

United States Bankruptcy Court
Northern District of Illinois
Eastern Division

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Bankruptcy Caption: In re John P. Messina

Bankruptcy No. 99 B 29371

Date of Issuance: September 29, 2003

Judge: John H. Squires

Appearance of Counsel:

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**UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION**

IN RE:)	Chapter 7
JOHN P. MESSINA,)	Bankruptcy No. 99 B 29371
)	Judge John H. Squires
Debtor.)	

MEMORANDUM OPINION

This matter comes before the Court on the motion of John P. Messina (the “Debtor”) for reimbursement of capital gains taxes. For the reasons set forth herein, the Court denies the Debtor’s motion.

I. JURISDICTION AND PROCEDURE

The Court has jurisdiction to entertain this matter pursuant to 28 U.S.C. § 1334 and Internal Operating Procedure 15(a) of the United States District Court for the Northern District of Illinois. This matter is a core proceeding under 28 U.S.C. § 157(b)(2)(A) and (O).

II. FACTS AND BACKGROUND

The Debtor is a practicing Illinois attorney doing business as the Law Office of John P. Messina. On September 22, 1999, he filed a Chapter 11 bankruptcy petition. Subsequently, on February 6, 2001, the case was converted to Chapter 7 and thereafter Lawrence Fisher was appointed as the case trustee (the “Trustee”). On April 8, 2003, the

Debtor filed his motion for reimbursement of capital gains taxes as costs of administration.

III. DISCUSSION

Pursuant to this motion, the Debtor seeks reimbursement for costs of administration in the amount of \$8,048.68. Specifically, the Debtor contends that on June 10, 1993, he and his wife purchased 100 shares of Microsoft common stock at a cost of \$9,654.00. The Debtor states that as a result of stock splits, the 100 shares of Microsoft grew to 1600 shares. According to the Debtor, he and his wife held the stock in a joint account at Fidelity Investments from the date of purchase through May 12, 1997.

On April 30, 1997, the Debtor executed a promissory note to Arthur and Alice Berney (collectively the "Berneys") in the amount of \$40,600.00. On May 12, 1997, the Debtor, with the consent of his wife, pledged the Microsoft stock as security for the loan. Thereafter, on August 19, 2002, the Berneys liquidated 1200 shares of the Microsoft stock at \$50.04 per share and applied the amount they received to the Debtor's indebtedness to them. The Debtor further maintains that pursuant to a brokerage statement, the liquidation yielded gross proceeds of \$60,048.00. After deducting \$81.31 for the costs of the sale, the net proceeds from the liquidation were \$59,966.69.

The Debtor contends that for purposes of calculating capital gains taxes, he and his wife had a basis of \$7,240.50 in the 1200 shares liquidated by the Berneys, resulting in capital gains of \$52,726.19. The Debtor further states in the motion that the federal capital gains taxes on this amount is \$10,545.24 (20%) and the Illinois state tax is

\$1,581.79 (3%). The Debtor maintains that the total taxes resulting from the liquidation of the 1200 shares of Microsoft stock are \$12,127.02. In an affidavit, the Debtor avers that on April 15, 2003, he and his wife filed a joint tax return with the United States and the State of Illinois wherein he reported capital gains of \$52,726.19 on the sale of 1200 shares of Microsoft stock on August 19, 2002. Further, the Debtor states that he and his wife paid the full amount of taxes due and owing on the capital gains realized from the liquidation of the stock (\$10,545.24 to the Internal Revenue Service and \$1,581.79 to the Illinois Department of Revenue).

The Debtor argues that he and the Trustee dispute the extent of the estate's interest in the Microsoft stock. The Trustee argues that the estate owns 100% of the stock and the Debtor, on the other hand, argues that his wife owns 50% of the stock. The Debtor concludes that at a minimum, the estate's share of the capital gains taxes is \$8,084.68 ($800/1200 \times \$12,127.02 = \$8,084.68$). Therefore, the Debtor requests, pursuant to 11 U.S.C. § 503(b)(1)(B), albeit in his reply to the Trustee's objection to the motion, that he be reimbursed in the amount of \$8,048.68 for costs of administration representing the capital gains taxes on 800 shares of Microsoft stock, without prejudice to the unresolved dispute over the ownership of the balance of the Microsoft stock.

The Trustee filed an objection to the Debtor's motion. First, the Trustee contends that the stock is the subject of an adversary proceeding he filed against the Debtor, his wife and the Berneys concerning the dispute about the true ownership of the stock and whether the Trustee and/or others are liable for taxes related to the sale of the stock. The Trustee maintains that any other issues regarding the stock are properly raised only in

that adversary proceeding. The Trustee further notes that the sale by the Berneys of the estate's interest in the stock was not authorized by the Court and thus is avoidable under 11 U.S.C. § 549. Next, the Trustee argues that the Debtor has not alleged that he actually paid any of the capital gains taxes and thus cannot be "reimbursed" for a payment that he has not made.¹ Moreover, the Trustee contends that the Debtor should not be entitled to the relief requested because he has unclean hands regarding the Microsoft stock.

Specifically, the Trustee argues that the Debtor's original and amended schedules filed in the bankruptcy case falsely state that he is the owner of only half of the stock, but the pledge agreement he gave the Berneys represents that he owns all of the stock. The Trustee surmises that the Debtor cooperated with the Berneys in the unauthorized sale of the stock or the subsequent and continuing refusal to pay the proceeds of the sale of the stock to the Trustee. Further, the Trustee argues that the Debtor has unclean hands regarding this bankruptcy case because he has failed to turn over to the Trustee all property of the estate, and therefore, he should not be entitled to relief from the estate. Finally, the Trustee maintains that he has a significant "setoff" to the Debtor's request under 28 U.S.C. § 1927 and the Court's inherent authority to sanction the Debtor.

The Debtor requests that the Court allow an administrative claim in his favor pursuant to § 503(b), which would result in the claim being entitled to first priority distribution under 11 U.S.C. § 507. An expense of administration claim is governed by § 503(b) which provides in relevant part:

¹ In his reply to the Trustee's response, the Debtor attached his affidavit wherein he states that he did in fact actually pay the capital gains taxes. Thus, the Trustee's argument on this point fails.

- (b) After notice and a hearing, there shall be allowed administrative expenses . . . including–
 - (1)(A) the actual, necessary costs and expenses of preserving the estate, including... (B) any tax–
 - (i) incurred by the estate, except a tax of a kind specified in section 507(a)(8) of this title. . . .

11 U.S.C. § 503(b)(1)(B)(i). Capital gains taxes have been classified as an administrative expense under this section. See In re Goffena, 175 B.R. 386, 392 (Bankr. D. Mont. 1994); In re DUBY, 98 B.R. 126, 127 (Bankr. D. R.I. 1989); In re Lambdin, 33 B.R. 11, 12 (Bankr. M.D. Tenn. 1983). “[A]dministrative expenses include taxes which the trustee incurs in administering the debtor’s estate, including taxes on capital gains from sales of property by the trustee and taxes on income earned by the estate during the case.” S. Rep. No. 989, 95th Cong., 2nd Sess. 66 (1978), *reprinted in* U.S. Code & Cong. & Admin. News 1978, pp. 5787, 5852. The Lambdin case, which was cited by the Debtor in support of his motion, is inapposite and not controlling here because the Berneys, not the Trustee, sold the stock to satisfy part of their debt.

Administrative priority claims are to be strictly construed because the presumption in bankruptcy cases is that the debtor has limited resources which will be equally distributed among creditors. See In re Amarex, Inc., 853 F.2d 1526, 1530 (10th Cir. 1988); In re Mammoth Mart, Inc., 536 F.2d 950, 953 (1st Cir. 1976) (“To give priority to a claimant not clearly entitled thereto is not only inconsistent with the policy of equality of distribution; it dilutes the value of the priority for those creditors Congress intended to prefer.”).

The policy underlying priority treatment for administrative expenses is to encourage creditors to extend credit to debtors which will enable a reorganization to succeed. See In re Jartran, Inc., 732 F.2d 584, 586 (7th Cir. 1984). To that end, in order to demonstrate the priority of an administrative claim, the debt must (1) arise out of a transaction with the debtor and (2) benefit the operation of the debtor's business. Id. at 587(citing Mammoth Mart, 536 F.2d at 954).

The claimant has the burden of proving entitlement to an administrative expense by a preponderance of the evidence. In re Kmart Corp., 293 B.R. 905, 909 (Bankr. N.D. Ill. 2003) (citation omitted). The claimant must demonstrate that the benefit is more than a speculative or potential benefit. Id. (citation omitted). The claimant must establish that the estate was benefitted as a whole. In re Pettibone Corp., 90 B.R. 918, 933 (Bankr. N.D. Ill. 1988).

Courts have articulated a two-prong standard to determine whether a tax should be classified as an administrative expense under § 503(b)(1)(B): (1) whether or not the tax was "incurred by the estate;" and (2) whether the tax is a tax under § 507(a). See In re Swann, 149 B.R. 137, 144-45 (Bankr. D. S.D. 1993) (citations omitted). Only taxes "incurred by the estate" can be administrative expenses pursuant to § 503(b)(1)(B). Hence, priority for tax claims extends only to post-petition taxes. Whether a tax has been "incurred by the estate" is not always easy to determine. 4 L. King, Collier on Bankruptcy ¶ 503.07[1] at 503-49 (15th ed. rev. 2003). The time of assessment or payment may not necessarily be equivalent to the time the tax is "incurred" for purpose of establishing priority under § 503(b)(1)(B). Id. The significant event is the date the tax

accrues and becomes a fixed obligation. See, e.g., In re Bondi's Valu-King, Inc., 126 B.R. 47, 51 (N.D. Ohio 1991) (tax is "incurred" for § 503(b)(1)(B) purposes when "all the acts necessary to create the tax liability" have occurred).

First, the Court rejects the Trustee's arguments that the Debtor's unclean hands and a potential 28 U.S.C. § 1927 claim against the Debtor prevent him from seeking the requested relief. Neither of these points constitutes a valid objection to the allowance of an administrative claim under § 503(b). The Court, however, sustains the Trustee's objection to the Debtor's motion on the ground that the issue of the ownership of the Microsoft stock and who may be liable for the payment of taxes related to the sale thereof has been raised by the Trustee in an adversary proceeding (02 A 01041). Thus, the Court finds that the Debtor's motion must be denied because the Court has not yet determined the ownership issue.

Moreover, it was not the Trustee of the bankruptcy estate who sold the stock. Rather, the Berneys sold the stock as secured creditors, holding the pledged stock as collateral for the debt owed them by the Debtor. This action provided no benefit to the bankruptcy estate. Rather, it solely benefitted the Berneys. Thus, the Court finds that the Debtor has not demonstrated that the tax was "incurred by the estate." In addition, as the Debtor argues, if the estate had no ownership interest in the Microsoft stock, or if the Debtor's spouse owned half of the stock, then the payment of the taxes did not benefit the Debtor's estate. Consequently, the Court denies the Debtor's motion for reimbursement of capital gains taxes.

IV. CONCLUSION

For the foregoing reasons, the Court denies the Debtor's motion for reimbursement of capital gains taxes.

This Opinion constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052. A separate order shall be entered pursuant to Federal Rule of Bankruptcy Procedure 9021.

ENTERED:

DATE: _____

John H. Squires
United States Bankruptcy Judge

cc: See attached Service List