

NOTES

BANKRUPTCY ACT—TITLE TO PROPERTY—INCOME TAX REFUNDS PASS TO TRUSTEE

In *Kokoszka v. Belford*¹ the United States Supreme Court held that an income tax refund is property that passes to the trustee in bankruptcy under section 70a(5) of the Bankruptcy Act² and that the limitations of the Consumer Credit Protection Act³ (CCPA) on wage garnishment do not apply to an income tax refund in a bankruptcy proceeding.

Henry Kokoszka filed a voluntary petition and was adjudicated a bankrupt on January 5, 1972. The only asset of value in the bankrupt estate was his 1971 income tax refund check. On February 3, the referee in bankruptcy ordered him to deliver the refund check to the trustee. After a motion to vacate the order was denied, Kokoszka petitioned for review in the district court. The district court denied relief. Kokoszka was granted leave to appeal, and the United States Court of Appeals for the Second Circuit affirmed the order of the district court.⁴ To resolve the conflict among the courts of appeals,⁵ the Supreme Court granted certiorari⁶ to hear argument on two questions: (1) does a bankrupt wage earner's federal income tax refund constitute "property" within the meaning of section 70a(5) and thus pass to the trustee in bankruptcy, or is the refund excluded from his reach under the "fresh start doctrine" as enunciated in *In re*

1. 417 U.S. 642 (1974).

2. The pertinent parts of section 70a(5) of the Bankruptcy Act, 11 U.S.C. §110a(5) (1970), read as follows:

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 . . . 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

3. 15 U.S.C. §1673 (1970) reads, in pertinent part:

[T]he maximum part of the aggregate disposable earnings of an individual for any work week which is subjected to garnishment may not exceed

(1) 25 per centum of his disposable earnings for that week

(c) No court of the United States or any state may make, execute or enforce any order or process in violation of this section.

4. 479 F.2d 990 (2d Cir. 1973).

5. Compare *In re Jones*, 337 F. Supp. 620 (D. Minn. 1971), cert. denied, 404 U.S. 1040 (1972) and *In re Kokoszka*, 479 F.2d 990 (2d Cir. 1973), cert. granted, 414 U.S. 1091 (1973) with *In re Cedor*, 470 F.2d 996 (9th Cir. 1972), cert. denied, 411 U.S. 973 (1973) and *In re Gehrig*, 491 F.2d 668 (8th Cir. 1974).

6. 414 U.S. 1091 (1973).

*Cedor*⁷ and (2) if the total amount of the refund—or some portion thereof—is “property” which vests in the trustee, will the Restriction on Garnishment provision of the Consumer Credit Protection Act apply to exempt up to 75 percent of that amount?⁸

What constitutes property to be transferred to the trustee in bankruptcy is governed by section 70a of the Bankruptcy Act. If a bankrupt has a contingent interest in a res—“not yet accrued and dependent upon the happening of some future event”⁹—such as an income tax refund check, then it must be determined if the interest is sufficient to constitute transferable property. In order to determine this, the purposes of the Bankruptcy Act “must ultimately govern.”¹⁰ The purposes of the Act are “to convert the estate of the bankrupt into cash and distribute it among creditors and then to give the bankrupt a fresh start,”¹¹ *i.e.*, to give him “a new opportunity in life.”¹²

The Supreme Court discussed the issues in *Kokoszka* in the light of two prior decisions. In *Segal v. Rochelle*¹³ the Court considered the twofold purpose of the Act and formulated a test for determining whether an interest in a res is section 70a(5) property. In that case, the question concerned a refund resulting from a loss-carryback claim.¹⁴ After balancing the purposes of the Act and construing “property” and “transferable” broadly, the Court decided that the refund was “sufficiently rooted in the prebankruptcy past and so little entangled with the bankrupt’s ability to make an unencumbered fresh start that it should be regarded as ‘property’ under section 70a(5).”¹⁵ In *Lines v. Frederick*,¹⁶ the Court was confronted with the

7. 470 F.2d 996 (9th Cir. 1972), *cert. denied*, 411 U.S. 973 (1973). In *Cedor*, the Ninth Circuit took a stand that was very favorable to the bankrupt wage earner. The difference between the wage earner’s actual income tax liability and the minimum amount required to be withheld by the Internal Revenue Code was held not to be section 70a(5) property and did not pass to the trustee. The court recognized that an astute candidate for bankruptcy could drastically increase his withholding if he knew that the refund eventually obtained after bankruptcy would be free of the claims of his creditors and the trustee. Therefore, the court also said that money withheld in an amount greater than the minimum required by the Internal Revenue Code was not section 70a(5) property. However, the court said this excess amount retained the same characterization as its source—wages—and thus passed to the trustee subject to the exemptions of the CCPA. This defeated the purpose of preventing the prospective bankrupt wage earner from increasing his withholding because, under the CCPA, only 25 percent of the excess amount could be claimed by the trustee, so it was still to the advantage of the wage earner in certain circumstances to increase withholding.

8. 42 U.S.L.W. 3376 (U.S. Dec. 25, 1973).

9. Note, *Title to Income Tax Refunds upon Adjudication in Bankruptcy*, 15 B.C. IND. & COM. L. REV. 554, 560-61 (1974).

10. *Segal v. Rochelle*, 382 U.S. 375, 379 (1966).

11. *Burlingham v. Crouse*, 228 U.S. 459, 473 (1913).

12. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

13. 382 U.S. 375 (1966).

14. *See* 26 U.S.C. §§172, 6411 (1970).

15. 382 U.S. at 380.

16. 400 U.S. 18 (1970).

question of whether a bankrupt wage earner's vacation pay, accrued but unpaid, constituted section 70a(5) property. Although the pay was based in the prebankruptcy past, the Court said, "The most important consideration limiting the breadth of the definition of 'property' . . . is to give the debtor a 'new opportunity in life.'"¹⁷ The Court noted that the vacation pay, as part of wages, was "a specialized type of property"¹⁸ and that the bankrupt was a wage earner "whose sole source of income, before and after bankruptcy, is [his] weekly earnings."¹⁹ If he was laid off, he would have no means of support and no way to provide the basic requirements of life without his vacation pay. This, the Court said, would deny him the "'new opportunity in life' . . . which it was the purpose of the statute to provide."²⁰ For that reason, the Court held that the vacation pay was not section 70a(5) property.

In *Kokoszka*, Chief Justice Burger conceded that the refund, like the vacation pay, was wage based and therefore a specialized type of property, but he concluded that the refund did "not relate conceptually to future wages"²¹ necessary to provide the basic requirements in life. The Court felt that this point was crucial stating:

"A tax refund is not the . . . 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 Just because [it] had its source in wages . . . does not give it special protection, for to do so would exempt from the bankrupt estate most of the property owned by many bankrupts . . . which had their origin in wages."²²

The Court held that the income tax refund was sufficiently rooted in the prebankruptcy past to be classed as property and that classifying it as such would not hinder a fresh start.²³

The Court then considered whether 75 percent of the refund was exempt under the CCPA. *Kokoszka* contended that the refund was disposable earnings taken by a garnishment within the definition of these terms in the CCPA,²⁴ which provides that no more than 25 percent of a person's aggre-

17. *Id.* at 19.

18. *Id.* at 20, quoting from *Sniadach v. Family Fin. Corp.*, 395 U.S. 337, 340 (1969).

19. 400 U.S. at 20.

20. *Id.*

21. 417 U.S. at 647.

22. *Id.* at 648 (emphasis in the original), quoting from 479 F.2d at 995.

23. 417 U.S. at 648.

24. 15 U.S.C. §1672 (1970) entitled "Definitions" states:

For the purpose of this subchapter:

(b) The term 'disposable earnings' means that part of the earnings of any individual remaining after the deduction from those earnings of any amounts required by law to be withheld.

(c) The term 'garnishment' means any legal or equitable procedure through which the earnings of any individual are required to be withheld for payment of any debt.

gate disposable earnings for a pay period may be garnished. The Bankruptcy Act is subject to exemptions to its application²⁵ and Kokoszka argued that this limitation on garnishment was one. If sustained, this argument would largely nullify the effect of classifying income tax refunds as section 70a(5) property.

It was apparent that the terms of the CCPA could apply, but the Court, after examining the legislative history and purpose of the Act, determined that in enacting the CCPA,

Congress' concern was not the *administration* of a bankrupt's estate but the *prevention* of bankruptcy in the first place . . . if despite [the CCPA's protection], bankruptcy did occur, the debtor's protection and remedy remained under the Bankruptcy Act.²⁶

The Court recognized that the legislative intent was to protect enough of a debtor's pay to ensure that he could provide for the basic requirements and not be unnecessarily forced into bankruptcy by a harsh garnishment law. The legislature was not concerned with a bankrupt's income tax refund or any other property that had its source in his prebankruptcy take-home pay. "It is not the function of an income tax refund to support the basic requirements of life."²⁷ The CCPA does not limit the bankruptcy trustee's right to treat the refund as property of the bankrupt's estate.

By rejecting both of Kokoszka's arguments, the Court overruled *Cedor*. The distinction in *Cedor* between voluntarily and involuntarily withheld taxes was not addressed. However, as involuntary payments pass to the trustee, it would be anomalous for voluntary payments not to do so. If a debtor is contemplating bankruptcy he should take the maximum number of exemptions so that the smallest amount will be withheld, as any excess withheld will go to the trustee if he subsequently does go bankrupt.

The refusal of the Court to extend the "fresh start doctrine" of *Lines* to income tax refunds delimits the extent of this exception to the general rule established in *Segal*. Concern had been expressed that a "failure to recognize the narrow holding of *Lines* could result in the bankrupt retaining all rights to deferred compensation,"²⁸ which retention would controvert the first purpose of the Bankruptcy Act. The "unrestricted, open-ended expansion"²⁹ of *Lines* by *Cedor* appeared to do just that. However, *Kokoszka* puts *Lines* in its proper perspective.

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25. See Bankruptcy Act §70(a), 11 U.S.C. §110(a) (1970) (the trustee takes title "except insofar as it is property which is held to be exempt."). See also Bankruptcy Act §6, 11 U.S.C. §24 (1970) (the act "shall not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States.").

26. 417 U.S. at 650-51 (emphasis in the original).

27. Note, *supra* note 9 at 567.

28. Note, *Treatment of the Bankrupt's Income Tax Refund under §70a(5) of the Bankruptcy Act*, 11 HOUSTON L. REV. 667, 678 (1974).

29. Lee, *Title to Property—Employee Bankrupts Income Tax Refunds*, 47 AM. BANKR. L.J. 239, 241 (1973).