United States Bankruptcy Court
Western District of Wisconsin

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In re Amble Landscaping, Inc., Debtor
Bankruptcy Case No. 96-32118-11

United States Bankruptcy Court
W.D. Wisconsin

November 27, 1996

Jerome M. Ott, Wyngaard & Wilson, Madison, WI, for debtor.
Richard D. Humphrey, Assistant U.S. Attorney, Madison, WI, for IRS.

Robert D. Martin, United States Bankruptcy Judge.

MEMORANDUM DECISION

The debtor, Amble Landscaping, Inc. ("Amble"), is operating as a debtor in possession and has permission from this court to use cash collateral for its landscaping business. Amble failed to file corporate income tax returns for fiscal year 1994, but it is estimated that the returns will show a refund due of $20,000.00. Amble owes IRS pre-petition "trust fund" and other "non-trust fund" taxes of $262,871.70. The IRS moved to compel Amble to file its 1994 tax return and for relief from stay under 11 U.S.C. § 553(a) to setoff the expected refund against the pre-petition tax debt.

In 26 U.S.C. § 6402(a), the IRS is allowed to setoff a taxpayer's overpayment against "any liability in respect of an internal revenue tax on the part of the person who made the overpayment . . . ." Thus the IRS has the discretion to apply overpayments to delinquencies or to refund them to the taxpayer. Pettibone Corp. v. United States, 34 F.3d 536, 538 (7th Cir. 1994). 11 U.S.C. § 553 preserves a right of setoff derived from non-bankruptcy law *in bankruptcy,* but limits it by the automatic stay of § 362. Section 553(a) provides in relevant part:

Except as otherwise provided in this section and in 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 a debtor that arose before the commencement of the case . . . .

Amble Landscaping does not object to setoff, but wants to designate the refund toward its *trust fund* tax liabilities, and the IRS objects. The sole issue for this decision is whether Amble can designate the application of the setoff amount.

The IRS requires employers to withhold funds from their employee's wages for income "in trust" and Social Security taxes. 26 U.S.C. §§ 3102(a), 3412(a). To ensure that employers withhold and pay, an individual responsible for the withholding can be held personally liable for any unpaid trust fund taxes. This is a penalty separate from the

employer's liability for the tax. Howard v. United States, 711 F.2d 729, 733 (5th Cir. 1983). Moreover, this "responsible persons" liability is not dischargeable in bankruptcy. United States v. Energy Resources Co., Inc., 871 F.2d 223 (1st Cir. 1989), aff'd on other grounds, 549 U.S. 545, 549 (1990). "Responsible persons" are not personally liable for unpaid *non*-trust fund taxes. Thus, if a corporate taxpayer owes trust fund as well as non-trust fund taxes, the principals of the taxpayer typically want to pay the trust fund tax first to avoid personal liability. The IRS, on the other hand, prefers to credit non-trust fund debt because it can still go after "responsible persons" for trust fund liabilities. Thus, both the taxpayer and IRS want to designate payment, but they seek different designations.

Generally, a taxpayer can designate when making a "voluntary" payment, but the IRS can designate "involuntary" payments. In the Matter of Avildsen Tools & Machine, Inc., 794 F.2d 1248 (7th Cir. 1985). Thus, the characterization of a payment as "voluntary" or "involuntary" is dispositive of which debt gets paid first.

In Muntwyler v. U.S., 703 F.2d 1030, 1032 (7th Cir. 1983), the Seventh Circuit articulated a standard for determining when a taxpayer's payment to the IRS is "voluntary." The court found payments designated by a trustee under a voluntary assignment for the benefit of creditors to be voluntary payments. It defined an "involuntary" payment as one received as a result of "levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor." Id. at 1032, citing Amos v. Commissioner, 47 T.C. 65, 69 (1966). Because the trustee had not paid pursuant to a "legal proceeding," but rather had responded to "a mere filing of a claim," the payment was voluntary.

The Supreme Court in U.S. v. Energy Resources, supra, decided that the IRS may be bound by a taxpayer's designation *when it is necessary to the success of a Chapter 11 reorganization*. The IRS objected to the company's plan of reorganization because it required payments to be applied first to trust fund debt. The Supreme Court held it was irrelevant "whether or not the payments . . . [we]re rightfully considered . . . "involuntary" because a bankruptcy court has the authority to order the IRS to apply the payments to trust fund liabilities if . . . this designation is necessary to the success of the reorganization plan." The Court reasoned that although not specifically authorized to approve plans designating tax payments, the bankruptcy court can rearrange debtor-creditor relationships and approve reorganization plans including any provision not inconsistent with the Code. In the end, Energy Resources does not resolve whether payments made in bankruptcy are "involuntary," but when a Chapter 11 debtor has proposed a plan which designates payments, the bankruptcy court may confirm that plan and bind the IRS if it is necessary to the reorganization. (1)

A court in the Seventh Circuit limited Energy Resources to its facts. In In re Arie Enter., Inc., 116 B.R. 641, 643 (S.D. Ill. 1990), the court refused to apply Energy Resources if the debtor had not proposed a plan of reorganization. Under Muntwyler, the court found there was sufficient "judicial action" to make the pre-plan payments "involuntary."

Energy Resources does not control the present case. Amble asks that the setoff issue "be held in abeyance pending a determination of whether the debtor can submit a successful plan and whether [it] would permit a direction of the payment toward the trust fund taxes." Essentially, Amble wants this court to wait until Energy Resources *is* applicable. Merely filing bankruptcy does not put designation of a payment within the bankruptcy court's discretion. As in Arie, a proposed plan is essential before a bankruptcy court has the discretion. Amble is only four months into its Chapter 11, and the IRS has an absolute right to setoff the pre-petition refund against the pre-petition debt under 26 U.S.C. § 6402(a). That right is preserved in bankruptcy by § 553(a) and excepted from the automatic stay by expeditious motion. The designation issue needs to be resolved

now, not at some later date when Amble may propose a plan.

Muntwyler controls whether Amble can designate the application of the setoff. Muntwyler did not consider payments made in bankruptcy,[(2)] but the Muntwyler test--has there been sufficient "judicial action" in this case to make the setoff "involuntary?"--would seem to apply equally *after* filing a bankruptcy.

The Seventh Circuit could have reached the Muntwyler question (but declined) in Avildsen Tools & Machine, supra, a case filed under Chapter XI of the prior Bankruptcy Act. Three years after filing, Avildsen still had not proposed a viable plan of reorganization and decided to liquidate its assets under Chapter 11. The court confirmed the sale of assets and Avildsen paid a portion of the tax claim, designating that the trust fund portion be paid first, and reached a settlement with the IRS for payment of the remainder. When Avildsen was unable to comply with the settlement, the IRS reapplied the earlier payment to the non-trust fund taxes. The bankruptcy court said the first payment was "voluntary," but the district court reversed finding the payment "involuntary" because Avildsen made it while "reorganizing under Chapter XI . . . ." The case went to the Seventh Circuit where the court noted that in Muntwyler, it had implied that payments in bankruptcy were "involuntary," but it ignored its own suggestion and chose to affirm Avildsen on other grounds.

The Ninth Circuit, on the other hand, found payments made after filing bankruptcy to be "involuntary." In In re Technical Knockout Graphics, Inc, 833 F.2d 797 (9th Cir. 1987), TKO Inc. failed to pay trust fund and non-trust fund taxes and then filed for Chapter 11. Before it had a plan on the table, TKO moved the bankruptcy court to be allowed to reduce its trust fund debt. Over the IRS' objection, the bankruptcy court, and then the bankruptcy appellate panel, agreed. While further appeal was pending, TKO made some designated payments, and the bankruptcy court confirmed a plan requiring the IRS to apply them as the debtor requested. On appeal, the Ninth Circuit held that under Muntwyler, the payments TKO made in bankruptcy before the plan was confirmed were "involuntary." The court stated, "TKO is not free to abuse the system by designating its payments in a way that benefits only its responsible persons . . . harm[ing] . . . the IRS, without the scrutiny of the court or other creditors."

Amble has filed for bankruptcy and subjected itself to the limits and duties that filing impose. The IRS is compelling Amble Landscaping to file its tax return, which precipitates setoff, through a *legal proceeding*. This may be contrasted with Muntwyler where the IRS "merely filed a claim," and the taxpayer's payment was deemed "voluntary."

Furthermore, in this case Amble wants to designate its tax refund--money already in the hands of the IRS resulting from an *overpayment*. The Eleventh Circuit has distinguished partial payments from overpayments and decided the IRS can designate setoff of any overpayment. In re Ryan, 64 F.3d 1516 (11th Cir. 1995). If the payment is an overpayment, then 26 U.S.C. § 6402(a) authorizes the IRS to designate payment, regardless of whether the payment is "voluntary."

The Seventh Circuit has not addressed whether the "voluntary" rule applies to overpayments, however, a Wisconsin bankruptcy court discussed an overpayment under *both* the "voluntary" rule and § 6402(a) and determined the IRS could designate payment. In re Kiesner, 194 B.R. 452 (Bankr. E.D. Wis. 1996) (McGarity, J.). The court in Kiesner was satisfied that overpayments are the IRS' prerogative whether "voluntary" or not.

On the foregoing analysis, the motion of the IRS must be granted. It is so ordered.

END NOTES:

1. The Seventh Circuit has not yet cited Energy Resources in a bankruptcy case, but other circuits have. See In re Deer Park, 10 F.3d 1478, 1481 (9th Cir. 1993) (citing Energy Resources for the proposition that the bankruptcy court has the authority to order the IRS to apply the payments to trust fund liabilities if necessary to the success of the reorganization plan); Fullmer v. U.S., 962 F.2d 1463, 1468 n. 5 (10th Cir. 1992) (same); In re Kare Kemical, Inc., 935 F.2d 243, 244 (11th Cir. 1991) (same).

2. The Seventh Circuit in that case suggested that payments are "involuntary" in an *involuntary* bankruptcy. The court in Muntwyler stated: "The [IRS] might have been correct in its claim if the corporation had been in bankruptcy, which it was not . . . . [A]ny creditor, including the [IRS] could have proceeded to file an involuntary petition for bankruptcy. . . ." Muntwyler, supra at 1034 n.2. However, that suggestion is dicta, and Amble Landscaping *voluntarily* filed Chapter 11.