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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA
SACRAMENTO DIVISION

In re:)
)
) Case No. 05-40939-B-13J
KENT/SHANNA HANDELSMAN,)
) Docket Control No. WW-4
)
Debtors.) Date: October 3, 2006
)
) Time: 9:30 a.m.

On or after the calendar set forth above, the court issued the following ruling. The official record of the ruling is appended to the minutes of the hearing.

Because the ruling constitutes a "reasoned explanation" of the court's decision under the E-Government Act of 2002 (the "Act"), a copy of the ruling is hereby posted on the court's Internet site, www.caeb.uscourts.gov, in a text-searchable format, as required by the Act. However, this posting does not constitute the official record, which is always the ruling appended to the minutes of the hearing.

DISPOSITION AFTER ORAL ARGUMENT

This matter continued from September 19, 2006 to allow debtors to advise the court regarding the status of the en banc appeal Zayler v. United States (In re Supreme Beef Processors, Inc.), No. 03-41345 (5th Cir. Sept. 30, 2003). This matter came on for hearing on October 3, 2006, at 9:30 a.m. Appearances are noted on the record. The following constitutes the court's findings of fact and conclusions of law, pursuant to Federal Rule of Bankruptcy Procedure 7052.

The motion is denied.

Debtors ask the court to authorize and approve a setoff of

1 debtors' short-term capital loss (the "STCL") from the 2001 tax year
2 (\$413,507.00 as of December 31, 2005) against their income in the
3 preceding tax year, the year 2000. The Internal Revenue Service ("the
4 Service") has filed Claim No. 3 in this case, which represents taxes,
5 interest and penalties for a single tax year, the year 2000, in the
6 amount of \$266,310.88. Debtors assert that, if the requested setoff
7 is authorized, their liability to the Service for taxes and interest
8 for tax year 2000 will be reduced from \$181,490.89 to \$42,794.06.

9 The Internal Revenue Code ("IRC") does not allow use of a
10 taxpayer's STCL in the manner proposed by debtors. Under the IRC, for
11 the purposes of reducing tax burden, a taxpayer's STCL may be netted
12 against capital gains and up to \$3,000 of ordinary income, received by
13 the taxpayer in subsequent tax years, i.e., years subsequent to the
14 year in which the STCL was incurred. See 26 U.S.C. §§ 1211(b),
15 1212(b)(1), Treas Reg. § 1.1212-1(b)(1). No provision of the IRC or
16 other substantive law allows an STCL to be netted against taxable
17 income from a year prior to the year in which the STCL was incurred.
18 The IRC does allow the United States to setoff a taxpayer's
19 overpayment of taxes against the taxpayer's unpaid tax debts. 26
20 U.S.C. § 6402. However, no such overpayment exists here, as debtors
21 have only the STCL from tax year 2001.

22 Debtors base their request primarily on 11 U.S.C. § 106(c), which
23 provides: "Notwithstanding any assertion of sovereign immunity by a
24 governmental unit, there shall be offset against a claim or interest
25 of a governmental unit any claim against such governmental unit that
26 is property of the estate."

27 Debtors argue that Section 106(c) provides for a right of setoff
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1 in itself that "allows setoffs beyond the limited areas found in
2 various other statutes and codes." (Debtors' Mot. at 10). Debtors'
3 interpretation of Section 106(c) fails to take into account the
4 explicit statement in Section 106(a)(5) that Section 106 creates no
5 claim or cause of action. See 11. U.S.C. § 106(a)(5) ("Nothing in
6 this section shall create any substantive claim for relief or cause of
7 action not otherwise existing under this title, the Federal Rule of
8 Bankruptcy Procedure, or nonbankruptcy law."). Even though Section
9 106(c) abrogates sovereign immunity for counterclaims against the
10 United States, those counterclaims must have an independent legal
11 basis. See Zayler v. United States, 279 F. Supp. 2d 805, 814-15 (E.D.
12 Tex. 2003). Debtors have provided no such independent legal basis for
13 their proposed setoff, and the court is aware of none.

14 The United States Supreme Court, in a case not involving Section
15 106(c), has stated that the right to setoff is only preserved, not
16 created, by the Bankruptcy Code. Any right of setoff must therefore
17 be derived from applicable nonbankruptcy law. See, e.g., Citizen's
18 Bank of Maryland v. Strumpf, 516 U.S. 16, 18-19 (1995) ("Although no
19 federal right of setoff is created by the Bankruptcy Code, 11 U.S.C. §
20 553(a) provides that, with certain exceptions, whatever right of
21 setoff otherwise exists is preserved in bankruptcy."). Interpreting
22 Section 106(c) to create an independent right of setoff would give
23 debtors in bankruptcy, simply by virtue of the fact that they filed a
24 bankruptcy case, a right of setoff far more expansive than any setoff
25 rights available to non-debtor taxpayers who incur short-term capital
26 losses. Interpreting Section 106(c) to create such new and expansive
27 rights would constitute a significant departure from the Bankruptcy
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1 Code's general approach to setoff, as stated in Strumpf, where no
2 intent to effect such a departure has been clearly expressed by
3 Congress. As a matter of statutory construction, "[w]here . . .
4 Congress adopts a new law incorporating sections of prior law,
5 Congress normally can be presumed to have had knowledge of the
6 interpretation given to the incorporated law, at least insofar as it
7 affects the new statute." Lorillard v. Pons, 434 U.S. 575, 581
8 (1978). Further, "no changes in law or policy are to be presumed from
9 changes of language in the revision unless an intent to make such
10 changes is clearly expressed." Fourco Glass Co. v. Transmirra
11 Products Corp., 353 U.S. 222, 227 (1957). There is no such clearly
12 expressed intent in Section 106(c).

13 Given the arguable ambiguity created by the language of Sections
14 106(a)(5) and 106(c), the court also looks to the legislative history
15 of the section. See Toibb v. Radloff, 501 U.S. 157, 162 (1991). The
16 language of Section 106(c) was originally enacted in 1978 and codified
17 as 11 U.S.C. § 106(b). The language of Section 106(a)(5) was not
18 enacted in 1978. The legislative history to the original Section 106
19 includes the following statement: "Section 106 provides for a limited
20 waiver of sovereign immunity in bankruptcy cases. Though Congress has
21 the power to waive sovereign immunity for the Federal government
22 completely in bankruptcy cases, the policy followed here is designed
23 to achieve approximately the same result that would prevail outside of
24 bankruptcy." H.R. Rep. No. 595, 95th Cong., 1st Sess. 317 (1977); S.
25 Rep. No. 989, 95th Cong., 2^d Sess. 27 (1978) (emphasis added). Section
26 106(a)(5) was added, and the original Section 106(b) became Section
27 106(c), in the Bankruptcy Reform Act of 1994. The 1994 amendments to
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1 Section 106 were intended, inter alia, to clarify Congress's intent to
2 abrogate sovereign immunity of governmental units with respect to
3 money judgments, declaratory relief and injunctive relief. 2 Lawrence
4 P. King, et. al., Collier on Bankruptcy ¶ 106.LH[4] (15th ed.
5 rev.2006). The Section-By-Section Description states that the 1994
6 amendments to Section 106 were designed to overrule two Unites States
7 Supreme Court cases that held that former Section 106(c) did not
8 abrogate sovereign immunity of the states or the federal government
9 with respect to suits for monetary relief. Id. The Section-By-
10 Section Description also refers to the Congressional Record: "Nothing
11 in this section is intended to create substantive claims for relief or
12 causes of action not otherwise existing under title 11, the Bankruptcy
13 Rules, or nonbankruptcy law." 140 Cong. Rec. H10,766 (daily ed. Oct.
14 4, 1994). The legislative history therefore does not support debtors'
15 argument that Section 106(c) creates the expansive independent right
16 of setoff that debtors ask the court to authorize and approve.

17 Furthermore, the court does not find persuasive the sources of
18 authority debtors cite in support of their interpretation of Section
19 106(c). Debtors' citation to 5 Lawrence P. King, et. al., Collier on
20 Bankruptcy ¶ 553.03 (15th ed. rev.2006) available at
21 <http://www.lexis.com> is not helpful. Collier states that "setoff
22 under section 106(c) is mandatory and the section itself creates a
23 right of setoff," but that conclusion is unsupported by any authority
24 or critical reasoning, and it is inconsistent with the legislative
25 history cited herein.

26 Debtors' citation to the Fifth Circuit Court of Appeal's decision
27 in Zayler v. United States (In re Supreme Beef Processors, Inc.), 391
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1 F.3d 629 (2004) is also unpersuasive. The Fifth Circuit held that
2 Section 106(c) creates an independent basis for setoff because reading
3 Section 106(a)(5) to prohibit setoffs without an independent legal
4 basis would render the plain language of Section 106(c) meaningless.
5 Id. at 635. To interpret Section 106(c) as the Fifth Circuit did in
6 Supreme Beef similarly renders Section 106(a)(5) meaningless, and that
7 interpretation is inconsistent with the legislative history cited
8 herein. The court also notes that Supreme Beef was recently re-heard
9 en banc by the Fifth Circuit. As a result, the continuing vitality of
10 the current published opinion as authority on this point is
11 questionable. Therefore, the court does not find Supreme Beef
12 persuasive, and, as it is not binding authority in this circuit,
13 declines to follow it.

14 The court notes that reading Section 106(c) not to create an
15 independent basis for setoff allows both Section 106(a)(5) and Section
16 106(c) to co-exist harmoniously. Section 106(c) abrogates sovereign
17 immunity with respect to setoff rights that otherwise exist, and
18 Section 106(a)(5) reaffirms the general approach of the Bankruptcy
19 Code regarding setoff - that no new or independent right of setoff is
20 created by any provision of Section 106.

21 Finally, the court is not persuaded by debtors' argument that the
22 right of setoff they ask the court to authorize and approve is
23 preserved under 11 U.S.C. Section 553. As noted herein, Section 553
24 creates no right of setoff and only preserves a right of setoff that
25 otherwise exists outside of bankruptcy. See Strumpf, 516 U.S. at 18-
26 19. Debtors' requested setoff is not authorized by the IRC or any
27 other law. Therefore, it cannot be preserved by Section 553. If it
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1 is to exist at all, it must be created by debtors' interpretation of
2 Section 106(c), an interpretation the court does not adopt.

3 The court will issue a minute order.

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