

News Analysis: The Tax Opinions of Judge Alito

by Lee A. Sheppard

Lee A. Sheppard analyzes the tax opinions written by Third Circuit Judge Samuel Alito, whom President Bush has nominated to the Supreme Court, and concludes that the judge picks and chooses his arguments based on where he wants the law to go.

Date: Nov. 8, 2005

Full Text Published by **taxanalysts™**

"Scalito." The left wing are up in arms already, but at least this time they have a target they can hit. As this article is being written, the Democrats have declared war on Third Circuit Judge Samuel A. Alito Jr., whom President Bush has nominated to the Supreme Court.

Judge Alito famously dissented in *Planned Parenthood v. Casey*, in which the Third Circuit Court of Appeals struck down a Pennsylvania law requiring that a woman notify her husband before having an abortion. There were outs, but this was a law that essentially regarded women as chattels of their husbands, and the Supreme Court said as much: "A state may not give to a man the kind of dominion over his wife that parents exercise over their children."

Both sides wanted an ideological fight about abortion, and the president has basically told them to knock themselves out, hoping, no doubt, that the fight will knock other bad things off the front page. Nonetheless, after watching his nomination of a crony viciously attacked on both sides, the president has now nominated a qualified candidate for the Supreme Court. Judge Alito is a real judge from a real court that hears real cases involving real people and real businesses. Judge Alito has sat on the Third Circuit for 15 years, and before that he was U.S. attorney for the district of New Jersey.


No matter what their views on the social issues that politicians on both sides use to distract voters from falling living standards, our readers will find a man after their own hearts -- a nitpicking lawyer who concentrates on statutory wording and parses legislative history. But Judge Alito is a former federal prosecutor, and it shows. He's a hardnose who tends to favor the government. However, unlike some Tax Court judges, he will not reargue the IRS's case for it and will hold the agency to its mistakes.

We found more than 20 tax opinions by Judge Alito, so we have a pretty good idea how he would decide federal tax cases -- assuming that the Roberts Court would accept any more federal tax cases than the Rehnquist Court did. Many of Judge Alito's tax opinions concern the technical grind of the less-than-glamorous end of tax practice -- investment tax credits, fuel tax refunds, innocent spouse relief. And because we are in the Third Circuit, we do find a fair amount of tax crime.

"Scalito?" In his social views, undoubtedly. But not in his statutory interpretation. Judge Alito gives free rein to legislative history, previous versions of the pertinent statute, colloquy, whatever is available in interpreting statutes. "Giulianito" might be a more accurate sobriquet for this former federal prosecutor. No, he's not flashy or publicity seeking or serially married, but the ex-prosecutor in Judge Alito is always evident. He's a solid technician who picks and chooses his arguments based on where he wants the law to go. Unlike Chief Justice Roberts, he does not let the law lead him.

Tax Shelters

A case about recovery of attorney fees required Judge Alito to analyze an equipment leasing shelter. He understood the statute, he understood the deal, but he did not understand that form might deviate from substance in a deal made between unrelated parties.


In *Nicholson v. Commissioner*, 60 F.3d 1020 (3d Cir. 1995), *Doc 95-7363*, *95 TNT 147-11* , the Third Circuit reversed a Tax Court denial of attorney fees to a taxpayer. The taxpayer had participated in an equipment leasing shelter, and the IRS had argued that he was not at risk on the largest of three promissory notes made to the deal's promoter for the purchase of the equipment. State law made the note presumptively recourse. The case was settled very favorably, without interest, allowing the taxpayer deductions based on the questionable note.

The taxpayer then sued for attorney fees on the ground that the IRS position was not "substantially justified" under section 7430. Judge Alito observed that the Tax Court had strained to find reasonableness in the IRS position. This required an analysis of section 465 and the catchall phrase "other similar arrangements" of section 465(b)(4). Judge Alito applied the economic reality test of *American Principals Leasing Corp. v. United States*, 904 F.2d 477 (9th Cir. 1990), which asks whether there is any realistic possibility that the taxpayer will suffer an economic loss if the lease is unprofitable.

Judge Alito clearly understood the circular flow of funds in an equipment leasing shelter. He did not, however, agree with the IRS's argument that the promoter's nonrecourse debt to the bank meant that the former had no reason to care whether the taxpayer paid his recourse note. If the ultimate user failed to pay the rent, and the bank foreclosed on the equipment, Judge Alito reasoned,

the promoter might still pursue the taxpayer, acting like an ordinary creditor. He agreed with the taxpayer that the collateral might be insufficient to cover the balance of the loan, and the promoter would want to recover its profits on the deal. He noted that the promoter had paid off the bank loan, breaking the circle.


Clearly the possibility of collusion between unrelated parties, which the IRS halfheartedly attempted to argue, eluded the judge here. He saw no basis to presume that the parties would not act according to the documents. Instead he chastised the IRS for failure to properly prepare its case; that is, the failure to notice the relevant state law and the promoter's payment of the loan until after the notice of deficiency had been issued. He chastised the Tax Court for failing to see the differences between the taxpayer's equipment lease and the case law.

Judge Alito had no trouble affirming negligence and substantial understatement penalties for a shelter customer in *Lax v. Commissioner*, 72 F.3d 123 (3d Cir. 1995), *Doc 95-10774*, 95 TNT 235-51 . The taxpayer argued reasonable, good-faith reliance on his accountants, who got him into the shelter, which was held to have no profit motive under section 183. Judge Alito concluded that the taxpayer's reliance on his advisers was not reasonable under the circumstances.


It did not trouble Judge Alito that the taxpayer had only a high-school education and did not understand his investment. He had run his own business for 30 years, and he should not have had blind faith in his accountants' investment advice because the accountants did not know anything about the shelter's oil and gas activity. Judge Alito concluded that the taxpayer should have sought independent professional advice about the shelter investment.

Nuts and Bolts

Prosaic stuff like fuel tax exemptions is useful for telling our readers how Judge Alito would read a statute. Our readers are not bringing too many First Amendment cases.

In *Bodine Oil Inc. v. U.S.*, 107 F.3d 6 (3d Cir. 1997), *Doc 97-3394*, 97 TNT 23-16 , the IRS revoked the taxpayer's fuel tax exemption for heating oil when it failed to answer an IRS status questionnaire that it claimed it never received. The IRS denied the taxpayer's application for a new exemption after an audit that revealed that the taxpayer had failed to file some income and employment tax returns. The taxpayer filed the returns, reapplied for exemption, and got a new exemption. That took a while. Exemption was then replaced by fuel dyeing. The taxpayer sued the government to recover the fuel taxes it had paid during a 2-1/2-year period when it had no exemption.

The district court granted summary judgment to the government, and Judge Alito affirmed. The taxpayer howled that the IRS's revocation of its exemption was arbitrary. Without going into the taxpayer's dodgy record of tax payments, Judge Alito held that the IRS's revocation, more than a year after the taxpayer had failed to respond to the questionnaire, was a reasonable action to protect the revenue. Judge Alito observed that the taxpayer could have passed some or all of the cost of the fuel taxes along to customers, who could claim a refund as ultimate purchasers. The taxpayer did not pass on the tax costs for competitive reasons.

Innocent spouse relief was the question in *Purificato v. Commissioner*, 9 F.3d 290 (3d Cir. 1993), *Doc 93-11893*, 93 TNT 237-20 . Readers are well aware that almost every spouse is innocent, and relief is rarely denied. This case concerned the wives of two brothers who operated a bakery as an S corporation and claimed losses on their joint returns. The IRS determined that the corporation was hugely profitable during the years in question. The tax cases were settled, but the wives claimed innocent spouse relief.

The Tax Court said no, on the ground that the wives had received "significant benefit" from the underpayment of taxes. Significant benefit, though not stated in the statute, was found in section 6013(e)(1)(D), which merely asked whether it would be "inequitable" to hold the spouse liable under all of the facts and circumstances. However, significant benefit was part of the original and prior provision that did not apply to the wives, and the legislative history of the version current when Judge Alito wrote but adopted only after the years before the court, said that significant benefit "should continue to be taken into account," Judge Alito noted.

It didn't help the wives' cases that neither couple made a full disclosure of their jointly owned assets at trial, or that they acquired substantial liquid assets during the years at issue. Because of the lack of disclosure, Judge Alito refused to infer that the couples had not acquired even more assets during the years at issue than the trial court knew about. He held that the Tax Court did not commit clear error in finding significant benefit from the underpayments.

The wives then fell back on an argument that they had meager lifestyles, had suffered family tragedies, and had no knowledge of the omissions of income. Judge Alito responded that the statutory language "does not require that weight be given to every personal fact and circumstance that a taxpayer chooses to adduce." Rather, it asks about equity, requiring credence to be given to only those facts and circumstances that have a "rational bearing" on the putatively innocent spouse's liability. He went back to the legislative history and found that pertinent circumstances would include divorce, desertion, and a situation in which the spouse would have to pony up the deficiency from her own assets.

Judge Alito nonetheless considered the wives' arguments. Turns out their husbands were cheapskates. Their modest lifestyle was not, however, inconsistent with having significantly benefited from the underpayments by means of asset accumulation, according

to Judge Alito. Moreover, the wives' alleged lack of knowledge of the omissions was a separate element, under section 6013(e)(1)(C), on which the Tax Court did not make a finding, so, Judge Alito held, lack of knowledge alone cannot be enough to satisfy subsection (D), even if overlap were permitted.

The wives said that their children committed crimes and did drugs, their parents were ill, and one husband was an alcoholic wife-beater. Judge Alito was sympathetic, but found those tragedies irrelevant. "The income tax laws do not as a general rule provide that those who have experienced unhappiness, tragedy, or abuse at the hands of family members may pay less tax than other people in identical financial circumstances who have experienced happiness, good fortune, and considerate treatment by their families," he wrote.

The wives were on solid ground compared to the phone company in *Bell Atlantic v. United States*, 224 F.3d 220 (3d Cir. 2000), *Doc 2000-21824*, *2000 TNT 163-6* [📄](#), when it argued that it should receive a \$77 million refund under the investment tax credit transition rule. That rule, enacted with the repeal of the credit in 1986, allowed taxpayers to get the credit for eligible property purchased after 1985 if it was "readily identifiable with and necessary to carry out a written supply or service contract" binding at the end of 1985.

The taxpayer argued that its franchises and tariffs to provide phone service were contracts for which it estimated that it needed hundreds of millions of dollars' worth of equipment. The government had argued that even if the tariffs and franchises qualified as contracts, no property was "readily ascertainable from the terms of the contract," as the legislative history demanded. It was on that latter point that Judge Alito agreed with the government. The district court said no. And get outta here, said Judge Alito in affirming.

The tariffs and franchise agreements required the taxpayer to maintain a specified level of phone service, but left it up to the taxpayer how to do it. The taxpayer argued that its own internal estimates should provide the necessary connection to the contracts. Those estimates were not contemporaneous, didn't bind anyone, and were not given to the other parties, Judge Alito noted. Congress wanted the specifications and amount of the property to be described in the contracts, according to the legislative history. Judge Alito would not countenance a reading that made the words "readily identifiable" in the transition rule meaningless.

In *Addison H. Gibson Foundation v. U.S.*, 958 F.2d 362 (3d Cir. 1992), *92 TNT 41-43*, the taxpayer, a foundation, settled an unrelated business income tax case with the IRS for an amount that the agent thought was 65 percent of the deficiency but the taxpayer thought was 35 percent. The taxpayer conditionally agreed to extend the statute of limitations based on the 35 percent number, but then reneged when the misunderstanding came to light.

Judge Alito had a contract case about whether the executed forms consenting to extension of the statute were valid. He found a binding agreement on the ground that the IRS examiner should have paid attention to the taxpayer's 35 percent condition. He held that the IRS agreed to a 35 percent settlement because, under the *Restatement of Contracts*, the IRS examiner was the only party who had reason to know of a mistake. Judge Alito's literal enforcement of the contract here is consistent with legal commentators' views that he is a strict enforcer of contracts. (*The Wall Street Journal*, Nov. 1, 2005, p. A1.)

Maybe those federal jurisdictional standards are too loose. In *Lichtman v. United States*, 166 F.3d 1205 (3d Cir. 1998), *Doc 98-27391*, *98 TNT 176-11* [📄](#), the plaintiff, an accountant, sued for a writ of mandamus to compel the IRS to investigate her father and uncle. In a memorandum opinion, Judge Alito booted her out for lack of standing due to failure to state a cognizable injury in fact. A loss of tax revenue shared by the entire population of the United States is not a concrete and particularized injury, Judge Alito observed. He added that even if the plaintiff had an injury, sovereign immunity would prevent her attempt to direct agency discretion.

Tax Evasion

For the cases discussed here, readers should know that the Justice Department has a habit of multiplicitous indictments -- charging defendants with every federal crime they could conceivably have committed.

In *United States v. Gricco*, 277 F.3d 339 (3d Cir. 2002), *Doc 2002-1037* [\[PDF\]](#), *2002 TNT 13-17* [📄](#), the defendant and his brother-in-law had been convicted of conspiracy to defraud the government, tax evasion, and filing false tax returns, having failed to report as income the more than \$3 million they stole from Philadelphia airport parking facilities by falsifying parking records in the course of their employment. The defendants appealed their conspiracy convictions, arguing that they had not conspired with the object of impeding tax collection by the IRS. (18 U.S.C. section 371.) Judge Alito affirmed their convictions but remanded their sentences, which were based on the tax evaded, according to the federal sentencing guidelines.

Judge Alito concluded that even if tax evasion was not an explicit objective of the conspiracy, that objective could be inferred from the conduct of the conspirators. Mere hiding of the proceeds of the fraud would impede the IRS even if done without that purpose. But a tax evasion charge could not stand on that alone because the evasion would have been a mere byproduct of the conspiracy. More had to be shown to support an inference that evasion was intended. The government could do that, Judge Alito concluded, and its best argument was that the defendants kept their money at home in cash. That was enough for the former

federal prosecutor.

In *United States v. Lee*, 359 F.3d 194 (3d Cir. 2004), *Doc 2004-3645 [PDF]*, *2004 TNT 35-18*, Judge Alito rejected Fourth Amendment claims by a defendant, the president of the International Boxing Federation, convicted of racketeering, money laundering, and filing false tax returns concerning the proceeds of taking bribes from promoters to get better ratings for their boxers. The defendant argued that videotapes of him dividing money with a colleague turned government informant should not have been admitted because the FBI did not have a warrant to tape him. Relying on *United States v. Hoffa*, 385 U.S. 293 (1967), Judge Alito concluded that the Fourth Amendment does not protect any expectation of privacy if a person at the meeting consented to the taping.

Apparently there are tax conspiracies all over the Third Circuit. In *United States v. Moses*, 98 AFTR2d 98-5056 (3d Cir. 1998), *Doc 98-22305*, *98 TNT 138-71*, Judge Alito held that a conspiracy should be deemed to continue until collection of the tax is time-barred. The defendant had been convicted of filing false personal and corporate tax returns and conspiracy to impede the IRS in collection of tax. As a Pennsylvania local government official, the defendant accepted kickbacks from vendors and had help in concealing the payments. The defendant contested the admission of grand jury statements of alleged coconspirators on the ground that the tax years at issue ended six years before the statements were made. Nope, said Judge Alito, a tax conspiracy can continue after the taxes are due, as long as the pertinent returns remain open.

Tax and financial crimes generally feature a showing of net worth, in which the government tries to reconstruct where the proceeds went. In *Paschal v. Commissioner*, 96-1 USTC 50,013 (3d Cir. 1995), *Doc 95-11175*, *95 TNT 245-46*, a New Jersey auto parts dealer became a mortgage lender. The IRS began a criminal investigation, and IRS agents discovered that he kept no books and records, commingled personal and business funds in his bank accounts, had his tax returns prepared from summary figures he gave to his accountant, and skimmed cash receipts from his business. He entered into a plea bargain, but challenged the amount of his tax liability, arguing that his opening net worth was understated. Judge Alito rejected the challenge, noting that net worth determinations use circumstantial evidence, and because the taxpayer had no books, the IRS was entitled to rely on his stipulations.

The former prosecutor maintained qualified immunity for IRS agents accused of Fourth Amendment violations in *Leveto v. Lapina*, 258 F. 3d 156 (3d Cir. 2001), *Doc 2001-23413 [PDF]*, *2001 TNT 175-47*. Fifteen armed IRS agents, with search warrants, had patted the taxpayer and his wife down, held them for hours, interrogated the wife without *Miranda* warnings, and generally traumatized the two. The agents thought they would find weapons on the taxpayer, a veterinarian -- they didn't find any. The district court gave the agents summary judgment. Judge Alito reversed the district court, holding that there were possible Fourth Amendment violations. A tax evasion investigation was insufficient to suspect that the pet doctor posed a threat.

Employee Benefits

Faced with a loan of pension plan assets to a corporation controlled by a union local, Judge Alito engaged in a tortured reading of ERISA to get to the right result for the wrong reasons.

In *Reich v. Compton*, 57 F. 3d 270 (3d Cir. 1995), *Doc 95-6016*, *95 TNT 117-14*, the secretary of Labor went after officials of a local chapter of the International Brotherhood of Electrical Workers for lending the union's pension fund money to a related not-for-profit corporation that had used the funds to build a building used as the union's office. The district court had granted summary judgment to the union officials on the ground that ERISA did not apply to a transaction that took place before ERISA was enacted.

But the loan remained outstanding a decade after ERISA was enacted, and the union asked Labor for an exemption from the ERISA provision, section 406(a), deeming the loan a prohibited transaction. Labor told the union to charge market interest, which was in the double digits at the time. The union instead caused the corporation to pay off the loan at a discount, using funds borrowed from the local, which the corporation then paid back to the local, so the money went in a circle.

Four years later, Labor sued the local, arguing that the corporation was the alter ego of the officials, making all transactions with it, including the loan and the discount payoff of the loan, prohibited transactions. Labor alleged all manner of fiduciary violations, including self-dealing, on the part of the officials, who were also trustees of the local's pension plan. Labor sought restoration of the funds to the plan and an injunction against further violations. Based on *Mertens v. Hewitt Associates*, 113 S. Ct. 2063 (1993), the district court granted summary judgment to the union officials.

The district court did not believe that there could be indirect self-dealing, as Labor had argued. "The transferee is either a party in interest under the statute or it is not," the district court insisted, noting that no pension plan assets went to the local itself. That was despite the wording of ERISA section 406(a)(1), which states in pertinent part:

A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect (A) sale or exchange, or leasing, of any property between the plan and a party in interest, (B) lending of money or other extension of credit between the plan and a party in interest . . . (D) transfer to, or use by or for the benefit of a party in interest, of any assets of the plan.

Our readers would say that this wording left it wide open for Labor to argue that the officials should not be able to circumvent prohibitions on self-dealing by means of a shell corporation controlled by them. Labor argued that section 406(a)(1) encompasses transactions between a plan and the alter ego of a party in interest, that is, the corporation in this case. Labor relied on *Chevron U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837 (1984), for deference to its interpretation.

Judge Alito did not agree that a transaction between a plan and the alter ego of a party in interest constituted an indirect transaction between a plan and a party in interest. In Judge Alito's mind, the extension of the concept of a "party in interest" to a phony corporation formed by a party in interest would be inconsistent with congressional intent. Under ERISA section 3(14), a "party in interest" includes, among other things, a fiduciary, an officer of the plan, or a corporation controlled by any of the foregoing. (A not-for-profit corporation may have been used in this case because control means 50 percent voting control.) Judge Alito accused Labor of wanting to create a new, overlapping category of "party in interest."

He did, however, accept Labor's argument that other aspects of the local's dubious transactions put them in the category of "indirect" transactions under ERISA section 406(a)(1)(D), which prohibits a fiduciary from causing a transaction that constitutes the indirect use of plan assets for the benefit of a party in interest. So while there is no such thing as an indirect party in interest, there can be an indirect transaction that benefits a party in interest, in Judge Alito's reasoning. The union officials were clearly fiduciaries. They caused the transactions that used plan assets.

But did those transactions benefit a party in interest? Aren't we back to asking whether there is such a thing as an indirect party in interest? Labor argued that the union officials should have known that the transactions would have some more than incidental benefit to a party in interest. The officials argued that subjective intent was required, and Judge Alito agreed, finding subjective intent required by the phrase "for the benefit." He wrote:

If "for the benefit of" is read to mean "having the effect of benefiting," section 406(a)(1)(D) would appear to prohibit a fiduciary from causing a plan to engage in any transaction that he or she should know would result in any form or degree of benefit for any party in interest, even if the transaction would be highly advantageous for the plan and the benefit for the party in interest would be unintended, indirect, and slight.

The judge, having backed himself into this corner, did not say which party to the transaction was supposed to harbor this subjective intent, but he did concede that the statutory requirement of constructive knowledge did not require subjective intent. Who would be the party in interest? The local itself, apparently. One official admitted at trial that the plan trustees would not sue the corporation to enforce the loan because it would be like suing the union members. Moreover, the local did not pay rent to the corporation for using the building as its office, and there was no lease. Hence the local could have benefited from the corporation's below-market loan from the pension plan, Judge Alito concluded.

The other issue in the case was whether Labor could go after nonfiduciaries who participated in self-dealing transactions under ERISA section 502(a)(5) and *Mertens*. Judge Alito concluded that Labor could go after nonfiduciaries who participated in transactions described in ERISA section 406(a)(1), but could not go after nonfiduciaries who participated in breaches of fiduciary duty. That is, he was unwilling to infer causes of action that the statute did not explicitly permit. But he found the power for Labor to pursue nonfiduciaries in the ERISA section 502(a)(3) equitable power to redress ERISA violations. He reasoned that a court needed jurisdiction over all the parties to a violation.

The first phase of large employers' reduction and withdrawal of heretofore traditional pension benefits has been the withdrawal of early retirement benefits -- essentially what the cash balance plan dispute has been about. As the automakers' recent troubles have demonstrated, this is basically a dispute between shareholders and retirees about who owns the residual value of the corporation.

In *Gillis v. Hoechst Celanese Corp.*, 4 F.2d 1142 (3d Cir. 1993), *Doc 93-9826*, *93 TNT 194-51*, former employees sued Hoechst for violations of ERISA for withdrawal of early retirement benefits when the Hoechst unit for which they worked was sold. The plaintiffs continued in their same jobs, and had the unit remained with Hoechst, they would have been entitled to early retirement benefits. They argued that Hoechst had underfunded the plan that was transferred to the new owner of the unit. The district court granted summary judgment to Hoechst on the ground that neither plaintiff qualified for early retirement benefits.

Hoechst argued that early retirement benefits are optional and so are not required to be funded under ERISA. ERISA does, however, require that transferred benefits be funded. The plaintiffs argued that ERISA should protect their right to continue to try to qualify for those benefits; that is, their years of service should have been credited with their new employer.

The Third Circuit majority reversed, on the ground that there was no clear answer to the question whether the employer could yank benefits for which employees had not yet qualified. If they had qualified, the answer would clearly be no, under ERISA section 204(g) and code section 411(d)(6). Looking at section 411(d)(6) and IRS interpretations of it, the majority concluded that the plaintiffs should be allowed to grow into early retirement benefits. Hoechst argued that they had changed jobs, but the IRS's

"same desk rule" said that they had not been separated from service because they continued in the same jobs with the new owner of the unit.

Judge Alito, concurring, saw the question as whether the promised early retirement benefits should have been funded on the transfer of the unit. In Rev. Rul. 85-6, 1985-1 C.B. 133, the IRS concluded that an employer could not terminate an overfunded pension plan unless it left enough money in the plan to fund promised early retirement benefits. That is, employees should be able to continue to earn the benefits after a plan termination. If Hoechst had terminated the plan before selling the unit, Judge Alito reasoned, it would have been required to fund the benefits. So a transfer of the unit followed by a termination should have required the same funding. Judge Stapleton, dissenting, noted that the plan may have had sufficient funding because termination-basis funding was all that was required on a transfer.

Bankruptcy

It is important that a federal judge hear cases coming under the bankruptcy code. The bankruptcy code has many broadly worded provisions that are subject to interpretation, as well as some highly specific provisions that tell claimants just where they are in the pecking order of recovery from the debtor's insufficient assets.


In re Burden, 917 F.2d 115 (3d Cir. 1990), 90 TNT 223- 30 , was pretty straightforward stuff. The debtor failed to pay income and employment taxes for five years. Taxes, interest, and penalties were assessed -- when a tax is assessed is an important concept in bankruptcy. The debtor filed chapter 13 bankruptcy, and the IRS filed a timely proof of claim for the assessed taxes, interest, and penalties. Most of the IRS's claim had been secured by liens placed on the debtor's property before his bankruptcy filing. The debtor asked the court to equitably subordinate his secured and unsecured penalties -- about one-fifth of the IRS's total claim -- to the claims of unsecured creditors.

As a court of equity, the bankruptcy court could do that, and did, under section 510(c) of the bankruptcy code. The district court affirmed. The IRS argued that the purpose of penalties would not be served if nonpecuniary loss penalties were subordinated. The Third Circuit reversed, but agreed with the debtor that a bankruptcy court had the power to subordinate penalties, on the basis of competing equities, even in the absence of creditor misconduct.

So what's the problem? Judge Alito filed a separate opinion concurring in the result and dissenting on the creditor misconduct point, calling the holding incorrect. The IRS had initially argued that equitable subordination was appropriate only in cases of bad conduct, but then conceded that in oral argument.

Judge Alito was appalled by the concession. He noted that the legislative history of the bankruptcy code showed that Congress intended to codify the case law, under which creditor misconduct was a condition predicate to equitable subordination. He cited floor statements and proposed versions of the legislation for that point. (Justice Antonin Scalia would never, ever do that.) Alito argued that Congress would have said so explicitly if it wanted equitable subordination of penalties, as it did in chapter 7, governing liquidations.

Judge Alito accused the majority of creating a new equitable subordination procedure not authorized by statute. The legislative history "strongly suggests that Congress did not want penalties to be subordinated on a wholesale basis in proceedings under chapters 9, 11, and 13. Yet the majority's position seems very likely to bring about precisely that result," he wrote.

In *In re Yuhas*, 103 F.3d 612 (3d Cir. 1997), Doc 97- 2793, 97 TNT 19-17 , the question was whether a state statute that shielded IRAs from creditors met the criteria of federal bankruptcy law for excluding the accounts from the bankrupt's estate. Readers will recall that the Supreme Court botched the question in *Patterson v. Shumate*, 504 U.S. 753 (1992), 92 TNT 124- 1 , by overreading the bankruptcy code and extending protection to accounts arguably not meant to be protected.

The pertinent bankruptcy code provision is section 541(c)(2), which states: "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." The bankruptcy trustee argued that the state law was not a transfer restriction because it did not restrict the debtor's ability to transfer the assets; that is, the debtor retained the power to liquidate the account. He wanted to include the debtor's IRA in his bankruptcy estate, subject to the state law. The practical effect would be that the trustee, standing in the shoes of the debtor, would liquidate the account.

Judge Alito read *Patterson* to say that any transfer restriction would keep the accounts entirely out of the bankruptcy estate. He then parsed the New Jersey statute to find that the exemption from the claims of creditors was "a restriction on the transfer of a beneficial interest." The trustee's reading, which did not prevail in *Patterson*, would have restricted coverage of section 541(c)(2) to pension plans and spendthrift trusts established by others. That is, the trustee was arguing that the transfer restriction had to be contained in the trust itself, not created by state statute.

The district judge, whose opinion the Third Circuit affirmed, found an overarching congressional policy to protect retirement accounts. "It is not for us to take sides in this policy debate," Judge Alito wrote.

He found that the text of section 541(c)(2) covered the question, and that the trustee had not met his heavy burden of showing that it should be read more narrowly than it had been in *Patterson*. Judge Alito explained his reasoning in a footnote: "In *Patterson*, the Court said that a debtor may exclude a trust from the bankruptcy estate if the trust contains an appropriate restriction; the court did not say that a debtor may exclude a trust ONLY if it, as opposed to a statute, contains such a restriction." (Emphasis in original.)

In *In re Hechinger Investment Co.*, 335 F.3d 243 (3d Cir. 2003), 2003 U.S. App LEXIS 14449, the question was whether the bankruptcy code would allow a debtor to obtain refunds of transfer taxes paid on sales of real estate assets made prior to confirmation of its reorganization plan. The state of Maryland and three counties appealed a decision of the bankruptcy court and the district court in favor of the debtor, conditioned on the eventual confirmation of the plan. The Third Circuit reversed.

Section 1146(c) of the bankruptcy code states that "the making or delivery of an instrument of transfer under a plan confirmed . . . may not be taxed under any law imposing a stamp tax or similar tax." There was no dispute that a transfer of a deed to real estate was a delivery of an instrument of transfer, and a transfer tax was a stamp tax, within the meaning of the statute. The dispute was about whether sales consummated prior to the confirmation of a bankruptcy reorganization plan were nonetheless made pursuant to that plan, which was eventually confirmed. The debtor argued that the sales were necessary to effect the plan, which ratified the sales.

Judge Alito read the word "under" in section 1146(c) narrowly to mean "authorized by" a confirmed plan, allowing that it could mean "in agreement with" a plan that was eventually confirmed, as the dissent argued. He noted that tax exemption provisions should be strictly construed, and "federal laws that interfere with a state's taxation scheme must be narrowly construed in favor of the state." When the debtor claimed that congressional policy would be furthered by a more generous interpretation of legislation, Judge Alito responded "as is often the case in disputes about the interpretation of legislation that affects the economic interests of different groups, the opposing sides both cite policies that Congress might have wished to further when it enacted the law at issue."

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Tax Analysts Information

Geographic Identifier: United States

Subject Area: Tax policy issues

Magazine Citation: Tax Notes, Nov. 7, 2005, p. 721; 109 Tax Notes 721 (Nov. 7, 2005)

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Institutional Author: Tax Analysts

Tax Analysts Document Number: Doc 2005-22506

Tax Analysts Electronic Citation: 2005 TNT 215-5

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