BANKRUPTCY AND WORKOUTS

Submitted by the Committee on Bankruptcy and Workouts
Frances D. Sheehy, Committee Chair;
Kenneth C. Weil,[1] Subcommittee Chair
on Important Developments

Legislation

The Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142, 12_ Stat. __, provides that income arising from the discharge of personal residence acquisition-debt of up to $2,000,000 ($1,000,000 for married filing separate taxpayers) can be excluded from gross income. I.R.C. § 108(a)(1)(E). The rule is applicable only for discharges in the years 2007, 2008, and 2009. Acquisition debt is incurred in acquiring, constructing, or substantially improving a personal residence. I.R.C. § 163(h)(3)(B). This means debt rising solely from a refinance does not qualify for the special exclusion. The exclusion does not apply to debt relief that is included in the amount realized as part of a sale. *See*, Treas. Reg. § 1.1001-2(c), Ex. 8. The exclusion also does not apply if the discharge is granted on account of services performed for the lender or any other factor not related to a decline in the value of the house or the financial condition of the debtor. The only tax attribute that is reduced because of the exclusion is basis in the taxpayer's principal residence. I.R.C. § 108(h).

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[1]Mr. Weil is the author of *Practical Guide to Resolving Your Client's Tax Liabilities*, (CCH 2d ed 2006). Portions of this article are adapted from proposed updates to that book.

The rules were apparently written with a write-off in mind and not a foreclosure, which can also produce debt discharge income. For example, while there is an ordering rule regarding a borrowing that is not 100% acquisition debt, the ordering rule does not answer the following question if a foreclosure occurs: Suppose $50 original basis on a personal residence all of which was borrowed with an interest-only loan; suppose a second interest-only loan of $50 is taken out after the house value rises to $100; suppose that only half of the proceeds from the second loan are used for substantially improving the residence; and suppose a subsequent foreclosure when the value is $75. Which $25 is included in the gain from sale and which $25 is potentially eligible for the discharge exclusion? In addition, there is no timing rule for the basis reduction of the principal residence. If the basis reduction occurs at the end of the year, *see*, I.R.C. § 108(b)(4)(A), then it is a no-never-mind, as the principal residence is gone. If the basis reduction occurs at the time of foreclosure, then Congress is giving with one hand (the debt discharge exclusion) and taking away with the other (basis reduction may create gain on sale) such that there is no benefit from the rule.

In § 8243 of the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, P.L. 110-28, 121 Stat. 7112, Congress amended I.R.C. § 6330(f) to provide that collection due process (CDP) appeals are not available before levies if there is a disqualified employment levy. Section 6330(h) defines a disqualified employment levy as any levy in connection with the collection of employment taxes for any taxable period if the person subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the most recent 2-year period before the beginning of the taxable period with respect to which the levy is served. Trust fund taxes appear to be excluded from this rule, as § 6330(h) defines employment taxes as any taxes under Chapters 21, 22, 23, or 24. Trust fund taxes, I.R.C. § 6672, are found in Chapter 68B.

Regulations

The IRS amended Treas. Reg. § 301.7701-2(c)(2)(iv) and (v), to provide that single members of LLCs, who elect to be taxed as individuals because the entity is disregarded for federal income tax purposes under the Section 7701 regulations, are no longer personally liable for employment taxes and certain excise taxes. Thus, the sole member can only be held liable for trust fund taxes and not all employment taxes. This amendment overrules *McNamee v. United States*, 2007-1 U.S.T.C. ¶ 50,515 (2nd Cir. 2007) (sole LLC member personally liable for payroll taxes); and *Littriello v. United States*, 484 F.3d 372, 2007-1 U.S.T.C. ¶ 50,426 (6th Cir. 2007) (same). The new rule is effective for wages paid on or after January 1, 2009. (For excise taxes, the effective date is January 1, 2008.)

Cases and Rulings

Dischargeability

United States v. Jacobs, 490 F.3d 913 (11th Cir. 2007) reinforces the belief that common sense is the best test to use when a practicing attorney is confronted with the issue of willful intent to evade or defeat tax. *See*, *Bankruptcy and Workouts Developments Report 2004* ("Determining the level of conduct that makes a tax nondischargeable is still an art form.") In *Jacobs*, the second sentence of the factual background reads as follows: "He [Mr. Jacobs] and his wife have lived since December 1995 in a house on Amelia Island Plantation, a golfing resort community that offers amenities such as tennis courts, a spa, boutique-style shops, a golf club, and a grocery store." Although the opinion continues for 11 more pages, the reader already knows that the tax will be held nondischargeable.

Other than the three-part test of the Fifth Circuit,[2] appellate courts use a two-part test to determine whether a taxpayer has willfully intended to evade or defeat the outstanding tax obligation. The two-part test consists of a conduct requirement and a state of mind requirement. Given that Mr. Jacobs engaged in an extravagant life-style, made large gifts to his family, mischaracterized income to avoid income tax

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[2] *Bruner v. United States (In re Bruner)*, 55 F.3d 195 (5th Cir. 1995) (debtor had a duty under the law; debtor knew of that duty; and debtor voluntarily and intentionally violated that duty).

withholding, and titled property in his wife's name to frustrate collection, the court had no trouble finding the two tests were met, and the tax obligation was nondischargeable.

In *Shorton v. Mass. (In re Shorton)*, 375 B.R. 26 (Bankr. D. Mass. 2007), the taxpayer ran afoul of a dischargeability rule added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), P.L. 109-8, 119 Stat. 23. As amended by BAPCPA, § 523(a)(1)(B) provides that a tax debt is not discharged if, under applicable law, a taxpayer fails to file a required return or equivalent report or fails to give notice of a change, if required. Thus, if a taxpayer is required to give notice to a state taxing authority of a federal tax change, and notice is not given by the taxpayer, the additional state tax caused by the federal tax change will not be discharged. In *Shorton*, the IRS assessed additional taxes on audit, the IRS reported the tax change to the Massachusetts Department of Revenue, but the taxpayer never reported the change to the state. The court held the Massachusetts tax nondischargeable. *See also*, *In re Meyers*, 2007 W.L. 4119071 (Bankr. E.D. Va. 2007) ("debtor's personal liability may survive any discharge granted in this case *if*, as the County Asserts, the debtor did not file required returns reflecting her ownership of the vehicle.") (emphasis in original; footnote omitted). Note, BAPCPA added flush language at the end of § 523 that defines a return. A return includes a final order entered by a nonbankruptcy tribunal. Query whether an assessment arising from a Tax Court ruling will be considered a return for state tax purposes.

United States v. McDaniel (In re McDaniel), 363 B.R. 239 (M.D. Fla. 2007) allowed the debtor to dismiss a pending bankruptcy case where the debtor's attorney miscalculated the three-year time-period for computing dischargeability. It affirmed *McDaniel v. United States (In re McDaniel)*, 350 B.R. 616 (Bankr. M.D. Fla. 2006), which was noted in Bankruptcy and Workouts Developments Report 2006. This is the first case to allow dismissal under these circumstances. In making its determination, the court adopted a fact-sensitive inquiry that is guided by equitable considerations and balances "the benefit and harm to creditor and debtor alike." *Contra*, *Leach v. United States (In re Leach)*, 130 B.R. 855 (9th Cir. B.A.P. 1991) (miscalculation of the 240-day period does not provide grounds for voluntary dismissal by debtor, who would like three-year period to run so tax is dischargeable).

Another case involving miscalculation of the applicable discharge time-period was *Elkins v. Comm'r (In re Elkins)*, 369 B.R.741 (Bankr. S.D. Ga. 2007). *Elkins* illustrates the interaction of returns filed on extension with the three-year rule for determining dischargeability and priority. The three-year time-period runs from the due date created by the extension, not the original due date. This rule came into play in

2005, when debtors were hurrying to beat the effective date of BAPCPA, which was Monday, October 17, 2005. Returns filed under the two-extension rule of the 2001 tax year were due on October 15, 2002, and the three-year period ran October 15, 2005. This left Sunday, October 16, 2005, as the only day to file bankruptcy petitions under the old law and still discharge the 2001 tax obligation. In *Elkins*, the petition was filed on Friday, October 14, 2005, and the 2001 tax obligation was not discharged.

Severo v. Comm'r, 129 T.C. No. 17, n.12 (2007) illustrates that Tax Court judges are not immune from miscounting time periods as it omitted a leap day in calculating the number of days in a 10-year period that began running on November 18, 1991. Three February 29ths passed in the ensuing 10 years,[3] and the appropriate number of days was 3653, not 3652 as posited by the court. More puzzling is why the court transmuted a ten-year rule into a 3652-day rule. *See*, *Elkins*, *supra*, 369 B.R. at 743 (it is well-established that unless otherwise expressed, the word "year" means a calendar year regardless of whether it be a leap year or otherwise).

In Rev. Rul 2007-59, 2007-2 C.B. 582, the Service ruled that the "due" date for returns, as defined in §§ 507(a)(8)(A)(i) and 523(a)(1)(B)(ii) does not change because the taxpayer is eligible to file a return without penalty at a later date. The ruling

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[3]Century years are leap years only if the year is divisible evenly by 400. The year 2000 was a leap century.

discusses both disaster victims and members of the armed forces serving in a combat zone. In one of the fact patterns, a member of the armed forces was assigned to combat duty from March 17, 2005 to August 1, 2006. Under the applicable rules, the due date for the 2004 return of April 15, 2005 was disregarded and the new date to file without penalty was February 26, 2007.[4] The taxpayer filed the return September 20, 2006. The taxpayer filed for bankruptcy on September 1, 2008. As § 7508 states that the due date is disregarded and not changed, the ruling held that the "due" date for the return did not change. The taxpayer passed the three-year rule, as September 1, 2008 is after April 15, 2008. The taxpayer flunked the two-year rule, which provides that taxes arising from late-filed returns are nondischargeable until two years after filing. Even though late-filed penalties were not assessable, the Service still considered the return late-filed, as § 7508 only disregards the due date and does not change it. The tax would have been dischargeable two years after September 20, 2006 or after September 20, 2008.

Priority

In re Lorber Indus. of Cal., 357 B.R. 617, 623-624 (9th Cir. B.A.P. 2007) asked when the transaction occurred that made the debtor liable for the excise tax owed for failure to pay on a self-insured worker's compensation claim. Under 11 U.S.C.

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[4] This is another time miscalculation. The actual due date should have been February 27, 2007.

§ 507(a)(8)(E), an excise tax is given priority if the transaction giving rise to the tax occurs within three years of the petition date. In Lorber, the Court held that three events need to occur for the transaction to arise. To be liable, the company needed to be self-insured, a worker needed to suffer an on-the-job injury, and the company needed to default on its self-insurance payment. As the company defaulted on its self-insurance payment postpetition, the claim did not qualify as a priority claim. *Lorber* should be compared to *In re Bliemiester*, 296 F.3d 858 (9th Cir. 2002). In that case, the company was not making its payments at the time of the injury. Accordingly, the transaction occurred at the time of the injury.

In *Mich. Unemployment Ins. Agency v. Boyd (In re Albion Health Servs.)*, 360 B.R. 599 (6th Cir. B.A.P. 2007), the Sixth Circuit Bankruptcy Appellate Panel joined the First and Third Circuits in holding that reimbursements for unemployment benefits paid by nonprofit entities that have opted out of the state unemployment system are not excise taxes entitled to priority. The court reasoned that (i) the state could protect itself under the Michigan system with a surety bond, which indicates the nontax character of the obligation, and (ii) the reimbursement obligation was limited to the benefits actually paid by the state.

Chapter 12

In re Hall, 376 B.R. 741 (Bankr. D. Ariz. 2007) held that the taxes generated from the postpetition sale of a farm did not qualify for priority under § 507. Accordingly, the taxes incurred on sale did not qualify for the special treatment accorded § 507 taxes in § 1222(a)(2)(A). That section characterizes the § 507 tax incurred on the sale of a farm asset as a nonpriority obligation. Nonpriority obligations need not be paid in full under a Chapter 12 plan. Priority obligations must be paid in full.

The only category under § 507 that might fit postpetition taxes is § 507(a)(2), which deals with administrative expenses.[5] Administrative expenses are defined in § 503(b). That section states that administrative expenses include the actual, necessary costs and expenses of preserving the estate. The court agreed with the IRS that, since a separate taxable estate is not created when a Chapter 12 petition is filed, there cannot be an administrative expense for tax due.

The court did not distinguish between the tax obligation, where there is not a separate taxable estate, and property of the bankruptcy estate, which included the farm and is a separate "legal entity." It is unquestioned that the costs of sale, including real estate fees, closing costs, etc., qualify for

[5]Postpetition taxes do not fit within § 507(a)(8), as these priorities are reserved for prepetition taxes.

payment as an administrative expense. The taxes incurred on sale should as well. Neither the debtor in *In re Brown*, 2006 W.L. 3370867 (Bankr. D. Mass. 2006) nor the debtor in *Hall* appeared to have included a provision in the order approving sale for the payment of taxes, or, at least an acknowledgment that the taxes should be considered an administrative expense for purposes of § 1222(a)(2)(A), and, if not, allowing withholding for the capital gains tax incurred on sale.

<u>Chapter 11</u>

The problem of not accounting for tax due on sale was also at issue in *In re Redcay*, 2007 W.L. 4270378 (Bankr. E.D. Pa. 2007). In that case, a confirmed Chapter 11 plan provided for the sale of assets. The case was closed, and, thereafter, the assets sold. The tax burden fell on the postconfirmation debtor, which owned the assets at the time of sale. The court denied the motion of the IRS to reopen the case so that it could file an administrative expense claim for the tax due on sale. Reopening the case would have been futile as the tax was not owed by the bankruptcy estate.

<u>Chapter 13</u>

In re Cushing, __ B.R.__, 2007 W.L. 4372810 (Bankr. D. Mass. 2007) dealt with the BAPCPA-added requirement of filing tax returns before a Chapter 13 plan can be confirmed. 11 U.S.C. § 1308. This rule is awkward if the debtor files before the tax return for the prior year is due, *e.g.*, debtor files within the first three months of the new year. To deal with this problem, BAPCPA provided in § 1308(b) that the trustee can hold the § 341 meeting open until the return is filed.

In *Cushing*, the debtor filed her case in June 2007. Prior thereto, she had filed an extension for her 2006 taxes to October 2007. The 341 meeting was held in July 2007. The trustee *did not* hold the meeting open until the return was filed. Since the 2006 return had not been filed, the IRS objected to plan confirmation. The court denied the objection. The court reasoned, at the time of plan confirmation, the debtor had done all the law required. Furthermore, pursuant to Treas. Reg. § 1.6081-4T(d), the IRS could have terminated the extension.

In re Ayre, 360 B.R. 880, 886-887 (C.D. Ill. 2007) held that the confirmation of a Chapter 13 plan and the claim adjudication process are equally valid methods to resolve a disputed, unsecured claim. Both are contested matters. Objection to confirmation is initiated by the creditor; objection to a claim is initiated by the debtor. Because the Illinois Department of Revenue's unsecured, priority claim was subject to a *bona fide* dispute, the treatment of its claim in the Chapter 13 plan was allowed to stand.

<u>Claims</u>

In *EDP Med. Computer Sys., Inc. v. United States* 480 F.3d 621 (2nd Cir. 2007), the Second Circuit joined *Siegel v. Fed. Home Loan Mortgage Corp.*, 143 F.3d 525 (9th Cir. 1998) in giving preclusive effect to a previous order allowing an uncontested claim. In *EDP*, after the closure of a Chapter 11 case, the debtor filed a claim for refund to recover taxes paid on an allowed claim in the Chapter 11 proceeding. The Second Circuit gave preclusive effect to the bankruptcy court claim order allowing the claim, and it denied the claim for refund.

Property of the Estate

The court in *Nichols v. Birdsell*, 491 F.3d 987 (9th Cir. 2007) found that a tax refund that had been irrevocably applied to the following year's taxes still constituted property of the bankruptcy estate. In January 2002, the taxpayers filed a tax return for 2001 that generated a refund and applied it to 2002 taxes. Sixteen days later, taxpayers filed for bankruptcy. The trustee demanded turn over of the value of the refund to the bankruptcy estate. The taxpayers protested, arguing that the refund was no longer available to them and the election was irrevocable.

The court rejected the taxpayers' arguments. Relying on the broad definition of property found in § 541, the court found that the refund still provided a valuable benefit to the taxpayers, and, as such, constituted property of the estate. Nothing in § 541 "requires that the debtor's interest be immediately capable of being liquidated into cash in order to constitute property of the estate." *Nichols*, *supra*, at 990. The court affirmed the bankruptcy court order (*see*, Bankruptcy and Workouts New

Developments Report 2004) that the taxpayers must deliver the dollar amount of the refund to the bankruptcy trustee. If *Nichols* is taken to its logical conclusion, does this mean that the trustee can recover all prepetition estimated tax payments and prepetition wage withholdings or does the ruling apply only to payments not required by law?

In re Worldcom, Inc., 364 B.R. 538 (Bankr. S.D.N.Y. 2007) held that the assets of a former director's rabbi trust were property of the bankruptcy estate. The Court reasoned that "an inherent and immutable feature" of rabbi trusts is that the employee holds *unsecured* contractual rights. *Id*. at 543. Accordingly, all assets in a rabbi trust must be property of the employer.

<u>Setoffs</u>

United States v. White, 365 B.R. 457 (M.D. Pa. 2007) followed the recent trend supporting the IRS's right to setoff against the taxpayer's claim of exemption. The basic fact pattern is prepetition tax owed, some priority/nondischargeable and some nonpriority/dischargeable, and a prepetition refund payable to the taxpayer. The taxpayer attempts to block the IRS right to setoff the refund against the tax obligation by arguing that, after the IRS takes the setoff against the nondischargeable tax obligation, the remaining balance of the refund can be exempted because the tax is otherwise dischargeable.

In *White*, the court held that the IRS's right of setoff trumped the exemption right, even as to a setoff against the dischargeable tax obligation. *See also*, *Emery v. IRS (In re Emery)*, __ B.R.__, 2007 W.L. 4462929 (Bankr. W.D. Ky. 2007) (IRS already had validly filed notice of lien that would have attached to refund and defeated the taxpayer's exemption claim). Note, other courts never even reach this issue as they have held that the refund does not even exist until all other income tax obligations are paid. *IRS v. Luongo (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001). *White* does not answer the following question: If the refund cannot pay the entire tax obligation, does the debtor have any mechanism available to force the IRS to apply the refund first to the priority/nondischargeable obligation?

United States v. Carey (In re Wade Cook Fin. Corp.), 375 B.R. 580 (9th Cir. B.A.P. 2007) found the Ninth Circuit Bankruptcy Appellate Panel entangled in the thicket of whether a tax year is bifurcated in the year of filing. For tax claim purposes, the tax year ends on December 31. A mid-year filing does not bifurcate the tax year, unless an individual taxpayer so elects. 11 U.S.C. § 507(a)(8)(A) ("for a taxable year *ending on or before* the date of the filing of the petition") (emphasis added); and I.R.C. § 1398(d)(2)(A) (providing individuals the ability to close the tax year as of the day before the filing). Refunds are *pro rated* between the prepetition and postpetition periods during the year of filing, *i.e.*, the year is bifurcated.

Doan v. Hudgins (In re Doan), 672 F.2d 831 (11th Cir. 1982) (refund prorated); and *Barowsky v. Serelson (In re Barowsky)*, 946 F.2d 1516 (10th Cir. 1991) (same). *Nichols v. Birdsell*, 491 F.3d 987 (9th Cir. 2007) essentially bifurcated the tax year when it held that a refund allocated to the subsequent year's tax payments could be recaptured by the trustee as estate property.

In *Wade Cook*, an involuntary bankruptcy petition was filed in mid-December. The tax refund for the year was not established until the end of December. The trustee argued against the IRS's setoff right by claiming lack of mutuality of obligation, *i.e.*, the refund was not established until after the petition was filed thereby making it a postpetition debt of the IRS.[6] This would mean there was no mutuality between the prepetition claim of the IRS and its postpetition debt.

The Bankruptcy Appellate Panel had no trouble finding that for mutuality purposes the tax refund could be bifurcated. In so doing, the court did not explain how the § 553(b) improvement-in-position test was to be applied. For filings in the early part of the new year, courts have held that the refund generated by the previous tax year accrues on December 31. *See e.g., In re Glenn*, 207 B.R. 418 (E.D. Pa. 1997) (refund accrued at year's end; not when tax return filed); and *United States v. Orlinski (In re Orlinski)*, 140 B.R. 600 (Bankr. S.D. Ga. 1991)

[6]The rules of § 553(b) are viewed from the creditor's perspective. Thus, the refund is the IRS's debt, and the tax owed is the IRS's claim.

(same). Under *Wade Cook*, the refund, for purposes of the improvement-in-position test, would be *pro rated* in the year of filing.

The court in *Wade Cook* remanded for further fact finding as to whether a subsidiary of Wade Cook and the parent company should be considered *alter egos* so that mutuality of obligation existed.

<u>Exemptions</u>

In re Jarboe, 365 B.R. 717 (Bankr. S.D. Tex. 2007) held that an inherited IRA could not be exempted under Texas exemption rules. *Cf*., *In re McClelland*, 2008 W.L. 89901 (Bankr. D. Idaho 2008) (inherited IRA qualified for exemption under Idaho law).

Query whether 11 U.S.C. § 522(n) has any application to *Jarboe*. That section, which was added to the Bankruptcy Code by BAPCPA, provides that the exemption available for any IRA described in I.R.C. § 408 shall be limited to $1,000,000. Section 408(d)(3)(C) specifically discusses inherited IRAs. Thus, inherited IRAs are described in § 408. Clearly, under § 522(n), if a debtor's IRA were greater than $1,000,000, then the Bankruptcy Code would override a state exemption statute such as Washington, where the IRA is unlimited and limit the IRA to $1,000,000. Should § 522(n) override state rules not allowing inherited IRAs to be exempt because, inherited IRAs are described in I.R.C. § 408? The answer is probably not.

Installment agreements

In Internal Revenue News Release IR-2007-163 (October 1, 2007), the IRS announced, effective October 1, 2007, changes to its collection financial standards. These changes included eliminating income ranges for the national standard expenses, creating a new national standard for health care expenses, adding an allowance for cell phone costs, equalizing the allowances for ownership of first and second vehicles, and creating a separate nationwide public transportation allowance. The changes correct one perceived inequity. Under the old standards, high income taxpayers were given a larger monthly food budget than low income taxpayers. The standardization of the national standard expenses eliminates this difference in treatment.

Seagrave v United States, 2007-1 USTC ¶ 50,479 (7th Cir. 2007) (not for publication) is an example of the taxpayer having the statute of limitation extended for more than nine months because the taxpayer proposed *oral* installment agreements. I.R.C. § 6331(k)(2) prohibits the IRS from making a levy if the taxpayer proposes an installment agreement. I.R.C. § 6331(i)(5) tolls the statute of limitation on collection if the IRS is prohibited from making a levy. The statute continues to run if the taxpayer gives written notice to the IRS waiving the levy restriction. I.R.C. § 6331(i)(3)(A)(i). These rules are incorporated into § 6331(k). I.R.C. § 6331(k)(3)(A). Thus, to avoid the result in *Seagrave*, many practitioners suggest sending a letter to the IRS with any proposed installment agreement waiving the levy restriction while it considers the installment agreement.

Forecast

Supreme Court

In *Fla. Dep't of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, 484 F.3d 1299 (11th Cir. 2007), *cert. granted*, *Fla. Dep't of Rev. v. Piccadilly Cafeterias, Inc.*, 128 S.Ct. 741 (2007), the Supreme Court will consider whether the "stamp tax" exemption for transfers pursuant to a Chapter 11 plan under 11 U.S.C. § 1146(c) [now § 1146(a)] can apply to preconfirmation transfers that are integral to the Chapter 11 plan. The Eleventh Circuit said yes. The Second and Fourth Circuits have said no. *Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Inv. Co. of Del.)*, 335 F.3d 243 (3rd Cir. 2003) (§ 1146(c) [now § 1146(a)] exempts property transfers occurring under Chapter 11 plan but not transfers that occur before the plan is confirmed); and *NVR Homes, Inc. v. Clerks of the Circuit Court for Anne Arundel County (In re NVR, LP)*, 189 F.3d 442 (4th Cir. 1999) (same), *cert. denied*, 528 U.S. 1117 (2000).

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Principal author contact information

Ken Weil
1001 Fourth Avenue # 3801
Seattle, WA 98154
206-292-0060
206-292-0535 (fax)
weilkc@weilkc.com