UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

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In re

RANDY R. WALLACE and
ADRIENNE L. WALLACE,

Case No. 95-21990-L

Debtors.

Chapter 13

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RANDY R. WALLACE and
ADRIENNE L. WALLACE,
Plaintiffs,

v.

Adv. Pro. No. 98-0460

DEPARTMENT OF THE TREASURY --
INTERNAL REVENUE SERVICE,
Defendant.

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**MEMORANDUM OPINION**

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Before the Court is the complaint of Randy B. Wallace and Adrienne Lee Wallace ("Debtors") to compel turnover of Mrs. Wallace's 1997 tax refund. It is undisputed that the Internal Revenue Service ("IRS") setoff the tax refund against the Debtors' postpetition joint tax liability pursuant to Internal Revenue Code § 6402. Based on the statements of counsel, the stipulations of the parties, and the entire record in this cause, the Court concludes that the IRS properly setoff the Debtors' tax liability against the tax refund, and that the demand for turnover should be denied. This opinion contains the Court's findings of fact and conclusions of law pursuant to FED. R. BANKR. P. 7052. This is a core proceeding. *See* 28 U.S.C. §§ 157(b)(1) and (b)(2)(E).

## I. FACTUAL SUMMARY

The following facts are not disputed. The Debtors filed their voluntary petition on February 23, 1995, and their Chapter 13 plan was confirmed on May 1, 1995. The Debtors subsequently failed to timely file postpetition income tax returns for the years 1995 and 1996. On December 22, 1997, however, the Debtors filed joint income tax returns for 1995 and 1996, indicating tax debts for those years of $1,566.00 and $3,110.00, respectively, excluding all penalties and interest.

In January, 1998, Mrs. Wallace timely filed a separate 1997 income tax return, indicating a refund owing to her in the amount of $3,896.00. Without seeking relief from the automatic stay, the IRS offset Mrs. Wallace's refund against the Debtors' full joint tax liability for 1995, and against a portion of the Debtors' joint tax liability for 1996. The tax debts for 1995 and 1996 are postpetition debts, and the tax refund represents a postpetition debt or the IRS to Mrs. Wallace.

The Debtors filed their complaint against the IRS to compel turnover of the 1997 tax refund on April 21, 1998, thereby commencing this adversary proceeding. The Debtors argue that the IRS' setoff violated the automatic stay or that the setoff is prohibited by negative inferences drawn from the provisions of 11 U.S.C. § 553(a). The Debtors propose to modify their chapter 13 plan to include payment of the postpetition tax debts.

This Court heard the parties' arguments on May 5, 1998, at which time the Debtors' counsel sought to introduce into evidence a copy of a letter drafted by him and addressed to Mr. Andrew

Papadakis, attorney for the IRS District Counsel, purportedly to establish the existence of an agreement between the parties to modify the Debtors' chapter 13 plan to include payment of the postpetition tax debt. The IRS objected to the introduction of the letter, alleging that the contents of the letter were inadmissible settlement negotiations. This Court denied Mr. Johnson's request because no authenticating evidence was presented. In their posttrial brief, the Debtors urge the Court to reconsider its prior ruling. The complaint did not allege a completed agreement, and the plaintiffs offered no other evidence of the existence of an agreement with the IRS. The IRS disputes the existence of an agreement concerning the treatment of the Debtors' postpetition tax debts.

The complaint alleges that recovery of the refund is necessary for maintenance of the Debtors' residence; specifically, the Debtors allege that their swimming pool requires repair and their carpeting needs to be replaced. IRS does not admit the necessity of these repairs, and the Debtors offered no evidence to support these allegations.

## II. CONCLUSIONS OF LAW

### A. Turnover

The Debtors argue that the IRS should be required to turnover Mrs. Wallace's tax refund pursuant to 11 U.S.C. Section 542(a) which provides:

> Except as provided in subsection (c) or (d) of this section, an entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or

> the value of such property, unless such property is of inconsequential value or benefit to the estate.

11 U.S.C. § 542(a). The Debtors seek to use Mrs. Wallace's tax refund not to fund their plan, but to repair their swimming pool and replace their carpet.

### B. Postpetition Setoff

The Debtors argue that setoff by the IRS is prohibited under the facts and circumstances of this case, based on the provisions of 11 U.S.C. § 553(a), which provides for setoff of mutual obligations arising prior to the commencement of the bankruptcy case. Pursuant to Internal Revenue Code § 6402, the IRS is authorized to credit overpayments against tax liabilities or other specified debts. *See* 26 U.S.C. § 6402.[1] The crediting of overpayments under I.R.C. § 6402(a) constitutes a setoff within the meaning of the Bankruptcy Code. *See Aetna Casualty & Surety Co. v. LTV Steel*

[1] I.R.C. § 6402 provides in pertinent part:

> (a) 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) and (d), refund any balance to such person.

*Co. (In re Chateaugay Corp.)*, 94 F.3d 772, 781 (2d Cir. 1996). Section 553 of the Bankruptcy Code provides in pertinent part:

> (a) 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). Section 553 applies only to the setoff of mutual *prepetition* debts. It is silent with respect to mutual *postpetition* debts. The general rule is that when postpetition obligations are mutual and setoff otherwise would be permissible under state or federal law, setoff is permitted. *See, e.g., Palm Beach County Bd. of Pub. Instruction v. Alfar Dairy, Inc. (In re Alfar Dairy, Inc.)*, 458 F.2d 1258 (5th Cir. 1972), *cert. den.* 409 U.S. 1048 (1972) (decided under the Bankruptcy Act); *Mohawk Indus., Inc. v. United States (In re Mohawk Indus., Inc.)*, 82 B.R. 174, 178-79 (Bankr. D. Mass. 1987); *Dery v. General Motors Corp. (Matter of Fordson Eng'g Corp.)*, 25 B.R. 506, 511 (Bankr. E.D. Mich. 1982); *see also* 5 LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 553.03[6] (15th ed. rev. 1997) ("[T]he general rule is that, subject to the restrictions imposed by section 362, a postpetition claim may be offset against a postpetition debt so long as the claim and debt constitute valid, mutual obligations.")

**C. The Automatic Stay**

The Debtors allege that even if setoff of mutual postpetition debts is permitted, the IRS's setoff violated the automatic stay. Bankruptcy Code Section 362(a) provides, in pertinent part:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title . . . operates as a stay, applicable to all entities, of -
>
> > (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
> >
> > (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor....
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> ***

11 U.S.C. § 362(a)(6) and (7). Acts to collect, assess, or recover a claim against the debtors that arose *after* the commencement of the case, and setoff of any debt that arose *after* the commencement of the case are not prohibited by Sections 362(a)(6) or (7).

Section 362(a)(3) does prohibit acts "to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3). Property of the estate in a Chapter 13 case consists of all property specified at Section 541 (generally all legal and equitable interests of the debtor in property as of the commencement of the case), together with all such property the debtor acquires and earnings from services performed by the debtor, after the commencement of the case but before the case is closed, dismissed or converted to another chapter. *See* 11 U.S.C. § 1306(a)(1) and (2). Mrs. Wallace's entitlement to a tax refund is a

property interest acquired by the debtor after the commencement of her case and thus would be property of the estate under Section 1306(a)(2). Section 1327 (b) provides that "except as otherwise provided in the plan or the order confirming the plan, the confirmation of the plan vests all property of the estate in the debtor." *See* 11 U.S.C. §1327(b). Under that provision, upon confirmation of the Debtors' plan, the Debtors' residence would no longer be property of the estate, and the automatic stay would not have prohibited setoff by the IRS. In this case, however, the order confirming the plan provided that "all property acquired and all earnings from services performed by the debtor(s) after the commencement of the case shall continue to be property of the estate." *See* Document No. 12. If the Court's analysis stopped here, the Court would be compelled to conclude that the Debtors' residence remained property of the estate following confirmation of their plan, and the IRS's action was a prohibited act to obtain possession of, or exercise control over, property of the estate.

The analysis does not stop there, however. The IRS correctly points to this Court's "Standing Order Granting Relief from Automatic Stay in Chapter 7 and Chapter 13 Proceedings" entered on March 5, 1990. That order provides, in pertinent part:

> ORDERED that the automatic stay provided by 11 U.S.C. § 362 shall be terminated in Chapter 7 and Chapter 13 proceedings as to the matters set forth below 45 days after the filing of the debtor's original petition, if neither the debtor nor any other party in interest files an objection and requests a hearing within said 45 day period:
>
> 1. IRS assessment of amount due,
>
> 2. IRS issuances of notices and demands under Title 26 of the United States Code, and

> 3. *IRS offset or credit of any amounts due in accordance with 26 U.S.C. § 6402.*

*In re Relief From Automatic Stay in Chapter 7 and Chapter 13 Proceedings*, Misc. No. 90-7, slip op. (Bankr. W.D. Tenn. March 5, 1990) (emphasis added).

The Standing Order grew out of a local bankruptcy rule adopted by the bankruptcy judges of this district in 1981 at the request of the IRS "to enable the IRS to forego imputing a computer "freeze" on debtors accounts in many cases, to allow the IRS' computers to resume the normal process of assessment of liabilities, and to allow the IRS to offset and refund balances due without having to file a formal written motion (then complaint) in each and every case." *Cohn v. Internal Revenue Service (In re Internal Revenue Service Liabilities and Refunds in Chapter 7 and 13 Cases),* Misc. No. G-87-0012, slip op. at 2 (Bankr. W.D. Tenn. December 9, 1987). The Standing Order is designed to allow the normal business of the IRS to continue during a taxpayer's bankruptcy case, while giving the bankruptcy debtor the opportunity to object to the termination of the automatic stay within forty-five days of the filing of the original petition, if the debtor's particular circumstances require the continued protection of the stay. Pursuant to the Standing Order, the automatic stay terminated with respect to the enumerated actions of the IRS forty-five days after the Debtors' petition was filed. Thus the postpetition setoff of Mrs. Wallace's tax refund did not violate the automatic stay.

Even were the Court to conclude that the automatic stay did prevent the action of the IRS, based upon the facts and circumstances of this case, the Court would conclude that the IRS would be entitled to have the automatic stay annulled and its prior setoff confirmed. The Debtors seek to use Mrs. Wallace's tax refund to repair their swimming pool and to replace their carpeting. The Debtors offered no proof concerning the necessity of these repairs to preserve the bankruptcy estate. These repairs do not appear to be necessary for the Debtors' performance under their plan. In connection with the Debtors' demand for turnover of the tax refund, the Court must consider the interests of the IRS because "a creditor whose right of setoff is stayed is entitled to 'adequate protection.'" *Cohn*, slip op. at 6; *see* 11 U.S.C. §§ 361, 362(d)(1). The burden of proof with respect to the issue of adequate protection lies with the Debtors. *See* 11 U.S.C. § 362(g). The Debtors offer to amend their plan to include repayment of their postpetition tax liabilities as a form of adequate protection. The Debtors offered no proof, however, concerning whether their plan, as modified, would be feasible.

Based on the facts and circumstances of this case, the Court finds that the Debtors' demand for turnover should be denied. This conclusion is consistent with the purpose of Chapter 13 of the Bankruptcy Code. A Chapter 13 plan is designed to enable eligible debtors to repay those debts that existed as of the commencement of their case over a specified period of time. A Chapter 13 plan is not intended to completely insulate debtors from the consequences of their financial activities *after* the filing of their petition.

**D. Letter Offered Into Evidence**

At the hearing on May 5, 1998, the Debtors' attorney, Mr. Patrick Johnson, Jr., offered into evidence a copy of a letter drafted by Mr. Johnson and addressed to Mr. Andrew Papadakis, attorney for the IRS District Counsel. The letter allegedly confirmed an agreement between the parties to modify the Debtors' chapter 13 plan to include payment of the postpetition tax debts. The IRS objected to introduction of the letter, based on the provisions of FED. R. EVID. 408, which prohibits the admission of evidence regarding compromise and offers to compromise. The Court denied the admission of the offered evidence, based on the lack of supporting authentication. Upon further consideration and review of the pleadings, the Court also concludes that exclusion of the letter was appropriate because the Debtors did not base their complaint for turnover upon an allegation that an agreement had been completed with the IRS with respect to the treatment of Mrs. Wallace's refund. Accordingly, the IRS's objection that the letter was inadmissible pursuant to FED. R. EVID. 408 was correct.

## III. CONCLUSION

Based upon the foregoing, the Debtors' demand for turnover of Mrs. Wallace's income tax refund will be denied. The Court will enter a separate order consistent with this Memorandum.

BY THE COURT

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JENNIE D. LATTA
United States Bankruptcy Judge

Date: June 19, 1998

cc: Debtors
Debtors' Attorney
United States Attorney
Chapter 13 Trustee
All Creditors and Interested Parties