IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF SOUTH CAROLINA

IN RE:	)	C/A No. 03-00229-W
	)	
James W. Strange and Lisa Strange,	)	**JUDGMENT**
	)	
Debtors.	)	Chapter 13
	)	

Based upon the Findings of Fact and Conclusions of Law as recited in the attached Order of the Court, the Internal Revenue Service's Motion to Lift Automatic Stay to Setoff Tax Refunds is granted.

John E. Waites
UNITED STATES BANKRUPTCY JUDGE

Columbia, South Carolina
June 13, 2003.

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF SOUTH CAROLINA

IN RE:	)	C/A No. 03-00229-W
	)	
James W. Strange and Lisa Strange,	)	**ORDER**
	)	
Debtors.	)	Chapter 13
	)	

THIS MATTER comes before the Court upon the Motion to Lift Automatic Stay to Setoff Tax Refunds (the "Motion") filed by the United States of America on behalf of the Internal Revenue Service (the "Service") on April 14, 2003. The Service filed an amended Proof of Claim on April 7, 2003, indicating that James W. Strange and Lisa Strange (the "Debtors") owe it $19,540.35. The claim is based upon Debtors' income tax liabilities for the 1997, 1999 and 2000 tax periods. As part of its claim, the Service asserts that it owes Debtors income tax refunds for the 2001 and 2002 tax periods in the total amount of $5,617.00 (the "Refund") and that the Service is secured in the total amount of the Refund. Pursuant to 11 U.S.C. § 553,[1] the Service moves to set off the amount of the Refund from the amount Debtors owe for prior tax liability. Further, the Service argues that Debtors cannot offer adequate protection as an alternative to the Refund that the Service now possesses. Accordingly, the Service asks the Court to grant its motion, lift the automatic stay, and allow the Service to set off the Refund against the 1997 and 1999 tax liabilities and a portion of the 2000 tax liability Debtors owe.

Debtors concede that the Service has a general right to setoff, but argue that the Refund should be paid directly to Debtors or to the Chapter 13 Trustee in that it is necessary for a successful

[1] Further references to the Bankruptcy Code shall be by section number only.

reorganization. Further, Debtors for the first time at the hearing argued that even if the Court grants the Service's request for setoff, the Court should mandate setoff of the Refund against the 2000 income tax liability which would otherwise constitute a priority tax claim rather than against the 1997 and 1999 income tax liabilities which would otherwise constitute unsecured general debts.[2]

The Court finds that the Service meets the requirements of setoff. See In re Kolb, C/A No. 02-05079-W, slip op. at 3-4 (Bankr. D.S.C. Aug. 26, 2002) (finding no adequate protection for payments when an unconfirmed plan did not properly treat the Service's claim as partially secured and the debtors had not objected to the Service's previously filed claim). The right to setoff exists under nonbankruptcy law pursuant to Internal Revenue Code § 6402(a),[3] mutuality is present, both debts arose pre-petition, and the right to setoff is not subject to an exception listed in § 553(a)(1-3) or (b). The remaining issue is the specific allocation of the Refund.

Debtors argue that it would be inequitable to permit the Service to apply the Refund first toward any otherwise unsecured debt and then toward the Service's priority claims inasmuch as the Service would receive greater payment on a debt than would otherwise be provided for in Debtors' proposed Chapter 13 plan. Further, Debtors contend that any additional payment toward the class

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[2] Debtor first raised an objection to the Service's proposed allocation at oral argument. The Motion stated that the Service sought to setoff the Refund against Debtors' 1997, 1999, and 2000 liability. Debtors' objection to the Motion states that the Service improperly calculated the amount of the tax liability. Debtors did not raise the issue of improper calculation at oral argument nor in its post-hearing submission.

[3] 26 U.S.C. § 6402(a) provides as follows:

> General rule.--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, subject to subsections (c), (d) and (e), refund any balance to such person.

of unsecured creditors beyond the 1% proposed in Debtors' plan might impair their ability to successfully complete their plan. The Service argues that this Court should follow the majority rule and permit the Service to apply the Refund in its best interest.

Whether the Bankruptcy Court has the authority to allocate payment of tax claims has been addressed in many cases with varying factual circumstances. The primary authority of a bankruptcy court to allocate tax payments is recognized in a 1990 United States Supreme Court case holding that a bankruptcy court may direct the Service to apply trust fund and non-trust fund employment tax payments under a Chapter 11 plan in a particular order, as long as the debtor showed that such allocation was necessary to the reorganization. United States v. Energy Resources Co., 495 U.S. 545 (1990). Under the facts present in Energy Resources, if the Chapter 11 payments were permitted to be applied first toward guarantied trust fund taxes, the Service was at risk for payment of the non-trust fund liabilities because, as opposed to trust fund liabilities, the Service had no alternative source of recovery in the event the debtor's reorganization fails.[4] Nevertheless, the Court reasoned that bankruptcy courts are courts of equity and have "broad authority to modify creditor-debtor relationships," and can thus direct payment where necessary for a reorganization's success. Id. at 549.[5] See also In re M.C. Tooling Consultants, Inc., 165 B.R. 590 (Bankr. D.S.C. 1993) (finding

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[4] If trust fund taxes are unable to be collected from the employer, the Government can recover individually from officers or employees responsible for collecting the tax. Energy Resources, 495 U.S. at 547; 26 U.S.C. § 6672.

[5] The Court in Energy Resources declined to specifically determine the voluntary or involuntary nature of the payments made. Energy Resources, 495 U.S. at 548-49. Such designation is often discussed because the general rule is that a debtor can allocate payments as it wishes if the payment is of a voluntary nature. See In re M.C. Tooling Consultants, Inc., 165 B.R. 590, 591 (Bankr. D.S.C. 1993). The Court in Energy Resources found the designation irrelevant based on the facts of the case. Similarly, this Court need not address the nature of the payment, noting that the issue was not raised by the parties and that cases have found the

allocation of payments first to trust portion and then to non-trust portion under Chapter 11 plan was necessary to an effective reorganization based upon testimony of president and officer). Debtors argue that Energy Resources stands for the proposition that the bankruptcy court maintains the broad authority to order the Service to allocate tax payments as the Court deems appropriate.

However, most courts have interpreted the holding of the Court in Energy Resources narrowly. See, e.g. In re Senise, 202 B.R. 403, 410 (Bankr. D.S.C. 1996) (courts have limited holding to its facts) (citing cases). The primary distinction made is that the issue in Energy Resources was the order of taxes proposed to be paid *in full* versus reallocation or reclassification of a claim in a manner that reduces the amount of taxes to be paid.[6] See Bates v. United States (In re Bates), 974 F.2d 1234 (10th Cir. 1992); In re Senise, 202 B.R. 403 (Bankr. D.S.C. 1996); In re Baker, No. 95-30947, 1996 WL 571764 (Bankr. N.D. Ind. July 2, 1996); In re Burgess, 171 B.R. 227 (Bankr. E.D. Tex. 1994); In re Divine, 127 B.R. 625 (Bankr. D. Minn. 1991). Many of these courts contend, *e.g.*, that the holding of Energy Resources is not meant to override the classification scheme of the Bankruptcy Code. See, e.g., Senise, 974 F.2d at 407-10.

This Court in Senise addressed the applicability of Energy Resources to a Chapter 13 case where a debtor objected to the composition of the Service's claim for secured, priority, and unsecured general taxes. 202 B.R. at 408 n.4, 410-411. In Senise, this Court did not permit the debtor to "reclassify the tax claim by stripping the properly filed secured tax claims for 1989 and 1990 and reclassifying these tax claims to general unsecured status, then reclassifying properly filed

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voluntary/involuntary nature of the payment inapplicable in the context of an overpayment pursuant to 26 U.S.C. § 6402(a). See, e.g., In re Ryan, 64 F.3d 1516, 1523-24 (11th Cir. 1995).

[6] Neither the Service nor Debtors object to the classification of the 2000 tax claim as a priority claim and the 1997 and 1999 taxes as general unsecured claims.

priority tax claims to secured status, thereby avoiding the payment of roughly $13,000 in properly filed tax claims." Id. at 407. The Court noted that while the tax liability in Energy Resources was to be paid in full, the debtor in Senise sought to pay less in taxes by discharging a larger amount of general unsecured claims. Id. at 408 n.4, 410-11 ("debtor seeks far more than merely compelling the IRS to apply in a particular order installment that will fully satisfy the federal tax claim.").

This Court in Senise examined the priority classification set forth in the Bankruptcy Code pursuant to § 507 as well as nonbankruptcy law to determine that the claims were properly classified and that the debtors could not reclassify the Service's claims to suit their needs. Id. at 411. While this Court recognizes that Debtors are not specifically seeking to reclassify the Service's claims, they are seeking to direct the Service to allocate the Refund first to priority tax debts, debts for which Debtors' plan must provide for full payment in deferred cash payments. See 11 U.S.C. § 1322(a)(2). This Court has recognized that the Service has "the prerogative to apportion the debtor's tax liabilities and the debtor cannot use the bankruptcy courts to dictate otherwise." Senise, 202 B.R. at 409. Even if Senise is factually distinguishable, Senise is instructive in its analysis of Energy Resources as well as the manner in which the Court should proceed in determining whether the Service has discretion to allocate the Refund as it chooses.

In addition, the majority of cases that have specifically addressed the allocation of a refund in the context of a setoff do not rely on or apply Energy Resources. Most of these courts have ruled in favor of the Service. See, e.g., In re Crawford, No. 00-3190, 2001 Bankr. LEXIS 1075, at 10 (Bankr. W.D. Wis. July 23, 2001) ("A setoff under § 553 is a preference condoned under the Code and an exception to the bankruptcy principle of equal distribution among creditors.") (citing cases); In re Sedlock, 219 B.R. 207, 210 (Bankr. N.D. Ohio 1998) ("[n]either 11 U.S.C. § 553 nor 26 U.S.C.

§ 6402(a) distinguishes between the type of debt that can be used in the context of set off, nor do those sections specify that a particular priority is required.") (citing cases); In re Lawson, 187 B.R. 6, 8-9 (Bankr. D. Idaho 1995) (no more inequitable than ordinary setoffs); In re Braniff Airways, Inc., 42 B.R. 443, 452 (Bankr. N.D. Tex. 1984) (decided prior to Energy Resources but noting that permitting setoff against non-priority claims of the Service preserves the priority payment scheme espoused by the Code).

Those cases that refer to Energy Resources distinguish it by emphasizing the fundamental nature and purpose of setoff. See In re Carter, 125 B.R. at 835 (holding of the Supreme Court is not meant to override the priority scheme of § 507 and the principles of setoff); In re Graybeal, 1993 WL 851378 at *4-5 (fairness and equity should not prevent the IRS from exercising its nonbankruptcy right of setoff). But see In re Moore, 200 B.R. 687, 690 (Bankr. D. Or. 1996) (following reasoning of the Supreme Court in that Sections 1141 and 1327 are similar; plan would not be feasible if allocation proposed by Service was allowed).

Section 553 permits setoff to the extent permitted by nonbankruptcy law. 11 U.S.C. § 553; Durham v. SMI Industries Corp., 882 F.2d 881, 883 (4th Cir. 1989) (Section 553 merely preserves the right of setoff pursuant to nonbankruptcy law). 26 U.S.C. § 6402(a) provides that the Service can apply an overpayment to any internal revenue tax liability the taxpayer owes. A setoff, by its nature, effectively prioritizes one creditor over another. See In re Lawson, 18 B.R. at 8 ("except in the extraordinary situation of a 100% payout plan or liquidation, setoffs generally result in a preference for creditor exercising his right to setoff."). A further example of the preferential treatment of a setoff claim is set forth in § 506(a). ("An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of . . . the

amount subject to setoff."); 4 Alan N. Resnick et al., Collier on Bankruptcy, ¶ 506.03[1][b] (15th ed. rev. 2001). See also Thompson v. Board of Trustees (In re Thompson), 182 B.R. 140, 154 (Bankr. E.D. Va. 1995) (setoff elevates unsecured claim to secured status) (citations omitted).

Further, § 507 dictates that certain tax claims are to be given priority, and in this case, that priority scheme would be respected by an application of the Refund first to non-priority claims. See Carter, 125 B.R. at 835 (citing In re Braniff Airways, Inc., 42 B.R. 443, 452 (Bankr. N.D. Tex. 1984)). Accordingly, to allocate the Refund in the manner prescribed by Debtors in this case would diminish the Service's setoff claim, deny the Service the preferential effect of its right to setoff, and defeat the priority nature of the Services' priority tax claims. Debtors have not convinced the Court that such a result is warranted.

Even if the Court has the broad authority under § 105 to allocate tax payments as indicated in Energy Resources, no compelling facts or circumstances were presented in this case to convince the Court to exercise such an extraordinary authority which is contrary to federal nonbankruptcy law, i.e. 26 U.S.C. § 6402(a). Debtors presented no evidence that their proposed allocation would be necessary for an effective reorganization, and only noted in a post-hearing submission that an allocation of the funds as urged by the Service would "diminish" or "reduce" the likelihood of successful completion of Debtors' plan. The Court further notes that the Chapter 13 Trustee did not appear or raise an objection to the Motion or argue that the interests of all creditors would be better served if the Court were to adopt Debtors' argument.

In examining the Service's right to setoff pursuant to nonbankruptcy law, as well as the classification scheme set forth in the Code, the Court has not been convinced that it is inequitable to permit the Service to exercise setoff and allocate the Refund first toward general unsecured debts

prior to priority debts in this case.

Accordingly, the Motion should be granted.

CONCLUSION

From the arguments discussed above, it is therefore

ORDERED that the Service's Motion is granted.

AND IT IS SO ORDERED.

John E. Waites
UNITED STATES BANKRUPTCY JUDGE

Columbia, South Carolina
June 13, 2003.