BANKRUPTCY AND WORKOUTS

Submitted by the Committee on Bankruptcy and Workouts
Kenneth C. Weil,[1] Committee Chair

Supreme Court

After the majority decided that the new health care law would be invalid under the Commerce Clause, the key, remaining issue in *Nat'l Fed. Ind. Businesses v. Sebelius*, 567 U.S. __ (2012) was the bankruptcy-tax issue of what is a tax and what is a penalty. *See*, *United States v. Unsecured Creditors' Comm. of C-T of Va. (In re C-T Va., Inc.)*, 135 B.R. 501 (W.D. Va. 1991), *aff'd*, 977 F.2d 137 (4th Cir. 1992), *cert. denied*, 507 U.S. 1004 (1993) (An excise tax is a tax on an event or transaction, while a penalty is designed to punish a certain behavior).

If the new law were a tax, it could (and would) be upheld under Congress's broad power to tax. On the issue of tax versus penalty, Justice Roberts wrote, "In distinguishing penalties from taxes, this Court has explained that 'if the concept of penalty means anything, it means punishment for an unlawful act or omission.' *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996)." *Sebelius*, *supra* at __.

> While the individual mandate clearly aims to induce the purchase of health insurance, it need not be read to declare that failing to do so is unlawful. Neither the Act nor any

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> other law attaches negative legal consequences to not buying health insurance, beyond requiring a payment to the IRS.

Id. at __.

In dissent, Justice Scalia argued,

> But we have never held - never - that a penalty imposed for violation of the law was so trivial as to be in effect a tax. We have never held that *any* exaction imposed for violation of the law is an exercise of Congress' taxing power—even when the statute *calls* it a tax, much less when (as here) the statute repeatedly calls it a penalty.

Id. at __.

Because Justice Roberts repeatedly stated that it was the Court's duty to uphold a law if it could, *id. at* __, the author doubts whether this case will move the needle one way or the other in the bankruptcy arena debate over tax versus penalty.

Hall v. United States, 566 U.S. __ (2012) decided once and for all that the special nonpriority rule for sales of farm assets is only available for prepetition sales. *See*, Bankruptcy and Workouts New Developments Report (BWNDR) 2006-2011. Statutorily, this interpretation of § 1222(a)(2)(A) can be justified because the farmer is the taxable entity under I.R.C. §§ 1398-1399 and there is no § 507 priority tax incurred by the bankruptcy estate. But, because most sales in a farm reorganization are postpetition, the result does not make sense from a policy point of view. An amendment is surely coming. A corollary to this rule is that gain on sale can qualify for

nonpriority treatment even if the sale is made before the plan of reorganization is approved by the court. Otherwise, no prepetition sale could ever qualify. This makes the rule different from the Chapter 11 excise tax exclusion rule. *See*, 11 U.S.C. § 1146(a); and *Fla. Dep't of Rev. v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33 (2008) (§ 1146(c) [now § 1146(a)] exempts property transfers occurring under Chapter 11 plan from real estate excise tax but not transfers that occur before the plan is confirmed); and BWNDR 2008. Query, how related must the prepetition sale be to the forthcoming plan of reorganization, if at all. See *Smith v. United States (In re Smith)*, 447 B.R. 435, 447 (Bankr. W.D. Pa. 2011) for a postpetition sale case decided before *Hall* finding that debtors had ceased farming operations, the sale was not done pursuant to terms of a confirmed plan, and, the special rule did not apply. Or, perhaps there can never be a qualifying sale.

Legislation

The American Taxpayer Relief Act of 2012, P.L. 112-___, 12_ Stat. __ at § 202 extended through 2013 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*, BWNDR 2007 and 2008.

IRS Guidance

In Rev. Proc. 2012-28, I.R.B. 2012-27, the IRS announced a safe harbor for publicly traded partnerships under which the IRS will not challenge a determination by the entity that income from discharge of indebtedness is qualifying income under section I.R.C. § 7704(d). As enacted, § 7704(d) omits cancellation of debt income as qualifying income, thereby jeopardizing publicly traded partnership status when the entity receives cancellation of debt income. Rev. Proc. 2012-28 is designed to resolve this problem.

Rev. Rul. 2012-14, I.R.B. 2012-24 incorporates the rules of Rev. Rul. 92-53, 1992-2 C.B. 48 into dealing with nonrecourse debt and the cancellation of debt treatment by partners in a partnership. In measuring a partner's insolvency for purposes of qualifying for the § 108(d)(3) insolvency exclusion, "each partner treats as a liability an amount of the partnership's discharged excess nonrecourse debt that is based upon the allocation of COD [cancellation of debt] income to such partner under § 704(b) and the regulations thereunder."

In IRS News Release IR-2012-31 (March 7, 2012), the IRS announced that wage earners who had been unemployed for 30 consecutive days or self-employed individuals with a 25% or greater reduction in business income in 2011 due to the economy would be eligible for a six-month grace period on the

failure-to-pay penalty on 2011 taxes. The penalty relief was limited to taxpayers with income of $200,000 or less if filing a joint return and income of $100,000 or less if filing a single or married filing separate return.

In addition, the IRS announced that the threshold for streamlined installment agreements would increase from $25,000 to $50,000. The time to complete a streamlined installment agreement was increased from 60 to 72 months. The IRS also indicated online that it would accept streamlined installment agreements from taxpayers who owe more then $50,000 subject to its right to request financial information. http://www.irs.gov/Individuals/Collection-Financial-Standards, last accessed January 10, 2013 ("In cases where taxpayers cannot full pay and do not meet the criteria for a streamlined agreement, they may still qualify for the six-year rule.")

In IRS News Release IR-2012-53 (May 21, 2012), the IRS announced changes to the offer in compromise (OIC) program to make it easier for a taxpayer to qualify for an offer. Those changes included (i) reducing the future income multiplier to 12 from 48[2] for offers paid in five months or less and to 24 for offers paid within 24 months of acceptance (all offers must be

[2]The multiplier of 48 was derived from the present value of an annuity in arrears over five years at 9% interest, which present value is approximately 48.17 or $1-(1.0075)^{-60}/.0075$. The original future income window was five years. This little bit of trivia seems to have been forgotten over time.

paid-in-full within 24 months); (ii) the time-frame for inclusion of dissipated assets in the offer computation was reduced to three years, with the caveat that it may be appropriate to review asset sales within six months of tax assessment, whether before or after the assessment; and (iii) allowable expenses now include student loan payments, payments on state and local delinquent taxes, and expansion of miscellaneous expenses to include expenses such as credit card payments and bank fees and charges.

Cases

Dischargeability

In *McCoy v. Miss. Tax Comm'n*, 666 F.3d 924 (5th Cir. 2012), *cert. denied*, __ U.S. __ (2012), the Fifth Circuit adopted a late-filed, nondischargeable rule for taxes due on state income tax returns. *See*, BWNDR 2008-2010. Under the *McCoy* rule, tax due on a return that is filed even one day late is nondischargeable. The IRS does not follow *McCoy*, see Chief Counsel Notice 2010-016, and, the holding in *McCoy* is specifically limited to tax due on state income tax returns.

In *Wogoman v. IRS (In re IRS)*, 475 B.R. 239 (10th Cir. B.A.P. 2012), *Smythe v. United States (In re Smythe)*, 2012 W.L. 843435 (Bankr. W.D. Wash. 2012), *Casano v. United States (In re Casano)*, 473 B.R. 504 (Bankr. E.D.N.Y. 2012), *Perry v. United States (In re Perry)*, 2012 W.L. 4762020 (Bankr. M.D. Ala. 2012), and *In re Shinn*, 2012 USTC ¶ 50,266 (Bankr. C.D. Ill. 2012), the

United States kept intact its record of winning all cases where the debtor filed tax returns after the IRS made its substitute for return assessments, *i.e.*, all tax, due on years where returns were originally filed by the IRS for the taxpayer, is nondischargeable. *See*, BWNDR 2006 and 2010. *Shinn* is particularly depressing for taxpayers, as it became the first court outside of the Fifth Circuit to adopt the *McCoy* holding that tax on a return even filed one day late is nondischargeable. And, at footnote 1, the judge essentially stated that he thought the rule was wrong but it was not his position to change it.

In November, the first taxpayer victory on the issue occurred in *Martin v. United States (In re Martin)*, 482 B.R. 635 (Bankr. D. Colo. 2012). In *Martin*, the judge found that applicable filing requirements do not include timeliness. He reasoned that such an interpretation would make the two-year late-filed rule of § 523(a)(1)(B)(ii) superfluous.

Green v. United States (In re Green), 472 B.R. 347 (Bankr. W.D. Tex. 2012) found that a computation in a Tax Court proceeding to determine liability after the court ruled did not qualify as "a written stipulation to judgment or final order entered by a nonbankruptcy tribunal" so as to qualify the tax due for discharge under 11 U.S.C. § 523(a)(*), which defines what qualifies as a return under § 523(a)(1)(B).

The most interesting willful intent case was *Rossman v. United States (In re Rossman)*, 2012-2 USTC ¶ 50,713 (Bankr. D. Mass. 2012). The debtor was the victim of a "bad" tax shelter that resulted in enormous amounts of tax, interest, and penalty being due for the tax year 1986. The debtor was an attorney with fluctuating income, but, in some years, particularly 2004 and 2005, the amounts earned were well into the mid-six figures. The Court found that the debtor did not live an extravagant life style. The debtor kept current on other taxes as they came due each year. But, when he had good years and made good money, he made no attempt to pay down his tax debt.

There is no provision in § 523(a)(1)(C) for splitting the tax liability in a year between dischargeable and nondischargeable. *See e.g.*, *Lynch v. United States (In re Lynch)*, 299 B.R. 62, 65 and 86-88 (Bankr. S.D.N.Y. 2003), *appeal dismissed on procedural grounds in District Court and aff'd*, 430 F.3d 600 (2nd Cir. 2005). Nonetheless, the Court split the liability. While not discharging the tax, the Court discharged interest and penalty that were being disputed in a pending Tax Court case. At note 18, the Court cited the student loan cases, where partial discharge is allowed.

The taxpayer in *Daniels v. Agin*, 482 B.R. 1 (D. Mass. 2012) ran his profit sharing plan as his own private investment bank with numerous prohibited transactions with disqualified persons

and failed to disclose his IRAs on his bankruptcy schedules. The exemption in the profit sharing plan was denied as it was not a qualified plan, and, his discharge was denied for failure to disclose the IRAs.

The taxpayer in *Waterman v. United States (In re Waterman)*, 2012-1 USTC ¶ 50,410 (Bankr. S.D. Iowa 2012) successfully defended against the IRS's attack against her discharge under the willful intent to evade or defeat standard of 11 U.S.C. § 523(a)(1)(C). Of particular interest is the Court's commentary on the IRS's required offer amount, which amount the debtor could not afford.

> The OIC submitted in June 2009 was rejected by a preliminary response from the IRS dated November 2009. [footnote omitted] It outlines cash assets of approximately $15,000 and income in the amount of approximately $45,000 in reaching a proposed settlement amount of not less than $60,750.64. This information was not explored at trial by either party. The IRS may have included funds on deposit at West Bank [footnote omitted] and all anticipated income for a full calendar year. **If that is the case, it is not clear how Waterman could be expected to make a lump sum payment under an OIC in the amount suggested by the IRS and still meet her necessary living expenses.**

Emphasis added. Of course, tax practitioners have been making this sort of complaint for years, and, there is no practical way to make an offer work without an outside source of funds.

Van Dyn Hoven v. Bank of Kaukauna (In re Van Dyn Hoven), 470 B.R. 822 (E.D. Wis. 2012) reversed *The Bank of Kaukauna v. VanDynHoven (In re VanDynHoven)*, 460 B.R. 214 (Bankr. E.D. Wis.

2011). BWNDR 2011. In *Van Dyn Hoven*, the debtor guaranteed payment of bank overdrafts on a corporate account; bank loans were mixed with corporate operating revenue and used to pay bills including the employment taxes. The court found that § 523(a)(14) did not apply and discharged the debt. There was no evidence that the debtor knew his payroll taxes were being paid with borrowed funds as opposed to the company earnings that were regularly deposited into the account. Knowledge of nonpayment is an essential element of responsible person liability, and, that was missing.

Employees Only, Inc. v. Provenzano (In re Provenzano), 2012-2 USTC ¶ 50,694 (Bankr. E.D. Mich. 2012) followed *Van Dyn Hoven* and found the debt allegedly owed by the debtor to a payroll service to be dischargeable. In *Provenzano*, a payroll service continued making tax payments to the government when the underlying business was not paying it and without any indication or promise that the underlying business would pay it.

Both *Provenzano* and *Van Dyn Hoven* indicate a trend in the case law that the challenging creditor must show an intent by the taxpayer to convert nondischargeable tax debt into dischargeable debt. The statute does not have this requirement, but, it is inferred from the language of § 523(a)(14).

Priority

United States v. Montgomery (In re Montgomery), 475 B.R. 742 (D. Kan. 2012) affirmed that there is only one 90-day add-on under the 90-day add-on rule of 11 U.S.C. § 507(a)(8)(*), even if there are multiple bankruptcy filings. *See*, BWNDR 2011.

Lastra v. United States (In re Lastra), 2012 W.L. 6681739 (Bankr. D.N.M. 2012) confirmed what many had suspected. It applied the extender language in 11 U.S.C. § 507(a)8)(*) to collection due process (CDP) hearings. As written, § 507(a)(8)(*) appears to apply only if all collection activity is prohibited. With a pending CDP, some collection activity can continue, including jeopardy assessments and the filing of the NFTL. The *Lastra* court found ambiguity in § 507(a)(8)(*) because it was unclear whether some or all collection activity must be prohibited, and, it looked to the committee reports, which clearly state that this new provision is designed for CDP hearings.

In contrast, *In re Paradis, Jr.*, 477 B.R. 295 (Bankr. D. Me. 2012) held that the tolling rule of § 507(a)(8)(*) for "request by the debtor for a hearing and an appeal of any collection action taken" does not apply to a request for an offer in compromise. In and of itself, there is no hearing connected to a request for an offer. *Id.* at 297.

Quiroz v. Mich Dep't of Rev., 472 B.R. 434 (E.D. Mich. 2012) was affirmed on appeal. *See*, BWNDR 2011. Quiroz found that the shareholder/member liability for nonpayment of the Michigan small business tax was an excise tax subject to the three-year nondischargeability rule of 11 U.S.C. § 507(a)(8)(E).

By contrast, the California Department of Revenue choose to make its nondischargeability argument under the failure to collect or withhold provisions of § 507(a)(8)(C) in *Cal. Emp't Dev. Dep't v. Hansen (In re Hansen)*, 470 B.R. 535 (9th Cir. B.A.P. 2012). It lost, and, the tax was discharged. The tax at issue was personal liability for a corporate officer for corporate nonpayment of employment tax. The Court reasoned that the tax was owed by the corporation and not collected by the corporation thereby flunking § 507(a)(8)(C).

In re Int'l Tobacco Partners, 468 B.R. 582 (Bankr. E.D.N.Y. 2012) found that assessments under the Fair and Equitable Tobacco Reform Act were excise taxes as they served a public purpose citing the test of *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996), which was cited by Justice Roberts in *Sebelius*, *supra*.

Claims

Everett Assocs., Inc. v. Comm'r, 103 TCM 1773 (2012) is a good reminder not to sleep on claims in bankruptcy as they may not be contestable later. In *Everett Associates*, the Tax Court

found that the taxpayer could not challenge the underlying tax assessments because a prior opportunity to do so had been available in bankruptcy court. *See*, BWNDR 2007; and *Siegel v. Fed. Home Loan Mortgage Corp.*, 143 F.3d 525 (9th Cir. 1998) (giving preclusive effect to a previous order allowing an uncontested claim in a Chapter 7 case).

In *Moore, Jr. v. Comm'r*, 2012 W.L. 5992817, T.C. Summ. Op. 2012-116, the shoe was on the other foot. The IRS filed its claim in the debtor's Chapter 13 case, but, the claim understated the taxpayer's liability. The claim was accepted as filed; the plan was confirmed; and the IRS's claim was paid in full. The debtors did not complete their plan, and, the case was converted to Chapter 7. The IRS asserted that its full claim could be collected because the tax debt was (i) not discharged in Chapter 13 and (ii) not dischargeable in Chapter 7. Citing *In re Habtemichael*, 190 B.R. 870, 874 (Bankr. W.D. Mo. 1996), the Tax Court found that where an approved claim is paid in full before the case is converted, the creditor's rights are totally extinguished. The result may be correct, but, it is probably for the wrong reason. *Habtemichael* dealt with the full payment of a secured claim, which is surely extinguished upon full payment. The Court would have been better served citing the rule used in *Everett Assocs.*, which gives preclusive effect to a claim allowed in a bankruptcy case.

Dubov v. Read (In re Read), 692 F.3d 1185 (11th Cir. 2012) held that § 505(a)(2)(C) overrides the general time limits for contesting claims under § 108(a). In general, § 505(a)(2)(C) provides that once the time has run for contesting a state claim, the debtor cannot reopen the issue in bankruptcy; Section 108 provides time limits for filing actions given an intervening bankruptcy filing. *Read* did not allow the debtor to use § 108(a) to extend the time to contest the valuation of real property beyond the 60-day period provided for under Florida law, which period ran soon after the bankruptcy was filed.

Contrary to the general Tax Court rule regarding entry of judgment against the taxpayer upon dismissal of a deficiency cases, in *Settles v. Comm'r*, 138 T.C. No. 19 (2012), the Tax Court voluntarily dismissed, upon taxpayer's request, a pending CDP appeal and did not enter a judgment against the taxpayer. It found the judgment rule applied only to deficiency cases. In addition, the Court found that the automatic stay did not prevent it from allowing the dismissal, particularly since a liability determination had already been made in the bankruptcy court.

Liens

The Court in *In re Strategic Labor, Inc.*, 467 B.R. 11, 21-25 (Bankr. D. Mass. 2012) allowed some management costs and attorney's fees to be surcharged against the IRS's lien under 11 U.S.C. § 506(c). Of note is this statement by the Court, "This

matter offers an object lesson in how not to run a chapter 11 case." *In re Strategic Labor, Inc.*, *supra*, at 13.

Rd. and Highway Builders, LLC v. United States, 702 F.3d 1365 (Fed. Cir. 2012) is an interesting follow-on suit to *United States v. Buenting (In re Crystal Cascades Civil, LLC)*, 415 B.R. 403 (9th Cir. B.A.P. 2009), *affirming*, *Buenting v. Crystal Cascades Civil, LLC (In re Crystal Cascades Civil, LLC)*, 398 B.R. 23 (Bankr. D. Nev. 2008), which were discussed in BWNDR 2008 and 2009. Road and Highway Builders (RHB) was the party that initially challenged the validity of the IRS's lien; and, it won. But, prior to the challenge, a senior creditor, senior to both the IRS and RHB, had foreclosed. RHB was the winning bidder at the foreclosure sale, and, it paid the IRS $100,000 to keep it from exercising its redemption rights. When it turned out the IRS's lien was not valid, RHB sued unsuccessfully to get its $100,000 back from the IRS.

Under the sale free and clear rules of 11 U.S.C. 363(f), the purchaser of debtor's assets in *In re PBBPC, Inc.*, 467 B.R. 1 (Bankr. D. Mass. 2012), *aff'd*, *Mass. Dep't of Unemployment Assistance v. OPK Biotech, LLC (In re PBBPC, Inc.)*, 2013 W.L. 203538 (1st Cir. B.A.P. 2013) prevented the imputation to it of the debtor's poor experience rating under the Massachusetts rules for unemployment insurance.

Exemptions

Chilton v. Moser (In re Chilton), 674 F.3d 486 (5th Cir. 2012) allowed the debtor to exempt her inherited IRA. *See*, BWNDR 2010-2011. This issue now seems decided in the debtor's favor. *Mullin v. Hamlin (In re Hamlin)*, 465 B.R. 863 (9th Cir. B.A.P. 2012); *Clark v. Rameker (In re Clark)*, 466 B.R. 135 (W.D. Wis. 2012); and *In re Seeling*, 471 B.R. 320 (Bankr. D. Mass. 2012) all allowed the exemption.

The debtor's exemption in her IRA was allowed in *In re Sutton-Robinson*, 472 B.R. 77 (Bankr. D. Ariz. 2012), where the financial institution make a bookkeeping error on its own without knowledge of the debtor and moved the funds to one of the debtor's other accounts, and, once the error was discovered, the funds were returned to the IRA. Funds that were not returned were not exempt.

The debtor's exemption in his IRA was disallowed in *In re Pellegrini*, 467 B.R. 117 (Bankr. W.D. Mich. 2012). In *Pellegrini*, the debtor's funds in his IRA had been removed fraudulently from his account. The debtor obtained a judgment against the wrongdoer. The Court did not allow an exemption in the judgment. Until the IRS announces that "recouped, stolen" funds can be redeposited in an IRA, this appears to be the correct result. *Cf.*, Rev. Rul. 2009-9, 2009-1 C.B. 735 and Rev. Proc. 2009-20, 2009-1 C.B. 749.

In *In re Ahmed*, 2012-2 U.S.T.C. ¶ 50,600 (E.D. Mich. 2012), the debtor deposited funds into an invalid IRA. Ahmed had received funds from her husband's 401(k) plan in exchange for the equity in the marital residence. Because the husband did not pay voluntarily, the funds had been seized from the husband's 401(k). The Court found that only $5,000 could be placed in a legal IRA, and, the remaining funds were the proceeds of the Court's order satisfying the marital obligation. The debtor in *Ahmed* failed to argue the validity of the IRA, which if successful, would have withstood the Court's attack. *See*, 11 U.S.C. § 522(d)(12) (under Federal exemptions, debtor may exempt retirement funds to the extent they are exempt from taxation under I.R.C. § 408).

In re Butler, 472 B.R. 786 (Bankr. W.D. Wis. 2012) analyzed the right to an exemption under the concept of a "similar plan" to a retirement plan under 11 U.S.C. § 522(d)(10)(E). It found that the debtor's right to receive payments under her employer Kwik Trip's long-term real-estate-investment plan, which provided Kwik Trip employees the right to participate in ownership in the company's real estate assets, qualified as a "similar plan" to a retirement plan.

The debtor's annuity in *In re Kiceniuk*, 2012-2 U.S.T.C. ¶ 50,605 (Bankr. D.N.J. 2012), which was purchased with proceeds from the debtor's 401(k) retirement plan, qualified for exemption under 11 U.S.C. § 522(d)(10)(E).

Zingale v. Rabin (In re Zingale), 693 F.3d 704 (6th Cir. 2012) explored the interaction of exemptions and refundable and nonrefundable tax credits. Refundable credits can be paid to the taxpayer in the form of a tax refund; nonrefundable credits only offset tax due. The nonrefundable part of the child tax credit was not a payment and did not qualify for exemption under Ohio law.

The Court reached a similar result in *Cohen v. Borgman (In re Borgman)*, 698 F.3d 1255 (10th Cir. 2012). There, the nonrefundable part of the child tax credit was not a payment and did not qualify for exemption under Colorado law.

In re Johnson, 480 B.R. 305 (Bankr. N.D. Ill. 2012) used reasoning similar to *Zingale*. In *Johnson*, the exemption of an adoption credit under Illinois law was at issue. In the applicable tax year, the adoption tax credit was a refundable credit, and, the court found it exempt under Illinois law.

In *In re Smith*, 2013-1 USTC ¶ 50,129 (Bankr. S.D. Ohio 2013), the adoption credit was found to be a refundable credit, and, the debtor was entitled to the exemption under Ohio law.

Clawbacks

In *Williams v. Milwaukee City Clerk (In re Williams)*, 473 B.R. 307, 317 and 322 (Bankr. E.D. Wis. 2012), the Court found that tax-foreclosure procedures should involve some sort of competitive bid process to insure that reasonably equivalent

value is paid. In *Williams*, the City of Milwaukee did not use a competitive bid process for its tax foreclosure sales, and, the Chapter 13 debtors successfully argued that the tax foreclosure sales were constructively fraudulent transfers.

In *The Majestic Star Casino, LLC v. Barden Dev. Inc. (In re The Majestic Star Casino, LLC)*, 466 B.R. 666 (Bankr. D. Del. 2012), the Court avoided the postpetition revocation of a subsidiary's Subchapter S election because it was an avoidable transfer under 11 U.S.C. § 549. This holding is consistent with rulings by other courts. *Id.* at 674-675; and *see*, BWNDR 2008. In *Majestic Star*, the debtor was a qualified S-corporation subsidiary and the disallowed S-revocation was attempted postpetition by its S-corporation parent.

In *Gold v. United States (In re Kenrob Info. Tech. Solutions, Inc.)*, 474 B.R. 799 (Bankr. E.D. Va. 2012), the trustee was unsuccessful in an attempt to get estimated tax payments back from the IRS under 11 U.S.C. § 548. The payments were made by an S-Corporation by agreement with its shareholders. The corporation paid for the incremental increase in the shareholder's income tax liability caused by distributions received from the corporation. The court found consideration to the corporation, thereby defeating the fraudulent transfer claim, because the S-election passed the corporate tax through to the

shareholders, *i.e.*, the corporation did not have a tax liability because of the election.

The Court reached the same result in *Crumpton v. Stephens (In re Northlake Foods, Inc.)*, 483 B.R. 247, 251-253 (M.D. Fla. 2012).

In *United States v. Menotte*, 2012 W.L. 5868578 (S.D. Fla. 2012), the trustee was also unsuccessful in an attempt to get estimated tax payments back from the IRS under 11 U.S.C. §§ 548 and 550. In *Menotte*, the government defended by arguing that it was not an initial transferee under § 550. The government argued that it was a conduit for the S-corporation shareholder, and, the Court agreed.

> When analyzing the transaction in its entirety, the IRS was acting as an intermediary which held the funds until Denson's [the shareholder] tax liability could be assessed. When Denson had no tax liability, the IRS simply transferred the funds as the Debtor [the S-corporation] instructed.

Id. at *8.

In *Southeast Waffles, LLC v. United States (In re Southeast Waffles, LLC)*, 702 F.3d 850 (6th Cir. 2012), the Chapter 11 debtor was unsuccessful in challenging the IRS that its prepetition penalty payments were fraudulent transfers. The Court found that "[i]t would defy common sense to find that debtors could avoid such penalties when the IRS was doing only what the tax statutes require."

In *PW Enters. v. N.D. (In re Racing Servs., Inc.)*, 482 B.R. 276, 291 (Bankr. D.N.D. 2012), the State of North Dakota argued successfully that it was not an insider of the debtor. The argument was made that it was an insider because of the North Dakota Racing Commission's intensive regulation of the state pari-mutual betting industry, and, therefore, the debtor's operations. A "normal" creditor faces a 90-day window for return of preferential payments; an insider's window is one year. Courts have been reluctant to find insider status because of financial oversight, even if the financial oversight is highly intrusive. In this case, the State did not direct payment of debtor's expenses and did not control day-to-day expenditures.

Automatic stay

The Court in *United States v. Colasuonno*, 697 F.3d 164 (2d Cir. 2012) ruled that, under 11 U.S.C. § 362(b), the automatic stay does not prevent a court from using its powers to force payment of criminal restitution. Prosecution of criminal actions are an exception to the automatic stay, and, the criminal action continues after sentencing through payment of the criminal restitution judgment.

Abstention

In *Johnston v. Middletown (In re Johnston)*, 484 B.R. 698 (Bankr. S.D. Ohio 2012), the Court continued the trend of courts not hearing trust fund tax cases in no-asset Chapter 7 cases.

See, BWNDR 2010. The court did not have jurisdiction because the case was not a core proceeding, *i.e.*, a case central to the bankruptcy process. The Court would have been determining the amount of the debt and not dischargeability, as everyone agrees trust fund tax debt is nondischargeable. *See*, 28 U.S.C. § 157(a)(2)(J) (core proceedings include complaints to determine dischargeability). Furthermore, whether the debt is owed at all is a law suit that arises under the Tax Code and not the Bankruptcy Code, and, without assets in the estate, the law suit cannot impact the bankruptcy estate.

Chapter 11

In *In re Breland*, 474 B.R. 766 (Bankr. S.D. Ala. 2012), the IRS was bound by its stipulation entered with the debtor regarding taxes the debtor owed the IRS in his Chapter 11 case. The court distinguished *In re Gurwitch*, 794 F.2d 584 (11th Cir. 1986), which found that confirmation of a debtor's Chapter 11 plan did not fix the debtor's tax liabilities. This case was different because of the stipulation agreed to by the IRS.

The IRS was not entitled to vote on the debtor's plan in *In re Mangia Pizza Invs., LP*, 480 B.R. 669 (Bankr. W.D. Tex. 2012). In *Mangia Pizza*, the IRS held a secured claim. Under 11 U.S.C. §§ 1129(a)(9)(C) and (D), when the taxing authority is a secured creditor and its claim would otherwise be entitled to priority under § 507(a)(8), its treatment under the Chapter 11 plan can be

no worse than the treatment it would have received as an unsecured creditor. (Before the BAPCPA enactment of 11 U.S.C. §§ 1129(a)(9)(C) and (D), debtors would often extend the time for payment of the IRS's secured claim beyond the priority time periods.) The Court found that the IRS was not an impaired class, and, it was not allowed to vote on the debtor's Chapter 11 plan.

The Court in *In re Jerath Hospitality, LLC*, 484 B.R. 245 (Bankr. S.D. Ga. 2012) allowed a balloon payment on a tax claim owed to the Georgia Department of Revenue. The debtor's Chapter 11 plan provided for 48 monthly installment payments and a balloon payment prior to the end of the 60th month. While Chapter 13 requires equal payments, 11 U.S.C. § 1325(a)(5)(B)(iii)(I), Chapter 11 only requires regular payments. 11 U.S.C. § 1129(a)(9)(C). Thus, balloon payments are allowed in Chapter 11 but not in Chapter 13.

Chapter 13

In re Murchek, 479 B.R. 521 (Bankr. N.D. Iowa 2012) indicates there is still vitality in the pre-BAPCPA rule requiring tax refunds to be included as part of projected disposable income if they are likely to continue. In *Murchek*, the trustee had the more persuasive argument that refunds would continue postpetition as they had prepetition. The debtor's change in amount of withholding was not a sufficient change in circumstance under *Hamilton v. Lanning*, 560 U.S. ___ (2010) to

warrant not counting the prepetition refunds in projected disposable income.

In re White, 482 B.R. 905, 912-913 (Bankr. W.D. Ark. 2012) rejected the taxpayer's argument that 11 U.S.C. § 1305 was available for use by the taxpayer to force payment of a postpetition tax claim under a Chapter 13 plan. That rule is only available for taxing authorities. Note, § 1305 is a problematic tool for taxing authorities as there is no clear rule that gives the taxing authority priority under § 507.

Tax refunds

The battle over entitlement to tax refunds, when one spouse files and the other does not, moved to the State of Illinois in *In re Ruhl*, 474 B.R. 596 (Bankr. N.D. Ill. 2012). Under Illinois law, the court held that the refund belonged to the spouse who earned the money. There was no 50/50 split like some other states. *See*, BWNDR 2009 and 2011.

In re Hraga 467 B.R. 527 (Bankr. N.D. Ga. 2011) was a 2011 case not published until 2012, and, it decided the same issue under Georgia law. The result was identical to *Ruhl*. Under Georgia law, the Court held that a spouse's employment earnings remain that spouse's separate property.

In *Warfield v. Salazar*, 465 B.R. 875 (9th Cir. B.A.P. 2012), which was a case converted from Chapter 13 to Chapter 7, the debtor defeated the trustee's attempt to claim the prepetition

portion of the debtor's tax refund in the year of filing because, the refund was no longer under the debtor's possession or control. 11 U.S.C. § 348(f)(1). *See also*, *In re Evans*, 464 B.R. 429, 441-442 (Bankr. D. Colo. 2011) (conversion of individual Chapter 11 case to one under Chapter 7 treated same as conversion of case from Chapter 13 to Chapter 7; Court addressed the debtor's tax refund under this rule).

Matos v. Rivera (In re Matos), 478 B.R. 506 (1st Cir. B.A.P. 2012) and *Santiago v. Rivera (In re Santiago)*, 478 B.R. 516 (1st Cir. B.A.P. 2012) both involved a Chapter 13 trustee who did not understand the bifurcation of the tax refund in the year of filing between prepetition and postpetition property. The debtors properly exempted the prepetition refund and included the postpetition refund as part of his Chapter 13 plan payment.

The Court in *United States v. Bond, Liquidating Tr. of the Liquidating Trust for PT-1 Commc'ns, Inc.*, ___ B.R. ___, 2012-2 USTC ¶ 50,567 (E.D.N.Y. 2012) ruled that a liquidating trustee could pursue a refund claim under 11 U.S.C. § 505 and the refunds were property of the bankruptcy estate since the applicable Chapter 11 plan transferred the claims to the liquidating trust.

Erroneous refund

In *In re Lancaster, Jr.*, 2012-2 USTC ¶ 50,496 (Bankr. E.D.N.C. 2012), the IRS erroneously paid postpetition a refund

from a net operating loss carryback to the debtor. This was done in spite of the trustee's preparation of the amended return and notice to the IRS that the refund should be sent to the trustee. Under 11 U.S.C. § 542(a), because it had control of the refund postpetition, the IRS was ordered to pay the refund a second time to the trustee. For a discussion of the debtor's liability for receipt of the erroneous refund, see *United States v. Frontone (In re Frontone)*, 383 F.3d 656 (7th Cir. 2004) (POSNER, J.) (IRS accounting error will create dischargeable liability; mistake that is part of a deficiency computation is potentially nondischargeable).

Discharge of Indebtedness Income

The Court in *Ayele v. Educ. Credit Mgmt. Corp. (In re Ayele)*, 468 B.R. 24, 36 (Bankr. D. Mass. 2012) crafted a creative solution for a student loan debtor's potential income tax problem. The Court ordered the debtor to make repayments under applicable programs. If, at a later date, the debtor were unable to make full payment, the Court prospectively discharged the student loan debt so it would qualify for exclusion under I.R.C. § 108(a)(1)(A).

Brooks v. Comm'r, 103 TCM 1160 (2012) confirmed the rule of I.R.C. § 108(e)(2) that cancellation of indebtedness income is not recognized if the amount forgiven is interest owed to the lender and payment of the interest would result in a deduction

for the taxpayer. Unfortunately for the taxpayer in *Brooks*, the forgiven interest was nondeductible. The court does make an inquiry as to whether the parties made a mistake in agreeing that the year at issue was 2003 when the loan was forgiven versus the year the funds were received and potentially taxable as an advance, as opposed to a loan.

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