4)(C) provides factors that support a determination that compromise would not undermine compliance. These include:

      - Taxpayer does not have a history of noncompliance

      - Taxpayer has not taken deliberate actions to avoid payment of taxes

      - Taxpayer has not encouraged others to refuse to comply with tax laws.
e. Contractual terms of the Form 656 must be met.

4. **Offer in Forfeiture Cases** – Offers in forfeiture area are based on doubt as to liability, not doubt as to collectibility, since the property is already in the government’s possession.

**Counsels Role and Delegation Order 11**

As noted above, Section 7122(b), IRC, provides that all offers where the assessed liability (including accruals) is $50,000, or more, must be reviewed by Counsel prior to final acceptance. Counsel’s review is to determine whether the offer is legally sufficient. Counsel does not review an offer for the valuation of assets or the analysis of income and allowable expenses unless the determination is obviously erroneous.

Typically, an offer cannot be accepted if it is not legally sufficient. However, Delegation Order 11 provides authority to accept an offer in the event Counsel renders a negative legal opinion, regardless of the amount of the liability sought to be compromised. Within the Appeals organization this authority has been delegated down to the Area Director.

**Special Circumstances**

Some taxpayers may not be able to pay the tax in full, but cannot offer an amount at least equal to their realizable equity in assets plus their future ability to pay due to special circumstances. Special circumstances might include:

- Advanced age,
- A serious illness from which recovery is unlikely, a situation where liquidation of assets would render the taxpayer penniless or
- Other unusual circumstances.

These types of offers are subject to approval under delegation Order 11 discussed above.

**How to Make an Offer**

Offers are submitted using Form 656, Offer in Compromise. The May 2001 revision is actually a booklet which includes information about offers, the actual offer Form 656, instructions, financial information Forms 433-A (for individuals) and 433-B (for businesses), worksheets and other information.
Beginning July 23, 2001 Virginia taxpayers submit Forms 656 to the Brookhaven Service Center.

- Taxpayers who are wage earners or are self employed and have no employees send their Form 656 to:

  Brookhaven Internal Revenue Service
  Center COIC Unit
  PO Box 9007
  Holtsville, NY 11742-9007

- All other taxpayers send their Form 656 to:

  Brookhaven Internal Revenue Service
  Center COIC Unit
  PO Box 9008
  Holtsville, NY 11742-9007

**Refunds Due Taxpayer**

Form 656 provides that as part of the consideration for the offer the United States can keep any amount due to overpayment of any liability for periods prior to and/or within the year the offer is accepted. The amount retained cannot exceed the difference between the amount compromised and the amount offered.

**Payment Terms**

There are three options to pay the offered amount:

1. **Cash Offer** – Payment of the entire amount offered must be paid in 90-days, or less, from the date the offer is accepted. The amount offered will include the quick sale value of the taxpayer's equity in assets (normally 80% of the fair market value) plus the total amount the IRS could collect through monthly payments over 48 months (or the remainder of the statutory period for collection, whichever is less).

2. **Short Term Deferred Offer** – Payment of the total amount takes more than 90-days, but final payment is within 24 months from the date the offer is accepted. The offered amount will include quick sale value of the taxpayer's equity in assets plus the total amount the IRS could collect through monthly payments over 60 months (or the remainder of the statutory period for collection, whichever is less).

3. **Deferred Payment Offer** – Payment of the total amount offered takes place more than 2-years from the date the offer is accepted. The Deferred Payment offer's terms are dependent on the taxpayer's ability to make monthly

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payments over the remaining life of the collection statute. Normally, these payments are made through monthly payments that last what would have been the collection statute.

**Not Processable**

Offers may be rejected prior to any investigation if they are considered not processable. If the offer is not processable the decision to reject the offer cannot go to Appeals. There are currently two grounds for rejecting an offer as not processable. They are:

- The taxpayer is not current with all required tax filings.
- The taxpayer is in bankruptcy.

**Low Dollar Offers**

RRA'98 amended Section 7122, IRC to provide that the Service will not reject an offer from a low-income taxpayer “solely on the basis of the amount of the offer”. Thus, if a small dollar amount represents the most, or more, than what the Service could otherwise expect to collect, the offer can be accepted.

**Public Policy Rejection**

Section 5.8.7.3 deals with “public policy” rejections and Policy Statement P5-89 states that...."if acceptance of an offer might in any way be detrimental to the Government's interest, it may be rejected even though it is shown conclusively that the amounts offered are greater than could reasonably be collected in any other manner.”

**Appeal of Proposed Rejection of Offers**

RRA'98 added Section 7122(d), IRC, which required the Service to establish procedures to allow a taxpayer to appeal any rejection of an offer to the IRS Office of Appeals. IRS procedures already provided for review by Appeals and the manner in which to request Appeals consideration. Where Compliance has proposed to reject an offer:

1. The taxpayer will receive a letter from the Service proposing a rejection of the offer and setting out the reasons for the proposed rejection. This is typically done with a Letter 238 (AOIC).

2. Appeals consideration should be requested through the office or function that is proposing to reject the offer or has sent the Letter 238. Typically, the request should be made within 30-days of the date of the proposed rejection letter. If the appeal is not timely, Compliance will reject the offer.
3. The protest requesting Appeals consideration should detail the why the taxpayer believes that the offer should be accepted.

4. The function receiving the request for Appeals consideration, will forward the file with the taxpayer’s protest to Appeals for consideration. In doing so, Compliance will comment on issues raised or mentioned by the taxpayer in their request for Appeals consideration if these were not previously addressed.

**Key Items for Consideration and Verification**

- **Real Estate** – Including real estate the taxpayer owns or has an interest in such as their residence, rental property, vacant lots, investment property, second homes, etc.
- **Motor Vehicles** – Including recreational vehicles, boats, motorcycles, jet skis, snowmobiles, etc.
- **Financial Accounts** – Including checking, savings, IRAs, 401Ks, money markets, mutual funds, bonds, stocks, etc.
- **Income** – Including salary or wages, income from business or investment and explanation of Form 1040, Schedule D and E income and losses.
- **Expenses** – Allowable expenses, all unusual or significant expenses including health, housing and insurance.
- **Recent tax returns of the taxpayer**
- **Valuation of current assets including interests in businesses**
- **Collateral agreements** are additional consideration for an offer and are part of the offer to which they relate. Collateral agreements can be used to take into account future income or the impact of basis in assets, net operating losses, bad debts, etc.
- **Areas of controversy** often involve items such as charitable contributions, private schools for dependents, college costs for dependents, life insurance, transportation expenses and similar items.

**Acceptance of an Offer**

No offer is accepted until the Commissioner or his delegate executes the appropriate acceptance form. This is typically a Form 7249, Offer Acceptance Report as well as an acceptance letter and the taxpayer is notified in writing of the acceptance of the offer. Acceptance of the offer is a legal contract between the...
Government and the taxpayer. An informal settlement between a taxpayer and an Appeals Officer is not binding on the Service unless, and until, it is accepted by and on behalf of the Commissioner. *Hoffmaster v United States*, 89-8417 (SD Fla 12/4/90).

Acceptance of a check is not a compromise in settlement. This is true even if the taxpayer writes on the check that the payment is in full of any balance due on the taxpayers' accounts. *Smith v US*, 86-2 USTC 9536 (ND Tex 1986); *Laurins v Commissioner*, 889 F.2d 910 (9th Cir., 1989).
APPENDIX

TAX CONTROVERSY PANEL STUDY SCENARIO

ABC Printing Company, a Virginia corporation, has a printing facility and sales office located in the City of Richmond. ABC Printing Company has five shareholders. Three of the shareholders are corporate officers. Robert Smith is President of ABC Printing Company, and a shareholder. Buster Brown is Vice President and Chief Operating Officer of the printing company. Tom Adams is ABC Printing Company's Chief Financial Officer and Corporate Treasurer. Both Tom Adams and Buster Brown are shareholders of ABC Printing Company.

ABC Printing Company was founded in 1982 as a small custom printing operation which grew fairly conservatively over the years. As a result of this slow growth, ABC Printing Company did not suffer from the occasional business downturn, including the tough times that occurred in the 1991-1992 time period. In 1996, ABC Printing Company acquired another local printing company which enabled it to double the size of its workforce. ABC Printing Company currently employs 84 people. The Company has also recently purchased two new German printing presses which required the company to obtain approximately $500,000 of financing to pay for the acquisition of these two new printing presses. In connection with the arrival of the two printing presses, ABC Printing Company relocated its printing and sales facility to a larger location. The new facility build-out was financed internally by the landlord and the cost was built in to ABC Printing Company's lease payments. ABC Printing Company entered into a 10 year lease of the facility.
After the move in of the new facility in 1999, ABC Printing Company expended a considerable amount of funds in advertising and promotional events in an effort to acquire larger customers. The results of this campaign were mixed, although, one of ABC Printing Company’s largest customers is a result of this promotional effort. However, in year 2000, this large customer experienced financial trouble and has increasingly stretched out the time period over which it paid off ABC Printing Company invoices. By early 2001, ABC Printing Company realized that its growth efforts had stalled and that most of its customers were paying bills slower and reordering supplies at a slower rate. By mid 2001, ABC Printing Company began to experience cash shortages which forced it to max out its credit line with the local bank, ABC Printing Company also stopped taking advantage of account payable discounts (2%-5%), which had been afforded to ABC Printing Company by its key suppliers. As a result of this combination of activities, ABC Printing Company was frequently required to pay for the delivery of paper and printing supplies on a COD basis.

Coinciding with the economic slow down were the tragic events of September 11, 2001, which greatly impacted ABC Printing Company’s revenues. Many custom printing job orders were cancelled. ABC Printing Company was now finding it difficult to locate additional sources of financing in order for it to timely pay its bills. ABC Printing Company was also experiencing an even greater degree of difficulty collecting its accounts receivables on a timely basis. This combination of events caused the company to “temporarily borrow” withheld employee income and employment taxes to pay its COD suppliers, with the expectation that the borrowed
funds would be replaced within several days; hopefully before the trust fund taxes had to be remitted to the federal and state tax authorities.

By November 2001, ABC Printing Company was now late in remitting the withheld employment and income taxes to the federal and state tax authorities and being penalized heavily for the late payments. ABC Printing Company is two weeks behind in remitting the current income and employment taxes which have been withheld from its employees and overdue with the tax authorities.

Tom Adams has approached you requesting assistance regarding how to properly negotiate out of these stressful times for ABC Printing Company. Furthermore, Tom informs you that a local community bank has expressed a willingness to provide short-term financing so that Tom can insure that the Company's wages are timely paid to its employees as well as to get "caught up" on the withheld income and employment taxes. Tom is also very concerned about any potential personal liability that he may have.

Tom confides in you that during the Company's last several planning sessions, forecasting of revenue for years 2002 and 2003 appear to be well below current levels and senior management does not seem able to find ways to increase revenue. Tom confides in you that he has been approached by Robert Smith (President) and Buster Brown (Chief Operating Officer), individually, with specific instructions to pay certain key vendors when supplies are delivered to insure that the current work orders on printing jobs are completed on a timely basis. Tom further confides in you that he is concerned that this will cause Tom to continue to borrow from withheld taxes and to cause future payments of income and employment taxes
to remain tardy. Tom essentially indicates that he has been ordered to take care of these key suppliers first and worry about the taxes later.

Can you help Tom out? Does your assistance to Tom pose any problems with your advice to ABC Printing Company? Can you help Tom structure the short term financing from the local community bank to avoid any Internal Revenue Code Section 3505 funding and tax liability issues? Are Robert Smith, Buster Brown, and Tom Adams at risk for Code Section 6672 assessments? Will Chapter 11 bankruptcy reorganization protect the company and its officers from these tax liabilities? Can the IRS still file liens and levy on the Company's assets, and the individual officers assets?