IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF IOWA

In the Matter of	:	
JERALD J. KNAPP, LISA ANN KNAPP,	:	Case No. 95-01771-C J
	:	Chapter 7
Debtors.	:	
JERALD J. KNAPP, LISA ANN KNAPP,	:	Adv. Pro. No. 95-95124
Plaintiffs,	:	
v.	:	
UNITED STATES OF AMERICA,	:	
Defendant.	:	

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MEMORANDUM OF DECISION AND ORDER

This matter is before the court on a complaint brought by Jerald J. Knapp and Lisa Ann Knapp, the Chapter 7 debtors (Knapps), against the United States of America (USA) pursuant to 11 U.S.C. sections 522(h) and 547. The Knapps seek to recover their 1994 tax overpayment that was transferred by the Internal Revenue Service (IRS) to the Veterans Administration (VA) for the purpose of offsetting a portion of the VA 1989 student loan judgment against Mr. Knapp.[1]

The court has jurisdiction of this matter pursuant to 28 U.S.C. section 1334(b). The controversy is a core matter under 28 U.S.C. section 157(b)(2)(A) and (F).

STATEMENT OF FACTS

[1] Trial on this matter began on September 12, 1996. In light of opening arguments and discussion with counsel, the court continued the matter for briefing on the issue of debtors' standing and the applicability of certain Eighth Circuit Court of Appeals caselaw. During a telephonic hearing on July 1, 1997 to determine the status of the controversy between the parties, new counsel for the United States of America clarified the government no longer contested the debtors standing and no longer contended the tax overpayments in 1994, rather than the offset between agencies, constituted the transfer in question.

On January 13, 1989 the Clerk of Court for the U.S. District Court for the Southern District of Iowa entered a default and judgment in Civil #88-1540-B against Mr. Knapp in the sum of $1717.07 plus prejudgment interest of $405.59, administrative costs of $78.09, together with interest thereon at the rate of 9.16%. The judgment stemmed from Mr. Knapp student loan indebtedness to the VA in the amount of $2135.66 as of July 18, 1988.

During October and November 1994, the VA submitted Mr. Knapp delinquent account to the IRS for the purpose of offset pursuant to 26 U.S.C. section 6402.

On or about February 26, 1995 the Knapps submitted their federal income tax return to the IRS.

Between March 8 and March 15, 1995, the IRS began processing the Knapps' return.

March 16, 1995 passed and later became the critical 90th day in this controversy.

On March 27, 1995 the IRS wired the Knapp tax overpayment, in the amount of $1771.84, to the VA for credit against Mr. Knapp unpaid student loan judgment.

On April 3, 1995 the IRS finalized processing the tax return. The overpayment amounted to $1780.63.[2]

On June 14, 1995 the Knapps filed a joint petition for relief under Chapter 7 of Title 11 of the United States Code.

[2] The difference between the final amount of the refund and the amount wired by the IRS to the VA paid for the administrative costs related to the offset program.

On Schedule C the Knapps claimed $1785.00 in an income tax refund and $215.00 in wages exempt under Iowa Code section 627.6(9)(c).

On Schedule F the Knapps listed Mr. Knapp indebtedness to the VA in the amount of $2054.70 and as a fixed and liquidated student loan.

In Section 5 of the Statement of Financial Affairs, the debtors indicated US Veterans Affairs Department seized $1785 federal joint tax refund to apply to Mr. Knapp student loan. This is a preference.

Neither the trustee nor any creditor objected to the Knapp's claim of exemption.

The trustee did not commence an adversary proceeding to recover the property in issue.

ESSENCE OF THE CONTROVERSY

The Knapps contend they may recover the tax overpayment because the transfer on March 27, 1995 was a preference under 11 U.S.C. section 547(b). The USA contends the same transfer was a valid setoff under 11 U.S.C. section 553.

APPLICABLE STATUTES

With respect to preferences, 11 U.S.C. section 547(b) provides:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent
>
> (4) made –
>
> (A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

With respect to setoffs, 11 U.S.C. section 553 provides:

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that--

(1) the claim of such creditor against the debtor is disallowed;

(2) such claim was transferred, by an entity other than the debtor, to such creditor

(A) after the commencement of the case; or

(B) (i) after 90 days before the date of the filing of the petition; and

(ii) while the debtor was insolvent; or

(3) the debt owed to the debtor by such creditor was incurred by such creditor

(A) after 90 days before the date of the filing of the petition;

(B) while the debtor was insolvent; and

(C) for the purpose of obtaining a right of setoff against the debtor.

(b) (1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(14), 365(h), 546(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the

trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of

> (A) 90 days before the date of the filing of the petition; and
>
> (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

(2) In this subsection, insufficiency means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

DISCUSSION

Whether the transfer is a valid setoff is the threshold issue. See In re Stall, 125 B.R. 754, 757 (Bankr. S.D. Ohio 1991). The USA bears the burden of proving its right to setoff by establishing the following three elements:

(1) A debt exists from the creditor to the debtor and that debt arose prior to the commencement of the bankruptcy case.

(2) The creditor has a claim against the debtor which arose prior to the commencement of the bankruptcy case.

(3) The debt and the claim are mutual obligations.

U.S. Through ASCS v. Gerth, 991 F.2d 1428, 1431 (8th Cir. 1993) (citations omitted).

With respect to the first and second requirements, both the tax refund the IRS otherwise owed the debtors and the VA judgment claim against Mr. Knapp arose prior to June 14, 1995. With respect to the mutuality requirement, the prevailing view appears to be that different agencies of the USA stand in the same right and capacity for the purpose

of section 553 setoffs. See In re Turner, 84 F.3d 1294 (10th Cir. 1996); Matter of Butz, 154 B.R. 541 (S.D. Iowa 1989)[3]; U.S. Through Small Business Admin. v. Rinehart, 88 B.R. 1014 (D. S.D. 1988) aff'd in part, rev'd in part, 887 F.2d 165 (8th Cir. 1989); In re Kalenze, 175 B.R. 35 (Bankr. D. N.D. 1994). Accordingly, that one USA agency owed the debtors money and one of the debtors was indebted to a different USA agency is of no consequence in this case. The setoff of the tax refund against the VA judgment was valid.

The limitations in section 553(a) do not apply. The VA judgment has not been disallowed. The VA judgment was not transferred to the IRS. Even if the VA submission of the delinquent account to the IRS for purposes of offset could be construed as such a transfer, that activity took place long before March 16, 1995. Finally, the tax refund was not incurred for the purpose of setoff but merely as a result of debtors overpaying their 1994 taxes. See Stall at 758

The limitation in section 553(b) does not apply. The USA did not improve its position between March 16, 1995 and June 14, 1995. The IRS did not attempt to increase the amount of the tax refund during that time period to better the position of the VA. The increase from the amount of the overpayment that was wired by the IRS to the VA on April 3, 1995 and the of the final amount established on April 3, 1995 is diminimus. That the $8.79 was applied to the administrative costs of the offset program is of no meaningful consequence. Id. at 759.

[3] The author of this opinion has held in debtors favor on mutuality issues in the past. See Matter of Hunerdosse, 85 B.R. 999 (Bankr. S.D. Iowa 1988); Matter of Butz, 86 B.R. 595 (Bankr. S.D. Iowa 1988); and Matter of Mehrhoff, 88 B.R. 922 (Bankr. S.D. Iowa 1988). One district court judge affirmed that ruling; one district court judge reversed. See Matter of Butz, 104 B.R. 128, n. 1 and 2 (Bankr. S.D. Iowa 1989). In any event, those prior rulings entailed postpetition setoffs. The concerns the court addressed in those cases do not arise in this factual setting.

Moreover, to the extent a tax refund accrues at the end of the tax year, it does not matter when the determination as to the existence and amount of the refund is completed. See generally Kalenze at 37.

Since the setoff in issue was valid and the statutory limitations do not apply, there is no need to analyze the facts under section 547.

CONCLUSION

WHEREFORE, based on the foregoing discussion, the court finds that the transfer in issue was a valid setoff under 11 U.S.C. section 553 and not subject to analysis under 11 U.S.C. section 547.

ORDER

THEREFORE, IT IS ORDERED that the debtors complaint be dismissed.

Dated this 15th day of October, 1997.

LEE M. JACKWIG
U.S. BANKRUPTCY JUDGE