BANKRUPTCY AND WORKOUTS

Submitted by the Committee on Bankruptcy and Workouts
Frances D. Sheehy, Committee Chair;
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on Important Developments

Legislation

The Emergency Economic Stabilization Act of 2008, P.L. 110-343, 12_ Stat. __ at § 303 extended through 2012 the special exclusion rules for qualified mortgage indebtedness enacted in The Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142, 121 Stat. 1803. *See*, Bankruptcy and Workouts Developments Report 2007.

Regulations

The IRS finalized regulations for Treas. Reg. § 1.368-1(e) providing that, in certain circumstances, the exchange of debt by creditors for stock will count towards the 50% continuity of interest requirement for a tax-free reorganization under § 368. As to senior claims, the value of the proprietary interest in the target corporation is determined by multiplying the fair market value of the senior claims times a fraction, in which the numerator is the fair market value of the proprietary interests in the issuing corporation received in the aggregate for the senior claims and the denominator is the sum of money and fair market value of all consideration received in the aggregate for

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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 senior claims. The value of proprietary interests in the target corporation of any junior claimants is the fair market value of the junior claim.

The IRS proposed regulations updating the lien filing rules found in Treas Reg. §§ 301.6323(b)(1), 301.6323(c)-2, 301.6323(f)-1, 301.6323(g)(1), and 301.6323(h)-1. Among other changes, the proposed regulations provide for electronic filing, add rules for real property construction or improvement financing agreements, update dollar amounts as adjusted for inflation, and provide rules for the refiling of liens that have automatically released. The proposed regulations appear to require that a notice of lien filed in multiple places must be updated in all places previously filed for the refiled lien to be valid. Prop. Treas. Reg. § 301.6323(g)-1(b)(3), Ex. 1. In the example, the notice of lien was filed in states M and N. The proposed regulation states as follows:

> In order to continue the effect of the notice of lien filed in *either* M or N, the IRS must refile, during the required refiling period, the notice of lien with the appropriate office in M *as well as* with the appropriate office in N.

(emphasis added).

Prop. Treas. Reg. § 1.108-8 provides clarification that if a partnership exchanges a partnership interest for the cancellation of debt, the partnership interest shall be valued at its liquidation value. The rule applies provided (i) the partnership maintains capital accounts according to the basic capital account accounting rules of Treas. Reg. § 1.704-11(b)(2)(iv); (ii) for purposes of determining their tax consequences in the transaction, all applicable parties treat the fair market value of the partnership interest as its liquidation value; (iii) the debt-for-equity exchange is an arms-length transaction; and (iv) after the transaction is concluded, neither the partnership redeems nor anyone related to the partnership purchases the partnership interest as part of a plan at the time of the exchange that had as its principal purpose the avoidance of cancellation of debt income.

Cases and Rulings

<u>Dischargeability</u>

Pizzuto v. IRS (In re Pizzuto), 384 B.R. 105, 113, n.5 (Bankr. D.N.J. 2008) raises, but does not answer, the interesting question of whether giving a return to a revenue officer or a CID agent will constitute filing a return even if that is not considered a properly filed return under Treas. Reg. § 1.6091-2(a) (tax return of individual shall be filed with any person assigned the responsibility to receive returns at the local IRS office that serves the legal residence or principal place of business of the person required to make the return).

In part, § 523(a)(1)(B) makes tax nondischargeable with respect to a return or equivalent report or notice, if required, if the return, report, or notice is not filed or *given*.[2] As *Pizzuto* observes in n.5, this new language could mean that a return delivered to a revenue officer, who is not a person designated to receive returns, might still be considered a valid return under § 523 because the return has been given to the taxing authority.

Allnutt, Sr. v. Comm'r, 523 F.3d 406 (4th Cir. 2008) also explored the edges of what constitutes a filed return. In *Allnutt*, on February 21, 1997, the taxpayer delivered the original returns to District Counsel's office. In turn, District Counsel delivered the returns to Special Procedures where the returns were received on March 10. The returns delivered to Special Procedures had no proof of delivery on them, and, Special Procedures entered the returns as received on March 10, as opposed to February 21. In 1997, a return was deemed filed if delivered to the District Director or a person designated in the district to receive returns. I.R.C. § 6091(b)(1)(A) and Treas. Reg. § 1.6091-2 (1997).

On February 21, 1997, the taxpayer also attempted to deliver copies of the return to the District Director. The District

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[2]Section 523(a)(1)(B) was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), P.L. 109-8, 119 Stat. 23. The changes to § 523(a)(1)(B) were designed to overrule cases like *Cal. Franchise Tax Bd. v. Jackson (In re Jackson)*, 184 F.3d 1046 (9th Cir. 1999), which held that the failure to file a report of a change in tax to the state taxing authority was not the equivalent of a failure to file a return, and, the tax could be discharged even if the report were not filed with the state.

Director was at lunch, and, the taxpayer gave the copies to an unknown person in the hallway, who promised to deliver them to the District Director. Mr. Allnutt received no proof of delivery from the unknown person.

The Fourth Circuit found that the returns were not filed until March 10, as the taxpayer had not complied with the rules regarding filed returns. The taxpayer had no evidence that the returns were ever filed with the District Director, as he had no evidence of delivery to the unknown gentleman in the hallway. As the notice of deficiency was issued March 6, 2000, the court found the notice of deficiency valid.

Interestingly, the taxpayer conceded that delivery to District Counsel's office was not proper delivery. *See*, *Allnutt, Sr.*, 523 F.3d at n. 1 & 2. Although District Counsel is not a designated person to receive returns, District Counsel is the attorney for the District Director, and, it is arguable that delivery to the District Director's attorney should be deemed a valid filing.

Imarah v. Comm'r, 95 TCM 1541 (2008) dealt with computing the three-year time period for discharge in a second bankruptcy when the tax in question (i) was incurred after the filing of a previous bankruptcy, but (ii) before the previous bankruptcy concluded, and (iii) the earlier bankruptcy involved a conversion from one chapter to another. While *Imarah* concerned multiple bankruptcies and two unpaid tax years, the facts can be simplified to illustrate the issue in question.

The debtor filed a Chapter 7 bankruptcy in 1996, and, subsequently, a return was filed for 1996 with tax due. Thereafter, the Chapter 7 case was converted from Chapter 7 to Chapter 11 and back to Chapter 7. An order of discharge was ultimately entered in 2002. A second bankruptcy was filed in 2003.

Under 11 U.S.C. § 348(a), the conversion of a case from one chapter to another does not affect a change in the date of filing, the commencement of the case, or the order of relief. But, under 11 U.S.C. § 348(d), if a claim arises between the order of relief and the conversion date, the claim is treated as a prepetition claim. The IRS argued that by operation of § 348(d) the 1996 postpetition claim should be treated as a prepetition claim and subject to tolling during the pendency of the first bankruptcy. If correct, pursuant to *Young v. Comm'r (In re Young)* 535 U.S. 43 (2002) (three-year period tolled by bankruptcy filing), and, today, the flush language at the end of § 507(a)(8), the tax would have been nondischargeable in the second bankruptcy as the first bankruptcy case remained open from 1996 to 2002.

The Tax Court found that § 348(d) is a payment priority rule and not a dischargeability rule. Thus, as to dischargeability, the tolling rules of § 507(a)(8) were not implicated by § 348(d), and, the taxes in question were discharged.

In the tax law, capital gain sometimes arises by definition, I.R.C. § 1221, and, sometimes it is deemed to exist by other code sections, *e.g.*, I.R.C. § 1231. Whenever capital gain is mentioned outside of § 1221 in the Tax Code, one must ask whether the Tax Code is referring to capital gain as defined or as deemed.
A similar issue exists here. Section 348(d) deems a claim subject to priority for payment purposes. The IRS argued that the claim should also be deemed prepetition for dischargeability purposes. The Tax Court disagreed. Here, at least, the "defined" rules controlled.

Imarah also considered whether a discharge determination was within the scope of what can be heard in a collection due process (CDP) hearing. At a CDP hearing, the taxpayer can raise, among other issues, challenges to the underlying tax liability as to existence or amount if the taxpayer failed to get a deficiency notice or otherwise lacked an earlier opportunity for disputing the tax liability and challenges to the appropriateness of collection actions. I.R.C. § 6320(c) applying I.R.C. § 6330(c). Since collection activity would be inappropriate if a tax has been discharged by a prior bankruptcy, the Tax Court held that discharge determination was an appropriate issue to raise in a CDP hearing.

Distad v. United States (In re Distad), 392 B.R. 482 (Bankr. D. Utah 2008) illustrates the administrative nightmare the IRS faces when the law of dischargeability changes to a more favorable taxpayer result, and, how it is impossible for the IRS to go back and change all the tax liabilities that it coded as nondischargeable to dischargeable.

In *Distad*, the taxpayer filed multiple bankruptcy petitions. Each petition tolled the three-year dischargeability period of § 507(a)(8)(A)(i). Based on the I.R.C. § 6503(b) six-month add-on to the statute of limitation, the IRS also added an additional six months to the three-year period.[3] In *Young v. United States*, 535 U.S. 43 (2002), the Supreme Court held that the three-year period was tolled by a bankruptcy filing, but, it was silent as to any six-month add-on. Immediately thereafter, the IRS stopped tacking on an additional six months. Unfortunately for the IRS, there is no easy way for it to go back into its computers and correct taxpayers' files where there has been a six-month add-on. In *Distad*, the IRS computers initially reflected pre-*Young* law, and, the IRS did not delete the add-ons in its old case files when the law changed. Thus, it continued its collection efforts. As a result, the IRS was found in violation of the discharge injunction of 11 U.S.C. § 524(a)(2). The court scheduled for further hearing the issue of the amount of monetary damages

[3]The seminal case for the six-month add-on was *Brickley v. United States (In re Brickley)*, 70 B.R. 113 (9th Cir. B.A.P. 1986).

proximately caused by the IRS's behavior. The court did not award punitive damages, citing 11 U.S.C. § 106(a)(3), which waives sovereign immunity but not as to punitive damages.

A *Distad* problem lurks in the 8th Circuit. That is the only circuit to overrule the IRS position that the subsequent filing of a return after the IRS does a substitute-for-return (SFR) assessment is a valid return. The other circuits to consider this issue have decided otherwise, so that the tax due from the SFR assessment is automatically nondischargeable as a nonfiled return under 11 U.S.C. § 523(a)(1)(B), even if a subsequent return is filed. *Cf.*, *Colsen v. United States (In re Colsen)*, 446 F.3d 836 (8th Cir. 2006); *with*, *Moroney v. United States (In re Moroney)*, 352 F.3d 902 (4th Cir. 2003), and *In re Payne*, 431 F.3d 1055 (7th Cir. 2005); and *see*, Bankruptcy and Workouts Developments Report 2006.

Federal Tax Liens

Sullivan v. United States (In re Hulett Corp.), 389 B.R. 610 (Bankr. N.D. Ill. 2008), *motion to amend judgment denied*, 397 B.R. 537 (Bankr. N.D. Ill. 2008) broke no new ground in tax lien law, but, it contained unusual facts. In *Hulett*, the IRS and the secured creditor filed their liens with the Illinois Secretary of State at exactly the same time, which was February 14, 2005 at 4:30 p.m. The court followed the Supreme Court holding in *United States v. McDermott*, 507 U.S. 447 (1993) and found that the IRS lien would be given priority as *McDermott* holds that the federal tax lien is given priority when there is simultaneous attachment.

Buenting v. Crystal Cascades Civil, LLC (In re Crystal Cascades Civil, LLC), 398 B.R. 23 (Bankr. D. Nev. 2008) illustrated the IRS's ongoing struggle to file liens that can be found under current-day computerized search logic. *See*, Bankruptcy and Workouts Developments Report 2005 discussing *United States v. Crestmark Bank (In re Spearing Tool and Mfg. Co.)*, 412 F.3d 653 (6th Cir. 2005).

It is well-settled that a notice of federal tax lien (NFTL) must properly identify the taxpayer. *See e.g.*, *Ducote v. United States (In re de la Vergne II)*, 156 B.R. 773 (Bankr. E.D. La. 1993) (lien must be in substantial compliance with statutory requirements so that reasonable inspection discloses existence of lien). Here, the issue was whether a NFTL in the name Crystal Cascades, LLC properly identified the actual taxpayer Crystal Cascades *Civil*, LLC. If it did, the NFTL would be valid.

The court determined a reasonable search must be viewed through the perspective of a nonprofessional searcher. The court acknowledged that the Clark County, Nevada search system employed wild cards, and, a search of Crystal Cascades would have found the applicable NFTL. But, the court also determined that a search of the full legal name would not have uncovered the NFTL. The court found that the IRS omitted a key part of the LLC's name, and, a nonprofessional searcher would not have found the IRS's NFTL. Thus, the IRS's NFTL was not valid.

Avoidance of tax attribute elections

Kapila v. United States (In re Taylor), 386 B.R. 361 (S.D. Fla. 2008) is consistent with cases that have previously allowed the bankruptcy trustee to avoid, as a fraudulent transfer under § 548, tax attribute elections such as busting a Subchapter S election or the carrying forward of net operating losses (NOL). *See*, *Parker v. Saunders (In re Bakersfield Westar, Inc.)*, 226 B.R. 227 (9th Cir. B.A.P. 1998) (prepetition revocation of Subchapter S election held fraudulent transfer; IRS considered a transferee); and *United States v. Sims (In re Feiler)*, 218 F.3d 948 (9th Cir. 2000) (election to carry forward NOL held avoidable fraudulent transfer under § 548). In *Taylor*, the trustee successfully avoided the NOL carry forward and was able to apply the NOL to generate an $11,000 refund in a prepetition tax year. *Taylor*, 386 B.R. at 364. On a go-forward basis, the NOL would have been of no value to the debtor. *Id*.

Chapter 11

In *Fla. Dep't of Rev. v. Piccadilly Cafeterias, Inc.*, 554 U.S. ___ (2008), the Supreme Court held that the 11 U.S.C. § 1146(a) stamp tax exemption for property transfers under a confirmed Chapter 11 plan applies only to transfers occurring under a confirmed Chapter 11 plan and does not apply to transfers approved by the plan but occurring before the plan is confirmed.

In so ruling, it upheld prior rulings of the Third and Fourth Circuits and reversed the position of the Eleventh Circuit. *Cf.*, *Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Inv. Co. of Del.)*, 335 F.3d 243 (3rd Cir. 2003) 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), *with*, *Fla. Dep't of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, 484 F.3d 1299 (11th Cir. 2007) (*per curiam*).

<u>Chapter 12</u>

In re Dawes, 382 B.R. 509 (Bankr. D. Kan. 2008) illustrated the continuing battle between the IRS and Chapter 12 debtors over whether the tax due on the postpetition sale of farm assets could be treated as a nonpriority tax obligation pursuant to 11 U.S.C. § 1222(a)(2)(A). See the discussion of Chapter 12 in *Bankruptcy and Workouts Developments Report 2006 and 2007*.[4] 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 IRS argued unsuccessfully that there is not a separate taxable estate created by a Chapter 12 filing and there cannot be

[4]Two cases discussed in 2007 were heard on appeal in 2008. *In re Hall*, 393 B.R. 857 (D. Ariz. 2008), *reversing*, 376 B.R. 741 (Bankr. D. Ariz. 2007) adopted the now majority position that the tax due from a postpetition sale of a farm asset is a nonpriority obligation. *United States v. Schilke (In re Schilke)*, 2008 W.L. 4224279 (D. Neb. 2008), *affirming, In re Schilke*, 379 B.R. 899 (Bankr. D. Neb. 2007) also adopted the majority position.

a Chapter 12 estate tax due when there is not a separate taxable bankruptcy estate. The debtor argued that there is a separate bankruptcy estate that can incur the tax even if there is not a separate taxable estate. The court held for the debtor and allowed the Chapter 12 plan to classify postpetition gain on sale as nonpriority. To be safe and focus the issue early in the case, a debtor should provide for the sale and § 1222(a)(2)(A) treatment in the Chapter 12 plan.

Later in the year, *In re Knudsen*, 389 B.R. 643 (N.D. Iowa 2008) joined the majority and found that the bankruptcy estate may continue to hold property that is necessary for effectuation of the plan, *i.e.*, the bankruptcy estate continues to exist even if property has revested in the debtor. Thus, there can be an estate that incurs an administrative expense. *Id*. at 681-682.

Knudsen also addressed the issue of what assets qualify as used in farming operations. In *Knudsen*, the debtors were required as part of their reorganization to liquidate their current stock of pigs, which they raised from birth to slaughter. Their new customer wanted the debtors to raise only the new customer's pigs. The court held under these facts that the hogs qualified as used in farming operations. This makes sense. Normally, hogs would not be considered assets used in farming operations, as they are the end-product, but, here, they were sold to make room for the new customer's pigs. *Id*. at 664.

In reaching the conclusion that these pigs qualified for special treatment, the court held that a sale must be part of a plan of reorganization. *Id*. at 659; and *see*, *Fla. Dep't of Rev. v. Piccadilly Cafeterias, Inc.*, 554 U.S. ___ (2008) (sale in Chapter 11 must be part of confirmed Chapter 11 plan to qualify for stamp tax exemption). This is at odds with the literal language of the statute and questionable from a policy perspective. Section § 1222(a)(2) requires only that the sale creating the tax arise from the sale of a farm asset. There is no temporal requirement. From a policy perspective, the prepetition liquidation of farm assets by a distressed farmer trying to stay afloat would not be part of a plan of reorganization that did not yet exist and the special treatment would be unavailable. Yet, this is exactly the person who should benefit from the legislation.

What amount of tax is allocated to the nonpriority item? *Knudsen* computed the tax due with gain from sale, and, again, without the gain from sale. The difference was held to qualify for the special treatment, and, the balance received priority treatment. *Id. at* 669 (the court called this the marginal method).

<u>Chapter 13</u>

The court in *In re Cushing*, 383 B.R. 16 (Bankr. D. Mass. 2008) withdrew its opinion reported at 379 B.R. 407 (Bankr. D. Mass. 2007) and reported in *Bankruptcy and Workouts Developments*

Report 2007. *Cushing* 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 for bankruptcy 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 11 U.S.C. § 341 meeting open until the return is filed. In *Cushing*, upon further review, the court found that the trustee's 341 meeting had never been concluded. Thus, the debtor filed her tax return within the appropriate statutory time limits. The court held open for another day the issue of how to deal with a tax return filed after the 341 meeting is concluded.

In re Perry, 389 B.R. 62 (Bankr. N.D. Ohio 2008) is the first reported case dismissing a Chapter 13 for failure to provide tax returns under § 1308. The court wrote that it was bound by the clear unambiguous language of the statute, notwithstanding that the debtor thereafter provided the tax returns. To prevent dismissal, the court suggested that debtors should ask the trustee to continue the 341 meeting. *Accord*, *In re Kuhar*, 391 B.R. 733 (Bankr. E.D. Pa. 2008).

In re Cespedes, 393 B.R. 403 (Bankr. E.D.N.C. 2008) illustrated one area where Chapter 13 can provide a benefit to taxpayers. Penalties are nonpriority obligations and still dischargeable in Chapter 13 regardless of age and without full payment. The court agreed with prior case law that the amounts due for early withdrawal from an IRA are penalties. *United States v. Dumler (In re Cassidy)*, 983 F.2d 161 (10th Cir. 1992).

Cespedes is also notable because it decides, without discussion, an interesting issue of payment allocation. After determining that the early-IRA-withdrawal created a penalty, the debtor was left with both priority and nonpriority obligations on her return. She made three types of payments during the year, and, those payments were income tax withholding; (ii) telephone excise credit; and (iii) 2005 refund applied to 2006 balance due. These payments did not full pay the tax due. The taxpayer argued that all her payments should be applied to her tax, *i.e.*, priority claim, thereby leaving the nonpriority claim unpaid. The IRS argued that all of her payments should first be applied to the early-withdrawal penalty, leaving the priority claim unpaid.

Taxpayers are allowed to allocate voluntary payments as they so choose. *See*, *IRS v. Energy Resources Co. (In re Energy Resources Co.)*, 871 F.2d 223 (1st Cir. 1989), *aff'd on other grounds*, *United States v. Energy Resources Co. (In re Energy Resources Co.)*, 495 U.S. 545 (1990); and Rev. Proc. 2002-26, 2002-1 C.B. 746. If an allocation is not made, the IRS is allowed to allocate payments as it so chooses.

The court applied 100% of the income tax withholding to the tax. This seems reasonable, as the withholding is directly related to the tax due. As to the telephone excise credit and the

2005 income tax refund, the court sided neither with the taxpayer nor the IRS. Instead, it made a *pro rata* allocation between the priority and nonpriority claims.

In re Sexton, 397 B.R. 375 (Bankr. M.D. Tenn. 2008) and *In re Pruitt*, 2008 WL 2079145 (Bankr. M.D. Ala. 2008) confirmed that courts remain split on whether the Chapter 13 trustee must honor an IRS levy on funds in the trustee's possession when the Chapter 13 case has been dismissed. *Sexton* held for the debtor, relying on the literal language of 11 U.S.C. § 1326(e), which directs payment of funds on dismissal to the debtor. *Pruitt* held for the IRS, relying on the literal language of I.R.C. § 6334. Section 6334(a) does not list as exempt from levy property held by a Chapter 13 trustee, and, § 6334(c) specifically states that, "[n]otwithstanding any other law of the United States," the only property exempt from levy is property listed in § 6334(a). *Sexton* follows *In re Inyamah*, 378 B.R. 183 (Bankr. S.D. Ohio 2007). *Pruitt* follows *Beam v. IRS (In re Beam)*, 192 F.3d 941 (9th Cir. 1999).

<u>Setoffs</u>

In re Gould, 389 B.R. 105 (Bankr. N.D. Cal. 2008) provided a thoughtful analysis of when taxpayers might defeat the IRS's setoff rights in an accrued but unpaid tax refund for the tax year prior to the bankruptcy filing. *See also*, Bankruptcy and Workouts Developments Report 2007.

The basic fact pattern is the taxpayer files a tax return for year xxx7, which includes a claim for refund. In year xxx8, the taxpayer files for bankruptcy before the refund has been paid and claims the refund as exempt. The IRS claims a right under 11 U.S.C. § 553 to set off the unpaid refund against otherwise dischargeable taxes from earlier tax years, *e.g.*, year xxx1.[5]

Gould set forth three theories that courts have used in analyzing how to resolve the conflict between the debtor's exemption rights and the IRS's setoff rights. First, some courts have disallowed the setoff, holding that the taxpayer's exemption rights trump the IRS's setoff rights. *Gould*, 389 B.R. at 118-119. Second, some courts have allowed the setoff, holding that the plain language of § 553 stating "this title does not affect any right of a creditor to offset a mutual debt" means the IRS's exemption rights trump the taxpayer's exemption rights. *Gould*, 389 B.R. at 120-121.

Third, some courts hold that under I.R.C. § 6402(a) there can be no right to refund unless the overpayment exceeds a taxpayer's unpaid tax liabilities. *Gould*, 389 B.R. at 122-123, citing *IRS v. Luongo (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001). *Gould* then made an important temporal distinction as to the third theory, which distinction was not highlighted by the

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[5]It is clear that the IRS is allowed a setoff against nondischargeable taxes, as 11 U.S.C. § 522(c)(1) provides that a debtor's exempt property is liable to pay nondischargeable tax debt.

Fifth Circuit, nor has it been highlighted by other courts. It stated that the rule of "no refund" applies only if the IRS setoff occurs before the taxpayer makes the exemption claim. *Gould*, 389 B.R. at 123 ("unusual, but crucial, factual circumstance in *Luongo*"). In other words, "*Luongo* stands for the simple proposition that when a setoff occurs prior to the exemption, there is nothing left to exempt--not that the IRS has some superior right to exempt funds through netting under IRC § 6402." *Id*.

In refusing to apply a blanket *Luongo* rule,[6] the court also compared the holdings of the Seventh Circuit and Second Circuit in discussing this third theory. In *Pettibone Corp. v. United States*, 34 F.3d 536 (7th Cir. 1994), the Seventh Circuit suggested, without dealing with the conflict between the exemption rule and the setoff rule, that the netting of prepetition tax liabilities is not a setoff. In *Aetna Casualty and Surety Co. v. LTV Steel Co. (In re Chateaugay Corp.)* 94 F.3d 772 (2nd Cir. 1996), the Second Circuit stated unequivocally that the IRS is subject to the provisions of 11 U.S.C. §§ 362 (relief from stay) and 553 and found that the IRS netting is a setoff. The *Gould* court found *Chateaugay* better reasoned and more persuasive.

[6]*See e.g.*, *In re Shortt*, 277 B.R. 683, 692 (Bankr. N.D. Tex. 2002) (applying *Luongo*); and *In re Pigott*, 330 B.R. 797 (Bankr. S.D. Ala. 2005) (applying *Luongo*).

In *Gould*, the IRS failed to object to the taxpayer's claim for exemption within 30 days of the first meeting of creditors. *See*, Fed. R. Bank. P. 4003(b). As the Supreme Court has held that this 30-day rule must be strictly applied, *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), *Gould* denied the IRS motion for setoff.[7]

Refunds

In re Middendorf, 381 B.R. 774, (Bankr. D. Kan. 2008) followed the reasoning of *In re Donnell*, 357 B.R. 386 (Bankr. W.D. Tex. 2006) and refused to follow blindly the majority rule of *pro rating* tax refunds in the year of filing between the bankruptcy estate and the debtor. *See*, *Bankruptcy and Workouts Developments Report 2006.* In *Middendorf*, the debtor had wage withholding and also made a large prepetition tax payment. The Court *prorated* the wage withholding, but, it allocated the prepetition tax payment to the prepetition ledger. As a result, after the tax liability was paid and the postpetition wage withholding allocated to the debtor, the court found that $15,000 of the debtor's refund in the year of filing was bankruptcy estate property.

Weinman v. Graves (In re Graves), 396 B.R. 70 (10th Cir. B.A.P. 2008) took a different approach to the refund allocation issue. In *Graves*, the court decided whether the trustee had the

[7]As an additional basis for finding for the taxpayer, the court found that the equities of this particular case favored allowing the exemption. *Gould*, 389 B.R. at 127-130.

power to compel the debtor to turnover a prepetition tax payment under 11 U.S.C. § 542. The court found that the trustee did not have that power. For § 542 to apply, the property must be in the possession of the debtor. But, with prepetition tax payments, the property is in the possession of the IRS. To quote the court, "A trustee in bankruptcy can no more compel a debtor to turnover funds that he does not have than he can squeeze blood out of a turnip." *Graves*, 396 B.R. at 75. The court specifically stated that it was not deciding the bankruptcy estate's interest in the prepaid funds or whether the bankruptcy estate has a valid claim against the IRS for the return of the funds. *Id*. *Middendorf* did not address this issue. In *Middendorf*, the IRS had apparently agreed that it was subject to turnover, as it had submitted funds to the debtor's counsel's trust account. The only issue before the court was the debtor's objection to the trustee's settlement with the IRS.

<u>Statute of Limitation on Collection</u>

Staso, Jr. v. United States , 2008-1 U.S.T.C. ¶ 50,216 (D. Kan. 2008) did an excellent job exploring the interaction of offers in compromises with various tolling rules passed by Congress between 1998-2002. Section 3461 of the IRS Restructuring and Reform Act of 1998, P.L. 105-206, 112 Stat. 685 (1998) banned the *contractual* extension of the statute of limitation on collection, provided the extension was not connected to an installment agreement.[8] The rule applied to contractual extensions that pushed the original collection statute of limitation end date (CSED) beyond December 31, 2002, and limited the extension to December 31, 2002. Section 3462 of the same Act provided a *statutory* extension of the CSED for pending offers by adding § 6331(k) to the Tax Code. As amended, § 6331(k) tolls the collection statute while an offer is pending and extends the CSED by 30 days. This statutory extension was effective for offers pending on or after December 31, 1999. In December 2000, Congress amended § 6331 and deleted key language that tied § 6331(k) to § 6331(i), which created the tolling rule.[9] As a result, offers did not toll the statute of limitation from December 21, 2000 to March 8, 2002. *See*, IRM 5.8.10.7 (September 23, 2008) (pending date of 1/1/2000 or later, offer rejected and taxpayer does not appeal).[10] Thereafter, Congress corrected its mistake, and, it reinstated the tolling plus 30-day rule.

In *Staso, Jr.*, the taxpayer made an offer in 1999, which was rejected June 1, 2001. The taxpayer argued that at the time of

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[8]Section 3461 did not amend the Tax Code. Because it is not in the Tax Code, § 3461 is a forgotten provision. It is also of little use because most statute extensions in the applicable time period were connected to installment agreements, which extensions do not receive the benefit of § 3461.

[9]Section 6331(k) prevents levies while offers and installment agreements are pending. Section 6331(i) tolls the statute of limitation on collection when levies are not permitted.

[10]At the time the case was decided in March 2008, the rule was found at IRM 5.8.10.7.8 (September 1, 2005).

the CDP appeal in March 2004, the CSED had passed. The court first applied § 3461 to shorten the CSED to December 31, 2002. It then applied the rules extending the CSED for intervening offers. When the court finished all its calculations, which included accounting for three offers and four bankruptcies, it concluded that the statute had not run by March 2004 when the CDP appeal had been filed.

Determination of Tax Liability

Central Valley AG Enters. v. United States, 531 F.3d 750, 764-765 (9th Cir. 2008) confirmed the well-accepted bankruptcy rule that the bankruptcy court has the power to determine tax due even if the taxpayer declined or missed an opportunity to contest the tax. 11 U.S.C. § 505(a)(2)(A). The Ninth Circuit was asked whether the district court[11] had the authority to hear the debtor's objection to an IRS proof of claim. The debtor's liability arose from a final partnership administrative adjudication (FPAA) that it had not contested. The court rejected the IRS's argument that the debtor's right to contest the liability ended with the FPAA. *Central Valley* may seem more significant to partnership-tax attorneys, who are generally not as familiar with bankruptcy-tax rules. *Cf.*, G. Germain, "Ninth Circuit Allows Challenges to Partnership Allocations by Bankrupt

[11]The initial case was in district court and not bankruptcy court because, on the IRS's motion, the district court had withdrawn its reference to the bankruptcy court. *Central Valley*, 531 F.3d at 754.

Partners--Does This Open the Door to TEFRA Abuse?", Fall 2008 ABA Section of Taxation Newsquarterly 13-14 (it is debatable whether reviewing a FPAA in a partner's bankruptcy should be within a bankruptcy court's power).

The court also made clear that its power is discretionary. Section 505(a) uses the word "may", and, it is well-established that bankruptcy courts may abstain from hearing a case. *Cf.*, *Miller v. IRS (In re Miller)*, 300 B.R. 422, 431-434 (Bankr. N.D. Ohio 2003) (the bankruptcy court emphasized the prejudice to the debtors if it did not hear the case, stating that "[b]etter they should fly to the moon under their own power" than pay the tax and contest the liability in district court).

<u>Cancellation of Debt Income</u>

The taxpayers in *Payne, Jr. v. Comm'r*, 95 TCM 1253 (2008) argued unsuccessfully that a reduction in interest rate by a credit card company, which reduction resulted in a reduced credit card bill, should qualify as an exclusion of income under the cancellation of indebtedness income rules. The Tax Court found that the purchase price reduction exception of § 108(e)(5) did not apply because the credit card company was simply a creditor of the taxpayers and had not sold property to the taxpayers. The court also declined to exclude the income as a reduction in a disputed interest rate. The court found that the taxpayers' obligation was fixed and subsequently cancelled, thereby creating taxable debt relief income.

The taxpayer in *Jones v. Cendant Mortgage Corp. (In re Jones)*, 396 B.R. 638, 645-646 (Bankr. W.D. Pa. 2008) argued unsuccessfully that a Pennsylvania rule deeming debt paid in full after a debt is cancelled by a mortgage foreclosure means there is no cancellation of debt income. The court found that in applying federal tax law it is not bound by a legal fiction created under state law. This is another illustration of deemed versus defined, which is discussed above in *Imarah v. Comm'r*, 95 TCM 1541 (2008).

Stimulus Payments

In re Andrews, 386 B.R. 871 (Bankr. D. Utah 2008) held that the 2008 stimulus payment created by Congress in the Economic Stimulus Act of 2008, P.L. 110-185, 121 Stat. 613 at § 101 was not property of the bankruptcy estate because the debtor's bankruptcy case was filed before the enactment of the law creating the property right. The property right does not exist before the law is enacted. At most, there is an expectancy. This result is consistent with cases from prior years that also considered rights to benefits conferred on taxpayers by Congress. *See e.g.*, *Bracewell v. Kelley (In re Bracewell)*, 454 F.3d 1234 (11th Cir. 2006), *cert. denied*, 127 S.Ct. 1815 (2007) (crop loss entitlement not property of bankruptcy estate; at time of bankruptcy filing, only crop loss existed).

In re Woolridge 393 B.R. 721, 724-725 (Bankr. D. Idaho 2008) presented the fact pattern of a bankruptcy petition filing after enactment of the statute and before receipt of the check. As expected, the court found the stimulus check to be property of the bankruptcy estate.[12] In *Woolrdige*, the debtor also argued that the stimulus check was similar to a tax refund, and, it should be prorated in the year of receipt as a tax refund is. *See*, *Sticka v. Lambert (In re Lambert)*, 283 B.R. 16 (9th Cir. B.A.P. 2002) (prorating payment received in 2001 under The Economic Growth and Tax Relief Reconciliation Act of 2001). The court disagreed, because it did not believe the stimulus check was the equivalent of a tax refund. It reasoned that anyone with at least $3,000 of qualifying income was eligible for the stimulus check, even someone who did not owe any taxes. Also, in its explanation of the stimulus check, the IRS was clear that the check was not a refund. This is consistent with the law itself, which describes the payment as a refundable credit and not a refund. I.R.C. § 6428(a).

The debtor in *In re Thompson*, 396 B.R. 5, 12 (Bankr. N.D. Ind. 2008) argued unsuccessfully that the portion of the stimulus payment attributable to his children belonged to his children and should not be property of his bankruptcy estate. The court found that the stimulus payment was made to the taxpayer and not his children. Thus, the entire stimulus payment was property of the bankruptcy estate.

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[12] If the debtor received and legally spent the check before filing, the trustee has no actionable claim to the check.

Forecast

Almost all practitioners believe it is very difficult to get offers in compromise approved by the IRS. *Cf*., National Taxpayer Advocate, *2004 Annual Report to Congress* 311-341, National Taxpayer Advocate, *2007 Annual Report to Congress* 374-387 (most serious problem, offers in compromise), National Taxpayer Advocate, *2008 Annual Report to Congress* 16 (number of accepted offers declined by 72% from 2001 to 2008). With the current economic crisis and pressure on other institutions to provide debt relief, *e.g.*, mortgage lenders, query whether there will be pressure on the IRS in the coming year to make the offer environment more taxpayer-friendly. To date, the IRS announcements designed to help taxpayers under economic distress have not broken any new ground. *See*, IR News Release 2008-141 (December 16, 2008) (explaining IRS lien discharge and lien subordination procedures) and IR News Release 2009-2 (January 6, 2009) (announcing IRS measures to help distressed taxpayers).

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