COMMONWEALTH of VIRGINIA

Department of Taxation

Richmond, Virginia 23282

MEMORANDUM

TO: Ronald B. Franklin, Assistant Director
Processing Services Division

FROM: Janie E. Bowen, Director
Tax Policy Division

DATE: April 17, 1991

SUBJECT: Setoff Debt Collection Procedures
Taxpayers in Bankruptcy

This is in response to your memorandum of April 20, 1990, seeking guidance as to the proper actions for set off debt collection personnel to take upon receiving notice that the taxpayer is in bankruptcy. I apologize for the delay in responding, but we have no record of receiving your memorandum. We understand that the Department of Accounts asked the Office of the Attorney General the same questions at the suggestion of setoff personnel, and that the questions were recently answered.

As stated in Jim Council's memorandum to Gary Crispens (copy attached) when an individual files a petition in a bankruptcy court federal law provides for an automatic stay applicable to any entity and effective from the moment of filing. The automatic stay prohibits setoff, among other things. Although there are exceptions that may permit a setoff to occur, they are complex and the Office of the Attorney General must be consulted.

The claimant agency bears the primary responsibility in this matter. The claimant agency should not include a debtor in the setoff program when it has received notice that the debtor has filed a petition in a bankruptcy court. If the claimant agency receives such a notice after transmitting the list to us, it should be required to notify us to remove the debtor from setoff.

However, the automatic stay also applies to the Tax Department. If we knowingly violate the automatic stay the department may be liable for damages. It is entirely possible, even likely, that the department would be liable for damages if a setoff occurs when STARS or non-setoff personnel have information showing a pending bankruptcy case. Therefore, whenever and however setoff personnel learn of a bankruptcy filing they must investigate before they setoff a refund. They can hold up a refund for a reasonable time while they investigate, but the length of time that a bankruptcy court would consider reasonable is likely to be quite short, especially after receiving notice of bankruptcy.

The Legal Unit of the Collections Section receives a notice of bankruptcy whenever the debtor lists TAX as a creditor. This information is keyed and shows up on the D22 screen (individuals) or the 418 screen (business). This is the first place setoff personnel should check to see if a bankruptcy is pending. However, the D22 screen shows nothing for Mr. Lonnie Walton, whose setoff triggered your question. Apparently he did not list the department as a creditor. In this case the filing must be verified by other means, such as calling the court.

You should instruct setoff personnel to document the date and nature of the notice they receive concerning a taxpayer's bankruptcy (e.g., notes of a telephone conversation). They should verify that a petition was actually filed with a bankruptcy court, not merely discussed with an attorney, and that the case is still pending. Therefore, setoff personnel should ask for the location of the bankruptcy court, the date that the petition was filed, and case number. If the taxpayer has a bankruptcy case pending, then setoff against the claimant agency's debt is prohibited by the automatic stay and the refund must be issued to the taxpayer, unless the Office of the Attorney General determines that an exception permits setoff to occur.

The safest course is for setoff personnel to check the D22 or 418 screen before making any setoff. As an alternative, STARS could be modified to check those screens automatically and alert the appropriate personnel to the possibility of an automatic stay.

There is another situation arising from bankruptcy that affects setoff differently and should be distinguished. The automatic stay is dissolved when a bankruptcy case has been closed or dismissed. If we learn that there was a bankruptcy case, but it has been concluded, then there is no automatic stay in effect and normal setoff procedures may apply. We can hold the refund while the taxpayer and claimant agency sort out the validity of the debt (including whether the claimant agency's debt was <u>discharged</u> at the conclusion of a bankruptcy case).

The Legal Unit of Collections Section has extensive experience with the bankruptcy courts in Virginia and may be able to assist you in verifying whether or not the taxpayer has actually filed a petition for bankruptcy and, if so, whether the case has been closed or dismissed. The Office of the Attorney General should be consulted if you have any other questions relating to bankruptcy.

c: Barbara Rose
Bill Hawkins
Ron Wheeler

INTER OFFICE MEMORANDUM
OFFICE OF THE ATTORNEY GENERAL

TO: Gary P. Crispens
Assistant Comptroller

APR 8 PM 3 42

FROM: James G. Council
Assistant Attorney General

DATE: April 2, 1991

RE: Virginia Debt Collection Act

This is in response to your memo dated February 15, 1991, and our earlier meetings related to the above. Following are answers to various questions you raise.

Q1: Is the CDS System governed by the Setoff Debt Collection Act, § 58.1-520 through 534?

A1. I agree with your negative answer.

Q2. Can the CDS system match and setoff vendor payments against debts that were submitted under the Individual Setoff Program rules and guidelines?

A2. I agree with your affirmative answer. I assume, however, that your question merely suggests that claimant agencies may report claims to both Departments of Accounts and Taxation or that the two agencies share claim information. Any setoff against tax refunds must still comply with the procedural requirements of § 58.1-525.

Q3. Are matches against debts submitted under Individual Setoff governed by the Setoff Debt Collection Act?

A3. I agree with your negative answer.

Q4. What types of payments would not be eligible for setoff?

A4. As indicated in our previous meeting, it is the responsibility of the various agencies to advise the Department as to whether payments by a particular agency are subject to setoff. I have, however, reviewed the ones which you consider in your letter to be eligible for setoff.

As a matter of policy, you should consider whether setting off employee suggestion awards and travel

reimbursements against debts due the Commonwealth is the most effective procedure available. Setoff may defeat the underlying purpose of suggestion awards which, I understand, is to enhance employee interest and job performance. Attaching travel reimbursements may, likewise, have a negative effect upon job performance.

In your reference to "Payments to hospitals or doctors incurred by a Workman's Compensation beneficiary," it is not clear whether the hospital or beneficiary would be the party indebted to the Commonwealth. Where the beneficiary is the debtor, § 65.1-82 provides that compensation and claims shall be exempt from all claims of creditors. Setoff of a workman's compensation beneficiary's compensation to satisfy his debt to the Commonwealth is not permissible. This section will also prevent the offset against a debt of the hospital, unless the claimant-beneficiary is relieved of his underlying obligation to the healthcare provider.

Q5. Will proposed Prompt Payment legislation be sufficient to disallow interest if payments are held?

A5. Yes. See related question below.

Second Set of Questions:

Q1. Can a penalty be imposed for vendors fraudulently providing a false Employer Identification Number or Social Security Number? If so, what should the penalty be? Is there any legislation currently in place that covers this situation? What would be required to prove fraud?

A1. I am not aware of any Virginia law which authorizes the imposition of a penalty against vendors for providing false identification numbers. I note, however, that a finding that an individual or firm is not a responsible vendor is grounds for debarment under § 3.3(g) of the Vendor's Manual, Division of Purchases and Supply, Department of General Services (July 1990).

Q2. What procedures should be followed if the Department of Taxation is notified by an attorney that a vendor (whose payment has been matched) is in bankruptcy? Should the bankruptcy be verified? How? Do procedures depend on the Chapter of Bankruptcy? Should the payment be released immediately? Under what scenarios (if any) should the payment be kept? What liability does the State have if an agency is aware of the bankruptcy but does not notify the CDS unit? Should the State cease doing business with the vendor? Should the State remove them from the approved vendor list?

A2. Sec. 362(a) of the Bankruptcy Code, 11 U.S.C. 362(a) (1982), provides that a bankruptcy petition operates as a stay against the commencement or continuation of a proceeding against the debtor. Section 362(a)(7) stays the exercise of a prepetition setoff. Retention of a refund by the Internal Revenue Service in a suspense account for offset against a prepetition tax liability has been found in violation of the stay. In re Mealey, 16 Bankr. 800 (E.D. Pa. 1982).

There are various exceptions to the automatic stay, depending upon the particular bankruptcy provisions under which relief is sought and the nature of the claim. These exceptions are, however, complex. If the Department is notified that a vendor has filed a bankruptcy petition, no action should be taken until this Office is consulted.

Verification can be made by obtaining a copy of the petition with an assigned case number by the court. Also, the listing of the Commonwealth as a creditor should be confirmed.

Q3. If a responsible officer of a corporation has a personal debt to the State, and a vendor payment is made to the corporation, can the corporate vendor payment be used to offset the personal debt of the officer of the corporation?

A3. A corporation is not liable for the personal debts of one of its officers, who may not have an ownership interest in the corporation. Absent a court decision that a corporation is merely an alter ego of the officer, a vendor payment to the corporation may not be used to offset an individual debt of an officer.

Q4. Can the IRS file liens against CDS recovery money? Is there any authority that would restrict liens on CDS money? Would the IRS or the State have first claim to any monies from the vendors?

A4. A debt owed by a state to a taxpayer is property against which a federal tax lien may be foreclosed. A state in possession of property of a taxpayer is a person. State of Cal. v. United States, 195 F.2d 530 (8th Cir. 1952). The rules related to priority of tax liens is complex and depends, in part, upon the relative times at which the Federal tax lien and state tax liability (or other liability to the state) arose.

As is the case with bankruptcy, upon notification of a federal tax lien, the Department should take no further action without consulting with this Office.

Q5. Should transactions related to condemnations or "right of way" be eligible for matching?

A5. Condemnation awards by courts are judgments. I have discussed this matter with Richard L. Walton, Jr., Senior Assistant Attorney General, Transportation Section. It is his opinion that court-ordered awards cannot be applied against debts due the Commonwealth unless the order authorizes the setoff.

Third Set of Questions: From September 11, 1990 memo discussed in our previous meeting.

Q1. Would the use of such list to encourage business with vendors who owe the Commonwealth money constitute discrimination against vendors who do not owe the Commonwealth money?

A1. Section 11-41 of the Virginia Public Procurement Act requires that all public contracts with nongovernmental contractors be awarded after competitive sealed bidding or competitive negotiation. Sections 11-47 through 11-47.2 enumerate specific preferences which are permitted, but no preference for vendors indebted to the Commonwealth is listed.

Q2. In reviewing the language in the Virginia Debt Collection Act, § 2.1-735, can we legally discontinue doing business with vendors who previously had bad debts with the Commonwealth, and if so what guidelines should be followed.

A2. Section 11-46.1 authorizes debarment of contractors and requires the state agency to establish a written debarment procedure. Section 3.3(g) of the Vendor's Manual establishes "[a]ny cause indicating that the individual or firm is not a responsible vendor" as a grounds for debarment. Section 3.6 of the Vendor's Manual also prescribes the acceptable debarment procedure an agency must follow.

Q3. Can the State Corporation Commission take any action regarding the corporate status of delinquent vendors?

A3. Your question would be more appropriately addressed by the State Corporation Commission. However, I am aware of no authority which permits the State Corporation Commission to revoke a corporate charter for failure to pay obligations to the Commonwealth, other than fees properly assessed by the State Corporation Commission.

Q4. In those cases where the debtor notification occurs after the payment due date, is interest payable for the days between the payment due date and the date the vendor is

notified by the claimant agency of intent to offset? How does the current seven-day grace period impact this?

A4. Section 11-62.5, as amended, precludes the accrual of interest for the period commencing with the date the Contractor is notified of the anticipated setoff. Interest, therefore, will accrue pursuant to § 11-62.5 until notification is given. Accrual of interest will commence seven days after the payment date, as defined in § 11-62.1.

Q5. Where there are multiple claimant agencies being offered a single vendor payment, does each claimant agency's notification and verification of debt process constitute a separate thirty-day interest penalty exception period?

A5. You will certainly want to refine regulations on this issue. It is, nevertheless, my opinion that interest will not accrue on any amount that the vendor is notified will be subject to setoff from the date of notification. Interest will accrue on any net balance due the vendor until he is notified of an additional agency claim. The thirty-day period will apply to each claim of each agency for which notification was given as to the particular amount of the claim.

Upon review of the above, I suggest that we meet to discuss implementation of procedures to avoid various problems you have raised above.

crispens/FTT/JGC

cc: Mary Yancey Spencer
Senior Assistant Attorney General

SM: A/35.1 - Debt Set-Off