DOCKET NUMBER: 96-11505
ADV. NUMBER: None
JUDGE: M. A. Mahoney
PARTIES: William G. Dodd, Margaret E. Dodd, United States of America (IRS)
CHAPTER: 7
ATTORNEYS: C. M. Smith, W. R. Sawyer
DATE: 12/6/96
KEY WORDS:
PUBLISHED:

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF ALABAMA

In Re

WILLIAM G. DODD
MARGARET E. DODD

Case No. 96-11505-MAM-7

Debtors.

ORDER DENYING UNITED STATES' MOTION FOR RELIEF FROM THE AUTOMATIC STAY

C. Michael Smith, Mobile, AL for Debtors
William R. Sawyer, Mobile, AL for the United States of America

This matter is before the Court on the Motion of the United States of America, on behalf of the Internal Revenue Service, for Retroactive Relief from the Stay. The appearances at the hearing were as noted in the record. The Court has jurisdiction to hear this matter pursuant to 28 U.S.C. §§ 157 and 1334 and the Order of Reference of the District Court. The matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2). For the reasons indicated below, the motion is denied.

FACTS

William and Margaret Dodd (the "debtors" or the "Dodds") filed their joint Chapter 7 bankruptcy case on April 24, 1996. They listed the Internal Revenue Service (the "IRS") as a creditor for 1992 and 1993 income taxes in the amounts of $1,846.08 and $585.02 respectively. The 1992 taxes are dischargeable in the Dodd's bankruptcy case pursuant to 11 U.S.C. § 523(a)(1). (Taxes for which tax returns are filed more than two years before filing of bankruptcy case are dischargeable.) The Dodds listed as an asset on their petition a $2,094.00 federal tax refund due them for the tax year ending December 31, 1995.

The Dodds' schedules also reflect that they were unemployed when their case was filed. Their income consisted of AFDC, food stamps and Supplemental Security Income or SSI from the federal government.

The Dodds claimed the tax refund as exempt property pursuant to ALA. CODE § 6-10-6 and 11 U.S.C.§ 522. No objections to the exemption were filed during the allowed period for such objections. Fed. R. Bankr. P. 4003. This resulted in the debtors having no assets except exempt ones. Their bankruptcy case is a "no asset" Chapter 7 case in which no creditor will receive a distribution.

In May, 1996, after the Dodd's bankruptcy filing, the IRS set off the tax refund against the 1992 and 1993 tax obligations. On September 16, 1996, the IRS filed a motion for relief from the automatic stay, seeking to retroactively validate the May 1996 setoff or to prospectively obtain relief from the stay. The Debtors argue the relief would be inappropriate because setoffs require mutuality of debts and the Dodds 1992 and 1993 tax debts are prepetition debts and the tax refund is a postpetition debt. Therefore, setoff is improper. The Dodds also argue that the IRS violation of the stay in the May 1996 setoff should preclude relief to the government now on equitable grounds.

LAW

The issue in this case is whether retroactive or prospective relief from the automatic stay to allow the IRS to set off the Dodd's tax refunds against their tax debts is appropriate. There are two levels to this question. First, is a setoff pursuant to 11 U.S.C. § 553 ever allowable against property of a debtor properly and finally claimed as exempt pursuant to 11 U.S.C.§ 522? Second, if a setoff against exempt property is permissible, is it appropriate under the facts of this case?

A.

SETOFFS AGAINST EXEMPT PROPERTY

The cases on setoff acknowledge that there is an apparent conflict between the language of Sections 553 and 522(c). Section 553 states:

> 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 . . . (Underlining added)

This section provides that its only exceptions are in Section 553 and 362 and 363.[1]

[1]The tax debt of the Dodds has not been disallowed. The Dodds admit that the debt for 1992 and 1993 federal income taxes is owed in Schedule E of their bankruptcy schedules. 11 U.S.C. § 553(a)(1). The claim was not transferred to the IRS from any other entity. 11 U.S.C. § 553(a)(2). The tax refund right of the Dodds did not arise within 90 days before their bankruptcy. *In re Rozel Industries, Inc*., 120 B.R. 944 (Bankr. N.D. Ill. 1990); *In re Eggemeyer*, 75 B.R. 20, 22 (Bankr. S.D. Ill. 1987) ("[I]ncome tax refunds are 'absolutely owing' on December 31 of the year in which the overpayment is made . . ."). 11 U.S.C. § 553(a)(3).

The IRS did not end up with a smaller claim during the 90-day period preceding bankruptcy due to the setoff. 11 U.S.C. § 553(b). Section 553(b) precludes a creditor from setoff if there is a net balance still owing the creditor by the debtor after the setoff which is larger than the net balance would have been 90 days before bankruptcy or upon the first date within the 90 days on which a net balance first existed. In this case the facts are:

Debts Owed	**90 Days Before Bankruptcy**	**At the Date of the Bankruptcy Filing**	**At the Date of Setoff**
Dodds owed IRS	$2,431.10	$2,431.10	$337.10
IRS owed Dodds	2,094.00	2,094.00	----
Net Insufficiency (Difference)	$ 337.10	$ 337.10	$337.10

There was no net change in the parties positions and therefore Section 553(b) does not apply.

Section 522(c) states that "property exempted under this section is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case." (Underlining added). It also contains exceptions which do not include Section 553.[2]

These sections appear to be in conflict. If a setoff of prepetition debt is allowed against exempt property, the exempt property is being held "liable . . . for [a] debt of the debtor that arose . . . before the commencement of the case." 11 U.S.C. § 522(c).

1. **Common law right of setoff outside bankruptcy.** In Alabama and elsewhere, there is a recognized common law right of a creditor to offset mutual debts between the creditor and the debtor. *Hinton v. Pollock Motor Car Co.*, 659 So.2d 649, 650, (Ala. Civ. App. 1995) ("Right of set-off is based on principle that natural justice and equity require that demands of parties mutually indebted be set off against each other"); *Head v. Southern Development Co*., 614 So.2d 1044 (Ala. 1993): *Studley v. Boulston National Bank*, 229 U.S. 523, 528, 33 S. Ct. 806, 808, 57 L. Ed. 1313 (1913).

When the setoff right arises under common law, the majority of cases have held that setoffs against property which is exempt under state law are not allowed. *Ex parte Hunt & Tally*, 62 Ala. 1 (1878) ("It is obvious if the set-off were allowed, the appellants [creditors] would, by indirection gain the mastery over the constitution and the statutes which freed the property converted from liability for the payments of debts"); *California State Employees' Association v.*

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[2]The exceptions are for certain nondischargeable debts, including tax debts. 11 U.S.C.§ 523(a)(1) and (5). The tax debts of the Dodds are dischargeable so this section does not apply. 11 U.S.C. § 522(c)(1). Another exception is for debts secured by liens. Although the effect of a setoff is like that of a lien, a setoff is not a right which creates or arises from a lien. 11 U.S.C. § 522(c)(2). The last exception is for nondischargeable debts owed by institution-affiliated parties involved with Federal depository institutions. The Dodds are not such persons. 11 U.S.C. § 522(c)(3).

State of California, 198 Cal. App. 3d 374,377, 243 Cal. Rptr. 602 (1988) (state attachment and garnishment laws take precedence over statutory setoff rights and preclude setoff when it would affect exempt wages. "The policy underlying the state's wage exemption statutes is to insure that regardless of the debtor's improvidence, the debtor and his or her family will retain enough money to maintain a basic standard of living . . ."); *In the Matter of the Estate of Lawson*, 222 Mont. 276, 721 P.2d 760 (1986) (No setoff allowed against homestead and family allowances to decedent's surviving spouse); *Commonwealth of Pennsylvania v. Saunders*, 317 Pa. Super. 184, 463 A.2d 1146 (1983); *Barnhill v. Robert Saunders & Co*., 125 Cal. App. 3d 1, 177 Cal. Rptr. 803 (1981); *Kruger v. Wells Fargo Bank*, 11 Cal. 3d 352, 521 P.2d 441, 113 Cal. Rptr. 449 (1974); *Finance Acceptance Co. v. Breaux*, 160 Colo. 510, 419 P.2d 955 (1966). As stated in 20 Am. Jur. 2d, *Counterclaim, Recoupment and Setoff*, § 33 (1965):

> Generally, in an action the subject of which is exempt property, a defendant will not be permitted to defeat the exemption by setting up a counterclaim or setoff, although there may be no express statutory provision protecting exempt property from the right of counterclaim or setoff.

A minority of courts have held that exempt property is subject to a common law right of setoff. *Clary v. Norris*, 1995 WL 140835 (Ohio App. Ct. 1995); *Daugherty v. Central Trust Company of Northeastern Ohio, N.A.*, 28 Ohio St. 3d 441, 504 N.W. 2d 1100 (1986).

The common law setoff rights of parties are not binding upon this court, but the law is instructive on the breadth of the setoff remedy absent statutory guidelines.

2. **Federal law of setoff outside bankruptcy.** The federal government has, by statute, its own law of setoff outside the bankruptcy realm. Relevant to this case are the setoff rights of the IRS. Section 6402(a) of title 26 states:

> (a) **General rule.** In the case of any overpayment, the Secretary [of the Treasury], 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 . . .

The Eleventh Circuit has ruled that, in a nonbankruptcy context, Section 6402 is controlling when it is in conflict with the Alabama personal property exemption statute. "Under the doctrine of preemption, which is based upon the Supremacy Clause of the United States Constitution, the federal law must control." *Bosarge v. United States Department of Education*, 5 F.3d 1414 (11th Cir. 1993). Therefore, the offset by the IRS would clearly be allowable if the Dodds were not in bankruptcy.

However, in this case, the Court must deal with potentially conflicting federal laws—11 U.S.C. §§ 522 vs. 11 U.S.C. § 553. Therefore, preemption does not resolve the problem.

3. **Legislative history of Sections 522 and 553.** The House of Representatives' version of Section 522 (c) was the version enacted into law. The legislative history to this section states:

> Subsection (c) insulates exempt property from prepetition claims, except tax and alimony, maintenance, or support claims that are excepted from discharge.

Legislative History, H. Rep. No. 95-595, p.361 (1977).

An unenacted Senate version of Section 522(c) would have allowed IRS claims to be levied against exempt property for dischargeable tax liabilities. The legislative history stated:

> Subsection (c)(3) permits the collection of dischargeable taxes from exempt assets. Only assets exempted from levy under Section 6334 of the Internal Revenue Code or under applicable state or local tax law cannot be applied to satisfy these tax claims. This rule applies to prepetition tax claims against the debtor regardless of whether the claims do or do not receive priority and whether they are dischargeable or nondischargeable. Thus, even if a tax is dischargeable vis-a-vis the debtor's after-acquired assets, it may nevertheless be collectible from exempt property held by the estate.

Legislative History, Senate Report No. 95-989, 95th Cong. 2nd Sess. 76 (1978). This provision never passed. Congress, therefore, rejected a version of Section 522(c) which allowed dischargeable federal tax claims to reach assets properly claimed as exempt under bankruptcy law. *In re Monteith*, 23 B.R. 601, 603-4 (Bankr. N.D. Ohio 1982). The Dodd's 1992 taxes which the IRS seeks to offset are dischargeable taxes.

This Court believes this history clearly establishes that the Bankruptcy Code exemption and discharge standards are meant to override the Internal Revenue Code requirements, at least where the IRS has no setoff rights which are governed by Section 553. The problem remains that neither the legislative history nor the Code give clear guidance where two sections of the Bankruptcy Code conflict.

The legislative history of Section 553 sheds no light on the problem. It merely restates the words of the statute.

4. **Statutory construction.** There are several principles of statutory construction which should be considered when reviewing conflicting statutes.

One statutory construction principle is that a more specific statute will be given precedence over a more general one. *Busic vs. United States*, 446 U.S. 398, 406, 100 S. Ct. 1747, 1752, 64 L. Ed. 2d 381 (1980). In this case, the Court cannot find that either statute is more specific than the other. Sections 553 and 522 both have limited, specific exceptions to blanket rules.

Yet another maxim holds that courts should adopt an interpretation which will allow both statutes to have effect if possible. "Where two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective." *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1018, 104 S. Ct. 2862, 2881, 81 L. Ed.

2d 815 (1984). There are several interpretations of sections 522 and 553 which would give life to both statutes. Setoffs could override exemptions or exemptions could override setoffs. Neither interpretation writes the overridden section out of the Code.

Another construction argument in favor of allowing setoff raised by some courts is that the presence of Section 542(b) in the Bankruptcy Code requires that setoffs be allowed against exempt property. Section 542(b) states:

> Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

This states that the only time a creditor with setoff rights must turn over property to the trustee is after the setoff is accomplished. The case of *Wiegand* and its predecessors reason from this that a creditor need not turn over to a debtor exempt property subject to setoff. *In re Wiegand v. Tahquamenon Area Credit Union (In re Wiegand)*, 199 B.R. 639 (W.D. Mich. 1996). [I]t necessarily follows that when the proceeding is over, a creditor with a valid setoff right also may retain property claimed as exempt." *Wiegand* at 199 B.R. 642, *citing*, *Posey v. IRS*, 156 B.R. 910, 916 (W.D.N.Y. 1993). The reasoning is, since the Bankruptcy Code explicitly requires turnover to a trustee after setoff, a debtor must have no right to keep his or her exempt assets except after setoff or the Bankruptcy Code would have so stated.

This Court does not see how that conclusion can be reached from Section 542(b). It does not state that the debtor has no right to seek recovery of properly exempted property from a party holding it. This right of a debtor is established elsewhere in the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure. Fed. R. Bankr. P. 7001(1) indicates an action to "recover money or property" is governed by it. Section 522(c) establishes the debtor's right.

5. **Policy concerns.** Most courts conclude by discussing the policy concerns behind Section 553 and Section 522 and attempt to reach a result which fairly considers the policies. The courts have found three policies to consider. *Wiegand, supra*.

"Setoffs in bankruptcy have long been 'generally favored,' [and] a presumption in favor of their enforcement exists." *Wiegand* at 199 B.R. 639, 641, *citing*, *In re De Laurentiis Entertainment Group, Inc*., 963 F.2d 1269, 1276 (9th Cir. 1992). It is true setoffs are specifically allowed, and, in general, setoffs are presumed appropriate. However, a limitation on the policy to recognize federally recognized state law exemptions does not in any way negate the general policy. As shown, at common law, setoffs are favored also, but not at the expense of exempt property.

"[T]he primary purpose of discharge is to prohibit post-bankruptcy debt collection." *Wiegand* at 199 B.R. 641. This policy is a corollary of the "fresh start" policy discussed below. It is argued that allowing setoffs during or before bankruptcy does not upset the discharge goal since no postpetition assets are taken. This argument does not alter the important need of a debtor to a new start with enough assets to make a new beginning. Congress thought this policy to be as important as the discharge policy as reflected in the language of the Code and the inclusion of exemption rights.

Exemptions are necessary for the "rebuilding of the debtor," the proverbial fresh start. *Wiegand* at 199 B.R. 642, n.3. *Wiegand* argues that requiring a creditor to pay a debtor while receiving nothing or less than a full recovery in return is unfair, and setoff is therefore crucial to the balance between debtors and creditors in bankruptcy. This "unfairness" is part of the bankruptcy process. Many, if not most, creditors remain unpaid in full or part. The Code requires creditors to refund monies paid to them by debtors pursuant to Sections 542, 544, 547,

548 and 549. Requiring return of monies claimed as exempt but otherwise subject to setoff seems no more onerous or inappropriate than these required returns. Creditors subject to return of assets have debts against the debtor as well. The purpose of the return of assets is to effect a fair distribution among creditors and to allow debtors to claim their exemptions, in some instances. See 542(a). The *Wiegand* case does not discuss the importance attached to giving debtors enough property after bankruptcy to renew their lives with some dignity and enough funds to deal with immediate needs.

6. **Conclusion.** The Court concludes that the better reasoned position in light of the above is to read Section 522(c) as overriding Section 553 as to exempt property setoffs. This best serves the nonbankruptcy law, the legislative history and the policy concerns at issue.

B.

IF SECTION 553 ALLOWS SETOFF BY THE IRS AGAINST EXEMPT TAX REFUNDS, IS A SETOFF UNDER SECTION 553 APPROPRIATE IN THIS CASE?

1. **Nature of Obligations**. The Dodds allege that the tax refunds cannot be set off postpetition against a discharged debt. There is no mutuality of obligation. Setoffs of a postpetition asset against a prepetition debt would be inappropriate under setoff law according to the Dodds. However, the 1992 and 1993 taxes and the 1995 refunds are prepetition obligations of the Dodds and the United States respectively. See footnote 1.

2. **Mandatory or permissive.** The case law on Section 553 indicates that a court has discretion as to whether to grant a creditor the right to exercise a setoff, even if the setoff is otherwise permissible. *In re Charter Co.*, 86 B.R. 280 (Bankr. M.D. Fla. 1988); *Photo Mechanical Serv. vs. E.I. Dupont De Nemours & Co. (In re Photo Mechanical Serv.)*, 179 B.R.

604 (Bankr. Minn. 1995); *In re Royal Crown Bottling Co.*, 10 BCD 713 (Bankr. N.D. Ala. 1981). Assuming the Court is incorrect on whether a setoff against exempt property is permissible at all, and because the 1993 taxes in the amount of $585.02 are not dischargeable, this issue must be considered.

3. **Concerns to be weighed.** In this case, the schedules reveal that the debtors are unemployed and living on AFDC, food stamps and SSI disability income. Assuming this is true, the equities do not favor the IRS. The only asset of any value the debtors appear to have with which to secure a fresh start is the $3,000 personal property exemption allowed by Section 522 and state law.

The IRS also acted in violation of the stay when it first offset the tax refund in May 1996. The IRS does not now claim that the offset was appropriate. The Eleventh Circuit has made clear that any offset done in violation of the automatic stay is null and void. *Borg-Warner Acceptance Corp. v. Hall*, 685 F.2d 1306 (11th Cir. 1982). However, the fact remains that an inappropriate seizure was made. After the seizure in May 1996, the money was not paid into court, nor was a motion for relief from stay filed for approximately five months.

4. **Conclusion.** The Court holds that based upon the equities of the situation, even if the Court is incorrect on the issue of whether exempt tax refunds in bankruptcy are subject to IRS setoff, a setoff in this case would be inappropriate. The IRS has violated the stay. The debtors are in need of the funds for a fresh start. The 1992 tax debt is otherwise dischargeable.

For these reasons, the Court holds that the United States is not entitled to set off federal income tax refunds properly and finally claimed as exempt against prepetition tax liabilities pursuant to 11 U.S.C. § 553 or 26 U.S.C. § 6402. Therefore, there is no need for the court to consider whether the IRS might be entitled to either retroactive or prospective relief. If the

Court is incorrect on the issue of the unavailability of setoff against exempt property, the Court alternatively rules that relief from the stay is inappropriate on equitable grounds.

THEREFORE IT IS ORDERED that the Motion of the United States of America for Retroactive Relief from the Stay is DENIED.

Dated: December 6, 1996

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MARGARET A. MAHONEY
CHIEF BANKRUPTCY JUDGE