UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE

IN RE:

JERRY R. BAGGOTT and
SALLY BAGGOTT,
Debtors.

Case No. 95-21694-B
Chapter 7

JERRY R. BAGGOTT and
SALLY BAGGOTT,
Plaintiffs,

v.

Adversary Proceeding
No. 95-1243

UNITED STATES OF AMERICA,
Defendant.

MEMORANDUM OPINION ON MOTION FOR SUMMARY JUDGMENT

Pending before the Court is the United States' motion for summary judgment. At issue is whether the Internal Revenue Service (IRS) may setoff the debtors' 1994 tax refund to pay a pre-petition tax liability which is dischargeable pursuant to 11 U.S.C. § 523(a)(l). This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (I), and (0). Based on the analysis set forth below, the United States' motion for summary judgment is hereby granted. The following constitutes findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052.

FACTUAL SUMMARY

The pertinent facts giving rise to the instant controversy are undisputed.[1] The debtors filed a joint chapter 7 petition on February 15, 1995. As of the date of the filing of the chapter 7 petition, the debtors owed income tax liabilities for the 1988 and 1989 tax years. Because such tax liabilities were both last due more than three years prior to the filing of the bankruptcy petition, these tax liabilities became dischargeable in the debtor's chapter 7 case pursuant to 11 USC. § 523(a)(1).[2]

After December 3 1, 1994, the debtors became entitled to receive a tax refund in the amount of $3,120.18 for the overpayment of their 1994 taxes. On August 15, 1995, the IRS setoff the 1994 overpayment of taxes and applied the refund to the 1988 tax liability.

In response to the IRS withholding the tax refund, the debtors filed a complaint to determine the dischargeability of their 1988 and 1989 tax liabilities and for return of the refund. The United States responded by filing the present motion for summary judgment asserting that although the taxes are dischargeable, such dischargeability does not vitiate its right of setoff.

DISCUSSION

Pursuant to FED. R CIV. PROC. 56(c), summary judgment is proper when there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. Celotex Corp. v. Catrett, 477 U.S. 3 17 (1986). As stated above, the facts of this proceeding are undisputed. Therefore, the primary inquiry is whether the United States is entitled to judgment as a matter of law. Because this Court concludes that the United States is entitled to judgment as a matter of law, the

[1] The United States filed an affidavit in support of its motion. The debtor filed no affidavit and adopted the government's statement of facts.

[2] The United States admits, on page 5 of its memorandum that these taxes are dischargeable pursuant to 11 U.S.C. § 727, 11 U.S.C. § 523(a)(l)(A), and 11 U.S.C. § 507(a)(8)(A)(I).

United States' motion for summary judgment will be granted.

A proper analysis of this proceeding requires the Court to resolve two distinct issues. First, the Court must determine whether the IRS had a valid right of setoff. Second, the Court must determine whether the dischargeability of the 1988 and 1989 tax liabilities vitiates the right of setoff of the IRS.

11 U.S.C. § 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.. . .

Pursuant to § 553 and subject to the provisions of the automatic stay, a creditor may setoff a debt owed to the debtor against a debt the debtor owes the creditor if (1) the creditor has a valid right of setoff under nonbankruptcy law, (2) the debts are mutual, and (3) the debts arose prior to the commencement of the bankruptcy case. In re Tillery, 179 B.R. 576, 577 (Bankr. W.D.Ark. 1995); See In re Julien Co., 136 B.R. 784, 790 (Bankr. W.D.Tenn. 1992); See In re Braniff Airways, Inc., 42 B.R. 443,447 (Bankr. N.D.Tex. 1984).

As a threshold matter, § 553 requires that the creditor have a valid right of setoff pursuant to nonbankruptcy law. 26 U.S.C. § 6402(a) of the Internal Revenue Code authorizes the IRS to credit any overpayment of tax against any tax liability owed by the person or persons otherwise entitled to a refund of the overpayment. In re Tiller-y, 179 B.R. at 578. Therefore, the IRS does have a valid right of setoff under nonbankruptcy law.

Secondly, § 553 requires that the debts be mutual. For debts to be considered mutual, **"they**

must subsist or be owing between the same parties, in the same right or capacity, and must be of the same kind or quality." In re Braniff Airways, Inc., 42 B.R. at 449. In the present case it is clear that the debts are owed between the same parties, in their same capacity, and are of the same kind and quality. Both debts are owed between the IRS and the debtors, in their identical capacities, and both debts center around federal income tax.

The final requirement of $553 is that both debts must have arisen prior to the commencement of the bankruptcy case. It is undisputed that the 1988 and 1989 income tax liabilities arose prior to the chapter 7 filing on February 15, 1995. Additionally, persuasive case law supports the proposition that an individual becomes entitled to an income tax refund, for overpayment of taxes, immediately after the last day of the tax year. In re Thorvund-Statland, 158 B.R. 837, 839 (Bankr. D.Idaho 1993); In re Conti, 50 B.R. 142, 148 (Bankr. E.D.Va. 1985) (holding that the obligation of the IRS to the debtor arose as of December 3 1). Therefore, this Court concludes that the debt owed by the IRS to the debtors arose immediately after December 3 1, 1994. Once again, this is clearly prior to the commencement of the bankruptcy case, which was filed on February 15, 1995.

Having determined that the IRS has a valid right of setoff under § 553, we turn to the issue of whether the dischargeability of the 1988 and 1989 tax liabilities vitiates the right of setoff of the IRS. The United States stipulates that the 1988 and 1989 income tax liabilities owed by the debtors are dischargeable pursuant to 11 U.S.C. § 727, 11 U.S.C. § 523(a)(l)(A), and 11 U.S.C. § 507(a)(8)(A)(I). However, the United States asserts that the dischargeability of these tax debts does not prevent the IRS from exercising its right to setoff the 1994 refund and apply the same in partial satisfaction of the tax liabilities.

A minority of courts have held that the discharge injunction provided for in 11 U.S.C. §

524(a)(2) prohibits a creditor from exercising its right of setoff against a debt that has been discharged. E.g., In re Dezarn, 96 B.R. 93 (Bankr. E.D.Ky. 1988). However, a significant majority of cases have held that a valid right of setoff existing prepetition is not extinguished by an order of discharge. Posev v. U.S. Dept. of Treasury-IRS, 156 B.R. 910,911 (W.D.N.Y. 1993); Runnels v. IRS (In re Runnels), 134 B.R. 562, 565 (Bankr.E.D.Tex. 1991); Camelback Hosp. v. Buckenmaier (In re Buckenmaier), 127 B.R 233,237 (9th Cir.BAP 199 1); Eggemever v. IRS (In re Eggemeyer), 75 B.R 20, 22 (Bankr.S.D.Ill. 1987); In re Conti, 50 B.R. 142, 149 (Bankr.E.D.Va. 1985). These courts have based their rationale on the language found in 11 U.S.C. § 553, which states that "this title does not affect any right of a creditor to offset...." E.g., Buckenmaier, 127 B.R. at 237. In addition, the court in In re Conti reasoned that the injunction found in 11 U.S.C. § 524(a)(2) applies only to the setoff of a postpetition debt owed by a creditor to the debtor against a prepetition discharged debt owed by the debtor to the creditor. Conti, 50 B.R. at 149. Furthermore, it would be "unfair to deny a creditor the right to recover an established obligation while requiring the creditor to fully satisfy a debt to the debtor." Davidovich v. Welton (In re Davidovich), 901 F.2d 1533, 1539 (10th Cir. 1990).

Finally, the court in In re Thompson noted that pursuant to 11 U.S.C. § 506(a), an allowed claim of a creditor that is subject to setoff under § 553 is a secured claim to the extent of the amount subject to setoff. Thomnson v. Board of Trustees of the Fairfax County Police Officers Retirement Svs. (In re Thompson), 182 B.R. 140, 154 (Bankr.E.D.Va. 1995). The court went on to hold that such a secured claim survives a bankruptcy discharge. Id.

The debtors raise two arguments in their memorandum in opposition to the motion for summary judgment. The debtors' first argument is that the automatic stay found in 11 U. S.C. § 362

prohibits the IRS from exercising its right of setoff. This argument is unpersuasive for the simple reason that the automatic stay was terminated pursuant to the standing order entered by this Court on March 5, 1990. Pursuant to this standing order, the automatic stay in chapter 7 and chapter 13 cases is terminated 45 days after the filing of the petition, if neither the debtor nor any other party in interest files an objection, in order for the IRS to effectuate a setoff in accordance with 26 U.S.C. § 6402. In the present case, the IRS did not exercise their right of setoff until 6 months after the filing of the petition.

The debtors' second argument centers around 11 U. S.C. § 547 and alleges that such a setoff is detrimental to other creditors. Once again, the debtors' argument is unpersuasive. 11 U.S.C. § 547 relates to the trustee's avoidance of preferences and has no application to the issues raised in this adversary proceeding. Even assuming that § 547 is applicable, there is no detriment to other creditors in the present case because the IRS is treated like a secured creditor in this situation pursuant to 11 U.S.C. § 506(a). The IRS received no more than it would have received in a chapter 7 liquidation, and therefore, 11 U.S.C. § 547(b)(5) would. not be satisfied.

CONCLUSION

Based on the analysis set forth above, by separate order, the United States' motion for summary judgment will be granted.

William Houston Brown
United States Bankruptcy Judge

10-23-96
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