

Estate income tax
Homestead exemption
Business expense
26 U.S.C. § 1398

Sticka v. USA 97-6214-fra
In re Kathleen Sturgill 695-63918-fra7

1/27/98 FRA Published at 217 BR 291

The Trustee filed a federal income tax return for the estate of the debtor, reporting income from the sale of the debtor's former residence. In addition to real estate commissions and other direct costs of the sale, the Trustee deducted the \$25,000 paid to the debtor for her homestead exemption as a cost of sale in determining the amount realized from the sale. He also claimed a business deduction in the amount of \$8,079 for legal and professional services and claimed the standard deduction in lieu of itemized deductions. In its audit of the Estate tax return, the IRS eliminated the deduction claimed for payment of the homestead exemption and eliminated the business deduction for legal and professional services. The business deduction was instead allowed as an itemized deduction, thus eliminating the standard deduction. The Trustee filed an adversary proceeding seeking a determination of the Estate's federal income tax liability and the IRS filed a motion for judgment on the pleadings.

26 U.S.C. § 1398 governs federal income taxation of bankruptcy estates. It states that, except as otherwise provided, a determination concerning tax deductions is to be made as if the amount paid were incurred by the debtor and as if the debtor were still engaged in the same businesses and activities he was engaged in prior to bankruptcy. The Trustee argued that the payment made for the homestead exemption should be a deduction in computing the amount realized from the sale because it was a necessary expense in clearing title to the property. The court, however, held that the debtor's right to the payment created an equitable lien under Oregon law; payment of the encumbrance was no more a deduction than paying off the mortgage holder.

The Trustee argued that the deduction for professional services should be classified as a business expense because a trustee is in the business of administering estates. The deduction is specifically allowed under § 1398; however, because it was not incurred in connection with a business in which the debtor engaged prior to bankruptcy, it must be claimed as an itemized deduction. Judgment was therefore granted in favor of the Defendant/IRS.

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UNITED STATES BANKRUPTCY COURT
DISTRICT OF OREGON

IN RE)	
)	
KATHLEEN PATRICIA STURGILL,)	Case No. 695-63918-fra7
)	
_____ Debtor.)	
)	
RONALD R. STICKA,)	Adv. Proc. No. 97-6214-fra
TRUSTEE,)	
)	
Plaintiff,)	
)	
vs.)	
)	
UNITED STATES OF AMERICA,)	
)	MEMORANDUM OPINION
_____ Defendant.)	

The Defendant in this proceeding has filed a motion for judgment on the pleadings. For the reasons that follow, Defendant's motion is allowed and judgment is granted to the Defendant.

BACKGROUND

The Plaintiff in this action is the Chapter 7 trustee of the bankruptcy estate of Kathleen Sturgill. As part of his duties as

1 trustee, the Plaintiff sold real property of the Estate which had
2 been the Debtor's residence. Debtor claimed a homestead
3 exemption of \$25,000 as allowed by Oregon state law. The selling
4 price was \$140,500 which, after deducting selling costs, fees,
5 payment of delinquent property taxes, and payment of the first
6 mortgage, yielded a net payment to the Estate of \$81,383.

7 In the Estate's federal income tax return for the period
8 ending September 30, 1996, the Trustee reported gross receipts
9 from the sale of \$140,500. From the gross receipts, he claimed
10 \$9,322 in expenses of sale and also deducted the \$25,000
11 homestead exemption in determining the amount realized from the
12 sale. Subtracting the adjusted basis in the property of \$55,000
13 from the amount realized produced a taxable capital gain of
14 \$51,178. The Trustee also filed a Schedule C with the tax return
15 in which he claimed \$8,079 in legal and professional services as
16 a business expense and claimed a standard deduction in lieu of
17 itemized deductions.

18 The return was submitted to the Internal Revenue Service
19 (IRS) with a request for prompt determination of any tax due.¹
20 In its audit report, the IRS eliminated the deduction made for
21 payment of the homestead exemption, eliminated the business
22 expense deduction of \$8,079 and, instead, allowed it as an

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24 ¹ 11 U.S.C. § 505(b) allows a trustee to submit the
25 bankruptcy estate's tax return to the appropriate taxing agency
26 with a request that the agency make a prompt determination of any
unpaid tax liability. When the trustee pays any amount shown due
or the amount later adjudicated to be due, the trustee is
generally discharged from liability for the tax.

1 itemized deduction, and eliminated the standard deduction since
2 itemized deductions were now being claimed. Upon receipt of the
3 notice of tax deficiency showing an additional tax due of \$7,874,
4 the Trustee filed a complaint seeking a determination by this
5 court of the Estate's federal income tax liability for the
6 relevant taxable year. The Government has filed a motion for
7 judgment on the pleadings, asserting that the IRS's determination
8 was correct and must, as a matter of law, be sustained.

9 JUDGMENT ON THE PLEADINGS

10 For purposes of a motion for judgment on the pleadings,
11 the allegations of the non-moving party must be
12 accepted as true, while the allegations of the moving
13 party which have been denied are assumed to be false. .
14 . Judgment on the pleadings is proper when the moving
15 party clearly establishes on the face of the pleadings
16 that no material issue of fact remains to be resolved
17 and that it is entitled to judgment as a matter of law.

18 Hal Roach Studios, Inc. v. Richard Feiner and Co., Inc., 896 F.2d
19 1542, 1550 (9th Cir. 1990) (citing Doleman v. Meiji Mutual Life
20 Ins. Co., 727 F.2d 1480, 1482 (9th Cir. 1984)).

21 The question of what is considered part of the pleadings may
22 be answered with reference to case law regarding motions to
23 dismiss under Fed.R.Civ.P. 12(b)(6) because a court "may not
24 consider any material beyond the pleadings in ruling on a Rule
25 12(b)(6) motion." Hal Roach Studios, 896 F.2d at 1555 n. 19.

26 "Material which is properly submitted as part of the complaint
may be considered on a motion to dismiss." Id. "A document is not
'outside' the complaint if the complaint specifically refers to
the document and if its authenticity is not questioned." Branch

1 v. Tunnell, 14 F.3d 449, 453 (9th Cir. 1994) (citing Townsend v.
2 Columbia Operations, 667 F.2d 844, 848-849 (9th Cir. 1982)).

3 With regard to the Defendant's motion, the court may thus
4 consider both the complaint and answer, and those documents
5 attached to the complaint which were included as exhibits.

6 DISCUSSION

7 Rules governing federal income taxation of bankruptcy
8 estates are to be found at 26 U.S.C. §1398²:

9 * * *

10 **(c) Computation and payment of tax; basic standard
deduction. --**

11 **(1) Computation and payment of tax.**--Except as
12 otherwise provided in this section, the taxable
13 income of the estate shall be computed in the same
14 manner as for an individual. The tax shall be
15 computed on such taxable income and shall be paid
16 by the trustee.

17 * * *

18 **(3) Basic standard deduction.**--In the case of an
19 estate which does not itemize deductions, the
20 basic standard deduction for the estate for the
21 taxable year shall be the same as for a married
22 individual filing a separate tax return for such
23 year.

24 * * *

25 **(e) Treatment of income, deductions, and credits.--**

26 **(1) Estate's share of debtor's income.**--The gross
income of the estate for each taxable year shall
include the gross income of the debtor to which
the estate is entitled under title 11 of the
United States Code. The preceding sentence shall
not apply to any amount received or accrued by the
debtor before the commencement date [generally the

25 ² Internal Revenue Code or IRC refers to Title 26 of the
26 U.S. Code; references to the Bankruptcy Code refer to 11 U.S.C.
§§ 101 to 1330.

1 bankruptcy petition date].

2 **(2) Debtor's share of debtor's income.**--The gross
3 income of the debtor for any taxable year shall
4 not include any item to the extent that such item
is included in the gross income of the estate by
reason of paragraph (1).

5 **(3) Rule for making determinations with respect to**
6 **deductions, credits, and employment taxes.**--Except
7 as otherwise provided in this section, the
determination of whether or not any amount paid or
incurred by the estate --

8 (A) is allowable as a deduction or credit
under this chapter, or

9 (B) is wages for purposes of subtitle C,

10 shall be made as if the amount were paid or
11 incurred by the debtor and as if the debtor were
12 still engaged in the trades and businesses, and in
the activities, the debtor was engaged in before
commencement of the case.

13 * * *

14 **(g) Estate succeeds to tax attributes of debtor.**--The
15 estate shall succeed to and take into account the
16 following items (determined as of the first day of the
debtor's taxable year in which the case commences) of
the debtor-- [list of tax attributes omitted].

17 **(h) Administration, liquidation, and reorganization**
18 **expenses; carryovers and carrybacks of certain excess**
19 **expenses.**--Any administrative expense allowed under
20 section 503 of title 11 of the United States Code, and
any fee or charge assessed against the estate under
chapter 123 of title 28 of the United States Code, to
the extent not disallowed under any other provision of
this title, shall be allowed as a deduction.

21 * * *

22 26 U.S.C. § 1398 was enacted as part of the Bankruptcy Tax
23 Act of 1980. The Act was intended, in part, to resolve
24 uncertainty concerning the federal income tax liability of the
25 bankruptcy estate and the debtor and was the first comprehensive
26

1 statutory treatment of these issues. S.Rep.No. 96-1035, 96th
2 Cong.(1980), *reprinted in* 1980 U.S.C.C.A.N. 7017. The Act
3 continued existing law by treating the bankruptcy estate of an
4 individual in Chapter 7 as a separate taxable entity for federal
5 income tax purposes.

6 **A. Deduction for Payment of Homestead Exemption**

7 Nature of Homestead Exemption

8 11 U.S.C. § 522 provides that a state may "opt out" of the
9 federal exemption scheme, thereby leaving state law as the sole
10 source for determining federal bankruptcy exemptions. Oregon has
11 opted out, see O.R.S. 23.305; Oregon law therefore determines
12 both the amount and the nature of the homestead exemption.
13 Oregon's homestead exemption is set out at O.R.S. 23.240 and
14 reads, in part, as follows:

15 (1) A homestead shall be exempt from sale on execution,
16 from the lien of every judgment and from liability in
17 any form for the debts of the owner to the amount in
18 value of \$25,000, except as otherwise provided by law.
19 . . .When two or more members of a household are
20 debtors whose interests in the homestead are subject to
21 sale on execution, the lien of a judgment or liability
22 in any form, their combined exemptions under this
23 section shall not exceed \$33,000. . . .

24 The homestead exemption is "limited to the money value of
25 the exemption fixed by statute. It is the value which is exempt,
26 not the property in and of itself." Boyd v. Ore, 249 Or. 513,
517, 439 P.2d 862, 864 (1968) (citing Fleischhauer v. Bilstad et
al., 233 Or. 578, 379 P.2d 880 (1963)). The interest of a debtor
claiming a homestead exemption gives rise to an equitable lien
which must be satisfied from the proceeds when the property is

1 sold. See In re Reich, 54 B.R. 995, 1002 (Bankr. E.D. Mich.
2 1985). See also In re Salzer, 180 B.R. 523, 529 (Bankr. N.D. Ind.
3 1993); In re Hollar, 184 B.R. 25, 30 (Bankr. M.D.N.C. 1995). In
4 this case, the nature of the homestead exemption for tax purposes
5 is no different than that of the mortgage lien.

6 Gross Income of Estate

7 26 U.S.C. § 1398(e)(1) provides that the gross income of the
8 estate consists of gross income of the individual debtor, other
9 than any amount received or accrued as income by the debtor prior
10 to commencement of the case, which under bankruptcy law
11 constitutes property of the bankruptcy estate, together with the
12 gross income of the estate beginning on and after the date the
13 bankruptcy case commenced. The only income in this case was the
14 capital gain on the sale of the homestead property. Because the
15 entire property was property of the estate (i.e. not reduced by
16 the amount of the homestead exemption, mortgage, or other
17 payments), the Trustee must report the entire proceeds received
18 from the sale as gross receipts on the estate tax return. See In
19 re Card, 114 B.R. 226 (Bankr. N.D. Cal. 1990); In re Duby, 98
20 B.R. 126 (Bankr. D.R.I. 1989).

21 The Trustee argues, not unreasonably, that the estate, and
22 thus the Debtor's creditors, should not have to pay tax
23 attributable to income or gain that the Debtor retains. However,
24 Congress has instead determined that tax liability arising from
25 income items such as unrealized gain on property of the estate
26 shall be borne by the estate, even if the gain may be said to

1 have accrued pre-petition. This allocation, and the structure of
2 IRC §1398 generally, advances the fresh start policy embodied in
3 the Bankruptcy Code. See McQueen and Williams, Tax Aspects of
4 Bankruptcy Law and Practice, Third Ed. §20:5.

5 Costs of Sale

6 26 U.S.C. § 1398(e)(3) states that "except as otherwise
7 provided in this section," a determination of whether an amount
8 paid by the estate shall be allowed as a deduction shall be made
9 as if the amount paid were incurred by the debtor and as if the
10 the debtor were still engaged in the same business or other
11 activities as before the commencement of the case. The Trustee
12 argues that the homestead exemption should be deductible as an
13 expense of sale because its payment was necessary to clear title
14 to the property. In order to be an allowable deduction, it must
15 be "otherwise provided" by § 1398 of the Internal Revenue Code,
16 or be a deduction which would be allowable under another section
17 of the Tax Code by the Debtor in the absence of bankruptcy.
18 Since 26 U.S.C. § 1398 does not provide a deduction for payment
19 of the homestead exemption, we must look to the Internal Revenue
20 Code as it applies to taxpayers in general. However, under the
21 Internal Revenue Code, expenses of sale for purposes of computing
22 capital gain are limited to the cost incurred in the sale process
23 itself, as opposed to obligations which must legally be
24 discharged out of the proceeds.³ Satisfaction of encumbrances

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26 ³ See e.g. Treas. Reg. § 1.1034-1(b)(4) which concerns sale
or exchange of residence and defines the "amount realized" as the

1 against the property, such as the equitable lien of the homestead
2 exemption, is also neither allowable under IRC § 63 and
3 associated sections as an itemized deduction, nor as a trade or
4 business expense under IRC § 162. Accordingly, the IRS's denial
5 of the deduction was correct.

6 **B. Deduction for Professional Services**

7 The Trustee argues that expenses for professional services
8 incurred by him in administration of the estate are an allowable
9 trade or business expense and should be deductible as such on the
10 Estate's return. He reasons that, because a trustee is in the
11 business of administering estates, the expenditure should be
12 treated as an ordinary and necessary business expense. The IRS
13 eliminated the business deduction and, instead, allowed it as an
14 itemized deduction, eliminating the standard deduction in the
15 process.

16 Expenditures by the Estate for professional services are
17 deductible. 26 U.S.C. § 1398(h) states that an administrative
18 expense allowable under section 503 of the Bankruptcy Code shall
19 be allowed as a deduction to the extent not otherwise disallowed.
20 The question is whether it is a trade or business expense
21 deductible in computing adjusted gross income, or an itemized
22 deduction deductible in computing taxable income. To answer the

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24 amount of consideration received less those items which are
25 properly an offset against the consideration received, such as
26 "commissions and expenses of advertising the property for sale,
of preparing the deed, and of other legal services in connection
with the sale."

1 question, one must look to 26 U.S.C. § 1398(e)(3), the subsection
2 dealing with determinations by the bankruptcy estate respecting
3 deductions, credits, and employment taxes. That section states
4 that a determination regarding whether an amount paid is
5 allowable as a deduction shall be made "as if the amount were
6 paid or incurred by the debtor and as if the debtor were still
7 engaged in the trades and businesses, and in the activities, the
8 debtor was engaged in before the commencement of the case." In
9 other words, the trustee steps into the shoes of the debtor with
10 respect to questions regarding deductions, credits, and
11 employment taxes. Because the payment of the trustee's
12 professional fees was not incurred in connection with a trade or
13 business in which the debtor engaged prior to commencement of the
14 case, it cannot be claimed as a trade or business expense by the
15 Estate. It follows that the payment is deductible as an itemized
16 deduction on the Estate's income tax return. Because the Estate
17 is claiming itemized deductions, 26 U.S.C. § 1398(c)(3) does not
18 allow for a standard deduction.

19 CONCLUSION

20 The Estate may not deduct payment of the statutory homestead
21 exemption from the consideration received from the sale of the
22 Debtor's former residence in calculating the amount realized from
23 the sale. Professional fees claimed as an administrative expense
24 under § 503 of the Bankruptcy Code are deductible as an itemized
25 deduction on the Estate's federal income tax return, rather than
26 as a trade or business expense. Accordingly, judgment on the

1 pleadings is granted to the Defendant. Counsel for the

2 /////

3 Government shall submit a form of judgment consistent with this

4 opinion.

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FRANK R. ALLEY, III
Bankruptcy Judge

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