TITLE TO INCOME TAX REFUNDS UPON ADJUDICATION IN BANKRUPTCY

Until recently it was firmly established that an income tax refund payable to a bankrupt after his adjudication as such is "property" which passes to the trustee in bankruptcy under section 70a(5) of the Bankruptcy Act (the Act).[1] One of the primary purposes of the Act is to give to the creditors everything of value possessed by the bankrupt, without at the same time driving him into a position from which he will be unable to reestablish himself and become solvent.[2] The tax refund was considered an asset which could pass to the trustee without presenting any such insurmountable obstacle to the bankrupt.

Despite the consistency of earlier cases within its jurisdiction as well as without, the United States Court of Appeals for the Ninth Circuit chose to deviate from this firm ground in *In re Cedor,*[3] decided late in 1972. However, five months later, the United States Court of Appeals for the Second Circuit, in *In re Kokoszka,*[4] explicitly refused to follow *Cedor*[5] and returned to settled judicial precedent.

The court in *Cedor* had consolidated the cases of two bankrupts, Cedor and James. In both of these cases, the trustee asserted his claim to an income tax refund which resulted from an excess of taxes withheld over the amount of taxes actually due. Cedor had had withheld the minimum required by the Internal Revenue Code;[6] James, however, did not initially claim all the exemptions to which he was entitled, thereby increasing the amount of his refund.[7]

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[1] 11 U.S.C. § 110(a)(5) (1970). The pertinent portion of § 70a(5) is quoted in the text at note 46 infra.

Several cases have dealt with the specific nature of the income tax refund and have held it is property which passes to the trustee in bankruptcy: In re Jones, 337 F. Supp. 620 (D. Minn. 1971), leave to appeal denied (8th Cir. May 14, 1971) (unreported), cert. denied, 404 U.S. 1040 (1972); In re Bistrick, [1967-1970 Transfer Binder] Bankr. L. Rep. ¶ 63,148, at 72,769 (E.D. Wis. 1969); In re Goodson, 208 F. Supp. 837 (S.D. Cal. 1962). The holding was implicit in other cases: In re Wetteroff, 453 F.2d 544 (8th Cir.), cert. denied, 409 U.S. 934 (1972); Danning v. Mintz, 367 F.2d 304 (9th Cir. 1966), cert. denied, 386 U.S. 990 (1967); Hoffman v. United States, 32 F. Supp. 939 (S.D.N.Y. 1940). The income tax refund was held to have passed to the trustee in bankruptcy in In re Kingswood, 343 F. Supp. 498 (C.D. Cal.), rev'd and remanded per curiam, 470 F.2d 996 (9th Cir. 1972), petition for cert. filed, 42 U.S.L.W. 3101 (U.S. Aug. 28, 1973) (No. 73-289), although it was subsequently reversed on appeal on the basis of In re Cedor, 470 F.2d 996 (9th Cir.), aff'g per curiam 337 F. Supp. 1103 (N.D. Cal. 1972), cert. denied, 411 U.S. 973 (1973), one of the principal cases of this comment.

[2] See, e.g., Stellwagen v. Clum, 245 U.S. 605, 617 (1918); Williams v. United States Fid. & Guar. Co., 236 U.S. 549, 554-55 (1915).

[3] 470 F.2d 996 (9th Cir.), aff'g per curiam 337 F. Supp. 1103 (N.D. Cal. 1972), cert. denied, 411 U.S. 973 (1973).

[4] 479 F.2d 990 (2d Cir. 1973), cert. granted, 42 U.S.L.W. 3352 (U.S. Dec. 11, 1973) (No. 73-5265).

[5] 479 F.2d at 995, 996.

[6] Int. Rev. Code of 1954, §§ 3201, 3202(a).

[7] The statement of facts is taken from 337 F. Supp. at 1104-05.

In each case the bankrupt had moved to recover at least a portion of his refund,[8] and the referee had denied the motion.[9] The United States District Court for the Northern District of California vacated the orders of the referee denying the motions and HELD:

> (1) Insofar as an income tax refund is attributable to *involuntary* payment—withholding of the minimum amount required by law—that portion of such refund *is not* "property" within the meaning of section 70a(5) of the Bankruptcy Act, and therefore does not pass to the trustee;[10]
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> (2) Insofar as an income tax refund is attributable to *voluntary* payment—withholding in excess of the minimum required amount—that portion of such refund *is* "property" within section 70a(5), and does, therefore, pass to the trustee;[11]
>
> (3) Insofar as an income tax refund is treated as "property" passing to the trustee, the Restriction on Garnishment provision of the Consumer Credit Protection Act (CCPA)[12] applies, thereby limiting the amount which may pass to the trustees to no more than twenty-five percent of the amount deemed "property."[13]

The court therefore remanded the case to the referee for the appropriate determinations.[14] On appeal, the Ninth Circuit affirmed per curiam on the basis of the district court opinion.[15]

The Second Circuit was faced with the identical issue in *Kokoszka*. The United States District Court for the District of Connecticut had consolidated the cases of bankrupts Kokoszka, Sands and O'Brien, each of whom was appealing the referee's denial of a motion to vacate an order to turn over his tax refund to the trustee in bankruptcy.[16] In each case, the bankrupt had claimed on his tax

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[8] The bankrupt James claimed the total amount of the income tax refund; Cedor originally claimed only seventy-five percent of the refund, conceding that twenty-five percent was an asset of the estate. In his brief on appeal, however, Cedor claimed the full amount of the refund for the first time. Id. at 1104.

[9] Id.

[10] Id. at 1105.

[11] Id. at 1106.

[12] 15 U.S.C. § 1673 (1970).

[13] 337 F. Supp. at 1107.

[14] Id. at 1108.

[15] 470 F.2d 996 (9th Cir. 1972).

[16] 479 F.2d at 993.

Henry Kokoszka was employed for approximately three months in 1971; his tax refund of $250.90 was presumably due to the fact that the periodic withholdings were based on a total annual compensation which was more than what was actually earned. Certificate of Referee on Petition for Review at 2-3, in Appendix of Appellants at 11A-12A, In re Kokoszka, 479 F.2d 990 (2d Cir. 1973). Upon the order of the referee, he turned over the refund amount pending this appeal, and was discharged. 479 F.2d at 993.

Herbert E. Sands received a refund which had been reduced from $535.04 to $201.97

withholding statement the maximum number of deductions to which he was entitled.[17] The Second Circuit, affirming the unreported decision of the district court,[18] HELD: an income tax refund payable to the bankrupt after filing a bankruptcy petition is "property" within the meaning of section 70a(5) and therefore passes to the trustee;[19] furthermore, the Restriction on Garnishment provision of the CCPA is not applicable to such property.[20] Although the question of voluntary withholding was not directly before the court in *Kokoszka,* it can be inferred that the holding was meant to apply to all tax refunds, whether attributable to voluntary or involuntary withholding, since even involuntary payments were held to pass to the trustee.

The decision in *Cedor* has sparked some criticism[21] as a broadening of the exceptions to section 70a(5). This comment will explore the reasoning which has led to the irreconcilable holdings in *Cedor* and *Kokoszka.* First, the remedy of bankruptcies, the purposes behind the Bankruptcy Act, and prior case law will be reviewed. Next, the reasoning of the two principal cases will be analyzed. Finally, recommendations for legislative and judicial consideration will be offered.

BANKRUPTCY AND THE BANKRUPTCY ACT

The Constitution authorizes Congress to establish "uniform Laws on the subject of Bankruptcies throughout the United States."[22] The relief thus provided by the bankruptcy system is a benefit created by Congress, not a right protected by the United States Constitution.[23] Congress used this power only sparingly during

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because of the government's claim for unpaid back taxes. The bankrupt disobeyed a turn-over order and spent the refund on furniture for his family. The referee therefore denied him a discharge in bankruptcy. Order on Trustee's Petition to Deny Discharge in Bankruptcy at 2, in Appendix of Appellants at 34A, In re Kokoszka, 479 F.2d 990 (2d Cir. 1973).

Frank O'Brien received a refund of $136.00, which he was ordered to turn over to the trustee. He refused to obey this order, whereupon the trustee moved to deny him a discharge. As of the date of the *Kokoszka* opinion, the referee had not yet ruled on this motion. 479 F.2d at 993.

In a related case, O'Brien v. Trevethan, 336 F. Supp. 1029 (D. Conn. 1972), bankrupts O'Brien and Sands contested the referee's refusal to certify the petitions for review of the denials of discharge because they could not pay the $10 filing fee. The district court held that 28 U.S.C. § 1915 (1970) applies to petitions for review, thus allowing for the waiver of the filing fee in the case of indigents. 336 F. Supp. at 1032. To impose the filing fee upon them would be to deprive them of their Fifth Amendment rights to due process. Id. at 1033.

[17] 479 F.2d at 993.

[18] Id. at 998.

[19] Id. at 995.

[20] Id. at 996.

[21] See id. at 995, 996; Lee, Title to Property—Employee Bankrupts' Income Tax Refunds, 47 Am. Bankr. L.J. 239 (1973).

[22] U.S. Const. art. I, § 8, cl. 4.

[23] Bankruptcy is not a right which demands "the lofty requirement of a compelling governmental interest before [it] may be significantly regulated." United States v. Kras, 409 U.S. 434, 446 (1973).

ing the first 110 years of our nationhood;[24] it was not until 1898 that bankruptcy legislation became a permanent part of our jurisprudence.[25]

The Bankruptcy Act of 1898 provides relief to individuals and businesses by allowing for: (1) voluntary bankruptcy, where a debtor of his own accord may seek adjudication as a bankrupt;[26] (2) involuntary bankruptcy, where creditors under certain conditions may force a debtor into bankruptcy;[27] and (3) certain court-administered plans.[28] After successfully meeting various administrative requirements, the bankrupt is entitled to a discharge,[29] releasing him from most of his provable debts.[30]

The purposes of the Act have been two-fold: (1) to secure all non-exempt assets of the bankrupt and to distribute them proportionately among his creditors;[31] and (2) to release the bankrupt from liability for most prior obligations, giving him "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[32] The legislative intent in enacting the Bankruptcy Act was for the purpose of giving the bankrupt a "fresh start" in life to be subordinate to that of establish-

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[24] The bankruptcy acts together covered a period of 15 years. Their temporary nature reflected legislative concern with the economic situation at the time. They were:

(1) Bankruptcy Act of 1800, ch. 19, 2 Stat. 19, repealed, Act of Dec. 19, 1803, ch. 6, 2 Stat. 248. The provisions of this act essentially worked against the interests of the debtor.

(2) Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, repealed, Act of March 3, 1843, ch. 82, 5 Stat. 614. This act grew out of the commercial casualties of the panic of 1837. It followed English reforms, adopting the theory that a debtor might be honest but unfortunate, and providing for his discharge.

(3) Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, repealed, Act of June 7, 1878, ch. 160, 20 Stat. 99. This act was enacted after the Civil War, and its subsequent amendments were influenced by the panic of 1873.

See Johnson, Commentary on the Chandler Act or Revision of the Bankruptcy Act, in 11 U.S.C.A. (§§ 701 et seq.) 357, 357-58 (1970); 1 W. Collier, Bankruptcy ¶¶ 0.04-.05 (14th ed. 1971); 1 H. Remington, Bankruptcy Law of the United States §§ 7-9 (5th ed. 1950).

[25] The Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, as amended, 11 U.S.C. §§ 1-1255 (1970), resulted from the panic of 1893, and its major amendment, the Chandler Act, ch. 575, 52 Stat. 840 (1938), from the Great Depression. See Johnson, supra note 24, at 358; 1 W. Collier, supra note 24, ¶ 0.06; 1 H. Remington, supra note 24, § 10. The Bankruptcy Act has been amended more than 90 times since its passage. D. Stanley & M. Girth, Bankruptcy: Problem, Process, Reform 11 (1971). The constitutionality of the Act was upheld by a unanimous Court in Hanover Nat'l Bank v. Moyses, 186 U.S. 181 (1902).

[26] 11 U.S.C. § 21(a) (1970).

[27] 11 U.S.C. § 21(b) (1970).

[28] 11 U.S.C. §§ 501-1086 (1970).

[29] 11 U.S.C. § 32 (1970).

[30] 11 U.S.C. § 35 (1970).

[31] See, e.g., Straton v. New, 283 U.S. 318, 320-21 (1931); Stellwagen v. Clum, 245 U.S. 605, 617 (1918); Williams v. United States Fid. & Guar. Co., 236 U.S. 549, 554 (1915).

[32] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934). Accord, *Stellwagen*, 245 U.S. at 617; *Williams*, 236 U.S. at 555; Hardie v. Swafford Bros. Dry Goods Co., 165 F. 588, 591 (5th Cir. 1908); United States v. Hammond, 104 F. 862, 863 (6th Cir. 1900).

An incidental effect is to promote a "financially self-sufficient" bankruptcy system. United States v. Kras, 409 U.S. 434, 449 (1973).

ing a procedure for collecting and distributing his non-exempt assets among his creditors.[33] Whereas early bankruptcy cases support this interpretation,[34] both the language[35] and the outcome[36] of more recent cases indicate that the balance may be tipping in favor of greater consideration of the bankrupt's interests.

The desire to achieve this dual purpose spurred the enactment of legislation vesting the bankruptcy courts "with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in [bankruptcy] proceedings . . . ."[37] While the "at law" provision was presumably inserted to meet the requirement of section 2(4) of the Act,[38] authorizing the trial and punishment of conduct in violation of the Act, the courts of bankruptcy are "essentially courts of equity, and their proceedings inherently proceedings in equity."[39] The equitable powers must be administered consistently with the Bankruptcy Act[40] and according to the general principles and practices of equity.[41] Nevertheless, some recent cases have stressed the equitable and remedial aspects of the Act, disregarding its express provisions in an attempt to reach a "fair" conclusion.[42]

SECTION 70a(5)

1. *Breadth of its Provisions*

What property passes to the trustee in bankruptcy is governed by section 70a of the Bankruptcy Act of 1898. While the language of

[33] See In re Leslie, 119 F. 406, 410 (N.D.N.Y. 1903). Judge Ray, who wrote this opinion, was a member of the House Judiciary Committee during passage of the Bankruptcy Act of 1898, and served as chairman of that committee during passage of the 1903 amendment. Note, 49 N.C.L. Rev. 738, 745 n.42 (1971).

[34] See *Straton,* 283 U.S. at 320-21; *Hardie,* 165 F. at 590; Barton Bros. v. Texas Produce Co., 136 F. 355, 357 (8th Cir. 1905); In re Dorgan's Estate, 237 F. 507, 509 (S.D. Iowa 1916).

[35] See *Local Loan,* 292 U.S. at 244-45; Bank of Marin v. England, 385 U.S. 99, 103 (1966); Meltzer v. C. Buck LeCraw & Co., 402 U.S. 954, 958 (1971) (Black, J., dissenting to denial of cert.).

[36] See Lines v. Frederick, 400 U.S. 18 (1970), aff'g per curiam 425 F.2d 215 (9th Cir. 1970); In re Cedor, 470 F.2d 996 (9th Cir.), aff'g per curiam 337 F. Supp. 1103 (N.D. Cal. 1972), cert. denied, 411 U.S. 973 (1973). Cf. Reading Co. v. Brown, 391 U.S. 471 (1968); Bank of Marin v. England, 385 U.S. 99 (1966).

[37] Bankruptcy Act of 1898, § 2, 11 U.S.C. § 11(a) (1970).

[38] 11 U.S.C. § 11(a)(4) (1970). See *Local Loan,* 292 U.S. at 240; Bardes v. Hawarden Bank, 178 U.S. 524, 535 (1900).

[39] *Local Loan,* 292 U.S. at 240; Pepper v. Litton, 308 U.S. 295, 304 (1939).

[40] See Young v. Higbee Co., 324 U.S. 204, 214 (1945); SEC v. United States Realty & Improvement Co., 310 U.S. 434, 455 (1940); Nelson v. Svea Publishing Co., 178 F. 136, 140 (W.D. Wash. 1910).

[41] Westall v. Avery, 171 F. 626, 628 (4th Cir. 1909). Equitable powers will be invoked so "that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." *Pepper,* 308 U.S. at 305. See also *U.S. Realty,* 310 U.S. at 455.

[42] See Reading Co. v. Brown, 391 U.S. 471 (1968); Bank of Marin v. England, 385 U.S. 99 (1966); Perry v. Commerce Loan Co., 383 U.S. 392 (1966). See generally Aug., Recent Trends in the Application of Equitable Principles of Bankruptcy, 43 Ref. J. 109 (1969).

prior bankruptcy laws was of a very general nature,[43] transferring to the trustee whatever would pass to the administrator of an estate in the case of an intestacy,[44] the current section 70a is a more comprehensive statute, phrased in more specific language and enumerating the kinds of property which pass to the trustee.[45] The subsection relied on in *Cedor* and *Kokoszka*, section 70a(5), reads in pertinent part:

> (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 . . . 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 . . . .[46]

This version of the section introduces the concept of transferability for the first time, in the words "which . . . he could by any means have transferred." Controversy has arisen over the interpretation of these words.[47] It has been argued that only transfers

[43] Bankruptcy Act of 1800, ch. 19, § 5, 2 Stat. 23, provided:

> . . . [C]ommissioners . . . shall have power to take into their possession, all the estate, real and personal, of every nature and description to which the said bankrupt may be entitled, either in law or equity, in any manner whatsoever . . . .

Bankruptcy Act of 1841, ch. 9, § 3, 5 Stat. 442, provided:

> . . . That all the property, and rights of property, of every name and nature, and whether real, personal, or mixed, of every bankrupt . . . shall, by mere operation of law, ipso facto, from the time of such decree [adjudication of bankruptcy], be deemed to be divested out of such bankrupt, . . . and the same shall be vested . . . in such assignee . . . .

Bankruptcy Act of 1867, ch. 176, § 14, 14 Stat. 522, provided:

> . . . That as soon as said assignee is appointed and qualified, the judge . . . shall . . . assign and convey to the assignee all the estate, real and personal, of the bankrupt, . . . and thereupon, by operation of law, the title to all such property and estate, both real and personal, shall vest in said assignee . . . .

[44] The intestacy test was first employed under the Bankruptcy Act of 1800 in Comegys v. Vasse, 26 U.S. 193, 218 (1828); under the Act of 1867 in Williams v. Heard, 140 U.S. 529, 543 (1891); and under the present Act in In re Evans, 253 F. 276, 277 (W.D. Tenn. 1918); cf. In re Brown, 4 F.2d 806 (2d Cir. 1924).

[45] The language of § 70a as originally enacted in 1898 was tightened up by subsequent amendments. The Chandler Act, ch. 575, § 70a, 52 Stat. 873 (1938), introduced a number of significant changes in § 70a, chief among them being that the date of filing a petition in bankruptcy was to be the date of cleavage. The changes instituted within § 70a(5) itself were the inclusion of the words "rights of action" and the proviso excepting purely personal actions from the reach of the section. See 4A W. Collier, supra note 24, ¶ 70.03. The 1952 amendment, ch. 579, § 23, 66 Stat. 429 (1952), included the words "wherever located" in § 70a in order to clarify that the trustee has title to the bankrupt's property whether it is located within the United States or outside its borders. See 4A W. Collier, supra at 31 n.1b.

[46] 11 U.S.C. § 110(a)(5) (1970).

[47] Legislative history is unhelpful on the issue, as § 70 received only cursory attention. See Recent Developments, 14 Stan. L. Rev. 380, 384 & n.18 (1962).

voluntarily made by the bankrupt, and not those interests passing by operation of law, were contemplated as passing to the trustee as "transferred" property.[48] Under the earlier acts, by virtue of an adjudication in bankruptcy, property passed automatically by operation of the law of intestacy, to the trustee.[49] The language of the new act must have intended to change this rule; otherwise, the more general language of the earlier acts would have been employed. Moreover, if such an involuntary transfer by operation of law were intended to be included under the language of transfer, there would be no reason to include the alternate method of reaching the bankrupt's property through levy or judicial sale.[50]

However, it is submitted that a broad reading of section 70a(5), encompassing both voluntary and involuntary transfers, is mandated. The word "transfer" is defined in the general definitional section of the Bankruptcy Act to include "involuntary transfers."[51] It has been construed in the common law to "[embrace] every transaction which passes over or conveys property to another."[52] Moreover, the term "transfer" should be broadly construed in light of the legislative intention to collect and distribute all the non-exempt assets of the bankrupt's estate among his creditors.[53]

2. *Interests Which Pass to the Trustee*

In deciding whether a res passes to the trustee under section 70a(5), there must be an initial determination whether the bankrupt's interest in the res at the time of filing his petition in bankruptcy was sufficient for it to constitute "property."[54] "Postponed enjoyment" will not disqualify an interest as "property."[55] However, where the claim is contingent—not yet accrued and de-

[48] See Segal v. Rochelle, 382 U.S. 375, 382 (1966). See also Recent Developments, supra note 47, at 383-86.

[49] See notes 43-44 supra and accompanying text.

[50] *Segal*, 382 U.S. at 382. Cf. Recent Developments, supra note 47, at 385.

[51] 11 U.S.C. § 1(30) (1970) provides:

> "Transfer" shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein or with the possession thereof . . . , absolutely or conditionally, *voluntarily or involuntarily*, by or without judicial proceedings . . . .

[Emphasis added.]

[52] In re Barrow, 98 F. 582, 583 (W.D. Va. 1899). Accord, Pirie v. Chicago Title & Trust Co., 182 U.S. 438, 444 (1901); Coder v. Arts, 152 F. 943, 949 (8th Cir. 1907), aff'd, 213 U.S. 223 (1909).

[53] Cf. Brown v. Crawford, 252 F. 248, 252 (D. Ore. 1918). See note 31 supra and accompanying text.

[54] Res which have been held to be "property" within the meaning of § 70a(5) include: disability payments—Legg v. St. John, 296 U.S. 489 (1936); a seat on the Philadelphia Stock Exchange—Page v. Edmunds, 187 U.S. 596 (1903); pending applications for patents—In re Cantelo Mfg. Co., 185 F. 276 (D. Me. 1911); and growing crops—In re Seiffert, 18 F.2d 444 (D. Mont. 1926); In re Barrow, 98 F. 582 (W.D. Va. 1899).

[55] *Segal*, 382 U.S. at 380; In re Leibowitt, 93 F.2d 333, 335 (3d Cir. 1937), cert. denied, 303 U.S. 652 (1938).

pendent upon the happening of some future event—its determination as "property" is not so evident. Although "contingency in the abstract is no bar,"[56] some courts have required that the claim be severable into portions attributable to events before and after bankruptcy, and some difficulty has been encountered where the claim is *not* readily divisible.[57] In determining whether a claim is severable, various factors are taken into account, including the intention of the parties, the terms, nature and purpose of the subject matter, and the surrounding circumstances.[58] The burden has been placed on the trustee to apply the "divisibility" test to the claim; if he cannot apportion it, the entire amount remains in the bankrupt.[59] Sometimes the focus is on the quantum of the post-bankruptcy services to be performed; an indivisible claim will not pass to the trustee where substantial post-bankruptcy services are contemplated.[60] However, where the amount of the claim can be apportioned between pre- and post-bankruptcy services, the fact that post-bankruptcy services to be performed were substantial presumably will not preclude transfer to the trustee of that portion of the claim which is attributable to compensation for pre-bankruptcy services.[61]

The remainder of the amount of the claim represents services to be performed by the bankrupt after his adjudication in bankruptcy. The bankrupt is released from his obligation to perform these services; but if he chooses to perform under the contract, the bankrupt rather than the trustee will receive the compensation.[62] To hold otherwise would be to require the bankrupt to labor in a kind of "involuntary servitude."[63]

This conclusion is in accord with analogous cases which hold that the assignment of future wages is merely an executory contract which becomes executed and to which an equitable lien attaches

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[56] *Segal*, 382 U.S. at 380.

[57] See, e.g., *Leibowitt*, 93 F.2d at 335-36; Wooten v. Walters, 110 N.C. 251, 254-56, 14 S.E. 734, 735-36 (1892).

> [T]he criterion is to be found in the question whether the whole quantity—all of the things as a whole—is of the essence of the contract. If it appear that the purpose was to take the whole or none, then the contract would be entire; otherwise it would be severable.

Id. at 256, 14 S.E. at 736. Once the contract itself is deemed severable, we reach the crucial question of whether the compensation under the contract can be appropriately apportioned. See Hudson v. Wylie, 242 F.2d 435, 444-47 (9th Cir.), cert. denied, 355 U.S. 828 (1957).

[58] *Wooten*, 110 N.C. at 254, 255, 14 S.E. at 735.

[59] *Hudson*, 242 F.2d at 445. See, e.g., In re Thomas, 204 F.2d 788, 795 (7th Cir. 1953) (court-appointed trustee at time of bankruptcy had performed only one of the four years of service required); *Leibowitt*, 93 F.2d at 335-36 (substantial services needed to be rendered after bankruptcy in order to earn commissions on insurance policies written before bankruptcy).

[60] See, e.g., *Leibowitt*, 93 F.2d at 335.

[61] See In re Edelman, 164 F. Supp. 728, 729 (E.D.N.Y. 1958).

[62] In re Home Discount Co., 147 F. 538, 547-48 (N.D. Ala. 1906).

[63] *Leibowitt*, 93 F.2d at 335. See also In re Wright, 157 F. 544, 546 (2d Cir. 1907); *Home Discount*, 147 F. at 547-48.

only when the wages are actually earned.[64] A discharge in bankruptcy, because it operates to release the bankrupt from the performance of any future contractual obligations as of the date of the adjudication, will cut off the assignee's equitable interest in future wages before it can come into existence.[65] Similarly, future wages will not pass to the trustee in bankruptcy upon adjudication. Accrued, but unpaid wages, on the other hand, which the bankrupt has clearly earned before adjudication in bankruptcy, will pass to the trustee.[66]

A New Test

In two recent decisions, *Segal v. Rochelle*[67] and *Lines v. Frederick*,[68] the Supreme Court formulated and applied a new test for determining whether a res is property which passes to the trustee under section 70a(5) of the Bankruptcy Act.[69] Although these cases dealt with the question of whether business-generated loss carryback tax refunds and accrued but unpaid vacation pay, respectively, fall within the reach of section 70a(5), the Court's reasoning in determining whether such property passes to the trustee in bankruptcy is used by analogy by the courts in *Cedor* and *Kokoszka,* and is therefore basic to an understanding of these cases.

1. *The* Segal *Test*

The Supreme Court in *Segal* was faced with the question whether a refund resulting from the loss carryback provisions of the Internal Revenue Code[70] was property within the meaning of section 70a(5). The refund had resulted from partnership losses in the taxable year which had been offset against income for the prior two years, reducing the amount of tax owed for that period.[71]

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[64] Seaboard Small Loan Corp. v. Ottinger, 50 F.2d 856, 857, 859 (4th Cir. 1931); In re West, 128 F. 205, 206 (D. Ore. 1904).

[65] *Home Discount,* 147 F. at 548; *West,* 128 F. at 206.

[66] In re Aveni, 458 F.2d 972, 974 (6th Cir.) (per curiam), cert. denied, 409 U.S. 877 (1972). See also Kolb v. Berlin, 356 F.2d 269 (5th Cir. 1966); In re Cohen, 276 F. Supp. 889 (N.D. Cal. 1967). See generally 4A W. Collier, supra note 24, ¶ 70.34.

[67] 382 U.S. 375 (1966). This case has been annotated in Seidman, Some Implications of Segal v. Rochelle, 40 Ref. J. 107 (1966); Recent Decisions, 50 Marquette L. Rev. 143 (1966); Recent Decisions, 39 Temp. L.Q. 368 (1966); Comment, 12 N.Y.L.F. 311 (1966); Note, 35 Fordham L. Rev. 342 (1966). The circuit court opinion, 336 F.2d 298 (5th Cir. 1964), is annotated in Recent Decisions, 40 Notre Dame Law. 118 (1964); Note, 60 Nw. U.L. Rev. 122 (1965). The district court opinion, 221 F. Supp. 282 (N.D. Tex. 1963), is annotated in Note, 42 Texas L. Rev. 542 (1964).

[68] 400 U.S. 18 (1970), aff'g per curiam 425 F.2d 215 (9th Cir. 1970). This case has been annotated in Greenfield, Lines v. Frederick: The Effect of Bankruptcy on a Bankrupt's Accrued Vacation Pay and Other Forms of Deferred Compensation, 47 Los Angeles B. Ass'n Bull. 67 (1971); Lee, Title to Property—Employee Bankrupt'[s] Vacation Pay, 45 Am. Bankr. L.J. 115 (1971); Note, 49 N.C.L. Rev. 738 (1971).

[69] The pertinent portion of § 70a(5) is quoted in the text at note 46 supra.

[70] Int. Rev. Code of 1954, §§ 172, 6411.

[71] 382 U.S. at 376.

In two earlier decisions dealing with the same issue,[72] the First and Third Circuits held that the taxpayer has no legal or equitable interest in the claim for the refund at the time of the bankruptcy filing; the right does not come into existence until the end of the taxable year, when the amount of the losses can be determined.[73] Although both courts regretted the decision because of the possibility of inequitable resultts,[74] they nonetheless held that the claim for the refund was neither "property" nor a "right of action" within the meaning of section 70a(5) and (6).[75]

The Supreme Court in *Segal*, however, examined the nature of section 70a(5) and decided that its "main thrust" was

> 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 and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed.[76]

The Court also considered other purposes of the Act which it deemed to limit the inclusive nature of section 70a(5). In particular, the Court took into consideration the purpose of enabling the bankrupt to be "free after the date of his petition to accumulate new wealth in the future."[77]

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[72] Fournier v. Rosenblum, 318 F.2d 525 (1st Cir. 1963); In re Sussman, 289 F.2d 76 (3d Cir. 1961). Cf. In re Gignac, 222 F. Supp. 557 (N.D.N.Y. 1963).

[73] 318 F.2d at 527; 289 F.2d at 77-78. The court in *Sussman* held that even if the claim were an existing property interest, it could not pass to the trustee because of the Assignment of Claims Act, 31 U.S.C. § 203 (1970). 289 F.2d at 78. The inapplicability of the prohibitions of this statute to the tax refund is discussed in the text at notes 116-19 infra.

[74] 318 F.2d at 527; 289 F.2d at 78. For example, if a bankrupt filed on Dec. 31, the trustee would have no right of action for the tax refund; the bankrupt would retain it. However, if the bankrupt were to file on Jan. 1, the trustee would succeed to the refund. Thus, a "windfall" may accrue to the bankrupt at the expense of the creditors on the basis of one day's difference in filing. This seems particularly unjust since it is often the very business losses which destroyed the capacity to pay the creditors that led to the tax refund. 289 F.2d at 78. In some cases, the amount of the refund is substantial and would be of great value to the trustee in paying off the bankrupt's creditors. For example, in *Fournier*, the taxpayer was entitled to a refund of $2800.52, and in *Segal*, $4236.32. 318 F.2d at 526; 336 F.2d at 299 n.2. The courts in both *Fournier* and *Sussman* stated that they regretted the result, but that any change would have to come from the legislature. 318 F.2d at 527; 289 F.2d at 78.

Considerable commentary has been written on this subject. Most contend that the trustee should succeed to the title of the refund, with some suggesting legislative change. See Herzog, Bankruptcy Law—Modern Trends, 36 Ref. J. 18 (1962); Recent Decisions, 40 Notre Dame Law. 118 (1964); Recent Developments, 14 Stan. L. Rev. 380 (1962); Recent Cases, 110 U. Pa. L. Rev. 275 (1961); Note, 17 U. Fla. L. Rev. 241 (1964); Note, 40 Texas L. Rev. 569 (1962); Note, 16 U. Miami L. Rev. 345 (1961).

[75] 11 U.S.C. §§ 110(a)(5), (6) (1970). Section 70a(6) provides that "rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to [the bankrupt's] property" shall pass to the trustee. Since the Government usually does not dispute the taxpayer's claim to a refund, this section is seldom used in this context.

[76] 382 U.S. at 379.

[77] Id.

The Court then formulated a new test, requiring consideration not only of the comprehensive nature of section 70a(5), but also of the equitable concern for providing the debtor with a new start in life, in determining whether property or a right of action is "sufficiently rooted in the pre-bankruptcy past and so little entangled with the bankrupts' ability to make an unencumbered fresh start that it should be regarded as 'property' under § 70a(5)."[78] The Court held that since a loss carryback refund was "sufficiently rooted" in the pre-bankruptcy period and since denying it to the bankrupt would not hinder his new opportunity in life, such a claim was property within the meaning of section 70a(5) and would pass to the trustee in bankruptcy.[79]

2. *Application of the* Segal *Test in* Lines

As a result of *Segal,* courts will be required to consider both the language of section 70a(5) itself and the question of whether a transfer to the trustee of the bankrupt's property will impede his new start in life. The application by the Supreme Court of this new formulation in *Lines v. Frederick*[80] resulted in the holding that accrued but unpaid vacation pay was not within the reach of section 70a(5), and thus narrowed the concept of "property" as it appears in that section.

The Court in *Lines,* in holding that the vacation pay was not "property," disregarded the facts that the pay was alienable or transferrable according to the applicable state law[81] and that it was based completely in pre-bankruptcy services. Instead, the Court looked at the nature of the "property" and analogized it to future wages.[82] It noted that wages are a specialized kind of property[83] and that in this case they were the bankrupts' sole source of income.[84]

In determining that the function of the accrued vacation pay was "to support the basic requirements of life for [the bankrupts] and their families during brief vacation periods or in the event of layoff,"[85] the Court found that the transfer of the rights to the vacation pay interfered with the bankrupts' opportunity to make a "fresh start."[86] Thus, vacation pay would be exempt from the section 70a(5) provision.[87]

[78] Id. at 380.

[79] Id.

[80] 400 U.S. 18 (1970), aff'g per curiam 425 F.2d 215 (9th Cir. 1970).

[81] Courts in bankruptcy are to follow state law in determining whether the bankrupt can transfer his property, unless preempted by some federal law. See Board of Trade v. Johnson, 264 U.S. 1, 10 (1924); In re Wetteroff, 453 F.2d 544, 546 (8th Cir.), cert. denied, 409 U.S. 934 (1972); Danning v. Lederer, 232 F.2d 610, 613 (7th Cir. 1956).

[82] 400 U.S. at 20. See also In re Public Ledger, Inc., 161 F.2d 762, 768 (3d Cir. 1947).

[83] 400 U.S. at 20, quoting Sniadach v. Family Fin. Corp., 395 U.S. 337, 340 (1969).

[84] 400 U.S. at 20.

[85] Id.

[86] The Court did not distinguish between the situations of the two bankrupts in this case. Frederick's employer closed down the plant for a week twice each year, forcing him to give up

The decision in *Lines* will have a significant impact on deferred compensation cases. A reexamination of all such "property"—vacation pay, wages, and income tax refunds—will be required. *Lines,* in applying the *Segal* test, has in effect overturned the long-established policy of leaving the determination of what property is exempt from section 70a(5) to state law and federal legislation.[88] Here the Court, and not Congress, has undertaken the formulation of a "national, uniform exemption policy."[89]

THE *Cedor* AND *Kokoszka* DECISIONS

The courts in *Cedor* and *Kokoszka* examined the income tax refund problem in light of *Segal* and *Lines*. A reading of the latter two cases together requires that certain exceptions be carved out of the otherwise comprehensive coverage of section 70a(5) where the effect of including a res as "property" conflicts with other policy considerations of the Act.[90] In deciding on which side of the line income tax refunds lie, the Second and Ninth Circuits arrived at opposite results.

1. *Section 70a(5) "Property"*

The *Cedor* court compared the income tax refund with the loss carryback claim in *Segal* and with vacation pay in *Lines*. The tax

two weeks' wages; without his vacation pay he would have nothing in the way of compensation for these two weeks. Harris, on the other hand, had the more conventional voluntary vacation plan; thus he had the option of forgoing his vacation and earning wages during that period. See *Kokoszka,* 479 F.2d at 994; In re Jones, 337 F. Supp. 620, 624 n.12 (D. Minn. 1971), leave to appeal denied (8th Cir. May 14, 1971) (unreported), cert. denied, 404 U.S. 1040 (1972).

The Court may have somewhat overstated the situation, since § 303 of the Consumer Credit Protection Act (CCPA), 15 U.S.C. § 1673 (1973), would apply to the vacation pay, exempting from the trustee's reach up to 75% of the amount due the bankrupts. See Lee, supra note 68, at 119. For a discussion of the application of the CCPA in another context, see text at notes 126-43 infra.

[87] This decision in effect overrules a lower court decision in the Ninth Circuit, In re Kuether, 203 F. Supp. 223 (N.D. Cal. 1962). The court of appeals in *Lines* also disapproved of In re Cohen, 276 F. Supp. 889 (N.D. Cal. 1967), in which accrued but unpaid wages were held to pass to the trustee. 425 F.2d at 216.

[88] Section 6 of the Bankruptcy Act of 1898, 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 in the State wherein they have had their domicile for the six months immediately preceding the filing of the petition, or for a longer portion of such six months than in any other State . . . .

Inconsistent treatment of the various kinds and amounts of exemptions has resulted from this policy. See Countryman, For a New Exemption Policy in Bankruptcy, 14 Rutgers L. Rev. 678 (1960). However, the Supreme Court has held that the provision is a constitutional exercise of the authority to enact "uniform Laws on the subject of Bankruptcies throughout the United States," on the theory that the uniformity required is "geographical and not personal." Hanover Nat'l Bank v. Moyses, 185 U.S. 181, 188 (1902). See U.S. Const. art. I, § 8, cl. 4.

[89] Lee, supra note 68, at 118. See also Note, N.C. L. Rev. 738, 746-47 (1971).

[90] See In re Jones, 337 F. Supp. 620, 624 (D. Minn. 1971), leave to appeal denied (8th Cir. May 14, 1971) (unreported), cert. denied, 404 U.S. 1040 (1972).

refund was found not to be "rooted in the pre-bankruptcy past" to the extent that it was in *Segal.* There the tax refund represented losses which had precipitated the bankruptcy; in *Cedor* it did not.[91]

As in *Lines,* the claim for the refund represented an involuntary withholding, accrued and unpaid, and which the bankrupt could not reach prior to a specific time—upon leave for vacation or termination of employment in the case of vacation pay, or upon the filing of a tax return in the case of the income tax refund. Although the amount of vacation pay is easier to calculate, the undetermined amount of a tax refund is an expected annual event. "To deprive the wage-earner of that planned-on annually recurring payment, cannot be said to be less severe than the deprivation of two weeks of paid vacation, in terms of a fresh start."[92] In order to afford him that "fresh start," the bankrupt was permitted to keep the refund.[93]

The court in *Kokoszka* similarly analyzed the tax refund in terms of the *Segal* and *Lines* decisions but came out with the opposite result. It stated that *Lines* had carved out "a very narrow exception to the general proposition that everything of value passes to the trustee."[94] The exception ought to be limited, then, to situations "where the minimal requirements for the economical survival of the debtor are at stake."[95] The vacation pay in that instance was necessary for "economic survival" during time off or in the event of termination; the bankrupt's opportunity for a fresh start would be hampered without this assistance. An income tax refund, on the other hand, is not the periodic income required by a wage-earner for his basic support, and depriving him of it would not interfere with his opportunity as a bankrupt to accumulate new wealth.

It is submitted that the approach taken by the *Kokoszka* court is the more appropriate one. Conceptually there is a significant difference between vacation pay and an income tax refund. In applying the *Segal* test, both find their source in pre-bankruptcy wages. The difference in their nature, however, is apparent when they are analyzed to determine whether their deprivation impedes a bankrupt's new start in life. The desperate situation in which one is dependent upon periodic payments of wages for his basic support and must forgo them for a certain period of time is distinguishable

[91] 337 F. Supp. at 1105. However, although on the particular facts in *Cedor* it could not be said that the losses resulting in the refund were the cause of the bankruptcy, there are situations in which the refund could be. For example, an uninsured casualty loss, large expenditures for medical bills, or an extended period of layoff from employment are all factors which could not only drive a debtor into bankruptcy but could also result in a sizeable refund check. See Lee, Title to Property—Employee Bankrupts' Income Tax Refunds, 47 Am. Bankr. L.J. 239, 241-42 (1973). The larger the amount of the refund, the more likely that its origin is found in the pre-bankruptcy past. Id. at 241.

[92] 337 F. Supp. at 1105.

[93] Actually, the bankrupt could keep only that portion resulting from withholding in excess of the minimum amount required by law. See text at notes 106-115 infra.

[94] 479 F.2d at 994.

[95] 400 U.S. at 20.

from the situation in which a debtor receives his wages and, in addition, his income tax refund. It is not the function of a refund to support the basic requirements of life; the bankrupt does not forgo future wages after bankruptcy because he has lost his tax refund based on pre-bankruptcy wages. In this context, accrued but unpaid vacation pay is more analogous to future wages, forming the basis for support sometime after bankruptcy. The income tax refund, on the other hand, is more in the nature of a bonus.[96]

Furthermore, in the case of vacation pay, the employee finds no similarity between earned wages which he will receive at the end of the week and the bookkeeping entries of accrued vacation pay credited to him.[97] In real economic terms, vacation pay is "earned" during the period of vacation after bankruptcy. But an income tax refund represents wages earned in the pre-bankruptcy past in both bookkeeping and economic terms.[98]

Once the vacation pay is accrued, there is no post-bankruptcy event which can vary the amount. In the case of an income tax refund, however, the amount accruing to the taxpayer at the time of his adjudication as a bankrupt is not firmly established, but is rather dependent upon post-bankruptcy events happening before the end of the taxable year. Moreover, in the case of an income tax refund, a portion of the taxpayer's wages are withheld under federal law for eventual tax liability. These funds never reach the taxpayer's hands; they become government property at the same time that the taxpayer receives his take-home pay. The wages are not withheld under any program whereby they or any portion thereof will be returned to the wage-earner at some future time to insure his support when he is without his daily earnings, as is the case with vacation pay.

The court in *Kokoszka* found unpersuasive the argument that since a tax refund is an annual "planned-on" event, the bankrupt ought to retain it.[99] Payment on Christmas Club accounts and year-end stock dividends are other annual occurrences, but that does not preclude them from the reach of section 70a(5). The purpose of the Act is to place the bankrupt on the same footing as others similarly situated on the date of bankruptcy;[100] but a refund would give the bankrupt a "head start," not just a "fresh start" in life.[101]

The *Cedor* court found the tax refunds "quite similar in a practical sense" to wages.[102] The court referred to *Sniadach v.*

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[96] See Lee, supra note 91, at 241.

[97] Frederick v. Lines, 425 F.2d at 217.

[98] Closing Brief of Appellants at 203, In re Cedor, 470 F.2d 996 (9th Cir. 1972).

[99] See *Kokoszka*, 479 F.2d at 995.

[100] In re Aveni, 458 F.2d 972, 973 (6th Cir.), cert. denied, 409 U.S. 877 (1972).

[101] 479 F.2d at 995. Cf. *Lines*, 400 U.S. at 21 (dissenting opinion). Similarly, in the case of vacation pay, it could be argued that the bankrupt should receive the same benefits as if he had been hired as a new employee on the date of bankruptcy. There is no reason why pre-bankruptcy employment should determine the length of any post-bankruptcy vacation. Greenfield, supra note 68, at 70.

[102] 337 F. Supp. at 1105.

Family Finance Corp.,[103] in which the Supreme Court recognized wages as "a specialized type of property presenting distinct problems in our economic system."[104] As *Kokoszka* indicates, however, the reference to wages is in the context of periodic payments that support the basic necessities in life.[105] The "special protection" required for wages is reserved for the periodic payments of wages, not for property whose source happens to be wages. Otherwise, any property which originated in wages—be it an automobile, a share in a corporation, or a savings account—would be equally entitled to treatment as "wages."

Cedor distinguishes the bankrupt who has an income tax refund resulting from withholding the minimum amount required by law from the one who elects to withhold more than the minimum amount required. In the case of the latter, *Cedor* concedes that the portion reflecting the amount withheld in excess of the minimum is "property" within the meaning of section 70a(5).[106] The court based its distinction primarily on the voluntary element involved. In *Lines,* the employee could not control the amount accrued—he could neither subtract from nor add to the fund—as one in effect can do in the case of a tax refund. The size of the refund can be increased by claiming fewer exemptions than one is actually entitled to,[107] as did the bankrupt James in *Cedor,*[108] or by declaring a larger estimated income than is actually received.[109] This degree of control in the case of a tax refund would create an opportunity for the potential bankrupt to defraud his creditors if the additional amount of the refund were not deemed "property."[110]

However, *Cedor* points out the injustice in establishing a system which, on the one hand, allows a taxpayer to elect the number of exemptions he may take in order to insure that his tax liability is met, and then, on the other hand, penalizes him with the loss of his refund in the case of bankruptcy.[111] If it is in the "national interest" to assure that the taxpayers withhold a sufficient amount so that taxes are promptly paid, a transfer to the trustee of the excess withholding would seem to "frustrate the objective of the withholding laws."[112] The new Form W-4, however, has been designed in conformity with section 3402(m) of the Internal Revenue Code[113] to

[103] 395 U.S. 337 (1969).

[104] Id. at 340. The importance of wages in our society, which the *Sniadach* Court stressed, has been established in a series of cases dealing with the constitutionality of prejudgment garnishment. E.g., McCallop v. Carberry, 1 Cal. 3d 903, 464 P.2d 122, 83 Cal. Rptr. 666 (1970); Termplan Inc. v. Superior Court, 105 Ariz. 270, 463 P.2d 68 (1969).

[105] 479 F.2d at 995.

[106] 337 F. Supp. at 1106.

[107] See, e.g., In re Goodson, 208 F. Supp. 837 (S.D. Cal. 1962).

[108] Opening Brief of Appellants at 2, In re Cedor, 470 F.2d 996 (9th Cir. 1972).

[109] See, e.g., Chandler v. Nathans, 6 F.2d 725 (3d Cir. 1925).

[110] 337 F. Supp. at 1106.

[111] Id. at 1107.

[112] Id.

[113] Int. Rev. Code of 1954, § 3404(m).

prevent the overpayment of income taxes. According to one commentator, a taxpayer who fails to exercise his options under this provision has "voluntarily" overpaid his taxes.[114] In that case, his refund can be likened to any other use to which the bankrupt voluntarily puts his wages, such as a loan to another or an investment in securities—property which undeniably passes to the trustee.

Kokoszka glosses over the voluntary element involved in this analysis, and, it is submitted, rightfully so. Clearly one who invests his money in securities, a savings account or an automobile voluntarily elects to do so. The taxpayer who claims the requisite number of exemptions has no choice: his wages are, in fact, involuntarily withheld to meet his eventual tax liability. However, retention of these wages by the employer in effect creates a savings account for the employee out of which he will pay his taxes for the year. When the taxpayer authorizes withholding in excess of the minimum required by law, he is simply adding to this savings account. There is no reason to treat this "forced savings account" differently from any other savings account which would pass to the trustee in bankruptcy. The element of voluntariness may be reflected in the size of the refund, but it should not be the decisive factor in determining whether the refund is "property" within section 70a(5).

It is submitted that the contortions required by the *Cedor* court are unnecessary in determining whether and to what extent a refund—or a portion thereof—is attributable to withholding in excess of the minimum. The fact that a taxpayer *might* defraud his creditors by misusing the exemption system is not a convincing reason to deny *all* taxpayers their refunds.[115] The similarities between vacation pay and income tax refunds should not be extended beyond the involuntary aspect and the common source in prebankruptcy wages. While the purposes of the Bankruptcy Act mandate that the bankrupt retain the vacation pay, no such urgency exists in the case of the tax refund. In analyzing the *Segal* test and its application in the *Lines* case, and its consequent treatment of the refund as "property," regardless of whether it results from voluntary or involuntary withholding, the *Kokoszka* court's analysis seems the correct one.

2. *Transferability*

After finding that a refund due to optional withholding was "property," the *Cedor* court considered whether it was capable of transfer to the trustee and held that it was.[116] Although transferabil-

[114] Lee, supra note 91, at 243.

[115] If there is a possibility that the exemption system could be misused in this fashion, a rebuttable presumption could be created that no fraud was intended. The burden would then be on the Commissioner of Internal Revenue to establish the fraud. The burden of proof is placed on the Commissioner in other situations, e.g., to establish fraud with intent to evade payment of taxes, Int. Rev. Code of 1954, § 7454(a); and to establish the illegality of a payment or bribe, Int. Rev. Code of 1954, § 162(c)(1).

[116] 337 F. Supp. at 1106.

ity in general is determined by state law,[117] it is preempted by federal law where an assignment of a claim against the government is involved. The Assignment of Claims Act[118] provides that "[a]ll transfers and assignments made of any claim upon the United States . . . shall be absolutely null and void" unless certain requirements not here relevant are met. However, the Claims Act will not prevent the assignment of a claim against the Government as between the parties since the purpose of the statute was simply to give protection to the Government.[119] Thus, the Claims Act will not stand in the way of the transfer of title to an income tax refund to a trustee in bankruptcy.

3. *Abandonment*

Kokoszka also dealt with the argument that the refund would be of no benefit to the creditors since it would be consumed by the expenses of administration.[120] The Bankruptcy Act sets a maximum scale for compensation allowed the trustee, permitting up to $150 plus expenses no matter how small the estate.[121] While the practice varies across the country, generally the trustee is awarded the maximum fee.[122] Where the amount of non-exempt assets is small, it may be cancelled out by the costs of administration.[123]

However, as a general rule, the fact that a refund may be small ought not to bar its inclusion within section 70a(5),[124] as it may be only one asset among others. Where the amount of the non-exempt assets of the bankrupt's estate in its entirety is insufficient to benefit

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[117] See notes 81 and 88 supra and accompanying text.

[118] 31 U.S.C. § 203 (1970).

[119] See *Segal*, 382 U.S. at 384; Martin v. National Sur. Co., 300 U.S. 588, 596 (1937).

[120] 479 F.2d at 995. Los Angeles has resolved this problem by adopting the practice that its trustees are not permitted to claim a tax refund unless it exceeds $150. See In re Kingswood, 343 F. Supp. 498, 505 (C.D. Cal.), rev'd and remanded per curiam, 470 F.2d 996 (9th Cir. 1972), petition for cert. filed, 42 U.S.L.W. 3101 (U.S. Aug. 28, 1973) (No. 73-289).

It has been suggested that the doctrine of "de minimis" might have been the real motivation and should have been the legal justification for the outcome in *Lines*. Greenfield, Lines v. Frederick: The Effect of Bankruptcy on a Bankrupt's Accrued Vacation Pay and Other Forms of Deferred Compensation, 47 Los Angeles B. Ass'n Bull. 67, 67 n.3 (1971).

[121] 11 U.S.C. § 76(c)(1) (1970). The stated purpose of the provision is to secure competent trustees and efficient administration by providing more adequate compensation. Snedecor, Fees and Allowances in Straight Bankruptcy, 40 Ref. J. 26, 27 (1966). See generally In re Schautz, 390 F.2d 797 (2d Cir. 1968); 2 W. Collier, Bankruptcy ¶ 48.06 (14th ed. 1971); D. Stanley & M. Girth, Bankruptcy: Problem, Process, Reform 91-92, 175-88 (1971).

[122] See Snededor, supra note 121, at 26, 27.

[123] Most of the debtor's non-exempt, unencumbered property is either valueless or has been attached or repossessed prior to bankruptcy. Cyr, Single Claim Jurisdiction for the United States Court of Consumer Affairs: An Interim Proposal for Relevant Regulation of Consumer Credit, 46 Am. Bankr. L.J. 199, 226 (1972). Of the bankruptcies filed in 1969, 15% had assets, 15% had only nominal assets (assets sufficient only to pay the administrative expenses), and 70% had no assets. Lee, [Book Review, 46 Am. Bankr. L.J. 159, 161 (1972).] See D. Stanley & M. Girth, supra note 121, at 20.

[124] See In re Wright, 157 F. 544, 546 (2d Cir. 1907); In re Goodson, 208 F. Supp. 837, 842 (S.D. Cal. 1962).

his creditors, the court in its discretion may grant an order of abandonment.[125] Abandonment is concerned, however, with the size of the non-exempt asset and not with whether the asset should be considered "property" within section 70a(5).

4. *Restriction on Garnishment*

The *Cedor* and *Kokoszka* courts also disagreed as to the application of the Restriction on Garnishment provision, section 303 of the Consumer Credit Protection Act (CCPA).[126] This provision provides that no more than twenty-five percent of one's "disposable earnings" may be subjected to garnishment. The bankrupts in *Cedor* had contended that section 303 would exempt up to seventy-five percent of the refund if it, or some portion thereof, were found to be "property."[127] Although the court in *Cedor* admitted that the theory was "somewhat strained at first glance,"[128] it arrived at the conclusion that the Restriction on Garnishment provision was applicable by an analysis of the definitions in section 302 of the CCPA, which provides:

> (a) The term "earnings" means 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.
>
> (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.[129]

The source of the refund was "earnings" as within the meaning of section 302(a). The court found no policy reason "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."[130] Since nothing was required to be withheld from the refund, it was "disposable earnings" as defined in section 302(b). The process by which the trustee took title to the refund was a "legal

[125] Courts have established their own standards for the abandonment of an asset. An asset may be abandoned, e.g., if it (1) is inherently worthless; (2) is too expensive to maintain; (3) has a speculative value; (4) involves too much time in collecting; or (5) cannot be sold or liquidated. Calverley, Income Tax Refunds Due Wage Earners, 39 Ref. J. 8, 10 (1965).

[126] 15 U.S.C. § 1673 (1970).

[127] 337 F. Supp. at 1104.

[128] Id. at 1107.

[129] 15 U.S.C. § 1672 (1970).

[130] 337 F. Supp. at 1107.

or equitable procedure" whereby the earnings of an individual were withheld for payment of a debt, a procedure falling within the definition of "garnishment" in section 302(c).[131]

The court in *Kokoszka* explicitly rejected the *Cedor* court's reasoning on this point,[132] holding that the tax refund was not "earnings" within the meaning of section 302 and was therefore not protected by section 303.[133] The court also looked to one of the primary purposes of the CCPA—to protect the wage-earner from the garnishment of all his take-home pay—in arriving at this conclusion.[134]

The kind of garnishment to which the CCPA refers is defined in Black's Law Dictionary as

> [a] statutory proceeding whereby [a] person's property, money or credits in possession or under control of, or owing by, another are applied to [the] payment of [the] former's debt to [the] third person by proper statutory process against [the] debtor and [the] garnishee.[135]

This traditional form of wage garnishment would seem to preclude the bankruptcy procedure whereby the trustee would receive the refund check; it is difficult to see how the referee's turn-over order can be construed as a garnishment where the title to the refund passes to the trustee by operation of law. The bankrupt has already received the object of "garnishment," *i.e.*, the tax refund check. He may voluntarily turn it over to the trustee or he may disobey the order and spend it.

Moreover, a semantic analysis of the Restriction on Garnishment provision reveals that the section is regulatory, limiting the amount of the wages which may be garnished; it does *not* exempt or immunize the wages from garnishment. The Bankruptcy Act, however, permits only those *exemptions* allowed by state and federal law.[136] It is submitted, then, that the provision of the CCPA does not apply to an income tax refund.

There is nothing in the legislative history of the CCPA to indicate that the legislature intended the restrictions of section 303 to extend beyond the protection of wage-earners from the creditors' remedy of garnishment. In a 1967 message on consumer protection, President Johnson stated that he was directing "a comprehensive study of the problems of wage garnishment [with recommendations as to] the steps to be taken to protect the hard-earned wages and the jobs of those who need the income most."[137] The resulting act has as

[131] Id.

[132] 479 F.2d at 996.

[133] Id.

[134] Id. at 996-97.

[135] Black's Law Dictionary 810 (4th ed. 1968).

[136] 11 U.S.C. § 24 (1970). The text of this section is quoted in note 88 supra.

[137] Message from President Johnson, H.R. Doc. No. 88, 90th Cong., 1st Sess. 10 (1967), reprinted in 2 U.S. Code Cong. & Ad. News 1966 (1968).

its preamble: "An Act [t]o safeguard the consumer in connection with the utilization of credit . . . by *restricting the garnishment of wages* . . . . ."[138] The purposes of the Act are set forth in House Report No. 1040, and include relief to debtors "to preserve their employment and insure a continued means of support for themselves and their families" so as to prevent them from being driven into bankruptcy.[139] Since the CCPA is federal legislation, the Uniform Consumer Credit Code (UCCC) has been formulated, embodying most aspects of the CCPA, for state adoption. The comments to the particular sections in the UCCC are used here to show how the UCCC provisions have been interpreted, and thus, by analogy, how the similar CCPA provisions are construed. The comments to sections 5.104-.105 of the UCCC, which are based on sections 302-03 of the CCPA, reiterate that the objective is to "assure the consumer debtor that he will retain enough of his earnings to be able to support himself and his dependents by exempting a portion of his earnings from garnishment . . . ."[140]

The legislative intent behind the CCPA, then, would seem to be the protection of a debtor's periodic take-home pay, not his annual income tax refund nor any other property which merely had its source in that pay. The language of section 303(a) itself refers to an individual's disposable earnings "for any workweek," limiting garnishment to a percentage of his disposable earnings "for that week." If a refund because it found its source in earnings retains its character as "earnings" despite the "somewhat circuitous route" back to the wage-earner, a stock dividend or interest from a savings account could be analyzed in a similar fashion. And yet, those latter two assets obviously would not be considered "earnings" paid as "compensation . . . for personal services;"[141] nor would the garnishment process be applied to an automobile or furniture because those items found their source in earnings.

Taxes withheld from a wage-earner and subject to a potential claim for a refund cannot be called "disposable earnings" within the

[138] Pub. L. No. 90-321, 82 Stat. 146 (1968) (emphasis added).

[139] H.R. Rep. No. 1040, 90th Cong., 2d Sess. (1968), reprinted in 2 U.S. Code Cong. & Ad. News 1962, at 1979 (1968). Testimony and evidence received by the House Banking and Currency Committee established a causal connection between harsh garnishment laws and high levels of bankruptcies. Id. at 1978. For example, while Texas and Pennsylvania, which prohibit garnishment of wages, have 5 and 9 consumer bankruptcies per 100,000 population, respectively, states with relatively harsh garnishment laws have had as many as 200 to 300. Id.

For an indication of the variation in state garnishment provisions before the passage of the CCPA, see D. Stanley & M. Girth, supra note 121, at 28-29; Brunn, Wage Garnishment in California: A Study and Recommendations, 53 Calif. L. Rev. 1214, 1250-53 (1965). See generally Shuchman & Jantscher, Effects of the Federal Minimum Exemption from Wage Garnishment on Non-business Bankruptcy Rates, 77 Com. L.J. 360 (1972); Wage Garnishment in Washington—An Empirical Study, 43 Wash. L. Rev. 743 (1968); Note, 1967 Wis. L. Rev. 759.

[140] Uniform Consumer Credit Code §§ 5.104-.105, comment 3.

[141] 15 U.S.C. § 1672(a) (1970).

meaning of section 302(b). The UCCC comments to that section specifically provide that "amounts required to be withheld for . . . income taxes . . . are excluded from 'disposable earnings.' "[142] That fund cannot logically resume its character as wages when returned to the bankrupt. "Disposable earnings" is that portion of the earnings remaining after any deductions required by law are withheld; the tax refund represents a portion of those deductions, and is thus the *inverse* of disposable earnings.[143]

Since a tax refund does not constitute "disposable earnings" under section 302(b) of the CCPA, it may pass to the trustee in bankruptcy without the restriction required by section 303. Thus, once again, it is submitted that the *Kokoszka* court reached a more suitable conclusion than the court in *Cedor* in deciding that the CCPA was inapplicable to income tax refunds.

CONCLUSION

Cedor has been criticized as "an unrestricted, open-ended expansion of the *Lines* doctrine."[144] At the time *Lines* was decided, section 70a(5) had traditionally been construed to encompass a wide range of property interests and to limit those which would remain in the possession of the bankrupt. It is submitted that the Supreme Court in *Lines* intended to carve out only a narrow exception to this general rule, and that *Cedor* extended the *Lines* holding to an untenable degree. The *Kokoszka* court's analysis was more accurate, and continues the well-established line of cases holding that a tax refund does constitute section 70a(5) property.[145] In addition, the court in *Kokoszka* accepted the necessity of considering the purposes of the Bankruptcy Act in analyzing the nature of the bankrupt's property. It weighed both the interests of the creditors and those of the bankrupt, and determined that the latter's ability to start anew would not be hampered by the passage to the trustee of his claim to an income tax refund. The Bankruptcy Act intended only to place the bankrupt on an equal footing with others from the time of his discharge in bankruptcy; a refund check received by the bankrupt subsequent to his discharge would in fact give him a "head start" over the others.

The situation created by *Kokoszka* and *Cedor* is one of uncertainty. A more analytical, and perhaps more subjective, determination of what constitutes "property" is required. In fact, all "property" has to be reexamined in light of these decisions. Courts will look beyond the mechanical test of section 70a(5) to the purposes behind the Bankruptcy Act. However, although these additional

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142 Uniform Consumer Credit Code §§ 5.104-.105, comment 3.

143 For further analysis of the language of § 1673, see generally Lee, Title to Property —Employee Bankrupts' Income Tax Refunds, 47 Am. Bankr. L.J. 239 (1973).

144 Id. at 241.

145 See note 1 supra.

factors may bring a more realistic approach to the question of what constitutes "property," the injection of subjectivity has led to inconsistency in treatment by various courts, as exemplified by the conflicting decisions in *Cedor* and *Kokoszka*. The Supreme Court's grant of certiorari[146] provides the opportunity to resolve the conflicting positions. It will 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 its reach under the " 'fresh start' doctrine" as enunciated in *Cedor;* 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 CCPA apply to exempt up to seventy-five percent of the amount?[147]

If the Supreme Court rules that a bankrupt wage-earner's income tax refund does not constitute "property" within the meaning of section 70a(5), it is submitted that Congress should pass legislation which would effectively abrogate the Court's position. The Internal Revenue Code could be amended so that an adjudication in bankruptcy would terminate the tax year, as is done with the death of a taxpayer.[148] In this way, the right to the refund would vest in the trustee from the date of bankruptcy rather than retroactively.[149] However, there would be administrative difficulties: the bankrupt would have to file two tax returns and possibly two claims for refunds, requiring wasteful duplication both on his part and on the part of the Government in processing them.[150] Coordinated construction of two separate statutes—the Bankrruptcy Act and the Internal Revenue Code—would also be required.[151] Even with such an amendment, there would still have to be a determination whether the claim was transferable prior to bankruptcy according to section 70a(5).[152] In order to avoid these difficulties, it would appear to be more effective to amend the Bankruptcy Act itself to provide that an income tax refund passes to the trustee in bankruptcy.[153]

Section 70a has been amended in the past in order to avoid problems of construction inherent in its language.[154] It is submitted

[146] 42 U.S.L.W. 3352 (U.S. Dec. 11, 1973) (No. 73-5265).

[147] 42 U.S.L.W. 3376 (U.S. Dec. 25, 1973) (No. 73-5265).

[148] Int. Rev. Code of 1954, § 443(a)(2). See Fournier v. Rosenblum, 318 F.2d 525, 527 n.3 (1st Cir. 1963); Seidman, Some Implications of Segal v. Rochelle, 40 Ref. J. 107, 108 (1966); Recent Cases, 110 U. Pa. L. Rev. 275, 280 (1961); Note, 17 U. Fla. L. Rev. 241, 253 n.62 (1964).

[149] Cf. Recent Cases, supra note 148, at 280.

[150] Id. at 280 n.31.

[151] Id. at 280.

[152] Note, 17 U. Fla. L. Rev. 241, 253 n.62 (1964).

[153] See id.

[154] The Chandler Act amendment of § 70a was enacted in order to prevent the passage of certain contingent interests to the bankrupt, as in, e.g., Dioguardi v. Curran, 35 F.2d 431 (4th Cir. 1929); In re Baker, 13 F.2d 707 (6th Cir.), cert. denied, 273 U.S. 733 (1926). See *Fournier*, 318 F.2d at 527 n.3.

that this section ought once again to be amended to avoid any confusion as to the nature of income tax refunds. A proposed amendment to be added to section 70a is:

> The trustee shall be vested with title to such income tax refund claims as may be vested in the bankrupt at the time of the filing of his petition in bankruptcy, or as may vest in the bankrupt subsequent to the filing of the petition insofar as they are attributable to pre-bankruptcy income, regardless of whether such refunds are attributable to the minimum withholding required by law or withholding in excess of that minimum.[155]

The "insofar as" clause would enact into law the practice of some courts of dividing the refund into portions attributable to pre- and post-bankruptcy periods.[156] Such prorating results in more equitable treatment for the taxpayer, particularly where large amounts are withheld. The courts should be able to work out mathematical formulae for apportioning the refund. Where the bankrupt continues to have a steady source of income for the entire taxable year, this will be relatively simple. Where the bankrupt realizes proportionately less income in the post-bankruptcy period, however, thereby generating a larger tax refund, the formula will have to be somewhat more complex. The "regardless of" clause is intended to resolve the contrary holdings of *Cedor* and *Kokoszka* with regard to minimum withholding in favor of the *Kokoszka* court's analysis.

If directly amending section 70a is not feasible, perhaps an indirect approach could be attempted. A national exemption law might more realistically—and, at least, more consistently—deal with the bankrupt.[157] Currently, many of the state exemption laws are outdated. Although the CCPA has initiated much-needed reform, a more liberal policy would place the bankrupt in a position where he would be better able to start out anew, without the necessity of awarding him his refund check.

Finally, major reform may be called for by means of a thorough

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[155] For similar proposed amendments to cover the loss carryback situation, see Note, 17 U. Fla. L. Rev. 241, 253-54 (1964); Note, 16 U. Miami L. Rev. 345, 348 n.26 (1961).

[156] For cases in which prorating has been used, see In re Cedor, 470 F.2d 996 (9th Cir.), aff'g per curiam 337 F. Supp. 1103 (N.D. Cal. 1972), cert. denied, 411 U.S. 973 (1973); In re Kingswood, 343 F. Supp. 498 (C.D. Cal.), rev'd on other grounds and remanded per curiam, 470 F.2d 996 (9th Cir. 1972), petition for cert. filed, 42 U.S.L.W. 3101 (U.S. Aug. 28, 1973) (No. 73-289). In re Jones, 337 F. Supp. 620 (D. Minn. 1971), leave to appeal denied (8th Cir. May 14, 1971) (unreported), cert. denied, 404 U.S. 1040 (1972); In re Cohen, 276 F. Supp. 889 (N.D. Cal. 1967); In re Goodson, 208 F. Supp. 837 (S.D. Cal. 1962). Cf. Segal v. Rochelle, 382 U.S. 375, 380 n.5 (1966).

[157] A national exemption policy has been urged by various commentators. See, e.g., Seligson, Major Problems for Consideration by the Commission on the Bankruptcy Laws of the United States, 45 Am. Bankr. L.J. 73, 107-08 (1971); S. Enzer, R. de Brigard & F. Lazar, Some Considerations Concerning Bankruptcy Reform 11, 55 (Report R-28, Institute for the Future, Menlo Park, Calif., March 1973) [hereinafter cited as S. Enzer].

revamping of the bankruptcy system itself.[158] The Ninety-First Congress created the Commission on the Bankruptcy Laws of the United States[159] to "study, analyze, evaluate, and recommend changes to [the present Bankruptcy Act], in order for such Act to reflect and adequately meet the demands of present technical, financial, and commercial activities."[160] The study will consider:

> the basic philosophy of bankruptcy, the causes of bankruptcy, the possible alternatives to the present system of bankruptcy administration, the applicability of advanced management techniques to achieve economies in the administration of the Act, and all other matters which the Commission shall deem relevant.[161]

The Commission is thus given considerable latitude in making recommendations for specific changes in the Act or for alternative methods of bankruptcy administration.

The time is ripe for a change in dealing with the question whether an income tax refund should stay in the hands of the debtor or should be used in the payment of his debts. The major impetus for change comes from the Supreme Court's grant of certiorari. Reform may also result from recommendations of the Commission on the Bankruptcy Laws, or from Congress, by amendment either of the Internal Revenue Code or of the Bankruptcy Act or by overhauling the entire Act.

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[158] As the system exists now, the bankrupt's discharge is inadequate as to all parties involved. The bankrupt, although freed from most of his past debts, is left with minimal assets and no immediate prospect of rehabilitation. See generally S. Enzer, supra note 157, at 8-10; Cyr, Bankruptcy Courts in Transition Toward Debtor Rehabilitation, 22 Me. L. Rev. 333 (1970). As for the bankrupt's creditors, there are rarely enough assets to cover the bankrupt's outstanding debts, so that creditors must settle for less than the full amount of the debt owed. The average creditor realizes only about sixteen cents on the dollar. D. Stanley & M. Girth, supra note 121, at 21. See also id. at 92-93; Countryman, The Bankruptcy Boom, 77 Harv. L. Rev. 1452, 1454 (1964). Annual credit losses from business and non-business bankruptcies are in excess of one billion dollars. Seligson, supra note 157, at 85. See generally D. Stanley & M. Girth, supra at 37-39.

[159] Pub. L. No. 91-354, § 1(a), 84 Stat. 468 (1970). A two-year period for completion and up to $600,000 was authorized for the study. Pub. L. No. 91-354, §§ 1(c), 6, 84 Stat. 468, 469 (1970). The Commission's report was not available at the time of this writing.

[160] Pub. L. No. 91-354, § 1(b), 84 Stat. 468 (1970).

[161] Id.