

# FOR PUBLICATION



## UNITED STATES BANKRUPTCY COURT CENTRAL DISTRICT OF CALIFORNIA

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In re	)	Case No. RS 10-18846 MJ
	)	
Marcos Vasquez Diaz	)	Chapter 13
Alma Lawreen Diaz,	)	
Debtor(s).	)	OPINION RE TAX
	)	REFUNDS IN CHAPTER
	)	13 PLANS

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## FACTS

The debtors, Marcos Vasquez Diaz and Alma Lawreen Diaz (“Debtors”), filed their Chapter 13 petition on March 26, 2010, at which time Rod Danielson (“Trustee”) was appointed chapter 13 trustee. Debtors filed their 2009 tax returns on April 30, 2010 and received their refund on or about June 2, 2010. Debtors listed in schedule B their 2009 expected tax refund of \$4,000. Debtors also claimed the tax refund as exempt in Schedule C under C.C.P. § 703.140(b)(5), the wild card exemption. On March 3, 2011, Debtors filed a proposed chapter 13 plan (“the Plan”) using the Central District of California mandatory plan form; the Plan was confirmed without objection. The Trustee submitted the

1 Confirmation Order, as is the common practice in the Riverside Division, and the  
2 Confirmation Order was entered on May 27, 2010.

3 The present dispute arises out of disparate treatment of tax refunds in the Plan and  
4 Confirmation Order. The Plan is silent regarding tax refunds while the Confirmation Order  
5 states, “in addition to regular monthly payments, all tax refunds are pledged into the plan.”  
6 As a consequence of contradictory form documents, the aforementioned difference exists in  
7 all chapter 13 plans and confirmation orders in the Riverside Division.<sup>1</sup>

8 On July 7, 2011, the Trustee moved to dismiss Debtors’ case for failure to turn over  
9 Debtors’ 2009 tax refund. Debtors filed an opposition and a hearing was held on July 28,  
10 2011. At the initial hearing Debtors’ counsel and the Trustee presented arguments  
11 regarding the Code’s treatment of tax refunds accrued on prepetition earnings. The Court  
12 asked Debtors’ counsel and the Trustee to submit briefs on the issue. On September 8,  
13 2011, the Court heard argument from both sides and took the matter under submission.<sup>2</sup>

## 14 DISCUSSION

### 15 I. Effect of the Plan Confirmation Order.

16 A Plan Confirmation Order is a final order that is preclusive as to all issues that were  
17 justiciable at the time of plan confirmation. United Student Aid Funds, Inc. v. Espinosa,  
18 130 S.Ct. 1367 (2010).

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23 <sup>1</sup> The inclusion of the tax refund provision in the order predates the current chapter 13 Trustee, who merely  
24 continued the practice of his predecessor. Prior to the present controversies, the tax refund provision had not been  
25 vetted by contested motions.

26 <sup>2</sup> The hearing on the motion in this case was consolidated with hearings on the same issue in several other cases.  
This opinion will be appended to the Court’s ruling in all similar cases.



1           **B. The Plan Confirmation Order Excludes PrePetition Tax Refunds.**

2           A bankruptcy judge has the power to interpret its own orders. In re Optical  
3           Technologies, Inc., 425 F.3d 1294, 1300 (8th Cir. 2005); See In re Conejo Enterprises, Inc.,  
4           96 F.3d 346 (9th Cir. 1996). The Court is persuaded that the term “all” in the Plan  
5           Confirmation Order refers to all tax refunds on income earned postpetition. The Court’s  
6           interpretation is consistent with the Debtors’ understanding at confirmation, as evinced by  
7           Debtors’ exemption of their prepetition tax refund on Schedule C.<sup>3</sup> The Court also notes  
8           that the language included in the Plan Confirmation Order regarding turnover of taxes was  
9           not included in the Debtors’ Proposed Plan, presented on the District’s mandatory plan  
10          form, and that the Trustee drafted and submitted the Plan Confirmation Order. More  
11          importantly, the Court’s interpretation is consistent with the law regarding *projected*  
12          disposable income and *future* earnings in sections 1322(a) and 1325(b), as discussed more  
13          thoroughly below. Any decision to the contrary would be anomalous; it would vest the  
14          Chapter 13 Trustee with unfettered discretion to seek contribution of all tax refunds,  
15          regardless of when those refunds were earned.

16           **II. Treatment of Prepetition Tax Refunds under the Bankruptcy Code.**

17          As a preliminary matter, the Court’s decision is not based on Debtors’ argument that  
18          prepetition tax refunds are excluded from disposable income because they are exempted  
19          under state law.<sup>4</sup>

20          The Trustee asserts that the prepetition tax refund is captured by the Plan under  
21          sections 1322(a)(1) and 1325(b)(1)(B). The Trustee’s argument hinges on the classification  
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23 <sup>3</sup> Although, as discussed below, the Court determines this is actually not an exemption question at all.

24 <sup>4</sup> See In re Hagel, 184 B.R. 793 (9th Cir. BAP 1995) (holding that social security benefits must be included in  
25          disposable income despite a debtor’s right to exempt them under state law) (superseded by statute); In re Scholz, 447  
26          B.R. 887 (9th Cir. BAP 2011) (affirming Hagel’s reasoning). See also In re Waters, 384 B.R. 432, 436 (Bankr. N.D.  
                W. Va. 2008).

1 of the tax refund as income.<sup>5</sup> However, the Supreme Court has held prepetition tax refunds  
2 are property and not income. Kokoszka v. Belford, 417 U.S. 642 (1974). The Court stated,  
3 “the income tax refund at issue in the present case does not relate conceptually to future  
4 wages and is not the equivalent of future wages for the purpose of giving the bankrupt a  
5 ‘fresh start.’ The payments refunded here were income tax payment withheld from  
6 petitioner prior to his filing for bankruptcy.” Id. at 648. The Supreme Court premised this  
7 holding on its prior case Segal v. Rochelle, 382 U.S. 375, 380 (1966), where that “Court  
8 concluded that the refund was ‘sufficiently rooted in the pre-bankruptcy past [...] that it  
9 should be regarded as property [...]’” The Ninth Circuit has similarly held that tax refunds  
10 are property. In re Feiler, 218 F.3d 948 (9th Cir. 2000). Even Congress adopted the  
11 Supreme Court’s view when enacting the present Bankruptcy Code: “The result of Segal v.  
12 Rochelle, 382 U.S. 375 (1966), is followed, and the right to a refund is property of the  
13 estate.” S.Rep. No. 989, 95th Cong., 2d Sess. 82. Under established precedent, therefore,  
14 tax refunds accrued on prepetition earnings but received postpetition are property, not  
15 income. They are “rooted in the pre-bankruptcy past,” disqualifying them from  
16 classification as income. To dispel any doubt, the Court will address the Trustee’s  
17 arguments.

18 Because the Code does not define “income,” the Trustee asks the Court to adopt the  
19 Code’s definition for “current monthly income” and apply it to sections 1322(a). The  
20 cardinal rule of statutory interpretation is to begin with the statutory language. Conn. Nat’l  
21 Bank v. Germain, 503 U.S. 249, 253 (1992). The Court must presume that Congress says  
22 what it means in a statute and means what it says. Id. “Where the statutory language is  
23 plain, the ‘sole function of the courts, at least where the disposition required by the text is

24 <sup>5</sup> The issue is whether the tax refund itself is income, not whether the prepetition wages, on which the refund  
25 accrued, are income.

1 not absurd, is to enforce it according to its terms.” Hartford Underwriters Ins. Co. v.  
2 Union Planters Bank, N.A., 530 U.S. 1 (2000) (citing United States v. Ron Pair Enters.,  
3 Inc., 489 U.S. 234, 241 (1989)).

4 Section 1322(a)(1) states that the plan shall:

5 Provide for the submission of all or such portion of future earnings or *other future*  
6 *income* of the debtor to the supervision and control of the trustee as is necessary for  
7 the execution of the plan. (emphasis added).

8 Section 1322(a)(1) uses the phrase “*future* income,” not current monthly income.

9 The Court must interpret the statute with deference to each word, including the word  
10 “future.” Accordingly, the Court interprets section 1322(a)(1) to only include  
11 income earned postpetition, not tax refunds on prepetition earnings.

12 Even if the Court believed the tax refunds fell within the Code’s definition of current  
13 monthly income, the Trustee would not be entitled to the entire tax refund. The Code  
14 defines “current monthly income” as:

15 (10A)The term ‘current monthly income’ –

16 (A) means the average monthly income from all sources that the  
17 debtor receives ... without regard to whether such income is taxable  
18 income, derived during the 6-month period ending on –

19 (I) the last day of the calendar month immediately preceding the date  
20 of the commencement of the case if the debtor files the schedule of  
21 current income ...

22 Under this definition, the Trustee is only entitled to the portion of tax refund accrued on  
23 earnings from the six months prior to the commencement of the case, not the entire refund.

24 But see In re Forbish 414 B.R. 400, 402 (Bankr. N.D. Ill. 2009) (“Because a debtor’s  
25 income consists of CMI, it is not technically correct to say [...] that a debtor’s tax refund  
26 constitutes “income” that must be devoted to the plan. The reason is that CMI is calculated

1 *before* withholding for taxes-indeed, before any kind of expense.”). The Court’s reluctance  
2 to ignore the word “future” in section 1322(a)(1) eliminates this awkward calculation.

3 The Trustee also asserts that the prepetition tax refund is captured by section  
4 1325(b)(1)(B) which states:

5 [...] the court may not approve the plan unless, as of the effective date  
6 of the plan –

7 (B) the plan provides that all of the debtor’s projected disposable  
8 income to be received in the applicable commitment period  
9 beginning on the date the first payment is due under the plan will  
10 be applied to make payments to unsecured creditors under the  
11 plan.

12 The Trustee asserts that the prepetition tax refund is disposable income *received* during the  
13 commitment period and, therefore, should be applied to the plan. The Trustee is correct  
14 that the tax refund is received within the commitment period, but the Trustee has not  
15 explained why the refund is “projected disposable income.” The term “disposable income”  
16 is defined by the Code in section 1325(b)(2) as:

17 current monthly income received by the debtor ([...]) less amounts  
18 reasonably necessary to be expended.

19 As with the case with section 1322 above, the plain language of section 1325(b)(1)(B) is  
20 inconsistent with the Trustee’s interpretation. Section 1325(b)(1)(B) uses the word  
21 “projected” to modify the term disposable income. Consequently, the plain meaning of the  
22 Code mandates the Trustee only capture projected or future income. See In re Heath, 182  
23 B.R. 557 (9th Cir. BAP 1995) (holding that section 1325(b) does not require the inclusion  
24 of tax refunds received by the debtors as projected disposable income); In re Kuehn, 177  
25 B.R. 671 (Bankr. D. Ariz. 1995) (holding that the trustee could not require debtors to turn  
26 over all tax refunds received during the plan without projecting whether there would be any

1 tax refunds). Accordingly, the Trustee is not entitled to tax refunds earned the year prior to  
2 filing bankruptcy.

3 **II. The Rationale for Pledging PostPetition Tax Refunds Into the Chapter**  
4 **13 Plan Does Not Apply to PrePetition Tax Refunds.**

5 The rationale for including tax refunds in the plan is to prevent debtors from  
6 overstating their tax withholdings. In re Schiffman, 338 B.R. 422, 427 (Bankr. D. Or.  
7 2006). Tax refunds are included in disposable income because they are an overstatement of  
8 an expense, not because they fall within the definition of “current monthly income.”

9 The calculation of disposable income is a two part analysis. First, the debtor adds up  
10 all of their “current monthly income” or all income over the six months prior to filing  
11 bankruptcy from all sources (pre-tax wages, investments, etc.). In re Forbish, 414 B.R.  
12 400, 403 (Bankr. N.D. Ill. 2009) (“CMI consists of ‘pre-tax income from all sources,  
13 similar to ‘gross income’ under the Internal Revenue Code.’”). Second, the debtor  
14 subtracts all necessary expenses over the same six month period, including taxes withheld  
15 on the debtor’s pay stubs. In re Spraggins, 386 B.R. 221, 227 (Bankr. E.D. Wisc. 2008)  
16 (“Since a tax refund is not income, but a correction of the over-estimation of an expense,  
17 the Debtor here could propose to keep her tax refunds and include a deduction from current  
18 monthly income for payroll taxes actually incurred.”). A tax refund is received only when  
19 the taxes withheld on the debtor’s pay stub exceeds the amount owed to the IRS. In this  
20 situation the debtor has overstated the amount of taxes necessary to be deducted from their  
21 current monthly income. The overstated amount, or tax refund, must be paid back to the  
22 creditors because it was an overstatement of necessary expenses.<sup>6</sup>

23  
24 <sup>6</sup> Below median debtors subtract expenses listed on debtors’ Schedule J. Forbish, 414 B.R. at 403-04. Code section  
25 1325(b)(3) instructs above median debtors to subtract expenses in accordance with § 707(b)(2)(A) and (B), allowing  
26 for a tax expense deduction from disposable income on Official Form 22C line 30.



1 A debtor's overstatement of prepetition taxes does not justify turnover of the  
2 overstated amount to the creditors because, unlike a postpetition refund, the debtor would  
3 not have been required to turn over the corollary increase in income had they not overstated  
4 their tax expense. The only relevance of a debtor's prepetition tax withholdings to  
5 disposable income is to use it as a "projection" of their postpetition tax withholdings.

6 The only circuit court to address the prepetition tax refund question directly was the  
7 Sixth Circuit in In re Freeman. 86 F.3d 478 (6th Cir. 1996). In Freeman, the debtor's plan  
8 required contribution of all tax refunds due to the debtors for a specific three-year period.  
9 Id. at 479. The debtors attempted to modify the plan when their tax refund on prepetition  
10 income was larger than they expected. Id. The debtors argued that the refund was exempt  
11 under state law, and therefore, not included as disposable income. Id. at 480-81. The court  
12 held that the tax refund was disposable income. Id. at 481. The court's only reason was  
13 that "disposable income under section 1325 is to be interpreted broadly in this Circuit." Id.  
14 Thereafter, the court qualified its holding by stating, "In this case, as a factual matter, the  
15 debtor had specifically identified that tax refunds should go to the plan [...]" Id.

16 Unlike the Sixth Circuit, the Ninth Circuit has not adopted a broad interpretation of  
17 "disposable income." In re Anderson, 21 F.3d 355, 358 (9th Cir. 1994). In Anderson the  
18 court rejected a chapter 13 trustee's certification that, in effect, required debtors to agree to  
19 pay all of their *actual*, not projected, income to the trustee during the life of the plan. Id.  
20 The court reasoned that, "We may not construe a statute so as to make any part of it mere  
21 surplusage." Id. at 358; U.S. v. Merhmanesh, 689 F.2d 822, 829 (9th Cir. 1982).

22 Applying that reasoning here, the Court cannot construe sections 1322(a) and 1325(b) to  
23 not include the words "projected" and "future." The instant case can also be distinguished  
24 from Freeman in that, here, Debtors' proposed plan did not pledge tax refunds. Instead, the  
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1 Trustee included the tax refund provision in the Confirmation Order. In Freeman, the court  
2 was interpreting the debtor's own plan provision and did not separately focus on whether  
3 the refund was "income."

4 Despite the Ninth Circuit's decision in Anderson, the bankruptcy court in In re  
5 Schiffman held that prepetition tax refunds should be contributed into the plan. 338 B.R.  
6 422. In Schiffman the debtor sought to remove the tax provision from the District of  
7 Oregon's chapter 13 plan form.<sup>7</sup> Id. at 425. The chapter 13 Trustee objected to the  
8 debtor's proposed modifications. Id. The court sustained the Trustee's objection, holding  
9 that both prepetition and postpetition tax refunds must be contributed to the plan. Id. at  
10 427. The court reasoned that, "The rationale for including tax refunds received by the  
11 debtor during the life of the plan as future earnings is if a debtor is regularly receiving  
12 substantial tax refunds, the debtor is probably overwithholding, and consequently  
13 underestimating future income." Id. The court also noted that, "tax refunds are property of  
14 the estate [...] and Section 1327 allows such property not to be revested in the debtor, *if the*  
15 *plan so provides.*"

16 First, the Court again notes the procedural differences between the two cases. In  
17 Schiffman the tax refund provision was part of the chapter 13 plan form, whereas here, the  
18 provision was not part of the Plan, but was added by the Trustee in the Plan Confirmation  
19 Order. Second, the Court agrees with the Oregon court's reasoning in Schiffman as it  
20 applies to postpetition refunds. The court noted that if postpetition refunds are not

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21 <sup>7</sup> Before Oregon's chapter 13 plan form was approved by the bankruptcy judges it was submitted in draft form for  
22 comments to various chapter 13 constituencies, including debtors' counsel, creditors' counsel, the chapter 13  
23 trustees, the Internal Revenue Service and the Oregon Department of Justice. The chapter 13 plan form "was drafted  
24 to treat the interests of the various parties in chapter 13 proceedings evenhandedly. It covers issues commonly faced  
25 in chapter 13 cases, with flexibility to allow for the unique circumstances of the particular case." Id. See also In re  
26 Spraggins, 386 B.R. 221, 227 (Bankr. E.D. Wisc. 2008) (following "local custom in the District" by limiting  
debtors' contribution of their tax refund to 50% because of the "complexity and uncertainty inherent in determining  
actual taxes incurred [...]").

1 collected by the trustee then debtors will have an incentive to overwithhold, thereby  
2 keeping postpetition earnings from creditors. However, the Court disagrees with this  
3 rationale as it applies to prepetition tax refunds. The rationale would suggest that if a  
4 debtor overwithholds on prepetition taxes, then the debtor risks contribution of the  
5 prepetition tax refund simply because it was received postpetition. By contrast, if the  
6 debtor withholds nothing prepetition, then the debtor can save that tax expense in a savings  
7 account and exempt it. The Court sees no difference between money held in a savings  
8 account or by the IRS. Forbush, 414 at 403 fn.5 (“In essence, the debtor has used the tax-  
9 withholding scheme as a kind of savings account.”).

10 To illustrate, suppose two identical debtors file their tax returns at the same time,  
11 one filing by mail and the other filing online. The debtor filing online receives his tax  
12 refund immediately and files for bankruptcy the next day. The debtor who filed by mail  
13 does not receive his tax refund for several weeks, filing bankruptcy in the interim. Under  
14 the Freeman and Schiffman decisions, the individual who filed online would keep his tax  
15 refund while the individual who filed by mail would forfeit that refund. The Court believes  
16 that the Code disfavors such arbitrary results.

### 17 III. Recommendation

18 The Court recognizes that its decision imposes a burden on the Trustee with regard  
19 to capturing five years of tax refunds for five years in a plan, or three as the case may be.  
20 The Court, however, is satisfied that the Trustee has the ability to hold cases open until the  
21 final tax refund, accrued on earnings within the commitment period, is received by the  
22 Debtors. See In re Midkiff, 27 B.R. 383 (10th Cir. BAP 2002), aff’d, 342 F.3d 1194 (10th  
23 Cir. 2003). The Court also recognizes that certain debtors may prefer paying the  
24 prepetition tax refund in return for a discharge as soon as their final plan payment is  
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1 submitted. Accordingly, the Court recommends that the Trustee permit debtors to make an  
2 election to either contribute the prepetition tax refund to the plan or delay their discharge.  
3 This election could be in the form of an order provision which specifies by year the five (or  
4 three) years of refunds the debtor will pay into the plan.

5 **IV. Conclusion**

6 Tax refunds received by debtors postpetition but accrued on prepetition earnings are  
7 property, not income, and are not subject to turnover to the Chapter 13 Trustee.  
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13 Dated: October 3, 2011

\_\_\_\_\_/s/\_\_\_\_\_  
MEREDITH A. JURY  
United States Bankruptcy Judge  
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In re:	CHAPTER:
Debtor(s).	CASE NUMBER:

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- 2) The title of the judgment or order and all service information must be filled in by the party lodging the order.
- 3) **Category I.** below: The United States trustee and case trustee (if any) will always be in this category.
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Notice is given by the court that the attached order was entered on the date indicated as "Entered" on the first page of this judgment or order and will be served in the manner indicated below:

**I. SERVED BY THE COURT VIA NOTICE OF ELECTRONIC FILING ("NEF")** – Pursuant to controlling General Order(s) and Local Bankruptcy Rule(s), I, deputy clerk who is making this entry; certify that service on all parties under Section II was completed, the foregoing document was served on the following person(s) by the court via NEF and hyperlink to the judgment or order. The following person(s) are currently on the Electronic Mail Notice List for this bankruptcy case or adversary proceeding to receive NEF transmission at the email address(es) indicated below.

Rod (MJ) Danielson (TR)  
notice-efile@rodan13.com

Gregory J Doan on behalf of Debtor Marcos Diaz  
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Ramesh Singh on behalf of Interested Party Courtesy NEF  
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United States Trustee (RS)  
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**II. SERVED BY THE COURT VIA U.S. MAIL:** I deputy clerk who is making this entry; certify that service on all parties under Section II was completed, A copy of this notice and a true copy of this judgment or order was sent by United States Mail, first class, postage prepaid, to the following person(s) and/or entity(ies) at the address(es) indicated below:

<b>Marcos Vasquez &amp; Alma Lawreen Diaz</b> 12395 Cape Court Moreno Valley, CA 92557	JP Morgan Chase Bank Department PO Box 201347 Arlington, TX 76006
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In re:	CHAPTER:
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Debtor(s).	CASE NUMBER:

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