

Tax Talk: Tax Closure

by Chad C. Coombs*

Under the federal priority statute, 31 U.S.C. Section 3713, a receiver of an insolvent estate who knew or should have known about the existence of federal claims against the receivership estate, including tax claims, may be held personally liable for failing to pay all such federal claims to the extent there were funds available to do so.ⁱ A receiver in such case will therefore want to make certain that all federal taxes are determined and paid or provided for before making distributions to other claimants and closing the case. But how?

For federal tax returns that the receiver files, the receiver may be able to seek prompt assessment,ⁱⁱ estimate a reserve for federal taxes or wait until the applicable statute of limitation expires before making distributions to other claimants. But there may be other federal tax liabilities, especially in complex cases or receiverships involving fraudulent activities. The receiver may need to conduct tax due diligence, such as reconstructing and analyzing accounting records, reviewing prior year tax returns, and seeking information from the taxing authorities.

The Internal Revenue Service, however, is generally not bound by informal communications. Even filing a claim in the receivership does not necessarily bind the IRS. The IRS may later assert additional taxes, even after distributions have been made, leaving the receiver exposed to personal liability for any unpaid federal taxes.ⁱⁱⁱ

Furthermore, the receiver cannot count on the receivership court to grant relief from the receivership's federal tax obligations or block the IRS from recovering against the receiver.^{iv} The sovereign immunity right of the United States from being sued and the federal Anti-Injunction Act generally prohibit (with limited exceptions) any suit to bar the IRS from assessing and collecting any federal taxes,^v and the Anti-Injunction Act also prohibits any suit to bar the assessment or collection of any liability of a receiver for any federal tax.^{vi}

But the receiver has some options. One possibility is a closing agreement with the IRS.^{vii} A closing agreement may cover many types of federal taxes, not just income taxes, and binds the IRS. The IRS may enter into a closing agreement when it is advantageous for the IRS to have the matter permanently or conclusively closed or the taxpayer has good reasons for a closing agreement and the IRS will not be prejudiced.^{viii} Moreover, the IRS acknowledges that an acceptable reason for a closing agreement is a receivership in which the receiver desires a final determination before making a distribution.^{ix}

While this sounds good, the IRS is not required to enter into a closing agreement and may be reluctant to execute one that resolves any or all potential federal tax claims, including claims that are unknown, or otherwise cannot be quantified.^x Thus, there is no guarantee that the IRS will consider a request for, or finalize, a closing agreement.^{xi}

Another potential solution is a constructive trust, but this only applies in limited circumstances. A receivership court may impose a constructive trust as an equitable remedy in fraud cases where the

receivership funds and assets can be traced to the victims. The cash and other assets improperly taken from the victims are deemed held in trust for the benefit of the victims and thus not available to pay tax claims against the perpetrators of the fraud. This effectively subordinates tax claims to the claims of the victims.

Department of Justice Tax Division Directive No. 137 states that in certain circumstances, the DOJ's Tax Division will recognize the priority of a victim's claim over a federal tax claim if the victim can trace its property to the receivership and either (a) the claims arise from the same transaction or (b) title has not passed to the perpetrator (e.g., in cases of theft) and a constructive trust was imposed prior to assessment of the tax or would be imposed absent any assessment. The directive instructs that the Tax Division should seek a reasonable settlement in these cases given that a court could relax the tracing requirements or find a means to rule in favor of the sympathetic victims. A receiver in a fraud case should therefore consider asking the IRS to subordinate its claim or, should that fail, file a motion with the receivership court seeking a constructive trust and subordination of the tax claim.^{xii}

What if these options fail or are unavailable? Each case depends on its own unique facts and circumstances, and the receiver may be able to reach some other type of agreement or arrangement with the IRS. But if not, this highlights the importance of the receiver seeking tax guidance from the outset of the case and exercising all necessary due diligence with respect to potential tax liabilities. Such actions will help demonstrate that the receiver did not know, and could not have known, about any unpaid federal taxes that the IRS may later assert.

ⁱ See 31 U.S.C. Section 3713(a) for when federal claims have priority over other claims. Courts have carved out exceptions to the federal priority statute for payment of secured claims and reasonable administrative expenses. Courts have also limited receiver liability to federal claims for which the receiver knew about or had inquiry notice. Federal taxes may also have priority pursuant to a federal tax lien.

ⁱⁱ See Coombs, Prompt Assessment, Receivership News, Issue 71 p. 18 (Spring 2021).

ⁱⁱⁱ See Internal Revenue Manual Section 34.4.1.8 regarding IRS collection policy in receiverships.

^{iv} See SEC v. Credit Bancorp, Ltd., 297 F.3d 127 (2d Cir. 2002).

^v Internal Revenue Code Section 7421(a).

^{vi} Internal Revenue Code Section 7421(b).

^{vii} Internal Revenue Code Section 7121.

^{viii} Internal Revenue Manual Section 8.13.1.2.2(1).

^{ix} Id.

^x IRS private letter rulings are also binding on the IRS but likewise might not be practical solutions as they are limited to the specific stated facts.

^{xi} For further discussion on closing agreements, see Strahan and Greenwald, Closing It Out – Past, Present & Future, Los Angeles Lawyer, Volume 44, No.11 Page 24 (February 2022).

^{xii} See Rosen, Does Constructive Trust Raise Harmed Parties' Claims Above Pre- Receivership Tax Debts?, Receivership News, Issue 21 p.1 4 (Spring 2006).

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