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

OFFICE OF
CHIEF COUNSEL

December 21, 2001

Number: **200217005**
Release Date: 4/26/2002

CC:PA:CBS:Br2
GL-140876-01
UIL 09.39.01-00
9999.98-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, SBSE

FROM: Lawrence Schattner, Chief, Branch 2 (CC:PA:CBS:Br2)

SUBJECT:

This is in response to your memorandum, dated October 29, 2001, requesting advice regarding whether the Service could credit a refund due to a nonbankrupt subsidiary to anticipated assessments to be made against the consolidated group, where the subsidiary's parent is in bankruptcy. In accordance with I.R.C. section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

AMOUNTS A
AMOUNT B
AMOUNT C
AMOUNT D
DATE A
DATE B
DATE C
DATE D
DATE E
DATE F
DATE G
DATE G
DATES H
ENTITY A
ENTITY B
ENTITY C
ENTITY D
ENTITY E
ENTITY F
ENTITY G
ENTITY H
ENTITY I
ENTITY J
LOCATION A
LOCATION B
LOCATION C
LOCATION D

YEAR A
YEAR B
YEARS C
YEARS D

ISSUES

1. May the Service offset income tax and excise tax overpayments due to a member of a consolidated group against tax liabilities of the consolidated group?

2. May the Service offset an overpayment due to a nonbankrupt member of a consolidated group against unagreed, proposed deficiencies in tax due from the consolidated group, but for which statutory notices of deficiency have not been issued?

   a. Does the filing of a proof of claim in bankruptcy constitute a sufficient determination of liability so that an "outstanding liability" exists within the meaning of Treas. Reg. § 301.6402-1?

   b. When a taxpayer is in bankruptcy, is the Service required to grant a refund once a determination has been made that there is an overpayment, or may the Service freeze the refund amount pending the determination of a tax liability and the outcome of the bankruptcy proceedings?

CONCLUSIONS

1. The Service may offset income tax and excise tax overpayments due to a member of a consolidated group against tax liabilities of the consolidated group as long as the tax liabilities of the consolidated group arise in a year in which the member that is owed the refund was a member of the consolidated group.

2. Pursuant to Internal Revenue Code Section 6402(a) and the regulations thereunder, the Service may not offset an overpayment against unagreed, proposed deficiencies for which no statutory notice of deficiency has been issued. An "outstanding liability" within the meaning of Treas. Reg. 301.6402-1 against which an overpayment may be offset exists only when an assessment has been made or a statutory notice of deficiency has been issued.

   a. Filing a proof of claim in a bankruptcy case is not a substitute for an assessment or a statutory notice of deficiency, and thus does not render the liability an "outstanding liability" within the meaning of Treas. Reg § 301.6402-1 against which an overpayment may be offset under Section 6402(a). Nonetheless, the Service still maintains a common law right of offset available to all creditors which empowers a creditor to offset a mutual debt owing by such creditor against a claim of such creditor against the debtor. However, the Service is prohibited from exercising this right, not only by reason of the automatic stay, but also due to the provisions of Treas. Reg. § 301.6402-1.

b. The Service is not required to grant a refund once a determination has been made that there is an overpayment. The Service may freeze the taxpayer's refund pending determination of an offsetting tax liability, in order to protect its right of offset and maintain its secured status. However, the Service should complete its examination activities as quickly as possible to determine that the amounts of the proposed deficiencies are accurate and defensible in an action the taxpayer might bring under Bankruptcy Code Section 505(a)(1) to contest the legality of the tax. The Service should consider assessing any tax liabilities that are immediately assessible and issuing a statutory notice of deficiency because the automatic stay no longer suspends the running of the statute of limitations for assessment under Internal Revenue Code Section 6501(a).

FACTS

ENTITY A wholly-owns, directly or indirectly, five subsidiaries that declared Chapter 11 bankruptcy, and three subsidiaries which have not declared bankruptcy. ENTITY A is incorporated in LOCATION A and has also declared Chapter 11 bankruptcy. The five subsidiaries that have declared bankruptcy are ENTITY B (incorporated in LOCATION B), ENTITY C (incorporated in LOCATION C), ENTITY D (incorporated in LOCATION C), ENTITY E (incorporated in LOCATION A), and ENTITY F (incorporated in LOCATION D). The three subsidiaries which have not declared bankruptcy are ENTITY G, ENTITY H, and ENTITY I. The Service's audit of the ENTITY C, consolidated group for tax years ending DATE A through YEAR A is nearly complete, and the proposed deficiency is between AMOUNTS A. The audit team has prepared "unagreed reports" to which the taxpayer is preparing responses. Approximately two months ago the Service began examining tax periods ending DATE B through YEAR B. The Service is also auditing ENTITY G, ENTITY H, and ENTITY I for tax years before they became members of the ENTITY C consolidated group.

ENTITY G was acquired by ENTITY A on DATE C. Immediately after the acquisition, ENTITY G merged into ENTITY J which was owned by ENTITY A. ENTITY J was renamed ENTITY G. After the merger, ENTITY G stock was transferred from ENTITY A to ENTITY C in exchange for stock of ENTITY C. Eventually the ENTITY G stock was transferred to ENTITY C, as a capital contribution. As of DATE D, ENTITY G was included on the consolidated return of ENTITY C. ENTITY G has proposed refunds of approximately AMOUNT B for tax years YEARS C. ENTITY G was not a member of the ENTITY C consolidated group for these tax years.

ENTITY H was acquired by ENTITY A on DATE E. After the acquisition, ENTITY H became a subsidiary of ENTITY C, and was included on ENTITY C's consolidated return as of DATE E. ENTITY H has proposed refunds of approximately AMOUNT C for tax years YEARS D. ENTITY H was not a member of the ENTITY C consolidated group for these tax years.

ENTITY I was acquired by ENTITY C on DATE F. As of DATE G, ENTITY I was included on the consolidated return of ENTITY C. ENTITY I has proposed refunds relating to pre-acquisition years and refunds relating to excise tax for the period of DATES H of AMOUNT D.

LAW & ANALYSIS

Issue 1.

Internal Revenue Code Section 6402(a) grants the Service the authority to credit overpayments against certain outstanding liabilities and to refund the balance to the taxpayer. Section 6402(a) provides that 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), (d), and (e), refund any balance to such person.[1]

The Service is not required or authorized by statute to refund tax payments claimed by a taxpayer if an overpayment has not been determined. Lewis v. Reynolds, 284 U.S. 281 (1932). Treasury Regulation Section 301.6402-1 provides, in part, that the Service may credit any overpayment of tax, including interest thereon, against any outstanding liability for any tax owed by the person making the overpayment. Internal Revenue Code Section 6401 states that overpayments include any amounts paid in respect to an internal revenue tax that is assessed or collected after the applicable period of limitations; any amount of allowable credits under sections 31 through 35 that exceed the tax imposed by subtitle A; and amounts erroneously overpaid as a tax.

The Supreme Court has defined overpayment "as meaning any payment in excess of that which is properly due. Such an excess payment may be traced to an error in mathematics or in judgment or in interpretation of facts or law. And the error may be committed by the taxpayer or by the revenue agents. Whatever the reason, the payment of more than is rightfully due is what characterizes an overpayment." Jones v. Liberty Glass Co., 332 U.S. 524, 531 (1947). Given this definition of the term "overpayment," both income tax refunds and excise tax refunds constitute overpayments and may be used to offset internal revenue tax liabilities.

Under Section 6402(a), the Service may credit an overpayment to an underpayment as long as the person who made the overpayment is liable for the tax against which the overpayment is to be credited. A common parent is the sole agent of the group and files claims for refund for all the members of the group in its own name. Any refund paid to the parent discharges any tax liability of any member of the affiliated group. See Treas. Reg. § 1.1502-77(a). Generally, a member of a consolidated group is severally liable for the income tax liability of the group for any year or partial year that it was a member of the consolidated group. See Treas. Reg. § 1.1502-6(a). When taxpayers are jointly and severally liable for a tax liability, the Service has the authority to collect the full amount of the unpaid tax from any of the liable taxpayers. See

[1] Subsections (c), (d), and (e) address: offset of past due support against overpayments, collection of debts owed to federal agencies, and collection of past due, and legally enforceable state income tax obligations.

McCray v. United States, 910 F.2d 1289, 1290 (5th Cir. 1990); U.S. Life Title Insurance Company of Dallas v. United States, 784 F.2d 1238, 1243 (5th Cir. 1986).

For any of the years ENTITY G, ENTITY H, and ENTITY I were included in ENTITY C's consolidated return, any overpayments from ENTITY G, ENTITY H, and ENTITY I can be credited against the liabilities of the ENTITY C consolidated group. It does not matter if the overpayment arose at a time when ENTITY G, ENTITY H, or ENTITY I was not a member of the consolidated group.

Issue 2.

A liability for a tax exists independently from an assessment. See Goldston v. United States, 104 F.3d 1198, 1199-1200 (10th Cir. 1997);); United States v. Latham, 754 F.2d 747, 750 (7th Cir. 1985). It derives from the statutory obligation to account for, collect, or pay a tax. Goldston, 104 F.3d at 1200. Assessment is the act of recording the taxpayer's liability on the Service's books and records. I.R.C. § 6201; Bull v. United States, 295 U.S. 247, 259 (1935). It does not create the tax liability.

While Internal Revenue Code Section 6402 and Treasury Regulation Section 301.6402-1 authorize the Service to credit any overpayment of tax against any outstanding liability for any tax owed by the person who made the overpayment, neither the statute nor the regulations provide any definition of what constitutes an "outstanding liability." However, it has long been the position of the Service and the courts that the Service may credit an overpayment only against a tax which has been formally assessed or for which a statutory notice of deficiency has been issued. See McCarl v. United States, 42 F.2d 346 (D.C. Cir. 1930), cert. denied, 282 U.S. 839 (1930); Tull & Gibbs v. United States, 48 F.2d 148 (9th Cir. 1931); GCM 32,064, Overpayments Offset Under ADP System, (Aug. 10, 1961); GCM 38,480 (June 30, 1981). Here, the Service has not yet made an assessment. The Service intends to issue a notice of deficiency to the consolidated group in the near future. Therefore, the Service cannot offset the overpayments as of yet under Section 6402.[2] Before offset can be made, there must be a formal assessment or statutory notice of deficiency issued for the anticipated liabilities.

Issue a.

As discussed above, the Service may not offset overpayments to other tax liabilities under Section 6402(a) and the regulations thereunder unless there has been an assessment or a statutory notice of deficiency has been issued. This remains true even where the Service has filed a proof of claim in a bankruptcy proceeding. However, the United States, like every creditor, has a common law right of setoff. United States v. Munsey Trust Co., 332 U.S. 234, 239 (1947).

[2] However, we do believe an overpayment can be retained via the use of a freeze code, as discussed in more detail in second 2.c., below.

Unagreed, proposed deficiencies set forth in a proof of claim are not only a claim against the debtor within the meaning of Bankruptcy Code Section 101(5), but also a "debt" of the debtor under Bankruptcy Code Section 101(12). Thus, when the taxpayer has made an overpayment of tax, the Service has a right to offset this overpayment against the unagreed, proposed deficiencies set forth in the proof of claim. Further, where the overpayment is due to an entity in bankruptcy, this right of offset entitles the Service to claim secured status under Bankruptcy Code Section 506(a). This is because the Bankruptcy Code generally recognizes the right of setoff and allows creditors to protect their setoff rights. 11 U.S.C. § 553. And where a creditor has a right of setoff involving a debt due the debtor or the estate, the creditor may claim secured status. 11 U.S.C. § 506(a).

However, though the Service has this setoff right, which may be protected in Bankruptcy, we believe that Code Section 6402(a), Treas. Reg. § 301.6402-1, and the case law interpreting them bars the Service from actually setting off the debt.

Here, the overpayments are due to nonbankrupt subsidiaries of the bankrupt corporate parent. Since the overpayments are not due to the debtor or the estate, the setoff right does not serve as a basis for claiming secured status. See I.R.C. § 506(a). However, if the bankrupt parent asserts some kind of property right in the overpayments, you may want to consider amending the Service's proof of claim, or seeking further guidance.

Issue b.

The Service is not required, however, to immediately refund an overpayment to the debtor. The Service may temporarily freeze the overpayments, pending conclusion of the audit of the income tax deficiencies due from the consolidated group. This temporary, administrative freeze, would be put in place to maintain the status quo for a period of time to allow the Service to complete its audit. Notwithstanding that the Service cannot offset under Section 6402, a concern might arise regarding whether placing an administrative freeze on the account is a setoff in violation of Bankruptcy Code Section 362(a)(7). However, we conclude for two reasons that an administrative claim does not violate the automatic stay.

First, an administrative freeze is not an attempt to permanently settle accounts with the nondebtor taxpayers. In order for a setoff to occur within the meaning of Bankruptcy Code Section 362(a)(7), the following "three steps must have been taken: (i) a decision to effectuate a setoff, (ii) some action accomplishing the setoff, and (iii) a recording of the setoff." Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 19 (1995). Here, there has been neither a decision to effectuate a setoff nor a recording of a setoff. Indeed, should there ultimately be no deficiencies in tax due from the consolidated group, the Service would release the freezes and refunds checks would be issued in due course. Thus, an administrative freeze would not violate the automatic stay. However, an indefinite freeze might begin to look like a setoff. Therefore, in cases where the Service expects some difficulty with concluding its audit process in an expeditious manner, you may want to consider acquiring the debtor's consent to the freeze or to file a motion to lift stay, or otherwise petition the court, to allow us to keep the freeze in place.

Second, the overpayments in issue here are not even due to any debtor in bankruptcy. Rather, they are due nondebtor subsidiaries of the corporate parent and consolidated group agent. Generally, the automatic stay does not bar collection from nonbankrupt codebtors. Aetna Cas. & Sur. Co. v. Namrod Devel. Corp., 140 Bankr. 56, 59 (S.D.N.Y. 1992). Some courts specifically have held that Bankruptcy Code Section 362 stay does not extend to guarantors of obligations of the debtor. See CAE Indus. Ltd. v. Aerospace Holdings Co., 116 Bankr. 31, 32 (S.D.N.Y. 1990) (noting that the bankruptcy stay is "not ordinarily extended to entities such as sureties, guarantors, co-obligors, or others with a similar legal or factual nexus to the Chapter 11 debtor") (internal quotations omitted); In re Larmar Estates, Inc., 5 Bankr. 328, 331 (Bankr. E.D.N.Y. 1980) ("The bankruptcy proceeding is meant to protect the debtor, not third-party guarantors."). Although a bankrupt entity may need temporary protection from litigation so as to reorganize, nonbankrupt co-debtors have no need for similar protection from liability. See Dental Benefit Management, Inc. v. Capri, 153 Bankr. 26, 28 (E.D.Pa. 1992). Thus, in this case, the Service simply will not be violating the stay because the debts being set off are due to and from nonbankrupt entities.

LITIGATING HAZARDS

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If you have any questions, please call (202) 622-3620.