OFFICE OF
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DEPARTMENT OF THE TREASURY
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MEMORANDUM FOR DISTRICT COUNSEL, NORTH CENTRAL DISTRICT, ST. PAUL

FROM: Michael R. Arner, Senior Technician Reviewer, Branch 1 (General Litigation)

SUBJECT: Taxpayer X
Payment to Chapter 7 Trustee Pursuant to Post Petition Refund Stipulation

This responds to your memorandum regarding the above subject. This document is not to be cited as precedent.

LEGEND

Taxpayer X
Date A
Date B
Date C
Date D
Date E
Date F
Date G
Date H
Date I
Date J

ISSUE(S):

1. Was the prepetition portion of a tax refund for the year of bankruptcy property of the estate where the debtor did not make an election pursuant to I.R.C. § 1398(d)(2) to terminate the tax year.

2. Did the taxpayers have a right to elect application of a prepetition tax refund for the year of bankruptcy, to be applied to a subsequent tax year after signing a stipulation only with the trustee but not the Internal Revenue Service (IRS) to turnover the refund to the bankruptcy estate.

3. Was the Internal Revenue Service (IRS) required to turnover the tax refund to the trustee pursuant to a stipulation with the taxpayer but not the IRS..

CONCLUSION: The prepetition portion of the refund for the year of bankruptcy was, arguably, property of the bankruptcy estate. The IRS is required to turnover the funds that constitute property of the bankruptcy estate to the Chapter 7 trustee.

FACTS: The taxpayers filed a Chapter 7 bankruptcy on Date A. On Date B, they executed a "Tax Refund Stipulation" with the trustee but not the IRS in which they agreed to turnover 74% of their 1996 federal income tax refund to the trustee after filing their return. The taxpayers were entitled to 26% of the refund. If the trustee received the entire refund directly from the IRS, the trustee would disburse their allocation to the taxpayers. If the taxpayers received the refund check directly from the IRS, they were to endorse the check to the trustee who would disburse their share to them. Subsequent to the stipulation, the taxpayers filed a tax return for Date C electing to have the $1,620.00 overpayment credited to their Date D liability.

The trustee mailed a copy of the stipulation to the IRS on Date E; however, the IRS did not enter a freeze code on the account. By letter of Date F, the IRS informed the trustee that it would not process the stipulation and asserted the legal argument that the Date C refund was not property of the estate.

On Date G, the trustee responded stating that the refund was property of the estate and that he would file a Motion for Turnover if the IRS did not cooperate. When the debtors filed their Date C federal income tax return, they elected to apply the refund to the Date D tax year. The IRS applied the refund to the Date D tax year on Date H. In response to the trustee's assertions, the district sought legal advice from district counsel who advised on Date I, that the IRS could accept Tax Refund Stipulations if they were in writing, signed by both parties, and the IRS received a copy of the stipulation. The opinion came too late to input a freeze code on the taxpayers' account for Date C. Finally, on Date J the trustee again demanded that the IRS forward the Date C tax refund.

LAW AND ANALYSIS

When individual debtors file a Chapter 7 petition in bankruptcy, a bankruptcy estate is created to which all the property of the estate is transferred. The definition of property of the estate is broad in scope and consists of "all legal and equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(1).

The United States Supreme Court held that the right to a refund is property of the estate in a Bankruptcy Act case. Segal v. Rochelle, 382 U.S. 375 (1966). The Court extended the Segal holding to individuals in Kokoszka v. Belford, 417 U.S. 642 (1974). Segal has been consistently followed and applied to Internal Revenue Code cases involving income tax refunds. Even though the opinion in Segal v. Rochelle was issued prior to the effective date of the Bankruptcy Code, it is cited with approval in the legislative history: "[t]The result of *Segal v. Rochelle* . . . is followed, and the right to a refund is property of the estate." H.R. Rep. No. 595, 95th Cong., 2d Sess. 367 (1977) (Citations omitted). Its holding is followed under the Bankruptcy Code. In re Canon, 130 BR 748 (Bankr. N.D. Tex 1991); In re Orndoff,100 BR 516 (Bankr. E.D. Cal. 1989); Matter of Doan, 672 F.2d 831 (11th Cir. 1982).

The question is whether the debtor has any legal or equitable interests in the refund as of the petition date. Some district counsel offices as well as the Department of Justice have argued that the right to a refund does not arise until the end of the taxable year. Unless the debtor has made an election pursuant to I.R.C.§ 1398 to split the tax year, the entire refund is post-petition and hence not property of the estate. In light of section 1398, which was enacted after the Segal case, Segal should no longer be applicable to cases involving income tax refunds, because its treatment results in wholly inconsistent treatment of Chapter 7 debtors' tax liabilities and tax refunds for the year during which the bankruptcy petition is filed. This argument seems to be consistent with our position regarding filing proofs of claims for tax periods straddling the petition year. See Memorandum to Gulf Coast District Counsel dated December 22, 1998, Proofs of Claim in Mississippi Bankruptcy Cases GL-608348-98, CCA199907016; 1/ Memorandum to Virginia-West Virginia District Counsel dated June 24, 1998, Chapter 7 Trustees' Requests for Turnover of Tax Refunds GL-600999-98 and letter to the Department of Justice dated November 8, 1991, in David Browning Canon, (N.D. Tex.), GL-0860-91, recommending appeal.

[redacted]

1/ In addition to its position that income tax liabilities arise on the last day of the tax year, this memorandum also takes the position that a refund arises on the last day of the taxable year for purposes of setoff pursuant to B.C. § 553.

We now turn to the liability of the Service with respect to the Tax Refund Stipulation. Although the debtors entered into a Tax Refund Stipulation with the Trustee, the Service was not a party to the Stipulation. The Stipulation is an agreement between the debtors and the Trustee, and is enforceable only as between them. 83 C.J.S. Stipulations § 14 (1998). It does not appear that the Government, not being a party to the agreement, could be held liable for the terms and conditions therein. Further, the Anti-Assignment Act, 31 U.S.C. § 3727(b), provided that an assignment of a claim, or of an interest in any claim, against the United States Government "may be made only after a claim is allowed, the amount of the claim is decided and a warrant for payment of the claim has been issued . . . ." One of the purposes of the Act is to protect the Government, to "prevent possible multiple payment of claims, to make unnecessary the investigation of alleged assignments, and to enable the Government to deal with the original claimant." United States v. Aetna Casualty & Surety Co., 338 U.S. 366, 373 (1949); see also Martin v. National Surety Co., 300 U.S. 588 (1937). At the time the parties executed the Stipulation, they failed to comply with the requirements of the Anti-Assignment Act, which rendered the agreement ineffective as to the Government. Nevertheless, the Service is liable to turnover the prepetition portion of the refund to the trustee because under numerous court decisions it is property of the bankruptcy estate. In re Wilson, 49 BR 19 (Bankr. N.D. Tex. 1985).

The final issue is whether the debtors had the right to elect application of their tax refund for Date C to a later year after filing a petition in bankruptcy. The taxpayers signed a Tax Refund Stipulation with the trustee agreeing that 74% of the 1996 refund was property of the estate. Therefore, the taxpayers did not have the right to make an election to have their income tax refund for Date C applied to Date D according to the rationale of In re Lange, 110 BR 907 (D. Minn. 1990) (taxpayer had no right to apply refunds that were property of the bankruptcy estate to later tax year). The taxpayers are personally liable to the trustee for the amount of the refund.

We recommend that the Service wait for the trustee to file a turnover motion, agree to the turnover, and attempt to fashion an agreed stipulation that would require the

debtors to repay the amount of the Date D taxes that were originally satisfied by the refund.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

We can identify no other litigating hazards that would change or qualify the conclusions reached in this memorandum.

If you have any further questions, please call Susan Watson at 202-622-3610.