

Effect of Debtor's Pre-Petition Election to Apply Tax Refund Toward Liability for Petition Year in Determination of Property of the Estate

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I. Introduction

Establishing what property of the debtor will pass into the bankruptcy estate is critical to effectuating the dual purposes of the Bankruptcy Code: to grant the debtor a fresh start and to divide assets of the estate equitably among creditors. In a chapter 7 proceeding, this threshold determination divides the debtor's assets into those that the debtor will retain and those that will be liquidated to satisfy creditors' claims.

In determining what is property of the estate, an issue arises when before filing for bankruptcy, the debtor files a return for a pre-petition tax year and elects to apply a refund toward her petition year's tax liability. Assuming the refund was property of the estate, how does the debtor's election, which is irrevocable under the Tax Code, affect the nature of the debtor's property interest? If the debtor retained an interest, then the refund is property of the estate under section 541 of the Bankruptcy Code and is subject to turnover under section 542 of the Code. *See* 11 U.S.C. §§ 541–542 (2006).

Recently, in *Nichols v. Birdsell*, 491 F.3d 987 (9th Cir. 2007), the Ninth Circuit confronted this issue and determined that the debtor's irrevocable election to apply a tax refund as a credit for the following tax year was not a bar to the bankruptcy trustee's turnover claim. Other courts that have encountered this issue have reached a different result.

Part II of this memo details the Bankruptcy Code's provisions relevant in determining what property belongs to the estate. Part III discusses case law from courts that have confronted the issue of a chapter 7 debtor's election to apply a pre-petition tax refund toward the petition tax year and illustrates that courts have adopted three different approaches in adjudicating the issue. Part IV explores the policy considerations involved in these three approaches. The memo concludes that regardless of the approach selected, the bankruptcy court must consider the competing interests of creditors and debtors.

II. Relevant Bankruptcy Code Provisions

A. Property of the Estate – Section 541

Section 541 of the Bankruptcy Code defines what constitutes property of the estate and has been described by commentators as the heart of the Code. *See* 6 COLLIER ON BANKRUPTCY, ¶ 541, at 541-8.1 (Alan N. Resnick et.al. eds., 15th ed. rev. 2006); 4 NORTON BANKRUPTCY LAW AND PRACTICE § 61, at 61-2 (William L. Norton, Jr. ed., 3d ed. 2007). The reach of section 541 is broad: “all legal or equitable interests of the debtor in property as of the commencement of the estate.” 11 U.S.C. § 541(a)(1) (2006). The estate consists of such property of the debtor “wherever located and by whomever held.” *Id.*

To promote equitable distribution to creditors, courts liberally have construed “property of the estate.” *See* *Wright v. IRS (In re Canon)*, 130 B.R. 748, 750 (Bankr. N.D. Tex. 1991). The Supreme Court has indicated that “an interest is not outside [the estate's] reach because [the interest] is novel or contingent or because enjoyment must be postponed.” *Segal v. Rochelle*, 382 U.S. 375, 379 (1966). Moreover, Congress provided in section 541(c)(1)(A) that “an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law– that restricts or conditions transfer of such interest by the debtor.” The estate's interests are limited, however, to those held by the debtor at the filing of the

petition. The estate's interests are neither expanded nor restricted beyond what the debtor might have claimed at the case's commencement. *See Grant v. United States (In re Simmons)*, 124 B.R. 606, 607 (Bankr. M.D. Fla. 1991).

B. Turnover of Property of the Estate – Section 542

[A]n entity . . . in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate. 11 U.S.C. § 542(a).

Under section 542, the trustee is empowered to make demand of any entity, including the debtor herself, to turnover property that the trustee believes is of value and belongs to the estate. *See Appellant v. Graves (In re Graves)*, 396 B.R. 71, 73 (B.A.P. 10th Cir. 2008); *Traina v. Orrill (In re Orrill)*, 226 B.R. 563, 565 (Bankr. E.D. La. 1997). The scope of section 542 is not restricted to property that can be physically transferred to the trustee. The statute also provides that the value of the property may be transferred to the trustee. *See Birdsell v. Nichols (In re Nichols)*, 309 B.R. 41, 45 (Bankr. D. Ariz. 2004).

III. The Effect on Debtor's Interest in Tax Refund of Prebankruptcy Election to Apply Tax

Refund for Pre-Petition Tax Year to Petition Year Tax Liability

A. Preliminary Note

Even before the passage of the 1978 Bankruptcy Code revisions, the Supreme Court established that a tax refund could be property of the estate. *See Barowsky v. Serelson (In re Barowsky)*, 946 F.2d 1516, 1517 (10th Cir. 1991) (citing *Kokoszka v. Belford*, 417 U.S. 642, 648 (1974)). The Court held that a tax refund was “sufficiently rooted in the prebankruptcy past and so little entangled with the bankrupt's ability to make an unencumbered fresh start that it should be regarded as ‘property.’ ” *Kokoszka v. Belford*, 417 U.S. 642, 647 (1974) (quoting *Segal*, 382 U.S. at 380). Thus, the issue presented is not whether a tax refund is property of the estate, but whether the

nature of the debtor's interest in a pre-petition tax year refund is changed by the debtor's irrevocable election to apply the refund toward her petition tax year liability.

B. Decisions Where the Court Ruled the Refund Was the Property of the Estate

1. *Nichols v. Birdsell*, 491 F.3d 987 (9th Cir. 2007)

In *Nichols*, the debtors filed their 2001 tax return two weeks before filing their chapter 7 petition and, pursuant to sections 6402(b) and 6513(d) of the Tax Code, irrevocably elected to apply their anticipated refund to the 2002 tax year. The following year, the debtors used almost all of the 2001 credit to satisfy their 2002 income tax obligation. The trustee instituted the suit against the debtors to recover the 2001 overpayment under section 542(a). *See In re Nichols*, 309 B.R. at 42–43. The bankruptcy court granted summary judgment to the trustee, holding that the debtors must deliver to the trustee the value of the 2001 refund. *Id.* at 46.

On their appeal, the debtors argued that the election had changed the character of the overpayment; however, the Ninth Circuit viewed the election as merely delaying the liquidation of the asset or preventing its transfer, neither of which, said the court, would prevent the overpayment from becoming property of the estate. *See Nichols*, 491 F.3d at 989–90. The circuit court found that after the debtors' election, they retained a credit with the Internal Revenue Service ("IRS") for which they were "provided a dollar-for-dollar tax reduction in the following year" and, absent the debtors' election, the overpayment would likely have been available to the estate at the filing of the petition. *Id.* at 990. The court indicated that the debtors' election was of no moment in the analysis, holding that the credit was property of the estate and either the credit or its value was subject to turnover under section 542. *Id.*

2. *Wright v. IRS (In re Canon)*, 130 B.R. 748 (Bankr. N.D. Tex. 1991)

In *In re Canon*, the debtor filed his 1987 tax return in March 1989 and realized a refund of \$14,900, which he irrevocably elected, pursuant section 6513(d) of the Tax Code, to apply to his

1988 tax liability. *In re Canon*, 130 B.R. at 749. In June, the debtor filed for chapter 7 protection. On his 1989 return, the debtor's withholding satisfied his tax liability and he received a refund for the \$14,900 overpayment. *Id.* The trustee sought the overpayment from the IRS under section 542. The parties cross moved for summary judgment and the court, granting the trustee's motion, ordered the IRS to turnover the \$14,900 overpayment. *Id.* at 753.

Discussing the legislative history of section 541, the court indicated that Congress intended "property of the estate" to be interpreted broadly. The court found that, at the time of the debtor's petition and in spite of his election on his 1987 return, the debtor retained "the right to a refund of any overpayment which might arise by computation of his 1988 tax return." *Id.* at 751. Citing the Supreme Court's ruling in *Segal*, the court indicated that the debtor's right to this possible overpayment became property of the estate "even though it was a contingent asset which could not be enjoyed until the close of the 1988 tax year." *Id.* Because the debtor then realized an overpayment on his 1988 tax return, the trustee was able to seek turnover of the 1988 tax refund. *Id.* at 753. Like the *Nichols* court, the *Canon* court found that the debtor's irrevocable election did not fundamentally alter the character of the debtor's interest in the tax refund such that it placed the asset beyond the scope of sections 541 and 542.

C. Decisions Where the Court Ruled the Refund Was Not the Property of the Estate

1. United States v. Pritchard (*In re Block*), 141 B.R. 609 (N.D. Tex. 1992)

Almost a year after the *In re Canon* case was heard in the bankruptcy court, the District Court for the Northern District of Texas, in *In re Block*, reached the opposite conclusion regarding the nature of the debtor's interest in a tax overpayment that had been irrevocably elected pursuant to section 6513(d) of the Tax Code. In filing their 1988 amended return, the debtors elected to apply their \$11,807 overpayment to the 1989 tax year. Two days later, the debtors filed for chapter 7 relief. The trustee sought to compel turnover of the refund under section 542. Faced with cross motions for

summary judgment, the bankruptcy court granted the motion of the trustee. The district court, reversing the bankruptcy court, held that after the debtors' election:

[debtors] no longer had an overpayment for which they could file a claim for refund; the overpayment became an advance payment of the [debtors'] 1989 taxes. Consequently, their "prepetition estimated tax payment cannot be considered a legal or equitable interest of the debtor in property as of the commencement of the case, and such payment is not subject to turnover." *United States v. Pritchard (In re Block)*, 141 B.R. 609, 611 (N.D. Tex. 1992) (quoting *In re Simmons*, 124 B.R. at 607–08).

The district court distinguished the Supreme Court's holdings in *Kokoszka* and *Segal*, noting that, at the time of the filings in those cases, the debtors had a right to payment of their respective income tax refunds. The court stated that, in the case at bar, no such right could transfer to the estate because the debtors no longer held an interest in receiving a refund. Thus, the overpayment was found not to be property of the estate under section 541 and ineligible for turnover under section 542. *Id.* at 611.

2. *Morton v. IRS (In re Metcalf)*, No. 00-10279-7, 2001 WL 1203344 (Bankr. N.D. Tex. Aug. 17, 2001)

Ten years later, the Bankruptcy Court of the Northern District of Texas again faced the issue of a debtor's irrevocable election to apply a pre-petition tax refund as a credit for the petition tax year. This time the court, following *In re Block*, held that the election, once made, removed the overpayment from the scope of sections 541 and 542. The debtor filed her 1999 tax return in March 2000 and claimed an overpayment of \$5,537. On her return, she elected to apply the overpayment to the 2000 tax year. One month later, she filed for chapter 7 protection. The trustee sought return of the 1999 overpayment from the IRS by filing an amended return seeking to overturn the debtor's election. The parties cross-moved for summary judgment and the court entered judgment against the trustee. The court found that "once the overpayment [was] properly transferred to the IRS pre-petition, it [could not] become property of the estate, and [was] not recoverable under [section] 542."

In re Metcalf, 2001 WL 1203344, at *2.

3. Grant v. United States (*In re Simmons*), 124 B.R. 606 (Bankr. M.D. Fla. 1991)

Six months prior to the *In re Canon* case, the Bankruptcy Court of the Middle District of Florida faced the issue and held that the debtor, in making the irrevocable election to apply his tax overpayment to the following tax year, lost all claim to the refund and, thus, maintained no legal or equitable interest in the overpayment. The overpayment was not available for turnover. The debtor had filed his 1987 tax return on March 18, 1988 and then filed for chapter 7 protection less than a week later. On his 1987 return, he elected to have his \$7,799 overpayment applied toward the 1988 tax year. See *In re Simmons*, 124 B.R. at 607.

The court noted that the trustee “[could not] recover an authorized pre-payment of taxes simply because it originated pre-petition.” *Id.* at 608. This included those pre-petition payments made by withholding from the debtor’s wages, an estimated tax payment made under section 6654 of the Tax Code, and any tax overpayment from one tax year elected forward to the following tax year. The court held that the tax overpayment sought by the trustee had been “properly transferred to the United States . . . and [was] not property of the estate.” *Id.* at 608.

D. A Middle Ground

1. Traina v. Orrill (*In re Orrill*), 226 B.R. 563 (Bankr. E.D. La. 1997)

The *In re Orrill* court struck a middle ground when it disallowed the trustee’s turnover claim to the debtor’s overpayment for the pre-petition tax year, but found that the subsequent year’s refund was property of the estate to the extent that the refund was “attributable to the pre-petition period.” *In re Orrill*, 226 B.R. at 566. The debtor filed his 1993 return on October 17, 1994. His return indicated an anticipated refund of \$14,121, of which the debtor elected to apply \$9,993 to his 1994 tax liability. The next day, the debtor filed for chapter 7 protection. Upon filing his 1994 taxes, the debtor was entitled to a refund of \$1,795. *Id.* at 564.

Analogizing the case to *In re Simmons* and *In re Block*, the court found that the overpayment,

as applied to the 1994 taxes, was not property of the estate as a matter of law. *Id.* at 566. The court permitted, however, the trustee to recover that portion of the 1994 tax refund that was attributable to the pre-petition portion of the year. Multiplying the 1994 refund by the proportion of the days pre-petition to the total days in the calendar year, the court calculated that the trustee was entitled to \$1,426.80 and the debtor was able to retain \$368.20. *Id.*

E. A Turnover Concern

1. Appellant v. Graves (*In re Graves*), 396 B.R. 71 (B.A.P. 10th Cir. 2008)

In *In re Graves*, the court assumed, without deciding, that the debtors' overpayment was property of the estate in order to focus its analysis more closely on section 542 as a method to obtain a tax overpayment from the debtors. The court concluded that turnover under section 542 was not appropriate as against the debtors. *In re Graves*, 396 B.R. at 75-76. The debtors filed their 2006 tax return in July 2007 and claimed a refund of \$3,000. On September 20, the debtors filed for chapter 7 protection. *Id.* at 72.

In analyzing the trustee's turnover claim, the court noted that turnover under section 542 was limited to " 'property that the trustee may use, sell or lease,' and [was] in the turnover target's possession or control during the bankruptcy case." *In re Graves*, 396 B.R. at 75 (quoting 11 U.S.C. § 542(a)). The court indicated that the debtors could not relinquish possession of funds held by the IRS in which the debtors held only a contingent reversionary interest. The court summed up its observations: "A trustee . . . can no more compel a debtor to turnover funds that he does not have than he can squeeze blood out of a turnip." *Id.* The court held that the debtors could not be compelled to turnover the tax overpayment because they were not in possession, custody or control of the funds sought by the trustee. *Id.* at 75-76.

IV. Policy Considerations

The case law presents three distinct approaches taken by the courts, each of which reflects a

policy choice as to whose interests, debtors or creditors, should be paramount.

First, there are courts that favor creditors by holding that the entire tax overpayment from the pre-petition tax year is subject to turnover. *See Nichols*, 491 F.3d 987. By subjecting the entire overpayment to turnover, a court will maximize the amount available for distribution to creditors. This pro-creditor approach, however, may impose a great financial hardship on chapter 7 debtors who depend on the tax refund to pay their post-petition tax liability.

Second, there are courts that favor the debtor by holding that after the debtor's election, the debtor has no right to the tax overpayment, thus preventing the overpayment from entering the estate. *See In re Block*, 141 B.R. 609. An asset withheld from the estate is generally left for the benefit of the debtor in making her fresh start. This pro-debtor solution is arguably unfair to unsecured creditors whose debts would likely be discharged, particularly as it is common in a chapter 7 proceeding for a tax refund to be one of the debtor's largest non-exempt assets.

Third, there are courts that split the difference and attempt to balance the interests of creditors and debtors. According to these courts, the debtor, at the time of the bankruptcy petition's filing, holds a contingent reversionary interest in any overpayment that results from the petition tax year. *See In re Canon*, 130 B.R. 748. Thus, these courts allow the estate to collect any refund that results from the subsequent tax year. A subset of this third group limits the potential refund to that portion that is attributable to the pre-petition portion of the year. *See In re Orrill*, 226 B.R. 563.

It is this third approach that best suits the dual purposes of the Bankruptcy Code. The debtor is ensured the best fresh start possible because the debtor retains the ability to use the tax overpayment for her petition year tax liability. In the event, however, the debtor is able to cover her tax liability via wage withholding and need not resort to use of the tax overpayment, the overpayment is returned to the estate for distribution to creditors.

It may be argued that by allowing the debtor the first chance to use the overpayment, an

ill-intentioned debtor may take advantage and prevent the estate access to a valuable asset that could be used to benefit creditors. In that factual situation, however, the trustee could resort to section 548(a)(1) and void the election as a fraudulent transfer. Yet the trustee must be wary because the tax overpayment allows the debtor to take a dollar for dollar credit, thus the trustee will need to argue and prove the debtor's actual intent to "hinder, delay or defraud." *See* 11 U.S.C. § 548 (2006); *cf. In re Middendorf*, 381 B.R. 774, 777–78 (Bankr. D. Kan. 2008), *In re Orrill*, 226 B.R. at 564, *In re Simmons*, 124 B.R. at 608.

V. Conclusion

Regardless of the approach taken by a court when confronted with a chapter 7 debtor who has elected to apply a pre-petition tax refund to her petition year tax liability, the choice itself demonstrates how a bankruptcy court must consider the dueling interests of creditors and debtors in deciding the threshold issue of what property of the debtor is property of the estate.

