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MEMORANDUM FOR ASSOCIATE AREA COUNSEL, SB/SE:

FROM: Lawrence H. Schattner, Chief, Branch 2
(Collection, Bankruptcy and Summonses)

SUBJECT: Setoffs After Segal v. Rochelle

This responds to the March 20, 2002, e-mail from your office involving the following issue.

ISSUE

For purposes of setting off pre-petition liabilities of a corporate debtor in a chapter 11 bankruptcy case, is the debtor's right to claim an income tax refund or tentative carryback adjustment that is generated by the carryback of a net operating loss (NOL) a prepetition debt if the carryback year (year to which the loss is carried) ends before the filing of the bankruptcy petition and the loss year (year in which the NOL is incurred) begins before, but ends after, the date on which the petition is filed?

ANALYSIS

Section 553 of the Bankruptcy Code preserves a creditor's right to set off a mutual debt owing by such creditor to the debtor that arose before the commencement of the case against a claim of such creditor against the debtor that arose before the commencement of the case. Among the setoff rights preserved by B.C. § 553 is the Internal Revenue Service's right under I.R.C. §§ 6402(a) or 6411(b) to set off an overpayment of tax against a tax liability.

The issue presented requires a determination of whether the overpayment generated by the carryback of the NOL is a post-petition debt or a pre-petition debt. It is assumed for purposes of this memorandum that a post-petition debt cannot be setoff against a pre-petition liability. See generally In re Gordon Selway, 270 F.3d 280 (6th Cir. 2001); In re Davidovich, 801 F.2d 1533, 1537-1538 (1st Cir. 1990); Boston Maine Corp. v. Chicago Pacific Corp., 785 F.2d 562, 565 (7th Cir. 1986); Cooper Jarrett, Inc. v. Central Transport, Inc., 726 F.2d 93, 96 (3rd Cir. 1984).

When a taxpayer has a right to file a claim for refund and files bankruptcy, the debtor's right to claim the refund passes to the bankruptcy estate pursuant to B.C. § 541. The property held by the estate is not the right to the return of prepetition tax payments but, rather, the right to file a claim for refund under the Internal Revenue Code and, if necessary, to bring a refund suit against the government.

It could be argued that a refund claim generated by the carryback of the NOL arises at the end of the loss year because the events that give rise to the refund have not all occurred before the end of that year. Before the end of the loss year there is no fixed right to a refund. Events that occur during the loss year after the filing of the petition may reduce or even eliminate any potential right to a refund that existed on the date the petition was filed. It could be argued that as of the filing of the petition, any right to a refund or tentative carryback adjustment is speculative.

The above approach was rejected by the Supreme Court in Segal v. Rochelle, 382 U.S. 375 (1966), which held that a contingent right to claim a refund is property of the estate. In Segal, the Supreme Court addressed whether a refund generated by the carryback to a prepetition year of a NOL from the year in which the bankruptcy case commenced is property of the estate under the predecessor to B.C. § 541. The bankruptcy trustee argued that the refund was property of the estate while the debtors argued that the refund arose post-petition and therefore belonged to them. The Court first explained that it was impossible to give any categorical definition to the word "property" under the Bankruptcy Act and that the purposes of the Act must ultimately govern. Id. at 379. The Court weighed the need to secure everything of value for creditors in the bankruptcy case against the need to leave the debtor free to secure new wealth in the future. Id. The Court held that the NOL carryback refund was "sufficiently rooted in the prebankruptcy past and so little entangled with the bankrupt's ability to make an unencumbered fresh start that it should be regarded as 'property' under the [Act]." Id. at 380. The Court explained that two key elements pointed towards the realization that the refunds existed at the time the bankruptcy petition was filed: first, the taxes had been paid prepetition and second, the losses in the petition year arose prepetition. Id. Both factors were essential to the Court's holding. Thus, we do not think the Court would have reached the same conclusion if all of the losses in the petition year had arisen postpetition.

Congress followed Segal when it enacted the Bankruptcy Code. The legislative history states:

> The estate is comprised of all legal and equitable interests of the debtor in property, wherever located, as of the commencement of the case. The scope of [section 541] is broad. It includes all kinds of property, including tangible and intangible property, causes of action . . . and all other forms of property currently specified in [the predecessor to section 541] . . . The result of Segal v. Rochelle,

> 382 U.S. 375 (1966) is followed, and the right to a refund is property of the estate.

S.Rep. No. 989 95th Cong., 2d Sess. 82, reprinted in 1978 U.S.C.C.A.N. 5787, 5868; H.Rep. No. 595, 95th Cong., 1st Sess. 367, reprinted in 1987 U.S.C.C.A.N. 5963, 6323. Courts continue to rely on Segal under the Bankruptcy Code. In In re Feiler, 218 F.3d 948, 955-956 (9th Cir. 2000), the court followed Segal in concluding that a right to refund is property of the estate for purposes of avoidance of the debtor's prepetition election to waive the carryback of an NOL. In In re Barowsky, 946 F.2d 1516, 1517-1518 (5th Cir. 1991), the court followed Segal in concluding that the portion of the debtor's tax refund attributable to the prepetition portion of the taxable year in which the bankruptcy was filed was property of the estate. In In re Prudential Lines, Inc., 928 F.2d 565, 571-573 (2nd Cir. 1991), the court followed Segal in concluding that a debtor-subsidiary's right to a NOL carryforward was property of the estate (and the bankruptcy court properly enjoined the parent from taking a deduction for the NOL that would have precluded the debtor from carrying the NOL forward). In In re Doan, 672 F.2d 831, 832-833 (11th Cir. 1982), the court followed Segal in concluding that the debtor's tax refund was property of the estate where the refund was based on the prepetition portion of the taxable year in which the bankruptcy petition was filed.

Debtors or other parties in interest may argue that Segal requires that a tax refund generated by the carryback of a NOL from the year in which the bankruptcy petition was filed to a prepetition year be apportioned into prepetition and post-petition portions based on when the losses were incurred. In Segal the losses were incurred entirely in the prepetition portion of the petition year. The Court noted in dicta that if losses had also been incurred in the post-petition portion of the petition year, a proration of the refund in the ratio of the losses before and after the petition date might be warranted. 382 U.S. at 380, n.5. We are not aware of any cases dealing with this precise issue although Barowsky, supra, held in a chapter 7 case (not involving a carryback refund) that the refund should be pro rated in this manner. Other cases similarly pro-rate refunds owed for the year in which the petition is filed. See In re Dussing, 205 B.R. 332, 333 (Bankr. M.D. Fla. 1996); In re Orndoff, 100 B.R. 516, 517 (Bankr. E.D. Cal. 1989); In re Smith, 77 B.R. 633, 635 (Bankr. N.D. Ohio 1987); In re Shults, 28 B.R. 395, 397 (B.A.P. 9th Cir. 1983); In re Edmonds, 27 B.R. 468, 469 (Bankr. M.D. Tenn. 1983); In re Verill, 17 B.R. 652, 654 (Bankr. D. Md. 1982); In re Thomas, 14 B.R. 759, 764 (Bankr. E.D. Mich. 1981); In re Koch, 14 B.R. 64, 66 (Bankr. D. Kan. 1981). See also In re Montgomery, 224 F.3d 1193 (10th Cir. 2000) (while not citing Segal, court held that prepetition portion of petition year earned income tax credit was property of the estate); In re Johnston, 209 F.3d 611 (6th Cir. 2000) (same). We therefore recommend that as a general matter the Service assert its right to set off the entire amount of the tentative carryback adjustment since it appears that most if not all of the losses were incurred before the petition date. In appropriate cases, a setoff of a portion of the carryback would be proper if the debtor clearly shows that the carryback adjustment is attributable only in part to a loss incurred before the filing of the bankruptcy petition.

Your office is concerned that Segal and other cases involving tax refunds may be inconsistent with the Service's longstanding position that tax liabilities for the straddle year (year in which the bankruptcy petition was filed) are entirely post-petition liabilities unless the debtor can, and does, elect to split the tax year into prepetition and post-petition years pursuant to I.R.C. § 1398. This concern may be based on the argument that because a tax refund for the straddle year or a refund based on an NOL carryback from the straddle year may, at least in part, be considered to arise pre-petition, so also must a tax liability for the straddle year or a portion of such a liability be considered to arise pre-petition. However, this argument, while based on a reasonable analogy between refunds and liabilities, ignores the fact that rights to claim refunds are governed by B.C. § 541 while liabilities for the straddle year raise issues under B.C. §§ 503(b)(1)(B) and 507(a)(8)(iii) as explained below.

Pursuant to B.C. § 541, property of the estate includes "all legal or equitable interests of the debtor as of the commencement of the case." This includes contingent debts owed the debtor, and, following Segal, includes contingent rights to refund when the refund is based on taxes paid and losses incurred pre-petition. Contingent debts owed by the government to the debtor are also considered prepetition debts for purposes of setoff under section 553. In re Gerth, 991 F.2d 1428 (8th Cir. 1993). While the definition of a "claim" against the estate in B.C. § 101(5) is also broad, B.C. § 503(b)(1)(B) specifically provides that taxes "incurred by the estate" are entitled to be paid as administrative expenses of the estate as long as they are not of the type in B.C. § 507(a)(8). An income tax is imposed on the cumulative results of all transactions within a taxpayer year, and is therefore "incurred" on the last day of the tax year. No portion of an income tax liability is incurred before the last day of the tax year. See In re Pacific-Atlantic Trading Co., 64 F.3d 1292, 1300 (9th Cir. 1995). The law does not recognize the concept of a tax liability being contingently incurred prior to the end of the year.

Further, our position is that no provision of section 507(a)(8) includes the prepetition portion of income tax liability for the straddle year. The three circuits that have held, contrary to our position, that the Service's claim for income tax for the straddle year should be split into prepetition and post-petition portions did not rely on, or even mention, Segal. Rather, these courts held that the prepetition portion of the petition year liabilities fell within the "plain language" of section 507(a)(8)(iii). In re Hillsborough Holdings Corp., 116 F.3d 1391 (11th Cir. 1997); In re L.J. O'Neill Show Co., 64 F.3d 1146 (8th Cir. 1995); Pacific-Atlantic.[1] The bases for our position that section

[1] The courts in Hillsborough Holdings and L.J. O'Neill declined to decide whether the prepetition portion of petition year income taxes were "incurred by the estate." 116 F.3d at 1394; 64 F.3d at 1149. However, as cited supra, the court in Pacific-Atlantic did reach the issue and held, consistent with our position, that for purposes of B.C. section 503(b)(1)(B) Congress intended for a tax on income to be considered "incurred" on the

507(a)(8)(iii) does not include liabilities for the straddle year are not inconsistent with Segal. Rather, our position is that section 507(a)(8)(iii) includes only those taxes which were assessable before the bankruptcy petition was filed, i.e., income taxes for which the tax year ended before the petition was filed. The straddle year ends after the petition is filed, and the Service cannot assess the tax before the year ends. Thus, the tax liability for the straddle year is not assessable before the petition is filed and is therefore not described in section 507(a)(8)(iii). The "plain language" interpretation of the three circuit court cases indicated above renders the phrase "not assessed before" superfluous, and would cause taxes for entirely post-petition years to fall within the scope of section 507(a)(8)(iii), an absurd result. Our position is supported by the legislative history of this provision, and harmonizes with sections 507(a)(8)(i) and (ii). Further, I.R.C. § 1398, which allows individuals to split the year in which the bankruptcy petition was filed into prepetition and post-petition portions, would have no purpose if the straddle year were automatically split under the Bankruptcy Code. None of these bases for our position as to the liability for the straddle year are inconsistent with Segal.

LITIGATION HAZARDS AND OTHER CONCERNS

[redacted]

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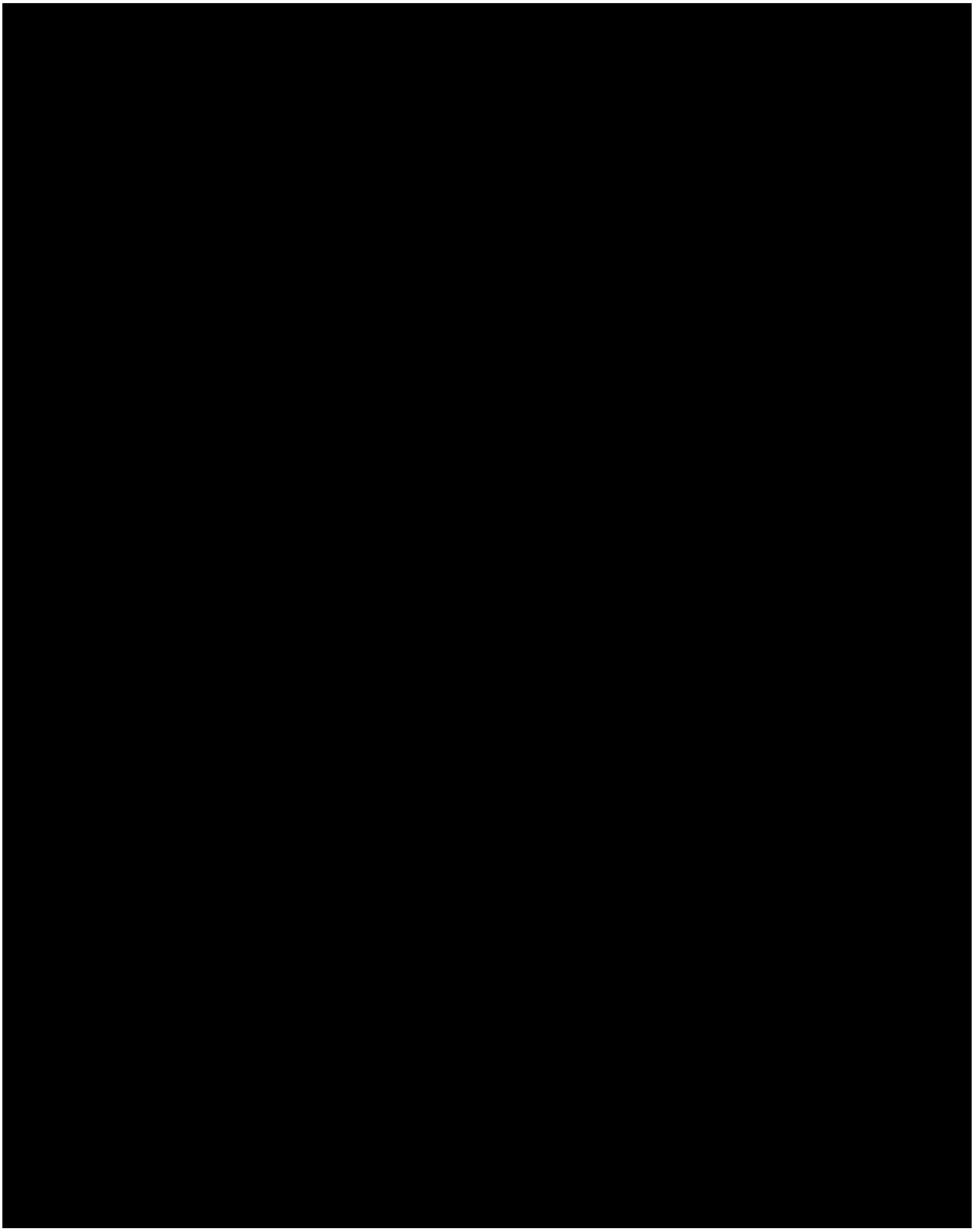
last day of the income period. 64 F.3d at 1300.



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CONCLUSION

We conclude that a refund generated by the carryback of a NOL from the straddle year to a prepetition year is a prepetition obligation for purposes of setoff, except to the extent it can be clearly shown that only a portion of the refund is attributable to a loss incurred before the filing of the petition. If you have any questions, please contact the attorney assigned to this matter at (202) 622-3620.