



Tip of the Month January 2012

Tax Refund Interception on Account of Discharged Debt

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Often, debtors that file for bankruptcy have liabilities to a local government, a state government or the federal government. Occasionally, these liabilities are discharged. However, even if the liability is discharged it may still affect the debtor's refunds for tax returns covering the year of the bankruptcy filing.

I. How Are Tax Refunds Affected?

A. Right to Setoff

The debtor should be advised that tax refunds accrued during the tax year in which the bankruptcy occurs, may be subject to setoff, which means the funds are available to satisfy a debt to the creditor by applying funds they hold and owe to the debtor. The typical example of setoff involves a debtor that is both a borrower and a depositor at the same bank. If the debtor defaults on their loan, state law usually allows the bank to use the debtor's deposits to satisfy the debt for the loan.

A valid setoff in bankruptcy requires mutuality and it is only valid as to debts arising prior to filing. Mutuality, for the purposes of setoff, means between the same parties and in the same right. It does not mean within the same transaction. The mutuality element is satisfied as to federal and state taxing authorities even if the debt is owed to another agency of the federal government or that state government. Because section 553 of the Bankruptcy Code preserves a creditor's right to setoff, a creditor may setoff a

mutual debt incurred prior to the filing after discharge without violating the permanent injunction provided by section 524, the provision prohibiting the collection of debts discharged in a bankruptcy.¹

A debtor's tax refund may only be offset to the extent that both tax liabilities and tax refunds had accrued up to the date of filing for bankruptcy. Any refunds or liabilities accruing after the date of filing would not arise before the commencement of the case and would thereby fail to satisfy the requirements of section 553. This means that the debtor may be entitled to a partial refund (for the portion that accrued after the filing of the petition). Furthermore, in future tax years, the debtors refund cannot be offset on account of the pre-petition liability discharged in the bankruptcy. (Though it may be offset on account of non-dischargeable liability, or liability arising after the bankruptcy was filed). For example, a debtor files for bankruptcy in September with \$1000 of dischargeable liability owed to a state agency all of which accrued prior to filing the bankruptcy. If the debtor is owed a \$1000 refund from the Minnesota Department of Revenue, \$500 accrued pre-petition and \$500 post-petition, only the \$500 portion accrued pre-petition is subject to setoff. However, the \$500 portion accrued post-petition could still be intercepted because of a statutory lien.

B. Statutory Liens

Clients also need to be advised of the potential for any statutory liens created on account of a liability to a governmental unit (such as an overpayment of unemployment benefits

¹ See *In re Buckenmaier*, 127 B.R. 233 (Bankr. 9th Cir. 1991); *Posey v. Dep't of Treasury*, 156 B.R. 910, 915 (W.D.N.Y. 1993); *Reich v. Davidson Lumber Sales Emp. Ret. Plan*, 154 B.R. 324, 334 (D. Utah 1993); *In re Thompson*, 182 B.R. 140, 154 (Bankr. E.D. Va. 1995); *In re Runnels*, 134 B.R. 562, 565 (Bankr. E.D. Tex. 1991); *In re Eggemeyer*, 75 B.R. 20, 22 (Bankr. S.D. Ill. 1987)

due to fraud, a debt owed to a state supported university or community college, or past due income taxes). The creation and perfection of statutory liens and property subject to attachment by those liens are governed by state law, like the Minnesota Revenue Recapture Act M.S. 270A.01 to 270A.12. IRS tax liens are governed by 26 U.S.C. §6321. Even if the underlying obligation is discharged, statutory liens will pass through bankruptcy, unless they are avoided under the limited circumstances outlined in 11 U.S.C. § 545.² However, in all jurisdictions having decided the issue, statutory liens may attach only to property to the extent the taxpayer had an interest in that property as of the bankruptcy petition date.³ Thus, as in the case of setoff, property that is acquired after the filing and refunds accrued after filing are not subject to this creditor interest. However, unlike setoff, the statutory liens often attach to all of the debtors pre-petition property in addition to enabling interception of an accrued refund.

II. What if the Debtor Exempts the Pre-petition Portion of Their Refund?

Because statutory liens perfected pre-petition against tax refunds accrued pre-petition typically will not be avoided in the bankruptcy, the liens will remain attached to the refunds and will not be affected by a Debtor's attempt to exempt or protect those refunds. The debtor cannot successfully exempt the refunds because their interest in the refund is subject to the lien, much in the same way a debtor's interest in real property may be subject to a security interest. If a creditor's secured interest is greater than the value of the property, the debtor effectively has no interest in the property to exempt. If a lien holder's interest in property of the debtor exceeds the amount of the accrued refund, the debtor effectively has no interest in the refund to exempt. If the statutory

²See Long v. Bullard 117 U.S. 617 (1886), In re Be-Mac Transport Co., Inc. 83 F.3d 1020 (8th Cir. 1996)

³ In re Marshall, 204 B.R. 838 (Bankr. S.D. GA 1997), In re Paeplow, 972 F.2d 730 (7th Cir. 1992)

lien attaches only to part of the Debtor's refund then the debtor should exempt the portion not subject to the statutory lien.

It is not clear whether or not exemption of pre-petition refunds otherwise subject to a creditor's right of setoff entitles the debtor to the pre-petition refunds. ⁴Neither the Eighth Circuit, nor the District of Minnesota has decided the issue. Currently, courts are divided on the matter.⁵

III. How to Advise Clients

The practice tip to take away from this is that advising the client that her liabilities to a government are dischargeable may not be enough. Many clients count on their refunds for basic living expenses. If the client is expecting to receive a refund after the discharge, she may not be anticipating a setoff arising out of discharged liability or the continued existence of a statutory lien. The attorney must determine whether the elements for a valid setoff are present and whether or not a statutory lien has been perfected. Based on this analysis, the attorney must advise the client of the implications for her tax returns. This will help ensure that the client can prepare for the recapture of her refunds and avoid any resulting financial distress.

The impact of setoffs and statutory liens on tax returns is a complex topic often requiring a complete understanding of the circumstances surrounding the debt. If you lack sufficient information or familiarity with bankruptcy law to make such a detailed

⁴ The purported ambiguity arises from a conflict between the language of § 553, preserving the right to setoff, and that of § 522(c), which states that property exempted is not liable during or after the case for any debt arising before the commencement of the case.

⁵ See *United States v. White*, 365 B.R. 457, 1 ST. JOHN'S BANKR. RESEARCH LIBR. No. 12, at 7 (2009), http://www.stjohns.edu/academics/graduate/law/journals/abi/sjbrl_main/volume/v1/griswold.stj

assessment, please refer clients to Volunteer Lawyers Network's weekly Bankruptcy Advice Clinic.

Bankruptcy Advice Clinic

Minneapolis Federal Courthouse
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300 South 4th Street, 7th floor
Minneapolis, MN 55415

St Paul Federal Courthouse
2nd & 4th Thursday 11 a.m. – 1 p.m.
316 North Robert Street, 2nd Floor
St. Paul, MN 55101