UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO
Bankruptcy Judge Elizabeth E. Brown

In re: DON RICHARD ILEY, Debtor.	Case No. 15-23985 EEB Chapter 11
In re: ILEY & ASSOCIATES, INC., Debtor.	Case No. 15-23986 EEB Chapter 11 **Jointly Administered Under** **Case No. 15-23985 EEB**
TOM H. CONNOLLY, chapter 7 trustee, Plaintiff, v. ASBESTOS ABATEMENT, INC., Defendant.	Adversary Proceeding No. 17-1519 EEB

ORDER GRANTING IN PART MOTION FOR SUMMARY JUDGMENT

THIS MATTER comes before the Court on the Motion for Summary Judgment, filed by Defendant Asbestos Abatement, Inc. ("AAI"), and the Trustee's Response. The Trustee has sued the Defendant, a former accounting client of the Debtors, to recover as preferential transfers certain payments the Debtors made to the IRS on AAI's behalf. The question presented is whether the monies transferred were the Debtors' property or rather statutory trust funds held for the benefit of the IRS under 26 U.S.C. § 7501. The Court concludes that, under the particular undisputed facts of this case, some of the funds were trust funds and, as such, the Trustee cannot avoid that portion of the funds under 11 U.S.C. § 547.[1]

I. BACKGROUND

The basic facts of this case are not in dispute. Don Iley was a certified public accountant who owned and operated Iley & Associates, Inc. ("I&A"), a tax and

[1] All references to "section" or "§" shall refer to Title 11, United States Code, unless expressly stated otherwise.

accounting business. I&A's business included payroll services for many of its clients. It calculated the client's federal employee taxes, prepared each client's IRS Form 941 quarterly tax return, and obtained the payroll tax monies owed by the client by means of an automated deduction from the client's bank account into an I&A bank account, referred to as account number x4136. I&A was then obligated to transmit the tax return and the payroll tax funds directly to the IRS.

In January 2009, Iley began a fraudulent scheme under which he prepared an accurate tax return for each client and transferred the client's payroll tax funds from the client's bank account into I&A's account x4136. He would transmit a copy of the accurate return to the client along with a letter indicating that I&A had or would pay the taxes and the client need not do anything further. Then he would modify the tax return that he transmitted to the IRS to show that the client had no employees and owed no payroll taxes for the quarter. Iley would then keep the client's tax funds for his own use. Through this scheme, Iley estimated that he stole at least $11 million of the payroll tax funds from more than 140 payroll clients. Iley spent the stolen money on a variety of things, including a luxury home, payments on personal credit cards, college tuition for his children, and other personal investments.

Defendant AAI was a payroll client of I&A from 2013 through 2015. During this period, AAI was a victim of the Debtors' fraudulent scheme—I&A filed false payroll tax returns for AAI and failed to forward the payroll taxes it obtained from AAI to the IRS. Records kept by both I&A and AAI show that for each pay period, I&A would prepare an "ACH Deduction Report" for AAI that listed the amounts I&A would be paying to AAI's employees as wages, and the amounts that it would purportedly be paying to the IRS for "Federal Payroll Tax Liability." *See* Trustee's Response, Ex. 4. Over the two-year period that AAI was a client of I&A, the ACH Deductions Reports and other records show that I&A deducted a total of $325,705.72 from AAI's bank account, purportedly for the payment of "Federal Payroll Tax Liabilities."[2] Although I&A represented to AAI that it paid these amounts to the IRS, it did not in fact do so.

In the fall of 2015, AAI, along with several other of I&A's other payroll clients, found out about the scheme. These clients demanded that Iley rectify the situation and he conceded to those demands. In the six weeks between September 30, 2015 and November 13, 2015, I&A made payments to the complaining clients totaling $1.8 million. The payments were made either directly to those clients or to their principals. For other clients, he made payments totaling $866,000 directly to the IRS on their behalf during

[2] The parties' stipulated facts refer to $325,767.54 as the total deducted for federal payroll taxes. The Court has reduced this figure to $325,705.72 to account for typos in AAI's calculation of federal payroll tax withholding for 2015 on the chart attached as Exhibit C-5 to AAI's Second Supplement. Specifically, AAI's chart mistakenly reports "Total Federal ACH" withholding of $1,457.08 on 3/6/15 and $2,393.74 on 3/20/15, when AAI's Tax Return for that period (Ex. C-3) shows these amounts are $1,475.08 and $2,393.78. In addition, AAI's chart lists $1,703.64 as the "Total Federal ACH" amount for April 2015. However, this figure mistakenly includes $43.86 in federal unemployment tax. In all previous periods on the chart, the "Total Federal ACH" amount did not include federal unemployment tax.

the same period. The vast majority of I&A's clients were not so "lucky" and did not learn of the scheme until after all the money was long gone.

When AAI discovered Iley's scheme, it demanded that he make payments to the IRS. Iley complied and caused I&A to issue the eight checks totaling $327,732.18 from account x4136 directly to the IRS (collectively, the "Payments"), along with amended tax returns:

Date	**Check No.**	**Payee**	**Amount**
10/22/15	19335	U.S. Treasury	$42,426.73
10/22/15	19336	U.S. Treasury	$51,408.54
10/22/15	23127	U.S. Treasury	$41,190.82
10/22/15	23128	U.S. Treasury	$44,460.38
10/22/15	23129	U.S. Treasury	$32,000.33
10/22/15	23130	U.S. Treasury	$40,368.08
10/22/15	23131	U.S. Treasury	$39,960.86
10/22/15	23132	U.S. Treasury	$35,917.07
		Total	**$327,732.81**

Two months later, Iley's scheme completely collapsed. In December 2015, the government executed a search warrant on I&A's office, the employees quit, and the business shut down. Creditors filed an involuntary chapter 7 petition against both Debtors on December 28, 2015. On January 21, 2016, the Debtors moved to convert their cases to chapter 11 proceedings. The Orders for Relief entered on January 26, 2016. On May 11, 2016, the Court re-converted these cases to chapter 7 proceedings and the Trustee received his appointment on the same day. At the Trustee's request, the Court granted an unopposed motion to substantively consolidate both chapter 7 estates into the Mr. Iley's case on November 16, 2016. This Order effectively terminated the I&A case, but it expressly provided that the "Trustee's avoidance powers and claims . . . are preserved as they existed on the Petition Date, without regard to substantive consolidation." Substantive Consolidation Order, at ¶ 4, *In re Iley*, No. 15-23985 EEB (Bankr. D. Colo. Nov. 16, 2016), ECF No. 478.

Eventually, Iley pled guilty to wire fraud and aiding in the preparation of false tax returns. He received a sentence of twelve and one-half years of incarceration, followed by three years of supervised release.

In this case, the Trustee seeks to recover the Payments as preferential transfers under 11 U.S.C. § 547. AAI's Motion for Summary Judgment argues that the Trustee has failed to establish all the required elements of that claim. In particular, AAI claims that the Trustee cannot establish that Payments were property of the Debtors because those funds were allegedly held in trust for the IRS pursuant to 26 U.S.C. § 7501.

II. APPLICABLE STANDARD

Federal Rule of Civil Procedure 56(c), made applicable to this proceeding by Fed. R. Bankr. P. 7056, provides that a court may award summary judgment only when there is no material issue of fact to be tried, and the movant is entitled to judgment as a matter of law. *Celotex Corp. v. Cattrett*, 477 U.S. 317, 322 (1986). In applying this standard, this Court examines the factual record and reasonable inferences therefrom in the light most favorable to the party opposing summary judgment. *Schwartz v. Bhd. of Maint. of Way Employees*, 264 F.3d 1181, 1183 (10th Cir. 2001). The movant bears the burden of showing that no genuine issue of material fact exists. *Sports Unlimited, Inc. v. Lankford Enter., Inc.*, 275 F.3d 996, 999 (10th Cir. 2002). If the moving party makes a prima facie case, the burden then shifts to the non-moving party to set forth specific facts demonstrated by evidence, "from which a rational trier of fact" could find in its favor. *Whitesel v. Sengenberger*, 222 F.3d 861, 866 (10th Cir. 2000).

When the movant will not bear the burden of persuasion at trial, it need not negate the nonmovant's claim, but may meet its burden by "pointing out to the court a lack of evidence for the nonmovant on an essential element of the nonmovant's claim." *Adler v. Wal-Mart Stores*, 144 F.3d 664, 671 (10th Cir. 1998). If the movant meets this initial burden, the nonmovant must "go beyond the pleadings" and "set forth specific facts" that would be admissible in evidence in the event of trial from which a rational trier of fact could find for the nonmovant." *Id.*

III. DISCUSSION

To establish a prima facie case for an avoidable preference under § 547(b), the Trustee must show that the transfer at issue: "(1) is of an interest of the debtor in property; (2) is for the benefit of a creditor; (3) is made for or on account of an antecedent debt owed by the debtor before the transfer was made; (4) is made while the debtor is insolvent; (5) is made on or within ninety days before the date the bankruptcy petition was filed; and (6) allows the creditor to receive more than the creditor would otherwise be entitled to receive from the bankruptcy estate." *Bailey v. Big Sky Motors, ltd. (In re Ogden)*, 314 F.3d 1190, 1196 (10th Cir. 2002). The Trustee has the burden of proof on each of these elements. *Id.* The parties do not dispute that I&A made the Payments in the ninety days prior to the petition date and that the Debtors were insolvent at that time. AAI argues that the Trustee, as a matter of law, cannot establish the remaining elements.

A. Interest of the Debtor in Property

1. IRS Trust Funds

AAI's primary argument relates to the first element—whether the Payments amount to "interest[s] of the debtor in property." AAI contends that I&A held the Payments in trust for the benefit of the IRS pursuant to 26 U.S.C. § 7501. That section is one of many in the Tax Code pursuant to which the IRS carefully regulates how employers must handle employee payroll taxes. The Tax Code requires employers to deduct and withhold certain federal taxes owed by its employees at the time it pays wages to those employees and then pay over those funds to the IRS on the employees' behalf. 26 U.S.C. §§ 3102(a), 3402(a). When an employer withholds such taxes owed by its employees, § 7501 provides that they "shall be held to be a special fund *in trust* for the United States." *Id.* § 7501(a) (emphasis supplied). Because the Payments were for payroll taxes, AAI argues that they were held in trust for the IRS and cannot be considered the Debtors' property for purposes of § 547.

The Bankruptcy Code does not define § 547's phrase "interest of the debtor in property." However, the Supreme Court has instructed that the phrase is "coextensive with 'interests of the debtor in property' as that term is used in 11 U.S.C. § 541(a)(1)." *Begier v. IRS*, 496 U.S. 53, 59 n.3 (1990). Section 541(a)(1) defines property of the estate broadly to include "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The definition of property of the estate, however, is not limitless. Where the debtor holds only legal title and not an equitable interest, § 541(d) provides that such property is included in the estate only to the extent of the debtor's legal title. The equitable interest is excluded. Given this limitation, courts have held that property a debtor holds in trust for another on the petition date is not included in property of the estate. *Begier*, 496 U.S. at 60. If property held in trust is excluded from the debtor's estate, then a debtor's transfer of that property in the ninety days before the petition date cannot be avoided under § 547. *See id*.

Identifying trust funds as separate from a debtor's property is not always easy. This is especially true when a debtor has comingled his own funds with purported trust funds in one bank account. In such situations, courts have applied a burden shifting analysis to determine if a proper showing has been made. *See Rocor Int'l, Inc. v. Alta AH&L (In re Rocor Int'l, Inc.)*, 352 B.R. 319, 328 (Bankr. W.D. Okla. 2006); *Redmond v. Rainstorm, Inc. (In re Lone Star Pub Operations, LLC)*, 465 B.R. 212, 261-17 (Bankr. D. Kan. 2012); *Cassirer v. Herskowitz (In re Schick)*, 234 B.R. 337, 343 (Bankr. S.D.N.Y. 1999). Under this analysis, the trustee has the initial burden of going forward by demonstrating that the debtor had legal title to the bank account and control over its use. *In re Rocor Int'l, Inc.*, 352 B.R. at 328. In the Tenth Circuit, there is a presumption that "deposits in a bank to the credit of a bankruptcy debtor belong to the entity in whose name the account is established." *Amdura Nat'l Dist. Co. v. Amdura Corp., Inc. (In re Amdura Corp.)*, 75 F.3d 1447 (10th Cir.1996) (citing 4 *Collier on Bankruptcy* ¶ 541.11, at 541–75 (15th ed. 1995)). Thus, account ownership is typically enough to satisfy the trustee's initial burden. The burden then shifts to the defendant asserting trust funds "(1) to show that the debtor held only legal title and (2) to trace the equitable owner's interest to the specific [funds] at issue." *In re Rocor Int'l, Inc.*, 352 B.R. at 328; *see Sender v. Nancy Elizabeth R. Heggland Family Trust (In re Hedged-Investments Assoc.)*, 48 F.3d 470, 474 (10th Cir. 1995) ("[A]s a general rule, any party seeking to impress a trust upon funds for purposes of exemption from a bankrupt estate must identify the trust fund in its original or substituted form.").

This burden-shifting analysis is well-suited to this case because I&A did not clearly segregate the funds it received from AAI. AAI and I&A did not have a written agreement as to how I&A would handle AAI's payroll taxes. Nothing in the Service Contract and Payment Agreement between I&A and AAI addresses the handling of the funds. In practice, I&A withdrew funds directly from AAI's bank account through an ACH deduction and then deposited them into its own account x4136. I&A did not segregate the funds into a separate bank account. Rather, the funds were comingled with other monies in x4136, including payroll taxes collected from other clients and revenues I&A earned for its services. AAI does not dispute that I&A owned account x4136. There is no evidence to suggest that anyone other than I&A, through Mr. Iley, had decision-making authority over the funds in x4136. This satisfies the Trustee's initial burden to show Debtors had an interest in the Payments made from x4136. The burden therefore shifts to AAI to show that Debtors held the funds in trust and to trace those trust funds and to distinguish them from the other funds in the account. *In re Hedged-Investments Assoc.*, 48 F.3d at 474.

AAI argues that the Supreme Court established the standard for identifying § 7501 trust funds in the case of *Begier v. IRS*, 496 U.S. 53 (1990). In that case, the debtor was an airline that had withheld payroll taxes from its employees' wages. Although the IRS had previously required the debtor to place all withheld payroll taxes into a segregated bank account, the debtor failed to do so and instead deposited most of them in its general operating account, later paying the taxes from that account. The chapter 11 trustee sought to avoid the tax payments made to the IRS in the ninety days before the petition date as preferential transfers. The Supreme Court held that the payments were trust funds and, therefore, not property of the debtor. As a result, the transfers were not avoidable under § 547.

The Supreme Court first determined that a trust was created under § 7501 at the time the debtor withheld the taxes and paid the remaining net wages to its employees, even though the debtor failed to put those taxes into a segregated bank account. The Court refused to apply the traditional common law principles that normally define when a trust is created—such as the identification of a specific trust res. This is because "[u]nlike a common-law trust, in which the settlor sets aside particular property as the trust res, § 7501 creates a trust in an abstract 'amount'-a dollar figure not tied to any particular assets-rather than in the actual dollars withheld." *Id.* at 62. Given the uniqueness of the § 7501 trust, the Court found "common-law tracing rules" to be "unhelpful" in determining whether such a trust has been created.

Without the assistance of common law principles to determine trust property, how is a bankruptcy court to decide if the § 7501 trust applies to a particular transfer of funds? The Supreme Court determined that there must be “some connection” or a “nexus” between the § 7501 trust and the payments at issue. *Id.* at 66-67. *Begier* does not specifically define this nexus, but instructs courts to use “reasonable assumptions” to make the determination. *Id.* at 67. The Supreme Court provided only one example of a “reasonable assumption” sufficient to establish the required nexus—an employer’s voluntary act of paying trust-fund taxes out of its own assets. This example comes from the legislative history behind § 541, which states:

> A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code § 7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments.

Id. at 66 (citing H.R. Rep. 95-595, p. 373 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5787, 6329).

Thus, “the debtor’s act of voluntarily paying its trust-fund tax obligation . . . is alone sufficient to establish the required nexus between the ‘amount’ held in trust and the funds paid.” *Id.* at 66-67. In other words, “the bankruptcy trustee could not avoid *any* voluntary prepetition payment of trust-fund taxes, regardless of the source of the funds.” *Id.* at 66 (emphasis original). But because the evidence demonstrated that the debtor had voluntarily paid the taxes out of its own assets, the Court held that the transferred amount had been held in trust by the debtor. This was so even though the debtor had commingled some of the tax payments with other funds in its general operating account and, therefore, could not directly trace the IRS payments to the monies it had previously withheld from its employees’ wages.

The facts of this case obviously differ from *Begier.* AAI did not make any direct payments to the IRS. Rather, I&A made the payments, acting as AAI’s payroll service provider. The Third Circuit dealt with a similar situation in *Slobodian v. United States (In re Net Pay Solutions, Inc.)*, 822 F.3d 144 (3d Cir. 2016). The debtor in *Net Pay* was also a payroll service provider. It managed its clients’ payroll by calculating the amount of payroll taxes due, transferring those funds from the client’s bank account to its own bank account, and then transferring the taxes due to the IRS. Although not specifically mentioned by the Third Circuit, it appears that the debtor commingled the funds it received from its various clients into one bank account, as it made multiple payments from that account to the IRS on behalf of different clients in the days leading up to the petition date. The trustee sought to recover the payments from the IRS, arguing *Begier* did not apply because the debtor, rather than the employer, had paid the trust-fund taxes to the IRS. The Third Circuit disagreed. It noted that § 7501 indisputably required the debtor’s client, as an employer, to withhold and pay over its employees’ trust-fund taxes to the IRS. The fact that the client had hired the debtor to perform that task did not invalidate the § 7501 trust: “[n]othing there suggests that an employer may avoid the fact that an amount required by law is being held in trust for the United States merely by outsourcing payroll processing to a third party.” *Id.* at 156. The Third Circuit determined that the “nexus” required by *Begier* had been met because the amount that the debtor had paid to the IRS on its client's behalf was ultimately paid out of the client's assets. The Third Circuit did not discuss the factual basis for this determination, but the lower court's opinion, affirmed by the Third Circuit, pointed to undisputed evidence that the debtor had withdrawn the disputed amount from the client's bank account and then transferred that same amount to the IRS several weeks later. *Slobodian v. United States*, 533 B.R. 126, 136 (M.D. Pa. 2015), *aff'd*, 822 F.3d 144 (3d Cir. 2016).

Thus, the required "nexus" in the *Net Pay* case was the link between the amount the debtor-payroll provider deducted from its client's account and the amount the debtor then paid to the IRS on the client's behalf. AAI attempts to establish a similar link by demonstrating through stipulated facts that I&A withdrew by ACH deduction a total of $325,705.72 from AAI's bank account for "federal employment taxes" and the Payments I&A made to the IRS totaled $327,732.81. Stipulated Facts, ¶ 1. Because these amounts are substantially similar, AAI argues this establishes a sufficient "nexus" and that all the Payments were trust funds. The Trustee disputes this conclusion for several reasons.

First, the Trustee argues that I&A's comingling of funds in account x4136 precludes any tracing of trust funds. However, this argument misses the point of *Begier*. In *Begier*, the Supreme Court expressly stated that common law rules of tracing do not apply to establishing a § 7501 trust because that trust is imposed over an amount, not as to traceable property. *Begier*, 496 U.S. at 62. In *Begier*, the trust existed even though the employer in that case had comingled the tax monies with other funds in its general operating account before paying the funds to the IRS. Based on the holding of *Net Pay*, which this Court finds persuasive, the same principles would apply to a payroll provider that commingles payroll taxes with other funds. Thus, commingling alone does not mean AAI cannot establish the necessary "nexus" through voluntary payment or some other "reasonable assumption." *Begier*, 496 U.S. at 66-67.

Next, the Trustee points out that the trust created by § 7501 benefits the IRS. Because AAI is not the beneficiary of that trust, the Trustee contends AAI cannot use the trust as a defense to a § 547 claim. Trustee cites the case of *McHale v. Boulder Capital LLC (In re The 1031 Tax Group, LLC)*, 439 B.R. 47 (Bankr. S.D.N.Y. 2010) for the proposition that "only the beneficiary or trustee of an express trust has standing to sue to establish and enforce the trust." *Id.* at 64. In that case, the defendant in a fraudulent transfer avoidance action attempted to argue that the property it received from the Debtor was not property of the estate because the debtor held it in either an express or constructive trust for other, non-party individuals. The bankruptcy court held that the defendant could not assert that defense because to do so would be asserting the rights of the putative beneficiaries, who were not parties to the dispute. *Id.* at 65.

The Trustee uses this reasoning to argue that only the IRS, as the beneficiary of the § 7501 trust, can assert a trust defense and since the IRS is not a party to this action, AAI cannot assert those rights. However, the principles outlined in *The 1031 Tax Group* case state that *either* a beneficiary *or* a trustee have standing to enforce a trust. In the case of the § 7501 trust, employers such as AAI are effectively acting a trustees of withheld taxes for the benefit of the IRS. *See* T. Keith Fogg, *In Whom We*

Trust, 43 Creighton L. Rev. 357, 358 (2010) ("As they collect [payroll] taxes, the business entities become trustees for the United States for the money they hold."). Indeed, the Tax Code imposes penalties on employers and other responsible persons who fail to honor their § 7501 trust obligations. *See* 26 U.S.C. §§ 6672, 7202. AAI has a direct pecuniary interest in ensuring that the trust funds it collected as a trustee were paid to the IRS in accordance with § 7501. Thus, the Court concludes that AAI has sufficient standing to assert that the § 7501 trust covers the Payments at issue in this case.

Finally, the Trustee argues that, even assuming payment of payroll taxes to the IRS might establish a sufficient nexus, AAI has not done so here because some of the amounts I&A deducted from AAI's bank account were for tax obligations not covered by § 7501 trust. As such, the Trustee argues that not all of the Payments constitute the payment of trust funds. A close review of the ACH deduction reports prepared by I&A show this to be the case.

For each payroll period, I&A prepared an "ACH Deduction Report" for AAI. *See* Trustee's Response, Ex. 4; AAI's Second Supplemental Submission, Ex. C-1. Each Deduction Report listed eight line-items and amounts deducted for each obligation. It looked something like this:

ACH Deduction Report [payroll date]	
Employee FICA Withholding	$[amount]
Employee Medicare Withholding	$[amount]
Employer FICA Matching	$[amount]
Employer Medicare Matching	$[amount]
Federal Withholding	$[amount]
Total Federal Payroll Tax Liability	**$[subtotal]**
Federal Unemployment (FUTA)	$[amount]
State Unemployment (SUTA)	$[amount]
CO State Withholding	$[amount]
Total ACH Deduction	$[grand total]

As shown above, I&A subtotaled the first five items and labeled that amount "**Total Federal Payroll Tax Liability**." This subtotal plus the rest of the line items equaled the "**Total ACH Deduction**" for each payroll period.

The "Total Federal Payroll Tax Liability" amounts from each of the pay periods during the two years I&A worked for AAI added together equals $325,705.72. The Payments made by I&A to the IRS total $327,732.18. It is these two figures that AAI relies on to show the trust nexus required by *Begier*. These totals are misleading, however, because the § 7501 trust provision only applies to three of the line-items included in the ACH Deduction Reports.

By its terms, § 7501 creates a trust fund in favor of the IRS when someone is required "to collect or withhold any internal revenue tax *from any other person* and to pay over such tax to the United States." 26 U.S.C. § 7501(a) (emphasis added). Thus, it is the withholding of tax *owed by another person* that creates trust fund obligations. In the employment context, an employer is required to withhold at least three different types of taxes owed by its employees: personal income tax, FICA, and Medicare taxes. 26 U.S.C. §§ 3402, 3101, 3102. These taxes are considered trust fund taxes covered by § 7501. *See United States v. Energy Resources Co., Inc*. 495 U.S. 545, 546-47 (1990) (stating that money employers withhold from their employees' paychecks representing the "employees' personal income taxes and Social Security taxes" are considered "trust fund taxes").

In addition to these trust fund taxes, the Tax Code also imposes a "matching" FICA and Medicare tax on employers that is equal to the amount of FICA and Medicare tax paid by its employees. 26 U.S.C. § 3111. This is *the employer's* tax obligation—not a tax owed by the employee. The Tax Code also imposes a federal unemployment tax (FUTA) on employers for each of its employees. *Id.* at § 3301. While an employer pays its matching portion of the FICA and Medicare tax on a quarterly basis at the same time it turns over its employees' withheld taxes, the employer's portion is not considered a trust fund tax covered by § 7501. *Ross v. United States*, 949 F. Supp. 2d 272, 275 (D.D.C. 2013) (demonstrating distinction between trust-fund and non-trust-fund payroll taxes). Likewise, the FUTA tax is not considered a trust fund tax. *Bates v. United States*, 974 F.2d 1234, 1235 n.1 (10th Cir. 1992) ("Non-trust fund taxes represent Debtors' (as employers) share of the social security tax and federal unemployment taxes.").

In this case, this means that the amounts I&A deducted for AAI's "Employer Matching" portion of FICA, Medicare taxes, and the FUTA tax are not trust funds under § 7501. Neither are the amounts it collected for state tax liabilities. Only those amounts deducted for "Employee FICA Withholding," "Employee Medicare Withholding," and "Federal Withholding" constitute trust fund taxes under § 7501. By the Court's calculation, these amounts are:

Time Period	Employee FICA	Employee Medicare	Employee Federal Withholding	§ 7501 Trust Funds Grand Total
2013[3]	$30,262.94	$12,343.57	$49,426.13	$92,032.64
2014	$37,250.47	$8,711.96	$59,356.68	$105,319.11
1Q 2015[4]	$9,766.24	$2,284.04	$14,024.69	$26,074.97
April 1-16, 2015[5]	$453.35	$106.04	$541.00	$1,100.39
Total	$77,733.00	$23,445.61	$123,348.50	**$224,527.11**

Thus, AAI's evidence establishes that, of the total $325,705.72 I&A deducted from AAI's bank account as "Federal Payroll Tax Liability," $224,527.11 were trust funds under § 7501. As instructed by *Begier*, the trust was created when I&A withheld this amount for payment of AAI's employees' tax obligations. By demonstrating that I&A paid at least that amount to the IRS on AAI's behalf, AAI has shown a nexus sufficient to demonstrate that these funds ($224,527.11) remained covered by the trust despite comingling in I&A's bank account. Accordingly, the Trustee cannot recover $224,527.11 of the Payments as preferential transfers because they were trust funds and not an "interest of the Debtors in property" as required by § 547.

That leaves the balance of $103,205.70 in Payments made by I&A.[6] As to this portion, AAI has not demonstrated that these funds were subject to the § 7501 trust.

[3] Figures for 2013 and 2014 were derived from the Spreadsheet attached as Exhibit C-5 to AAI's Second Supplemental Submission, the ACH Deduction Reports attached as Exhibit C-1 to AAI's Second Supplemental Submission, and the ACH Deduction Reports attached as Exhibit 4 to the Trustee's Summary Judgment Response.

[4] According to the Trustee, I&A's client records for 2015 were in disarray. As such, the parties derived payroll figures for this period from other sources. Figures for the first quarter of 2015 were derived from the Form 941 Employer's Quarterly Federal Tax Return attached as Exhibit C-3 to AAI's Second Supplemental Submission. The Tax Return totals the employee and employer portions of social security (FICA) and Medicare together in Column 2 of lines 5a and 5c of the Return, respectively. The combined tax rates on the Return for both employer and employee portions is 12.4% for FICA and 2.9% for Medicare. The separate FICA tax rate for the employee and employer is half that, or 6.2% each for FICA and 1.45% each for Medicare. *See* Internal Revenue Service, Instructions for Form 941 (listing the individual tax rate for the employee and employer). Thus, the employee share of FICA and Medicare is one-half of the amounts listed in Column 2 of lines 5a and 5c of the Tax Return. The amount listed for employee withholding ($14,024.69) includes the $.23 listed on line 7 of the Tax Return for the "current quarter's adjustment for fractions of cents," less $.01 to reflect the extra cent added when splitting the FICA tax portions.

[5] Figures for April 2015 were derived from the Payroll Summary attached as Exhibit C-4 to AAI's Second Supplemental Submission.

[6] $327,732.81-$224,527.11=$103,205.70

Nor has AAI attempted to establish any other "reasonable assumption" that might establish the required nexus for these funds. As such, AAI has not met its burden to show that $103,205.70 of the Payments were trust funds and excluded from the Debtors' estate. Thus, AAI is entitled to summary judgment in its favor as to $224,527.11 of the Payments, but not as to the remaining $103,205.70.

2. Stolen Funds

In addition to its trust fund argument, AAI also argues that the Payments were not transfers of the Debtors' property because the funds in I&A's bank account were embezzled from AAI and the Debtors' other accounting clients. AAI cites to a long-standing common law principle that a thief does not take title to the property he steals. If the Debtors never had title to the funds they stole, AAI argues, then I&A's later transfer of some of those funds to the IRS on AAI's behalf were also not transfers of the Debtors' property.

AAI cites the case of *Kitchen v. Boyd (In re Newpower)*, 233 F.3d 922 (6th Cir. 2000) in support of this argument. In that case, the debtor was a director and shareholder of a corporation. The debtor embezzled money from the corporation and then transferred it to himself and various third parties to pay personal expenses. The Sixth Circuit, applying Michigan law, held that the debtor never obtained title to the embezzled funds and, as such, the automatic stay did not prevent the corporation and its other shareholder from seeking to recover funds that were traceable to the embezzlement from the third parties. The Sixth Circuit rejected the chapter 7 trustee's argument that, because the debtor obtained the funds through fraud, he had obtained at least "voidable title" to the funds. The *Newpower* court relied on a distinction in Michigan law between larceny crimes (such as embezzlement) and the crime of false pretenses. With larceny crimes, title to stolen property remains with the victim because the transfer is involuntary, and the victim never intends to pass title to the thief. As a result, the thief cannot pass title of the stolen goods to a bona fide purchaser. With false pretenses, the thief, through fraudulent means, convinces the victim to "voluntarily" part with both possession and title to the property. In that case, the thief obtains "voidable" title, which the thief can then pass to a bona fide purchaser. The Sixth Circuit concluded that the debtor in *Newpower* committed a larceny crime because the victim corporation never intended to give the debtor title to the funds he stole. As such, the Sixth Circuit concluded that the embezzled funds were not property of the debtor's estate.

AAI has not cited a case from this jurisdiction to support its argument. However, it appears that Colorado courts, at least at one time, recognized a similar distinction between the common law crimes of larceny and false pretense. *See Zarate v. People*, 429 P.2d 309, 311 (Colo. 1967) (noting that the distinction between obtaining property by false pretense and larceny is "very narrow."); *West v. Roberts*, 143 P.3d 1037, 1040 (Colo. 2006) (holding that Colorado's current stolen property statute includes both robbery-type theft and theft by deception). Colorado courts also generally recognize the principle that "one who steals or converts property to his own use does not thereby acquire title thereto." *Stewart v. People*, 566 P.2d 1069, 1070 (Colo. 1977). However, even assuming that the Debtors in this case did not obtain title to the funds they misappropriated from clients over their six-year fraudulent scheme, that argument does not fully resolve the issue. As stated by the Tenth Circuit in addressing a similar argument regarding title to misappropriated funds, it is "correct as far as it goes." *Jobin v. Youth Benefits Unlimited, Inc. (In re M&L Bus. Mach. Co.)*, 59 F.3d 1078 (10th Cir. 1995). The flaw in AAI's argument is that the same common law that provides a thief does not acquire title to misappropriated property, also provides that a claimant seeking to reclaim that misappropriated property from a perpetrator must be able to "identify or trace" the property to which he claims ownership. *Id.*

An owner's right to reclaim property that has been improperly transferred is a form of restitution. As stated in the Restatement of Restitution, "[a] person who obtains a benefit by misappropriating financial assets, or in consequence of their misappropriation by another, is liable in restitution to the victim of the wrong." Restatement (Third) of Restitution and Unjust Enrichment § 41. The remedy arises regardless of the type of wrongdoing involved, whether it be "theft, embezzlement, fraud or conversion." *Id.* § 41, cmt. a. In other words, restitution is a means of preserving the claimant's ownership of property that has come into the hands of another through some sort of "nonconsensual transfer," or a transfer that is "without adequate legal basis" or that is "insufficiently voluntary" because it was induced by fraud or mistake. Andrew Kull, *Restitution in Bankruptcy: Reclamation and Constructive Trust*, 72 Am. Bankr. L.J. 265, 282 (1998) [hereinafter *Kull*] ("[Restitution's] chief concern is to define the obligations of the recipient with respect to benefits obtained under circumstances that are legally anomalous, in that the transfer from the claimant to the recipient was neither a gift nor the product of a voluntary exchange.").

When such an involuntary transfer occurs, the Restatement recognizes two broad categories of restitution remedies available to a victim: restitution in the form of money damages and restitution via rights in identifiable property. Restatement (Third) of Restitution and Unjust Enrichment §§ 49-61. If selecting a remedy in the latter category, the claimant forgoes money damages in favor of attempting to reclaim the transferred property or its product. *Id.* at § 54. This type of reclamation remedy includes assertion of a constructive trust or equitable lien on the property the claimant is seeking to reclaim. *Id.* at § 55, 56.

An important requirement of reclaiming property through restitution is that the claimant must be able to adequately identify the misappropriated property, whether in the hands of the perpetrator or some third party. *Id.* at § 58 & cmt. a ("The common requirement of any claim to asset-based restitution . . . is that the claimant identify specific property in the hands of the recipient in which the claimant asserts rights of ownership."). Sometimes, this requirement takes the form of "tracing." *See id.* at § 59. "Generally speaking, tracing principles furnish the necessary link between the original property of the claimant and the property from which the claimant now seeks restitution." *Id.* at § 58, cmt. a. The extent to which tracing is necessary is dependent on the type of property involved. With identifiable personal property, tracing is usually unnecessary. For example, if a claimant's wallet is stolen, he may seek restitution of the wallet so long as he can adequately identify it as his property. Money, however, is fungible. If it is comingled with other funds, it becomes impossible to pinpoint which specific dollars belonged to the claimant. In that case, tracing becomes essential. *See id.* at § 59 (requiring tracing where the funds at issue have been "deposited in a common account or otherwise commingled with other property so that it is no longer separately identifiable."). Tracing rules, such as the lowest intermediate balance test, provide an avenue for the claimant to try and identify at least some of his property in a commingled account.

The Restatement cites two primary reasons behind the tracing requirement. The first and most obvious is that seeking restitution of particular property, as opposed to merely seeking money damages, is an assertion of ownership. Tracing is a method of establishing that ownership claim. If the property in question is untraceable, the claimant loses his equitable claim to the specific property and must instead resort to a general claim for damages. *Id.* at § 55, cmt. h; *State of Colo. v. Benjamin*, 587 P.2d 1207, 1209 (Colo. App. 1978) (holding that State could not impose a constructive trust on stolen funds because it did not adequately trace the funds or the proceeds therefrom, making the State a merely general lien creditor).

The second reason behind the tracing requirement comes into play when the defendant is insolvent and there are competing creditors seeking repayment from the defendant. *Id.* In that situation, a successful restitution claimant will get priority over the defendant's general creditors by reclaiming the property at issue and thereby making that property unavailable for distribution to the defendant's other creditors. In most cases, this is considered an equitable result because the defendant's general creditors are not entitled to be paid with funds that do not belong to the defendant. *Id.* at § 59, cmt. b. If the restitution claimant is unable to trace funds, however, he loses his priority and becomes merely a general creditor of the defendant. In this way, tracing rules "make a rough, practical compromise between the competing interests of the restitution claimant and of the other persons with an interest in the fund." *Id.*

This "practical compromise" often plays out in the context of a bankruptcy case. A restitution claimant will assert that his property is not property of the defendant's bankruptcy estate under § 541 and thus should not be available to pay the debtor's general creditors. In order to succeed in that argument, the claimant must be able to adequately identify or trace his property as separate from the estate. As put by one commentator, "the restitution claimant who succeeds in bankruptcy prevails over the general creditors because he is not himself merely a creditor, but an owner." *Kull*, 72 Am. Bankr. L.J. at 284. In the case of commingled money, the claimant will have the burden to trace the funds he alleges that he owns. *Jobin v. Youth Benefits Unlimited, Inc. (In re M&L Bus. Mach. Co.)*, 59 F.3d 1078, 1081 (10th Cir. 1995) ("[A] claimant must be able to identify or trace the fraudulently deprived funds or property to which he claims ownership."); *Sender v. Nancy Elizabeth R. Heggland Family Trust (In re Hedged-Inv. Assoc., Inc.)*, 48 F.3d 470, 474 (10th Cir. 1995) (holding that party asserting constructive trust in order to exempt funds from the bankruptcy estate "must identify the trust fund in its original or substituted form"). Failure to trace will result in the claimant being paid pro rata along with other general creditors.

Here, AAI is asserting that the funds used to make the Payments were not Debtors' property but were instead funds stolen from AAI. In other words, AAI is arguing that the funds are its property, not the Debtors. However, AAI has made no effort to trace the funds I&A stole within the commingled x4136 account. Without establishing this link, AAI cannot succeed in its argument that the Payments were not the Debtors' property. As such, AAI is not entitled to summary judgment on that basis.

The Court further notes that obtaining restitution from a comingled account through tracing is not always available. Courts often suspend tracing in cases where the debtor has commingled monies from many victims into one fund that is insufficient to satisfy all claims. For instance, in the original Ponzi scheme case, the Supreme Court held that that tracing would not apply because none of the equally-innocent victims could trace their funds. *Cunningham v. Brown*, 265 U.S. 1, 13 (1924). As such, the Supreme Court held the more equitable result would be for all the victims to share pro rata. The Tenth Circuit has likewise declined to apply tracing where there is a commingled account comprised of funds acquired from several, similarly-situated fraud victims. In that situation, tracing by one victim would unfairly elevate that person's claims over victims who were similarly defrauded. *Hill v. Kinzler (In re Foster)*, 275 F.3d 924, 927-28 (10th Cir. 2001) (citing *Cunningham v. Brown*, 265 U.S. 1, 13 (1924)).

In this case, the Debtors have admitted to misappropriating funds from 140 different clients. Of those clients, only twelve (including AAI) received some sort of repayment from Debtors as the scheme started to crumble. In order to prevail on its argument that the funds belong to AAI rather than the Debtors, this Court will need to be convinced that application of tracing rules, which could elevate the claim of AAI over that of the other equally-innocent victims, will produce the most equitable result. No such showing has been made. Thus, AAI is not entitled to summary judgment on the basis that the Payments are stolen funds and not property of the Debtors.

B. To or For the Benefit of a Creditor

AAI next argues it is entitled to summary judgment because the Trustee failed to establish the second element of a preference claim—that the Payments were to or for the benefit of a creditor. The term "creditor" is defined broadly by the Code to include any "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10). In this case, AAI meets this definition because it has a claim against Debtors for the money Debtors embezzled. *See Bailey v. Big Sky motors, Ltd. (In re Ogden)*, 314 F.3d 1190, 1201 (10th Cir. 2002) (holding that when debtor converted funds from defendant, the defendant became a creditor with a conversion claim against the debtor). Indeed, AAI has filed a proof of claim in the case in the amount of $504,816 representing Debtors' alleged "personal liability for Tax Funds embezzled ACH's for Taxes." Proof of Claim No. 26. Although the Debtors did not make the Payments directly to AAI, this element of § 547 is nevertheless satisfied if AAI benefited from the Payments. *See Nat'l Bank of Newport v. Nat'l Herkimer Co. Bank*, 225 U.S. 178, 184 (1912) ("To constitute a preference, it is not necessary that the transfer be made directly to the creditor. It may be made to another, for his benefit."). The Payments benefited AAI because it reduced AAI's liability to the IRS for both trust fund taxes and non-trust fund taxes.

AAI argues the Payments really benefited Iley because Iley has direct liability to the IRS for the unpaid payroll taxes as a so-called "responsible person" under sections 6672 and 7202 of the Tax Code. Those sections "were designed to assure compliance by the employer with its obligation to withhold and pay the sums withheld, by subjecting the employer's officials responsible for the employer's decisions regarding withholding and payment to civil and criminal penalties for the employer's delinquency." *Slodov v. United States*, 436 U.S. 238, 247 (1978). The Court need not decide if Iley was a "responsible party," because even if he was, it does not change the fact that AAI, as the employer, also had direct liability to the IRS for payment of the outstanding payroll taxes. When Debtors paid that obligation on AAI's behalf, it benefited AAI. Thus, the Court concludes that there is sufficient evidence to meet the second element of the Trustee's preference claim.

C. Antecedent Debt

AAI argues the Trustee has not shown that the Payments were made on account of an "antecedent debt" as required by the third element of § 547(b). Instead, AAI argues the Payments were merely transfers of § 7501 trust funds. As discussed above, however, AAI has not established that all of the Payments were trust funds. As such, AAI cannot rely on that argument as to at least $103,205.70 of the Payments.

As also discussed above, AAI is a creditor of the Debtors based on the Debtors' embezzlement of its funds. *Bailey v. Big Sky motors, Ltd. (In re Ogden)*, 314 F.3d 1190, 1201 (10th Cir. 2002). There is no dispute that the Debtors incurred this debt before the Payments were made. Accordingly, there is sufficient evidence to support the "antecedent debt" element of § 547 as to $103,205.70 of the Payments.

D. Receive More Than in a Chapter 7 Case

Finally, AAI argues that the Trustee cannot establish § 547(b)(5), often called the hypothetical liquidation test. It requires a showing that the transfers at issue allowed the defendant to receive more than it would have in a chapter 7 liquidation case, had the transfers had not been made and instead the creditor received payment of the debt to the extent provided by the Code. This test requires the court "to construct a 'hypothetical Chapter 7 case;' i.e., to determine what the creditor would have received in a liquidation." *Still v. Rossville Bank (In re Chattanooga Wholesale Antiques, Inc.)*, 930 F.2d 458, 464 (6th Cir. 1991). The hypothetical test is determined as of the petition date. *Sloan v. Zions First Nat'l Bank (In re Casteltons, Inc.)*, 990 F.2d 551, 554 (10th Cir. 1993). Under the hypothetical test, unless unsecured creditors would receive a 100% payout, "any unsecured creditor . . . who receives a payment during the preference period is in a position to receive more than it would have received under a Chapter 7 liquidation." *In re Chattanooga Wholesale*, 930 F.2d at 465.

AAI attempts to side-step this test by arguing that the Debtors had an independent, nondischargeable debt to the IRS for the Payments and so, in a hypothetical liquidation, the IRS would receive payment on that claim from the Debtors. The focus of the § 547(b)(5) test in this context, however, is on the benefit conferred on AAI. The test examines whether AAI is better off "vis-à-vis the other creditors of the bankruptcy estate than [it] would have been had [it] waited for liquidation and distribution of the assets of the estate." 5 *Collier on Bankruptcy* ¶ 547.03 (16th ed. 2019). If the Debtors had not made the Payments prepetition, AAI would be in the same situation as Debtors' numerous other former clients whose payroll taxes were not paid. All of these clients have unsecured claims against the estate for the funds Debtors embezzled rather than paying the IRS. It is undisputed that the Debtors' estates are insolvent and that no unsecured creditor, priority or otherwise, will receive a 100% payout. AAI's claim for the unpaid taxes, like Debtors' other former clients, would not have been paid in full under the hypothetical test. The Court therefore concludes that there is sufficient evidence to support this element of the Trustee's preference claim.

IV. CONCLUSION

For its Motion for Summary Judgment to prevail, AAI had the burden to point out a lack of evidence to support an essential element of the Trustee's § 547 claim. *See Adler v. Wal-Mart Stores*, 144 F.3d 664, 671 (10th Cir. 1998). AAI has met this burden as to $224,527.11 of the Payments but failed as to the remaining $103,205.70. Accordingly, the Court hereby ORDERS that AAI's Motion for Summary Judgment is GRANTED in part and DENIED in part. AAI is entitled to judgment in its favor that $224,527.11 of the Payments were not preferential payments under 11 U.S.C. § 547. AAI's Motion for Summary judgment is denied as to the remaining $103,205.70 in Payments.

DATED this 17th day of September, 2019.

BY THE COURT:

Elizabeth E. Brown

Elizabeth E. Brown, Bankruptcy Judge