TAXES - The Tax Magazine, The Impact of *Energy Resources* and *Begier* on IRS Policy Statement P-5-60, (Jan. 1, 1991)

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Stephen P. Kauffman discusses two recent decisions by the U.S. Supreme Court and their effect on the options available to financially distressed businesses

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In the spring of 1990, the Supreme Court decided two cases which will significantly expand the options available to financially distressed businesses with delinquent payroll tax obligations. On May 29, 1990, the Supreme Court decided *United States v. Energy Resources, Inc.*[1] In *Energy Resources*, the Court held that a Bankruptcy Court has the power to order the IRS to allocate payments of delinquent taxes to trust fund taxes first if such allocation is necessary to the reorganization's success.[2]

On June 4, 1990, the Supreme Court decided *Begier v. IRS.*[3] In *Begier,* the Court held that a trustee in a Chapter 7 bankruptcy proceeding does not have the power to set aside voluntary payments of trust fund taxes which the debtor makes to the IRS out of the general operating account within 90 days of the filing of the petition in bankruptcy.[4]

It is the policy of the IRS, as set forth in Policy Statement P-5-60 ("PS P-5-60"), to apply payments to delinquent payroll taxes to non-trust fund liabilities[5] first, unless a taxpayer makes a "voluntary designation."[6] This article will address the impact of the *Energy Resources* and *Begier* decisions on PS P-5-60 and the planning opportunities arising as a result of those decisions.

The *Energy Resources* Decision

Facts. In *Energy Resources* the Supreme Court had occasion to consider the Government's appeal of two companion cases from the First Circuit Court of Appeals: *In Re: Energy Resources Co., Inc.*[7] and *In Re: Newport Offshore Limited.*[8] Both cases involved Chapter 11 debtors in possession with significant payroll tax delinquencies consisting of trust fund[9] and non-trust fund components. Both debtors filed plans of reorganization pursuant to which payment of the payroll tax delinquencies would be allocated first to trust fund obligations. The Bankruptcy Courts approved both plans over the objections of the IRS.

The IRS appealed the *Energy Resources* matter to the U.S. District Court for the District of Massachusetts.[10] and the *Newport Offshore* matter to the U.S. District Court for the District of Rhode Island.[11] The United States District Court for the District of Massachusetts affirmed the decision of the Bankruptcy Court while the United States District Court for the District of Rhode Island reversed.

The First Circuit Court of Appeals, in a consolidated appeal, reversed the decision of the United States District Court for the District of Rhode Island and affirmed the decision of the United States District Court for the District of Massachusetts, thereby confirming the authority of a Bankruptcy Court to allocate payments of delinquent payroll taxes to trust fund taxes first, if such allocation was necessary to the success of the reorganization.[12] The Supreme Court granted the Government's petition for certiorari to review the decisions of the First Circuit Court of Appeals[13] and, in deciding the *Energy Resources* case, resolved a conflict among the Courts of Appeals of several circuits.[14]

Supreme Court's Analysis. In deciding *Energy Resources*, the Court, while acknowledging that the Bankruptcy Code does not "explicitly authorize the Bankruptcy Courts to approve reorganization plans designating tax payments as either trust fund or non-trust fund,"[15] noted that Bankruptcy Courts "as courts of equity, have broad authority to modify creditor-debtor relationships … [and retain] residual authority to

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approve reorganization plans including 'any … appropriate provision not inconsistent with the applicable provisions of the [Bankruptcy Code].'"[16] The Court recognized the IRS's desire to use Internal Revenue Code Section 6672 as a lever to collect delinquent trust fund taxes; however, it rejected the Government's argument that the Bankruptcy Court's ability to apply payments to trust funds taxes first contravenes IRC Section 6672. The Court reasoned that Section 6672 is an option available to the Government "both during and after the corporate Chapter 11 filing as an alternative collection source for trust fund taxes."[17] In closing its succinct, almost summary decision, the Court concluded that Section 6672 was designed to promote the collection of *trust fund taxes*, not insure the collection of *all* taxes.[18]

The *Begier* Decision

Facts. American International Airways, Inc. ("AIA") was a commercial airline. In early 1984, AIA became delinquent in its payroll tax obligations, and the IRS ordered AIA to establish a separate account (the "Trust Account") and to deposit all trust fund taxes into that account.[19] AIA established the Trust Account, but deposited only a portion of the trust fund taxes into it. Through June of 1984, AIA remitted over $1,500,000 of trust fund taxes to the IRS, paying $695,000 from the Trust Account and over $946,000 from its general operating account (the "General Account").

In July of 1984, AIA filed a voluntary petition in bankruptcy under Chapter 11 of the Bankruptcy Code. In September of 1984 the court converted the proceeding into a Chapter 7 bankruptcy and appointed Harry Begier, Jr. as trustee.

Begier sought to set aside all payments made to the IRS within the 90-day period ending on the date that the bankruptcy petition was filed.[20] The Bankruptcy Court set aside only those payments which were made out of the General Account. The District Court affirmed the Bankruptcy Court's decision; however, the Third Circuit Court of Appeals reversed, holding that "*any* prepetition payment of trust fund taxes is a payment of funds that are *not the debtor's property* and that such a payment is therefore not an avoidable preference."[21] (Emphasis added.) The Supreme Court affirmed the decision of the Third Circuit Court of Appeals.

Supreme Court's Analysis: *(1) Scope of the Trustee's Avoidance Powers.* The Court commenced its analysis with an examination of the extent of a bankruptcy trustee's ability to set aside a preferential transfer under Section 547(b) of the Bankruptcy Code.[22] Under BRC Section 547(b), the trustee's avoidance powers extend only to "property of the estate." BRC 541(a)(1) provides that "property of the estate" includes "all legal or equitable interests of the debtor in property as of the commencement of the case"; however, under BRC Section 541(d), property in which the debtor holds pure legal title is included in the estate only to the extent of the debtor's interest. Therefore, if, and to the extent that the funds which AIA remitted to the IRS were funds held in trust for the benefit of the IRS, the trustee would not have the power to set aside AIA's payment. The issue, as framed by the Court, was "whether the money AIA transferred from its [General Account] to the IRS was property that AIA had held in trust for the IRS."[23]

(2) Creation and Scope of the Trust Imposed by IRC Section 7501. IRC Section 7501 imposes a trust over taxes collected or withheld by third parties. Section 7501 provides that "whenever any person is required to *collect or withhold* any Internal Revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States." In *Begier*, the trustee argued that a trust fund tax *has not been collected or withheld* until it is *remitted to the IRS with a relevant return or placed in a separate account.* (Emphasis added.) The Court rejected the trustee's position, citing various sections of the Internal Revenue Code in support of the proposition that trust fund payroll taxes are deemed to be collected or withheld as and when the wages are paid. Nevertheless, the Court recognized that the *mere existence of a trust*, in and of itself, *does not resolve the issue of what particular funds, if any, are subject to the trust.*[24] (Emphasis added.) In other words, did AIA transfer funds to the trust which was created when it paid its employees wages?

In analyzing this issue, the Court first distinguished the Section 7501 trust from the common law trust and decided the common law tracing rules were not helpful. Next, the Court considered the applicability of *United States v. Randall*,[25] a case involving a postpetition transfer of estate property to satisfy prepetition

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trust fund tax obligations. In *Randall*, the Court "refused to permit the IRS to recover the taxes ahead of administrative expenses, stating that ‘the statutory policy of subordinating taxes to cost and expenses of administration would not be served by creating or enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and services created the assets.'"[26]

The Court then examined the legislative history of BRC Section 541 to the extent that it addressed the issue of prepetition trust fund taxes withheld or collected. Based on this analysis, the Court concluded that Congress had abrogated the rule set forth in *Randall* when it revised the Bankruptcy Code in 1978.[27] The Court seized on language in the legislative history of BRC Section 541 directing courts to "permit the use of reasonable assumptions under which the IRS, and other tax authorities, can demonstrate the amounts of withheld taxes which are still in the possession of the debtor at the commencement of a case."[28] Further analysis of the legislative history led the majority of the Court to adopt the "reasonable" assumption that "any *voluntary prepetition* payment of trust fund taxes out of the debtor's assets is not a transfer of the debtor's property."

The Mandate of PS P-5-60

In order to enhance the performance of IRS personnel, the IRS National Office issues policy statements.[29] Policies are defined as follows:

> Policies are those major decisions of the Commissioner or Deputy Commissioners within the framework of basic tax and administrative policies of Treasury and Congress, which govern and guide Service personnel in the administration of Internal Revenue laws and which do not directly relate to time schedules or the allocation of funds, staffing, equipment, or other resources.

IRS Policy Statements are contained in the Handbook, Policies of the Internal Revenue Service. PS P-5-60, "100% Penalties, Transferee Assessments and Third Party Liabilities," provides guidance to IRS revenue officers in connection with the use of the 100 percent penalty to collect delinquent trust fund taxes. PS P-5-60 provides, in relevant part, as follows:

> In determining the amount of the 100% penalty to be assessed in connection with withheld income and employment taxes, *any payment made on the corporate account involved is deemed to represent payment of the nonwithheld portions of the liability* (including assessed and accrued penalty and interest) *unless there was some specific designation* to the contrary by the taxpayer. The taxpayer, of course, has no right of designation in the case of collections resulting from enforced collection measures. [Emphasis added.][30]

The IRS's rationale underlying this policy is clear: by applying payments to non-trust fund liabilities first, the IRS maximizes the utility of the 100 percent penalty and presumably increases the probability of ultimately collecting the *total* tax liability. If, for example, a corporate taxpayer with total cash on had of $40,000, had accrued payroll tax liabilities of $100,000, 50 percent of which were non-trust fund taxes, then the IRS would hope to ultimately recover a total of $90,000 from two sources: $40,000 from the corporation and $50,000 from any persons liable for the 100 percent penalty. Furthermore, the 100 percent penalty is not dischargeable in bankruptcy[31] and the statute of limitations on administrative collection does not commence until the penalty has been assessed.[32] However, in light of the *Energy Resources* and *Begier* decisions, and for other reasons discussed in the remainder of this article, the IRS's logic as expressed in PS P-5-60 is dependent on a variety of factors.

Planning Considerations

The *Energy Resources* and *Begier* decisions may prove useful during the course of negotiations with the IRS revenue officer (the "R.O.") assigned to investigate the payroll tax delinquency. Hopefully, the practitioner will have an opportunity to meet with the R.O. before he or she has taken any enforced collection action. If the R.O. threatens to levy or seize the client's property, the practitioner can respond in kind by assuring the R.O. that any such action will trigger the filing of a petition in bankruptcy.

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While discussion of all the benefits and detriments associated with the filing of a bankruptcy petition is beyond the scope of this article, several factors are relevant to that decision in the context of a payroll tax delinquency.

First, bankruptcy stays all collection actions against the debtor, including IRS collection actions. Additionally, *Energy Resources* endows the Bankruptcy Court with the authority to order the IRS to apply the debtor's payments of delinquent taxes to trust fund taxes first, if the court determines that such an allocation is "necessary to the success of the reorganization." This standard begs the question: Under what circumstances will such an allocation be necessary to the success of the reorganization? While this issue was not addressed by the Court in deciding *Energy Resources*, the following analysis is suggested: (1) identify those individuals who are potentially "responsible persons"; (2) adduce proof that tends to establish (a) that the ultimate success of the reorganization, without the cooperation of one or more of these individuals, is remote, and (b) that the magnitude of the potential trust fund liability is substantial in relation to the income and net worth of these individuals; and (3) establish that these individuals will be unwilling to actively participate in the reorganization process if they face the specter of a large 100 percent penalty assessment.

If the IRS has already resorted to enforced collection measures, the R.O. may be persuaded to reallocate the funds seized, if any, to trust fund tax liabilities, in consideration of the client's agreement to forebear from filing a petition in bankruptcy. Although such a concession would be extremely rare, if not unprecedented, the prospect of having a trustee set aside these payments as a preference may provide a sufficient impetus for the R.O. to consider such a reallocation if the R.O. can be convinced that the 100 percent penalty lacks value in the particular case. For example, if the potentially responsible persons have limited resources in terms of income and net worth, and limited prospects of acquiring additional resources in the future, the R.O. may elect to apply the seized funds to trust fund taxes as insurance against a future bankruptcy filing, in light of the *Begier* decision. Additionally, despite the fact that trust fund taxes are not dischargeable in bankruptcy, the R.O. may choose to reconsider the value of the immediate payment of trust fund taxes in light of the taxpayer's ability, in the context of a bankruptcy proceeding, to secure a payout over a period of five years from the date of assessment.

PS P-5-60: An Impediment to the Collection of Delinquent Trust Fund Taxes

One of the primary reasons for incorporating small businesses is the desire of the owners of the business to avoid personal liability for business obligations. State laws generally require the existence of egregious circumstances to justify the disregard of the corporate entity with the concomitant imposition of liability on corporate shareholders. In effect, Section 6672 is a statutory exception to the limited liability afforded shareholders, since it is used almost exclusively to impose liability on key employees of closely held businesses who are usually controlling shareholders. The "egregious circumstances" justifying the "piercing of the corporate veil" are the willful failure of responsible employees to collect, account for and pay over trust fund taxes withheld from employees. However, it is difficult to see how application of payment to non-trust fund taxes first will promote the collection of trust fund taxes. The IRS has not adopted PS P-5-60 in an effort to expedite the collection of delinquent *trust fund taxes*, but to enhance the ultimate collectability of *total delinquent taxes*. This policy defeats the legislative purpose underlying enactment of Section 6672 and will not further the IRS's desired goal.

Adherence to PS P-5-60 diminishes the overall recovery of delinquent payroll taxes because it promotes delay and inefficiency due to increased administrative cost and tends to encourage the filing of bankruptcy petitions. A taxpayer with serious financial problems is now well advised to consider filing for bankruptcy if the IRS collects, or threatens to collect, funds administratively, because any such payment can be set aside eventually and brought back into the bankruptcy estate. Once the petition is filed, all IRS-enforced collection activity is stayed. Additionally, the Bankruptcy Court is now authorized to approve a plan of reorganization pursuant to which tax payments are applied first to unpaid trust fund taxes.

By failing to apply payments to trust fund taxes first, the IRS hitches its hopes of recovering delinquent taxes almost exclusively to the 100 percent penalty, which has not proved to be a cost-effective tool. A further argument against the application of PS P-5-60 is that the IRS has breached its fiduciary duty to the Social Security Administration. The IRS is the collection agent for the SSA. The IRS has a conflict of interest to the extent that it decides to risk the collectability of FICA taxes in order to attempt to collect total tax.

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Conclusion

The *Energy Resources* and *Begier* decisions, when coupled with some creative planning, give taxpayers' representatives some additional bargaining power in an arena where one must recognize and exploit every potential advantage.

The IRS is urged to give its Collection Division greater discretion in allocating payments of delinquent payroll taxes, both voluntary and involuntary, and to free them from the bonds of blind adherence to PS P-5-60. Such a policy would better serve the interests of all parties concerned and may have the salutary effect of reducing the volume of bankruptcy filings. Further, this policy would be consistent with the legislative goal of expediting the collection of delinquent trust fund taxes as embodied in Section 6672 and as acknowledged by the IRS.

Footnotes

1 *United States v. Energy Resources, Inc., et al.*, 90-1 USTC ¶ 50,281, 110 S.Ct. 2139 (1990).

2 Id. at 2143.

3 *Begier v. IRS*, 90-1 USTC ¶ 50,294, 110 S.Ct. 2258 (1990).

4 Id. at 2261.

5 Non-trust fund liabilities include the employer's share of FICA taxes, FUTA taxes, assessed and accrued penalties and interest.

6 A taxpayer making a voluntary remittance to the IRS is entitled to direct the manner in which the payment is applied (e.g., to delinquent trust fund taxes first). See Rev. Rul. 79-284, 1979-2 CB 83, modifying Rev. Rul. 73-305, 1973-2 CB 43, superseding Rev. Rul. 58-239, 1958-1 CB 94. See IRM 56(18)6.2 for a description of involuntary payments.

7 *In Re: Energy Resources Co., Inc.*, originated in the U.S. Bankruptcy Court for the District of Massachusetts, 59 B.R. 702, when the Chief Judge of the court directed the IRS to allocate payments from the debtor to trust fund taxes first. The IRS appealed to the U.S. District Court for the District of Massachusetts, which affirmed the Bankruptcy Court's decision. The case was then appealed to the First Circuit Court of Appeals, where it was consolidated with *In Re: Newport Offshore, Ltd.*89-1 USTC ¶ 9249, 871 F.2d 233 (CA-1).

8 *In Re: Newport Offshore, Ltd.* originated in the U.S. Bankruptcy Court for the District of Rhode Island, 75 B.R. 919, when the court directed the IRS to apply payments received from the debtor to trust fund taxes first. On appeal, the U.S. District Court for the District of Rhode Island reversed and the debtor appealed the case to the First Circuit Court of Appeals, where it was consolidated with *Energy Resources*.

9 Trust fund taxes in the context of payroll tax delinquencies consist of the employee's share of FICA taxes and federal withholding taxes.

10 See n. 7, supra.

11 See n. 8, supra.

12 See *In Re: Energy Resources*, 871 F.2d at 230-34, discussing the rationale for the court's decision.

13 110 S.Ct. 402.

14 See, e.g., *In Re: Ribs-R-Us, Inc.*, 828 F.2d 199 (CA-3, 1987).

15 *Energy Resources*, 110 S.Ct. at 2142.

16 Id.

17 Id. at 2143.

18 Id.

19 *Begier*, 110 S.Ct. at 2261.

20 Id. at 2262.

21 Id.

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22 Bankruptcy proceedings are governed by Title 11 of the United States Code. BRC 547(b) vests the trustee with the powers:

> To avoid any transfer of an *interest of the debtor in property* —
>
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made on or within ninety days before the filing of the petition …; and
> (5) that enables such creditor to receive more than such creditor would receive [in a Chapter 7 proceeding if the transfer had not been made]…. [Emphasis added.]

23 *Begier*, 110 S.Ct. at 2263.

24 See, e.g., *Slodov v. U.S.*, 78-1 USTC ¶ 9447, 436 U.S. 238 (1978) where the Court held that the trust does not encumber after-acquired funds (i.e., funds received in a subsequent payroll tax period) and, therefore, a new owner has no obligation to use after-acquired funds to pay trust fund liabilities which accrued prior to his acquiring an interest in the enterprise.

25 *U.S. v. Randall*, 401 U.S. 513 (1971).

26 See *Begier*, 110 S.Ct. at 2265, citing *Randall*, 401 U.S. at 517.

27 Id., at 2266.

28 Id., at 2266-67.

29 See IRM 1211, MT 1200-273.

30 See Policies of the IRS Handbook IRM 1305-14, MT 1218-200.

31 *U.S. v. Sotelo*, 78-1 USTC ¶ 9446, 98 S.Ct. 1795.

32 See IRC Sec. 6501.

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