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## TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

### *The Supreme Court's 2001-2002 Term*

Continuing its trend toward fewer decisions in the tax field, the Supreme Court decided only three tax cases of note during its last term. All three cases addressed different facets of the Internal Revenue Service's ability to collect taxes, ranging from assessment of Social Security taxes, application of the Bankruptcy Code to the discharge of debts and the availability of federal tax liens. In all three cases, the Court sided with the IRS, and in each case the Court gave an expansive reading to the IRS's authority.

#### Apparent Loophole

Bankruptcy Ploy Fails to Discharge Tax Liability. In its decision in *Young v. United States*,<sup>1</sup> a unanimous Court closed an apparent loophole in the bankruptcy law relating to the dischargeability of tax debt. The Bankruptcy Code provides that taxes due for the three-year period preceding the filing of a bankruptcy provision are not dischargeable and are given a priority.<sup>2</sup> The taxpayers in *Young* sought to avoid the operation of the "lookback" provision by filing a petition under Chapter 13 of the Bankruptcy Code, successfully moving to have that petition dismissed before a reorganization plan was confirmed, and then filing a petition under Chapter 7. They argued that while the lookback provision would have prevented discharge of their tax debt for the three-years immediately preceding their Chapter 13 petition, that debt was dischargeable under the Chapter 7 petition because it pertained to taxes that were due more than three years before the filing of the second, Chapter 7 petition.

The Court acknowledged the apparent loophole created from back-to-back filings of Chapter 13 and Chapter 7 petitions: because



*John J. Tigue Jr.*

*Jeremy H. Temkin*

the automatic stay prevents the IRS from taking any collection action during the pendency of the Chapter 13 petition, the taxes remaining due would be subject to discharge if the Chapter 7 petition is filed after the lookback period has lapsed. The Court held that the taxpayer's effort to exploit this loophole was not permitted by the Bankruptcy Code. It found that the lookback period was a limitations period subject to traditional principles of equitable tolling, and that the period during which the Chapter 13 petition was pending should be excluded from the three-year lookback period, rendering the tax debt non-dischargeable.

The Court reasoned that the lookback period should be treated as a limitations period in that it prescribes a period during which the IRS is encouraged to protect its rights by collecting the debt, or perfecting a lien. If the IRS sleeps on its rights, and fails to act within the three-year period, it loses its priority and the debt becomes dischargeable. As such, the Court observed that the "lookback period serves the same basic policies [furthered by] all limitations provisions: repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities."

Having determined that the lookback period was a limitations period, the Court next explained that such periods were customarily subject to equitable tolling because the IRS is precluded by the automatic stay from pursuing its rights during the pendency of the earlier petition. It found that tolling was appropriate in this case regardless of whether the petitioners filed the back-to-back petitions in good faith, or solely to run down the lookback peri-

od, because "in either case, the IRS was disabled from protecting its claim during the pendency of the Chapter 13 petition."

#### Liability Based on Estimates

Social Security Liability Based on IRS Estimates. Until 1987, tips that restaurant employees received were not considered remuneration received from the restaurant, and restaurants were not responsible for making Federal Insurance Contribution Act (FICA or Social Security) payments based on those amounts. For the past 15 years, however, restaurant owners have been required to make FICA contributions on tips received by employees.<sup>3</sup> While the code expressly absolves employers of keeping certain records of the tips each employee receives,<sup>4</sup> restaurants are required to base their FICA contributions on tip reports provided by employees. Not surprisingly, the reports often understate the amounts of tips actually received. The code provides that the IRS may make an assessment against the restaurant for unreported tips, but that penalties and interest on contributions for the unreported tips will not accrue until after payment is demanded by the IRS.<sup>5</sup>

In *United States v. Fior D'Italia*,<sup>6</sup> the Court considered the IRS's methodology for determining the amount of unreported tips on which a restaurant owes additional FICA contributions. In an opinion written by Justice Stephen G. Breyer, a seven-member majority of the Court upheld the IRS's practice of calculating a restaurant's FICA contributions through an "aggregation estimate," which computes unreported tips paid to all of a restaurant's employees, rather than on an individualized, employee-by-employee basis. Under the method approved by the Court, the IRS reviewed the restaurant's credit card slips and determined that the customers had tipped an average of just over 14 percent on their bills. Working on the assumption that cash-paying customers tip at the same rate, the IRS then multiplied the restaurant's total receipts during the periods in question by the 14 percent figure, subtracted the tips already reported, and calculated the amount of FICA contributions due on the remainder. The restau-

**John J. Tigue Jr.** is a principal in *Morvillo, Abramowitz, Grand, Iason & Silberberg* and a fellow of the American College of Trial Lawyers. **Jeremy H. Temkin** is a principal in *Morvillo, Abramowitz, Grand, Iason & Silberberg*. **Judith L. Mogul**, an attorney, assisted in the preparation of this article.

rant challenged the IRS's statutory authority to use this aggregation estimation method, agreeing for the purposes of that litigation not to dispute the underlying facts upon which the IRS had relied in making its determination.

The Court held that the method used by the IRS was statutorily authorized, finding that by granting the IRS the power to make an assessment, §6201(a) "must necessarily grant the IRS power to decide how to make that assessment." It noted that courts have consistently upheld IRS estimates so long as they are reasonable and rejected the restaurant's argument that the aggregation method was unreasonable because, by failing to focus on individual taxpayers, it taxed tips that fell outside the "wage band" that subjects wages to FICA contribution only to the extent they fall between \$20 per month and an annual cap (which, for the years in question ranged from \$53,000 to \$55,000 per year). The restaurant also argued that the aggregation method was likely to overstate the amount of tips because it did not take into account that cash-paying customers tend to tip at a lower rate than credit card customers, and that some restaurants deduct credit card fees from the employees' tips, leaving the employee with a lower tip than that reflected on the credit card slip. The majority summarily rejected these arguments, observing that the restaurant had stipulated that it would not challenge the particular calculation used by the IRS and that, absent such a stipulation, any other taxpayer would be free to present evidence that the aggregation method had produced inaccurate results in a particular case.

### Aggregation Method

The dissent, authored by Justice David H. Souter, agreed with the taxpayer that the aggregation method was likely to overestimate liability, and was troubled by "[t]he strangeness of combining a statute excusing employers from recordkeeping with an administrative practice of making probably inflated assessments." It also noted that because of the code's special treatment of restaurants — making them liable for unreported tips only after demand by the IRS, the usual sequence of assessment, followed by notice and demand for payment, was reversed in this case, where an assessment must be preceded by notice and demand. Accordingly, the dissent posited, the IRS estimate in this case is technically a pre-assessment estimate, for which no statutory authority exists.

Lurking not so far beneath the surface in Fior D'Italia is the question of the IRS's motivation in pursuing the employer rather than the employee for contributions on unreported tips. Both the taxpayer and the dissent argued that the aggregation estimate approach effectively forces the employer into the position of verifying and monitoring its employees' tip reporting, a responsibility that Congress has "steadfastly refused to transfer from the IRS to the employ-

er." The majority acknowledged that under the Internal Revenue Service Restructuring and Reform Act, the IRS is prohibited from using the threat of an audit to coerce a restaurant into policing its employees, but concluded that the restaurant in this case had not claimed that the IRS had actually violated the statute, and that the mere possibility of such an abuse was insufficient to invalidate the method as a matter of law.

### Which Law Governs?

Tax Liens and Property Rights: Which Law Governs, Federal or State? Underscoring that the law governing what property is or is not subject to a federal tax lien is based on federally defined rights, a divided Court held in *United States v. Craft*,<sup>7</sup> that a taxpayer's interest in property held by the entirety could be attached by the IRS under a federal tax lien. The property in question was located in Michigan and held by the taxpayer and his wife in a tenancy

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by the entirety. Under Michigan law, property owned by the entireties is deemed not to belong to either party, but to belong jointly and inseparably to the couple and thus is not subject to levy by creditors of either spouse alone. Quoting its opinion in *Drye v. United States*,<sup>8</sup> the majority stressed that state law determines only what rights the taxpayer has in the property, while federal law determines "whether the state-delineated rights qualify as 'property' or 'rights to property' within the compass of the federal tax lien legislation." The Court went on to note that in determining the rights created under state law, it is important to "consider the substance of the rights the state law provides, not merely the labels the State gives these rights or the conclusion it draws from them."

After tracing the development of the various common-law forms of property ownership, the Court looked to the attributes of modern-day tenancy by the entirety, which is available only to married couples. In such an ownership arrangement, either spouse has the right to use the property, to exclude third parties from it and to share in income produced by the property. In addition, a tenant by the entirety has the right of survivorship, the right to become a tenant in common upon dissolution of the marriage and the right to sell the property and

retain half the proceeds of the sale, with the consent of the other tenant. The Court concluded that these rights gave the taxpayer in this case enough breadth of control over the property to subject his interest in the property to a federal tax lien. It rejected the argument that the right of unilateral alienation was essential to a determination that an interest constituted property for the purposes of the federal tax law, noting other instances where the Court had permitted a lien to attach, even where property could not be unilaterally sold.<sup>9</sup>

### The Dissent

In dissent, Justice Clarence Thomas, joined by Justices Antonin Scalia and John Paul Stevens, disputed the majority's conclusion that the taxpayer's interest rose to the level of a property interest subject to attachment. They observed that in contrast to other "interests in property" to which federal tax liens have attached, the taxpayer's interest in the property held by the entireties was neither valuable nor pecuniary, inasmuch as it could not be levied upon or sold by government. They stressed in addition to lacking a present divisible vested interest in the property, a tenant by the entirety is not able to devise any portion of the property because the other tenant has an indestructible right of survivorship.

The dissenting Justices accused the majority of creating a new federal common law that contravenes the previously settled rule that the definition of property is left to the states.

They further criticized the majority for having erased "the careful line between state laws that purport to disclaim or exempt property interests after the fact, which the federal tax lien does not respect, and state laws' definition of property rights, which the federal tax lien does respect."

(1) 122 S.Ct. 1036 (2002).

(2) 11 USC §523(a) and §507(a)(8)(A)(i).

(3) 26 USC §3121(q).

(4) 26 USC §6001; see 26 USC §6053(c)(1).

(5) 26 USC §3121(q).

(6) No. 01-463, 2002 WL 1305728 (June 17, 2002).

(7) 122 S. Ct. 1414 (2002).

(8) 528 U.S. 49 (1999).

(9) 122 S. Ct. at 1423, citing, *United States v. Rodgers*, 461 US 677, 703 n.31 (1983) (allowing attachment of homestead property which could not be sold without consent of spouse); *Drye*, 528 US at 60 n.7 (interest in spend-thrift trust constitutes property even though beneficiary may not transfer it).