

“Trust Me – I’m From the IRS”

*Written by:
Gerald L. Baldwin
Frost Brown Todd LLC
Cincinnati, Ohio 45202
gbaldwin@fbtlaw.com*

The phrase used as the title of this article has been the punch line in a lot of bad jokes. But it certainly isn't a joke when the IRS files its claim in your bankruptcy case and you have to decide whether to do an in-depth examination of that claim. Surely, the trustee and the creditors can trust that the IRS has done all its homework, knows the proper amount and priority of its claim. At the very least, we can be confident that the IRS is “doing the right thing” and not overreaching, can't we? Think again.

First, put aside the concept that the IRS is a huge organization with all of the record-keeping and knowledge-base problems that plague large entities. We have all made or seen innocent calculation errors. What this article will discuss is much more sinister and parties in a bankruptcy need to be alert to it. “It” is the belief of the IRS, and apparently the Department of Justice, that the IRS is not bound by the distribution scheme in § 726 of the Code. Specifically, the IRS has adopted a philosophy that it can apply some tax payments in the manner which it deems to be in “the best interest of the IRS.”

Assume for the moment that you are a chapter 7 trustee or a creditor of an estate in a case that was recently converted. The IRS files a proof of claim that asserts pre-petition taxes, penalties and interest in amounts significant enough to eliminate any distribution potential for unsecured creditors. Surely the IRS has made an appropriate and accurate computation. Why spend the time and effort to “test” that claim? Because,

as some of us have learned, you cannot always trust the IRS. Sure, there will always be innocent computational or record-keeping errors. However, the subject of this article is an entirely different type of conduct that the IRS seems to believe is authorized by its own Revenue Procedures.

Maximizing The IRS Claim

The issues specific to this discussion arise when the IRS receives a post-petition tax payment from a debtor who has not designated the manner in which the payment is to be applied. Consider a recent case¹ from the Eastern District of Kentucky. Debtor and her husband both filed chapter 11 cases which were later converted to separate chapter 7 cases. Both debtors had operated their own businesses and both had pre-and post-petition tax problems. After a decade long battle, all of the parties agreed to a settlement with the IRS, or so they thought. Post-petition, the husband had made several payments to the IRS on his own tax liability and had designated specific application of those payments to certain tax items. However, these payments did not completely resolve tax claims against either debtor. Particularly important to this case, the IRS assessed both pre-and post-petition taxes against the wife. The disputes gave rise to adversary proceedings, which were filed in the husband's case, involving both trustees, both debtors and the IRS. In 2001, the parties all reached a settlement which took the form of an Agreed Order. Husband agreed to pay another \$300,000 to the IRS which would be applied to certain of his pre-petition taxes in a specified manner. He received a release from all pre-petition tax liability. In addition, the debtors agreed to make a separate payment of \$250,000 for which the wife would receive a full and complete release from all pre-petition liability

¹ "Recent" is a deceptive term; the bankruptcy case was filed in 1991 as a chapter 11, converted in 1992. *In re Linda S. Sergeant*, No. 5:91-bk-51276. (Bankr. E.D. Ky.) The Court's Memorandum Opinion was entered on Jan. 7, 2008 as Docket Entry 651 in the case.

and post-petition accruals. The agreement did not provide that either estate would be released, nor did it specify how the IRS was to apply the payment.²

Following the settlement, the IRS submitted an amended claim against the wife's estate asserting that various tax priority items were still owed. The trustee believed that these items had been discharged through the application of the wife's payment under the Agreed Order. The trustee and two creditors filed objections to the amended claim and conducted discovery concerning the manner in which the IRS had calculated the amended claim. Internal memoranda, which the IRS fought to protect from discovery, revealed that the IRS had determined that it would apply the \$250,000 payment in the manner which would *maximize* its claim against the wife's estate. The payment priorities set forth in § 726 of the Code were specifically considered and the IRS purposely avoided applying the credits to the highest priority claims. Instead, the payment was used to eliminate items which the IRS knew would never be recoverable from the estate. According to the internal documents, the Department of Justice concurred.

Best Interest Of The Service

The IRS documents revealed that the Service had decided to apply a what it calls the "best interest of the Service" rule.³ This is apparently a rule little known outside the halls of the IRS and the Department of Justice. Hopefully, this article will serve to change that. It was the position of the IRS and the Department of Justice that by applying the rule, the \$250,000 payment could be applied to the liabilities of the wife in the manner that created the largest possible recovery from the estate for the IRS. Because a

² Even if the agreement had specified how the payment was to be applied, it might not have made any difference to the IRS because the IRS generally takes the position that any payment received during a bankruptcy is "involuntary" and therefore its application cannot be designated by the debtor.

³ Sometimes the Department Of Justice referred to the rule as the "best interest of the United States" rule.

portion of the IRS “claim” was for taxes and charges that were either non-priority or not recoverable at all under the Code, the IRS determined that the payment would be applied first to those taxes, penalties and post-petition interest which it otherwise would not recover. Had this treatment been permitted, it would have virtually eliminated recovery by any other creditors.

The “best interest of the Service” rule appears to have had its origin in Revenue Ruling 73-305, a ruling that had nothing to do with bankruptcy. The ruling simply stated

where additional taxes, penalty, and interest are assessed for one or more taxable periods and there are no specific instructions as to the application of the partial payment tendered by the taxpayer, the amount of the payment will be applied by the Service to tax, penalty, and interest, in that order, for the earliest period, then to tax, penalty, and interest, in that order, for the next succeeding period, until the payment is absorbed.

The ruling does not address either the “best interest of the Service” or the implications of the Bankruptcy Code. Nonetheless, its next version did.

In 2002, the earlier Revenue Ruling was replaced by Revenue Procedure 2002-26 in which the Service declared that the IRS had the right to apply undesignated payments in the manner it deemed to be in its best interest. Substantively, the Revenue Procedure simply provided for a different order for the application of an undesignated payment; it would be applied “to satisfy the liability for successive periods in descending order of priority.” However, in the preamble leading up to that pronouncement, the Service appears to have launched a new doctrine, declaring that somehow the interest of the IRS played some role in payment methodology. The specific language was:

the Service will apply the payment to periods in the order of priority *that the Service determines will serve its best interest.* (Emphasis added).

In the *Sergent* case, the Service seems to have elevated the judgment of some revenue agent as to what was in the best interest of the Service over the specific direction of Revenue Procedure 2002-26 in determining what taxes should be paid first. In *Sergent*, the Service attempted to apply the post-petition payment first to those taxes and charges with the lowest priority. By doing so, the Service appears to have declared that the “best interest of the Service” rule gives a revenue agent the power to ignore the specific mandate set forth in the Procedure that the payment should be supplied in *descending* order of priority.

Neither Revenue Procedure 2002-26 nor its predecessor mention any interplay with the provisions of the bankruptcy code. However, the IRS has consistently taken the position that any payments received from a debtor in bankruptcy must be considered to have been involuntary and therefore not subject to designation by the taxpayer as to their application. Once a payment is deemed to have been involuntary, the IRS can decide that it is in the “best interest of the Service” to apply the payment so as to increase the likelihood that the IRS will obtain the maximum recovery for the treasury. The IRS has apparently concluded that, in a chapter 7 case, a post-petition payment is not subject to the holding in *Energy Resources* that the bankruptcy court has the power to determine how to apply the payment.

Until 1989, decisions were favorable to the IRS position that any payments made as a result of bankruptcy were deemed to be involuntary and therefore subject to application as the IRS might determine.⁴ However, in 1990, the Supreme Court decided the *Energy Resources* case, holding that post-petition payments by a chapter 11 debtor

⁴ See *In re Ribs-R-Us, Inc.* 828 F.2d 199 (3d Cir. 1987); *In re Howell*, 1988 Bankr. LEXIS 2649 (Bankr. W.D.N.C. Nov. 30, 1988); *In re Gilley Consulting Eng'rs, Inc.*, 105 B.R. 734 (Bankr. N.D. Ga. 1989); *In re Puget Sound Plywood, Inc.*, 1989 Bankr. LEXIS 1434 (Bankr. W.D. Wash. Jan. 9, 1989).

made pursuant to a plan, could be designated for application by the debtor, thereby binding the IRS to apply the payments as designated.⁵ As one might expect, the issue of how to apply post-petition payments has generally arisen in the context of either a chapter 11 reorganization or an individual's chapter 13 case,⁶ perhaps because chapter 7 debtors infrequently tender post-petition payments on pre-petition taxes. This absence of case law may make the *Sergent* case unique.

Court Response

How did the “best interest of the Service” rule fare with the Court? The Court was not impressed with the IRS position. Two sentences disposed of the IRS position.

Clearly, these otherwise applicable IRS rules or regulations have been subordinated in bankruptcy cases to the distribution scheme provided for by section 726 of the Bankruptcy Code. The IRS has no greater right than any other creditor to manipulate the order of distribution provided by the Code.⁷

The Court held that the distribution hierarchy set forth in §726 of the bankruptcy code was superior to the power of the IRS to dictate the application of a post-petition payment in its regulations and procedures. The Court concluded that, by applying a payment in a manner that would increase the claim of the IRS and the resulting distribution, the IRS was circumventing the distribution scheme set forth in the bankruptcy code. The Court determined that it had the power to disallow the claim of the IRS to the extent that it reflected such a distortion.

Notwithstanding the holding in *Energy Resources*, the IRS did not extend its application to *Sergent*. The reason might be the fact that the *Sergent* case involved the

⁵ *United States v. Energy Resources Co., Inc.*, 495 U.S. 545 (1990).

⁶ See cases at fn. 4.

⁷ See *Sergent*, Docket Entry 651.

application of post-petition payments to tax claims in a chapter 7 case. It is just as probable that the IRS differentiated the case from *Energy Resources* because, in *Sergent*, the taxpayer had made no designation for the payment because the taxpayer had negotiated a full release of all tax claims against the debtor. In that scenario, the IRS may have felt free to apply the payment in such a manner as to maximize its priority claims. Either way, the IRS never clearly articulated any rationale for its position in *Sergent*.

Although those two sentences quoted above from the Court's decision are dispositive, the Court had more to say about the arguments made by the Department of Justice. The Court declared that it could not permit the government to apply post-petition payments in a manner that would deprive unsecured creditors of their fair share of the distributions. The Court used words like "high-handedness" to describe the position of the Service in attempting what the Court called "an act to exercise control over a bankruptcy estate, an act enjoined by section 362(a)(3)."

This case may be an anomaly; I have never had another occasion to see this approach taken by the IRS. One would hope that the "best interest of the Service" rule has seldom been so liberally applied. After all, it is directly at odds with the Internal Revenue Service Manual covering collections, which states:

the priority of payments made in a Chapter 7 case is set forth in 11 USC §726. Because general unsecured claims are paid ahead of any claims for non-pecuniary loss penalties, payments should not be applied to non-pecuniary loss penalties until all other general unsecured claims are paid.⁸

⁸ Part 5, Chapter 9, Section 15.4.

On the other hand, perhaps it is commonplace to disregard §726 when the IRS receives post-petition payments. The Court was not sure how widespread the practice is but had this to say:

The court does not know whether application of payments in the manner demonstrated in this case is a common IRS practice in bankruptcy cases. If so, it should be stopped.

It certainly does not appear as if there is a wealth of case law dealing with the subject. Perhaps that is due to the fact that few chapter 7 debtors make post-petition payments. In reality, it may not be economic for the trustee or creditors to thoroughly examine claims made by the IRS. Although tax calculations, payments, penalties and interest may be difficult to fathom, the examination of the IRS's methodology may prove to be the difference between the receipt of a dividend or not to the unsecured creditors.