

TAX PROCEDURE: THE IMPACT OF BANKRUPTCY ON REFUND CLAIMS

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Last week, a district court addressed a series of refund claims that had an unusual jurisdictional complication: The Taxpayers initiated the refund claims while they were debtors in a Chapter 7 bankruptcy case, and the refunds they sought were property of the bankruptcy estate. The government sought to dismiss their refund action on a variety of grounds; while the motion was denied, the resulting opinion addresses a number of interesting issues concerning the complications that a bankruptcy case can add to a refund claim. [Martin v. United States](#), No. 3:13-cv-03130, 2017 U.S. Dist. LEXIS 1285 (C.D. Ill. Jan. 5, 2017).

Martin involved refund claims for 1996, 1997, 2001, and 2002; the government moved to dismiss the refund claims for 1996, 1997, and 2001. *Martin*, 2017 U.S. Dist. LEXIS 1285 at *1-*2. The government's motion focused on a Chapter 7 bankruptcy case that the taxpayers had commenced in May 2002. After receiving their discharge, the taxpayers filed a series of amended returns in February of 2005, before their bankruptcy case was closed; for 2001 they reported losses, and they amended their 1996 and 1997 returns to carry back losses and request refunds. *Id.* at *4-*5. The taxpayers filed another amended 2001 return in January 2006. *Id.* at *5.

The IRS denied the refund claims in 2011, and the Martins filed a refund action in 2013. While the bankruptcy case was closed, the tax refunds had not been listed as an asset in the case. Consequently, the U.S. Trustee moved to reopen the bankruptcy case, and the bankruptcy court granted that motion. *Id.* at *6. The bankruptcy trustee moved to abandon the refund claims under section 554 of the Bankruptcy Code and that motion was granted; the bankruptcy case was then closed again. *Id.* at *7.

The government moved to dismiss on a variety of grounds, all of which were tied to the prior bankruptcy. Initially, the government challenged the court's subject matter jurisdiction, arguing that the taxpayers had not properly exhausted their administrative remedies. This argument was premised on the fact that the taxpayers' amended returns had been filed at a time that the refund claims were still technically property of the estate under section 541 of the Bankruptcy Code; in the government's view, this meant that the taxpayers' amended returns were not "duly filed" as required by section 7422 of the Internal Revenue Code and that the court, therefore, lacked jurisdiction. *Id.* at *9.

The district court acknowledged that the refund claims were property of the estate under section 554(d) of the Bankruptcy Code because they were not scheduled and had not been administered during the

bankruptcy. *Id.* at *12. The abandonment of the refund claims by the trustee, however, vested those claims in the taxpayers, “as if the bankruptcy case had never been filed.” *Id.* at *13. The government argued that the abandonment occurred too late, as the time to file an administrative claim under section 6511 of the Internal Revenue Code had already expired by the time the taxpayers actually had authority to pursue a refund. *Id.* at *15-*16. The court rejected that argument, reasoning that the abandonment should be treated as vesting the right to pursue the refunds in the taxpayers *nunc pro tunc*. *Id.* at *19-*20. The district court reasoned that the equities favored preserving the refund claims and that the administrative exhaustion requirement had been satisfied, as the IRS had been afforded an opportunity to address the claims administratively. *Id.* at *19.

Next, the government attacked the taxpayers’ standing, arguing that they filed their refund action in district court at a time when only the bankruptcy trustee was authorized to file suit. *Id.* at *20. In the court’s view, the taxpayers had demonstrated that they had constitutional standing as they alleged a concrete injury traceable to the government’s failure to issue a refund. *Id.* at *23 (citing *Dunmore v. United States*, 358 F.3d 1107, 1112 (9th Cir. 2004); *Williams v. United Techs. Carrier Corp.*, 310 F. Supp. 2d 1002, 1010 (S.D. Ind. 2004)). The court treated the government’s motion as a challenge to prudential standing as it questioned whether the taxpayers were the real parties in interest. *Id.* at *24. Here, the court noted that the Federal Rules of Civil Procedure contemplate that an action filed by a plaintiff who is not the real party in interest should not be dismissed, as the problem could be cured, even after the statute of limitations expired. *Id.* at *26-*27 (citing Fed. R. Civ. P. 17(a)(3); 6A Charles A. Wright & Arthur Miller, *Federal Practice and Procedure* § 1555 (3d Ed. & 2016 update)). Faced with what appeared to be a mistake by the taxpayers and a defendant that could not identify any prejudice, the court ruled the trustee’s abandonment of the refund claims operated to ratify the filing of the complaint by the taxpayers *nunc pro tunc*. *Id.* at *27.

The government’s final argument rested on judicial estoppel. While the court acknowledged that the failure to disclose a claim on bankruptcy schedules can result in preclusion where the debtor subsequently seeks to recover, it held that the issue was not suitable for disposition on a motion to dismiss, because the taxpayers made a plausible argument that their prior failure to disclose the refund claims was not an exercise in concealment, as they only became aware of the claims after receiving their discharge orders and had ultimately disclosed them to the bankruptcy court. *Id.* at *30-*31.

While the district court’s reasoning appears sound, the taxpayers were also quite fortunate, as the case could easily have come out differently.



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