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BANKRUPTCY OFFICIALS VS. THE INTERNAL REVENUE SERVICE: A FEDERAL HOUSE DIVIDED AGAINST ITSELF

by

CRAIG J. LANGSTRAAT*
MARK S. AQUADRO**

INTRODUCTION

With the increasing usage of the bankruptcy laws[1] over the last several years, the interest of the federal government in collecting taxes has frequently collided with the bankruptcy policies of protecting similarly-situated creditors while providing a fresh start for the debtor.[2] These continuing conflicts have resulted in several recent significant court cases, including two cases heard and decided by the United States Supreme Court during its 1989-90 term.[3] Considering the historical record of relatively few tax cases being heard by the Supreme Court, the fact that two bankruptcy/tax cases were decided in one term demonstrates the importance of the subject area.

This article will discuss several current areas of dispute between bankruptcy officials; i.e., trustees and judges, and the Internal Revenue Service ("IRS") as evidenced by litigation in the U.S. Supreme Court and certain federal circuit courts of appeal. A policy resolution to the numerous conflicts will be suggested along with specific statutory modifications to alleviate the costly burden of continued future litigation.

MULTIPLE CONFRONTATIONS

The areas of confrontation between bankruptcy officials and the IRS are many and varied. The following issues are representative of the current substantial litigation.

The issue of whether the Bankruptcy Court has the power, in a corporate (Chapter 11) reorganization, to allocate tax payments between "trust fund" taxes; i.e., taxes which certain corporate officers have personal liability, and non-trust fund

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[1] U.S. Bankruptcy Code at 11 U.S.C. §§ 101-1103, 1982.
[2] 11 U.S.C. § 726(b) (1982); H.R. REP. No. 595, 95th Cong., 177-78 (1977).
[3] United States vs. Energy Resources Co., 110 S. Ct. 2139 (1990), and Begier vs. IRS. 110 S. Ct. 2258 (1990).

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taxes was addressed in *IRS v. Energy Resources* case.[4] The question of whether the bankruptcy trustee could recover pre-petition trust fund tax payments made to the IRS as preferences was decided in *Begier v. IRS*.[5] The Internal Revenue Service managed a split in these two U.S. Supreme Court decisions.

Three significant federal circuit court of appeals decisions which impact the bankruptcy/tax area have also recently been released. The Sixth Circuit in *I.R.S. v. Nordic Village*,[6] decided whether the doctrine of sovereign immunity[7] protected the IRS from the bankruptcy trustee's power to recover voidable transfers of the debtor's funds. The Eighth Circuit ruled as to whether the bankruptcy automatic stay rules[8]

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[4] 110 S. Ct. at 2139 (1990).

[5] 110 S. Ct. at 2258.

[6] IRS v. Nordic Village Inc., 915 F.2d 1049 (6th Cir. 1990), *cert. granted*, 111 S. Ct. 2823 (1991).

[7] The Eleventh Amendment of the Constitution generally grants the states immunity from suit in federal court:

> "Suits against states - Restriction of judicial power - The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."

U.S. CONST. amend. XI.

[8] The automatic stay rules are prescribed by 11 U.S.C. § 362:

> "(a) Except as provided in sub (b) of this, a petition filed under 301, 302, or 303 of this title, or an application filed under 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78 eee (a)(3), operates as a stay, applicable to all entities, of -
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement to the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
>
> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
>
> (3) any act to obtain possession of property of the estate of the estate or of property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce any lien against property of the estate;
>
> (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
>
> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
>
> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
>
> (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor."

11 U.S.C. § 362(a)(1982).

and the Anti-Injunction Act[9] prohibited an IRS levy on bankruptcy funds already allocated to a third party creditor in *Laughlin, Trustee v. IRS.*[10] In *In re Russell*[11] the Eighth Circuit discussed whether the debtor's pre and post-petition irrevocable elections to carry forward net operating losses for future tax benefit (instead of carrying back the losses for refund) could be set aside as voidable transfers.

POWER TO ALLOCATE TAX PAYMENTS IN REORGANIZATION

Background

When any person or entity is required to withhold or collect federal taxes; i.e., payroll taxes, the amounts withheld or collected are required to be held as a trust fund for the benefit of the federal government.[12] Two types of penalties are provided in the event that the trust funds are not properly paid over to the federal government.[13]

Criminal fines and incarceration are possible consequences for any person who *willfully* fails to pay over the trust fund taxes.[14] In addition, responsible persons; i.e., corporate officers, are personally liable for any amount of unpaid trust fund taxes in all nonpayment situations, whether willful or not.[15]

Since corporate officers generally do not have personal liability for non-trust fund unpaid taxes such as corporate income tax, the allocation of payments between trust fund and non-trust fund taxes is vital where both types may not be paid in full.

The IRS position on allocation of partial payments is dependent on whether the payments are characterized as voluntary or involuntary. Under IRS administrative procedures, the taxpayer is allowed to designate voluntary payments as applying to trust fund or non-trust fund taxes.[16] With regard to involuntary payments, however, the IRS position is that the Service controls the allocation of payments between trust fund and non-trust fund taxes.[17]

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[9] The Anti-Injunction Act, § 7421 of the Internal Revenue Code, states in part:

> "Except as provided in §§ 6212(a) and (c), 6213(a), 6672(b), 6694(c), 7426(a) and (b)(1), and 7429(b), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed."

IRC § 7421(a) (1991).

[10] Laughlin v. IRS, 912 F.2d 197 (8th Cir., 1990), *cert. denied*, 111 S. Ct. 1073 (1991).

[11] *In re* Russell, 927 F.2d 413 (8th Cir. 1991), 91-1 U.S. Tax Cas. (CCH) Para. 50,128.

[12] IRC § 7501(a) (1991).

[13] IRC § 7501(b) (1991).

[14] IRC § 7202 (1991).

[15] IRC § 6672(a) (1991).

[16] Rev. Rul. 79-284, 1979-2 CB 83; *See also* Wood v. United States, 808 F.2d 411 (5th Cir., 1987); Muntwyler v. United States, 703 F.2d 1030 (7th Cir. 1983).

[17] IRS Policy Statement P-5-60, 1 Administration, Internal Revenue Service Manual (CCH) 1305-15; Muntwyler v. United States,703 F.2d 1030 (7th Cir. 1983).

Circuit Court Conflict

Between 1987 and 1989, five different circuit courts of appeal considered the issue of allocation of tax payments in the context of a corporate reorganization under Chapter 11. The basic fact pattern was similar in each case. The reorganization plan approved by the Bankruptcy Court, over IRS objections, provided that any tax payments would first be allocated to trust fund taxes.

The appellate process then crystallized the conflicting policies of the Internal Revenue Code--maximizing revenue collection--and the Bankruptcy Code--protection from creditors to maximize the rehabilitation potential.

The initial circuit court of appeals decision on this issue was rendered by the Eleventh circuit in *United States v. A & B Heating & Air Conditioning.*[18] The Court held that the appropriate approach to the conflict was a case-by-case analysis, based on such factors as history of the debtor, pre-bankruptcy collection measures, terms of the reorganization plan, any other adminsitrative and/or court action, any agreements between the debtor and the IRS, exceptional or special circumstances, and the likelihood that the plan would be fully completed.

The next series of cases focused on whether the tax payments under a Chapter 11 plan of reorganization were voluntary or involuntary. Taxpayers argued that only actual seizures of property; i.e., levies, should be defined as involuntary. Taxpayers also pointed out that, as debtors in possession under Chapter 11, they remained in possession of their assets and could dispose of their assets in the ordinary course of business. On the other hand, the government argued that any payment in the context of court proceedings was involuntary.

While not adopting the government's broad characterization, the Third,[19] Ninth[20] Circuit the Sixth[21] Circuits held that tax payments in context of a Chapter 11 reorganization were involuntary. Therefore, the IRS was allowed to apply the tax payments in its discretion.

This same issue was treated by the First Circuit in *IRS v. Energy Resources.*[22] The First Circuit agreed with its sister circuits that the subject tax payments were involuntary. However, this circuit court held that the Bankruptcy Court had the power to allocate even involuntary payments to trust fund taxes, regardless of IRS administrative policy. The *Energy Resources* case was the vehicle selected by the U.S. Supreme Court to settle the conflict between the several circuits.[23]

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[18] United States v. A & B Heating & Air Conditioning Inc., 823 F.2d 462 (11th Cir. 1987).
[19] *In re* Ribs-R-Us Inc., 828 F.2d 199 (3rd Cir., 1987).
[20] *In re* Technical Knockout Graphics Inc., 833 F.2d 797 (9th Cir. 1987); *see also* United States v. Stanmock, 103, Barks 228 (9th Cir. 1991).
[21] *In re* DuCharmes & Co.., 852 F.2d 194 (6th Cir. 1988).
[22] IRS v. Energy Resources Co., 871 F.2d 223 (1st Cir. 1989), *cert. granted*, 110 S. Ct. 559 (1989).
[23] 110 S. Ct. at 402.

The Supreme Court Speaks

The Supreme Court's opinion in *Energy Resources* focused solely on the power of a bankruptcy court to allocate tax payments, in spite of any IRS internal policy. In an 8-1 decision, the Court found that the Bankruptcy Code does imbue a bankruptcy court with the necessary power to allocate such tax payments to trust fund taxes, where the court determines that such an allocation is necessary for the reorganization's success.

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",[24] and to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Act]".[25] The Court found no Internal Revenue Code section or any other statute which limits the authority of a bankruptcy court in these types of situations.

FEDERAL TRUST FUND TAX PAYMENTS AS BANKRUPTCY PREFERENCES: BEGIER V. IRS

The Facts

Begier v. IRS[26] involved the bankruptcy of American International Airlines, Inc. ("AIA"). Prior to any bankruptcy filing, AIA fell behind in the payment of its trust fund taxes, including withheld income taxes, FICA, and certain excise taxes. Pursuant to statute,[27] the IRS required AIA to deposit all trust fund taxes in a separate bank account.

AIA made some deposits into the separate bank account, but the deposits were not sufficient to cover all trust fund tax liabilities. AIA remained current in its obligations to the federal government by making transfers from the separate account and from its general operating funds.

After AIA filed for bankruptcy, the trustee in bankruptcy tried to recover trust fund tax payments made within 90 days before the bankruptcy filing, as preferences under the Bankruptcy Code.[28]

The Issue

The issue decided by the Supreme Court was whether the pre-petition pay-

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[24] 11 U.S.C. § 1123(b)(5)(1984).
[25] 11 U.S.C. § 105(1984).
[26] 110 S. Ct. 2258 (1990).
[27] IRC § 7512 (1991).
[28] 11 U.S.C. § 547(b) (1984).

ments to the IRS were property of the debtor, or merely funds held in trust for the federal government. The Bankruptcy Court and the reviewing district court hearing the case had held that the payments from the separate account were trust funds, but that the payments from the general operating funds made within 90 days of the petition were property of the debtor, subject to reclamation by the trustee as preferences.

In its decision, the Third Circuit had determined that none of the payments qualified as property of the debtor, as all payments were from trust funds, and therefore, no reclamation by the trustee was allowable.[29]

The Decision and the Analysis

The Supreme Court found that, under the language of the Internal Revenue Code, the trust fund nature of the subject taxes began at the time the tax was withheld or collected.[30] This approach clearly covered the amounts paid from the separate account. Then, the key question became whether the dollars paid from the general operating funds were, in fact, the trust fund dollars or property of the debtor.

The Court reviewed the legislative history of the bankruptcy preference provision[31] and concluded that specific tracing of trust funds was not required. All nine justices found that the payment under a trust fund obligation was evidence of payment to the trust funds, rather than a mere tranfer of property of the debtor. The IRS was not liable to return the trust fund taxes to the trustee in bankruptcy.

VOIDABLE TRANSFERS VERSUS IRS SOVEREIGN IMMUNITY: IRS v. NORDIC VILLAGE

The Facts

IRS v. Nordic Village [32] resulted after Nordic Village had filed a Chapter 11 petition on March 27, 1984, acting as a debtor-in-possession.[33] Josef Lah was then an officer and shareholder of Nordic, which was doing business as Swiss Haus, Inc. On July 18, 1984, Lah drew a $26,000 counter-check on the corporate account, made payable to the bank. The bank, in turn, issued several cashier's checks to Lah. The cashier's check at issue here, in the amount of $20,000, was made payable to the IRS.

[29] 878 F.2d 762 (3d Cir. 1989), *cert. granted*, 110 S. Ct. 714 (1990).
[30] *See* IRC §§ 4291 (excise taxes); 3102(1) (FICA); and 3402(a)(1) (withholding).
[31] 110 S. Ct. at 2265 - 67 (1990).
[32] 915 F. 2d 1049 (6th Cir. 1990).
[33] The debtor-in-possession is generally the debtor placed in the shoes of the Chapter 11 trustee with generally the same rights, powers and responsibilities as such trustee, subject to any liabilities or conditions prescribed by the court. 11 U.S.C. §§ 1101(1), 1107.

The subject check to the IRS had the notation "REMITTER: SWISS HAUS, INC." The notation had a line drawn through it at some point, but remained legible. Lah delivered the check to the IRS, requesting that the payment be applied against the tax liabilities of Josef Lah, doing business as Josef's Hair Design, rather than against the tax liabilities of Nordic Village. The IRS credited Lah's account as requested.

After appointment, the bankruptcy trustee proceeded to try to recover several unauthorized post-petition transfers, including the transfer to the IRS. The trustee argued that the post-petition transfer was voidable as an unauthorized preference under Bankruptcy Code Sec. 549,[34] and that the IRS was an initial transferee having sufficient knowledge of the transfer's voidability, via the legible notation on the check, under Bankruptcy Code § 550.[35]

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[34] Bankruptcy Code § 549, regarding postpetition transfers, states:

"(a) Except as provided in subsection (b) (involuntary bankruptcy) or (c) (real property) of this section, the trustee may avoid a transfer of property of the estate -

(1) that occurs after the commencement of the case; and

(2)(A) that is authorized only under § 303(f) or 542(c) of this title:

or

(B) that is not authorized under this title or by the court...

(d) An action or proceeding under this section may not be commenced after the earlier of -

(1) two years after the date of the transfer sought to be avoided;

or

(2) the time the case is closed or dismissed.

11 U.S.C. § 549 (1984).

[35] Bankruptcy Code Section 550 involves the liability of the transferee of an avoided transfer:

"(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from -

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.

(b) the trustee may not recover under section (a)(2) of this section from -

(1) a transferee that takes for value, including satisfaction or securing of a presenter antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or

(2) any immediate or mediate good faith transferee of such transferee...

(e) An action or proceeding under this section may not be commenced after the earlier of -

The Issues

The IRS defense brought two issues into focus. The IRS claimed that the doctrine of sovereign immunity, as articulated by the Supreme Court in *Hoffman v. Connecticut Department of Income Maintenance*,[36] precluded the trustee in bankruptcy from proceeding against the IRS. The backup argument for the IRS was that the lined-through notation on the check was insufficient notice that the transfer was voidable.

The Decision and the Analysis

The primary IRS defense against repayment of the subject funds was the doctrine of sovereign immunity. The Sixth Circuit found that the *Hoffman*[37] case, in which it was held that the waiver of the sovereign immunity provision in the Bankruptcy Code[38] does not apply to states because of the Eleventh Amendment,[39] was inapplicable to the current case dealing with a federal agency.

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.[40] The court also held that the notation on the check was sufficient notice to the IRS to make the payment voidable. Therefore, judgement was rendered against the IRS.

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(1) one year after the avoidance of the transfer on account of which recovery under this section is sought; or

(2) the time the case is closed or dismissed.

11 U.S.C. § 550 (Supp. 1981).

[36] Hoffman v. Conn. Dep't. of Income Maintenance, 109 S. Ct. 2818 (1989).

[37] *Id.*

[38] Bankruptcy Code Section 106 waives sovereign immunity:

"(a) A governmental unit is deemed to have waived sovereign immunity with respect to any claim against such government unit that is property of the estate and that arose out of the same transaction or occurrence out of which such governmental unit's claim arose.

(b) There shall be offset against an allowed claim or interest of a governmental unit any claim against such governmental unit that is property of the estate.

(c) Except as provided in sub (a) and (b) of this section and notwithstanding any assertion of sovereign immunity -

(1) a provision of this title that contains "creditor", "entity", or "governmental unit" applies to governmental units; and

(2) a determination by the court of an issue arising under such a provision binds governmental units."

11 U.S.C. § 106 (1979).

[39] *See U.S. Const.* amend. XI.

[40] *In re* Nordic Village Inc., 915 F.2d 1052 (6th Cir. 1990).

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IRS LEVY ON ALLOCATED BANKRUPTCY PROCEEDS: LAUGHLIN, TRUSTEE V. IRS

The Facts

In *Laughlin*,[41] the IRS served the bankruptcy trustee with a notice of levy on funds payable to a creditor of the bankrupt debtor. The levy was to collect funds in satisfaction of the creditor's tax liabilities. Because the levy in question did not refer to any specific bankruptcy action, extensive administrative work was required of the trustee to determine the specific bankruptcy actions involved.[42]

In order to avoid further administrative time, the trustee filed a motion in bankruptcy court to enforce the Bankruptcy Code's automatic stay provisions.[43] The motion for stay was denied in both the bankruptcy court and the district court.[44] The trustee then appealed in the Eighth Circuit, claiming that the IRS had willfully violated the automatic stay provisions of the Bankruptcy Code, with its attendant provisions for liability for related costs and attorney fees.[45]

The Decision and the Analysis

The Bankruptcy Code imposes an automatic stay of acts to obtain possession of property, enforcement of any liens on property, and collection or recovery from the debtor or against property of the estate under 11 U.S.C. sec. 362.[46] In deciding whether the automatic stay was violated, the Eighth Circuit looked to the purpose of the automatic stay, which is to facilitate the orderly disposition of the debtor's assets in the best interests of the debtor and the creditors.[47]

While noting the resulting administrative burden being imposed on the trustee,[48] the court held that "The debtors, estates, and creditors - those entities the automatic stay is designed to protect - are unaffected by the levy."[49] The court emphasized that the levy in question was on funds owed the creditor, as determined and approved for payment by the bankruptcy court. The emphasis was on the lack

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[41] 912 F.2d 197 (8th Cir. 1990), *cert. denied*, 111 S. Ct. 1073 (1991).
[42] *Id.* at 198.
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *See* 111 U.S.C. § 362(a).
[47] "*In re* MacDonald, 755 F.2d 715, 717 (9th Cir. 1985)

> 'The automatic stay gives the bankruptcy court an opportunity to harmionize the interests of both debtor and creditors while preserving the debtor's assets for repayment.'"

912 F.2d 197, 198 (8th Cir. 1990).
[48] "It is really the administrative burden created by the notice of levy to which the trustee objects. As indicated. . .we, like the bankruptcy court, do not minimize the extent of the burden."
Id. at 198.
[49] *Id.*

of direct interference on the orderly administration of the assets of the estate.[50]

In regard to the trustee's claim for relief in associated costs and attorney fees from the levy, the court considered the protection accorded to the IRS under the Anti-Injunction Act.[51] Internal Revenue Code § 7421(a) generally prohibits actions against the assessment or collection of tax.[52]

Although the Eighth Circuit considered the automatic stay question only in regard to the direct effect on the assets of the estate to be distributed, the opinion does deny relief to the trustee for costs and attorney fees. The Court did cite *Bostwick v. United States*[53] in which the Anti-Injunction Act was held ineffective to bar the Bankruptcy Court from restricting the government's collection of taxes.[54] However, the Eighth Circuit ruled that the Anti-Injunction Act controlled this case, because there was no violation of the automatic stay provisions. Therefore, the trustee's claims for costs and attorney fees were denied.[55]

The Court based both conclusions on the fact that the IRS was "seeking only to collect directly from the trustee that which the debtors owe the taxpayer-creditor according to the terms and conditions of confirmed Chapter 13 plans."[56] Apparently, the resulting costs of administration the estate incurred after the approval of the Chapter 13 plan were not considered to affect the interests of any parties to the bankruptcy.

Perhaps the most disturbing aspect of this case is that the IRS was willing to litigate rather than provide the trustee with the information needed to comply with the levy in an efficient and cost-effective manner.[57] With such conflict possible and occurring, the need for additional legislation in this area is clearly demonstrated.[58]

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[50] *Id.*

[51] IRC § 7421 (1991).

[52] *Id.*

[53] Bostwick v. United States, 521 F.2d 741 (8th Cir., 1975).

[54] "We concluded that Congress' enactment of a complete scheme governing bankruptcy proceedings overrode the general policy represented by the Anti-Injunction Act. We based our conclusion on our belief that:

> 'the overriding policy of the Bankruptcy Act is the rehabilitation of the debtor and we are convinced that the Bankruptcy Court must have the power to enjoin the assessment and/or collection of taxes in order to protect its jurisdiction, administer the bankrupt's estate in an orderly and efficient manner, and fulfill the ultimate policy of the Bankruptcy Act.' *Bostwick v. United States*, 521 F.2d 744 (8th Cir., 1975)."

912 F.2d at 199.

[55] *Id.* at 199-200.

[56] *Id.* at 199.

[57] "As the bankruptcy court recognized, the administrative burden of future levy notices that do not identify the property or even the debtors to which the levy applies is not a fanciful fear on (the trustee's) part." *Id.* at 200.

[58] "Although it appears to us that the IRS could easily spare trustees the possibly enormous burden of sifting through hundreds or even thousands of cases, we have no basis here for dictating to the IRS the methods by which it collects taxes. It is for Congress to impose upon the IRS the requirement of specifying the estates upon which the notice of levy is to apply or to create a bankruptcy exception to the Anti-Injunction Act." *Id.*

NET OPERATING LOSS CARRYFORWARD ELECTION AS AN AVOIDABLE TRANSFER: IN RE RUSSELL

The Facts

In re Russell[59] involves an individual under Chapter 11 with substantial tax net operating losses ("NOL"). [60]In August, 1983, Russell filed his properly-extended 1982 federal tax return. The return contained a substantial NOL.[61] On the 1982 return, the taxpayer made an irrevocable election to forego the carryback option and instead use the NOL in future years.[62]

The taxpayer filed a voluntary bankruptcy petition in July, 1984. He managed the bankruptcy estate as a debtor-in-possession until March, 1985, when co-trustees were appointed.[63] In October, 1984, while functioning as a debtor-in-possession, the taxpayer filed his properly-extended 1983 federal tax return. Again, he elected to forego the carryback of another substantial NOL in favor of carrying forward the loss to future tax years.[64]

In February, 1986, the trustees filed amended federal tax returns on behalf of the bankruptcy estate for the years 1976 through 1981. Thr trustees disregarded the taxpayer's elections to forego the NOL carrybacks and claimed refunds totaling $1,234,134 for the prior years based on the carryback, application of the 1982 and 1983 NOL's.[65] The IRS ignored the claim for refund, and refund litigation initiated by the trustees ensued.[66]

The Issues and the Decision

The threshold issue in *Russell* is whether a trustee's powers under the Bankruptcy Code can be used to invalidate a debtor's irrevocable tax election under the

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[59] 927 F.2d 413 (8th Cir. 1990).
[60] The term "net operating loss" denotes the excess of business deductions over gross business income with certain modifications.
IRC § 172(c) (1991).
[61] 927 F.2d at 415, 91-1 U.S. Tax Cas. (CCH) Para. 50,128.
[62] A taxpayer normally may carry the NOL back to the third preceding tax year of the loss and use it as a deduction in that year. Unused NOLs are applied to and deducted in the following two years. Any unused NOL that remains after this carryback to the three years prior to the year of the loss may be carried forward and deducted from the taxpayer's income in subsequent years until it is exhausted beginning with the year after the loss was incurred. Any unused NOL after fifteen such years expires. IRC § 172(b)(1)(A). An election is provided that allows a taxpayer to relinquish the carryback period and only apply the NOL to future years. This election is made upon the filing of the tax return for the loss year and once made is irrevocable. IRC § 172(b)(3).
[63] 927 F.2d at 414, (8th Cir., 1991), 91-1 U.S. Tax Cas. (CCH) Para. 50,128.
[64] *Id.* at 415, 91-1 U.S. Tax Cas. (CCH) Para. 50, 128.
[65] *Id.*
[66] *Id.*

Internal Revenue Code.[67] This was an issue of first impression for the Eighth Circuit.

The IRS argued that Congress did not expressly authorize trustees to avoid irrevocable elections, and for the court to do so would "create administrative chaos."[68] The trustees argued that to allow such an irrevocable election by the debtor to bind bankruptcy trustees would enable debtors to improperly draw assets from the estate.[69]

The Eighth Circuit noted that the purpose of the irrevocability of the NOL election was to ensure that the taxpayer assumes the risk that the carryback would later prove more beneficial.[70] Since the bankruptcy trustees were merely seeking to preserve the estate, rather than attempting to avoid the consequences of a prior election which proved less beneficial, the purpose of IRC § 172(b)(3)(C) was not at issue.

In the Eighth Circuit's opinion, the controlling purpose was that purpose underlying a trustee's broad avoidance power; that is, the protection of the bankruptcy estate from improper transfer.[71] The court ruled that the purpose underlying a bankruptcy trustee's avoidance powers, and the danger of permitting a debtor to improperly manipulate the Internal Revenue Code, require that a trustee have the ability to avoid, rather than revoke, the NOL carryforward election. Once the election is avoided, the trustee is free to elect as the trustee sees fit. According, the trustees were ruled to have the ability to avoid a debtor's irrevocable election to carry forward NOL's.[72]

With the power to avoid the irrevocable election decided, the Eighth Circuit turned to the bankruptcy issue of whether the tax elections were unauthorized pre-petition or post-petition transfers voidable under Bankruptcy Code § 548[73] and

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[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] Young v. Commissioner, 783 F.2d 1201, 1206 (5th Cir. 1986).

[71] "Congress has given bankruptcy trustees extraordinary abilities to avoid and recover various liens and transfers' for the purpose of protecting the bankruptcy estate. *In re* Haugen Constr. Serv. 104 BR. 233, 239 (Bankr. D.N.D. 1989). These avoidance powers 'are' exclusively geared toward protecting the rights of creditors via protection of the bankruptcy estate,' Palmer & Palmer , P.C. v. United States Trustees (*In re* Hargis), 887 F.2d 77, 79 (5th Cir. 1989), clarified, 895 F.2d 1025 (5th Cir. 1990), and are so broad that they even enable trustees to avoid transfers considered 'irrevocable' under state law. *See* Flanigan v. Lewis. (*In re* Lewis), 45 Bankr. 27, 29-30 (Bankr. W.D. Mo. 1984)."
927 F.2d 413, 416 (8th Cir. 1991), 91-1 U.S. Tax Cas. (CCH) Para. 50,128.

[72] *Id.*

[73] Bankruptcy Code 548 regarding fraudulent transfers and obligations states:

"(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily -

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer

549.[74] The trustees argued that the NOL election with the 1982 return constituted a fraudulent transfer,[75] and that the election with the 1983 return constituted an unauthorized post-petition transfer.[76] The IRS did not address the trustees' claims directly, but responded with procedural arguments.[77]

The Eighth Circuit ruled that Bankruptcy Code §§ 548 and 549, involving unauthorized transfers, did apply, and that the requirement of each must be met to avoid the elections. The requirements found to be at issue involved the debtor's intent in making the elections. Specifically, under Bankruptcy Code § 548(a)(1), whether the debtor intended to hinder, delay, or defraud any existing or future creditors must be determined.[78] With regard to Bankruptcy Code § 549, the issue is whether the taxpayer made the election in the ordinary course of business.

The case was remanded to the district court with instructions that it be returned to the bankruptcy court for a determination as to the debtor's intent for the 1982 tax year election, and for determinations as to whether the 1983 tax year election was in the ordinary course of business.[79]

RECOMMENDATIONS AND CONCLUSION

The preceeding discussion above delineates five major areas in which bankruptcy officials and the IRS have been in conflict. These conflicts have resulted in significant resources being wasted in bankrupt estates, as well as in the federal government sector, both in the federal court system and in the IRS. Since the federal government has control over both the Bankruptcy Code and the Internal Revenue Code, it is imperative that Congress and the executive branch act to eliminate, or at least reduce, the conflicts in this area with the attendant wasting of resources.

In three of the discussed cases, there was a direct conflict between the policies

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was made or such transfer was made or such obligation was incurred, indebted; . . ."
11 U.S.C. § 548(a) (1984).

[74] *See* 11 U.S.C. § 549 (1984).

[75] Bankruptcy Code § 548(a)(1) permits a trustee to avoid a debtor's transfer of property made within one year of filing for bankruptcy if the debtor intended to hinder, delay, or defraud any creditor. *See* 11 U.S.C. § 548(a). 927 F.2d 413 (8th Cir. 1991), 91-1 U.S. Tax Cas. (CCH) Para. 50,128.

[76] Bankruptcy Code Section 549(a) permits the trustee to avoid a transfer of estate property that occurs after the commencement of the bankruptcy case and is not authorized by a court or statute. See n. 34.
927 F.2d 413 (8th Cir. 1991), 91-1 U.S. Tax Case. (CCH) Para. 50,128.

[77] *Id.*

[78] *Id.*

[79] "The fourth element of § 549 is that the transfer not be authorized by any court or statute. Russell's election was not authorized by a court, so we turn to the Bankruptcy Code to determine if any of its provisions authorized Russell's transfer. After filing for Chapter 11 bankruptcy, Russell was appointed debtor-in-possession. A debtor-in-possession has almost all of the rights, powers, and duties of a Chapter 11 trustee. 11 U.S.C. § 1107(a) [*See, supra,* note 33.]. This includes the power to operate the debtor's business. *Id.* § 1108. Thus, the issue for determination is whether Russell elected to carry forward the NOLs in the ordinary course of business."
Id.

supporting the Bankruptcy Code and the maximum revenue collection under the Internal Revenue Code. The issues involved were, respectively, allocation of tax payments in *Energy Resources*, soveriegn inmunity, versus voidable transfers in *Nordic Village*, and voidability of irrevocable NOL elections in *Russell*. In each of these cases, the highest deciding court, including the Supreme Court in *Energy Resources*, determined that the legislative intent was that the policies underlying the bankruptcy statutes prevail over revenue collection. This is an appropriate reading of Congressional intent.

The two discussed cases in which the IRS prevailed were *Begier*, involving transfer of trust fund taxes, and *Laughlin*, which involved a levy on proceeds to third-party creditors. Both presented situations in which the underlying policies of the bankruptcy statutes are not violated by normal IRS collection activity. In *Begier*, the funds collected by the IRS were withheld from the debtor's employees wages and properly belonged to the government. In *Laughlin*, the IRS levy was not on the bankrupt estate, but rather on proceeds already payable to a third party creditor.

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 funds and non-trust fund taxes based on the overall reorganization plan. (See *Energy Resources*).[80]
2. The Bankruptcy Code should be amended to remove the transfer of trust fund taxes from the definition of a voidable preference. (See *Begier*).[81]
3. The Internal Revenue Code should be amended to require every notice of levy to a bankruptcy trustee to specifically detail the bankruptcy action involved. (See *Laughlin*).[82]
4. The Bankruptcy Code should be amended to specifically include tax elections in the definition of a voidable preference. (See *Russell*).[83]

In addition, the Internal Revenue Service litigation policies should be changed to prohibit 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.

The adoption of the above-described statutory modifications and administra-

[80] 871 F.2d 223 (1st Cir. 1989).
[81] 110 S. Ct. 2258 (1990).
[82] 912 F.2d 197 (8th Cir. 1990), *cert. denied*, 111 S. Ct. 1073 (1991).
[83] 927 F.2d 413 (8th Cir. 1991), 91-1 U.S. Tax Cas. (CCH) Para. 50,128.

tive policy changes would significantly reduce, if not eliminate, conflicts between the bankruptcy officials and the IRS. With the volume of bankruptcy cases now being filed, it is essential for Congress and the executive branch to clarify these and any other bankruptcy/tax conflicts. The wasting of resources in this area must be stopped.