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Protecting Potential Tax Refunds For Secured Creditors

Law360, New York (June 08, 2010) -- Tax refunds may provide a valuable source of repayment for lenders faced with borrowers whose better days have passed. Moreover, secured lenders may be able to better monetize rights to such refunds due to recent legislation expanding the Net Operating Loss ("NOL") carryback period as a stimulus measure by allowing businesses to carry back deductions that can be claimed for an immediate tax refund.

It is well-established that the right to receive a tax refund and the anticipated tax refunds themselves are "general intangibles."[1] Therefore, secured lenders with properly perfected blanket liens covering general intangibles and, in some cases, receivables, have been found to have liens on tax refunds.[2] Under U.C.C. § 9-203, a security interest attaches when "the debtor has signed a security agreement which contains a description of the collateral, value has been given and the debtor has rights in the collateral."[3]

Because a creditor's security interest does not attach until "the debtor has rights in the collateral," the question of when a debtor's right to a tax refund arises has significant implications on a secured creditor's right to such collateral. For example, if the right to a refund came into existence prepetition and the creditor perfected its security interest prepetition, the fact that the debtor receives the tax refund post-petition does not alter the priority of the creditor's lien in general intangibles as applied to the tax refund.[4] Conversely, if the right to a tax refund arises post-petition, such tax refunds cannot be considered collateral of the secured lender as of the date of entry of an order for relief.[5]

There is a split of authority as to when a right to a tax refund arises. The majority view is that such right arises, and becomes property of the estate, at "the end of the debtor's tax year, subject only to the debtor's filing a tax return claiming the refund within the time limitations prescribed by I.R.C. § 6511(a)."[6] While the minority, and far more dubious view, is that the right to a tax refund arises on the date the debtor filed its tax return.[7] The basis for the latter view is I.R.C. § 6407 which considers the date of allowance of a tax refund to be "the date on which the secretary or his delegate first authorizes the scheduling of an overassessment in respect of any internal revenue tax."[8] That section of the I.R.C. has been distinguished by the majority when considering the right to a tax refund under applicable Bankruptcy Code sections.[9]

The majority courts have reasoned that relating a tax refund to the taxable year rather than the date a return is filed, prevents a significant power shift from creditor to the debtor, who would otherwise be able to transform its right to a tax refund into a post-petition claim merely by delaying filing of its return or claim for refund until after filing its bankruptcy case.[10] These courts have also ruled that creditors should be able to measure their rights in bankruptcy based on the objective economic facts existing on the date a petition is filed.[11]

In order to maintain its collateral position as to tax refunds that may be found to arise post-petition—based either on the fact that the petition was filed prior to the end of the tax year or a court decides to follow the minority rule described above — a secured creditor should take steps to extend the right immediately upon the commencement

of a bankruptcy case. For example, a secured creditor can seek an adequate protection lien through a cash collateral order or seek to obtain collateral under a debtor-in-possession financing order. Without such protections, the creditor is at risk of losing a potentially valuable source of recovery.

The determination as to when the right to a tax refund arises is also critical to certain avoidance actions that could affect secured creditors, such as preference liability. One court recently applied the majority view described above in determining when a debtor "acquired rights in the property transferred" under Bankruptcy Code § 547(a)(3).[12] Specifically, in the context of NOLs and the corresponding tax refund, it was held that the right to the refund attaches at the end of the year in which the NOLs occurred that entitled the debtor to the refund.[13]

As a result, while the fact that a refund is received post-petition will normally not affect a creditor's prepetition lien on the refund (following the majority view described above), the creditor's lien itself could become subject to attack as a preferential transfer where the security interest attached during the preference period.[14] If the end of the tax year — and date on which a debtor's right to a refund arises — falls within the preference period, creditors are open to such an attack.

The issue of when the debtor's right to a refund arises is also crucial in determining whether a creditor's collateral will be subject to a taxing authority's right to set off prepetition tax claims against the debtor's claim for a refund. The mutuality requirement under § 553 of the Bankruptcy Code requires that both claims subject to setoff arise prepetition.[15] Courts have held that the date on which a right to the tax refund arises is the one by which mutuality is to be established for purposes of setoff.[16]

Therefore, if the majority view is followed and a debtor's right to a tax refund is determined to arise prepetition, then its claim for such refund is also prepetition and a taxing authority will have a right to set off its prepetition tax claims against the debtor's refund. As a result, secured creditors must take into account the possibility of setoff when valuing a potential tax refund as collateral and particularly when they are aware that the borrower is behind in paying its taxes.

In sum, while secured lenders cannot control when a debtor files a bankruptcy petition, they should be aware of the implications such a filing will have on their rights to tax refund collateral and take any available precautions to avoid losing such rights. Initially, creditors must take care to timely comply with all applicable filing requirements to ensure their liens on tax refunds are properly perfected and attach as soon as the debtor's right to such refunds arises. In the event the debtor's right is deemed to arise post-petition, creditors should take steps at the outset of a bankruptcy case to extend their rights to post-petition collateral.

As a practical matter, lenders should be aware of the status of a borrower's accountant's progress with regard to filing returns, including whether the borrower has provided the accountant with all necessary information. Timely filing of returns should be included as a covenant in all loan documents, including guaranties. Lenders should ensure that the borrower properly maintains the hardware and software necessary for maintenance and transmission of financial data. In addition, lenders should always know the identity and contact information for employees who are key to collecting and delivering the relevant data. Finally, it is helpful to develop relationships with forensic accountants capable of cleaning up a mess if a borrower implodes.

--By Michael J. Small (pictured) and Derek L. Wright, Foley & Lardner LLP

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[1] In re TCMI Elecs., 279 B.R. 552, 555 (Bankr. N.D. Cal. 1999); In the Matter of Palmetto Pump & Irrigation, Inc., 81 B.R. 109, 111 (Bankr. M.D. Fla. 1987); In re American Home Furnishings Corp., 48 B.R. 905, 908 (Bankr. W.D. Wash. 1985); In re Metric Metals Int'l, Inc., 20 B.R. 633, 636 (S.D.N.Y. 1981).

[2] See, e.g., In re Tousa, Inc., 406 B.R. 421, 424-25 (Bankr. S.D. Fla. 2009); In re Metric Metals Int'l, Inc., 20 B.R. at 635.

[3] U.C.C. § 9-203 (1) (emphasis added).

[4] In the Matter of Don Connolly Constr. Co., Inc., 110 B.R. 976, 978 (Bankr. M.D. Fla. 1990).

[5] 11 U.S.C. § 552(a); In re TCMI Electronics, 279 B.R. at 555.

[6] See In re Conti, 50 B.R. 142, 148 (Bankr. E.D. Va. 1985); In re Tousa, Inc., 406 B.R. at 432; U.S. v. White, 365 B.R. 457, 460 (M.D. Pa. 2007); In re Beaucage, 334 B.R. 353, 358 (Bankr. D. Mass. 2005); In re Stienes, 285 B.R. 360, 362 (Bankr. D. N.J. 2002); In re Glenn, 207 B.R. 418, 421 (E.D. Pa. 1997).

[7] See In re Harbaugh, 99 B.R. 671, 676 (Bankr. W.D. Pa. 1989), rev'd Harbaugh v. United States, 1989 WL 139254, *3 (W.D. Pa. 1989), aff'd Harbaugh v. United States, 902 F.2d 1560 (3d Cir. 1990); In re Don Connolly Constr. Co., 110 B.R. at 979 (follows the bankruptcy court decision in Harbaugh about five months after that decision was reversed by the district court but a few weeks before the court of appeals affirmed); In re Hankerson, 133 B.R. 711, 718 (Bankr. E.D. Pa. 1991), rev'd on other grounds, Hankerson v. U.S. Dep't Educ., 138 B.R. 473 (E.D. Pa. 1992), appeal dismissed, Matter of Pettis, 146 B.R. 653 (E.D. Pa. 1992) (written the year after the reversal of Harbaugh was affirmed by the court of appeals in its circuit).

[8] I.R.C. § 6407.

[9] See In re Conti, 50 B.R. at 148 (holding that the date of allowance of a tax refund pursuant to § 6407 is not the same as the date the obligation arose for purposes of § 553 of the Bankruptcy Code).

[10] In re Rozel Industries, Inc., 120 B.R. 944, 951 (Bankr. N.D. Ill. 1990).

[11] In re Debra Thorvund-Statland, 158 B.R. 837, 839 (Bankr. D. Idaho 1993).

[12] In re Tousa, Inc., 406 B.R. at 429-32.

[13] Id. at 432.

[14] Id.

[15] 11 U.S.C. § 553(a).

[16] See In re Conti at 148.