United States Bankruptcy Court
Western District of Wisconsin

Cite as: [Unpublished]

Glenn A. and Sue M. Kadrmas, Debtors
Bankruptcy Case No. 00-31338-7

United States Bankruptcy Court
W.D. Wisconsin

September 19, 2000

Jerry J. Armstrong, Madison, WI, for debtors.
Richard D. Humphrey, Assistant U.S. Attorney, Madison, WI, for IRS.

Robert D. Martin, United States Bankruptcy Judge.

MEMORANDUM DECISION

The debtors, Glenn and Sue Kadrmas, filed for Chapter 7 relief on March 30, 2000. At the time of their petition, the debtors were entitled to a federal income tax refund for the year 1999 in the amount of $2,059.00, and owed federal income tax liability for the year 1990 in the amount of $3,493.13. The debtors listed their income tax refund as an asset on their Schedule B, and claimed this refund exempt on their Schedule C. The debtors also listed the Internal Revenue Service as a creditor on their Schedule F, holding an unsecured nonpriority claim in the amount of $3,175.68.

The Internal Revenue Service ("IRS") filed a relief from stay motion on May 26, 2000, seeking to offset the debtors' income tax refund against their income tax liability. At the preliminary hearing, the parties agreed to have this matter determined on briefs, which have been filed.

The debtors argue that the IRS is not entitled to a setoff because their debt to the IRS was discharged on June 20, 2000. Further, the debtors argue that because they claimed the tax refund as exempt, the IRS' right to a setoff under 11 U.S.C. §553(a) must yield to the debtors' right to exempt and protect assets under 11 U.S.C. §522(c).

The IRS argues that its right to setoff of the tax refund met the requirements of 11 U.S.C. §553(a) at the time the debtors filed their petition and that discharge of a debt in a bankruptcy proceeding does not affect this right. Further, the IRS argues that §553(a) should trump §522(c).

The parties do not dispute that, absent the debtors' claim of exemptions and discharge, the IRS had a valid right to setoff under 11 U.S.C. §553(a). Section 553(a) provides:

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 the debtor that arose before the commencement of the case....

11 U.S.C. §553(a). Under §553, three requirements must be met: (1) there must be mutual obligations; (2) that arose from separate transactions; and (3) that occurred pre-petition. *See* In re Eggemeyer, 75 B.R. 20, 21-22 (Bankr. S.D. Ill. 1987, J. Meyers).

The IRS owes a 1999 income tax refund to the debtors, and the debtors owe a 1990 income tax liability to the IRS. Therefore, there are mutual obligations that arose from separate transactions. Both the debtors' 1990 tax liability and the debtors' right to a refund arose pre-petition. The fact that the debtors filed their income tax return after they filed their bankruptcy petition is irrelevant under the case law. "For the purposes of §553, income tax refunds are 'absolutely owing' on December 31 of the year in which the overpayment is made or the liability accrues.... The date the return is actually filed is not relevant in determining when the debt arose." *See* In re Eggemeyer, 75 B.R. at 21-22, In re Mason, 79 B.R. 786, 788 (Bankr. N.D. Ill. 1987, J. Schwartz); In re Rozel Industries, Inc., 120 B.R. 944, 950 (Bankr. N.D. Ill. 1990, J. Katz); In re Runnels, 134 B.R. 562 (Bankr. E.D. Tex. 1991, J. Sharp). The debtors became entitled to an income tax refund on December 31, 1999, three months before they filed their bankruptcy petition. Therefore, all the requirements for a setoff under §553(a) are met.

Effect of Discharge

The leading case on whether a creditor's right to setoff is affected by a debtor's discharge is In re Conti, 50 B.R. 142 (Bankr. E.D. Va. 1985, J. Shelley).[(1)] In Conti, the court found that a creditor's pre-petition right to setoff is unaffected by a debtor's discharge. In reaching this conclusion, the court compared a creditor's post-discharge right to setoff to the automatic stay:

The question in this regard is whether a creditor who otherwise meets the requirements for setoff pursuant to §553 is prohibited from exercising its right to setoff because of extinguishment of the debtor's obligation to the creditor as a result of the discharge. It is well-settled that the automatic stay prohibits the right of setoff but does not destroy the right to setoff itself.... Courts have allowed a creditor to seek relief from stay in order to exercise setoff rights prior to discharge.... However, nothing in the Code or in the case law would indicate that discharge would bar a creditor from exercising a right to setoff which existed at the time of filing the petition.... To hold otherwise would mean that if a creditor failed to file for relief from stay or failed to have its relief from stay granted prior to discharge, its right to setoff would be lost. In addition to follow this line of reasoning would mean precluding a third party who stands as both debtor and creditor of the bankrupt from effecting a setoff upon demand by the trustee in bankruptcy for the balance of the debt due to the debtor, which demand may be made after the debtor has received his discharge. Therefore, this court finds that the injunction of §524(a)(2) which enjoins creditors from offsetting any debt which has been discharged refers only to the setoff of a post-petition debt by a creditor to the debtor which the creditor would then seek to setoff against a prepetition discharged debt owed by the debtor to the creditor. This Court finds that §524(a)(2) is not meant to extinguish the right to setoff which is preserved in §553 of the Code, and thus the Court disapproves of the debtor's conclusion that the setoff here cannot be achieved post-discharge.

Id. *citing* In re Handy, 41 B.R. 172 (Bankr. E.D. Va. 1984).

The holding in Conti has been adopted by a number of other courts. In Eggemeyer, the court held that "[t]he discharge of a debt in a bankruptcy proceeding does not affect the creditor's right to setoff, provided that the right of setoff existed at the time the bankruptcy petition was filed." 75 B.R. at 22. *See also* In re Posey, 156 B.R. 910 (W.D.N.Y. 1993, J. Skretny) (holding that it was proper for the bankruptcy judge to allow setoff against discharged income tax liability). Furthermore, in In re Wiegand, 199 B.R. 639 (W.D. Mich. 1996, J. Quist), the district court held that a creditor's pre-

petition right to setoff survives the debtor's discharge. The court stated:

Because "setoffs in bankruptcy have been 'generally favored,' [ ] a presumption in favor of their enforcement exists.... Moreover, the primacy of setoffs is essential to the equitable treatment of creditors.... It would be unfair to deny a creditor the right to recover a debt from a debtor while at the same time requiring the creditor to fully satisfy the debt to the debtor.... Further, the primary purpose of discharge is to prohibit post-bankruptcy debt collection. Credit Union did not collect its debt from Wiegand. It merely offset its obligation to the Wiegands with that of the Wiegands to Credit Union. The primary purpose of discharge in bankruptcy is not disserved. Thus, it was proper for the bankruptcy judge to allow setoff against discharged debt.

Id. at 641-642.

No case holding the contrary has been cited or found.

§553(a) vs. §522(c)

The crux of this case is whether §553(a), which provides that, except for §362 and §363, the Bankruptcy Code does not affect a creditor's right to setoff, or §522(c), which provides that property exempted is not liable for any pre-petition debt of the debtor, wins the trick. Section 522(c) provides:

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

11 U.S.C. §522(c). There is a split of authority.

More courts have held that a debtor's right to exempt assets under §522(c) is paramount to a creditor's right to setoff under §553(a). The recent case of In re Jones, 230 B.R. 875 (M.D. Ala. 1999, J. Albritton) (and cases cited therein) is the one on which the debtors rely.[(2)] The Jones court, following what it characterizes as the majority view, determined that a creditor's "right to setoff under §553(a) must yield to a debtor's right to exempt and protect assets under §522(c)" for three reasons. First, if the creditor could exercise its right to setoff against exempt property, §522(c) would apply to only some prepetition debts while the statute uses the fully inclusive word "any." According to the Jones court, the narrower interpretation would "nullify" §522(c) while the majority view gives effect to both §522(c) and §553(a). The court also invokes the general concern for a debtor's "fresh start." And, finally, according to the Jones court, the legislative history of §522 supports its view, because an earlier version of §522(c), which would have contained a provision allowing the IRS to "perform the setoff in question" was rejected by Congress, presumably "'indicating that Congress 'did not intend that exempt property be liable to the payment of dischargeable tax debts.'" Id. at 881 *citing* In re Alexander, 225 B.R. 145 (Bankr. W.D. Ky. 1998).

Fewer courts in better reasoned opinions have found that a creditor may exercise a right to setoff against exempt property. The leading case for this minority is In re Wiegand, 199 B.R. 639 (W.D. Mich 1996, J. Quist). In Wiegand, the debtors listed a credit union as an unsecured creditor on their schedules, and claimed a $900 account balance with the credit union as exempt. Although the credit union did not file an objection to the exemption, it refused to release the debtors' funds. Holding that the credit union could setoff the debtors' account against the debt owed by the credit union to the debtors, the district court stated:

The key to resolving the apparent conflict between Sections 522(c)and 553(a) of the

Bankruptcy Code is found in the distinction between offsetting a mutual obligation and collecting a unilateral debt. The right to setoff under 11 U.S.C. §553 allows parties that owe money to each other to assert amounts owed, subtract one from the other, and pay only the balance, "thereby avoiding 'the absurdity of making A pay B when B owes A....'" Allowing setoff against exempt property would not undermine the general policy behind the Bankruptcy Code because a debtor will not be denied the ability to hold property exempt from liability for pre-petition debts. Only creditors who possess a valid setoff right can offset their obligation with a debtor's exempt property. Under 11 U.S.C. §522, debtors can still exempt property from the reach of all other creditors possessing pre-petition claims. Finally, it should be noted that the Bankruptcy Code allows a creditor with a valid setoff right to retain exempt property during the bankruptcy proceeding, rather than turning the property over to the trustee. 11 U.S.C. §542(b). Therefore, if a creditor's setoff right is not defeated by exemption pursuant to §542(b) while a bankruptcy proceeding is in progress, then a creditor's setoff right is not defeated by exemption pursuant to §553(a) after a bankruptcy proceeding is over.

Id. at 642-643.

The district court in Posey v. United States Dep't of Treasury - Internal Revenue Service, 156 B.R. 910 (W.D.N.Y. 1993, J. Skretny), reached the same conclusion as the Wiegand court. The court stated:

While the purpose of the exemption provision is to allow a debtor to reserve property for a fresh start after bankruptcy, in actuality, §542(b) breaches this purpose because it allows the creditor with a valid setoff right to retain the property claimed as exempt before the bankruptcy proceeding is over. Therefore, if a creditor's setoff right is not defeated by debtor's claim of exempt property pursuant to §542(b) when the bankruptcy proceeding is still continuing, then setoff of exempt property is permissible pursuant to the language of §553(a) after the bankruptcy proceeding is over. While a discharge of debt does occur when the bankruptcy proceeding is over...the discharge of a debt does not affect the creditor's right to setoff.

Id. at 916-917. *See also* In re Runnels, 134 B.R. 562 (Bankr. E.D. Tex. 1991, J. Sharp) and In re Eggemeyer, 75 B.R. 20 (Bankr. S.D. Ill. 1987, J. Meyers) (holding that the IRS can exercise a valid right of setoff against exempt property based on §542(b) which excepts property subject to a setoff from turnover).

The Ninth Circuit B.A.P. also adopted the minority view based on another rule of statutory construction. *See* In re Pieri, 86 B.R. 208 (9th Cir. B.A.P. 1988, J. Meyers). According to the Pieri court:

It is long settled that where there is an irreconcilable conflict between different parts of the same act, the last in order of arrangement will control.... Here that would mean that Section 553 would control over Section 522(c) on any point of conflict. The result so dictated appears to be one that forwards Congressional intent, which is the overriding objective of any court interpreting statutes....

Id. at 212-213.

The Seventh Circuit has not adopted either the majority or the minority view. In fact, the only court within the Seventh Circuit to rule on this issue is the Southern District of Illinois in In re Eggemeyer, 75 B.R. 20 (Bankr. S.D. Ill. 1987, J. Meyers). In Eggemeyer, the bankruptcy court held that a creditor could exercise its right of setoff against exempt property. In so ruling, the court relied on §542(b), which enables a creditor "who has a valid right of setoff to retain the property, regardless of its exempt status." However, there have been similar issues discussed in the Chapter 13 context by

other courts in the Seventh Circuit. In In re Munson, 248 B.R. 343 (C.D. Ill. 2000, J. Mihm), the District Court held that a creditor's right to setoff is preserved despite the debtor's confirmed plan which claimed the property subject to the setoff as exempt. In Munson, the debtor filed a Chapter 13 plan in which she listed the IRS as having an unsecured priority claim, and then claimed her tax refund as exempt. The IRS failed to object to the debtor's Chapter 13 plan. The bankruptcy court held that the IRS' failure to timely object to the debtor's exemption barred it from claiming its right to setoff, and that the effect of the confirmed plan was to preclude the IRS from exercising this right. The district court reversed the bankruptcy court, stating:

The plain language of §553 states that, except for certain exceptions that are inapposite here, "this title does not affect any right of a creditor to offset a mutual debt..." (emphasis added.) Section 1327, which establishes the effect of the confirmation of a Chapter 13 plan, is necessarily included in "this title...." Thus, giving precedence to §1327 would ignore and render meaningless the plain language of §553. Furthermore, allowing Munson to retain her refund will result in a windfall to her without any additional benefit to her creditors.

Id. at 346. *See also* In re Mason, 79 B.R. 786 (Bankr. N.D. Ill. 1987, J. Schwartz) (holding that a pre-petition right to setoff is not forfeited by confirmation of the debtor's Chapter 13 plan). It seems that the reasoning of the Munson court can be applied to the §522(c) vs. §553(a) debate as well. Based on the plain language of §553(a), the IRS should be able to exercise its right to setoff against exempt property. Allowing the debtors to retain all of their refund would result in a windfall to them.

Conclusion

The IRS has a valid right to setoff despite the fact that the debtor's debt to them was discharged. Although there is a split of authority as to whether a creditor can exercise a right to setoff against exempt property, the better reasoning supports that a creditor's right to setoff against exempt property. Therefore, the IRS' motion for relief from stay to setoff the debtors' tax refund against their tax liability must be granted.

It is so ordered.

END NOTES:

1. As an initial matter, the substantive law which grants the IRS a right to setoff is 26 U.S.C. §6402, which allows the government to credit a tax overpayment made by a taxpayer against that taxpayer's tax liability. *See* 26 U.S.C. §6402.

2. Other "majority cases" listed as "see also."