

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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date: October 14, 2010

to: Associate Area Counsel
(Area 5)

from: Senior Technician Reviewer
(Branch 5)

subject: Re: Pre-Petition Credit Elections under I.R.C. § 6402(b) in Ch. 7 Bankruptcy Actions

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

On May 11, 2010, you requested our advice regarding 6402(b) credit elections in Chapter 7 bankruptcy.

ISSUE

Whether under 11 U.S.C. § 542, the IRS must turn over to a Chapter 7 bankruptcy trustee an overpayment that a taxpayer elects under I.R.C. § 6402(b) to apply to future tax liabilities.

CONCLUSION

The IRS is not required, under 11 U.S.C. § 542, to turn over to a Chapter 7 bankruptcy trustee an overpayment once a taxpayer's election, under I.R.C. § 6402(b), to credit the overpayment to future tax liabilities has become irrevocable.

FACTS

You asked that we consider the following fact pattern: John and Jane Smith filed Form 1040 for tax year 2008 on March 10, 2009, reporting a \$2,000 overpayment. The Smiths requested a refund of \$1,200 and elected to apply the remaining \$800 to their tax liability for 2009. The IRS mailed a refund of \$1,200 to the Smiths on March 20, 2009,

and applied the \$800 to the 2009 tax year. Sometime after making the election to credit their 2008 overpayment to their 2009 taxes and after the deadline for filing their 2008 tax return had passed, the Smiths filed a voluntary petition for Chapter 7 bankruptcy. The Trustee requested that the \$800 be turned over to him pursuant to 11 U.S.C. § 542.

LAW AND ANALYSIS

Property of the bankruptcy estate is identified in 11 U.S.C. § 541 and generally includes all legal and equitable interests of the debtor in property as of the commencement of the case. If the debtor had the right to claim a tax refund, the right to claim a refund and to bring a refund suit, if necessary, became property of the estate. Such a refund claim would be a debt owed to the debtor and should be paid to a Chapter 7 trustee under 11 U.S.C. § 542(b).¹ The Service has administrative procedures for Chapter 7 trustees to request refunds that are property of the estate. See IRM 5.9.6.1.3 (Chapter 7 trustee refund turnover requests). If the Service determines that no refund is owed and the trustee disagrees, the trustee's remedy is to properly request the refund under 11 U.S.C. § 505(a)(2)(B) and, if necessary, seek a section 505(a) determination of the refund claim. See Rev. Proc. 2010-27.²

In your example, however, the taxpayer elected to credit \$800 of the overpayment to a future tax year. The overpayment for which a taxpayer made an I.R.C. § 6402(b) election is not subject to turnover request. If the debtor, having made the election, had no right to claim a refund when the bankruptcy petition was filed, there is no debt owing to the debtor for that tax year that would be subject to turnover under section 542.

I.R.C. § 6402(b) and Treas. Reg. § 301.6402-3(b)(5) permit a taxpayer to apply current year overpayments of tax against estimated tax for the succeeding taxable year. Treas. Reg. § 301.6402-3(a)(5) provides that if a taxpayer reports an overpayment for a taxable year and states on the relevant tax return that all or part of the overpayment is to be applied to the taxpayer's estimated income tax for the following taxable year, the taxpayer's statement constitutes an election to so apply the overpayment. If an I.R.C. § 6402(b) election is made, I.R.C. § 6513(d) places the overpayment beyond the reach of the taxpayer, stating that "no claim for refund of such overpayment shall be allowed

¹ When the debtor is owed a tax refund for a prepetition period, the property in the estate is a claim or cause of action against the Government, not the right to the return of the actual funds used to pay the Government. The applicable turnover provision is therefore section 542(b), which directs that an entity that owes a matured debt that is property of the estate must pay the debt to the trustee, except to the extent the debt may be offset against another prepetition liability owed the debtor. See *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 21 (1995) (debtor's bank deposit accounts were debts owed the debtor – the debtor did not have a property interest in the funds deposited). The applicable turnover provision is not section 542(a), which directs that an entity that is holding property of the estate shall deliver the property to the trustee.

² We do not address herein whether the trustee may avoid the taxpayer's irrevocable election as a fraudulent conveyance under 11 U.S.C. § 548. Note, however, that a fraudulent conveyance action must be brought in an adversary proceeding under Bankruptcy Rule 7001 and that the Service should require that the taxpayer be joined in any such proceeding.

for the taxable year in which the overpayment arises." Courts have generally held that a credit election is irrevocable and that the election binds both the taxpayer and the IRS. *Georges v. United States*, 916 F.2d 1520, 1520-21 (11th Cir. 1990); *Martin Marietta Corp. v. United States*, 572 F.2d 839, 841-42 (Ct. Cl. 1978); *Starr v. Comm'r*, 267 F.2d 148, 151 (7th Cir. 1959). A number of courts have acknowledged that when the debtor made a prepetition election under I.R.C. § 6402(b), the bankruptcy trustee cannot seek the forgone refund from the Service. See *Morton v. I.R.S.*, 90 AFTR 2d 2002-5195, 2001 WL 1916895 (Bankr..N.D.Tex. 2001); *Matter of Orrill*, 226 B.R. 563 (Bankr.E.D.La. 1997); *Block v. United States*, 141 B.R. 609, (N.D. Tex. 1992); *In re Simmons*, 124 B.R. 606 (Bankr. M.D. Fla. 1991).

The trustee's authority to revoke a taxpayer's prepetition § 6402(b) credit election was recently addressed by the Tenth Circuit in *In re Graves*, 609 F.3d 1153 (10th Cir. 2010). In *Graves*, a taxpayer made an election under § 6402(b) to carry forward a 2006 overpayment prior to filing under Chapter 7. The Chapter 7 trustee sought an order compelling the debtor, rather than the Service, to turn over the value of the forgone refund from the debtor under section 542(a). The Tenth Circuit explained that 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. Applying the principal, the Tenth Circuit held that the trustee's interest in the application of the tax refund must be limited to the same extent as the debtors' interest — by the strictures of 26 U.S.C. § 6513(d) that make debtors' refund-application election irrevocable. The court held that while the trustee may have a right to a portion of the debtor's 2007 refund (if the debtor were in fact entitled to a 2007 refund), the trustee had no right under section 542(a) to a 2006 refund because the debtor had no such right.³ The court reasoned that section 542(a) only required the turnover of property in the debtor's possession and the debtor simply did not possess the 2006 refund. Similarly, in the fact pattern you asked about, the debtor had no right to the overpayment for tax year 2008 because of the irrevocable election under § 6402(b). The debtor therefore had no right to claim a refund that passed to the bankruptcy estate that could be subject to turnover under section 542(b).

The Tenth Circuit's decision in *Graves* is at odds with the Ninth Circuit's decision in *Nichols v. Birdsell*, 491 F.3d 987, 988 (9th Cir. 2007). *Nichols* also involved a section 542 turnover proceeding brought by the trustee against the debtors. In *Nichols*, the debtors overpaid their 2001 income tax liability before filing a Chapter 7 case and the Chapter 7 trustee sought the value of the overpayment from the debtors. The Ninth Circuit stated:

³ If the debtor is entitled to a refund for the year in which the petition was filed, the prepetition portion of the refund is deemed to be property of the estate based on the Supreme Court's decision in *Segal v. Rochelle*, 382 U.S. 375 (1966). See *In re Barowsky*, 946 F.2d 1516, 1517-19 (10th Cir. 1991). Again, see IRM 5.9.6.1.3 (Chapter 7 trustee refund turnover requests).

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 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 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” under *Feiler*, we hold that this credit toward future taxes constituted estate property at the time the Debtors filed for bankruptcy.

Id. at 990. Thus, the debtors were compelled to pay over the value of the credit to the trustee. The Tenth Circuit in *Graves* explained that the *Nichols* court did not consider the case in light of section 542(a) and it was therefore unclear how the Ninth Circuit should apply the statutory requirements for turnover that clearly require possession of property as a prerequisite to turnover. We agree that *Nichols* is distinguishable on that ground. We also believe that *Nichols* is distinguishable from the fact pattern at issue here because *Nichols* involved a section 542(a) turnover request against the debtor rather than a section 542(b) turnover request against the Service.

RECOMMENDATION

Under the fact pattern you asked about, the Service does not have an obligation under section 542 to turnover to the trustee the portion of the 2008 overpayment that the debtor elected to apply to the 2009 liability pursuant to section 6402(b). If you have any questions or concerns about this advice, please contact attorney Meghan Mahaney at (202) 622-3620.

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