

When, Why, And How Should A District Court Be Asked To Withdraw The Reference Of A Tax Controversy To A Bankruptcy Court?

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Who will hear what when bankruptcy meets the tax code?

FOR MANY YEARS, the availability of the bankruptcy court as a forum for litigating tax disputes was overlooked by some tax practitioners. Those who thought of it at all tended to view the bankruptcy court as a forum for disputes about the payment or dischargeability of previously determined tax liabilities. During the last two decades, however, this view has changed dramatically—bankruptcy courts now routinely determine substantive tax disputes

ranging from the very nominal to the quite substantial. This new reality has brought with it occasional questions by parties, more often than not by the government, about when and how a tax dispute might be moved to one of the more traditional courts for such litigation. This article analyzes one of the procedural vehicles for transferring a tax dispute from the bankruptcy court to the district court by “withdrawing the reference” and compares it with other potential

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vehicles. The procedure for requesting such a withdrawal and the situations in which it might be sought will also be considered.

METHODS FOR MOVING THE LITIGATION OF A TAX DISPUTE FROM THE BANKRUPTCY COURT TO ANOTHER FORUM

• In 1978, Congress imposed profound changes on the bankruptcy laws and their administration with the enactment of the Bankruptcy Code. This action, which replaced the Bankruptcy Act that had governed for the preceding 80 years, provoked an immediate constitutional challenge because it purported to give all of the district courts' bankruptcy jurisdiction directly to the bankruptcy courts. The Supreme Court held that this delegation of Article III power to non-Article III courts violated the separation of powers established by the Constitution. *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). The resulting crisis in bankruptcy administration was resolved in 1984 when Congress embraced the solution to this problem provided by the "Emergency Rule" that had been in place for the intervening two years.

Jurisdictional Predicate For Withdrawing The Reference

Under the terms of the Bankruptcy Amendments and Federal Judgeship Act of 1984, district courts are authorized to "refer" all proceedings arising under the Bankruptcy Code to their respective bankruptcy courts. These bankruptcy courts, which are considered to be "units" or "adjuncts" of the district courts, will then proceed to rule on the issues that come before them; and disappointed parties can appeal those rulings to the district courts, or, in some instances to Bankruptcy Appellate Panels ("BAPs"). The relevant statutory provisions are 28 U.S.C. §1334, which gives the district courts jurisdiction over bankruptcy cases, and 28

U.S.C. §157(a), which permits the district courts to refer "any or all cases under title 11" to the bankruptcy courts. This reference is accomplished by standing orders in each district that provide for all bankruptcy cases to be filed directly in the bankruptcy courts.

There are certain circumstances, however, when a district court can withdraw this reference of its bankruptcy jurisdiction and act as the trial court for some or all of the issues in a particular bankruptcy proceeding. The same statute that permits referring cases to the bankruptcy courts also specifies:

"The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown. The district court shall, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other law of the United States regulating organizations or activities affecting interstate commerce." 28 U.S.C. §157(d).

Congress's use of the word "may" in the first sentence and "shall" in the second is generally understood to allow for both permissive and mandatory withdrawal of the reference. Although the authority to withdraw the reference is clear, instances in which that authority has been exercised continue to be rare. Indeed, the leading treatise on bankruptcy law observes that district courts are often not receptive to motions to withdraw the reference due to concerns about forum shopping and the disruption of the bankruptcy process. 1 *Collier on Bankruptcy*, ¶ 3.04[1][b] (Alan N. Resnick and Henry J. Sommer, eds., Matthew Bender, 15th ed. rev. 2005).

When district courts have been asked to withdraw the reference with respect to a tax dispute in a bankruptcy proceeding, they have analyzed the requests as both permissive and

mandatory withdrawals. In a case involving an alleged “daisy chain” conspiracy to avoid federal excise taxes on gasoline, one district court identified four “factors” to be considered in determining a motion for permissive withdrawal:

- Uniformity in bankruptcy administration;
- Reduction of forum shopping and confusion;
- Fostering the economical use of debtors’ and creditors’ resources; and
- Expediting the bankruptcy process.

In re Oil Co., Inc., 140 B.R. 30, 33 (E.D. N.Y. 1992). The court proceeded to hold that “cause” for permissive withdrawal existed, but it then went on to hold that mandatory withdrawal was also appropriate because the issues related to the excise tax provisions were complex and appeared to be ones of first impression. *Id.*, at 35.

Several years later, a corporate debtor that had confirmed a Chapter 11 plan of reorganization objected to the Service’s disallowance of the interest deduction it claimed for its Corporate-Owned Life Insurance (“COLI”). The district court granted the government’s motion for mandatory withdrawal of the reference after it determined that the issue had resulted in conflicting decisions elsewhere and was one of first impression in its own circuit. *Internal Revenue Service v. CM Holdings, Inc.*, 221 B.R. 715, 722 (D. Del. 1998). Focusing on the second sentence of section 157(d), the court found that the first of its two “prongs” was easily satisfied since a resolution of the issue would obviously require consideration of federal law outside of the Bankruptcy Code. Under the second prong, this consideration had to be “‘substantial and material,’ such that there is a ‘meaningful consideration’ of the federal law and not just a straightforward ‘simple application’ of federal law to the facts of the case.” *Id.* 721. In reaching its decision to withdraw the reference, the court rejected the debtor’s reliance on the Bankruptcy

Code’s authorization for bankruptcy courts to determine any tax liability (11 U.S.C. §505) as “besides the point.” *Id.* at 722 n.22.

Both *Oil Co.* and *CM Holdings* were discussed by the district court in *United States v. G–I Holdings, Inc.*, 295 B.R. 222 (D. N.J. 2003), in disposing of a motion by the government seeking mandatory withdrawal of the reference. The motion concerned an objection to a substantial tax claim requiring an interpretation of section 707(a)(2)(B) of the Internal Revenue Code (“IRC”), a question of first impression. Rejecting an argument against withdrawal based upon the fact that bankruptcy courts regularly decide issues of state law, the court noted that the issue before it involved federal tax law.

“The difference here is that significant interpretation of a federal statute is required and there is a Congressional presumption in favor of Article III courts conducting such interpretation, especially when the [non-Bankruptcy Code] issue is dominant. Although the mandatory withdrawal provision is to be construed narrowly, G–I’s position would nearly eliminate mandatory withdrawal pursuant to 28 U.S.C. §157(d).” 295 B.R. at 225.

(Note: The district court was obviously concerned with its relationship to the bankruptcy court and possibly did not mean to include the Tax Court or the Court of Federal Claims in its remark about the presumption in favor of Article III courts.) The complexity of the issue and the lack of other cases on point led the court to grant the motion.

In an unusual case, a district court granted the government’s motion for summary judgment in a “lease stripping tax shelter” after it had withdrawn the reference. *Central Valley AG Enterprises v. United States*, 326 B.R. 807 (E.D. Cal. 2005). The court held that the failure of any partner to challenge a Notice of Final Partnership Administrative Adjustment (“FPAA”)

within the prescribed 150-day period meant that it had become non-reviewable and the court was without jurisdiction to adjudicate the issues the debtor sought to raise. Because the only issues remaining after this ruling implicated well-settled issues of bankruptcy law, the court vacated its earlier order withdrawing the reference.

Abstention By The Bankruptcy Court As An Alternative To Withdrawal Of The Reference

The Bankruptcy Code provides that the bankruptcy court "may determine the amount or legality of any tax." 11 U.S.C. §505(a). The language is permissive but not mandatory, leaving open the question of when the bankruptcy court should exercise this authority. The two purposes of section 505(a) are (1) to provide a forum for determination of tax claims, if the administration of the bankruptcy case would be delayed by allowing the determination to be made in other proceedings; and (2) to provide an opportunity for the trustee to contest a tax claim if the debtor had been unable or unwilling to challenge the claim prepetition. *In re Beisel*, 195 B.R. 378 (Bankr. S.D. Ohio 1996).

Many courts looking at the issue of abstention have cited a list of factors initially developed in the *Hunt* case. *In re Hunt*, 95 B.R. 442, 445 (Bankr. N.D. Tex. 1989). These factors include:

- The complexity of the tax issues to be decided;
- The need to administer the bankruptcy case in an orderly and efficient manner;
- The burden on the bankruptcy court's docket;
- The length of time required for trial and decision;
- The asset and liability structure of the debtor; and

- The prejudice to the debtor relative to the prejudice to the taxing authority from inconsistent assessments.

Government Abstention Requests

Usually, it is the government requesting the bankruptcy court to abstain from hearing a tax case. There are certain circumstances in which the government routinely makes this request, and there are certain principles that can be taken from those situations and applied generally. The most common situation in which the government requests abstention occurs when a debtor in a no-asset Chapter 7 case seeks to litigate the merits of a tax liability. In that situation, the outcome of the merits litigation will have no impact on the bankruptcy proceeding, in the government's view, making the bankruptcy court the wrong place to hear the case. Most, but not all, courts agree with that view. *Compare In re Williams*, 190 B.R. 225 (Bankr. W.D. Pa. 1995); *In re Gossman*, 206 B.R. 264 (Bankr. N.D. Ga. 1997); *In re Diez*, 45 B.R. 137 (Bankr. S.D. Fla. 1985) *with In re D'Alessio, Jr.*, 181 B.R. 756 (Bankr. S.D.N.Y. 1995); *In re Anderson*, 171 B.R. 549 (Bankr. W.D. Va. 1994).

Courts agreeing that abstention is the proper route in no-asset cases discuss the burden on the bankruptcy estate of keeping the case open when the outcome will not result in any benefit to the unsecured creditors. Courts refusing to abstain in this circumstance focus on the debtor rather than on the estate or on the creditors. They hold that the provisions of the Bankruptcy Code should be liberally construed in favor of the debtor, that the debtor cannot obtain a truly fresh start without a determination of the tax obligation, and that Congress vested the bankruptcy court with authority to determine taxes.

State Requests For Abstention

State taxing authorities may also request abstention under section 505(a) when a debtor