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Craig J. Langstraat

K. Dianne Jackson

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BANKRUPTCY OFFICIALS VS. THE INTERNAL REVENUE SERVICE: THE BEAT GOES ON

by

CRAIG J. LANGSTRAAT*
&
K. DIANNE JACKSON**

INTRODUCTION

Over the last several years, the maximum collection tax policy of the federal government under the Internal Revenue Code has frequently clashed with the policy of a fresh start for the bankruptcy debtor under the bankruptcy laws.¹ These conflicts have resulted in several recent significant court cases, including two cases heard and decided by the United States Supreme Court.² Given the historical record of relatively few tax cases being heard by the Supreme Court, the recent attention to bankruptcy related tax cases demonstrates the importance and growing controversy in the subject area.

This author has previously addressed several areas of conflict between bankruptcy officials; i.e., trustees and judges, and the Internal Revenue Service ("IRS").³ Due to continued litigation, both in the U.S. Supreme Court and in certain federal courts of appeal, some of these areas will be reevaluated in this article. In addition, new areas of conflict resulting in litigation in various levels of the federal court system will be discussed. Policy and statutory modifications will be suggested to alleviate the growing costly burden of litigation.

MULTIPLE CONFRONTATIONS

The areas of conflict between bankruptcy officials and the IRS are varied and continually growing in number. Whenever a taxpayer becomes a debtor in a bankruptcy proceeding, the resolution of any tax matter involving the debtor becomes entwined with the resolution of the bankruptcy process. The following issues are representative of the conflicts between tax policy and bankruptcy policy:

* Professor, School of Accountancy, Memphis State University; J.D., Arizona State University; LL.M. (Taxation), University of San Diego; C.P.A.; Member of Arizona and California Bars.

** B.B.A. Texas Tech University; M.S. Memphis State University, C.P.A.

¹ See 11 U.S.C.S. §§ 101-1330 (Law. Co-op. 1985 & Supp. 1993).

² See *United States v. Nordic Village, Inc.*, 112 S.Ct. 1011 (1992), and *United States v. Energy Resources Co., Inc.*, 495 U.S. 545 (1990).

³ See Craig J. Langstraat & Mark S. Aquadro, *Bankruptcy Officials versus the Internal Revenue Service: A Federal House Divided Against Itself*, 8 AKRON TAX J. 131 (1991).

- (1) Designation and Allocation of Bankruptcy Tax Payments-Supreme Court decision *United States v. Energy Resources Co., Inc.*,⁴ and its progeny.
- (2) IRS Sovereign Immunity - Supreme Court decision *United States v. Nordic Village, Inc.*⁵ and later litigation.
- (3) Availability of Qualified Plan Assets for Satisfaction of Tax Debts-Supreme Court decision *Patterson v. Shumate*.⁶
- (4) Conflict in Statutory Terms between The Internal Revenue Code and the Bankruptcy Code-Sixth Circuit decision *In re Mansfield Tire & Rubber Co.*⁷ and contrary Circuit Court opinions.

DESIGNATION AND ALLOCATION OF BANKRUPTCY TAX PAYMENTS

Background

Trust fund tax liabilities represent monies withheld by a business or collected by a business which are required to be held as a special fund in trust for the benefit of the federal government.⁸ The most common trust fund tax liability is the withholding of federal income tax from an employee's wages. The Internal Revenue Code provides two types of penalties in the event trust fund taxes are not paid over to the federal government.⁹

Criminal fines and incarceration are possible consequences for any person who *willfully* fails to pay over the trust fund taxes.¹⁰ In addition, the government may hold a responsible person; i.e., a corporate officer, personally liable for a penalty equal to 100% of the amount of tax withheld, but not paid to the government.¹¹ This penalty is

⁴ 495 U.S. 545 (1990).

⁵ 112 S.Ct. 1011 (1992).

⁶ 112 S.Ct. 2242 (1992).

⁷ *United States v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Company, 942 F.2d 1055 (6th Cir. 1991)), cert. denied*, 112 S.Ct. 1165 (1992).

⁸ I.R.C. § 7501(a) (Law. Co-op. 1993).

⁹ I.R.C. § 7501(b) (Law. Co-op. 1993).

¹⁰ I.R.C. § 7202 (Law. Co-op. 1993).

¹¹ I.R.C. § 6672(a) (Law. Co-op. 1993).

generally applied to any person required by the Internal Revenue Code to collect, account for, and pay over any tax imposed by the Code.¹²

The IRS has full discretion (at least under its own rules) to allocate "involuntary" tax payments in a manner which will maximize the amount of assessed tax that may be collected.¹³ In the case of a "voluntary" tax payment, the taxpayer is allowed to designate the manner in which the payment will be allocated.¹⁴ It is the policy of the IRS to designate involuntary tax payments to non-trust fund taxes first and then to trust fund taxes.¹⁵ If there are inadequate payments from the corporation to cover both trust and non-trust fund liabilities, this policy ensures that the IRS can obtain the maximum collection possible by assessing the 100% penalty against the responsible persons for any unpaid trust fund liabilities.

In a bankruptcy reorganization situation, a debtor corporation often desires to allocate any tax payments made during bankruptcy to the trust fund taxes first. This approach can be a benefit to both the debtor corporation and its responsible persons. The debtor corporation is able to decrease its tax liability while protecting its officers or other responsible persons whose services may be needed for a successful reorganization. The responsible persons' primary liability for the 100% penalty under IRC § 6672 will be reduced or eliminated.

The conflict in this area between the goals of the bankruptcy officials and those of the IRS have generally focused on two issues: (1) whether a tax payment is voluntary or involuntary and (2) whether the bankruptcy officials or courts have the authority to allocate payments made to the IRS in a manner that is inconsistent with IRS policy.

Tax Payment Designation

The issue of tax payment designation between voluntary and involuntary in a Chapter 11 bankruptcy proceeding has been addressed by the First,¹⁶ Third,¹⁷ Sixth,¹⁸ Eighth,¹⁹

¹² *Id.*

¹³ See Stuart K. Salchow, *IRS Practice & Policy*, 3A Tax Mgmt. (BNA) 1080.B.6 (Mar. 1993). See also Muntwyler v. United States, 703 F.2d 1030 (7th Cir. 1983); Rev. Rul. 79-284, 1979-2 C.B. 83.

¹⁴ See Rev Rul 79-284, 1979-2 C.B. 83. See also Wood v. United States, 808 F.2d 411 (5th Cir. 1987); Muntwyler, 703 F.2d at 1030.

¹⁵ See Salchow, *supra* note 13, at 1080.C.

¹⁶ See IRS v. Energy Resources Co., Inc., (*In re Energy Resources Co., Inc.*), 871 F.2d 223 (1st Cir. 1989), *cert granted, sub nom.* United States v. Energy Resources Co., Inc., 493 U.S. 963 (1989), *aff'd*, 495 U.S. 545 (1990).

¹⁷ *In re Ribs-R-U's, Inc.*, 828 F.2d 199 (3d Cir. 1987).

¹⁸ DuCharmes & Co., Inc. v. Michigan (*In re DuCharmes & Co.*), 852 F.2d 194 (6th Cir. 1988).

¹⁹ Jehan-Das, Inc. v. United States (*In re Jehan-Das, Inc.*), 925 F.2d 237 (8th Cir. 1991), *cert. denied*, 112 S.Ct. 55 (1991).

Ninth,²⁰ and Tenth²¹ Circuits. These courts have held that tax payments in the context of a Chapter 11 reorganization were involuntary. In a tax court decision, cited often in cases involving bankruptcy proceedings, an involuntary payment was defined as "any payment received by the IRS as a result of distraint or levy or from a legal proceeding in which the United States is seeking to collect delinquent taxes or file a claim therefor."²²

The Supreme Court selected the First Circuit case, *IRS v. Energy Resources Co., Inc.*,²³ to ultimately resolve the conflicts in this area. However, as discussed in more detail below, the Court focused on the authority to allocate tax payments of bankrupt estates rather than on the issue of the designation of such payments as voluntary or involuntary. Thus, the circuit court decisions still control in the determination of involuntary versus voluntary status of tax payments in bankruptcy.

Tax Payment Allocations

In *Energy Resources*, the Supreme Court focused on the allocation of tax payments by the bankruptcy court in a Chapter 11 reorganization plan which was in direct conflict with IRS administrative policy. The Court found that a bankruptcy court does have the authority under the Bankruptcy Code to allocate tax payments of the bankrupt estate, where the court determines that such an allocation is necessary for the reorganization's success.²⁴

This opinion was based on the bankruptcy court's authority to rearrange debtor-creditor relationships in a title 11 case in order to give the debtor an opportunity to rehabilitate with a "fresh start." The key language in the Bankruptcy Code relied on by the Supreme Court are provisions which empower a bankruptcy court to approve "any . . . appropriate provision not inconsistent with the applicable provisions of this title,"²⁵ and to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Act]."²⁶

Post-Energy Resources Litigation

While the Supreme Court decision in *Energy Resources* may have resolved the controversy surrounding authority to allocate tax payments in a Chapter 11 reorganiza-

²⁰ *United States v. Technical Knockout Graphics, Inc. (In re Technical Knockout Graphics, Inc.)*, 833 F.2d 797 (9th Cir. 1987).

²¹ *Fullmer v. United States (In re Fullmer)*, 962 F.2d 1463 (10th Cir. 1992).

²² *Amos v. Commissioner*, 47 T.C. 65, 69 (1966).

²³ *IRS v. Energy Resources Co., Inc. (In re Energy Resources Co., Inc.)*, 871 F.2d 223 (1st Cir. 1989), cert. granted sub nom. *United States v. Energy Resources Co., Inc.*, 493 U.S. 963 (1989), aff'd, 495 U.S. 545 (1990).

²⁴ *United States v. Energy Resources Co., Inc.*, 495 U.S. 545, 547-49 (1990).

²⁵ 11 U.S.C.S. § 1123(b)(5) (Law. Co-op. 1987).

²⁶ 11 U.S.C.S. § 105 (Law. Co-op. 1985).

tion, several Circuit court opinions since *Energy Resources* have held that in bankruptcy proceedings other than Chapter 11 reorganization, *Energy Resources* is not controlling.

In the case of *In re Kare Kemical, Inc.*,²⁷ the Eleventh Circuit held that the Court's reasons for allowing payment allocation in Chapter 11 reorganizations in *Energy Resources* were not present in liquidation cases.²⁸ Therefore, the bankruptcy court did not have authority to approve the Chapter 11 liquidation plan of Kare Kemical which required the IRS to allocate tax payments to the principal portion of trust fund taxes first and then to interest or penalties. Similarly, the Third Circuit held that in a Chapter 7 liquidation proceeding, in the absence of a showing of need for a reorganization or similar purpose, a bankruptcy court is not free to direct the allocation of tax payments in contravention of the policy behind I.R.C. § 6672 and long-standing IRS procedures.²⁹ Lower courts are following the same line of reasoning as these Circuit Courts in distinguishing *Energy Resources* from bankruptcy proceedings that do not involve a reorganization.³⁰

One bankruptcy court and the Ninth Circuit has allowed the allocation of tax payments in a Chapter 11 liquidating plan.³¹ In *In re Deer Park*, the Bankruptcy Appellate Panel held the fact that the bankruptcy plan in question was a liquidating plan under Chapter 11 did not forego the applicability of the holding in *Energy Resources*.³² The panel cited Bankruptcy Code §1129(a)(11) which provides that liquidation may be contemplated in a valid Chapter 11 plan of reorganization, despite the label "reorganization."³³ The Panel concluded that the allocation of tax payments by the bankruptcy court was necessary for the success of the liquidating plan as the services of a former corporate officer were needed to complete the liquidation of the debtor's assets.³⁴

Without statutory clarification, litigation will continue in this area to the extent that the bankruptcy courts must (1) determine the designation of tax payments made in bankruptcy, (2) apply the *Energy Resources* doctrine in deciding if a bankruptcy allocation of tax payments is necessary to the successful reorganization of the debtor, and (3) determine the applicability of *Energy Resources* to bankruptcy proceedings other than reorganizations.

²⁷ *United States v. Kare Kemical, Inc. (In re Kare Kemical, Inc.)*, 935 F.2d 243 (11th Cir. 1991).

²⁸ *Id.* at 244.

²⁹ *United States v. Pepperman*, 976 F.2d 123, 131 (3d Cir. 1992).

³⁰ See *In re Visiting Nurse Ass'n of Tampa Bay, Inc.*, 128 B.R. 835 (Bankr. M.D. Fla. 1991) (Chapter 11 liquidation); *In re F.A. Dellastationous, Inc.*, 121 B.R. 487 (Bankr. E.D. Va. 1990) (Chapter 7 liquidation).

³¹ *United States v. Deer Park, Inc. (In re Deer Park, Inc.)*, 136 B.R. 815 (Bankr. 9th Cir. 1992).

³² *Id.* at 818.

³³ *Id.* (citing 11 U.S.C.S. § 1129(a)(1) (Law. Co-op. 1987)).

³⁴ *Id.* at 819.

THE BANKRUPTCY CODE AND IRS SOVEREIGN IMMUNITY

IRS v. Nordic Village-The Circuit Court

The case of *IRS v. Nordic Village* resulted from a transfer made by an officer and shareholder of Nordic Village, Inc., who used the corporate funds after a Chapter 11 petition had been filed to pay his personal tax liabilities.³⁵ The bankruptcy trustee attempted to recover this transfer from the IRS as a voidable preference.³⁶ The IRS claimed that the doctrine of sovereign immunity, as articulated by the Supreme Court in *Hoffman v. Connecticut Department of Income Maintenance*,³⁷ precluded the trustee in bankruptcy from proceeding against the IRS.³⁸

The Sixth Circuit found that the *Hoffman* case, in which it was held that the waiver of the sovereign immunity provision in the Bankruptcy Code does not apply to states because of the Eleventh Amendment,³⁹ was inapplicable to the current case dealing with a federal agency.⁴⁰ The court held that Bankruptcy Code §106 effectively and explicitly abolishes the defense of sovereign immunity in a claim involving a federal agency such as the IRS and therefore, judgement was rendered against the IRS.⁴¹

United States v. Nordic Village-The Supreme Court

The Supreme Court focused on the waiver of sovereign immunity of the federal government for monetary recoveries in bankruptcy.⁴² While, the Court affirmed the Circuit Court's holding that the *Hoffman* case had no bearing to the case at hand, the Court did not agree with the lower courts application of §106.⁴³

The Court held that waivers of the Government's sovereign immunity, to be effective, must be "unequivocally expressed"⁴⁴ and are not to be "liberally construed." The Court analyzed Bankruptcy Code §106(a) and (b) and found that these two sections plainly waive sovereign immunity with regard to monetary relief in two settings: compulsory counterclaims to governmental claims, and permissive counterclaims to govern-

³⁵ *IRS v. Nordic Village, Inc. (In re Nordic Village, Inc.)*, 915 F.2d 1049 (6th Cir. 1990), cert. granted sub nom. *United States v. Nordic Village, Inc.*, 111 S.Ct. 2823 (1991), rev'd, 112 S.Ct. 1011 (1992).

³⁶ *Id.* at 1050.

³⁷ 492 U.S. 96 (1989).

³⁸ *IRS v. Nordic Village, Inc.*, 915 F.2d at 1051. The IRS also successfully argued that there was insufficient notice that the transfer was voidable. *Id.*

³⁹ *Hoffman*, 492 U.S. at 104.

⁴⁰ *IRS v. Nordic Village, Inc.*, 915 F.2d at 1053.

⁴¹ *Id.* at 1052.

⁴² *United States v. Nordic Village, Inc.*, 112 S.Ct. 1011 (1992).

⁴³ *Id.* at 1017.

⁴⁴ *Id.* at 1014 (quoting *Irwin v. Veterans Administration*, 498 U.S. 89, 95 (1990), in turn quoting *United States v. Mitchell*, 455 U.S. 535, 538 (1980)).

mental claims capped by a setoff limitation.⁴⁵ A compulsory counterclaim occurs when the United States' and the debtors' claims against each other arise out of the same transaction.⁴⁶ For example, a debtor can sue the United States under §106(a) when the IRS has violated the automatic stay provisions by placing a lien on bankruptcy estate property.⁴⁷

While §106(b) does not allow affirmative recovery of monetary damages, to the extent a taxpayer has any valid claim against the United States which is property of the debtor's estate, sovereign immunity is waived to the extent necessary to allow the setoff of that claim against any claim asserted by the United States against the debtor.⁴⁸ For example, if the debtor has a claim against the IRS for prior year income tax refunds and the IRS has filed a proof of claim against the bankruptcy estate for income tax liability, the debtor can sue the United States in order to have the refunds offset the liability.⁴⁹ If the refunds exceeded the liability, the debtor cannot sue the government for any excess under §106(b).⁵⁰

The facts of *Nordic Village* did not fall under either of these provisions. Therefore, the Court analyzed §106(c) and developed at least two interpretations of the section, neither of which authorize monetary relief.⁵¹ However, the opinion states that the section may create a waiver of government immunity as to requests for injunctive and declaratory relief.⁵² For example, if a levy exists on property of the bankruptcy estate, the debtor can bring action against the government in order to have the levy removed where the IRS does not yet have possession of the levied property. This is not to say that relief will always be granted in such circumstances,⁵³ but that the debtor can seek relief against the government.

⁴⁵ *Id.* at 1015.

⁴⁶ 11 U.S.C.S. 106(a) (Law. Co-op. 1985).

⁴⁷ See *supra* notes 59-64 and accompanying text.

⁴⁸ 11 U.S.C.S. § 106(b) (Law. Co-op. 1985).

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *United States v. Nordic Village, Inc.*, 112 S.Ct. 1011, 1015 (1992). One interpretation was that the two paragraphs of subsection (c) should be read as complementary rather than independent. In that case, "the second paragraph specifies the manner in which there shall be applied to governmental units the provisions identified by the first paragraph, i.e., a manner that permits declaratory or injunctive relief but not an affirmative monetary recovery." See *id.* at 1015.

The second interpretation requires the reading of the two paragraphs of subsection (c) as being independent. In such a reading, the phrase that introduces subsection (c) ("except as provided in subsections (a) and (b) of this section") would mean that the rules established in subsection (a) and (b) for waiver of Government claims are exclusive, and preclude any resort to subsection (c). See *id.* at 1016.

⁵² *Id.* at 1015.

⁵³ See *supra* notes 65-77 and accompanying text.

The Court rejected the respondent's arguments that the necessary waiver could be found in 28 U.S.C. § 1334(d)⁵⁴ or that a bankruptcy court's *in rem* jurisdiction overrides sovereign immunity.⁵⁵ In a 7-2 decision, the Court found that "neither § 106(c) nor any other provision of law establishes an unequivocal textual waiver of the Government's immunity from a bankruptcy trustee's claims for monetary relief" and therefore, reversed the Circuit Court decision.⁵⁶

Nordic Village establishes a standard of waiver of sovereign immunity not only for § 106(c), but also for § 106(a) and (b). Although the Court ruled that sovereign immunity had not been waived in the *Nordic Village* case, the decision did not clearly establish a final interpretation of § 106(c). Rather the Court determined that the statutory language was too ambiguous as to allow for a clear and precise interpretation in favor of monetary recovery.⁵⁷ Since the Supreme Court conceded that its two interpretations of § 106(c) are "assuredly not the only readings"⁵⁸ of the section, it appears that, without statutory clarification, litigation will continue in this area.

Post-Nordic Village Litigation

In a recent Chapter 13 case, the court considered an application of the *Nordic Village* decision in determining whether or not the federal government had waived its sovereign immunity under § 362(h) of the Bankruptcy Code.⁵⁹ In, *In re Pinkstaff*, the Ninth Circuit found that the IRS, by filing a notice of federal income tax lien after the Pinkstoffs had filed their bankruptcy petition, had waived its sovereign immunity under § 106(a).⁶⁰ Therefore, the court held that the debtor's were entitled to recover actual damages, including costs and attorney fees resulting from the violation of the automatic stay.⁶¹

The court's conclusion was based, in part, on the *Nordic Village* opinion which states that § 106(a) unequivocally expresses the government's consent to be sued for money damages whenever a compulsory counterclaim is brought in response to a claim filed by

⁵⁴ 28 U.S.C. § 1334(d) grants the district court in which a bankruptcy case is initiated "exclusive jurisdiction of all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate." 28 U.S.C.S. § 1334(d) (Law. Co-op. Supp. 1993). The court held that the application of this section to waive sovereign immunity in *Nordic Village* would also run afoul of the unequivocal-expression requirement. *United States v. Nordic Village, Inc.*, 112 S. Ct. at 1016-17.

⁵⁵ *United States v. Nordic Village, Inc.*, 112 S.Ct. at 1016-17. The court found that the premise for the argument of the bankruptcy court's *in rem* jurisdiction overriding sovereign immunity was missing, since respondent did not invoke, and the bankruptcy court did not purport to exercise, *in rem* jurisdiction. *Id.* The court held that even if *in rem* jurisdiction was applicable, it has never been applied to the sovereign-immunity bar against monetary recovery. *Id.* at 1017.

⁵⁶ *Id.* at 1017.

⁵⁷ *Id.* at 1015.

⁵⁸ *Id.* at 1016.

⁵⁹ *Pinkstaff v. United States (In re Pinkstaff)*, 974 F.2d 113 (9th Cir. 1992).

⁶⁰ *Id.* at 115-16.

⁶¹ *Id.* at 115.

the government.⁶² The court also relied on its own previous opinion, *In re Town & Country*⁶³ which states “[w]hen a governmental unit formally invokes the jurisdiction of the bankruptcy court by filing a proof of claim, the government’s exposure to counterclaim liability under section 106(a) is unquestioned.”⁶⁴

A recent bankruptcy court’s use of the *Nordic Village* decision illustrates the differentiation drawn by the Supreme Court in the application of §106(a) and §106(c).⁶⁵ In, *In re Francis Quillard*, the IRS placed levies in September of 1990 on the Quillards’ IRA accounts in two banks, Shawmut Bank and Hampden Savings Bank.⁶⁶ Hampden Savings Bank subsequently paid over all funds in the Quillard’s bank account to the IRS on February 21, 1992 after the Quillards had filed a Chapter 7 petition on February 10, 1992.⁶⁷ At the time of the court proceeding, Shawmut Bank had not paid over the levied funds to the IRS.⁶⁸ The Quillard’s filed an adversary proceeding seeking to avoid as preferential transfers the two pre-petition IRS tax levies.⁶⁹

The court first examined the issue of waiver of sovereign immunity, as the resolution of such could render any other arguments of the parties moot.⁷⁰ The Government argued that *Nordic Village* should apply to the levies of both of the accounts because the debtors are seeking monetary relief in a case where the Government has not waived its sovereign immunity.⁷¹ The court analyzed each bank account separately.⁷²

In the case of the Hampden Savings Bank in which funds were already in the possession of the IRS, §106(c) as interpreted by the Supreme Court in *Nordic Village* does not act to waive the government’s sovereign immunity. The debtors were not seeking injunctive relief in relation to the Hampden Savings funds, but rather monetary relief.⁷³

On the other hand, the court held that §106(c) does apply to the Shawmut Bank funds.⁷⁴ Since the funds were still at the bank and the IRS did not have possession of such funds, the debtors could seek release of the levy as an injunctive relief under §106(c) as

⁶² *United States v. Nordic Village, Inc.*, 112 S.Ct. at 1015.

⁶³ *Pinkstaff v. United States*, 974 F.2d at 115.

⁶⁴ *Sullivan v. Town & Country Home Nursing Servs., Inc. (In re Town & Country)*, 963 F.2d 1146, 1150 (9th Cir. 1992).

⁶⁵ *See Quillard v. United States (In re Quillard)*, 150 B.R. 291 (Bankr. D.R.I. 1993).

⁶⁶ *Id.* at 292.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at 293.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.* at 294.

interpreted by *Nordic Village*.⁷⁵ In its final analysis, the court held the Shawmut Bank levy to be valid as it was filed prior to bankruptcy and that it should remain, even though the underlying debt would be discharged in bankruptcy.⁷⁶ This case clearly demonstrates the mystifying distinction of whether the IRS has physically received the money. This is not a viable distinction with non-federal government creditors (i.e. voidable preferences law).⁷⁷ Should the result be different for the IRS?

ERISA PENSION PLANS, BANKRUPTCY AND THE IRS

Patterson v. Shumate

Prior to the 1992 decision in *Patterson v. Shumate*,⁷⁸ there was a split among the circuit courts of appeal as to whether or not an anti-alienation provision in an ERISA-qualified pension plan constitutes a restriction on transfer enforceable under "applicable nonbankruptcy law" for purposes of the §541(c)(2) exclusion of property from the debtor's bankruptcy estate.⁷⁹ Shumate filed for bankruptcy in 1984 and Chapter 7 proceedings were begun with Patterson serving as bankruptcy trustee.⁸⁰ Subsequent to Patterson's petition, the pension plan, in which Shumate was a participant, was terminated and liquidated with all participants receiving full distributions except Shumate.⁸¹ Patterson filed an adversary proceeding to recover Shumate's interest in the plan for the benefit of Shumate's bankruptcy estate.⁸² The plan satisfied all applicable requirements of ERISA and qualified for favorable tax treatment under the Internal Revenue Code.⁸³ Specifically, the plan contained the anti-alienation provision required for qualification under ERISA.⁸⁴

⁷⁵ *Id.* at 296.

⁷⁶ *Id.* at 295.

⁷⁷ See 11 U.S.C.S. § 547 (Law. Co-op. 1986 & Supp. 1993).

⁷⁸ 112 S. Ct. 2242 (1992).

⁷⁹ Compare *Gladwell v. Harline (In re Harline)*, 950 F.2d 669 (10th Cir. 1991), *cert. denied* 112 S. Ct. 2991 (1992); *Velis v. Kardanis*, 949 F.2d 78 (3d Cir. 1991); *Forbes v. Lucas (In re Lucas)*, 924 F.2d 597 (6th Cir. 1991), *cert. denied sub nom. Forbes v. Holiday Corp. Sav. & Retirement Plan*, 111 S. Ct. 2275 (1991) and *Anderson v. Raine (In re Moore)*, 907 F.2d 1476 (4th Cir. 1990) with *Heitkamp v. Dyke (In re Dyke)*, 943 F.2d 1435 (5th Cir. 1991); *Daniel v. Security Pac. Nat. Bank (In re Daniel)*, 771 F.2d 1352 (9th Cir. 1985), *cert. denied*, 475 U.S. 1016 (1986); *Lichstrahl v. Bankers Trust (In re Lichstrahl)*, 750 F.2d 1488 (11th Cir. 1985); *Samore v. Graham (In re Graham)*, 726 F.2d 1268 (8th Cir. 1984); and *Goff v. Taylor (In re Goff)*, 706 F.2d 574 (5th Cir. 1983).

⁸⁰ *Patterson v. Shumate*, 112 S. Ct. at 2245.

⁸¹ *Id.*

⁸² *Id.*

⁸³ See I.R.C. §§ 401-409 (Law. Co-op. 1993).

⁸⁴ See 29 U.S.C.S. § 1056(d)(1) (Law. Co-op. 1990).

The district court held that §541(c)(2) of the Bankruptcy Code, which states “A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under *applicable nonbankruptcy law* is enforceable in a case under this title,”⁸⁵ referred to state law only and not federal law such as ERISA.⁸⁶ The court applied the state law and held that Shumate’s interest in the plan did not qualify for protection as a spendthrift trust.⁸⁷ This analysis and conclusion was consistent with several circuit court opinions.⁸⁸ The Fourth Circuit then reversed.⁸⁹

The Supreme Court used the Patterson case to resolve the conflict among the circuit courts. The Court upheld the Fourth Circuit’s opinion by finding that the term “applicable nonbankruptcy law”⁹⁰ must be read to include both federal as well as state law.⁹¹ The Court was confident that Congress, when it desired to do so, knew how to restrict the scope of applicable law to “state law.”⁹² The Court concluded that this holding gives full and appropriate effect to ERISA’s goal of protecting pension benefits and cited a prior Supreme Court case:

Section 206(d) [ERISA, 29 U.S.C. §1056(d)(1)] reflects a considered congressional policy choice, a decision to safeguard a stream of income for pensioners (and their dependents, who may be, and perhaps usually are, blameless), even if that decision prevents others from securing relief for the wrongs done them.⁹³

In re Michael Duawayne Jacobs, Sr.

Subsequent to the *Patterson* decision, the Bankruptcy Court of the Western District of Pennsylvania heard a similar case with slightly different facts.⁹⁴ The IRS filed a tax lien against Jacobs on May 2, 1991 for tax liabilities related to 1985 and 1986.⁹⁵ On September 17, 1991, Jacobs filed for Chapter 13 bankruptcy.⁹⁶ The dispute in question was whether the IRS lien was valid.⁹⁷ If found not valid, the tax liabilities would be discharged in the bankruptcy proceeding and the IRS would not be paid.⁹⁸

⁸⁵ See 11 U.S.C.S. § 541(c)(2) (Law. Co-op. 1986).

⁸⁶ *Patterson v. Shumate*, 112 S.Ct. at 2245.

⁸⁷ *Id.*

⁸⁸ See *supra* note 79.

⁸⁹ *Patterson v. Shumate*, 112 S.Ct. at 2245.

⁹⁰ See 11 U.S.C.S. §541(c)(2) (Law. Co-op. 1986).

⁹¹ *Patterson v. Shumate*, 112 S.Ct. at 2248.

⁹² *Id.* at 2246.

⁹³ *Id.* at 2250 (quoting *Guidry v. Sheet Metal Workers National Pension Fund*, 493 U.S. 365, 376 (1990)).

⁹⁴ See *Jacobs v. IRS (In re Jacobs)*, 147 B.R. 106 (Bankr. W.D. Pa. 1992).

⁹⁵ *Id.* at 107.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

The court stated from the outset that the debtor agreed that the pension plan should be included in his estate, which, based on the facts given, seems odd in light of the *Patterson* decision.⁹⁹ The debtor argued that the non-alienation provision of I.R.C. §401(a)(13), which essentially provides for the same non-alienation provision as §206(d)(1) of ERISA, should preclude the IRS's lien from attaching to his pension fund.¹⁰⁰

In contrast to the *Patterson* decision, neither the debtor nor the court, raised the connection drawn in *Patterson* between Bankruptcy Code §541(c)(2)'s exclusion and the non-alienation provisions. Rather, the court analyzed I.R.C. §6334(a) which provides exemption from IRS levy for specified items and concluded that the debtor's pension plan was not accorded exemption by this section.¹⁰¹ The debtor did raise the applicability of *Patterson*, but the court distinguished the Supreme Court case in that it did not involve the Internal Revenue Code. The court stated: "the conclusion there [*Patterson v. Shumate*], that the bankruptcy trustee cannot get access to a debtor's ERISA qualified pension plan, does not have a significant bearing on the rights of the IRS to reach the same assets under the Internal Revenue Code."¹⁰² The court concluded that the IRS had a valid lien on all of the Debtor's assets including the pension plan.¹⁰³

If the *Jacobs* decision can be upheld in a higher court, it seems that *Patterson* and *Jacobs* together establish that in a bankruptcy situation, an ERISA-qualified pension plan may be subject to collection by the IRS where it cannot be reached by any other creditor. Although, the bankruptcy court did not address the issue, a valid question is whether the ERISA plan would have been subject to IRS collection in bankruptcy had there been no pre-petition lien. Based on *Patterson*, the answer would be no and based on the automatic stay provisions of the Bankruptcy Code, the IRS would be barred from administering a levy post-petition.¹⁰⁴ If, as these cases suggest, the IRS can access a debtor's ERISA-qualified pension plan through a pre-petition levy, but not otherwise, this is difficult to reconcile with the ERISA goal of safeguarding a stream of income for pensioners or with the Bankruptcy Code policy of "fresh start." Without statutory clarification, this area is one which will surely see future litigation between the IRS and bankrupt debtors.

PRIORITY OF IRS CLAIMS: EXCISE TAX VS. PENALTY

The Bankruptcy Code provides for the priority of pre-petition tax claims, including excise taxes, in bankruptcy.¹⁰⁵ A common dispute which arises between bankruptcy

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 108.

¹⁰² *Id.* at 109.

¹⁰³ *Id.*

¹⁰⁴ See 11 U.S.C.S. § 362(a)(4) (Law. Co-op. 1985).

¹⁰⁵ See 11 U.S.C.S. § 507(a)(7) (Law. Co-op. 1985).

officials and the IRS is whether or not a particular "excise tax," as labeled by Congress, is actually an excise tax to be granted priority status or a penalty related to a pecuniary loss which would constitute a subordinated claim.¹⁰⁶

In re Mansfield Tire & Rubber Co.

The Sixth Circuit recently addressed the priority to be accorded federal pension excise tax claims under the Bankruptcy Code.¹⁰⁷ After Mansfield Tire & Rubber Co. had filed petition for relief under chapter 11, the IRS filed proof of claim for the debtor's pension excise tax liability under I.R.C. §4971(a).¹⁰⁸ As the court's analysis indicates, §4971 is located in Subtitle D of the I.R.C. under the heading "Miscellaneous Excise Taxes."¹⁰⁹

Specifically, §4971(a) imposes a yearly tax of 10% on the amount of the accumulated funding deficiency under a pension plan.¹¹⁰ The court rejected the bankruptcy trustee's argument that the assessments under §4971(a) are actually penalties disguised as taxes and held that since Congress labeled the assessments under §4971 excise taxes and since such law was in existence when the Bankruptcy Code drafters used the term excise in §507, it was not up to the court's discretion to redefine the nature of the assessment.¹¹¹ "Congress at the very least meant to include those exactions which Congress itself had previously deemed to be federal excise taxes."¹¹²

In re: C-T of Virginia, Inc.

In a similar case, the Fourth Circuit determined that a tax imposed under I.R.C. §4980 (10% of the assets of a qualified pension plan in the event the assets of the plan revert to the employer upon the plan's termination) is a monetary imposition in the nature of an excise tax and subject to priority treatment in bankruptcy.¹¹³

However, unlike the Sixth Circuit in *Mansfield*, the Fourth Circuit did use its authority to determine the purpose of the tax, rather than letting the name of the tax control.¹¹⁴ The court cited its own prior decision in *In re Kline*, which held: "An enactment which has as its purpose the punishment of conduct perceived as wrongful should be deemed

¹⁰⁶ See 11 U.S.C.S. §§ 507(a)(7)(G), 726 (Law. Co-op. 1985).

¹⁰⁷ See *United States v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Co.)*, 942 F.2d 1055 (6th Cir. 1991), *cert. denied*, 112 S. Ct. 1165 (1992).

¹⁰⁸ *Id.* at 1056.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 1057.

¹¹¹ *Id.* at 1059.

¹¹² *Id.*

¹¹³ *United States v. Unsecured Creditors' Comm. of C-T of Va., Inc. (In re C-T of Va., Inc.)*, 977 F.2d 137 (4th Cir. 1992), *cert. denied*, 113 S.Ct. 1644 (1993).

¹¹⁴ *Id.* at 139.

a "penalty" . . . regardless of the terminology employed by the legislature."¹¹⁵ The court affirmed the lower court's holding that just because a tax is intended to discourage certain conduct, similar to a penalty, it is not prevented from being an excise tax entitled to priority treatment in bankruptcy.¹¹⁶

United States v. Dumler

The Tenth Circuit explicitly rejected *Mansfield*, and determined that the exaction under I.R.C. §72(t) is a "penalty" for purposes of determining priority in bankruptcy.¹¹⁷ Unlike the "excise tax" in *Mansfield*, the §72(t) tax is labeled "additional tax" under the Internal Revenue Code.¹¹⁸ The court used its authority to determine whether the additional tax was actually a disguised penalty and relied on a Supreme Court case not cited by the Sixth Circuit in *Mansfield*. In that case, the court was required to determine whether an exaction under Title VIII of the Social Security Act constituted a debt or a tax for purposes of priority in bankruptcy: "a tax . . . includes any 'pecuniary burden laid upon individuals or property for the purpose of supporting the Government,' by whatever name it may be called."¹¹⁹ The court concluded that the "penalty" under I.R.C. §72(t), which provides for a 10% assessment on individuals for early pension plan withdrawal, is punitive in nature, and not entitled to priority under §507 of the Bankruptcy Code.¹²⁰

RECOMMENDATIONS AND CONCLUSION

The preceding discussion above delineates four major areas of conflict between bankruptcy officials/debtors and the IRS. Other areas of conflict abound.¹²¹ These conflicts have resulted in wasted resources on the part of the bankrupt estates and the federal government. Congress and the executive branch have control over the Bankruptcy Code and the Internal Revenue Code. As such, action should be taken to eliminate these areas of conflict and the resulting waste of resources.

¹¹⁵ *Id.* (quoting *United States v. Feinblakt (In re Kline)*, 403 F. Supp. 974, 978 (D. Md. 1975), *aff'd*, 547 F.2d 823 (4th Cir. 1977). Note that *In re Mansfield Tire & Rubber Co.* specifically rejects the decision in *In re Kline*. *In re Mansfield Tire & Rubber Co.*, 942 F.2d at 1060.

¹¹⁶ *In re C-T of Va., Inc.*, 977 F.2d at 140, *aff'd* 135 B.R. 501 (W.D. Va. 1991).

¹¹⁷ *United States v. Dumler (In re Cassidy)*, 983 F. 2d 161 (10th Cir. 1992).

¹¹⁸ See I.R.C. § 72(t) (Law. Co-op. 1993).

¹¹⁹ *In re Cassidy*, 983 F.2d at 163 (quoting *United States v. New York*, 315 U.S. 510, 515 (1942), in turn quoting *New Jersey v. Anderson*, 203 U.S. 483, 492 (1906)) (emphasis added).

¹²⁰ *Id.* at 164.

¹²¹ See Langstraat and Aquadro, *supra* note 3.

Based on the forgoing analysis, the following specific statutory amendments are suggested:

1. The Bankruptcy Code should be amended to specifically allow the trustee to allocate tax payments between trust fund and non-trust fund taxes when it is necessary for the success of the "fresh start" of the debtor, regardless of the type of bankruptcy proceeding.¹²²
2. The Bankruptcy Code should be amended to explicitly provide that the government's sovereign immunity is completely waived in bankruptcy situations. This will ensure that the policies of "fresh start" and the equal treatment of all creditors under long-approved priorities will be respected.¹²³
3. The Bankruptcy Code should be amended to specifically exclude ERISA-qualified pension plans from the bankruptcy estate and to preclude the use of ERISA-qualified pension plans to resolve debts of the bankrupt debtor including those under liens of the IRS.¹²⁴
4. The Bankruptcy Code should be amended to specifically list excise taxes which are allowed priority treatment in bankruptcy (i.e. all listed in I.R.C. Subtitle D).¹²⁵

In addition, the Internal Revenue Service litigation policies should be changed to discourage bankruptcy litigation which conflicts with the underlying policies of the Bankruptcy Code. Likewise, trustees in bankruptcy should be instructed to allow, without confrontation, IRS collection actions which do not jeopardize the policy-based protections for the bankrupt estate.¹²⁶

The policy behind the Internal Revenue Code is to promote maximum assessment and collection of taxes. The policy behind the Bankruptcy Code is to provide debtors with a "fresh start." In attempting to protect these goals, both the IRS and bankruptcy officials have managed to waste precious resources, resulting in a partial loss of effectiveness for both policies. Hopefully, Congress will take action in the near future to resolve these conflicts and allow both sides to attain their goals in the most efficient manner.

¹²² See *IRS v. Energy Resources Co., Inc. (In re Energy Resources Co., Inc.)*, 871 F.2d 223 (1st Cir. 1989), cert. granted sub nom. *United States v. Energy Resources Co., Inc.*, 493 U.S. 963 (1989), aff'd, 495 U.S. 545 (1990); see also *United States v. Deer Park, Inc. (In re Deer Park, Inc.)*, 136 B.R. 815 (Bankr. 9th Cir. 1992).

¹²³ See *United States v. Nordic Village, Inc.*, 112 S.Ct. 1011 (1992).

¹²⁴ See *Patterson v. Shumate*, 112 S.Ct. 2242 (1992); see also *Jacobs v. IRS (In re Jacobs)*, 147 B.R. 106 (Bankr. W.D. Pa. 1992).

¹²⁵ See *United States v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Co.)* 942 F.2d 1055 (6th Cir. 1991), cert. denied, 112 S.Ct. 1165 (1992).

¹²⁶ See Langstraat and Aquadro, *supra* note 3.

