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BANKRUPTCY LAW NEWSLETTER

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IRS AND BANKRUPTCY

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During my eight (8) year career with the Office of District Counsel in Grand Rapids, Michigan, I represented the Internal Revenue Service in hundreds of bankruptcy matters. During that time, it became apparent that many of the problems practitioners have with Federal tax issues arise out of a lack of understanding of the bankruptcy process within the IRS. This article is a general overview of that process related to the policies and procedures within the IRS and the Office of Chief Counsel ("Chief Counsel") for the IRS.

Tax liability determinations are generally made unilaterally by the IRS either through the audit or collection process. The taxpayer has certain appeal rights that allow the challenge of those determinations (i.e., Office of Appeals, Tax Court, or District Court). When those appeal rights are exercised unsuccessfully, or waived through the failure to act, the IRS will make an "assessment" of the remaining liability.

The date of assessment becomes significant in determining priority status in bankruptcy under the 240-day rule (§ 507(a)(7)(A)(ii)) of the Bankruptcy Code or under the Internal Revenue Code's ten (10) year collection statute of limitation (IRC § 6502(a)). During the 240-day period following the assessment, the IRS will attempt to properly file its liens in order to secure its claim and take the 240-day rule out of play. However, even though the IRS may appear to have a secured claim in the bankruptcy form, the 240-day rule may still be significant where a debtor has insufficient equity to secure the IRS's claim. To the extent equity is lacking, the secured claim of the IRS may be challenged and re-evaluated as an unsecured claim under the priority provisions (in most cases, the IRS will accept the value

assigned in the schedules for stipulation purposes).

Prior to filing a bankruptcy for a debtor having primarily tax liabilities, alternative non-bankruptcy means of resolving tax liabilities should be evaluated. Payment agreements or Offers-in-Compromise are alternatives that may stop the IRS collection process short of filing a bankruptcy.

Once a bankruptcy is filed, post-petition IRS problems (i.e., violations of the stay) are often the result of insufficient notice to the IRS. Until proper notice is received, the IRS will continue to offset refunds, levy or seize assets, or take other collection action. Notice must be given to the IRS, District Director, Detroit, Michigan, Attn: Special Procedures Branch ("SPB") in order to have proper "freeze codes" entered in the debtor's account on the IRS's computer system. Collection action can originate out of numerous cites or branches of the IRS and unless the computer freeze codes are imputed, the stay will not be recognized.

Within the IRS Collection Division, SPB was created to handle bankruptcy tax matters. This group is specially trained to receive and review bankruptcy notices, petitions, plans, pleadings, and the related tax history. It is SPB that inputs "freeze codes" and makes the initial determination on various issues, such as proofs of claim and plan objections. If legal action is required, it is SPB that refers the matter to the Office of District Counsel for the IRS ("District Counsel").

A common error many practitioners make is to assume that District Counsel is part of the IRS. It is not. The IRS and the Chief Counsel are parallel agencies extending independently under the umbrella of the Department of Treasury. Within the IRS, there is the National Commissioner, the Regional Director, and the District Director. Within the Office of Chief Counsel, there is the National Chief Counsel, Regional Counsel, and the District Counsel. The intent of this structure is to create an attorney-client relationship. It is designed to avoid a situation in which legal counsel ("District Counsel") is under the absolute control of the client ("District Director").

District Counsel attorneys are educated and trained in both tax and in bankruptcy matters. District Counsel was originally assigned the task of reviewing SPB referrals, formulating the legal position for the IRS, and then referring cases to the Department of Justice, U.S. Attorney's Office, to act as the advocate for the IRS in all bankruptcy proceeding.

In the early 1980's, a program was instituted whereby District Counsel Attorneys were sworn in as Special Assistant United States Attorneys ("SAUSA") which authorized them to retain jurisdiction of bankruptcy cases involving federal tax issues and handle the related bankruptcy proceedings directly. The Grand Rapids District Counsel Sub-Office was established in 1987 as primarily a SAUSA office for the Western District cases assigned to Grand Rapids, Kalamazaoo, and Lansing. Traverse City and Marquette cases continued to be handled, through the referral process, by the U.S. Attorneys Office.

In August of 1996, the Grand Rapids District Counsel Sub-Office became a casualty of the current Chief Counsel reorganization. With its closure, all Western District cases are now being handled by Detroit District Counsel Office, who will review and refer bankruptcy matters to the U.S. Attorney's Office in Grand Rapids. The Grand Rapids District Counsel docket attorneys (Tanya Marcum, Jim Mauro, and Terry Zabel) all declined re-assignments to Detroit and have found new positions in the private sector.

As part of the reorganization, the Regional Office in Cincinnati, Ohio, for both IRS and Chief Counsel was also eliminated (October 1, 1995). Michigan is now part of the Northeast Region, which is run out of Manhattan, New York. While the Cincinnati Service Center remains open, some of its work is being diverted to the Philadelphia Service Center. Policies and

procedures are changing in accordance with philosophies coming out of the new Regional Office.

The reorganization process is also responsible for the reduction of staffing within both the IRS and Chief Counsel. Early retirement offers have caused many of the most knowledgeable and experienced employees to leave. Eliminations of offices, the frustration caused by cut backs in resources, and rising caseloads have caused other employees to seek employment elsewhere. Moral, quality, and service have suffered as a result of these changes.

In order to minimize the negative impact an IRS claim (or potential claim) may have on you and your client, begin each case with an understanding of the system that you will be dealing with in trying to resolve it. Be prepared to initiate solutions to problems up front. Prepare and present unfiled returns as soon as possible. Have reasonable settlement stipulations prepared for presentation to either SPB, District Counsel, or the U.S. Attorney's Office. Develop a good working relationship with individuals representing the IRS through communication and cooperation. Avoid frivolous pleadings (i.e., objection to estimated claims when your client's failure to file returns caused the problem). Make sure you use proper taxpayer identification numbers and include such on all letters, documents, and pleadings sent to the IRS. Make sure all copies of tax returns contain a proper signature. If an adequate protection agreement is necessary for use of cash collateral, submit it to the IRS at the time the case is filed (or shortly thereafter). Keep copies of everything you send to the IRS and always note who you have dealt with.

IRS problems can create delays and headaches for you and your client. If not identified and resolved as soon as possible, the problems may become an even greater problem in the future. Taking the extra time and effort to resolve IRS problems up front will not only help the IRS but may help you and your client in the long run.

RECENT BANKRUPTCY COURT DECISIONS

The Western District Court decisions were summarized by Dean Rietberg.

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The Honorable JoAnn C. Stevenson, in the adversary proceeding Butler, et al. v Clark (In re Clark), 202 B.R. 243 (Bankr. W.D. Mich. 1996), dismissed dischargeability actions brought against the Debtor, a financial planner, by several investors who lost access to their retirement funds and other capital given to the Debtor or one of his related entities to invest according to his philosophy of Christian stewardship.

The plaintiffs' §523(a)(2)(A) claims for fraudulent misrepresentation were not persuasive for various reasons. The Court followed Western District of Michigan precedent in finding that certain investors failed to establish that the Debtor obtained a substantial benefit as a result of the investment. In another circumstance, the Court ruled that the investor's claim was not actionable because the wrongdoing was not committed at the time the debt at issue was incurred.

In other circumstances the facts did not withstand the Court's application of the subjective "justifiable" reliance standard recently set forth by the Supreme Court in the case of Field v Mans, __ U.S. __, 116 S. Ct. 437 (1995). Regarding the role of the religion in the investments at issue, the Court stated "while a fraud perpetrated in the name of religion may seem particularly repugnant ... the Court will not imply fraud merely because [the Debtor] applied a Christian philosophy to investing, or because his approach was a

factor Plaintiffs considered before they invested." Clarke at 255.

The Plaintiffs' §523(a)(4) claims alleging fraud or defalcation while acting in a fiduciary capacity were also not proven for several reasons. First, §523(a)(4)'s "requirement that funds at issue must be subject to an express or technical trust mandates that trusts implied at law are insufficient," or in other words, " both the trust status of funds and the concomitant fudiciary duty to manage the funds must arise when the debt is incurred, not at the time of the alleged wrong." Id. at 256.

Here the Court found that the Debtor had no fiduciary duty to manage the particular funds at issue at the time the investments were made. A mere showing of the debtor-creditor relationship is insufficient. Regarding the Bankruptcy Code's undefined use of the term "defalcation", the Court determined that the investor's claims were more properly viewed as unmet demands for the return of funds which were subject to an SEC "freeze", rather than as the Debtor's failure to account for funds or meet obligations.

Finally, concerning the plaintiffs' §523(a)(6) claim for willful and malicious injury, the Court found no proof of the conversion of the investors' funds because the Debtor did not exercise any unauthorized or wrongful dominationor control over the funds. The investors failed to show that the Debtor exceeded his investment authority with the intent to use the investors' funds for his own improper purposes.

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Dischargeability Under Sections 523 (a)(2)(A) and (B):

In another dischargeability action brought under 11 U.S.C.§523(a)(2)(A), the Honorable JoAnn Stevenson in Paul v Redburn (In re Redburn), (Bankr. W. D. Mich. December 6, 1996), dismissed the Plaintiffs' complaint for different reasons. Significantly, as will soon become apparent, the plaintiffs had earlier clarified that they no longer sought relief under §523(a)(2)(B).

In this adversary proceeding twelve minority shareholders of the Debtor's bankrupt corporation sought to have their state court consent judgment for misrepresentation damages against the Debtor declared nondischargeable. The minority shareholders alleged that, in order to raise additional capital and induce their investment, the Debtor, as majority shareholder of the company in which they would receive an equity interest, had represented to each of them that the assets of the company were unencumbered.

After trial the Court first reviewed the standards for nondischargability under both §523(a)(2)(A) and (B). Focusing on the key language for purposes of this case found in the last phrase of §523(a)(2)(A), "other than a statement respecting the Debtor's or an insider's financial condition ," the Court concluded that subsections (A) and (B) of §523 are mutually exclusive. In the Court's words, "statements regarding the Debtor's or an insiders financial condition are expressly excluded from the reach of subsection (A) and are only actionable under (B)."

After examining the lines of cases interpreting both the "limited" and "expansive" readings of the phrase "statements respecting ... financial condition," the Court applied a modified "expansive" view. Concluding that Congress could have used the more precise term "financial statement" (emphasis added) but chose not to, the Court determined that "the only" 'statements' which fall within subsection (A)'s exception -- and are therefore actionable only under subsection (B), and only then if they are in writing -- are those 'respecting the Debtor's or an insider's financial condition.'"

Applying the newly articulated legal rule to the facts before it, the Court found that the statements contained in the distributed stock reports were intended to convey material financial information about the Debtor's company, in an "insider" of the Debtor, to investors of the company, and therefore are only

actionable under §523(a)(2)(B). Accordingly, since the creditors had earlier waived their subsection (B) claims, electing to proceed only under (A), the Court dismissed their complaint.

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Dischargeability Under §523(a)(6)/ Collateral Estoppel:

"Does a Michigan state court criminal conviction for felonious assault, based upon a nolo contendere plea, collaterally estop a Defendant-Debtor from litigating a nondischargeability action under §523(a)(6) of the Bankruptcy Code?" and " Does Michigan state court civil judgment for assault and battery, based upon a "true default," i.e., there was no appearance and absolutely no participation in the state court action, collaterally estop a Defendant-Debtor from litigating a nondischargeability action under §523(a)(6) of the Bankruptcy Code?" were the two related issues framed by the Honorable James D. Gregg in the case of Vogel v Kalita (In re Kalita), (Bankr. W.D. Mich. November 18, 1996).

In a thorough review of the judicial principles of res judicata, collateral estoppel, and full faith and credit in the context of nolo contendere pleas and default judgments under both state and federal law, Judge Gregg answered both questions in the negative. The Court alternatively held that full faith and credit should not be given to true default judgments because a limited, but valid federal purpose exception exists.

STEERING COMMITTEE

The next Steering Committe meeting will be January 17, 1997 at the Peninsular Club in Grand Rapids at noon.

BANKRUPTCY NEWS

The 1997 Sixth Circuit Judicial Conference is scheduled for May 14-16, 1997 at the Opryland Hotel in Nashville, Tennessee. If you would like to attend please return the registration form by January 31, 1997. Please see insert for more details.

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FIFTY-SEVENTH

CONFERENCE

of the

SIXTH JUDICIAL CIRCUIT OF THE UNITED STATES

May 14-16, 1997

The Opryland Hotel
Nashville, Tennessee

To: All Federal Practitioners in the Sixth Circuit

1997 Sixth Circuit Judicial Conference

For the first time in its history, the Sixth Circuit will hold an open Conference and all attorneys admitted to practice in the federal courts in the Sixth Circuit are cordially invited to attend.

The 57th Sixth Circuit Judicial Conference will be held May 14-16, 1997 at the Opryland Hotel in Nashville, Tennessee. The Conference program will present an opportunity for judges and lawyers to exchange ideas on how the federal courts are operating and how they can be improved.

The Conference will open with a plenary session entitled, "Whose Case Is It?" on Thursday morning, May 15, and be followed by breakout sessions on Thursday afternoon. Topics for the group sessions include Contemporary Linguistics and Statutory Interpretation; Use and Abuse of Expert Testimony; Bankruptcy Appellate Panels; Impact of Bankruptcy on State Court Proceedings; a criminal session entitled "Everything But Trial"; Providing Effective Representation in Death Penalty Habeas Corpus Cases; ADR: What Works and Why; Employment Law; and Computer Enhanced/Generated Demonstrative Evidence.

The program will continue on Friday morning with District Meetings. A common group of topics will be identified and placed on the agenda for each of these meetings.

Friday afternoon will be free for recreational activities. The Conference will conclude with a banquet on Friday evening, May 16.

All program sessions will be held at The Opryland Hotel.

During the program sessions, there will be optional recreational activities for spouses.

For those attorneys from Kentucky, Ohio and Tennessee, the Conference will seek approved CLE credit for attendance at this program.

If you are interested in attending the 1997 Sixth Circuit Judicial Conference, please complete this information form so that registration materials can be sent to you in March. Please return by <u>JANUARY 31, 1997</u> to:

James A. Higgins
Circuit Executive
503 Potter Stewart
United States Courthouse
Cincinnati, Ohio 45202
Fax: 513/564-7210
E-Mail: ***conf97@ck6.uscourts.gov***

Name: ______________________________

Title: ______________________________

Mailing Address: ______________________________

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Telephone: ______________________________

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Admitted to Practice in Federal Judicial District:
(Circle appropriately)

6CA EDKY WDKY EDMI WDMI

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If you have any questions concerning the Conference, please contact the

Circuit Executive's Office at
Telephone: 513/564-7200

CHAPTER 13 TRUSTEES

1122 LEONARD NE, GRAND RAPIDS MI 49503
(616) 732-9000 FAX (616) 732-9005

To all Bankruptcy Practitioners, Creditors and Interested Parties:

Due to the large volume of Chapter 13 cases that have been filed in the Western District of Michigan over the last year, our office has had to make some changes in order to become more efficient. We have implemented an inquiry program accessible to you through a computer equipped with a modem or we have a computer set up at our office that local parties may find convenient.

For security reasons, the inquiry program is set up on a separate computer system. A copy of our information is loaded on to this computer system. This information is updated on a weekly basis and is accessible by modem 24 hours a day 7 days a week except Friday mornings when the information is being updated. For those of you who are local and wish to access the information directly at our office, you may do so Monday through Thursday, 9:00a.m. through 4:30 p.m. and on Fridays from 11:00 a.m. through 4:30 p.m.

Due to the extra effort it takes to administer the increased number of cases, we will be limiting telephone access to our case analysts. We strongly encourage you to implement this inquiry system either by modem or by the system available in our office.

To access inquiry program with your modem:

If you have an IBM compatible PC with a modem, access would require the following:

- SOFTWARE: Reachout (will work in DOS, WINDOWS and WINDOWS 95)
- COST: Approximately $150.00
- WHERE TO BUY: You can usually order your software through a local vendor or mail order software company. If you cannot find the software, our hardware support can order it for you. They are as follows: KORE-HICOM (616) 361-3666.
- SETUP: Once you have loaded and setup the software on your computer system, you will need the following information:

  1. Your name or your company name.
  2. A password of your choice for the Reachout program.
  3. The phone number from which you will be dialing on your modem.

  Once you have the above information at hand, contact our office at (616) 732-9000. Enter extension 19 for Jari. The above information will be set up in our system and you will be informed of our modem number and the procedures for accessing the inquiry program. Should you wish, a code key can be mailed or faxed to you for interpreting our information.

Thank you for your understanding and support in this matter.

Sincerely,

RAYMOND B. JOHNSON
BRETT N. RODGERS
Chapter 13 Trustees

ISSUE SUMMARY

NAME OF CASE: ____

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CHAPTER: ____

RELIEF SOUGHT: ____

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ISSUE: ____

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BENCH DECISION: ____

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REPORT SUBMITTED BY: ____