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DECEMBER 2001 *BULLETIN NO. 495*

COLLECTION, BANKRUPTCY AND SUMMONSES BULLETIN

Department of the Treasury Office of Chief Counsel Internal Revenue Service

Tax Court Restricts CDP Jurisdiction, Overruling Prior Opinions, In Series of Three Decisions

1. Court Does About-Face on Question of CDP Jurisdiction, Will No Longer Look Behind Notice of Determination to Address Whether "Hearing" Was Conducted

Reversing Meyer v. Commissioner, 115 T.C. 417 (2000), a majority of the Tax Court stated it would not look behind an Appeals notice of determination in deciding whether it has jurisdiction over a collection due process case. In Lunsford v. Commissioner, 117 T.C. No. 16 (2001) ("Lunsford I"), the court held that, as long as the notice of determination under I.R.C. 6330 is valid on its face and a timely petition for review has been filed, the Tax Court will have jurisdiction to review that determination.

At the Appeals hearing in this CDP case, the taxpayers challenged the validity of the assessments, asserting the lack of a "valid summary record of assessment." In response, the appeals officer wrote a letter to the taxpayers indicating that the assessments had been verified and attaching a copy of the Form 4340, Certificate of Assessments and Payments. The letter invited the taxpayers to contact the appeals officer by a specific date if they wished to discuss other matters, such as resolution of the liability. The taxpayers did not respond to the letter and the appeals officer issued a notice of determination sustaining the proposed levy. The taxpayers timely filed a petition for Tax Court review.

The trial judge raised the question of the court's jurisdiction on the ground that the taxpayers may not have been afforded a proper hearing before Appeals. In Meyer v. Commissioner, supra at 422-423, the Court had held that it lacked jurisdiction under section 6330(d) if the taxpayer was not given an opportunity for an Appeals hearing.

Writing for the court, Judge Ruwe began by observing that the Meyer court should not have decided whether the notice of determination was valid because it did not have subject

matter jurisdiction over the type of tax at issue. The validity of the hearing in Meyer was a matter for determination by a district court, which has subject matter jurisdiction over CDP cases involving frivolous return penalties.

The court further reasoned that its analysis in Meyer improperly required it to look behind the notice of determination. Analogizing to notice of deficiency cases, the court held that it had jurisdiction under section 6330(d)(1)(A) where there is a written notice that embodies a determination to proceed with the collection of the taxes at issue and a timely filed petition. The court overruled Meyer to the extent that it holds that the court must first look behind the notice of determination to see whether a proper hearing was offered in order to have jurisdiction.

Judge Halpern wrote a lengthy concurring opinion, looking to provisions of the Administrative Procedure Act for support for the proposition that a failure to offer the taxpayer a section 6330(b) hearing is not a jurisdictional defect. He also found support in the APA for the proposition that it is up to the Commissioner to determine the form of a section 6330(b) hearing. He pronounced Meyer incorrect to the extent it appeared to hold that an exchange of correspondence could not constitute a proper CDP hearing. Judge Beghe also wrote a brief concurrence.

Judge Foley dissented, stating that Meyer was correct and that the court must first determine whether a "hearing" took place in order to conclude it has jurisdiction. Judge Vasquez also dissented, complaining that the court had unnecessarily departed from principles of stare decisis.

2. Tax Court Need Not Determine if "Hearing" Conducted Where Lack of Hearing Not Raised in Taxpayers' Petition

In a second opinion in the Lunsford case, the Tax Court held that, having concluded it had jurisdiction, it need not address the validity of the CDP Appeals hearing where the taxpayers had not challenged the validity of the hearing in their petition for review. Lunsford v. Commissioner, 117 T.C. No. 17 (2001) ("Lunsford II").

In their petition, the taxpayers had contended that the appeals officer could not rely merely on a Form 4340 to verify the existence of a valid assessment. The court readily dispensed with that argument, noting that it had been rejected in Davis v. Commissioner, 115 T.C. 35 (2000). The court went on to conclude that the taxpayers were not asserting that respondent failed to offer them a hearing per se. Although they were seeking relief in the form of a remand to Appeals, the court found that a remand would not be necessary or productive. It noted that there may be cases in which a taxpayer was not given a proper opportunity for an Appeals hearing where it would be appropriate to require that an Appeals hearing be held, but this was not such a case.

Judge Halpern concurred, incorporating his comments in Lunsford I.

Judge Colvin led off a series of dissenters, stating that the Commissioner had the obligation to provide the taxpayers with an opportunity for a hearing before an appeals officer whether or not the taxpayers raised the issue in their petition, and that the court should require the Commissioner to provide that opportunity. Judge Laro penned a lengthy dissent, taking issue first with the majority's conclusion that the taxpayers had failed to assert their right to a hearing. Laro also took the majority to task for ignoring what he termed the "legislative mandate" that all taxpayers be offered a face-to-face hearing with Appeals in CDP proceedings. Finally, Judge Foley dissented separately to make clear his view that taxpayers must be offered a face-to-face hearing with Appeals even if the court believes it would be unproductive.

3. Tax Court Will Not Determine Whether 6330(b) Hearing Requirement Met Where it Lacks Subject Matter Jurisdiction, Again Overruling Earlier CDP Opinion

In Johnson v. Commissioner, 117 T.C. 18 (2001), another full Tax Court opinion, the Court held that where it does not have jurisdiction over the underlying type of tax, it is inappropriate for it to determine whether the petitioner was provided with a collection due process "hearing" for purposes of I.R.C. § 6330(b). The court overruled Meyer v. Commissioner, 115 T.C. 417 (2000), "to the extent it holds to the contrary," for the second time in the same day.

Following Van Es v. Commissioner, 115 T.C. 324, 328-329 (2000), the court held that it lacked jurisdiction under section 6330(d)(1)(A) to review a determination to collect by levy a frivolous return penalty under section 6702. Treating case law governing the disposition of deficiency cases as analogous, the Court dismissed the taxpayer's petition for lack of jurisdiction without addressing whether the Appeals hearing was proper.

Judge Vasquez concurred with the majority holding that the Court lacked jurisdiction in light of Lunsford I, but found the majority's discussion of Meyer unnecessary. He also noted his disagreement with Judge Behge. In dissent, Judge Behge maintained that the Court should have taken jurisdiction, held that the hearing requirement was satisfied, and upheld respondent's determination "to put an end" to what he regarded as the taxpayer's attempt merely to delay. He also suggested that the Tax Court may have jurisdiction in all CDP cases, regardless of the type of underlying tax. This, he stated, was a preferred reading of section 6330(d)(1)(B), since it would eliminate the opportunity for abuse by taxpayers who intentionally file in the wrong court. Judge Behge invited Congress to enact more explicit language that would ensure "one stop shopping" in all CDP cases, and he warned taxpayers and their counsel who file CDP cases in the Tax Court that should be filed in a district court that they face penalties of up to $25,000 under section 6673.

COLLECTION DUE PROCESS

First Circuit Reverses BAP To Hold Interest on Post-petition Taxes Entitled to First Priority in Chapter 7

The Court of Appeals for the First Circuit, in In re Weinstein (United States v. Yellin), 2001 U.S. App. LEXIS 25446 (1st Cir., November 30, 2001), has held that interest on a post-petition tax claim filed in a Chapter 7 case is entitled to first priority treatment along with the tax claim, and is payable pursuant to B.C. § 726(a)(1).

The issue presented in Weinstein was whether interest on a post-petition tax claim was entitled to payment pursuant to B.C. § 726(a)(1), which affords first-priority treatment to administrative expense claims, or pursuant to B.C. § 726(a)(5), which affords fifth-priority treatment to "payment of interest ... from the date of the filing of the petition ... ." Both the bankruptcy court and the Bankruptcy Appellate Panel (BAP) determined that Section 726(a)(5) mandated that the interest be paid separately from the underlying post-petition tax claim, as a fifth-priority expenditure.

In reversing the BAP's decision, the First Circuit initially noted that four other circuits had resolved in the Government's favor that interest accruing on post-petition liabilities of the estate is entitled to administrative expense priority status under B.C. § 503. The court noted, however, that none of those cases either "arose entirely under" Chapter 7 or addressed the potential relevance of Section 726(a)(5). The court then considered the text of the statute itself, ultimately determining that the interrelationship among sections 503(b), 726(a)(1), and 726(a)(5) rendered the language of the statute unclear so that the court could not rely on any plain language meaning alone to resolve whether interest on post-petition taxes of the estate is entitled to the same priority status as the taxes themselves.

Next, the court examined the Bankruptcy Code in the context of case law preceding its enactment. The court viewed Nicholas v. United States, 384 U.S. 678 (1966), relevant to the extent that Nicholas holds that a post-petition tax claim includes interest accrued during the same phase of the bankruptcy proceeding. The court reasoned that Congress, in enacting the Code, would have assumed that the courts would preserve the rule of Nicholas unless otherwise directed, suggesting that in post-Code cases, interest should be afforded the same priority as the obligation on which it accrues. The court went on to address the legislative history of the statute, determining that the legislative history was largely inconclusive.

Finally, the court considered the policies underlying the statute, finding that the most compelling policy consideration was the need to ensure that trustees pay post-petition tax claims promptly. The court determined that the statutory scheme of imposition of penalties provides inadequate incentives to satisfy this need, whereas affording first-priority

treatment to payment of interest would do so. The court stated that it found this policy consideration, as well as the Code's historical context, "most useful" in analyzing the issue presented. The court concluded that a proper reading of the statute includes interest as part of a post-petition tax incurred by a bankruptcy estate, and held that the Service was entitled to payment of interest on its post-petition tax claim as an administrative expense under Section 726(a)(1).

BANKRUPTCY CODE CASES: Interest: Distribution in Chapter 7

CASES

1. **BANKRUPTCY CODE CASES: Appeals**
   In re Pattullo, 2001 U.S. App. LEXIS 24947 (9th Cir., November 21, 2001) – Court determined that appeal before it, presenting issue of whether Service was precluded by res judicata from raising an issue pertaining to debtor's Chapter 13 eligibility, was moot, since the dismissal of the underlying bankruptcy case prevented the court from granting any effective relief with respect to the issue presented. The court noted that neither the fact that the bankruptcy might be reinstated nor the fact that another bankruptcy case presenting the same issue might be filed was relevant to the mootness inquiry.

2. **BANKRUPTCY CODE CASES: Jurisdiction of bankruptcy court**
   In re Numed Healthcare Inc., 2001 U.S. Dist. LEXIS 19264 (M.D. Fla., October 12, 2001) – District court denied Service's request to have its lien priority case tried in district court, rather than in bankruptcy court, where bankruptcy court was already familiar with the numerous creditors and debtors involved in the underlying bankruptcy case, where disposition of the lien priority issue did not necessitate any substantial or material consideration of nonbankruptcy federal law, and where the discovery needed to resolve the issue would be more efficiently conducted in the context of the bankruptcy proceeding than in that of a district court proceeding.

3. **COLLECTION DUE PROCESS**
   Moore v. Commissioner, T.C. Memo. 2001-305 (November 27, 2001) – Where taxpayer did not affirmatively deny that he received Notices of Deficiency which were documented to have been mailed by the Service, and where he never challenged the deficiencies by instituting appropriate proceedings in the Tax Court, the taxpayer was precluded from raising a statute of limitations defense in a proceeding to review a Notice of Determination regarding the same liabilities.

4. **COLLECTION DUE PROCESS**
   Strickland v. Commissioner, T.C. Memo. 2001-312 (December 13, 2001) – Since Tax Court petition contained no allegation of error as to the Service's Notice of Determination, the Tax Court, pursuant to Lunsford v. Commissioner, 117 T.C. No. 17 (2001)(Lunsford II)(see pp. 2-3, supra), confined its analysis to only the issues raised in the petition. Moreover, the taxpayer was precluded from raising the issue of the amount and/or the existence of an underlying tax liability since he never contested the Notices of Deficiency issued by the Service, and the court found that the Service did not abuse its discretion in refusing to accept an offer to compromise a liability of $8,422.16 for $0. Pursuant to Lunsford II, the Court considered taxpayer to have

abandoned the potential issue of whether the Service properly substituted a revenue agent for an Appeals officer to hold the Collection Due Process hearing, since that issue was not presented in the Tax Court petition.

5. INNOCENT SPOUSE

Flores v. United States, 2001 U.S. Claims LEXIS 232 (U.S. Ct. Cl., November 28, 2001) – In a case of first impression, the Court of Federal Claims held that the effective date provision for I.R.C. § 6015(f), added to the Code in 1998 to afford entitlement to "innocent spouse" relief on an equitable basis, indicates that relief under Section 6015(f) should be granted from the entire liability at issue, rather than solely the portion remaining unpaid as of the provision's effective date, if any portion of the liability remained unpaid as of that date.

6. LEVY: Honoring, effect of

Scott v, Hilton Grand Vacations Club, 2001 U.S. Dist. LEXIS 21143 (D. Hawaii, October 16, 2001) – Pursuant to I.R.C. § 6332(e), taxpayer's employer was immune from liability for withholding funds from taxpayer's wages because employer did so in compliance with the Service's levy. Moreover, taxpayer was not entitled to bring suit against the Service in district court since he did not either seek review in Tax Court or fully pay the amount of the alleged liability prior to initiating the district court lawsuit.

7. LIENS: Priority over security interests
Filing

Whiting-Turner/A.L. Johnson v. PDH Development Inc., 2000 U.S. Dist. LEXIS 5105 (M.D. Ga., March 21, 2000) – Bank's security interest in accounts receivable had priority over federal tax lien pursuant to I.R.C. § 6323(a) and (c) where its security interest came into existence prior to the filing of the Notice of Federal Tax Lien. Moreover, tax lien was properly filed pursuant to I.R.C. § 6323(f) regardless of the fact that the identification of the taxpayer contained in the filing was incorrect in certain minor respects, since a reasonable inspection of the local lien index would have revealed the existence of the federal tax lien.

8. PROPERTY SUBJECT TO COLLECTION: Trusts

United States v. Delano, No. 99-S-2209 (D. Colo., November 2, 2001) – Where circumstances surrounding the creation and terms of a trust indicated that it was not a "discretionary" trust, taxpayer, the sole beneficiary and a co-trustee of the trust, possessed a property interest in the trust under applicable state law, and the federal tax lien attached to that property interest.

9. SUMMONSES: Third-party summonses: Right to intervene or proceed to quash
Third-party recordkeeper

Gilmartin v. IRS, 2001 U.S. Dist. LEXIS 19790 (S.D.N.Y., November 26, 2001) – Court dismissed taxpayer's petitions to quash 11 summonses to third-party recordkeepers, on grounds that: 1) two of the petitions were untimely; 2) the court lacked jurisdiction over two of the petitions because the summonses to which they were related were not issued to third-party recordkeepers as defined by I.R.C. § 7603(b)(2); and 3) the remaining summonses satisfied the requirements for enforcement established by United States v. Powell, 379 U.S. 48 (1964).

10. THIRD-PARTY CONTACTS

Seawright v. Commissioner, 117 T.C. No. 24 (December 18, 2001) – Tax Court held Section 7602(c) did not apply to impose restrictions on the Service's contacts with third parties, where all the contacts at issue either took place prior to January 19, 1999, the effective date of Section 7602(c), or were made in the context of preparing for trial and not with respect to examination or collection activities. Section 7602(e) was similarly inapplicable, since the alleged violations of that provision took place prior to July 22, 1998, the effective date of Section 7602(e).

11. TRANSFEREES AND FRAUDULENT CONVEYANCES: Nominee

United States v. Novotny, No. 99-D-2196 (D. Colo., November 8, 2001) (decision on reconsideration) – In reversing in part its prior decision to not address the Government's allegation that the trusts at issue were actually nominees of the taxpayer or were sham trusts, the court deemed the theory germane, but ultimately determined that the Government was not entitled to summary judgment as genuine issues of material fact remained.

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

CHIEF COUNSEL ADVICE

BANKRUPTCY CODE CASES: Assessment
(See supplemental CCA following)

CC:PA:CBS:BR1
June 4, 2001

UILC: 6213.09-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR LOS ANGELES ASSOCIATE AREA COUNSEL, SBSE

FROM: Assistant Chief Counsel (Collection, Bankruptcy & Summonses)
CC:PA:CBS

SUBJECT: Validity of an assessment made during a bankruptcy case where statutory notice of deficiency was previously issued during the same bankruptcy case

This Chief Counsel Advice responds to your memorandum dated February 16, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Year 1= 1993

ISSUES

(3) Is the Year 1 assessment valid, where the statutory notice of deficiency was issued and assessment was made during the taxpayer's uninterrupted Chapter 11 bankruptcy proceeding?

(4) If the assessment is invalid, on what basis should the case be decided?

CONCLUSIONS

1. The assessment is invalid because the 90-day period during which the taxpayer could file a petition with the Tax Court was suspended by the bankruptcy proceeding. Therefore, when the assessment was made, the 90-day period had not expired.

! We should enter into a stipulated decision that the Year 1 liability is $0, based on the invalidity of the December 2, 1996 assessment.

FACTS

The taxpayer is challenging the accuracy of her Year 1 liability in a Tax Court petition seeking review of a notice of determination issued by the Internal Revenue Service (Service) Office of Appeals pursuant to I.R.C. § 6330(d). The relevant facts are as follows.

The taxpayer filed a Chapter 11 bankruptcy case on May 24, 1996. While the case was pending, the Service sent her a statutory notice of deficiency for the Year 1 tax liability on July 3, 1996, an act permitted by the express language of 11 U.S.C. § 362(b)(9). However, the taxpayer was precluded by the automatic stay, 11 U.S.C. § 362(a)(8), from filing a petition with the Tax Court based on the statutory notice, unless she obtained an order from the bankruptcy court lifting the stay. The docket sheets from the Chapter 11 proceeding do not show that the taxpayer applied to lift the stay to bring a proceeding in the Tax Court. On December 2, 1996, the Service assessed the deficiency against the taxpayer. The Chapter 11 case was dismissed on January 29, 1997, thereby lifting the stay. No plan of reorganization was ever confirmed by the court. On March 13, 1997, forty-three days after the dismissal, an involuntary Chapter 7 case was filed against the taxpayer. The Chapter 7 case was dismissed on April 6, 1998, thereby lifting the stay.

LAW AND ANALYSIS

The general rule is that if a taxpayer does not file a petition within 90 days after the notice of deficiency is mailed, the deficiency may be assessed. I.R.C. § 6213(a). However, because of 11 U.S.C.§ 362(a)(8)'s prohibition on the filing of a Tax Court petition, I.R.C. § 6213(f) suspends the 90-day period for 60 days, plus the period the automatic stay is in effect. Guerra v. Commissioner, 110 T.C. 271, 275 (1998); Thompson v. Commissioner, 84 T.C. 645, 648 (1985); Douglass v. Commissioner, T.C. Memo 1997-272, 1997 Tax Ct. Memo LEXIS 332.

The first 43 days of the 90-day period ran between the dismissal of the Chapter 11 case and the filing of the Chapter 7 petition. The remaining 47 days, plus the 60 days added by section 6213(f), began to run after the dismissal of the Chapter 7 case on April 6, 1998. Therefore, the taxpayer had until July 22, 1998, to petition the Tax Court. In other words, the time for filing a Tax Court petition had not expired when the deficiency was assessed on December 2, 1996.

An assessment made prior to the expiration of time to petition the Tax Court is invalid. Philadelphia & Reading Corp. v. United States, 944 F.2d 1063, 1070-1071 (3d Cir. 1991); Maxwell v. Campbell, 205 F.2d 461 (5th Cir. 1953); United States v. Yellow Cab Co., 90 F.2d 699 (7th Cir. 1937); Ventura Consolidated Oil Fields v. Rogan, 86 F.2d 149, 153-154 (9th Cir. 1936); cf. Johnson v. United States, 990 F.2d 41 (2nd Cir. 1993). But see Lyddon & Co. v. United States, 141 Ct. Cl. 545, 158 F. Supp. 951 (1958); Lehigh Portland Cement Co. v. United States, 90 Ct. Cl. 36, 30 F. Supp. 217 (1939). Because the time for the taxpayer to file a petition had not expired when the Year 1 assessment was made, we conclude the assessment is invalid.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Considering the three year statute of limitations for assessment under I.R.C. § 6501(a), including the suspension of the statute of limitations pursuant to I.R.C. § 6503(a)(1) during the bankruptcy cases, plus 60 days, the time to reassess the deficiency under section 6501(a) has passed. Even if the deficiency can be reassessed under some other provision, such as section 6501(e), the I.R.C. § 6330 petition should be conceded.

In the notice of determination, the Appeals officer determined pursuant to I.R.C. § 6330(c)(2)(B) that the taxpayer could not challenge her Year 1 liability because she had been given an opportunity to challenge the deficiency when she received the statutory notice of deficiency. Notwithstanding the correctness of the Appeals officer's determination under section 6330(c)(2)(B), he should have determined under I.R.C. § 6330(c)(1) that the assessment is invalid. Because the taxpayer's sole challenge in her petition is to the Year 1 assessment, and because the assessment is invalid, we should enter into a stipulated

decision that the Year 1 liability is $0. However, care should be taken in drafting the decision document so as not to prevent reassessment of the liability in the event some statutory exception to the three-year statute of limitations is applicable.

BANKRUPTCY CODE CASES: Assessment
(Supplements previous CCA)

CC:PA:CBS:BR1

September 7, 2001

UILC: 6213.09-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR LOS ANGELES ASSOCIATE AREA COUNSEL, SBSE

FROM: Assistant Chief Counsel (Collection, Bankruptcy & Summonses) CC:PA:CBS

SUBJECT: Supplemental response - Validity of an assessment made during a bankruptcy case where statutory notice of deficiency was previously issued during the same bankruptcy case

This Chief Counsel Advice responds to your memorandum dated February 16, 2001, to be released as 200137010 on September 14, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Year 1= 1993

This memorandum supplements our June 4, 2001 advice to you in connection with the taxpayer's Tax Court case brought under I.R.C. § 6330(d). We would like to clarify that the stipulated decision should not state that the Year 1 liability is $0. While we concluded that the current Year 1 assessment is invalid, we also concluded that a deficiency might be reasserted

under a provision other than I.R.C. § 6501(a), such as I.R.C. § 6501(e). Accordingly, the liability may not be $0. The decision should state that the assessment is invalid and that the appeals officer abused his discretion in permitting the proposed levy.

BANKRUPTCY CODE CASES: Chapter 11 (Reorganization)

August 10, 2001

CC:PA:CBS:BR2
GL-114587-01
UIL 09.11.00-00

MEMORANDUM FOR AREA COUNSEL SMALL BUSINESS - SELF EMPLOYED (AREA 2), GREENSBORO, CC:SBSE:2:GBO

FROM: Mitchel S. Hyman, Assistant Branch Chief, Branch 2 (Collection, Bankruptcy and Summonses)

SUBJECT:

By way of memorandum dated June 29, 2001, you asked for our review of the debtor's proposed Chapter 11 plan and disclosure statement involving an I.R.C. section 368 reorganization. We forwarded these documents to the office of Associate Chief Counsel (Corporate), and the following reflects their views.

The Plan

The plan provides that certain note-holders, who are the only unsecured creditors impaired under the plan, will receive the common stock of the reorganized debtor as well as stock warrants (options to purchase future issues of stock). However, the plan, on page 21, also provides that a small portion of stock and the warrants will be reallocated to the old common stock holders. This provision is written as follows:

> However, if the Effective Date occurs, the Holders of Allowed Senior Note-Related Claims shall be deemed to have reallocated and directed the Disbursing Agent to distribute pro rata to Holders of Old Common Stock (Class 7): (i) 40,000 shares of New Common Stock of the Reorganized Company and (ii) Warrants (the "Reallocation Provision").

The disclosure statement makes the following statements on pages 59-60 with regard to the federal income tax consequences to the reorganized debtors:

COI income that is realized by the Reorganized Debtors will not be recognized under I.R.C. § 108. The Reorganized Debtors will be required to reduce certain tax attributes, such as net operating loss carryovers ("NOLs"), certain tax credits, and the tax basis of their assets, by the amount of the COI income that is realized as of the beginning of the tax year following the year in which the Effective Date occurs. It is not entirely clear whether the tax attributes that must be reduced as a result of COI income realized by the Reorganized Company (the Reorganized Debtors included in such return being referred to herein as the "Consolidated Group") are limited to tax attributes attributable to that particular Reorganized Debtor or include attributes of other members of the Consolidated Group. The Reorganized Debtors intend to take the position that attribute reduction is applied on a Debtor-by-Debtor basis. If the Internal Revenue Service were to successfully assert a contrary position, the Reorganized Debtors' future Federal income tax liability could be significantly increased.

The Reorganized Company will under go an ownership change for purposes of I.R.C. § 382 as a result of consummation of the Plan, and, accordingly, the amount of the future income of the Reorganized Debtors that can be offset by their remaining NOLs and certain tax credit carryforwards will be subject to an annual limitation (the "Section 382 Limitation"). The Section 382 Limitation generally will be determined by multiplying the value of the Company's equity before the ownership change, adjusted to reflect the increase in value arising from the reduction in indebtedness as a result of the Plan, by the long-term tax-exempt rate.

Discussion

With regard to the discussion of the federal income tax consequences of I.R.C. section 108 on pages 59-60 in the disclosure statement, we note that the position the reorganized debtor intends to assert is contrary to that of the Service. It is the Service's position that, in the case of NOLs, the reduction of attributes of the members of a consolidated group is not done on a member-by-member basis, as apparently proposed by the debtors. In the case of a consolidated group, there is only one NOL, the consolidated NOL ("CNOL"). See United Dominion Industries, Inc. v. United States, --

U.S. –, No. 00-157 (June 4, 2001).

With regard to the discussion of I.R.C. section 382 on page 59-60 of the disclosure statement, we note that the debtor will have to make an election under section 382(l)(5)(H) to have the tax consequences discussed.[1] Pursuant to Treas. Reg. section 1.382-9(i), such election must be made by the due date of the loss corporation's tax return for the taxable year which includes the change date.

BANKRUPTCY CODE CASES: Chapter 11 (Reorganization)

August 10, 2001

CC:PA:CBS:BR2
GL-607466-00
UIL 09.11.00-00

MEMORANDUM FOR AREA COUNSEL SMALL BUSINESS - SELF EMPLOYED (AREA 2), GREENSBORO, CC:SBSE:2:GBO

FROM: Mitchel S. Hyman, Assistant Branch Chief, Branch 2 (Collection, Bankruptcy and Summonses)

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[1]Section 382(l)(5)(A) provides that section 382(a) shall not apply to any ownership change if, inter alia, the old loss corporation is (immediately before such ownership change) under the jurisdiction of the court in a title 11 or similar case. Since Worldtex is an old loss corporation and under the jurisdiction of the court in a title 11 case, then, pursuant to section 382(l)(5)(A), section 382(a) does not apply. However, section 382(l)(5)(B) provides that the pre-change losses of the old loss corporation which may be carried to a post-change year shall be computed as if no deduction was allowable under this chapter for the interest paid or accrued by the old loss corporation on indebtedness which was converted into stock pursuant to title 11 or similar case during a certain specified period. Thus, an old loss corporation applying section 382(l)(5) would have to reduce its NOL carryforward by such amount. As noted above, section 382(l)(5)(H) provides that a new loss corporation may elect not to have the provisions of section 382(l)(5) apply. Section 382(l)(6) provides that if section 382(l)(5) does not apply to an exchange of debt for stock in a title 11 or similar case, the value under section 382(e) shall reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction.

SUBJECT: , et al.

This responds to your memorandum dated June 26, 2001, in which you asked for our comments on the debtor's proposed Chapter 11 plan and disclosure statement with respect to the liquidating trust. We forwarded these documents to the office of Associate Chief Counsel (Passthroughs & Special Industries), and the following reflects their views.

BACKGROUND

The above named debtor and its 30 subsidiaries (together the "debtors") filed bankruptcy under Chapter 11, and subsequently filed their proposed plan and disclosure statement with the bankruptcy court. Section 7.1 of the plan provides that shortly after confirmation the debtors will transfer the trust assets, which are generally defined in section 1.74 as all property of the debtors and their consolidated estates of every type and nature, to a liquidating trust for the benefit of the holders of allowed claims. Upon confirmation, the subsidiaries will merge into the debtor. The trust is to be managed by a trust administrator who will also dissolve the debtors according to state law.

Section IV(A) of the disclosure statement provides that the debtors will transfer the trust assets to the trust free and clear of all liens, claims and encumbrances of any kind whatsoever except as otherwise provided in the plan and in certain documents relating to the settlement of claims. The documents include the Collateral Sharing Agreement, the Collateral Sharing Order, the APA, and the Approval Order. The settlement was previously approved by the bankruptcy court. Article XII of the plan and section IV(H) of the disclosure statement provide that upon the effective date the documents will be deemed ratified and reaffirmed in their entirety and incorporated into the plan and disclosure statement. Section 7.5 of the plan provides that the trust administrator, with the advice of a post confirmation committee to be formed under the plan, is authorized to enter into contracts and make all other arrangements necessary or appropriate to collect, sell, or otherwise dispose of all trust assets except for the claims.

Article III of the plan classifies the claims and interests in the plan. The allowed claims and interests, other than allowed administrative claims, are divided into the following five classes; (1) Class 1 consists of all allowed priority claims, (2) Class 2 consists of all allowed (secured) claims, (3) Class 3 consists of all allowed unsecured claims other than the certain claims in Class 4, (4) Class four consists of all allowed Subordinated Claims (subordinated per settlement), (5) Class 5 consists of all interests in the debtors.

Section 7.2 of the plan provides that it is intended that the trust shall be classified for federal income tax purposes as a liquidating trust. The transfer of the trust assets to the trust are to be treated for federal income tax purposes as a deemed transfer of the

trust assets to certain holders of allowed claims (generally in proportion to the amount that each such allowed claim bears to the total of such allowed claims) followed by a deemed transfer of the trust assets by such holders of allowed claims to the trust.

Section VII(D)(1) of the disclosure statement provides that although the holders of allowed claims generally will be treated for federal income tax purposes as having received the trust assets from the debtors and then transferring them to the trust, because holders of allowed administrative claims and Class 1 claims will receive specified fixed amounts from the trust, the trust administrator intends to treat the actual payments made to holders of allowed administrative claims and Class 1 claims from the trust as being made in exchange for these claims on the date of payment thereof. Accordingly, a holder of an allowed administrative claim or a Class 1 claim should generally recognize gain or loss equal to the cash received (plus the fair market value of other property received, if any) with respect to its claim less its adjusted basis in its claim.

Section VII(D)(2) of the disclosure statement provides that although not free from doubt, holders of allowed claims in Classes 2 and 3 as of the effective date should be treated as receiving from the debtors their share of the trust assets remaining after distributions to holders of allowed administrative claims and Class 1 claims in satisfaction of their allowed claims, and simultaneously transferring such trust assets to the trust. Accordingly, a holder of a Class 2 or Class 3 allowed claim as of the effective date should initially recognize gain or loss in an amount equal to its share of the amount of cash and the fair market value of any other trust assets deemed received on the effective date (other than attributable to accrued and unpaid interest), less the adjusted tax basis of its claim. Additionally, such holder should recognize its allocable share of taxable income on the trust assets realized by the trust on an annual basis.

Section VII(D)(3) provides that it is highly unlikely that holders of Class 4 claims will receive any distributions under the plan. Accordingly, although not free from doubt, on the effective date a holder of a Class 4 allowed claim should recognize gain or loss in an amount equal to the amount of cash and the fair market value of any other property that the holder actually receives with respect thereto (other than for accrued but unpaid interest).

Section VII(D)(4) provides that equity holders will not receive any consideration under the plan. In general, if any security which is a capital asset (such as an interest) becomes worthless during a taxable year, the loss resulting therefrom (equal in amount to the holder's basis therein) shall be treated as a loss arising from the sale of exchange of such security on the last day of the taxable year.

LAW AND ANALYSIS

Section 301.7701-4(d) of the Procedure and Administration Regulations provides that certain organizations which are commonly known as liquidating trusts are treated as

trusts for purposes of the Internal Revenue Code (the Code). An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for purposes of the Code because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust.

Rev. Proc. 94-45, 1994-2 C.B. 684, provides conditions under which the Service will consider issuing an advance ruling classifying an entity created pursuant to a bankruptcy plan under Chapter 11 of the Bankruptcy Code as a liquidating trust under section 301.7701-4(d) of the Procedure and Administration Regulations. We would like to bring the following issues to your attention.

1. Business Purpose

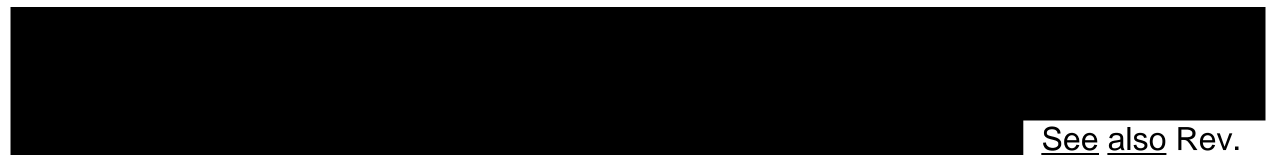
2. Taxation of the Transfer

<u>The Transfer</u>

The disclosure statement and the plan do not clearly explain the tax consequences of the transfer of the assets to the trust. Section 7.2 of the plan provides that the transfer of the trust assets to the trust shall be treated for federal income tax purposes as a deemed transfer of the trust assets to certain holders of allowed claims (generally in proportion to the amount that each such allowed claim bears to the total of such allowed claims) followed by a deemed transfer of the trust assets by such holders of

allowed claims to the trust. While section VII(D)(1) of the disclosure statement provides that although the holders of allowed claims will generally be treated for federal income tax purposes as having received the trust assets from the debtors and then transferring them to the trust, because holders of allowed administrative claims and Class 1 claims will receive specified fixed amounts from the trust, the trust administrator intends to treat the actual payments made to holders of allowed administrative claims and Class 1 claims from the trust as being made in exchange for these claims on the date of payment thereof. Sections VII(D)(2) and (3) of the disclosure statement provide similar provisions with respect the holders of other classes of claims.

The Service believes that a transfer to a liquidating trust for the benefit of creditors must be treated for all purposes of the Code as a transfer to the creditors (e.g., sections 61(a) (12), 483, 1001, 1012, and 1274) to the extent that the creditors are beneficiaries of the trust. The transfer will be treated as a deemed transfer to the beneficiary-creditors followed by a deemed transfer by the beneficiary-creditors to the trust. To the extent that the trust is being created for the benefit of equity interest holders in the debtor, the transfer to the trust should be treated as a transfer to the equity interest holders. See Rev. Rul. 94-45.



See also Rev. Rul. 85-13, 1985-1 C.B. 184, where the IRS considered whether, to the extend that a grantor is treated as the owner of a trust, the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.

Cancellation of Indebtedness Income

The property transfer from the debtors to the trust will be taxable to the debtors under section 1001 of the Code. The debtors are treated as having transferred their property to their creditors in return for relief from an amount of debt equal to the fair market value of the property. See Danenberg v. Commissioner, 73 T.C 370 (1979). The debtors will realize gain or loss on the difference between the debtor's basis in the property and its fair market value.

Because the debtors are in bankruptcy, the fair market value of any property to be transferred to the trust presumably will be less than the amount of debt being discharged. Therefore, the debtors will probably realize COD (cancellation of indebtedness) income under section 61(a)(12) on the difference between the amount of debt discharged and the total of the cash and fair market value of the property transferred. However, due to the bankruptcy proceeding, the COD income will be excluded from the debtor's gross income and will reduce any of the debtor's tax attributes transferred to the estate. I.R.C. § 108(a)(1)(A) and (b).

It is unlikely that any tax will ultimately be payable upon the transfer from the debtors to the trust (as contended in section VII(B) of the disclosure statement). However, if there is a tax liability, the bankruptcy estate will be left without assets to satisfy this liability. Further, the bar date for the payment of administrative claims from the trust assets will have passed before any such liability could be determined. (See plan sections 2.11 and 10.3 which require requests for payment of administrative claims be filed no later than 45 days after effective date.)

3. Taxation of the Trust

Generally, liquidating trusts are taxed as grantor trusts with the creditors treated as the grantors and deemed owners. The theory is that the debtor transferred its assets to the creditors in exchange for relief from its indebtedness to them, and that the creditors then transferred those assets to the trust for purposes of liquidation. The transfer to the creditors need not actually take place. It is deemed to have occurred.

The beneficiaries of the bankruptcy estate will be the grantors of the liquidating trust. They will be treated as the deemed owners of the trust because the property used to fund it came from them and all the income will be distributed to them or used to pay the expenses of their trusts. The beneficiaries must report each item of income or gain as it is earned by the trust.

CONCLUSION

COLLECTION DUE PROCESS

CC:PA:CBS:Br1:LKWilliams
GL-805109-00
UIL# 6330.00-00
November 2, 2000

MEMORANDUM FOR ASSOCIATE AREA COUNSEL SBSE - SAN FRANCISCO
CC:SB:7:SF:1

Attn: TRMackinson

FROM: Alan C. Levine
Chief, Branch 1 (Collection, Bankruptcy & Summonses)
CC:PA:CBS:Br1

SUBJECT: ________________________________

This memorandum responds to your request for advice dated July 20, 2000. This document is not to be cited as precedent. I.R.C. § 6110(k)(3).

QUESTION PRESENTED

Do taxpayers have a right to a collection due process hearing (CDP) under I.R.C. § 6320 where after a collection suit was brought by the Department of Justice, the lien to be foreclosed was erroneously released, the release was then revoked and a new notice of federal tax lien was filed?

CONCLUSION

The taxpayers have a right to a CDP hearing under section 6320. The Internal Revenue Service (Service) Office of Appeals (Appeals), however, is limited in what it can consider at the hearing because of the pending collection suit. These limitations are set forth below.

BACKGROUND

On , the U.S. Attorney's office in San Francisco filed a suit to foreclose federal tax liens against a parcel of real property owned by , and a parcel of adjacent real property owned jointly by . The improvement made to the parcel owned by is used as the residence. The suit also seeks to reduce to judgment the federal income liabilities of Mr. for tax years 1982, 1983, 1984, 1988 and 1989. The liabilities for 1982, 1983, and 1984 were fixed by a closing agreement entered into by the Service and Mr. and Mrs. in settlement of contested deductions taken in connection with a tax shelter. Mrs. income tax liabilities for 1982, 1983, 1984, 1988, and 1989 were discharged in Chapter 7 bankruptcy, but the federal tax liens continue to attach to the parcels of real property. See The case is set for trial in .

After the initiation of the suit, the notices of federal liens for three tax periods, 1982, 1983, and 1984, erroneously self-released. When the mistake was discovered, the Service issued a revocation of the certificate of release, in order to reinstate the

assessment liens imposed by I.R.C. § 6321. [1] A new notice of federal tax lien was filed in place of the erroneously-released notices of federal liens relating to the three tax years, and a CDP notice pursuant to section 6320 was issued to the taxpayers. As a result, Mr. and Mrs. made a single, timely request for a CDP hearing, in which they assert two challenges to the filing of the notice of federal tax lien: (1) the statute of limitations has expired and therefore the notice of federal tax lien and underlying assessment liens are no longer valid; and (2) is entitled to innocent spouse relief from the 1982, 1983, and 1984 liabilities.

ANALYSIS

Pursuant to section 6320, a taxpayer against whose property a notice of federal tax lien has been filed, on or after January 19, 1999, has the right to a CDP hearing. In this case, Mr. and Mrs. were entitled to receive a CDP notice under section 6320, because the filing was not merely a refilling as described in Temp. Treas. Reg. § 301.6320-1T(a)(2), Q&A-A6. The self-release of a notice of federal tax lien has the same effect as the filing of a certificate of release. Municipal Trust and Savings Bank v. United States, 114 F.3d 99, 102 (7th Cir. 1997), reh'g denied, 1997 U.S. App. LEXIS 16535 (7th Cir. 1997); Griswold v. United States, 59 F.3d 1571, 1579 n. 18 (11th Cir. 1995); In re Cole, 205 B.R. 668, 673 (Bankr. D. Mass. 1997). Consequently, the self-release extinguishes the lien, which can be reinstated through the filing of a notice of revocation of release. Treas. Reg. § 301.6325-1(f)(2)(iii)(b). Although the released federal tax lien can be reinstated, the released notice of federal tax lien, and the priority status the notice provides, cannot. Treas. Reg. § 301.6325-1(f)(2)(iii)(b); United States v. Winchell, 793 F. Supp. 994 (D. Colo. 1992). Thus, filing of a new notice of federal tax lien is necessary to render the assessment lien valid against a subsequent purchaser, holder of security interest in the property, mechanic's lienor, or judgment lien

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[1] A certificate of revocation of a lien release must be filed prior to expiration of the collection statute of limitation. I.R.C. § 6325(f)(2). The statute of limitations for collecting taxes is tolled by the filing of a collection suit. United States v. Winchell, 793 F. Supp. 994, 997 (D. Colo. 1992); United States v. Reid, 2000-1 U.S.T.C. ¶ 50,340, 2000 U.S. Dist. LEXIS 5106. In addition, the statute of limitations was tolled during the period of time Mrs. was in bankruptcy. I.R.C. § 6503(h). Therefore, the certificate of revocation was timely filed in this case.

creditor. Treas. Reg. § 301.6325-1(f)(2)(iii)(b); I.R.C. § 6323(a). Because the previous priority status is lost upon release and a new notice of federal tax lien is required to establish priority as of the filing date, it is our conclusion that the filing of a notice of federal tax lien under the circumstances presented in this case entitles Mr. and Mrs. to a CDP hearing under section 6320.

Moreover, nothing in the Internal Revenue Code, or the legislative history of the IRS Restructuring and Reform Act of 1998, suggests that the taxpayer cannot receive such a hearing if his or her tax liability is the subject of a collection suit in a United States district court. Accordingly, the are entitled to a CDP hearing even though there is currently a suit to foreclose federal tax liens against their residence and to reduce tax assessments against Mr. to judgment. However, because of the pending matter in court, there are restrictions, discussed below, as to what the Office of Appeals may consider in the CDP hearing.

Once the Service has referred a case to the Department of Justice for defense or prosecution, only the Attorney General or his or her delegate has the authority to compromise the case. I.R.C. § 7122(a). See also IRM 34.11.1.5; United States v. LaSalle National Bank, 437 U.S. 298, 312 (1978); United States v. Wingfield, 822 F.2d 1466, 1476 n. 8 (10th Cir. 1987). In an Attorney General opinion to the Secretary of the Treasury, the Attorney General concluded that the Department of Justice has the authority to compromise not only the case pending before it, but "... any other matter germane to the case which the Attorney General may find it necessary or proper to consider before he invokes the aid of the courts;...." 38 Op. Atty. Gen. 98 (1934); see also Executive Order No. 6166.

Because of the pending suit, Appeals does not have the authority to settle or compromise the tax liabilities. IRM 8.1.1.4.7.8; see also Ferrel v. United States, 1994 U.S. Dist. LEXIS 14194 (W.D. Wa.) (Service cannot act on an administrative refund claim once the matter has been referred to the Department of Justice for litigation). This includes challenges to tax liabilities based on the expiration of the collection statute of limitations and innocent spouse relief, as asserted by Mr. and Mrs. in their CDP hearing request. [2]

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[2] Even if Appeals could consider a liability challenge, should be precluded from raising innocent spouse relief because she has raised the issue before in a judicial proceeding in which she meaningfully participated. Temp. Treas. Reg. § 301.6320-1T(e)(1) and (e)(3), Q&A-E4. Mrs. asserted her entitlement to innocent spouse relief under I.R.C. § 6013(e), now codified as part of I.R.C. § 6015, in a 1995 bankruptcy adversary proceeding, .

(continued...)

In addition, Appeals cannot consider any offer involving the release of the federal tax liens or withdrawal of the notice against the two parcels. Because these parcels are the subject of the collection suit, the settlement authority belongs to Department of Justice, not Appeals. The assessment liens are necessary to the suit because these are the liens being foreclosed. See Treas. Reg. § 301.6325-1(f)(2)(iii)(b); c.f. United States v. Berg, 190 F.R.D. 539, 545 (E.D. Cal. 1999) (notice of federal tax lien does not need to be refiled after the filing of lien foreclosure suit in order to foreclose lien, because assessment lien remains attached to property); Title Guar. Co.of WY Inc. v. Internal Revenue Service, 667 F. Supp. 767, 771 (D. Wyo. 1987) (same). The filed notice is necessary to the suit because it protects the priority of the federal tax lien against subsequent purchasers and lienors of the property. [3] Any requests for release or withdrawal, therefore, must be directed to the Department of Justice.

As a result of these limitations, Appeals would only be able to consider in the CDP hearing only offers involving the discharge from the federal tax liens, pursuant to I.R.C. § 6325(b), of property owned by the other than the parcels in the suit. For example, such offer could be a bond, or a lump sum payment of tax liabilities, in an amount equal to the value of the tax liens on the property. Nevertheless, before Appeals concludes any agreement with the taxpayers, it must obtain Justice Department approval. IRM 8(13)10, subsection 613.7.

Because of the split jurisdiction between the Justice Department and Appeals, and the potential for confusion, we would recommend that Appeals simply wait until the conclusion of the district court action before holding the CDP hearing requested by the . If the Government prevails and Mr. or Mrs. or both decide to appeal the court's decision, the hearing would have to be delayed until the conclusion

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[2](...continued)

). The bankruptcy court held she was not entitled to innocent spouse relief from her 1982, 1983, and 1984 income tax liabilities. The court's holding was affirmed on appeal to the district court, , and the district court's decision was affirmed by the Ninth Circuit Court of Appeals in .

[3] Filing a notice of lis pendens as an alternative to filing a notice of federal tax lien would probably not be sufficient to protect the Government in this situation. At least one court has held that the priority of judgment lien creditors is not affected by a lis pendens because lis pendens is not intended to give them notice. R.I.O. Inc. v. Anderson, 50 Wn. App. 459, 798 P.2d 1136, 1138 (Wash. Ct. App. 1988). However, the lis pendens would probably protect the priority of an unfiled federal tax lien against subsequent purchasers and holders of a security interest. See United States v. Woodtke, 627 F. Supp. 1034, 1042 (N.D. Iowa 1985); cf. Theo. H. Davies & Co. v. Long & Melone Escrow, 876 F. Supp. 230, 234 (D. Hawaii 1995); Nat'l Acceptance Co. of America v. Mardigian, 259 F. Supp. 612, 617 (E.D. Mich. 1966); Lebanon Savings Bank v. Hollenbeck, 29 Minn. 332, 13 N.W. 145 (Minn. 1882).

of the appeal. It is our understanding that Appeals does not wish to keep a case in its inventory any longer than necessary. However, we believe the unique circumstances of this case warrant the delay in holding the hearing until the exhaust their right to appeal any adverse district court decision.

Once the litigation is concluded, the taxpayers may raise at the CDP hearing any issues not resolved by the district court. For example, if the Government prevails on all issues and the property is sold for an amount less than Mr. and Mrs. liabilities, then Mr. , whose liability has been reduced to judgment, may request an installment agreement or submit an offer-in-compromise with respect to the remaining unpaid liability. However, the should be advised that Appeals may not consider any challenge to liability or any issue decided by the district court. I.R.C. §§ 6320(c), 6330(c)(2)(B), and 6330(c)(4).

LEVY: Levy procedure

August 24, 2001

CC:PA:CBS:Br1:KLBaker
GL-123729-01
ULI 50.20.00-00

MEMORANDUM FOR AREA COUNSEL SB/SE: Area 5
St. Paul
Attn: John Schmittdiel

FROM: Alan C. Levine, Chief, Branch 1
(Collection, Bankruptcy, and Summonses

SUBJECT: Opin re: Custodia Legis Issue, Failure to Honor Levy

By telephone on July 6, 2001, and via e-mail dated July 9, 2001, you requested our advice as to whether the Service has an interest (either by a levy served under Section 6332 of the Internal Revenue Code or by virtue of its lien under Section 6321 of the Code), or an interest worth asserting, in money in a bank account deposited by the clerk of the state court pursuant to a state court action. Additionally, you inquired as to how, if the Service an interest, it should go about asserting its interest, particularly before the state court arrives at a decision and the money disappears.

ISSUE:

Whether the Service has an interest, pursuant to its tax lien or by levy, in money in a bank account deposited by the clerk of a state court pursuant to a state court action. If the Service does have an interest, how should it assert its interest.

CONCLUSION:

By virtue of its tax liens, the Service has an interest in the money deposited with the state court (which was subsequently deposited with a bank). This interest has priority over any interest of and

FACTS:

In late 1997 and early 1998, the (the Health Department) began investigating allegations of improper disposal of asbestos-containing material on properties owned by either the corporation, , or .

The Health Department subsequently issued an Environmental Cleanup Order (ECO) and it appears that then retained the corporation, , as its environmental consultant and to conduct asbestos abatement and cleanup of the properties cited in the ECO. submitted a plan of action for removal of the asbestos on and then subcontracted with the company to perform some of the asbestos abatement work.

On April 9, 1998, requested an extension to comply with the Order, noting that compliance had been delayed due to insufficient payments to .

On , the Health Department issued Notices of Violation against .

On , the IRS made an assessment against for unpaid Form 941 taxes for the quarter of in the amount of $.

On , the filed a complaint against , (hereinafter, "defendants") in state court. The complaint alleged numerous violations of statutes pertaining to inspection, removal, transportation, and disposal of asbestos from properties the defendants owned, and t the imposition of civil penalties.

On that same date, the parties filed a consent agreement with the court. This agreement stipulated that the defendants had violated numerous provisions of the Code relating to hazardous waste management and asbestos removal. In settlement of these violations, the consent agreement provided for the levying of a

civil penalty against the defendants in the amount of $

Additionally, section of the consent agreement provided as follows:

> " , shall satisfy any monetary obligations owing to , the environmental remediation contractor who performed the asbestos cleanup on the identified buildings in , within two years of the date of entry of judgment herein. The contractors shall retain the right to seek compensation from Defendant prior to the two year period."

Section further provided that, if were current on their installment payments of the $, the Health Department would not execute on its judgment. Additionally, the Health Department agreed to provide partial releases of any real estate or other property encumbered by the judgment as long as the net proceeds from such sale, after payment of closing costs and superior lienholders, were distributed in fulfillment of obligations encumbered by the consent agreement.

The consent agreement provided that the defendants agreed to the entry of judgment in accordance with its terms and an Order for Judgment was signed that day.

On , judgment was entered in the state action which ordered that the defendants be levied a $ civil penalty, subject to the terms and conditions delineated in the Order for Judgment. The judgment set forth the payment terms of the $ penalty, i.e., $ to be paid over years, $ to be suspended under certain conditions. The judgment also included the exact language from Sections and of the consent agreement.

Subsequently, in , the IRS made assessments against for unpaid Form 941 tax liabilities for the quarter of , and the quarters of , respectively, totaling approximately $. Additionally, on , a notice of federal tax lien was filed against in , and with the for the corporation's unpaid Form 941 tax liabilities.

On (hereinafter, "plaintiffs") filed a complaint in state court against the Health Department and In their complaint, the plaintiffs allege that they retained to conduct the asbestos removal and cleanup required by the ECO and thereafter subcontracted with to perform some of the asbestos removal work.

Plaintiffs contend that issued two bills to for its services, one dated , in the amount of $ and one dated , in the amount of $. Plaintiffs further allege that they made payments totaling $ in and , to , but that charges exceeded the work set forth in plan of action as well as the usual and customary rates charged for said services. Plaintiffs cited to the , judgment which provided for payment to and and noted that it had negotiated a settlement with and had attempted to settle with but had been unable to do so. Accordingly, the plaintiffs requested a determination of their rights and obligation with respect to and the proper amount of compensation, if any to which was entitled for the work performed.

On that same date, the plaintiffs filed an ex parte motion to deposit $ with the Clerk of the Court and requested that the Clerk of the Court deposit the funds in an interest bearing account. The source of these funds is not known. The plaintiffs' motion was granted, however, and the money was subsequently deposited with the .

On , the Health Department filed an answer to the complaint, alleging that the plaintiffs' action was barred by estoppel and laches because it had years to resolve the payment issue. It also argued that the court should decide whether the plaintiffs had complied in good faith with the , judgment.

also filed an answer on , alleging that plaintiffs' action was barred by the affirmative defenses of accord and satisfaction, laches, estoppel, release, waiver and fraud. further alleged that the complaint was barred by res judicata and collateral estoppel because, pursuant to the previous judgment, the plaintiffs were required to satisfy any monetary obligation owing to within two years of the date of entry of the judgment.

On , the Service served a levy on for Form 941 tax liabilities as had previous accounts at the bank. In response to the levy, the bank identified accounts in s name, one of which was a in the amount of $, issued as follows:

Signers by court order only

The bank refused to honor the levy, stating that withdrawals were only permitted pursuant to a court order.

On filed a motion for summary judgment in the state court action, arguing res judicata. A hearing on the motion was scheduled for .

LAW & ANALYSIS:

Section 6321 of the Internal Revenue Code provides that a lien arises in favor of the United States upon all property and rights to property, real or personal, belonging to any person who refuses to pay his taxes. 26 U.S.C. § 6321. The lien arises upon assessment, 26 U.S.C. § 6322, and attaches to all after-acquired property of the taxpayer. Glass City Bank v. United States, 326 U.S. 265 (1945).

Upon assessment of the Form 941 tax liabilities, the IRS had a lien on all property of . This lien attached to the money when acquired it and continued even though the money was subsequently deposited with the state court (which then deposited it with the bank).

Under section 6323 of the Code, the lien imposed by section 6321 is not valid against any purchaser, holder of a security interest, mechanic's lienor or judgment lien creditor until the Service has filed a notice of its lien.

Section 6323(h)(2) defines a mechanic's lienor as any person who, under local law, has a lien on real property (or on the proceeds of a contract relating to real property) for services, labor or materials furnished in connection with the construction or improvement of such property. mechanic's lien statute, , further provides:

> "Any person who improves real estate by the contribution of labor, skill, or materials, whether under contract with the owner of such real estate or under contract with any agent, trustee, contractor, or subcontractor of the owner, has a lien upon the improvement and upon the land on which it is situated or to which it may be removed for the price or value of such contribution."

This lien attaches, as against an encumbrancer without notice, upon the "actual and visible beginning of the improvement."

removed hazardous materials from properties owned by the plaintiffs, one could argue that made improvements on said properties. However, the statute indicates that would have a lien on the property it improved, not money, in this case the source of which is unknown.

The parties in the original state action did not include , nor did a representative from sign the consent agreement which was subsequently incorporated into the judgment. Instead, there is only a judgment which requires the plaintiffs to "satisfy any monetary obligations owing to" .

The issue then arises as to whether the Service can obtain the funds given the doctrine of custodia legis, i.e., a court's power to assume complete control over assets in its possession. (We assume the Collection Due Process requirements under I.R.C. § 6330 have been met.)

LIENS: Estate tax liens

November 1, 2001

UILC 51.06.00-00
CC:PA:CBS:Br1
GL-152006-01

MEMORANDUM FOR SBSE ASSOCIATE AREA COUNSEL (NEWARK)

FROM: Alan C. Levine
Chief, Branch 1 (Collection, Bankruptcy & Summonses)

SUBJECT: I.R.C. § 2057 Federal Estate Tax Lien on Personal Property

This memorandum responds to your e-mail request for advice, pertaining to the special estate tax election under I.R.C. § 2057. This document may not be used or cited as precedent. I.R.C. § 6110(k)(3).

ISSUES:

1. For personal property located in New Jersey used to secure the section 2057(i)(3)(P) lien, what would be the proper manner to describe such property on the Form 668H?

2. Is the client required to forward to Counsel for legal review each and every section 2057(i)(3)(P) lien filing request?

3. Would a section 2057(i)(3)(P) lien on personal property be enforceable against either a competing creditor who executed and levied upon the asset or a purchaser of the asset, while the section 2057(i)(3)(P) lien was in effect?

4. If personal property subject to a section 2057(i)(3)(P) lien is either sold/transferred or executed and levied upon by a creditor within the 10-year recapture period imposed under I.R.C. § 2032A(c)(1), what would be the effect on the recapture tax?

CONCLUSIONS:

1. The personal property description should be sufficient as long as it reasonably identifies what is described.

2. Counsel review is required if the only property securing the section 2057(i)(3)(P) lien is personal property or if the lien is secured by real and personal property, but the real property in itself is inadequate to fully secure the lien.

3. The section 2057(i)(3)(P) lien, once filed, would be enforceable against a subsequent purchaser or creditor who purchases/executes against the subject property. There are practical concerns with seeking such enforcement, however, as further discussed below.

4. The recapture tax would be triggered, unless the sale was to a member of the qualified heir's family, in the ordinary course of business, a like-kind exchange, or an involuntary conversion.

DISCUSSION:

The Taxpayer Relief Act of 1997, P.L. 105-34, added a new estate tax election, current section 2057, which permits estates meeting certain requirements to deduct from the gross estate the value of qualified family-owned business interests (up to $675,000). For section 2057 elections, section 2057(i)(3)(P) provides the mechanism for establishing, by reference to I.R.C. § 6324B, a lien for the collection of the additional estate tax imposed if a recapture event, described in section 2057(f), occurs: "Rules similar to the following rules shall apply: ... (P) Section 6324B (relating to special lien for additional estate tax)." Section 2057(i)(3)(P). Thus, a lien arises by operation of law under section 2057(i)(3)(P) at the time the section 2057 election is made. See I.R.C. § 6324B(b).

For purposes of the section 2057 election, all family members who have acquired from the decedent an interest in a qualified family-owned business (qualified heirs), and all other persons with an interest in business property to which the section 2057(i)(P)(3) lien is to attach, must sign an agreement consenting to the creation and filing of the lien. Section 2057(b)(1)(B); section 2057(h); section 2057(i)(3)(H); I.R.M. 5.5.8.3.1(2); Form 706 United States Estate (and Generation-Skipping Transfer) Tax Return, Schedule T. The property that will be subject to the section 2057(i)(3)(P) lien is listed in an attachment to the agreement. We have been advised by the Office of Associate Chief Counsel (Passthroughs and Special Industries) that section 2057 encompasses both real and personal property.

You have been contacted by your local Technical Support Advisory Unit with several questions pertaining to the filing of a section 2057(i)(3)(P) lien on both real and personal property. We will address each issue raised in turn, below.

1. How should personal property be described on the Form 668H?

The section 2057(i)(3)(P) lien is filed on Form 668H, Notice of Federal Estate Tax Lien, as modified pursuant to guidance issued to all Compliance Area Directors on May 4, 2001. There are no specific requirements in section 2057 or section 6324B to govern how personal property should be described in the lien notice.
We take the position that a description of personal property should be sufficient as long as it reasonably identifies what is described. For example, the description should not merely provide the name of the qualified family-owned business corporation but should sufficiently reference the property used to secure the section 2057(i)(3)(P) lien, i.e., the number of shares of stock held in XYZ corporation. We don't believe that such exact and detailed information as serial or i.d. numbers is required, however.

2. <u>When is Counsel review of the section 2057(i)(3)(P) lien required?</u>

Technical Support does not need to seek the concurrence of Counsel in every case in which the property subject to the section 2057(i)(3)(P) lien consists, in any part, of personal property. If both real and personal property are available, and a lien on the real property can adequately secure the Government's interest, there is no requirement to seek Counsel's advice. However, if the real property involved is inadequate, or if only personal property is involved, you should contact Counsel for assistance in adequately protecting the Government's interest.
3. <u>Would a section 2057(i)(3)(P) lien on personal property be enforceable against a subsequent purchaser of, or creditor who executed against, such property</u>?

Notice of a section 2057(i)(3)(P) lien must be filed in order to protect the Government's interest in the subject property. The filing of a notice of a section 6324B lien is governed by I.R.C. § 6324A(d)(1). Section 6324B(c)(1); Treas. Reg. §20.6324B-1(d). Because section 2057(i)(3)(P) makes applicable rules similar to section 6324B, section 6324A(d)(1) would also apply to a section 2057(i)(3)(P) lien. Section 6324A(d)(1) requires that a notice of lien meeting the requirements of I.R.C. § 6323(f) be filed in order for the lien to be valid against any purchaser, holder of security interest, mechanic's lien or judgment lien creditor.

Accordingly, as long as the section 2057(i)(3)(P) lien notice is filed in accordance with section 6323(f), the section 2057(i)(3)(P) lien will have priority over a subsequent purchaser, holder of security interest, mechanic's lien or judgment lien creditor. The section 2057(i)(3)(P) lien is, therefore, enforceable against a purchaser of, or creditor who executes by levy against, the subject property.

There are practical problems associated with the enforcement of the section 2057(i)(3)(P) lien against personal property, however. The Internal Revenue Service (the "Service") may have no way of knowing the section 2057(i)(3)(P) lien property has been transferred or executed upon. The Service may not, therefore, be able to locate the purchaser or creditor in possession of the property in order to enforce its lien interest.
Accordingly, it is preferable, whenever possible, to obtain an agreement to use real property to secure the section 2057(i)(3)(P) lien. The "interest" in the qualified family-owned business may include the underlying real property itself and is not limited to the type of ownership interest in the property such as shares of stock.

We have been informally advised of certain offices entering into additional agreements which may be effective to secure the Service's interest and prevent transfer of the section 2057(i)(3)(P) lien property in some cases. For example, we have learned that one office has drafted an escrow agreement which may be executed by the Service, the estate representative, the qualified heirs, and an escrow agent. Pursuant to such agreement, shares of stock used as section 2057(i)(3)(P) property are deposited with and held by an escrow agent bank, to be held and distributed by such agent only in accordance with certain terms and conditions. The agreement provides that in the event of tax recapture under section 2057(f) (described in item 4 below), the Service may pursue enforcement including requiring the administrative sale or delivery to the Service of the escrow property. The agreement further provides for termination of the escrow agreement upon the lapse of the time period for recapture under section 2057(f) or upon full payment of all estate taxes owed. Upon termination and agreement by the Service, the shares may be released to the qualified heirs if all taxes have been satisfied. You may wish to consider the use of a similar agreement, contingent upon local law.

4. What is the effect upon the recapture tax if the section 2057(i)(3)(P) lien property is sold/transferred or executed upon by levy?

Section 2057(f)(1)(B) provides for the imposition of a recapture tax if, within 10 years after the date of the decedent's death and before the date of the qualified heir's death, the qualified heir "disposes" of any portion of a qualified family-owned business interest (other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution under section 170(h)).

We coordinated this question with the Office of Associate Chief Counsel (Passthroughs and Special Industries). It is that office's position that, in general, the sale or transfer of the section 2057(i)(3)(P) lien property would trigger the recapture tax, pursuant to section 2057(f)(1)(B), unless the sale: (i) was to a member of the qualified heir's family;

(ii) was through a qualified conservation contribution; (iii) qualifies as a § 1031 transaction (like-kind exchange); (iv) qualifies as a § 1033 transaction (involuntary conversion); or (v) was in the ordinary course of business. It is also that office's position that a third party levy would trigger section 2057(f)(1)(B) recapture. See Priv. Ltr. Rul. 9333002 (concluding that foreclosure proceedings instituted by mortgagee over taxpayer's property did not constitute a disposition under section 2032A(c)(1)(A) since no transfer of the property had taken place); Rev. Rul. 89-4, 1989-1 C.B. 298 (holding that an estate's sale of specially valued real estate to halt a foreclosure constitutes a disposition for purposes of section 2032A(c)).