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The Practitioner's Corner is a regular feature where NAFER members can contribute their personal perspective on issues facing receivers.

Tax Issues: A Checklist for Receivers

By Joshua D. Smeltzer and Cort Thomas

If you are a receiver or attorney representing a receiver, you doubtless have encountered a variety of tax questions and may not know where to start. If you are an accountant who frequently works with receivers, you may already know where to start but want to be prepared to answer some of the specific, more nuanced, tax questions a receivership presents. The purpose of this article is to identify a checklist of several common tax issues encountered during the life of a receivership, to provide summary explanations to assist you in evaluating your compliance obligations, and to assist you in determining when it is time to seek additional tax advice.

It is important to note from the outset that tax advice is often complex and dependent on the specific facts and circumstances involved. Our hope in writing this article is that we will be able to assist receivers and their professionals in identifying potential tax issues on the front end – potentially avoiding a waste of additional time and resources or even personal liability and prolonged litigation on the back end. We also hope that this article will provide you with an independent resource that you can share with others in the receivership community.

1. Ensure the appointment order includes access to necessary documents and authority to file taxes

Some receivers have more input into their appointment orders than others. Regardless, it is important for receivers and their professionals to know what their appointment order says about their authority when it comes to taxes and to consider asking the court to amend the

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appointment order if it is deficient. At the very least, a receiver should ensure that the appointment order provides: 1) access to required documents; and 2) authority to fulfill basic tax obligations.

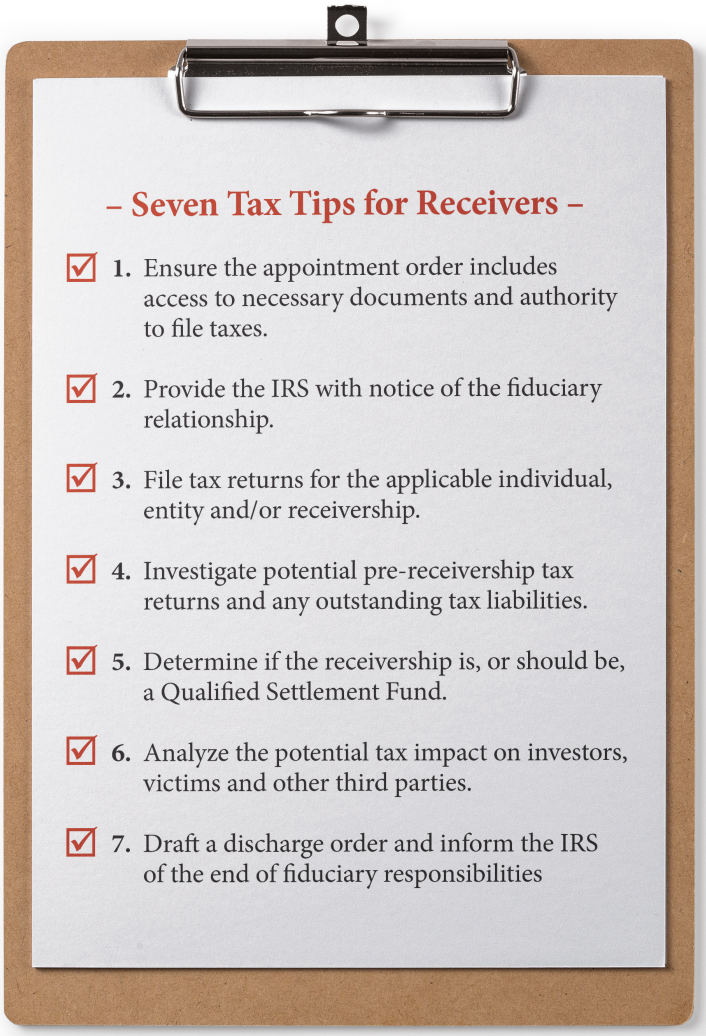
In terms of access to required documents, the appointment order should give the receiver the right to access all information needed for tax compliance. If necessary, specific categories or individual documents should be named. However, if the types of documents are unknown at appointment, a general right to inspect or receive documents necessary for determining, investigating, reporting and paying current or potential tax obligations may be sufficient. Similarly, if there are specific tax issues known at the time of appointment, those might necessitate special provisions in the appointment order.

As to fulfilling basic tax obligations, an appointment order should outline specific grants of authority necessary to meet tax obligations. For example, the order should specify the authority to file all tax returns and pay any amounts due. This obviously includes any federal taxes, but should also include any state, foreign, or local tax obligations as well. The receiver usually has informational return filing requirements, in addition to income tax filing requirements, and those should be considered and put in the appointment order – where appropriate. Beyond the basic right to pay all taxes owed, the receiver may also need the ability to delay other distributions until taxes are paid or resolved. Tax disputes can arise if tax amounts are owed or as part of the administration of the assets. Receivers should therefore provide that they have the right to hire the appropriate tax advisors and defend against any enforcement action by the IRS or other taxing authorities.

The appointment order should also provide authority to settle tax disputes. Settlement procedures at the Internal Revenue Service and Department of Justice Tax Division can involve multiple steps, forms, and required approvals. The practical and strategic considerations of settlement with the government is beyond the scope of this article. However, a receiver does not want to add a dispute over their authority to settle the claims to the mix of issues when trying to resolve tax claims.

2. Provide the IRS with notice of the fiduciary relationship

As an agent of the appointing court, the receiver acts for the benefit of anyone with an interest in the receivership assets until final resolution.[1] Therefore, a receiver owes a fiduciary duty to all parties, including federal, state and local taxing authorities. For federal tax purposes, this fiduciary relationship must be disclosed on IRS Form 56 within 10 days of the appointment.[2] Once IRS Form 56 is filed the receiver officially assumes the powers, rights, duties and privileges associated with taxes of the entity or person that is the subject of the receivership, including receiving IRS notices. Also, the filing of Form 56 prevents suspension of the time for the IRS to make assessments.[3] As a general matter, the IRS has three years to assess additional tax if the agency believes the amount of tax has been understated.[4] That period can be extended to six years, however, if the IRS determines that gross income is understated by more than 25 percent.[5] Even longer periods can sometimes apply if the IRS can show fraud, but this is much less likely. Regardless of the applicable deadline, the sooner it starts the sooner it expires.



3. File tax returns for the applicable individual, entity, and/or the receivership

For federal income tax purposes, the receiver is generally treated as stepping into the shoes of the entity or owner of the assets in the receivership. Therefore, the receivership is not usually a separate taxable entity requiring its own tax returns. However, there are different requirements if the receivership is treated as a Qualified Settlement Fund ("QSF"), discussed below. If the receivership is not a QSF, the receiver must nonetheless file the returns for the entity or owner of the property that is the subject of the receivership.[6] Therefore, the receiver must determine what individual, corporate, or partnership filing responsibilities are involved.

Subject to the appointment order, a receiver for an individual must prepare and file individual returns unless the receiver is only in possession of a portion of the individual's assets.[7] For example, if a receiver's possession of an individual's assets involves only one of many companies or company stock and not other assets, then tax filing may not be required.[8] What is considered full or partial possession of assets is a factual question based on all the relevant circumstances.

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A receiver for a corporation must file corporate returns if the receiver is in possession of all or substantially all of the corporate assets or business.[9] However, according to IRS regulations, if the receiver is in charge of only a small part of the property of a corporation then they are not required to handle the tax return.[10] Obviously, determining what is substantially all is based on the specific facts of each receivership.

Partnerships are more complicated because they are not specifically mentioned in the statute and the law for auditing partnerships recently changed. IRS guidance appears to indicate that, like a corporation, when a receiver has control of substantially all of the assets, the IRS expects receivers to prepare and file partnership tax returns.[11] The law regarding the audit of partnerships changed significantly for partnerships filing returns after December 17, 2017 unless a partnership specifically elects "out."[12] Electing out of the new partnership audit rules is done separately for each taxable year on the partnership tax return.[13] If the partnership does not or cannot elect out, then a designated "partnership representative" is the sole person authorized to act on behalf of the partnership; those actions bind all partners.[14] It is important to note that if a "partnership representative" is not named, the IRS has authority to appoint one. Because the new audit procedures fundamentally change the manner in which the IRS will determine, assess and collect partnership adjustments a receiver must be aware of these rules when determining tax compliance. This is especially true if there is a dispute with the IRS over amounts owed. In general, the IRS assesses any underpayment against the partnership in the adjustment year.[15] However, there is an election, available to the partnership representative, to have the reviewed-year partners assessed instead of the partnership (i.e. a "push-out election").[16] Many partnership agreements contain new or updated provisions for these new laws and a receiver should review partnership agreements for provisions applicable to the new audit regime.

At the end of the receivership, final tax returns should be considered. Unless the receivership is a QSF, a portion of the taxable year may remain following termination of the receivership. A receiver should plan to meet known tax obligations through the end of the taxable year when the receivership ends. Once the termination of the fiduciary relationship is filed, pursuant to IRS Form 56, the receiver may lose access to records or information necessary to complete or investigate certain tax issues. Therefore, the receiver should plan for cooperation with the individual or entity that assumes control.

4. Investigate potential pre-receivership tax returns and any outstanding tax liabilities

A receiver may discover that an individual or entity in receivership has not filed tax returns for several years. Bankruptcy courts have indicated that if a trustee has all or substantially all of the property of the business, then filing requirements extend even though the taxable year may have ended prior to filing the petition.[17] Knowledge of outstanding tax returns could also be considered notice of potential outstanding tax liabilities. Therefore, the receiver may want to seek approval to file any overdue tax returns to protect against potential liability and to determine any implications for current tax years. For example, if a company has employees there could be outstanding withholding tax liabilities that were never withheld from employee paychecks and turned over to the government. A receiver may be held personally liable if found to be a "responsible person" charged with authority to satisfy outstanding withholding tax liabilities upon being appointed and made aware of amounts owed.[18] Personal liability for unpaid withholding taxes is not limited to those within the formal structure of the business and can extend to anyone with the authority to be considered a "responsible person."[19] If withholding taxes are involved a receiver should consider potential personal liability before paying any other creditors of the receivership.

Also, a receiver will want to know all current and potential federal tax claims, including those arising pre-receivership, to avoid potential personal liability under the Federal Priority Act, 28 U.S.C. §3713.[20] Section 3713 provides that a receiver of an insolvent estate must pay outstanding federal claims or they can become personally liable to the extent of the unpaid claims.[21] Personal liability can be asserted against a receiver that knew, or should have known, about the existence of the federal tax claims.[22] The representative of a person or estate (except for bankruptcy trustees) paying any part of a debt of the person or estate before paying a government claim, including taxes, is liable to the extent of the unpaid claim.[23] Therefore, as a practical matter, it is likely in the receiver's best interest to: 1) to request transcripts of returns for prior tax years; and 2) prepare and file any known overdue tax returns and assess if there are taxes owed or the effect on tax years during receivership. This will help a receiver determine all known, and potentially should be known,

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tax liabilities and plan accordingly.

Although tempting to seek clarity on potential assessment and collection from the appointing court, receivers should know that the federal court may lack jurisdiction. Federal district courts are prevented from hearing cases, under the Declaratory Judgment Act[24] and Anti-Injunction Act[25], seeking to restrain the assessment or collection of any tax regardless of whether it is filed by the taxpayer or a third party.[26] The Anti-Injunction Act specifically prohibits suits restraining the assessment or collection of the amount of the liability of a fiduciary under Section 3713.[27]

5. Determine if the receivership is, or should be, a Qualified Settlement Fund

Although a receivership generally does not create a separate entity, if the receivership meets certain criteria it can be treated as a Qualified Settlement Fund ("QSF").[28] A QSF is often used in multi-claimant litigation requiring additional time for parties to obtain counseling, negotiate multiple settlement claims, or handle other end of year tax planning. Under the right circumstances, receivers may find a QSF beneficial for administration with multiple claimants and their own tax preparation. A QSF is a separate taxable entity subject to federal income tax requirements that files its own returns – sometimes in addition to the individual or entity subject to the receivership. The legal standards related to QSFs is complicated and, of all the tax issues facing receivers, these issues almost always require advice from a qualified professional with experience in qualified settlement funds and receivership taxation.

A QSF can also request "prompt assessments" of its tax liabilities within 18 months – effectively shortening the normal assessment period of the IRS.[29] Final returns are also easier with QSFs because they can be filed at the end of the receivership even if time remains on the normal taxable year. However, these conveniences come at the additional cost and expense of managing a separate entity, so they should be considered carefully.

6. Analyze the potential impact on investors, victims and other third parties

Many receiverships involve victims or creditors whose individual tax situation can be impacted by the actions of the receiver and receivership. For example, receivers may step into the shoes of Ponzi scheme companies or the individuals perpetrating the fraudulent Ponzi scheme. The issues surrounding Ponzi-scheme losses are complex and dependent on the specific facts and circumstances of the scheme. Also, as a receiver, offering any tax advice in any form to investors/victims or their advisors is potentially dangerous and should be avoided. However, an understanding of available relief may help a receiver understand inquiries from concerned investors/victims or their advisors, and this article can provide a starting place for research those advisors might undertake.

Victims of Ponzi-schemes may have an ability to claim certain theft losses.[30] The Tax Cuts and Jobs Act ("TCJA")[31] enacted in 2017 and subsequently amended (also known in the vernacular as the Trump Tax Cuts) made substantial changes to the Internal Revenue Code. For tax years 2018 through 2025, theft losses in

excess of personal casualty gains for the year are deductible only to the extent that such losses are attributable to federally-declared disasters.[32] The IRS has not provided clear guidance on whether any theft of property can be considered "attributable to" a federally-declared disaster.[33] The TCJA also significantly changed the law related to Net Operating Losses ("NOLs"), which can generally be claimed by individuals, C corporations, estates and trusts, and exempt organizations. The ability to claim a NOL will depend on the specific facts of when the loss occurred (e.g., before or after 2018). Further complicating matters are provisions recently enacted by the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act").[34] This law, enacted in response to the COVID-19 pandemic, now allows NOLs arising in the 2018, 2019, and 2020 tax years to be carried back to the five preceding taxable years in which the NOL arises.[35] This new legislation may, in some cases, provide otherwise unavailable relief to defrauded investors.

In the wake of the Bernie Madoff Ponzi scheme (and prior to the TCJA and CARES Act) the IRS issued two revenue procedures providing guidance and safe-harbors for determining when theft losses occur and how to compute the amount of theft losses.[36] In general, a theft loss is sustained in the taxable year the taxpayer discovers the loss.[37] For purposes of the safe harbor, the discovery year is the taxable year of the investor in which the indictment, information, or complaint is filed against the lead figure of the scheme.[38] However, the IRS guidance recognizes that in a Ponzi scheme, when and whether an investor meets theft lost requirements is highly factual and often can't be made in the year the loss is discovered.[39] An investor/victim may ask

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a receiver for information involving potential recoveries against the perpetrator of the fraud or potential third-parties as they attempt to determine individual tax consequences.[40]

Another tax consequence for investors in Ponzi scenarios is the treatment of "clawback" amounts. A receiver, charged with safeguarding and managing distribution of disputed assets, will often pursue clawback claims against investors who potentially benefited from the scheme (the "Net Winners"). Section 1341 of the Internal Revenue Code allows a taxpayer to compute tax liability from earlier years, excluding income reported but eventually paid back.[41] However, the IRS has clearly indicated that "clawback" repayments are not additional theft loss deductions but are calculated separately to determine the lowest tax liability under either the theft loss provisions or Section 1341.[42] Again, receivers may be asked for specific information related to "clawback" amounts or claims based on the investor/victim's attempt to assess their personal tax costs. The ultimate tax treatment very possibly will arise in the context of settlement negotiations with Net Winners.

There are also priority issues that will often arise during the receivership regarding various investor/victim claims and the taxes owed to the government. The U.S. Department of Justice will sometimes give priority to defrauded investors/victims over the federal tax claims.[43] However, in order to prevail, the Department of Justice will require the victim to trace assets to the property to show that title never passed to the wrongdoer or funds were lost due to fraud and the court has or would impose a constructive trust on behalf of the defrauded investor.[44] A receiver may therefore be involved in tracing specific assets and determining when and whether title to certain assets actually passed to the wrongdoer. Courts have recognized that some claims are too remote to be readily identifiable or traceable.[45] As always, specific facts must be examined.

7. Draft a discharge order and inform the IRS of the end of fiduciary responsibilities

At a minimum, a receiver should ensure that any discharge order grants permission to prepare and submit any necessary post-receivership tax returns and provides a means for the receiver to pay tax professionals from reserved funds. Although tempting to request broad releases in the discharge order regarding taxes, as noted above, specific statutes prohibit courts from restraining the assessment or collection of tax. A receiver can consider requesting confirmation from taxing authorities that the receivership entities do not have any outstanding liabilities. Any such confirmation should be obtained or confirmed in writing in case there are future issues.

When the receivership fiduciary relationship is revoked or terminated notice should be provided to the IRS on IRS Form 56, Part II. Notice of the termination will usually discontinue the receiver's fiduciary responsibilities to the IRS and federal tax responsibilities as a fiduciary.[46] However, the receiver should ensure that they have necessary tax information before providing this notice. Once authority is lost, the receiver may not have access to necessary records from the IRS. Handling any outstanding affairs of the receivership, with regard to taxes, without access to the necessary information can become impossible. Therefore, the receiver should consider what issues may resurface, or remain outstanding, after their fiduciary responsibilities have ended and plan accordingly.

Conclusion

This article only scratches the surface of potential tax issues a receivership may face. Proper tax advice requires fact-specific analysis of the particular circumstances from a qualified tax professional. The vast majority of NAFER members have chosen to pursue receivership work because it is rewarding in any number of ways. Dealing with complex tax issues is probably not one of them. Although it may be tempting simply to ignore tax issues as inconsequential or contrary to the ultimate goals of the receivership, unfortunately, they never seem to go away. By being proactive – identifying and addressing tax issues from the outset of the receivership – receivers should be able to minimize hassles down the road.

ENDNOTES

1 *See* 28 U.S.C. §3103(b)-(c)(explaining the powers of a receiver and duration of the receivership).

2 26 U.S.C. §§6036, 6903(b); Treas. Reg. §§301.6036-1(a)(2), 301.6903-1.

3 *See* 26 U.S.C. §6872 (suspending the statute of limitations until proper notice of fiduciary relationship is filed).

4 26 U.S.C. §6501(a).

5 26 U.S.C. §6501(e)(1)(A).

6 28 U.S.C. §960 (requiring anyone conducting business under the jurisdiction or authority of any U.S. court to file all tax returns and pay all taxes as they become due).

7 26 U.S.C. §6012(b)(2); Treas. Reg. §1.6012-3(b)(5).

8 *See* IRS PLR 200219018.

9 26 U.S.C. §6012(b)(3).

10 Treas. Reg. §1.6012-3(b)(4). *See also*, PLR 200219018.

11 *See* IRS Technical Advice Memorandum 8210029 (citing 26 USC §7701(a)(1) as including partnership in definition of "person"); *see also* CCA 201052004 (discussing the duty of consistency but indicating that the receiver properly filed partnership returns consistent with fiduciary duties).

12 *See* The Bipartisan Budget Act of 2015 (BBA), Pub. L. No. 114-74 §1101(g)(1).

13 IRC §6221(b)(1)(D)(i); Treas. Reg. §301.6221(b)-1, (c)(1).

14 IRC §6223.

15 *See* IRC §6221(a).

16 *See* IRC §6226; Treas. Reg. §301.6225-3(b)(6).

17 *See In re Hudson Oil Company, Inc.*, 91 B.R. 932, 946 (D. Kansas 1988); *see also*, *In re JD Tool, Inc.*, 2013 WL 168219 *3 (W.D. Missouri 2013)(citing *Hudson Oil* for same proposition).

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[18] *See* IRC §6672.

[19] *See e.g. Canterino v. United States*, 794 F.2d 1 (1st Cir. 1986) (finding liability of a non-officer of a company as having the ability to determine whom a company will or will not pay).

[20] For a more detailed discussion the Federal Priority Act, see "Understanding the Federal Priority Act," *The Receiver*, December 2019, Issue 9.

[21] 28 U.S.C. §3713; *See United States v. Renda*, 709 F.3d 472, 479-480 (5th Cir. 2013).

[22] *See United States v. Renda*, 709 F.3d 472, 479-480 (5th Cir. 2013).

[23] 31 U.S.C. §3713(b).

[24] *See* 28 U.S.C. §2201(a)(providing a remedy "except with respect to Federal taxes").

[25] 26 U.S.C. §7421.

[26] *See S.E.C. v. Credit Bancorp., Ltd*, 297 F.3d 127, 137-138 (2d Cir. 2002)(denying receiver's request for priority of customer debts and protection against his own liability for federal tax debts).

[27] 26 U.S.C. §7421(b)(2).

[28] *See* Treas. Reg. 1.468B-1(c); *see also, Henry Housing Limited Partnership v. United States*, 121 Fed. Cl. 537 (2015)(discussing the qualifications of a QSF).

[29] Treas. Reg. §1.468B-2(k)(2)(ii); IRS PLR 200452026; IRS PLR 200821019.

[30] *See* IRC 165(a), (c)(3), (e).

[31] The Tax Cuts and Jobs Act Pub. L. No. 115-97 (2017).

[32] IRC §165(h)(5).

[33] On March 13, 2020, President Trump declared a national emergency in response to the COVID-19 pandemic. In response the IRS, pursuant to Treas. Reg. §301.7508A-1(e), extended the time for performing multiple acts because of a nationwide federally declared disaster. *See* IRS Notice 2020-23. To the extent a theft loss can be attributed to a federal disaster, the COVID-19 pandemic could potentially expand the availability of claiming such losses. However, no specific guidance on how the pandemic situation effects theft losses is currently available.

[34] Coronavirus Aid, Relief, and Economic Security Act Pub. L. No. 116-136 (2020).

[35] *See* IRS Notice 2020-26.

[36] *See* IRS Rev. R. 2009-9; IRS Rev. Proc. 2009-20.

[37] IRC §165(e); Treas. Reg. §1.165-8.

[38] *See* IRS Rev. Proc. 2009-20 at Section 4.02 and Section 4.04.

[39] *See* IRS Rev. Proc. 2009-20.

[40] *See* IRS Rev. Proc. 2009-20 (outlining the safe-harbor calculations and information required to determine amounts).

[41] IRC §1341; Treas. Reg. §1.1341-1.

[42] *See* IRS FAQs on Ponzi Scheme Clawback Treatment (https://www.irs.gov/newsroom/faqs-related-to-ponzi-scenarios-for-clawback-treatment).

[43] *See* Department of Justice Tax Division Directive No. 137.

[44] *See* Department of Justice Tax Division Directive No. 137; *see also*, *United States v. Schwimmer*, 968 F.2d 1570, 1583-1584 (2d Cir. 1992); *Rosenberg v. Collins*, 624 F.2d 659,663 (5th Cir. 1980).

[45] *See United States v. Peoples Benefit Life Ins. Co.*, 271 F.3d 411, 416 (2d Cir. 2001).

[46] *See* IRC §6903(a).