BANKRUPTCY AND WORKOUTS

Submitted by the Committee on Bankruptcy and Workouts
George Nelson, Committee Chair;
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on Important Developments

Legislation

The American Recovery and Reinvestment Act of 2009 (ARRA), P.L. 111-5, 123 Stat. 115 at § 1231 added new I.R.C. § 108(i) to provide for the delayed amortization of cancellation of debt income over a five-year period, starting in tax year 2014 for cancellation of debt income incurred in 2009-2010, provided the income arises from the reacquisition of an applicable debt instrument. The election under § 108(i) is made in lieu of any other exclusion under § 108.

An applicable debt instrument is any bond, note, or other contractual arrangement constituting debt within the meaning of § 1275(a)(1) and issued by a "C corporation" or any other person in connection with the conduct of a trade or business. The reacquisition must be made by the issuing taxpayer or a related person. A reacquisition includes a cash repurchase, a debt for debt exchange, or the complete forgiveness of the debt by the holder.

The deferred income is recognized immediately if the taxpayer dies, is liquidated, or sells substantially all of the

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[1]Mr. Weil is the author of *Practical Guide to Resolving Your Client's Tax Liabilities*, (CCH 3rd ed 2010) (online edition forthcoming). Portions of this article are adapted from that online edition.

taxpayer's assets. This recognition rule also applies if there is a sale or exchange or redemption of an interest in a partnership, S corporation, or other pass thru entity. Curiously, this recognition appears to apply for any sale or exchange and not the sale or exchange of a majority interest.

Any deduction derived from original issue discount in the newly issued instrument must be delayed until the cancellation of debt income is recognized.

In Rev. Proc. 2009-37, 2009-2 C.B. 309, the IRS provided guidance. An election statement must be attached to the tax return of the applicable year. *Id.* at § 4.01(1)(a). The election statement asks for great detail about the reacquisition transaction, *e.g.*, a general description of the reacquisition transaction, amount of cancellation of debt income, the amount of cancellation of debt income being deferred, and, in the case of partnerships and S-corporations, the identifying numbers and names of each partner and shareholder and each one's deferred amount. *Id.*at § 4.05. Detailed annual statements are required for each year of deferral thereafter. *Id.* at § 5. The Revenue Procedure extends the time for making the election by 12 months from the due date of the return. *Id.* at § 4.01(2). A protective election may be made by an entity that does not think it has cancellation of debt income, in the event it is determined otherwise at a later date. *Id.* at § 4.11.

ARRA § 1211 amends the net operating loss carry back rules of § 172 to allow an eligible business in the tax year 2008 only, whether the tax year begins or ends in 2008, to elect a three, four, or five-year carry back. An eligible business is a corporation, partnership, or sole proprietorship with average gross receipts over a three-year period of $15 million or less.

In Rev. Proc. 2009-26, 2009-1 C.B. 935, the IRS provided guidance. Among other items, the IRS requires the taxpayer to file either an appropriate carryback form (1139 for corporations or 1045 for individuals) or an amended return for the earliest year for which the carryback is being claimed. *Id.* at § 4.01(3)(a). The taxpayer is required to file the appropriate form "on or before the later of the date that is 6 months after the due date (excluding extensions) for filing the taxpayer's return for the taxable year of the applicable 2008 NOL or April 17, 2009." *Id.* at § 4.01(3)(b).

The Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA), P.L. 111-92, 123 Stat. 2984 at § 13 expanded the amendment of § 172 by ARRA § 1211 to include all businesses and to encompass both the 2008 and 2009 tax years, except that the election can only be made for one of the two years and not both. TARP (Troubled Asset Relief Program) recipients are not eligible for the election.

In Rev. Proc. 2009-52, 2009-2 C.B. 744, the IRS provided guidance. If the return had already been filed without the

election, the procedure explains that an amended return should be filed that makes the election. *Id.* at § 4.01(3)(a). If the return had already been filed with an election, whether backwards or forwards, an amended return is filed. *Id.* at § 4.02. In either situation, the notice of election "must state that the taxpayer is electing to apply § 172(b)(1)(H) or § 810(b)(4) under Rev. Proc. 2009-52, and that the taxpayer is not a TARP recipient nor, in 2008 or 2009, an affiliate of a TARP recipient." *Id.* at § 4.01(4)(a). The statement must also state the length of the carryback period elected. *Id.*

Regulations

In Treas. Reg. § 301.6159-1, the IRS finalized regulations for installment agreements. In general, the regulations restate the statutory changes made to the installment agreement rules over the last thirteen years. For example, Treas. Reg. § 301.6159-1(c)(1)(iii) discusses the procedures for guaranteed installment agreements, which agreements were first added to the Tax Code in 1998. The regulations also clarify what was already accepted practice. For example, installment agreements are pending when accepted for processing by the IRS. Treas. Reg. § 301.6159-1(b)(2). The IRS can request financial updates from the taxpayer at any time. Treas. Reg. § 301.6159-1(c)(3)(v). All installment agreement payments will be applied by the government in its best interest. Treas. Reg. § 301.6159-1(c)(3)(iv).

Cases and Rulings

Dischargeability

From a taxpayer's perspective, *McCoy v. Miss. Tax Comm'n (In re McCoy*), 2009 W.L. 2835258 (Bankr. S.D. Miss. 2009), *Creekmore v. IRS (In re Creekmore)*, 401 B.R. 748 (Bankr. N.D. Miss. 2008),[2] and *Links v. United States (In re Links)*, 2009 W.L. 2966162 (Bankr. N.D. Ohio 2009) take a rigid view as to what constitutes a valid return for purposes of determining dischargeability of tax debts. BAPCPA added flush language at the end of § 523(a) that defines a valid return. The new definition requires the return to satisfy "the requirements of applicable nonbankruptcy law (including applicable filing requirements)." These courts believe that a late-filed return fails to meet the applicable filing requirement and is not a valid return, and, the tax debt is nondischargeable.

While these rulings may literally be correct, the holding does not make sense. The holding means that a person taking advantage of the military/disaster rule, which holds that late-filed returns for overseas military and disaster victims are not timely filed but eligible for penalty waiver, could never qualify for a discharge. Rev. Rul. 2007-59, 2007-2 C.B. 582; and *see*, Bankruptcy and Workouts Developments Report 2007. It is hard to imagine that a national rule will be adopted that makes the

[2]While *Creekmore* is a 2008 case, it was not published until the Spring of 2009, and, it was not included in the Bankruptcy and Workouts Developments Report 2008.

taxes of soldiers and disaster victims always nondischargeable. The rule is also puzzling in that it almost writes the two-year rule out of the Code. The flush language at the end of § 523(a) does allow for returns prepared by the IRS under I.R.C. § 6020(a) or a written stipulation to a judgment entered by a nonbankruptcy tribunal. Theoretically, that would be the only place left where the two-year rule would apply.

In the author's opinion the parenthetical phrase "including applicable filing requirements" was meant to reinforce the BAPCPA-added requirement in § 523(a)(1)(B) that notice or an equivalent report be filed or given to the applicable state agency for a state tax debt to be dischargeable.[3] That provision overruled *Cal. Franchise Tax Bd. v. Jackson (In re Jackson)*, 184 F.3d 1046 (9th Cir. 1999). That case had held that the report of a change on the federal return that was due to the state taxing authority was not the equivalent of a return, and, the failure to make this report to the state did not prevent the tax from being discharged. The other BAPCPA changes in the flush paragraph also dealt with the pressing issues of the day.[4]

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[3]It may also have been meant to reinforce the nondischargeability of SFR returns.

[4]Cases of the day included the following: *Carapella v. United States (In re Carapella)*, 84 B.R. 779 (Bankr. M.D. Fla. 1988) (Form 870 valid return); *Berard v. United States (In re Berard)*, 181 B.R. 653 (Bankr. M.D. Fla. 1995) (Form 4549 valid return); and *Lowrie v. United States (In re Lowrie)*, 162 B.R. 864 (Bankr. D. Nev. 1994) (Form 1902-B valid return); *Gushue v. IRS (In re Gushue)*, 126 B.R. 202 (Bankr. E.D. Pa. 1991) (Tax Court settlement not equivalent of filed return); *Schmitt v. United*

Maryland v. Ciotti, 2009 W.L. 4884022 (D. Md. 2009) illustrates the effectiveness of this equivalent-report language. The debtor's failure to report an audit change to the state taxing authority resulted in the state tax debt being nondischargeable. *See also*, Bankruptcy and Workouts Developments Report 2007.

Depasture v. United States (In re Depasture), 419 B.R. 518 (Bankr. M.D. Ga. 2009) found the applicable income tax nondischargeable under the 240-day rule of § 507(a)(8)(A)(ii), as the taxpayer filed for bankruptcy only two months after the assessment.

Depasture is of greater interest because it illustrates tacking. The tax years at issue were 1994 and 1995. By execution of the Form 872, the taxpayer extended the three-year assessment period to December 31, 1999. On October 19, 1999, which was 73 days prior to the assessment-statute-end-date, the IRS issued a notice of deficiency. The taxpayer challenged the notice of deficiency in Tax Court. The Tax Court entered its decision for

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States (In re Schmitt), 140 B.R. 571 (Bankr. W.D. Okla. 1992) (because taxpayer failed to sign jurat, Tax Court settlement not equivalent of filed return); *United States v. Ashe (In re Ashe)*, 228 B.R. 457 (C.D. Cal. 1998) (taxpayer provided information to IRS on schedule--but did not file a Form 1040--that enabled IRS to calculate tax due and enter stipulation signed by taxpayer in Tax Court; held, tax dischargeable); and *Elmore v. United States (In re Elmore)*, 165 B.R. 35 (Bankr. S.D. Ind. 1994) (taxpayer attached tax returns to Tax Court petition and taxpayer and IRS reached agreed settlement; held, taxpayer filed returns for purposes of 11 U.S.C. § 523(a)(1)(B)(i)); *Bergstrom v. United States (In re Bergstrom)*, 949 F.2d 341 (10th Cir. 1991) (IRS substitute-for-return not a valid return).

the IRS on July 1, 2003. Under applicable rules, the IRS receives an additional 60 days to assess upon issuance of the notice of deficiency and an additional 90 days to assess upon entry of the Tax Court decision. This left the IRS with 223 days to assess (90 + 60 + 73), or, until February 9, 2004. As the IRS assessed January 16, 2004, the assessment was timely.

Liens

United States v. Buenting (In re Crystal Cascades Civil, LLC), 415 B.R. 403 (9th Cir. B.A.P. 2009) affirmed *Buenting v. Crystal Cascades Civil, LLC (In re Crystal Cascades Civil, LLC)*, 398 B.R. 23 (Bankr. D. Nev. 2008), which was discussed in Bankruptcy and Workouts Developments Report 2008. The BAP agreed with the bankruptcy court that the test for determining whether a notice of federal tax lien (NFTL) properly identifies the debtor should be based on an inspection by an ordinary prudent person and the standard will vary by locality.

Estate of Brandon v. Comm'r, 133 T.C. No. 4 (2009) found that a NFTL filed in the name of a decedent, as opposed to his estate, was a valid lien. Prior to the taxpayer's death, the IRS assessed a § 6672 trust fund penalty against the taxpayer. Under operation of law, the IRS's secret lien attached to all his property. At death, all the decedent's property with the secret lien attached, passed to the decedent's estate. Thereafter, the IRS filed its NFTL in the taxpayer's name. As the secret lien was valid and as Mr. Brandon's property passed to his estate with the

secret lien attached and as the lien identified the person against whom the tax was assessed, the Tax Court validated the NFTL. Other than stating that the NFTL named the taxpayer against whom the tax was assessed, the Tax Court did not delve into the issue of whether the NFTL properly identified the taxpayer.[5] What the Tax Court misses is that the controlling issue is not whether the lien identifies the taxpayer who was liable when the tax was assessed but whether a search of the applicable taxpayer, *i.e., the estate,* would direct a searcher to the NFTL. *See*, *Davis v. United States*, 89-2 USTC ¶ 9592 (C.D. Ill. 1989) (notice of lien filed in a remarried taxpayer's previous name does not provide notice). And, under the facts of *Brandon*, that appears to be an open question.

Prince v. Comm'r, 133 T.C. No. 12 (2009) is a Tax Court regular decision that reaffirms the well-established rule that a bankruptcy discharge does not discharge *in rem* obligations, *e.g.*, the IRS lien that is attached to the taxpayer's assets. The mystery in *Prince* is why the Tax Court felt it needed a regular decision.

United States v. Houghton, Jr. (In re Szwyd), 408 B.R. 547, 550 (D. Mass. 2009) applied the doctrine of marshaling against the IRS. Marshaling is an equitable doctrine that applies when a senior lienor has two funds from which a claim can be satisfied

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[5]The Tax Court did recognize that there was no controlling statute or regulation dealing with NFTLs and deceased taxpayers.

and a junior lienor has only one. *Id.* at 550. Marshaling requires the senior lienor to satisfy its claim out of the fund that the junior lienor has no claim to so that the recovery for creditors can be maximized. In *Szwyd*, the government argued that marshaling should not apply to it. The court asked why the government was being so petty, *id*. at 553, when it was clear that its claim could be fully satisfied out of exempt funds that the other creditors of the bankruptcy estate could not reach. If the government's position had been adopted, there would have been very little left for the unsecured creditors, though the debtor would have retained the exempt property. The government complained that the court's holding would result in an unspecified, dreadful consequence. *Id.* The court's response is worth quoting in full:

> Counsel merely reiterated the principle that the bankruptcy court in this context lacked the power to order the government to be sensible and humane, and, if a precedent were established recognizing this power, unspecified but dreadful consequences might result. It appears counsel forgot that sometimes the best way to avoid an unhelpful precedent is to exercise common sense.

Id.

In re Boyd, Jr., 414 B.R. 223 (Bankr. N.D. Ohio 2009) examined when payments on tax liens could be counted as part of the projected disposable income computations of Chapter 13. Payments on "contractually due" debt can be deducted. 11 U.S.C. §§ 1325(b)(2) and 707(b)(2)(A)(iii)(I). But, tax debt is due by statute and not by contract, and, it is not an allowable expense

under this provision. Section 707(B)(2)(A)(iii)(II) does allow payments to secured creditors to be counted if the payment allows the debtor to maintain possession of property necessary for the support of the debtor. The trustee in *Boyd* did concede an allowable deduction under this provision, but, it was much less than the amount sought by the debtor.

Claims

Warren v. Comm'r, 97 T.C.M. 1835 (2009) provided no help[6] in enlightening tax practitioners on when *res judicata* applies subsequent to a bankruptcy case and when it does not. *Compare*, *EDP Med. Computer Sys., Inc. v. United States* 480 F.3d 621 (2nd Cir. 2007) and *Siegel v. Fed. Home Loan Mortgage Corp.*, 143 F.3d 525 (9th Cir. 1998), which both gave preclusive effect to an order in a bankruptcy case allowing the IRS's claim, *with*, *Hambrick v. Comm'r*, 118 T.C. 348 (2002), which allowed the IRS to assert additional amounts for a tax year that was not discharged by taxpayer's Chapter 11 plan. *See also*, Bankruptcy and Workouts Developments Report 2006 and 2007. A review of Mr. Warren's case docket revealed that a claim order was never entered, so the Tax Court was correct in not applying *res judicata*. *In re Warren*, Bankr. M.D. Fla. No. 05-00229 (9/26/09 docket review).

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[6]In fairness, the court did say that "[I]f a bankruptcy court does not render a final judgment as to the tax liability, res judicata is inapplicable...." *Id.* at ___.

In re Collier, 416 B.R. 713 (Bankr. N.D. Cal. 2008)[7] examined California's redemption penalties for delinquent real property tax payments. The redemption penalty is an 18% per annum add-on that is assessed when the property owner fails to pay real property taxes when due. The California statute also provides that in an administrative hearing or bankruptcy proceeding, the redemption penalty constitutes the assessment of interest.

Under 11 U.S.C. § 511, interest on taxes is paid at the applicable nonbankruptcy rate. The court found that the purpose of § 511 was to permit states to impose the same interest rate on bankruptcy and nonbankruptcy debtors. The court found that California's rule did just the opposite, as it created a distinction between bankruptcy and nonbankruptcy debtors. The court found that the rule deeming the penalty to be interest was preempted by the Supremacy Clause of the United States Constitution, and, the court did not treat the penalty as interest.

The court also declined to include the penalty as part of the county's secured claim. It cited California case law and found that redemption penalties are not part of the tax obligation. The court concluded that the redemption penalties were general, unsecured claims.

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[7] *Collier* was not published until the final quarter of 2009.

Refunds

Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am. (In re TOUSA, Inc.), 406 B.R. 421 (Bankr. S.D. Fla. 2009) illustrated the continuing diversity of rulings regarding how refunds are considered to accrue, *i.e.* at the end of the year when the tax year concludes or throughout the year. See, Bankruptcy and Workouts Developments Report 2006 and 2008. In TOUSA, a security interest was created in the debtor's tax refund. The issue was whether, for preference purposes, the refund accrued throughout the year or only on January 1 of the following year. The court found that the refund did not exist until the end of the tax year. Since the security interest could not attach until the refund existed and the first of the following year was within 90 days of the bankruptcy filing, the attachment of the security interest to the refund was subject to preference attack.

In re Lee, 415 B.R. 518 (Bankr. D. Kan. 2009) (opinion designated for electronic use but not print publication) also took a stab at dealing with the different elements of a tax refund and deciding which portions were attributable to prepetition earnings and part of the bankruptcy estate and which portions were attributable to postpetition earnings and not part of the bankruptcy estate. The court discussed the additional child tax credit, the Kansas food tax credit, the earned income credit, and the rebate recovery payment.

Additional child tax credit. The debtor's additional child tax credit turned out to be 15% of her income in excess of $8,500. The court divided the credit between the debtor and the bankruptcy estate based on income earned pre and postpetition, which was approximately 20% prepetition and 80% postpetition. The court rejected the debtor's argument that the additional child tax credit was entitled to exemption under 11 U.S.C. § 522(d)(10)(A) as a public assistance benefit. Because the credit was granted by the federal government, the court could not see clear to find that the additional child tax credit was a public assistance benefit, which by law, is limited to a "local" benefit.

Kansas food tax credit. The court found that the Kansas food tax credit was entitled to exemption under 11 U.S.C. § 522(d)(10)(A), as a public assistance benefit. Because it was exempted from the bankruptcy estate, the court did not have to deal with *pro rating* the exemption.

Earned income credit. The court's division of the federal earned income credit (EIC) between the debtor and the bankruptcy estate is very difficult to follow. The court reasoned that the amount of the EIC is dependent on debtor's income. It found that, based on the debtor's prepetition income alone, the debtor would have qualified for a $1,330 federal EIC. Based on the debtor's postpetition income alone, the debtor would have qualified for the maximum benefit of $4,824 for the federal EIC. Because the

federal EIC for the year ($4,648) was less than the maximum amount, the court decided to do an allocation. It allocated 27.57% of the total allowed of $4,648, because $1,330 was 27.57% of the maximum allowed, to the prepetition amount. As to the Kansas, EIC, it used the same allocation method. A simpler, more reasonable allocation would have been to use the ratio of prepetition income to total income, which would have allocated approximately 20% of the federal EIC allowed to the prepetition amount. The court rejected this method because the EIC fluctuates depending on income amount.[8] The debtor did not claim an exemption in the prepetition portion of the EIC. The Kansas earned income credit is 17% of the federal amount so the court allocated it in the same manner as the federal EIC.

Stimulus payment/recovery rebate. The debtor had insufficient income in 2007 to qualify for payment of the stimulus check payment in early 2008. Instead, she qualified for the recovery rebate credit. The court did not follow the stimulus payment cases and hold that the recovery rebate credit was earned 100% prepetition. *See*, Bankruptcy and Workouts Developments Report 2008, and *In re Schwinn*, 400 B.R. 295, 303 (Bankr. D. Kan. 2009). Instead, the court prorated the recovery rebate credit between pre and postpetition amounts based on days of the year

[8]For this debtor, the EIC maxed out at $4,860 for income between approximately $12,050 and $15,750. For income larger than $15,570, as this debtor had, the EIC started to decrease ($176 in this case).

pre and postpetition, which in this case was 121/366 for prepetition.

In re Laroche, 409 B.R. 862 (Bankr. E.D. Mich. 2009) struggled with the failure to disclose a potential tax refund on bankruptcy schedules when the refund comes as a complete surprise to the taxpayer. Mr. Laroche had not been employed for much of 2008, and, nothing was withheld from the income he did receive. *Id*. at 865. The debtors had no knowledge of the refund when their 341 meeting was held in December 2008. The debtors first learned of the refund in February 2009, but, the debtors did not immediately contact the trustee nor amend their schedules. The refund was sent to the trustee by the IRS in late March 2009, and, the debtors amended their exemptions on April 1. Although the debtors behavior was not exemplary, *e.g.*, the debtors did not notify the trustee in February when it became apparent that a refund would be available, the court allowed the debtors to amend their exemptions and retain their refund. The case is worthy of mention because of the admonition given by the Court to practitioners:

> [T]he Court has noted in other cases such as this one, that attorneys for debtors were not aware that tax refunds were and are property of the estate. Hopefully, cases such as this one and other related cases, send a clear message to practitioners that tax refunds must be disclosed on Schedule B, even if the amount is an estimate based upon prior years experiences.

Id. The Court suggested that debtors estimate the potential tax refund, and, once the actual amount is learned, amend the

schedules within 14 days. It was the hope of the Court to "end the chess match that is played between debtors and debtors' counsel on one side and the trustee and trustee's counsel on the other." *Id.* at 866.

In re Garbett, 410 B.R. 280 (Bankr. E.D. Tenn. 2009) dealt with the allocation of exemptions in tax refunds between spouses who filed for bankruptcy. *See*, Bankruptcy and Workouts Developments Report 2005. One spouse had limited income; the other spouse paid all the tax withholding that generated the refund. The court held that in Tennessee there is a presumption of ownership of marital property as entireties property. The court found that the trustee did not rebut that presumption and divided the refund 50/50 between the spouses thereby rejecting the argument that the refund should be allocated based on the withholding percentage of each spouse.

In re Spina, 416 B.R. 92 (Bankr. E.D.N.Y. 2009) also dealt with the allocation of exemptions in tax refunds between spouses who filed for bankruptcy. Like the Tennessee court, the New York court adopted a rebuttable presumption that the refund is allocated 50/50.

Setoffs

United States v. Gould (In re Gould), 401 B.R. 415, 428 (9th Cir. B.A.P. 2009) held that the setoff rule of § 553 trumps the exemption rule of § 522(c). In so holding, it reversed *In re*

Gould, 389 B.R. 105 (Bankr. N.D. Cal. 2008), which was discussed in the Bankruptcy and Workouts Developments Report 2008.

The basic fact pattern is the taxpayer files a tax return for year xxx8, which includes a claim for refund. In year xxx9, 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.[9]

The bankruptcy court in *Gould* set forth the 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 ("this title does not affect any right of a creditor to offset a mutual debt") means the IRS's setoff 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).

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[9]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.

The Ninth Circuit Bankruptcy Appellate Panel adopted the second theory. It held that under its previous precedent and established rules of statutory construction[10] that § 553(b) trumped § 522(c).

In re Flying J, Inc., 2009 W.L. 5215000 (Bankr. D. Del. 2009) revisited the issue of whether the IRS can setoff tax refunds generated by net operating losses (NOLs) in the year of filing that are carried back to prepetition years. If the setoff is allowed, the refund is applied against prepetition tax debt and not retained by the bankruptcy estate. See the discussion of *United States v. Carey (In re Wade Cook Fin. Corp.)*, 375 B.R. 580 (9th Cir. B.A.P. 2007) in Bankruptcy and Workouts Developments Report 2007. Setoffs are allowed only if the claim and debt are mutual obligations, *i.e.*, both prepetition obligations. When the petition is filed during the year, is the loss from that year prepetition or postpetition? The Delaware court relied on the seminal case of *Segal v. Rochelle*, 382 U.S. 375 (1966) to answer prepetition. Segal "held that a claim for an NOL carryback tax refund was property of the estate because it was 'sufficiently rooted in the pre-bankruptcy past.'" The *Flying J* court found that the NOL was to be applied solely to prepetition tax years. Therefore, the refund claim was sufficiently rooted in the

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[10]Where there is an irreconcilable conflict between different parts of the same act, the last in order of arrangement will control. *United States v. Gould (In re Gould)*, 401 B.R. 415, 427 (9th Cir. B.A.P. 2009).

prebankruptcy past so that the refund claim was estate property, *i.e.*, a prepetition asset. As mutuality of obligation existed, the IRS setoff was allowed.

As in *Wade Cook*, 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) (same). Under the rationale in *Wade Cook* and *Flying J*, it appears the refund, for purposes of the improvement-in-position test, should be *pro rated* in the year of filing.

Chapter 11

In re New 118th Inc., 398 B.R. 791 (Bankr. S.D.N.Y. 2009) explored the limits of *Fla. Dep't of Rev. v. Piccadilly Cafeterias, Inc.*, 554 U.S. ___ (2008), which was discussed in Bankruptcy and Workouts Developments Report 2008. Piccadilly stands for the proposition that the stamp tax exemption of § 1146(a) only applies to transfers under a confirmed Chapter 11 plan. In *New 118th*, the sale was agreed to prior to plan confirmation, but, closing was delayed until after confirmation. The court found that the debtors qualified for the stamp tax exemption. The court also found that the exemption applies in liquidating Chapter 11 plans.

The debtor in *Johnston, III v. United States (In re Johnston, III)*, 2009 W.L. 2365184 (Bankr. D. Ariz. 2009) successfully avoided the payment of gap interest, which is the interest due on nondischargeable tax debt that accrues between the date the bankruptcy petition is filed and the Chapter 11 plan is confirmed. The general rule is that gap interest is nondischargeable. *Ward v. Bd. of Equalization of Cal. (In re Artisan Woodworkers)*, 204 F.3d 888 (9th Cir. 2000) (debtor individually liable for postpetition gap interest not provided for in plan). In *Johnston, III*, the debtor properly disclosed in the Chapter 11 plan that gap interest would not be paid. The IRS's rights were impaired under the plan, but, the IRS failed to object to the plan. *See*, 11 U.S.C. § 1124 (definition of impaired claims). The court held that the plan controlled, and, the gap interest was discharged.

Chapter 12

In *Knudsen v. IRS*, 581 F.3d 696 (8th Cir. 2009), the IRS lost another case in its battle with debtors over whether the tax due on the postpetition sale of "farm assets" "used in" the debtor's "farming operation" can 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 2006-2008*. Section § 1222(a)(2)(A) characterizes the § 507-priority tax incurred on the sale of a farm assets used in the farming operation 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 that there is not a separate taxable estate created by a Chapter 12 filing and there cannot be 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. One new twist was the court's reasoning that the no-separate-taxable-estate rule is found in the Tax Code and not the Bankruptcy Code. *A priori*, this is important, as the court is interpreting the Bankruptcy Code and not the Tax Code.

Knudsen addressed the issue of what assets qualified as used in farming operations. The court parsed the statute and analyzed separately the meaning of "farm assets," "used in," and "debtor's farming operation." The court adopted a very broad definition of "used in" such that all assets used in the business, including inventory, can qualify for the special priority stripping treatment. In addition, in Note 3, the court rejected the lower court's requirement that the sale had to occur as part of a plan of reorganization. The dissent would have limited the benefit of § 1222(a)(2)(A) to the sale of capital assets and not included the sale of inventory.

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. The court called this the marginal method.

United States v. Nazar (In re Dawes), 415 B.R. 815 (D. Kan. 2009) affirmed *In re Dawes*, 382 B.R. 509 (Bankr. D. Kan. 2008), which was discussed in Bankruptcy and Workouts Developments Report 2008. The court rejected the IRS argument that the special nonpriority tax treatment could not apply to postpetition transactions.

Chapter 13

United States v. Cushing (In re Cushing) 401 B.R. 528 (1st Cir. B.A.P. 2009) reversed *In re Cushing*, 383 B.R. 16 (Bankr. D. Mass. 2008), *granting in part motion to alter or amend*, 379 B.R. 407 (Bankr. D. Mass. 2007) and dismissed a Chapter 13 case where the tax return was filed after the deemed conclusion of the 341 meeting.[11] *Cushing* dealt with the BAPCPA-added requirement of filing tax returns before a Chapter 13 plan can be confirmed, which sets the due date as the day before the 341 meeting. 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

[11]The 2007 *Cushing* case was discussed in Bankruptcy and Workouts Developments Report 2007, and, the 2008 *Cushing* case was discussed in Bankruptcy and Workouts Developments Report 2008.

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*, the Court found that holding open a 341 meeting requires some formal procedure. *Cushing* at 534 and 538. As the trustee made no formal statement at the 341 meeting, the Court found the 341 meeting had been concluded, and, it dismissed the debtor's case.

Cal. Franchise Tax Bd. v. Jones (In re Jones), 420 B.R. 506 (9th Cir. B.A.P. 2009) explores the interaction of §§ 507(a)(8), 1306 and 1327, which interaction was also discussed in Bankruptcy and Workouts Developments Report 2006. Under § 1306, property of the bankruptcy estate includes property and earnings obtained postpetition. Under § 1327(b), upon Chapter 13 plan confirmation, all property of the bankruptcy estate is vested in the debtor. Section 507(a)(8), flush language, tolls applicable bankruptcy time periods for any time that the government is prohibited from collection because of the existence of a confirmed plan. Which section controls, § 1306, so that there is no property to collect and tolling occurs, or, § 1327 so that there is property of the debtor outside the bankruptcy estate and there is no tolling? *Jones* did a good job of outlining the four approaches courts have used.

Estate preservation approach. Under this approach all property remains part of the bankruptcy estate. The theory is that the estate property vests in the debtor as property

of the bankruptcy estate.[12] If all property is part of the bankruptcy estate, then, the tolling rules of § 507(a)(8) apply, as there is no property available for the IRS to attach.[13] This means the three-year time period does not run for any postpetition taxes. This was the approach taken in *In re Brensing*.

Modified estate preservation approach. Under this approach, existing property vests in the debtor; after-acquired property remains in the bankruptcy estate.[14] Tolling would depend on whether there is any existing property that remains with the debtor.

Estate transformation approach. Under this approach, only property needed to fund the debtor's plan is estate property; any remaining property is the debtor's. Tolling would depend on whether there is property that is not needed to fund the plan. This approach is somewhat puzzling. Presumably, the debtor's exempt property will be considered necessary for the plan, as the debtor needs a place to live.

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[12]*In re Brensing*, 337 B.R. 376, 386 (Bankr. D. Kan. 2006). *Brensing* was discussed in Bankruptcy and Workouts Developments Report 2006.

[13]Is this really true? What about the debtor's exempt property. It can still be attached. Neither *Brensing* nor *Jones* discuss this issue.

[14]*United States v. Harcher*, 371 B.R. 254, 268 (N.D. Ohio 2007) (property acquired after confirmation is property of the estate).

Yet, exempt property is automatically not property of the estate. How is the debtor's exempt property classified? Estate termination approach. Under this approach, all property vests in the debtor. The theory is that the more specific statute § 1327 controls. Since property vests in the debtor, the IRS is free to collect, and, there is no tolling of the three-year period. This is the approach adopted by *Jones*. Note, if the debtor provides in the plan that all property remains in the bankruptcy estate, the plan would override the statute.

Cancellation of debt income

Higgins v. United States (In re Higgins), 403 B.R. 537 (E.D. Tenn. 2009) rejected the taxpayers' argument that they did not have cancellation of debt income. The debt had been discharged in Georgia's form of a nonjudicial foreclosure. The IRS's rule on sale of property by foreclosure is that the taxpayer has gain on sale with the amount realized equal to the fair market value of the property at the time of foreclosure. To the extent the applicable debt is larger than the fair market value of the property, the taxpayer has discharge of debt income. *See,* Treas. Reg. § 1.1001-2(c), Ex. 8 and Rev. Rul. 90-16, 1990-1 C.B. 12. Although not cited in the case, it is this rule that the taxpayers challenged unsuccessfully.

In *Bononi v. Bayer Employees Fed. Credit Union*, 407 B.R. 684 (Bankr. W.D. Pa. 2009), the debtor argued that the issuance of

the cancellation of debt income forms meant that the creditor did not have a claim in the Chapter 7 bankruptcy. The court disagreed, writing that the issuance of the Form 1099 did not alter the creditor's legal right to attempt to collect the debt and it did not act as an admission that the debt was no longer due. *Id.* at 688-689. *Bononi* did order the creditor to amend the Forms 1099 issued to the debtor, which was proper, as the creditor received a distribution from the Chapter 7 bankruptcy estate.

McCormick v. Comm'r, 98 T.C.M. 375 (2009) serves as a reminder that cancellation of debt income is not recognized if there is a dispute regarding the debt "cancelled." In *McCormick*, the taxpayer successfully challenged the amounts due under a loan and a credit card. The banks issued Forms 1009 for the amounts that they could not collect. Because of the *bona fide* dispute, the taxpayer successfully defeated the IRS's challenge that there was cancellation of debt income.

Levies

In Chief Counsel Advice 200927019, the Service made clear its position that it can levy a taxpayer's § 223 Health Savings Account (HSA). An HSA is a property right held by the taxpayer, and, there is no exemption from levy provided for in § 6334. Funds withdrawn because of the levy are not withdrawn for the payment of a medical expense. That makes these funds subject to

tax and the 10% penalty, unless the taxpayer qualifies for a waiver of the 10% penalty, *e.g.*, taxpayer age 65 or older.

Net Operating Losses

In *Ron Lykins, Inc. v. Comm'r*, 133 T.C. No. 5 (2009), the Tax Court explored the interaction of net operating losses, *res judicata*, and collection due process appeals.

The taxpayer in *Ron Lykins* had, in a previous Tax Court proceeding, battled with the IRS over its tax liability for 1999 and 2000. Contemporaneously, but separate and apart from the Tax Court proceeding, the taxpayer received a refund of its 1999 and 2000 taxes based on a loss incurred in 2001. The taxpayer assumed incorrectly, at least in the Tax Court's opinion, that the previous Tax Court proceeding was *res judicata* as to any right of the IRS to contest the nol carryback. But, the nol carryback had not been part of the first Tax Court proceeding. The taxpayer had actually deleted the issue from its Tax Court pleadings.

After the conclusion of the previous trial but a year before the Tax Court ruled, the IRS summarily assessed a liability for 1999 and 2000 based on a disallowance of the nol carryback generated in 2001, demanded repayment of the refunds, and issued a notice of intent to levy when the refunds were not forthcoming. The taxpayer protested through a CDP hearing, which disallowed the protest because the taxpayer had a prior opportunity to protest the denial of the refund in the previous Tax Court proceeding. The Tax Court found that the IRS was not barred by

res judicata from summarily assessing the tax liability. This part of the holding was based on the IRS's inherent right to open closed years when deciding whether to issue refunds generated by carrybacks. *A priori*, the taxpayer had not had a prior opportunity to litigate the issue. But, the taxpayer did not raise in its appeal to the Tax Court the issue of whether it should have been allowed to contest the underlying liability at the CDP hearing. Having failed to raise the key issue at the CDP hearing, the Tax Court did not allow this issue to be raised for the first time before it. As a result, the Tax Court found that the IRS had not abused its discretion in upholding at the CDP hearing the summary assessment. Thus, the taxpayer was left to pay the tax and sue for refund.

Like-kind exchanges

In three separate letters to Congressmen, INFO-2009-0063, INFO-2009-0066, and INFO-2009-0106, the IRS stated its position that the bankruptcy of a qualified intermediary (QI) holding funds for the completion of a § 1031 like-kind exchange, which bankruptcy prevents the QI from completing the § 1031 transaction, will result in the recognition of gain to the seller. INFO-2009-0063 and INFO-2009-0066 acknowledge that there may be losses available from the nonpayment, and, those letters state that the IRS was considering some type of unspecified relief for taxpayers in this situation. INFO-2009-0106 states the IRS's understanding that there is a bill pending in the House of

Representatives to suspend the 180-day period to complete the like-kind exchange in the case of the bankruptcy of the QI. INFO-2009-0106 also states that the IRS is "independently coordinating with the Office of Tax Policy at the Treasury Department to determine whether" relief can be provided through published guidance or other administrative means. INFO-2009-0106 inherently recognizes that the bankruptcy of the QI does not mean that the funds will not be returned. For example, if the funds were held in a separate bank account, then, the funds could be considered the seller's funds held in trust, either by express or constructive trust, and not the funds of the bankruptcy estate. *See e.g.*, *Conn. Gen. Life Ins. Co. v. Universal Ins. Co.*, 838 F.2d 612, 618 (1st Cir. 1988).

Collection Statute End Date

Severo v. Comm'r, 586 F.3d 1213 (9th Cir. 2009) falls into the "what was the taxpayer thinking" department. The debtor's 1990 tax was assessed on November 18, 1991. Thereafter, the debtor spent three years, five months, and twenty days in bankruptcy, and, the statute of limitation on collection did not run during that time. With the six-month collection statute add-on of § 6503(h)(2), the collection statute end date (CSED) was pushed to November 7, 2005, *i.e.*, thirteen years, eleven months and twenty days after the original assessment. The IRS filed its NFTL on September 8, 2005. Before the CSED, the taxpayer requested a CDP hearing. Why? The lien is unenforceable

after the CSED. What was the IRS going to do in the one month remaining after the CDP hearing time ran.

Offers in Compromise

The IRS revised its offer forms in 2009 to make them more user friendly. There was no indication that the issuance of these forms had changed the IRS's general hostility towards offers. *See*, Bankruptcy and Workouts Developments Report 2008 (forecast).

Exemptions

In *Robertson v. Deeb*, 16 So.3d 936 (2d Dep't Ct. App. 2009), Florida joined other states, such as Texas and Alabama, in holding that inherited IRAs are not exempt under their state law exemption rules. *See*, *In re Navarre*, 332 B.R. 24, 31 (Bankr. M.D. Ala. 2004) (Tax Code treats inherited IRAs differently; different treatment in Bankruptcy Code is also acceptable); and *In re Jarboe*, 365 B.R. 717, 724 (Bankr. S.D. Tex. 2007) (only very weak argument can be made that inherited IRA protects debtor's retirement income). *Jarboe* is a post-BAPCPA bankruptcy case, but, it does not discuss 11 U.S.C. § 522(b)(3)(C). That section was added by BAPCPA and provides an exemption for IRAs, regardless of what the state exemption rule may be. *In re Orr*, 2008 W.L. 244168 (Bankr. C.D. Ill. 2008).[15]

Section § 522(b)(3)(C) exempts retirement funds to the extent those funds are in a fund or account that is exempt from

[15]This exemption is subject to a $1,000,000 limitation. 11 U.S.C. § 522(n).

taxation under IRC § 408.[16] The lead-in language of § 408 supports the argument that inherited IRAs are exempt under the federal rule. It provides as follows: "For purposes of this section, the term 'individual retirement account' means a trust created or organized in the United States for the exclusive benefit of an individual or his *beneficiaries* ... " (emphasis added). The trustee's counter argument is that the inherited IRA is not a retirement fund, thus, never getting to the issue of whether inherited IRAs are part of § 408. No post-BAPCPA court has tackled this issue head-on in § 522(b)(3)(C).

In re Patrick, 411 B.R. 659 (Bankr. C.D. Cal. 2008)[17] denied the debtor's claim to an exemption in a rollover IRA, where the debtor had already made one rollover in the applicable tax year and the second rollover resulted in the IRA losing its tax-free status.

Baker v. Tardif (In re Baker), 590 F.3d 1261 (11th Cir. 2009) and *Gladwell v. Reinhart (In re Reinhart)*, 2009 W.L. 5083432 (10th Cir. 2009), *modified* 2010 W.L. 286563 (10th Cir. 2010) (changing "described by" to "described in" to match the language in the statute) both asked whether retirement plans were exempt under applicable state exemption rules. In *Baker*, the Eleventh Circuit found the retirement plan exempt under Florida's rules. The plan at issue was a one-person plan, which can qualify for the special rules for retirement plans in the Tax Code but is

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[16]Other sections included in this rule are 401, 403, 408A, 414, 457, and 501(a).

[17]This case was published in 2009.

not an ERISA plan. The court found that a non-ERISA plan can qualify for the Florida exemption. In *Reinhart*, the debtor's plan was operationally in default but met the literal terms of the Utah statute as it was described by the rules of the Internal Revenue Code. The Tenth Circuit certified to the Utah Supreme Court whether the plan could be exempt if it were operationally in default.

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