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Cover Page Footnote

Members of the New York Bar.

THE BANKRUPT ESTATE, TAXABLE INCOME AND THE TRUSTEE IN BANKRUPTCY

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INCOME and profits, and taxes thereon, do not at first appear to be a principal factor or concern during the administration of a bankrupt estate. With the 1963 amendment of Section 47a(2) of the Bankruptcy Act, permitting the deposit of bankrupt estate funds into interest-bearing accounts,[1] the problem of taxable income and the tax impact thereon served to focus the Treasury Department's attention on the trustee in bankruptcy.[2]

Generally, the absence of income and profits has precipitated bankruptcy proceedings. However, when the trustee in bankruptcy begins to dispose of the bankrupt's property, income tax complications arise by virtue of the technical language of the Internal Revenue Code and the necessity of accounting for taxes on an annual basis. At the time of bankruptcy, a bankrupt may have assets worth 500,000 dollars and liabilities of 2,000,000 dollars. A considerable period of time may elapse from the filing of the petition in bankruptcy until the estate is liquidated and a dividend is paid to creditors. During this administration, a variety of transactions will take place, many of which have tax consequences which pose interesting problems. A few hypothetical illustrations may serve to point out the problems that may arise.

The estate may include a parcel of real estate. If this property has been owned by the bankrupt for any substantial period of time, it may have appreciated in value over its original cost of acquisition, thereby resulting in a gain upon disposition. Further, during the administration of the bankrupt estate, the trustee may have entered into lease arrangements, thereby receiving rental income. Under current accelerated depreciation allowances, there is a likelihood that the amount realized by the trustee from the sale of business assets will exceed the tax basis of the assets (cost minus depreciation) and produce a gain upon the transaction. All of these transactions may result in the realization of income. Furthermore, the bankrupt estate may consist of income producing properties, such as royalties from patents or dividends from marketable securities.

It is the purpose of this article to analyze and review the relevant

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1. Bankruptcy Act § 47a(2), 77 Stat. 14 (1963), 11 U.S.C. § 75(a)(2) (1964), amending 52 Stat. 860 (1938).

2. Letter From Treasury Department to the Administrative Office of the United States Courts, Dec. 3, 1964.

statutory, administrative, and judicial developments relating to the taxable income of bankrupt estates.

I. The Trustee's Obligation To Notify the Treasury of His Qualification

Of primary importance is the question of information returns to be filed by the trustee during administration of the bankrupt estate. It may come as a shock to the bankruptcy practitioner to learn that every receiver, trustee in bankruptcy, or other fiduciary must give notice of his qualification.[3] Such person, including the debtor in possession, within ten days of his appointment or authorization, must give written notice to the director of the Internal Revenue district in which the debtor is required to make returns.[4]

Treasury Form 56 (Notice to Commissioner) may be used for this purpose. The notice should provide, among other things, the date of appointment, the name and address of the debtor, the name and location of the court in which the proceedings are pending, and the dates and places of any scheduled hearings. One reason why the practitioner's omission to file this notice has not had more serious consequences is that the fiduciary is not required to file this notice if, within the ten-day period, a notice of the bankruptcy proceedings has been given to the Treasury Department under any provision of the Bankruptcy Act.[5] Generally speaking, a copy of the petition in bankruptcy is submitted to the Treasury Department by the clerk of the court in which the bankruptcy proceeding is pending. This action constitutes adequate notice to the Treasury.

The Internal Revenue Code also requires that a fiduciary give notice to the Treasury Department of his fiduciary relationship.[6] The operative language of section 6903 provides that where "any person is acting for another person in a fiduciary capacity, such fiduciary shall assume the powers, rights, duties, and privileges of such other person in respect of a tax imposed . . . ."[7] The term fiduciary means "a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."[8] It is not wholly clear whether a trustee in bankruptcy is included within the context of "fiduciary" as that term is used in section 6903. It is questionable whether the trustee

3. Int. Rev. Code of 1954, § 6036.
4. Treas. Reg. § 301.6036-1 (1960).
5. Ibid.
6. Int. Rev. Code of 1954, § 6903.
7. Ibid.
8. Int. Rev. Code of 1954, § 7701(a)(6); Treas. Reg. § 301.6903-1(d) (1957).

in bankruptcy can be said to be acting for the bankrupt. Indeed, he is an elected officer who administers the estate in the interest of the creditors. However, the Government is not required to collect the taxes solely from the income which was earned, but, instead, may look to all of a taxpayer's property with which to satisfy the tax liability.[9] Under this principle, it has been held that, when a trustee in bankruptcy takes over a bankrupt's assets, the trustee is subject to the transferee provisions of the Internal Revenue Code.[10]

The notice to be filed pursuant to section 6903 also may be made on Treasury Form 56. If notice of qualification of a trustee is required to be filed under section 6036, the filing of said notice shall be considered as complying with both sections 6036 and 6903.[11] However, it is not clear from the Treasury Regulations whether the filing of a petition by the clerk of the bankruptcy court with the Treasury Department satisfies the obligation of a fiduciary to file a notice of relationship under section 6903. In view of the fact that section 6036 makes mandatory the filing of a notice of qualification of a trustee,[12] the trustee should file the notice himself and not rely upon the clerk of the bankruptcy court to file a copy of the petition with the Treasury Department. This will satisfy the requirements of section 6036, as well as avoid any problems which may arise under section 6903.

II. The Obligation of Trustees in Bankruptcy To File Income Tax Returns and Pay Taxes On Behalf of the Bankrupt Estates of Corporations

It is necessary to discuss corporate bankruptcies separate and apart from individual bankruptcies because the revenue laws applicable to each are dissimilar. The filing of all income tax returns is controlled by Section 6012 of the Internal Revenue Code.[13] Subdivision (a)(2) of that section provides that a corporate income tax return shall be filed annually by the corporation, whether or not the corporation has any income.[14]

Where a receiver, trustee in bankruptcy, or assignee, either by order of court or by operation of law or otherwise, receives possession of or

9. Paschal v. Blieden, 127 F.2d 398, 404 (8th Cir. 1942).

10. Id. at 403-04. For the transferee provisions of the Code, see Int. Rev. Code of 1954, §§ 6901-03.

11. Treas. Reg. § 301.6036-1(c) (1960).

12. See Int. Rev. Code of 1954, § 6036; text accompanying note 3 supra.

13. Int. Rev. Code of 1954, § 6012.

14. Compare Int. Rev. Code of 1954, §§ 6012(a)(1), (3), (4), which require individuals, estates, and trusts to file income tax returns only where they have $600 or more in gross income.

holds title to all, or substantially all, of the property or business of a corporation, whether or not such property or business is being operated,[15] the receiver, trustee, or assignee must make the income tax return for such corporation.[16] The failure to file a corporate income tax return carries both civil and criminal penalties.[17]

While section 6012(b)(3) relates only to the filing of corporate income tax returns, it seems clear that the trustee in bankruptcy bears the sole responsibility for the payment of any tax that may be due.[18] A failure to pay the corporate income taxes may result in personal liability on the part of the trustee for the amount of the tax.[19] The mere fact that a bankruptcy proceeding which involves a corporation is commenced in no way affects the corporate existence for tax purposes.

A corporation in existence during any portion of a taxable year is required to make a return. . . . A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued. If the corporation has valuable claims for which it will bring suit during this period, it has retained assets

15. The 1954 Code marks a substantial departure from prior law. The Code of 1939 provided that the receiver or trustee in bankruptcy should file a corporate return only if he operated the property or business of the corporation. Int. Rev. Code of 1939, ch. 1, § 52, 53 Stat. 27. The 1954 Code eliminated the uncertainty which had developed by case law regarding what acts by the trustee in bankruptcy constituted "operating the property or business." Ibid.; see Pinkerton v. United States, 170 F.2d 846 (7th Cir. 1948); Louisville Property Co. v. Commissioner, 140 F.2d 547 (6th Cir.), cert. denied, 322 U.S. 755 (1944); United States v. Metcalf, 131 F.2d 677 (9th Cir. 1942), cert. denied, 318 U.S. 769 (1943); In re Heller, Hirsch & Co., 258 Fed. 208 (2d Cir. 1919) (per curiam); In re Owl Drug Co., 21 F. Supp. 907 (D. Nev. 1937); U.S. Code Cong. & Ad. News, 83d Cong., 2d Sess. 4543, 5211 (1954).

16. Int. Rev. Code of 1954, § 6012(b)(3).

17. Int. Rev. Code of 1954, §§ 6651, 6653, 7203. The civil penalties are computed upon the amount of taxes involved, whereas the criminal penalty is predicated upon a willful failure to file the required return. In view of the fact that these penalties are attributable to the conduct or misconduct of the trustee, it would seem that § 57 of the Bankruptcy Act, 52 Stat. 866 (1938), as amended, 11 U.S.C. § 93 (1964), would not operate to bar the Government's claim for penalties against the trustee.

18. United States v. Sampsell, 266 F.2d 631, 635 & n.3 (9th Cir. 1959). Int. Rev. Code of 1954, § 6151(a) provides: "Except as otherwise provided in this section, when a return of tax is required under this title or regulations, the person required to make such return shall, without assessment or notice and demand from the Secretary or his delegate, pay such tax . . . ." The term "person" includes a trustee in bankruptcy. Treas. Reg. § 301.7701-1(a) (1960).

19. Rev. Stat. § 3467 (1875), 31 U.S.C. § 192 (1964), provides: "Every executor, administrator, or assignee, or other person, who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate to the extent of such payments for the debts so due to the United States, or for so much thereof as may remain due and unpaid."

and therefore continues in existence. *A corporation does not go out of existence if it is turned over to receivers or trustees who continue to operate it.*[20]

The estate of a corporation either in receivership or in bankruptcy differs from the estate of a deceased person or of a trust in that the former is not a taxable entity separate from the entity for whom the fiduciary is acting.[21] Therefore, for income tax purposes, the Internal Revenue Code continues the existence of the corporation and makes the trustee in bankruptcy something in the nature of a super-board of directors, insofar as he is responsible for the filing of the returns and the payment of the taxes.

Traditionally, corporations and individuals have been taxed differently under the revenue laws. When individuals become bankrupt, a separate tax entity is created for the bankrupt estate.[22] Apparently, the difference in income tax treatment is based upon the contrast in economic realities between individuals and corporations. The assets of a corporation form the basic existence of the corporate entity. On the other hand, individuals, after the transfer of their property to the trustee in bankruptcy, may acquire new employment or new assets by way of additional financing. Generally, corporations become dormant upon the filing of a petition in bankruptcy unless, of course, the court authorizes the debtor to continue to operate and conduct its business. In the latter case, clearly there is every reason to continue filing the corporate tax return. Nevertheless, in the usual case of the liquidation of the assets of the corporation by the trustee, the principals of the debtor corporation who wish to resume business activities do not continue business or commence a new business with the charter and shell of the bankrupt corporation, but, rather, will form new corporations. Under these circumstances, there is little justification for severing the corporation into a pre-bankruptcy petition taxpayer and a post-bankruptcy petition taxpayer. From the viewpoint of administering the revenue laws, it makes little sense to have the trustee file a corporate return showing no income and expenses and also to have the trustee file a second tax return reflecting transactions during his trusteeship.

However, the aforesaid procedures set forth in the Internal Revenue Code with respect to the filing of corporate returns overlook the problems involving a corporate bankrupt which obtains a discharge under Section

20. Treas. Reg. § 1.6012-2(a)(2) (1960). (Emphasis added.) This is a simple restatement of Treas. Reg. 118, § 39.52-1(b) (1953), promulgated under the 1939 Code. No significance should be attached to the use of the word "operate" in view of the amendment to the 1954 Code.

21. Treas. Reg. § 1.641(b)-2(b) (1956), as amended, T.D. 6580, 1961-2 Cum. Bull. 123; text accompanying note 42 infra.

22. See note 26 infra and accompanying text.

14 of the Bankruptcy Act[23] and resumes business activity. For example, suppose a discharge is granted shortly after the petition is filed, and the corporation resumes business activity with the infusion of new capital while the trustee continues to liquidate the assets in the bankrupt estate and to administer the estate for several years thereafter. In such a case, the Internal Revenue Code fails to specify what tax returns, if any, the trustee should file.

Should the trustee file a corporate return for the bankrupt corporate estate which he is still administering? The answer would seem to be "No." The trustee in bankruptcy has authority and responsibility with respect to the property that he administers during the bankruptcy proceeding.[24] The discharged corporation which resumes business activity must file a corporate tax return.[25] Obviously, the trustee has no connection with the resumed activity of that corporation. There should not be two corporate tax returns filed for the same corporation relating to the same taxable periods.

Should the trustee file a fiduciary income tax return as he does in the case of bankrupt individuals, reporting the income realized during his trusteeship? It would appear that he should file such a return. Since the trustee would not be responsible for filing a corporate tax return for the discharged corporation that has continued in business, it would seem that the discharge in bankruptcy would operate at that moment to sever the estate of the bankrupt corporation from the corporation itself, similar to the situation where the tax entity of an individual is severed immediately upon the filing of a petition in bankruptcy.

III. The Obligation of Trustees in Bankruptcy To File Income Tax Returns and Pay Taxes on Behalf of the Bankrupt Estates of Individuals

In the case of bankruptcy proceedings involving individuals, a new taxable entity consisting of the "bankrupt estate" comes into being.[26] The provisions of Subchapter J of the Internal Revenue Code,[27] relating to the income taxation of decedents' estates and private trusts, are made

23. Bankruptcy Act § 14, 52 Stat. 850 (1938), as amended, 11 U.S.C. § 32 (1964).

24. Bankruptcy Act § 47, 52 Stat. 860 (1938), as amended, 11 U.S.C. § 75 (1964).

25. Int. Rev. Code of 1954, § 6012.

26. G.C.M. 24617, 1945-1 Cum. Bull. 235; G.C.M. 8488, X-1 Cum. Bull. 270 (1931); O.D. 174, 1 Cum. Bull. 175 (1919). It should be noted that bankrupt partnerships are treated, for tax purposes, under the same principles as those relating to bankrupt individuals. Therefore, the trustee files the partnership information return (Form 1065) and the fiduciary returns (Form 1041) for the bankrupt estates of each individual partner. G.C.M. 24617, 1945-1 Cum. Bull. 235.

27. Int. Rev. Code of 1954, §§ 641-92.

applicable to bankrupt estates.[28] Apparently, the rationale of the Treasury Department in applying Subchapter J principles to bankrupt estates is founded on the premise that legal title to the bankrupt's property vests by operation of law in the trustee.[29] Accordingly, the trustee in bankruptcy files a Treasury Form 1041 (Fiduciary Income Tax Return) reporting his income and expenses during his administration of the estate.[30] The trustee may elect whether to file on a calendar or fiscal year basis.[31]

The bankrupt individual, whether or not he receives his discharge, continues to file his individual income tax return, reporting his income and expenses for his entire taxable period.[32] The fact that a new taxable entity is created, however, is not deemed to be a transaction upon which a tax is imposed.[33] In view of the fact that the transfer of the assets to the trustee occurs without the imposition of tax, the trustee would acquire the bankrupt's tax basis for those assets received.[34]

The above treatment is in marked contrast to other situations where property is transferred from one taxpayer to another. For example, when an individual dies, an estate tax is assessed and the person who receives the property acquires a new tax life therein, recording this property at fair market value.[35]

Inter vivos transfers are taxed in a variety of ways. Generally, when property is transferred to another person and other property is received in exchange, a gain is realized, consisting of the difference between the value of what is received minus the tax cost of what was transferred.[36] Whether this gain constitutes ordinary income or capital gain to the transferor depends largely upon the nature of the property transferred. In either event, the new property received by the transferor acquires a tax cost of fair market value.[37] Where the transfer is made by way of a gift, the donor pays a gift tax and the donee acquires a tax cost in the

28. G.C.M. 24617, 1945-1 Cum. Bull. 235.

29. See note 26 supra; Bankruptcy Act § 70a, 52 Stat. 879 (1938), as amended, 11 U.S.C. § 110(a) (1964).

30. See note 26 supra.

31. I.T. 3959, 1949-1 Cum. Bull. 90.

32. See note 26 supra.

33. I.T. 2898, XIV-1 Cum. Bull. 70 (1935).

34. Int. Rev. Code of 1954, § 1015(b); see In re Loehr, 98 F. Supp. 402 (E.D. Wis. 1950).

35. Int. Rev. Code of 1954, §§ 1014, 2001.

36. Int. Rev. Code of 1954, §§ 1001-02.

37. Int. Rev. Code of 1954, §§ 1012, 1015(c). The Code also exempts from immediate taxation the exchanges of certain types of property. E.g., Int. Rev. Code of 1954, §§ 1031 (exchange of property held for productive use or investment), 1032 (exchange of corporate stock for property), 1033 (conversion into similar property where involuntarily converted).

property at the same amount that the donor had, plus the amount of the gift tax paid.[38]

From the discussion above, it may be seen that there is no provision in the Internal Revenue Code expressly relating to the obligations of a trustee in bankruptcy to file tax returns and to pay taxes for the estates of bankrupt individuals with respect to income earned and profits made during the period of trusteeship.[39] The application of Subchapter J principles to the bankrupt estates of individuals is a matter determined solely by Treasury Department published policy.[40] Also, as pointed out above,[41] the Code references and Treasury Regulations thereunder, relating to bankrupt estates of corporations, completely overlook the circumstance of a bankrupt corporation that obtains a discharge in the bankruptcy proceedings.

It is questionable whether the Treasury's policy in applying Subchapter J principles to bankrupt estates constitutes a proper interpretation of the revenue laws. While Subchapter J itself does not expressly state that it does not apply to bankrupt estates, the plain import of the provisions thereof indicates that it relates solely to decedents' estates and private trusts. The Treasury Regulations promulgated under Subchapter J plainly infer that these provisions do not apply to bankrupt estates.

The *estate* . . . in general, *of an individual* or *corporation in receivership or a cor-*

38. Int. Rev. Code of 1954, §§ 2501, 1015(a)-(b).

39. Congress has expressly dealt with certain income tax aspects of bankruptcy proceedings. Int. Rev. Code of 1954, § 7507 exempts insolvent banks from income taxation. Int. Rev. Code §§ 371-72 provide for the non-recognition of gain or loss with respect to the transfers of corporate assets to another corporation which is organized or made use of to effect a plan of reorganization in a receivership, foreclosure or similar proceeding, or in a proceeding under Chapter X of the act. The acquiring corporation will take over the transferor corporation's tax basis of its assets. Bankruptcy Act §§ 268, 395, 520, 679, 52 Stat. 904, 915, 929, 938 (1938), 11 U.S.C. §§ 668, 795, 920, 1079 (1964), exempts income from taxation as a result of the cancellation or adjustment of indebtedness of a debtor. These provisions are found respectively in Chapter X (Corporate Reorganizations), Chapter XI (Arrangements), Chapter XII (Real Property Arrangements), and Chapter XIII (Wage Earners' Plans). While Int. Rev. Code of 1954, § 61(a)(12) provides in broad terms that gross income shall include income from the discharge or cancellation of an indebtedness, Treas. Reg. § 1.61-12(b)(1) (1957) not only incorporates the aforesaid provisions of the Bankruptcy Act, but also provides that no income is realized by a taxpayer by virtue of the discharge of an indebtedness pursuant to § 14 of the act or pursuant to an agreement consummated with creditors outside of bankruptcy, provided, however, that the debtor is insolvent before and after the reduction of the indebtedness. It is generally accepted that a discharge in bankruptcy is not "income" to a taxpayer. Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934).

40. See notes 26-29 supra and accompanying text.

41. See text accompanying notes 23 & 24 supra.

poration in bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or of a trust.[42]

Nevertheless, the Treasury's ruling policy has been followed in at least two cases that merit consideration. *In re Loehr*[43] involved a trustee in bankruptcy who, during liquidation of the real estate properties of the individual bankrupt, received rentals as well as proceeds of sale in excess of the bankrupt's tax basis therein. The trustee argued that, because he was liquidating and not conducting the business, he was not required to pay income taxes since section 960 of the Judicial Code was not applicable.[44] The district court concluded that the conduct of business within the purview of section 960 included all activity in connection with the handling of the bankrupt estate and, therefore, the trustee was responsible for the payment of these taxes. Actually, the *Loehr* case was decided upon the erroneous premise that section 960 itself imposed taxes.[45]

In the Matter of Steck[46] involved farm income for the taxable year 1961. The bankrupt had owned an interest in two farms which were operated by his brothers. The trustee in bankruptcy had no direct connection with the operation of the farms, and the court had not authorized the trustee to conduct the business of the bankrupt. During 1961, the trustee received 2,380.04 dollars as income from these farms while he was attempting to liquidate the bankrupt's interest therein. The district court concluded that the trustee should have filed a fiduciary income tax return and that he was required to pay tax on the net income received from the farms.

In marked contrast to *Loehr* and *Steck* is *In the Matter of Kirby*.[47] This case involved the taxable years 1934-1959. The bankruptcy proceedings had been pending since 1933, and the Government, while a party thereto since inception, filed a claim for income taxes in 1960, relating to the taxable years 1934-1959, predicated upon the receipts of the estate from the property being liquidated. The bank-

42. Treas. Reg. § 1.641(b)-2(b) (1956), as amended, T.D. 6580, 1961-2 Cum. Bull. 123. (Emphasis added.)

43. 98 F. Supp. 402 (E.D. Wis. 1950).

44. Id. at 403. 28 U.S.C. § 960 (1964) provides: "Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation."

45. The section merely subjects court-appointed officials to taxes imposed by some revenue statute. Brown v. Collector of Taxes, 247 F.2d 786, 788 n.9 (D.C. Cir. 1957).

46. 62-2 U.S. Tax Cas. ¶ 9702 (S.D. Ill. Aug. 3, 1962).

47. 62-2 U.S. Tax Cas. ¶ 9752 (S.D. Tex. Aug. 29, 1962), appeal dismissed, 64-1 U.S. Tax Cas. ¶ 9184 (5th Cir. Oct. 18, 1963).

ruptcy referee disallowed the claim, holding that the Internal Revenue Code does not impose income taxes on the estates of individuals in bankruptcy. The district court sustained the referee, concluding that Subchapter J of the 1954 Code[48] was not intended to apply to estates in bankruptcy and that any doubts on this point have been resolved by the Treasury's own regulations.[49] The district court also took judicial notice of the "common understanding" among bankruptcy officers and practitioners that income realized by a trustee during a bankruptcy proceeding is not subject to income taxes, at least where no commercial business of the bankrupt is being conducted.[50] The precedential value of the *Kirby* case was undermined substantially in 1964 when the appeal was dismissed as moot by the Fifth Circuit because the district court had authorized the referee to compromise the tax liability claimed by the Government.[51]

At this point, it is helpful to describe briefly the income tax mechanics of Subchapter J. Where the typical decedent's estate is involved, the estate serves as a conduit for tax purposes. That is to say, the income received by an estate is taxed to the estate unless the fiduciary distributes the income to the beneficiary within the taxable year of receipt.[52] Where the income is so distributed, it is then reported by the beneficiary on his tax return and he pays the tax due thereon.[53] However, the application of this Subchapter J principle to estates of bankrupt individuals (or to the estates of bankrupt corporations that have received their discharge) results in discriminatory income tax treatment of the bankrupt's creditors by taxing the income twice. To illustrate, assume that the trustee in bankruptcy receives 20,000 dollars interest income from funds he placed on deposit in bank accounts and that 5,000 dollars of deductible expenses were incurred. Assume further that the referee makes an order of distribution providing that the trustee distribute the available funds to creditors. Pursuant to section 643 of the Code, the estate has "distributable net income" of 15,000 dollars.[54] Section 661 provides that "in any taxable year there shall be allowed as a deduction in computing the taxable income of an estate . . . the sum of—(1) any amount of income for such taxable year required to be distributed currently . . . and (2) any

48. Int. Rev. Code of 1954, § 641.

49. 62-2 U.S. Tax Cas. ¶ 9752, at 86050; see Treas. Reg. § 1.641(b)-2(b) (1956), as amended, T.D. 6580, 1961-2 Cum. Bull. 123.

50. 62-2 U.S. Tax Cas. ¶ 9752, at 86051.

51. United States v. Kerr, 64-1 U.S. Tax Cas. ¶ 9184 (5th Cir. Oct. 18, 1963).

52. See Int. Rev. Code of 1954, §§ 651-52, 661-62.

53. The application of these principles becomes complex when the income is received and the distribution is made in different taxable years. Int. Rev. Code of 1954, §§ 665-68.

54. Int. Rev. Code of 1954, § 643(a).

other amounts properly paid . . . ."[55] Therefore, the bankrupt estate would have a 15,000 dollar deduction and zero taxable income. The character of the distribution to the beneficiary is tested at the fiduciary level (trustee in bankruptcy), and, therefore, the creditor in such a case is deemed to have received 15,000 dollars of interest income.[56] Such treatment is manifestly unfair from the creditor's point of view because he has received merely a partial return of capital, namely, a part of his investment in the property which he sold to the bankrupt. The dividend received by the creditor is determinative of the amount of his bad debt deduction on his own tax return.[57] If the creditor also had to pay an income tax upon the proceeds received from the trustee because these proceeds are characterized by Subchapter J as interest income, the creditor has been doubly taxed and the Government has received a windfall. By way of example, assume that the bankrupt estate had only one creditor with a claim of 100,000 dollars for merchandise sold to the bankrupt. If the 15,000 dollars of the "distributable net income" were distributed to this creditor, he would receive a 15,000 dollar bankruptcy dividend and would be entitled to a bad debt deduction of 85,000 dollars. If the creditor is in a fifty per cent tax bracket and Subchapter J is consistently applied, the creditor would have to pay 7,500 dollars in income tax on the 15,000 dollar bankruptcy dividend that he received. Therefore, the net proceeds received by the creditor only amount to 7,500 dollars (15,000 dollar bankruptcy dividend minus the 7,500 dollars of income tax). Notwithstanding the fact that, under the circumstances, the creditor would have an economic loss of 92,500 dollars in connection with the claim against the bankrupt, his bad debt deduction would be limited to 85,000 dollars. Therefore, the creditor pays taxes on the 15,000 dollars he received and also loses the benefit of an income tax deduction relating to his full economic loss on the transaction. It must also be noted that the creditor had paid income taxes in an earlier period, reflecting the sale of the merchandise.

Treating the proceeds as interest income is unrealistic and the Treasury did nothing to resolve the problem when it promulgated the rule that dividends distributed to creditors by the trustee in bankruptcy are not deductible by the estate.[58] The rationale of this ruling was that the money distributed as a bankruptcy dividend lost its character as interest income and was not in the nature of income, but, rather, constitutes a distribution

55. Int. Rev. Code of 1954, § 661(a).
56. Int. Rev. Code of 1954, § 662(b).
57. Int. Rev. Code of 1954, § 161.
58. G.C.M. 24617, 1945-1 Cum. Bull. 235.

of the corpus of the estate.[59] The Government's ruling was predicated upon the case of *Helvering v. Butterworth.*[60] In *Butterworth*, the issue was whether amounts paid as an annuity to a wife from the husband's estate were deductible by the trustee in computing the taxable income of the estate. The husband provided in his will for his wife to receive an annuity of 50,000 dollars, to be paid quarterly and payable to her irrespective of the income earned by the trust fund. The Supreme Court held that the payments to the wife were not dependent upon any income of the trust estate and were in discharge of a gift or a legacy. Consequently, the trustee was not permitted to deduct these quarterly payments in computing the taxable income of the trust.

In 1942, the Internal Revenue Code was amended to allow deductions to the estate or trust for payments of fixed amounts out of income or principal,[61] and that amendment was carried over into the 1954 Code.[62] It would appear, therefore, that the *Butterworth* case was overruled by statute. Nevertheless, the Internal Revenue ruling in 1945 made no reference to the amendment of the Internal Revenue Code.

In any event, the analogy of the *Butterworth* case to a bankrupt estate is not sound. In *Butterworth*, the widow had not expended any money or transferred any property in order to receive the benefits under the trust. In every sense, the widow was the beneficiary of a gift or a legacy. In the case of a bankruptcy dividend, the amount received by a creditor from the trustee of the bankrupt's estate cannot, by any stretch of the imagination, constitute a gift or legacy. In this respect, the Court in *Butterworth* stated:

> The evident general purpose of the statute was to tax in some way the whole income of all trust estates. If nothing was payable to beneficiaries, the income without deduction was assessable to the fiduciary. But he was entitled to credit for any sum paid to a *beneficiary within the intendment of that word,* and this amount then became taxable to the beneficiary. Certainly, Congress did not intend any income from a trust should escape taxation unless definitely exempted.[63]

Clearly, the creditor is not a beneficiary "within the intendment of that word."

It would seem that the *Butterworth* case cannot constitute authority for the application of Subchapter J to bankrupt estates. Regardless of whether the income tax is paid at the fiduciary level (trustee in bankruptcy), or at the creditor level, it is really the creditor who bears the

59. Id. at 236.
60. 290 U.S. 365 (1933). This case is often referred to as Helvering v. Pardee.
61. Int. Rev. Code of 1939, ch. 619, § 111(b), 56 Stat. 809 (1942).
62. Int. Rev. Code of 1954, § 661(a)(1); see Treas. Reg. § 1.661(a)-2(b) to (c) (1956).
63. 290 U.S. at 369. (Emphasis added.)

burden of the tax because he ultimately receives less money and must bear all of the losses.

IV. AVAILABILITY OF THE BANKRUPT'S NET OPERATING LOSSES TO THE TRUSTEE IN BANKRUPTCY

The 1954 Code provides for the aggregation of business profits and losses over a period of years in order to prevent a distortion of taxes occasioned by the fact that income taxes are paid annually at graduated rates. Thus, losses may be applied to offset profits of past or future years.[64] If the bankrupt, at the time of filing his petition in bankruptcy, had suffered operating losses in previous tax years and had the right to claim a refund of income taxes which were paid in earlier profitable years, this right to claim a refund constitutes "property" within the meaning of Section 70 of the Bankruptcy Act[65] and, therefore, passes to the trustee.[66]

The trustee in bankruptcy has the right to, and should, file a claim for refund of these taxes. The Supreme Court determined recently that, where a bankrupt has suffered business losses during the current tax year in which a petition in bankruptcy is filed, the right to claim a refund at the end of the taxable year similarly constitutes "property" of the bankrupt which passes to the trustee in bankruptcy.[67] The claim for a refund may not be made, however, until the close of the bankrupt's taxable year, in order to determine the amount of loss.[68] To illustrate, if the bankrupt is on a calendar year tax basis and has suffered 200,000 dollars of business losses between January 1, 1965, and September 1, 1965 (the date on which his petition in bankruptcy is filed), these losses may be used by the trustee to bottom a claim for refund of taxes paid by the bankrupt for 1962, 1963, and 1964. However, the trustee must wait until December 31, when the bankrupt's taxable period is concluded, in order to ascertain the total amount of the operating loss. In this respect, whatever income that the bankrupt receives for the remainder of the taxable year would offset the 200,000 dollar loss sustained. Therefore, if the bankrupt resumed business activities, or abandoned his business and obtained a job elsewhere on a salary basis, or acquired properties

64. Int. Rev. Code of 1954, § 172(b)(1). Under existing law, losses from business operations may be carried back to the three taxable years immediately preceding the year of loss. If the profits during those three years are less than the amount of losses being carried back, the remaining balance of losses may be carried forward for a period of five subsequent years to offset future profits.

65. Bankruptcy Act § 70, 52 Stat. 879 (1938), as amended, 11 U.S.C. § 110 (1964).

66. I.T. 3959, 1949-1 Cum. Bull. 90; Segal v. Rochelle, 86 Sup. Ct. 511 (1966).

67. Ibid.

68. Id. at 516

which were sold subsequently at a profit during that same taxable year, these items of income would offset the pre-bankruptcy business losses.

The aforesaid principles apply solely with respect to the claims for tax refunds attributable to profits on which taxes were paid in years prior to the time of the bankruptcy proceeding. A totally different question is presented with respect to the prospective use of these operating losses, which losses are commonly referred to as net operating loss carryovers. Recently, the Supreme Court, in *Segal v. Rochelle*,[69] refused to consider this question, stating: "Without ruling in any way on a question not before us, it is enough to say that a carryover into post-bankruptcy years can be distinguished conceptually as well as practically."[70]

Let us assume that the bankrupt made profits of 50,000 dollars in each of the three years prior to the year in which the bankruptcy petition was filed and that he paid taxes thereon. Assume that in the year of bankruptcy, the taxpayer suffered a 500,000 dollar business loss. While the trustee in bankruptcy may apply the 500,000 dollar loss to seek a refund of those taxes which were paid with respect to the three years of profits totalling 150,000 dollars, there would still be 350,000 dollars of business losses which have not been used to offset any profits. The question arises whether the trustee in bankruptcy may use any part of the 350,000 dollars of business losses to offset any income or profits which he realizes during the administration and liquidation of the bankrupt estate.

Let us examine first the availability to the trustee of the benefits of the net operating loss carryover provisions with respect to individual bankrupts and, secondly, with respect to corporate bankrupts. The trustee in bankruptcy may not avail himself of the benefits of the net operating loss carryover in the case of bankrupt individuals.[71] This is so whether the profits are realized as a result of the operation of a business, or as a result of gains in the liquidation of business assets, or as income from interest on moneys constituting assets of the estate or any other income of the estate. The individual taxpayer who suffered a business loss is the sole person entitled to avail himself of the benefits therefrom.

With respect to corporate taxpayers which are bankrupt, the application of net operating loss carrybacks and carryovers is stringently regulated by statute[72] as well as by a substantial body of case law.[73] The large body of statutory and judicial law with respect to corporate carry-

69. 86 Sup. Ct. 511 (1966).

70. Id. at 516.

71. See Mellott v. United States, 257 F.2d 798 (3d Cir.), cert. denied, 358 U.S. 864 (1958); Estate of R.R. Russell, 34 B.T.A. 715, 721 (1936); cf. Rev. Rul. 65-140, 1965 Int. Rev. Bull. No. 22, at 9.

72. Int. Rev. Code of 1954, §§ 172, 269, 381-82, 482.

73. E.g., Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).

overs is necessary because of the basic premise that only the taxpayer who suffers a loss may avail himself of the benefits from said loss. Corporations undergo substantial revisions in their capital structures, including mergers, consolidations, reorganizations, recapitalizations, and re-incorporations; and complex problems arise as to whether the altered corporation actually is the "taxpayer" who suffered the business loss. Stockholders of loss companies have found active markets for their stock and there are many instances where profitable companies have purchased this stock in order to avoid taxation of their own corporate profits. It is not the intention of this article to explore the concepts of net operating losses.[74] Suffice it to say that Congress, in 1954, substantially revised the Internal Revenue Code in order to restrict the availability of corporate net operating losses to benefit solely the "economic unit" that sustained the losses. Notwithstanding the applicable provisions of local corporate law, for purposes of tax consequences, the income tax law makes specific provisions regulating the "economic unit" entitled to the benefit of these business losses.[75] From the tax standpoint, an examination is made to see whether there have been changes at the shareholder level and changes in the nature of the activities by the business which had suffered the losses. These considerations will determine and limit the availability of the net operating loss provisions.

With respect to the trustee in bankruptcy of the estate of a corporate bankrupt, the present statutory scheme continues the corporate tax existence and the trustee files a corporate tax return. Therefore, the benefit of these operating losses would be carried forward by the trustee in filing the corporate tax return for the post-bankruptcy periods.[76] However, an extremely difficult problem arises where the corporation obtains its discharge in bankruptcy and resumes business activities. In such a case, it would appear that the unused net operating loss carryovers would not pass to the trustee in bankruptcy to offset any income or profits realized during the administration of the estate. Simply stated, the trustee in bankruptcy and the bankrupt estate are not the taxpayers who incurred the loss.[77] This result would seem to follow from the analogy of the discharged corporation which continues to file its corporate tax return while the trustee would file a fiduciary income tax return for the estate of the bankrupt corporation.[78]

74. See generally Comment, 69 Yale L.J. 1201 (1960).

75. Int. Rev. Code of 1954, §§ 381-82.

76. The application of net operating loss carryovers in Chapter X reorganizations is a separate topic worthy of independent consideration. For such a discussion, see Krantz, Loss Carryovers in Chapter X Reorganizations, 16 Tax. L. Rev. 359 (1961).

77. See New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440-41 (1934).

78. See pp. 405-08 supra.

V. Who Should Bear the Burden of the Tax in Bankruptcy Proceedings

Traditionally, the person who earns the income is the person who is taxed thereon.[79] Similarly, income realized from the disposition of property or from the use of property is taxed to the owner of the property.[80] Undoubtedly, these basic principles of taxation underlie the Treasury's determination to tax the bankrupt estate through the trustee, in view of the fact that the trustee has legal title to the bankrupt's property. However, these traditional tax principles were developed in healthy economic environments where tax laws could be frustrated by skillfully prepared legal documents under which legal formalities would dominate the substance of the transaction. If form were allowed to govern substance, it would be a simple matter to shift income among family members who are in low tax brackets or to convert ordinary income into capital gains and thereby avoid taxes in a manner not intended by Congress. Where economic conditions are unhealthy, as in a bankruptcy proceeding, the social and economic justifications for applying these tax principles no longer exist. Therefore, the trustee in bankruptcy is not a proper person to be taxed on current realized income.

The underlying philosophy of the Bankruptcy Act is to permit a debtor to rehabilitate himself by giving him a fresh economic start in life. This rehabilitation is at the expense of the bankrupt's creditors who share ratably in the distribution of the bankrupt's property. The Treasury Department has aided the bankrupt in his rehabilitation by relieving him of his income tax responsibilities to the extent that indebtedness is canceled or discharged under the Bankruptcy Act.[81]

Experience has shown that bankruptcies tend to escalate, *i.e.*, when a debtor fails to pay his creditors, the financial positions of the creditors themselves become impaired. Imposing income taxes upon the trustee in bankruptcy for the sale or use of the bankrupt's property during the bankruptcy proceeding adds insult to injury and thwarts economic rehabilitation. It is reasonable for the Government to absorb a share of the rehabilitation process of the bankrupt and to forgive any tax that would be due upon income earned during the administration of the bankrupt estate, at least to the extent that the income realized is still insufficient to satisfy creditors' claims in full. Obviously, in those infrequent cases where estates are liquidated in amounts in excess of creditors' claims, it would be proper to impose taxes on such excesses.

79. Lucas v. Earl, 281 U.S. 111 (1930).

80. Helvering v. Clifford, 309 U.S. 331 (1940); Blair v. Commissioner, 300 U.S. 5 (1937).

81. Treas. Reg. § 1.61-12(b) (1957); Rev. Rul. 58-600, 1958-2 Cum. Bull. 29; see Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934).

No useful purpose is served by shifting to the bankrupt the tax upon the unrealized appreciation in his assets, which appreciation is realized upon liquidation in bankruptcy. Such tax treatment simply would frustrate the theory of rehabilitation of giving a debtor a fresh start and should not be a part of any statutory amendments.

The unavailability to the trustee of the use of the net operating loss carryovers of the bankrupt to offset any income or profits made during the administration of the bankrupt estate results in a harsh inequity to creditors. In looking at the economic realities of business losses, it is the very assets in the bankruptcy proceeding that produced the operation losses.[82] If the underlying policy of imposing taxes upon bankrupt estates is applied, there is every justification for using the bankrupt's business losses to offset any income or profits made by the trustee.

VI. Conclusion

The inequities inherent under the present system may be shown by an illustration. If the debtor had transferred his property in kind to his creditors in satisfaction of their claims, there would be no income realized by the creditors at the time of the receipt of the property unless the value of the property exceeded the amount of their claims.[83] The debtor would be deemed to have realized income in the taxable year in which he transferred the property in an amount equal to the excess of the appreciated value of the property over the debtor's tax cost therein.[84] When this illustration is applied to a settlement of accounts between a debtor and his creditors outside the aegis of the bankruptcy court, the debtor would have the right to use the current or previous year's business losses to offset any taxes which become due by virtue of the fact that he delivered the appreciated property in satisfaction of his debts.

However, as we have noted, the intervention of a bankruptcy proceeding involving an individual debtor (or a corporate debtor that has received its discharge) creates a new tax entity in the form of the bankrupt estate, which entity is separate and apart from the pre-bankruptcy taxpayer. Since the creation of the new entity occurs without the imposition of tax, any realized gain upon the disposition of the bankrupt's property results in the imposition of tax directly against the estate and indirectly against the creditors by the reduction of their bankruptcy dividend. Thus, the incidence of bankruptcy has the effect of shifting the tax from the debtor to his creditors. While the debtor would not have to pay the tax because

82. See Libson Shops, Inc. v. Koehler, 353 U.S. 382, 384-86 (1957).

83. Int. Rev. Code of 1954, §§ 1001-02.

84. Int. Rev. Code of 1954, §§ 61(a)(12), 1001-02; cf. Commissioner v. Mesta, 123 F.2d 986, 988 (3d Cir. 1941), cert. denied, 316 U.S. 695 (1942).

he could use his business losses to offset the income, the bankrupt estate does not have a similar right to use the debtor's pre-bankruptcy business losses to offset any income it realizes. The Government receives a tax windfall by virtue of the bankruptcy proceedings, which is at the expense of the creditors.

Either no taxes should be imposed upon "taxable income" earned during the administration of a bankrupt estate or, at the very minimum, the trustee in bankruptcy should be entitled to all of the tax benefits to be derived from a debtor's pre-bankruptcy history of operating losses.

The question of taxable income during the administration of a bankrupt estate is fraught with social and economic considerations. These considerations must be resolved by Congress rather than by the courts. It is clear that the present statutory scheme and the judicial developments have proceeded upon an *ad hoc* basis and have resulted in distinctions in law where there are no differences in factual substance.