

[TAXES - The Tax Magazine \(2006 to Present\), THE KNIGHT WATCH— Litigating Tax Disputes in Bankruptcy Court, \(Mar. 12, 2023\)](#)

TAXES - The Tax Magazine (2006 to Present)

[Click to open document in a browser](#)

© 2024 CCH Incorporated and its affiliates. All rights reserved.

By *Kevin E. Packman and Andrew H. Weinstein* ^[1]

Kevin E. Packman is a Partner in Holland & Knight LLP's Private Wealth Services Department. He leads the firm's International Estate Planning Group. **Andrew H. "Andy" Weinstein** is a Partner in Holland & Knight's Miami office and a Member of the firm's Taxation Practice.

When litigating tax disputes, litigators should be aware that the Bankruptcy Courts can be an efficient venue. Unfortunately, not all tax disputes can be heard by a Bankruptcy Court, and if the tax dispute can be heard by the Bankruptcy Court, there are detailed procedures to be followed, which can appear confusing and contradictory. This column will discuss the tax issues that can be heard in Bankruptcy Court as well as how to qualify for Bankruptcy Court jurisdiction. Unless otherwise noted, this column is focused on Federal tax disputes.

What Is a Bankruptcy Court?

Bankruptcy Courts are specialty courts established under Article I of the U.S. Constitution. ^[1] They do not have the full judicial power of District Courts, which are established under Article III. ^[2] As a result, there are both statutory and constitutional limits on the ability of Bankruptcy Courts to hear and decide cases.

Similar to the U.S. Tax Court (Tax Court), Bankruptcy Courts have their own rules of procedure, known as the Federal Rules of Bankruptcy Procedure. Although these rules are similar to and, in many cases, incorporate parts of the Federal Rules of Civil Procedure, there are numerous bankruptcy-specific rules. As such, counsel should always incorporate the assistance of bankruptcy counsel when a case is in Bankruptcy Court.

Bankruptcy Venue

When a debtor files for bankruptcy, it has some leeway in choosing where to file. This happens because the case will be heard by the Bankruptcy Court where the debtor has been located for the greater part of the last 180 days. ^[3] However, a debtor can also file where there is a pending bankruptcy case for a debtor's affiliate, general partner, or partnership. ^[4] According to 11 USC § 505 (the Bankruptcy Code), a debtor's location means its "domicile, residence, principal place of business, or principal assets." ^[5] A corporation is generally considered to be "domiciled" in its place of incorporation, but even a case in an eligible District Court can be transferred elsewhere "in the interest of justice" or "for the convenience of the parties." ^[6] As a result, though debtors can generally choose a forum that is convenient for them, courts may balk at venue choices that are technically permissible, but in practice rather inconvenient for everyone else.

Bankruptcy Court Jurisdiction

District Courts have exclusive jurisdiction over all bankruptcy cases. ^[7] They also have original but non-exclusive jurisdiction over all civil proceedings "arising under" the Bankruptcy Code, or "arising in or related to" a bankruptcy case. ^[8] District Courts, however, are permitted to refer bankruptcy cases to the Bankruptcy Court for

their District Court. ^[9] When a case is referred by the District Court, the process is so seamless that litigants are often unaware that the matter is technically being referred from one court to another. ^[10]

Once a case has been referred to a Bankruptcy Court, bankruptcy judges have statutory jurisdiction to “hear and determine all cases arising under” the Bankruptcy Code, all “core proceedings arising under” the Bankruptcy Code, or “arising in” a bankruptcy case. ^[11] In addition, bankruptcy judges may hear proceedings that are not “core,” but are “related to” a bankruptcy case and submit proposed findings of fact and conclusions of law to a District Court, similar to the process involving a federal magistrate. ^[12] Some courts have adopted a procedure in non-core cases allowing parties to consent to a bankruptcy judge making the final determination without presentation of findings to a District Court.

Arising Under vs. Arising in vs. Related to

Cases “arising under” the Bankruptcy Code are based on bankruptcy-specific causes of action. “Proceedings ‘arising in’ a bankruptcy case are those that could not exist outside of a bankruptcy case but for which no cause of action exists under the Bankruptcy Code.” ^[13] “A proceeding is ‘related to’ a bankruptcy case if it could have commenced in Federal or state court independently of the bankruptcy case, but the ‘outcome of that proceeding could conceivably have an effect on the estate being administered in bankruptcy.’” ^[14] Thus, virtually every tax dispute involving a debtor in bankruptcy will be at least “related to” the bankruptcy and can be heard and decided in Bankruptcy Court or findings of fact can be referred by the Bankruptcy Court to the District Court for entry of decision. A Bankruptcy Court may only empanel a jury if specially designated to do so by the District Court, and with the express consent of all parties. ^[15] In nearly all tax cases, however, this is a non-issue, because filing a proof of claim in a bankruptcy case usually extinguishes a party’s right to trial by jury. ^[16]

Core vs. Non-Core

While the list of core proceedings is lengthy, what follows is a list of issues that should be most relevant to tax practitioners:

- (A) matters concerning the administration of the estate;
- (B) allowance or disallowance of claims against the estate;
- (C) counterclaims by the estate against persons filing claims against the estate;
- (F) proceedings to determine, avoid, or recover preferences;
- (I) determinations as to the dischargeability of particular debts;
- (K) determinations of the validity, extent, or priority of liens; and
- (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury or wrongful death claims. ^[17]

We will review these categories and discuss some of the types of tax disputes that can be litigated as core. Some courts interpret what is core more strictly than others. For example, in the U.S. Court of Appeals for the 10th Circuit, “[c]ore proceedings are proceedings which have no existence outside of bankruptcy ... [a]ctions which do not depend on the bankruptcy laws for their existence and which could proceed in another court are not core proceedings.” ^[18] However, other circuit courts, including both the 1st and the 2nd Circuits, have espoused a broader view of core proceedings. ^[19] Consultation with bankruptcy counsel may be necessary to determine if a specific proceeding would be subject to “core” or “non-core” jurisdiction. At a minimum, actions that can only exist in bankruptcy are “core” in all jurisdictions. Notwithstanding, as stated above, simply because a matter is non-core does not necessarily mean a Bankruptcy Court cannot hear the dispute. As explained below, however, there may be limitations on the jurisdiction to finally decide the dispute as opposed to refer findings of fact to the District Court for entry of decision. ^[20]

The Bankruptcy Code

In general, the Bankruptcy Code allows Bankruptcy Courts to “determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.” [\[21\]](#) In other words, as long as the tax dispute is related to a bankruptcy, a Bankruptcy Court can generally perform the same role as other courts having jurisdiction to hear tax disputes. This may include unpaid assessed taxes (whether or not self-assessed), tax deficiencies, and tax refunds.

There are a few exceptions. For example, Bankruptcy Courts cannot (i) determine tax disputes that were previously adjudicated by another court, (ii) adjudicate refund rights until 120 days after the trustee or debtor in possession, as applicable, makes a request for refund or the taxing authority makes a determination, or (iii) review the amount or legality of *ad valorem* personal property taxes if the non-bankruptcy time has run. [\[22\]](#)

As recently as 2021, Anoka County, Texas, argued that the Tax Injunction Act, which prevents District Courts from enjoining, suspending, or restraining the collection of taxes under state law, meant that the Bankruptcy Court for the Southern District of Texas could not exercise subject matter jurisdiction over a property tax determination. That contention was rejected, and the subject matter jurisdiction of the Bankruptcy Court to adjudicate tax matters under the Bankruptcy Code was upheld. [\[23\]](#) While this may be surprising for tax practitioners, this result is consistent with decisions around the country and means that Bankruptcy Courts, despite being Article I courts, have more power to adjudicate state tax controversies than their Article III cousins. [\[24\]](#)

Constitutional Limits

Despite the foregoing broad interpretation of jurisdiction, the U.S. Supreme Court has held that if a proceeding referred to a Bankruptcy Court is not core but is “related to” a bankruptcy proceeding, “the Constitution does not permit a Bankruptcy Court to enter final judgment” but that “the relevant statute nevertheless permits a Bankruptcy Court to issue proposed findings of fact and conclusions of law to the District Court for de novo review and entry of judgment.” [\[25\]](#) As a result, the type of jurisdiction the Bankruptcy Court has over a particular matter may impact the procedure for adjudication of that matter.

Types of Bankruptcy Litigation

In general, there are three types of proceedings in bankruptcy. First, a “main case,” this is the debtor’s bankruptcy proceeding and is denoted by a case number and a caption with the name of the debtor. Second, “contested matters” that are litigated, such as motions or objections to claims. Third, “adversary proceedings,” which are lawsuits litigated in Bankruptcy Court, whether they were filed in Bankruptcy Court or removed to Bankruptcy Court. These matters are assigned a double caption, which includes both the caption of the main case, a separate caption with the plaintiffs and defendants of the adversary proceeding, and a separate case number. Adversary proceedings have a docket independent of the main case, while contested matters are part of the main case’s docket.

Tax Issues in the Main Case

Once a bankruptcy case is filed, almost all litigation—including actions to collect pre-bankruptcy debt—are automatically stayed. However, there are limited exceptions. [\[26\]](#) While relief from the automatic stay can be granted in the right circumstances, the automatic stay is a powerful tool that provides tax debtors with time. Notwithstanding the general rule, audits, notices of tax deficiencies, demands for tax returns, and tax assessments are not stayed. [\[27\]](#)

Early on in the case, a *notice of claims* bar date may be mailed to all creditors disclosed by the debtor. However, in cases where the case is swiftly dismissed or the bankruptcy trustee decides not to administer it because there would be no assets for creditors, no such notice will be issued. The notice triggers the deadline for all creditors, including taxing authorities, to file proofs of claim setting forth all monies they believe are owed to them by the debtor as of the date the debtor filed a bankruptcy case. If another party, such as the debtor or another creditor, disagrees with the validity or amount of a claim, they may object to the claim, which would initiate a contest.

Unless a claim is objected to, it is deemed valid. [\[28\]](#)

In Chapter 11 (business reorganization), Chapter 12 (family farmer or fisherman reorganizations), or Chapter 13 (individual reorganization) cases, creditor claims, including those belonging to taxing authorities, may be paid under a payment plan, provided that the proposed plan meets the requirements of the Bankruptcy Code. The specific requirements applicable to a payment plan differ by chapter and are too detailed to cover in this column. Notwithstanding, tax counsel should be aware that it can be possible to initiate a bankruptcy filing to force a reasonable payment plan on taxing authorities, even if the taxing authorities would not approve the payment plan outside of bankruptcy.

Tax Issues in Contested Matters

The most common tax-related contested matter is a claim objection. In this situation, a taxing authority has filed a proof of claim, asserting a tax owed, and someone, usually the debtor, disagrees and files an objection to the claim. The Bankruptcy Court can then determine, subject to the limitations set forth in the Bankruptcy Code, all aspects of the validity of the tax claim, including its amount and legality. [\[29\]](#) Extensive further procedural information is available in both the Justice Manual and the Internal Revenue Manual. [\[30\]](#) When referring to these sources, however, practitioners should keep in mind that they merely represent the government's position.

Bankruptcy Courts have the power to value a debtor's property and determine whether alleged lienholders are in fact secured. [\[31\]](#) Consider the situation where a first lienholder has a lien of \$300,000 on collateral valued at \$250,000, and a taxing authority has a junior lien of \$500,000. Because the collateral is fully encumbered and the taxing authority's junior lien has no equity with which to attach, the Bankruptcy Court could determine that the taxing authority is in fact unsecured, potentially increasing the amount of tax debt a debtor could discharge in bankruptcy. [\[32\]](#) Depending on the specific procedural posture, these valuation proceedings can take the form of contested matters or adversary proceedings, where the value of the property is generally the fact most in dispute.

Bankruptcy Courts also have the power to approve the sale of property free and clear of liens, with the liens attaching to the proceeds, including even the rights of co-owners in the property. [\[33\]](#) While the sale price must be commercially reasonable to be approved, this nonetheless presents a powerful tool to force the liquidation of assets subject to tax liens for fair market value. Sales free and clear take the form of contested matters, with the reasonableness of the purchase price generally the fact most in dispute.

Tax Issues in Related Adversary Proceedings

Non-bankruptcy tax proceedings may be removed to a Bankruptcy Court after a bankruptcy is filed. [\[34\]](#) While some such proceedings may be subject to mandatory or permissive abstention, others may not. [\[35\]](#) Thus, removal can potentially be a means to consolidate tax disputes with other financial disputes before the same court, or even, potentially, escape a hostile forum.

The turnover provisions of the Bankruptcy Code provide that creditors who have repossessed property other than money pre-bankruptcy, but who have not yet liquidated that property, can be forced to return that property to the bankruptcy debtor. This occurs as long as that property is not of inconsequential value and benefit to the

estate. ^[36] In the *Whiting Pools* case, for example, this exact method was used to force the Internal Revenue Service (IRS) to return a taxpayer's personal property that it seized pre-bankruptcy. ^[37]

The turnover provisions may also be applicable to tax refunds owed to a taxpayer but withheld by a taxing authority. ^[38] Where a taxing authority has a valid, non-bankruptcy right of setoff based on mutual pre-bankruptcy debts, the bankruptcy code preserves that right. ^[39] While some courts have found that a tax refund claimed exempt under the bankruptcy code is not subject to setoff post-bankruptcy, ^[40] other courts disagree. These courts instead hold that where pre-bankruptcy tax liabilities exceed pre-bankruptcy overpayments, there is no net refund for an exemption to attach. ^[41] The utility of turnover proceedings in bankruptcy to obtain a contested refund is therefore dependent on both the facts at issue and the jurisdiction in which the case is to be filed. In the right circumstances, turnover proceedings can be a powerful tool because defenses to turnover are quite limited. Of further note is that the *Flora* rule requiring that the tax first be paid in full in order for the District Court to have jurisdiction to hear and decide a refund suit does not apply in bankruptcy and the trustee, including a debtor in possession, can compel turnover of property of the estate held by another (for a federal refund, that is to say, the IRS). ^[42]

Taxpayers may be able to go even further and turn back the clock on certain collection actions by taxing authorities. This can include priority of liens and levies on assets if the liens were defective or if the lien or levy occurred within 90 days of the bankruptcy filing. The Bankruptcy Code ^[43] allows a bankruptcy estate to undo certain transfers to creditors in the 90 days before a bankruptcy if those transfers would enable the creditor to receive more than it would in a hypothetical Chapter 7 case where the transfer did not happen. ^[44] In theory, these transfers are "preferential" to one creditor over other creditors and therefore against the spirit of equality among similarly situated creditors inherent in the Bankruptcy Code. The bankruptcy estate can also avoid certain tax payments made by the debtor as fraudulent transfers. ^[45] Likewise, under the Bankruptcy Code, bankruptcy estates have the same powers as a hypothetical judicial lien creditor, an execution creditor, or a *bona fide* purchaser of real property to avoid any defective liens placed on estate property, even if those liens are placed by taxing authorities. ^[46] In those situations where it is not clear to the bankruptcy court that disputed property rights belong to the bankruptcy estate, property held by a nominee of the debtor may not be recovered by the bankruptcy estate. Query if the debtor faced with litigation by the United States to recover assets held by an alleged nominee might fare better in a bankruptcy court because of the unique, albeit arguably broad, application of avoidance powers. In the right circumstances, these powers can be highly advantageous to a beleaguered taxpayer.

By way of summary, a debtor in bankruptcy has options that are not available in District Court litigation, including (i) a sale free and clear of liens, the effect of which may produce greater sales proceeds than a forced sale by the government; (ii) if the bankruptcy proceeding is under Chapter 11 or Chapter 13 and (a) the plan is to pay a secured claim in full over a term of years, the sale can be prevented as long as the payments are timely made, or (b) if financing is available the sale can likewise be prevented; and (iii) avoidance of the tax lien if the bankruptcy is filed within 90 days following the attachment of the lien. By way of contrast, it should be noted that debtors cannot shift their own tax liability to the bankruptcy estate when the tax liability emanates from a single-member LLC treated as a disregarded entity for income tax purposes. ^[47] Debtors also cannot discharge tax liabilities attributable to tax fraud. ^[48] In general, for any of these options to be available, it must be clear to the Bankruptcy Court that the subject asset is property of the bankruptcy estate, such as assets in the name of an alleged nominee, which must first be subject to recovery as assets of the debtor.

Conclusion

Although the caveats are complex, Article I Bankruptcy Courts have significant authority to hear and decide tax matters and, in some circumstances, can even hear and decide tax matters that Article III courts cannot. In addition, bankruptcy estates have access to an arsenal of powerful remedies that are unavailable outside

of bankruptcy, including the automatic stay, avoidance actions, sales free and clear of liens, and confirmation of bankruptcy plans. While the consequences and costs of filing bankruptcy are significant and a bankruptcy recommendation should not be made without consulting an experienced bankruptcy professional, in the right situation, bankruptcy can be a powerful option for taxpayers faced with tax liabilities that are unlikely to otherwise be favorably resolved.

Footnotes

- * The authors can be reached by e-mail at kevin.packman@hkllaw.com and andrew.weinstein@hkllaw.com.
- 1 Article 1, Sec. 8, Cl. 4.
- 2 *Id.*
- 3 28 USC § 1408.
- 4 *Id.*
- 5 *Id.*
- 6 28 USC 1412; Fed. R. Bankr. P. 1014(a).
- 7 28 USC 1334(b); *see generally* Nessler, Bankruptcy Court's Jurisdiction to Resolve Tax Claims, Lexology, Nov. 19, 2020.
- 8 *Id.*
- 9 28 USC 157(a).
- 10 On motion, a party can seek to “withdraw the reference” from the District court to the Bankruptcy court if the matter involves both bankruptcy law and federal regulation of activities affecting interstate commerce. 28 USC 157(d).
- 11 28 USC 157(b)(1).
- 12 28 USC 157(c)(1).
- 13 *In re Midgard Corp.*, CA-10, 204 BR 764 (1997) (citing further cases).
- 14 *Id.*
- 15 28 USC 157(e).
- 16 *See Langenkamp v. Culp*, SCt, 498 US 42, 45, 111 SCt 330 (1990).
- 17 28 USC 157(b)(2).
- 18 *In re Gardner*, CA-10, [91-1 USTC ¶150,290](#), 913 F2d 1515 (1990) (further citations omitted).
- 19 *See In re Ben Cooper, Inc.*, CA-2, 896 F2d 1394 (1990); *In re Arnold Print Works, Inc.*, CA-1, 815 F2d 165 (1987).
- 20 However, certain non-core matters may be subject to mandatory abstention under 28 USC 1334.
- 21 11 USC 505(a)(1).
- 22 11 USC 505(a)(2).
- 23 *WPG Northtown Venture, LLC v. County of Anoka (In re Washington Prime Group Inc. et al.)*, 642 BR 771 (Bankr. S.D. Tex. 2022).
- 24 *See, e.g., In re Stoecker*, CA-7, 179 F3d 546 (1999); *In re Pontes*, 310 FSupp2d 447 (D.R.I. 2004); *Daniels v. County of Chester et al. (In re Daniels)*, 304 BR 695 (Bankr. E.D. Pa. 2003).
- 25 *Executive Benefits Ins. Agency v. Arkison*, SCt, 573 US 25, 28, 134 SCt 2165, (2014).
- 26 11 USC 362.
- 27 11 USC 362(b)(9).
- 28 11 USC 502(a).

- 29 See 11 USC 502(b); 11 USC 505.
- 30 Justice Manual, chapter 6-5.600 *et seq.* (US Department of Justice); IRM 5.9.1 (Nov. 24, 2023) *et seq.*
- 31 11 USC 506(a).
- 32 See 11 USC 523 for types of tax debts not discharged in bankruptcy.
- 33 11 USC 363(f), (h). Note, however, that in situations involving back-to-back bankruptcies, taxing authorities may apply equitable tolling to increase the amount of debt that is not dischargeable. See, e.g., *Rader (In re Rader)*, 2023 WL 3011249 (Bankr. M.D. Tenn. 2023). Given subject matter jurisdiction in bankruptcy court, it may be that equitable tolling is more broadly available in bankruptcy proceedings than in the United States Tax Court. *cf. Boechler, P.C.*, 596 US ___, slip op. at 1 (2022) and *Culp*, No. 22-1789 (3rd Cir. July 19, 2023); see also generally Jerrold L. Strasheim, *Fundamentals of Summary Jurisdiction in Straight Bankruptcy over Controversies between Trustees and Third Persons*, 51 NEB. L. REV. 505 (1972).
- 34 Fed. R. Bankr. P. 9027; United States Tax Court Rules of Practice and Procedure 13(e); IRM 34.3.1.2.1 (Jan. 20, 2015); see also IRM 35.2.1.1.8 (Aug. 11, 2024) (effect of automatic stay on pending Tax Court litigation) and IRS Publication 908 (02/2022, *Bankruptcy Tax Guide* [including the requirement to file returns in bankruptcy proceedings]); just as with respect to the requirement to file returns, the newly effective Corporate Transparency Act (CTA), §§ 6401-6403 of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Pub.L. No. 116-283 (H.R. 6395) does not include among its 23 exemptions an exemption from reporting when a reporting entity is in bankruptcy and it should not be assumed that the filing of a bankruptcy will excuse CTA compliance.
- 35 28 USC 1334.
- 36 11 USC 542(a).
- 37 *Whiting Pools, Inc.*, S.Ct., [83-1 USTC ¶9394](#), 462 US 198, 103 S.Ct 2309 (1983).
- 38 See *In re Patriot Coal Corp.*, 631 BR 648 (Bankr. E.D. Mo. 2021).
- 39 11 USC 553. See also *In re Faasoa*, 576 BR 631 (Bankr. S.D. Ca. 2017); *In re Shortt*, BC-DC-TX, [2002-2 USTC ¶50,530](#), 277 BR 683 (2002).
- 40 See, e.g., *In re Bourne*, 262 BR 745 (Bankr. E.D. Tenn. 2001).
- 41 *In re Gould*, CA-9, 401 BR 415 (BAP 2009); *U.S. Dept. of Agriculture Rural Housing Service v. Riley*, 485 BR 361 (W.D. Ken. 2012). See also *Miller*, 422 BR 168 (W.D. Wi. 2010) (summarizing cases on both sides).
- 42 *W.W. Flora*, S.Ct., [60-1 USTC ¶9347](#), 362 US 145 (1990) (citing 28 USC 1346(a)(1) and 11 USC 542).
- 43 11 USC 547.
- 44 11 USC 547(b).
- 45 *Miller*, CA-10, No. 21-4135, (2023).
- 46 11 USC 544.
- 47 *Gordon v. Gazes (In re 22 Fiske Place, LLC)*, CA-2, No. 22-1788 (2023).
- 48 11 USC § 523(a)(1)(C). In some circuits, tax debts for which no return was filed are also considered non-dischargeable, although the IRS is, at time of this writing, currently treating most such debts as if they were discharged. See *In re Mallo*, CA-10, [2015-1 USTC ¶50,129](#), 774 F3d 1313 (2014); *In re McCoy*, CA-5, 666 F3d 924 (2012), but see *In re Shek*, CA-11, 947 F3d 770 (2020).