

INTERNAL REVENUE SERVICE

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MEMORANDUM FOR DISTRICT COUNSEL (KENTUCKY-TENNESSEE)

FROM: Chief, Branch 3 (General Litigation)

SUBJECT: Chapter 13 Trustee Refund Orders:
Where Taxpayer Makes Election Under I.R.C. § 6402(b)

This constitutes our formal response to your request for an opinion on several issues pertaining to the interrelationship of I.R.C. § 6402(b) and the Bankruptcy Code. This document is not to be cited as precedent.

ISSUES: To what extent is an election to credit the amount of a tax overpayment for a taxable year preceding the date of a bankruptcy petition, to a liability for the subsequent year, pursuant to I.R.C. § 6402(b), valid in the context of a Chapter 13 bankruptcy?

(1) Can a Chapter 13 Trustee's refund order override a taxpayer's section 6402(b) election? If so, how is this consistent either with the Service's position on the irrevocable nature of a section 6402(b) election, or with I.R.C. § 6513(d), which essentially precludes a refund claim for an amount which the taxpayer has already elected to receive as a credit pursuant to section 6402(b)?

(2) Does it make a difference whether: a) the Chapter 13 plan specifically provides that all refunds are property of the bankruptcy estate? b) the Trustee's order was issued before or after the date the section 6402(b) election was made?

CONCLUSION: If the election is made prepetition, the overpayment amount is not part of the bankruptcy estate and, accordingly, is not subject to the Trustee's refund order. If the election is made post-petition, for a prepetition tax year, and if it is made before the Trustee issues a refund order, the election is effective even though the overpayment amount is property of the bankruptcy estate. Once the plan is confirmed, whether the amount is subject to the refund order is determined by the terms of the plan: although in a Chapter 13 case property normally reverts in the debtor upon confirmation of the plan unless the terms of the plan otherwise indicate, in a situation where a refund order exists, we would expect the refund order to require that refunds be used to fund the plan.

FACTS: The facts are as follows. A taxpayer files a Chapter 13 bankruptcy. During the bankruptcy, the Chapter 13 Trustee issues an order that all refunds owed to the taxpayer are to be paid to the Trustee. ^{1/} At some point in time, the taxpayer makes an election, pursuant to I.R.C. § 6402(b), to apply an overpayment on his previous year's taxes to his estimated tax liability for the following year. Normally, the Service's policy, as discussed below, is that this election is irrevocable by either the Service or the taxpayer himself. The questions you present all involve the validity of this election in light of its juxtaposition with the occurrence and the timing of various events in bankruptcy.

LAW AND ANALYSIS: The answers to your questions turn in part on the relative timing of the taxpayer's election and the filing of his bankruptcy petition. Some of the potential scenarios which could occur depending on when the relevant events occur are discussed separately, following a brief background discussion, below.

A. Background

I.R.C. § 6402(b) is entitled "Credits Against Estimated Tax," and affords the Secretary of the Treasury authority to prescribe regulations for "crediting against the estimated income tax for any taxable year of the amount determined by the taxpayer or the Secretary to be an overpayment of the income tax for a preceding taxable year." Section 301.6402-3 of the regulations, in turn, states in pertinent part that:

A return or amended return shall constitute a claim for refund or credit if it contains a statement setting forth the amount determined as an overpayment and advising whether such amount shall be refunded to the taxpayer or shall be applied as a credit against the taxpayer's estimated income tax for the taxable year immediately succeeding the taxable year for which such return (or amended return) is filed. If the taxpayer indicates on its return (or amended return) that all or part of the overpayment shown by its return (or amended return) is to be applied to its estimated income tax for its succeeding taxable year, **such indication shall constitute an election to so apply such overpayment, ... and such amount shall be applied as a payment** on account of the estimated income tax for such year or the installments thereof.

Treas. Reg. § 301.6402-3(a)(5)(emphasis supplied).

^{1/} We have been told that in your district, plans normally specify that if a tax refund is less than \$1500, it need not be given to the Trustee. Therefore, for purposes of this opinion, we assume any refund at issue is in the amount of at least \$1500.

Furthermore, the Internal Revenue Code provides that where an overpayment of tax is claimed as a credit against the next year's estimated tax liability pursuant to section 6402(b),

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.

I.R.C. § 6513(d).

Based on these provisions of the Code and regulations, the Service generally considers a section 6402(b) election to be binding on both itself and the taxpayer, and does not generally permit revocation of the election. See generally Rev. Rul. 77-339, 1977-2 C.B. 475 (Service cannot offset overpayment, which taxpayer previously elected would be applied to succeeding year's estimated tax liability, against additional liability for year of overpayment); Georges v. U.S. Internal Revenue Service, 916 F.2d 1520 (11th Cir. 1990)(taxpayer, once having made election under section 6402(b), may not opt to receive overpayment in form of refund).

Thus, at least outside of bankruptcy, a taxpayer's valid election, pursuant to I.R.C. § 6402(b), to credit one year's overpayment against the next year's estimated tax liability, is generally viewed as irrevocable – and the character of the overpayment, once the election has been made, is generally viewed as unchangeable.

B. Election occurring prepetition

If a taxpayer makes a section 6402(b) election and subsequently files a Chapter 13 bankruptcy petition, does the Trustee's refund order affect the validity of the election? It is our position that the Trustee's refund order is not effective to revoke the election in this context, since the election is valid as long as it was made before the bankruptcy petition was filed. The reason is that, in this scenario, the right to a refund no longer belongs to the debtor as of the time the bankruptcy petition is filed, and it therefore never becomes property of the bankruptcy estate subject to the administration of the Chapter 13 Trustee.

The relevant authorities appear to be unanimous in indicating that (at least where bankruptcy is not a complicating factor) once a taxpayer makes an election under I.R.C. § 6402(b), his decision is irrevocable; i.e., his overpayment for the initial tax year irretrievably becomes an "advance payment" for the next. In other words, before the election is made, the taxpayer may recover his overpayment either in the form of a refund or the form of a credit; the decision is his. Once he makes the election under section 6402(b), however, his decision is final. This means, in our view, that where the election occurs prepetition, the overpaid amount is, at the time the bankruptcy petition

is filed, not property with respect to which the taxpayer has any rights. Accordingly, the amount of the overpayment does not constitute a “legal or equitable [interest] of the debtor in property as of the commencement of the case” ; i.e., the amount is not property of the bankruptcy estate. See B.C. § 541(a)(1). See also In re Block, 141 B.R. 609, 611 (N.D. Tex. 1992).

Moreover, the interests of the bankruptcy estate (and, by extension, those accessible to the Trustee) generally cannot be greater than those of the taxpayer. See, e.g., In re Halle, 132 B.R. 186 (Bankr. D. Colo. 1991). Thus, since the bankruptcy estate has no interest in the amount the taxpayer has elected be credited to a future tax liability, any order issued by the Trustee cannot reach that amount. As a result, neither the event of the bankruptcy filing nor the subsequent issuance of the Trustee’s refund order would have any effect on the earlier election made under I.R.C. § 6402(b).

We recognize that our analysis in this regard conflicts with at least one judicial decision, In re Russell, 927 F.2d 413 (8th Cir. 1991). In Russell, the Eighth Circuit held that a bankruptcy Trustee’s powers essentially supersede a taxpayer’s ability to make pre- and post-petition elections to carry forward net operating losses (NOLs), which – like the type of election here under discussion – are specifically authorized by the Internal Revenue Code. We believe that Russell is incorrect in several respects, including its holding pertaining to the authority of a bankruptcy Trustee to nullify a prepetition election generally viewed as irrevocable. Moreover, we think that an election under I.R.C. § 6402(b), which generally affords a taxpayer a dollar-for-dollar credit for an amount he would otherwise be entitled to receive in the form of a refund, is materially different from an NOL, which may or may not afford a taxpayer a benefit depending on the liability against which it is set off. For these reasons, we do not think the analysis set forth in Russell necessarily ends the inquiry with respect to the issue of the validity of section 6402(b) elections in Chapter 13 bankruptcies. Of note is that we have been unable to locate any legal authority which indicates that the section 6402(b) election, once properly made, somehow can be invalidated by events occurring in bankruptcy. Accordingly, we do not believe Russell requires that prepetition elections necessarily be viewed as voidable where a Chapter 13 Trustee has issued a refund order.

Similarly, our position is that the overpaid/credited amount is not properly the subject of a turnover action initiated by the Trustee under B.C. § 542, or an action based on prepetition fraudulent transfer under B.C. § 548. As was noted previously, the taxpayer did not hold any interest in the amount once he made his election, and the amount, therefore, was never estate property and, accordingly, is not subject to turnover under B.C. § 542. See In re Block, supra; In re Simmons, 124 B.R. 606, 608 (Bankr. M.D. Fla. 1991)(Chapter 7 Trustee cannot recover amount which, before bankruptcy, was subject of section 6402(b) election “simply because it originated prepetition”). Moreover, although an argument could be made that the Trustee’s issuance of a refund order could be viewed as an attempt on his part to revoke the prepetition election under B.C. § 548, section 548 would seem to be inapplicable here, as it requires as an

element of a fraudulent transfer action that the transferor either have made the transfer with “actual intent” to defraud creditors, or have received “less than a reasonably equivalent value in exchange for [the amount transferred].” B.C. § 548(a)(1). Here no indication exists that the taxpayer made his section 6402(b) election with the intent of adversely affecting any creditors, and here the taxpayer is clearly receiving dollar-for-dollar value (namely, a dollar-for-dollar reduction of his future tax liability) as a result of his election to credit the overpayment. Accordingly, the prerequisites for an action under B.C. § 548 would not appear to be satisfied. See Simmons, supra.

C. Post-petition election

If a taxpayer makes his section 6402(b) election for a prepetition tax year 2/ after filing his bankruptcy petition, then as of the commencement of the bankruptcy, he would have possessed a right to a tax refund. As the right to a refund constitutes a prepetition interest existing as of the petition date, it would constitute property of the estate as of the time the bankruptcy petition was filed. See, e.g., Kokoszka v. Belford, 417 U.S. 642, 94 S. Ct. 2431 (1974); Segal v. Rochelle, 382 U.S. 375, 86 S. Ct. 511 (1966). The real question here is whether, irrespective of the fact that the interest in the overpayment is estate property as of the petition date, the interest is subject to the Trustee’s refund order.

Notwithstanding the fact that the debtor’s right to a refund is property of the Chapter 13 estate, it is our view that the debtor has the right to make a section 6402(b) election before confirmation of the plan and before the trustee has issued a refund order. B.C. § 1306(b) provides that the debtor shall remain in possession of all property of the estate except as otherwise provided in the confirmed plan or the order confirming the plan. Moreover, B.C. § 1322(a)(1) contains a mandatory requirement for Chapter 13 plans that all or such portion of the debtor’s future earnings or income shall be submitted to the trustee as is necessary for the execution of the plan. These provisions indicate that the debtor may remain in possession or control of any property interest not needed to fund the Chapter 13 plan. In addition, B.C. § 1303 provides that the debtor shall have the rights and powers of a trustee under subsections (b), (d), (e), (f), and (l) of section 363, and these provisions allow the trustee, subject to certain conditions, to use, sell, or lease property of the estate. Accordingly, we believe the debtor may exercise his election under section 6402(b) and a subsequent refund order by the trustee would not be effective to overturn this election.

2/ If the election is for a post-petition tax year, the Trustee’s refund order normally would precede the election. Accordingly, the overpayment amount would be subject to the order if the amount is estate property. In a Chapter 13 bankruptcy, property acquired post-petition can be included in estate property. B.C. § 1306(a).

However, once the trustee issues his refund order, it would appear that the trustee intends to use the refunds to execute the provisions of the plan. Hence, any attempt by the debtor to exert control over the overpayment by attempting to apply it directly to the following year's tax liability might be viewed as an action to use property of the estate contrary to the terms of the plan and as undermining the ability of the trustee to execute and consummate the plan. Accordingly, we believe that an attempt by the debtor to make an election under section 6402(b) after the trustee issues a refund order would be ineffective. We assume that the plan confirmed by the court would incorporate the trustee's refund order and that the refunds would be necessary under the terms of the plan to make the required distributions to creditors. If, for some reason, a plan is confirmed indicating that refunds are not necessary to fund the plan, a debtor may want to request that the trustee revoke his order so that the debtor may exercise his section 6402(b) election.

Thank you for soliciting our opinion on this matter. If you have further questions, please call

cc: Office of Assistant Chief Counsel (Field Service)
Attn: Senior Technician Reviewer, Procedural Branch