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Giving Up Your Tax Refund to Keep It: Tax Prepayment in the Context of the Bankruptcy Estate

C.D. Bradley¹

INTRODUCTION

When taxpayers file their income tax returns each year, those who have paid in more taxes than they owe face a choice of which they may not be aware. Almost all taxpayers take the refund. They have another choice, though: they could apply the amount of the overpayment to their tax bill for the following year. Assume one makes the latter choice and then files for Chapter 7 bankruptcy protection. A key tenant of bankruptcy law is that any property owned by the debtor at the time of the petition becomes property of the bankruptcy estate, and it is used to satisfy the debts which necessitated the protection.² The question presented is this: does the tax prepayment become property of the estate?

Courts considering the question have come up with a variety of conflicting answers to it, from positive to negative to somewhere in-between. Over the past twenty years, courts have failed to reach a consensus at the federal circuit level, and the Supreme Court passed up an opportunity to do so in early 2011.³ While these positions are supported by valid policy arguments, these inconsistent holdings should not co-exist. Theoretically, there is great appeal to the idea that the tax prepayment should be included in the bankruptcy estate. Given several practical considerations and the interplay of the applicable statutes, however, this Note argues that, in the vast majority of cases, courts should hold that a refund used for prepayment of future taxes should not become property of the estate.

Part I of this note examines how the Bankruptcy Code⁴ defines property of the estate, how courts have broadly construed that definition, and how one

¹ University of Kentucky College of Law, JD 2012. The author would like to offer sincere thanks to Professors Jennifer Bird-Pollan and Christopher Frost for offering needed criticism and advice.

² See *Taylor v. Freeland & Kronz*, 503 U.S. 638, 642 (1992) (“When a debtor files a bankruptcy petition, all of his property becomes property of a bankruptcy estate.”).

³ *Weinman v. Graves*, 131 S. Ct. 906 (2011) (mem.) (denying certiorari to *In re Graves*, 609 F.3d 1153 (10th Cir. 2010)). The case is discussed at length *infra* Part IV.B; see also *infra* text accompanying notes 96–97.

⁴ The Bankruptcy Code refers to Title 11 of the U.S. Code (hereinafter “Code”).

recent case placed limits on the generally broad scope of the estate. Part II discusses the Internal Revenue Code's clear position that the taxpayer has no rights to a refund or return of any prepayment. Part III reviews how this tension has played out in a series of lower court rulings, with each reaching a different result. Part IV compares the Ninth Circuit's decision in *Nichols v. Birdsell*, which included the prepayment in the bankruptcy estate,⁵ and the Tenth Circuit's subsequent *In re Graves* decision, which excluded a tax prepayment from the bankruptcy estate while holding open the possibility of including a potential refund.⁶ Part VI analyzes the interplay of federal bankruptcy and tax statutes and how courts should ultimately resolve the issue. This note concludes by recommending the adoption of a rule excluding tax prepayments for the bankruptcy estate for those bankruptcy petitioners whose debts are consumer in nature.

I. BANKRUPTCY'S BROAD CONCEPTION OF PROPERTY

Section 541 of the Code makes it clear that commencing a bankruptcy case creates an estate that is comprised of property "wherever located and by whomever held."⁷ This includes "all legal or equitable interests of the debtor in property as of the commencement of the case."⁸ As commentators have noted, the language is broad by design; that intent is "evident from the language of the [bankruptcy code]," and "[i]t would be hard to imagine language that would be more encompassing."⁹

Courts have indeed construed that language broadly in a variety of cases under both the pre- and post-Bankruptcy Reform Act of 1978,¹⁰ holding that a wide variety of interests are included in the property of the estate.¹¹ The Fifth Circuit, for example, opined that "[t]he scope of property rights and interests included in a bankruptcy estate is very broad: [t]he

5 *Nichols v. Birdsell*, 491 F.3d 987, 988 (9th Cir. 2007).

6 *In re Graves*, 609 F.3d 1153, 1158–59 (10th Cir. 2010), *cert. denied*, 131 S. Ct. 906 (2011). The court in *Graves* acknowledged the Ninth Circuit's decision in *Nichols* and rejected its ultimate decision. *Id.*

7 11 U.S.C. § 541(a) (2006).

8 *Id.* § 541(a)(1).

9 5 COLLIER ON BANKRUPTCY § 541.01 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. 2010).

10 Bankruptcy Act of Nov. 6, 1978, Pub.L. No. 95–598, 92 Stat. 2549. The Act is commonly referred to as the 1979 reform because of its effective date.

11 Those interests include "trademarks, corporate names, stock voting rights, property held out by a corporate debtor's principal to be the corporation's property, a stipulated right to possession of disputed property pending resolution of a lawsuit, money borrowed by the debtor, the right to accept or reject a gift previously received by the debtor, and licenses." 8A C.J.S. *Bankruptcy* § 552 (2011) (footnotes omitted).

conditional, future, speculative, or equitable nature of an interest does not prevent it from being property of the bankruptcy estate.”¹²

In 1966, the Supreme Court held that loss-carryback tax refunds are part of the estate,¹³ but the Court discussed the possible limitations of the broad definition:

[The basic purpose of the statute] is to secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition. To this end the term ‘property’ has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed. However, limitations on the term do grow out of other purposes of the Act; one purpose which is highly prominent and is relevant in this case is to leave the bankrupt free after the date of his petition to accumulate new wealth in the future. Accordingly, future wages of the bankrupt do not constitute ‘property’ at the time of bankruptcy nor, analogously, does an intended bequest to him or a promised gift—even though state law might permit all of these to be alienated in advance.¹⁴

Given the inclusion of property in which the debtor has a non-possessory interest, the Bankruptcy Code also provides a requirement that any entity in possession of estate property “shall deliver to the trustee, and account for, such property or the value of such property.”¹⁵

Although tangential to the issues here, an Eleventh Circuit case found a limit to the broad scope of the estate,¹⁶ which is instructive in considering the issue. A farmer lost much of his crop to drought in 2001, leaving him unable to pay his bills and pushing him into bankruptcy.¹⁷ After his petition was filed,¹⁸ Congress approved funding to pay farmers who had suffered losses from drought in 2001 and 2002.¹⁹ The debtor applied for and received this payment while his bankruptcy was pending, which opened the question of whether the payment was property of the estate.²⁰ In ruling it was not, the court stated, “[I]f *Bracewell* ‘had no right or interest that constituted property within the meaning of § 541(a)(1) at the commencement of the case, then the payment he later received cannot be proceeds of property of the estate under § 541(a)(6).”²¹ The bulk of the majority opinion directly

12 *In re Kemp*, 52 F.3d 546, 550 (5th Cir. 1995); see also *In re Yonikus*, 996 F.2d 866, 869 (7th Cir. 1993) (“In fact, every conceivable interest of the debtor[—] future, nonpossessory, contingent, speculative, and derivative[—] is within the reach of § 541.” (citations omitted)).

13 *Segal v. Rochelle*, 382 U.S. 375, 380 (1966). This was prior to the 1979 Amendments.

14 *Id.* at 379–80 (citations omitted).

15 11 U.S.C. § 542(a) (2006).

16 *In re Bracewell*, 454 F.3d 1234 (11th Cir. 2006).

17 *Id.* at 1236.

18 He originally filed a petition under Chapter 12, but later it was converted to Chapter 7. *Id.*

19 *Id.*

20 *Id.* at 1236.

21 *Id.* at 1247 (quoting *Burgess v. Sikes*, 438 F.3d 493 (5th Cir. 2006) (en banc)).

addresses the reasoning of the dissent, who argued for including the payment in the estate:

The Supreme Court has held that the debtor estate includes contingent interests that ripen into legal rights after commencement of the bankruptcy proceeding. . . . The Court stated that “property” under section 541 is “construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed.”²²

The dissent also objected on the grounds that the payment, if not included in the estate, became a “windfall” for the debtor.²³ Furthermore, the dissent noted that “[t]he exclusion of the payment as proceeds of the debtor estate violates the fundamental tenet of bankruptcy law to preserve the security interests of creditors Under the majority’s view, a debtor can effectively void a valid security interest held by a creditor by filing a bankruptcy petition.”²⁴

While crop payments are not tax refunds, the issues at play – how we define property and the limitations on that definition, as well as how bankruptcy law interacts with other aspects of the law – are similar. Also analogous are the divisions in the court when applying those conflicting rules, with the majority narrowing the scope of the estate in the face of other legal rules and the dissent favoring the broad scope of the estate.

Still, almost anything that could be construed as an interest is construed in just that way and therefore included in the property of the estate. This incorporation reflects the belief “that a chief purpose of the bankruptcy laws is ‘to secure a prompt and effectual administration and settlement of the estate of all bankrupts within a limited period’”²⁵ Applying a broad scope to what comprises the estate simplifies that step as the case moves towards a settlement, but only if the property in question is in the possession of the debtor at the time of petition or can be recovered from whoever holds it. If the property is not recoverable, there is the possibility that rather than being “prompt and effectual”, the administration of the bankruptcy estate will draw out as the court struggles with how to deal with those interests.

II. THE TAX CODE’S BRIGHT LINE

While the Bankruptcy Code seeks to be broadly inclusive, the Tax Code²⁶ aims for certainty instead. The Tax Code allows taxpayers to elect

22 *Id.* at 1249 (Pryor, J., dissenting) (quoting *Segal v. Rochelle*, 382 U.S. 375, 379 (1966)).

23 *Id.* at 1248.

24 *Id.* at 1258.

25 *Katchen v. Landy*, 382 U.S. 323, 328–29 (1966) (quoting *Ex parte Christy*, 44 U.S. 292, 312 (1845)).

26 Tax code refers to Chapter 26 of the United States Code, which governs the federal

to have overpayments applied to the succeeding year's tax liability.²⁷ If the taxpayer makes that election, "such amount shall be considered as a payment of the income tax for the succeeding taxable year . . . and *no claim for credit or refund of such overpayment shall be allowed for the taxable year in which the overpayment arises.*"²⁸

The applicable Treasury Regulation reflects that idea, stating that "[a]n election so to credit an overpayment of income tax precludes the allowance of a claim for credit or refund of such overpayment for the taxable year in which the overpayment arises."²⁹ Both the Internal Revenue Service ("IRS") and the courts have unanimously and repeatedly held that the decision, once made, is irrevocable.³⁰ This is because "[a]t that point, the amounts lose their character as overpayments for the years in which they arose and become tax *payments* for the succeeding year."³¹ Courts have even declared that the taxpayer loses any interest in the foregone refund, stating:

If a taxpayer makes such an election to credit part or all of an overpayment to a succeeding year's estimated tax liability, *no statutory interest . . . is allowable on the amount of the overpayment so credited.* . . . If a taxpayer, such as plaintiff, elects to credit an overpayment to its succeeding taxable year's estimated tax liability, that election is irrevocable and binding upon both the taxpayer and the [IRS].³²

If the taxpayer has no interest, not even a contingent one, then there is nothing to include in the estate.³³

Aside from the issue of the taxpayer's loss of interest in tax prepayments, another relevant issue is the bankruptcy court's authority to issue orders to the IRS. In 1992, the Supreme Court held that the IRS enjoys sovereign immunity from monetary claims unless it explicitly waives it.³⁴ That holding, and the subsequent enactment of a statute clarifying sovereign immunity,³⁵ generally bars trustees³⁶ from seeking turnovers directly from

income tax among other taxes collected by the federal government.

²⁷ 26 U.S.C. § 6513(d) (2006).

²⁸ *Id.* (emphasis added).

²⁹ Treas. Reg. § 301.6513-1(d) (1955).

³⁰ *See, e.g.*, Rev. Rul. 55-448, 1955-2 C.B. 595.

³¹ *Fisher v. United States*, 61 F. Supp. 2d 621, 623 (E.D. Mich. 1999) (emphasis added).

³² *Martin Marietta Corp. v. United States*, 572 F.2d 839, 841-42 (Ct. Cl. 1978) (emphasis added) (citations omitted).

³³ 11 U.S.C. § 541(a)(1) (2006).

³⁴ *United States v. Nordic Village, Inc.*, 503 U.S. 30 (1992), *superseded by*, 11 U.S.C. § 106(c) (1994).

³⁵ § 106(c); *see* S. Elizabeth Gibson, *Congressional Response to Hoffman and Nordic Village: Amended Section 106 and Sovereign Immunity*, 69 AM. BANKR. L.J. 311, 326 (1995).

³⁶ *Vreugdenhil v. Hoekstra*, 773 F.2d 213, 215 (8th Cir. 1985) ("The trustee is the 'legal representative' of the bankrupt estate, with capacity to sue and be sued. Furthermore, with certain exceptions not applicable here, it is the trustee who is empowered under the Code to avoid or subordinate security interests and liens, and to use, sell, or lease property of the estate

the IRS; courts which have decided to include tax prepayments in the estate have therefore either conceptualized the property interest as a credit against future tax liabilities³⁷ or sought a turnover of the resulting refund.³⁸ In either case, the typical bankruptcy rules have to be adjusted in the tax context.

III. LOWER COURTS STRUGGLE TO DEFINE THE RULE

A. Simmons: *Prepaid Taxes Are Not Property of the Estate*

The first case was decided in the Middle District of Florida in 1991.³⁹ The debtor filed his 1987 tax return in March 1988, opting to apply an overpayment of \$7,799.02 to his 1988 taxes instead of receiving a refund.⁴⁰ Six days later, he filed a petition for Chapter 7 bankruptcy.⁴¹ The trustee of the estate subsequently sued the IRS seeking the turnover of the money.⁴²

The court noted that the bankruptcy code requires "all property of the debtor... to be delivered to the trustee", but clarified that this cannot "expand the debtor's rights... more than they exist[ed] at the commencement of the case."⁴³ It therefore follows that "if those interests were limited at that time, [then] the trustee's rights to possession are similarly limited."⁴⁴ The court found such a limitation in the tax code's bar on seeking return of the money, stating:

Thus, [the] debtor's overpayment, at his election, became a payment of his 1988 estimated tax rather than an overpayment of his 1987 taxes. Once [the] debtor made this election, as a matter of law, he no longer had an overpayment for which he could file a claim for refund. Consequently, the debtor's 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.⁴⁵

in the ordinary course of business." (citations omitted)).

37 *Nichols v. Birdsell*, 491 F.3d 987, 990 (9th Cir. 2007) ("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... [T]his credit toward future taxes constituted estate property at the time the Debtors filed for bankruptcy." (citations omitted)).

38 *See In re Canon*, 130 B.R. 748 (Bankr. N.D. Tex. 1991).

39 *In re Simmons*, 124 B.R. 606 (Bankr. M.D. Fla. 1991).

40 *Id.* at 607.

41 *Id.*

42 *Id.*

43 *Id.* (citing 4 COLLIER ON BANKRUPTCY ¶ 541.01, at 541-5, ¶ 541.01, at 541-7 (15th ed. 1979)).

44 *Id.*

45 *Id.* at 607-08.

Because the debtor made the transfer before filing the bankruptcy petition, the court concluded, it could not be property of the estate.⁴⁶

Next, the trustee argued that the election constituted a fraudulent transfer, but the court held that there was not “evidence. . . [of] any actual intent on behalf of the debtor to hinder, delay, or defraud . . . creditors” and, furthermore, that “the debtor received a reasonably equivalent value. . . [for the] exchange. . . .”⁴⁷ Thus, the trustee failed to prove the requisite elements for a fraudulent transfer under the Code.⁴⁸ Given the “corresponding dollar-for-dollar reduction in his tax obligation” resulting from the election, the latter element will necessarily be present and therefore precludes avoidance on the ground of fraudulent transfer under these facts.⁴⁹

The trustee also tried to avoid the election on the grounds that it was a post-petition transfer, but this argument was rejected by the court in short order.⁵⁰ The court held that “[t]he subject transfer was made by the debtor prior to the filing of his petition. The debtor did not retain a legally cognizable property interest which could be considered property of the estate.”⁵¹

B. Canon: The Resulting Refund Is Property of the Estate

Shortly thereafter, the U.S. Bankruptcy Court for the Northern District of Texas considered a similar set of issues.⁵² The debtors filed their 1987 tax return on March 31, 1988.⁵³ They had \$62,887 withheld, which included an overpayment of \$14,900 they elected to apply to their 1988 tax liability.⁵⁴ They filed a Chapter 7 bankruptcy three months later.⁵⁵

Unlike the Florida case, the debtors filed their 1988 return and received a refund in the exact amount of their 1987 overpayment: \$14,900.⁵⁶ The court latched on to that fact in distinguishing the two cases:

[W]e are not deciding the Florida issue. There the debtor needed the overpayment which he elected to apply to his estimated tax liability for the year in which he filed his bankruptcy petition to meet his tax liability. In this case[,] the 1987 overpayment[,] which the [debtors] elected to apply to their 1988 estimated tax liability was not needed

⁴⁶ *Id.*

⁴⁷ *Id.* at 608.

⁴⁸ *Id.* (citing 11 U.S.C. § 548(a) (2006)).

⁴⁹ *See id.*

⁵⁰ *See id.*

⁵¹ *Id.*

⁵² *See In re Canon*, 130 B.R. 748 (Bankr. N.D. Tex. 1991).

⁵³ *Id.* at 749.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

for the 1988 taxes and was refunded. . . . [B]ecause the refund was sufficiently rooted in the prebankruptcy past, it became property of the estate as defined in §541.⁵⁷

Although the court did not consider the same issue as in the Florida case, it construed *Segal*⁵⁸ to support the opposite conclusion reached in *Simmons*,⁵⁹ holding that "the [debtors'] inability to revoke the election and claim a refund of the overpayment during the 1988 taxable year does not remove the \$14,900 in question from the property of the estate."⁶⁰ *Segal*, however, dealt with a refund stemming from loss carryback to prior tax years, not future years,⁶¹ and the court cited several other cases that also did not rely on section 6513(d).⁶² The court also noted that because the Canons' 1988 withholding accurately reflected their tax liability for the year, "the application of the 1987 overpayment of \$14,900 to the 1988 estimated tax liability was virtually a savings account for the Canons."⁶³

The first two courts to consider the issue came to opposite conclusions, with the second explicitly rejecting the reasoning of the first. A third court would soon reject the reasoning of the second just as explicitly.

C. Block: Reasoning of Canon Court Rejected

Less than a year later, the U.S. District Court for the Northern District of Texas, reviewing a case from the same bankruptcy court that decided *Canon*, reversed a nearly identical decision on appeal.⁶⁴ The debtors filed their 1988 income tax return in late April 1989, which would have amounted to a tax refund of \$11,807.⁶⁵ Two weeks after filing their original tax return, and only two days before they filed a Chapter 7 bankruptcy, the debtors amended their tax return to apply the refund amount as a prepayment of their 1989 taxes.⁶⁶

In an interesting turn, when the trustee sought return of the overpayment, the IRS returned it to the debtors instead of the trustee,

57 *Id.* at 752.

58 *Segal v. Rochelle*, 382 U.S. 375, 380 (1966).

59 *In re Simmons*, 124 B.R. 606 (Bankr. M.D. Fla. 1991).

60 *In re Canon*, 130 B.R. at 750.

61 *Segal*, 382 U.S. at 379-381. ("Without ruling in any way on a question not before us, it is enough to say that a carryover into post-bankruptcy years can be distinguished conceptually as well as practically." *Id.* at 381.)

62 *See id.* at 751 (citing *In re Doan*, 672 F.2d 831, 833 (11th Cir. 1982); *In re Orndoff*, 100 B.R. 516, 517 (Bankr. E.D. Cal. 1989); *In re Sutphin*, 24 B.R. 149, 150 (Bankr. E.D. Va. 1982); *In re DeVoe*, 5 B.R. 618, 619-20 (Bankr. S.D. Ohio 1980)).

63 *Id.* at 751-52.

64 *See In re Block*, 141 B.R. 609, 611 (Bankr. N.D. Tex. 1992).

65 *Id.* at 610.

66 *Id.*

which the IRS conceded was an error in the course of the case.⁶⁷ The debtors then “applied the funds to their 1989 taxes, in accordance with their original intention.”⁶⁸ The bankruptcy court, in line with its decision in *Canon*, found for the trustee and ordered the turnover of the funds.⁶⁹ The District Court disagreed:

The Blocks made their election prior to filing their petition in bankruptcy. Once they made the election, they no longer had an overpayment for which they could file a claim for refund; the overpayment became an advance payment of the Blocks’ 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 this case, and such payment is not subject to turnover.” 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 of the Bankruptcy Code.⁷⁰

The court also rejected the theory that once refunded, the money should become property of the estate.⁷¹ In doing so, the court reasoned that “[t]he [debtors] had no right to the funds and, by reapplying the funds to their 1989 taxes after the erroneous return of the funds, the [debtors] merely returned to the United States its rightful property.”⁷²

Up to this point, the courts that had considered the issue made clear, yet irreconcilable, decisions: the prepayment was either in the estate or out. The next court to consider it attempted to find some middle ground.

D. Orrill: Prepayment Excluded, Refund Included on Pro-Rata Basis

The fourth case, in the U.S. Bankruptcy Court for the Eastern District of Louisiana, followed *Simmons* in rejecting fraudulent and preferential transfer arguments.⁷³ In considering the receipt of a refund stemming from the prior year’s overpayment, however, it reached a different conclusion than in *Canon*.⁷⁴

The debtor filed his 1993 tax return in October 1994, showing an overpayment of \$14,121, of which he elected to prepay \$9,993 to his 1994 taxes.⁷⁵ The next day he filed a Chapter 7 bankruptcy.⁷⁶ When the debtor

67 *Id.*

68 *Id.*

69 *Id.*

70 *Id.* at 611 (citations omitted).

71 *Id.*

72 *Id.*

73 *See In re Orrill*, 226 B.R. 563 (Bankr. E.D. La. 1997).

74 *See id.* at 566.

75 *Id.* at 564.

76 *Id.*

filed his 1994 tax return, he received a refund of \$1,795, which was directly turned over to the trustee.⁷⁷

The trustee argued that the prepayment of \$9,993 was recoverable either as a fraudulent or preferential transfer, and, if not, then it was still property of the estate.⁷⁸Citing *Simmons*, the court summarily rejected the first two arguments before turning to the third.⁷⁹In holding that the prepayment was not property of the estate, the court distinguished *Canon*, finding that the debtor had not been refunded his overpayment from year one after filing his year two taxes.⁸⁰

The Bankruptcy Court decided to split the difference.⁸¹It held that the original overpayment was not property of the estate:

However, the \$1,795.00 refund following the 1994 tax year, insofar as it is attributable to the pre-petition period, is properly considered property of the estate. . . . [The trustee's] portion is the proportion of the refund attributable to the number of days in the year before the petition date, while the [d]ebtor would be entitled to the portion of the refund attributable to the number of days in the year after the petition date.⁸²

Because the petition was filed on October 18, the court awarded 290/365ths (\$1,426.80) to the trustee, with the balance going to the debtor.⁸³

The lower courts' inability to come to any consensus would be duplicated even as the issues rose to higher courts. This has resulted in a circuit split between the Ninth and Tenth Circuits.

IV. CIRCUIT COURTS ALSO UNABLE TO FIND COMMON GROUND

To this point, the issue of whether tax prepayments were includable in estate property had remained in the lower courts, which reached a variety of conclusions. Two Circuit courts have since considered the issue, but their opposing decisions have failed to bring much-needed clarity to the issue.

A. *The Ninth Circuit and Nichols: Property of the Estate*

Almost a decade after *Orrill* was decided, the issue finally reached a higher court—the Ninth Circuit.⁸⁴ The debtors filed their 2001 tax return in January of 2002.⁸⁵ It included a \$2,231.57 overpayment for their

77 *Id.*

78 *Id.*

79 *See id.* at 564–65.

80 *See id.* at 565–66.

81 *See id.* at 566.

82 *Id.*

83 *Id.*

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

85 *In re Nichols*, 309 B.R. 41, 42 (Bankr. D. Ariz. 2004), *aff'd sub nom., Nichols*, 491 F.3d

federal taxes, which they applied to their 2002 federal tax liability.⁸⁶ They subsequently filed a petition for Chapter 7 bankruptcy relief two weeks later.⁸⁷ They filed their 2002 tax return on February 4, 2003, using up “virtually all” of the prior year’s overpayment.⁸⁸

The U.S. Bankruptcy Court for the District of Arizona considered the debtors’ argument based on *Simmons* and *Block* that the overpayment was not property of the estate, but rejected the precedents as non-binding.⁸⁹ The debtor argued that once the overpayment was applied to the following year’s liability, it was not property of the estate.⁹⁰ The resulting credit that caused a reduction in “future tax liabilities or, if there were no such tax liabilities in the succeeding tax year, result in a refund[,]” however, would be property of the estate.⁹¹ “That credit, although not immediately realizable by the [d]ebtors on the petition date, was an asset that would ultimately realize for the [d]ebtors a dollar-for-dollar value at the conclusion of the succeeding tax year”⁹²

The bankruptcy court noted that the ability to instantly liquidate the interest is not required by the Code, and in fact that it allows for the transfer of the property or the “value of such property.”⁹³ The fact that the debtors could not recover the particular money prepaid in taxes did not preclude them turning over its equivalent value: “As the Supreme Court held in *Segal*, an interest is not outside of property of the estate simply ‘because it is novel or contingent or because enjoyment must be postponed.’”⁹⁴ The court decided that the resulting tax credit constituted such an interest and should therefore be included in the property of the estate.⁹⁵

The debtors appealed, and the Ninth Circuit decided the case in 2007 by affirming the lower court’s ruling.⁹⁶ The court rejected the debtors’ argument that they had no right to the funds once the irrevocable election was made.

As a result of the election, the [d]ebtors were left with a credit with the IRS that provided a dollar-for-dollar tax reduction in the following year. If the Nichols had not elected to prepay their taxes, those funds would have been refunded to them and would likely have been available for the bankruptcy estate when they voluntarily filed for bankruptcy just 16

987.

86 *Id.*

87 *Id.*

88 *Id.*

89 *Id.* at 43.

90 *Id.*

91 *Id.* at 45, n.2.

92 *Id.*

93 *Id.* at 45.

94 *Id.*

95 *Id.*

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

days later. The fact that the election, once made, was irrevocable, does not change the analysis. In light of the expansive definition of property contained in the Bankruptcy Code and our broad interpretation of "property" . . . we hold that this credit toward future taxes constituted estate property at the time the [d]ebtors filed for bankruptcy.⁹⁷

In so holding, the court favored the Bankruptcy Code's inclusive theory of the estate over the Tax Code's elimination of property rights in prepayments. In effect, it held that the prepayment represented a property right despite its lack of recognition as such in the Tax Code.⁹⁸ It was the first Circuit Court to take up the issue, giving its opinion some persuasive value as the issue arose elsewhere, but not enough to convince the next Circuit Court to consider prepayments that its decision was the correct one.

B. The Tenth Circuit and Graves: Not So Fast

Three years after *Nichols*, another Circuit heard a similar case. As we have seen in our review of cases on this issue, lower courts found little common ground, rejecting each other's reasoning seemingly every time it came up. The Circuits have proven no different; the Tenth Circuit came to a wholly different conclusion than the Ninth.⁹⁹

In July 2007, the debtors filed their 2006 tax return, which included an overpayment of \$3,000 they elected to apply to their 2007 tax liability.¹⁰⁰ Within two months they then filed a Chapter 7 bankruptcy.¹⁰¹

The Trustee sought turnover of the overpayment, but was denied by both the bankruptcy court and the bankruptcy appellate panel.¹⁰² Looking at the issue, the court reasoned, "The [t]rustee seeks to obtain from the [d]ebtors that which they simply do not have: the amount they could have received from the IRS in 2007, but did not."¹⁰³ The court pointed out that the debtors had no right to the prepayment at either the filing of their Chapter 7 or at the filing of the adversary proceeding.¹⁰⁴ The court further explained, "A contingent right to a refund in the event that the [d]ebtors overpaid their 2007 taxes is not something, in our opinion, that is subject to turnover. Simply put, under these facts, the [t]rustee may not take that which the [d]ebtors do not have."¹⁰⁵

97 *Id.* at 990(citations omitted).

98 *See supra* Part II.

99 *In re Graves*, 609 F.3d 1153 (10th Cir. 2010).

100 *Id.* at 1155.

101 *Id.*

102 *See In re Graves*, 396 B.R. 70 (B.A.P. 10th Cir. 2008).

103 *Id.* at 73.

104 *Id.* at 75.

105 *Id.*

The trustee then appealed to the Tenth Circuit, which ruled on the issue in June 2010.¹⁰⁶ The court noted:

One of the central precepts of bankruptcy law is that a bankruptcy trustee succeeds only to the title and rights in property that the debtor had at the time she filed the bankruptcy petition. Filing a bankruptcy petition does not expand or change a debtor's interest in an asset; it merely changes the party who holds that interest.¹⁰⁷

As such, the court held that the debtors, and accordingly the trustee, had no right to any refund “until after their 2007 tax liability is determined, and then only if they are entitled to a further refund. The portion of that further refund attributable to pre-petition earnings would become property of the estate.”¹⁰⁸

While the court distinguished the case from *Nichols* in that it was concerned with whether turnover was allowable rather than the Ninth Circuit's focus on whether the overpayment was property of the estate, it did concede that the court was “aware that, to a large extent, this holding conflicts with the Ninth Circuit's decision in *Nichols*. . . .”¹⁰⁹ Although the Tenth Circuit limited its consideration to turnover, it allowed that the Ninth Circuit's reasoning related to value exchange was appealing: “The fact that all or part of a tax prepayment can be estate property, however, does not determine the extent of the property interest in the hands of the trustee nor . . . does it determine whether that interest is subject to turnover.”¹¹⁰ The court also acknowledged and rejected the reasoning of *Simmons* and *Block*.¹¹¹

The court determined “that only the part of the refund that . . . is attributable to pre-petition earnings and . . . reverted to debtors after application of the refund to their ultimate (2007) tax liability, is subject to turnover.”¹¹² The trustee appealed to the U.S. Supreme Court, asking the Court to resolve the question of whether “bankruptcy debtors' contingent or illiquid interests, such as a deferred tax refund reserved to reduce a debtor's future tax liability, subject to turnover to bankruptcy trustees as property of the estate under 11 U.S.C. § 542(a)?”¹¹³ The Supreme Court declined to hear the case.¹¹⁴

106 *In re Graves*, 609 F.3d 1153.

107 *Id.* at 1156 (quoting *In re Sanders*, 969 F.2d 591, 593 (7th Cir. 1992)).

108 *Id.*

109 *Id.* at 1158 (citing *In re Nichols*, 491 F.3d 987 (9th Cir. 2007)).

110 *Id.* at 1159.

111 *Id.* at 1157 n.1.

112 *Id.* at 1159.

113 Petition for a Writ of Certiorari, *Weinman v. Graves*, 131 S. Ct. 906 (2011) (mem.) (No. 10-401), 2010 WL 3722062.

114 *Weinman*, 131 S. Ct. 906 (denying certiorari).

V. ANALYZING TENSION BETWEEN THEORETICAL AND PRACTICAL APPROACHES

Normatively, there's great abstract theoretical appeal to including tax prepayments in the bankruptcy estate. "[A] Chapter 7 filing by an individual debtor effects such a critical cleavage between the pre-petition and post-petition worlds that, metaphorically, bankruptcy is financial death."¹¹⁵ If we apply that framework, from a financial perspective the debtor is now "dead," with an estate to be settled, and has been reborn as a new and separate financial entity. At the same time, "an interest is not outside [the estate's] reach because it is novel or contingent or because enjoyment must be postponed."¹¹⁶ If the tax prepayment is considered as such an interest, that would also support inclusion.

That theory, however, quickly runs into the practicality of the tax code, which explicitly denies any right to a claim against the tax prepayment¹¹⁷ and thus implicitly undercuts the argument that it is an interest at all. As noted above, the tax code denies the taxpayer any rights to a claim against the overpayment once applied to future tax liability.¹¹⁸ The Supreme Court has defined property as being "more than the mere thing which a person owns. It is elementary that it includes the right to acquire, use, and dispose of it."¹¹⁹ In this instance, the taxpayer debtor can do none of those things with the overpayment once the election is made. Furthermore, while the financial death theory has appeal, it does not transfer to the tax code. The debtor files a tax return that includes both pre- and post-petition income, and the taxpayer's tax liability for the year is therefore based on both pre- and post-petition income.¹²⁰ The cleavage is substantial but not complete, and therefore the fresh start goal of bankruptcy is substantially but not totally realized in the income tax context.

These clashes of theoretical and practical considerations have divided courts, which have variously held that overpayments of taxes applied to

¹¹⁵ *A Debtor's Rights Under Laws Not Yet Enacted as Property of the Estate*, BANKR. L. LETTER, Apr. 2002, at 4.

¹¹⁶ *Segal v. Rochelle*, 382 U.S. 375, 379 (1966).

¹¹⁷ *See supra* Part II.

¹¹⁸ 26 U.S.C. § 6513(d) (2006).

¹¹⁹ *Buchanan v. Warley*, 245 U.S. 60, 74 (1917). The courts that have concluded that tax prepayments should be included in the bankruptcy estate have analogized them to contingent interests. *Canon* at 751, *Nichols* at 990. By definition, it is the enjoyment (or use) that is contingent, not the acquisition or disposition: A contingent interest is "[a]n interest that the holder may *enjoy* only upon the occurrence of a condition precedent." *Black's Law Dictionary* (9th ed. 2009) (emphasis added). In the case of tax prepayments, none of those options are available to the taxpayer.

¹²⁰ In an individual Chapter 7 bankruptcy, the estate is treated as a separate tax entity which must claim income derived from property of the estate, but that would not include income earned prior to petition. *See* I.R.S. Publication 908 (Mar. 31, 2009).

future tax liabilities either are property of the estate or are not.¹²¹ Among those who have held that it is not, the potential resulting refund has either been held to be property of the estate in its entirety¹²² or proportionately property of the estate depending on the petition filing date.¹²³

The Supreme Court passed on the opportunity to bring clarity to this muddle by denying cert to the bankruptcy trustee in *Graves*. Given the range of ultimately incompatible opinions, the Court should eventually take up the issue, and when it does so, it should hold that tax overpayments applied to future tax liabilities are not property of the estate. This position has the benefit of simplicity and aligns nicely with the fresh start purpose of bankruptcy protection while avoiding the inevitable problems any other holding would necessarily trigger.

Consider the alternatives. If the court declines to draw a firm line against inclusion in the estate, it has two other choices: default inclusion in the estate, or exclusion with the lingering possibility of a reach-back of some or all of any tax refund the following year.

As the court in *Graves* noted, including the overpayment in the estate is problematic for the simple reason that the debtor neither has the money nor can he or she get it back.¹²⁴ While it is possible that the prepayment might be refunded after the next year's taxes are filed, it is equally possible that there will be no refund. Even if there is a refund, it remains an open question as to what extent such a refund would be attributable to the prepayment, and to what extent it would be attributable to the income and withholding in the second year. For example, a taxpayer in year one elects to apply a \$1,000 tax refund to that year's liability, then files a bankruptcy petition under Chapter 7. He has had \$1,000 withheld for taxes up to that point in the year. The taxpayer loses his job in July and ends the year with less income than would be predicted by annualized withholding that began on January 1, and is therefore due a \$1,000 refund. Is the refund necessarily due to the prepayment, or is it due to over-withholding during the first six months of the year? This situation assumes a regular salary. What if the taxpayer is paid piecemeal? If so, that could skew incentives to work post-petition to balance out the tax liability and the amount prepaid or withheld. In either case, the fresh start of bankruptcy is put on hold, because the ultimate tax liability for the year by definition cannot be determined until the year ends, no matter the date of the petition. Because the liability necessarily depends on events both before and after petition, unless the petition is filed on December 31 or January 1, it is impossible to determine as of the petition what the impact of the prepayment will be, and it can be

¹²¹ See *supra* Part III–IV.

¹²² See *Supra* Part III B.

¹²³ See *Supra* Part III D.

¹²⁴ See *In re Graves*, 609 F.3d 1153, 1156 (10th Cir. 2010).

equally difficult to determine *ex post* what would have happened but for the prepayment.

This also ignores the possibility that tax losses in future years could be applied backwards to previous years. If the tax prepayment is applied but results in no tax refund, but then a loss two years later leads the taxpayer to amend his return resulting in a refund, should the bankruptcy estate then be reopened? Would such a refund be attributable to the prepayment, in whole or in part?

In addition to the cases considered above, courts considering the issue in several contexts have ruled that once taxpayers have made the election, it is irrevocable and they have no right to a refund,¹²⁵ as the language of the tax code makes clear.¹²⁶ In that way, such prepayments are most closely analogous to taxes withheld from pay, which are also not property of the estate unless they result in a refund.¹²⁷ Furthermore, it is important to remember that the court in *Block* held that the Internal Revenue Service enjoys sovereign immunity from “an action seeking monetary recovery in bankruptcy.”¹²⁸

If the trustee cannot compel the Internal Revenue Service to turn over the money, that leaves only the debtor, who doesn’t have it at the time of petition or presumably for many months afterward. For the reasons outlined above, the taxpayer may or may not get a refund the following year, which may or may not be directly attributable to the prepayment. If there is no refund forthcoming, the debtor has only two possible sources of money: pre-petition property that would otherwise be shielded by bankruptcy law exemptions, or post-petition income which is otherwise protected by the Bankruptcy Code¹²⁹ and its goal of providing a fresh start. Both options are necessarily at odds with the underlying policy purposes of bankruptcy.

The court in *Graves* declined to include the overpayment in the bankruptcy estate but left an opening for the trustee in case the debtor was due a tax refund the next year.¹³⁰ In that case, the court determined that the estate maintained a “contingent reversionary interest in the pre-

125 See *Georges v. United States*, 916 F.2d 1520, 1521 (11th Cir.1990); *Fisher v. United States*, 61 F.Supp.2d 621, 623 (E.D. Mich. 1999) (“When a taxpayer files an income tax return, rather than obtaining a refund of overpayment, he may indicate on the return that all or part of the overpayment shown on the return is to be applied to his estimated tax liability for the following year. Such an indication constitutes an election to so apply the overpayment and, once indicated, the election is irrevocable.” (footnote omitted)).

126 See *supra* Part II.

127 See, e.g., *In re Barowsky*, 946 F.2d 1516, 1518 (10th Cir. 1991) (“Every court that has considered this issue has held that the portion of an income tax refund that is based upon the pre-petition portion of a taxable year constitutes property of the bankruptcy estate.”).

128 *In re Block*, 141 B.R. 609, 611 (Bankr. N.D. Tex. 1992).

129 The bankruptcy estate only includes “interests of the debtor in property as of the commencement of the case.” 11 U.S.C. § 541(a)(1) (2006)

130 See *In re Graves*, 609 F.3d 1153, 1159(10th Cir. 2010).

payment attributable to pre-petition earnings.”¹³¹The court acknowledged the contrary analysis of *Block* and *Simmons*, but dismissed it, stating, “Given that some part of an applied refund may be available after the ultimate tax liability is determined and that part of that amount may be attributable to pre-petition earnings, we think a more comprehensive result is as expressed herein.”¹³²

The two “mays” above neatly illustrate the problem with this compromise. The first indicates that there’s no guarantee of a refund. That is largely due to the uncertainty of future behavior; whether there is a refund after the liability is determined will usually depend on what happens post-petition, namely how much of the debtor’s income is withheld for tax purposes. Such a rule, if implemented, would incentivize lowering withholding to a level that would result in no refund. The flaw can be demonstrated by considering the alternative result: if the applied overpayment was not enough to cover the tax liability, it would be the post-petition debtor, not the bankruptcy estate, who would have the responsibility to make up the shortfall, even though the tax liability stems, in part, from pre-petition income. It would also necessitate keeping open a bankruptcy estate until tax liability could be determined, cutting against the goal of prompt and efficient administration of the estate and delaying the fresh start.¹³³ For consistency’s sake, if we are to keep the estate open to claim a refund, it should also be liable for any withholding shortfall. For all those reasons, such a rule would work at cross-purposes with the purpose of Chapter 7 bankruptcy in part by effectively creating another potential debt.

The second “may” alludes to a problem that the courts which have chosen this path have found to be tricky, without any clear answer. The question was not at issue in *Graves* because there had yet to be a refund. It did arise, however, in two of the aforementioned cases. In *Canon*, the refund was the same amount as the overpayment, and the court ordered the turnover of the full amount, calling it “virtually a savings account” for the debtors.¹³⁴ In *Orrill*, the refund was less than the overpayment, and the court used a proportionality test, allowing the trustee to obtain a turnover

¹³¹ *Id.* at 1156–57.

¹³² *Id.* at 1157 n.1.

¹³³ In 2010, “the mean time interval from filing to disposition [of Chapter 7 bankruptcy cases] was 178 days, and the median. . . was 120 days, “meaning that around half of all Chapter 7 bankruptcies are resolved in four months or less. ADMIN. OFFICE OF THE U.S. COURTS, OFFICE OF THE JUDGES PROGRAM, 2010 REPORT OF STATISTICS REQUIRED BY THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 13 (2011), available at <http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BAPCPA/2010/2010BAPCPA.pdf>.

¹³⁴ *In re Canon*, 130 B.R. 748, 752 (Bankr. N.D. Tex. 1991).

of the share of the refund equal to the portion of the year in question before the bankruptcy petition was filed.¹³⁵

The *Canon* rule more heavily incentivizes lower withholding levels, but it also requires as its basis an assumption that the estate's right to pre-petition income overrides the debtor's right to post-petition income. The payment of the tax liability comes from both sources, but the rule would return all of what it declares the estate has a right to – which clearly remains an open question – while granting none of what the debtor has a right to under the plain meaning of the bankruptcy statute.¹³⁶

The *Orrill* rule attempts to remedy that problem, but uses an arbitrary method to achieve that end. It uses the date of the petition to determine the proportions without regard to when the income was earned, a question of little matter for tax purposes but of vital concern in bankruptcy. If the income was earned wholly or disproportionately pre-petition, the rule would favor the debtor in much the same way it's trying to avoid: by allowing pre-petition earnings to bypass the estate. If the income was disproportionately earned post-petition, it violates the debtor's right to post-petition income designed to provide the fresh start. In either case, it fails to find an answer that reflects the spirit of the bankruptcy rules.

As an aside, the pro-rata method is also often applied in the simpler cases of a tax refund from a tax year in which the taxpayer petitioned for bankruptcy protection.¹³⁷ Doing so invites taxpayers to game the system by reducing or stopping withholding as far as the tax code allows as soon as they file their petition or as soon as they've had enough withheld to meet their likely tax liability. That the rule offers such an obvious and easy workaround illustrates its flawed nature while again underscoring how post-petition actions can change the nature of the bankruptcy estate if courts follow this line of reasoning.

Again, this also defies the financial death metaphor of bankruptcy, with the scope of the estate decided in part by decisions made by the financially-reborn debtor post-petition.¹³⁸ The ability to, in effect, change the past from a bankruptcy perspective illustrates the key clash between bankruptcy and the tax code. The former divides time by the filing of the petition, with all events happening either before or after that date. The latter divides time into tax years, in the case of individuals almost always from January 1 to December 31. Those timeframes very rarely align, and that lack of synergy invites conflict when courts are forced to apply both bankruptcy and tax law to any given set of facts. In the factual confluence

135 *In re Orrill*, 226 B.R. 563, 566 (Bankr. E.D. La. 1997).

136 *See Fisher v. United States*, 61 F. Supp.2d 621, 623 (E.D. Mich. 1999).

137 *See In re Meyers*, 616 F.3d 626, 628–29 (7th Cir. 2010).

138 Even assuming pre-planning, myriad decisions and elections which affect the outcome of this question – for example, whether or not to apply loss carry forwards or carry backs – must be made at the time of filing a tax return the year after petition in this scenario.

examined herein, that is the crux of the problem. Given that the nature of the two legal regimes are dependent on those conceptions of time, and that the conflict cannot be addressed by bringing them into alignment on that level, courts have two options. They can either try to design rules that bend the two closer together (which often appears to be the legal equivalent of forcing a square peg into a round hole), or they can opt to avoid that issue, in effect choosing simplicity and predictability over the opportunity to come to a normatively more attractive decision no matter the difficulties involved. The costs in money, time, and judicial efficiency in seeking such an ideal outcome seem to far outweigh the benefits.

That cost–benefit analysis shifts further toward the simpler approach of excluding tax prepayments from the bankruptcy estate given recent changes in the Code. In particular, the means test,¹³⁹ implemented in the 2005 bankruptcy reform, serves to curb potential abuses. The test creates a presumption which pushes most debtors with above–median incomes out of Chapter 7 and into Chapter 13 bankruptcies. Generally limiting the availability of shifting potential refunds to a time after discharge to those people whose incomes are below the median of their states serves both to place a soft ceiling on the amount of the refund in question as well as offer the benefits to those presumably most in need of a fresh start.

It must be noted that the means test only applies to debtors “whose debts are primarily consumer debts,” and allows for dismissal or conversion to a Chapter 11 or 13 case if the debts are instead non–consumer, or business, in nature.¹⁴⁰ The overwhelming majority of Chapter 7 cases in recent years involve consumer debt rather than consumers with business debt.¹⁴¹ The small percentage of cases that do involve primarily non–consumer debts, however, are not subject the means test. It stands to reason that such business–savvy debtors are in a better position to pre–plan their bankruptcy well enough in advance to take advantage of a rule excluding tax prepayments from the property of a bankruptcy estate. Accordingly, while this article recommends the adoption of a rule excluding tax prepayments from the property of the Chapter 7 estate, the recommendation is limited only to those cases involving primarily consumer debts which are subject to the means test. Again, that limitation excludes a small fraction of Chapter

¹³⁹ See 11 U.S.C. § 707(b)(1)–(2)(A)(iii) (2006).

¹⁴⁰ *Id.* § 707(b)(1).

¹⁴¹ In each of the past three years, more than ninety–six percent of Chapter 7 filings have involved primarily consumer rather than business debt. In calendar 2011, 992,332 petitions were filed under Chapter 7; of those, 958,634 involved debts that were primarily consumer rather than business debt. *Bankruptcy Statistics – Filings*, U.S. CTS., <http://www.uscourts.gov/statistics/bankruptcystatistics.aspx> under (follow “12–month period ending December” hyperlink) (last visited June 12, 2012). In 2010, 1,139,601 Chapter 7 petitions were filed and 1,100,116 involved primarily consumer debt. *Id.* In 2009, 1,050,832 Chapter 7 cases were filed, with 1,008,870 involving primarily consumer debts. *Id.*

7 cases, fewer than four percent in recent years.¹⁴² It also serves to protect those debtors whose income falls below the median where they live – the debtors who are most likely in need of help while seeking a fresh start — while not extending such assistance to often more sophisticated debtors who seek to take advantage of the bankruptcy process.

While many of the other arguments in favor excluding such tax prepayments from the estate – primarily simplicity and efficiency – still apply, on balance the probable sophistication of business debtors and their added incentive to take advantage of such a rule argue against offering them its protection. Further, the statute contemplates abusive use of Chapter 7 bankruptcies and gives courts the authority to convert Chapter 7 cases to chapters 11 or 13 “if it finds that the granting of relief would be an abuse of the provisions of this chapter.”¹⁴³ Because courts can dismiss the most abusive cases, whether they involve consumer or business debts, adopting the rule urged by this note does not completely tie the hands of judges faced with obvious system-gaming. Still, in consumer debt cases, the simplest and most efficient solution remains exclusion of tax prepayments from the estate.

CONCLUSION

In addition to the theoretical support for excluding these tax prepayments from the bankruptcy estate, several policy arguments illustrate the strong practical benefits. Such a rule simplifies the bankruptcy process by more clearly defining the scope of the estate at the date of petition, rather than leaving that an open question, which allows debtors to take actions post-petition to change the estate. When half of all Chapter 7 bankruptcies are completed in four months or less, and the average case lasts less than six months,¹⁴⁴ it does not appear worth it on balance to leave the estate open for an additional year or more for a potential refund that may not be forthcoming, particularly given that whether or not there is a refund necessarily depends on what happens post-petition. Should there be a refund, whether it is attributable to the pre-petition income can be a difficult question to answer; keeping the prepayment out of the estate both eliminates the need to make that determination as well as using flawed calculation methods to do so.

Finally, it would support the fresh start idea underlying bankruptcy, both by preserving the full rights of post-petition income to the debtor and shortening the process to bring discharge and the payback of creditors

¹⁴² *Id.*

¹⁴³ § 707(b)(1). In (b)(3), the statute directs courts considering the question of abuse to consider whether the petition was filed in bad faith or the totality of the circumstances. *Id.* § 707(b)(3).

¹⁴⁴ *See* ADMIN. OFFICE OF THE U.S. COURTS, *supra* note 133, at 13.

about more quickly. For creditors, the certainty and efficiency this rule brings generally outweighs the potential recovery of additional money at great expense and a year or more later. For debtors, it maintains the possibility that the bankruptcy process can be brought to conclusion in months, usually four or less, rather than lasting substantially more than a year. And for courts, facing a rising caseload,¹⁴⁵ it allows for quicker and simpler case administration.

None of the various methods courts have used to tackle this issue are without flaws, and each has its own merits. Embracing the tax code's bright line against including overpayments applied to future tax liabilities makes the most sense because it guarantees more efficient outcomes rather than seeking what may be more theoretically pleasing results through the use of sometimes arbitrary metrics and subject to actions taken post-petition. Applying a clear rule that brings about quicker resolutions offers benefits to debtors, creditors and courts alike. For those reasons, tax prepayments applied to future tax liabilities should be excluded from the estate property in the overwhelming majority of Chapter 7 cases that involve primarily consumer debt.

¹⁴⁵ Bankruptcy filings rose fourteen percent in 2010 to nearly 1.6 million cases. JAMES C. DUFF, ANNUAL REPORT OF THE DIRECTOR 10 (2010), available at [http://www.uscourts.gov/uscourts/FederalCourts/AnnualReport/2010/images/annualReport 2010.pdf](http://www.uscourts.gov/uscourts/FederalCourts/AnnualReport/2010/images/annualReport%2010.pdf).

