OFFICE OF
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**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

November 2, 2000

Number: **200051009**
Release Date: 12/22/2000

CC:PA:CBS:Br2
GL-604422-00
UILC: 09.08.01-00
9999.98-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SBSE), AREA 3
CC:SB:3:NAS

FROM: Kathryn A. Zuba
Chief, Branch 2 (Collection, Bankruptcy & Summonses)

SUBJECT: Retention of Refunds in Chapter 13 Cases

This is in response to the request for advice dated July 28, 2000, from District Counsel, Kentucky-Tennessee District.

ISSUE: Whether the failure to pay a claimed refund for a prepetition tax period pending examination of the return for which the refund is claimed during a Chapter 13 case violates the automatic stay, B.C. § 362(a)?

CONCLUSION: The Service's failure to pay a refund for a prepetition tax period which is under examination and for which the Service has not yet determined there is an overpayment does not violate the automatic stay.

BACKGROUND: You have presented two hypothetical examples 1/ which we will summarize as follows:

Example 1: Taxpayer filed a Chapter 13 case in January 2000. The Service filed a priority claim for $1,700 for 1998, and an unassessed priority claim for 1999 for $1,700. After the petition is filed, taxpayer submitted a claim for refund for $1,300 for 1999 as part of his 1999 return. The Service does not issue the refund because of problems identified in the return and instead selects the return for examination. A TC 420 code is input on taxpayer's account to prevent issuance of the refund pending the examination. Pursuant to normal procedures, this examination may take more than a few months.

Example 2: Taxpayer filed a Chapter 13 case in January 2000. The Service filed a priority claim for $1,700 for 1996, and an unassessed priority claim for 1997 for $1,700.

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1/ We will not separately address your third hypothetical since we do not believe it raises any issues which are not already raised by Examples 1 and 2.

Prior to the time the bankruptcy petition was filed, taxpayer submitted a claim for refund for 1997 for $1,300 which the Service did not issue because it selected the 1997 return for examination. Shortly after the bankruptcy petition is filed, the Service completes the examination for 1997 and two weeks after the bankruptcy petition the Service issues a thirty-day notice of deficiency for $1,700. The Service continues to retain the refund by use of the TC 420 code.

You state that pursuant to the authority of United States v. Norton, 717 F.2d 767 (3d Cir. 1983), and Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995), an indefinite retention of a refund may violate the automatic stay. You, thus, conclude that in Example 1, the Service must expedite the examination, since the retention of the claimed refund for the extended period that it normally takes to complete an examination may constitute a violation of the automatic stay. You request our assistance in establishing guidelines for how long Examination should have to complete an audit before being required to release a claimed refund to ensure that the automatic stay is not violated.

You conclude that in Example 2, after the notice of deficiency is issued the Service is not violating the automatic stay because it has completed the examination and has determined that no refund is due. You ask, however, whether the automatic stay is violated during the period from the filing of the bankruptcy petition to the date the thirty day notice is issued.

DISCUSSION: We conclude that the Service's decision not to immediately honor a claim for a refund based on a return the Service has selected for examination is not a violation of the automatic stay. Thus, the Service does not violate the automatic stay in both examples.

Depending on the facts of the case, the following provisions of the automatic stay may arguably be implicated by the retention of a refund: section 362(a)(3) (prohibiting an act to obtain possession of property of the estate or to exercise control over property of the estate); section 362(a)(6) (prohibiting any act to collect or recover a prepetition claim against the debtor); and section 362(a)(7) (the setoff of any prepetition debt owing to the debtor against any claim against the debtor).

As a preliminary matter, we note that even after the Service determines that there is an overpayment and that a refund is due to the taxpayer, neither sections 362(a)(3) nor 362(a)(6) would be violated by the retention of such refund. The Supreme Court in Citizens Bank held that a bank's freeze of the debtor's bank account did not violate sections 362(a)(3) and (6) because the bank did not exercise dominion over property belonging to the debtor. The Court explained that a bank account is only a promise to pay from the bank to the depositor and, thus, the bank's temporary refusal to pay was not an exercise of control over debtor's property but merely a refusal to perform its promise. 516 U.S. 21. Based on the analysis in Citizens Bank, the retention of a tax refund will arguably never violate either sections 362(a)(3) or (6), because the Service

is not exercising control over the taxpayer's claim to a refund and is not taking any act to collect or recover a claim against the debtor. Rather, the Service is merely withholding payment of the taxpayer's refund claim. See In re Mountaineer Coal Co., Inc., 247 BR 633 (Bankr. W.D. Va. 2000) (section 362(a)(3) not violated by failure to pay debt owed to the bankruptcy estate).

But even if the retention of a refund owed to the debtor can be considered a violation of sections 362(a)(3) or (6), there cannot be a violation of those provisions until the Service first determines that there is an overpayment. The Service is entitled to take all income, deductions, credits and other adjustments into account before determining the tax due for a particular taxable period for the income tax, and if based on such computations the taxpayer has not made an overpayment of tax under I.R.C. § 6402, the taxpayer is not entitled to a refund. See Lewis v. Reynolds, 284 U.S. 281, 283 (1932) ("An overpayment must appear before refund is authorized.") While the Service is performing the examination to determine whether there is an overpayment, it is not taking an act to obtain possession of property of the estate or to control property of the estate under section 362(a)(3), and is not taking an act to collect or recover a prepetition debt under section 362(a)(6), because it is merely in the process of making a determination as to the correct tax due to determine whether the taxpayer is in fact entitled to a refund under the Internal Revenue Code.

Additionally, the Service is not making a setoff (or a retention of a refund amounting to a setoff) under section 362(a)(7) under these circumstances because it is not seeking to set off a prepetition debt owed to the debtor against a claim against the debtor. Instead, the Service is computing the tax for one taxable period to determine whether or not it owes a prepetition debt (e.g., a refund), or has a prepetition claim, for that period. See Lewis v. Reynolds, supra.

We finally note that once the Service has completed the examination and determined that there is an overpayment for a prepetition taxable period, if the Service were to indefinitely retain such overpayment to preserve its right to set off the overpayment against a tax liability due for another tax period (such as the earlier tax years in both examples), then such retention could possibly violate section 362(a)(7) pursuant to Citizens Bank. In addition, there is case authority for the proposition that the Service cannot exercise setoff rights to collect a prepetition tax debt which is provided for in full

in a confirmed Chapter 13 plan that is not in default. Norton, supra; United States v. Reynolds, 764 F.2d 1004 (4th Cir. 1985). Due to litigation hazards presented by this case authority, our position is that after confirmation of a Chapter 13 plan, if the Service does not wish to release a refund to preserve its setoff rights with respect to a tax liability provided for in the plan, the Service should either promptly file for relief from the stay, or, if the plan is in default and taxpayer will not cure the default, seek dismissal of the case. CCDM 34.10.2.6(2); IRM 5.9.4.3.1. Thus, in Example 1, if the Service ultimately determines that a refund is due, it should not retain the refund to preserve its setoff rights with respect to the earlier tax year after confirmation of the plan, assuming that the plan provides in full for the earlier tax liability and is not in default, without seeking relief from the stay.

Please contact this office at (202) 622-3620 if you have any questions or comments.