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CHAPTER 7 TRUSTEE'S RIGHT TO PRO-RATED PORTION OF TAX REFUND

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A CLE Presentation

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Substantive Law

Section 541(a)(1) of Bankruptcy Code

- (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
- (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

The United States Supreme Court in *Segal v. Rochelle*, 382 U.S. 375 (1966), determined that a tax refund for loss-carryback constituted property under § 70a(5) (Bankruptcy Act of 1898). In *Segal*, the Court stated that the purpose of § 70a(5) was to “secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition,” and that the term “property” under this section had been “construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed.” *Segal* 382 U.S., at 379. In addition, the basic purposes of the 1898 Bankruptcy Act was to “leave the bankrupt free after the date of his petition to accumulate new wealth in the future.” *Id.* Consequently, the Court concluded that the loss-carryback refund claim was “sufficiently rooted in the pre-bankruptcy past and so little entangled with the bankrupts’ ability to make an unencumbered fresh start that is should be regarded as ‘property’ under § 70a(5).” *Id.* at 380.

The Supreme Court then had the opportunity to determine whether an income tax refund was “property” within the meaning of § 70a(5) (Bankruptcy Act of 1898), in *Kokoszka v. Belford*, 417 U.S. 642 (1974). The Court granted certiorari to resolve a conflict among the Court of Appeals on this issue, and concluded that the income tax refund was “property,” that would be included in the bankrupt’s estate. *Kokoszka*, 417 U.S., at 642. In coming to this conclusion, the Court looked to two cases that served as precedent, *Segal* and *Lines v. Frederick*, 400 U.S. 18 (1970). Even though the Court reached contrary results in these two cases “construing § 70a(5) in almost identical language,” this was because they found the “crucial analytical key... in an analysis of the nature of the asset involved” in light of the purpose of the statute. *Kokoszka*, 417 U.S., at 646.

In *Lines*, the Court applied the test from *Segal* and held that vacation pay “accrued but unpaid at the time of filing” of bankruptcy petition did not pass to the trustee in bankruptcy as “property” under § 70a(5). *Lines*, 400 U.S., at 18. The Court held this since the bankrupt’s “sole source of income, before and after bankruptcy, is their weekly earnings,” and vacation pay is “a specialized type of property presenting distinct problems in our economic system.” *Id.* at 20. The Court reasoned that when “the minimal requirements for the economic survival of the debtor are at stake, legislatures have recognized that protection that might be unnecessary or unwise for other kinds of property may be required.” *Id.*

In *Kokoszka*, the Court determined that an income tax refund was “not the weekly or other periodic income required by a wage earner for his basic support.” *Kokoszka* 417 U.S., at 648. The Court makes a distinction between vacation pay and a tax refund, stating that merely because “some property interest had its source in wages...does not give it special protection.” *Id.* Since the income tax refund was “sufficiently rooted in the prebankruptcy past,” then it is defined as property under § 70a(5). *Kokoszka* 417 U.S., at 648.

Note that the three Supreme Court cases discussed above were decided under § 70a(5) of the Bankruptcy Act (1898). However, the legislative history of § 541 of the Bankruptcy Code “is clear that the result of *Segal v. Rochelle* is adopted by § 541 at least in so far as the right to a tax refund is property of the estate.” *In re Nichols*, 4 B.R. 711, 714 (Bankr. E.D. Mich. 1980). Further, this section effectively overruled *Lines*, “which held that the estate did not include accrued, but unpaid, vacation pay of the bankrupt.” *Id.* Most important, “[t]he import of section of 541, as viewed in the light of its legislative history, is to create an estate which is much broader than that which was found under prior law.” *Nichols*, 4 B.R., at 714. This means that all future wage and equivalent are included as property of the estate under § 541.

Section 541(a) of the Bankruptcy Code broadened the scope of what was to be property of the estate. In addition, the scope of “property” under section 541 “is necessarily limited to the property owned by the debtor at the commencement of the case.” *In re Quality Health Care*, 215 B.R. 543, 560 fn 10 (Bankr. N.D. Ind. 1997). This section “eliminated the requirement that property must be transferable or subject to process in order to become initially part of the state.” *Id.* Now, “[e]very conceivable interest of the debtor, future, non-possessory, contingent, speculative, and derivative is within the reach of § 541.” *Id.*

Therefore, the debtor’s estate “includes any and all interest in property he owned, claimed or possessed as of the date of filing his voluntary petition in bankruptcy.” *In re DeVoe*, 5 B.R. 618, 619 (Bankr. S.D. Ohio 1980). This includes the contingent right to an income tax refund of excess withholdings for the petition year. The court in *DeVoe* concluded that the method the IRS uses to collect income tax is have the money withheld from the earnings of a particular year, to be applied to the “final tax obligation at the end of the tax year.” *Id.* Thus, “[d]uring the course of the year, withholdings are in the nature of a savings account. Withholdings in excess of tax liability are ultimately available for debtor’s use and control, even though enjoyment is postponed until a return is filed and the refund is returned.” *Id.*

The valuation of the portion of the tax refund that is received after the petition date, which is property of the estate, is determined on a calendar proration. This means that any income tax received after the filing date is “subject to turnover if at least a portion of the tax year preceded the filing of the bankruptcy case.” *In re Dussing*. 205 B.R. 332, 333 (Bankr. M.D. Fla. 1996). Therefore, portion of the tax refund that is attributable to the pre-petition withholdings is property of the estate, and courts will “prorate refunds based upon the number of calendar days before and after the petition. For instance, if the debtor filed its petition of December 30, the bankruptcy trustee would be entitled to 364/365 of the debtor’s refund.” *Id.*

Procedure

Sections 521(3), (4) of Bankruptcy Code

The debtor shall—

- (3) if a trustee is serving in the case, cooperate with the trustee as necessary to enable the trustee to perform the trustee’s duties under this title;
- (4) if a trustee is serving in the case, surrender to the trustee all property of estate and any recorded information, including books, documents, records, and papers, relating to property of the estate, whether or not immunity is granted under section 344 of this title

Section 727(c)(1) of Bankruptcy Code

The trustee, a creditor, or the United States trustee may object to the granting of a discharge under subsection (a) of this section.

Section 727(d) of Bankruptcy Code

- (d) On request of the trustee, a creditor, or the United States trustee, and after notice and a hearing, the court shall revoke a discharge granted under subsection (a) of this section if—
 - (1) such discharge was obtained through the fraud of the debtor, and the requesting party did not know of such fraud until the granting of the discharge;
 - (2) the debtor acquired property that is property of the estate, or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report acquisition of or entitlement to such property, or to deliver or surrender such property to the trustee;
 - (3) the debtor committed an act specified in subsection (a)(6) of this section.

Rule 4001 of Federal Rules of Bankruptcy Procedure

- (a) Time for filing complaint objecting to discharge; notice of time fixed. In a chapter 7 liquidation case a complaint objecting to the debtor's discharge under § 727(a) of the Code shall be filed not later than 60 days after the first date set for the meeting of creditors under § 341(a).
- (b) Extension of time. On motion of any party in interest, after hearing on notice, the court may for cause extend the time to file a complaint objecting to discharge. The motion shall be filed before the time has expired.

Rule 7001 of Federal Rules of Bankruptcy Procedure

An adversary proceeding is governed by the rules of this Part VII. The following are adversary proceedings...

- (4) a proceeding to object to or revoke a discharge

The debtor has a duty cooperate with the trustee in order to allow the trustee to perform its duties, and to surrender all property of the estate. 11 U.S.C. § 521(3), (4). This means that all debtors are expected to “comply with the duty to turnover property of the estate, including tax refunds, and to turnover copies of their books and records, including tax returns.” *In re Espinoza*, 2003 WL 21981591, 4 (Bankr. D. Idaho 2003). If a debtor fails to comply with the duties listed in § 521, there may be serious consequences. For example, a debtor could “lose his right to a discharge if he transfers or conceals property of the estate after the filing of the petition, see § 727(a)(2)(B); or if he conceals, destroys, or fails to keep recorded information regarding his financial condition, see § 727(a)(3); or if he withholds from the trustee recorded information relating to his property or financial affairs, see § 727(a)(4)(D).” *Id.* In addition, an improper handling of a debtor's tax return could then implicate one or all of these sections. *Id.*

In order to obtain the portion of a debtor's tax refund that belongs to the estate, the trustee usually gives the debtor a consent to an extension of time which the trustee can object to the discharge at the 341 meeting. Without this consent, the trustee only has 60 days after the 341 meeting to object to the debtor's discharge under § 727(a). *Rule 4001(a) of the Federal Rules of Bankruptcy Procedure*. In addition to obtaining consent from the debtor to extend the time, the trustee may choose to file a motion with the court within 60 days of the 341 meeting. *Rule 4001(b) of the Federal Rules of Bankruptcy Procedure*.

After receiving the extension of time to object to the debtor's discharge, the trustee now has leverage over the debtor in collecting the portion of the tax refund that is property of the estate—which is probably the best leverage the trustee has. Therefore, if the debtor does not cooperate in turning over the tax refund, the trustee may then object to the granting of a discharge. 11 U.S.C. § 727(c)(1). If the debtor elects to split the tax year under §1398 of the Internal Revenue Code, the trustee will likely obtain either consent from the debtor at the 341 meeting, or file a motion with the court to extend the time, in order to have on hand the right to object to the discharge. The trustee is then covered later when the debtor receives the tax refund which is property of the estate.

If the trustee does not either obtain a consent from the debtor or file a motion with the court to extend the time to object to the debtor's discharge, and the debtor's discharge is granted, the trustee would then move to revoke the discharge—which would be an adversary proceeding, according to *Rule 7001 of the Federal Rules of Bankruptcy Procedure*. Courts are usually hesitant to revoke a discharge, however. Some courts have revoked a debtor's discharge for failure to turn over tax refunds, while other courts “have denied revocation for failure to turn over tax refunds when the failure was not ‘knowing or fraudulent.’” *In re Guerrero*, 30 B.R. 463, 466 (Bankr. N.D. Ind. 1983).

A bankruptcy court cannot order the IRS to pay the debtor's tax refund to the trustee—“[a]bsent an unequivocally expressed waiver, sovereign immunity is a jurisdictional bar to suit against the United States.” *In re Knapp*, 294 BR 334, 336 (Bankr. W.D. Wash. 2003). A “suit” is “against the United States” if the judgment sought “‘would expend itself on the public treasury or domain, or interfere with the public administration,’ or if the effect of the judgment would be to ‘restrain the government from acting, or to compel it to act.’” *Id.* (quoting *Land v. Dollar*, 330 U.S. 731, 738 (1947)). The court in *In re Knapp*, noted

that “[u]nder the IRS’s automated system, refund checks are normally sent to the debtor. In order to comply with the bankruptcy court’s order, the IRS would have to override the existing system and manually process the refund.” *Id.*, at 336-7. In addition, overriding the system would “require a significant expenditure of resources’ which would eliminate the advantages of the investment in the newly automated program.” *Id.*, at 337.

The court thus concluded that the bankruptcy court’s order granting the trustee’s motion to direct the IRS to send future refunds to the trustee rather than the debtor (this was a Chapter 13 petition), was a “suit” as the Supreme Court had described in *Land*, since the “order compels the IRS to act and would interfere with the public administration.” *Id.* The court held that sovereign immunity had not been waived, therefore the bankruptcy court “lacked subject matter jurisdiction to issue an order pursuant to § 1325(c).” *In re Knapp* was a Chapter 13 case, dealing with § 1325(c), which the court found was not included in § 106 of the Bankruptcy Code as abrogating the government’s sovereign immunity.

Arguments that have failed

1. *Income tax refund that is attributable to excessive withholdings from the petition year, but received in the following year, are not property of the estate since they do not mature until the end of a tax year.*

This argument has been attempted by numerous debtors, but has not been accepted by the courts. In *Segal*, the debtors argued that “under the statutory scheme no refund could be claimed from the Government until the end of the year.” *Segal* 382 U.S., at 380. In *Segal*, the issue was whether the loss-carryback refund was property of the estate, and the debtors had essentially argued that the any earnings they might make post-petition, may diminish or eliminate the loss-carryback refund claim. *Id.* The Supreme Court did not accept this argument, and held that “contingency in the abstract is no bar and the actual risk that the refund claims may be erased is quite far from a certainty.” *Id.* Furthermore, the Court noted that prior case law indicates that “postponed enjoyment does not disqualify an interest as ‘property.’” *Id.*

The debtors attempted a similar argument in *In re Meade*, 84 B.R. 106 (Bankr. S.D. Ohio 1988). In this case, the debtors argued that the certain percentage of income tax refunds that the trustee wanted was not “recoverable at this time because the possibility of their being audited by the IRS makes the amounts received as refunds uncertain.” *Meade*, 84 B.R., at 108. Further, they contend that if audited, “they will in all likelihood be required to repay the IRS.” *Id.* The debtors were not successful in their argument, for the court stated that they could not “conclude that the possibility of a tax audit renders the amount of the refunds uncertain so as to preclude their recovery by the trustee.” *Id.* In determining that income tax refunds are property of the estate despite the possibility of a tax audit, the court relied on an Eleventh Circuit case, *Matter of Doan*, 672 F.2d 831 (1982), which dealt with the same issue, “whether the uncertainty as to the actual amount of the refund excludes the application of 11 U.S.C. § 541(a).” *Meade*, 84 B.R., at 108. In *Doan*, the court concluded that “Supreme Court precedent makes clear, however, that this argument does not limit the broad sweep of Section 541.” *Meade*, 84 B.R., at 108.

2. *An earned income credit (EIC) is not property of the estate under § 541 because debtor has no legal or equitable interest in the EIC at filing of the bankruptcy petition.*

An EIC is “a refundable tax credit provided for low income workers who have dependent children and who maintain a household.” *In re Brockhouse*, 220 B.R. 623, 623 (Bankr. C.D. Ill. 1998). The debtors in *In re Montgomery*, 224 F.3d 1193 (10th Cir. 2000) argued that the EIC does not accrue until the end of the tax year, “it is contingent and therefore does not become property of the debtor’s estate if the debtor files for bankruptcy before the end of that tax year.” *Montgomery*, 224 F.3d, at 1194-5. In this case, the court determined that this argument was not persuasive, “in view of Congress’ clear intent that contingent interests are to be included in the property of a bankruptcy estate.” *Id.*, at 1195. Therefore the court held that even though the EIC is “not finalized until the end of the tax year is not an impediment to its inclusion in the bankruptcy estate.” *Id.* The court’s reasoning was based on the “broad interpretation of section 541 together with the classification and treatment of EICs as tax refunds.” *Id.*

Other debtors have tried to cite *Hoffman v. Searles*, 445 F. Supp. 749, (D. Conn. 1978) in support of their argument that EICs should not be included in the bankruptcy estate. The court in *Searles* had determined that EIC was not included in the bankruptcy estate. This case, however, was “decided under the Bankruptcy Act, the predecessor to the present Bankruptcy Code, and has been widely rejected by courts since the repeal of the Bankruptcy Act.” *In re Johnston*, 222 B.R. 552, (BAP 6th Cir. 1998). Now it appears that the “clear trend” of recent cases “is to hold that earned income credits are property of the estate.” *Brockhouse*, 220 B.R., at 624.

3. *A percentage of the income tax refund is exempt under the provisions of the Consumer Credit Protection Act (15 U.S.C. §§ 1671, 1672).*

According to the Consumer Credit Protection Act, “no more than 25% of a person’s aggregate disposable earnings for any workweek or other pay period may be subject to garnishment.” *Kokoszka*, 417 U.S., at 649. The debtors in *Kokoszka* had argued that 75% of the refund was exempt under this Act, that “a tax refund, having its source in wages and being completely available to the taxpayer upon its return without any further deduction, is ‘disposable earnings’ within the meaning of the statute.” *Kokoszka*, 417 U.S., at 649 (citing 15 U.S.C. § 1672(b)).

The Supreme Court in *Kokoszka* observed that “Congress did not enact the Consumer Credit Protection Act in a vacuum,” and the drafters were “aware that the provisions and the purposes of the Bankruptcy Act and the new legislation would have to coexist.” *Kokoszka*, 417 U.S., at 2436. The Court held that “Congress did not intend to create a separate bankruptcy exemption when it enacted this statute.” *In re Urban*, 262 B.R. 865, 870 (Bankr. D. Kan. 2001).

There have been bankruptcy courts, however, that have held that “state garnishment statute provides an exemption that may be claimed in bankruptcy.” *In re Bubb*, No. 02-05321-JKC-7, fn 3 (Bankr. S.D. Ind. Oct. 4, 2002) (order overruling trustee’s objection to exemptions). The court in *In re Urban*, 262 B.R. 865 (Bankr. D. Kan. 2001), noted that “[w]hether or not Congress intended to create such an exemption sheds no light on whether the Kansas legislature sought to create an exemption when it borrowed 15 U.S.C. § 1673(a)’s language.” *Urban*, 262 B.R., at 870. The court then held that the Kansas legislature intended to create an exemption that could be claimed in bankruptcy. *Id.*

Similar to Kansas’ garnishment statute, Indiana’s garnishment statute I.C. § 24-4.5-5-105 “closely tracks 15 U.S.C. § 1672 and § 1673.” *Fisher Body v. Lincoln Nat. Bank & Trust Co. of Fort Wayne*, 563 N.E.2d 149, 151 (Ind. App. 3rd Dist. 1990). While there has not been an Indiana court that has addressed whether the garnishment statute provides a separate exemption, “the Indiana Supreme Court has acknowledged that ‘[g]arnishment exemption statutes in Indiana have constitutional underpinnings.’” *In re Bubb*, No. 02-05321-JKC-7. Further, it has been held in an order overruling trustee’s objection to exemptions, that “Indiana Code § 24-4.5-5-105 constitutes an exemption under Indiana law that may be claimed by a debtor in bankruptcy.” *Id.*

4. *Calendar day proration could result in an inequitable division of the refund.*

The debtors in *In re Rash*, 22 B.R. 323 (Bankr. D. Kan. 1982) argued that the “calendar day formula is based on the premise that excessive withholding is proportional per day.” *Rash*, 22 B.R., at 325. However, if there is “a change in income, marital status, or number of dependents,” then there would be a disproportional withholding. *Id.* Furthermore, this approach could “result in a windfall to the trustee or the debtor, depending on the circumstances of the case.” *Id.*, at 326. The court in *Rash* found merit in the debtor’s argument, but concluded “as a practical matter, calendar day prorationing is the most efficient method to determine how much the estate is entitled.” *Id.*

5. *The debtor's fresh start would be impaired.*

§ 541(a)(1) makes all property of the debtor, even that needed for a fresh start, property of the bankruptcy estate. Once it becomes property of the estate, the debtor may be permitted to exempt it under § 522.

6. *There would not be a meaningful distribution.*

Courts do not really even address this argument, and if it is mentioned, then it is usually brushed aside without much discussion.

Questions and Examples

1. Wife is sole debtor. Husband has \$100,000 gross income, and Wife has \$10,000
2. Wife is sole debtor. Husband took depreciation for expenses, so his adjusted gross income is \$2,000 and the Wife's is \$10,000.
3. Can a debtor who files in November argue that the Trustee's collection efforts against the tax refund in November violates equal protection—if Trustee does not recover the tax refund of a debtor who files in February?
4. Could the Trustee seek the pro-rated portion of a substantial bonus from a debtor who works at Lilly?
5. Could the Trustee seek the pro-rated portion of a debtor's vacation pay?
6. What do you advise your client about when to file for bankruptcy?
7. Does the Trustee have a right to protect the tax refund?
 - o One way that the tax refund may be protected is if the debtor elects under § 1398 of the Internal Revenue Code a short tax year. This means that the first tax year would end as of the day before the bankruptcy petition, and the second tax year would begin on the date of the bankruptcy petition. It does not appear, however that the estate or trustee may elect a short tax year.
 - o The trustee could either get an extension to object to the discharge either by consent of the debtor, or on a motion to the court.
 - o If the debtor does not turn over the tax refund and a discharge had been granted, then the trustee may be able to institute an action under § 727(d) of the Bankruptcy Code to revoke the discharge.
8. Is a debtor liable for the amount of pro-rated tax refund that is reduced substantially post filing for bankruptcy due to debtor's voluntary or involuntary acts? (i.e. sold 401K and incurred penalties, laid off from work).