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Bankruptcy -- Title to Loss Carry-back Tax Refunds

David S. Kenin

It is hoped that in future "establishment clause" cases the Court will not be as willing to uphold laws that directly benefit religious groups. If religion is to remain free from governmental interference, religious groups might well consider rejection of secular aid, because it is likely to be followed by secular control.[61]

HENRY M. SCHMERER

BANKRUPTCY — TITLE TO LOSS CARRY-BACK TAX REFUNDS

In March 1957, the trustee in bankruptcy filed a successful claim for refund of federal income taxes on behalf of the bankrupt. The trustee carried back a net operating loss sustained during 1956. The bankrupt reported income on a calendar year basis. He contended that he, not the trustee, was entitled to the refund because section 70(a) of the Bankruptcy Act[1] vests title in the trustee only to property vested in the bankrupt at the time of the filing of the petition in bankruptcy. Since the petition in bankruptcy was filed in June of 1956 and because the right to the refund did not arise until December 31, 1956, he argued that the trustee was not entitled to the funds. *Held*: the expectation before the end of a taxable year of a refund for a loss carry-back is not a "right of action" or "property" which by statute vests in the trustee in bankruptcy, and the bankrupt taxpayer is entitled to the refund. *In re Sussman*, 289 F.2d 76 (3d Cir. 1961).

The taxpayer's right to a loss carry-back refund does not vest in him until the end of the taxable year in which the loss occurs. The Internal Revenue Code, which authorizes loss carry-backs, does so on the basis of a taxable year.[2]

Section 70(a) of the Bankruptcy Act provides that the trustee in bankruptcy takes title to such "property" as the bankrupt could have transferred by any means at the time of the filing of the petition in bankruptcy.[3]

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they are not in church to do other activities. 3 STOKES, CHURCH AND STATE IN THE UNITED STATES 158 (1950). *But see*, Brief for the Archdiocesan Council of Catholic Men as Amicus Curiae, Crown Kosher Super Market v. Gallagher, 176 F. Supp. 466 (D. Mass. 1959) (by implication).

61. The Court subsequently held as unconstitutional a section of the Maryland Constitution requiring a belief in God in order to hold public office as violative of the establishment and free exercise of religion clauses. " '[W]e have staked the very existence of our country on the faith that complete separation between the state and religion is best for the state and best for religion.' " Torcaso v. Watkins, 81 Sup. Ct. 1680, 1683 (1961). See Cahn, *How To Destroy the Churches*, Harper's, Nov. 1961, p. 33.

1. 52 Stat. 879 (1938), as amended, 11 U.S.C. § 110(a) (1958).

2. INT. REV. CODE OF 1954, § 172(c). It is evident that one who sustains a net operating loss for a portion of his taxable year may earn enough income during the balance of the year to offset or reduce the loss.

3. This interpretation has been adopted in Fairbanks Steam Shovel Co. v. Wills, 240 U.S. 642 (1916); Fish v. East, 114 F.2d 177 (10th Cir. 1940); Dannel v. Wilson-

After-acquired property does not pass to the trustee.[4] The act establishes three specific exceptions to this rule: contingent interests in real estate which become assignable by the bankrupt within six months after bankruptcy;[5] bequests, devises and inheritances which vest in the bankrupt within six months of bankruptcy;[6] and property held in an estate by the entireties with another at the time of the bankruptcy, which becomes transferable by the bankrupt alone, within six months after bankruptcy.[7]

It is often difficult to determine what property the bankrupt could have transferred within the meaning of section 70(a) of the Bankruptcy Act. The generally accepted test is that property which the bankrupt could have transferred by any means, or upon which his creditors might have levied, or which they might have seized or impounded will vest in the trustee upon the filing of the petition in bankruptcy.[8] This property vests in the trustee by operation of law[9] and includes both corporeal and incorporeal property.[10]

Since the concept of transferability is the key to section 70(a) of the Bankruptcy Act, one dealing with that section must be familiar with the law of assignments within his own jurisdiction. The federal courts will follow state law in determining whether or not particular property is transferable.[11] They will follow federal law in determining whether a transfer

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Weesner-Wilkinson Co., 109 F.2d 364 (6th Cir. 1940); City of Long Beach v. Metcalf, 103 F.2d 483 (9th Cir.), *cert. denied*, 308 U.S. 602 (1939) L; *In re* Park Beach Hotel Bldg. Corp., 96 F.2d 886 (7th Cir.), *cert. denied*, 305 U.S. 638 (1938); see generally 8 C.J.S. *Bankruptcy* § 200 (1938).

Bankruptcy Act § 70(a)(5), (6), 52 Stat. 880 (1938), as amended, 11 U.S.C. § 110(a)(5), (6) (1958). "(a) The trustee of the estate of a bankrupt . . . shall in turn 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 . . . 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: . . . (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property . . . ."

4. *In re* Judson, 192 Fed. 834 (2d Cir.), *aff'd*, 228 U.S. 474 (1913); *In re* Burka, 104 Fed. 326 (E.D. Mo. 1900); Sibley v. Nason, 196 Mass. 125, 81 N.E. 887 (1907); Bloomer v. Southwest Wash. Prod. Credit Ass'n, 36 Wash. 2d 752, 220 P.2d 324 (1950).

5. Bankruptcy Act § 70(a)(7), 52 Stat. 880 (1938), as amended, 11 U.S.C. § 110(a)(7) (1958).

6. Bankruptcy Act § 70(a), 52 Stat. 879 (1938), as amended, 11 U.S.C. § 110(a) (1958).

7. *Ibid.*

8. Bankruptcy Act § 70(a)(5), 52 Stat. 880 (1938), as amended, 11 U.S.C. § 110(a)(5) (1958); Globe Bank & Trust Co. v. Martin, 236 U.S. 288 (1915); *In re* Duncan, 148 Fed. 464 (D.S.C. 1906); 8 C.J.S. *Bankruptcy* § 169 (1938); 6 AM. JUR. *Bankruptcy* § 844 (1950).

9. Bankruptcy Act § 70(a), 52 Stat. 879 (1938), as amended, 11 U.S.C. § 110(a) (1958).

10. *Ibid.*

11. Adelman v. Centaur Corp., 145 F.2d 573 (6th Cir. 1944); Seymour v. Wildgen, 137 F.2d 160 (10th Cir. 1943); *In re* L. H. Duncan & Sons, 127 F.2d 640 (3d Cir. 1942); *In re* Landis, 41 F.2d 700 (7th Cir. 1930).

falls within the meaning of section 70(a) of the Bankruptcy Act.[12] Expectancies, which are not vested in the assignor at the time of assignment, are not capable of assignment in law in most jurisdictions.[13] Many expectancies and contingencies are capable of assignment in equity provided that the assignee has paid a valuable consideration therefor.[14] These expectancies and contingencies include choses in action,[15] contingent remainders in realty,[16] rights expected to arise under a future contract,[17] and an expectancy of an inheritance.[18] The federal courts have recognized assignments enforceable in equity as being proper transfers within the meaning of section 70(a) of the Bankruptcy Act, when those assignments were sanctioned by applicable state law.[19]

In attempting to assign an expectation of a right to a federal tax refund, one may be severely restricted by the Assignment of Claims Act.[20] It is recognized, however, that the Assignment of Claims Act does not affect assignments by operation of law[21] or assignments for the benefit of creditors.[22] Since the purpose of the Assignment of Claims Act is to protect

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12. *Ibid.*

13. Casady v. Scott, 40 Idaho 137, 237 Pac. 415 (1924); Aetna Trust & Sav. Co. v. Nackenhorst, 188 Ind. 621, 123 N.E. 353 (1919); Fisher's Estate, 14 Pa. D. & C. 89 (Orphans' Ct. 1930).

14. *In re* Landis, 41 F.2d 700 (7th Cir. 1930); Keys v. Keys, 148 Md. 397, 129 Atl. 504 (1925).

15. See Garford Motor Truck Co. v. Buckson, 34 Del. (4 W.W. Harr.) 103, 143 Atl. 410 (1927); Hillsdale Distillery Co. v. Briant, 129 Minn. 223, 152 N.W. 265 (1915); McClure v. Weigand Tea & Coffee Co., 158 Okla. 115, 12 P.2d 977 (1932); see generally WILLISTON, CONTRACTS § 405 (3d ed. 1960); KEETON, EQUITY, 173-203 (5th ed. 1961); 6 C.J.S. *Assignments* § 5 (1937).

16. *In re* Landis, 41 F.2d 700 (7th Cir. 1930); Casady v. Scott, 40 Idaho 137, 237 Pac. 415 (1924); *In re* Heye's Estate, 149 Misc. 890, 269 N.Y. Supp. 530 (Surr. Ct. 1933).

17. See generally WILLISTON, CONTRACTS § 413 (3d ed. 1960): "[W]ith reference to assignment of choses in action, it is still true that apart from statute a complete legal title . . . cannot be transferred without consent of the debtor. The practical effect of assignment of such property is produced whether the parties so state or not, by the legal authority or power of attorney which the owner of the claim gives to the assignee to collect it and keep the proceeds, and what may be called an equitable ownership as hereafter defined.

The same kind of effect can easily be given if desirable to an assignment of a *future claim*, though no equitable interest in what is assigned can arise until it comes into existence. It is possible in this sense to assign effectively a claim the performance of which is not yet due, and apart from considerations of public policy there seems no limit to the principle . . . . " (Emphasis added.)

18. *In re* Landis, 41 F.2d 700 (7th Cir. 1930); Casady v. Scott, 40 Idaho 137, 237 Pac. 415 (1924); Thornton v. Louch, 297 Ill. 204, 130 N.E. 467 (1921); Gannon v. Graham, 211 Iowa 516, 231 N.W. 675 (1930); Keys v. Keys, 148 Md. 397, 129 Atl. 504 (1925); Burges v. Gray, 211 S.W. 2d 776 (Tex. Civ. App. 1948).

19. *In re* Landis, *supra* note 18. State law determines the assignability of the property in question and the federal courts determine what is a proper transfer within the meaning of § 70(a) of the Bankruptcy Act. See cases cited note 11 *supra*.

20. 10 Stat. 170 (1853), as amended, 31 U.S.C. § 203 (1958).

21. United States v. Aetna Cas. & Sur. Co., 338 U.S. 366 (1949); Malman v. United States, 202 F.2d 483 (2d Cir. 1953); Morgenthau v. Fidelity & Deposit Co., 94 F.2d 632 (D.C. Cir. 1937); Chandler v. Nathans, 6 F.2d 725 (3d Cir. 1925); Ozanic v. United States, 83 F. Supp. 4 (S.D.N.Y. 1949), *aff'd*, 188 F.2d 228 (2d Cir. 1951).

22. Chandler v. Nathan, 6 F.2d 725 (3d Cir. 1925); Singer v. United States, 115 F. Supp. 166 (Ct. Cl. 1953).

the United States from conflicting claims,[23] it should not affect the transferability of claims to the trustee in bankruptcy.

The court relied heavily upon the provisions of section 70(a) of the Bankruptcy Act in reaching its conclusion. It reasoned that the bankrupt had only an expectation of a claim against the United States at the time of the filing of the petition.[24] The expectation of this claim was not property that the bankrupt could have transferred or that his creditors could have levied upon. The court maintained that even if this expectation were capable of assignment, it probably would be barred by the Assignment of Claims Act. It recognized that this result was unfortunate in that the very business losses which destroyed the bankrupt's capacity to pay his creditors resulted in a windfall to the bankrupt at the expense of the creditors. The court suggested that the "matter requires a legislative solution."[25]

Certainly a legislative solution in the form of an amendment to section 70(a) of the Bankruptcy Act is desirable.[26] It is suggested, however, that the court might have found that the expectation of a tax refund is transferable within the meaning of section 70(a) of the Bankruptcy Act since the assignment of this expectation would probably have been enforceable in equity under state law.[27] The rule resulting from the instant

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23. Martin v. National Sur. Co., 300 U.S. 588 (1937); Bank of California, Nat'l Ass'n v. Commissioner, 133 F.2d 428 (9th Cir. 1943); Stebbins v. R. H. Siegfried Co., 327 P.2d 447 (Okla. 1958).

24. This writer believes that it may be argued that the "property" giving rise to the right to the loss carry-back refund is really based upon a right which arises when an income tax is paid (in years prior to the loss). Under this theory, a taxpayer would acquire a right to a loss carry-back refund as soon as he pays an income tax. This right would be subject to divestment by the passing of the statutory period of tax years without a loss. Should this view be accepted, then certainly the trustee in bankruptcy would be vested with the right to the loss carry-back.

25. *In re* Sussman, 289 F.2d 76, 78 (3d Cir. 1961). The Court apparently did not consider the argument made in the district court, that the bankrupt and his wife were tenants by the entireties in the proceeds of the refund. For a discussion of this theory see *In re* Sussman, 188 F. Supp. 320 (E.D. Pa. 1960); see also *In re* York Radio & Refrigeration Parts, 20 Pa. D. & C.2d 85 (Orphans' Ct. 1959).

26. The suggested amendment might be accomplished by inserting into § 70(a) the following:

> The trustee shall be vested with title to such tax refund claims as may be vested in the bankrupt at the time of the filing of the petition, or as may vest in the bankrupt subsequent to the filing of the petition *provided* that such subsequently arising claims shall be due to losses incurred by the bankrupt during the tax year in which the petition is filed.

It should be noted that this suggested amendment would vest the trustee with the right to a refund on losses incurred subsequent to the petition, within the tax year of the filing of the petition. This writer believes that this is necessary in order to prevent the bankrupt from starting a new activity or enterprise within the same tax year and forcing his old creditors to underwrite the losses incurred in the initial stages of that new enterprise. If the bankrupt were to be allowed a proportionate share of the refund based upon after-incurred losses within that tax year, his share of the refund might be too large. The practical effect of that condition would result in the old creditors "bankrolling" the new business.

27. Section 70(a)(5) of the Bankruptcy Act, 52 Stat. 880 (1938), as amended. 11 U.S.C. § 110(a)(5) (1958) clearly indicates that rights of action that the bankrupt could have transferred by any means shall vest in the trustee. It seems apparent that the

case leads to the conclusion that a debtor, on a calendar year tax period, seeing himself hard pressed, may file a petition in bankruptcy on December 30, of a loss year, and may, by midnight of the following day be entitled to a tax loss carry-back refund which his creditors can not touch. This rule must carry with it the possibilities of fraud, collusion, and windfall.

DAVID S. KENIN

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use of the term *any means* is significant. It can be argued that an assignment of an expected loss carry-back would be enforceable in equity and would fall within the intent of the act.

If the assignment of inchoate rights such as expectancies of inheritance, rights expected to arise under a future contract, and contingent remainders is enforceable in equity, should not an expectation of a tax loss carry-back refund be assignable? If an assignee paid valuable consideration for this assignment and the obligor (the United States) paid the claim, would not a court of equity enforce the assignment? Would equity not do that which ought to be done? In what manner does the assignment of an expected claim against the United States differ from the assignment of other expectancies enforceable in equity?

It might seem that this assignment would be barred by the provisions of the Assignment of Claims Act, 10 Stat. 170 (1853), as amended, 31 U.S.C. § 203 (1958). But since that act does not affect assignments by operation of law (as in bankruptcy). United States v. Aetna Cas. & Sur. Co., 338 U.S. 366 (1949); Malman v. United States, 202 F.2d 483 (2d Cir. 1953); Chandler v. Nathans, 6 F.2d 725 (3d Cir. 1925), and since the purpose of the act is to protect the United States from conflicting claims, it should not bar this assignment. In *Sussman* the United States had already disbursed the loss carry-back funds to the trustee in bankruptcy. Assuming that the trustee took title to the claim by operation of law, the United States needed no protection from conflicting claims. The issue was between the assignor-bankrupt and the assignee-trustee. Moreover, the disbursement by the United States to the trustee would seem to indicate that the United States acquiesced in what it must have thought to have been an assignment by operation of law.