BANKRUPTCY AND WORKOUTS

Submitted by the Committee on Bankruptcy and Workouts
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SUPREME COURT

In *Clark v. Rameker*, __ U.S. __, 2013 W.L. 4776250 (2013), the Supreme Court granted certiorari to determine whether inherited IRAs qualify for exemption under the Bankruptcy Code. This has been a hotly debated issue, and, this year's developments are discussed below under exemptions.

IRS GUIDANCE

<u>Mortgage settlement recovery</u>

In mid-December, in Rev. Rul. 2014-2, I.R.B. 2014-2, the IRS announced that if a taxpayer receives a recovery under the national mortgage settlement litigation, that recovery can be treated as eligible for exclusion under I.R.C. § 121. For multi-use property, the recovery can be allocated to the personal residence portion of the property.

<u>Tax treatment of short sale of personal residence in California</u>

In a September 19, 2013 letter from the IRS to Senator Boxer, the IRS addressed the tax consequences of a short sale under California's new short sale rules. Under California law, any "purchase-financing" debt is anti-deficiency debt. This means

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that if the home is foreclosed upon for less than the outstanding loan balance, the lender cannot go after the debtor for the deficiency. As to subsequent financing, the anti-deficiency rule applies only to post-2012 refinancing. Pre-2013 refinancing is still recourse debt. California recently passed legislation that holds that any short sale of a personal residence (among other property) must be given anti-deficiency treatment. In its letter to Senator Boxer, the IRS indicated that the home sale should be treated under the nonrecourse rules. As to the purchase-money financing and post-2012 refinancing, this is not news as that debt is already nonrecourse. This is a significant change in IRS position as to the pre-2013 refinancing. *See*, Rev. Rul. 90-16, 1990-1 C.B. 12. In some states, the creditor chooses between foreclosure with a deficiency and without a deficiency. In Washington state, the foreclosure without a deficiency is called a nonjudicial deed of trust foreclosure. The Washington state election by the creditor to do a nonjudicial deed of trust foreclosure is economically identical to the California short sale with pre-2013 refinancing. Yet, Rev. Rul. 90-16, 1990-1 C.B. 12, unlike the September 19 letter, treats the nonjudicial deed of trust foreclosure as recourse debt not nonrecourse debt.

CASES

Dischargeability

Judge Babcock in *Martin v. United States (In re Martin)*, 500 B.R. 1 (D. Colo. 2013) and *Mallo v. United States (In re Mallo)*, 498 B.R. 268 (D. Colo. 2013) rejected the IRS's argument that its making of an SFR assessment automatically makes any subsequently filed document purporting to be a return not a return for purposes of § 523. Judge Babcock adopted the *Beard* test for determining whether a tax return is valid. *See*, BWNDR 2005 and 2006. The fourth prong of *Beard* is whether the taxpayer made an honest and reasonable attempt to comply with the law. Because neither taxpayer had a good reason for why the returns were filed after the SFR assessment, Judge Babcock ruled for the government and found the taxes nondischargeable in both cases. Although the analysis was similar, in result, this meant the Court overturned *Martin v. United States (In re Martin)*, 482 B.R. 635 (Bankr. D. Colo. 2012). *See*, BWNDR 2012.

The IRS lost another SFR case in *Rhodes, III v. United States (In re Rhodes, III)*, 498 B.R. 357 (Bankr. N.D. Ga. 2013).

The Court in *Brown v. Mass. Dep't of Rev. (In re Brown)*, 489 B.R. 1 (Bankr. D. Mass. 2013) rejected the *McCoy* position and found dischargeable the tax due on a late-filed state income tax return. *See*, BWNDR 2012. The *McCoy* position is that the tax due on any return that is filed late, even one day late, is nondischargeable. *McCoy v. Miss. State Tax Comm'n*, 666 F.3d 924 (5th Cir. 2012), *cert. denied*, __ U.S. __ (2012).

Several months later, a split developed among Massachusetts bankruptcy courts because the Court in *Pendergast v. Mass. Dep't of Rev. (In re Pendergast)*, 494 B.R. 8 (Bankr. D. Mass. 2013) followed *McCoy*.

McCoy remains alive and well in many jurisdictions including the Southern District of Florida as decided in *Wendt v. United States (In re Wendt)*, 2013-2 U.S.T.C. ¶ 50,607 (Bankr. S.D. Fla. 2013). *Wendt* did do a nice job of discrediting the IRS argument raised in *Wogoman v. IRS (In re Wogoman)*, 2011-2 U.S.T.C. ¶ 50,593 (Bankr. D. Colo. 2011), *aff'd on other grounds*, 475 B.R. 239 (10th Cir. B.A.P. 2012) and *Smythe v. United States (In re Smythe)*, 2012 W.L. 843435 (Bankr. W.D. Wash. 2012), among other cases, that the tax debt arises at the time of the assessment. Therefore, the IRS argues, there is no return to go with the assessment. This is nonsense as the debt arises at the end of the applicable tax year, and, the *Wendt* court so explained.

Perry v. United States, 500 B.R. 796 (M.D. Ala. 2013), in affirming the Bankruptcy Court, found that under any of the available tests the government wins. It affirmed the Bankruptcy Court's *McCoy* argument. *See*, BWNDR 2012. It also found the tax nondischargeable under the IRS's SFR test and the *Beard* test.

In allowing the dischargeable elements of a late-filed employment tax return to be discharged, *Pitts v. United States (In re Pitts)*, 497 B.R. 73 (Bankr. C.D. Cal. 2013) cited *Brown* with approval. Pitts does an excellent job of illustrating the interaction among SFR assessments, late-filed returns, and the three-year rule. *Pitts*, *supra* at 80-83.

In re Weiss, 2013 W.L. 6726502 (Bankr. D. Kan. 2013) confirmed that *United States v. Victor*, 121 F.3d 1383 (10th Cir. 1997) is still good law in the 10th Circuit, even after enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), P.L. 109-8, 119 Stat. 23. The discharge in Chapter 13 is denied for claims under 11 U.S.C. § 507(a)(8)(C), which are unsecured trust fund claims. 11 U.S.C. § 1328(a)(2). What happens if the IRS files a secured claim only for the trust fund claim and that claim is paid in full in the Chapter 13? *Weiss* confirmed the holding in *Victor* that the IRS's trust fund claim is discharged because the IRS did not have an unsecured trust fund claim, as required by 11 U.S.C. § 1328(a)(2). Section 507(a)(8)(C) is a priority rule for unsecured debt. Presumably, § 1328(a)(2) would need to list 11 U.S.C. § 523(a)(1)(A), which would then catch all trust fund claims.

In re Ryan, 2014-1 USTC ¶ 50,120 (Bankr. D. Mass. 2013) deals, at least to some extent, with whether a return can be filed if mailed, *i.e., given,* to a revenue officer. This issue was raised in *Pizzuto v. IRS (In re Pizzuto)*, 384 B.R. 105, 113, n.5 (Bankr. D.N.J. 2008) and discussed in BWNDR 2008. *Ryan* indicated that mailing the return to the revenue officer would not be sufficient, citing *Pizzuto* but without discussing note 5. Note 5 in *Pizzuto* asks whether a return can be given to the IRS given the language added by BAPCPA to § 523(a)(1)(B) (return may be filed or given). The Court rejected the debtor's claim of delivery as it did not find credible the affidavit produced in support of mailing to the revenue officer. Accordingly, the tax for the applicable years was nondischargeable.

In re Adalian, 500 B.R. 402 (Bankr. M.D. Pa. 2013) is a reminder that the failure to file timely tax returns can be considered a failure to maintain adequate records. In *Adalian*, the debtor's discharge was denied under 11 U.S.C. § 727(a)(3), which denies discharge if a debtor fails to maintain or keep records. The Court stated that "debtor's failure to timely file tax returns--especially for several years in a row--is a blatant example of a failure to maintain adequate records." *Id.* at 407. The Court also stated that "a debtor's records must be kept in a manner which is contemporaneous to the events as they unfold." *Id.* at 409 (citation omitted).

The denial of the discharge for the overreaching taxpayer in the 2012 *Daniels* case was affirmed in *Daniels v. Agin*, 2013-2 U.S.T.C. ¶ 50,602 (1st Cir. 2013). *See*, BWNDR 2012.

In *United States v. Fletcher (In re Fletcher)*, 489 B.R. 224, 238 (Bankr. N.D. Okla. 2013), the IRS lost its bid for summary judgment on the issue of nondischargeability under the willful intent rule of § 523(a)(1)(C) and the transfer, hinder or destroy property rule of § 727(a)(2). The taxpayer is not out of the woods because a trial still looms. The real fun in this case is the quote the Court used when denying the IRS's motion:

> Paper wraps rock, rock breaks scissors, scissors cut paper and, when it comes to questions of law before this Court, the United States Court of Appeals for the Tenth Circuit trumps the IRS.

The annual case of miscounting, or, in this case, failure to order the tax transcript was *In re Newton*, 490 B.R. 126 (Bankr. D.D.C. 2013). In *Newton*, the taxpayer did not realize that an earlier tax representative had extended the applicable statutory periods under the extender rules of § 507(a)(8).

In *Raso v. Fahey, Jr. (In re Fahey, Jr.)*, 494 B.R. 16, 23 (Bankr. D. Mass. 2013), the debtor, in his capacity as trustee and treasurer of three ERISA plans, failed to make contributions to those plans. The Court found that when a debtor prioritizes the payment of corporate expenses that are beneficial to him, because of personal guarantees, over the payment of ERISA contributions, the debt is nondischargeable because of the debtor's defalcation in a fiduciary capacity.

Priority

In *In re Intercare Health Sys. Inc.*, 2013-2 USTC ¶ 50,593 (Bankr. C.D. Cal. 2013), an IRS employment tax claim received priority treatment. At issue, was the length of time the three-year time period was tolled because of a prior bankruptcy filing/Chapter 11 plan confirmation. 11 U.S.C. § 507(a)(8)(*). The debtor had some trouble making its plan payments and negotiated a change in payment terms. The Court found that the change in payment terms was not a material modification in the terms of the Chapter 11 plan. As the IRS remained bound by the Chapter 11 plan, the three-year time period remained tolled.

In re Whitson, 2013-2 USTC ¶ 50,583 (Bankr. E.D. Tenn. 2013) found that money owed to the IRS for the overpayment of the earned income credit and the child care credit by the IRS were creatures of the Tax Code and properly treated as a priority tax and not an overpaid public assistance benefit. Buttressing the Court’s decision was the fact that the debtor received the credits after claiming improper deductions thereby lowering taxable income.

Claims

In re Mead, Jr., 2013-1 USTC ¶ 50,140 (Bankr. E.D.N.C. 2013) disallowed the IRS's Chapter 13 claim in the "full" amount due. Prior to the bankruptcy filing, the IRS had accepted the debtor's offer in compromise. The Court would only allow a claim in the amount of the offer. The basis for disallowing the full IRS claim was 11 U.S.C. § 525(a), which provides that a person cannot discriminate against a debtor because of a bankruptcy filing. The discrimination here is the IRS's insistence on not dealing with or accepting offers when a bankruptcy is filed. There was no explanation in the case why the IRS did not file a contingent claim for the full amount if the offer payments were not completed.

In *Imperial Bank Corp. v. FDIC (In re Imperial Bank Corp.)*, 492 B.R. 25 (S.D. Cal. 2013), the Court found that a tax refund allocation agreement created a debtor/creditor relationship between a subsidiary bank and its holding company parent. Here, the holding company parent was in bankruptcy, and, the subsidiary bank was in a receivership with the FDIC acting as the receiver. The tax allocation agreement clearly provided that a consolidated return would be filed by the parent. The Court found that the $30 million tax refund belonged to the parent holding company. This left the subsidiary a claim in the parent’s bankruptcy case.

The debtor in *Zucker v. FDIC (In re BankUnited Fin. Corp.)*, 727 F.3d 1100 (11th Cir. 2013) was a bank holding company. It received a consolidated return tax refund. The Eleventh Circuit held that the refund belonged, not to the holding company, but to the subsidiaries pursuant to a tax sharing agreement.

The Eleventh Circuit also allocated the tax refund to the subsidiary in *FDIC v. Zucker (In re NetBank, Inc.)*, 729 F.3d 1344 (11th Cir. 2013).

The debtor in *Giuliano v. FDIC (In re Downey Fin. Corp.)*, 499 B.R. 439 (Bankr. D. Del. 2013) was also a bank holding company. It received a consolidated return tax refund. The Delaware bankruptcy court held that the refund belonged, not to the subsidiary, but to the holding company pursuant to a tax sharing agreement. The Delaware Court distinguished *BankUnited Fin. Corp.* as that tax sharing agreements provided for totally different responsibilities regarding paying the tax. *Id.* at 457-459.

<u>Liens</u>

The debtor in *Ryan v. United States (In re Ryan)*, 725 F.3d 623 (7th Cir. 2013) attempted to use § 506(d) to strip down an IRS lien in Chapter 13. The debtor had over $100,000 in debt and less than $2,000 in assets. The Seventh Circuit held that *Dewsnup v. Timm*, 502 U.S. 410 (1992) applied, and, it prevented using

§ 506(d) to strip down[2] a lien in Chapter 13. *Ryan* does not appear to prevent a strip off, but, that is not clear.[3]

In re Brinson, 485 B.R. 890 (Bankr. N.D. Ill. 2013) was decided before *Ryan*, and, it was not cited by *Ryan. Brinson* confirmed that lien stripping in Chapter 13 occurs under the rules of Chapter 13 and not 11 U.S.C. § 506(d). Furthermore, while the procedure to determine the extent of the IRS lien is an adversary proceeding, which is brought early in the case, release of the lien does not occur until the Chapter 13 plan is completed and the underlying debt discharged. This seems to be the right answer; the debtor in *Ryan* did not make these arguments.

In re Williams, Sr., 488 B.R. 492 (Bankr. M.D. Ga. 2013) grappled with one of the issues left for another day in *Dewsnup v. Timm*, 502 U.S. 410, 417. In *Dewsnup*, the Supreme Court held that the strip down of a partially secured lien in Chapter 7 was

[2]Lien stripping can be a strip down, which involves a partially unsecured lien, and a strip off, which involves a totally unsecured lien. *See*, *In re Williams, Sr.*, 488 B.R. 492, 495 at n.3 (Bankr. M.D. Ga. 2013). *Dewsnup* involved a strip down; most of the subsequent, successful litigation for the debtor has involved strip offs.

[3]*Briseno v. Mut. Fed. Sav. and Loan Ass'n (In re Briseno)*, 496 B.R. 509, 519-520 (Bankr. N.D. Ill. 2013) found the holding in *Ryan* to be that the strip off is allowed under § 506(d) only if the lien is totally unsecured and the claim has been disallowed. In *Briseno*, the claim had been allowed, and, the Court did not allow the strip off of the junior mortgage lien under § 506(d). The Court noted in n.11 that the proper method for strip off was under the rules of Chapter 13. *See*, 11 U.S.C. § 1322(b)(2) (Chapter 13 plan can modify secured claims, other than claims solely secured by the debtor's personal residence).

not permissible. While many circuits take the position that the strip off of a totally unsecured lien in Chapter 7 is not permissible, that is not the rule in the Eleventh Circuit. *See*, *McNeal v. GMAC Mortg., LLC*, 477 Fed. Appx. 562 (11th Cir. 2012 (unpublished). The unresolved question in Eleventh Circuit Chapter 7 cases is whether the IRS's claim is valued by only looking at the real property in question or whether the value of the lien against the personal property must also me considered. *Williams, Sr.* found that valuation of the IRS lien must include the value of the personal property. Because there was value in the debtor's personal property, a lien strip off was not allowed.

The transferee of real property in *Wren Alexander Invs., L.L.C. v. IRS (In re Wren Alexander Invs., L.L.C.)*, 2013 W.L. 2421945 (5th Cir. 2013) took real property with an IRS lien attached with knowledge that the transfer price was not a fair price and that the transferor was insolvent. Thus, the transferee, who was a related party to the transferor, could not take in good faith under the Texas Uniform Fraudulent Conveyance Statute. The transferee took the real property subject to the IRS's tax lien, which had been filed between the purchase date and the recording date.

Under the sale free and clear rules of 11 U.S.C. 363(f), the purchaser of debtor's assets in *In re United Fleet, Inc.*, 496 B.R. 79 (Bankr. E.D.N.Y. 2013) was not stuck with the debtor's poor experience rating under the New York state rules for unemployment insurance. *See also*, BWNDR 2012.

In *Olsen v. Vollrath (In re Gilmore)*, 2013-2 USTC ¶ 50,536 (Bankr. W.D. Mo. 2013), the IRS asserted that its NFTL was superior to the bankruptcy trustee’s security interest that it acquired through an avoidance action. Here, a bank had obtained a deed of trust but failed to record it. As between the bank and the debtor, the bank had a valid security interest. When the trustee successfully avoided the security interest because it was not properly perfected, it stepped into the shoes of the bank, which did have a security interest. This security interest was sufficient under I.R.C. § 6323(a) and (h)(1) to prime the IRS’s NFTL. The Court found that § 6323 grants priority over the NFTL to a security interest, not a validly perfected security interest.

Colon v. Strawberry, 2013 W.L. 6068858 (N.D. Fla. 2013) illustrated the IRS’s first-in-time first-in-right lien rights. In *Strawberry,* ex-major league baseball player Darryl Strawberry owed the IRS a large sum of money, and, the IRS filed a NFTL to protect its position. Thereafter, the IRS levied upon Strawberry’s deferred compensation rights, which were owed to him by the New York Mets. The conflict arose because Strawberry’s ex-wife received rights to the fund in a subsequent divorce proceeding. The IRS prevailed over the ex-wife.

Property of the estate

In re Leitch, 494 B.R. 918 (8th Cir. B.A.P. 2013) found that a health savings account (HSA) was a trust account (essentially, a self-settled trust with unlimited access to funds) and not a medical savings plan, and, it was included in property of the bankruptcy estate. *See*, 11 U.S.C. § 541(b)(7)(A)(ii) (exclusion of health insurance plans from bankruptcy estate). The HSA did not qualify for an exemption because it was not a medical plan paid for the benefit of the taxpayer, *see*, 11 U.S.C. §§ 522(d)(10)(C) and 522(d)(11)(D); the funds in the HSA were paid directly to the taxpayer and could be used in any manner that the taxpayer so chose. The special tax benefit of "use the funds as prepetition dollars" applies only if the funds are used for medical purposes. The debtor in *In re Mooney*, 2014 W.L. 32388 (Bankr. M.D. Ga. 2014) was also unsuccessful in an attempt to exempt an HSA.

Exemptions

In re Clark, 714 F.3d 559 (7th Cir. 2013) proved the author wrong; the inherited-IRA battle is back in full conflagration. See BWNDR 2010-2012. In this Seventh Circuit case, Judge Easterbrook did not believe that the inherited IRA constituted retirement funds and disallowed the exemption. This created a split between the Seventh Circuit on one side and the Fifth Circuit and the Ninth Circuit Bankruptcy Appellate Panel on the other. *Chilton v. Moser (In re Chilton)*, 674 F.3d 486 (5th Cir. 2012) (exemption allowed); and *Mullin v. Hamlin (In re Hamlin)*, 465 B.R. 863 (9th Cir. B.A.P. 2012) (exemption allowed). In November, the Supreme Court granted certiorari in *Clark v. Rameker*, __ U.S. __, 2013 W.L. 4776250 (2013).

The battle continues unabated, as the debtor's exemption in an inherited IRA was allowed in *In re Bauer*, 2013-1 USTC ¶ 50,387 (Bankr. D.S.C. 2013).

Diamond v. Trawick (In re Trawick), 497 B.R. 572, 585-589 (Bankr. C.D. Cal. 2013) found inherited IRAs exempt under federal exemptions but not exempt under California law.

In *Daley, Jr. v. Mostoller (In re Daley, Jr.)*, 717 F.3d 506 (6th Cir. 2013), the Sixth Circuit reversed the bankruptcy decision that an IRA could be invalidated by provisions in the brokerage agreement giving the brokerage house rights in the IRA. *See*, BWNDR 2011. The Court reasoned that no money had ever been loaned and the lien did not secure a debt, so, the prohibited transaction provisions regarding impermissible loans between the IRA and the owner had not been violated.

The IRA exemption was also upheld under similar facts in *In re James*, 489 B.R. 731 (Bankr. E.D. Tenn. 2013).

In re Rudd, 2013-1 USTC ¶ 50,379 (Bankr. E.D.N.C. 2013) involved a trustee's objection to an IRA exemption. In *Rudd*, the debtor withdrew money from the IRA but returned it within the allowable 60-day rollover period, so that there was not a taxable event. Because this type of transaction is specifically allowed by the Tax Code rules, the Court found the IRA exemption valid.

An IRA rolled over into an IRA that invested in an annuity was found exempt in *Running v. Miller (In re Miller)*, 500 B.R. 578 (8th Cir. B.A.P. 2013). The trustee argued that the IRA annuity was not exempt because there were no annual premium payments. *See*, I.R.C. § 408(b)(2)(C) (annual premium payment shall not exceed allowed dollar amount found in I.R.C. § 219). The Court dismissed the Trustee's argument, finding that the annual-premium-limitation rule applied only if the holder of the annuity were making annual premium payments. The rule did not apply here because the annuity was purchased with one lump-sum payment. The case also illustrates that broad retirement exemptions are available in the Bankruptcy Code even if the debtor elects state-law exemptions and the state-law exemption is limited. 11 U.S.C. § 522(b)(3)(C). In this case, the bankruptcy exemption was much larger than the Minnesota exemption.

An IRA received in a divorce but still in the other spouse's name was held exempt in *In re Remia*, __ B.R. __, 2013 W.L. 6798949 (Bankr. D. Mass. 2013). The Court found nothing in 11 U.S.C. § 522(d)(12) that indicated the IRA had to be in the debtor's name.

The debtor in *In re Marve*, 484 B.R. 735 (Bankr. N.D. Ind. 2013) commingled the deposit from an earned income credit in a bank account with other funds. The Court found that the earned income credit was entirely exempt, but, the problem was determining how much of the credit remained in the bank account. The Court rejected the use of the lowest intermediate balance test and applied a first in first out test to determine the exempt funds remaining in the bank account.

The debtor's tax refund in *In re Matsuura*, 2013 W.L. 6577389 (Bankr. D. Idaho 2013) consisted of an exempt earned income credit and a nonexempt child tax credit. The debtor deposited the entire tax refund in an empty bank account. Then, the debtor withdrew an amount equal to the child tax credit leaving an amount equal to the earned income credit in the account. The Court allowed the debtor's exemption in the full amount of the earned income credit.

Clawbacks

The government successfully defended a clawback suit in *Kapila v. IRS (In re ATM Fin. Servs.)*, 2013-1 USTC ¶ 50,319 (11th Cir. 2013). It argued that the entity's primary shareholder was the initial transferee, and, as the mediate transferee, it was entitled to use the good faith defense. The sole shareholder of the debtor had written a check on the debtor's account to pay the employment tax owed by another corporation he owned.

Given the government's success is winning clawback lawsuits when S-Corporations make tax payments for their shareholders, *see*, BWNDR 2012, the posture of the government in *United States v. Equip. Acquisition Res., Inc.*, 2013-1 USTC ¶ 50,132 (N.D. Ill. 2013) seemed odd. In the cases reported in 2012, the government defeated one fraudulent conveyance clawback lawsuit by arguing that the S Corporation received equivalent value when it made tax payments for its shareholders. *Gold v. United States (In re Kenrob Info. Tech. Solutions, Inc.)*, 474 B.R. 799 (Bankr. E.D. Va. 2012). It won another by arguing that it was not an initial transferee under § 550. *United States v. Menotte*, 2012 W.L. 5868578 (S.D. Fla. 2012). In *Equipment Acquisition*, the United States had brought motions to dismiss based under sovereign immunity. It lost in the bankruptcy court, and, it lost in the district court. The most interesting argument concerned the state-law fraudulent conveyance claim under § 544(b). Under that rule, there must be one creditor who could have brought the claim prepetition. The government argued unsuccessfully that, because of sovereign immunity, there would have been no such creditor. The Court found that § 106(a)(1), which waives sovereign immunity under § 544, trumped the government's argument. Presumably, the winning arguments from 2012 will be raised in a motion for summary judgment.

Crumpton v. Stephens (In re Northlake Foods, Inc.), 715 F.3d 1251 (11th Cir. 2013) was another loss for a trustee who argued that distributions to S-Corporation shareholders, for payment of tax due because of the S-Corporation income, were fraudulent transfers. *See*, BWNDR 2012.

In *The Majestic Star Casino, LLC v. Barden Dev. Co. (In re The Majestic Star Casino, LLC)*, 716 F.3d 736 (3rd Cir. 2013), on direct appeal from the Bankruptcy Court, the Third Circuit reversed the Bankruptcy Court's finding that the revocation of a Subchapter S corporation's status was an avoidable transfer under § 549. *See*, BWNDR 2012 and 2008. In *Majestic Star*, the debtor was a qualified S-corporation subsidiary and the allowed S-revocation was made postpetition by its S-corporation parent. The Third Circuit reasoned that the S-Corporation status belonged to the parent and was not property. *Id*. ("tax classification over which a debtor has no control and that is not alienable or assignable is not a 'legal or equitable interest of the debtor in property.'" Even if the S status were property, it was not property of the subsidiary's bankruptcy estate.

New York state successfully defended a preference attack in *Pryor v. N.Y. Dep't of Tax. and Fin. (In re Waring)*, 491 B.R. 324 (Bankr. E.D.N.Y. 2013). In *Waring*, the trustee argued that payment of tax between the original April 15 due date and the extension date of October 18 resulted in payment on an antecedent debt. In hard to understand reasoning, the Court disagreed with the trustee as the tax was not due without penalty until the extension date. The Court reasoned that there could not be a payment on an antecedent debt if there were no penalty. *Id.* at 331-332. The Court seemed to misunderstand the difference between the failure to file penalty, which would not be owed, and the failure to pay penalty, which would have been accruing from the original due date.

Milwaukee v. Gillespie, 487 B.R. 916 (E.D. Wis. 2013) affirmed the lower court ruling that there needed to be a competitive bid process to insulate the City of Milwaukee's tax foreclosure sales from a clawback suit under the fraudulent transfer rules. *See*, BWNDR 2012, which reported on a companion case *Milwaukee v. Williams*, which is named in the *Gillespie* caption.

The Court reached a similar result in *Berley Assocs., Ltd. v. Eckert (In re Berley Assocs., Ltd.)*, 492 B.R. 433 (Bankr. D.N.J. 2013). The sale in *Berley Assocs.* was conducted under New Jersey law, which does not provide for advertising or competitive bidding. *Id.* at 440. As the Court stated, "[t]here is no correlation between the sale price and the value of the property." *Id.* at 439.

And, another government tax sale was overturned in *Clinton v. Warehouse at Van Buren Street, Inc.*, 496 B.R. 278 (N.D.N.Y. 2013).

And, another tax sale was found to be potentially fraudulent in *In re Varquez*, 502 B.R. 186 (Bankr. D.N.J. 2013).

Chapter 11

The proposed plan in *In re Castleton Plaza, LP*, 707 F.3d 821, 823 (7th Cir. 2013) violated the absolute priority rule by "bestowing equity on an investor's spouse". The plan granted the former 98% equity holder's spouse a power of to buy all the entity's equity. Judge Easterbrook found that violated 11 U.S.C. § 1129(b)(2)(B)(ii). He reasoned that, since the exercise of a power of appointment is treated as income under the Tax Code, it should be considered income under the absolute priority rule. Judge Easterbrook found that the 98% equity holder received value on account of his investment.

The Ninth Circuit in *Wilshire Courtyard v. Cal. FTB (In re Wilshire Courtyard)*, 729 F.3d 1279 (9th Cir. 2013) found that it was appropriate to reopen a long-closed Chapter 11 case to resolve a tax issue raised by the California Franchise Tax Board, which issue turned on the characterization of the core transaction in the debtor's bankruptcy case. The Court found that the tax issue was "sufficiently closely related to the bankruptcy proceeding" to warrant a reopening. *Id.* at 1294.

Chapter 12

In re Ferguson, 2013 W.L. 28694 (Bankr. C.D. Ill. 2013) deals with some of the unpleasant taxpayer fallout from *Hall v. United States*, 566 U.S. __ (2012). *See*, BWNDR 2012. In *Hall*, the Supreme Court held that the special nonpriority rule for sales of farm assets is only available for prepetition sales. The Supreme Court found that the farmer is the taxable entity under I.R.C. §§ 1398-1399 and there is no § 507 priority tax [administrative expense] incurred by the bankruptcy estate. *Ferguson* held that if the tax is incurred by the farmer and the farmer is a separate entity from the bankruptcy estate, then, any tax due on sale of the farm assets cannot be paid by the bankruptcy estate.

Chapter 13

In re Cunningham, 485 B.R. 275 (Bankr. W.D.N.Y. 2013) involved a number of "save the house" Chapter 13 bankruptcy filings. In each case, the debtor (i) was delinquent on taxes, (ii) lost the house at tax foreclosure sale, (iii) entered a reacquisition agreement with the taxing authority County of Chautauqua for repayment of the defaulted taxes over one year, (iv) defaulted on the reacquisition agreement, and (v) filed for relief in Chapter 13 to save the house. The County moved for relief from stay. The Court found that the reacquisition agreement was an executory contract subject to the rules of 11 U.S.C. § 365(b)(1). Because the debtors did not propose a quick cure of the defaulted reacquisition agreements as required under the executory contract rules of § 365(b)(1), the Court granted relief from stay.

The debtor's eligibility to remain in Chapter 13 in the case of *In re Walls, Jr.*, 496 B.R. 818 (Bankr. N.D. Miss. 2013) depended on whether he was over or under the unsecured debt limit. In turn, that issue depended on whether his income tax debt had been discharged in a prior bankruptcy. The "proper" procedure to hear the dischargeability issue would have been (i) dismissing the current case to prevent having two cases pending simultaneously, (ii) reopening the prior Chapter 7 case, and (iii) filing an adversary proceeding in the reopened Chapter 7 case. The Court found that it had jurisdiction to determine the dischargeability of the tax in the prior bankruptcy and elected not to make the debtor "jump through" the above described procedural hoops to determine whether the tax debt had been discharged. *Id.* at 828.

The Court dismissed the debtor's Chapter 13 case upon the IRS's motion in *In re Lin*, 499 B.R. 430 (Bankr. S.D.N.Y. 2013). The Court's summary paragraph is priceless, "As the Court finds the Debtor's extortion story wholly unbelievable and other aspects of her case problematic, the Court grants the Motion."

Administrative Expenses

Kipperman v. IRS (In re 800Idea.com, Inc.), 496 B.R. 165 (9th Cir. B.A.P. 2013) wrestled with whether a failure to file penalty assessed for the nonfiling of a Subchapter S return was entitled to priority under the administrative expense rules of 11 U.S.C. § 503. The Court rejected administrative expense status under § 503(b)(1)(A) as that section requires the expense to preserve, *i.e.*, substantially benefit, the estate, and, the penalty did not benefit the estate. It remanded to the bankruptcy court the issue of whether administrative expense status should be allowed under § 503(b)(1)(C). That section allows administrative expense status for penalties related to a tax. As there is no tax due, can this penalty receive administrative expense status? The Court commented that, if the penalty did not receive administrative expense status, it was unsure how to characterize it.

Tax Refunds

In *Newman, Jr. v. Schwartzer (In re Newman, Jr.)*, 487 B.R. 193 (9th Cir. BAP 2013), the Ninth Circuit BAP held firm to the Ninth Circuit position that the debtor can forced to turn over a tax refund under 11 U.S.C. § 542, even if the refund is no longer in the debtor's possession. *See*, BWNDR 2007 and 2010. Note, in January 2014, the Ninth Circuit agreed with the Bankruptcy Appellate Panel that the debtor did not have to be in possession of property to be subject to a § 542 turnover action. *Shapiro v. Henson*, ___ F.3d ___ (9th Cir. 2014).

In re Winters, 485 B.R. 375 (Bankr. M.D. Tenn. 2013), *issue not raised on appeal, rev'd on other grounds*, ___ B.R. ___ (6th Cir. B.A.P. 2013) found that an erroneous refund issued by the IRS for a prepetition tax year and received by the debtor postpetition and returned to the IRS was not property of the bankruptcy estate. Because the debtor had no rights in the refund neither did the bankruptcy estate.

The battle of exemption versus setoff resurfaced in *Newberry v. United States (In re Newberry)*, 2013-1 USTC ¶ 50,198 (Bankr. S.D. Ill. 2013). *See*, BWNDR 2009. The Court followed the *IRS v. Luongo (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001) line of cases, which hold that there is no refund before the government's claims have been paid. In *Luongo*, the refund was applied against another tax claim. In *Newberry*, the claim was owed to the Department of Agriculture.

Newberry cited *United States Dep't of Agric. Hous. Servs. v. Riley (In re Riley)*, 485 B.R. 361 (W.D. Ky. 2012), which is a 2012 case that was reported too late for inclusion in BWNDR 2012. In *Riley*, the Court found that

> an overpayment is subject *not only* to an offset of previous tax liability, 26 U.S.C. § 6402(a), but also to the limitations contained in § 6402(c), (d), (e) or (f). Only once the Secretary has applied the limitations in subsections (c), (d), (e) and (f), does

> the interest in the balance change from an overpayment to a tax refund.

The battle over the allocation of income tax refunds between spouses when only one spouse files flared again in the case of *In re Duarte*, 492 B.R. 100 (Bankr. E.D.N.Y. 2013). *See*, BWNDR 2009, 2011, and 2012. *Duarte* adopted the approach used by the Internal Revenue Service in its rulings and the IRM. *See*, BWNDR 2011. *Duarte* did a nice job of setting forth the four approaches used by courts, which are (i) allocation by withholding; (ii) 50/50 split; (iii) allocation by income earned; and (iv) the separate filings rule, which is the method used by the IRS. *Duarte* describes the separate filings rule in the following manner:

> each spouse's separate tax liability is determined based on a calculation of what each spouse's tax obligation would have been if the spouses had filed separately and a calculation of the contributions each spouse has actually made to the total payments.

Id. at 106.

<u>Cancellation of Indebtedness Income</u>

In *Pinn v. Comm'r*, T.C. Memo 2013-45, the taxpayers borrowed money from their corporate welfare plan, which plan was established to pay death benefits to union members. Curiously, the taxpayer-owners qualified for the death benefit. The taxpayer-owners promised to repay the loan with the proceeds of their death benefit. Only one payment was made on the loans, and, the plan reported the loans as in default. As long as the death benefit exceeded the loan amount, the Tax Court found there was no relief of indebtedness income because the loans could still be repaid upon the death of the taxpayer-owners.

In re Reed, 492 B.R. 261 (Bankr. E.D. Tenn. 2013) broke ranks from the majority position and held that the issuance of a Form 1099C prevented the bank from including in its proof of claim the principal debt listed as discharged in the Form 1099C. *See*, BWNDR 2009 and 2011. The Court reasoned that the identifiable events listed in the 6050P regulations are all events of discharge. *Reed*, 492 B.R. at 273 (the regulations "reflect the intention that cancellation of indebtedness income must be based upon an event that does, in fact, relieve a debtor from his or her obligation to pay the indebtedness.") The Court did not give a full analysis of the 36-month rule. *See*, *id*. at 267, note 1. The Court did allow a proof of claim for accrued interest and attorney's fees.

Installment agreements

The Tax Court upheld the disallowance of tithing as a conditional expense for installment agreement purposes in *Thompson v. Comm'r*, 140 T.C. No. 4 (2013). Disallowance of the tithing was not found to violate the Religious Freedom and Restoration Act of 1993, 107 Stat. 148. In addition, the IRS was found to have conformed with its guidelines under the Internal Revenue Manual. The result in the Tax Code is in sharp contrast to the result under the Bankruptcy Code, which may allow a tithing expense. *Compare*, 11 U.S.C. § 707(b)(1) (in making determination whether to dismiss under this section, charitable contributions to religious organizations may not be taken into account; which may still mean that the charitable contribution cannot be calculated in the means test, *In re Burks*, 2009 W.L. 103618 (Bankr. N.D. Tex. 2009) (charitable contribution deduction not allowed in § 707(b)(2)); *with*, *In re Littman*, 370 B.R. 820, 832 n.31 (Bankr. D. Idaho 2007) (United States Trustee's argument rejected that charitable contribution should be eliminated); and *see*, 11 U.S.C. § 1325(b)(2)(A)(ii) and (b)(3) (charitable contribution to religious organization of 15% of gross income allowed for both above and below median debtors in Chapter 13).

Damages and exhaustion of administrative remedies

In re Consol. Health Servs., Inc., 2013-2 USTC ¶ 50,478 (Bankr. E.D.N.C. 2013) found that the bankruptcy trustee had not exhausted administrative remedies under § 7433(e) in seeking damages from the IRS. In so doing, the Court expressed frustration with the convoluted process for obtaining damages.

> [I]s it true that § 7433(e) could be clearer in highlighting the "prior exhaustion of administrative remedies" requirement? Absolutely. Would it be appropriate for the IRS itself to highlight this requirement, and provide sufficient information for taxpayers to take note of, and then comply with, the IRS's own regulatory procedure? Absolutely. Did the trustee take reasonable steps in responding, repeatedly, to the IRS notices at the addresses specified in the notices by the IRS itself? Again,

> absolutely. And is it frustrating for the trustee, for the next hapless taxpayer, and for this court to see the IRS seemingly get a “pass” for its blatant disregard of the automatic stay, now that this matter finally has attracted the IRS's attention, by virtue of its ability to now point to 26 C.F.R. 301.7433-2(e)(1) as if all concerned should have simply availed themselves of that “opportunity” all along? Absolutely.

The taxpayer in *Murphy v. United States (In re Murphy)*, 2014-1 USTC ¶ 50,112 (Bankr. D. Me. 2013) proved that the IRS violated the discharge injunction. Interestingly, the damages part of the litigation were to follow without an IRS administrative determination whether its position was substantially justified under § 7433. *Murphy* found that the two-year period to bring a claim started to run from the date the IRS levied and not previously when the IRS informed the taxpayer that it believed the taxes were nondischargeable.

<u>Trust fund recovery penalty</u>

Dixon v. Comm’r, 141 T.C. No. 3 (2013) contains the best discussion this author can remember reading on how the crediting system works when the employer or employee pays employment taxes. The discussion is found mostly under the heading of “Credit under Section 31," but, that discussion must also be combined with the text in and around note 7 in Judge Holmes’s dissent.

In *Dixon*, the taxpayer owed substantial income tax for very old years. The interest alone was almost 90% of the tax. Due to a quirk in the IRS crediting system, the taxpayer made a contribution to the almost defunct corporation, and, the corporation then made the employment tax payment with a specific designation to the delinquent employee’s withholding. The taxpayer’s attorney figured that the IRS might give the credit as of the applicable tax year and not when the payments were made.

The Tax Court found that designation to a specific employee’s liability was permissible. In part, it reasoned that allocation is permissible when voluntary payments are made. In dissent, Judge Holmes found no statutory basis for the allocation to a specific employee’s liability. He found a statutory basis for a credit to the employer if the employee pays the tax, but, not vice versa. Furthermore, the taxpayer should have recognized income in the form of wages for the payment made by the corporation on the taxpayer’s behalf. And, Judge Holmes was not enamored of the additional basis created by the taxpayer in the corporate stock and the additional capital loss. Almost certainly, *Dixon* will be appealed.

<u>Offer in compromise</u>

Isley v. Comm’r, 141 T.C. No. 11 (2013) confirmed that the IRS does not have unilateral authority to compromise a criminal restitution order with an offer in compromise. The authority to adjust the restitution order rests with the Department of Justice. Mr. Isley is one of the Rock and Roll Hall of Fame Isley Brothers.

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