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UNITED STATES BANKRUPTCY COURT EASTERN
DISTRICT OF CALIFORNIA

FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA

Case No. 17-12272-A-7

In re:

LEONARD E. HUTCHINSON, and
SONIA C. HUTCHINSON,

Debtors.

Adv. No. 17-1076-A

LEONARD E. HUTCHINSON, and
SONIA C. HUTCHINSON,

US-1

Plaintiffs,

MEMORANDUM

v.

UNITED STATES OF AMERICA and
JAMES E. SALVEN,

Defendants.

Argued and submitted on November 1, 2017

at Fresno, California

Honorable Fredrick E. Clement, Bankruptcy Judge Presiding

Appearances: _____
David R. Jenkins for plaintiffs Leonard E.
Hutchinson and Sonia C. Hutchinson;
Jonathan M. Hauck for the United States;
Russell Reynolds for James E. Salven

1 The chapter 7¹ trustee may avoid liens against estate property
2 for fines, penalties, or forfeitures and preserve those liens for the
3 estate. If the trustee does not do so, the debtor may avoid the lien
4 and preserve it for the debtor's own benefit. Among the liens that
5 the trustee (but not the debtor) can avoid are liens for tax
6 penalties. If the trustee avoids such a tax lien, for whose benefit
7 is the lien avoided?

8 **I. FACTS**

9 Leonard E. Hutchinson and Sonia C. Hutchinson ("Hutchinsons") owe
10 back taxes, including penalties, to the United States Department of
11 the Treasury, Internal Revenue Service ("IRS").

12 Prior to the date the Hutchinsons filed bankruptcy, the IRS
13 perfected a tax lien against their property, including their home.
14 The penalty portion of that lien is \$162,690 ("§ 726(a)(4) claim").

15 The Hutchinsons filed a chapter 7 bankruptcy. The trustee
16 overseeing their case is James E. Salven ("Salven"). Among the
17 assets of the estate listed in their schedules, the Hutchinsons listed
18 their residence, which they valued at \$185,000. It is encumbered by a
19 first deed of trust in the amount of \$87,000. The Hutchinsons claimed
20 an exemption for their home in the amount of \$100,000.

21 **II. PROCEDURE**

22 When the trustee did not exercise his tax-lien-avoidance powers
23 under §§ 724(a) and 726(a)(4), the Hutchinsons filed a complaint to
24 avoid the penalty component of the tax lien under § 522(h) and to
25 preserve that lien for their benefit to the lesser of the § 726(a)(4)

26
27 ¹ Unless specified otherwise, all chapter and section references are to
28 the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and all "Rule" references are to
the Federal Rules of Bankruptcy Procedure, Rules 1001-9037. All "Civil Rule"
references are to the Federal Rules of Civil Procedure, Rules 1-86.

1 claim or the \$100,000 homestead for their benefit. See 11 U.S.C. §
2 522(i)(2).

3 The Hutchinsons named the IRS and Salven as defendants. Salven
4 answered and cross-complained asserting his rights under §§ 724(a) and
5 726(a)(4).

6 The IRS has moved to dismiss, arguing that only the trustee has
7 standing to assert § 724(a) lien-avoidance rights and that
8 § 522(c)(2)(B) allows it to assert its lien against exempt property.
9 The debtors oppose the motion, asserting (1) their entitlement to
10 assert § 724(a) lien-avoidance rights, provided the trustee does not
11 do so, and (2) their right to preserve for their benefit the lien
12 avoided and exempt that property, subject only to the limitations of
13 the homestead exemption claimed.

14 **III. JURISDICTION**

15 This court has jurisdiction. See 28 U.S.C. §§ 1334, 157(a),
16 (b)(1); General Order No. 182 of the U.S. District Court for the
17 Eastern District of California. This is a core proceeding in which
18 this court may enter final orders. See 28 U.S.C. § 157(b)(2)(K), (O).

19 **IV. DISCUSSION**

20 Under Federal Rule of Civil Procedure 12(b)(6), a party may move
21 to dismiss a complaint for "failure to state a claim upon which relief
22 can be granted." Fed. R. Civ. P. 12(b)(6), *incorporated by* Fed. R.
23 Bankr. P. 7012(b). "A Rule 12(b)(6) dismissal may be based on either
24 a lack of a cognizable legal theory or the absence of sufficient facts
25 alleged under a cognizable legal theory." *Johnson v. Riverside*
26 *Healthcare Sys., LP*, 534 F.3d 1116, 1121-22 (9th Cir. 2008); *accord*
27 *Navarro v. Block*, 250 F.3d 729, 732 (9th Cir. 2001).

1 **A. Lien Avoidance under § 724(a)**

2 **1. The trustee's powers**

3 Chapter 7 trustees may avoid tax liens for fines, penalties or
4 forfeitures. Section 724(a) of the Bankruptcy Code provides, "The
5 trustee may avoid a lien that secures a claim of a kind specified in
6 section 726(a)(4) of this title." In turn, § 726(a) establishes the
7 distribution priority for various claims in chapter 7 cases. Section
8 726(a)(4) identifies the type of claim that has the fourth priority as

9 any allowed claim, whether secured or unsecured,
10 for any fine, penalty, or forfeiture, or for
11 multiple, exemplary, or punitive damages, arising
12 before the earlier of the order for relief or the
13 appointment of a trustee, to the extent that such
14 fine, penalty, forfeiture, or damages are not
15 compensation for actual pecuniary loss suffered
16 by the holder of such claim[.]

17 11 U.S.C. § 726(a)(4). Section 726(a)(4) encompasses a broad spectrum
18 of fines, penalties, and forfeitures, including tax penalties. See
19 *e.g.*, *In re Comstock Fin'l Services, Inc.*, 111 BR 849, 860 (Bankr.
20 C.D. Cal. 1990) (RICO treble damages); *In re Adelpia Communications*
21 *Corp.*, 327 B.R. 143 (Bankr. S.D.N.Y. 2005) (SEC penalty); *In re Gill*,
22 574 B.R. 709 (9th Cir. 2017) (tax penalty).

23 **2. The debtor's powers**

24 If the trustee does not exercise the avoidance power under
25 § 724(a), § 522(h) gives a debtor the power to avoid liens (other than
26 tax liens) under that subsection but only to the extent that the
27 debtor could have exempted the transferred property under § 522(g)(1).

28 **The debtor may avoid a transfer of property of
the debtor or recover a setoff to the extent that
the debtor could have exempted such property
under subsection (g)(1) of this section if the
trustee had avoided such transfer, if--(1) such
transfer is avoidable by the trustee under
section 544, 545, 547, 548, 549, or 724(a) of**

1 this title or recoverable by the trustee under
2 section 553 of this title; **and (2) the trustee**
3 **does not attempt to avoid such transfer.**

4 11 U.S.C. § 522(h) (emphasis added). In most instances, § 522(g)
5 allows a debtor to exempt property recovered by the trustee if the
6 transfer was not voluntary and the property was not concealed or if
7 the transfer was avoidable by the debtor as a nonpossessory,
8 nonpurchase-money security interest in personal property.

9 Notwithstanding sections 550 and 551 of this
10 title, **the debtor may exempt under subsection (b)**
11 **of this section property that the trustee**
12 **recovers** under section 510(c)(2), 542, 543, 550,
13 551, or 553 of this title, **to the extent that the**
14 **debtor could have exempted such property under**
15 **subsection (b) of this section if such property**
16 **had not been transferred,** if--(1)(A) such
17 transfer was not a voluntary transfer of such
18 property by the debtor; and (B) the debtor did
19 not conceal such property; or (2) the debtor
20 could have avoided such transfer under subsection
21 (f)(1)(B) of this section.

22 11 U.S.C. § 522(g) (emphases added).

23 The Ninth Circuit has enumerated five conditions that must be
24 satisfied before a debtor can avoid a lien under § 522(h). "(1) the
25 transfer cannot have been a voluntary transfer of property by the
26 debtor; (2) the debtor cannot have concealed the property; (3) the
27 trustee cannot have attempted to avoid the transfer; (4) the debtor
28 must exercise an avoidance power usually used by the trustee that is
listed within § 522(h); and (5) the transferred property must be of a
kind that the debtor would have been able to exempt from the estate if
the trustee (as opposed to the debtor) had avoided the transfer
pursuant to one of the statutory provisions in § 522(g)." *In re*
DeMarah, 62 F.3d 1248, 1250 (9th Cir. 1995).

But where the lien sought to be avoided secures back taxes,

1 § 522(c)(2)(B) eviscerates the debtors' § 522(h) powers. *In re*
2 *DeMarah*, 62 F.3d 1248, 1249 (9th Cir. 1995) (insofar as debtors are
3 concerned § 522(c)(2)(B) "brings back the whole of any tax lien"
4 notwithstanding §§ 724(a), 726(a)(4)). It does this by allowing taxing
5 authorities to assert properly perfected, unavoided tax liens against
6 exempt property both during and after the case.

7 Unless the case is dismissed, property exempted
8 under this section is not liable during or after
9 the case for any debt of the debtor that arose,
10 or that is determined under section 502 of this
11 title as if such debt had arisen, before the
commencement of the case, except . . . (2) a debt
secured by a lien that is . . . (B) a tax lien,
notice of which is properly filed.

12 11 U.S.C. § 522(c)(2)(B).

13 The seminal Ninth Circuit case is *In re DeMarah*, 62 F.3d at 1249.
14 There, a chapter 7 debtor filed an adversary action to, *inter alia*,
15 determine the dischargeability of certain federal taxes and to avoid
16 tax liens to the extent they secured liability for tax penalties. The
17 bankruptcy court avoided the tax liens under § 522(h) and § 724(a), to
18 the extent that they secured tax penalties. *Id.* The district court
19 reversed the bankruptcy court's decision. The Ninth Circuit affirmed
20 the district court's reversal.

21 The Ninth Circuit drew a distinction between the debtor's ability
22 to exempt property subject to a tax lien and the ability to avoid the
23 lien. *Id.* at 1251. "The fact that [the debtor] may be able to exempt
24 the property that is subject to the tax lien from the bankruptcy
25 estate does not mean that he can remove the lien itself, or that
26 portion of it which secures the penalty." *Id.*

27 The Ninth Circuit held that § 522(c)(2)(B) precludes chapter 7
28 debtors from avoiding tax liens from otherwise exempt property even if

1 the tax lien could be avoided by a trustee under § 724(a). *See id.* at
2 1251-52. It reasoned that exempt property remains subject to tax
3 liens, including tax liens securing penalties, because (1)
4 “[§] 522(c)(2)(B) itself does not specifically exempt penalties from
5 the definition of tax liens,” and (2) the Internal Revenue Code
6 section creating tax liens does not distinguish between the tax and
7 the penalty or interest portion of such liens. *Id.* at 1252. Such a
8 reading allows only the trustee to avoid the penalty component of tax
9 liens, which will inure to the estate’s benefit. But it avoids
10 rewarding debtors for failing to pay their taxes.

11 In short, exempt property remains subject to tax liens regardless
12 of whether the tax liens are for noncompensatory penalties that fall
13 within the scope of § 724(a) and § 726(a)(4). As a consequence, the
14 debtors in this case cannot use § 522(h) and § 724(a) to avoid the
15 IRS’s tax lien for penalties.

16 **B. Tax-Lien Preservation**

17 For whose benefit, the debtor or the estate and its creditors,
18 are avoided tax-penalty liens preserved? Section 551 provides the
19 general rule, which preserves the avoided liens for the estate. **“Any**
20 **transfer avoided under** section 522, 544, 545, 547, 548, 549, or **724(a)**
21 **of this title, or any lien void under section 506(d) of this title, is**
22 **preserved for the benefit of the estate** but only with respect to
23 property of the estate.” 11 U.S.C. § 551. (emphases added).

24 In contrast, § 522(i)(2) preserves some avoided liens for a
25 debtor’s benefit. It provides:

26 Notwithstanding section 551 of this title, **a**
27 **transfer avoided under** section 544, 545, 547,
28 548, 549, or **724(a)** of this title, **under**
subsection (f) or (h) of this section, or
property recovered under section 553 of this

1 title, **may be preserved for the benefit of the**
2 **debtor** to the extent that the debtor may exempt
3 such property under subsection (g) of this
4 section or paragraph (1) of this subsection.

5 11 U.S.C. § 522(i)(2) (emphases added).

6 But § 522(i)(2) conditions the debtor's preservation of an
7 avoided lien on the debtor's avoidance of such lien under § 522(h)
8 together with the other lien-avoidance statutes incorporated into that
9 subsection.

10 In this case, § 522(c)(2)(B) precludes the debtors from ever
11 invoking § 522(h) to avoid a tax lien securing penalties. It follows
12 that the debtors cannot rely on § 522(i)(2) to preserve an avoided tax
13 lien for their benefit.

14 Furthermore, § 551 controls, and, if avoided, the tax lien is
15 preserved for the estate, and derivatively, creditors. Simply stated,
16 if the trustee acts to avoid the penalty component of a tax lien, the
17 lien is preserved for the estate. *In re Heintz*, 198 B.R. 581, 586
18 (9th Cir. BAP 1996) (preferential lien avoided by the trustee for the
19 benefit of the estate); *In re Gingery*, 48 B.R. 1000, 1003-1004 (D.
20 Colo. 1985); see also 4 *Collier on Bankruptcy* ¶ 522.12 (Alan N.
21 Resnick & Henry J. Sommer eds., 16th ed. rev. 2012) ("In keeping with
22 the notion that the debtor is exercising the powers of the trustee in
23 these transfer avoidance actions, section 522(i)(2) adopts the rule of
24 section 551 that avoided transfers are preserved. Under section 551,
25 these transfers are preserved for the benefit of the estate, while
26 under section 522(i)(2), they are preserved for the benefit of the
27 debtor.")

28 *Heintz* is instructive. There the debtor listed a "myriad of
personal property and tools" in his schedules. He also exempted those

1 items in amounts "clearly exceed[ing] the statutory limitations.
2 Neither the chapter 7 trustee, nor creditors, objected to the claim of
3 exemption. The trustee collected the property and, after court
4 approval, sold it at auction. The trustee and the judgment lien
5 creditor entered into a stipulation to avoid the lien as a preference,
6 § 547, and the court approved the stipulation, preserving the lien
7 under § 551. The debtor moved to compel delivery of the proceeds of
8 the exempt property to himself, arguing that the personal property and
9 equipment were exempt by default, were no longer property of the
10 estate, and could no longer be preserved for the benefit of the
11 estate. The bankruptcy court denied the motion, the debtor appealed
12 and the Bankruptcy Appellate Panel affirmed. It held that "[o]nce a
13 trustee recovers an asset for the estate through one of the transfer
14 or lien avoidance provisions, § 551 automatically preserves the asset
15 for the estate." *Id.* at 584. In contrast, where the trustee fails to
16 act and the debtors do so, they may preserve the avoided lien for
17 their own benefit by claim of exemption. *Id.* at 586.

18 Section 551 controls the preservation right as to the IRS's tax
19 lien to be avoided by Salven. If Salven prevails in his efforts to
20 avoid the penalty component of the tax lien, that avoided lien is
21 preserved for the benefit of the estate's creditors. Consequently,
22 debtors cannot state a claim for preserving a tax lien for their
23 benefit.

24 **V. CONCLUSION**

25 The Bankruptcy Code precludes the debtors from avoiding the IRS's
26 tax lien for penalties. Because the debtors cannot avoid this lien,
27 the debtors cannot preserve it for their own benefit. Section 551
28 controls when the trustee avoids a lien. If the trustee avoids the

1 IRS's lien, § 551 authorizes the trustee to preserve the lien for the
2 benefit of the estate's creditors. For each of these reasons, the
3 United States' motion to dismiss is granted with prejudice.

4 Dated: January 2, 2018

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Fredrick E. Clement
United States Bankruptcy Judge