INTERNAL REVENUE SERVICE

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MEMORANDUM FOR DISTRICT COUNSEL (KENTUCKY-TENNESSEE)
Attention: Martha J. Weber, Senior Attorney

FROM: Chief, Branch 3 (General Litigation)

SUBJECT: Application of Payments Received During Chapter 13 Bankruptcy Once Case is Dismissed

This constitutes our response to your transmittal, dated December 4, 1998 (copy attached), of a request for an advisory opinion made by your Special Procedures Branch. This document is not to be cited as precedent.

ISSUE: Where a Chapter 13 case has been dismissed, may the Service retroactively apply payments received from the Chapter 13 Trustee in its "best interest," or must the Service honor the Trustee's earlier designation regarding how the payments should be credited?

CONCLUSION: No legal authority specifically precludes the Service from disregarding the Chapter 13 Trustee's designation once the bankruptcy has been dismissed. However, we believe that the Service may not always find it administratively desirable to reapply the payments retroactively.

FACTS: In January 1998, a taxpayer files a bankruptcy case under Chapter 13 of the Bankruptcy Code. At that time, the Service files a proof of claim encompassing: 1) a secured claim for $6,000, for income taxes allegedly due for tax years 1986 through 1989; 2) an unsecured priority claim for $15,000, for taxes attributable to 1995 and 1997; and 3) an unsecured general claim for $6,500, for penalties attributable to 1995 and 1997, and for taxes, penalties, and interest for 1982 and 1983. The Service subsequently agrees that the extent of the taxpayer's unencumbered assets is such that only $2,000 of the secured claim, part of the amount for 1986 taxes, can be satisfied; the balance of the secured claim amount will be classified as unsecured general.

The taxpayer remains in bankruptcy for eight months. During that period, the Service receives eight payments of $100, for a total of $800, from the Chapter 13 Trustee, who designates each payment as being for 1986. On September 2, 1998, the taxpayer voluntarily dismisses the bankruptcy. The question presented by your office is whether, once the bankruptcy is dismissed, the Service may disregard the designation of the Chapter 13 Trustee and apply all or

part of the $800 received during the bankruptcy in whatever manner is in its "best interest," or whether the Service is instead bound by the Trustee's designation regardless of the fact that the bankruptcy has been dismissed.

LAW AND ANALYSIS: Responding to this question necessitates considering two distinct subject areas: designation of payments and dismissal of bankruptcies. Some general background on these two areas is set forth below.

A. Designation of Payments

This term pertains to how payments made to the Service are to be credited when two or more outstanding liabilities exist on the part of the same taxpayer. The issue frequently arises where, for example, a question exists as to whether a payment or a series of payments should be credited to liability for Trust Fund taxes or liability for non-Trust Fund taxes, or where, as here, several classifications of claims exist in a bankruptcy situation. The significance of the designation of payments issue lies in the fact that whether or not a designation by someone other than the Service is honored can affect whether, and to what extent, the Service ever receives payment on a particular outstanding liability.

The leading case relevant to designation of payments is Amos v. Commissioner, 47 T.C. 65 (1966). In Amos, the Tax Court initially noted:

> Generally, when a debtor voluntarily makes a payment to a creditor, the payment will be applied as the debtor directs; and, if the debtor fails to make a timely application, the payment will be applied as the creditor directs.

Amos at 68. The Tax Court went on to state that:

> An involuntary payment of Federal Taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor. ... [W]e believe that, as between the debtor and the creditor and in the interest of orderly administration, the better rule for Federal tax purposes is to permit the Commissioner's agent to apply involuntary payments in the manner he chooses.

Id. at 69.

Historically, the Service's position has followed Amos. See generally IRM 56(18)6.1; 56(18)6.3; Rev. Rul. 73-305, 1973-2 C.B. 43. See also Policy Statement P-5-60 (taxpayer has no right to designate application of payments made as a result of enforced collection measures). In the bankruptcy context, and where two or more outstanding liabilities exist on the part of the taxpayer, the Service traditionally has applied payments in whatever manner best executes

the bankruptcy court's wishes, if those wishes are expressed by court order. Where no bankruptcy court order addresses how payments should be applied, the Service's policy is to apply the payments "in such a way as to give maximum benefit to the United States." See IRM 56(18)4.1. Moreover, payments received through bankruptcy are considered by the Service to be "involuntary" payments. IRM 5.9.13.1(2)(Bankruptcy Handbook)(October 16, 1998). 1/ Prior to 1990, the question of whether the Service possessed authority, either inside or outside a bankruptcy context, to decide how a particular payment should be applied, was directly determined by whether the payment was properly construed as "voluntary" or "involuntary." See, e.g., DuCharmes & Co. v. State of Michigan, 852 F.2d 194 (6th Cir. 1988)(payments made in Chapter 13 case "involuntary"); Muntwyler v. United States, 703 F.2d 1030 (7th Cir. 1983)(since action taken by Service insufficient to render payment "involuntary," taxpayer could designate how payment should be credited); In re Junes, 76 B.R. 795 (Bankr. D. Ore. 1987)(payments made pursuant to Chapter 13 plan were required and thus "involuntary," so Service possesses authority to determine how payments should be applied).

The nature of determinations pertaining to designation of payments changed, at least with respect to payments made in bankruptcies, with the Supreme Court's decision in United States v. Energy Resources Co., Inc., 495 U.S. 545, 110 S. Ct. 2139 (1990). In that case, which involved a Chapter 11 bankruptcy, the Court held that bankruptcy courts could participate in the determination of how payments should be applied. Specifically, the Supreme Court held that bankruptcy courts possess authority to designate how payments -- even those which are clearly "involuntary" payments" -- are to be applied, where such a designation is deemed necessary for the reorganization's success. Thus, after Energy Resources, the Service no longer can argue that the characterization as "involuntary" of a payment made through bankruptcy necessarily means that the payment can only be applied in a manner most beneficial to the Government's interests.

The question remaining after Energy Resources is whether the decision applies to bankruptcies which are not Chapter 11 cases, or even to those Chapter 11 cases which involve circumstances materially distinguishable from those existing in Energy Resources. This is especially unclear in light of the fact that the Court principally based its decision in Energy Resources on two Bankruptcy Code provisions applicable to only Chapter 11 cases, sections 1123(b)(5) and 1129. See 110 S. Ct. at 2142. The case law emanating from the lower courts is split on whether, and to what extent, Energy Resources should be limited to its specific facts. See, e.g., In re Kaplan, 104 F.3d 589 (3d Cir. 1997)(Energy Resources not necessarily applicable to all Chapter 11 cases); United States v. Pepperman, 976 F.2d 123 (3d Cir. 1992)(payments made in Chapter 7

1/ The Bankruptcy Code does not specifically address the matter of whether or how events occurring during bankruptcy affect a designation of payments.

bankruptcy involuntary; Energy Resources generally not applicable to Chapter 7 cases).

Moreover, although most of the relevant case law involves Chapter 11 cases, a split among the courts also exists with respect to Chapter 13 cases. See, e.g., Matter of Baker, 1996 Bankr. LEXIS 956 (Bankr. N.D. Ind. 1996)(court indicates that Energy Resources may apply to Chapter 13 cases, but finds debtors' proposed allocation of payments not necessary to success of plan; moreover, since involvement of court in bankruptcy proceeding renders payments involuntary, payments will be allocated in accordance with IRS policy); In re Klaska, 152 B.R. 248 (Bankr. C.D. Ill. 1993)(involuntary-voluntary characterization not relevant to issue of designation of payments in Chapter 13, since determination of how payments should be applied is now controlled by Energy Resources analysis).

Thus, while existing law on the "voluntary" or "involuntary" nature of payments made in Chapter 13 bankruptcies may be relatively clear, the relevant legal authorities fail to definitively resolve the question of whether this distinction matters in light of Energy Resources. The issue is further complicated when one factors in the effect of dismissal of a Chapter 13 case, as discussed below.

B. Effect of Dismissal

Section 362 of the Bankruptcy Code provides, with certain exceptions not relevant here, that the filing of a bankruptcy petition "operates as a stay, applicable to all entities," of various actions and events. B.C. § 362(a). The stay terminates upon the occurrence of any one of several events, including the dismissal of the case. B.C. § 362(c)(2)(B). Section 349, which is entitled "Effect of dismissal," enumerates a variety of specific actions which are reinstated or vacated upon, or otherwise affected by, case dismissal, but this provision does not address the effect of dismissal on actions comparable to a designation of payments. See B.C. § 349(b). The legislative history of section 349(b) states, however, that the purpose of section 349(b) "is to undo the bankruptcy case, as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case." S. Rep. No. 989, 95th Cong., 2d Sess 49, reprinted in 1978 U.S.C.C.A.N. 5787, 5785. This interpretation of section 349(b) is supported by case law indicating that dismissal of a Chapter 13 "effectively" vacates a previously confirmed plan. See In re Nash, 765 F.2d 1410 (9th Cir. 1985).

In Nash, the Ninth Circuit specifically noted that the Chapter 13 Trustee was not "required to continue making distributions of the estate under the plan after the case had been dismissed (footnote omitted)." 765 F.2d at 1413 (emphasis in

original). 2/ We believe that the legislative history of section 349(b) of the Bankruptcy Code, taken together with the above-cited language in Nash, support the notion that, once a Chapter 13 case is dismissed, the Chapter 13 Trustee's decision regarding how payments should be applied among two or more outstanding liabilities on the part of the taxpayer is no longer effective. Thus, payments which for some reason are received by the Trustee after the dismissal occurs – for example, after the case is converted to one under Chapter 7 -- need not be applied by the Service in a manner consistent with the Trustee's earlier designation.

Whether payments which were received before dismissal may retroactively be reapplied, once the Chapter 13 is dismissed, is a more difficult question. Initially, even if Energy Resources, supra, is deemed applicable to Chapter 13 cases, effectively vesting in the bankruptcy court the power to designate how payments are to be applied, it is unclear whether this power would be retained by the court upon the event of dismissal. Moreover, even if the potential impact of Energy Resources is disregarded, we think it is questionable whether the Service should "redesignate" payments retroactively, given that those payments were only made in the first place because of the bankruptcy, and given that the Service, accordingly, might not even have possessed authority to decide how they should be credited had the bankruptcy not occurred. In accord, Matter of Depew, 115 B.R. 965, 970 (Bankr. N.D. Ind. 1989)(holding that Congress did not intend for dismissal to undo an entire Chapter 11 case, court restores effect of confirmed plan and prevents Service from reapplying payments made pursuant to that plan). However, these uncertainties do not compel a conclusion that the Service is legally prohibited from retroactively applying payments in its best interest. Accordingly, we leave it to the client to decide, on a case-by-case basis, whether should a "reapplication" should occur. 3/

2/ As the court noted in Nash, B.C. §1326, which addresses the duties of the debtor and the Chapter 13 Trustee in making payments, does not address the Trustee's duties with respect to the making of payments upon dismissal of the case.

3/ We note that, in cases such as the current one, where only a small amount is at issue, overriding the Trustee's designation may not be viewed as worth the administrative effort required to do so.

In summary, we believe it is unclear whether Energy Resources applies to Chapter 13 cases, such as this one, to render irrelevant the significance of characterizing payments made during a bankruptcy as “voluntary” or “involuntary,” and to provide to the bankruptcy court the authority to decide how the payments should be credited. Accordingly, our opinion is that the Service is not legally precluded from reapplying payments in its best interest once the case is dismissed, since the dismissal has the effect of undoing the Trustee’s prior designation.

Thank you for soliciting our opinion on this matter. If you have further questions, please call 202/622-3630.

Attachment:(1)