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FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re: SANDRA J. TILLMAN, Debtor, UNITED STATES OF AMERICA, Appellant, v. LAWRENCE J. WARFIELD, Trustee; SANDRA J. TILLMAN, Appellees.	No. 21-16034 D.C. No. 3:20-cv-08204-DWL OPINION (Filed Nov. 18, 2022)

Appeal from the United States District Court
for the District of Arizona
Dominic Lanza, District Judge, Presiding

Argued and Submitted July 5, 2022
Seattle, Washington

Before: CLIFTON and BUMATAY, Circuit Judges,
and CHEN,* District Judge.

Opinion by Judge Chen;
Dissent by Judge Bumatay

* The Honorable Edward M. Chen, United States District Judge for the Northern District of California, sitting by designation.

COUNSEL

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Thomas H. Allen, Allen Barnes & Jones PLC, Phoenix, Arizona, for Appellee Sandra J. Tillman.

OPINION

CHEN, District Judge:

Sandra J. Tillman (the "Debtor") purchased a house in Prescott, Arizona (the "Prescott Property"). The Internal Revenue Service ("IRS" or "the government") held a secured claim on the Prescott Property arising from a tax penalty lien. Thereafter, Debtor filed a petition for Chapter 7 bankruptcy and claimed a $150,000 homestead exemption in the house under Arizona law. Appellee Trustee Lawrence J. Warfield (the "Trustee") instituted an adversary proceeding to avoid the IRS's tax lien on the exempt property and to preserve the value of the lien for the benefit of the bankruptcy estate. The Bankruptcy Court granted

summary judgment to the Trustee and the District Court affirmed. The government appealed.

We are presented with a matter of first impression: may a trustee use 11 U.S.C. §§ 724(a) and 551 to avoid and preserve a tax penalty lien on a debtor's exempt property for the benefit of the bankruptcy estate? We hold that a trustee may not. Therefore, we reverse the decision of the District Court affirming the Bankruptcy Court.

I. BACKGROUND

A. LEGAL BACKGROUND

At the outset, we briefly summarize the terminology and statutory provisions of the Bankruptcy Code relevant to this dispute.

First, after a bankruptcy petition is filed, a bankruptcy estate is formed consisting of specified property interests of the debtor. 11 U.S.C. § 541(a).

Second, in some circumstances, a debtor may exempt property from the bankruptcy estate, thereby removing it from the bankruptcy estate. *Mwangi v. Wells Fargo Bank, N.A. (In re Mwangi)*, 764 F.3d 1168, 1175–76 & n.4 (9th Cir. 2014). In such circumstances, the debtor generally retains the exempt property, and the exempt property cannot be used by the bankruptcy estate to satisfy the claims of unsecured creditors. *Owen v. Owen*, 500 U.S. 305, 308 (1991). Section 522 of the Bankruptcy Code enumerates exemptions available to an individual debtor in bankruptcy, but § 522(b)(1) also

authorizes state legislatures to "opt out" of the § 522 exemption scheme and provide their own exemption schemes. "If a State opts out, then its debtors are limited to the exemptions provided by state law." *Owen*, 500 U.S. at 308.

As relevant here, Arizona has opted out of the § 522 exemptions and provides its own set of exemptions to Arizona residents. Arizona Revised Statutes ("A.R.S.") § 33-1133(B). Among other things, Arizona provides a homestead exemption that permits a resident to exempt her "interest in real property . . . in which [she] resides," up to $150,000 "in value." *Id.* § 33-1101(A)(1) (2004 version, effective prior to Jan. 1, 2022). Arizona, however, provides that consensual loans, such as mortgages, are not "subject to or affected by" the homestead exemption. A.R.S. § 33-1104(D). Thus, depending on the value of the property, a mortgage can diminish the amount of the homestead exemption available to the homeowners. Notably, the Arizona homestead exemption does *not* provide for any reduction in the exemption amount for tax liens.

Third, the Bankruptcy Code limits a debtor's ability to shield exempted property from liability for certain pre-petition debts. Section § 522(c) provides:

> (c) Unless the case is dismissed, **property exempted under this section is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case, except**—
>
> . . .

> (2) **a debt secured by a lien that is—**
>
> (A)(i) not avoided under subsection (f) or (g) of this section or under section 544, 545, 547, 548, 549, or 724(a) of this title; and
>
> (ii) not void under section 506(d) of this title; or
>
> (B) **a tax lien, notice of which is properly filed**. . . .

11 U.S.C. § 522(c) (emphasis added). In short, § 522(c) provides that a debtor remains liable for certain debts secured by liens, such as tax liens, even if the debtor has otherwise exempted property from the reach of unsecured creditors. Of note, an IRS tax lien lies "upon all property and rights to property, whether real or personal, belonging to such person." 26 U.S.C. § 6321.

Fourth, under § 724(a) of the Bankruptcy Code, a trustee may "avoid" a "lien that secures a claim of a kind specified in section 726(a)(4)" for the estate. Section 726 deals generally with distribution of property of the estate, and § 726(a)(4), as relevant here, addresses claims for non-compensatory penalties. 11 U.S.C. § 726(a)(4) (addressing "payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim").

Fifth, if a trustee avoids a lien using § 724(a), the lien's priority position is automatically "preserved for the benefit of the estate but only with respect to property of the estate." 11 U.S.C. § 551. Thus, generally, once the trustee avoids a lien against property of the estate, he steps into the shoes of the lienholder and can recover that property interest for the estate, thereby increasing the property of the estate available to satisfy claims of unsecured creditors. *Retail Clerks Welfare Trust v. McCarty (In re Van de Kamp's Dutch Bakeries)*, 908 F.2d 517, 519 (9th Cir. 1990).

B. FACTUAL BACKGROUND

Having described the relevant statutory provisions, we now turn to the facts of this case.

In 2015, Debtor purchased a residence in Prescott, Arizona and granted a mortgage to Bank of America. The Prescott Property became the Debtor's homestead under Arizona law. *See* A.R.S. § 33-1101 (2004 version, effective prior to Jan. 1, 2022). The Debtor owed income tax for 2015 but failed to timely file a return or pay her 2015 taxes. The IRS assessed Debtor's 2015 income tax liability and related penalties and interest. Debtor eventually fully paid the original tax liability but did not fully pay the penalties and interest, which initially totaled over $18,000. On December 24, 2018, the IRS recorded a notice of a federal tax lien (the "IRS Tax Lien") securing the penalties against the Prescott Property.

On January 30, 2019, Debtor filed a Chapter 7 bankruptcy petition in the U.S. Bankruptcy Court for the District of Arizona. The IRS filed a claim for Debtor's 2015 tax liabilities and indicated its claim was secured by the IRS Tax Lien it had filed. Debtor claimed a homestead exemption of up to $150,000 on the Prescott Property under A.R.S. § 33-101, which the Bankruptcy Court permitted. that time, the Debtor's mortgage was for $364,381 and the IRS's secured tax lien was for $24,686.26.

C. PROCEDURAL BACKGROUND

Thereafter, the Trustee filed the adversary proceeding currently at issue and sought a summary judgment order: (1) avoiding the federal tax lien on the Prescott Property pursuant to 11 U.S.C. § 724(a), and (2) preserving the value of the avoided federal tax lien on the Prescott Property for the benefit of the bankruptcy estate pursuant to 11 U.S.C. § 551. The government responded that lien avoidance under § 724(a) and preservation under § 551 did not apply to liens encumbering exempt property, such as the Prescott Property, which was subject to Arizona's homestead exemption. The Debtor also intervened and asserted her right to an increased exemption under § 522(g).

The Bankruptcy Court granted the Trustee's summary judgment motion, holding that the Trustee could avoid the portion of the federal tax lien securing the tax penalties and interest under § 724(a) and that the

value of the lien was preserved for the estate's benefit under § 551.

The Bankruptcy Court rejected the government's argument that lien avoidance under § 724(a) and preservation under § 551 for the benefit of the bankruptcy estate did not apply to the Debtor's exempted homestead property. Specifically, the Bankruptcy Court found that the IRS held a secured claim for a tax penalty, which is of the kind specified in § 726(a)(4), and was, thus, subject to avoidance by the Trustee under § 724(a). It observed that the IRS Tax Lien was held against the Prescott Property, which the Debtor claimed exempt under Arizona's homestead exemption—and which the Bankruptcy Court had previously granted—but that the grant of this exemption did not preclude the Trustee from avoiding the lien and preserving it for the benefit of the estate.

The Bankruptcy Court quoted *Heintz v. Carey* (*In re Heintz*) for the proposition that "§ 551 does not exclude exempt property from preservation" and that "[a]n avoided interest or lien encumbering exempt property is automatically preserved for the benefit of the estate under § 551." 198 B.R. 581, 586 (B.A.P. 9th Cir. 1996). Relying on *Heintz*, the Bankruptcy Court concluded that the Debtor's homestead was property of the bankruptcy estate at the commencement of the case and remained property of the estate for purposes of § 551 even after the Debtor's homestead exemption was allowed.

The Bankruptcy Court further reasoned that, under Arizona law, the Debtor's exemption was limited to an "interest" in her homestead, up to $150,000, equal to the property's value after subtracting both the value of the mortgage lien and the value of the federal tax lien. The court explained that Arizona's exemption laws explicitly excluded the value of consensual liens, such as her mortgage, from the amount of the Debtor's homestead exemption. And, as to the federal tax lien, the court observed that Arizona's exemption laws were "ineffective" against the federal tax lien. The Bankruptcy Court held this ineffectiveness meant the Debtor's homestead exemption did not include "the value of the lien positions occupied by [Bank of America] or the IRS," and it was only the Debtor's equity beyond the mortgage and tax lien that the Debtor was entitled to exempt. Thus, the Bankruptcy Court concluded that "[a]t all relevant times, the IRS's Tax Lien encumbered property of the estate."

Accordingly, the court explained that "[t]he trustee may avoid the IRS's Tax Lien under § 724(a)," and "[u]pon avoidance of the IRS's Tax Lien, the IRS's Tax Lien is preserved for the benefit of [the] bankruptcy estate under § 551."[1]

In so concluding, the Bankruptcy Court also rejected the government's argument that the court's holding would cause inequitable results for the Debtor,

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[1] The Bankruptcy Court also rejected the IRS and Debtor's argument that the avoided lien is preserved for the benefit of *the debtor* under § 522(g) instead of for the benefit of the estate under § 551. This argument is not re-asserted on appeal.

because the Debtor's exemption could be reduced twice as a result of the same lien—first, as a deduction from the amount that Debtor could exempt, and then, again, when the Debtor is required to satisfy the value of the lien to the IRS. The Bankruptcy Court reasoned that the Debtor would not have to unfairly pay twice on the same lien because the IRS Tax Lien "never attached to the Debtor's homestead exemption." "[T]he value of the Debtor's exemption was always subordinate to the Tax Lien" and "[w]hen the Tax Lien is avoided, the Trustee steps into that avoided position." Therefore, the court explained, "[i]f it so happens that the IRS's now unsecured claim is also nondischargeable, it is no different than any other nondischargeable claim which will need to be paid by the Debtor."

The government appealed the Bankruptcy Court's grant of summary judgment to Trustee, and the District Court affirmed in full. The District Court, also relying on *Heintz*, concluded that § 551's "property of the estate" limitation did not prevent the Trustee's avoidance and preservation of the IRS lien, and found that the Debtor was only entitled to use Arizona's homestead exemption to exempt unencumbered property—*i.e.*, the exemption excluded the mortgage and the IRS lien. The District Court agreed with the Bankruptcy Court that the IRS's tax lien never attached to Debtor's exemption. This appeal followed.

D. INTERVENING DEVELOPMENTS

During the pendency of the appeal from the adversary proceeding, on July 9, 2020, Debtor found a buyer for the Prescott Property and moved for approval to sell. The Bankruptcy Court permitted the sale of the Prescott Property for $475,000, of which Debtor was ordered to pay $378,062.78 to Bank of America to cover the cost of the mortgage. The Bankruptcy Court ordered the Trustee, after paying costs and the mortgage, to set aside a portion of the proceeds equal to the total value of the IRS's tax lien, $26,771, pending the outcome of the litigation now before this Court. The remaining proceeds of the sale after costs, approximately $30,000, were provided to Debtor as the value of her homestead exemption.

II. JURISDICTION AND STANDARD OF REVIEW

The government timely appealed the District Court's affirmance of the Bankruptcy Court's grant of summary judgment to the Trustee. We have jurisdiction over this appeal pursuant to 28 U.S.C. §§ 158(d), 1291. *See SS Farms, L.P. v. Sharp (In re SK Foods, L.P.)*, 676 F.3d 798, 802 (9th Cir. 2012).

We review *de novo* the district court's decision on appeal from a bankruptcy court. *Decker v. Tramiel (In re JTS Corp.)*, 617 F.3d 1102, 1109 (9th Cir. 2010). "We apply the same standard of review applied by the district court" and "review [the] bankruptcy court decision independently and without deference to the district

court's decision." *Id.*; *see Galam v. Carmel (In re Larry's Apt., L.L.C.)*, 249 F.3d 832, 836 (9th Cir. 2001) (citing *Robertson v. Peters (In re Weisman)*, 5 F.3d 417, 419 (9th Cir. 1993)). As such, "[t]he bankruptcy court's findings of fact are reviewed for clear error, while its conclusions of law are reviewed de novo." *In re JTS Corp.*, 617 F.3d at 1109 (quoting *Leichty v. Neary (In re Strand)*, 375 F.3d 854, 857 (9th Cir. 2004)).

III. DISCUSSION

A. AVOIDANCE AND PRESERVATION UNDER §§ 724(a), 551

The government argues that the Bankruptcy Court erred in holding that the Trustee could avoid a tax lien for penalties on the Debtor's exempt homestead property under 11 U.S.C. § 724(a) and then use 11 U.S.C. § 551 to take the value of the lien from the Debtor's exemption and preserve it for the benefit of the bankruptcy estate. In the government's view, the Bankruptcy Court erred because the Debtor's homestead exemption withdrew her exempt property from the property of the estate. Therefore, the government contends, the Trustee cannot use § 724(a) and § 551 to avoid and preserve a lien on exempted property, because such property is *not* property of the estate.

1. Parameters of § 724(a)

The parties do not dispute that the tax penalty lien at issue here is the type of lien contemplated for avoidance by a trustee under § 724(a). Under § 724(a),

"[t]he trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title." 11 U.S.C. § 724(a). Section 726(a)(4), in turn, specifies "property of the estate shall be distributed . . . in payment of any allowed claim, whether secured or unsecured, for any fine or forfeiture or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee . . . " 11 U.S.C. § 726(a)(4). Under 11 U.S.C. § 551, "[a]ny transfer avoided under section . . . 724(a) of this title . . . is preserved for the benefit of the estate but only with respect to property of the estate." 11 U.S.C. § 551. The trustee's power under § 551 is thus predicated on its power first to avoid the tax lien under § 724(a). The key question here is whether the Debtor's exempted property—her homestead exemption under Arizona law—is subject to the Trustee's avoidance of the tax lien under § 724(a) and the ensuing preservation of the tax lien under § 551. It is not.

Property interests held by the estate evolve over the course of bankruptcy proceedings. Section 541(a)(1) of the Bankruptcy Code explains that the filing of a bankruptcy case "creates an estate . . . comprised of" the debtor's specified property interests "as of the commencement of the case." 11 U.S.C. § 541(a). However, the holdings of the estate do not remain static after the commencement of the bankruptcy case. The term "estate" refers to the property at a particular point in time—such as at the commencement of the case as referred to in § 541(a)(1)—rather than the estate in perpetuity. *See Owen*, 500 U.S. at 308 ("An estate in

bankruptcy consists of all the interests in property, legal and equitable, possessed by the debtor at the time of filing, as well as those interests recovered or recoverable through transfer and lien avoidance provisions.").

Section 541(a) provides that a trustee may increase the property of the estate if the trustee can recover non-debtor interests in property through the various transfer and lien avoidance provisions in the Bankruptcy Code. *See* 11 U.S.C § 541(a)(3)-(7).

Conversely, the property interests of the estate may be reduced during the course of bankruptcy proceedings, such as through a judicially authorized sale of assets, payment of expenses related to the administration of the estate, or payment of a debtor's unexpired lease obligations. *See* 11 U.S.C. § 363(b) (sale of property of the estate); *Tamm v. U.S.T. (In re Hokulani Square, Inc.)*, 776 F.3d 1083, 1085 (9th Cir. 2015) (describing a secured creditor's purchase of estate property via credit bid, such that "the creditors get the property, and the estate's debt is reduced by the amount of the bid"); 11 U.S.C. § 503 (allowance of administrative expenses); 11 U.S.C. § 365 (payment on unexpired leases).

Additionally, the property interests of the estate may be reduced by a judicially authorized exemption. *See* 11 U.S.C. § 522. Although initially "[a]n estate in bankruptcy consists of all the interests in property legal and equitable, possessed by the debtor at the time of filing," "[a]n exemption is an interest *withdrawn*

from the estate (and hence from the creditors) for the benefit of the debtor." *Owen*, 500 U.S. at 308 (emphasis added). Likewise, § 522 of the Bankruptcy Code "authorizes a debtor to exempt certain property from the bankruptcy estate so that it may not be reached by the trustee in bankruptcy." *DeMarah v. United States (In re DeMarah)*, 62 F.3d 1248, 1250 (9th Cir. 1995). Indeed, § 522(b)(1) expressly states that "[*n*]*otwithstanding section 541 of this title*"—the statutory provision describing the property interests that comprise the estate at the *commencement* of proceedings—"an individual debtor may exempt from property of the estate the property" listed in the relevant subsections of § 522. 11 U.S.C. § 522(b)(1) (emphasis added).

We have consistently recognized that authorized exemptions modify the property interests of the estate. After the commencement of bankruptcy proceedings, property interests which are exempted by a debtor are "withdrawn from the estate," *Gebhart v. Gaughan (In re Gebhart)*, 621 F.3d 1206, 1210 (9th Cir. 2010), (quoting *Owen*, 500 U.S. at 308) and are no longer property of the estate. *See In re Kahan*, 28 F.3d 79, 81 (9th Cir. 1994) ("The bankruptcy estate includes all of the debtor's interests in property at the commencement of the case, except property that the debtor elects to exempt based on applicable federal or state law.") (citing 11 U.S.C. §§ 541(a), 522(b)(2)). "The general rule is that exempt property immediately revests in the debtor." *In re Mwangi*, 764 F.3d at 1175.[2] *See In re*

[2] Where an asset itself is exempt, the asset immediately revests in the debtor upon the end of the objection period. *In re*

Gebhart, 621 F.3d at 1210 ("This principle is consistent with the text of the Bankruptcy Code, which defines exempt property as property that, unlike all the debtor's other property, does not belong to the bankruptcy estate.") (citing 11 U.S.C. § 522(b)(1)); S. Rep. No. 95-989, at 52 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5838 (recognizing that exempt property "ceases to be property of the estate"); *see also Owen*, 500 U.S. at 308 (recognizing that the relationship between a debtor's exempt property and property of the estate may change, such that "[n]o property can be exempted (and thereby immunized) . . . unless it *first* falls within the bankruptcy estate") (emphasis added).

Recognizing the dynamic nature of the bankruptcy estate through the pendency of bankruptcy proceedings, we must analyze the text of the avoidance provision at issue here, 11 U.S.C. § 724(a), and interpret it in context to determine whether the Trustee may avoid a tax lien on the Debtor's exempt property. *In re Consol. Freightways Corp. of Delaware*, 564 F.3d 1161, 1165 (9th Cir. 2009) ("[O]ur examination must begin with the words of the provision itself. Of course, that does not mean that we limit ourselves to the provision in perfect isolation. We must, instead, construe that [Bankruptcy Code] provision with the statutory

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Mwangi, 764 F.3d at 1175–76. When the exemption consists of an interest in an asset, the asset remains in the estate while "only an `interest' in the property equal to the value of the exemption claimed at filing is removed from the estate." *Id.* at 1174–75 (citation omitted).

scheme in which it is embedded." (internal citations omitted)).

Examining the statutory text in this context, under § 724(a), "[t]he trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title." 11 U.S.C. § 724(a). Section 726(a)(4), in turn, specifies that "*property of the estate* shall be *distributed* . . . in payment of any allowed claim, whether secured or unsecured, for any fine or forfeiture or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee. . . ." 11 U.S.C. § 726(a)(4) (emphasis added); *see also id.* § 726 (statutory section is titled "Distribution of property of the estate"). Thus, § 724(a) applies to property that is part of the estate at the time of distribution based on its express reference to § 726(a)(4). *See Einstein/Noah Bagel Corp. v. Smith (In re BCE W., L.P.)*, 319 F.3d 1166, 1171 (9th Cir. 2003) ("Statutory construction of the Bankruptcy Code is 'a holistic endeavor' requiring consideration of the entire statutory scheme.") (quoting *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988)).

The statutory context makes this clear. First, § 724 deals with the "treatment of certain liens" at the point in time that property of the estate is to be *distributed* to creditors. *See*, *e.g.*, § 724(b) ("Property in which the estate has an interest and is subject to a lien that is not avoidable . . . and secures an allowed claim for a tax, or proceeds of such property, shall be *distributed*. . . ."); § 724(c) ("If more than one holder of a

claim is entitled to *distribution* . . . *distribution* to such holders under such paragraph shall be in the same order as *distribution* to such holders would have been other than under this section.") (emphases added). Hence, § 724(a) operates on the bankruptcy estate not at the commencement of the proceedings but at a later stage—distribution.

Second, § 724(a) only permits lien avoidance of a lien that secures an "allowed claim." 11 U.S.C. § 726(a)(4). By definition, the Bankruptcy Code provides that an allowed claim is one in which sufficient proof has been provided to the bankruptcy court *after* the commencement of proceedings and any objections to the proof of claim have been resolved. *See* 11 U.S.C. § 502(a).

Thus, it is clear from the express language of § 724(a) and its cross-reference to § 726(a)(4), as well as the statutory context provided by §§ 724 and 726, that § 724(a) concerns the trustee's avoidance of qualifying liens attached to the *property of the estate* at the time of *distribution*.

When a debtor properly exempts a property interest under § 522, the exemption withdraws that property interest from the estate and, thus, from the reach of the trustee for distribution to creditors. *See Owen*, 500 U.S. at 308; *In re DeMarah*, 62 F.3d at 1250. Such an exempted property interest revests with the debtor and no longer belongs to the estate. *In re Gebhart*, 621 F.3d at 1210. Accordingly, because exempt property is not "property of estate" which may be "distributed," we

conclude that a trustee may not avoid a lien under § 724(a) (that secures the kind of claim specified in § 726(a)(4)) attached to exempt property which is no longer part of the estate.

2. Prior Rulings

This holding is consistent with our prior rulings. We have not previously had the occasion to expressly address whether a trustee may use § 724(a) to avoid a lien which is not secured by property of the estate, such as a lien secured only by a debtor's exempt property. The district court in *DeMarah v. United States*, 188 B.R. 426, 431 (E.D. Cal. 1993), *aff'd*, 62 F.3d 1248 (9th Cir. 1995), concluded (as we do here) that § 724(a) lien avoidance actions are limited to property of the estate, explaining

> The trustee's avoiding powers under Section 724(a) are limited to the types of liens secured by claims specified in Section 726(a)(4). Section 726(a)(4) concerns non-compensatory tax penalty claims. However, § 726(a)(4) does not stand in isolation, it is a part of Section 726 which is concerned only with "property of the estate." 11 U.S.C. § 726(a)(4) allows the trustee to avoid claims for penalties against the property of the estate. The avoiding powers of Debtor, like those of the trustee, are limited to penalty claims against property of the estate.

Id. In affirming the district court's holding in *DeMarah*, we neither reached nor cast doubt on the district court's analysis that lien avoidance actions under

§ 724(a) are limited to liens on property of the estate. *See In re DeMarah*, 62 F.3d at 1252.

In *DeMarah*, we addressed whether a *debtor* could assert a trustee's avoidance and preservation authority against a tax lien on the debtor's exempt property for the *debtor's* own benefit. We affirmed the district court's decision that a debtor could not do so by acknowledging that, *even if* avoidance of a tax lien on exempt property under § 724 in the first instance were permissible, the debtor could not ultimately escape liability for the tax lien on his exempt property because § 522(c)(2)(B) "brings back the whole of any tax lien" on the exempt property. *In re DeMarah*, 62 F.3d at 1252. In so noting, we observed that the outcome—that a debtor may not avoid and preserve a tax lien on exempt property for his own benefit—is the same whether the analysis is based on a finding that the policies behind §§ 724 and 726 prevent avoidance of liens on tax penalties attached to exempt property, or whether the analysis is based on the statutory language of § 522(c) preventing a debtor from avoiding a tax lien penalty. *Id.* We recognized two district court decisions that interpreted § 724(a) differently, but we did not need to decide which interpretation was correct because both confirmed the relevant holding that a debtor could not escape liability for a tax penalty lien. *Id.* (*citing In re Carlton*, 19 B.R. 73, 75 (D.N.M. 1982); *In re Gerulis*, 56 B.R. 283, 287 (Bankr. D. Minn. 1985)).

Because a trustee may not *avoid* a tax lien attached to exempt property through § 724(a), it follows that a trustee is not permitted to *preserve* the tax lien

for the benefit of the estate under § 551. Section 551 provides for automatic preservation of certain avoided liens, including liens avoided under § 724(a). *See In re Van de Kamp's Dutch Bakeries*, 908 F.2d at 519; 11 U.S.C. § 551. But where there is no avoidance under § 724(a), there is no avoided lien for the trustee to preserve.[3]

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[3] Having assumed that the Trustee could use § 724(a) to avoid the tax lien on the Debtor's exempt property, the Bankruptcy Court focused on whether the Trustee could then preserve the value of the avoided lien for the benefit of the estate under § 551. The Bankruptcy Court relied on the Bankruptcy Appellate Panel's decision in *In re Heintz*, 198 B.R. 581, 583 (B.A.P. 9th Cir. 1996) addressing "[w]hether an avoided lien is preserved for the benefit of the estate pursuant to § 551 when the avoided lien encumbers exempt property." The BAP construed § 551's language that an avoided lien "is preserved for the benefit of the estate but only with respect to property of the estate" to apply to property of the estate as defined as what was held by the estate *at the commencement of proceedings*. *Id.* at 585–86. The BAP explained that "the fact that property was removed from the estate after a case is commenced, through exemption or some other means, does not change the fact that it was property of the estate as of the commencement of the case." *Id.* at 585. Therefore, the BAP concluded, "[g]iven that all exempt property is property of the estate as of the commencement of the case, we conclude that § 551 does not exclude exempt property from preservation. An avoided interest or lien encumbering exempt property is automatically preserved for the benefit of the estate under § 551." *Id.* at 586.

The government urges us to declare *Heintz* wrongly decided. The government requests a categorical rule that § 551 *never* applies to exempt property. It is unnecessary for us to decide this issue. As we have already explained, the Bankruptcy Court erred in overlooking the predicate question of whether § 724(a) permits avoidance of tax liens attached to exempt property. Because we hold that § 724(a) does not allow the Trustee to avoid a lien on exempt property, there is no avoided lien to which § 551's

In summary, we conclude that § 724(a) does not permit a trustee to avoid a tax lien secured by exempt property because such securing property is not property of the estate. Accordingly, because a trustee may not use § 724(a) to avoid the lien, the trustee does not trigger operation of § 551's automatic preservation authority.

In reaching our holding, we conclude that the Bankruptcy Court erred by overlooking the key question of first impression before us: whether a trustee may use § 724(a) to avoid a lien secured by a debtor's exempt property. The Bankruptcy Court did not analyze this question. Instead, the Bankruptcy Court appears to have assumed that the Trustee could use § 724(a) to avoid a lien on the Debtor's exempt property.[4]

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preservation power could apply. Thus, § 551 does not apply here and we need not construe the provision.

The dissent errs in stating that the majority relies on § 551 and its reference to "with respect to property of the estate" in determining that the tax penalty lien on exempt property is immune from avoidance. Dissent at 30. Our holding only addresses the predicate question of the application of § 724(a), not the scope of § 551.

[4] The Bankruptcy Court suggested that the IRS tax lien never attached to Debtor's exempt property because the IRS tax lien was simply deducted from the value that Debtor could exempt under Arizona law. This analysis was incorrect for two reasons. First, it fails to properly apply binding *federal* law making clear that an IRS tax lien attaches to all of a debtor's property interests, with no carve-out for exempt property, and that an exemption authorized under the Bankruptcy Code remains liable for tax penalty liens. *See* 26 U.S.C. § 6321; 11 U.S.C. § 522(c)(2)(B); *In re*

Specifically, the Bankruptcy Court noted that in *In re Bolden*, 327 B.R. 657, 665 (Bankr. C. D. Cal. 2005), the "bankruptcy court refused to order the abandonment of debtor's exempt homestead where IRS penalty tax liens could be avoided for the benefit of the bankruptcy estate." But in *Bolden* the government did not dispute that the trustee could avoid a tax penalty lien on exempt property under § 724(a). Indeed, *Bolden* noted that "[i]n this case, the trustee . . . is seeking, *with the cooperation of the IRS*, to avoid the penalty portion of the IRS tax liens in order to benefit unsecured creditors of the estate." 327 B.R. at 663 n.5 (emphasis added). There is no indication in the *Bolden* decision that any party challenged the propriety of the trustee's avoidance of tax penalties on exempt property; the bankruptcy court in *Bolden* was not presented with and, therefore, did not address this question.

Similarly, the Bankruptcy Court cited approvingly to *In re Gill*, 574 B.R. 709 (9th Cir. BAP 2017) for the BAP's rejection of a debtor's request for an order requiring the estate to abandon the debtor's homestead exemption and determination that the trustee could avoid an IRS tax lien under § 724(a) and create

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DeMarah, 62 F.3d at 1251. Second, the Bankruptcy Court misapplied *state* law, as Arizona's homestead exemption statute does not deduct the value of tax liens from the amount that a debtor may exempt. *See* A.R.S. § 33-1101(A)(1). Indeed, the Arizona statute *does* state that a "consensual lien, including a mortgage," "shall not be subject to" the homestead exemption, but makes no such statement as to tax liens. *Id.* § 33-1104(D). Thus, the Bankruptcy Court's suggestion that the IRS tax lien never attached to the Debtor's exempt property is incorrect.

value for the estate by preserving the value of the tax lien through § 551 for the benefit of the estate. But, again, in *Gill* there was no dispute as to the propriety of the trustee's authority to avoid a lien under § 724(a) on exempt property, as there was evidence that the IRS consented to the avoidance, and there is no indication that the debtor challenged the avoidance. *See* 574 B.R. at 717. Thus, because the courts in *Bolden* and *Gill* were not presented with and did not decide the question of whether § 724(a) applies to a debtor's exempt property, the Bankruptcy Court's reliance on those decisions was misplaced.

Our analysis and holding here are consistent with our recent decision in *Hutchinson v. IRS (In re Hutchinson)*, 15 F.4th 1229 (9th Cir. 2021). In *Hutchinson*, the government and the trustee of the estate entered into a stipulated judgment in which the trustee "and the Government agreed that the 'penalty portions' of certain of 'the IRS's liens' against Plaintiffs' [] residence 'are avoided pursuant to 11 U.S.C. § 724(a).'" *Id.* at 1232. The debtors asserted an entitlement to a homestead exemption of up to $100,000 in the residence under California law. *Id.* The debtors did not contest the agreement between the government and the trustee to avoid the IRS's tax penalty lien against the debtor's property, including the exempt property under § 724(a). Rather than contest the legality of the agreement as applied to the exempt property, the debtors sought to take advantage of the § 724(a) avoidance agreement between the government and trustee by seeking to preserve the avoided lien for the benefit of

the *debtors*. *Id.* ("Plaintiffs alleged that, to the extent the liens were avoided, they should be preserved 'for the benefit of the Plaintiffs.' "). The debtors argued that they should be able to parlay the government and trustee's § 724(a) avoidance agreement into assets for themselves by using § 522(i)(2), which allows a debtor to preserve a lien avoided by a trustee under § 724(a) "for the benefit of the *debtor* to the extent that the debtor may exempt such property" under the relevant subsection. *See id.* at 1234 (citing 11 U.S.C. § 522(i)(2)) (emphasis added). The debtors contended that because the government and trustee's § 724(a) avoidance agreement concerned debtors' exempt homestead property interest, the debtors had satisfied the requirements of § 522(i)(2) and were entitled to preserve the avoided lien for the benefit of the debtors. *Id.*

We rejected the debtors' attempt to *preserve* the value of the tax lien for their own benefit, applying our holding in *DeMarah* that § 522(c)(2)(B) "makes quite clear . . . that debtors cannot use exemption authority to escape tax liens." *Id.* at 1235. We further observed that "§ 522(c)(2)(B) would operate, vis-à-vis a debtor, to preserve 'tax lien[s]' against otherwise exempt property *regardless* of whether the trustee had avoided them." *Id.* (emphasis and alteration in the original). Considering the clear and unambiguous language of § 522(c)(2)(B), we explained that "it would be completely contradictory to then construe § 522(i)(2) (or § 522(g), for that matter) as allowing a debtor, after a *trustee* has avoided the tax lien, to then preserve the avoided lien 'for the benefit of the *debtor*' by claiming

an exemption under § 522(g)." *Id.* (emphases in original). "Such a result—having the trustee avoid the lien only to turn over the benefits to the debtor, whose exempt property would then be free of the lien—would create precisely the kind of end-run around § 522(c)(2)(B) that we rejected in *DeMarah*." *Id.* at 1236. We, therefore, rejected the debtors' theory that §§ 522(i)(2) or 522(g) could be used by the debtors to transform a tax lien for which they were responsible into an asset which they could protect for their own benefit. *Id.* ("The only way to read these provisions sensibly together is to conclude that, with respect to a tax lien covered by § 522(c)(2)(B), a debtor may not invoke § 522(i)(2) in order to override § 551's otherwise applicable rule that, after the trustee avoids a lien under § 724(a), the lien 'is preserved for the benefit of the estate.'") (citation omitted).

We do not disturb *Hutchinson*'s careful reasoning and construction of § 522(i)(2). In *Hutchinson*, we accepted the government and the trustee's stipulated agreement that the trustee could avoid the tax lien on debtor's property under § 724(a), including the portion of the property which was exempted under California law. No party objected to the stipulated agreement and no argument was presented to us as to whether the trustee could avoid a lien on debtor's exempt property under § 724(a). Indeed, the debtors accepted the premise that § 724(a) could be used by the trustee to avoid a lien on debtors' exempt property and attempted to transform that premise into an argument that the *debtors* could preserve the avoided lien for the debtors'

benefit. The parties did not present us with the question of whether § 724(a) could be used to avoid a lien on exempt property.

Thus, in *Hutchinson* we were not called upon to resolve any dispute as to the applicability of § 724(a) to the property at issue, and, abiding by the party presentation principle, we had no occasion nor any need to address the question. *See United States v. Sineneng-Smith*, 140 S. Ct. 1575, 1579 (2020) ("As a general rule, our system is designed around the premise that parties represented by competent counsel know what is best for them, and are responsible for advancing the facts and argument entitling them to relief.") (cleaned up). Accordingly, nothing in our decision here conflicts with our analysis or holding in *Hutchinson*.[5] Indeed, *Hutchinson*'s holding that "a debtor may not invoke § 522(i)(2) in order to override § 551's otherwise applicable rule that, after the trustee avoids a lien under § 724(a), the lien 'is preserved for the benefit of the estate,'" 15 F.4th at 1236, applies with full force.

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[5] In *Hutchinson*, having accepted the undisputed fact that the trustee and government entered an uncontested stipulated judgment through which the trustee avoided the tax penalty liens on the property at issue under § 724(a), we referenced *Heintz* for the notion that § 551 operated to preserve those liens avoided by stipulation for the benefit of the estate. 15 F.4th at 1234. As noted previously, we do not address *Heintz*'s interpretation of § 551 here.

B. APPLICATION

We conclude that the Trustee may not use § 724(a) to avoid the $26,771 IRS tax penalty lien on the Debtor's exempt interest in the Prescott Property and, accordingly, cannot preserve the value of the tax penalty lien for the benefit of the estate through § 551. Once the Bankruptcy Court allowed the Debtor's homestead exemption under Arizona law, the Debtor withdrew her exempted property interest from the property of the estate. Therefore, the Debtor's exempt homestead interest in the Prescott Property is no longer property of the estate and, therefore, is not property to which § 724(a) applies.

Accordingly, the Debtor is entitled to exempt up to the full $150,000 value of the homestead exemption interest permitted under the applicable version of Arizona's exemption law, A.R.S. § 33-1101(A)(1) (2004 version, effective prior to Jan. 1, 2022), after accounting for the Debtor's responsibility for her consensual loan, the Bank of America mortgage, *id.* § 33-1104(D). The value of the Debtor's homestead exemption is *not* subject to a deduction of the IRS tax penalty lien. However, as compelled by our holding in *DeMarah*, the Debtor takes her exempt interest in the Prescott Property subject to the IRS tax penalty lien. *See* 62 F.3d at 1252 ("We hold that Congress has denied debtors the right to remove tax liens from their otherwise exempt property. *See* 11 U.S.C. § 522(c)(2)(B). Moreover, we hold that even the penalty portion of the tax lien remains fixed on that property. We see nothing capricious or absurd about that. It simply adds to the taxpayer's

incentive to render unto the government that which is its due.").

Moreover, the Bankruptcy Court's holding that permits the Trustee to avoid the IRS's tax lien on the exempt property and to apply the value of the lien for the benefit of the bankruptcy estate, while the exempt homestead of the Debtor remains encumbered by the tax lien, creates a troubling result: the Debtor is burdened twice by the same debt, resulting in a double penalty. The first penalty flows from the Bankruptcy Court's holding that the Trustee's avoidance and preservation of the tax lien on the Debtor's exempt property reduced the value of the exemption by the amount of the tax lien. The second penalty flows from the operation of 11 U.S.C. § 522(c)(2)(B) and our binding precedent that a tax lien remains attached to property which is exempted. *See In re DeMarah*, 62 F.3d at 1251 ("[I]t is pellucid that property exempted from the estate remains subject to tax liens."). In effect, the Debtor is required to pay twice on the same tax lien: first, in the reduction of value in her homestead exemption by the value of the lien (here amounting to $26,771), and then, a second time, when she is required to pay off the lien that survives and remains attached to her already reduced exempt property (for another $26,771).[6] That makes her worse off, with regard to the

[6] The Bankruptcy Court purported to resolve this double penalty by concluding the "tax lien position against the [Prescott] Property never attached to the Debtor's homestead exemption," such that "[w]hen the lien is avoided, the Trustee steps into that avoided position." The Bankruptcy Court held that the Trustee's avoidance and preservation of the tax lien extinguished the tax

tax lien debt, than she was before she filed the bankruptcy petition.

This result cannot be what is intended by the Bankruptcy Code, which is aimed at giving the debtor a "fresh start," subject to the decision of Congress to maintain a debtor's responsibility for a tax lien. *See In re DeMarah*, 62 F.3d at 1252 ("11 U.S.C. § 522 allows debtors to exempt stated property from the bankrupt estate so that they may have a fresh start. It also provides for the survival of tax liens on that property. 11 U.S.C. § 522(c)(2)(B). In defining fresh start, Congress took cognizance of the fact that tax liens would survive.") (quoting *In re Isom*, 901 F.2d 744, 746 (9th Cir. 1990)).

That fresh start would hardly be served by doubling the burden of the previously existing tax lien on the debtor. We are not aware of any policy rationale articulated by Congress, nor endorsed in any of our previous decisions, that supports the view that a debtor should pay *twice* on a tax penalty lien. Our holding provides that the Debtor will be subject to the IRS tax lien once—as a surviving lien on her homestead exemption. It thus vindicates the debtor's homestead exemption under Arizona law, which reduces the value available to exempt by the value of a mortgage, but not by the

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lien. This conclusion, however, conflicts with § 522(c)(2)(B) and our binding authority holding that a tax lien remains attached to exempt property. *See In re DeMarah*, 62 F.3d at 1251. Therefore, the Bankruptcy Court did not resolve the double penalty. *See infra* § III(A)(2).

value of an IRS tax lien. *See* A.R.S. §§ 33-1101(A)(1), 33-1104(D).

It seems highly unlikely to us that our dissenting colleague's bankruptcy professor would countenance an interpretation of bankruptcy law that imposed a double penalty on the debtor. *See* Dissent at 27. That the dissent's interpretation of the statute produces such a perverse result provides powerful reason to reject that interpretation.

At the same time, our holding does not disturb the application of § 724(a) to *non-exempt* property of the estate and is consistent with our recognition that "'Congress could logically have wanted to allow tax penalties to be avoided if that would benefit unsecured creditors,' while 'eschew[ing] benefiting debtors who incurred those penalties by failing to pay their taxes.'" *In re Hutchinson*, 15 F.4th at 1233 (quoting *In re DeMarah*, 62 F.3d at 1252). Indeed, we do not quibble with the dissent's assertion that "the asset remains estate property" when a statute "does not allow the debtor to exempt the entire property interest, but instead permits exemption of an interest in the property up to a particular dollar amount." Dissent at 33 (citing *In re Mwangi*, 764 F.3d at 1172–73). But while the trustee may certainly avoid the tax lien on non-exempt property that remains in the estate, the circumstances of this case—specifically, the fact that the mortgage on the Prescott Property renders any lien on the estate's portion of the property valueless—demarcate our holding to only the application of § 724(a) to exempt property.

IV. CONCLUSION

The Trustee may not use 11 U.S.C. § 724(a) to avoid the $26,771 IRS tax penalty lien on the Debtor's exempt interest in the Prescott Property and, therefore, cannot preserve the value of the tax penalty lien for the benefit of the estate through § 551. Accordingly, the Debtor is entitled to exempt up to the full value of the homestead exemption interest permitted under the applicable version of Arizona's exemption law, after accounting for the Debtor's responsibility for her mortgage. A.R.S. §§ 33-1101(A)(1), 33-1104(D). The value of the Debtor's homestead exemption is not subject to a deduction of the IRS tax penalty lien. However, the Debtor takes her exempt interest in the Prescott Property subject to the IRS tax penalty lien.

REVERSED and REMANDED to the District Court with instructions for further proceedings consistent with this order.

BUMATAY, Circuit Judge, dissenting:

As my bankruptcy professor once said, a bankruptcy case is like dividing a pie. *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 785 (1987). The pie owner promises different slices of the pie to others—sometimes in exchange for other items, sometimes as a payment for other debts. And sometimes, the pie owner overpromises—leaving not enough pie to go around. All those promised pie must then get in line and try to claim their piece. In bankruptcy, a trustee

steps in and distributes the slices in the order of priority set by law and approved by a bankruptcy judge.

The Bankruptcy Code also grants a trustee a special authority. It allows the trustee to "avoid" a federal tax penalty lien and "preserve" the lien for the benefit of the bankruptcy estate. *See* 11 U.S.C. §§ 724(a), 726, 551. That means, in divvying up the pie, the trustee may save the piece belonging to the IRS for a debtor's failure to pay taxes and hold it for others in line. This increases the amount of pie for distribution to others.

In this case, the IRS challenges the trustee's express avoidance authority. The IRS contends that a trustee can't avoid a federal tax lien on "exempt" property. Exempt property is generally the piece of the pie that a debtor gets to keep throughout the bankruptcy. But the Bankruptcy Code creates no exception to the trustee's avoidance power for liens on exempt property. So we should have affirmed the trustee's avoidance of the IRS tax penalty lien here.

In invalidating the trustee's avoidance authority, the majority is more concerned with the Bankruptcy Code's "troubling result" than its text. Maj. Op. at 24. It lets concerns over the consequences of avoidance override the statutory text and it nullifies the trustee's avoidance power to prevent these consequences. But because our duty is to follow the text of the Bankruptcy Code no matter how the pie gets sliced, I respectfully dissent.

I.

"The plain text of the Bankruptcy Code begins and ends our analysis." *Puerto Rico v. Franklin Cal. Tax-Free Tr.*, 579 U.S. 115, 125,(2016). The Bankruptcy Code is straightforward; by its ordinary meaning, a trustee may avoid an IRS tax penalty lien and preserve it for the benefit of the bankruptcy estate. *See* 11 U.S.C. §§ 724(a), 726, 551. Our precedent confirms that. *See Hutchinson v. United States* (*In re Hutchinson*), 15 F.4th 1229, 1234 (9th Cir. 2021). And nothing in the Code sets aside the trustee's avoidance authority just because the tax penalty lien attaches to exempt property.

A.

Under the Bankruptcy Code, a trustee may avoid a federal tax penalty lien in distributing the property of the estate. Section 724 of the Code provides that "[t]he trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title." 11 U.S.C. § 724. In this context, "avoid[ance]" means that the trustee may take the slice of pie reserved for a specific lienholder and distribute it to others in line. *See Retail Clerks Welfare Tr. v. McCarty* (*In re Van de Kamp's Dutch Bakeries*), 908 F.2d 517, 519 (9th Cir. 1990) (explaining the "well-established principle that a trustee who avoids an interest succeeds to the priority that interest enjoyed over competing interests"). Avoidance increases the property of the estate available to satisfy claims of unsecured creditors. *See id.* In

other words, instead of a lienholder being at the front of the line, the holder must wait for a share like everyone else, which increases the amount of pie for others.

The Code then specifies the types of claims a trustee may avoid. The trustee's avoidance power applies to:

> [A]ny allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim[.]

11 U.S.C. § 726(a)(4). In short, a trustee has the authority to avoid any claim for non-compensatory penalties, including a federal tax penalty lien. *See Hutchinson*, 15 F.4th at 1232 (By stipulation, "the Government agreed that the 'penalty portions' of certain of 'the IRS's liens' against . . . [the] residence 'are avoided pursuant to 11 U.S.C. § 724(a).'"); *Gill v. Kirresh* (*In re Gill*), 574 B.R. 709, 716 (9th Cir. BAP 2017) ("Taken together, §§ 724(a) and 726(a)(4) allow a chapter 7 trustee . . . to avoid a lien to the extent the lien secures the claim for a penalty, including a tax penalty.").

Next, when a trustee avoids a transfer, the transfer is automatically preserved for the benefit of the estate. That's because under § 551 of the Code "[a]ny transfer avoided under section . . . 724(a) . . . is preserved for the benefit of the estate but only with respect to

property of the estate." 11 U.S.C. § 551. So when a trustee avoids the penalty portions of the tax liens under § 724(a), "it follows that, under the plain language of § 551, those liens are preserved for the benefit of the estate." *Hutchinson*, 15 F.4th at 1234. Doing so expands the pie available for unsecured creditors. As we've said, "Congress created avoidances of noncompensatory penalties to protect unsecured creditors from the debtor's wrongdoing." *DeMarah v. United States* (*In re DeMarah*), 62 F.3d 1248, 1252 (9th Cir. 1995) (simplified). Avoiding the tax penalty and preserving it for the estate "benefit[s] unsecured creditors" by allowing the amount on the penalty to go to them instead of the IRS. *Id.*

So as a straightforward matter of text and precedent, the answer here is simple: a trustee may avoid a federal tax lien and preserve it for the benefit of the estate. We've already endorsed this view in *Hutchinson*, where we clearly stated: "a trustee is 'expressly authorized . . . to avoid, subordinate and preserve the penalty portion of the IRS's tax lien for the benefit of the estate's unsecured creditors.'" *Id.* at 1233 (quoting *Gill*, 574 B.R. at 716).

Here, the bankruptcy court and the district court both concluded that the trustee was permitted to avoid the IRS penalty lien on Sandra Tillman's house and preserve its value for Tillman's bankruptcy estate. Based on the above authorities, we should have easily affirmed here. And as discussed below, it makes no difference that a portion of the value of Tillman's house was exempt property.

B.

Contrary to the IRS and majority's view, the trustee's authority to avoid a federal tax penalty lien isn't nullified because it encumbers exempt property. The majority incorporates § 726's reference to the distribution of the "property of the estate" to bar a trustee's avoidance authority. The IRS instead relies on § 551's limitation of preservation of liens "only with respect to property of the estate." In both cases, they insist that "exempt property" isn't "property of the estate" and so a trustee can't avoid a lien on exempt property. In the majority's view, estate property "evolve[s] over the course of bankruptcy proceedings" and a lien on exempt property somehow disappears from such property. Maj. Op. 10. No matter the supposed statutory basis for curbing a trustee's avoidance power, because a tax penalty lien on exempt property is undoubtedly "property of the estate," the IRS and majority's view is incorrect.

To understand why the majority's "evolution" idea is mistaken, some background in bankruptcy is necessary. The Supreme Court has helpfully summarized where exempt property falls into the bankruptcy scheme:

> Chapter 7 of the Bankruptcy Code gives an insolvent debtor the opportunity to discharge his debts by liquidating his assets to pay his creditors. 11 U.S.C. §§ 704(a)(1), 726, 727. The filing of a bankruptcy petition under Chapter 7 creates a bankruptcy "estate" generally comprising all of the debtor's property. § 541(a)(1).

> The estate is placed under the control of a trustee, who is responsible for managing liquidation of the estate's assets and distribution of the proceeds. § 704(a)(1). The Code authorizes the debtor to "exempt," however, certain kinds of property from the estate, enabling him to retain those assets post-bankruptcy. § 522(b)(1). Except in particular situations specified in the Code, exempt property "is not liable" for the payment of "any [prepetition] debt" or "any administrative expense." § 522(c), (k).

Law v. Siegel, 571 U.S. 415, 417–18 (2014). In other words, with some statutory exceptions, exempt property is "immunized against liability for prebankruptcy debts." *Owen v. Owen*, 500 U.S. 305, 308 (1991). Thus, the Court only describes exempt property as protected from prepetition debts, but not wholly removed from the bankruptcy estate.

The Code specifies what property is exempted and even allows States to set their own criteria for exemptions. 11 U.S.C. § 522(b)(3)(A), (d). Many States have set a "homestead exemption" that is more generous than under federal law. *Law*, 571 U.S. at 418. At the time of this case, Arizona permitted a person to keep "interest in real property . . . in which the person resides," up to $150,000 in value, subject to any "recorded consensual lien," such as a mortgage. Ariz. Rev. Stat. §§ 33-1101(A)(1), 33-1105(D) (2004). Thus, up to $150,000 in equity from an Arizona home is generally immune from prepetition debts.

The question then is whether a tax penalty lien on exempt property constitutes "property of the estate." The answer is easily yes. The Code defines "property of the estate," in relevant part, as consisting of "all legal or equitable interests of the debtor in property *as of the commencement of the case*." 11 U.S.C. § 541(a)(1) (emphasis added). Defining the property of the estate in this way creates a "sharp cleavage between the prepetition and postpetition worlds with regard to estate property." Charles Jordan Tabb, Law of Bankruptcy 404 (5th ed. 2020). The Code "takes a snapshot of the debtor's assets at the moment of filing, bringing all of those assets into the estate," and then "settles the debtor's financipal affairs, assets and liabilities alike, as of th[at] time." *Id.*

Under the straightforward language of § 541(a)(1), "property of the estate" includes all property at the filing of the bankruptcy petition, including what's later claimed exempt. As the Court has clearly stated, "[a]n estate in bankruptcy consists of all the interest in property, legal and equitable, possessed by the debtor *at the time of filing*, as well as those interests recovered or recoverable through transfer and lien avoidance provisions." *Owen*, 500 U.S. at 308 (emphasis added). So exempt property and its encumbrances must be "property of the estate"; after all, "[n]o property can be exempted (and thereby immunized) . . . unless it first falls *within* the bankruptcy estate." *Id.* at 308 (simplified). Thus, it is well-settled that "[a]ll of the debtor's property[] as . . . defined in section 541 of the Bankruptcy Code, as of the commencement of a case . . . ,

including property which may be claimed as exempt, becomes property of the estate." 4 Collier Bankruptcy Practice Guide ¶ 74.02[1] (1st ed. 2022).

It is a misconception to think that a lien on exempt homestead property is immediately removed from the bankruptcy estate. Rather,

> [I]f the statute permitting the debtor to claim a particular exemption does not allow the debtor to exempt the entire property interest, but instead permits exemption of an interest in the property up to a particular dollar amount, ... [then] the asset remains estate property, and the estate does not relinquish the property until it is administered in the bankruptcy, the trustee abandons the property, or the bankruptcy case is closed.

Mwangi v. Wells Fargo, N.A. (*In re Mwangi*), 764 F.3d 1168, 1172–73 (9th Cir. 2014) (simplified). This case provides a good example of why this so. The IRS tax penalty lien is on *all of* Tillman's house. In contrast, Arizona law only allows Tillman to exempt a *portion* of the value of the house. Thus, in no way does the homestead exemption remove the entirety of Tillman's house or its lien from the bankruptcy estate. The lien on the house always remains part of the bankruptcy estate even if a specific dollar amount of the house's value is protected from pre-petition debts. So there's no reason to treat the lien on the exempt property as removed from the bankruptcy estate for § 551 purposes.

This too makes intuitive sense with the pie analogy. Exempt property generally means that a debtor

gets to keep a small piece of the pie even after the pie is divvied up among the creditors—no matter what. The pie is "set" at the time of the bankruptcy filing. And when a slice of the pie is saved for the debtor, that piece remains *within* the pie until distribution. Contrary to the majority's view then, the size of the pie does not "evolve" during the bankruptcy proceedings based on exempt property. *See* Maj. Op. 10. Rather, exempt property only tells us what assets a debtor may "retain . . . post-bankruptcy," *Law*, 571 U.S. at 417, or which slice of pie is left for the debtor at the end of bankruptcy proceedings.

Moreover, even under the majority's "evolving" bankruptcy estate thesis, the majority doesn't explain why a lien on both *exempt* and *non-exempt* property, like the tax lien on Tillman's residence, falls out of the bankruptcy estate. If any part of Tillman's house remains non-exempt estate property, then any lien on the house necessarily remains estate property. So, under any theory of bankruptcy law, the IRS tax lien here is property of the estate.

Thus, a trustee retains authority to avoid and preserve a tax penalty lien, even when it attaches to exempt property. As we've recently acknowledged, "regardless of whether the debtor claims an exemption, any interest of the debtor in property at the commencement of the bankruptcy case is 'property of the estate' as that phrase is used in § 551." *Hutchinson*, 15 F.4th at 1234 (referencing the holding of *Heintz v. Carey* (*In re Heintz*), 198 B.R. 581, 585–86 (9th Cir. BAP 1996)).

Indeed, it is hard to square the majority's holding with *Hutchinson*. *Hutchinson* assumed—over and over—the trustee's authority to avoid and preserve a tax penalty lien on exempt property. While explaining why a *debtor* could not avoid a properly filed tax penalty lien, *Hutchinson* repeatedly contrasted the case with the *trustee*'s ability to avoid the lien under § 724(a). *See*, *e.g.*, *Hutchinson*, 15 F.4th at 1233 ("We acknowledged in *DeMarah* that this reading of the code could lead to a disparity in which *trustees* might be able to avoid such liens under § 724(a), while debtors cannot.") (simplified); *id.* at 1234 ("Under our binding decision in *DeMarah*, Plaintiffs cannot invoke § 522(h) to avoid a properly filed tax lien, *even if that lien would be avoidable by the trustee under § 724(a).*") (emphasis added). Even though the trustee's avoidance power wasn't the precise issue in *Hutchinson*, "[w]ell-reasoned dicta is the law of the circuit." *Li v. Holder*, 738 F.3d 1160, 1164 n.2 (9th Cir. 2013) (simplified).

The majority justifies the departure from precedent and statutory text based on the fear of a so-called "double penalty." *See* Maj. Op. 23–26. The majority contends that allowing the trustee to avoid the penalty lien here would lead to the "troubling result" of penalizing Tillman twice. *Id.* at 24. That's because the bankruptcy judge reduced her homestead exemption by the amount of the lien even though the IRS may still seek the value of the lien from her after bankruptcy.[7]

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[7] The Code appears to permit a tax lien on a debtor's exempt property to remain post-bankruptcy, which means that IRS may still collect on the penalty. *See* 11 U.S.C. § 522(c)(2)(B). But I take

But even if the trustee's tax penalty avoidance here creates a "double penalty," we cannot circumvent the plain text of the Bankruptcy Code or our precedent to avoid those concerns. This is an issue for Congress—not for us—to resolve.

II.

Because the Code and our caselaw require affirming here, I respectfully dissent.

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no position on whether the bankruptcy court was correct to deduct the amount of the tax penalty lien from Tillman's homestead exemption. That question is immaterial to the question before us, which is whether the trustee is permitted to avoid the tax lien in the first place.

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ARIZONA

United States of America, Appellant, v. Lawrence J. Warfield, et al., Appellees.	No. CV-20-08204-PCT-DWL **ORDER** (Filed Apr. 19, 2021)

INTRODUCTION

In 2015, Sandra J. Tillman ("Debtor") purchased a house valued at $475,000 in Prescott, Arizona. Bank of America ("BofA") and the Internal Revenue Service ("IRS") held secured claims on the house arising from, respectively, a mortgage and a pre-bankruptcy tax penalty lien.

In 2019, Debtor filed a petition for Chapter 7 bankruptcy and claimed a $150,000 homestead exemption in the house under Arizona law. The Trustee instituted an adversary proceeding to avoid the IRS's tax lien and preserve the lien for the benefit of the bankruptcy estate. The government and Debtor objected, arguing that the Trustee could not avoid the lien or, in the alternative, that the avoided lien could not be preserved for the benefit of the estate and, instead, should fall within Debtor's homestead exemption and be preserved for her benefit. The Trustee filed a motion for

summary judgment, which the government and Debtor opposed. The bankruptcy court, after allowing supplemental briefing and holding oral argument, issued a detailed order granting summary judgment to the Trustee.

The government now seeks review of the bankruptcy court's order. For reasons explained below, that order is affirmed.

BACKGROUND ON BANKRUPTCY CODE PROVISIONS

I. Exemptions

"An estate in bankruptcy consists of all the interests in property, legal and equitable, possessed by the debtor at the time of filing, as well as those interests recovered or recoverable through transfer and lien avoidance provisions." *Owen v. Owen*, 500 U.S. 305, 308 (1991), *superseded by statute on other grounds as recognized in In re Ehlen*, 202 B.R. 742, 744-45 (Bankr. W.D. Wis. 1996). *See also* 11 U.S.C. § 541. In some circumstances, however, a debtor may exempt property, which serves to remove it from the bankruptcy estate. *In re Heintz*, 198 B.R. 581, 585 (9th Cir. BAP 1996). In other words, the debtor generally retains exempt property, and it cannot be used to satisfy the claims of unsecured creditors in the bankruptcy proceeding. *Owen*, 500 U.S. at 308 ("An exemption is an interest withdrawn from the estate (and hence from the creditors) for the benefit of the debtor."); *Heintz*, 198 B.R. at 585 ("Once property is exempted, its status as property of

the estate is terminated and the property is ultimately revested in the debtor."). "The federal exemptions in the Bankruptcy Code were enacted to ensure that a debtor coming out of the bankruptcy process retains sufficient possessions to obtain a fresh start." *In re Butcher*, 189 B.R. 357, 369 (D. Md. 1995). *See also Matter of Hahn*, 5 B.R. 242, 244 (Bankr. S.D. Iowa 1980) (the "basic purposes for exemption laws" are to "provide a debtor enough money to survive," to "protect his dignity and his cultural and religious identity," to "afford a means of financial rehabilitation," to "protect the family unit from impoverishment," and to "spread the burden of the debtor's support from society to his creditors").

Although § 522 of the Bankruptcy Code enumerates the exemptions available to a debtor in bankruptcy, § 522(b)(1) authorizes state legislatures to "opt out" of the § 522 exemption scheme and provide their own exemption schemes. "If a State opts out, then its debtors are limited to the exemptions provided by state law." *Owen*, 500 U.S. at 308. Arizona, like many other states, has opted out of the § 522 exemptions and provides its own to Arizona residents. A.R.S. § 33-1133(B). Among other things, Arizona provides a homestead exemption that permits a resident to exempt her "interest in real property . . . in which [she] resides," up to $150,000 "in value." *Id.* § 33-1101(A)(1).

Section 522 also "places limitations on a debtor's ability to shield exempted property from liability for prepetition tax debts." *In re Wright*, 156 B.R. 549, 554 (N.D. Ill. 1992). For example, "exempted property remains

liable for certain nondischargeable pre-petition tax debts." *Id.* A "properly filed tax lien is unavoidable in bankruptcy; exempted property on which the IRS has properly filed a tax lien remains liable for any debt secured by that lien." *Id.* (collecting cases). *See also* 11 U.S.C. § 522(c)(2)(B) ("[P]roperty exempted under this section is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case, except . . . a debt secured by a lien that is . . . a tax lien, notice of which is properly filed.").

II. Avoidance

Under § 724(a) of the Bankruptcy Code, a trustee may "avoid" a "lien that secures a claim of a kind specified in section 726(a)(4)," such as a lien for pre-petition tax penalties.[1] When a trustee avoids a lien, it is essentially transformed into an unsecured claim, which maintains a lower priority in the distribution of bankruptcy estate assets. *See*, *e.g.*, *In re Gill*, 574 B.R. 709, 717 (9th Cir. BAP 2017) ("[I]t is clear by operation of §§ 724(a) and 726(a)(4) that a penalty which is secured by a tax lien is automatically demoted in a chapter 7

[1] Section 726(a)(4) concerns, among other things, "payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture." A lien for pre-petition tax penalties appears to fall within the bounds of § 726(a)(4). *See*, *e.g.*, *In re Hutchinson*, 579 B.R. 860, 862 (Bankr. E.D. Cal. 2018) ("Section 726(a)(4) encompasses a broad spectrum of fines, penalties, and forfeitures, including tax penalties."); 6 Collier on Bankruptcy ¶726.02[4] (16th ed. 2012) ("[S]ection 726(a)(4) includes prepetition tax penalties if they are not compensation for actual pecuniary loss.").

case from the highest priority to the lowest priority, payable only after general unsecured creditors are paid in full."); 6 Collier on Bankruptcy ¶ 724.02[6] ("In enacting section 724(a), . . . Congress made a policy determination that payment of claims for penalties or punitive damages should be subordinated to payment of general unsecured claims.").

III. Preservation

Under § 551 of the Bankruptcy Code, "[a]ny transfer avoided under section 522 . . . or 724(a) . . . is preserved for the benefit of the estate but only with respect to property of the estate."[2] In essence, this permits the trustee to recover the value of the avoided claim and use it to "increase the assets of the estate for distribution to creditors." *Heintz*, 198 B.R. at 585. *See also* 11 U.S.C. § 541(a)(4) ("[The bankruptcy] estate is comprised of . . . [a]ny interest in property preserved for the benefit of . . . the estate under section . . . 551. . . ."). Section 551 "serves as a 'follow-up' provision explaining how assets and property avoided under other Code provisions should be handled." *Jurista v. Amerinox Processing, Inc.*, 492 B.R. 707, 774 (D.N.J. 2013).

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[2] The term "transfer" includes the "creation of a lien." 11 U.S.C. § 101(54). *See also In re Haberman*, 516 F.3d 1207, 1210 & n.4 (10th Cir. 2008) (classifying liens as a subset of transfers); 5 Collier ¶ 551.02[1] ("Section 551 preserves only 'transfers' and 'liens.' ").

"Once a trustee recovers an asset for the estate through one of the transfer or lien avoidance provisions, § 551 automatically preserves the asset for the estate." *Heintz*, 198 B.R. at 584. *See also In re Trible*, 290 B.R. 838, 844 (Bankr. D. Kan. 2003) ("As this Court reads § 551, upon avoidance of [the] lien . . . , the lien is *automatically* preserved for the benefit of the estate."). "The rationale behind the automatic preservation rule for transfers and liens avoided by a trustee in bankruptcy is that the estate should benefit from each avoidance rather than promoting the priority of unavoidable junior secured interests who would otherwise improve their positions at the expense of the estate." *Matter of DeLancey*, 94 B.R. 311, 313 (Bankr. S.D.N.Y. 1988). In other words, when a trustee avoids a lien, preservation allows the trustee to occupy the priority of the avoided lien and use that priority to distribute estate assets to unsecured creditors. *In re Haberman*, 516 F.3d 1207, 1210 (10th Cir. 2008) ("[T]he trustee, on behalf of the entire bankruptcy estate, in some sense steps into the shoes of the former lienholder, with the same rights in the collateralized property that the original lienholder enjoyed. Likewise, the trustee, on behalf of the entire estate, assumes the original lienholder's position in the line of secured creditors; in this way, Congress sought to assure that the avoidance of a lien doesn't simply benefit junior lienholders who would otherwise gain an improved security position and might, when the estate is limited, prove the only beneficiaries of the trustee's actions."). Without preservation, junior lienholders would jump in priority, be able to obtain a greater share of the estate, and leave

less available for distribution to unsecured creditors. *In re Seibold*, 351 B.R. 741, 746 (Bankr. D. Idaho 2006) ("[Section 551] operates to preserve an avoided lien for the benefit of the bankruptcy estate so as to permit the trustee to step into the position of the creditor whose lien has been avoided, thereby preventing a junior lien holder (or a debtor) from improving its position at the expenses of a debtor's unsecured creditors.").

BACKGROUND

I. Factual Background And Bankruptcy Proceedings

On June 30, 2015, Debtor purchased a house located at 154 W. Soaring Ave. in Prescott, Arizona (the "Property") valued at $475,000. (Doc. 11-3 at 23.)

In February 2018, the IRS assessed penalties against Debtor for failing to timely file her 2015 tax return—despite having received a six-month extension to do so—and for not sufficiently pre-paying her tax liabilities through withholdings or deposits. (Doc. 11-5 at 24-25.) The initial penalties totaled over $18,000. (*Id.* at 25.)

On December 24, 2018, the IRS recorded a notice of federal tax lien against Debtor and the Property (the "Tax Lien"). (*Id.*)

On January 30, 2019, Debtor filed a voluntary petition for Chapter 7 bankruptcy. (Doc. 11-3 at 23.) In her petition, Debtor disclosed the IRS's claim on the

Property and claimed a $150,000 exemption in the Property. (*Id.* at 23-24.)

On February 27, 2019, Debtor filed a motion to compel abandonment of the Property. (*Id.* at 24.)[3] Debtor argued that "there was no equity in the Property above her homestead exemption." (*Id.*)

On April 19, 2019, the Trustee filed an objection to Debtor's claimed exemptions. (*Id.*) The bankruptcy court later denied this objection, allowing Debtor's homestead exemption in the Property and "clarifying that the homestead exemption is subordinate to BofA's mortgage lien and the Tax Lien." (*Id.*)

On July 3, 2019, the Trustee moved to list and sell the Property. (*Id.*) Debtor objected. (*Id.*) The bankruptcy court "held a preliminary hearing at which time [it] encouraged the parties to continue (or revitalize) settlement discussions." (*Id.*)

On December 27, 2019, BofA moved for relief from the automatic stay so it could foreclose its lien on the Property. (*Id.*) The Trustee objected because his motion to sell the Property was still pending, and Debtor objected because she "claimed to be current on her

[3] When estate property is abandoned, the property is removed from the estate and taken by one having interest in the property, such as the debtor or a secured creditor. The purpose of abandonment is to allow the trustee to remove property from the estate that is "burdensome to the estate or that is of inconsequential value and benefit to the estate." 11 U.S.C. § 554(a).

payments and . . . BofA's interests were adequately protected." (*Id.* at 24-25.)

On February 21, 2020, the Trustee instituted an adversary proceeding in which he sought a "declaration that the Trustee can avoid the Tax Lien under § 724(a) and that the value of the avoided Tax Lien is preserved for the benefit of the estate." (*Id.*) The IRS answered the complaint and "disput[ed] Trustee's ability to avoid the Tax Lien for the benefit of the estate." (*Id.*) Debtor intervened and answered the complaint, arguing that "her allowed homestead exemption remove[d] the Property from [the] bankruptcy estate and any recovery from the avoided Tax Lien belong[ed] to" her. (*Id.*)

On March 26, 2020, the Trustee again moved for the bankruptcy court's approval to sell the Property, to which the IRS objected. (*Id.*) On April 7, 2020, the bankruptcy court held a hearing, during which the "parties advised the [bankruptcy court] that there was no pending buyer." (*Id.*)

On April 10, 2020, the Trustee filed a motion for summary judgment, to which the IRS and Debtor filed responses and the Trustee filed a reply. (*Id.* at 25-26.) The bankruptcy court later authorized the submission of a sur-reply and sur-sur-reply. (*Id.* at 26.)

On July 9, 2020, Debtor filed a motion for the bankruptcy court to approve a sale of the Property. (Doc. 11-10 at 1-4.)

On July 17, 2020, the bankruptcy court issued its order granting summary judgment to the Trustee. (Doc. 11-3.)

On July 22, 2020, the bankruptcy court held a hearing on the sale motion (Doc. 1 1- 12) and approved the sale the next day (Doc. 11-9 at 1-4).

The Property sold for $475,000, and $26,771 was set aside for the current balance on the Tax Lien. (Doc. 11-8 at 13, 15.)

II. The Bankruptcy Court's Decision

As noted, the bankruptcy court issued an order granting summary judgment to the Trustee. (Doc. 11-3.) The court addressed the following issues: (1) whether the Trustee could "avoid the Tax Lien under § 724(a) and preserve the value of the avoided Tax Lien for the benefit of the bankruptcy estate under § 551"; (2) if so, whether Debtor could "claim the avoided Tax Lien as exempt pursuant to § 522(g)"; and (3) whether the IRS could "satisfy its unsecured (but possibly nondischargeable) claim from the exemption proceeds from the sale of the Debtor's homestead." (*Id.* at 26.)[4]

[4] The bankruptcy court did not address the third issue in its order, stating that the issue was not ripe because there were "no sale proceeds yet available for seizure by the IRS." (Doc. 11-3 at 38.)

A. **Avoidance And Preservation Of The Tax Lien**

The bankruptcy court began by noting that the IRS "holds a secured claim of the kind specified in § 726(a)(4)," *i.e.*, payment for a pre-petition penalty. (*Id.* at 28.) Debtor and the IRS argued that, because Debtor claimed an exemption in the Property, the Property was "removed from the bankruptcy estate" and the Trustee thus could not preserve the avoided Tax Lien under § 551, as § 551 permits a trustee to preserve an avoided lien "only with respect to property of the estate." (*Id.*) The bankruptcy court disagreed, concluding that a "debtor cannot exempt [an] asset in its entirety from the estate" because a debtor's exemption—including a homestead exemption—only removes the debtor's interest in the asset up to the permitted value. (*Id.* at 28-29.)

The bankruptcy court then discussed *In re Heintz*, 198 B.R. 581 (9th Cir. BAP 1996), in which the BAP held that a judgment lien avoided by the trustee was preserved for the benefit of the estate, notwithstanding that the debtor had exempted the property that was the subject of the lien. (*Id.* at 29.) Although *Heintz* did not end the bankruptcy court's analysis,[5] the court concluded that *Heintz* "tell[s] us that property cannot be exempted from a bankruptcy estate unless it is first property of the estate." (*Id.*) Accordingly, because "the Property was property of this estate at the

[5] Among other things, the bankruptcy court noted that *Heintz* "did not address the interplay between § 551" and portions of § 522. (*Id.* at 29 n.46.)

commencement of Debtor's bankruptcy case . . . § 551 applie[d] to the Trustee's efforts to avoid the IRS's Tax Lien." (*Id.* at 30.)

The bankruptcy court also noted that there was "another reason why the Property [was] property of [the] bankruptcy estate for § 551 purposes, even after the Court allowed the Debtor's exemption on the Property." (*Id.*) The court interpreted Arizona's homestead exemption, A.R.S. § 33-1101(A), to exempt "only the Debtor's *interest* in the Property and then only to the extent of the *value* of that interest, up to $150,000." (*Id.*) But the value of Debtor's exemption "at all times[] was no greater than the value of the Property, less the voluntary BofA lien granted by the Debtor against the Property and less the involuntary lien held by the IRS." (*Id.*) In other words, Debtor's exemptible interest in the Property did "not include the value of the Property which [was] encumbered by BofA's lien" and, because tax liens are effective against even exempt property, Debtor's exemptible interest in the Property also did not include the value of the Property which was encumbered by the Tax Lien. (*Id.* at 31-32.) Debtor's exemption was therefore "third in line, behind BofA's 1st lien and the 2nd position occupied by the IRS's Tax Lien." (*Id.* at 32.) Given this backdrop, the bankruptcy court concluded that the Trustee could avoid the Tax Lien under § 724(a). (*Id.* at 32-33.)

B. **Debtor's Exemption**

The next question before the bankruptcy court was "whether the avoided IRS Tax Lien is preserved for the benefit of the estate or the Debtor and what rights [were] held by the IRS after its Tax Lien was avoided." (*Id.* at 33.) The bankruptcy court noted that, under § 522(g), a debtor may exempt property recovered by the trustee under § 551 "so long as the debtor did not conceal the property" and the lien was "not voluntarily created by the debtor." (*Id.*) The bankruptcy court acknowledged that both conditions seemed to be satisfied here, as Debtor neither voluntarily granted the Tax Lien nor concealed the Property. (*Id.* at 34.)

Nevertheless, the bankruptcy court reasoned that § 522(c)(2)(B) "limits a debtor's right to invoke § 522(g) when a lien is avoided, and the property preserved by the trustee is a tax lien." (*Id.* at 35.) In reaching this conclusion, the bankruptcy court relied on *In re DeMarah*, 62 F.3d 1248 (9th Cir. 1995), in which the Ninth Circuit held that a debtor could not avoid a tax lien and preserve the avoided lien for his own benefit under § 522(h). The bankruptcy court acknowledged that this case involves a different statutory subdivision, § 522(g), but reasoned that *DeMarah*'s assessment of § 522(h) was instructive because both provisions contain the same limiting language (*i.e.,* "to the extent that the debtor could have exempted such property"). (*Id.*)

The bankruptcy court also acknowledged another "difference between *DeMarah* and [this] case"—namely, that this case involves an attempt by "the Trustee, not the Debtor," "to avoid the Tax Lien and preserve the avoided lien for the benefit of the estate's creditors and not for the benefit of the Debtor." (*Id.* at 36.) The bankruptcy court concluded, however, that when read together, *DeMarah* and the language of § 552(c)(2)(B) compel the conclusion that a debtor cannot "co-opt a tax lien otherwise avoidable under § 724(a)." (*Id.*) The court noted that to "hold otherwise would enable a Debtor to wrongfully fail to pay her tax bill and then use § 522(g) to claim the avoided tax penalty lien for herself and to the detriment of her creditors." (*Id.* at 36-37.)

Last, the bankruptcy court rejected the IRS's and Debtor's argument that the Trustee's proposed approach would require Debtor to "in effect[] pay twice on the IRS claim because the IRS [would] be able to then seize homestead sale proceeds to the extent those proceeds would otherwise be exempt." (*Id.* at 37-38.) The court noted that the "Tax Lien position against the Property never attached to the Debtor's homestead exemption," so if it "so happens that the IRS's now unsecured claim is also nondischargeable, it is no different than any other nondischargeable claim which will need to be paid by the Debtor." (*Id.* at 38.)

STANDARD OF REVIEW

In the bankruptcy context, "[a] reviewing court will affirm a grant of summary judgment only if it appears from the record, after viewing all evidence and factual inferences in the light most favorable to the nonmoving party, that there are no genuine issues of material fact and that the moving party is entitled to prevail as a matter of law. A bankruptcy court's grant of summary judgment is reviewed de novo." *In re Pioneer Tech., Inc.*, 107 B.R. 698, 700 (9th Cir. 1988) (citations omitted).[6]

ANALYSIS

I. Whether The Trustee Can Avoid The Tax Lien

A. Whether Debtor's Exemption Was Initially Property Of The Estate

As noted, the bankruptcy court concluded that the Trustee could invoke § 551—the provision of the Bankruptcy Code authorizing the preservation of an avoided tax lien for the benefit of a bankruptcy estate—because "the Property [was] property of this bankruptcy estate for § 551 purposes, even after the Court allowed the Debtor's exemption on the Property." (Doc. 11-3 at 30.) In Part A of its opening brief, the government challenges the bankruptcy court's

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[6] The government requested oral argument. (Docs. 11, 14.) This request is denied because the "facts and legal arguments are adequately presented in the briefs and record, and the [Court's] decisional process would not be significantly aided by oral argument." Fed. R. Bankr. P. 8019(b)(3).

conclusion on this issue. (Doc. 11 at 14-22.) More specifically, the government accuses the bankruptcy court of improperly grafting a temporal element onto § 551 and applying a principle of "once property of the estate, always property of the estate for purposes of § 551" that is "inconsistent with the Bankruptcy Code and related case law." (*Id.*) In a related vein, the government argues that the bankruptcy court erred in relying on *Heintz*, which it characterizes as outdated and non-precedential, and suggests that upholding the bankruptcy court's approach would result in a parade of horribles, including allowing unsecured creditors to reach exempt assets they would otherwise be unable to reach and preventing debtors from receiving the fresh start that the bankruptcy process promises. (*Id.*) The Trustee responds that the bankruptcy court rightly decided the issue and that *Heintz* is on point. (Doc. 13 at 1-6.) The Trustee further argues that the government's arguments are, at bottom, policy arguments more appropriately directed to Congress. (*Id.*) The government replies that the Trustee conflates the distinct questions of "whether exempt interests in property should be deemed 'property of the estate'" and "the nature and extent of the exemption, *i.e.*, what is the specific interest that is exempted." (Doc. 14 at 3-10.)

The bankruptcy court correctly determined that the avoided tax lien was property of the estate and, therefore, could be preserved by the Trustee for the benefit of the estate under § 551. In *Owen*, the Supreme Court confirmed that property that is exempted is nevertheless initially the property of the bankruptcy

estate. The Court stated that "[n]o property can be exempted (and thereby immunized [against liability under § 522]) . . . unless it first falls *within* the bankruptcy estate" and noted that "[s]ection 522(b) provides that the debtor may exempt certain property 'from property of the estate'; obviously, then, an interest that is not possessed by the estate cannot be exempted." *Owen*, 500 U.S. at 308. In short, as the BAP noted in *Heintz*, "the fact that property is removed from the estate after a case is commenced, through exemption or some other means, does not change the fact that it was property of the estate as of the commencement of the case." 198 B.R. at 585. *See also In re Rains*, 428 F.3d 893, 906 (9th Cir. 2005) (acknowledging the "well settled rule that property cannot be exempted unless it is first property of the estate") (quoting *Heintz*). Debtor thus could not have exempted any interest in the Property if the Property had not first been considered property of the estate under § 541.

The crux of the government's argument is that § 551 does not look to property's status as of the petition date because it does not contain an express "temporal requirement," whereas Congress has included express temporal requirements in other Bankruptcy Code provisions. *See*, *e.g.*, 11 U.S.C. § 506(a)(2) ("[V]alue with respect to [a debtor's] personal property securing an allowed claim shall be determined . . . as of the date of the filing of the petition. . . ."). This is, in essence, an *expressio unius* argument. Although this argument has surface appeal, it overlooks that "[s]tatutory construction . . . is a holistic endeavor." *United Sav. Ass'n of Tex.*

v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 371 (1988). The *expressio unius* canon "does not apply unless it is fair to suppose that Congress considered the unnamed possibility and meant to say no to it," and the "canon can be overcome by contrary indications that adopting a particular rule or statute was probably not meant to signal any exclusion" because the "background presumptions governing [the subject at issue] are a highly relevant contextual feature." *Marx v. Gen. Revenue Corp.*, 568 U.S. 371, 381 (2013) (internal quotation marks omitted). Here, the relevant background presumptions and details suggest that Congress didn't include an express temporal requirement in § 511 because other features of bankruptcy law already dictate that the property of the bankruptcy estate is assessed at the commencement of the case—and, thus, including verbiage to that effect in § 511 would have been redundant. As the BAP in *Heintz* noted, "property of the estate" is a defined term in the Bankruptcy Code. 198 B.R. at 585. Although § 551 does not have a temporal restriction in it, § 541—which defines "property of the estate"—does: it includes "all legal and equitable interests of the debtor in property *as of the commencement of the bankruptcy case*." *Id.* § 541(a)(1) (emphasis added). "When a term used in a statute is defined by that statute or by any other relevant statutory provision, [courts] generally presume that definition applies to the statute's use of the term" unless "interpreting a term consistently with its statutory definition would . . . lead to obvious incongruities or would destroy one of the major [congressional] purposes." *United States v. Olson*, 856 F.3d 1216, 1223 (9th Cir. 2017) (third

alteration in original) (citation and internal quotation marks omitted). The Court thus presumes that Congress intended for the term "property of the estate" in § 551 to mean what it says in § 541.

The government has not offered any persuasive reason to depart from this presumption and interpret "property of the estate" differently across the two different Code provisions. The government argues that "several Code provisions suggest that exempt property always belongs to the debtor, from the start, albeit conditionally" and cites § 522(b), arguing that it does "not exempt the property 'out of the estate' at some point in the future" but rather "exempt[s] property 'from property of the estate' in the first place." (Doc. 11 at 18.) This argument fails because the Supreme Court has adopted an interpretation of this provision that forecloses the government's interpretation: "Section 522(b) provides that the debtor may exempt certain property 'from property of the estate'; obviously, then, an interest that is not possessed by the estate cannot be exempted." *Owen*, 500 U.S. at 308.

The government also cites § 522(c), which provides that "property exempted under [§ 522] is not liable during or after the case for any debt of the debtor," arguing that this language connotes that exempt property maintains its exempt status from the outset of the case, rather than after the deadline to object passes. This argument is too clever by half, because it fails to consider that a debtor can only exempt what is rightfully hers—the legal and equitable interest she carried into bankruptcy, which extends only to her

unencumbered equity in the asset and no further. As the Supreme Court explained in *Owen*:

> [I]f a debtor holds only bare legal title to his house—if, for example, the house is subject to a purchase-money mortgage for its full value—then only that legal interest passes to the estate; the equitable interest remains with the mortgage holder. And since the equitable interest does not pass to the estate, neither can it pass to the debtor as an exempt interest in property. Legal title will pass, and can be the subject of an exemption; but the property will remain subject to the lien interest of the mortgage holder.

500 U.S. at 308-09 (citation omitted). Admittedly, this portion of *Owen* rested partly on § 541(d), which is not at issue in this appeal, but *Owen*'s reasoning is nevertheless instructive in evaluating the character of the Tax Lien. It is clear that the "paramount right to collect taxes of the federal government overrides a state statute providing for exemptions." *Leuschner v. First W. Bank & Tr. Co.*, 261 F.2d 705, 708 (9th Cir. 1958). In other words, it is well established that exemptions provided under state law are ineffective against federal tax liens. *Id. See also United States v. Heffron*, 158 F.2d 657, 659 (9th Cir. 1947) ("Against [federal tax] liens, exemptions prescribed by State laws are ineffective. Bankruptcy does not invalidate such liens or prevent their enforcement.") (footnote omitted); *United States v. Howard*, 2008 WL 4471333, *8 (D. Ariz. 2008) (noting that it is "well-settled that homestead exemptions under state law are ineffective against federal tax liens"

and collecting cases). Here, the Tax Lien attached to Debtor's equity interest in the Property, which meant that, upon bankruptcy, the homestead exemption that otherwise could have served to remove Debtor's interest in the Property from the property of the estate was ineffective to allow Debtor to reclaim that portion of the interest encumbered by the Tax Lien. Thus, even assuming without deciding that the government's interpretation of § 522(c) is correct, Debtor could not claim an exemption for the value of the Property encumbered by the Tax Lien.[7]

This conclusion finds ample support in the relevant case law. In *Gill*, the BAP "conclude[d] that the Code expressly authorized [the] Trustee to avoid, subordinate and preserve the penalty portion of the IRS's tax lien for the benefit of the estate's unsecured creditors." 574 B.R. at 716. Although the court did not expressly address whether the tax lien was property of the estate, the court noted that "[e]nforcement of penalties against a debtor's estate serves not to punish the

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[7] The government argues that the version of Federal Rule of Bankruptcy Procedure 4003(b)(2) in effect when *Heintz* was decided, which provided that a trustee had 30 days to file an objection to a claimed exemption, means that *Heintz* "sought to solve a problem that . . . should no longer exist," because Rule 4003(b)(2) now permits a trustee to file an objection to a claimed exemption up to one year before the close of bankruptcy proceedings. (Doc. 11 at 14-15.) This argument is unpersuasive. The BAP did not assign any significance to Rule 4003(b)(2) in its ruling that an exemption was "property of the estate" for purposes of § 551. At any rate, for the reasons already explained, Debtor's claimed exemption did not extend to the value of the Property encumbered by the Tax Lien.

delinquent taxpayers, but rather their entirely innocent creditors." *Id.* The government's cited cases do not hold otherwise. In *In re Covington*, 368 B.R. 38 (Bankr. E.D. Cal. 2006), for example, the debtor owed a domestic support obligation but claimed exemptions in a $1,000 bank deposit and an automobile. *Id.* at 40. The trustee objected to the claimed exemptions and sought to liquidate the exempt property to pay the domestic support obligation. *Id.* The bankruptcy court disagreed and analogized the domestic support obligation to a nondischargeable tax claim, noting that "[w]hen a debtor exempts property, it is effectively removed from the estate." *Id.* If, however, the "property declared exempt by the debtor has value beyond the exemption amount, or if it appreciates beyond the exemption amount after the petition is filed, the nonexempt amount or appreciation is property of the estate that may be administered by the trustee." *Id.* at 40 n.1. Notably, the trustee did not provide any authority "indicating that he may liquidate *otherwise exempt property* because the debtor happens to owe a nondischargeable tax claim." *Id.* at 41 (emphasis added). Unlike the exempt property in *Covington*, Debtor's exemption here did not extend to the full value of the Property encumbered by the Tax Lien, and the *Covington* court made clear that value in the asset "beyond the exemption amount" *was* property of the estate.

Finally, the government contends that allowing trustees to avoid penalties would permit them to "step into the shoes of penalty liens against any and all exempt assets subject to federal tax liens and other

special liens," such as retirement accounts. (Doc. 11 at 20-22.) But it is not this Court's role to decide hypothetical cases with different facts or weigh policy arguments about how statutes should be written. The plain language of §§ 551, 541, and 522, as well as Supreme Court precedent interpreting them, compel the conclusion that any interest held by Debtor in the Property was property of the bankruptcy estate from the commencement of bankruptcy proceedings and that Debtor's interest did not extend to the value of the Property encumbered by the Tax Lien. The bankruptcy court did not err in reaching this conclusion.

This does not end the inquiry. In Part B of its brief, the government argues that a tax lien doesn't exist in a different position than the debtor's exemption and instead exists conterminously with the exemption. (Doc. 11 at 22-30.) The Trustee disagrees (Doc. 13 at 6-9), and both parties cite authorities they view as supporting their positions. Although it is a close call, the Court agrees with the bankruptcy court that Debtor's homestead exemption was third in line behind the Tax Lien, rather than existing alongside the Tax Lien.

The government emphasizes the language of § 522(c)(2)(B), which provides that "property exempted under this section . . . is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case, except . . . a debt secured by a lien that is . . . a tax lien, notice of which is properly filed." The government argues that the statute's use of the words "property exempted" means that "property can be 'exempted' and remain liable for a

debt secured by 'a tax lien' at the same time" and that, if "exemptions apply only after tax liens are accounted for, § 522(c)(2)(B) would have little meaning." (Doc. 11 at 24-25.) In the Court's view, this reads too far into the statute. The Court interprets this provision as merely providing that a creditor can reach exempt property after bankruptcy proceedings to satisfy its claim. *See*, *e.g.*, 6 Collier ¶ 724.02[5] ("Section 522(c)(2)(B) provides that properly filed tax liens continue to encumber exempt property after case closure."). One purpose of this provision is to prevent debtors from avoiding tax liens under other portions of § 522. *Id.* ("Courts are nearly uniform in holding that section 522(c)(2)(B) prevents debtors from avoiding tax penalty liens under section 522(h)."). *See also Demarah*, 62 F.3d at 1251-52. Sections 522(g) and (h) are instructive. Section 522(h) provides that a debtor may avoid a transfer "to the extent that the debtor could have exempted such property under subsection (g)(1) if the trustee had avoided [the] transfer" under certain conditions, and section 522(g) permits a debtor to exempt property that the trustee recovers "to the extent that the debtor could have exempted such property" under certain conditions. The government's interpretation of § 522(c)(2)(B) would render §§ 522(g) and (h) superfluous. "One of the most basic interpretive canons [is] that a statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant." *Corley v. United States*, 556 U.S. 303, 314 (2009) (cleaned up). If a tax lien exists conterminously with a debtor's exemption (*i.e.*, encumbering the exemption rather than the debtor's

pre-bankruptcy equity in the asset), then §§ 522(g) and (h) would be unnecessary because any transfer avoided under § 522(h) or any property that the trustee recovered that the debtor could exempt under § 522(g) would automatically revert to the debtor as an exemption. The Court views the better interpretation of § 522(c)(2)(B) as simply preventing a debtor from escaping liability for tax liens after bankruptcy.[8]

Other courts agree that tax liens are not conterminous with a debtor's exemptions. For example, in *Gill*, the debtor claimed a $40,000 homestead exemption in a property valued at $500,000. 574 B.R. at 712. The property was subject to a $371,000 mortgage and secured tax claims totaling $161,530, including over $48,000 in tax penalties. *Id.* at 711-12. The debtor sought to have the property abandoned because there was not sufficient value beyond the secured claims and the debtor's exemption to distribute to unsecured creditors. *Id.* at 712. Although the court did not directly address whether the tax lien coincided with the debtor's

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[8] The government's cited cases support this unremarkable view. *See*, *e.g.*, *In re Ruppel*, 368 B.R. 42, 44 (Bankr. D. Or. 2007) (Section 522(c)(1) "provides that notwithstanding [an asset's] exempt status, exempt property *remains liable for those debts*") (emphasis added); *Covington*, 368 B.R. at 41 ("Section 522(c)(1) does not provide for the disallowance of an exemption. Rather, it provides that property exempted by the debtor is *nonetheless liable* for a domestic support obligation.") (emphasis added); *In re Reed*, 127 B.R. 244, 246 (Bankr. D. Haw. 1991) ("Every court that has discussed section 522(c)'s exception for properly filed tax liens has come to the same conclusion: a properly filed tax lien attaches to the debtor's otherwise exempt property and *survives bankruptcy*.") (emphasis added)

exemption, the court did suggest that the lien occupied a different sphere than the exemption. The court noted that, because the bankruptcy court found there was "substantial value" for the "estate's unsecured creditors with [the] Trustee's sale of the Residence free and clear of the IRS's lien," "it implicitly determined" that the Trustee could avoid the tax lien for penalties and if the "court had not determined so, the[ ] Debtor's claimed homestead exemption would have exhausted the remaining equity after paying [the mortgage holder], leaving nothing for unsecured creditors and making abandonment appropriate." *Id.* at 716. As the Trustee points out (Doc. 13 at 7-8), if it were true that tax liens attached solely to a debtor's exemption, there would have been no need to avoid the tax lien or abandon the property because there would have been a substantial amount of value left in the property even after satisfying the debtor's homestead exemption.

Similarly, in *In re Bolden*, 327 B.R. 657 (Bankr. C.D. Cal. 2005), the debtor claimed a $50,000 homestead exemption in a property that was valued at $925,000. *Id.* at 659-60. The IRS had "eight secured tax liens against the property totaling $1,324,632.52." *Id.* at 659. The debtor argued that the trustee needed to abandon the property because the sale would not satisfy the liens on the property. *Id.* at 661. The court noted that the "homestead exemption does not have precedence over the tax liens" and that "[g]enerally, a debtor is not entitled to claim a homestead exemption on property that is subject to an IRS levy." *Id.* at 662-63. "In other words, § 522(c)(2) neutralize[d] [the

debtor's] claim that he is entitled to collect on his homestead exemption claim here [even though there was] no timely objection" to his exemption claim. *Id.* The court then concluded that the trustee could avoid the tax penalty liens and preserve them for the benefit of the estate under § 551, notwithstanding the debtor's claimed homestead exemption. *Id.* at 663-64. These cases suggest that secured tax liens occupy a different place in line than the debtor's claimed exemption, and the value of the debtor's exemption is determined by how much value the debtor has in the asset unencumbered by other liens.

The government's cited cases do not compel a different result. In *In re Bird*, 577 B.R. 365 (10th Cir. BAP 2017), the Tenth Circuit BAP held that debtors could "claim valid homestead exemptions, notwithstanding a lack of equity in the Homesteads." *Id.* at 383. However, as the Trustee points out, the BAP's decision was decided based on Utah law, and the government has not argued that the result would be the same in this circuit or under Arizona law. And in *In re Selander*, 592 B.R. 729 (Bankr. W.D. Wash. 2018), a debtor claimed a $125,000 homestead exemption in a property that was subject to a judgment lien and tax liens and was sold for $825,000. *Id.* at 730-32. The parties entered into an agreement that the sale of the property would be "strictly conditioned" upon the debtor receiving the full $125,000 for his homestead exemption. *Id.* at 731. The IRS objected to the sale because paying the homestead exemption would "ignore[ ] the existence of tax liens that [it] assert[ed] would take priority over

[the homestead] exemption." *Id.* The trustee and the IRS ultimately "resolved the objection with a stipulation authorizing the sale of the Residence but reserving the issue of whether the Debtor or the IRS was entitled to the $125,000 in sale proceeds allocated for the Homestead Exemption." *Id.* After the sale, the trustee filed a motion "requesting that the Court authorize distribution of the Homestead Exemption to the IRS, pursuant to its Notice of Federal Tax Lien against the property, but only after significant reductions for the costs of sale and administrative expenses." *Id.* at 732. Accordingly, the question before the bankruptcy court was whether the trustee could "use the tax lien subordination provisions of § 724(b) to pay administrative expenses associated with the sale of real property from a debtor's allowed exemption in homestead proceeds still subject to the tax lien." *Id.* The IRS argued that the "subordination provision of § 724(b) [did] not apply . . . because of the exempt nature of the $125,000 in proceeds subject to the tax lien." *Id.* The trustee, on the other hand, argued that "the superior interest of the IRS in the Homestead Exemption funds allow[ed] him to use the subordination provisions of § 724(b) notwithstanding the claimed exemption." *Id.*

The government here makes much of the fact (Doc. 11 at 26) that the bankruptcy court said that "in certain circumstances a tax lien may in fact exist on property that is not otherwise subject to the interests of creditors." *Id.* at 734. But the question facing the *Selander* court was markedly different than the question facing this Court—in *Selander*, the "situation . . . [was]

that of an IRS lien relying on a debtor's homestead exemption *for its very existence*," but no similar situation is present here. *Id.* (emphasis added). Also different is that the parties *agreed* that the debtor would receive the full $125,000 homestead exemption, so it is logical that the IRS would argue and the bankruptcy court would hold that the tax lien attached to the debtor's exemption and would survive bankruptcy under § 522(c)(2)(B). *Id.* at 735 ("Debtor's Homestead Exemption removed the value of $125,000 from the estate but such exemption was powerless to eliminate the interest of the IRS in those funds claimed with the exemption."). Another "[u]nique" feature of *Selander*, not present here, was "the fact that Debtor's Homestead Exemption [was] superior to [the judgment] lien but not the statutory tax lien." *Id.* at 733. But here, as explained above, Debtor's claimed exemption in the Property falls in line after the Tax Lien—the Tax Lien attached to Debtor's pre-bankruptcy equity in the Property. The bankruptcy court did not err in holding that the Tax Lien occupied a higher priority than Debtor's homestead exemption.

II. Whether The Avoided Lien Is Preserved For The Benefit Of The Estate

Because the Trustee could avoid the Tax Lien under § 724(a), the next question is whether the Trustee could preserve the avoided Tax Lien for the benefit of the estate (as opposed to the Debtor recovering the value of the avoided lien under § 522(g)). The government argues that the bankruptcy court erred

in holding that Debtor could not recover the avoided tax lien under § 522(g) because the "test under § 522(g) is whether . . . the Debtor could have exempted the property had there never been a tax lien—and there is no doubt she could." (Doc. 11 at 31-38.) The Trustee argues that the government has no standing to argue that Debtor could recover the avoided tax lien and that the Ninth Circuit's decision in *DeMarah* forecloses Debtor's ability to do so. (Doc. 13 at 9-11.)

Unless Debtor is able to recover the avoided lien under § 522(g), the self-executing nature of § 551 means that the avoided lien is automatically preserved for the benefit of the estate. *See*, *e.g.*, *In re Trout*, 609 F.3d 1106, 1108 (10th Cir. 2010) (calling § 551 an "automatic preservation of avoided transfer for benefit of the estate"); *In re Van de Kamp's Dutch Bakeries*, 908 F.2d 517, 519 (9th Cir. 1990) ("[T]he legislative history stresses the automatic nature of preservation under section 551."); *In re Kavolchyck*, 164 B.R. 1018, 1023-24 (S.D. Fla. 1994) ("[P]reservation under § 551 is an automatic consequence of avoidance of a lien. . . ."). "The rights and ability of a debtor to avoid liens on property claimed as exempt or to claim the benefits of liens avoided by the trustee on exempt property are governed exclusively by [§ 522]. Once the lien has been avoided by the trustee, the debtor must come within one of subsections [in § 522] in order to avoid the operation of [§ 551]." *In re Dipalma*, 24 B.R. 385, 387 (Bankr. D. Mass. 1982). *See also* 5 Collier on Bankruptcy ¶ 551.02[2] (16th ed. 2012) ("[T]he preservation of an avoided transfer for the benefit of the estate

under section 551 is subject to any preservation for the benefit of an individual debtor regarding exempt property under section 522(g) and (i)(2). This, however, does not allow a debtor to exempt property subject to the trustee's preserved lien position, unless such preserved lien was otherwise avoidable under section 522.").

Although the government's argument has some force, and the outcome might be different if the Court were writing on a blank slate, *DeMarah* compels the result that Debtor cannot recover the avoided Tax Lien under § 522(g). In *Demarah*, the debtor "failed to pay various federal income taxes, employment taxes, and the interest and penalties associated with them," so the IRS filed a tax lien "against all of DeMarah's property." 62 F.3d at 1249. The debtor then filed for bankruptcy and declared all of his property exempt under § 522. *Id.* On appeal, the issue was whether the debtor could avoid the tax lien under § 522(h). *Id.* at 1250-51.[9] The parties didn't dispute that DeMarah met most of the requirements of § 522(h): "[h]e did not attempt to conceal any property and the trustee did not attempt

[9] Section 522(h) provides, in relevant part: "The debtor may avoid a transfer of property of the debtor . . . to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee avoided such transfer" and if the trustee could have avoided the transfer but did not attempt to do so. Section 522(g) in turn provides that "[n]otwithstanding sections 550 and 551 . . . the debtor may exempt . . . property that the trustee recovers under section . . . 551 . . . to the extent that the debtor could have exempted such property under subsection (b) . . . if such property had not been transferred" and if the transfer was involuntary and the debtor did not "conceal such property."

to set aside the tax liens," nor was the "attachment of a tax lien a voluntary transfer of property." *Id.* The court also agreed that "§ 522(h) would normally allow DeMarah to avoid a lien that secures a claim for non-compensatory penalties." *Id.* at 1251. The question was therefore whether the "transferred property [was] 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." *Id.* at 1250. The debtor argued that, because he "would have been able to exempt his property from the estate if the trustee had recovered the transfer . . . the last condition [was] met." *Id.* at 1251. The Ninth Circuit disagreed. Although the court acknowledged that the debtor's "argument would be powerful, even conclusive, if § 522(h) existed in a vacuum," the court emphasized that a different statutory provision, § 522(c), limited a debtor's ability to avoid a tax lien. *Id.* Thus, the "fact that DeMarah may [have] been able to exempt the property that is subject to the tax lien from the bankruptcy estate does not mean that he [could] remove the lien itself, or that portion of it which secure[d] the penalty." *Id.* The "explicit language" of § 522(c)(2)(B) "belie[d] any argument that the debtor [could] escape a part of the tax lien." *Id.* at 1252. The court additionally noted that "Congress could logically have wanted to allow tax penalties to be avoided if that would benefit unsecured creditors" while "at the same time . . . eschew[ing] benefiting debtors who had incurred those penalties by failing to pay their taxes." *Id.* "Congress created avoidances of noncompensatory penalties to protect unsecured creditors from the debtor's wrongdoing," but "if

DeMarah were allowed to avoid the penalties creditors would not be protected; instead, DeMarah would gain the benefit of avoiding the penalties he incurred by not paying income and employment taxes." *Id.*

Although *DeMarah* addressed § 522(h) and not § 522(g), which is relevant here, its holding is nevertheless instructive given that one of the requirements a debtor must meet to avoid a transfer under § 522(h) is that the debtor could have exempted the property under § 522(g)(1). In other words, the Ninth Circuit necessarily ruled that the debtor would have been unable to exempt the property from the estate under § 522(g). Accordingly, *DeMarah* compels the conclusion that Debtor may not exempt the Property under § 522(g). *See also* 6 Collier ¶ 724.02[4] ("The scope of section 724(a) is limited to property of the estate. . . . For instance, if a lien for a penalty . . . has attached to property that is exempt and not part of the debtor's chapter 7 estate, section 724 cannot be used by the debtor to avoid the lien."); *id.* ¶ 724.02[5] ("Courts are nearly uniform in holding that section 522(c)(2)(B) prevents debtors from avoiding tax penalty liens under section 522(h).").

Accordingly,

IT IS ORDERED that the grant of summary judgment to the Trustee is **affirmed**. The Clerk of Court is directed to enter judgment accordingly and to close this case.

Dated this 16th day of April, 2021.

/s/ Dominic W. Lanza
Dominic W. Lanza
United States District Judge

SO ORDERED.
Dated: July 17, 2020 [SEAL]

/s/ Daniel P. Collins
Daniel P. Collins, Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT

DISTRICT OF ARIZONA

In re: **SANDRA J. TILLMAN,** **Debtor,**	Chapter 7 Proceedings Case No. 3:19-bk-01074-DPC
LAWRENCE J. WARFIELD, TRUSTEE; **Plaintiff,** **vs.** **UNITED STATES OF AMERICA,** **Defendant,** **and** **SANDRA J. TILLMAN,** **Defendant – Intervenor**	Adversary No. 3:20-ap-00038-DPC **UNDER ADVISEMENT RULING RE: MOTION FOR SUMMARY JUDGMENT** **[NOT FOR PUBLICATION]** (Filed Jul. 17, 2020)

Before this Court is the Motion of Lawrence J. Warfield ("Trustee") for Summary Judgment regarding whether the Trustee can avoid a tax lien ("Tax Lien")

under 11 U.S.C. § 724(a)[1] and, if avoided, whether the avoided lien is preserved for the benefit of the estate or for Sandra J. Tillman ("Debtor") and what rights the United States of America ("IRS") holds against the Debtor's homestead or proceeds from the sale of that property. As Debtor's counsel correctly noted at oral argument, the issues before this Court have not been squarely resolved in this Circuit.

The Trustee contends the Tax Lien may be avoided under § 724(a) and the value of the avoided lien preserved for the benefit of the estate pursuant to § 551. The Debtor and IRS both contend the Trustee may not avoid the Tax Lien for the benefit of the estate. If the Tax Lien is avoided, Debtor argues she is entitled to claim an exemption in the avoided Tax Lien pursuant to § 522(g). The IRS argues its surviving claim must be paid from any distribution to the Debtor from the sale of the homestead. Apparently believing the IRS will get its pound of flesh one way or the other, the Debtor and IRS together oppose the Trustee's motion

On June 19, 2020, this Court heard oral argument on this matter. Having heard the parties' arguments and having reviewed their briefs, this Court now holds there exists no genuine issue of material fact and the Trustee may avoid the Tax Lien for the benefit of the estate pursuant to § 551. The Debtor is only entitled to claim as exempt value over and above the voluntary

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[1] Unless indicated otherwise, statutory citations refer to the U.S. Bankruptcy Code ("Code"), 11 U.S.C. §§ 101-1532, and to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037.

1st lien and the involuntary IRS lien against her residence. After avoidance of its Tax Lien, the IRS holds an unsecured (but possibly nondischargeable) claim against the Debtor in the amount of the avoided Tax Lien. The Debtor may not employ §522(g) because the Debtor may not exempt that portion of the value of the Property occupied by the Tax Lien, whether that Tax Lien is held by the IRS or is avoided and then held by the Trustee for the benefit of this bankruptcy estate. Trustee's Motion for Summary Judgment is hereby granted.[2]

I. BACKGROUND

A. The Property Value, Liens and the Homestead Exemption

On June 30, 2015, Debtor purchased her home located at 154 W. Soaring Ave. Prescott, AZ 86301 (the "Property").[3] According to a residential property brokers' price opinion, the Property is valued at $475,000.[4] According to Debtor's counsel, Debtor's broker has listed the Property for sale at $475,000. Debtor's counsel filed on July 9, 2020, a motion to sell the Property ("Debtor's

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[2] This ruling (the "Order") constitutes the Court's findings of fact and conclusions of law pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure.

[3] DE 34, page 2. "DE" references a docket entry in this Adversary Proceeding 3:20-ap-0038-DPC.

[4] DE 34, page 3.

Sale Motion") to an arm's length 3rd party buyer for $475,000.[5]

Bank of America ("BofA") holds a $371,350[6] secured first-priority lien against the Property. The IRS filed a lien against the Property for unpaid taxes plus a penalty of $19,915 for the tax year 2015.[7] Although the tax itself has now been satisfied, the penalty remains unpaid as does accrued interest in the amount of $4,771.[8] The Tax Lien now totals $24,686.[9] The pre-bankruptcy Tax Lien was recorded by the IRS and it now holds a 2nd (but involuntary) lien position against the Property.[10]

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[5] Administrative. DE 82. "Administrative DE" references a docket entry in the administrative bankruptcy case 3:19-bk-01074-DPC. The Trustee filed a limited objection. Administrative DE 88. A hearing on Debtor's Sale Motion is set for July 22, 2020 at 11:00 a m.

[6] DE 34, page 2.

[7] DE 23, page 2.

[8] It is unclear whether the interest portion of the Tax Lien is wholly attributable to the unpaid penalty or is in some measure attributable to interest which had accrued on the principle balance of the IRS's tax claim. What is clear is that the principle balance of the IRS's tax claim (i.e. the tax itself) has been fully satisfied and is not a part of the Tax Lien.

[9] DE 32, page 3.

[10] DE 22, page 2. Because BofA holds a first position lien totaling $371,350 and the Tax Lien is $24,686.26, the potential value of Debtor's homestead exemption appears to be approximately $83,964.

B. Procedural History

On January 30, 2019 ("Petition Date"), Debtor filed her chapter 7 bankruptcy case.[11] In her Bankruptcy Schedules, Debtor disclosed her ownership of the Property as well as the IRS's claim.[12] On Schedule C,[13] pursuant to A.R.S. § 33-1101(A), Debtor claimed an exemption of $150,000 in the Property.

On February 27, 2019, Debtor filed a Motion to Compel Abandonment of Property ("Motion to Compel Abandonment") arguing there was no equity in the Property above her homestead exemption.[14] The Trustee objected to Debtor's Motion to Compel Abandonment because Debtor's § 341 meeting had not occurred and Debtor did not have an allowed exemption but, rather, an "asserted exemption" in the Property.[15]

On April 19, 2019, the Trustee filed his Objection to Exemptions ("Objection to Exemptions").[16] Debtor responded,[17] and Trustee replied.[18] Following the § 341 meeting, this Court denied the Objection to Exemptions and allowed Debtor's homestead exemption in

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[11] Administrative DE 1.

[12] DE 34, page 2.

[13] DE 34, page 2.

[14] Administrative DE 11, page 2.

[15] Administrative DE 22, page 2. The Court has not ruled on the Motion to Compel Abandonment but, in view of this Order, now hereby denies the Motion to Compel Abandonment.

[16] Administrative DE 25.

[17] Administrative DE 26.

[18] Administrative DE 28.

the Property, clarifying that the homestead exemption is subordinate to BofA's mortgage lien and the Tax Lien.[19]

On July 3, 2019, Trustee filed a Motion to Authorize the Listing and Sale of Real Property ("Trustee's Motion to Sell").[20] Debtor objected to Trustee's Motion to Sell.[21] This Court held a preliminary hearing at which time the Court encouraged the parties to continue (or revitalize) settlement discussions.[22]

On December 27, 2019, BofA filed a Motion for Relief from the Automatic Stay ("Motion for Stay Relief"). BofA seeks to foreclose its lien on the Property.[23] The Trustee objected to BofA's Motion for Stay Relief because Trustee's Motion to Sell was still pending.[24] Debtor also objected to BofA's Motion for Stay Relief because Debtor claimed to be current on her payments and that BofA's interests were adequately protected.[25] This Court held a preliminary hearing on BofA's Motion for Relief from Stay and continued the hearing to May 15, 2020.[26]

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[19] Administrative DE 38.

[20] Administrative DE 42.

[21] Administrative DE 53.

[22] Administrative DE 56.

[23] Administrative DE 58.

[24] Administrative DE 60.

[25] Administrative DE 61.

[26] Administrative DE 65. That preliminary hearing has since been continued to August 14, 2020 at 10:30 a m.

On February 21, 2020, Trustee initiated this Adversary Proceeding.[27] The Complaint seeks this Court's declaration that the Trustee can avoid the Tax Lien under § 724(a) and that the value of the avoided Tax Lien is preserved for the benefit of the estate.[28] The IRS filed an answer to Trustee's Complaint, disputing Trustee's ability to avoid the Tax Lien for the benefit of the estate.[29] Debtor filed a Motion for Leave to Intervene ("Motion to Intervene")[30] which the Court granted.[31] Debtor subsequently filed her answer to Trustee's Complaint. Debtor argues her allowed homestead exemption removes the Property from this bankruptcy estate and any recovery from the avoided Tax Lien belongs to Debtor.[32]

On March 26, 2020, Trustee filed a Motion to Approve Sale of Real Property ("Trustee's 2nd Sale Motion").[33] The IRS objected to the Trustee's 2nd Sale Motion.[34] At the hearing on April 7, 2020, the parties advised the Court that there was no pending buyer. Debtor's Sale Motion is set for hearing on July 22, 2020.

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[27] DE 1.

[28] DE 1, page 3.

[29] DE 11, page 4.

[30] DE 13.

[31] Administrative DE 76.

[32] DE 27, page 2.

[33] Administrative DE 66.

[34] Administrative DE 73.

The Trustee filed his Motion for Summary Judgment and Statement of Facts ("TSOF") on April 10, 2020.[35] Both the IRS and Debtor filed responses.[36] The Trustee replied. On June 5, 2020, the IRS filed a Motion for Leave to Present a Limited Sur-Reply ("Motion for Sur-Reply"), and Trustee filed his objection.[37] This Court granted the IRS's Motion for Sur-Reply.[38]

II. JURISDICTION

Pursuant to 28 U.S.C. §§ 157(b)(2)(A), (B), (K), and (O), this Court has jurisdiction over the matters presented by the parties.

III. ISSUES

A. May the Trustee avoid the Tax Lien under § 724(a) and preserve the value of the avoided Tax Lien for the benefit of the bankruptcy estate under § 551?

B. If the Trustee may avoid the Tax Lien, may the Debtor claim the avoided Tax Lien as exempt pursuant to §522(g)?

C. If the Trustee may avoid the Tax Lien and defeat the Debtor's §522(g) claimed exemption, may the IRS satisfy its unsecured (but possibly nondischargeable) claim from the exemption

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[35] DE 21.

[36] DE 31, 33.

[37] DE 42, 45.

[38] DE 46.

> proceeds from the sale of the Debtor's homestead?

IV. ANALYSIS

A. Standard for Summary Judgement

Under Fed.R.Civ.P. 56 (made applicable to adversary proceedings by Fed.R.Bankr.P. 7056), summary judgement is appropriate only "if the pleadings, depositions, answers to interrogations, and admissions on file, together with the affidavits, if any, show that there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law." *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986).

B. Lien Avoidance under § 724(a) and Preservation of the Avoided Lien For the Benefit of the Estate.

Under § 724(a), a chapter 7 trustee may avoid a lien securing a claim of the kind specified in § 726(a)(4). The type of claim specified in § 726(a)(4) is:

> any allowed claim, whether secured or unsecured, for any fine or forfeiture or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee . . .

Read together, §§ 724(a) and 726(a)(4) allow a chapter 7 trustee to avoid a lien to the extent the lien secures the claim for a penalty, including a tax penalty.

> The purpose behind section 724(a) is to protect innocent creditors from the consequences of the debtor's wrongdoing. The types of claims that are subject to lien avoidance under section 724(a) are obligations that were created in order to punish the debtor for the debtor's wrongful conduct. The debtor will not be punished, however, if those claims are paid in the bankruptcy case through the proceeds of liens that secure those claims. To the contrary, payment of those claims, which may not be dischargeable in the case, could serve to benefit the debtor who is getting his or her other debts discharged.[39]

In the words of the United States Supreme Court, "[t]ax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors." *Simonson v. Grandquist*, 369 U.S. 38, 82 S. Ct. 537, 539 (1962). Where the penalty portion of tax liens are avoided and preserved for the benefit of creditors, "the estate is enriched while the IRS still obtains the principle portion of its liens, with interest, in the order and priority of each respective lien." *In re Bolden*, 327 B.R. 657, 665 (Bankr. C. D. Cal. 2005) (bankruptcy court refused to order the abandonment of debtor's exempt homestead where

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[39] Collier on Bankruptcy, 16th Edition, page 724-8, 724.02[6].

IRS penalty tax liens could be avoided for the benefit of the bankruptcy estate.)

Here, the IRS holds a secured claim of the kind specified in § 726(a)(4).[40] The IRS's Tax Lien is against the Property, a residence which the Debtor claimed exempt.[41] The Court granted that exemption over the Trustee's objection.[42] If the Trustee is permitted to avoid the Tax Lien, § 551 notes that the lien "is preserved for the benefit of the estate but only with respect to property of the estate."[43] Much of the Debtor's and IRS's opposition to the Trustee's Motion for Summary Judgment argues that the Property is not property of this chapter 7 estate and, therefore, § 551 is inapplicable. They argue that, once this Court allowed Debtor's exemption on the Property, the Property was removed from the bankruptcy estate and, therefore, the Trustee cannot preserve the avoided Tax Lien for the benefit of the estate under § 551.

Section 541 defines property of the estate as "all legal or equitable interests of the debtor in property as of the commencement of the case." Notwithstanding § 541, § 522(b) allows an individual debtor to exempt property from the bankruptcy estate. "By claiming property as exempt, a debtor removes the property

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[40] Assuming no portion of the Tax Lien pertains to interest on the underlying principal balance of the IRS's tax claim.

[41] Administrative DE 8 at page 10.

[42] Administrative DE 38.

[43] § 551 states: "Any transfer avoided under section . . . *724(a)* of this title . . . is preserved for the benefit of the estate *but only with respect to property of the estate*." (emphasis added)

from the estate and places it beyond the reach of creditors . . . Once property is exempted, its status as property of the estate is terminated and the property is ultimately revested in the debtor." *In re Heintz*, 198 B. R. 581, 585 (9th Cir. BAP 1996). The *Heintz* court went on to conclude that "§ 551 does not exclude exempt property from preservation" and that "[a]n avoided interest or lien encumbering exempt property is automatically preserved for the benefit of the estate under § 551."[44]

A debtor cannot exempt the asset in its entirety from the estate. See *Schwab v. Reilly*, 560 U.S. 770 (2010). In *Schwab*, the Supreme Court recognized that, in the context of federal exemptions under § 522(d), the "property" a debtor "may claim as exempt" is defined as the debtor's "interest" – up to a specified dollar amount – in the asset, not the asset itself. *Id.* at 782. Although *Schwab* was dealing with federal exemptions, similar limiting language is present in the applicable Arizona exemption statute. As discussed in further detail below, A.R.S. § 33-1101(A) limits a debtor's homestead exemption to a $150,000 interest in a debtor's residence. A debtor's allowed homestead exemption does not remove the entire homestead from property of the estate and instead removes, at most, the value of a debtor's interest in the homestead up to $150,000.

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[44] *Id.* at 586.

In the 9th Circuit Bankruptcy Appellate Panel ("BAP") case of *In re Heintz*,[45] the debtor consented to the sale of his exempt property as did the debtor's brother, a creditor secured by a judgment lien against that property. The brother's judgment lien was avoided through the trustee's stipulation with the brother that acknowledged that the avoided lien was preserved for the benefit of the estate under § 551. Like the Debtor and IRS in the case at bar, the debtor in *Heintz* argued the trustee could not preserve the avoided lien for the benefit of the estate because § 551 is limited to liens that encumber property of the estate. Over the debtor's demand that the trustee deliver the sales proceeds to him, the BAP held that proceeds from the sale of the exempt property belonged to the bankruptcy estate, not the debtor, because those proceeds were subject to the estate's lien under § 551 once the trustee avoided the brother's judgment lien.

While *Heintz* does not resolve the Trustee's dispute with the IRS in the case at bar,[46] the BAP does tell us that property cannot be exempted from a bankruptcy estate unless it is first property of the estate.[47] Given all exempt property is property of the estate at the commencement of a case, the *Heintz* court held

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[45] *In Re Heintz*, 198 B.R. 581, 586 (9th Cir. BAP 1996).

[46] Among other things, *Heintz*, like *Gill* (discussed below) did not address the interplay between § 551 and §§ 522(c)(2)(B) and (g).

[47] Where there is no controlling decision from the District Court for the District of Arizona, this Court follows the 9th Circuit BAP's opinions. See *In re Sample*, 2013 WL 3759795 (Bankr. D. Ariz. 2013).

"§ 551 does not exclude exempt property from preservation for the estate." *Id.* at 586. All exempt property must be property of the estate at the commencement of a debtor's bankruptcy. Here, the Property was property of this estate at the commencement of Debtor's bankruptcy case. As in *Heintz*, in this case, § 551 applies to the Trustee's efforts to avoid the IRS's Tax Lien.

There is another reason why the Property is property of this bankruptcy estate for § 551 purposes, even after the Court allowed the Debtor's exemption on the Property. Under Arizona's homestead statutes, the Debtor's homestead exemption begins where the voluntary BofA lien and the involuntary IRS Tax Lien end. A.R.S. § 33-1101(A) allows any person over the age of 18 who resides within the State of Arizona to

> hold as a homestead exempt from attachment, execution and forced sale, not exceeding one hundred fifty thousand dollars in value any one of the following:
> 1. the person's interest in real property in one compact body upon which exists a dwelling house in which the person resides . . . (emphasis added)

When this Court approved the Debtor's exemption on the Property, what was exempted was only the Debtor's interest in the Property and then only to the extent of the value of that interest, up to $150,000. It was only the value of the Debtor's interest that was removed from this bankruptcy estate and only then once the Debtor's homestead exemption claim was approved

by this Court.[48] The value of the Debtor's interest in the Property, at all times, was no greater than the value of the Property, less the voluntary BofA lien granted by the Debtor against the Property and less the involuntary lien held by the IRS. This Court said as much in its Order[49] denying the Objection to Exemptions.

Several statutes and cases must be reviewed to explain this Court's conclusion. First, A.R.S. § 33-1103(A) notes that a homesteaded property

> is exempt from process and from sale under a judgment or lien, except:
> 1. a consensual lien, including a mortgage or deed of trust, or contract of conveyance.

A.R.S. § 33-1104(D) also tells us that,

> [a]ny recorded consensual lien, including a mortgage or deed of trust, encumbering homesteaded property shall not be subject to or affected by the homestead claim or exemption.

Together, these two statutes reveal that the value of the Debtor's interests in the Property (i.e. the Debtor's homestead exemption) does not include the value of the Property which is encumbered by BofA's lien.

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[48] *See In Re Gebhart*, 621 F. 3d 1206, 1210 (9th Cir, 2010) ("By it's plain language, the Arizona homestead exemption thus appears to track the federal exemption in applying only to an interest up to a given monetary amount.")

[49] Administrative DE 38.

But what about the value of the Property which is encumbered by the Tax Lien? The Arizona homestead exemption statutes indicate that such involuntary liens against a debtor's homestead are "exempt from attachment, execution and forced sale." However, federal tax lien law provides a crucial element to this discussion. 26 U.S.C. § 6321 creates a lien in favor of the IRS against all of a taxpayer's property.[50] The 9th Circuit long ago recognized that:

> [a]gainst such [federal tax] liens, exemptions prescribed by State laws are ineffective. Bankruptcy does not invalidate such liens or prevent their enforcement. Section 6 [of the Bankruptcy Act] recognizes exemptions prescribed by State laws but does not render such exemptions effective against Federal tax liens.[51]

Like the Bankruptcy Act of yesteryear, the Bankruptcy Code today also recognizes Arizona's exemption laws[52] but does not make such exemptions effective against the IRS's Tax Lien. A claim of exemption, by itself, does not affect the validity of liens on the property

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[50] Section 6321 states: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."

[51] *United States v. Heffron*, 158 F. 2d 657 (9th Cir. 1947).

[52] See § 522(b)(2) (permitting states to opt out of the federal exemption scheme) and A.R.S. § 33-1133(B) (Arizona has opted out of the federal exemption scheme found at § 522(d)).

claimed as exempt. *See In re DeMarah*, 62 F.3d 1248, 1251 (9th Cir. 1995) (stating "it is pellucid that property exempted from the estate remains subject to tax liens").

Under a similar, but not identical, fact pattern the BAP held that a trustee's ability to avoid the penalty portion of a federal tax lien under § 724(a) and to preserve that avoided lien under § 551 for the benefit of the estate precluded abandonment of the estate's property encumbered by that lien.[53] In *Gill*, the debtor moved to compel the trustee to abandon his residential property. The debtor claimed the property was of inconsequential value to the estate in light of the magnitude of the debtor's claimed homestead exemption plus the mortgage lien plus the IRS's tax lien.[54] The BAP held the trustee could avoid the penalty portion of the IRS tax lien under § 724(a) for the benefit of the estate, thereby creating value for unsecured creditors when that avoided lien was preserved for the benefit of creditors under § 551.

At the commencement of this bankruptcy case, property of this estate included the entire value of

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[53] *In re Gill*, 574 B.R. 709 (9th Cir. BAP 2017). *See also In re Savage*, 216 B.R. 919, 920 (Bankr. S.D. Ga. 1997) (stating trustee can avoid a portion of the IRS lien for penalties and statutory additions that secured a claim of the kind specified in § 726(a)(4)).

[54] After considering the value of the home, the first position mortgage, and the IRS's tax lien, the *Gill* court noted the debtor had no equity in the residence. Debtor's residence was valued at $500,000. There was a $371,00 first position mortgage, and an IRS secured claim for $161,530, including $48,276.33 in tax penalties.

the Property. When the Court approved the Debtor's homestead exemption it was only the value of the Debtor's interest in the Property which was removed from the bankruptcy estate. The value of the Debtor's interest in the Property never included the value of the lien positions occupied by BofA or the IRS. Instead, here the Debtor's homestead exemption is third in line, behind BofA's 1st lien and the 2nd position occupied by the IRS's Tax Lien. The Debtor's homestead exemption is ineffective against the IRS's Tax Lien. In other words, it is the Debtor's equity in the Property which is exempt, and that equity position is subordinate to both the BofA lien and the Tax Lien.

At all relevant times, the IRS's Tax Lien encumbered property of this estate. The trustee may avoid the IRS's Tax Lien under § 724(a). Upon avoidance of the IRS's Tax Lien, the IRS's Tax Lien is preserved for the benefit of this bankruptcy estate under § 551. Here, like *Gill*, the Trustee has the power to avoid the IRS's Tax Lien under § 724(a) to the extent the Tax Lien secures penalties and interest on those penalties. Also, like the trustee in *Gill*, the Trustee may preserve this avoided lien under § 551. Moreover, once the Tax Lien is avoided, the Trustee " . . . inherits the position of the entity whose lien was avoided."[55] As will be seen below, that "position" includes the special powers afforded the IRS's Tax Lien under § 522(c)(2)(B).

Gill, however, did not address all the issues before this Court because the *Gill* court was not asked to

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[55] Colliers at§ 551.02, page 551-4.

determine the impact §§ 522(c)(2)(B) and (g) have upon a lien which is avoided under § 724(a) and preserved under § 551. The next questions before this Court, therefore, are whether the avoided IRS Tax Lien is preserved for the benefit of the estate or the Debtor and what rights are held by the IRS after its Tax Lien is avoided.

C. § 522(g), § 522(c)(2)(B) and the Power of Avoided Tax Liens.

In certain instances, a debtor may exempt property preserved by the Trustee under § 551. Section 522(g) states:

> the debtor may exempt under subsection (b) of this section property that the trustee recovers under section . . . 551 . . . of this title, *to the extent that the debtor could have exempted such property* under subsection (b) of this section if such property had not been transferred, if –
>
> (1) (A) such transfer was not a voluntary transfer of such property by the debtor; and
>
> (B) the debtor did not conceal such property . . .
>
> (emphasis added)

Once a trustee avoids a lien that was not voluntarily created by the debtor, the debtor may claim the value of the lien as exempt so long as the debtor did not conceal the property. Here, the Debtor did not voluntarily

grant the IRS the Tax Lien. Moreover, the Debtor disclosed to the Court both the Property and the Tax Lien.

In re Hannon, 514 B.R. 69 (Bankr. D. Mass. 2014) is cited by the Debtor and the IRS as the principle case supporting the proposition that avoidance and preservation of the Tax Lien by the Trustee will result in the Debtor's allowed exemption stepping into the lien position recovered and preserved by the Trustee. In *Hannon*, the IRS had a tax lien on all of the chapter 7 debtors' real and personal property. The debtors claimed an exemption on all the property, but the IRS lien was greater than the value of the property claimed exempt. The chapter 7 trustee sold all of the property[56] and then filed an adversary proceeding seeking, under § 724(a), to avoid that portion of the IRS's lien attributable to penalties and interest on the tax penalties and then seeking to preserve the avoided lien for the benefit of the bankruptcy estate under § 551. The court correctly recognized that the value of debtor's exemption was $0 because the amount of the IRS's lien exceeded the value of the property claimed exempt. The court also properly acknowledged that the exempt property remained property of the bankruptcy estate notwithstanding the magnitude of the IRS's lien and the fact that the debtor had claimed the property exempt.[57] Bankruptcy Judge Hillman also accurately

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[56] The trustee's sales were with the consent of the IRS and without any objection from the debtors.

[57] In dicta at footnote 36 Judge Hillman stated:

> [i]f The Debtors wished to deal with the IRS outside of their bankruptcy case, as they insist, the Debtors could

cited the 9th Circuit's *DeMarah* decision for the proposition that the Hannons could not themselves avoid the IRS's tax lien and preserve that avoided lien for the debtors. Without explaining its rationale, however, the court ultimately concluded:

> . . . that, even if the Trustee is successful in the Avoidance Action, the entirety of its tax lien will survive as to the property claimed as exempt. Pursuant to § 522(g), if the Trustee avoids the IRS lien on property in which the Debtors have claimed an exemption, the value of the avoided lien will accrue first to the Debtors exemption, not to the estate. Thus, once the Avoidance Action is completed, there may be sale proceeds which are exempted from the bankruptcy estate. Then, pursuant to § 522(c)(2)(B), any exempt portion of the sale proceeds would be liable for the entirety of the IRS lien, not solely for the non-penalty portion. Nevertheless, only if the Trustee succeeds in the Avoidance Action will any of these sale proceeds become exempt property.[58]

> have objected to the sale and moved for the trustee to abandon the property. They failed to do so.

In this Court's estimation Judge Hillman's observation unnecessarily goes too far by assuming there could be no benefit to the estate under this fact pattern. As will be discussed in greater detail below, this Court finds that, notwithstanding § 522(g), the bankruptcy estate will indeed benefit from the Trustee's avoidance of the Tax Lien and preservation of that lien for the benefit of the estate.

[58] *Hannon* at 79.

As will be explained below, this Court disagrees with (and, of course, is not bound by) *Hannon's* conclusion that, under § 522(g), a debtor's exemption will displace the Trustee when he avoids the Tax Lien on the Property and seeks to preserve that Tax Lien for the benefit of the estate.

On its face, § 522(g) appears to allow the Debtor to exempt any avoided penalty lien. However, § 522(c)(2)(B) limits a debtor's right to invoke § 522(g) when a lien is avoided, and the property preserved by the trustee is a tax lien. Section 522(c)(2)(B) states:

> property exempted under this section is not liable during or after the case for any debt of the debtor that arose . . . except – a debt secured by a tax lien, notice of which is properly filed.

In re DeMarah is a case that is factually distinguishable but nevertheless important to the disposition of the case at bar. In *DeMarah*, the debtor attempted to avoid a federal lien to the extent the lien was for tax penalties and then tried to preserve the avoided lien for the debtor's benefit. The debtor argued § 522(h)[59] allowed him to avoid the lien because the trustee had not done so under § 522(g). The 9th Circuit noted that § 522(i)(2) conditions the debtor's preservation of an

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[59] Section 522(h) states: The debtor may avoid a transfer of property of the debtor . . . 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 . . . 724(a) of this title . . . and (2) The trustee did not attempt to avoid such transfer.

avoided lien on the debtor's avoidance of such lien under §522(h). However, § 522(h) contains the same limiting language as § 522(g) – *to the extent that the debtor could have exempted such property.* The 9th Circuit found § 522(c)(2)(B) precludes a debtor from ever invoking § 522(h) to avoid a tax lien. For this reason, a debtor cannot receive the benefit of an avoided tax lien under § 522(i)(2). Rejecting the debtor's arguments, the 9th Circuit held § 522(c)(2)(B) prevents the debtor from avoiding the tax lien under § 522(h) and then preserving the avoided lien under §522(i)(2).[60]

DeMarah explained that the purpose of allowing a trustee to avoid a tax lien for penalties is "to benefit unsecured creditors." Unsecured creditors would be unprotected if debtors could gain the benefit of avoiding penalties they incur. The court concluded, "Congress has not allowed debtors to avoid all blemishes wrought by their past deeds . . . " "[o]ne of those blemishes is caused by the failure to pay taxes."[61]

The principal difference between *DeMarah* and the case before this Court is that here the Trustee, not the Debtor, seeks to avoid the Tax Lien and preserve the avoided lien for the benefit of the estate's creditors and not for the benefit of the Debtor. However, the 9th

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[60] Section 522(i)(2) states: "Notwithstanding 551 of this title, a transfer avoided under section . . . 724(a) of this title, under subsection (f) or (h) of this section . . . *may be preserved for the benefit of the debtor* to the extent that the debtor may exempt such property under subsection (g) of this section or paragraph (1) of this subsection." (Emphasis added.)

[61] Id at 1252.

Circuit recognized that while "§ 522(c)(2)(A) indicates that a debt secured by a lien that is avoided pursuant to § 724(a) does not remain attached to the exempt property . . . § 522(c)(2)(B) . . . brings back the whole of any tax lien."[62] Section 522(c)(2)(B) does not distinguish between § 724(a) lien avoidance by a trustee or a debtor. Section 522(g) is not available to the debtor unless "the debtor could have exempted such property." Section 522(c)(2)(B) prevents the debtor from exempting that portion of the property encumbered by the IRS tax lien. As in *DeMarah*, § 522(c)(2)(B) blocks the Debtor's ability to co-opt a tax lien otherwise avoidable under §724(a). Liens for tax penalties and interest on those penalties may be avoided under § 724(a) but only for the benefit of the estate's creditors. *DeMarah* and § 522(c)(2)(B) compel this result. To hold otherwise would enable a Debtor to wrongfully fail to pay her tax bill and then use § 522(g) to claim the avoided tax penalty lien for herself and to the detriment of her creditors. This is not what § 724(a) was designed to accomplish nor what §522(c)(2)(B) mandates nor what the 9th Circuit would countenance. This Court finds that, read together, §§ 522(g) and 522(c)(2)(B) prohibit a debtor from claiming an exemption in the recovery of a tax lien avoided by a trustee under § 724(a) and preserved estate under § 551.

Two decades after *DeMarah*, a fellow 9th Circuit bankruptcy judge had occasion to address the tension between § 522(c)(2)(B) and a debtor's homestead

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[62] *DeMarah* at 1252.

exemption.[63] In *Hutchinson*, the debtors brought an adversary proceeding to avoid the penalty portion of the IRS's tax lien on their homestead. The court held that "debtors cannot . . . preserv[e] a tax lien for their benefit" because § 522(c)(2)(B) precludes a debtor from avoiding the IRS tax lien.[64] There, the court held § 551 controls the preservation right as to the IRS tax lien avoided by the trustee. The court also noted that, where the lien sought to be avoided secures back taxes, § 522(c)(2)(B) eviscerates the debtor's avoidance power and brings back the whole of any tax lien notwithstanding §§ 724(a) or 726(a)(4). The avoided lien is preserved for the benefit of the estate. *See also 4 Collier on Bankruptcy* ¶ 522.12 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. rev. 2012) (under § 551, transfers are preserved for the benefit of the estate, while under § 522(i)(2) transfers are preserved for the benefit of the debtor).[65]

Finally, the IRS and Debtor both complain that, if the IRS's tax lien is avoided by the Trustee and preserved only for the estate's benefit, then the Debtor will, in effect, pay twice on the IRS claim because the IRS will be able to then seize homestead sale proceeds to the extent those proceeds would otherwise be

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[63] *In re Hutchinson*, 579 B.R. 860, (Bankr. E.D. Cal. 2018).

[64] *Id.* at 864.

[65] In an unpublished memorandum decision, the 9th Circuit BAP affirmed the bankruptcy court's decision and held: "Generally, debtors can assert exemption rights on property avoided by the trustee pursuant to § 522(g). However, where the avoided transfers are liens securing tax penalties, Debtors cannot claim an exemption on the property secured by the liens."

exempt. The Court disagrees that the Debtor will be unfairly docked twice on the IRS claim. The Tax Lien position against the Property never attached to the Debtor's homestead exemption. As explained above, the value of the Debtor's exemption was always subordinate to the Tax lien. When the Tax Lien is avoided, the Trustee steps into that avoided position. If it so happens that the IRS's now unsecured claim is also nondischargeable, it is no different than any other nondischargeable claim which will need to be paid by the Debtor. Whether the IRS can force payment of its unsecured and nondischargeable claim from exempt proceeds from the sale of the Property is not an issue ripe for this Court's determination as there are no sale proceeds yet available for seizure by the IRS.

V. CONCLUSION

Based on the foregoing, this Court determines there are no genuine issues of material fact and the Trustee is entitled to entry of summary judgment as a matter of law. Pursuant to §§ 724(a) and 551, Trustee may avoid the Tax Lien and preserve the value of the avoided lien for the benefit of the estate. The Debtor is not entitled to reap the benefits of that avoided Tax Lien. The position of value occupied by the Tax Lien was never covered by Debtor's homestead exemption and this fact will not be changed by § 522(g) now that the Trustee steps into the shoes of the avoided Tax Lien. Whether the IRS holds any rights to any portion of the exempt proceeds from the sale of Debtor's homestead is another issue for another day. That issue may,

in part, turn on whether the now unsecured IRS claim is nondischargeable.

DATED AND SIGNED ABOVE.

COPY of the foregoing mailed by the BNC and/or sent by auto-generated mail to interested parties.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re: SANDRA J. TILLMAN, Debtor, UNITED STATES OF AMERICA, Appellant, v. LAWRENCE J. WARFIELD, Trustee; SANDRA J. TILLMAN, Appellees.	No. 21-16034 D.C. No. 3:20-cv-08204-DWL District of Arizona, Prescott ORDER (Filed Sep. 26, 2023)

Before: CLIFTON and BUMATAY, Circuit Judges, and CHEN,* District Judge.

Judges Clifton and Chen voted to deny the petition for panel rehearing, and Judge Bumatay voted to grant the petition for panel rehearing. Fed. R. App. P. 40. Judge Bumatay voted to grant the petition for rehearing en banc. Judges Clifton and Chen recommended denying the petition for rehearing en banc. The full court has been advised of the petition, and no judge has requested to vote on whether to rehear the matter en banc. Fed. R. App. P. 35. The petition for panel

* The Honorable Edward M. Chen, United States District Judge for the Northern District of California, sitting by designation.

rehearing and rehearing en banc (Dkt. No. 49) is therefore **DENIED**.

11 U.S.C. § 522. Exemptions

(b)(1) Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection. In joint cases filed under section 302 of this title and individual cases filed under section 301 or 303 of this title by or against debtors who are husband and wife, and whose estates are ordered to be jointly administered under Rule 1015(b) of the Federal Rules of Bankruptcy Procedure, one debtor may not elect to exempt property listed in paragraph (2) and the other debtor elect to exempt property listed in paragraph (3) of this subsection. If the parties cannot agree on the alternative to be elected, they shall be deemed to elect paragraph (2), where such election is permitted under the law of the jurisdiction where the case is filed.

* * *

(c) Unless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except –

> **(1)** a debt of a kind specified in paragraph (1) or (5) of section 523(a) (in which case, notwithstanding any provision of applicable nonbankruptcy law to the contrary, such property shall be liable for a debt of a kind specified in such paragraph);

(2) a debt secured by a lien that is –

(A)(i) not avoided under subsection (f) or (g) of this section or under section 544, 545, 547, 548, 549, or 724(a) of this title; and

(ii) not void under section 506(d) of this title; or

(B) a tax lien, notice of which is properly filed;

* * *

(1) The debtor shall file a list of property that the debtor claims as exempt under subsection (b) of this section. If the debtor does not file such a list, a dependent of the debtor may file such a list, or may claim property as exempt from property of the estate on behalf of the debtor. Unless a party in interest objects, the property claimed as exempt on such list is exempt.

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11 U.S.C. § 541. Property of the estate

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

* * *

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.

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11 U.S.C. § 551. Automatic preservation of avoided transfer

Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

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11 U.S.C. § 554. Abandonment of property of the estate

(a) After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.

(b) On request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.

* * *

(d) Unless the court orders otherwise, property of the estate that is not abandoned under this section and

that is not administered in the case remains property of the estate.

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11 U.S.C. § 724. Treatment of certain liens

(a) The trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title.

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11 U.S.C. § 726. Distribution of property of the estate

(a) Except as provided in section 510 of this title, property of the estate shall be distributed –

> **(4)** fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

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26 U.S.C. § 6321. Lien for taxes

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to

property, whether real or personal, belonging to such person.

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26 U.S.C. § 6322. Period of lien

Unless another date is specifically fixed by law, the lien imposed by section 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time.

Fed. R. Bankr. P., Rule 4003. Exemptions

(a) Claim of exemptions

A debtor shall list the property claimed as exempt under § 522 of the Code on the schedule of assets required to be filed by Rule 1007. If the debtor fails to claim exemptions or file the schedule within the time specified in Rule 1007, a dependent of the debtor may file the list within 30 days thereafter.

(b) Objecting to a claim of exemptions

(1) Except as provided in paragraphs (2) and (3), a party in interest may file an objection to the list of property claimed as exempt within 30 days after the meeting of creditors held under § 341(a) is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later. The court may, for cause, extend the

time for filing objections if, before the time to object expires, a party in interest files a request for an extension.

A.R.S. § 33-1101 (2004). Homestead exemptions; persons entitled to hold homesteads

A. Any person the age of eighteen or over, married or single, who resides within the state may hold as a homestead exempt from attachment, execution and forced sale, not exceeding one hundred fifty thousand dollars in value, any one of the following:

1. The person's interest in real property in one compact body upon which exists a dwelling house in which the person resides.

* * *

C. The homestead exemption, not exceeding the value provided for in subsection A, automatically attaches to the person's interest in identifiable cash proceeds from the voluntary or involuntary sale of the property. The homestead exemption in identifiable cash proceeds continues for eighteen months after the date of the sale of the property or until the person establishes a new homestead with the proceeds, whichever period is shorter. Only one homestead exemption at a time may be held by a person under this section.

A.R.S. § 33-1104. Abandonment of homestead; encumbrance of homestead

D. Any recorded consensual lien, including a mortgage or deed of trust, encumbering homestead property shall not be subject to or affected by the homestead claim or exemption.

A.R.S. § 33-1133. Other exemption laws

B. Notwithstanding subsection A, in accordance with 11 U.S.C. 522(b), residents of this state are not entitled to the federal exemptions provided in 11 U.S.C. 522(d). Nothing in this section affects the exemptions provided to residents of this state by the constitution or statutes of this state.