UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF WISCONSIN

Cite as: 2001 WL 1136919

Wayne K. Crawford, Plaintiff v.
Department of Treasury Internal Revenue Service, Defendant
(In re Wayne K. Crawford, Debtor)
Bankruptcy Case No. 00-34046-13
Adversary Case No. 00-3190-13

United States Bankruptcy Court
W.D. Wisconsin, Madison Division

July 23, 2001

Catherine J. Gloeckler, UAW-GM Legal Services, Janesville, WI for Plaintiff
LaQuita Taylor-Phillips, Washington, DC for Defendant

Robert D. Martin, United States Bankruptcy Judge

MEMORANDUM DECISION

On June 21, 1996, the debtor filed his timely 1995 federal income tax return. On June 4, 2000, the debtor filed his 1999 federal income tax return, which showed that he was entitled to a refund of $2,890. During the week of July 3, 2000, the IRS applied the refund to the debtor's 1993 federal income tax deficiency.

On September 18, 2000, the debtor filed the present chapter 13 bankruptcy. On October 10, 2000, the IRS filed a proof of claim in the amount of $30,263.77, of which $10,925.56 was unsecured priority tax due for 1995 and 1996 and $19,338.21 was unsecured non-priority tax due for 1993 and 1994. The debtor then brought this adversary proceeding to reallocate the funds set off by the IRS and object to the IRS's claim of priority for the 1995 taxes.

I. The first issue presented is the propriety of the IRS setoff of the 1999 refund against the debtor's 1993 tax deficiency. The parties agree that the IRS had a valid right to setoff under §553(a). Section 553(a) provides:

(a) Except as otherwise provided in this section and sections 362 and 363 of

> this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case....

11 U.S.C. §553(a). This section avoids the "absurdity of making A pay B when B owed A." Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, ----, 116 S.Ct. 286, 289, 133 L.Ed.2d 258 (1995) *quoting* (Studley v. Boylston National Bank, 229 U.S. 523, 528, 33 S.Ct. 806, 808, 57 L.Ed. 1313 (1913)). "Although no federal right of setoff is created by the Bankruptcy Code, 11 U.S.C. §553(a) provides that, with certain exceptions, whatever right of setoff otherwise exists is preserved in bankruptcy." Strumpf, 516 U.S. at 18, 116 S.Ct. at 289. Once the existence of a non-bankruptcy right to setoff is shown, §553 permits the exercise of that right in bankruptcy if: (1) the creditor owes a pre-petition debt to the debtor; (2) the creditor has a pre-petition claim against the debtor; and (3) the debt and the claim are both "mutual" obligations. *See* In re Benefit Management Corp., 1988 WL 384076 at 3 (Bankr. W.D. Wis. 1988).

In our case, the IRS had a right under non-bankruptcy law to setoff the debtor's refund against any outstanding tax liability, pursuant to 26 U.S.C. §6402(a):

> In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall ... refund any balance to such person.

26 U.S.C. §6402(a). That right was preserved in bankruptcy because all the requirements of §553 were met. The IRS owed the debtor a pre-petition debt in the form of a 1999 tax refund and the debtor owed the IRS a pre-petition debt in the form of a 1993 tax deficiency. The debts were mutual because the parties and relationships were the same in each claim– that of tax collector and taxpayer. *See* In re Lundell Farms, 86 B.R. 582, 585 (Bankr. W.D. Wis. 1988) ("[t]he term 'mutual debt' as used in section 553(a) ... require[s] that the debts 'must subsist or be owing between the same parties, in the same right or capacity, and must be of the same kind or quality'") (citation omitted).

An otherwise proper setoff under §553 may be disallowed in some circumstances. However, "'the rule allowing setoff, both before and after bankruptcy, is not one that courts are free to ignore when they think application would be 'unjust,'" In re Elcona Homes Corp., 863 F.2d 483 (7th Cir. 1988) *quoting* In re Applied Logic Corp., 576 F.2d 952, 957 (2nd Cir. 1978), and the disallowance of a valid setoff is permitted only where compelling circumstances exist. As Judge Hagan explained in In re Lawson, 187 B.R. 6 (Bankr. D. Idaho 1995):

> Section 553 ... "is permissive, not mandatory. 'Its application, when properly

> invoked before a court, rests in the discretion of that court, which exercises such discretion under the general principles of equity....'" Nevertheless, setoff is a favored remedy which should not be denied unless the allowance of the setoff "would not be consistent with the provisions of the Bankruptcy Act as a whole...." The bankruptcy cases in which courts have exercised discretion to block a setoff may be divided into two general categories. In one class of cases, the creditor is denied the immediate right of setoff, but the setoff claim is treated as a secured claim as provided by Bankruptcy Code Section 506(a). This situation usually arises in chapter 11 cases where the right of setoff is acknowledged, but the debtor needs the funds owed by the creditors in order to have any chance at a successful reorganization.... A second class of cases denies all right of setoff to a creditor either on grounds of public policy or because the creditor committed an inequitable, illegal or fraudulent act.

Id. at 7-8 (citations omitted).

The debtor contends that it is inequitable to permit the IRS to setoff against non-priority debts, rather than priority debts, because this gives the IRS a preference over other general creditors (both parties agree that the 1993 tax debt against which the IRS exercised setoff would have been a general unsecured claim). Finally, the debtor argues that the inequity of permitting such a preference in this case is heightened because one of the general creditors, Rock County, holds a non-dischargeable claim for child support arrearages.[1] The IRS counters that it has unfettered discretion under §6402(a) to apply any overpayment to any tax debt of the debtor.

Generally, whether the debtor may compel the IRS to allocate overpayments to specific tax liabilities depends on whether the payment in question was voluntary or involuntary. This is known as the voluntary payment rule. The most widely cited case on the distinction between a voluntary and an involuntary payment is Amos v. Commissioner, 47 T.C. 65 (1966):

> An involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.

Id. at 69. The Seventh Circuit adopted Amos' definition of an involuntary payment in Muntwyler v. United States, 703 F.2d 1030 (7th Cir. 1983).

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[1]This allegation is very questionable in light of In re Platter, 140 F.3d 676 (7th Cir. 1998), where the Seventh Circuit held that a statutory claim brought by a state agency for reimbursement of expenses incurred in maintenance and support of debtor's child were not in the nature of support under §523(a)(5) and were therefore dischargeable in bankruptcy.

However, the reported cases hold that the voluntary payment rule does not apply to overpayments covered by §6402(a). In one such case, In re Ryan, 64 F.3d 1516 (11th Cir. 1995), the debtors requested that a 1990 overpayment be applied to their unpaid 1989 tax liability. The IRS refused and instead applied the overpayment to the debtors' unpaid 1986 tax liability. The debtors filed for bankruptcy and obtained a discharge of tax liabilities for the year 1986 but not for the year 1989. The debtors then initiated an adversary proceeding, arguing that the voluntary payment rule obligated the IRS to honor their request on application of the 1990 overpayment (if applied as instructed, the overpayment would have extinguished the debtors' 1989 tax liability). The Eleventh Circuit disagreed, stating:

> The Treasury Regulations promulgated under § 6402(a) demonstrate that the IRS does not apply the voluntary payment rule to overpayments. Mirroring the statute, the regulations authorize the IRS to credit "any overpayment of tax" against "any outstanding liability for any tax ...." 26 C.F.R. § 301.6402-1 (1994). The regulations further delineate that, when a taxpayer's withheld wages exceed the amount of tax shown on his return, the IRS "may make credit or refund of such overpayment without awaiting examination of the completed return and without awaiting filing of a claim for refund." 26 C.F.R. § 301.6402-4 (1994). The regulations do provide that a taxpayer can instruct the IRS to credit his overpayment against the estimated tax for the taxable year immediately succeeding the overpayment. 26 C.F.R. § 301.6402-3(a)(5) (1994). However, the regulations also provide that the IRS may override that election and apply the overpayment against "any outstanding liability for any tax ...." 26 C.F.R. § 301.6402-3(a)(6)(i)(1994). The Treasury Regulations, therefore, contradict the Ryans' position that the IRS has chosen to restrict its statutorily granted discretion to control the allocation of overpayments. To the extent that the IRS has decided to give a taxpayer any ability to designate the application of overpayments, it has limited the taxpayer to requesting a credit for the succeeding tax year, and even that request can be refused by the IRS.

Id. at 1523-1524 (some citations omitted). *See also* Kalb v. United States, 505 F.2d 506, 509 (2nd Cir. 1974), *cert. denied*, 421 U.S. 979, 95 S.Ct. 1981, 44 L.Ed.2d 471 (1975) (section 6402(a) "clearly gives the IRS discretion to apply a refund to 'any liability' of the taxpayer"); Pettibone Corp. v. United States, 34 F.3d 536, 538 (7th Cir.1994) (section 6402(a) "leaves to the Commissioner's discretion whether to apply overpayments to delinquencies or to refund them to the taxpayer"). Section 6402 vests sole discretion in the IRS to determine how and to which tax liabilities the debtor's overpayment should be applied. Furthermore, the IRS was not precluded from exercising its right of setoff against non-priority tax claims, notwithstanding that the IRS also held priority tax claims in the same case. *See* In re Sedlock, 219 B.R. 207 (Bankr. N.D. Ohio 1998).

A setoff under §553 is a preference condoned under the Code and an exception to the bankruptcy principle of equal distribution among creditors. *See* In re Lawson, 187 B.R. 6

(Bankr. D. Idaho 1995); In re Whimsy, 221 B.R. 69, 75 (S.D. N.Y. 1998); In re Sedlock, 219 B.R. 207 (Bankr. N.D. Ohio 1998); In re Express Freight Lines, Inc., 130 B.R. 288, 291 (Bankr. E.D. Wis. 1991); In re Carter, 125 B.R. 832 (Bankr. D. Kan. 1991). Absent the existence of compelling circumstances, setoff is favored and it is not inequitable to allow the IRS to exercise setoff against general tax debts, rather than against priority tax debts. The IRS has properly exercised its ability to offset in this case.

II. The second issue presented is whether the 1995 taxes are entitled to priority under §507(a)(8)(A)(i). That section provides:

> (a) The following expenses and claims have priority in the following order:
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> (8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for-- (A) a tax on or measured by income or gross receipts-- (i) for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition...

11 U.S.C. §507(a)(8)(A)(i). This section bestows eighth-level priority status on taxes for which a return was last due within three years prior to the bankruptcy filing. Section 523(a)(1)(A), in turn, excepts from discharge those taxes entitled to priority treatment under §507(a)(8)(A)(i):

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt-- (1) for a tax or a customs duty-- (A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed...

11 U.S.C. §523(a)(1)(A).

In our case, the debtor's 1995 tax return was last due on August 15, 1996. Because that date fell outside the three-year period preceding the present bankruptcy case (filed on September 18, 2000), the 1995 taxes would ordinarily not be entitled to priority under §507(a)(8). There is an added wrinkle in this case, however. The debtor previously filed a bankruptcy case on April 9, 1996 and was discharged on September 18, 1997. The IRS argues that the three-year period of §507(a)(8) is tolled during the period of the prior bankruptcy case and for an additional six months thereafter. The debtor counters that a recent decision, In re Palmer, 219 F.3d 580 (6th Cir. 2000), rejects the view that the three-year period is automatically tolled by a prior bankruptcy case.

Two statutory provisions are implicated in our consideration of this issue. The first is

§108(c):

> (c) Except as provided in section 524 of this title, if applicable nonbankruptcy law ... fixes a period for commencing or continuing a civil action in a court other than a bankruptcy court on a claim against the debtor ... and such period has not expired before the date of the filing of the petition, then such period does not expire until the later of-- (1) the end of such period, including the suspension of such period occurring on or after the commencement of the case; or (2) 30 days after notice of the termination or expiration of the stay under section 362, 922, 1201, or 1301 of this title, as the case may be, with respect to such claim.

11 U.S.C. §108(c). The second, found in the Internal Revenue Code, is §6503(h):

> (h) Cases under Title 11 of the United States Code--The running of the period of limitations provided in section 6501 or 6502 on the making of assessments or collection shall, in a case under title 11 of the United States Code, be suspended for the period during which the Secretary is prohibited by reason of such case from making the assessment or from collecting and-- (1) for assessment, 60 days thereafter, and (2) for collection, 6 months thereafter.

26 U.S.C. §6503(h). A majority of circuits hold that §108(c), considered in conjunction with §6503, tolls the three-year period of §507(a)(8) during the time in which a prior bankruptcy case is pending, and for an additional six months thereafter. In In re Montoya, 965 F.2d 554 (7th Cir. 1992), the Seventh Circuit held that the three-year period was tolled not only for the period during which the stay was imposed in prior bankruptcy cases, but also for the period during which the tax claims were disallowed by the bankruptcy court. In Montoya, the debtors owed income taxes for 1982 and 1983. On March 11, 1983, the debtors filed a chapter 11 case. On January 14, 1985, a plan was confirmed which provided for full payment of the taxes. On March 6, 1985, the debtors objected to the IRS' claim. The bankruptcy court sustained the objection on April 4, 1985, but later entered an agreed order on April 23, 1986, which reinstated the claim and set the matter for a hearing. No hearing was held, however, and the estate was closed on August 11, 1987. On February 15, 1989, the debtors filed a chapter 7 case, which was dismissed on July 12, 1989. Two days after the dismissal, the debtors filed another chapter 7 case and moved to discharge their 1982 and 1983 taxes. The Seventh Circuit stated:

> Section 507 mandates that taxes due within three years of the bankruptcy petition are not dischargeable.... [A]bsent the Chapter 11 proceeding the Montoyas' tax debt would have been discharged because the last date on which the their tax returns could have been filed fell outside the three-year nondischargeability or what the parties have called the "look- back" period. The Chapter 11 and first Chapter 7 proceedings, however, affect this calculation. Under § 362 of the Bankruptcy Code, an automatic stay is imposed

> on all creditors' actions against the debtor until the time of confirmation, so that between March 11, 1983 and January 14, 1985, and February 15, 1989 and July 12, 1989, the IRS was prohibited from collecting any taxes. Section 108(c) of the Code extends the time creditors have to collect claims that have been stayed by a bankruptcy proceeding. This section provides that an unexpired nonbankruptcy statute of limitations continues for 30 days after the stay has been lifted or until the limitations period has expired, whichever is later. Parallel provisions to § 108(c) are found in § 6503 of the Internal Revenue Code. The IRS generally has three years to assess and six years to collect taxes. 26 U.S.C. §§ 6501 and 6502. These limitations periods are tolled when the taxpayer's assets are tied up in a court proceeding and for an additional six months. 26 U.S.C. § 6503(b). Section 6503(h) specifically suspends the time for assessing or collecting taxes when the IRS is precluded from acting because of a pending bankruptcy case.
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> The tolling provisions of § 6503 are given effect in the context of a bankruptcy proceeding by § 108(c) of the Bankruptcy Code.... Section 108(c) implicitly incorporates the limitations period of § 6503 by preserving nonbankruptcy statutes of limitations which have not yet expired. The relevant legislative history of § 108(c) is also clear on this point: In the case of Federal tax liabilities, the Internal Revenue code suspends the statute of limitations on a tax liability of a tax payer from running while his assets are in the control or custody of a court and for 6 months thereafter.... The amendment applies this rule in a title 11 proceeding. Accordingly, the statute of limitations on collection of a nondischargeable Federal tax liability of a debtor will resume running after 6 months following the end of the period during which the debtor's assets are in the control or custody of the bankruptcy court. This rule will provide the Internal Revenue Service with adequate time to collect nondischargeable taxes following the end of the title 11 proceedings. S.Rep. No. 989, 95th Cong., 2nd Sess. 30-31 (1978) U.S.Code Cong. & Admin.News 1978, pp. 5787, 5816-5817.

Id. at 955-57 (footnotes omitted). To calculate the three-year period of §507(a)(8), the Seventh Circuit excluded the period when the stay was in place during the prior two bankruptcy cases and the period when the tax claims were disallowed:

> It would be similarly inconsistent with the intent of § 108(c) to fail to exclude from the look-back period the time the IRS claims were disallowed as to charge the IRS for the time the automatic stay was in place. The IRS was as equally barred from acting when the disallowance was in place as it was when its claims were stayed.... There is no doubt that in the face of a court order

> disallowing the tax assessments, the IRS was prohibited from continuing to assert its claims. Tolling the look-back period during the time the IRS claims were disallowed ensures that proceedings in the bankruptcy court do not prevent the IRS from having adequate time to bring an action against delinquent taxpayers. The disallowance, along with the automatic stay, acted to bar the IRS from collecting. Because the IRS has not yet had 3 years and 6 months to collect the assessments, the Montoya's tax liability is not discharged.

Id. at 558. *See also* In re Brent, 212 B.R. 311 (C.D. Ill. 1997).

To date, three court of appeal decisions have held that the three-year period of §507(a)(8) is not automatically tolled by a prior bankruptcy case: In re Morgan, 182 F.3d 775 (11^{th} Cir. 1999); In re Quenzer, 19 F.3d 163 (5^{th} Cir. 1993) and In re Palmer, 219 F.3d 580 (6^{th} Cir. 2000). However, it is the law of the Seventh Federal Circuit which controls the decision of this court. Montoya explicitly holds that §6503(h) is given effect by §108(c) and that the two provisions operate jointly to toll the three-year period in §507(a)(8) "when the taxpayer's assets are tied up in a court proceeding" Montoya, 965 F.2d at 556. This holding is consonant with the views expressed by a majority of circuits and with the sound policy of preserving the collectability of taxes in bankruptcy. Thus, the 1995 taxes are entitled to priority under §507(a)(8). It may be so ordered.