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INCOME TAX REFUND PART OF BANKRUPT'S ESTATE

In re Kokoszka

Within the past twenty-five years, the number of personal insolvencies has risen at a phenomenal rate.[1] This increase has created a substantial burden upon the government's judicial and legislative machinery to provide equitable relief to both debtors and creditors. Pursuant to constitutional mandate[2] the law in this area is partially governed by the Federal Bankruptcy Act.[3] Section 70(a)(5) of the Act provides that a trustee shall, upon the bankrupt's filing of a petition in bankruptcy, obtain title to all of his transferable property interests.[4] The scope of the specific property encompassed by this section has been a source of uncertainty.[5] The Supreme Court has held that a broad definition should apply.[6] Thus if the item was "sufficiently rooted in the pre-bankruptcy past and so little entangled with the bankrupt['s] ability to make an unencumbered fresh start" it would be included within the bankrupt's estate.[7]

The Second Circuit, in *In re Kokoszka*,[8] ruled that title to a bankrupt's income tax refund checks vests in the trustee in bankruptcy.

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1 In 1950, there were 18,000 cases of personal bankruptcy. For the fiscal year ending June 30, 1967, this total rose to 208,000. H.R. REP. No. 1040, 90th Cong., 2d Sess. (1968), 2 U.S. CODE CONG. & AD. NEWS 1962, 1978 (1968). Currently, it is estimated that each year one American in a thousand files a petition in bankruptcy. As a result, $2 billion in debts are cancelled. D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 1 (1971) [hereinafter cited as STANLEY & GIRTH].

2 U.S. CONST. art. I, § 8.

3 11 U.S.C. § 1 *et seq.* (1970). The states also make provision for insolvency proceedings. *See, e.g.*, N.Y. DEBT. & CRED. LAW (McKinney 1945).

4 In pertinent part, § 70(a)(5), 11 U.S.C. § 110(a)(5) (1970), provides:

> (a) The trustee of the estate of a bankrupt . . . [shall] be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located . . . (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered. . . .

5 *See In re* E.V. Moore of Calif., Inc., 447 F.2d 1106, 1108 (9th Cir.), *cert. denied*, 404 U.S. 995 (1971), where the court stated that there are "difficulties which confront an inferior federal court which must interpret words such as 'property,' 'wages,' and other words in the Bankruptcy Act, and apply those words to specific sets of facts, before the Supreme Court has had occasion to elaborate the conflicting policies which urge its members in one or another direction."

6 Segal v. Rochelle, 382 U.S. 375, 379 (1966), where the Court set down the general rule that: "The main thrust of § 70(a)(5) is to secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition. To this end the term 'property' has been construed most generously."

7 *Id.* at 380. In *Segal* it was determined that a tax refund resulting from a loss-carryback claim was property within the meaning of the statute. A primary example of items that are not so includable is future wages. *Id. See In re* Aveni, 458 F.2d 972 (6th Cir.), *cert. denied*, 409 U.S. 877 (1972).

8 479 F.2d 990 (2d Cir. 1973).

This decision involved three cases wherein tax refund checks were received by the appellants after they had filed bankruptcy petitions. Each party was ordered by the referee to turn over the entire proceeds to the trustee.[9] After consolidating the cases, the district court held that in accordance with section 70(a)(5), the tax refunds were part of the bankrupts' estate.[10] The petitioners appealed to the Second Circuit contending that the right to a tax refund, where the minimum amount allowable had been withheld, was not subject to the requirements of section 70(a)(5). Alternatively, they argued that even if the tax refunds were deemed property under the Bankruptcy Act, only 25 percent of them would vest in the trustee by virtue of the Consumer Credit Protection Act's limitation on garnishment.[11]

Kokoszka was precipitated by the Supreme Court's decision in *Lines v. Frederick*.[12] There, the Court resolved the issue of whether or not vacation pay, which became payable after an individual filed for bankruptcy, vested in the trustee. Interpreting the objective of the Bankruptcy Act as to provide the debtor with a "new start in life,"[13] the Court held that vacation pay should not vest in the trustee. However, in recognition of creditor interests, *Lines* was narrowed to situations "[w]here the minimal requirements for economic survival of the debtor are at stake. . . ."[14] Notwithstanding this caveat, *Lines* represents a major shift from the broad approach previously applied.[15]

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[9] The amounts refunded were $250.90, $201.97, and $136.00 respectively. In each case, these amounts represented the only assets in the bankrupt's estate. Only one of the three complied with the order pending the determination of the litigation while the other two disobeyed the order by spending their refunds. *Id.* at 993.

In prior decisions, the right to the refund was deemed to accrue as of the moment the withholding was made and not as of the date a tax return was filed. *See, e.g., In re* Goodson, 208 F. Supp. 837 (S.D. Cal. 1962), where a petition in bankruptcy was filed on November 30, 1960, but a tax return for 1960 was not filed until sometime after January 1, 1961. The court determined that as of the date of bankruptcy, the right to eleven-twelfths of the tax refund had accrued to the bankrupt. As a result, this portion of the refund was ordered transferred to the trustee.

In each instance in *Kokoszka*, the bankruptcy petitions were filed in the year following that for which the tax refunds were due. Therefore, there was no need for apportioning the refund between the bankrupts and the trustee. For example, Kokoszka filed on January 5, 1972, and the trustee sought his refund for overwithholdings on 1971 wages.

[10] Herbert Sands, No. 36,028, Frank O'Brien, No. 36,197, Henry A. Kokoszka, No. 37,437 (D. Conn., July 21, 1972).

[11] 15 U.S.C. § 1673 (1970).

[12] 400 U.S. 18 (1970) (per curiam).

[13] The Court noted: "[T]he basic purpose of the Bankruptcy Act [is] to give the debtor a 'new opportunity in life and a clear field for future efforts, unhampered by the pressure and discouragement of pre-existing debt.'" *Id.* at 19, *quoting* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

[14] 400 U.S. at 20.

[15] In recent years, the law of bankruptcy evolved to the point where liberal treatment is afforded the honest but unfortunate debtor. The Supreme Court has indicated a will-

Although prior law indicated that the trustee would acquire title to all claims of a bankrupt for repayment of taxes,[16] appellants analogized to *Lines*. They claimed that the tax refund is a specialized type of property and as such is protected by virtue of the Court's decision in *Sniadach v. Family Finance Corp.*[17] Moreover, inasmuch as the receipt of the tax refund was an annual event, the taxpayer comes to rely on it. Therefore, the petitioners reasoned, it is analogous to accrued vacation pay and necessary to provide a fresh start.

Appellants' position was bolstered by *In re Cedor*,[18] a Ninth Circuit opinion holding that the tax refund was not property within the meaning of the Bankruptcy Act. There, the characteristics of tax refunds were analyzed in light of the reasoning adopted in *Lines*. It was noted that minimum tax withholdings and accrued vacation pay are similar in various respects. For example, once the tax is withheld the employee cannot recover any part of it prior to his filing a tax return the following year. Similarly, accrued vacation pay is unavailable until the employee takes his vacation or terminates his employment. Also, both the tax withholding and the accrual of vacation pay are not subject to the consent of the employee. He, in effect, has no option but to agree to the requirements of the Government or the procedures of his employer. Finally, both a tax refund and payment of vacation pay are anticipated as annual events by the wage-earner, and he comes to rely on receipt of these funds.[19]

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ingness to invoke its equity powers to relieve the debtor of the burdens of his indebtedness, thereby allowing him to make a fresh start in life. *See* 73 W. VA. L. REV. 302, 306 (1971). *See also* Bank of Marin v. England, 385 U.S. 99, 103 (1966). One author feels it would be extremely easy for a court to rationalize any desired decision under the "fresh start" concept applied in *Lines*. Greenfield, Lines v. Frederick: *The Effect of Bankruptcy on a Bankrupt's Accrued Vacation Pay and Other Forms of Deferred Compensation*, 47 L.A. BAR BULL. 67 (1971).

16 *See* 4A W. COLLIER, BANKRUPTCY ¶ 70.28(4) (14th ed. 1971).

17 395 U.S. 337 (1969). There, the Court determined that a prejudgment garnishment of wages violated procedural due process. In so holding, the Court's reasoning appeared heavily influenced by the special nature of wages as opposed to other forms of property. The Court described wages as "a specialized type of property presenting distinct problems in our economic system," and the garnishment's result as the "driv[ing of] a wage-earning family to the wall." *Id.* at 340, 341-42.

18 337 F. Supp. 1103 (N.D. Cal.), *aff'd*, 470 F.2d 996 (9th Cir. 1972) (per curiam). It should be noted that conflicts had arisen concerning this issue among the lower courts in the Ninth Circuit. In *In re* Kingswood, 343 F. Supp. 498 (C.D. Cal.), *rev'd*, 470 F.2d 996 (9th Cir. 1972), the district court expressly disagreed with the reasoning applied in *Cedor*. In doing so, it accepted a referee's finding that refunds were property within the meaning of section 70(a)(5) and as such vested in the trustee. *See In re* Wetteroff, 453 F.2d 544 (8th Cir.), *cert. denied*, 409 U.S. 934 (1972); *In re* Goodson, 208 F. Supp. 837 (S.D. Cal.).

19 This reasoning, expressed by District Judge Wollenberg in *In re* Cedor, 337 F. Supp. 1103 (N.D. Cal. 1972), was adopted by the Ninth Circuit, 470 F.2d 996 (9th Cir. 1972) (per curiam).

Although these similarities were given credence in *In re Cedor*, the Second Circuit found them unpersuasive. In rejecting the petitioner's claim Judge Anderson, writing for a unanimous panel,[20] interpreted *Lines* very narrowly.[21] He noted that although *Sniadach* and *Lines* referred to wages as a specialized form of property warranting special protection, this protection does not extend to all property merely because wages can be traced as the ultimate source. "[T]o do so would exempt from the bankrupt estate most of the property owned by many bankrupts, such as savings accounts and automobiles which had their origin in wages."[22] Additionally, the court held that, merely because the tax refund may be anticipated as an annual event, this fact does not make it necessary for the basic requirements of life. Judge Anderson observed that other annual payments such as a Christmas club or annual dividends vest in the trustee and "[p]ermitting a bankrupt to retain his tax refund would not be giving him a 'fresh start' to accumulate new wealth but a 'head start' over others who had no such refund."[23]

The second issue confronting the Second Circuit in *Kokoszka* was whether the refund should be deemed partly exempt within the terms of the Consumer Credit Protection Act's limitation on garnishment, thereby limiting the trustee to 25 percent of the amount refunded.[24] Looking to the legislative intent, the court held that the tax refund did not represent disposable earnings, as defined in that Act.[25] One purpose of the statute was to prevent debtors from plunging into bankruptcy. Also, it was hoped that such a limitation would insure adequate weekly support for the debtor and his family.[26] Based on these factors, the court felt that the statute was designed to guarantee

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20 The panel consisted of Judges Anderson, Kaufman, and Mansfield.

21 Judge Anderson stated: "What we have in *Lines* is a *very narrow exception* to the general proposition that everything of value passes to the trustee, *i.e.*, vacation pay which will become essential for basic week to week support in the future does not pass." (emphasis added). 479 F.2d at 994-95.

22 *Id.*

23 *Id.*

24 15 U.S.C. § 1671 *et seq.* (1970). Section 1672(a) defines earnings as: "compensation paid or payable for personal services, whether denominated as wages, salary, commission, bonus, or otherwise, and includes periodic payments pursuant to a pension or retirement program."

25 15 U.S.C. § 1673 (1970) provides, in pertinent part, that "the maximum part of the aggregate disposable earnings of an individual for any workweek which is subject to garnishment may not exceed (1) 25 per centum of his disposable earnings for that week . . . ." Disposable earnings are defined in Section 1672(b) as "that part of the earnings . . . remaining after the deduction from those earnings of any amounts required by law to be withheld."

26 *See* H.R. REP. No. 1040, 90th Cong., 2d Sess. (1968), 2 U.S. CODE CONG. & AD. NEWS 1962, 1977-79 (1968).

that basic needs could be met from the debtor's "take home" weekly wages.[27] Since the refund did not represent such compensation, it was deemed excluded from the limitation.[28]

The Second Circuit, in *Kokoszka*, properly concluded that tax refunds neither fall within the Supreme Court's exemption in *Lines* nor within the statutory limitations on garnishment. When the Court promulgated the "fresh start" approach in *Lines* it was solely concerned with avoiding the effects of depriving a wage-earner of "the new opportunity in life which the Bankruptcy Act intended to provide."[29] Vacation pay has generally been considered a form of additional wages,[30] the function of which is to "support the basic requirements of life . . . during brief vacation periods or in the event of layoff."[31] The tax withheld was not of that nature since it had lost its status as wages and had become a claim against the Government.[32] When refunded, its normal function would be to supplement the wages of the bankrupt rather than to provide basic life requirements. Based on these factors, the Second Circuit's denial of exempt status to tax refunds appears sound and fits within the guidelines set by *Lines* and prior Supreme Court decisions.[33] Yet, it is arguable that substan-

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27 479 F.2d at 996-97. This view seems further supported by the statutory wording which applies the limitation only to "disposable earnings of an individual for any workweek." 15 U.S.C. § 1673(a) (1970).

28 By virtue of this holding, *Kokoszka* stands in direct conflict with the Ninth Circuit. *See In re* Cedor, 337 F. Supp. 1103 (N.D. Cal.), *aff'd*, 470 F.2d 996 (9th Cir. 1972), where it was held that the refund had not lost its character as wages. As the *Cedor* district court stated: "There does not appear to be any reason of policy why the amount of the refund should be held to have lost its character as earnings by reason of its somewhat circuitous route to the wage-earner's hands." 337 F. Supp. at 1107. This conclusion appears inconsistent with the established position that, once withheld, the amount loses its character as wages and becomes a claim against the Government. *See* note 32 *infra*. Despite interesting arguments in *Cedor* for the position that bankruptcy orders fall within the Consumer Credit Protection Act, 337 F. Supp. at 1107, the court's position lacks validity without an initial determination that the tax refunds are earnings. *See* 4A W. COLLIER, BANKRUPTCY ¶ 70.34 (14th ed. Supp. 1972).

29 400 U.S. at 20.

30 *See In re* Wil-low Cafeterias, Inc., 111 F.2d 429 (2d Cir. 1940).

31 400 U.S. at 20.

32 *See* 4A W. COLLIER, BANKRUPTCY ¶ 70.28(4) (14th ed. 1971). The tax refund's status is further discussed in a referee's report in the opinion in *In re* Kingswood, 343 F. Supp. 498 (C.D. Cal.), *rev'd*, 470 F.2d 996 (9th Cir. 1972).

33 The court held:

> Because a tax refund is not the weekly or other periodic income required by a wage earner for his basic support, to deprive him of it will not hinder his ability to make a fresh start unhampered by the pressure of pre-existing debt. Therefore, the tax refund is . . . property which passes to the trustee.

479 F.2d at 995.

Such a holding is further supported by consideration of the decision upon which *Lines* is, in part, based, *viz.*, Sniadach v. Family Fin. Corp., 395 U.S. 337 (1969). There, a state prejudgment garnishment procedure, which could result in the debtor being deprived of all his wages, was declared invalid. Clearly, less hardship exists where vacation pay, as in *Lines*, is involved. *See* 49 N.C.L. REV. 738, 745 (1971). A further extension to tax refunds could easily be considered a strained interpretation.

tial justice was not done by the *Kokoszka* court. The refunds were relatively small and comprised the only asset in the bankrupts' estates. After compensating the trustee for his services, little or no funds would remain thereafter for payment to creditors.[34] Judge Anderson noted that "[c]learly the purpose of the Bankruptcy Act was to benefit creditors and debtors, not trustees."[35] Nonetheless, the Second Circuit's suggestion that the debtor use the remedy of abandonment[36] is unpalatable. To gain such relief, the debtor has the burden of making the appropriate motion. Realistically, the awareness of such a procedure depends on legal advice, which may be as expensive as turning over the refund to the trustee.[37] One method which may be implemented to provide relief for debtors in this situation would be a provision for exemption allowances whereby trustees would not be permitted to claim title to tax refunds below a certain level.[38] However, provision of such relief is a legislative function. In light of the conflict between the Second and Ninth Circuits, the resolution of this issue may well lie with the Supreme Court.[39]

The court's logic is also supported by *In re* Jones, 337 F. Supp. 620, 624 (D. Minn.), *cert. denied*, 404 U.S. 1040 (1972). There, the court noted the decision in *Lines*, but refused to apply it to a tax refund, saying "[i]t is not clear . . . that wages withheld prior to adjudication are so entwined with the bankrupt's future wage earning activity that they should receive the same treatment as future wages." *See also In re* Kingswood, 343 F. Supp. 498 (C.D. Cal.), *rev'd*, 470 F.2d 996 (9th Cir. 1972).

34 The court noted that a trustee can receive up to $150 in fees no matter how small the bankrupt's estate. 479 F.2d at 995. If such were the case here, one estate would be completely used for trustee's fees while the other two estates would be left with balances of $100.90 and $51.97, respectively, for creditors.

35 *Id.* at 995-96.

36 *Id.* at 996. *See In re* Mirsky, 124 F.2d 1017 (2d Cir.), *cert. denied*, 317 U.S. 638 (1942).

The abandonment process requires the debtor to set forth evidence that no injustice would result if the creditors abandoned the assets and no trustee was appointed. The decision to deny or grant the motion is discretionary with the referee. It should be granted if (1) all the assets will be consumed by trustee's and administration fees, (2) there is not a likely opportunity that the trustee will recover additional assets, and (3) the trustee's absence will not cast a burden on the bankruptcy court. 479 F.2d at 996. Upon a granting of a motion, the bankrupt retains whatever title he originally had in the assets. *In re* Wattley, 62 F.2d 828 (2d Cir. 1933).

For a discussion of the procedure and effects of abandonment when a trustee has already been appointed see Note, *Abandonment of Assets by a Trustee in Bankruptcy*, 53 COLUM. L. REV. 415 (1953).

37 STANLEY & GIRTH, *supra* note 1, at 85, comment: "Debtors who are carefully advised and who can wait do not file in bankruptcy until tax refunds have been cashed and spent — frequently for attorney's fees and costs."

38 *Id.* at 86. *See In re* Kingswood, 343 F. Supp. 498 (C.D. Cal.), *rev'd on other grounds*, 470 F.2d 996 (9th Cir. 1972).

39 The Bankruptcy Act, itself, indicates its authors' willingness to incorporate within the Act exemptions enacted by both the Congress and state governments. Section 6 of the Act, 11 U.S.C. § 24 (1970), provides: "This title shall not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States or by the State laws in force at the time of the filing of the petition. . . ." The burden may well be upon the various legislatures to correct any possible injustices created by decisions such as *Kokoszka*.