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May 12, 2000

MEMORANDUM FOR DISTRICT COUNSEL, MICHIGAN DISTRICT, DETROIT

FROM: Lawrence Schattner, Chief, Branch 3
(General Litigation)

SUBJECT: Bankruptcy Court Orders Requiring Turnover of Tax Refunds

This memorandum responds to your request for advice dated April 6, 2000, regarding the authority of the bankruptcy court to issue ex parte orders directing the Service to turn over the future tax refunds of chapter 13 debtors to the trustee.

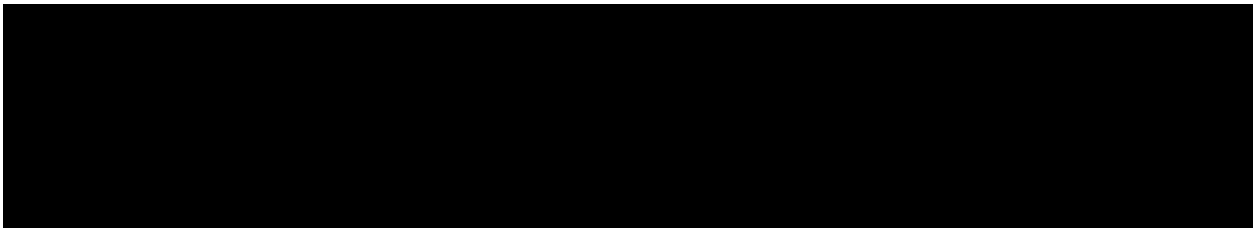
ISSUES

Whether sovereign immunity is a viable defense to the enforcement of income deduction orders that are entered pursuant to section 1325(c) of the Bankruptcy Code against the Service with respect to debtors' future income tax refunds.

Whether chapter 13 debtors' future income tax refunds fall within the meaning of "income" in section 1325(c).

Whether the Assignment of Claims Act applies to bar the enforcement of an order directing the Service to pay debtors' future income tax refunds to the chapter 13 trustee.

CONCLUSIONS



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FACTS

Years ago, the Michigan District adopted the practice of sending income tax refunds that were owed to chapter 13 debtors directly to the trustee. This practice was followed in cases where the Service filed a proof of claim and in "no-liability" cases where the Service did not file a proof of claim and was not otherwise a party to the bankruptcy case.

Due to the increased burden on the Michigan District to manually process income tax refunds that were sent directly to the chapter 13 trustees, the District decided to discontinue this practice. A letter was sent to the chapter 13 trustees in the district informing them that beginning on January 1, 2000, the Service would no longer be providing this service. Thereafter, the chapter 13 trustees filed ex parte applications with the court to obtain orders directing the Service to remit tax refunds directly to the trustees. Citing section 1325(c) for its authority, the bankruptcy court has entered at least 215 ex parte orders directing the Service to forward to the chapter 13 trustee "any and all monies due and payable to the debtor(s) ..., particularly any and all income tax monies due and otherwise payable to said debtors(s)."

LAW & ANALYSIS

Section 1325(c) of the Bankruptcy Code, 11 U.S.C., provides that after confirmation of a chapter 13 plan, "the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee." The definition of the term "entity" includes a governmental unit, and the definition of the term "governmental unit" includes the United States. See 11 U.S.C. §§ 101(15) and 101(27).

1. Sovereign Immunity as a Defense

Section 658(2) of the Bankruptcy Act preceded section 1325(c). Under section 658(2), the bankruptcy court was empowered to "issue such orders as may be requisite to effectuate the provisions of the plan, including orders directed to any employer of the debtor." Rule 13-213(b) facilitated this authorization by providing that the order of confirmation or a separate payment order was to specify the amount and manner in which payments were to be made by the debtor or to be

obtained from the employer of the debtor. Thus, instead of having the debtor collect his entire wages and make the payment to the trustee, the Bankruptcy Act provisions authorized the court to direct the debtor's employer, where requisite, to deduct from the debtor's earnings the amount which the debtor is supposed to pay under the plan. 10 Collier on Bankruptcy, ¶ 29.08 (14th ed. 1978).

In United States v. Krakover, 377 F.2d 104 (10th Cir.), cert. denied, 389 U.S. 845 (1967), the court held that an order entered pursuant to section 658(2) which required the United States to pay part of the wages of one of its employees to the trustee was barred by sovereign immunity. Applying the rule that general language in the Bankruptcy Act cannot be construed as a waiver of sovereign immunity, the court rejected the trustee's argument that the reference to "any employer" in section 658(2) included the United States. Id. at 106. The court also noted that its ruling did not deprive federal employees of the benefits of chapter 13 because federal employees could be ordered to endorse and turn over their pay checks to the trustee. Id. at 107.

Under the Bankruptcy Reform Act of 1978, the class of persons eligible to file a petition under chapter 13 was expanded and no longer limited to wage earners. See In re Buren, 725 F.2d 1080, 1082 (6th Cir.), cert. denied, Hildebrand v. Social Sec. Admin., 469 U.S. 818 (1984) (discussion of legislative history). Section 1325(b), the successor statute to section 658(2) of the Bankruptcy Act and what is now section 1325(c), was also enacted as part of the Bankruptcy Reform Act of 1978. The legislative history to section 1325(b) indicates that Congress used the term "entity" in the statute because it intended income deduction orders to apply to governmental units. See Sen. Rep. No. 95-989, at 142 (1978), *reprinted in* 1978 U.S.C.C.A.N., 5787, 5928 ("Subsection (b) authorizes the court to order an entity, as defined by Section 101(15), to pay any income of the debtor to the trustee. Any governmental unit is an entity subject to such an order."). See also, In re Howell, 4 B.R. 102, 105 (Bankr. M.D. Tenn. 1980) (the language used in § 1325(b) of the Bankruptcy Code and the definitions of "entity" and "governmental unit" contained in § 101 clearly overrule the immunity analysis in Krakover); In re Hughes, 7 B.R. 791, 795 (Bankr. E.D. Tenn. 1980) (noting that the Senate committee report flatly states that "any" governmental unit is subject to an order under § 1325(b), court states that "[o]nly by obtuseness can the administration avoid the avoid the conclusion that § 1325(b) was meant to overrule United States v. Krakover.").

In holding that there was an explicit waiver of sovereign immunity, the courts in Howell and Hughes also relied upon the language contained in section 106(c) prior to its amendment under the Bankruptcy Reform Act of 1994 (the "BRA"). See In re Howell, 4 B.R. at 105-106; and In re Hughes, 7 B.R. at 796. Section 106(c) previously provided that sovereign immunity was waived in any situation in which the applicable bankruptcy statute contained the trigger words of "creditor," "entity," or "governmental unit."

[redacted]

[redacted] Section 106(a) was amended to set forth a list of statutory provisions for which sovereign immunity is abrogated as to a governmental unit. Section 1325 is not included in this list. Further, the provision in section 106 that waived sovereign immunity when a statute contained certain trigger words, such as "entity," was not retained in the amended version of the statute. [redacted]

2. Whether "income" includes future income tax refunds

Under the Bankruptcy Code, any "individual with regular income" is eligible for chapter 13 relief. 11 U.S.C. § 109(e). Section 101(30) defines "individual with regular income" as an individual whose income is sufficiently stable and regular to enable such individual to make payments under a chapter 13 plan. Section 1325(b)(2) defines the term "disposable income" as income received by the debtor which is not reasonably necessary to be expended for the maintenance or support of the debtor. The term "income" is not defined in the Bankruptcy Code.

In Freeman v. Schulman, 86 F.3d 478 (6th Cir. 1996), the Sixth Circuit held that future income tax refunds can be considered "projected disposable income" under section 1325(b). In Freeman, the debtors received an income tax refund in an amount greater than expected and tried to amend their chapter 13 plan to exempt a portion of the refund. Id. at 479. Relying upon the particular facts in the case, the court determined that the refund qualified as "projected disposable income" because the debtor specifically provided that tax refunds should go to the plan and made no argument that the funds were needed for the maintenance and support of the debtor or her dependents. Id. at 481.

[redacted]

[redacted][1][redacted]

[redacted] As noted above, the predecessor statute to section 1325(c) applied to "employers" of the debtor. Thus, the statute applied to wages received by debtors. When the Bankruptcy Reform Act expanded the eligibility of debtors to file chapter 13 so that relief was not limited to wage earners, it extended eligibility to any "individual with regular income." Under section 101(30), an "individual with regular income" is defined as an "individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title." [redacted]

While courts have recognized a variety of nontraditional sources of money as income under section 101(30), the income must be regular and stable enough to fund a plan. See In re Murphy, 226 B.R. 601, 605 (Bankr. M.D. Tenn. 1998), and cases cited therein. Similarly, the income against which courts have upheld income deduction orders under section 1325(c) is the regular and stable income that is used to fund chapter 13 plan payments. See, e.g., United States v. Devall, 704 F.2d 1513, 1515 (11th Cir. 1983) (debtors listed social security benefits as regular income in all of their chapter 13 plans); In re Howell, 138 B.R. 484 (W.D. Pa. 1992) (debtors entitled to monthly AFDC grants which were used to fund chapter 13 plans); In re Simmons, 94 B.R. 74 (Bankr. W.D. Pa. 1988) (debtor received monthly

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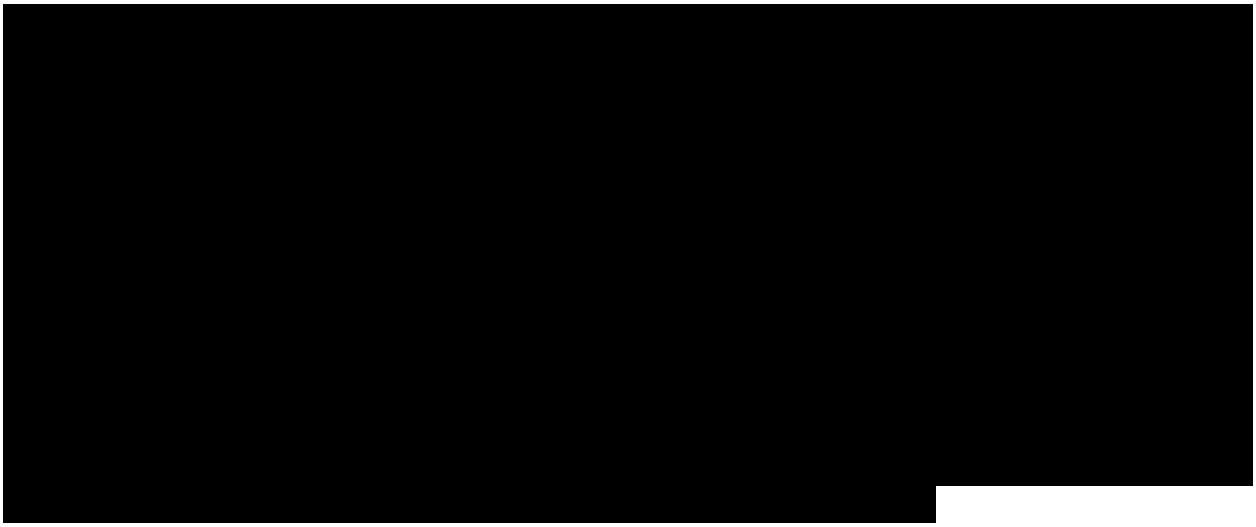
[1] In In re Anderson, 21 F.3d 355 (9th Cir. 1994), the Ninth Circuit held that the requirement that a chapter 13 plan provide for payment of all of the debtor's "projected disposable income" to the trustee does not entitle the trustee to require that the debtor agree to pay all actual disposable income to the trustee. Relying upon Anderson, the court in In re Kuehn, 177 B.R. 671 (Bankr. D. Ariz. 1995), held that the trustee cannot require a blanket turnover of all tax refunds without a showing that such refunds are in fact projected in a certain amount. Thus, debtors may object to plan provisions which require them to commit all or a portion of their future tax refunds to the plan on the grounds that future tax refunds are not "projected disposable income." [redacted]

income from a teacher's retirement system); Michigan Employment Sec. Comm'n. v. Jenkins, 64 B.R. 195 (W.D. Mich. 1986) (debtor received unemployment benefits in lieu of wages); In re Williams, 13 B.R. 640 (E.D. Wash. 1981) (debtors' schedules listed as income monthly social security benefits). In all of these cases, the income deduction order was entered against a stream of regular payments that were used to fund the chapter 13 plan payments.



3. The applicability of the Assignment of Claims Act

In In re Cochran, 141 B.R. 270, 273 (M.D. Ga. 1992), the United States argued that the Assignment of Claims Act (the Act) bars a bankruptcy court from ordering the Service to send the debtor's tax refund to the trustee. The court rejected this argument on the grounds that section 1325(c) impliedly modified the Act to allow the assignment of tax refunds to the trustee via income deduction orders. Id. Although the issue was not raised in Cochran, there is also a question as to whether the Assignment of Claims Act even applies in a bankruptcy proceeding.

In a couple of cases, courts have determined that the Assignment of Claims Act does not apply where tax refunds were transferred to the trustee by operation of bankruptcy law or in accordance with a plan of arrangement. In Segal v. Rochelle, 382 U.S. 375 (1966), the Supreme Court held that a loss-carryback refund that was inchoate on the date of the petition was property that passed to the trustee under section 70a(5) of the Bankruptcy Act. In determining whether the refund constitutes property that could be transferred within the meaning of section 70a(5), the Court noted that the predecessor statute to the Assignment of Claims Act, 31 U.S.C. 22 203, does not prevent transfers by operation of law. Accordingly, the Court reasoned that the Assignment of Claims Act does not interfere with the vesting in the trustee of property coming within section 70a(5) because all transfers of property to the bankruptcy estate under section 70a(5) are explicitly by operation of law. Id. at 382, n. 7.

Similarly, in In re Kepp Elec. & Mfg. Co., 98 F. Supp. 51, 53 (D. Minn. 1951), the court held that a debtor's assignment of "any and all tax refunds which may be due or owing to the debtor from the United States government" was not within the purview of the Assignment of Claims Act, and that the assignment was therefore valid and effective to vest in a receiver any right of the debtor to the tax refunds. Because the tax refunds claimed by the debtor were transferred to the receiver pursuant to plan of arrangement under Chapter XI of the Bankruptcy Act that was approved and confirmed by the bankruptcy court, the court determined that the transfer constituted "an act of the law" and was not within the prohibition of the Assignment of Claims Act. Id. at 60-61.

Under section 1306(a) of the Bankruptcy Code, all property that the debtor acquires after the commencement of the case is property of the estate. Under section 1327, property of the estate vests in the debtor upon confirmation except as otherwise provided in the plan or the order confirming the plan. [redacted]

4. The ex parte nature of the orders

[redacted] Under Rule 9013, Fed. R. Bankr. P., a request for an order must be made by written motion and every written motion, other than one which may be considered ex parte, must be served by the moving party on those entities specified by the rules. The opportunities for legitimate ex parte applications are extremely limited. In re Intermagnetics America, Inc., 101 B.R. 191, 192 (C.D. Cal. 1989) (due to an increase in ex parte applications, court notes in some detail why they are "nearly always improper."). See also In re Dinova, 212 B.R. 437, 445 (2nd Cir. BAP 1997) ("Even if notice is burdensome in a particular case, the American Judicial system is predicated on the adversary process and forbids *ex parte* communications on substantive matters by statute, rule, and code of ethics. Virtually every substantive motion in American jurisprudence must be on notice to affected parties.").

[redacted] Under Rule 7001(7), a proceeding to obtain an injunction or other equitable relief must be brought as an adversary proceeding, except when the chapter 13 plan provides for the relief. [redacted]

[redacted]

[redacted] Under Rule 9014, relief in a contested matter which is not otherwise governed by the Federal Rules of Bankruptcy Procedure is required to be made by motion, and reasonable notice and opportunity for hearing must be afforded the party against whom relief is sought. Other than Rule 7001, we are not aware of any other Bankruptcy Rule which could be construed as governing a request for an income deduction order. [redacted]

It should be noted that the bankruptcy court in In re Williams, 13 B.R. 640, 641 (Bankr. E.D. Wash. 1981), held that there is no notice or service requirement for income deduction orders issued pursuant to section 1325. In Williams, the court signed an order requiring the Social Security Administration to pay benefits directly to the trustee, which order was mailed by the trustee to the Social Security Administration's regional office. Id. Approximately five months later, the United States filed a Motion to Reconsider or in the Alternative for a Stay of Execution Pending Appeal. In addition to arguing that the order was void due to the anti-assignment provision under the Social Security Act, the United States argued that the order was void and unenforceable for lack of proper service. The bankruptcy court rejected both of these arguments.

With respect to service of the order, the bankruptcy court determined that the issuance of an order under section 1325 is not an adversary proceeding under Rule 13-701(a), the predecessor to Bankruptcy Rule 7001(a). In re Williams, 13 B.R. at 642. Further, the court determined that under Rules 13-203(a) and (b), the predecessors to Bankruptcy Rules 2002(a) and (b), there is no requirement for notice of orders issued under section 1325. Id. at 643. While stating that the Social Security Administration has the option of questioning the propriety of the court's order upon receipt, the bankruptcy court determined that notice is not afforded for reasons of obvious judicial and administrative efficiency. Id. Thus, the court held that the trustee acted properly by mailing a copy of the income deduction order to the Social Security Administration's regional office. Id.

[redacted]

[redacted]

CONCLUSIONS

[redacted]

[redacted]

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If you have any questions, please call (202) 622-3630.

cc: District Counsel, Ohio District, Cincinnati
Attn: Louis H. Hill

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