

INTERNAL REVENUE SERVICE

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MEMORANDUM FOR NORTH FLORIDA DISTRICT COUNSEL

FROM: Joseph W. Clark
Acting Branch Chief
Branch 2 (General Litigation)

SUBJECT: Offset of a Refund Against Discharged / Abated Tax Liabilities

This responds to your request for advice dated July 1, 1999. This document is not to be cited as precedent.

LEGEND:

Taxpayer
Years 1 - 9
Year 13
Year 14
Date A
Date B
Date C
X amount

ISSUE:

Can the Service credit a refund to the taxpayer against taxes previously discharged and abated by the Service?

CONCLUSION:

No. The Service may not credit an overpayment against abated tax liabilities.

FACTS:

Taxpayer filed a Chapter 7 bankruptcy on Date A. At that time, the taxpayer had unpaid income tax liabilities for Years 1 - 9. The taxes for Year 13 and Year 14 were fully paid. The taxpayer received a discharge on Date B. B.C. § 727. On Date C, pursuant to internal guidelines, the Service abated the unpaid liabilities for Years 1 - 9.

The Service released its Notice of Federal Tax Lien (NFTL) on the same date. After the taxes for Years 1 - 9 were abated by the Service, the taxpayer filed amended returns for Year 13 and Year 14, claiming refunds. The amount determined to be due to the taxpayer as a result of these claims is approximately \$X amount. The Special Procedures function asked whether they may credit (i.e., offset) this amount against the taxpayer's unpaid, but discharged and abated, tax liabilities for Years 1 - 9.

LAW & ANALYSIS:

The Bankruptcy Code does not create a federal right of offset. Instead, if a creditor possesses a right of setoff outside of bankruptcy, section 553 of the Bankruptcy Code preserves that right when certain requirements are met. B.C. § 553(a); Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18 (1995). The Service's non-bankruptcy right to setoff derives from section 6402(a) of the Internal Revenue Code. This section provides in relevant part as follows:

In case of an overpayment, the Secretary, within applicable period of limitations, may credit the amount of such overpayment ... against any liability in respect of an internal revenue tax on the part of the person who made the overpayment ...

I.R.C. § 6402(a).

While the term "liability" is not defined in the statute, it has long been established that a tax liability which can be enforced through normal assessment and collection procedures (i.e. a tax liability which has been assessed or for which a statutory notice of deficiency has been issued), is a prerequisite to making an offset under section 6402. See Treas. Reg. § 301.6402-1. The Service generally may not apply an overpayment to a tax liability which was either paid or abated, because the taxpayer is no longer liable for this tax. Therefore, unless the Service can reestablish the abated tax, either by reversing the previous abatement or by making a new assessment within the applicable limitations period, the Service cannot set off the overpayment against the abated tax.

Section 6404 of the Internal Revenue Code grants the Service the authority to make abatements. Section 6404(a) authorizes the Service to abate the unpaid portion of the assessment of any tax or any liability in respect thereof which is excessive in amount, assessed after the expiration after the expiration of statute of limitations for assessment, or is erroneously or illegally assessed. Section 6404(c) provides that "[t]he Secretary is authorized to abate the unpaid portion of the assessment of any tax, or any liability with respect thereof, if the Secretary determines ... that the administration and collection cost involved would not warrant collection of the amount due." I.R.C. § 6404(c). Treasury Regulation section 301.6404-1(d) further provide that the Commissioner may issue uniform instructions authorizing the district directors to abate

amounts where collection is not warranted because of administrative and collection costs.

Abating a liability previously discharged in bankruptcy generally constitutes a section 6404(c) abatement, as this usually results from a determination that the administration and collection costs involved do not warrant collection of the amount due from exempted or abandoned assets of the taxpayer. Pursuant to the guidelines contained in the Internal Revenue Manual, a Service employee generally evaluates what the Service can expect to receive from collectible pre-petition assets and determines where this amount is worth the cost of keeping a freeze code on the taxpayer's account to prevent other collection actions in violation of the discharge injunction. If the amount is not worth the cost of manually monitoring the taxpayer's account, the discharged taxes will be abated. See, e.g., IRM 57(13)4.521.

It is also possible that abating a previously discharged tax may constitute a section 6404(a) abatement in some instances. For example, if the Service employee determines that there are not exempt or abandoned assets available for collection, the abatement will generally be made on the grounds that the assessment is excessive in amount. In either case, the effect of the abatement is the same.

Once the Service abates a tax liability under either section 6404(a) or 6404(c), the taxpayer's liability may only be reestablished through the statutory and regulatory procedures for making an assessment within the statute of limitations set forth in I.R.C. § 6501. In the case of taxes discharged in bankruptcy, however, a new assessment will be prohibited by the discharge injunction.

In the instant case, the Service abated the discharged taxes and released the liens on Date C. At the time the taxpayer filed the claim for refund, therefore, he no longer had any outstanding tax liabilities to which the overpayment could be applied. The Service may not offset the claimed overpayment against the previously discharged and abated tax liabilities. I.R.C. § 6402(a).¹

If we can be of further assistance in this matter, please contact the attorney assigned to this case at 202-622-3620.

¹ Although the Service may not offset the claimed overpayments against the abated tax liabilities, the Service (as a creditor in bankruptcy) may petition the bankruptcy court to revoke the discharge under B.C. § 727(d)(1) or (2). The Service has until December 1, 1999, to do so.