25493

REPORT BY THE

Comptroller General

OF THE UNITED STATES

Legislative Change Needed To Enable IRS To Assess Taxes Voluntarily Reported By Taxpayers In Bankruptcy

The Bankruptcy Reform Act provides qualified debtors with certain protections from creditors--including IRS. The act restricts IRS' authority in many cases to assess, collect, or recover a claim against an individual or a business during bankruptcy proceedings. Because of this restriction, IRS must process returns from bankrupt taxpayers manually rather than through its automated processing system. During fiscal year 1982, these additional processing steps cost IRS an estimated $500,000.

GAO believes that the Bankruptcy Act should be amended to allow assessment of the taxes that bankrupt taxpayers report on their returns. Allowing IRS to assess--but not collect--these taxes would enable bankrupt taxpayers to be protected at less cost than is presently being incurred.

Also, IRS needs to modify its automated collection system to assure that bankrupt taxpayers will not receive collection notices. IRS agrees with the report's conclusions and strongly supports GAO's recommendations.

UNITED STATES GENERAL ACCOUNTING OFFICE

GAO/GGD-83-47
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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-211231

The Honorable Dan Rostenkowski
Chairman, Joint Committee on Taxation

The Honorable Robert J. Dole
Vice Chairman, Joint Committee on Taxation
Congress of the United States

As part of your committee's July 1981 request to examine the effects of bankruptcy laws on tax administration, we have reviewed the impact that the 1978 Bankruptcy Reform Act's restriction on tax assessments is having on the Internal Revenue Service (IRS) and bankrupt taxpayers. [1] Tax assessments, as you know, are bookkeeping entries required by the Internal Revenue Code to record tax liabilities on IRS' books.

The Bankruptcy Reform Act provides qualified debtors with certain protections from creditors--including IRS. The act restricts IRS' authority in many cases to assess, collect, or recover a claim against an individual or a business during bankruptcy proceedings. Administratively, this restriction has caused problems for IRS because it requires IRS to process returns from many bankrupt taxpayers manually rather than through its automated processing system. During fiscal year 1982, these additional processing steps cost IRS an estimated $500,000 in administrative expenses.

Returns filed by bankrupt taxpayers show that the taxpayer is either (1) fully paid, (2) overpaid and due a refund, or (3) not fully paid. With respect to fully paid and refund returns, IRS has taken the position--which to us seems reasonable--that these taxes can be assessed under current law. Thus, IRS' assessment problem relates to those remaining returns where bankrupt taxpayers owe taxes.

IRS has attempted to resolve the remaining assessment problem through court orders. At the time of our review, IRS had been successful in getting bankruptcy courts to lift the assessment restriction in 29 of the 94 bankruptcy court districts, but

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[1]/Federal judicial workload statistics prepared by the Administrative Office of the United States Courts showed that a total of 373,853 bankruptcy cases were filed during the 12-month period ending September 30, 1982. Of these, 310,330 were nonbusiness related and 63,523 pertained to businesses.

the assessment restriction was still in force in the remaining 65 districts. Thus, similarly situated taxpayers are not being treated uniformly.

On the basis of our examination, we believe the assessment restriction should be amended to allow IRS to assess the taxes that bankrupt taxpayers report on their returns. Allowing IRS to assess--but not collect--these taxes would not affect the status of either IRS or bankrupt taxpayers during bankruptcy proceedings. Moreover, removing the assessment restriction would ensure consistent treatment for all bankrupt taxpayers.

Regardless of whether the assessment restriction is eliminated, IRS needs to modify its collection procedures to make sure that it does not violate the legislative restriction on initiating collection action against bankrupt taxpayers. Presently, some bankruptcy court districts permit IRS to assess taxes against bankrupt taxpayers, but IRS does not have procedures to stop the automated collection notices from being sent to these bankrupt taxpayers once the taxes are assessed but not paid. IRS officials informed us that they can change the computerized collection procedures to stop collection notices from being sent to bankrupt taxpayers at a cost of about $65,000. This change needs to be made to protect bankrupt taxpayers from collection action once taxes have been assessed by IRS.

We are not proposing that the protection from collection actions afforded by the 1978 Bankruptcy Reform Act be changed. We are recommending, however, that, for purposes of administrative efficiency, the act be amended to allow IRS to make a bookkeeping entry through its automated system to assess the taxes voluntarily reported by bankrupt taxpayers on their returns. We are also recommending that, for purposes of better assuring that the protections afforded by the act are realized, IRS should modify its automated collection system to stop collection notices from being sent routinely to bankrupt taxpayers once the reported taxes have been assessed. We believe that the combined effect of our recommendations would be to protect bankrupt taxpayers from collection action at less cost than is presently being incurred.

In evaluating the effects of the Bankruptcy Code's restriction against assessing tax claims on bankrupt taxpayers, we performed work at IRS offices in Washington, D.C.; Chicago, Illinois; Milwaukee, Wisconsin; and Kansas City, Missouri. We interviewed IRS officials and congressional staffs regarding their views on the assessment of taxes on bankrupt taxpayers. We also reviewed IRS' policies, procedures, and practices for dealing with the restriction on tax assessments during bankruptcy proceedings. In determining the cost of the assessment restriction we relied heavily on IRS' estimates. Our review was performed in accordance with generally accepted Government auditing standards.

THE TAX ASSESSMENT, APPEAL, AND COLLECTION PROCESS

Taxes are first assessed when IRS processes tax returns filed by taxpayers. These assessments, required by the Internal Revenue Code under 26 U.S.C. §§ 6201-04, are bookkeeping entries to record the amount of taxes reported by taxpayers on their tax returns. These tax liabilities cannot be appealed unless the taxes are paid and refund claims filed. In fiscal year 1982, IRS assessed $867 billion in taxes shown on over 127 million returns in this manner. [2]

On a more limited scale, IRS assesses additional taxes determined through subsequent audits of tax returns. In fiscal year 1982, IRS assessed $8.9 billion based on audits of tax returns. These additional audit-determined tax assessments affected less than 2 percent of the total returns filed. Currently, these audit-determined taxes are not assessed until the taxpayers either agree with IRS' audit findings or exhaust available administrative and legal appeals. Taxpayers generally have the right to appeal IRS' audit-determined taxes both with IRS and the Tax Court before IRS can assess these taxes. Once the taxes are assessed, however, taxpayers must generally pay their taxes before further appeal procedures can be initiated. In other words, while taxpayers do not have the right to appeal the taxes they reported on their tax returns before assessment, they do have the right to appeal additional audit-determined taxes before assessment.

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[2]/Total tax revenues for 1982 were $632 billion. Total tax assessments are usually higher than total tax revenues because, for internal IRS accounting purposes, some taxes are assessed twice but only paid once. For example, income taxes withheld from employee wages are assessed when employers file quarterly employment tax reports. These taxes are assessed again when the individual taxpayers file their annual income tax returns. At that time, the taxpayer's total tax is assessed and the taxpayer is credited for the taxes already withheld.

Once unpaid taxes have been assessed, based either on the taxpayers' returns or through subsequent audits of the returns, IRS' automated collection procedures begin. Computer-generated demand notices are sent to taxpayers shortly after the unpaid taxes are assessed. IRS generally sends taxpayers four demand notices through its automated system before the delinquent accounts are sent to its district offices where more severe collection actions, such as levy and seizure, are considered if the assessed taxes remain unpaid. (See app. I for a flowchart of the assessment, appeal, and collection process.)

THE 1978 BANKRUPTCY ACT'S RESTRICTION ON ASSESSMENT WAS BROADER THAN NECESSARY FOR PROTECTING TAXPAYERS' APPEAL RIGHTS DURING BANKRUPTCY

The 1978 Bankruptcy Reform Act was the first major legislation dealing with bankruptcies in 40 years. Before that act was passed, the Internal Revenue Code allowed IRS to immediately assess audit-determined taxes before bankrupt taxpayers had the opportunity to appeal them. This deprived bankrupt taxpayers of appeal rights which were available to other taxpayers. To remedy this situation, the Congress included an assessment restriction in the 1978 Bankruptcy Reform Act which stated in part that:

> "* * * a petition filed under * * * this title operates as a stay, applicable to all entities, of * * *
>
> (6) any act to collect, <u>assess,</u> or recover a claim against the debtor that arose before the commencement of the case under this title [emphasis added]." 3/

This restriction prevents IRS from exercising the authority provided by the Internal Revenue Code to assess taxes for many bankrupt taxpayers unless it can get the bankruptcy court to lift the stay.

The assessment restriction in the 1978 act protected the bankrupt taxpayers' appeal rights by preventing the immediate assessment of audit-determined taxes. But, because the language was not specific as to the type of assessments involved, it also restricted IRS from making the bookkeeping entry it normally makes for taxes voluntarily determined and reported by bankrupt

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3/This restriction is codified in the Bankruptcy Code at 11 U.S.C. § 362(a).

taxpayers on their returns. Taxpayers cannot, and have no need to, appeal the tax liability which they have determined and voluntarily reported before that liability has been assessed. Thus, the broad language in the 1978 act provided a greater degree of protection than was necessary.

The Congress subsequently amended the Internal Revenue Code through the Bankruptcy Tax Act of 1980, but this action did not affect the assessment restriction established in 1978. The 1980 act repealed the provision of the Internal Revenue Code that had given IRS the authority to immediately assess audit-determined taxes before bankrupt taxpayers had the opportunity to appeal them. However, it left in effect the broader restriction on IRS' authority to assess taxes for bankrupt taxpayers. This restriction is not necessary to protect their rights.

The broad restriction on tax assessments does not affect the status of IRS or bankrupt taxpayers during bankruptcy. The Bankruptcy Code provides that a tax need not be assessed before IRS can file a claim with the bankruptcy court and further provides that the priority for payment of a tax claim is unaffected by the assessment status. Also, the Bankruptcy Code allows the bankrupt taxpayers to litigate the merits of the tax liability in the bankruptcy courts, regardless of whether the tax has been assessed. In addition, the assessment affects neither bankrupt taxpayers' tax liabilities nor IRS' ability to collect from bankrupt taxpayers after the bankruptcy proceedings are completed.

THE BROAD RESTRICTION ON ASSESSMENTS HAS INCREASED IRS' ADMINISTRATIVE COSTS

Restricting the assessment of taxes which bankrupt taxpayers have voluntarily reported on their returns requires IRS to stop its automated processing of these returns and perform many special processing steps. These additional steps include manual processing procedures at IRS service centers and local district offices (see app. II for a flowchart of these additional procedures). IRS estimates that, because of the tax assessment restriction for bankrupt taxpayers, over 93,000 tax returns required special processing in 1981 at a cost of about $270,000. IRS also estimates that, in 1982, 178,000 returns required special processing at a cost of $2.89 per return for a total of about $514,000. Because of the annual fluctuations in the volume of bankruptcies, we are unable to project future costs. However, it seems reasonable to assume that the future costs would be substantial.

IRS HAS TRIED TO MINIMIZE THE ADMINISTRATIVE COSTS RESULTING FROM THE ASSESSMENT RESTRICTION

IRS is taking two measures to minimize the costs related to the bankruptcy assessment problem. First, in an attempt to solve the problem at the district level, IRS tried to obtain bankruptcy court orders in each bankruptcy court district to allow assessments during bankruptcy proceedings. As of December 1982, IRS had obtained court orders allowing assessment, but not collection, in 29 of the 94 bankruptcy court districts. This approach, although a positive attempt to resolve the problem, is time consuming, does not constitute permanent resolution since individual court orders can be rescinded, and does not assure uniformity of treatment among taxpayers.

Second, IRS currently assesses taxes shown on fully paid and refund returns filed by taxpayers engaged in bankruptcy proceedings. IRS justifies this action because it believes that the Congress did not intend to prohibit the assessment of taxes on fully paid and refund returns. In this regard IRS points out that there is no need for it to file a claim in bankruptcy proceedings on fully paid or refund returns. In addition, IRS states that the purpose of restricting assessments and collections, which is to provide the bankrupt individual or business immediate protection from collection efforts of creditors, is not hindered by IRS' assessing taxes on fully paid and refund returns.

Although the above two measures are reasonable, they constitute only a partial solution. Because not all bankrupt taxpayers are affected, IRS will continue to incur unnecessary administrative expense as a result of the Bankruptcy Code's restriction on assessment. Since this situation cannot be resolved through regulation, IRS has prepared a legislative proposal which, among other things, would amend the Bankruptcy Code to allow the assessment of taxes shown on returns filed during bankruptcy proceedings. This proposal has since been forwarded to the Congress through the Department of the Treasury. We believe that the language of this proposal, as shown in appendix III, will adequately solve the problem without affecting bankrupt taxpayers' access to the Tax Court.

COLLECTION PROCEDURES NEED TO BE MODIFIED

Although bankrupt taxpayers are not afforded additional protections through the assessment restriction, they are provided important protections through the restriction on collection actions. The Senate report accompanying the 1978 Bankruptcy Reform Act states that the collection restriction "* * * is one of the fundamental debtor protections provided by the bankruptcy laws * * *. It stops all collection efforts, all harassment, and all foreclosure actions."

IRS' computerized collection procedures automatically result in demand notices being sent to taxpayers once taxes are assessed but not paid. In most of the districts where assessments are now being made through court orders, IRS began assessing the taxes shown on all returns through its automated system in January 1983. Since no revisions were made to IRS' computerized collection system, IRS officials agree that, if bankrupt taxpayers in these districts file returns during bankruptcy showing taxes due, collection notices would be sent to the bankrupt taxpayers contrary to the Bankruptcy Code's restriction on collection actions. Therefore, even if the assessment restriction is not eliminated, IRS must change its collection procedures to avoid violating the collection restriction in those instances in which bankrupt taxpayers are now being assessed.

IRS estimates that the necessary changes to the system would cost about $65,000. This would be a one-time cost which could be more than offset by recurring annual savings that would result from eliminating the assessment restriction established by the 1978 Bankruptcy Reform Act. For example, as previously discussed on page 5, IRS estimates that it incurred additional expenses of about $514,000 in the special processing of these returns during 1982.

CONCLUSION

The Bankruptcy Code's broad tax assessment restriction relating to bankrupt taxpayers does not provide such taxpayers additional rights or protections and causes IRS processing delays and administrative costs. In fiscal year 1982, it cost IRS an estimated $500,000 in additional expenses to process bankrupt taxpayers' returns because of the assessment restriction.

Eliminating the Bankruptcy Code's assessment restriction would not adversely affect the administration of the bankruptcy laws or the rights of bankrupt taxpayers. It would not provide IRS with any special advantage over other creditors or enhance IRS' position against the bankrupt taxpayer during the bankruptcy proceedings. It would simply eliminate IRS' unnecessary administrative expenses.

However, to continue to provide protection to bankrupt taxpayers once the assessment restriction is eliminated, IRS needs to modify its procedures to prevent collection action from starting once delinquent taxes are assessed against bankrupt taxpayers. Since some taxes are already being assessed through court orders, this change needs to be made even if no action is taken on the assessment restriction.

RECOMMENDATION TO THE CONGRESS

The Congress should amend the Bankruptcy Code to allow IRS to assess the taxes reported by bankrupt taxpayers on their returns. We suggest that the statutory language proposed by the Department of the Treasury be considered in this regard (see app. III).

RECOMMENDATION TO THE COMMISSIONER OF INTERNAL REVENUE

The Commissioner should modify IRS' automated collection procedures to prevent sending collection notices that would violate the protection afforded taxpayers by the Bankruptcy Code.

AGENCY COMMENTS AND OUR EVALUATION

The Commissioner of Internal Revenue commented on a draft of this report by letter dated April 12, 1983. (See app. IV.) The Commissioner stated that the report adequately presents the administrative problem that IRS has experienced. He said that IRS was in agreement with our conclusions and strongly supported the report's recommendations.

The Commissioner stated that IRS fully concurred with our recommendation to modify its collection procedures to prevent collection notices from being sent to bankrupt taxpayers, and said that IRS is now in the process of establishing data processing requirements and criteria for implementing the recommendation. He also said that the related modifications will take place in conjunction with the major computer reprogramming efforts now occurring in the Service.

With regard to current procedures, the Commissioner stated that IRS does take into consideration the unique circumstances of those taxpayers involved in bankruptcy proceedings. He said that taxpayers have a right to be notified of assessments and stressed that, although notices are sent, no collection enforcement efforts are made.

We reported on this matter because sending collection notices to bankrupt taxpayers appeared to us to be contrary to the Bankruptcy Code's restriction on any collection actions. Since that situation will continue to exist until the actions outlined by the Commissioner are fully implemented, we encourage IRS to proceed as quickly as possible.

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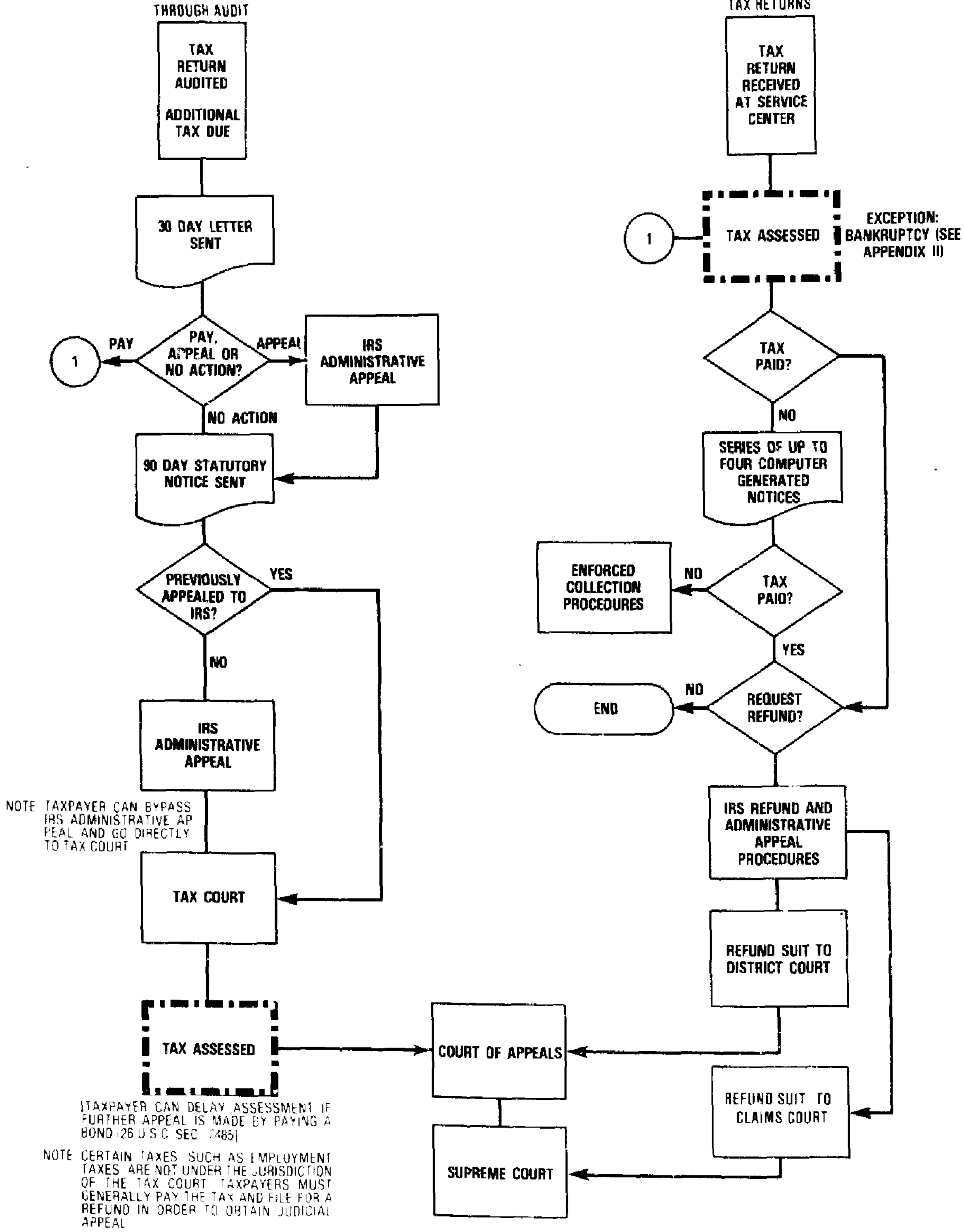
As arranged with your committee, we are sending copies of this report to other congressional committees and subcommitees; the Secretary of the Treasury; the Attorney General; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

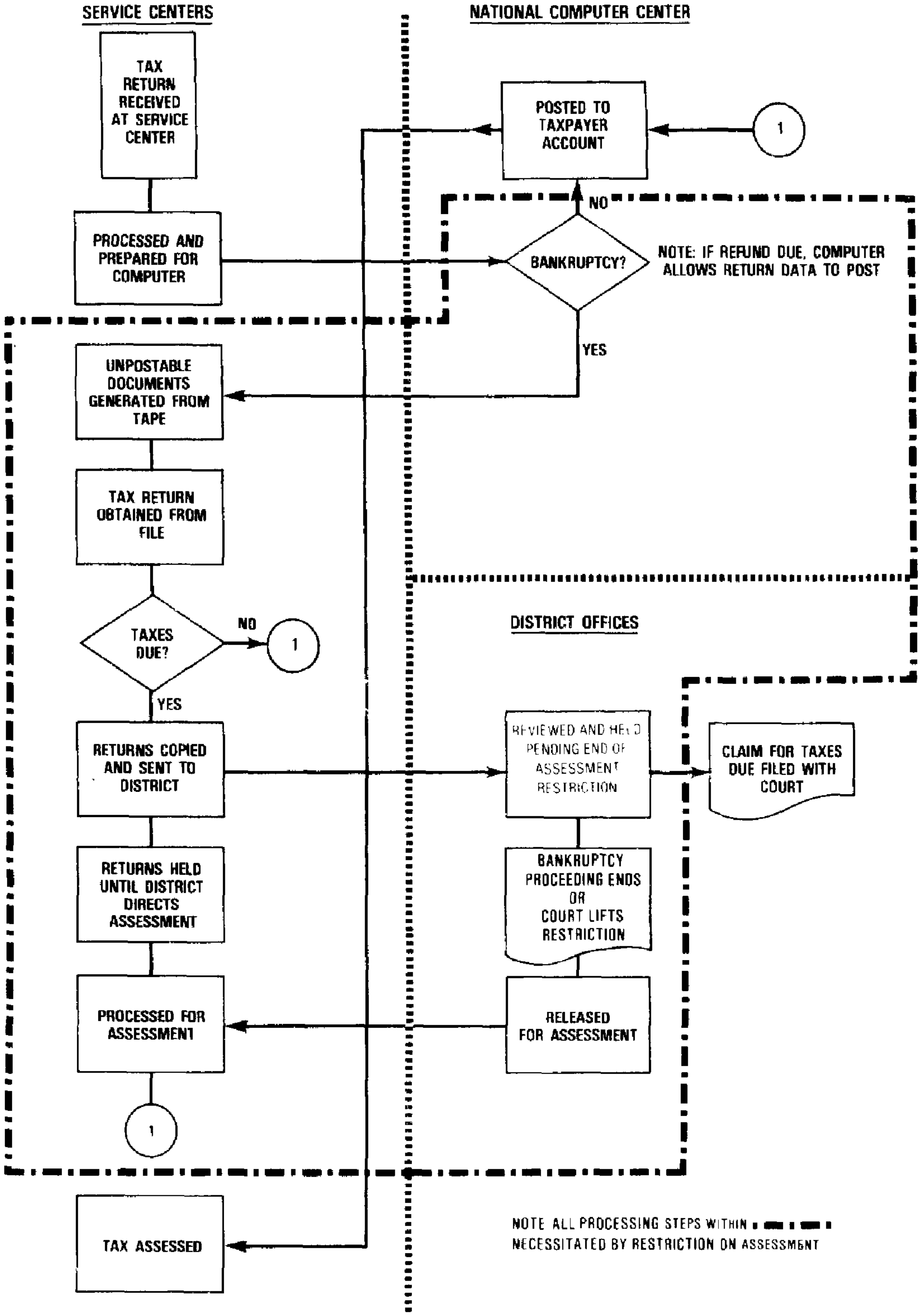
Charles A. Bowsher

Comptroller General
of the United States

FLOWCHART OF THE NORMAL ASSESSMENT, APPEAL AND COLLECTION PROCESS



FLOWCHART OF ADDITIONAL IRS PROCESSING PROCEDURES
REQUIRED BY RESTRICTION ON ASSESSMENT



TREASURY'S PROPOSAL TO AMEND THE BANKRUPTCY CODE TO ALLOW TAX ASSESSMENTS

Section 362(a) of Title 11, United States Code, provides for a stay on all tax assessments during bankruptcy proceedings. (See pp. 4 and 5 of this report.) 11 U.S.C. § 362(b) provides the exceptions to this general rule and identifies those instances in which the stay will not operate. Treasury has proposed that section 362(b) be amended to provide, among other things, an exception allowing IRS to assess taxes reported by bankrupt taxpayers on their returns. Under this proposal section 362 would read in part as follows:

§ 362. Automatic stay

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302 or 303 of this title operates as a stay, applicable to all entities, of-

* * * * *

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

* * * * *

(b) The filing of a petition under section 301, 302 or 303 of this title does not operate as a stay-

* * * * *

(8) under subsection (a) of this section,

(A) of the issuance to the debtor by a governmental unit of a notice of tax deficiency;[1] or

(B) of the assessment of any tax liability which can be assessed by a governmental unit without the issuance of a notice of deficiency,

provided, that any lien created by, or relating to, the assessment of a tax liability described in this subparagraph shall not be enforceable until after the stay expires or is terminated.[2]

In addition to allowing IRS to assess taxes reported by bankrupt taxpayers on their returns, Treasury's proposal would, among other things: (1) allow IRS to assess certain audit-determined taxes, such as employment taxes, which are not subject to a notice of deficiency and are not appealable to the Tax Court; and (2) allow other governmental units, such as State governments, to assess taxes which are not subject to a notice of deficiency procedure. Even so, Treasury's proposal is consistent with our report in that it would allow assessments only in those situations where a taxpayer's access to the Tax Court is not affected.

1/A notice of deficiency is not a collection action. The notice informs the taxpayer of IRS' determination of a tax liability and provides the taxpayer with an opportunity to go to the U.S. Tax Court.

2/Treasury's proposed amendment is identified by the underscored statutory language.

APPENDIX IV

COMMISSIONER OF INTERNAL REVENUE
Washington, DC 20224

APR 12 1983

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft report entitled "Legislative Change Needed So That IRS Can Assess Taxes Voluntarily Reported by Bankrupt Taxpayers."

The report adequately presents the administrative problems which the Service has experienced in complying with the automatic stay against assessment of taxes owed by taxpayers involved in bankruptcy proceedings. We are in agreement with the report's conclusions and strongly support its recommendations.

We believe that inclusion of your recommendation to Congress that it enact Treasury's proposal to amend the Bankruptcy code (to allow the assessment of any tax liability which can be assessed by a governmental unit without the issuance of a notice of deficiency) will facilitate passage of that amendment.

We fully concur with your recommendation to modify our automated collection procedures. We are now in the process of establishing data processing requirements and criteria to implement this recommendation with three new closing codes allowing assessment but suppressing the issuance of demand notices until after the lifting of the automatic stay. These modifications will take place in conjunction with the major computer reprogramming efforts now occurring within the Service.

In the interim, however, current procedures regarding the notice process do take into consideration the unique circumstances of those taxpayers involved in bankruptcy proceedings. When a notice and demand is issued, it is merely advising the taxpayer that we have made an assessment and its amount, a requirement under IRC §6303. We believe the taxpayers have a right to be so notified. We must stress that in the case of taxpayers involved in bankruptcy proceedings, no collection enforcement action is taken once the assessment is made which, after all, is the purpose of the automatic stay provisions. In fact, in Publication 594 (Rev. April 1982) The Collection Process (Employment Tax Accounts), which accompanies the second notice, we specifically advise the taxpayer in paragraph IID, Bankruptcy Proceedings, on page 2:

Department of the Treasury Internal Revenue Service

Mr. William J. Anderson

> If you are a debtor in an ongoing bankruptcy, do not pay this bill without first immediately contacting your local IRS office. While the bankruptcy proceeding will not necessarily relieve you of your obligations to pay, a temporary stay of collection may be in effect.

We hope that these comments, as well as those provided during discussions with your staff, will be helpful in preparing your final report.

With kind regards,

Sincerely,

(268122)

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