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The Roll of Offset in the Collection of Federal Taxes

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THE ROLE OF OFFSET IN THE COLLECTION OF FEDERAL TAXES

by

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ABSTRACT

The legal principle of offset has played a key role in debt collection by private parties for centuries. In 2021, offset continues to play an equally essential role in the United States government's collection of debts owed to it, accounting for billions of dollars in funds taken from outgoing payments. The right of offset arises when two parties owe each other debts. The party asserting offset can subtract what is owed to them from what they owe, allowing the parties to avoid an unnecessary transaction. Offset thus makes intuitive sense, simplifying two payment flows into one. But offset becomes far more complex when one of the parties is the federal government, which is unlike a traditional private creditor in important ways.

Offset has perhaps its largest impact in the tax system, where Congress has legislated that the Internal Revenue Service (the "Service") has the authority (and sometimes, the mandate) to offset tax refunds. Refunds are commonly offset when a taxpayer owes prior year

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tax liabilities, other agency debts (e.g., student loans), state taxes or past-due child support. Despite its frequent use by the Service, offset is subject to minimal procedural protections, likely due to its origin in longstanding common law doctrine. Unlike other forms of tax collection, offset does not carry a right to prepayment judicial review in Tax Court. Nor does offset require the Service to issue a notice to the taxpayer prior to taking collection action. Courts also treat offset inconsistently when the applicable taxpayer/debtor is protected by a collection stay under Title 26 or Title 11, allowing offset in some scenarios and denying it in others.

Finally, Congress and the Service have often failed to use their authority to make offset more equitable, particularly as applied to low-income taxpayers. The Service has a limited administrative remedy available for taxpayers to affirmatively request bypass from the offset of their refund to a tax debt. But the remedy is little-publicized, little-used and difficult to administer. During the COVID-19 pandemic and recession, Congress legislatively protected advance stimulus payments from some forms of offset. But Congress failed to make that protection expansive or to extend it to conventional tax refunds, both of which would have put needed funds in the hands of millions of taxpayers during an economic crisis. Similarly, the Service declined to exercise its statutory discretion to systemically suspend offset of conventional tax refunds to past tax liabilities. These issues extend to payments of the Earned Income Tax Credit (EITC), which are subject to offset. Both Congress and the Service have failed to acknowledge the EITC's unique nature as a type of public benefit, treating it instead as a conventional tax refund subject to offset. This disproportionately hurts the low-income taxpayers, and their children, that the EITC was enacted to benefit. I argue that policymakers should pay closer attention to offset and make the necessary changes to apply it in a more equitable and logical manner.

I. Introduction

An interesting phenomenon has occurred at the tax blog Procedurally Taxing.[1] The blog receives an unusually high number of visitors seeking information about offset. The visitors primarily appear to be ordinary taxpayers—not tax professionals—searching for an answer concerning what happened to the refund they expected to receive.[2] The high interest of the general public in the complicated topic of offset has increased as a result of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act")[3] and the economic crisis caused by the COVID-19 virus generally.[4] Watching this interest in offset and realizing that the area of offset receives little attention in the academic press, I decided to write this Article with the hope that it will provide a greater understanding of the most frequently used collection tool in the Service's arsenal.

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1. *See* Procedurally Taxing, proceduralytaxing.com [https://perma.cc/Q5CK-ZDG4]. Author Keith Fogg is a founder and frequent contributor to this blog.

2. The most popular post on the blog for the past few years concerns offset bypass refunds. The popularity of that post has been eclipsed during the pandemic by the posts concerning offset of the non-liable spouse's refund.

3. Pub. L. No. 116-136, 134 Stat. 281 (2020).

4. *See* Michelle Singletary, *Many People May Not Get Promised Stimulus Payments in Hand if They Owe Back Taxes*, Wash. Post (Jan. 26, 2021), https://www.washingtonpost.com/business/2021/01/26/stimulus-payments-back-taxes/ [https://perma.cc/RPE6-GWMX] (giving the representative story of a married couple who haven't received their second stimulus payment and are concerned about offset if claimed as a refund).

Offset (sometimes interchangeably called "setoff") involves mutual debts and actions of the parties taken with respect to those debts outside the judicial setting. Just because offset occurs outside the judicial setting does not mean that the judiciary never becomes involved in offset, though at least in the federal tax area, impediments exist to judicial review.

In federal tax practice three common situations raise offset issues: (1) the assertion of offset by a third party, typically a bank, to prevent the Service from collecting by lien or levy; (2) the Service seeking to offset a refund against an outstanding tax liability in situations where the taxpayer and the Service are mutual debtors; (3) the assertion of offset by the federal government where the taxpayer and the federal government are mutual debtors and the Treasury Department acting on behalf of other federal agencies (and some state agencies) seeks to offset a tax refund against an outstanding liability to an agency.

This Article discusses the three typical situations and explains the rights of the parties in each setting. Before discussing the typical situations in which offset issues arise, the Article traces the development of offset from common law into the Tax Code ("Code").[5] Then it discusses the development of tax offsets in case law including the common applications of the concept in federal tax situations. After setting the scene regarding what is happening with offsets, the Article discusses certain policy decisions regarding offset and the situations in which the current policy fails the system.

Offset serves not only as a powerful and cheap collection tool but one that the government must implement with care in order to avoid misuse. When the Service makes a systemic mistake in its application of offset, as has occurred with the Economic Impact Payments (EIP) created in the CARES Act, there is significant anger and frustration in the affected population.[6] The problem with the CARES Act occurred

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5. U.S.C. Title 26. Unless otherwise stated, all statutory citations are to the Code and all citations to regulations are to Treasury regulations promulgated thereunder.

6. *See* Caleb Smith, *Injured Spouse and EIP: Continued and Increasingly Troublesome Issues*, Procedurally Taxing (June 16, 2020), https://procedurallytaxing.com/injured-spouse-and-eip-continued-and-increasingly-troublesome-issues/ [https://perma.cc/6P6M-3NUR]; Caleb Smith, *Injured Spouse and Economic Impact Payments*, Procedurally Taxing (Apr. 14, 2020),

when the Service implemented a new procedure in extreme haste. Mistakes in that setting present no surprises, and the Service acted relatively quickly to resolve the problem. Broader offset issues involving policy decisions made with greater deliberation and care deserve analysis to determine if these decisions—whether legislative, administrative or judicial—best serve overall offset policy.

II. General Provisions Regarding Offset

A. Common Law Offset Principles

Offset is an equitable right allowing parties who are mutual debtors and creditors to each other to net out their debts, even if those debts arise from separate transactions. "The right of setoff . . . allows entities that owe each other money to apply their mutual debts against each other, thereby 'the absurdity of making A pay B when B owes A.'"[7]

The common law right of offset arises for (a) equally matured obligations that are (b) between the same parties, who are (c) acting in the same capacity.[8] With regard to (a), matured debt requires that a debt be due and not merely a potential debt. Just because one party has potential claims under a contract that has not yet been breached does

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https://proceduralltaxing.com/injured-spouse-and-economic-impact-payments/ [https://perma.cc/5MN3-VKRA]; *see also* Keith Fogg, *Offset of Injured Spouse Stimulus Payment*, Procedurally Taxing (May 9, 2020), https://proceduralltaxing.com/offset-of-injured-spouse-stimulus-payment/ [https://perma.cc/EAG5-2A26]. The large number of comments to these posts tells a story of woe among spouses of individuals owing back child support, because of the decision of the Service (or maybe lack of planning by the Service) to offset the Economic Impact Payments (EIPs) of non-liable spouses to the past-due child support of the person with whom they filed a joint return. If the comments made in response to the posts are any indication of the scope of the problem, offsets of these payments are significant and deeper than might be expected. As a result, many individuals married to someone with outstanding child support obligations did not receive their EIP, creating not only financial hardship but emotional hardship as well.

7. Citizens Bank of Md. v. Strumpf, 516 U.S. 16, 18 (1995) (quoting Studley v. Boylston Nat'l Bank of Bos., 229 U.S. 523, 528–29 (1913)).

8. *See, e.g.*, Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138, 149 (2d Cir. 2002) ("[D]ebts are mutual when they are due to and from the same persons in the same capacity.").

not give that party the right to offset a debt presently owing the debtor.[9] With regard to (b), the debts must be held by the same parties, or in other words, be considered mutual. For example, if one debt is joint and the other is not, they cannot be offset.[10] Expanding on (c), the debts must be held in the same capacity. Thus, if one debt arises in a fiduciary capacity (such as a bailment or constructive trust), and the other debt arises simply as a straight debtor-creditor relationship, courts have held that the parties do not hold the mutual debts in the same capacity, thus denying offset rights.[11]

Related concepts of recoupment and counterclaim exist that deserve brief mention. Recoupment occurs in the special case where the mutual debts arise from the same transaction.[12] Equitable recoupment arises in tax law as a defense raised by either the taxpayer or the Service in situations time barred from payment.[13] A counterclaim is simply an offset or recoupment asserted in litigation.

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9. *See, e.g.*, Pub. Serv. Co. of N.H. v. New Hampshire Elec. Coop. (*In re* Pub. Serv. Co.), 884 F.2d 11, 16 (1st Cir. 1989) (finding that New Hampshire state law does not allow creditor to setoff potential damages under unbreached contract against liability owed to debtor); Barnett Bank of Tampa v. Tower Env't, Inc. (*In re* Tower Env't, Inc.), 217 B.R. 933, 939 (Bankr. M.D. Fla. 1997) ("It is well established in Florida that contingent or unmatured claims may not be used to effect a setoff.").

10. 20 Am. Jur. 2d *Counterclaim, Recoupment and Setoff* § 53 (1995); *see, e.g.*, Gray v. Rollo, 85 U.S. 629 (1873) (holding that debt from individual to partner was not mutual with debt from the partnership to the individual). However, the manner in which the party holding the debt acquires it does not matter, so long as the debts run between the same parties. *See, e.g.*, Metco Mining & Minerals, Inc. v. PBS Coals, Inc. (*In re* Metco Mining & Minerals, Inc.), 171 B.R. 210, 216–17 (Bankr. W.D. Pa. 1994) (allowing creditor of bankrupt debtor to offset claim against amount owed debtor, even though the claim was obtained through an assignment from another creditor). In the federal tax context this concept will be discussed further below in a discussion of the injured spouse defense to offset.

11. *See, e.g.*, Cohen v. Sav. Bldg. & Loan Co. (*In re* Bevill, Bresler & Schulman Asset Mgmt. Corp.), 896 F.2d 54, 58 (3d Cir. 1990) (bailment example); Marshall v. Shipman Elevator Co. (*In re* Marshall), 240 B.R. 302, 305 (Bankr. S.D. Ill. 1999) (constructive trust example).

12. *Recoupment*, Black's Law Dictionary (6th ed. 1990); 20 Am. Jur. 2d *Counterclaim, Recoupment and Setoff* § 1 (1995).

13. "[A] party litigating a tax claim in a timely proceeding may, in that proceeding, seek recoupment of a related, and inconsistent, but now

The Service obtains its right to offset from two sources, namely, common law and statute.

The common law right of offset arises from the principle that one "should not be compelled to pay one moment what he will be entitled to recover back the next."[14] Courts of equity have long used offset to eliminate the need for two separate lawsuits by netting out the amounts owing and entering a single judgment.[15] The federal government has the same common law right of setoff as any private party.[16] The government may use its common law setoff rights to set off tax overpayments against both tax debts and non-tax debts, which allows for the Treasury Offset Program offsets, discussed further below.[17]

B. Tax Code Offset Provisions

The statutory basis for offset of federal tax refunds against unpaid federal taxes as well as other unpaid debts to state and federal governments exists in section 6402 of the Code. This section creates a regime

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time-barred tax claim relating to the same transaction." United States v. Dalm, 494 U.S. 596, 608 (1990).

14. William H. Loyd, *The Development of Set-off*, 64 U. Pa. L. Rev. 541, 541 (1916) (explaining offset's origin in ancient Roman law).

15. Citizens Bank of Md. v. Strumpf, 516 U.S. 16, 18 (1995); *see also* HAL, Inc. v. United States (*In re* HAL, Inc.), 196 B.R. 159, 162 (B.A.P. 9th Cir. 1996), *aff'd*, 122 F.3d 851 (9th Cir. 1997) (discussing the evolution of offset).

16. United States v. Munsey Tr. Co. of Wash., D.C., 332 U.S. 234, 239 (1947) ("The government has the same right which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him."); Aetna Cas. & Sur. Co. v. LTV Steel Co. (*In re* Chateaugay Corp.), 94 F.3d 772, 779 (2d Cir. 1996) (providing that the Service may use common law authority to set off tax overpayments against debts owed to other federal agencies).

17. Cherry Cotton Mills, Inc., v. United States, 327 U.S. 536 (1946) (debts owed by taxpayer to Reconstruction Finance Corporation); *see also* Luther v. United States, 225 F.2d 495 (10th Cir. 1955) (debts owed to Commodity Credit Corporation). *See* Rev. Rul. 85–70, 1985–1 C.B. 361 (ruling that the Service may use its common law setoff powers, if allowed by local law, to supplement § 6402 setoff powers in applying overpayments shown on a joint return to one spouse's unpaid tax liability in community property states).

for offsetting federal tax overpayments, first against outstanding tax liabilities and then against a list of other types of outstanding liabilities to other federal and state authorities permitted to benefit from a federal tax refund offset.[18] In 2011, 2012 and 2013 approximately $7 billion of federal tax refunds were offset against outstanding federal tax liabilities each year.[19] The offset program thus serves as a substantial part of the Service's effort to collect outstanding liabilities. Offset represents the cheapest and easiest method for the Service to collect outstanding tax debts, and it occurs without the need for a notice of federal tax lien or a levy. Because offset takes a refund for the year in which the overpayment occurs, taxpayers frequently confuse the offset of their refund with a problem in the year of the overpayment, rather than the application of the payment to a year with an outstanding balance. Obtaining account transcripts to follow the trail of the payment is a necessary step in providing assistance to a taxpayer whose refund has been offset.[20]

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18. Section 6402(a) provides that within the applicable period of limitations the Secretary may credit the amount of any overpayment against any liability in respect of an internal revenue tax on the part of the person who made the overpayment. It also provides that the Service shall refund any balance to the taxpayer, subject to a taxpayer's electing to apply an overpayment to a future liability under section 6402(b) or to offsets to other federal or state obligations specifically enumerated in sections 6402(c)–(f), discussed below. For a general discussion of how the offset program works within the Service, see Treasury Inspector General for Tax Administration, Revising Tax Debt Identification Programming and Correcting Procedural Errors Could Improve the Tax Refund Offset Program (2016).

19. *Id.* at 2 fig.1 (counting offset totals of $7.7 billion for 2011, $7.3 billion for 2012 and $6.8 billion for 2013); *see also* Keith Fogg, *IRS Offset Program*, Procedurally Taxing (May 19, 2016), https://procedurallytaxing.com/irs-offset-program/ [https://perma.cc/9BD2-S3R4] (discussing TIGTA report).

20. The offset can have collateral tax consequences beyond the mere payment of an earlier liability. Under the innocent spouse rules, it serves as a "collection activity" for purposes of the rule requiring a party to request relief within two years of the first collection activity. Reg. § 1.6015–5(b)(2)(i). An offset does not, however, trigger notice or hearing rights under the collection due process provisions. *See* Boyd v. Comm'r, 451 F.3d 8, 13 (1st Cir. 2006); Bullock v. Comm'r, T.C. Memo. 2003-585, 2003 WL 43374, at *2 (2003). Because the offset can satisfy a liability for a prior year, it also triggers the running of the two-year statute of limitations for filing a refund claim pursuant to section 6511(a). The Service will send the taxpayer a notice that

One key question for the offset analysis is: When does a tax liability become an "outstanding liability"? An assessment is not a necessary predicate to creation of a tax liability, and therefore assessment is not necessary before the Service may perform an offset.[21] The Service takes the position that it may offset an agreed overpayment against an unagreed *proposed* deficiency.[22] This issue was raised in the early

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offset has occurred but will not explain in the notice all of the collateral consequences nor necessarily list the tax periods satisfied by the offset.

21. *See, e.g.*, Cohen v. Gross, 316 F.2d 521, 522–23 (3d Cir. 1963) ("[A]ssessment is a prescribed procedure for officially recording the fact and the amount of a taxpayer's administratively determined tax liability, with consequences somewhat similar to the reduction of a claim of judgment."); Ewing v. United States, 914 F.2d 499, 502–03 (4th Cir. 1990), *cert. denied*, 500 U.S. 905 (1991) (rejecting taxpayer's argument that, prior to assessment, there can be no tax liability and therefore no "payment" of taxes); *see also* Greene v. United States, 124 Fed. Cl. 636 (2015) (allowing offset of federal tax refund against fine imposed following criminal case); Keith Fogg, *A Different Type of Offset Fight—Illegal Exaction*, Procedurally Taxing (Mar. 16, 2016), https://proceduralltaxing.com/a-different-type-of-offset-fight-illegal-exaction/ [https://perma.cc/P6P8-A7DZ].

22. In *McCarl v. United States ex rel. Leland*, 42 F.2d 346, 347 (D.C. Cir. 1930), the court held that credits by the Commissioner against alleged deficiencies were proper even though the deficiencies were being contested before the Board of Tax Appeals and had not yet been assessed. *McCarl* may not be good law today, however, because there, the tax laws were structured so that the taxpayer received a huge interest rate on the overpayment, but the government was denied recovery of interest on the underpayment. Thus, the taxpayer would have gained a large advantage if setoff had not been allowed. The *McCarl* court was clear in its determination not to allow the taxpayer this advantage:

> The inequity of appellee's position is still more apparent when it is noted that the government could exact interest on the deficiency assessment from February 26, 1926, only. In other words, the government would be compelled to pay interest from the date of the overpayment to approximately the date of the refund, while it could exact interest on the deficiency assessment from February 26, 1926, only. . . . We cannot conceive that Congress intended such a result, nor do we think that an interpretation producing such a result should be placed upon the statute.

cases where the courts were interpreting the precursor statutes to section 6402.[23]

The Service can be expected to take the position that it can offset a liability as soon as the taxable year has closed. Older IRS guidance provided that an agreed overpayment may be offset against "an unagreed proposed deficiency."[24] While that guidance does not define an "unagreed proposed deficiency," one can reasonably read it to mean at least the 30-day letter.[25] In 2007, the Service issued clarifying guidance, which holds that it can offset an overpayment "against unassessed internal revenue tax liabilities that have been determined in a notice of deficiency sent to the taxpayer."[26] While it is unclear how often the

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Id. (citations omitted). Most of the cases following *McCarl* either repeat its analysis or simply cite the case. *See, e.g.*, United States *ex rel.* Cole v. Helvering, 73 F.2d 852, 853 (D.C. Cir. 1934); Tull & Gibbs, Inc. v. United States, 48 F.2d 148, 150 (9th Cir. 1931). However, the Court of Claims extended the *McCarl* analysis in *Standard Oil Co. v. United States*, 5 F. Supp. 976 (1934). There, the court upheld the Service's discretion in applying a previous year overpayment to a later alleged deficiency and declining to apply a payment by the taxpayer that was designated to pay off that deficiency. *Id.* at 991. This was again an instance of interest arbitrage, where the taxpayer wished to benefit from the high interest accrual on its prior overpayment. *Id.* at 985.

23. *See, e.g.*, *McCarl*, 42 F.2d at 347; *Standard Oil*, 5 F. Supp. at 985.

24. Rev. Rul. 54–378, 1954–2 C.B. 246.

25. In G.C.M. 32,064 (Aug. 10, 1961), the question was whether the new ADP system should be programmed to offset agreed overpayments against unagreed and unassessed taxes. General Counsel's Memorandum (GCM) 38,480 (June 30, 1981) takes the position that offset may only occur once a 90-day letter is issued and not before that time. GCM 38,480 comments on a policy expressed in Revenue Ruling 54–378 of refusing to refund the full amount of an agreed overpayment for one taxable year when there was an unagreed proposed deficiency for another year. After stating what Revenue Ruling 54–378 says, the GCM then analyzes the prior law, the *McCarl* case, and quotes extensively from GCM 32,064. It notes that Revenue Ruling 54–378 is to be modified to follow the GCM.

26. Rev. Rul. 2007–51, 2007–2 C.B. 573 ("Although sections 6402(a) and 6411(b) do not require a deficiency determination or assessment as a prerequisite to the Service crediting an overpayment or a carryback adjustment to a tax liability, the Service generally does not make such credits until the tax liability is determined with specificity. When the Service issues a notice of deficiency, it has determined the tax liability with specificity."); Chief. Couns. Adv. 2013-16-020 (Apr. 19, 2013) ("While 'liability' is not

Service acts upon this interpretation, such an offset could potentially deprive a taxpayer of prepayment judicial review in Tax Court if the offset fully satisfied the proposed deficiency.

The offset system established in section 6402 reflects Congressional priorities in much the same way that the bankruptcy provisions create a list for paying creditors in a specific order. The language of section 6402(a) contains the word "may" in referring to the offset against other federal tax obligations but the word "shall" in referring to other federal and state obligations mentioned in the statute. This gives the Service discretion in deciding whether to exercise its offset power when the taxpayer owes federal taxes but removes the discretion when another qualifying state or federal party exists.[27] The exercise of discretion by the Service to forgo the offset is discussed below under the heading of offset bypass refund and permeates other sections as well.

C. Priority Scheme for Offsetting Tax Overpayments

Under Code section 6402(a), overpayments are first offset against outstanding federal tax obligations. When a taxpayer has a federal tax overpayment, the IRS computer system searches all of the taxpayer's accounts to determine if an outstanding assessment exists. If the computer system finds an outstanding assessment, the overpayment gets

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specifically defined, it [is] the Service's longstanding position that offset is available only against a liability which has been assessed or is shown on a statutory notice of deficiency.").

27. Despite the statutory mandate for the Service to offset the non-tax debts listed above, other parts of the federal government also possess the discretion to halt any refund offset originating from debts they hold. *See* Press Release, U.S. Dep't of Educ., Secretary DeVos Directs FSA to Stop Wage Garnishment, Collections Actions for Student Loan Borrowers, Will Refund More Than $1.8 Billion to Students, Families (Mar. 25, 2020), https://content.govdelivery.com/accounts/USED/bulletins/2831e5c [https://perma.cc/8YG9-96GZ] (announcing suspension of offsets for delinquent student loan borrowers). When the Department of Education makes the decision to exercise its discretion and forgo offset for some period or with respect to a specific type of debt, it alerts the Bureau of Fiscal Services not to offset federal payments headed to an individual with an outstanding debt to the Department of Education. This could have the effect of allowing a federal tax refund to reach the taxpayer rather than be offset through the TOP process.

applied to the earliest period in which an outstanding liability exists, first to the tax liability, then to any penalty, and then interest.[28] If, after paying off the earliest year, funds remain from the overpayment, the Service will apply the overpayment to the next oldest year in the same order and continue applying the payments in chronological order, until all of the outstanding federal tax liabilities have been satisfied or the funds from the overpayment are exhausted.

If any of the overpayment exists after satisfaction of the federal tax assessments, the Service next offsets the overpayment against any outstanding support obligations that the taxpayer might have.[29] Next, the remaining overpayment is applied to delinquent debts owed by the taxpayer to other federal agencies.[30] This offset occurs at the Treasury Department Bureau of the Fiscal Service (BFS) rather than the Service. As noted *infra*, the BFS offsets also carry the name Treasury Offset Program, commonly known as TOP. At this point the Service has sent the overpayment information to BFS which serves as the clearinghouse for payments from the federal government. All federal agencies owed money have the opportunity to provide notice of an unpaid debt to BFS. BFS checks its files for markers from other federal agencies before it issues a refund to a taxpayer.[31]

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28. Rev. Rul. 73–305, 1973–2 C.B. 43 (setting out the default order for applying an undesignated payment).

29. § 6402(c). Section 464(c) of the Social Security Act provides the definition for the type of past-due support to which the offset applies. *See, e.g.*, Blue v. U.S. Treas. Dep't, No. 1:19 CV 1926, 2019 WL 7282095, at *2 (N.D. Ohio Dec. 27, 2019). The Code establishes the priority for offsets for liabilities other than for federal tax liabilities. *See* §§ 6402(d)(2), 6402(e)(3), 6402(f)(2); Reg. § 301.6402–6(g) (summarizing priority rules); *see also* I.R.M. § 21.4.6.4(4) (listing priorities for offsets for non-federal tax debts).

30. § 6402(d); *see, e.g.*, U.S. Dep't Housing & Urban Dev. v. Wood (*In re* Wood), 611 B.R. 782 (S.D.W. Va. 2019) (discussing the offset provisions regarding other federal agencies but refusing to allow it for the year before the court due to the bankruptcy stay), *rev'd sub nom*. Wood v. U.S. Dep't Housing & Urban Dev. (*In re* Wood), 993 F.3d 245 (4th Cir. 2021); Greene v. United States, 124 Fed. Cl. 636 (2015) (allowing offset of tax refund against a fine resulting from a section 7201 criminal conviction; even though the fine resulted from a tax crime, the offset was done through the TOP since the fine itself was not a tax liability).

31. Reg. § 301.6402–6; *see also* Bureau of the Fiscal Serv., Fact Sheet: Treasury Offset Program (accessed on Apr. 5, 2020). There is little

Assuming that the taxpayer has no outstanding federal tax debts, support payments or other federal debts, BFS then checks to see if it has received a debt marker from a state for income taxes. The state income tax must have been assessed or reduced to judgment. The BFS regulations provide the state with guidance on how to make the request for the offset.[32] After paying state income taxes, the overpayment becomes available to satisfy unemployment compensation owed to the state.[33] The process follows essentially the same path as that for state income taxes.

The Service is also able to do the reverse and seize state tax refunds to pay off federal taxes.[34] However, its ability to do so is deemed a levy, rather than an offset.[35] State tax refund levies still closely resemble offset, as section 6330(f)(2) allows the Service to levy without issuing a pre-collection notice with the right to a pre-collection hearing.[36] However, once the Service levies on the state refund, taxpayers have access to judicial review in Tax Court via a timely appealed notice of determination following a Collection Due Process hearing.[37]

TOP was created as part of the Debt Collection Improvement Act of 1996 (DCIA), which requires federal disbursing agencies to run

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explanatory guidance on how BFS checks the markers. The regulations provide that priority goes to earlier-accrued debts and defines "date accrued" as "the time at which the agency determines that the debt became past due." Reg. § 301.6402–6(g)(2). Because agencies incur a mandatory reporting requirement on "past-due" debts that are more than 120-days delinquent, a logical conclusion would be that the agency that reports first will coincidentally also be the agency with the earlier-accrued debt and thus be first in line for any overpayment offsets. But because agencies can also discretionarily notify BFS of past-due debts that are less than 120-days delinquent for offset (see 31 C.F.R. § 285.5(d)(2)), that might not necessarily always hold true. In other words, agency *X* could determine a debt is past due on Aug. 7 and agency *Y* could do the same on Aug. 8—but agency *Y* would not be able to get priority even if it discretionarily reported the debt first.

32. 31 C.F.R. § 285.8 (2013).

33. § 6401.

34. The Service administers the State Income Tax Levy Program, in which states with an income tax reach an agreement with the Service for state tax refunds to be applied to federal tax liabilities. *See* I.R.M. 5.19.9.2.

35. § 6330(f)(2).

36. *Id.*

37. *See* Clark v. Comm'r, 125 T.C. 108, 110 (2005) (holding that the Tax Court has jurisdiction to hear appeal of levy of state tax refund).

their payments through BFS so that designated federal payments will allow the United States to collect outstanding debts.[38] DCIA specifically exempted certain federal payments from this general federal offset program and limited the amount of certain other federal payments.[39] These exemptions evidence a congressional determination that the government's interest in providing certain welfare-related payments outweighed its interest in efficient tax collection.

D. Creditor Offset After Receipt of Levy

The Service sends levies to parties that owe money to the taxpayer in order to obtain that money and apply it to the taxpayer's outstanding tax debt. Sometimes, not only does the party receiving the levy owe money to the taxpayer but the taxpayer owes money to that party; in this situation, the party receiving the levy could have offset its mutual debt obligations with the taxpayer in satisfaction, or partial satisfaction, of the debt. Such a situation is most typically found in commercial lending between a bank and a business taxpayer. When the levy arrives before the third party has exercised its right of offset, a question arises regarding the amount of money the third party should pay over to the Service. Should it pay over to the Service the full amount of money it owes to the debtor or pay over only that amount remaining after the third party affects an offset of the money owed to it?

The Service has litigated this issue on several occasions.[40] The Service takes the position that the party in receipt of the levy must pay

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38. Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, 110 Stat. 1321, 1321-359 to -361 (1996) (codified at 31 U.S.C. § 3716(c)).

39. See, for example, the complete exemption of certain higher education payments pursuant to 31 U.S.C. section 3716(c)(1)(C) and certain Department of Veterans Affairs payments pursuant to 38 U.S.C. section 5301(a) and partial exemption of certain payments by the Social Security Administration pursuant to 31 U.S.C. section 3716(c)(3)(A)(ii) as well as certain means tested program payments when requested by the agency head pursuant to 31 U.S.C. section 3716(c)(3)(B). For an explanation of means tested payments, such as food stamps and TANF payments, *see* Dep't of Treasury, Bureau of the Fiscal Serv., Debt Mgmt. Servs. Exemption of Classes of Fed. Payments from the Treasury Offset Program: Standards and Procedures (June 4, 2001, as updated Sept. 3, 2013).

40. *See, e.g.*, United States v. Cent. Bank of Denver, 843 F.2d 1300 (10th Cir. 1988); State Bank of Fraser v. United States, 861 F.2d 954 (6th Cir.

over to the Service the full amount of money owed to the taxpayer if, prior to receipt of the levy, the third party has not yet exercised its right of offset.[41] Third parties with offset rights—typically banks—historically took the contrary position that exercise of offset eliminates the taxpayer's property interest in the funds offset, taking them out of the reach of the Service's levy.[42]

While most of the circuits accepted the Service's position, a unique feature under several state statutes caused several circuits to reach somewhat contrary results. Where a provision of state law provides for an "automatic" offset upon debt maturation by operation of law, the Third and Fifth Circuits have held that the third party need not affirmatively exercise offset rights in order to take offset funds beyond the reach of the Service.[43] These holdings leave open the possibility that a lender in such states could include clauses in its commercial loan agreements that provide for accelerating debt maturity upon issuance of a Service notice of intent to levy.[44]

1988); United States v. Bank of Celina, 721 F.2d 163 (6th Cir. 1983); Pittsburgh Nat'l Bank v. United States, 657 F.2d 36 (3d Cir. 1981); United States v. Sterling Nat'l Bank & Tr. Co. of N.Y., 494 F.2d 919, 921 (2d Cir. 1974).

41. *Cent. Bank of Denver*, 843 F.2d at 1309 ("This issue between the Government and Central turns on whether the latter made a timely exercise of its setoff right so as to defeat the attachment of the IRS lien and notice of the administrative levy.").

42. As a practical matter, offset funds are still encumbered by a federal tax lien even after passing to the third party. *See* United States v. Bess, 357 U.S. 51, 58 (1958) ("The transfer of property subsequent to the attachment of the lien does not affect the lien . . . .").

43. *Pittsburgh Nat'l Bank*, 657 F.2d at 40 (applying Pennsylvania automatic setoff law); United States v. Nat'l Bank of Com., 246 F. Supp. 597, 599 (E.D. La. 1965) (applying Louisiana automatic setoff law).

44. However, bank offset rights are somewhat less relevant today because of the combination of section 6323(b)(10), which allows for a lien super priority for loans secured by a savings account, and state laws that provide banks with an automatic security interest in a customer's deposit account. *See* U.C.C. § 9-104 (Am. L. Inst. & Unif. L. Comm'n 1998). The Service takes the position that neither offset nor super priority relieves a bank from complying with a levy, though the bank may subsequently request a release or file a wrongful levy suit. *See* Rev. Rul. 2006–42, 2006–2 C.B. 337; C.A.M. 200849001 (July 29, 2008) (concluding that the § 6323(b)(10) super priority extends to loans secured by a bank account under state law).

E. Federal Tax Overpayment to Federal Tax Offset—Contesting Underlying Liability

If the Service offsets an overpayment toward a federal tax debt and the taxpayer believes that the offset is incorrect because the debt is not valid, then the taxpayer can contest the debt through the means available for the year to which the payment is applied. For example, if the offset fully paid the debt for a specific tax period the taxpayer contests, then the taxpayer can seek the return of the funds through the tax refund process by filing a refund claim for that period.[45]

If the offset amount does not fully satisfy the amount due for the period to which the Service applied it, the taxpayer can seek audit reconsideration or a doubt as to liability offer in compromise (OIC) for the year to which the payment was applied.[46] Audit reconsideration or a doubt regarding liability OIC essentially act as a request for abatement of tax. If the Service abates the tax for the year to which the overpayment was applied, then an overpayment will exist for that year. If an overpayment exists for the year to which the payment was applied, the Service will refund the overpayment from that year as long as the statute of limitations for refund has not expired.

For taxpayers who satisfy a liability, in part or in whole, through offset payments, the statute of limitations can create a barrier to a refund of payments applied to earlier years. One of the most common reasons for this situation is known as the *Flora* rule, which requires a taxpayer to pay the entire tax liability before bringing a refund suit against the government.[47] For example, the Service audits Harry, assessing a tax liability of $15,000 for 2015 within a year after he filed the return. Harry makes no payments on the liability to reduce it but each year starting with his 2016 return he claims a refund of $3,000. The Service would take the refund each year and apply it to

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45. For rules with respect to refund claims, see Michael Saltzman & Leslie Book, IRS Practice and Procedure ¶ 11.03 (2021).

46. However, if offsets reduce a liability to zero, then a doubt as to liability OIC will no longer be available, as the Service takes the position that there is no longer a liability to compromise. Audit reconsideration would also be unavailable. Full payment would allow the taxpayer to file a refund claim and, if denied, file a suit for refund in the appropriate district court or the Court of Federal Claims. For more on audit reconsideration, *see* I.R.M. 4.13.3.

47. United States v. Flora, 362 U.S. 145, 177 (1960).

Harry's outstanding 2015 debt. He would pay off the tax in five years and the interest and penalties in another two years. Now that he has fully paid the liability, he meets the criteria necessary to bring suit under the *Flora* rule.[48] In his suit he will only recover the amount paid within two years of filing his claim, losing all of the earlier payments made by offset—even if he succeeds in showing that he did not owe the additional tax assessed on the 2015 return.

This fact pattern plays out regularly for taxpayers who cannot fully pay their taxes within two years, placing them in a disfavored position compared to taxpayers with the financial ability to pay and thus bring a timely refund claim. The unfortunate consequence of the bar to recovery is not limited to the situation of offset, as any payment of a liability over a time period exceeding two years creates a refund barrier. Offset payments, however, frequently fall into this category.

F. Federal Tax to Federal Tax or TOP Offset—Injured Spouse Defense

One common way of contesting an offset or preventing an offset from occurring in the first place involves the assertion of injured spouse status.[49] The concept of injured spouse frequently gets confused with that of innocent spouse, but the two concepts serve completely different purposes, though both protect one spouse from tax or other debt issues created by the other. The innocent spouse provisions receive explicit statutory authority in section 6015, whereas the injured spouse provisions come from a recognition of property law principles.[50] The injured spouse provisions specifically seek to prevent the Service from

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48. *See* Keith Fogg, *Access to Judicial Review in Nondeficiency Tax Cases*, 73 Tax Law. 435 (2020).

49. Keith Fogg, *Special Statute of Limitations for Injured Spouse Relief*, Procedurally Taxing (Sept. 2, 2016), https://procedurallytaxing.com/special-statute-of-limitations-for-injured-spouse-relief/ [https://perma.cc/GJ7T-UB6X]; *see* Treasury Inspector General for Tax Administration, Injured Spouse Cases Were Not Always Timely Resolved, Resulting in the Unnecessary Payment of Interest 1 (2016) [hereinafter TIGTA Injured Spouse Report]; Michelle Lyon Drumbl, Tax Credits for the Working Poor: A Call for Reform 178–80 (2019).

50. *See* Drumbl, *supra* note 47 ("This is not a statutory right granted by the Code; rather, it is an administrative procedure that was created because of the recognized principles of property law.").

offsetting the portion of a federal tax refund attributable to a spouse who does not owe any back taxes or other debt subject to offset against an outstanding liability of the other spouse.[51] This is done by calculating the property interest of each spouse in the overpayment.[52]

The person claiming injured spouse status does not need to prove financial hardship or any wrongdoing by their spouse. The Service makes the determination by looking at the amount each spouse contributed to the overpayment.[53] The formula for doing this when the taxpayers claim the EITC has its own special rules.[54]

For example, Harry and Sally get married in 2020 and decide to file a joint return. On the joint return they report an overpayment of $5,000. Assume that the calculation used by the Service for 2020 is that $3,000 of the refund results from Sally's contributions and $2,000 from Harry's. The injured spouse issue arises in one of two situations. In the first situation, Harry has outstanding federal taxes of $12,000 due from 2017, a year prior to his marriage to Sally. Sally has no outstanding federal or state liabilities.

In the second situation Harry has a $12,000 child support obligation that predates his marriage to Sally and that remains unpaid. Sally has no outstanding federal or state obligations. The child support agency properly certifies the debt to the BFS, and the TOP program computer stands poised to offset any refund due to Harry. Here, the child support serves as an example of a debt, other than a federal tax debt, to which the federal government may apply a federal tax overpayment through TOP.

In both situations the entire $5,000 federal tax refund will be offset to satisfy Harry's outstanding obligation. In the first situation, in the absence of contrary directions, the IRS computer will take the entire refund from the joint return and use it to partially satisfy Harry's

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51. The injured spouse issue can cause significant professional responsibility issues for practitioners jointly representing spouses where one spouse has a meritorious injured spouse claim. The spouses may disagree on whether the offset refund should be protected from the prior debt or not, causing a conflict of interest.

52. *See* Rev. Rul. 85–70, 1985–1 C.B. 361; I.R.M. 25.18.5.3; I.R.M. 25.18.5.4.

53. *See* C.A.M. 201012033 (Jan. 8, 2010) (citing Rosen v. United States, 397 F. Supp. 342, 343 (E.D. Pa. 1975)).

54. Rev. Rul. 87–52, 1987–1 C.B. 347.

2017 federal income tax liability. In the second situation TOP will take the entire refund and apply it to partially satisfy the outstanding child support obligation.[55]

The injured spouse provisions allow Sally to prevent the offset of her portion of the federal tax refund or to obtain a return of the offset funds with respect to the amount attributable to her share of the refund. In both situations, that amount is $3,000. While this remedy sounds simple, resolution does not always work out that way. The Treasury Inspector General for Tax Administration (TIGTA) has studied the process to identify where the problems exist.[56]

The TIGTA report states that a spouse can qualify for injured spouse status if that person is not required to pay the past-due amount that the Service offsets under section 6402 and meets any of the following criteria:

- The injured spouse made and reported tax payments (e.g., Federal income tax withholdings from his or her wages or estimated tax payments)[;]
- The injured spouse had earned income (e.g., wages, salaries or self-employment income) and claimed the earned income tax credit or the additional child tax credit[; or]

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55. Additional variations on the theme of the injured spouse provision exist. One possible variation exists where Harry would bring into the marriage a 2017 federal tax debt and Sally would bring in a 2015 federal tax debt. Might they prefer to pay Harry's debt because Sally's debt has reached the age that it is dischargeable in bankruptcy? Could they achieve that result by failing to elect injured spouse status or would the Service pay off Sally's older debt? If Harry's debt was student loan debt which would likely never be dischargeable, could they choose to do nothing and have that debt paid off instead of her old dischargeable tax debt? The failure to do anything would cause their 2020 overpayment to go first to satisfy Sally's debt. The tax overpayment would pay off a tax assessment no matter the age of the two liabilities. Only after payment of outstanding federal taxes, should funds remain, would they go to pay or partially pay Harry's debt. Through an injured spouse election some of the refund would go to Sally's preexisting debt and some to Harry's. Harry's portion of the refund would be offset to pay his almost impossible to discharge student loan debt. *See* 11 U.S.C. § 523(a)(8) (setting out provisions for discharge of student loan debt).

56. *See* TIGTA Injured Spouse Report, *supra* note 47.

- The injured spouse claimed a refundable tax credit, such as the premium tax credit or the refundable credit for prior year minimum tax.[57]

When a taxpayer believes they qualify for injured spouse status, they should attach a Form 8379 to their tax return.[58] Doing so will prevent the offset of the portion of the refund attributable to the non-liable spouse. Some married couples attach this form year after year because of the existence of one spouse's debt which will trigger offset. Of course, a newlywed in Sally's situation may not know that her partner has a debt or may not appreciate how the tax offset program operates and so may not know that she should proactively file the Form 8379. When the Form 8379 does not accompany the return, the injured spouse can file it after the fact by submitting a paper copy of the form to the service center where the return was filed.[59] According to the TIGTA report, in each of the calendar years 2014 and 2015, more than 360,000 injured spouse claims were filed.[60] If, as happened in the payout of the stimulus payment authorized by the CARES Act, the Service does not have time to code the injured spouse request, the pre-offset process can break down, causing significant pain to taxpayers and back-end problems for the Service.[61]

G. Federal Tax Offset Effected Through TOP

If the overpayment goes to satisfy either a federal debt other than a tax debt or a state obligation, the taxpayer cannot contest the offset with the Service. The taxpayer instead must contest the offset with the federal or state agency to which the money was sent using the procedure established by that federal or state agency.[62] This can mean that the

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57. *Id.* at 1.

58. *See* Rev. Rul. 85–70, 1985–1 C.B. 361; I.R.M. 25.18.5.3; I.R.M. 25.18.5.4.

59. IRS Form 8379 (2016).

60. TIGTA Injured Spouse Report, *supra* note 47, at 2 fig.1.

61. *See supra* note 4

62. § 6402(g); Reg. § 301.6402–6(1); *see* Blue v. U.S. Treas. Dep't, No. 1:19 CV 1926, 2019 WL 7282095, at *2 (N.D. Ohio Dec. 27, 2019) (dismissing a suit against the Service for recovery of an offset of a federal tax refund

person who normally represents the taxpayer in tax matters may need to affiliate another attorney who specializes in the type of debt giving rise to the offset.[63] The process of tracing and contesting the debt to which a federal tax refund was applied can be slow and laborious. The IRS transcript of account, which provides a picture of a taxpayer's status for federal tax debts, does not show how much debt a taxpayer owes to the parties who are entitled to obtain an IRS refund through the procedures of section 6402, nor does it identify those parties. To find out this information, practitioners need another type of power of attorney, one for the BFS.[64] The BFS can only provide the identity of the federal or state entities that have placed a debt marker; it does not have total information regarding the amount owed and has no information regarding the reason for the debt. Each individual federal or state agency would then need to be contacted to find out the specifics for the debt owed and to determine how to contest the debt.

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against a support obligation); *see also* Nelson v. United States, 817 F. App'x 949, 952 (Fed. Cir. 2020) (dismissing suit against the Service for offset of refund to pay student loan debt). For further discussion, see Keith Fogg, *Suing to Recover Offset of Tax Refund Against Student Loan Debt,* Procedurally Taxing (July 28, 2020), https://procedurallytaxing.com/suing-to-recover-offset-of-tax-refund-against-student-loan-debt/ [https://perma.cc/2DD5-HU9A].

63. *See, e.g.*, Toby Merrill & Alec Harris, *Offset of Tax Refund to Pay Student Loan Debt*, Procedurally Taxing (Mar. 1, 2018), https://procedurallytaxing.com/offset-of-tax-refund-to-pay-student-loan-debt/ [https://perma.cc/T9VZ-LHEZ] (discussing student loan debt which the Department of Education collects through the TOP; individuals with student loan debt who have their tax refunds taken to satisfy a delinquent or allegedly delinquent student loan debt need to work out the issue with the Department of Education in order to obtain their refund or to stop future offsets).

64. The BFS has a toll-free number, 800-304-3107. To obtain information from the Bureau, practitioners must have authorization from the taxpayer; however, the power of attorney form used by the BFS differs from the power of attorney form used by the Service. *See* Bureau of the Fiscal Service, FS Form 13: Authorization for Release of Information, https://fiscal.treasury.gov/files/forms/FS_Form13.pdf [https://perma.cc/VA5F-3CAU] (accessed on Apr. 7, 2020).

III. Offset During Collection Stays

A. Collection Stays Imposed by Title 26

A number of actions taken by taxpayers stay administrative enforcement of collection action. Examples include requesting innocent spouse relief,[65] making an OIC,[66] reaching an installment agreement,[67] and filing for bankruptcy.[68] Generally speaking, these collection stays suspend the collection statute of limitations but do not stop the Service from offsetting a taxpayer's overpayment against an outstanding liability;[69] however, unlike the other examples of stay listed, the Service does not offset in situations in which the taxpayer has requested innocent spouse relief.[70]

The Service has also adopted a policy of waiving offset in the post-acceptance year if the taxpayer makes an OIC based on Effective Tax Administration or a Doubt as to Collectability Offer in Compromise based on special circumstances.[71] This policy affects offset with respect to refunds received by the taxpayer after acceptance of the offer but does not stop the Service from offsetting refunds while it considers

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65. § 6015(e)(1)(B).
66. § 6331(k)(1).
67. § 6331(k)(2).
68. 11 U.S.C. § 362(a)(6).
69. § 6503.
70. *See* I.R.M. 25.15.18.5.1.3.1. The situation with bankruptcy is also complicated and discussed further *infra* Part III.B.
71. Effective Tax Administration (ETA) offers are described in Reg. § 301.7122–1(b)(3). *See* Saltzman & Book, *supra* note 43, at ¶ 15.06[4][c]. The Service considers these offers when a taxpayer has the ability to pay the outstanding liability in full but doing so would leave the taxpayer in an unacceptable financial situation. Special circumstances offers occur when a taxpayer cannot pay the outstanding liability in full but seeks an offer for less than the taxpayer's reasonable collection potential, essentially for the same reasons as someone seeking an Effective Tax Administration offer. *See id*. at ¶ 15.06[8][a]. When a taxpayer's offer in compromise is accepted, the taxpayer and the Service sign a Form 656 memorializing the offer terms. The preprinted Form 656 contains a specific paragraph regarding post-offer acceptance offsets. The general terms permit the Service to offset any refund stemming from the year of acceptance; however, if the parties enter into an

the offer.[72] While this may seem a minor issue in the abstract, in reality the Service's often slow processing of OICs can subject low-income taxpayers to multiple refund offsets.[73] For a taxpayer who is already seeking an OIC because of an inability to pay taxes owed, multiple offsets could be a heavy financial blow. In particular, if the taxpayer is unable to receive the Earned Income Tax Credit and the Additional Child Tax Credit, offset during the pendency of an offer can be quite expensive. Frequently, it will take parts of two calendar years before an acceptance of the OIC, causing the loss of the refundable credits in the year of acceptance of the offer, even when the offer is accepted at the beginning of the year. Taxpayers who do not receive good instruction on the operation of the offset following OIC acceptance can become understandably quite agitated when learning that a refund they expected a year or more after acceptance of their OIC will go to satisfy a now compromised debt.

ETA or special circumstances offer, the offset of the refund for the year of acceptance is waived. IRS Form 656 § 7(e) (2021) provides:

> The IRS will keep any refund, including interest, that I might be due for tax periods extending through the calendar year in which the IRS accepts my offer. I cannot designate that the refund be applied to estimated tax payments for the following year or the accepted offer amount. If I receive a refund after I submit this offer for any tax period extending through the calendar year in which the IRS accepts my offer, I will return the refund within 30 days of notification. *The refund offset does not apply to offers accepted under the provisions of Effective Tax Administration public policy/equity or Doubt as to Collectability with special circumstances based on public policy/equity considerations*.

(emphasis added).

72. For a general discussion of offset during the consideration of offers, see Christine Speidel, *Offers in Compromise and Tax Refunds— Part Two*, Procedurally Taxing (Mar. 15, 2019), https://procedurallytaxing.com/offers-in-compromise-and-tax-refunds-part-two/ [https://perma.cc/TTB3-4V33].

73. Nat'l Taxpayer Advoc., 2018 Annual Report to Congress: Policy Changes Made by the IRS to the Offer in Compromise Program Make It More Difficult for Taxpayers to Submit Acceptable Offers 275.

An administrative hold on collection, known as currently not collectible (CNC), also does not prevent offset.[74] Offset occurs even if the Service could not levy upon a taxpayer due to hardship as defined in section 6343(a)(1)(D) and the corresponding regulations.[75] In general, offset will occur whenever a taxpayer has an overpayment and, at the time of the overpayment, has an outstanding federal tax liability. To avoid having the offset automatically occur and send an overpayment to satisfy an outstanding federal tax liability, the taxpayer must seek a bypass of the offset as discussed below.[76]

Certain assets and certain sources of payment are exempt from levy by statute.[77] Section 6334(a) sets out a litany of payments exempt from levy.[78] When a payment exempt from levy goes into a taxpayer's bank account, generally nothing prohibits the Service from levying on the taxpayer's bank account, even if the taxpayer can "trace" the payment to their account and show that it derived from a source otherwise exempt.[79] A few cases have invoked tracing to deny offset in this

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74. *See, e.g.*, Etoty v. Comm'r, T.C. Memo. 2020-49, 2020 WL 1910833, at *3 (2020) ("While petitioner's CNC status will defer collection action with respect to any future State tax refunds, the IRS may continue to apply Federal tax overpayments against her assessed liability for 2008.").

75. *See* § 6343(a)(1)(D) ("[T]he Secretary shall release the levy . . . if . . . the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer. . . ."); Greene-Thapedi v. Comm'r, 126 T.C. 1, 7 (2006) ("An offset under section 6402 does not constitute a levy action. . . ."); *see also* Reg. § 301.6343–1(b)(4).

76. *See infra* Part IV.A.

77. § 6334.

78. Among the items exempt from levy are clothing apparel and school books, fuel, furniture, and personal effects and tools of the trade. § 6334(a)(1)–(3). These three provisions trace their roots to the beginning of the levy exemption statute in the 1860s. Since that time, Congress has added numerous additional items exempt from levy including pension payments, workman's compensation payments and certain public assistance payments among others. *See* § 6334(a)(4)–(13).

79. *See, e.g.*, Calhoun v. United States, 61 F.3d 918 (Fed. Cir. 1995) (unpublished table decision) (*per curiam*) ("Here, the sums levied upon were not payable to Calhoun by the credit unions as service-connected disability benefits, but instead were balances in Calhoun's accounts payable to him as deposits."); United States v. Coker, 9 F. Supp. 3d 1300, 1302 (S.D. Ala. 2014) (interpreting the exemption from levy of "[a]ny amount payable to an individual as workmen's compensation" as prospective and inapplicable to funds

situation, treating a payment as exempt even after deposit into a taxpayer's account.[80] Some laws have established the type of tracing that would prevent a levy from reaching exempt assets, but almost none of those laws stop the Service.[81] These cases involve the collection

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already paid); Cathey v. United States, 35 F. Supp. 2d 518, 520–21 (S.D. Tex. 1998) (same), *aff'd sub nom.* Cathey v. U.S. IRS, 200 F.3d 814 (5th Cir. 1999); Fredyma v. U.S. Treas. Dep't, No. 96-477-SD, 1998 WL 77993, at *3–4 (D.N.H. Jan. 9, 1998) (same), *aff'd sub nom.* Fredyma v. Lake Sunapee Bank, 181 F.3d 79 (1st Cir. 1998); *see also* Hughes v. IRS, 62 F. Supp. 2d 796, 800 (E.D.N.Y. 1999) (allowing levy of already-paid disability benefits resulting from court's interpretation of "payable" to mean "not-yet paid").

80. *See, e.g.*, Maehr v. Koskinen, 664 F. App'x 683, 685–86 (10th Cir. 2016) (sustaining pro se plaintiff's wrongful levy claim and remanding for further consideration), *remanded*, No. 16-cv-00512-PAB-MJW, 2018 WL 1406877 (D. Colo. Mar. 21, 2018); Leslie Book, *Tenth Circuit Raises Possible Defense to IRS Levying Bank Account with Veteran's Disability Payments*, Procedurally Taxing (Oct. 27, 2016), https://proceduralltytaxing.com/tenth-circuit-raises-possible-defense-to-irs-levying-bank-account-with-veterans-disability-payments [https://perma.cc/EH42-P4U4]. In *Maehr*, the Service levied on a veteran's disability benefits once they were deposited into the taxpayer's bank account. 664 F. App'x at 684. The Tenth Circuit noted that the Service could not directly levy on these benefits and decided that it should not have the right to levy on them indirectly after deposit into the bank account. *Id.* at 686. For a more recent example of using tracing to exempt funds from levy, see Keith Fogg, *Death and Taxes*, Procedurally Taxing (May 24, 2021), https://proceduralltytaxing.com/death-and-taxes/ [https://perma.cc/KY8F-6N66] (discussing the tracing of federal assistance for COVID-19 funerals).

81. In the areas of veteran's benefits and Social Security, Congress has written fairly broad exceptions to levy or offset on these benefits. *See* 38 U.S.C. § 5301(a)(1); 42 U.S.C. § 407(a). Section 3501(a)(1) of Title 38 provides that payments administered by the VA "shall be exempt from taxation, *shall be exempt from the claim of creditors*, and shall not be liable to attachment, levy, or seizure by or under any legal or equitable process whatever, *either before or after receipt by the beneficiary*. The preceding sentence shall not apply to claims of the United States arising under such laws nor shall the exemption therein contained as to taxation extend to any property purchased in part or wholly out of such payments." (emphasis added). The exceptions have been broadly construed by the courts. *See* Porter v. Aetna Cas. & Sur. Co., 370 U.S. 159, 162 (1962) (holding that veterans' benefits retained their exempt quality after deposit in bank account). In *Philpott v. Essex Cnty. Welfare Bd.*, the Supreme Court held that section 407(a) of the Social Security Act

remedy of levy and not offset, but there is a related tracing issue that arises when the Service seeks to offset. The offset provisions contain no statutory exemption. As discussed above, the Service, through its policies, and the offset statute, through its permissive provision regarding federal tax to federal tax offsets, give the Service some discretion to decide not to offset. No statutory guidance, however, exists mandating that the Service allow refunds of a certain type to pass through to a taxpayer without offset. Should the Service allow some payments to be exempt from offset the same way that payments receive an exemption from levy in section 6334? The debate in the cases on where the funds reside when the Service effects the levy could, in part, inform the decision on whether to create exemptions from offset.[82] More on this is discussed below in the section on the Federal Payment Levy Program, which is a hybrid levy/offset program.[83]

B. Collection Stay Imposed by Title 11

Although section 362(a)(7) of the Bankruptcy Code specifically prohibits offset, Congress added an exception to the automatic stay that permits the Service to offset under prescribed circumstances.[84] In 2005, Congress amended the Bankruptcy Code to allow taxing authorities to

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barred a New Jersey welfare agency's attempt to recover a welfare overpayment triggered by petitioner's receipt of retroactive Social Security benefits. 409 U.S. 413, 417 (1973). And, for example, the state of New York has allowed tracing to prevent a levy of Social Security and other safety net type funds after receipt. *See, e.g.*, Colton v. Martell, 359 N.Y.S.2d 632 (Dutchess Cnty. Ct. 1974).

82. For a discussion related to this topic, see Am. Bar Ass'n Sec. of Tax'n, Response to Comment Request Concerning Review of Regulatory and Other Relief to Support Economic Recovery (2021).

83. *See infra* Part III.D.

84. *Compare* 11 U.S.C. § 362(a)(7) (prohibiting offset during the period of the automatic stay), *with* 11 U.S.C. § 362(b)(26) (creating an exception to the general rule prohibiting offset and permitting offset of tax liabilities against other identical tax liabilities). Prior to 2005, a patchwork of offset local rules had developed. The ability to offset was important to the Service. It approached bankruptcy judges around the country seeking local orders permitting offset. Some judges were receptive to the dilemma facing the Service in the offset situation, while others pointed out that if Congress intended the Service to have this offset ability it would have made it clear.

offset prepetition overpayments against prepetition outstanding federal tax debts as long as the overpayment is offset against a tax of a like kind. For example, the Service can offset a refund of a taxpayer's income tax for a prepetition tax period filed during the time the automatic stay is in effect against a prepetition liability for income taxes.[85] The Service, however, is not permitted to offset an income tax overpayment arising during the period of the automatic stay against a taxpayer's prepetition non-income tax liability. The amended statute does not allow offset of a prepetition liability against a post-petition refund because these debts lack mutuality, as one is a debt of the debtor while the other is an obligation owed to the bankruptcy estate.

In addition, Bankruptcy Code section 362(a)(26) does not allow the offset of a prepetition debt for the Trust Fund Recovery Penalty[86] or some other type of tax obligation that is not an income tax against a post-petition refund generated by an income tax return. Some courts apply the bankruptcy stay to prevent offset of a federal tax refund against debts due to other federal and state agencies.[87]

In the case of *Citizens Bank of Md. v. Strumpf*, the Supreme Court addressed a question of when an offset occurs in the context of a bankruptcy case.[88] The debtor owed the bank and the bank owed the debtor, due to the fact the debtor had a checking account at the bank. After the filing of the bankruptcy case and while the automatic stay was in effect, the bank froze the debtor's bank account. The bank argued that it froze the account so that it could make a request to the bankruptcy court to lift the automatic stay. Reversing the lower courts, the Supreme Court found that freezing the account for this purpose did not constitute an offset and, therefore, did not violate the automatic stay. This decision has significance for the Service as well as banks,

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85. *See, e.g.*, Copley v. United States, 959 F.3d 118 (4th Cir. 2020) (permitting the Service to offset an overpayment arising from a prepetition period on a return filed post-petition against a prepetition liability despite the debtor's claiming the overpayment as exempt property).

86. § 6672.

87. U.S. Dep't Housing and Urban Dev. v. Wood (*In re* Wood), 611 B.R. 782, 790–91 (S.D.W. Va. 2019*), rev'd sub nom.* Wood v. U.S. Dep't Housing & Urban Dev. *(In re* Wood*)*, 993 F.3d 245 (4th Cir. 2021); *see* Keith Fogg, *Limited Ability to Offset Tax Refunds*, Procedurally Taxing (Jan. 3, 2020), https://procedurallytaxing.com/limited-ability-to-offset-tax-refunds/ [https://perma.cc/6CKZ-HWFT].

88. Citizens Bank of Md. v. Strumpf, 516 U.S. 16, 18 (1995).

since the Service frequently finds itself in the same situation.[89] Of course, in order to avoid the appearance of a de facto offset, the creditor who freezes the account cannot sit on its hands but must quickly take affirmative steps to request permission from the bankruptcy court.

The issue of offset and bankruptcy presents many complicated situations that could justify its own article. Bankruptcy Code section 553 preserves a creditor's right to offset if it exists outside of bankruptcy law. In the recent case of *In re Richards*, the court noted the ongoing split of authority concerning whether the Service can offset a liability of a debtor once a plan is confirmed.[90] The bankruptcy court in *Richards* was able to dodge the question however, as it determined that the attempted IRS offset of a post-petition payment to a prepetition dischargeable tax did not fall under Bankruptcy Code section 553

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89. For a recent example, see *Waters v. United States* (*In re Waters*), No. 3:15-cv-1506 (AWT), 2021 WL 1215879, at *15 (D. Conn. Mar. 31, 2021) (applying *Strumpf* to allow freezing of debtor's tax refund because it "merely maintained the status quo" and did not constitute an action violating the automatic stay).

90. *In re* Richards, 616 B.R. 879, 882 (Bankr. S.D. Ind. 2020) ("Courts are divided as to whether a confirmed plan under § 1141, § 1227 or § 1327 bars the IRS from exercising its § 553 setoff rights. Courts within the Seventh Circuit have held that, absent an express plan provision extinguishing such rights, a creditor's § 553 rights survive confirmation. Section 553 provides that this title does not affect any right of a creditor to offset a mutual debt and courts have reasoned that the effect of confirmation provisions [is] contained in this title (Title 11) and thus, do not affect the creditor's § 553 rights.") (internal quotations omitted); U.S. v. Munson, 248 B.R. 343, 346 (C.D. Ill. 2000) (§ 553 trumps § 1327); *In re* Bare, 284 B.R. 870, 874–75 (Bankr. N.D. Ill. 2002) ("[C]onfirmation of a debtor's plan . . . does not extinguish prepetition setoff rights, especially . . . where the plan does not specifically treat those setoff rights. . . .").

However, a creditor's setoff rights under section 553 of the Bankruptcy Code may be extinguished by express provision under a confirmed plan. *See* Daewoo Int'l (America) Corp. Creditor Tr. v. SSTS Am. Corp., No. 02 Civ. 9629(NRB), 2003 WL 21355214, at *4 (S.D.N.Y. June 11, 2003) ("Indeed, where there is a specific provision in the confirmation order prohibiting setoff claims, courts have indicated that the right to setoff may not survive the confirmation plan."); IRS v. Driggs, 185 B.R. 214, 215 (D. Md. 1995); *In re* Lykes Bros. Steamship Co., 217 B.R. 304, 310 (Bankr. M.D. Fla. 1997) (holding that § 1141 takes precedence over § 553 where plan of reorganization specifically prohibited setoff).

because the debt lacked mutuality.[91] Outside of the Seventh Circuit, some courts view confirmation of a plan as an event that overrides the ability to offset that the Bankruptcy Code otherwise preserves.

In addition to the offset issues raised by confirmation of a plan, an issue of offset exists where a debtor claims the tax refund as exempt property. The Fourth Circuit recently addressed this issue in the case of *Copley v. United States*.[92] A brief discussion of *Copley* will provide some insight into the effect of the claim to exempt the refund as it impacts the ability of the Service to offset a prepetition tax debt.[93] In *Copley*, the debtors filed their bankruptcy petition and immediately claimed their prepetition tax refund as exempt property.[94] The Fourth Circuit determined that although the refund was property of the estate, the conflict between Bankruptcy Code section 522 (which protects exempt property) and section 553 (which protects the right of offset) required the preservation of offset to prevail. Therefore, the Fourth Circuit permitted the Service to offset the refund against a prepetition liability. Several other circuits have held similarly.[95]

However, the *Copley* decision stands in contrast to other decisions interpreting the two statutes. The lower courts widely hold that debtors can exempt their refund from offset, holding that Bankruptcy Code section 522 trumps section 553.[96] There is an additional view that an offset refund never becomes a part of the bankruptcy estate, and therefore it cannot be exempted under Bankruptcy Code section 522.[97]

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91. *Richards*, 616 B.R. at 883.

92. Copley v. United States, 959 F.3d 118 (4th Cir. 2020); *see also* Keith Fogg, *Refund Offset Versus Bankruptcy Exempt Property Claim*, Procedurally Taxing (Jan. 14, 2021), https://procedurallytaxing.com/refund-offset-versus-bankruptcy-exempt-property-claim/ [https://perma.cc/6PXF-FCFK].

93. For an extended discussion of this issue, see Michelle Lyon Drumbl, *Bankruptcy, Taxes, and the Primacy of IRS Refund Offsets:* Copley v. United States, 72 S.C. L. Rev. 893 (2021).

94. *Copley*, 959 F.3d at 120.

95. *E.g.*, United States v. Gould (*In re* Gould), 401 B.R. 415, 427 (B.A.P. 9th Cir. 2009), *aff'd*, 603 F.3d 1100 (9th Cir. 2010).

96. United States v. Jones (*In re* Jones), 230 B.R. 875, 879 (M.D. Ala. 1999); Alexander v. IRS (*In re* Alexander), 225 B.R. 145, 149 (Bankr. W.D. Ky. 1998); *In re* Cole, 104 B.R. 736, 739–40 (Bankr. D. Md. 1989).

97. *See* IRS v. Luongo (*In re* Luongo), 259 F.3d 323, 335 (5th Cir. 2001) ("Because the prior unpaid tax liability exceeded the amount of the overpayment, the debtor was not entitled to a refund and the tax refund did

Many of the cases also blur the distinction between offsets to tax debt and TOP offsets.[98] The government raised this very point in its opening brief in the *Wood* case.[99] In its eventual decision in *Wood*, the Fourth Circuit looked to section 6402(d)'s mandatory TOP language ("the Secretary shall") as providing an "even stronger" case for preserving offset rights than the permissive language of section 6402(a) ("the Secretary . . . may") examined in *Copley*.[100] This issue will undoubtedly be the subject of further litigation.

Offsets of a refund to non-tax debts are permissible in bankruptcy, as the debt and claim are deemed mutual since the United States government is a unitary creditor.[101] These non-tax offsets cannot occur automatically pursuant to Bankruptcy Code section 362(b)(26) but require specific permission of the court to lift the stay to permit the offset. Whenever the government must seek this type of permission rather than use its computers to automatically effect an offset, the prospect for a violation of the automatic stay exists; however, the principle here is a normal creditor principle involving offset of mutual debt even though the debt crosses agency or departmental lines. The federal

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not become property of the estate."); Lyle v. Santa Clara Cnty. Dep't Child Support Servs. (*In re* Lyle), 324 B.R. 128, 133 (Bankr. N.D. Cal. 2005) (holding that there was no violation of the automatic stay because the stay only protects property of the estate, and offset funds are not part of the estate); *In re* Shortt, 277 B.R. 683, 692 (Bankr. N.D. Tex. 2002) (finding that refund did not become property of the estate based on *Luongo*).

98. Addison v. U.S. Dep't Agric. (*In re* Addison), 533 B.R. 520 (Bankr. W.D. Va. 2015), *aff'd*, No. 1:15CV00041, 2016 WL 223771 (W.D. Va. Jan. 19, 2016); Sexton v. IRS (*In re* Sexton), 508 B.R. 646 (Bankr. W.D. Va. 2014).

99. Brief for Appellant at 17, *In re* Wood, No. 20-1161, (4th Cir. 2020), 2020 WL 4001436 ("Many courts have concluded that the offsets included in subsections (a) and (d) of Section 6402 are analogous for purposes of Section 553(a).").

100. Wood v. U.S. Dep't Housing & Urban Dev. *(In re* Wood*)*, 993 F.3d 245, 251 (4th Cir. 2021) ("[T]he Treasury's authority to exercise its right to offset the Woods' tax overpayment against their debt to HUD is anchored firmly in § 6402(d) and [Bankruptcy Code] § 553(a).").

101. *See In re* HAL, Inc., 122 F.3d 851, 853–54 (9th Cir. 1997).

government is generally considered one entity for purposes of this mutuality.[102]

C. Judicial Review of Offset

Section 6402(g) limits judicial review of refund offsets to satisfy either a federal debt, other than a tax debt, or a state obligation.[103] Section 6402(g) also, however, preserves the right of taxpayers to bring any "legal, equitable, or administrative action against the federal [or other] agency . . . to which the amount of such reduction was paid."[104]

Section 6512(b)(4) denies the Tax Court jurisdiction to restrain or review an offset.[105] Usually, parties look for a grant of jurisdiction in order to determine if a particular court can hear a matter. Here, Congress provides a very explicit denial of jurisdiction.[106]

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102. An exception arises when the agency is acting in a "distinctive private capacity." *Id.* at 853.

103. Section 6402(g) provides in relevant part: "[n]o court of the United States shall have jurisdiction to hear any action, whether legal or equitable, brought to restrain or review a [tax refund] reduction authorized by subsection (c) [regarding past-due support as defined in Social Security Act § 464(c)], (d) [regarding tax refund offsets for debts owed to federal agencies], (e) [regarding tax refund offsets for past-due, legally enforceable State income tax obligations], or (f) [unemployment compensation debts]. . . . No action brought against the United States to recover the amount of any such reduction shall be considered to be a suit for refund of tax."

104. § 6402(g) (final sentence); *see also* Bible v. United States, 141 Fed. Cl. 718, 722 ("Congress, however, explicitly barred judicial review of any action "brought to restrain or review a reduction authorized by subsection . . . (f)" and further explained that "[n]o action brought against the United States to recover the amount of any such reduction shall be considered to be a suit for refund of tax."), *aff'd*, 783 F. App'x 1039 (Fed. Cir. 2019), *cert. denied*, 140 S. Ct. 2542 (2020); Terry v. Comm'r, T.C. Memo. 2016-88, 2016 WL 2604563, at *3 (2016) ("Because the Secretary is legally required to make this offset, he cannot review the validity of an agency debt of which he has been properly notified.") (internal quotations omitted).

105. "The Tax Court shall have no jurisdiction under this subsection to restrain or review any credit or reduction made by the Secretary under section 6402."

106. *See* Winn-Dixie Stores, Inc. v. Comm'r, 110 T.C. 291, 294 (1998) ("Section 6512(b)(4) restricts our jurisdiction in two situations. First,

The case of *Luque v. Commissioner* provides an illustrative example. There, the Tax Court examined the taxpayers' account to determine if an offset did occur.[107] The opinion went into a detailed examination of the facts before determining that an offset occurred. Consequently, the Tax Court then noted that it had no jurisdiction to review the offset itself and denied the taxpayers any relief. Judicial relief from a wrongful offset would thus have to come in the form of a refund suit; however, such a suit requires full payment of the taxes under the rule established in *Flora v. United States*.[108] If the year to which an overpayment is offset has a large assessment and the amount of the offset is small, it may occur that the taxpayer will effectively have no opportunity for judicial review of an offset, as litigation would be financially inefficient.[109]

Taxpayers also face a denial of jurisdiction when seeking to challenge an offset made under the mandatory offset provisions of section 6402. In the recent case of *Blue v. United States Department of Treasury*, the court dismissed a suit seeking to contest the offset of the taxpayer's refund to satisfy child support, determining that the government has not waived sovereign immunity to allow for suits to stop offsets.[110] Such suits, often brought by *pro se* taxpayers, appear periodically in the district courts.[111]

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we may not restrain or prevent respondent from reducing a refund by way of credit or reduction pursuant to section 6402. Second, we may not review the validity or merits of any reduction of a refund under section 6402 after such a reduction has been made by respondent.").

107. Luque v. Comm'r, T.C. Memo. 2016-128, 2016 WL 3675831, at *6 (2016); *see also* Caleb Smith, *On Offsets and Posted Dates*, Procedurally Taxing (July 20, 2016), https://procedurallytaxing.com/on-offsets-and-posted-dates/ [https://perma.cc/K2LX-REGL].

108. Flora v. United States, 362 U.S. 145 (1960). For a discussion of *Flora* and the full payment rule, see Saltzman & Book, IRS Practice & Procedure ¶ 11.11[1][c]; *see also* Fogg, *supra* note 46.

109. Smith, *supra* note 4.

110. Blue v. U.S. Treas. Dep't, No. 1:19 CV 1926, 2019 WL 7282095, at *2 (N.D. Ohio Dec. 27, 2019); *see also* Keith Fogg, *Offset of Tax Refund to Satisfy Unpaid Child Support*, Procedurally Taxing (Jan. 13, 2020), https://procedurallytaxing.com/offset-of-tax-refund-to-satisfy-unpaid-child-support/ [https://perma.cc/RK8U-SYAW].

111. *See, e.g.*, Hadsell v. United States, No. 20-CV-03512-VKD, 2021 WL 391299, at *4 (N.D. Cal. Feb. 3, 2021) (rejecting challenge to offset

Early on, federal common law recognized an expansive IRS right to apply overpayments of tax to liabilities in the refund context through the principle of recoupment, which closely mirrors offset. The Supreme Court first addressed the principle in *Lewis v. Reynolds*.[112] The Court reasoned that because the applicable statutes[113] required an overpayment for a successful refund claim, the Service had the implied right to reexamine the tax year in question and determine whether an overpayment existed.[114] If the Service then determined that no overpayment existed (i.e., an unassessed liability would have zeroed out any overpayment), then the claimed funds could be offset against that unassessed liability.[115]

Although it has the same effect, the recoupment described in *Lewis* is not identical to the type of offset described above. The *Lewis* recoupment could instead be described as a recalculation of the refund available rather than an offset of funds. The reduction of the refund available to the taxpayer does not result from a prior liability to which the Service offsets the refund; instead, it occurs from a recalculation of the true amount due from or due to the taxpayer for the year at issue in the refund suit.[116] If the statute of limitations on assessment has expired by the time of the filing of the refund suit, the recalculation of the liability would not allow the Service to seek a payment from the taxpayer. The recalculation in that instance would simply deny the

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of refund to past-due child support); Ivy v. Comm'r, 197 F. Supp. 3d 139 (D.D.C. 2016), *aff'd*., 877 F.3d 1048 (D.C. Cir. 2017) (dismissing challenge to offset of refund to delinquent student loans).

112. Lewis v. Reynolds, 284 U.S. 282 (1932), *modified by*, 284 U.S. 599 (1932).

113. Revenue Act of 1928 § 322, 45 Stat. 861 (1928); Revenue Act of 1926 § 284, 44 Stat. 66 (1926).

114. *Lewis*, 284 U.S. at 284.

115. *Id.*

116. *See, e.g.*, Williams-Russell & Johnson, Inc. v. United States, 371 F.3d 1350, 1353 (11th Cir. 2004) ("That the assessment here was made late therefore does not change the fact that the taxes were justly owed and paid, so it would be nonsensical to allow a taxpayer to recover those taxes now."); Bachner v. Comm'r, 109 T.C. 125, 131 (1997), *aff'd*., 172 F.3d 859 (3d Cir. 1998) (applying *Lewis* to allow Service to retain portion of timely payment despite its failure to timely assess a liability).

refund completely but not result in a tax due.[117] Recent case law has relied on *Lewis's* reasoning to further limit the Service's use of recoupment in litigation to only refund suits.[118] As the Fourth Circuit has evocatively observed, *Lewis* made offset available as a "shield . . . to ward-off refund suits; [but] did not forge a sword with which the IRS could assess or collect additional taxes."[119]

While the Service has broad discretion to apply payments to prior time-barred tax years, that privilege does not extend to taxpayers.[120] Courts have denied 'reverse-*Lewis*' claims, where a taxpayer attempts to offset a time-barred refund against a valid deficiency assessment for a subsequent year.[121] One of the consequences of failing to file tax returns for a multi-year period is that some of the years might result in refunds, while some result in balance due returns. No matter how far back the balance due extends, the taxpayer remains liable for the balance due, while refunds requested in late-filed returns are barred by the statute of limitations.[122] So, a taxpayer who seeks to become compliant in filing returns after a long period of non-compliance and files ten years at once could find that, even though on balance they owed nothing, the breakdown of the timing of the balance due returns and the refund returns could result in a substantial liability not forgiven by the offsetting or netting of the group of returns.

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117. Dysart v. United States, 169 Ct. Cl. 276, 282 (1965) (describing the doctrine of tax setoff as involving a refund claim and setoff on the same tax year and same taxpayer).

118. *See* Estate of Michael v. Lullo, 173 F.3d 503, 508 (4th Cir. 1999); Hamilton v. United States, 156 F. Supp. 3d 1269, 1273 (D. Colo. 2016).

119. *Estate of Michael*, 173 F.3d at 508 (internal quotations omitted).

120. *See, e.g.*, Estate of Bender v. Comm'r, 827 F.2d 884, 887 (3d Cir. 1987) ("Under [section] 6402(a), the discretionary power to offset . . . rests exclusively with the IRS.").

121. *See, e.g.*, United States v. Koss, 1999 No. CIV-A 99-61, 1999 WL 732973, at *6–7 (Sept. 21, 1999 E.D. Pa.); Acker v. United States, 519 Supp. 171, 181 (N.D. Ohio 1981) ("Acker claims he is not barred by the statute of limitations from having his 1962, 1963 and 1966 tax overpayments credited to his tax deficiencies in 1964, 1965 and 1967 because whenever an overpayment occurs in a given year, it becomes an automatic credit to the tax liability of the subsequent year. There is no merit to this contention.").

122. *See* § 6511.

A limitation on offset occurs when an individual overpays the liability of another taxpayer.[123] In a situation in which an individual, who was a responsible officer of an entity, intends to pay the trust fund portion of the entity's liability and designates the payment but overpays the amount, the Fifth Circuit refused to allow the Service to offset the overpayment against other liabilities of the entity.[124] However, if a taxpayer sends in a payment that overpays the taxpayer's own liability, courts have allowed the Service to offset the excess payment against liabilities not included in the designation.[125] Another limitation can occur when the government attempts to use offset to pay off court-ordered restitution. If the criminal defendant is in compliance with the terms of their restitution order (i.e., is regularly making court-ordered installment payments), offset cannot be used to collect excess restitution.[126]

D. Federal Payment Levy Program

The Federal Payment Levy Program (FPLP) is a unique form of continuing levy that is akin to offset. Its development illustrates the wide discretion that the Service possesses to collect revenue and to structure offset programs so as not to disproportionately burden low-income taxpayers. Under the program, certain disbursed federal payments are subject to an ongoing levy of up to 15% until full payment of

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123. Laird v. United States, 790 F. App'x 606, 614 (5th Cir. 2019); *see also* Keith Fogg, *Whose Offset Does the IRS Hold*, Procedurally Taxing (Nov. 26, 2019), https://procedurallytaxing.com/offset-whose-funds-does-the-irs-hold/ [https://perma.cc/XBX4-HBHP]; Rev. Proc. 2002–26, 2002–1 C.B. 746 (establishing the voluntary payment rule).

124. *Laird*, 790 F. App'x at 614.

125. *See* United States v. Ryan, 64 F.3d 1516, 1523 (11th Cir. 1995) (permitting offset and finding that "the IRS has not extended its voluntary payment rule to overpayments"); Bryant v. Comm'r, T.C. Memo. 2009-78, 2009 WL 981715, at *4 (2009) ("[S]ection 6402(a) and the regulations promulgated thereunder demonstrate that a taxpayer's right to designate the application of his voluntary payment does not extend to an overpayment reported on a return."), *aff'd*, No. 09-1957, 2010 WL 4251118 (6th Cir. Oct. 12, 2010).

126. *See, e.g.*, United States v. Taylor, No. 06-658-03, 2021 WL 3051901, at *7 (E.D. Pa. July 20, 2021) ("Because Taylor has timely made her restitution payments, her restitution debt is not delinquent, and the government cannot use TOP to collect on her debt.").

delinquent tax. The FPLP is essentially another form of offset aimed at federal employees, retirees and other benefit recipients. For such recipients who owe tax to the government, the FPLP automatically kicks in to offset a portion of received payments. The FPLP is derived from section 6331(h), which provides broad authority to continually levy on any disbursed federal payments except (1) means-tested welfare payments; (2) certain payments exempt from levy under section 6334; and (3) annuity or pension payments under the Railroad Retirement Act or Railroad Unemployment Insurance Act.[127] Section 6331(h)(3) also statutorily increases the ongoing levy to a full 100% in the case of payments made to vendors or Medicare providers.[128] Over time, the FPLP has administratively developed to generally filter out taxpayers whose income falls below 250% of the federal poverty level[129]—a criterion that may constitute an "economic hardship" qualifying for a levy release under section 6343(a)(1)(D).[130]

Because of its federal nature, the burdens of the FPLP fall disproportionately on those who rely on the federal government for benefits that are not means tested. Perhaps most prominently, military retirees with tax debts can be exposed to significant financial strains from the FPLP. In May 2017, the Service responded to a recommendation from the Treasury Inspector General[131] and discretionarily expanded the application of the FPLP to military retirement

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127. *See* § 6331(h).

128. *Id.*

129. *See* I.R.M. 5.19.9.3.2.3(1).

130. *See* Nat'l Taxpayer Advoc., *Federal Payment Levy Program: The New IRS Automated Levies on Military Retirement Payments May Be Harming Veterans Experiencing Economic Hardship*, NTA Blog (Aug. 23, 2017), https://www.taxpayeradvocate.irs.gov/news/ntablog-federal-payment-levy-program-the-new-irs-automated-levies-on-military-retirement-payments-may-be-harming-veterans-experiencing-economic-hardship/ [https://perma.cc/MRQ2-AUKY]; *see also* Reg. § 301.6343–1(b)(4) (establishing the economic hardship exception if a taxpayer is "unable to pay his or her reasonable basic living expenses").

131. Michael E. McKenney, Treas. Inspector Gen. for Tax Admin., Most Federal Employee/Retiree Delinquency Initiative Cases Are Resolved With the Collection of Revenue; However, Some Program Improvements Can Be Made, (2015), https://www.treasury.gov/tigta/auditreports/2015reports/201530051fr.html [https://perma.cc/BG82-BWVF] (identifying that military retirees constituted around 30% of all federal employees/

payments.[132] But the expansion of the FPLP initially failed to exclude some military retirees with incomes below 250% of the federal poverty level, many of whom would likely be eligible for an economic hardship release under section 6343(a)(1)(D).[133]

Applying the FPLP to such retirees made little economic or policy sense. For those retirees able to contest the levy under section 6343, the Service would need to expend its scarce resources in responding to—and then likely acquiescing in—a textbook levy release case. And for those retirees unaware of their hardship release opportunity, the 15% levy likely constituted a significant and ongoing financial burden. Even leaving aside the potential for economic hardship, the very application of the FPLP to military retiree payments may implicate significant policy concerns about the value of military service and the purpose of retirement compensation for veterans. In January 2018, the Service acquiesced to Congressional pressure.[134] However, the Service's broad discretion in this area may necessitate further congressional involvement in the form of legislation—perhaps by statutorily exempting federal payments made to taxpayers with income below the 250% filter.[135]

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retirees with delinquent taxes and owed around 44% of all such tax owed in tax year 2014).

132. Interestingly, veteran retiree payments issued to Medal of Honor recipients are excluded from participation in the FPLP—this further demonstrates the policy-oriented, discretionary expansion of the program. *See* Memorandum from Michael Mullin, Acting Dir., to Directors, Field Collection (June 28, 2017), https://www.irs.gov/pub/cmpsrc/IRM%205.11.7%20Federal%20Payment%20Levy%20Program%20NEW.pdf [https://perma.cc/ET7S-K9Y9].

133. *See* Keith Fogg, *Applying the Federal Payment Levy Program to Veterans*, Procedurally Taxing (Sept. 28, 2017), https://proceduralltaxing.com/applying-the-federal-payment-levy-program-to-veterans/ [https://perma.cc/88YA-RVDH]; *see also* Nat'l Taxpayer Advocate, *supra* note 127.

134. *See, e.g.*, Nat'l Taxpayer Advoc., *supra* note 127 ("Serving in the United States Armed Forces requires years of tremendous sacrifice, challenging and dangerous assignments, frequent moves across the country, long separations from family, and fairly meager pay. Whether viewed as the sole means of income or a reward from the U.S government for serving 20 years in the Armed Forces, a service member's retirement pay should not be considered another automatic FPLP funding stream.").

135. *See, e.g.*, Letter from Sen. Elizabeth Warren & Sen. Thom Tillis, to John Koskinen, IRS Comm'r (Oct. 25, 2017), https://www.warren

Without congressional intervention, military retirees and other federal payment recipients are potentially vulnerable to future policy changes.

IV. Policy Decisions Regarding Offset

As discussed above, the Code gives the Service the discretion to forgo offsetting tax refunds against outstanding tax liabilities. A few examples of the exercise of this discretion are discussed above, such as the decision not to offset while the Service considers an innocent spouse request.[136] In some instances discussed below, the Service and Congress have made broader policy decisions regarding the exercise of discretion to refrain from offset. Further opportunities exist for examining the exercise of this discretion.

A. Offset Bypass

Under the right circumstances, the Service will apply administrative procedures to override the general rule required by section 6402(a) to offset the refund of a taxpayer to satisfy an outstanding tax liability.[137] This administrative process, known by the name offset bypass refund (OBR), can provide significant assistance to a taxpayer struggling with a financial hardship. Even though not required to do so by the Code, the Service will step back from taking the refund and allow it to go to the taxpayer despite outstanding tax liabilities.

Sometimes a taxpayer with past-due federal tax obligations faces a severe financial hardship at the time of filing a return claiming a refund. The hardship may be a pending cut-off of electricity, eviction, foreclosure, need for heating oil, or other basic life needs. The taxpayer could use the tax refund to avert these crises, but the tax refund will not come to them because of the outstanding liability. In these

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.senate.gov/files/documents/2017_10_25%20_IRS_Letter_FPLP.PDF [https://perma.cc/U5KF-93MS].

136. *See supra* note 47.

137. *See generally*, U.S. Gov't Accountability Office, GAO-09-517R, Possible Implications of Expanding Refund Offset Provisions (2009); *see also* Keith Fogg, *Requesting an Offset Bypass Refund and Tracing Offsets to Non-IRS Sources*, Procedurally Taxing (Dec. 9, 2015), https://procedurallytaxing.com/requesting-an-offset-bypass-refund-and-tracing-offsets-to-non-irs-sources/ [https://perma.cc/9GWL-JCRN].

circumstances, the Service can override, or "bypass," the offset and send the taxpayer the refund. In order to ensure that the Service overrides the refund offset, the taxpayer must contact the Service and set up the bypass at the time of filing the tax return.[138] Otherwise, failure to receive approval for a "bypass" before the posting date of the original return forecloses the opportunity to bypass the offset.[139] If the tax refund has already been applied to the prior tax obligation, the Service will not reverse the offset unless there was a clerical error.[140]

OBR is governed by the Internal Revenue Manual.[141] The request must occur prior to assessment and must demonstrate the financial hardship the taxpayer faces. The amount of money needed to avert the crisis limits the amount of the OBR. For example, if the taxpayer would receive a $1,000 refund and the taxpayer demonstrates a $600 hardship in order to pay the rent and avoid eviction, the OBR will be $600 and not the entire amount of the refund available. The balance of the refund will go to pay the past-due tax liability under the normal offset rules. Although the Taxpayer Advocate Service (TAS) is usually associated with OBR, the OBR need not go through TAS. If the Service fails to make the properly requested OBR before assessment, the Service can reverse the offset and pay the taxpayer the amount it would have paid based on the taxpayer's demonstrated hardship.

Before contacting TAS about using this procedure, it is important to know if the taxpayer has other outstanding debts subject to the TOP. These other debts prevent the Service from granting the OBR since section 6402 forbids "bypasses" if the taxpayer also has a TOP debt (i.e., federal agency nontax debt, state income tax obligations, unemployment compensation debt or child support).[142] While the statute gives the Service discretion to waive an offset of a tax refund to pay federal taxes, the statute provides no discretion regarding other

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138. *See* Program Manager Technical Advice Memorandum 2013-013 (June 11, 2013).

139. *Id.* ("If a taxpayer contacts the IRS to request an OBR and the 23C date has passed, IRS employees are instructed to tell the taxpayer that the overpayment has been applied to the balance due account and the IRS cannot stop it.").

140. *See* I.R.M. 3.17.79.3.16(5) (Note).

141. I.R.M. 21.4.6.5.11.

142. Section 6402(a) provides for discretionary offset authority for federal tax debts but mandates offset for other debts listed in section 6402(c)–(f). *See* I.R.M. 3.17.79.3.16(2) (Note); I.R.M. 21.4.6.5.5.

liabilities. Using the prior example, except that now the taxpayer owes $2,000 in past-due child support, the Service would be willing to step back to allow the taxpayer to receive $600 in order to avoid eviction; however, in this situation, the taxpayer would not receive a refund, and the funds would go to pay past-due child support.

The OBR process suffers from problems from the perspective of both the Service and taxpayers. For the Service, it requires a labor-intensive effort during the filing season that clogs up the refund/offset pipeline. From the taxpayer's perspective, the process is little known and, for those aware of it, is one that can require a significant amount of documentation.[143] The process has also received criticism as one that the Service does not administer fairly.[144]

A decision by the Service to create a systemic waiver would avoid the administrative difficulties created in trying to quickly make OBR determinations during filing season. It would also create an offset exemption roughly equivalent to the levy exemptions set out in section 6343, equalizing how both tax collection methods account for taxpayer hardship. The ABA Tax Section has recently submitted a comment to the Service suggesting that it use its discretion to (1) systemically waive offset in cases in which the taxpayer's refund results from the Earned Income Tax Credit (EITC) since that type of refund seeks to lift children out of poverty, and/or (2) systemically waive offset for individuals with income less than 250% of the poverty level to reflect the Congressional goals in other settings of providing assistance to those in need.[145]

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143. Treasury Inspector General for Tax Administration, Controls Over Offset Bypass Refunds Processed by the Taxpayer Advocate Service Should Be Improved to Reduce the Risk of Abuse and Allow for More Consistent Treatment of Taxpayers, RN 2020-10-069 (2020) (finding that the Taxpayer Advocate Service processed only 761 total OBRs in 2017 and 2018). Note that this amount does not include OBRs initiated directly through the Service—that statistic is not publicly available.

144. *Id.*

145. *See* ABA Sec. of Tax'n, *Response to Comment Request Concerning Review of Regulatory and Other Relief to Support Economic Recovery* (Jan. 15, 2021), https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/2021/011521comments.pdf [https://perma.cc/G73T-DBYF].

B. Offset During COVID-19 Pandemic

Contrasting the COVID-19 pandemic response of the Service with responses by the Department of Education and other agencies demonstrates the need for a consistent position on offset across federal government agencies. During the early weeks of the pandemic, on March 25, 2020, the U.S. Department of Education announced its decision to suspend collection of student loan liabilities via offset.[146] The Department then went a step further, announcing plans to refund any funds already offset to cover student loan liabilities collected since March 13, 2020.[147] Subsequently, Congress passed the CARES Act, which statutorily directed the Secretary of Education to refrain from collection activity on student loans until September 30, 2020.[148] Despite documented problems with the Department of Education's (DOE's) implementation of its suspension of collection activities,[149] DOE's stated suspension of offset provided needed relief to its delinquent borrowers. The failure of the Service and Treasury to take equivalent equitable action to suspend offset of conventional 2019 and 2020 refunds to prior year tax liabilities left individuals with tax debts more vulnerable during the pandemic. The CARES Act itself even provided a helpful

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146. Danielle Douglas-Gabriel, *Education Department to Halt Collection of Defaulted Student Loans, Refund $1.8 Billion*, Wash. Post (Mar. 24, 2020), https://www.washingtonpost.com/education/2020/03/24/student-loans-collection-coronavirus/ [https://perma.cc/DT38-5GP2].

147. March 13th was the date that President Trump issued a determination of a national emergency under the Stafford Act. *Id.* Interestingly, however, the decision to limit returning offset funds to those seized after March 13 sharply limits the intended equitable policy of the decision. The many taxpayers that filed their returns early in the 2020 tax season and had their refunds offset pre-March 13 are thus penalized, despite being in no less potential need of a return of their refund.

148. CARES Act, Pub. L. No. 116–136, § 3513, 134 Stat. 281, (2020) (mandating that the Secretary of Education suspend all payments and involuntary collection on student loans).

149. Some student loan borrowers continued to experience wage garnishments in violation of the collection stay in the CARES Act. Borrower protection groups filed suit against the Department of Education for violating the applicable section 3513(e) of the CARES Act and then failing to refund seized funds. *See* Barber v. DeVos, No. 1:20-cv-1137 (D.D.C. 2020).

blueprint for the Service[150] and Treasury to follow. Offset of the $1,200 economic impact payments (EIPs) issued by the Service under the Act was nearly entirely forbidden, with the sole exception being the collection of past-due child support payments. Similarly, the Consolidated Appropriations Act of 2021 (CAA) and the American Rescue Plan Act of 2021 enacted similar economic stimulus tax credit,[151] which were exempted from offset on an even broader scale than the CARES Act by extending exemption from offset to past-due child support.[152]

However, the CAA also enacted other changes to offset treatment, including a retroactive change to the CARES Act that removed offset protections from the EIP portion of a conventional refund claimed on a tax return.[153] In other words, the stimulus was exempt if in the form of an advance payment but would be subject to offset if claimed as a refund.

This distinction was crucial for the millions of taxpayers who were eligible for EIPs from the CARES Act but did not receive them, perhaps due to not filing a 2019 tax return, moving to a new address, or

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150. Note that the Treasury did exempt Social Security Administration benefit payments from offset to non-tax debts until September 21, 2020, in response to COVID-19, but that exemption does not appear to extend to offset to tax debts. *See* U.S. Treas. Dep't., Treasury Offset Program Technical Bulletin F-2020-7 (Mar. 26, 2020), https://library.nclc.org/technical-bulletin-number-f2020-7 [https://perma.cc/2LJR-BN4B].

151. American Rescue Plan Act of 2021, Pub L. No. 117-2, § 9601(c) (2021); Consolidated Appropriations Act of 2021, Pub. L. No. 116–136, § 2201(d), 134 Stat. 338 (2020); Jessica Tollestrup, Congressional Research Service, IN11322, The Child Support Federal Tax Offset of CARES Act Economic Impact Payments (2020), https://crsreports.congress.gov/product/pdf/IN/IN11322 [https://perma.cc/HY56-BUDL]; *see also* Lockhart v. Jackson *(In re* Lockhart), Nos. 1:17-bk-00532, 1:20-ap-38, 2021 WL 2593870 (Bankr. N.D.W. Va. June 24, 2021) (permitting offset of CARES Act EIP to past-due child support and rejecting debtor's argument that the EIP was a credit rather than a refund).

152. The provision also largely exempted the EIPs from garnishment by private creditors. H.R.133, 116th Cong., § 272(d)(2)(C) (2020).

153. *Id.* at 274(b); *see also* Leslie Book, *Some Quick Thoughts on a Key Difference Between the Advance Payment of an EIP and Claiming the 6428 and 6428A Credit on a 2020 Tax Return*, Procedurally Taxing (Jan. 22, 2021), https://procedurallytaxing.com/some-quick-thoughts-on-a-key-difference-between-the-advance-payment-of-an-eip-and-claiming-the-6428-and-6428a-credit-on-a-2020-tax-return/ [https://perma.cc/8QG4-299S].

mistakenly discarding an EIP check or prepaid debit card.[154] The category of vulnerable taxpayers notably includes many incarcerated individuals whose eligibility for EIPs was litigated by the government for much of 2020,[155] leading to delays or unreceived payments.[156] The Service regularly assured such taxpayers that they would be eligible to claim the full EIP as a recovery rebate credit on their 2020 tax return.[157] But if any such taxpayers owed past-due federal taxes, an EIP claimed as a refund on their 2020 tax return would be offset to satisfy those debts, as Congress only included offset protections for advance payments. Accordingly, these taxpayers would lose statutory exemption from offset in part because the Service failed in timely getting payments to those who were entitled. The disparate treatment of similarly situated taxpayers, viz. no offset for taxpayers receiving the EIP

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154. U.S. Treas. Dep't, *Fact Sheet: Treasury to Work to Ensure Families Get Access to Economic Impact Payments* (Jan. 22, 2021), https://home.treasury.gov/news/featured-stories/fact-sheet-treasury-to-work-to-ensure-families-get-access-to-economic-impact-payments [https://perma.cc/TUZ7-KVHY].

155. *See infra* note 154[156?]. It is also important to note that, as the Congressional Black Caucus forcefully stated in a letter to former Treasury Secretary Mnuchin, the burdens of the Service's restrictive (and ultimately unlawful) position were felt disproportionately by incarcerated Black individuals and their families. Cong. Black Caucus, *The Congressional Black Caucus Statement on Letter to Secretary Mnuchin on Withheld Stimulus Payments to Incarcerated Individuals* (Oct. 6, 2020), https://cbc.house.gov/news/documentsingle.aspx?DocumentID=2238 [https://perma.cc/R5BL-Z4J2].

156. Incarcerated individuals face an additional hurdle to receiving their EIPs: some state prisons garnished the received EIPs to pay for restitution, fees and other costs of incarceration. While the CARES Act EIPs may be vulnerable to these garnishments, the 2021 Act exempts the second round of EIPs from private party garnishments. However, some state prison systems apparently took the aggressive position that the second EIPs are equivalent to Social Security checks that are already subject to garnishment. *See* Asher Stockler & Daniel Moritz-Rabson, *Prisons Are Skimming Big Chunks of CARES Act Stimulus Checks*, The Intercept (Feb. 17, 2021), https://theintercept.com/2021/02/17/stimulus-checks-cares-prisons-skimming-irs/ [https://perma.cc/DQM2-AJUR].

157. *See, e.g.*, IR-News Rel. 2020–257, https://www.irs.gov/newsroom/nov-21-deadline-nears-to-register-online-for-economic-impact-payment-some-people-can-claim-special-credit-next-tax-filing-season [https://perma.cc/Y3SM-NASA].

directly versus offset of tax refund claimed on a return but based on EIP, appears to have been a drafting oversight rather than a legitimate policy decision. Acknowledging this disparity, the Service eventually announced that it would exercise its discretion to suspend offset of recovery rebate credits claimed on returns.[158]

While this limited relief undoubtedly helped many low-income Americans, Congress's failure to suspend ordinary tax refund offsets and to fully exempt EIPs from offset as part of its various stimulus acts was inconsistent with the broad legislative purpose of providing financial relief directly to families during a pandemic and economic downturn.[159] These legislative omissions, however, do not allow Treasury to simply blame Congress for its failure to legislatively mandate an offset suspension. As demonstrated by its policy on recovery rebate credit offset, the Service retains broad discretion to administratively suspend offset against prior year taxes, as section 6402 states that the Secretary of the Treasury "*may* credit the amount of overpayment . . . against any liability."[160]

If the Treasury had chosen to exercise its discretion to broadly suspend offset to prior year taxes during the pandemic, this action—coupled with the Department of Education's suspension of student loan offsets—would have allowed many taxpayers to receive refunds who otherwise would not have. Suspending offset of one type of obligation owed to the government (student loans) while allowing offset of another

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158. Nat'l Taxpayer Advoc., *NTA Blog: Update on Offset of Recovery Rebate Credits: The IRS Has Agreed to Exercise Its Discretion to Stop Offsets of Federal Tax Debts* (Mar. 15, 2021), https://www.taxpayeradvocate.irs.gov/news/nta-blog-update-on-offset-of-recovery-rebate-credits-the-irs-has-agreed-to-exercise-its-discretion-to-stop-offsets-of-federal-tax-debts/ [https://perma.cc/59VF-4HNQ].

159. *See, e.g.*, Cong. Rec. H1820 (2020) (statement of Rep. Richard Neal, chairman of H. Ways & Means Comm.) ("[T]he direct infusion of $1,200 in cash for American adults whom we fought for will help families through these challenging times."); *see also* Singletary, *supra* note 3 ("Under normal circumstances, it makes sense to offset a refund to reduce the debts people owe. But these are not normal times.").

160. § 6402(a). This discretion is demonstrated by the existence of the OBR program, where taxpayers with demonstrated hardship can request relief from offset. In contrast, Treasury does not have the authority to suspend offset for payment of debts owed other federal agencies, as section 6402(d)(1) places a mandatory duty on the Treasury.

(federal taxes) appears arbitrary and undercuts any attempt at a universal federal government policy. While taxes are nominally distinct from student loans in that their purpose is to raise revenue (not to repay already distributed funds), that purpose is notably absent in an economic crisis, where the government is prepared to run substantial budget deficits in order to get stimulus funds to taxpayers. Allowing full tax refunds to be issued to taxpayers is thus functionally no different than mailing out stimulus checks; both have the effect of getting needed funds in the hands of taxpayers, and both incur fiscal costs. By not recognizing this and taking corrective action, the federal government failed to construct a unified policy response to COVID-19's economic challenges; instead, it distributed funds to Americans with one hand and clawed them back with the other. The offset problems of the pandemic provide a lesson for the Treasury and Service about the importance of working with other offsetting federal agencies to coordinate a more uniform and effective offset policy.

C. Offset of Refunds Generated by EITC

From a policy perspective, Earned Income Tax Credit (EITC) payments should also be protected from offset because of their unique function as financial assistance to low-income taxpayers. In addition, on a macroeconomic level, allowing these types of refunds to end up in the hands of taxpayers would serve to stimulate the economy and allow for more efficient repayment of consumer debt.

The EITC dates back to 1975 and remains one of the primary federal government anti-poverty programs.[161] As a refundable credit, the EITC essentially operates as a negative income tax, providing an extra subsidy for qualifying[162] low-income taxpayers even if they owe no tax.[163] Accordingly, as many commentators have observed, the EITC is more properly characterized as a distributive social welfare program

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161. Margot L. Crandall-Hollick, Congressional Research Service R44825 The Earned Income Tax Credit (EITC): A Brief Legislative History 1 (2018).

162. Qualifying taxpayers must have earned income not in excess of certain limits, which are increased for taxpayers who claim a qualifying child as a dependent. § 32.

163. Drumbl, *supra* note 47.

than a simple tax benefit.[164] Yet the apparent distributive intent behind the EITC conflicts with the administrative practice of offset—and indeed with much of IRS enforcement and collection activity from EITC refunds.[165] If the EITC is intended as financial assistance for low income taxpayers, then offset of an EITC refund often misallocates funds away from where they are most needed.

A policy change to protect EITC payments from offset could occur administratively in certain situations if the Service decided to exercise its discretion in a blanket manner.[166] Absent a change in Service policy regarding broad authority to exercise discretion, a blanket waiver of the right to offset will likely require Congressional intervention.

If the Service decided to waive offset for refunds generated by the EITC, Congressional action would be necessary to avoid offset of the EITC under TOP because of the mandatory nature of the language of section 6402(c). In 1986, the Supreme Court held that the EITC is subject to mandatory offset to past-due child support under section 6402(c).[167] In *Sorenson v. Secretary of Treasury*, the Court examined the case of a husband and wife whose joint refund was offset to

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164. *See* Lawrence Zelenak, Symposium: *Rethinking Redistribution: Tax Policy in an Era of Rising Inequality: Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. Rev. 1867 (2005); Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 Harv. L. Rev. 533 (1995).

165. *See* Leslie Book, *The IRS's EITC Compliance Regime, Taxpayers Caught in the Net*, 81 Or. L. Rev. 351, 352 (2002) ("[I]n administering the EITC, the IRS's practices and procedures do not reflect the special circumstances that attend taxpayers who are entitled to the EITC."); *see also* Dorothy Brown, *Race & Class Matters*, 107 Colum. L. Rev. 790, 793–94 (2007) (pointing to race-based perception of welfare recipients as undeserving as an explanation for the EITC's inefficiencies and complexities).

166. In response to a request from the Service to make suggestions for COVID-19 relief, the ABA Tax Section recommended that the Service exercise its discretion to waive offset globally for certain low-income taxpayers and taxpayers with a pending OIC. *See* ABA Sec. of Tax'n, *Response to Comment Request Concerning Review of Regulatory and Other Relief to Support Economic Recovery* (Jan. 15, 2021), https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/2021/011521comments.pdf [https://perma.cc/5BB9-TVQY].

167. Sorenson v. Sec'y of Treas., 475 U.S. 851 (1986).

pay past-due child support to the husband's previous spouse. After an administrative protest, the wife was able to retain her half of the refund because her home state of Washington was a community property state.[168] The wife then challenged the offset of her husband's portion, arguing that the offset of the EITC was contrary to statutory text and Congressional purpose.[169] The Court granted *certiorari* to resolve a circuit split, as both the Second and Tenth Circuits had determined that the EITC was exempted from offset, while the Ninth had dismissed Mrs. Sorenson's appeal.[170]

As a matter of statutory interpretation, the Court—in an opinion by Justice Blackmun—readily dismissed this initial argument, finding excess EITC constituted an 'overpayment' subject not only to 6402(a)'s refund provision but also to 6402(c)'s offset provision.[171] More relevantly here, the Court rejected Mrs. Sorenson's Congressional purpose argument.[172] In the Court's view, "it defie[d] belief that Congress was unaware" that the 6402 offset of "any overpayment" would sweep

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168. In a non-community property state, the non-liable spouse could preserve their portion of the refund using the injured spouse provisions discussed above. The formula for the injured spouse amount might yield a higher or lower amount of refund that would escape offset depending on the earnings and tax payments of the spouse not liable for child support.

169. *Sorenson*, 475 U.S. at 855.

170. Rucker v. Sec'y of Treas. of U.S., 751 F.2d 351, 357 (10th Cir. 1984) ("In the absence of evidence that Congress intended such a substantial cutback on the earned income credit program, we interpret the intercept legislation before us so as to avoid . . . a result clearly at odds with the goals of the earned income credit program."); Nelson v. Regan, 731 F.2d 105, 112 (2d Cir. 1984) (determining that exemption of the EITC was consistent with congressional purpose and reasoning that despite reading inconsistency into the use of 'overpayment,' "[l]ogic and symmetry have never been the hallmarks of the Internal Revenue Code and Social Security Act").

171. *Sorenson*, 475 U.S. at 859; *compare* § 6402(a) ("In the case of *any overpayment*, the Secretary . . . may credit the amount of such overpayment . . . against any liability . . . on the part of the person who made the overpayment and shall, subject to subsections (c), (d), (e), and (f), *refund any balance to such person*.") *with* § 6402(c) ("The amount of *any overpayment to be refunded* to the person making the overpayment shall be reduced by the amount of any past-due support owed by that person. . . .") (internal parenthetical omitted) (emphasis added).

172. *Sorenson*, 475 U.S. at 865.

up EITC payments.[173] And because "[t]he ordering of competing social policies is a quintessentially legislative function," the Court left to Congress to determine whether the government interest in collecting past-due child support was outweighed by its interest in getting EITC payments to recipients.[174] While the Court's holding was focused on the 6402(c) past-due child support offset, its rationale would apply to bar a challenge to EITC offset toward unpaid tax and other federal agency debts.[175]

Despite the Court's strict interpretation of the Code, the policy rationales for exempting the EITC from offset remain highly persuasive. A low-income taxpayer who owes a prior year tax debt (or any other 'offsetable' agency debt) is likely juggling other competing private lender liabilities that are far more pressing. Instead of the EITC going directly to such a taxpayer in order to help them pay for urgent day-to-day expenses, the credit is often reduced simply to numbers moving between columns on a government ledger.[176] This makes little policy sense and appears to be an unfortunate and inequitable byproduct of using the tax system as a benefit distribution mechanism.

Nor does it make macroeconomic sense, from the federal government's perspective, to prioritize offset collection of relatively small EITC refunds over ensuring low-income taxpayers receive funds to help cover expenses and pay off consumer debts.[177] Even in the

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173. *Id.* at 863 (emphasis omitted).

174. *Id.* at 865.

175. *See, e.g.*, Bosarge v. U.S. Dep't of Educ., 5 F.3d 1414, 1420 (11th Cir. 1993) (finding that *Sorenson* applied with "equal weight" to offset of EITC to a federal student loan).

176. The primary exception to the internal intra-agency nature of offset is payments offset to a state government for past-due child support. Such payments may well be justifiable on policy grounds, even during times of economic recession, as they are ultimately received by individuals rather than absorbed by federal government deficits. *See* Drumbl, *supra* note 47, at 198. But as discussed *supra*, such offsets may still cause significant hardship, particularly when an unsuspecting individual later files a joint return with a spouse who owes past-due child support. Such individuals are subject to significant administrative burdens and uncertainty in seeking to reclaim a portion of the joint refund via an injured spouse election. Those burdens should still be alleviated or rectified by IRS administrative action or legislation.

177. "For processing year 2015 1,308,146 (4.8%) refunds associated with returns claiming EITC were offset against other IRS tax liabilities."

aggregate, offset collections of EITC refunds are a tiny drop in the ocean of federal government debt.[178] Yet despite its smaller amounts, the EITC is still an important source of financial benefit for low-income taxpayers. Moreover, small dollar EITC refunds can still act as targeted economic stimulus; low-income taxpayers are far more likely to quickly spend their refunds on consumer goods and at small businesses, injecting money into the economy at the ground level.[179] During periods of economic recession, providing an EITC refund without offset would seem even more imperative, as the federal government generally seeks to increase spending and runs higher deficits to stimulate consumer spending.

The EITC also stands largely alone as a welfare type benefit subject to offset. Under 31 U.S.C. section 3716(c)(3)(B), the Treasury must exempt welfare payments from offset when so requested by the head of the distributing agency.[180] As a result, many forms of government welfare assistance are exempted from offset under this provision, including food stamps, certain low income housing benefits and

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Taxpayer Advoc. Serv., 2016 Annual Report to Congress (Vol. 1) 353, n.141 (2016). (This figure does not include offsets against nontax debts. Thus, the number of EITC-related refunds affected by offsets is higher than stated here).

178. *See* Drumbl, *supra* note 47, at 176 (citing *id*., at 353, n. 141 (2016)); *cf.* Congressional Budget Office, The Budget and Economic Outlook: 2021 to 2031 (Feb. 11, 2021), https://www.cbo.gov/publication/56970 [https://perma.cc/E573-4FHJ] (projecting the federal budget deficit to total $2.3 trillion and the federal debt to top 102% of GDP in 2021).

179. *See* Andrew Goodman-Bacon & Leslie McGranahan, *How Do EITC Recipients Spend Their Refunds?*, Fed. Reserve Bank of Chi. (2008), https://www.chicagofed.org/~/media/publications/economic-perspectives/2008/ep-2qtr2008-part2-goodman-etal-pdf.pdf [https://perma.cc/NNE4-YM9Y] (finding *inter alia* that EITC recipients spend more on automobiles and transportation than non-EITC recipients during tax refund season); *see also* William Adams et al., *Liquidity Constraints and Imperfect Information in Subprime Lending*, 99 Am. Econ. Rev. 49, (2009) (finding that overall demand among consumers with low income and poor credit is around 50% higher during tax refund season).

180. Drumbl, *supra* note 47, at 176. (See extensive discussion in Chapter 7 comparing the treatment of offset provisions impacting most benefit programs with the EITC.)

September 11th Victims' Fund payments.[181] The use of the section 3716(c)(3)(B) exemption appears to be a recognition of the irrationality of applying offset to other forms of welfare payments.[182] Bankruptcy courts also sometimes recognize the special nature of the EITC and additional child tax credits (ACTC) as the types of benefits that satisfy its exemption provisions.[183] This recognition of the special nature of the EITC and ACTC in bankruptcy has not translated into recognition outside of bankruptcy for the EITC (or the ACTC).

To the extent Congress allows offset of a welfare-type payment similar to the EITC or the ACTC, the use of offset of an EITC payment could perhaps be limited only to satisfying an outstanding liability based on the overpayment of the EITC in a prior year. Such a limitation would follow the practice of collecting Social Security overpayments by reducing benefits in subsequent years or recouping overpaid

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181. *See* Bureau of the Fiscal Serv., *Treasury Offset Program: Payments Exempt from Offset by Disbursing Officials*, https://www.fiscal.treasury.gov/files/dms/dmexmpt.pdf [https://perma.cc/64WR-LY5R].

182. In passing the Debt Collection Improvement Act of 1996, which enacted section 3716(c)(3)(B), Congress intended for the federal government to take special care in collecting from means-tested payments. *See* H.R. Rep. No. 104-537, at 565 (1996) ("[T]he conferees recognize that those who receive federal benefits, particularly Social Security benefits, may be dependent upon them for a substantial part of their income. In order to avoid unreasonable hardship, the conferees insist that any federal debt collection effort give full consideration to the financial situation of the individual who may repay the debt.").

183. *See, e.g.*, Marshall v. Blake, 885 F.3d 1065 (7th Cir. 2018) (concluding that the EITC should be prorated in calculating monthly disposable income in a chapter 13 bankruptcy); for further discussion, see Keith Fogg, *Proper Treatment of Earned Income Tax Credit in Calculating Disposable Income*, Procedurally Taxing (Oct. 12, 2018), https://procedurallytaxing.com/proper-treatment-of-earned-income-tax-credit-in-calculating-disposable-income/ [https://perma.cc/5ZEA-S7B8]); *see also* Hardy v. Fink, 787 F.3d 1189, 1193 (8th Cir. 2016) (allowing exemption of ACTC based on analysis of state public benefit statute and purpose of statute); *In re* James, 406 F.3d 1340, 1346 (11th Cir. 2005) (exempting EITC refund as public assistance under state law). *Cf.* Matter of Diaz, 972 F.3d 713 (5th Cir. 2020) (allowing debtor in Chapter 13 to retain refund based on EITC). For additional discussion, see Marilyn Ames, *Tax Refunds and the Disposable Income Test*, Procedurally Taxing (Sept. 8, 2020), https://procedurallytaxing.com/tax-refunds-and-the-disposable-income-test/ [https://perma.cc/F63Z-THBT]).

Supplemental Nutritional Assistance Program (SNAP) benefits via a monthly SNAP reduction.[184] This change would introduce much-needed "logic and symmetry"[185] into the provision of the EITC while still protecting the government from potential loss of revenue from EITC overpayments.

While the EITC has too often failed those it was created to benefit,[186] exempting the credit from offset would be a simple and equitable move towards a more effective EITC. Exemption of the EITC from offset could be easily accomplished via congressional action or partially through Treasury administrative action. As discussed above,[187] as part of the CARES Act, Congress exempted both EIP and discretionary payments made to state and local governments and air carriers from offset.[188] Those exemptions, as well as the other similar institutionalized exemptions mentioned above, are blueprints for a legislative EITC exemption. If Congress is unable or unwilling to act, Treasury still possesses sufficient delegated authority to discretionarily suspend some offsets of EITC payments, at least when applied to prior year tax liabilities.[189] However, Treasury would lack authority to suspend EITC

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184. *See, e.g.*, 20 C.F.R. § 416.571 (Social Security overpayments); 7 C.F.R. § 273.18(g)(1) (SNAP overpayments); *see also* Drumbl, *supra* note 47, at 192–96.

185. Rucker v. Sec'y of Treas. of U.S., 751 F.2d 351, 357 (10th Cir. 1984).

186. This is especially important in light of the many practical barriers that already discourage taxpayers from taking advantage of the EITC. In its current form, the EITC is already overly complicated and confusing to many Americans, with about 20% of eligible taxpayers failing to claim the credit. *See* IRS, *EITC Participation Rates by States*, https://www.eitc.irs.gov/eitc-central/participation-rate/eitc-participation-rate-by-states [https://perma.cc/RP6F-GBQU]. Many taxpayers seeking the credit must rely upon paid tax preparer services, which often charge high fees that reduce any eventual refund. And once taxpayers file their returns claiming the credit, they still face disproportionately high audit rates by the Service. *See also* Paul Kiel, *It's Getting Worse: The IRS Now Audits Poor Americans at About the Same Rate as the Top 1%*, ProPublica (May 30, 2019), https://www.propublica.org/article/irs-now-audits-poor-americans-at-about-the-same-rate-as-the-top-1-percent [https://perma.cc/MRS4-9WCZ].

187. *See supra* note 146

188. CARES Act, Pub. L. No. 116–136, § 2201(d), 134 Stat. 338 (2020).

189. *See* § 6402(a).

offset to past-due child support, other federal agency debts, state income taxes and erroneously paid state unemployment compensation. While administrative action can solve many problems with the current EITC system, a fundamental and universal solution to the problem would require Congressional action.[190]

V. Conclusion

Academic literature tends to overlook offset, focusing on other collection tools available to the Service. Because of its importance to the Service's ability to collect and because of the policy implications embedded in so many aspects of the decision to offset, Congress needs to pay more attention to offset in order to craft policies consistent with the levy procedures and with other federal programs. The use of offset to collect payments, such as the EITC or stimulus payments, that the Service distributes as part of its function as a provider of benefits deserves much more attention. These payments should not serve to repay general tax obligations of the taxpayer. When the Service sends a refund based on the EITC, the payment does not represent a repayment of a tax overpayment but rather a benefit payment. This type of payment should no more result in offset to satisfy past-due taxes than does the payment for food stamps or housing vouchers. As we craft a policy for offset of tax refunds, the source of the refund should play a significant role in determining the scope of its use for offset.

190. *See* § 6402(c)–(f).