RECURRING ISSUES IN CHAPTER 7 CASES

by

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I. Allocation of Tax Refunds Between a Husband and Wife.

A. The "Withholding Rule"

1. This is the rule used by a majority of cases and divides the tax refund based on the separate withholdings of each spouse. See, *In re Carlson*, 394 B.R. 491 (8th Cir. B.A.P. 2008); *In re Kleinfeldt*, 287 B.R. 291 (10th Cir. B.A.P. 2002); *In re Gartman*, 372 B.R. 790 (2007); *In re Smith*, 310 B.R. 320 (Bankr. N.D. Ohio 2004); *In re Lyall*, 191 B.R. 78 (E.D. Va. 1996).

2. This rule has been typically applied in districts where applicable state law does not presume equal ownership of property by spouses. While easy to apply to the allocation of a refund, this rule has been criticized by some courts because it considers only one component of several that may affect the amount of a refund, such as tax credits.

B. The "50/50 Rule"

1. This rule is considered a minority approach. It divides the tax refund equally between the spouses and is generally based on the application of state law regarding the ownership or division of the property interests of the husband and wife. See, *In re McKain*, 455 B.R. 674 (Bankr. E.D. Tenn. 2011)(following *Bass*); *In re Glenn*, 430 B.R. 56 (Bankr. N.D.N.Y. 2010); *In re Innis*, 331 B.R. 784 (Bankr. C.D. Ill. 2005)(following *Bass*); *In re Aldrich*, 250 B.R. 907 (Bankr. W.D. Tenn. 2000)(following *Bass*); *Bass v. Hall*, 79 B.R. 653 (W.D. Va. 1987).

2. These cases rely upon the proposition that applicable state law defines property interests and that federal tax law creates no property rights, but merely attach federally defined consequences to property rights created under state law. ("[T]he filing of joint tax returns does not alter property rights between husband and wife". *In re Barrow*, 306 B.R. 28 (Bankr. W.D.N.Y. (2004), quoting *Callaway v. C.I.R.*, 231 F.3d 106, 117 (2d. Cir. 2000).

3. Most of the courts utilizing the 50/50 Rule treat the 50/50 division as a rebuttable presumption, the equal division adjusted based on a variety of factors, including history of conduct, such as whether (a) bank accounts are jointly held, (b) bills are paid from a joint account and are considered the joint responsibility of the husband and wife, (c) there is an absence of separate accounts, (d) there is equal access to the joint accounts, (e) tax refunds have been historically deposited in joint accounts, and (f) the

refunds are used for household expenses. See *In re Hejmowski*, 296 B.R. 645 (Bankr. W.D.N.Y. 2003).

4. In *Bass*, Judge Kiser found that Virginia law presumes that tenants in common have equal ownership of property in the absence of proof to the contrary and founds support for the equal division of tax refunds between husband and wife in both *Virginia Code §* 6.1-125.3, addressing joint bank accounts of a husband and wife, and case law that supported the presumption of equal ownership of negotiable instruments. The Court also found support for equal division of the tax refunds in equitable distribution considerations and in the fact that the filing of a joint tax return created joint liability for any taxes owed. *Bass*, 79 B.R. at 656-57.

5. While the 50/50 Rule has the virtue of simplicity, it has been criticized for its reliance in certain cases on domestic relations law. See *In re Crowson*, 431 B.R. 484 (10th Cir. B.A.P. 2010) ("[the] laws of marital dissolution require a just and equitable distribution of property between spouses based on the means and needs of each. In bankruptcy, the court is concerned with whether the debtor has a property interest that is available for distribution to creditors…").

C. The "Income Rule"

1. The Income Rule provides for the division of the tax refund based on the proportionate amount of each spouse's income during the tax period. See *In re Verill*, 17 B.R. 652 (Bankr. D. Md. 1982); *In re Kestner*, 9 B.R. 334 (Bankr. E.D. Va. 1981).

2. This rule has the weakness of dividing the refund based on a factor that may have very little to do with the actual contributions to the total tax obligations between the spouses and has generally fallen into disuse.

D. The "Separate Filings Rule"

1. This rule was first articulated in 2010 in the case of *In re Crowson* (citation above) and has been relied upon by a number of courts since that time. See In re Duarte, 492 B.R. 100 (E.D.N.Y. 2011); *In re Evans*, 2010 WL 6612501 (Bankr. N.D. Ga. 2010); *In re Palmer*, 2011 WL 890690 (Bankr. D. Mont. 2011).

2. In Crowson, after considering and rejecting the Withholding Rule and the 50/50 Rule, the court considered several relevant revenue rulings issued by the IRS regarding the allocation of overpayments between taxpayers filing joint returns, finding them to provide helpful guidance on the issue. Although it was not bound by such rulings, the Court reviewed both *Revenue Ruling* 74-611, in which the IRS ruled that when a husband and wife file a joint return, each spouse has a separate interest in the jointly reported income and in any overpayments, and *Revenue Ruling* 80-7, in which the IRS addressed the determination of what portion of a married couple's current year joint refund the IRS could retain and offset against one spouse's prior year individual tax liability. In essence, this approach is a determination of what each spouse's tax liability

would have been if each spouse had filed separately and of the contributions each spouse actually made to the total payments and credits.

E. Conclusions: The Separate Filings Rule is most likely to achieve results that are consistent with the purposes of the Bankruptcy Code, that is, allocation of the tax refunds between the spouses so that their creditors obtain the appropriate distribution from that property. However, it is the most difficult and complex to apply. The 50/50 Rule has the virtue of simplicity, but may also be subject to the uncertainty of a rebuttable presumption based on the manner in which the spouses have conducted their pre-bankruptcy financial affairs. Although *Bass* is not controlling in the bankruptcy courts of the Western District of Virginia, it certainly provides a sound basis for debtors to assert an interest in tax returns on the basis of the 50/50 Rule, provided the debtors recognize the risk that the court may find a different allocation scheme more applicable.

II. Property of the Estate in a Chapter 7 Case Converted from Chapter 13.

A. Applicable Statutes

1. Section 348

a. Section 348(a) provides that: conversion of a case from a case under one chapter to a case under another chapter of this title constitutes an order for relief under the chapter to which the case is converted, but, except as provided in subsections (b) and (c) of this section, does not effect a change in the date of the filing of the petition, the commencement of the case, or the order of relief.

b. Section 348(f)(1)(A) provides that: except as provided in paragraph (2), when a case under chapter 13 of this title is converted to a case under another chapter under this title – (A) property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or control of the debtor on the date of conversion.

c. Section 348(f)(1)(B) provides that: except as provided in paragraph (2), when a case under chapter 13 of this title is converted to a case under another chapter under this title – (B) valuations of property and of allowed secured claims in the chapter 13 cases shall…not [apply] in a case converted to a case under chapter 7….

d. Section 348(f)(2) provides that: if a debtor converts a case under chapter 13 to a case under another chapter of this title in bad faith, the property of the estate in the converted case shall consist of the property of the estate as of the date of the conversion.

2. Section 1327(b) provides that: except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

B. Making Sense of the Effect of the Applicable Statutes: *In re Krick*.

1. The case of *In re Krick*, 373 B.R. 593 (Bankr. N.D. Ind. 2007) provides a great deal of help in understanding the effect of the interaction between section 1327(b), sections 541(a) and 1306 (regarding property of the estate), and section 348(f).

2. In *Krick*, the debtor owned an interest in real property at the time she filed a chapter 13 petition. The Court confirmed a chapter 13 plan of the debtor and her co-debtor husband that contained the express provision that the property of the debtors would re-vest in the debtors on confirmation of the plan. Almost two years later, the debtor quitclaimed her interest it the real property to a third party and a little more than one year thereafter converted her case to chapter 7. The chapter 7 trustee, thereafter sought to sell the property. The issue before the Court was whether the chapter 7 estate had any interest in the transferred real property.

3. The Court noted that there were four divergent views on what section 1327(b) meant. Those views were:

a. At confirmation, the estate ceases to exist and all property acquired before or after confirmation becomes property of the debtor.

b. At confirmation, all property of the estate becomes property of the debtor, except property essential to the debtor's performance of obligations under the plan.

c. At confirmation, all property of the estate becomes property of the debtor, but the chapter 13 estate continues to exist and "refills" with property defined in section 1306 that is acquired after confirmation, without regard to whether the property is necessary for performance under the plan.

d. At confirmation, the vesting of the property in the debtor under section 1327(b) does not remove any property from the chapter 13 estate.

4. The Court in *Krick* held that section 1327(b) meant something more than a change in possessory rights and that it was reasonable to conclude that it meant that the property of the estate moved out of the estate and into the possession and control of the debtor.

5. The Court next grappled with what it described as the "inherent inconsistency" between the "relation back" provision of section 348(f)(1) and the "re-vesting" provision of section 1327(b). In order to reconcile that conflict, the court ruled that to give effect to section 348(f)(1)(A), this statute must be read to effect a re-vesting of the property of the debtor into the chapter 7 estate, to the extent that on the date of conversion, the debtor remains in "possession" or "control". It concluded that because

the debtor had transferred her interest in the real property prior to the conversion, the estate had no interest in that real property.

C. Applying the Lessons Provided by *In re Krick*.

1. Lesson 1: Whether a conversion from chapter 13 to chapter 7 occurs before or after confirmation of a plan may sometimes make a difference. The most likely circumstance would be where the debtor has disposed of property between plan confirmation and conversion.

2. Lesson 2: If the debtor uses property of the estate during the pendency of the chapter 13 case and before conversion, such as a tax refund received postpetition, that property does not re-vest in the chapter 7 estate upon conversion.

D. Application of section 348(f) to specific property of the estate.

1. Tax Refunds: Tax refunds attributable to pre-petition earnings are property of the estate, but tax refunds attributable to post-petition earnings are not property of the estate of the chapter 7 case. *Taylor v. Burns,* 344 B.R. 523 (W.D. Ky. 2004).

2. Life Insurance Proceeds: An interest in life insurance proceeds acquired during a chapter 13 case but more than 180 days from the date of the petition did not become property of the estate upon the conversion of the case to chapter 7. *In re Brinkley,* 323 B.R. 685 (Bankr. W.D. Ark. 2005); *In re Carter,* 260 B.R. 130 (Bankr. W.D. Tenn. 2001).

3. Wages: The debtor's wages earned after the filing of the chapter 13 petition did not become property of the chapter 7 case upon conversion. *In re Stamm,* 222 F.3d 216 (5th Cir. 2000).

4. Plan Payments Held by Chapter 13 Trustee: Absent bad faith by the debtor, the chapter 13 trustee should return funds held by the trustee at the time of conversion to the debtor. *In re Michael,* 699 F.3d 305 (3d Cir. 2012); but see *In re Pegues,* 266 B.R. 328 (Bankr. Md. 2001).

E. Filing Amended Schedules of Property After Conversion. Unless the debtor has acquired property that was previously unscheduled (such as described in section 541(a)(5)) and will become property of the estate upon conversion, the debtor has no duty to file amended schedules of the debtor's property. *In re Batten,* 351 B.R. 256 (Bankr. S.D. Ga. 2006).

III. The Scope of Reasonable Inquiry.

A. Federal Rule of Bankruptcy Procedure 9011

1. (a) Every petition, pleading, written motion, and other paper, except a list, schedule, or statement, or amendment thereto, shall be signed by at least one attorney of record in the attorney's individual name.

2. (b) By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney…is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, -- (1) it is not being presented for any improper purpose.., (3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery….

B. Section 707(b)

1. Section 707(b)(4)(C) provides that: [t]he signature of an attorney on a petition…shall constitute a certification that the attorney has – (i) performed a reasonable investigation into the circumstances that gave rise to the petition..

2. Section 707(b)(4)(D) provides that: [t]he signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with the petition is incorrect.

C. The Applicability of Rule 9011 to Schedules Filed in a Chapter 7 Case.

Because of the language of Rule 9011 which seemingly excludes the schedules, the statement of financial affairs, and other statements filed in a case, the application of Rule 9011 to such documents filed in a case was questionable prior to 2005. However, the amendments to the Bankruptcy Code by BAPCPA definitively settled the question by amending section 707(b). *In re Kayne*, 453 B.R. 372 (9th Cir. B.A.P. 2011). In addition, and to avoid any doubt, BAPCBA included a "Sense of Congress" provision, instructing that sections 707(b)(4)(C) and (D) be read together with Rule 9011, so that the requirements of reasonable investigation applied to the verification of information in the schedules filed in the case. *Id.*

D. The Scope and Depth of Reasonable Investigation.

1. The reasonable investigation requirement under section 707(b) is indistinct from the reasonable inquiry requirement of Rule 9011. *In re Seare*, 493 B.R. 158 (Bankr. D. Nev. 2013). The attorney must perform an objective reasonable investigation giving rise to the petition. *Id.*

2. The attorney cannot accept all of the client's assertions at face value or rely solely on the information provided by the client. The attorney may rely upon a client's objectively reasonable assertions, but where the client-provided information is internally or externally inconsistent, materially incomplete, or raises "red flags", the attorney is obligated to inquire further. An attorney cannot rely upon a client's limited

understanding of what constitutes the "complete" or "necessary" information that the attorney must have or what information is or is not relevant to the client's particular case. *Id.* The reasonableness of an attorney's inquiry is focused not on whether the claim or information was incorrect or frivolous, but whether, from an objective standard under the circumstances, the inquiry was adequate. *In re Withrow,* 405 B.R. 505 (1st Cir. B.A.P. 2009); *Nosek v. Ameriquest Mortg. Co. (In re Nosek),* 386 B.R. 374 (Bankr. D. Mass. 2008); *In re Bailey,* 321 B.R. 169 (Bankr. E.D. Pa. 2005).

3. Among the factors in determining whether an attorney fulfilled his or her statutory duties of reasonable inquiry include (i) whether the attorney impressed upon the debtor the critical importance of accuracy in the preparation of the schedules, (ii) whether the attorney requested and then reviewed all documents that were within the debtor's possession, custody, and control in order to verify the information provided by the debtor, and (iii) whether the attorney employed all external verification tools that were available and not time or cost prohibitive, such as on-line searches. *In re Dean,* 401 B.R. 917 (Bankr. D. Idaho 2008). Taken together, Rule 9011 and section 707(b) evidence a requirement that the debtor's attorney exercise independent diligence and care in ensuring that there is evidentiary support for the information contained in the client's bankruptcy schedules. *Id.*

E. As If the Risk of Sanctions Was Not Enough.

1. Section 554. Pursuant to sections 554(c) and (d), property not listed in the schedules and not abandoned by the trustee in a case, remains property of the estate after the case is closed.

2. Federal Rule of Bankruptcy Procedure 1009. Pursuant to Rule 1009(a), the debtor may amend a petition, schedule, list or other statement at any time **before the case is closed**.

3. A re-opened case is not the same as a not yet closed case. Rule 1009 is not applicable to amendments made or sought to be made after a case had been closed. As a result, a debtor loses his or her absolute right to amend the schedules at the closing of the case. Instead, the relevant standard is set forth in Rule 9006(b)(1), which specifies that enlargement of time to perform an act only upon the showing the failure to act was due to excusable neglect. *In re Wilmoth,* 412 B.R. 791 (Bankr. E.D. Va. 2009). The ability to show that the attorney conducted a reasonable inquiry would likely assist the debtor in meeting the excusable neglect standard, while a lack of reasonable inquiry would likely weigh against the debtor in the court's determination.