

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Frederick W. Schindler
Director, Collection Policy
(Small Business/Self Employed)

from: Glenn Melcher
Chief, Branch 5
(Procedure & Administration)

subject: The Service's obligation to correct and prevent violations of the automatic stay and the permanent injunction

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Does the Service have the affirmative duty to correct and prevent violations of the automatic stay and the discharge injunction in bankruptcy cases?
2. If the Service violated either the automatic stay or the discharge injunction, the collection period for the prepetition liability has expired, and there are no other periods to which a setoff could be made, must the Service refund overpayments to taxpayers who timely filed administrative refund claims?

CONCLUSIONS

1. Yes, the Service has the affirmative duty to correct and prevent violations of the automatic stay and discharge injunction in bankruptcy cases.
2. Yes, in these situations, the Service must refund overpayments to taxpayers who timely filed administrative refund claims.

BACKGROUND

The Bankruptcy Noticing Center provides four types of electronic notices to the Service: filings, conversions, discharges, and dismissals. Since 2003, after receiving notices of a filing in bankruptcy, on certain occasions the Service has deleted some notices. In some situations, this was not an error as the Service has received multiple notices of filing for the same case. In other situations, it was a mistake to delete the notice of filing. A consequence of mistakenly deleting a notice was that a freeze code would not

have been entered for that particular case, so the Service may have taken collection action violating the automatic stay. Also, the Service would not have been aware of subsequent bankruptcy electronic notices, such as the granting of a discharge order, so the Service may have violated the discharge injunction. We understand that the Service's set off of a refund would have been the predominate violation of either the automatic stay or the discharge injunction.¹

LAW & ANALYSIS

Automatic stay

The automatic stay arises as of the petition date in bankruptcy and bars a variety of collection actions. 11 U.S.C. § 362(a). If a creditor has violated the automatic stay, he has an affirmative duty to correct the violation, In re Dyer, 322 F.3d 1178, 1192 (9th Cir. 2003), and prevent future violations, In re Soares, 107 F.3d 969, 978 (1st Cir. 1997). See also, In re McMullen, 386 F.3d 320, 330 (1st Cir. 2004) ("a creditor, that commits a technical violation of the automatic stay, due to a lack of notice, has an affirmative duty to remedy the violation as soon as practicable after acquiring actual notice of the stay").

Applying the above to the present situation, the Service has the affirmative duty to enter electronic notices and examine cases so that it can remedy setoffs violating the automatic stay by reversing the setoffs and prevent future violations.

Moreover, examining the bankruptcy cases would be a first step to asserting a valid setoff. The Service's setoffs violating the automatic stay are invalid. The majority of jurisdictions would characterize such invalid setoffs as void, legal nullities, but recognizing that equitable considerations may alter some outcomes. E.g., In re Soares, 107 F.3d 969 (1st Cir. 1997); Schwartz v. United States, 954 F.2d 569 (9th Cir. 1992). The minority of jurisdictions would characterize the invalid setoffs as voidable, i.e., although the invalid setoff has no legal force, a bankruptcy court has the power to cure the invalidity and make the act valid. E.g., Easley v. Pettibone Mich. Corp., 990 F.2d 905 (6th Cir. 1993); Sikes v. Global Marine, Inc., 881 F.2d 176 (5th Cir. 1989). In the latter jurisdictions, a bankruptcy court would grant such relief only in limited situations. "Actions taken in violation of the stay are invalid and voidable and shall be voided absent limited equitable circumstances." Easley, 990 F.2d at 911. Unless the Service examines the cases, it will not know the jurisdictions involved or the facts that would support equitable relief.

¹ After October 17, 2005, the effective date of BAPCPA, it would not be a violation of the automatic stay to setoff a prepetition income tax refund against a prepetition income tax liability. 11 U.S.C. § 362(b)(26).

[REDACTED] The Service's prior invalid setoff does not prevent the Service from now making a valid setoff. In re Rush-Hampton, 98 F.3d 614 (11th Cir. 1996). To make a valid setoff, however, the Service would have to know if the collection period was still open. Examining the electronic notices and the facts of the case would provide this information. Also, such an examination would reveal whether the automatic stay was still in effect for a particular case. If the automatic stay were still in effect, the Service has the right to freeze the setoff funds and request a lifting of the automatic stay. In re Strumpf, 516 U.S. 16 (1995).

Discharge injunction

The discharge enjoins creditors from taking action to recover discharged debts. 11 U.S.C. 524(a)(2). "Creditors are obligated to maintain procedures to ensure that they do not violate section 524 and may be held liable for damages and attorney's fees if they do not." 4 Colliers on Bankruptcy § 524.02[2][b] (15th ed. 2008). E.g., In re Roush, 88 B.R. 163, 164 (Bankr. S.D. Ohio 1988) (bank failed to provide adequate safeguards to protect against violations of the discharge injunction). We think that most courts would conclude that creditors have an affirmative duty to prevent and correct violations of the discharge injunction.

To determine whether the Service violated the discharge injunction, the Service would have to input the electronic notices and review the cases. In some cases, the Service's setoff would not have violated the discharge injunction because the Service may setoff a prepetition tax liability against a prepetition refund after a discharge. In re Luongo, 259 F.3d 323, 333 (5th Cir. 2001). It would be a violation of the permanent injunction, however, to set off a prepetition tax liability against a postpetition refund if the liability were discharged.

[REDACTED] Attempting to avoid damages, the government argued that "the IRS was not reviewing each individual no-asset Chapter 7 case for dischargeable taxes due to (1) the overwhelming number of these cases, (2) the IRS manpower shortage, and (3) the fact that in the experience of the IRS a majority of no-asset Chapter 7 cases had no dischargeable taxes." Id. at 144. The bankruptcy court rejected the defense of administrative burden. "The IRS is not privileged to ignore the dischargeability of certain taxes because of the burden or inconvenience which it may cause." Id. at 146.

Refunds

Inputting the electronic notices and examining the cases will also alert the Service to cases in which the taxpayer is due a refund. This would arise in cases where the Service violated either the automatic stay or the permanent injunction by setting off an overpayment, no other periods exist to which a setoff could be made, and now it is too late to make a valid setoff because the collection period has expired for the prepetition liability. Consider the following example in which Taxpayer filed bankruptcy on 1/2/2003. The IRS did not enter a freeze code. On 1/15/2004, Taxpayer filed his Form 1040 for 2003 and requests a refund of \$4000. Not realizing that the automatic stay is in effect, the Service offset the refund against an old income tax liability from 1990 on 2/15/2004. In Taxpayer's jurisdiction, violations of the automatic stay are void. Taxpayer received his discharge on 6/1/2004; the case is closed on 8/1/2004. Today, realizing that the offset violated the automatic stay, the Service reverses the offset, but the collection period for the 1990 liability has expired. There are no other liabilities to which a setoff could be made.

In this situation, the Service must issue the taxpayer a refund. The Service's refund authority is governed by I.R.C. § 6402(a) which authorizes a credit/refund of an overpayment within the "applicable period of limitations". The only applicable period of limitations is found in I.R.C. § 6511, which provides the period within which to file a timely refund claim. Specifically, section 6511(b) provides that the Service cannot make a refund or credit after the expiration of the limitations period unless there has been a timely refund claim. Note that the Taxpayer's Form 1040, filed on 1/15/2004, is a refund claim. Treas. Reg. § 301.6402-3(a)(5) provides that a properly executed original income tax return constitutes a claim for refund within the meaning of section 6402 and section 6511 for the amount of the overpayment disclosed on the return. There is no period of limitations within which a refund pursuant to a timely claim must be actually paid.

In other words, there is no period of limitations governing timing of payment of an overpayment. As long as the Service has determined there is an overpayment, and there was a timely refund claim, the Service must refund (or credit) the money. A taxpayer does not ever have to bring suit in order to be entitled to a refund. I.R.C. §§ 7422 and 6532 provide limitations on when a suit may be brought, but don't require suit.

Damages

The statutory provisions and regulations addressing the award of damages for violations of the automatic stay and the discharge injunction are extensive. To summarize these provisions, I.R.C. § 7433(e)(1) provides that a taxpayer may petition the bankruptcy court to recover damages for willful violations of the automatic stay and the discharge injunction. For willful violations of the automatic stay, subsections 7433(e)(1) and (2)(B) provide that a taxpayer may recover damages under either section 7433(e) or 11 U.S.C.

§ 362(k). For willful violations of the discharge injunction, section 7433(e) is the taxpayers' exclusive remedy. A taxpayer cannot recover damages under a bankruptcy court's contempt powers contained in 11 U.S.C. § 105 for either violation. The statute of limitations for filing a petition under section 7433(e) is two years from the date the cause of action accrued. I.R.C. § 7433(d)(3). We believe the bankruptcy court has sole jurisdiction over actions for violations of the automatic stay or discharge injunction, regardless of whether brought under section 362(k) or section 7433(e).

In cases involving violations of the discharge injunction or requests for damages for violating the automatic stay brought under section 7433(e), section 7433 and the corresponding regulations apply. Section 7433 limits the amount of damages a taxpayer may recover to the lesser of \$1,000,000 (\$100,000, in the case of negligence) or the sum of actual, direct economic damages and costs of the action. I.R.C. § 7433(b). Punitive damages are not recoverable as actual, direct economic damages. Likewise, administrative and litigation costs (including attorney fees) are not recoverable as actual, direct economic damages but may be recovered under section 7430. Treas. Reg. § 301.7433-2(b)(2).

Actions for damages under section 7433 are subject to an exhaustion of administrative remedies requirement. Treas. Reg. § 301.7433-2(d)(1) requires that an administrative claim be filed with the Service prior to filing suit. Furthermore, the taxpayer must wait until the earlier of the date the service denies the claim or six months after the claim has been filed. Treas. Reg. § 301.7433-2(d)(1). Section 7430 and the corresponding regulations also contain an exhaustion of administrative remedies requirement as a prerequisite to recovering attorney fees in section 7433 actions. See Treas. Reg. §§ 301.7430-1(e) and 301.7430-7.

Section 362(k) provides for the recovery of actual damages, including attorney fees and costs, to taxpayers injured by a willful violation of the automatic stay. Although section 362(k) provides for punitive damages in appropriate circumstances, the United States' limited waiver of sovereign immunity precludes an award of punitive damages against the Service. 11 U.S.C. § 106(a)(3). In actions brought under section 362(k), there is no damages limitation and the taxpayer need not file a claim to exhaust administrative remedies. In addition, it is unclear as to whether attorney fees may be awarded pursuant to section 362(k) or exclusively under section 7430. Under the treasury regulations, attorney fees may only be awarded under section 7430, however, bankruptcy courts have awarded fees under section 362(k) without opposition from the Service. See I.R.C. § 7433(e)(2)(B)(i).

The key consideration is the definition of "willful," as it is the operative term for both violations of the automatic stay and the discharge injunction in section 7433(e). For the automatic stay, "[a] willful violation does not require a specific intent to violate the automatic stay. The standard for a willful violation of the automatic stay ... is met if there is knowledge of the stay and the defendant intended the actions which constituted the violation." Fleet Mortg. Group, Inc. v. Kaneb, 196 F.3d 265, 269 (1st Cir. 1999)

(citing other federal appellate courts using the same definition). Failure to remedy an inadvertent violation may transform that violation into a willful one. Ind. Dept. of Rev. v. Williams, 301 B.R. 871 (S.D. Ind. 2003). Courts will also use this definition of willful for violations of the discharge injunction in suits under section 7433(e).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

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Please call (202) 622-3620 if you have any further questions.