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POINTS TO REMEMBER

Fighting the Post-Bankruptcy Survival of Federal Tax Liens on Property That Is Excluded from the Bankruptcy Estate (Part 2)

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Editor's Note: This is the second of a two-part article, which provides an overview of the federal tax system's forced collections tools. Part 1 appeared in the *NewsQuarterly*, Vol. 33, No. 4, Summer 2014 issue.

Judicial Collection Actions

Although its administrative enforcement tools are at the heart of federal tax collection, the Service can seek judicial assistance to enforce a tax liability. As a practical matter, the Service seeks judicial assistance only when its administrative procedures for collecting taxes are ineffective. Because the Service employs judicial collection actions sparingly, a taxpayer is unlikely to be subject to a section 7403 action. For example, in 2010, the Service filed roughly 1.1 million NFTLs and 3.6 million notices of levy on third parties, but civil actions under section 7403 produced only 46 judicial opinions. Internal Revenue Service. Data Book 2010. Table 16 (2011), available at http://www.irs.gov/pub/irs-soi/10databk.pdf; National Taxpayer Advocate, 2010 Annual Report to Congress, Executive Summary, at 43, available at http://www.irs.gov/pub/irs-pdf/p2104c.pdf.

There are two chief reasons why the Service uses judicial collection actions as a last resort. First, as section 7421 recognizes, a federal lawsuit to enforce a lien can be a potentially long and drawn out adversarial process. Second, the Service cannot, itself, bring an action in federal court to enforce the lien through foreclosure. Instead, it must persuade the Department of Justice, which has its own priorities and demands on its resources, to commence the action on behalf of the United States. I.R.C. § 7401.

The purpose of a collection action is to reduce the federal tax assessment to judgment and to foreclose the tax liens on specific property. But the Service can also request more unusual relief. For example, it may obtain certain relief on an ex parte basis, including the authority to open, or at least be present at the opening of, a safety deposit box, and to obtain a warrant to enter property without the owner's consent. *In re Gerwig*, 461 F. Supp. 449, 451 (C.D. Cal. 1978).

The Service may also attempt to set aside a conveyance as fraudulent. Such action is taken when it believes that the taxpayer transferred property prior to the federal tax lien (or levy) in order to avoid payment. I.R.C. § 6901. Generally, when a conveyance

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is found under the applicable state law to have been fraudulent, it is deemed void. Therefore, the creditor can reach the property. State laws regarding fraudulent conveyances determine whether a transaction will be set aside for the benefit of the United States. Such laws typically require the government to prove that: (1) the property was transferred by an insolvent debtor, or a debtor rendered insolvent by the transfer; (2) the recipient of the property paid insufficient consideration; and (3) the debtor intended to defraud or evade his creditors.

If the IRS initiates judicial action, it does so in federal district court. District courts have the power to issue orders, processes, and judgments for enforcement of the Code. Under section. 7402, suits may be brought to reduce tax claims to judgment. Under section 7403, the Service may initiate an action to reduce a tax lien to judgment. Typically, this type of suit is brought when there is specific property to pay all or part of the tax.

Section 7403 is most often used when the Service needs to extend the ten-year statute of limitations for collecting assessed liabilities. A levy's timeliness is measured with respect to the date that it is made. But an action under Section 7403 is timely so long as the action is commenced within the limitations period. I.R.C. § 6502(b); I.R.M. 5.17.4.7. And, if the Service prevails, it secures a judgment lien against the taxpayer's property. This judgment lien has its own additional independent and lengthy statute of limitations and also extends the life of the federal tax lien, which continues its independent existence. 28 U.S.C. § 3201 (providing that the judgment lien is effective, unless satisfied, for 20 years and may be renewed for one additional period of 20 years by filing a notice of renewal).

As part of the judicial process, federal district courts can compel any person to appear, testify, and produce books and papers. I.R.C. § 7402(b). This power is particularly important because it provides an avenue of enforcement in situations where no specific enforcement provision otherwise exists. For example, if an individual is taxed under section. 301 on a dividend, this provision may be used to compel disclosure of the corporation's earnings and profits.

A federal tax lien may be foreclosed against property held by a transferee, nominee or alter-ego when the taxpayer is the equitable owner of the property. The Service may also bring suit to enforce a levy. I.R.C. § 6332.

Returning to our hypothetical, there are still some questions that remain unanswered. First, what affirmative steps may John take to extinguish or modify the tax lien? He would bring an adversary proceeding to determine the validity, priority, or extent of the lien. Essentially, he would be asking the court to issue an order releasing his home from the lien. If he is successful, the Service would no longer have a claim against his property. The release would also prevent the Service from making a new assessment at a later time. *See* Practical Tax Professional, *supra*.

Let's assume that the IRS uses the courts to reduce its assessment to judgment and to foreclose its federal tax lien on John's home. It may not be too late for John to challenge the *merits* of the underlying tax liability in federal court. An incorrect tax assessment can be asserted as a defense to an action brought by the government to enforce its lien. I.R.C. § 7403; I.R.M. 5.17.5.17.8.

When the Service (through DOJ) initiates an action to reduce a tax lien to judgment, it opens the assessment to judicial scrutiny in all respects. *United States v. O'Connor*, 291 F.2d 520 (2d Cir. 1961). This includes the merits of the claim. *United States v. Camejo*, 666 F. Supp. 1542 (S.D. Fla. 1987).

Mounting such a challenge can be a daunting feat. First, the assessment of tax upon which the lien is based is presumed to be valid. However, it is only a rebuttable presumption. Nonetheless, challenging the correctness of a tax assessment is an uphill battle.

There are also issues related to shifting of burdens of proof, production, etc. Before the court will even begin to entertain arguments challenging the underlying tax liability, John must overcome some formidable obstacles. If these obstacles prove insurmountable, then he will be barred from mounting such a challenge. The shifting of burdens is summarized below:

(1) The government has the burden of coming forward and persuading the judge that there is a tax liability. If the assessment was never challenged administratively, by filing a protest upon receipt of a 30-day letter, or judicially by filing a petition in Tax Court, the assessment establishes that liability. As you might expect, this will be easy for the government.

(2) The taxpayer has the burden of persuading the judge—by a preponderance of the evidence—that the assessment was arbitrary. Good records will go far to overcome the presumption of correctness attaching to the assessment. To the extent that good records are not available, the taxpayer will be forced to rely on the credibility of witnesses who can fill in the gaps in information. The taxpayer will no doubt be a prime witness. In the absence of any records, it becomes increasingly more challenging to persuade the judge that the Service's assessment is not as reliable as the taxpayer's word or recollection.

(3) The burden then shifts to the government to establish that a deficiency exists and, if so, in what amount. The government can meet this burden even if the tax liability it asserts is *different*

from the amount initially asserted. The government merely has to establish that there was a tax liability.

A twist on the facts will help illustrate the mechanics of the shifting of burdens. Assume that instead of filing its NFTL after John filed his bankruptcy petition, the Service filed it *before*. Further, assume that after learning about the NFTL, John immediately requested a CDP hearing. In other words, the request for a CDP hearing was made—and the hearing occurred—after the government filed its NFTL but before John filed for bankruptcy.

At the CDP hearing, John unsuccessfully attempted to persuade the Service to remove the notice of lien. John did not obtain judicial review of that decision in Tax Court. At that very same hearing, John disputed the merits of his tax assessment. Although the general rule is that a taxpayer may *not* challenge the merits of a tax assessment at a CDP hearing, there is an exception for taxpayers who have had *no* statutory opportunity to contest their underlying tax liability pre-assessment.

A taxpayer has no statutory opportunity to contest an underlying tax liability pre-assessment if he "did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such liability." Recall that the notice of deficiency is a taxpayer's ticket to Tax Court. If the taxpayer received a notice of deficiency, he had the right to contest his liability in Tax Court. Indeed, all that was required was the filing of a petition with the Tax Court for a redetermination of the deficiency.

Consequently, the failure to petition the Tax Court upon receiving a notice of deficiency is fatal to the review of a taxpayer's underlying tax liability at a CDP hearing. Similarly, a taxpayer who *waives* his right to a notice of deficiency on Form 870 or Form 4549 will be deemed to have had a previous opportunity to contest his underlying tax liability. Such a taxpayer will be barred from challenging the merits of his tax liability at a CDP hearing.

Assume that the reason John was permitted to dispute his underlying tax liability at the CDP hearing was because the Service mailed his notice of deficiency to the wrong address. As a result, he never received it. At the CDP hearing, John's challenge to his tax assessment suffered the same fate as his request to extinguish the tax lien. It was denied.

What impact does this adverse ruling have on John's attempt to challenge the merits of the tax assessment at the foreclosure hearing? Will he be barred from mounting such a challenge in this action? The knee-jerk answer to this question might appear to be "yes" in light of the fact that John previously had an opportunity to challenge the tax assessment and lost. But that would be wrong.

Most circuits favor the rule allowing taxpayers to challenge the merits of an assessment in an action brought by the government to reduce a tax lien to judgment. Therefore, the fact that John already had "one bite at the apple" is meaningless. The case will move forward.

Of course, that will not stop the Service (through DOJ) from arguing that John should be *estopped* from challenging his tax liability. In so doing, it will rely on the fact that John had the opportunity to challenge his tax liability at an earlier CDP hearing and to have the merits of that liability ruled upon. The fact that that ruling was adverse to him does not mean that he should get a second bite at the apple.

John will likely fail in his attempt to rebut the presumption of correctness that attached to the $ 50,000 assessment. As a result, the judge will order that the federal tax lien be foreclosed and that his home be sold. She will then order that the proceeds of such sale be distributed first to the costs of the sale and other priority interests, namely the first mortgage, and then to the United States. Whatever remains will go to John. To the extent that the home is sold to satisfy the lien, the government may bid at the sale but only up to the amount of the tax lien plus selling expenses. ■