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Interest in a Debtor's Right to Tax Overpayments for Pre-Petition Years

The Internal Revenue Service (IRS) requires that everyone pay taxes on income they receive during the year, whether it is from a job, self-employment or other sources.¹ The IRS expects to receive tax payments as income is earned, not just at the end of the year when a tax return is filed.² The federal income tax is referred to a pay-as-you-go tax, and there are two ways to pay as you go.³

The first way to pay federal taxes is through withholding taxes. Employers typically withhold income or other tax on an employee's behalf.⁴ The amount withheld is paid to the IRS by the employer in the employee's name.⁵

The second way is through payment of estimated tax.⁶ Estimated tax is a method of paying tax on income that is not subject to withholding tax, and is paid directly to the IRS by individuals who do not have their taxes withheld.⁷ This can include income from self-employment, business earnings, interest, rent, dividends and other sources.⁸

Such withholding or estimated tax payments ordinarily will be applied to a debtor's federal tax liability, which arises at the close of the taxable year.⁹ The general rule is that the filing of a bankruptcy case does not change the taxable year of the debtor, unless the debtor takes the short tax year election as set forth in § 1398(d)(2) of the Internal Revenue Code (IRC).¹⁰ This might mean that a debtor's right to overpayments as of the date that a bankruptcy case is filed becomes property of the estate subject to § 541 of the Bankruptcy Code.¹¹ This might also be the case — even if the debtor elects to apply such overpayments to a future tax return.¹²

Consequently, a bankruptcy estate might have the right to the turnover value of the overpayments as of the filing date or, alternatively, avoid and recover any transfer of pre-petition tax overpayments to pay post-petition tax liabilities. The IRS and debtors, on the other hand, generally have taken the position that a debtor's irrevocable election under IRC §§ 6402(b) and 6513(d) to apply a tax overpayment to a future tax liability prevents a bankruptcy estate from asserting any interest in the overpayment.¹³ This article examines the nature of a bankruptcy estate's interest in such tax overpayments.

Tax Credit as Property of the Estate *Nichols*: Tax Credit Is Property of the Estate

The irrevocable nature of a debtor's election to apply tax overpayments to future tax liabilities still might not bar a bankruptcy estate's action for turnover under § 542(a).¹⁴ In *In re Nichols*, the debtors overpaid their 2001 federal and state income tax returns and were entitled to tax refunds as a result of the overpayments.¹⁵

Rather than obtain a current refund of the money, the debtors elected to have those overpayments held as credits and applied to their future federal and state tax liabilities.¹⁶ Sixteen days after filing their 2001 returns, the debtors filed chapter 7.¹⁷ The trustee demanded that the debtors turn over the credits to the trustee, but this was not done.¹⁸ The debtors subsequently proceeded to have the credits applied to their 2002 tax liabilities.¹⁹

The bankruptcy court granted the trustee's motion for summary judgment, concluding that the prepayment of the tax liability was an asset of the bankruptcy estate as of the petition date, and that the debtors were required to deliver to the trustee the value of that asset pursuant to § 542(a), without any deduction of their current year 2002 tax liabilities.²⁰ The district court denied the appeal.²¹ Affirming the



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1 See generally "What Is Estimated Tax and Who Does It Apply To?," IRS, available at [irs.com/articles/what-estimated-tax-and-who-does-it-apply](https://www.irs.com/articles/what-estimated-tax-and-who-does-it-apply) (unless otherwise indicated, links in this article were last visited on March 27, 2017).

2 *Id.*

3 See "Tax Withholding," IRS, available at [irs.gov/individuals/employees/tax-withholding](https://www.irs.gov/individuals/employees/tax-withholding).

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 See *supra* n.1.

9 See, e.g., *In re Polichuk*, 506 B.R. 405, 427 (Bankr. E.D. Pa. 2014); *Klein v. C.I.R.*, 135 T.C. 166, 174 (2010).

10 See 26 U.S.C. § 1398(d)(1) and (2). Section 1398(d)(2) provides that "Election to terminate debtor's year when case [under title 11 of the U.S. Code] commences — (A) In general. — Notwithstanding section 442, the debtor may (without the approval of the Secretary) elect to treat the debtor's taxable year which includes the commencement date as [two] taxable years — (i) the first of which ends on the day before the commencement date, and (ii) the second of which begins on the commencement date."

11 See, e.g., 11 U.S.C. § 541; *Nichols v. Birdsell (In re Nichols)*, 491 F.3d 987, 990 (9th Cir. 2007). Overpayments for the purpose of this article are defined as any amount resulting after the application of these withholding/estimated payments to pre-petition tax liability.

12 *Id.*

13 *Weinman v. Graves (In re Graves)*, 609 F.3d 1153 (10th Cir. 2010), cert. denied, *Weinman v. Graves*, 562 U.S. 1135 (2011); see, e.g., *Nichols*, *supra* n.11 at 990.

14 11 U.S.C. § 542(a).

15 *Nichols*, *supra* n.11 at 990.

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 *Id.* ("[N]othing in section 541 requires that the debtor's interest be immediately capable of being liquidated into cash in order to constitute property of the estate. Instead section 541(c)(1) provides that a debtor's interests become property of the estate, even in circumstances in which the interest cannot be liquidated and transferred by the debtor.")

21 *Id.*

bankruptcy and district courts, the Ninth Circuit Court of Appeals noted:

As a result of the election, the Debtors were left with a credit with the IRS that provided a dollar-for-dollar tax reduction in the following year. If the [debtors] had not elected to prepay their taxes, those funds would have been refunded to them.... In light of the expansive definition of property contained in the Bankruptcy Code ... we hold that this credit toward future taxes constituted estate property at the time [that] the Debtors filed for bankruptcy.²²

Graves: Tax Credit Is Not Property of the Estate Where Election to Apply Credit to Future Tax Liability Was Made Pre-Petition, with the Exception of Any Contingent Reversionary Interest

In *In re Graves*, prior to filing their chapter 7 case, the debtors filed their 2006 tax return.²³ Pursuant to that return, instead of choosing to receive a current refund, the debtors elected to apply the overpayment to their future tax liability.²⁴ When the debtors filed their bankruptcy case two months later, the trustee filed a motion for turnover of the debtor's 2006 tax refund under § 542(a).²⁵

The bankruptcy court denied the trustee's motion, and the bankruptcy appellate panel (BAP) affirmed. In agreeing with the bankruptcy court, the BAP concluded that § 542 did not empower the trustee to demand turnover where the debtors had no present right to possession of the pre-paid taxes because of IRC § 6513(d), which makes a debtors' election to apply a refund to future tax liability irrevocable.²⁶

Noting the principle that the estate can only succeed to the same property interest that a debtor possesses, the Tenth Circuit Court of Appeals found that it was clear that the trustee's interest in the application of the tax refund was limited by the strictures of IRC § 6513(d).²⁷ In *Graves*, the court of appeals held that the estate's interest in a pre-petition tax overpayment was limited to the debtors' contingent reversionary interest pending the final determination of the debtors' tax liability.²⁸

Estate Remedies

The court of appeals in *Graves*, while noting that all or part of a tax overpayment could be estate property, found that the requirements of § 542 were not met as the debtors were never in "possession, custody or control" of the 2006 tax refunds during the bankruptcy case.²⁹ It noted that the court of appeals in *Nichols* had not analyzed this requirement of § 542(a).³⁰

However, the related issue of the liability of the debtor for post-petition taxes was not discussed in either *Graves* or *Nichols*. If the application of the pre-petition refunds to

post-petition liabilities is permissible (as held by *Graves*), this would appear to be at odds with the ruling that a debtor may not use pre-petition assets to pay his/her personal post-petition income taxes.³¹

In *Smith*, a chapter 11 debtor used property of the estate to pay his federal income tax liability for the year in which the bankruptcy case was filed.³² The court held that the trustee was entitled to judgment against the debtor under § 549 as an unauthorized post-petition transfer, and that the trustee could recover the transfer from the debtor for whose benefit the transfer was made under § 550(a)(1).³³

As set forth in IRC § 1398, when an individual files for chapter 7 or chapter 11, the estate is liable for taxes.³⁴ The gross income of the bankruptcy estate for each taxable year is calculated separately, which excepts property of the debtor such as earnings for services performed after the commencement of the case.³⁵ As the debtor in *Smith* had not taken the short tax year election, he was not authorized to pay his post-petition tax liabilities with estate assets.³⁶

Under certain circumstances, a pre-petition election to apply tax credits to a future return might also be recoverable by the trustee as a fraudulent transfer under § 548.³⁷ In *Feiler*, five months prior to filing their chapter 7 case, the debtors elected to waive net operating losses (NOLs) and carry them forward against future tax liability.³⁸ Absent the election to carry forward the NOLs, the debtors would have been entitled to tax refunds of approximately \$287,493.³⁹

The trustee filed an adversary proceeding against the government seeking to avoid the election as a fraudulent transfer under § 548.⁴⁰ The bankruptcy court granted summary judgment to the trustee, and the BAP affirmed.⁴¹ The court of appeals agreed that § 548 could be used to avoid the election, which was a transfer of an interest of the debtors in property.⁴²

Short Tax Year Election

A remedy is available to debtors as set forth in IRC § 1398. The short tax year election provides debtors in a chapter 7 or 11 case with the option to break an individual debtor's calendar tax year into two short years: one ending on the day before the petition date, and one commencing on the petition date.⁴³

A debtor's short tax year election would permit tax liability of the first short tax year to constitute a priority pre-petition claim against the bankruptcy estate.⁴⁴ Pre-petition amounts reserved to pay the pre-petition short year taxes could then be properly offset.

22 *Id.* (internal citations omitted).

23 *Graves*, *supra* n.13 at 1155.

24 *Id.*

25 *Id.*

26 *Id.* at 1155-56. Once a debtor elects to apply a tax overpayment to the following tax year under IRC § 6513(d), the IRS provides a method to reverse the credit election and refund the overpayment if certain conditions are met. See *Internal Revenue Manual* 21.4.1.4.6 (05/26/2016), Credit Elect Problems, 21.4.1.4.6.1 (10-09-2015), Credit Elect Reversals, available at irs.gov/irm/part21/irm_21_004-001r.html.

27 *Id.* at 1156.

28 *Id.* at 1156-57 (citing *In re Middendorf*, 381 B.R. 774, 778-80 (Bankr. D. Kan. 2008); cf. *Redmond v. Lentz & Clark PA (In re Wagers)*, 514 F.3d 1021, 1029 (10th Cir. 2007)).

29 *Id.* at 1157, n.2.

30 *Id.* at 1158.

31 See *Nussbaum v. United States and Smith (In re Smith)*, 210 B.R. 689, 692 (Bankr. D. Md. 1997).

32 *Id.* at 691.

33 *Id.*

34 26 U.S.C. § 1398; *Hall v. U.S.*, 132 S. Ct. 1882, 1887 (2012).

35 *Id.*, *supra* n.31 at 691-92 (citing 11 U.S.C. § 541(a)(6)).

36 *Id.* at 692.

37 Cf. *U.S. v. Sims (In re Feiler)*, 218 F.3d 948 (9th Cir. 2000) (finding that irrevocable, pre-petition election to waive NOL carryback and carry-forward NOLs was fraudulent transfer).

38 *Id.* at 950-51.

39 *Id.* at 951.

40 *Id.*

41 *Id.*

42 *Id.* at 954-56.

43 *Id.*, *supra* n.31 at 691.

44 *Id.*

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Conclusion

The short tax year election might be particularly important for self-employed debtors or individuals making large estimated tax payments to the government pre-petition to consider prior to filing chapter 7 or 11. This would permit

tax payments made up to the time of filing to be used to pay the pre-petition taxes owed, with any excess remaining after the payment of that liability being available for turnover to the bankruptcy estate and applied to the payment of other allowed claims. **abi**

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