The Bankrupt's Right to Loss - Carryback Tax Refunds: Segal v. Rochelle

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RECENT DECISIONS

The Bankrupt’s Right to Loss—Carryback Tax Refunds: Segal v. Rochelle—In Segal v. Rochelle the United States Supreme Court foreclosed a bankrupt’s windfall and amplified section 70a(5) of the Bankruptcy Act. A unanimous Court ruled that claims for loss-carryback tax refunds, due a bankrupt for losses suffered prior to the filing of bankruptcy, vest in the trustee in bankruptcy. Three circuit courts of appeals had split on this point. The First Circuit in Fournier v. Rosenblum, and the Third Circuit in In re Sussman, held that claims to the refund remained in the bankrupt. In the Segal case the Fifth Circuit ruled that the trustee was entitled to the claim, thus establishing the split which the Supreme Court resolved.

On September 27, 1961, voluntary bankruptcy petitions were filed in a federal court in Texas by Gerald Segal, Sam Segal, and their business partnership, Segal Cotton Products. Rochelle was appointed trustee in bankruptcy. After December 31, 1961, the Segals sought and obtained loss-carryback tax refunds from the United States under section 172 of the Internal Revenue Code of 1954. This section allows a taxpayer who suffers a net operating loss for his taxable year to credit that loss against his gross income for the three preceding years and the five succeeding years. The entire loss is carried back to the first year, what remains over the taxable income of that year to the second year, and so on until the loss is exhausted. Application for the refund may not be made until the close of the taxable year in which the loss was sustained. In this case, the losses were carried back to 1959 and 1960 to reduce income on which the Segals had paid taxes in those years, and entitle them to a refund.

On agreement, the Segals applied to the referee in bankruptcy to award them the refund, as opposed to awarding it to the trustee. Four years later the United States Supreme Court handed down the final solution to the problem. The claims pass to the trustee by section 70a(5) of the Bankruptcy Act which section vests in the trustee “property... which prior to the filing of the petition... [the bankrupt] could by any means have transferred...”

3. 318 F. 2d 525 (1st Cir. 1963).
4. 289 F. 2d 76 (3rd Cir. 1961).
5. 336 F. 2d 298 (5th Cir. 1964).
6. 30 Stat. 565 (1898), as amended, 11 U.S.C. §110(a) (5) (1964). More fully, this section states: “a. The trustee of the estate of a bankrupt... shall... be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to all 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...”
The Concept of Property

The courts in both Fournier and Sussman held the claim for the refund to be too tenuous to be classified as “property.” It could not be presented to the Internal Revenue Service as a claim until the close of the taxable year. Between the filing of bankruptcy and the close of the year, the bankrupt could erase his right to the refund by receiving enough income to offset his prior losses during the year. The courts, therefore, viewed his interest as a mere expectancy. It was not “property,” because the bankrupt, at the time of filing, could point to “no existing fund or cause of action in which he had any legal or equitable interest.”

The Fifth Circuit avoided this result by viewing the interest as a possibility coupled with an interest:

This right of action springs from and rests on the fact that the income taxes theretofore paid were paid subject to adjustment in the event of future losses, and are available for that purpose to the end of providing the refund. The right to adjustment is definite; the time for filing the claim is definite; only the amount of the refund is contingent, and this meets the test of a possibility vested with an interest...

Past cases have held that a vested interest subject to complete divestment, a contingent interest and a possibility coupled with an interest pass to the trustee under section 70a(5), but that an expectancy does not. Rather than plunging into this entanglement to seek out a label for a claim to a tax refund, the Court stated that “property” under section 70a(5) will not be bound by such technical distinctions. It stated that “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.” The Court also held that, in interpreting this section, “it is impossible to give any categorical definition to the word ‘property’...”

The Bankruptcy Act defines “property” according to its own purposes. Broadly speaking, those purposes are to secure all the valuable property of the bankrupt for his creditors, while still leaving him

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7 In re Sussman, 289 F. 2d 76, 78 (3rd Cir. 1961).
8 Segal v. Rochelle, 336 F. 2d 298, 302 (5th Cir. 1964).
9 Board of Trade v. Johnson, 264 U.S. 1 (1924).
11 Kleinschmidt v. Schroeter, 94 F. 2d 707 (9th Cir. 1938).
14 Id. Actually, the Court is making a specific application of the doctrine that bankruptcy courts should exercise their equitable powers in such manner 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 v. Litton, 308 U.S. 295, 305 (1939). See also Am. Jur. 2d Bankruptcy §848 (1963).
15 Segal v. Rochelle, 382 U.S. 375, 379 (1966). The concept of property is not governed by state law, as is the concept of transferability. See note 21 infra and accompanying text.
free to make a fresh start. This freedom to gain new wealth after he has filed is the main limitation on the broad construction of “property” contained in section 70a(5). However, the Court felt that the claim to the loss-carryback tax refund “is sufficiently rooted in the pre-bankruptcy 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).” These refunds are unlike future wages or an intended bequest, neither of which would pass to the trustee, because it springs directly from the bankrupt’s past. The refund, if paid, will be paid because the bankrupt has “earned” it (i.e., by operating at a net loss) in his pre-bankruptcy past. Furthermore, whether it is technically classified as an expectancy or not, it is a thing of substance. The bankrupt has paid taxes in the past and is operating at a net loss at the time of filing. The possibility that the bankrupt will erase the loss during the remainder of the year in which the petition is filed is unlikely.

Of course whatever income he does receive during the remainder of the year would reduce the refund; thus the claim, though vested in the trustee, would be open to both partial and total divestment. If the bankrupt continues to lose money after filing, the Fifth Circuit Court of Appeals has suggested that a “proration of the refund in the ratio of the losses before and after the filing date would be indicated . . . .” Also, although it chose not to deal directly with the question, the Supreme Court implied that any claims to net loss-carryover refunds (i.e., a loss so great that it would carry over into the five succeeding years) would not vest in the trustee in bankruptcy. The carryover lacks the substance and relative certainty of the carryback. While the latter definitely has prior gross income against which it may be charged, the former has no such existing fund—it can look only to contingent future earnings. Apparently, this is enough to distinguish the two in the judgment of the Supreme Court.

**The Concept of Transferability**

Under section 70a(5) the interest must not only be “property” but must also be “transferable” at the time of filing. Save on rare occa-

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16 Of course, §70(a) (5) itself, including its concept of property, is limited by the rest of the Bankruptcy Act. E.g., there are exemptions within §6, and there are eight classes of property enumerated in §70(a). That these specific enumerations qualify the general meaning of property within (5), see Board of Trade v. Weston, 243 F. 332, 335 (7th Cir. 1917).


18 Segal v. Rochelle, 336 F. 2d 298, 302 n.5 (5th Cir. 1964). The Supreme Court notes but does not expressly adopt this approach. Segal v. Rochelle, note 17 supra, at 380 n.5.

19 Segal v. Rochelle, note 17 supra, at 381. Also, since the purposes of the Bankruptcy Act are to govern, keeping the estate open for such a length of time would seem to work a hardship on the bankrupt.

20 The section also provides for vesting in the trustee, if alternatively the property “might have been levied upon and sold under judicial process against him, or
sions, the federal courts will follow state law in determining whether or not particular property is transferable. They will then follow federal law in determining whether that particular transfer falls within the meaning of section 70a.21

However, before even approaching the applicable state law (here, that of Texas), the Court in Segal deals with the problem of the federal "anti-assignment" statute.22 This statute would appear to be an insuperable bar to assignment of net loss-carryback refunds, as it states that "all transfers and assignments made of any claim upon the United States . . . shall be absolutely null and void" unless certain conditions are met, such as the allowance of the claim and the ascertainment of the amount due.23 Obviously, the achievement of these conditions at the time of filing is not possible.

It has been held that this statute does not apply to transfers by operation of law.24 Since section 70a(5) provides that "the trustee . . . shall . . . be vested by operation of law with the title of the bankrupt . . . ," the trustee argued that the non-assignment statute did not apply. However, the Court ruled that "transferable" in section 70a(5) means that the bankrupt could have voluntarily transferred the interest at the time of filing.25 Once it has been hypothetically determined that the property could have been transferred voluntarily at the time of filing, it vests by operation of law in the trustee. It is only the latter transaction which is exempt from the anti-assignment statute.

However, just as the Court avoided the technical limitations of the word "property" by looking to the purposes of the Bankruptcy Act, so it avoided the literal application of the words "absolutely null and void" by looking to the purposes of the anti-assignment statute. In otherwise seized, impounded, or sequestered. . . ." 30 Stat. 565 (1898), as amended, 11 U.S.C. §10(5) (1964). However, both the trustee and the Court recognize those procedures do not apply here. Segal v. Rochelle, note 17 supra, at 382 n.8.

21 4 Collier, Bankruptcy, 70.15 at pp. 1034-35 n.22 (14th ed. 1962).
23 Rev. Stat. §3477 (1875), as amended, 31 U.S.C. §203 (1964). Sussman relied on this as an alternative reason for not allowing the claim for the tax refund to vest in the trustee. Fournier did not discuss this point.
25 "Not only is there practically no form of property that would not be transferable under the broader reading, but it also makes redundant the alternative route for complying with §70(a)(5) through showing that the property 'might have been levied upon and sold under judicial process. . . .'" Segal v. Rochelle, 382 U.S. 375, 382 (1966).

The Court thus requires voluntariness, even though the Bankruptcy Act defines "transfer" as including "the sale and every other and different mode, direct or indirect, of disposing of or parting with property or with an interest therein or with the possession thereof or fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, pledge, mortgage, lien, encumbrance, gift, security or otherwise. . . ." (Emphasis added.) Bankruptcy Act §1(30) 52 Stat. 842 (1938), 11 U.S.C. §1(30) (1964). The Court justifies this by holding that Congress did not intend this definition to apply to "transfer" as it is used within §70(a)(5).
Martin v. National Surety Co., the Court interpreted this statute as being primarily "to give protection to the Government," so that it did not become "embroiled in conflicting claims, with delay and embarrassment and the chance of multiple liability." Once it had paid the claim to its original owner, the government would no longer be in danger or be concerned. Therefore it would not be contrary to the anti-assignment statute to allow the enforcement of a previously "null and void" assignment as between the parties themselves. So once the assignor had been paid, the assignee could enforce his right under the doctrine of equitable assignment. Equity will force the assignor to comply with the invalid assignment by causing him to transfer his recovery to the assignee.

In this case the doctrine of equitable assignment serves a twofold purpose: a.) it prevents strict application of the anti-assignment statute, and b.) it expands the meaning of "by any means" transferable in section 70a(5). In the latter sense the Segal case vindicates a 1930 holding by the Seventh Circuit Court of Appeals. In re Landis declared that "by any means" transferable included not only transfers in law but also transfers enforceable only in equity. No other circuit ever supported Landis, and at least five circuits have expressly refused to allow future interests that aren't freely transferable to pass to the trustee. Their most forceful argument (in addition to the policy argument that passing an expectancy led to a maximum of sacrifice on the debtor's part, since the sale of an

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26 300 U.S. 588, 596 (1937).
27 Id. at 594.
28 It is interesting to note that if the bankrupt actually did make such an assignment to a debtor, the assignment would not be a perfected transfer but would be judged "preferential" and voided under §§3(a)(2), 60(a) of the Bankruptcy Act, unless the assignor-bankrupt was paid on his claim at least four months before the filing of bankruptcy. Matter of Ideal Mercantile Corporation, 244 F. 2d 828 (2d Cir.), cert. denied 355 U.S. 856 (1957). And the assignee himself cannot sue the Government on the claim, even if he joins the assignor. United States v. Shannon, 342 U.S. 288, 293-94 (1958).
29 However, for the purposes of the hypothetical transfer of §70(a)(5), it is simply enough that the bankrupt could have assigned his interest at the time of filing, which assignment the assignee could enforce whenever (and if) the assignor received payment of his claim.
30 For further problems caused by the anti-assignment statute, see 12 A.L.R. 2d 460 (1950).
31 41 F. 2d 700, 702 (7th Cir.), cert. denied 282 U.S. 872 (1930).
32 52 Calif. L. Rev. 129, 135 (1964). To be freely transferable the interest must be "transferable without consideration by quitclaim deed to a stranger to the title." Halbach, Creditors' Rights in Future Interests, 43 Minn. L. Rev. 217, 224 (1958).
33 Nor did the decision fare well at the hands of the critics. Professor Simes has stated that "... a more reasonable interpretation of the statute would be to the effect that transferable 'by any means' really means transferable 'by every means.' That is to say, the statute refers to interests which are alienable without restriction." Simes, Future Interests §40, at 120 (1951). See also 2 Powell, Real Property, §287, at 520 (1950) and Restatement, Property §168, comments e, f (1936). But that there were those who did support Landis, see 4 Collier, Bankruptcy, ¶70.37, at pp. 1293-95 n.6 (14th ed. 1962) and MacLachlan, "By Any Means," 67 Com. L. J. 193 (1962).
expectancy would not bring proceeds commensurate with the interest given up) was section 70a(7) of the Bankruptcy Act. This section vests in the trustee:

"contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates . . . ."

As can be appreciated, even though some of these interests could not have been assigned at law in some jurisdictions, they were all assignable in equity. If "by any means" transferable in (5) was to include assignments in equity, why would Congress pass interests to trustee by subsection (7) which would have already passed by subsection (5)?

Although the Supreme Court did not deal with this inconsistency, their rationale probably would have been: a.) the purposes of the Bankruptcy Act are to control; b.) section 70a(7) was added to the Act in 1938, while loss-carryback refunds were not created until 1939; c.) section 70a(7) passes some interests (e.g., devises received within six months of bankruptcy) which would not pass by section 70a(5) because of a failure to qualify as "property."

At any rate, having approved the doctrine of equitable assignment, the Court then looked to the state law of Texas and noted that its courts of equity would enforce such an assignment. Thus, the claim is transferable at the time of filing. Having already passed the "property" test, the bankrupt's claims for loss-carryback tax refunds vested in the trustee by operation of law.

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32 See note 15 supra and accompanying text.
33 52 Stat. 880 (1938).
34 53 Stat. 867 (1939).
35 Trinity Univ. Ins. Co. v. First State Bank, 143 Tex. 164, 183 S.W. 2d 422 (1944). The Court also states that a Texas court of equity might even force a reluctant assignor to collect such claim. Segal v. Rochelle, 382 U.S. 375, 385 (1966). However, the Court cites no authority for this and does not appear to be deeming such action necessary. It is enough that the equity court would force a transfer, once the assignor had received payment.
36 The bankrupt may have claims for other tax refunds which would also pass to the trustee. In Chandler v. Nathans, 6 F. 2d 725, 728 (3rd Cir. 1925), there was an overpayment of taxes by the bankrupt. The court ruled it passed to the trustee by §70(a)(6) of the Bankruptcy Act, which vests in the trustee "rights of action . . . [for] the unlawful taking or detention of . . . property."
However, since the Internal Revenue Service isn't really in the position of an unlawful taker, the better interpretation is that the claim to a refund would pass by §70(a)(5). This was the procedure in In re Goodson, 208 F. Supp. 837, 847 (S.D. Cal. 1962), dealing with a refund of withholding taxes. The 5th Circuit Court of Appeals approved of it passing by §70(a)(5) rather than §70(a)(6). Segal v. Rochelle, 336 F. 2d 298, 303 n.7 (5th Cir. 1964).
As to withholding taxes, "The trustee in bankruptcy is entitled to that part of a federal income tax refund attributable to withholdings from the wages of the bankrupt prior to his bankruptcy, and the amount of the refund attributable
The Court's expansion of the term "transferable" was a natural corollary to its freeing of the term "property." The same technical distinctions that had restricted "property" would have reappeared in a limited definition of "transferable" (i.e., it may now be property, but it still is not transferable) to defeat the purposes of the Bankruptcy Act. The only real limitations within section 70a(5) now appear to be whether or not the interest is one sufficiently connected with the bankrupt's future and his ability to make a fresh start, and whatever limits the equity courts of a particular state may apply.

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Municipal Corporations: The Rule of Reason As Applied to Annexations—In Village of Elmwood Park v. City of Racine, the village of Elmwood Park sought a reversal of the judgment of the circuit court dismissing its petition for annexation to the town of Mt. Pleasant. Elmwood Park was incorporated as a village in 1960 and has an area of approximately 103.51 acres and a population of 432. Mt. Pleasant, which was to be annexed, has an area of approximately 22,810 acres and a population of 12,023. Both Elmwood Park and Mt. Pleasant border on the city of Racine and receive many of their governmental services under contract from Racine. Apparently out of fear of continued loss of territory to the city, Mt. Pleasant sought to merge with Elmwood Park and they worked out an agreement to accomplish that purpose.

In order to carry out the proposed merger, Mt. Pleasant and Elmwood Park had a choice of proceeding under either the consolidation statute, section 66.02, or the annexation statute, section 66.024. The consolidation statute sets forth a procedure for consolidating any town, village or city with a contiguous town, village or city. Generally, the procedure calls for an ordinance to be passed by a two-thirds vote of each board or council and by a majority of votes in each municipality to withholdings from wages thereafter is the property of the bankrupt." 3 Remington, Bankruptcy, §1211.11 (Supp. 1966). That the exact refund may not be determined or claimed until the end of the taxable year would make no difference as the United States Supreme Court has now established.

37 That there are substantial limitations on §70(a)(5) from without, see note 16 supra.

38 In Wisconsin, future interests, whether vested or contingent, are alienable at law. Wis. Stats. §§230.07-.13, 230.35 (1963). That this applies to future interests in both realty and personalty, see Meyer v. Reif, 217 Wis. 11, 16-18, 258 N.W. 391, 393-94 (1935) and Estate of Tantillo, 24 Wis. 2d 19, 22, 127 N.W. 2d 798, 800 (1964).

An expectancy may not be assigned at law, however, such assignment, if sustained by a sufficient consideration, will be enforced in equity. Hofmeister v. Hunter, 230 Wis. 81, 88, 283 N.W. 330, 333 (1939). Thus it would seem the claim for a loss-carryback tax refund of a Wisconsin bankrupt would also vest in the trustee in bankruptcy.

1 Village of Elmwood Park v. City of Racine, 29 Wis. 2d 400, 139 N.W. 2d 66 (1966).