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Bankruptcy, Taxes, and the Primacy of IRS Refund Offsets: Copley v. United States

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**BANKRUPTCY, TAXES, AND THE PRIMACY OF IRS REFUND OFFSETS:
*COPLEY v. UNITED STATES***

Michelle Lyon Drumbl*

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I. INTRODUCTION

The Bankruptcy Code and the Internal Revenue Code (I.R.C.) are statutory labyrinths of federal law. *Copley v. United States* called on the Fourth Circuit to resolve a question that arose when respective provisions of each collided.¹ At the heart of *Copley* was a married couple seeking a fresh

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1. *Copley v. United States (Copley III)*, 959 F.3d 118, 120 (4th Cir. 2020).

start with an expected \$3,208 income tax refund.² The Copleys wished to resolve their outstanding debts in bankruptcy and maximize the relief afforded to them under the Virginia homestead exemption provision,³ as permitted by the Bankruptcy Code.⁴ On the other side of the proverbial table was the Internal Revenue Service (IRS) armed with I.R.C. § 6402(a), which gives the agency discretion to offset a taxpayer's refund against outstanding federal tax debt.⁵

Whose interest should prevail, and consequently, who is entitled to the refund? *Copley* answered this question, resolving muddled statutory interpretations that have produced mixed results in bankruptcy courts both inside and outside of the Fourth Circuit.⁶ In particular, *Copley* established precedent favoring the IRS's offset authority over the debtor's right to exemption. This Article unpacks the issues at stake for bankruptcy debtors by explaining the IRS's refund offset authority and outlining the bankruptcy case law split. Additionally, it assesses the lower court decisions in *Copley* before describing the broader significance of the Fourth Circuit's decision.

Part II provides the factual background behind *Copley*, allowing one to understand the magnitude of the conflicting laws at play. Part III outlines these laws: namely, a debtor's exemption rights under § 522 of the Bankruptcy Code and the government's preserved authority to offset a tax refund under § 553 of the same. Part IV summarizes select cases and analyses on both sides of the conflict. Part V discusses *Copley*, first describing the bankruptcy court's ruling and the district court's opinion affirming that ruling and then summarizing the Fourth Circuit opinion and its significance moving forward. Part VI concludes by reemphasizing *Copley*'s importance and reiterating the powerful nature of the IRS's refund offset authority under § 6402.

II. FACTUAL BACKGROUND: THE COPLEYS AND THEIR TAX REFUND

On May 29, 2014, Matthew and Jolinda Copley filed a Chapter 7 bankruptcy petition.⁷ Generally, Chapter 7 bankruptcy allows debtors the opportunity to obtain a discharge of outstanding unsecured debts in exchange

2. See *Copley v. United States (In re Copley) (Copley I)*, 547 B.R. 176, 177–78, 185 n.21 (Bankr. E.D. Va. 2016), *vacated and remanded by Copley III*, 959 F.3d 118.

3. VA. CODE ANN. § 34-4 (West, Westlaw through 2021 Reg. Sess.).

4. 11 U.S.C. § 522(b)(3)(A), (c) (providing that property exempted under applicable state law is not liable for prepetition debts).

5. I.R.C. § 6402(a) (granting the IRS discretionary authority to credit any overpayment of tax against an outstanding federal tax liability).

6. See *Copley I*, 547 B.R. at 180, 183–84.

7. *Id.* at 177.

for liquidating their nonexempt assets, if any.⁸ Thus, the question of which assets are “exempt” for purposes of bankruptcy is a meaningful one. The Copleys had few assets: a mere \$8,200 in household goods and \$150 in clothing.⁹ Apart from their expected tax refund, the Copleys’ only other liquid asset was \$642 in their bank accounts.¹⁰

The Copleys listed the IRS as a creditor on their bankruptcy schedules; they owed outstanding federal taxes that totaled \$13,547.10 for the 2008, 2009, and 2010 tax years.¹¹ Due to the age of the debt, their tax liabilities for 2008 and 2009 were non-priority, general unsecured claims dischargeable as unsecured debts.¹² Knowing they would be owed a tax refund of \$3,208 from overwithholding the prepetition tax year (2013), the Copleys listed this refund as a homestead exemption on their bankruptcy schedule.¹³ The Copleys filed their 2013 income tax return on June 6, 2014—less than one month after filing their petition.¹⁴

By taking these measures, the Copleys intended to prevent the IRS from applying the \$3,208 refund to their \$13,547.10 past-due debt.¹⁵ The Copleys were presumably counseled that their outstanding tax debts for 2008 and 2009 (totaling \$6,253.67) would be discharged in bankruptcy.¹⁶ Their hope for claiming the \$3,208 refund as a homestead exemption was likely two-fold: (1) they wished to preserve it as an asset for their financial fresh start, and (2) they wanted to avoid it being applied to a debt that would ultimately be discharged in bankruptcy, particularly if part of their tax debt was not dischargeable.¹⁷

8. C. RICHARD MCQUEEN & JACK F. WILLIAMS, *Chapter 7, in TAX ASPECTS OF BANKRUPTCY LAW AND PRACTICE* § 1:6 (3d ed. 2020); see 11 U.S.C. §§ 542(a), 726(a)(2). For more detail about exemptions in bankruptcy and role of state law, see *infra* Section III.A.

9. Brief for the Appellees at *1, *Copley III*, 959 F.3d 118 (No. 18-2347).

10. *Id.*

11. *Copley I*, 547 B.R. at 177.

12. *Id.* at 179 n.6; see 11 U.S.C. § 507(8)(A)(i) (describing the priority treatment for discharge of taxes in bankruptcy).

13. *Copley I*, 547 B.R. at 178. The Virginia exemption statute provides: “Every householder shall be entitled . . . to hold exempt from creditor process arising out of a debt . . . money and debts due the householder not exceeding \$5,000 in value.” VA. CODE ANN. § 34-4 (West, Westlaw through 2021 Reg. Sess.).

14. *Copley I*, 547 B.R. at 178.

15. *Id.*

16. The balances due for tax years 2008 and 2009 and the application of the 2013 refund offset are detailed in the opinion. *Id.*

17. As to the second point, the IRS has the power to apply involuntary payments, including refund offsets, in its best interest. See IRM 5.11.5.5(1) (Dec. 22, 2020). Typically, this means that the IRS applies offsets to the tax year(s) for which the collection statute expiration date will expire first, which generally—but not always—means the oldest debt. By applying the refund to the 2008 and 2009 tax years, which it ultimately did, the IRS recouped money that would have been written off in the bankruptcy. The IRS’s transcripts in the bankruptcy court decision reveal that the IRS applied the refund first to reduce tax year 2008 to a zero balance

The Copleys never received their \$3,208 refund; the IRS exercised its refund offset authority and applied the amount to the balance due for the 2008 and 2009 tax years.¹⁸ In response, the Copleys brought an adversary proceeding in the U.S. Bankruptcy Court for the Eastern District of Virginia, seeking turnover of their tax refund.¹⁹ This complaint set into motion the issue that was ultimately decided by the Fourth Circuit.²⁰

III. THE LAWS IN CONFLICT: A CLOSER LOOK

The Copleys' main focus was getting their \$3,208 refund; the court's focus, by contrast, was statutory interpretation.²¹ This Part explains seemingly conflicting statutory provisions in the Bankruptcy Code, which incorporates Virginia law by reference, and provides a detailed explanation of the I.R.C.'s offset provision.

A. *The Virginia Exemption Provision and Bankruptcy Code Offset Rules*

Given that a Chapter 7 debtor generally must turn over to the trustee any nonexempt assets for liquidation,²² the exemption rules are critical for settling a bankruptcy. This is where state law enters the picture: each state has its own set of bankruptcy exemption laws.²³ The Bankruptcy Code also provides a set of federal exemptions.²⁴ Depending on the debtors' state of residence, they may be able to choose between § 522(d)'s federal exemption rules and their

before applying the rest of the refund to reduce tax year 2009 to a balance of \$3,045.67. *Copley I*, 547 B.R. at 178. The remaining \$3,045.67 was discharged in bankruptcy. *Id.* While the decision does not explicitly say, it implies that the outstanding balance for tax year 2010—\$7,293.43, calculated by subtracting the other two tax years from the total debt—was not dischargeable in the bankruptcy. Although the Copleys were trying to keep the \$3,208, their next best option would have been for the IRS to apply the refund to the nondischargeable debt. Thus, the outcome of the case—the IRS applying the refund offset to dischargeable debt—was the least desirable economic outcome for the Copleys.

18. *Copley I*, 547 B.R. at 178–79.

19. *Id.* at 177.

20. *Copley III*, 959 F.3d 118, 121 (4th Cir. 2020).

21. *See id.* at 123.

22. 11 U.S.C. § 542(a).

23. *See* § 522(b)(3)(A). *See generally* 4 COLLIER ON BANKRUPTCY ¶§ 522.02 (16th ed. 2021) (discussing state exemptions under the Bankruptcy Code).

24. § 522(d); *see also* Richard C. Maxwell & B. Webb King, *Exemptions—Preserving a Debtor's Assets*, VA. LAW., Oct. 2003, at 22, 22 (explaining the opt-out and Virginia's homestead exemption).

state's exemption laws.²⁵ However, most states, including Virginia,²⁶ do not allow debtors to choose; rather, debtors must use state exemption laws and cannot rely on the federal exemption rules provided in § 522(d).²⁷

Virginia's homestead exemption has been called "Virginia's primary statutory exemption."²⁸ When the Copleys filed for bankruptcy, the homestead exemption provided that a Virginia resident could claim an exemption of up to \$5,000 in real property; personal property, including money due to the debtor; or both.²⁹ Bankruptcy Code § 522(c) provides that, with certain exceptions, property that may be claimed as exempt under that section is not liable for prepetition debts.³⁰ Thus, the Copleys invoked § 522(c), coupled with the Virginia homestead exemption provision, to shield their tax refund from offset by the IRS.³¹

Yet because the IRS is a creditor of sorts under I.R.C. § 6402, a tension exists as to whether § 553 preserves the agency's right to offset. Section 553 protects creditor offset rights in bankruptcy by providing a general rule that

25. Section 522(b)(1) provides: "an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection." Section 522(b)(2) cross-references the standard federal exemptions, which are in § 522(d) "unless the State law that is applicable to the debtor under paragraph (3)(A) specifically does not so authorize." This is the so-called "opt-out" clause.

26. Title 34 of the Virginia Code provides: "No individual may exempt from the property of the estate in any bankruptcy proceeding the property specified in subsection (d) of § 522 of the Bankruptcy Reform Act (Public Law 95-598), except as may otherwise be expressly permitted under this title." VA. CODE ANN. § 34-3. (West, Westlaw through 2021 Reg. Sess.).

27. See Lawrence Ponoroff, *Constitutional Limitations on State-Enacted Bankruptcy Exemption Legislation and the Long Overdue Case for Uniformity*, 88 AM. BANKR. L.J. 353, 355-65 (2014) (providing a comprehensive explanation of bankruptcy exemptions, describing the "opt-out" scheme, and identifying "[t]he general awkwardness of the marriage between state and federal law in bankruptcy . . .").

28. Maxwell & King, *supra* note 24, at 24. All states have some form of a homestead exemption that affords debtors a basic level of protection in bankruptcy. Ryan P. Rivera, *State Homestead Exemptions and Their Effect on Federal Bankruptcy Laws*, 39 REAL PROP. PROB. & TR. J. 71, 72 (2004). Virginia's homestead exemption has been described as "exceptionally limited, providing debtors with a meager exemption of five thousand dollars." *Id.* at 73. The exemption was amended and expanded in 2020, though it is still modest compared to most other states. 2020 Va. Acts 328 (codified as VA. CODE ANN. § 34-4). Virginia's homestead exemption now allows up to \$25,000 in value of a principal residence to be claimed. VA. CODE ANN. § 34-4 (West, Westlaw through 2021 Reg. Sess.). Compare *id.*, with COLO. REV. STAT. ANN. § 38-41-201(1)(a)-(b) (West, Westlaw through 2021 1st Reg. Sess. of the 73d Gen. Assemb.), and MINN. STAT. ANN. § 510.02 (West, Westlaw through 2021 Reg. Sess.), and TEX. PROP. CODE ANN. § 41.001(a)(1)-(2) (West, Westlaw through 2019 Reg. Sess. of the 86th Legis.).

29. VA. CODE ANN. § 34-4.

30. 11 U.S.C. § 522(c). The statute provides exceptions, including for a debt secured by a notice of federal tax lien, but none of these exceptions applied in *Copley*. 959 F.3d 118, 124 (4th Cir. 2020).

31. *Copley I*, 547 B.R. 176, 178 (2016), vacated and remanded by *Copley III*, 959 F.3d 118.

Title 11 “does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of [the bankruptcy] against a claim of such creditor against the debtor that arose before the commencement of [the bankruptcy].”³² This section does not create any right of offset: it merely preserves, with certain exceptions, any preexisting rights of offset.³³

The pivotal question thus becomes whether Bankruptcy Code § 553 preserves the right of offset granted to the government by I.R.C. § 6402. Courts throughout the country are split on this question, as Part IV details.

B. Tax Refund Offsets as a Collection Tool Generally

The United States has several ways to recoup money from individuals. I.R.C. § 6402 grants the Secretary of the Treasury authority to offset an “overpayment”³⁴ of tax due to an individual (including interest) against certain other outstanding debts owed by that individual.³⁵ This refund offset statute is a powerful one. Notably, § 6402 grants the Secretary *discretionary* authority to offset the refund against outstanding federal tax debt.³⁶ If there is no outstanding federal tax debt or there is a remaining overpayment once the tax debt is satisfied, the balance of the overpayment is *mandatorily* subject to

32. 11 U.S.C. § 553(a). In some places, the Bankruptcy Code uses the term “setoff” while the I.R.C. uses the term “offset.” For consistency, I use the term offset throughout except when quoting a court. Functionally, these terms mean the same thing: the right of a creditor to offset a debt against a claim. In the I.R.C., the context is specific to a tax refund claim, but the debt can include a tax debt, *see* I.R.C. § 6402(a), as well as certain types of nontax debt, *see* I.R.C. § 6402(c)–(d).

33. *Copley III*, 959 F.3d at 124 (citing *Durham v. SMI Indus. Corp.*, 882 F.2d 881, 883 (4th Cir. 1989)); *see also* *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995).

34. An overpayment is the excess of payments and refundable credits over the tax liability. I.R.C. § 6401(a). In the *Copleys*’ case, the overpayment resulted from too much income tax withheld during the taxable year. *See Copley I*, 547 B.R. at 178.

35. § 6402(a).

36. In particular, I.R.C. § 6402(a) provides that, “[i]n the case of any overpayment, the Secretary . . . may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c), (d), (e), and (f), refund any balance to such person.” *Id.*

The IRS can exercise discretion and issue a tax refund to the taxpayer despite outstanding tax debt but, as a policy, will not do so if there is an outstanding nontax debt subject to offset under the Treasury Offset Program. *IRS Clarifies Procedures for Issuing Offset Bypass Refunds*, 2013 TAX NOTES TODAY 207–12 (Oct. 25, 2013); *see also* IRM 21.4.6.5.5(3) (Sept. 22, 2017). If it did otherwise, it would lose the money to another agency and the taxpayer would have no benefit.

the Treasury Offset Program (TOP).³⁷ TOP, administered by the Bureau of the Fiscal Service, applies the tax overpayment in the following order of priority: (1) past-due child support payments; (2) outstanding debts to other federal agencies, such as federal student loan debt; (3) outstanding state income tax debt; and (4) outstanding unemployment compensation debt owed to a state.³⁸

Every year, millions of individuals are subject to tax refund offsets, with billions of dollars being intercepted annually.³⁹ The refund offset authority is a significant collection tool for the federal government, largely because there are few circumstances in which taxpayers can avoid it: refund offsets occur even in circumstances that typically warrant a collection stay.⁴⁰

Bankruptcy is a special case. As a general matter, the Bankruptcy Code's automatic stay rule prohibits offset of any bankruptcy debtor's prepetition debt.⁴¹ However, in 2005, Congress enacted an exception to this prohibition, allowing the IRS to offset a prepetition income tax refund against a prepetition tax liability.⁴² This exception does not extend to an offset under TOP.⁴³ The distinction between offsetting tax debt and nontax debt is factually significant, though, at times, courts have blurred the distinction and cited TOP offset cases in cases involving tax debt offsets and vice versa.⁴⁴

37. Section 6402(d) provides that the Secretary *shall* credit any remaining overpayment against certain other types of debts. *See also* 31 U.S.C. § 3720A (providing for offset of TOP debts).

38. I.R.C. § 6402(c)–(f); *see also* IRM 21.4.6.4(4) (Apr. 27, 2017) (setting out the tax overpayment order of priority).

39. *See, e.g.*, TREASURY INSPECTOR GEN. FOR TAX ADMIN., DEP'T OF THE TREASURY, REVISING TAX DEBT IDENTIFICATION PROGRAMMING AND CORRECTING PROCEDURAL ERRORS COULD IMPROVE THE TAX REFUND OFFSET PROGRAM 2 (2016), <https://www.treasury.gov/tigta/auditreports/2016reports/201640028fr.pdf> [<https://perma.cc/RHH3-PTL8>] (detailing volume and dollar amounts of refund offsets to tax debt in tax years 2011 through 2013).

40. For example, the IRS can offset refunds while a taxpayer is in an installment agreement and while an Offer in Compromise is pending. For a detailed discussion of IRS refund offsets, including during collection stays, *see* MICHAEL SALTZMAN & LESLIE BOOK, IRS PRACTICE & PROCEDURE ¶ 14A.01[3] (2021) (explaining refund offset authority).

41. 11 U.S.C. § 362(a)(7).

42. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, sec. 718, § 362(b), 119 Stat. 23, 131 (codified as amended at 11 U.S.C. § 362(b)(26)). For tax years prior to 2005, the IRS would freeze the refund and request the bankruptcy court to lift the automatic stay. *See* IRM 5.17.8.27 (Apr. 13, 2020).

43. *See* § 362(b)(26) (allowing the exception “for relief against an income tax liability”).

44. *See* Brief for Appellant at *17, *Wood v. U.S. Dep't of Hous. & Urb. Dev.* (*In re Wood*), No. 20-1161 (4th Cir. Apr. 7, 2021) (citing examples of when courts have done so).

IV. THE BANKRUPTCY COURT SPLIT IN TAX REFUND OFFSET CASES

In *Copley*, two questions were before the bankruptcy court and, ultimately, the Fourth Circuit: (1) was the Copleys' tax refund part of the bankruptcy estate, and (2) does the offset provision in § 553 trump the exemption provided in § 522(c), thereby allowing the IRS to apply the refund to the Copleys' outstanding tax liability?⁴⁵

The first question is a threshold question of sorts. Some courts outside of the Fourth Circuit distinguish the terms "refund" and "overpayment," holding that taxpayers have only a contingent property interest in their refunds until the IRS determines whether the overpayment should be offset to liabilities according to I.R.C. § 6402.⁴⁶ Other courts, including in Virginia, conclude that taxpayers' property interests in their tax refunds vest at midnight on December 31 of the tax year for which the refunds are due.⁴⁷

As to the second question, the bankruptcy court in *Copley* noted,⁴⁸ and the district court underscored, there is "a great deal of conflicting case law"⁴⁹ across the country as to the effect of a bankruptcy filing on tax refund offset,

45. *Copley III*, 959 F.3d 118, 121 (4th Cir. 2020).

46. See, e.g., *In re Gould*, 401 B.R. 415, 424–25 (B.A.P. 9th Cir. 2009); *IRS v. Luongo* (*In re Luongo*), 259 F.3d 323, 335 (5th Cir. 2001); *Lyle v. Santa Clara Cnty. Dep't of Child Support Servs.* (*In re Lyle*), 324 B.R. 128 (Bankr. N.D. Cal. 2005); *U.S. Dep't of Agric. Rural Hous. Serv. v. Riley*, 485 B.R. 361 (W.D. Ky. 2012).

Generally, these cases involve the automatic stay, either because they are pre-2005 cases or because they involve an offset against nontax debt; thus, the government would have been making arguments to keep property out of the estate as a way around the automatic stay issue. Because these cases do not find the tax refund to be part of the estate, they fail to reach the conflict between § 522 and § 553: "A taxpayer is generally only entitled to a tax refund to the extent that the taxpayer's overpayment exceeds his unpaid governmental debt but where the unpaid governmental debt exceeds the entire tax overpayment, 'there is no money left over to become property of the estate.'" *Riley*, 485 B.R. at 365 (quoting *In re Abbott*, No. 12-01166-8, 2012 WL 2576469, at *2 (Bankr. E.D.N.C. July 3, 2012)). One court referred to this as a more recent "third path" or "emerging view" distinct from the majority and minority views on whether § 522 or § 553 should prevail. *Jones v. IRS* (*In re Jones*), 359 B.R. 837, 839–40 (Bankr. M.D. Ga. 2006).

47. See, e.g., *Porter v. IRS* (*In re Porter*), 562 B.R. 658, 661 & n.3 (Bankr. E.D. Va. 2016) (finding debtor had legal rights in her tax overpayment as of midnight at the end of taxable year, while clarifying that "[t]he issue of whether the Debtor's right to exempt the refund supersedes the government's setoff rights is not an issue presented in this case." (citing *Addison v. U.S. Dep't of Agric.* (*Addison II*), No. 1:15CV00041, 2016 WL 223771, at *3 (W.D. Va. Jan. 19, 2016))).

48. *Copley I*, 547 B.R. 176, 183–84 (Bankr. E.D. Va. 2016), *vacated and remanded by Copley III*, 959 F.3d 118.

49. See *United States v. Copley* (*Copley II*), 591 B.R. 263, 274–75 (E.D. Va. 2018) (noting that the bankruptcy court "masterfully understated" the conflict in case law: "Federal courts across the country have taken varying approaches, and reached contrary outcomes, when addressing the interplay of setoffs and exemptions under the Bankruptcy Code"), *vacated and remanded by Copley III*, 959 F.3d 118.

including “some tension . . . recently among Virginia federal courts.”⁵⁰ This tension set the stage for the Fourth Circuit’s clarification of the issue.

A. Bankruptcy Courts Favoring the Debtor’s Exemption

1. Virginia Case Law

Although *In re Sexton* and *In re Addison*—both recently decided in the Western District of Virginia—provided seemingly favorable case law for debtors, these cases involved an important factual distinction.⁵¹ Like *Copley*, both cases involved Chapter 7 bankruptcies, claims under the Virginia homestead exemption for anticipated tax refunds, and postpetition tax refund offsets applied by the government to prepetition debts.⁵² Unlike the debtors in *Copley*, however, the tax refund offsets in *Sexton* and *Addison* were both applied against a nontax federal debt.⁵³

Judge Connelly’s opinion in *Sexton* included a detailed consideration of conflicting case law with respect to whether the tax refund was part of the bankruptcy estate and thus protected by the Bankruptcy Code’s automatic stay.⁵⁴ Judge Connelly concluded that Ms. Sexton’s interest in her tax refund arose at midnight on December 31, 2012—the tax year in which the overpayment occurred—and her interest in the bankruptcy estate vested when she filed the petition prior to the government’s offset.⁵⁵ Consequently, the refund was protected by the Bankruptcy Code’s automatic stay provision.⁵⁶

50. Compare *id.* at 275 (citing *United States v. Benson (In re Benson)*, 566 B.R. 800 (Bankr. W.D. Va. 2017)) (resolving the issue in favor of the government), with *Sexton v. Dep’t of Treasury (In re Sexton)*, 508 B.R. 646 (Bankr. W.D. Va. 2014) (finding in favor of the debtor), and *Addison v. U.S. Dep’t of Agric. (Addison I)*, 533 B.R. 520 (Bankr. W.D. Va. 2015) (same).

51. *Sexton*, 508 B.R. at 646; *Addison I*, 533 B.R. at 520. The government’s later appeal from *Sexton* was dismissed as untimely. *U.S. Dep’t. of Agric. v. Sexton*, 529 B.R. 667 (W.D. Va. 2015). *Addison I* was affirmed on appeal in the district court, but the appeal was with respect to the automatic stay issue, not with respect to the interplay between § 522 and § 553. *Addison II*, 2016 WL 223771, at *3–4.

52. *Copley I*, 547 B.R. at 177–78; *Sexton*, 508 B.R. at 649–51; *Addison I*, 533 B.R. at 522, 527.

53. *Copley I*, 547 B.R. at 182 & n.12 (contrasting the tax liability in *Copley* specifically with the nontax debt in *Sexton* and *Addison I*); see also *infra* note 56 (explaining this distinction in more depth).

54. *Sexton* declined to follow *Luongo*, which was decided prior to the enactment of Bankruptcy Code § 362(b)(26). *Sexton*, 508 B.R. at 658. Judge Connelly reasoned that Congress subsequently chose to carve out an exception to the automatic stay for tax debts and that it could also have carved out an exception for nontax debts but did not. *Id.* at 663.

55. *Id.* at 662.

56. The Bankruptcy Code’s automatic stay provision, § 362(a), was relevant in *Sexton* because the offset was applied to a nontax debt. *Id.* at 663. Section 362(b)(26) provides an

In finding that the automatic stay was violated, the court did not need to discuss the conflict between Bankruptcy Code § 522 and § 553. In a portion of the opinion that is arguably dictum, Judge Connelly noted: “it is settled law within the Fourth Circuit that a properly-claimed exemption trumps a creditor’s right to offset mutual prepetition debts and liabilities.”⁵⁷

Under similar facts, Judge Black’s opinion in *Addison* followed *Sexton*, finding that the debtor’s interest in the tax refund arose as of midnight at the end of tax year, that it vested in the bankruptcy estate upon the filing of the petition, and that the automatic stay applied to protect the tax refund from offset in the case of a nontax debt.⁵⁸

Judge Black acknowledged “[c]ourts are . . . divided over whether section 522(c) trumps a creditor’s right to setoff preserved under section 553”⁵⁹ and referenced *Sexton* on this question, writing: “[in] the eastern and western districts of Virginia, ‘it is settled law . . . that a properly-claimed exemption trumps a creditor’s right to offset mutual prepetition debts and liabilities.’”⁶⁰ However, as in *Sexton*, because the debtor was protected by the automatic stay, this appears to be dictum.

Less than two years later, Judge Black revisited the conflict between § 522 and § 553 and its underlying case law.⁶¹ In *In re Benson*, the debtor sought to exempt a tax refund that would be subject to offset by the IRS for a federal tax debt.⁶² With this critical distinction in mind, Judge Black came to a different conclusion and held that the IRS offset was proper under § 553.⁶³ He stated: “Upon further review of [two of the cases relied upon by *Sexton*],

exception to the automatic stay rule, permitting a taxing authority to offset certain tax debts without first seeking relief from the stay. *Id.* Thus, the automatic stay was not at issue in *Copley*, which involved an offset to a tax debt. *Copley I*, 547 B.R. at 182.

57. *Sexton*, 508 B.R. at 662 (first citing *Moore v. U.S. Dep’t of Hous. & Urb. Dev. (In re Moore)*, 350 B.R. 650, 656 (Bankr. W.D. Va. 2006); and then citing *In re Ward*, 210 B.R. 531, 536 (Bankr. E.D. Va. 1997)). The Fourth Circuit came out the opposite way in *Copley III*, holding that the plain language of Bankruptcy Code § 553(a) provides that the exemption in § 522 does not affect the IRS’s right of offset granted by I.R.C. § 6402(a). 959 F.3d 118, 123–24 (4th Cir. 2020); see *infra* Part IV.

58. *Addison I*, 533 B.R. 520, 528–29, 531 (Bankr. W.D. Va. 2015). *Addison I* followed *Sexton* by distinguishing *Luongo* because it was decided prior to the enactment of Bankruptcy Code § 362(b)(26). *Id.* at 530 (citing *Sexton*, 508 B.R. at 663).

59. *Id.* (citing *Miller v. United States*, 422 B.R. 168, 172–73 (W.D. Wis. 2010)).

60. *Id.* (quoting *Sexton*, 508 B.R. at 662). Neither *Moore* nor *Ward* involved the offset of a tax refund against a tax debt. *Moore*, 350 B.R. at 652; *Ward*, 210 B.R. at 532.

61. See *infra* Section III.B.

62. *Benson v. United States (In re Benson)*, 566 B.R. 800, 803 (Bankr. W.D. Va. 2017). The *Copley* case temporally fell between Judge Black’s two opinions: *Copley* was decided by the bankruptcy court in March 2016, which was after *Addison* but before *Benson*. *Addison I* was decided in July 2015. 533 B.R. at 520. *Benson* was decided in April 2017. 566 B.R. at 800.

63. *Benson*, 566 B.R. at 815.

there being no Fourth Circuit case on point, and the extensive briefing in this case, the Court agrees with the IRS that the law is no [sic] so settled.”⁶⁴

Many cases outside of Virginia have addressed the interplay between § 522 and § 553.⁶⁵ While these cases generally pre-date the enactment of § 362(b)(26), which exempted an offset against tax liability from the automatic stay rules,⁶⁶ some have facts similar to *Copley*—involving the offset of a tax refund against a tax debt.⁶⁷ As the next Section discusses, many cases refer to a “majority view” that the debtor’s right to exempt and protect assets trumps the creditor’s right of offset.

2. Case Law in Other States

Over time, because enough courts have emphatically found that the debtor’s exemption prevails over the government’s right of offset, this has been referred to as the “majority view.”⁶⁸

Citing a number of bankruptcy cases in a variety of states, *In re Alexander* followed the majority view in a case involving offset of a tax refund to an outstanding tax debt.⁶⁹ *Alexander* is useful for its lengthy analysis, which outlined three arguments commonly invoked by courts that rule in favor of the debtor’s exemption.⁷⁰ First, the *Alexander* court reasoned that, if § 522’s exemption rule was not given priority over § 553’s offset rule, then the exemption rule “would simply have no meaning.”⁷¹ Second, the court emphasized that the objective of exemption is to promote a “fresh start . . . for the purpose of ensuring that the debtor and the debtor’s family are not deprived of the basic means to survive.”⁷² Third, the opinion “note[d] that the

64. *Id.* at 811 n.14.

65. See *Miller*, 422 B.R. at 172 (collecting cases).

66. See *supra* note 42 and accompanying text.

67. See, e.g., *In re Pace*, 257 B.R. 918, 920 (Bankr. W.D. Mo. 2000); *Alexander v. IRS* (*In re Alexander*), 225 B.R. 145, 149 (Bankr. W.D. Ky. 1998).

68. In affirming a bankruptcy court that followed the “minority view,” the court in *Miller* acknowledged that “more courts have held that exempt property is not subject to setoff, than have reached the opposite conclusion.” 422 B.R. at 172–173 (citing cases that support the majority view, including *United States v. Jones* (*In re Jones*), 230 B.R. 875, 879 (M.D. Ala. 1999)); *Alexander*, 225 B.R. at 149; *In re Cole*, 104 B.R. 736, 739–40 (Bankr. D. Md. 1989)).

69. *Alexander*, 225 B.R. at 149.

70. *Id.* at 149–50; accord *Miller*, 422 B.R. at 172 (citing *In re Kadrmas*, No. 00-31138-7, 2000 WL 33364195, at *3 (Bankr. W.D. Wisc. Sept. 19, 2000)) (identifying the same three reasons that courts following the majority view generally adopt).

71. *Alexander*, 225 B.R. at 149. This is sometimes referred to as the “nullification” argument. See, e.g., *In re Benson*, 566 B.R. 800, 811 (Bankr. W.D. Va. 2017); *Miller*, 422 B.R. at 173.

72. *Alexander*, 225 B.R. at 149. The “fresh start” reasoning has been explained as follows:

legislative history of section 522 supports the conclusion that Congress did not intend that exempt property be liable for discharged tax debts, through set-off or otherwise.⁷³

While many courts have cited *Alexander* and been persuaded by its reasoning, plenty of others have come out the opposite way.⁷⁴

B. Bankruptcy Courts Favoring the Government's Right of Offset

Many bankruptcy court rulings outside of the Fourth Circuit have rejected the so-called “majority view,”⁷⁵ particularly in the last two decades, with one court classifying it as the “majority view until 2001.”⁷⁶ The reference to 2001 is a nod to *In re Luongo*, a Fifth Circuit case decided that year.⁷⁷

In *Luongo*, Constance Luongo’s tax debt had been discharged in bankruptcy; after the IRS offset her subsequent tax refund against the discharged debt, Luongo reopened her bankruptcy and filed amended schedules listing the refund as exempt property.⁷⁸ The Fifth Circuit reasoned that “the tax refund did not become property of the estate[,]” and therefore, there was nothing to claim as exempt.⁷⁹ Significantly, this reasoning meant that *Luongo* did not need to evaluate a conflict between § 522 and § 553.⁸⁰ It did, however, provide courts with an easy precedential path to uphold the government’s right of offset where an argument could be made that the refund was not part of the bankruptcy estate.⁸¹

[T]he debtor should not be stripped bare of his belongings and property so as to be rendered a pauper . . . a person shall not be deprived of a fair opportunity to make an honest living so as not to be precluded from casting off the economic shackles with which his debts have bound him.

Id. at 150 (quoting *Cole*, 104 B.R. at 738).

73. *Id.* at 150. Other courts adopting the “majority view” have similarly been persuaded by the Bankruptcy Code’s “chief policy” of providing the debtor a fresh start and by the legislative history of § 522. *See, e.g.*, *United States v. Jones (In re Jones)*, 230 B.R. 875, 880–81 (M.D. Ala. 1999).

74. *See, e.g.*, *Benson*, 566 B.R. at 810–12.

75. *See, e.g.*, *Miller*, 422 B.R. at 172–73 (rejecting the “majority view” and citing other courts that have rejected the majority view, including *In re Gould*, 401 B.R. 415, 427–28 (B.A.P. 9th Cir. 2009), *In re Jones*, 359 B.R. 837, 839–40 (Bankr. M.D. Ga. 2006), *In re Kadrmas*, 2000 WL 33364195, at *3 (Bankr. W.D. Wisc. Sept. 19, 2000), and *In re Bourne*, 262 B.R. 745, 754 (Bankr. E.D. Tenn. 2001)).

76. *In re Pigott*, 330 B.R. 797, 799, 802 (Bankr. S.D. Ala. 2005) (citing *In re Luongo*, 259 F.3d 323, 335–36 (5th Cir. 2001)) (not getting to the question of whether § 553 trumps § 522 after being persuaded by the *Luongo* holding that a tax refund is not property of the estate and thus cannot be exempted prior to offset).

77. *Luongo*, 259 F.3d at 323.

78. *Id.* at 327.

79. *Id.* at 335.

80. *Id.* at 328.

81. *See infra* note 105 and accompanying text.

1. *Virginia Case Law*

One recent Virginia bankruptcy court opinion, *In re Benson*—decided the year after the bankruptcy court decided *Copley*—distinguished the facts of *Sexton* and *Addison* and held that the IRS’s refund offset to pay a tax debt was proper despite the debtor having claimed protection under the homestead exemption.⁸² Like *Sexton* and *Addison*, *Benson* arose in the Western District of Virginia.⁸³ But unlike *Sexton* and *Addison*, which involved offsetting tax refunds against nontax debts, the tax refund in *Benson* (as in *Copley*) was offset against an outstanding federal tax liability.⁸⁴ The relevant facts of *Benson* are thus fully on point with *Copley*; the court had to decide “the enforceability of [a debtor’s] exemption and how it intersects with the IRS’s ability to exercise a setoff.”⁸⁵

Benson is particularly notable because it was decided in April 2017 by Judge Black, who authored the *Addison* opinion in July 2015.⁸⁶ In *Addison*, Judge Black cited *Sexton* to support his proposition that “in the eastern and western districts of Virginia ‘it is settled law . . . that a properly-claimed exemption trumps a creditor’s right to offset mutual prepetition debts and liabilities.’”⁸⁷ Judge Black reconsidered this proposition in *Benson*, stating that the law was unsettled on this point.⁸⁸

Contrary to *Addison*, the *Benson* court held that the IRS’s offset was proper and within the bounds of Bankruptcy Code § 553.⁸⁹ Judge Black noted that, while *Addison* and *Benson* may seem difficult to reconcile, *Addison*’s “essential holding” was that the automatic stay operated to protect the debtor’s exemption precisely because the case involved a nontax liability offset.⁹⁰

82. *In re Benson*, 566 B.R. 800, 814–15 (Bankr. W.D. Va. 2017).

83. *Id.* at 807.

84. *Id.* at 814–15.

85. *Id.* at 805. Whether the tax refund was part of the bankruptcy estate was not before the court in *Benson*.

86. *Id.* at 801; *Addison I*, 533 B.R. 520, 522 (Bankr. W.D. Va. 2015).

87. *Addison I*, 533 B.R. at 530.

88. A footnote in *Benson* revisited *Sexton*’s statement that “it is settled law in the Fourth Circuit that a properly-claimed exemption trumps a creditor’s right to offset mutual prepetition debts and liabilities.” 566 B.R. at 811 n.14 (quoting *In re Sexton*, 508 B.R. 646, 662 (Bankr. W.D. Va. 2014)). The footnote then stated that “[u]pon further review . . . the Court agrees with the IRS that the law is no [sic] so settled.” *Id.*

89. *Id.* at 815.

90. *Id.* (citing *Addison I*, 533 B.R. at 530).

Although *Benson* was decided after the bankruptcy court's decision in *Copley*, the *Benson* court declined to follow *Copley*, which is significant given that both cases involved a tax liability offset.⁹¹

The *Benson* court discussed case law on both sides of the issue.⁹² It cited *Alexander* as “best explain[ing] those cases finding a creditor’s right of setoff is subordinate to a debtor’s exemptions rights”⁹³ and outlined the arguments that the *Alexander* court relied upon.⁹⁴ In its discussion of cases that held § 553 offset rights should prevail over the debtor’s exemption, the *Benson* court extensively discussed *In re Bourne*⁹⁵ and *In re Buttrill*.⁹⁶ Ultimately, Judge Black reached “a result similar to that of *Bourne* and *Buttrill*” and held that the IRS refund offset was proper despite the exemption “but for different reasons” than those stated by other courts.⁹⁷

2. Case Law in Other States

Bourne and *Buttrill* are representative of a long line of so-called “minority view” cases.⁹⁸ Minority view cases outside of the Fourth Circuit hold that the government’s right of offset supersedes the debtor’s right of exemption.⁹⁹

In *Bourne*, the court set forth a detailed analysis that revisited *Alexander*’s three arguments in favor of the majority view and rebutted each argument in turn.¹⁰⁰ As to the argument that § 522 must prevail or it is nullified, the court found that allowing § 522 to prevail would merely nullify § 553.¹⁰¹ As to the “fresh start” argument, the court reasoned that this policy is not always

91. Noting “[t]here is no binding guidance in the Fourth Circuit,” the *Benson* court observed that *Copley I* was (at the time *Benson* was decided) on appeal to the district court and had been remanded to the bankruptcy court on other grounds. *Id.* at 807 n.6.

92. *Id.* at 807.

93. *Id.* at 808.

94. *See id.* at 808–10.

95. *In re Bourne*, 262 B.R. 745 (Bankr. E.D. Tenn. 2001).

96. *In re Buttrill*, 549 B.R. 197 (Bankr. E.D. Tenn. 2016).

97. *Benson*, 566 B.R. at 813–14 (reading the plain language of § 553 to be that “the preservation of the setoff right should be paramount to the right to claim an exemption” and further finding that “a debtor cannot bootstrap himself into free and clear ownership of a property interest by claiming an exemption in something subject to a valid Section 553 offset, and then claim the exemption invalidated the offset because no one objected”).

98. *Bourne*, 262 B.R. at 754–55; *Buttrill*, 549 B.R. at 208.

99. *See, e.g.*, *Miller v. United States*, 422 B.R. 168 (W.D. Wis. 2010).

100. *See supra* notes 70–73 and accompanying text.

101. *Bourne*, 262 B.R. at 756 (“It is just as logical to give effect to both provisions by holding that a debtor may claim an exemption which is valid as to all creditors except one having a right of offset.”).

paramount.¹⁰² The court was also unpersuaded by the legislative history argument.¹⁰³ The opinion additionally emphasized that I.R.C. § 6402 is an offset provision premised on a federal statute and distinguished that fact from cases relying on state common law as the basis for exemption.¹⁰⁴

Further muddying debtors' rights is the "emerging view" line of cases outside of the Fourth Circuit, which follow the reasoning of *Luongo* and find that, notwithstanding a debtor's exemption claim, a refund offset is proper because the refund never became part of the bankruptcy estate.¹⁰⁵ As the next Part explains, the bankruptcy court in *Copley* addressed both of these arguments.¹⁰⁶

V. *COPLEY V. UNITED STATES*

In *Copley*, the Fourth Circuit ultimately held that Bankruptcy Code § 553(a) favors the IRS insofar as that section "preserves whatever right of offset a creditor may possess outside the federal bankruptcy code."¹⁰⁷ Significantly, the court agreed that, when the Copleys filed their bankruptcy petition, their 2013 tax refund became part of the bankruptcy estate.¹⁰⁸ The court then proceeded to hold that the IRS remained entitled to offset the refund

102. *Id.* at 757 ("Just as the Bankruptcy Code's general policy in favor of a fresh start must give way to the specific exceptions to discharge set forth in the Code, it must also bow to the more specific provision preserving setoff found in § 553.").

103. *Id.* ("[I]t must be noted that the legislative history to [§ 522] does not mention setoff rights in any respect whatsoever or whether they may be defeated by an exemption.").

104. *Id.* at 752 n.2; see also *Buttrill*, 549 B.R. at 206 (adopting *Bourne's* reasoning).

105. See e.g., *In re Pigott*, 330 B.R. 797, 802 (Bankr. S.D. Ala. 2005) (following *Luongo* and *In re Lyle*, 324 B.R. 128 (Bankr. N.D. Cal. 2005), and holding that the refund was not part of the estate and therefore could not be exempted, the court stated "[b]ut for the newest argument as to the status of a refund as property of the estate or not, this court would rule in accord with [the majority view on § 522]"); see also *In re Baucom*, 339 B.R. 504, 507 (Bankr. W.D. Mo. 2006); *Beaucage v. United States*, 342 B.R. 408, 411 (D. Mass. 2006) ("As the *Luongo* court . . . correctly realized, without an asset, there can be no valid exemption."). Some of these cases involved offsets against tax debt, while others involved offsets to nontax debts.

106. *Copley I*, 547 B.R. 176, 177–78, 185 n.21 (Bankr. E.D. Va. 2016), *vacated and remanded by Copley III*, 959 F.3d 118.

107. *Copley III*, 959 F.3d at 124 ("[W]e conclude that the plain language of 11 U.S.C. § 553(a) resolves this apparent conflict.").

108. *Id.* at 122. The Fourth Circuit distinguished *Copley III* from *In re Luongo*, 259 F.3d 323 (5th Cir. 2001). *Id.* at 123. The Fourth Circuit found that "*Luongo* is inapposite" because, in that case, the bankruptcy debtor claimed the tax refund as exempt *after* the IRS exercised its right of offset. *Copley III*, 959 F.3d at 123 (citing *Luongo*, 259 F.3d at 335). The Fourth Circuit's opinion in *Copley III* went further than *Luongo* insofar as it acknowledged the tax refund was property of the estate yet was still subject to offset by the IRS. *Id.* at 123.

against the Copleys' outstanding tax debt.¹⁰⁹ This Part explains the history of *Copley* and contextualizes the Fourth Circuit's decision.

A. *How the Bankruptcy Court Ruled*

The primary question before the bankruptcy court in *Copley* was whether the debtors could exempt and recover their anticipated federal income tax refund in bankruptcy notwithstanding the IRS's authority to offset a refund against prepetition federal tax liability.¹¹⁰ The court noted this question "has generated a great deal of conflicting case law" with no binding precedent in the Fourth Circuit.¹¹¹

The court began by describing the rulings in *Sexton* and *Addison* that a debtor's interest in his or her tax refund arises at midnight on December 31 of the tax year.¹¹² While the court noted that both *Sexton* and *Addison* involved offsetting a nontax debt and thus implicated the automatic stay rule in a way that *Copley* did not,¹¹³ it still followed those cases to find that the Copleys' refund was property of the bankruptcy estate.¹¹⁴

After concluding that the refund was part of the bankruptcy estate, the court next decided whether the Copleys' right to exempt the refund under Bankruptcy Code § 522(c) trumped the IRS's offset authority, which was

109. *Copley III*, 959 F.3d at 123. While the Fourth Circuit in *Copley III* distinguished *Luongo*, the IRS prevailed in both cases. *Id.* at 126; *Luongo*, 259 F.3d at 336. When the Fourth Circuit decided *Copley III*, there were no circuit court cases in which a debtor had prevailed in exempting a tax refund from offset. The Ninth Circuit affirmed a bankruptcy appellate panel's finding that the IRS's right of offset supersedes the debtor's exemption rights. *In re Gould*, 401 B.R. 415 (B.A.P. 9th Cir. 2009), *aff'd*, 603 F.3d 1100 (9th Cir. 2010). The *Copley III* decision diverges from *Gould* insofar as *Gould*, like *Luongo*, held that a tax overpayment was not part of the bankruptcy estate. *Id.* at 430 (citing *Luongo*, 259 F.3d at 335). The *Copley III* opinion also commented that the Ninth Circuit's decision in *Gould* "consists of a one-paragraph order summarily adopting the conclusions of a bankruptcy appellate panel, and contains no independent analysis, lessening the decision's persuasive value." *Copley III*, 959 F.3d at 123 n.4.

110. *Copley I*, 547 B.R. at 176.

111. *Id.* at 180. In his opinion, Judge Phillips noted that, in an unpublished opinion, the Fourth Circuit affirmed an Eastern District of Virginia holding that, "generally, a right of setoff cannot be exercised against the exempt assets of the debtor." *Thompson v. Bd. of Trs. of Fairfax Cnty. Police Officers Ret. Sys. (In re Thompson)*, 182 B.R. 140, 153 (Bankr. E.D. Va. 1995), *aff'd*, 92 F.3d 1182 (4th Cir. 1996). Judge Phillips acknowledged that unpublished opinions are not binding precedent and further noted that the government "maintains that *Thompson* is distinguishable" because it involves a state common law offset than a federal offset. *Copley I*, 547 B.R. at 180 n.8.

112. *Copley I*, 547 B.R. at 181.

113. *Id.* at 181–82 (calling this "[t]he most significant factual distinction between *Sexton* and *Addison* and the case at hand").

114. *Id.* at 185.

preserved under § 553(a).¹¹⁵ The court described the majority view that “the right to exempt property trumps the right to setoff,”¹¹⁶ noted that “[a] number of more recent decisions have rejected this position,”¹¹⁷ and observed that “persuasive arguments can be made to support either view.”¹¹⁸ It then noted that *Sexton* declared this issue to be “settled law within the Fourth Circuit” but also acknowledged the reasons why the United States disagreed.¹¹⁹ Although it recognized the statutory conflict is more difficult when offset is rooted in federal law,¹²⁰ the court seemed persuaded by the argument that “the legislative history of section 522 supports the conclusion that Congress did not intend that exempt property be liable for discharged tax debts, through set-off or otherwise.”¹²¹

The bankruptcy court’s opinion expressly stated that the court would follow *Sexton* and *Addison* to find that the Copleys’ homestead exemption right under § 522(c) supersedes the IRS’s right of offset under § 553.¹²² Based on those findings, the court ordered the IRS to release the \$3,208 refund to the Copleys.¹²³

B. *The District Court Affirms*

The government appealed to the district court,¹²⁴ which affirmed the bankruptcy court’s findings on the two questions discussed above.¹²⁵ As to whether the refund was part of the bankruptcy estate, the district court agreed

115. *Id.* at 182.

116. *Id.* at 183–84.

117. *Id.* at 184.

118. *Id.*

119. *Id.* (quoting *In re Sexton*, 508 B.R. 646, 662 (Bankr. W.D. Va. 2014)).

120. *Id.* (citing *In re Bourne*, 262 B.R. 745, 761 n.2 (Bankr. E.D. Tenn. 2001)).

121. *Id.* at 184–85 (quoting *In re Alexander*, 225 B.R. 145, 150 (W.D. Ky. 1998) (citing *In re Jones*, 230 B.R. 875, 880–81 (M.D. Ala. 1999)). In a footnote, Judge Phillips quoted the legislative history: “The historical purpose of these exemption laws has been to protect a debtor from his creditors, to provide him with the basic necessities of life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge.” *Id.* at 185 n.21.

122. Acknowledging that the court is not bound to follow the precedent set in the Western District of Virginia, Judge Phillips explained: “Nevertheless, the Court is also aware that a split among the courts in Virginia would have the practical effect of creating disparate treatment of creditors and debtors within the Commonwealth of Virginia.” *Id.* at 185 n.23.

123. *Id.* at 185.

124. The first appeal to the district court included an argument that the bankruptcy court lacked jurisdiction. The district court remanded to the bankruptcy court on that issue, and on resolution of it, the government renewed its appeal on other grounds, including that the tax refund was not part of the bankruptcy estate and that the IRS’s right of offset under 11 U.S.C. § 553 supersedes the debtors’ exemption right under 11 U.S.C. § 522. *Copley III*, 959 F.3d 118, 120 (4th Cir. 2020).

125. *Copley II*, 591 B.R. 263, 268 (E.D. Va. 2018).

that the refund vested as a property interest at midnight on December 31, 2013, and became part of the bankruptcy estate when the Copleys filed their petition on May 29, 2014.¹²⁶ While the district court acknowledged that “a number of non-binding decisions have followed the reasoning of *In re Luongo* in recent years,” it nonetheless followed *Sexton* and *Addison* to adopt “the long-standing approach embraced by the majority of the courts, including the majority of Virginia bankruptcy decisions that have considered the issue.”¹²⁷

Having found that the tax refund was part of the estate, the court had to consider the second question of whether the debtors’ rights under § 522 supersede the government’s rights under § 553.¹²⁸ The district court agreed with the bankruptcy court: the debtors’ rights prevail.¹²⁹ The court noted “some tension has developed recently among Virginia federal courts”¹³⁰ on this question and then set forth its own analysis of the standard arguments in support of § 522 superseding § 553.¹³¹ The district court concluded that, while “[p]ersuasive arguments exist on either side of the debate[,] . . . [t]he Bankruptcy Court acted within its equitable discretion because compelling circumstances exist to disallow the setoff.”¹³²

C. *The Fourth Circuit Opinion*

The Fourth Circuit reviewed the bankruptcy court’s legal conclusions de novo, with the government challenging two conclusions that were made by the bankruptcy court and affirmed by the district court: (1) that the tax refund became part of the bankruptcy estate when the Copleys filed for bankruptcy and (2) that the Copleys’ right to exempt the tax overpayment supersedes the IRS’s right to offset that overpayment against preexisting federal tax debt.¹³³ Ultimately, the Fourth Circuit agreed with the first conclusion and disagreed with the second.¹³⁴

As to the first issue, it is significant that the Fourth Circuit differentiated the facts in *Copley* and *Luongo*—the Fifth Circuit case that substantively

126. *Id.* at 277, 288.

127. *Id.* at 279.

128. *Id.* at 281.

129. *Id.* at 275.

130. *Id.*

131. *Id.* at 284–88 (discussing the unqualified language in § 522, the concerns over nullification of § 522, and the “fresh start” goal of bankruptcy law).

132. *Id.* at 288.

133. *Copley III*, 959 F.3d 118, 122 (4th Cir. 2020).

134. *Id.* at 120. The Fourth Circuit vacated the district court’s judgment and remanded for further proceedings consistent with its opinion. *Id.*

considered this issue.¹³⁵ The *Luongo* holding rested on a distinction between an “overpayment” and a “refund,” finding that, “[b]ecause the prior unpaid tax liability exceeded the amount of the overpayment, the debtor was not entitled to a refund and the refund did not become property of the estate.”¹³⁶ Having reached this conclusion, the Fifth Circuit did not need to address whether I.R.C. § 6402 supersedes Bankruptcy Code § 522.¹³⁷

While other courts have referred to the *Luongo* logic as an “emerging view”¹³⁸ distinct from the majority view, the Fourth Circuit failed to address *Luongo*’s analysis. Instead, it distinguished the facts of *Copley*, calling *Luongo* “inapposite” and holding that the Copleys’ interest in their overpayment became part of the bankruptcy estate when they filed their bankruptcy petition.¹³⁹

Having found this, the court turned to the issue of whether the right of offset supersedes the right of exemption.¹⁴⁰ It concluded that the right of offset prevails “based on the plain language of the governing statutes,” specifically, § 553(a)’s language that no provision of the Bankruptcy Code “‘affect[s]’ a creditor’s right to a mutual, prepetition debt with a bankruptcy debtor.”¹⁴¹

Albeit in a footnote, the Fourth Circuit emphasized the primacy of a federal offset statute, stating that the bankruptcy court improperly relied on the Virginia common law principle that a creditor may not exercise a right of setoff against exempt property.¹⁴²

While grounding its holding in the plain language of § 553(a), the Fourth Circuit went on to address the Copleys’ reliance on arguments that have persuaded other courts to find for the debtor’s exemption:¹⁴³ (1) the “fresh start” rationale, (2) the need to avoid nullification of § 522, (3) the

135. See *supra* notes 77–80 and accompanying text. The Fourth Circuit’s opinion acknowledged that its analysis diverged from the reasoning adopted by the Ninth Circuit in *Gould*, 603 F.3d 1100 (9th Cir. 2010), but the court’s conclusion was the same: “[T]he government’s right of offset withstands a taxpayer’s attempt to exempt an overpayment.” *Copley III*, 959 F.3d at 123 n.5.

136. *In re Luongo*, 259 F.3d 323, 335 (5th Cir. 2001). The government made this argument in *Copley III*, and the Fourth Circuit disagreed. 959 F.3d at 122.

137. *Luongo*, 259 F.3d at 336 (“[W]e leave open the question of whether 522(c) immunizes exempt property from setoff.”).

138. See *supra* note 105 and accompanying text.

139. *Copley III*, 959 F.3d at 123. The Fourth Circuit pointed out that, in *Luongo*, “the bankruptcy debtor did not attempt to claim her tax overpayment as exempt property until *after* the IRS had exercised its right of offset.” *Id.* (citing *Luongo*, 259 F.3d at 335). By contrast, the Copleys sought to exempt the property *before* the government offset their debt. See *id.*

140. *Id.*

141. *Id.* at 123–24 (“The very broad scope of Section 553(a) necessarily includes the property exemption provisions contained in 11 U.S.C. § 522(c).”).

142. *Id.* at 124 n.7. But the court noted that the state common law rule “[did] not govern or affect [its] interpretation of 26 U.S.C. § 6402(a).” *Id.*

143. *Id.* at 125–26.

“permissive” nature of § 553(a), and (4) the legislative history of § 522.¹⁴⁴ The court briefly rebutted each of these arguments before reiterating that “the plain language of [I.R.C.] § 6402(a) and 11 U.S.C. § 553(a) dictates that the government’s right of offset was not affected by the Copleys’ attempt to claim the tax overpayment as exempt property in this case.”¹⁴⁵

D. Significance of the Fourth Circuit’s Opinion

The Fourth Circuit’s decision in *Copley* settles that, within the circuit, the IRS’s right of offset under I.R.C. § 6402(a) is unaffected by a debtor’s exemption claim under Bankruptcy Code § 522.¹⁴⁶ In doing so, the Fourth Circuit spoke to a question that had been unsettled in Virginia’s bankruptcy courts, as well as in bankruptcy courts outside of the Fourth Circuit, for years.

Significantly, *Copley* was the first circuit court opinion to find that a debtor’s tax refund was part of the bankruptcy estate.¹⁴⁷ The Fourth Circuit factually distinguished *Copley* from the Fifth Circuit’s holding in *Luongo* based on the timing of the offset in each case.¹⁴⁸ However, when coupled, these two cases may prove to be a bulwark for the IRS’s right to offset a tax refund. In cases like *Luongo*, where the offset occurred before the debtor claimed the exemption,¹⁴⁹ or in cases involving nontax debt and thus implicating the automatic stay, the IRS will continue to argue that the refund never became part of the bankruptcy estate. In cases like *Copley*, where the debtor claimed the exemption before claiming the refund,¹⁵⁰ the IRS will argue that its right of offset prevails under the plain language of Bankruptcy Code § 553(a).

Whereas the Fifth Circuit in *Luongo* merely danced around the primacy of offset and decided the question on other grounds,¹⁵¹ the Fourth Circuit’s opinion in *Copley* gets to the heart of the tension between § 522 and § 553 and proclaims that § 553 clearly prevails.¹⁵² This represents a significant victory for the IRS and the primacy of federal tax offsets.

It is too soon to know how courts will apply *Copley*. For example, will the holding be limited to offsets of tax refunds against tax debts, as distinguished from offsets of tax refunds against nontax debts?¹⁵³ The Fourth

144. *Id.*

145. *Id.* at 126.

146. *Id.*

147. *See id.* at 120, 126.

148. *Id.* at 123.

149. *In re Luongo*, 259 F.3d 323, 327 (5th Cir. 2001).

150. *See Copley I*, 547 B.R. 176, 178 (Bankr. E.D. Va. 2016).

151. *See Luongo*, 259 F.3d at 336.

152. *See Copley III*, 547 B.R. at 123.

153. *See supra* note 44 and accompanying text.

Circuit faced this question within a year of deciding *Copley*.¹⁵⁴ In *In re Wood*, the debtors argued that the holding in *Copley* should be limited to debts owed to the IRS and should not apply to nontax debts.¹⁵⁵ Notwithstanding this factual distinction, the Fourth Circuit followed *Copley* and held that “the Treasury’s authority to exercise its right to offset . . . tax overpayment against [nontax debt] is anchored firmly in § 6402(d) and § 553(a)[.]” and “[t]his offset right supersedes the general exemption protections of § 522(c).”¹⁵⁶ Though the Fourth Circuit has chosen to apply *Copley* broadly, other circuits may follow a different path.

More practically, *Copley* underscores the critical intersection between bankruptcy and taxation, with at least three takeaways for debtors. First, individuals contemplating a bankruptcy in the near term should review their income tax withholding. The Copleys’ tax refund resulted from too much withholding, a situation that is often avoidable.¹⁵⁷ To the extent that individuals can adjust their withholding throughout the year, doing so may minimize the size of their refund. While it would be unwise to reduce withholding to a level that would create significant liability at tax time,¹⁵⁸ it may be to the debtor’s strategic advantage to minimize any potential tax overpayment, rendering the possibility of an IRS offset less relevant (or completely irrelevant).¹⁵⁹

154. *In re Wood*, 611 B.R. 782, 789–90 (S.D.W.V. 2019), *rev’d*, 993 F.3d 245 (4th Cir. 2021).

155. See Brief for Appellees at *4, *Wood v. U.S. Dep’t of Hous. & Urb. Dev.*, 993 F.3d 245 (4th Cir. 2021) (No. 20-1161) (arguing that “a debt arising from a foreclosed home loan is different from an income tax debt, and is treated differently by the Bankruptcy Code”) In *Wood*, the district court relied on the now-vacated district court opinion in *Copley* to hold that “§ 522 of the Bankruptcy Code trumps the offset provisions of § 553 of the Bankruptcy Code and § 6402 of the TOP.” 611 B.R. at 786.

156. 993 F.3d at 251.

157. A notable exception to this is for low-income taxpayers with children who are eligible for refundable tax credits, such as the Earned Income Tax Credit and the Child Tax Credit. These individuals may be entitled to a refund of several thousand dollars even if no tax liability is due. Because taxpayers cannot reduce their tax withholding below zero, the entire refundable credit may be subject to offset. I have written previously about the reach of § 6402 as a collection tool for the IRS, observing that the possibility of losing one’s entire income tax refund to offset “betrays the [Earned Income Tax Credit]’s function as an antipoverty supplement.” MICHELLE LYON DRUMBL, *TAX CREDITS FOR THE WORKING POOR: A CALL FOR REFORM* 176 (2019).

158. I.R.C. § 6654(a)–(b). Doing so may result in an underpayment of estimated tax penalty under I.R.C. § 6654. More practically, if individuals cannot pay the income tax liability when the return is filed, then they have exacerbated their financial woes in addition to owing interest and a failure to pay penalty on the balance due.

159. Note that *Luongo* expressed concern about the opposite—namely, that if a debtor’s exemption could trump the IRS offset authority, this impermissibly “would open the proverbial floodgates to all manner of deception . . . [it] would permit a debtor to shelter assets from his creditors by making substantial overpayments to the IRS during a given tax year.” *In re Luongo*, 259 F.3d 323, 334–35 (5th Cir. 2001).

Second, because the IRS's offset authority is *discretionary* with respect to outstanding tax debt,¹⁶⁰ debtors due a tax refund should explore whether it might be appropriate to request an Offset Bypass Refund (OBR)—which, if granted, would allow the IRS to release part or all of the refund despite outstanding tax debt.¹⁶¹ Such a request must be initiated by the taxpayer prior to filing an income tax return and requires a showing of economic hardship.¹⁶² If the IRS agrees to grant an OBR, the debtor will still need to claim exemption under § 522 to protect the refund from other creditors.¹⁶³

Third, debtors should remember that they may have non-bankruptcy options to address outstanding tax debt and, thus, should seek tax counsel and analyze these options before proceeding with bankruptcy. For example, an individual with tax debt can submit an Offer in Compromise (OIC) to the IRS, proposing to settle the debt for less than what is owed based on the debtor's ability to pay.¹⁶⁴ Depending on the circumstances, this is an alternative way for individuals to seek a “fresh start” with respect to their tax debt. This option may be particularly attractive if the tax debt would not be dischargeable in bankruptcy. An important caveat with an OIC is that, as a term of accepting the offer, the IRS will exercise its right under I.R.C. § 6402 to offset any tax refund due to the individual through the calendar year in which the offer is accepted.¹⁶⁵ While this sounds similar to the outcome in *Copley*, it is not: had the Copleys pursued an OIC prior to filing bankruptcy¹⁶⁶ and had the IRS accepted the offer in calendar year 2013, the IRS still would have offset the 2013 tax refund as a condition of accepting the offer. However, the tax debt would have been fully settled prior to bankruptcy. Recall that part of the

160. See *supra* note 5 and accompanying text.

161. IRM § 21.4.6.5.5(3) (Sept. 22, 2017). The IRS will not exercise this discretion if the taxpayer has nontax debt subject to the TOP. For insights on requesting an OBR, see 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/WS7P-REXA>].

162. For this purpose, “economic hardship” is defined in I.R.C. § 6343 and Department of Treasury Regulation § 301.6343-1(b)(4)(ii). IRM § 21.4.6.5.11.1(1) (Dec. 8, 2017). The IRS requires documentation, such as an eviction or utility shut-off notice, and will only grant an OBR to the extent of the documented dollar amount. *Id.* § 21.4.6.5.11.1(14).

163. See 11 U.S.C. § 522(e).

164. I.R.C. § 7122(a); see also *Offer in Compromise*, IRS (Nov. 23, 2020), <https://www.irs.gov/payments/offer-in-compromise> [<https://perma.cc/GX2E-GKYP>].

165. IRM § 5.19.7.10(1) (July 9, 2020); 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/FE4V-9WW8>] (discussing that refund offsets do not count toward the offer amount and describing the exceptions to the offset recoupment rule).

166. The IRS will not process an OIC if a taxpayer is currently in a bankruptcy proceeding. IRM § 5.8.2.4.1(1) (Sept. 22, 2020) (“An offer will not be considered while a taxpayer is in bankruptcy.”).

Copleys' outstanding tax debt was not dischargeable, resulting in them losing their 2013 tax refund and still having an outstanding tax debt balance after bankruptcy.¹⁶⁷ Whether someone is a good candidate for an OIC is a fact-specific question; for some debtors, it may be beneficial to pursue an OIC and resolve tax debt prior to addressing nontax debts in bankruptcy.

VI. CONCLUSION

The *Copley* decision will provide clarity and uniformity within the Fourth Circuit going forward, which is important given the conflicting outcome in recent Virginia bankruptcy cases. Time will tell whether *Copley* will encourage courts across the United States to firmly reject the so-called "majority view" when comparing the debtor's right of exemption and the government's right of offset. In the meantime, *Copley* underscores how I.R.C. § 6402 remains a powerful collection tool for the IRS.

167. See *supra* note 17.