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The Tax Recommendations of the Commission on the Bankruptcy Laws—Income Tax Liabilities of the Estate and the Debtor

William T. Plumb Jr.

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**THE TAX RECOMMENDATIONS OF THE
COMMISSION ON THE BANKRUPTCY LAWS—
INCOME TAX LIABILITIES OF THE ESTATE
AND THE DEBTOR**

William T. Plumb, Jr.

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THE TAX RECOMMENDATIONS OF THE COMMISSION ON THE BANKRUPTCY LAWS— INCOME TAX LIABILITIES OF THE ESTATE AND THE DEBTOR†

*William T. Plumb, Jr.**

THE Commission on the Bankruptcy Laws of the United States (Commission), pursuant to congressional mandate,¹ has reported its recommendations for the first comprehensive revision of the bankruptcy laws since the Chandler Act of 1938.² This Article deals with the proposals concerning the obligation of the trustee in bankruptcy to file returns of income and to pay federal and state taxes on the income, and concerning the calculation of the taxable incomes of the bankrupt estate and the debtor (including their rights to utilize each other's carryovers), as well as with certain problems in those areas in which the Commission has made no recommendations.

I. THE FIDUCIARY'S TAX LIABILITY

The Commission recommends that a trustee in a straight bankruptcy proceeding, whether or not he is operating the business of the debtor, be relieved of any obligation to file returns or pay taxes imposed by federal or state law upon, or measured by, income of the estate, unless the property available for distribution proves to be greater than the allowable claims, in which event returns shall be filed before final distribution and the accumulated taxes shall be paid from the surplus otherwise distributable to the debtor.³ Income taxes incurred by the debtor, computed as if his taxable year ended at the date of the petition, would be allowable as claims against the estate, but the trustee (in straight bankruptcy) would not

† This Article is based in part on reports prepared by the writer as a consultant to the Commission on the Bankruptcy Laws of the United States. As will be readily apparent from the discussion, the views expressed herein are the author's and not necessarily those of the Commission or its staff.

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1. Jt. Res. of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

2. Act of June 22, 1938, ch. 575, 52 Stat. 840 (codified in scattered sections of 11 U.S.C.).

3. COMMISSION ON BANKRUPTCY LAWS OF THE UNITED STATES, REPORT pt. II, H.R. Doc. No. 93-137, 93d Cong., 1st Sess., pt. II, § 5-104(a) (1973) [hereinafter COMMISSION REPORT]. The proposed legislation has been introduced in Congress as H.R. 10792 and S. 2565, 93d Cong., 1st Sess. (1973).

be required to report the bankrupt's income in returns filed by him.⁴ In reorganization cases (which would embrace in one unified procedure those now covered by Chapters X, XI and XII⁵), the trustee, receiver, or debtor in possession would not be relieved of filing returns of income, but gains and losses on sales (other than those in the ordinary course of business) made during the pendency of the proceeding or pursuant to the provisions of a plan would be disregarded for tax purposes, except that the net taxes otherwise payable on such sales would ultimately be allowed to the extent, if any, that the plan would otherwise recognize an interest retained by the debtor, its partners, or its shareholders.⁶

A. Power To Tax the Estate

It has been said that "under the common law, property in the hands of a receiver was not taxable, or, rather, . . . property *in custodia legis* is taxable only upon statutory authorization."⁷ This statement, however, is nothing more than the truism that taxes must be imposed by statutes and that the coverage of the tax law will generally not be extended beyond its express terms.⁸ There has never been any doubt, for example, that, if the legislature clearly so intended, a state property tax could be imposed upon property and money in the hands of a trustee in bankruptcy, for

[b]y the transfer to the trustee no mysterious or peculiar ownership or qualities are given to the property. It is dedicated, it is true, to the payment of the creditors of the bankrupt, but there is nothing in that to withdraw it from the necessity of protection by the State and municipality, or which should exempt it from its obligations to either. If Congress has the power to declare otherwise and wished to do so the intention would be clearly expressed, not left to be collected or inferred from disputable considerations of convenience in administering the estate of the bankrupt.⁹

It has also been long established that a federal court receiver appointed to carry on the business of the corporation and thus exercising "the powers belonging to the corporation by legislative grant" can be subjected to a state corporate franchise tax, if the legislature

4. COMMISSION REPORT, *supra* note 3, § 5-104(b).

5. 11 U.S.C. §§ 501-926 (1970).

6. COMMISSION REPORT, *supra* note 3, § 7-315(c).

7. *Howe v. Atlantic, Pac. & Gulf Oil Co.*, 4 F. Supp. 162, 164 (W.D. Mo. 1933), *rev'd. sub nom. Kansas City v. Johnson*, 70 F.2d 360 (8th Cir.), *cert. denied*, 293 U.S. 617 (1934).

8. *See Gould v. Gould*, 245 U.S. 151, 153 (1917).

9. *Swarts v. Hammer*, 194 U.S. 441, 444 (1904).

so intends, for "[t]axes owing to the Government, whether due at the beginning of a receivership or subsequently accruing, are the price that business has to pay for protection and security."¹⁰

A series of decisions, which distinguished taxes on property and franchises from taxes on *transactions* engaged in by court officers, held trustees and receivers in bankruptcy not amenable to sales and gross receipts taxes (at least in the absence of language expressly including them).¹¹ Congress, in 1934, reacted promptly to the earliest of those decisions by enacting the following statute:

[A]ny receiver, liquidator, referee, trustee, or other officers or agents appointed by any United States court who is authorized by said court to conduct any business, or who does conduct any business, shall, from and after June 18, 1934, be subject to all State and local taxes applicable to such business the same as if such business were conducted by an individual or corporation.¹²

The reports on the bill declared: "No good reason is perceived why a receiver should be permitted to operate under such an advantage as against his competitors not in receivership, and the States and local governments be deprived of this revenue."¹³ Although the statutory words, "conduct any business," suggest that only operating fiduciaries are to be subjected to tax liabilities, and although some courts have so construed the language,¹⁴ other courts have broadly interpreted the consent of Congress to embrace state and local taxation of "any activity or operation in connection with the handling and management of the bankrupt estate," whether with a view to liquidation or with a view to rehabilitation.¹⁵

When title 28 of the United States Code was revised and codified in 1948, the foregoing provision (§ 960) was reworded as follows: "Any officers and agents conducting any business under authority

10. *Michigan v. Michigan Trust Co.*, 286 U.S. 334, 344 (1932).

11. *In re Messenger's Merchants Lunch Rooms*, 85 F.2d 1002 (7th Cir. 1936); *In re Flatbush Gum Co.*, 73 F.2d 283 (2d Cir. 1934), *cert. denied*, 294 U.S. 713 (1935); *Howe v. Atlantic, Pac. & Gulf Oil Co.*, 4 F. Supp. 162 (W.D. Mo. 1933), *revd. sub nom. Kansas City v. Johnson*, 70 F.2d 360 (8th Cir.), *cert. denied*, 293 U.S. 617 (1934).

12. Act of June 18, 1934, ch. 585, 48 Stat. 993, *as amended*, 28 U.S.C. § 960 (1970).

13. H.R. REP. No. 1138, 73d Cong., 2d Sess. 1 (1934); S. REP. No. 1372, 73d Cong., 2d Sess. 1 (1934). See *Palmer v. Webster & Atlas Natl. Bank*, 312 U.S. 156, 162-63 (1941).

14. *In re California Pea Prod., Inc.*, 37 F. Supp. 658 (S.D. Cal. 1941); *In re Statmaster Corp.*, 332 F. Supp. 1248, 1256-58 (S.D. Fla. 1971) (referee opinion), *revd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *affd.*, 465 F.2d 978 (5th Cir. 1972). See *In re F.P. Newport Corp.*, 144 F. Supp. 507, 509 (S.D. Cal. 1956), *revd. sub nom. United States v. Sampsell*, 266 F.2d 631 (9th Cir. 1959).

15. *Missouri v. Glick*, 135 F.2d 134, 136-37 (8th Cir. 1943); *In re Mid America Co.*, 31 F. Supp. 601, 606 (S.D. Ill. 1939).

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."¹⁶ The deletion of the express reference to trustees, receivers, and referees is without significance, since they are clearly "officers" acting under the authority of a United States court.¹⁷ The mention of "Federal" taxes, which were not previously embraced by this provision, was "in recognition of the liability of such officers for Federal taxes under the revenue laws"¹⁸ but is without substantive significance, since the provision "is not a statute which imposes any taxes [but] serves merely to affirm liability for local, state and federal taxes which are validly imposed by other statutes."¹⁹ Since both the revenue laws and 28 U.S.C. § 960 are acts of Congress, the latter "does not exclude liability for taxes otherwise validly imposed" by congressional tax legislation on trustees and receivers in bankruptcy *whether or not* they are deemed to be "conducting any business."²⁰

B. *The Law to Date*

1. *Corporate Bankruptcies*

Prior to ratification of the sixteenth amendment, which cleared the way for a general income tax, Congress imposed an excise tax on the income of "every corporation . . . with respect to the carrying on or doing business by such corporation."²¹ The Supreme Court, in *United States v. Whitridge*,²² held receivers not subject to the tax, since the receivers were deemed to be acting "as officers of the court, and subject to the orders of the court; not as officers of the respective corporations, nor with the advantages that inhere in corporate organization as such." The Court also noted that the law did not "in terms impose any duty upon the receivers of corporations or of corporate property, with respect to paying taxes upon the income arising from their management of the corporate assets, or with respect to making any return of such income."²³ The first income tax²⁴ imposed under the sixteenth amendment likewise

16. 28 U.S.C. § 960 (1970), formerly ch. 585, 48 Stat. 993 (1934).

17. Bankruptcy Act § 1(22), 11 U.S.C. § 1(22) (1970).

18. 28 U.S.C.A. § 960, reviser's note (1968) (emphasis added).

19. *In re Kirby*, 62-2 U.S. Tax Cas. ¶ 9752, at 86,051 (S.D. Tex. 1962).

20. See *Brown v. Collector of Taxes*, 247 F.2d 786, 788 n.9 (D.C. Cir. 1957).

21. Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 112.

22. 231 U.S. 144, 149 (1913).

23. 231 U.S. at 149.

24. Act of Oct. 3, 1913, ch. 16, § 2, 38 Stat. 166.

omitted any express reference to receivers for corporations and was, accordingly, held not to subject such receivers to tax.²⁵

The response of Congress to the *Whitridge* decision was to enact, in the Revenue Act of 1916, the following provision:

In cases wherein receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, joint-stock companies or associations, or insurance companies, subject to tax imposed by this title, such receivers, trustees, or assignees shall make returns of net income as and for such corporations, joint-stock companies or associations, and insurance companies, in the same manner and form as such organizations are hereinbefore required to make returns, and any income tax due on the basis of such returns made by receivers, trustees, or assignees [sic] shall be assessed and collected in the same manner as if assessed directly against the organizations of whose businesses or properties they have custody and control²⁶

The War Revenue Act of 1917 imposed, in addition to the income tax, an excess profits tax on certain income of "every corporation, partnership or individual" derived from trade or business.²⁷ Those provisions came before the Supreme Court in *Reinecke v. Gardner*,²⁸ in which the Court noted that, since the title in the property of the bankrupt corporation had vested in the trustee, "the income in question was not the income of the bankrupt corporation, but of the trustee and was subject to income and excess profits tax only if the statutes authorized the assessment of the tax *against him*."²⁹ Since the excess profits tax law "made no mention of executors, receivers, trustees or persons acting in a fiduciary capacity,"³⁰ who were regarded as a different breed from the corporations, partnerships, and individuals expressly subjected to tax, and since the above-quoted provision of the income tax law was not deemed to have been made effectively applicable, the trustee was held not to be subject to excess profits tax. The Court, however, held the quoted provision to be valid and effective to subject the bankruptcy trustee operating the business of the corporation to payment of income tax "in the same manner" as the corporation. With immaterial verbal changes, that provision continued in effect until the repeal in 1954 of the Internal Revenue Code of 1939 (in which it was section

25. *Scott v. Western Pac. R.R.*, 246 F. 545 (9th Cir. 1917).

26. Act of Sept. 8, 1916, ch. 463, § 13(c), 39 Stat. 771.

27. Act of Oct. 3, 1917, ch. 63, § 201, 40 Stat. 303.

28. 277 U.S. 239 (1928).

29. 277 U.S. at 241 (emphasis added).

30. 277 U.S. at 242.

52(a)); with one significant change, it remains in effect as section 6012(b)(3) of the Internal Revenue Code of 1954 (IRC or Code):

In a case where a receiver, trustee in bankruptcy, or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns.

a. *Liquidating v. operating bankruptcies.* The most controversial question that has arisen under section 6012(b)(3) and its predecessors is whether a receiver or trustee in bankruptcy of a corporation is required to file income tax returns and pay tax when he is merely liquidating the estate of the bankrupt, rather than "operating" its business or property. The express terms of the law in effect from 1916 to 1953 required such filing and payment only of "receivers, trustees in bankruptcy, or assignees [who] are operating the business or property of corporations."³¹ The Treasury Regulations after 1934 took an expansive view of that requirement, however, by specifying:

If a receiver has full custody of and control over the business or property of a corporation, *he shall be deemed to be operating* such business or property within the meaning of section 52, whether he is engaged in carrying on the business for which the corporation was organized or *only in marshalling, selling, and disposing of its assets for the purposes of liquidation.*³²

The Internal Revenue Service (Service) argued therefrom that the term "operating" included "liquidating."³³ Close reading of the quoted regulation by courts, however, disclosed that it referred only to the obligation of a receiver and said nothing of a trustee in bankruptcy who, having acquired title, was engaged exclusively in liquidation.³⁴ Therefore, while the courts generally found even relatively limited activities (such as the making of leases, the collection of rents and royalties, the orderly disposition over a period of years of realty initially held for sale, and the management of the

31. Act of Sept. 8, 1916, ch. 463, § 13(c), 39 Stat. 771 (now INT. REV. CODE OF 1954, § 6012(b)(3)).

32. Treas. Reg. 86, art. 52-2 (1934) (emphasis added); Treas. Reg. 118, § 39.52-2 (1953) (emphasis added).

33. See Feigenbaum, *Observations Concerning Trustees in Bankruptcy and Federal Income Taxes*, 43 REF. J. 73, 74 (1969).

34. See *In re Town Crier Bottling Co.*, 123 F. Supp. 588, 591 (E.D. Mo. 1954); *In re International Match Corp.*, 43-1 U.S. Tax Cas. ¶ 9281 (S.D.N.Y. 1943).

investments of an insurance company) to constitute "operating" the debtor corporation's business or property,³⁵ even when they occurred after an order for liquidation had been entered,³⁶ the courts generally rejected the proposition that a trustee in bankruptcy or a receiver who had disposed of the business of a corporation was taxable on interest earned on funds of the estate pending completion of administration;³⁷ on royalties from patents not yet disposed of;³⁸ on income earned by, but not previously taxable to, the corporation itself;³⁹ or on recoveries of previously deducted bad debts⁴⁰ or of amounts illegally diverted from the corporation by its officers and directors.⁴¹

In response to those decisions, Congress, in 1954, enacted section 6012(b)(3), above quoted, by which a receiver, trustee in bankruptcy, or assignee was required to file returns for a corporation if he merely "ha[d] possession of or . . . title to all or substantially all [its] property or business . . . , *whether or not* such property or business [was] being operated."⁴² Clearer words could hardly have been chosen to establish that the distinction theretofore drawn between operating and liquidating trustees was being repudiated. Unfortunately, apparently in a clumsy effort to strengthen the hand of the Service in cases still pending under the former law, the committee reports on the 1954 Code state merely that "[a] clarifying change from the wording of existing law has been made in subsection (b)(3), relating to the filing of corporation returns by receivers or other fiduciaries."⁴³

Seizing upon the statement in the reports that the law was merely clarified by the 1954 amendment, the referee in the recent *Stat-master* case declared that, while the regulation that prior decisions had declined to apply had now "purportedly 'become the law,'"

35. *Pinkerton v. United States*, 170 F.2d 846 (7th Cir. 1948) (receiver); *Louisville Property Co. v. Commissioner*, 140 F.2d 547 (6th Cir.), *cert. denied*, 322 U.S. 755 (1944) (assignee); *United States v. Metcalf*, 131 F.2d 677 (9th Cir. 1942), *cert. denied*, 318 U.S. 769 (1943) (trustee in bankruptcy); *State ex rel. Gibson v. American Bonding & Cas. Co.*, 225 Iowa 638, 231 N.W. 172 (1938) (receiver).

36. *United States v. Sampsell*, 266 F.2d 631 (9th Cir. 1959).

37. *In re Owl Drug Co.*, 21 F. Supp. 907 (D. Nev. 1937).

38. *Doehler Die Casting Co. v. Meadows Mfg. Co.*, 38-2 U.S. Tax Cas. ¶ 9498 (S.D. Ill. 1938).

39. *In re Heller, Hirsh & Co.*, 258 F. 208 (2d Cir. 1919).

40. *In re International Match Corp.*, 43-1 U.S. Tax Cas. ¶ 9281 (S.D.N.Y. 1943).

41. *Standard Oil Co. v. Apex Oil Corp.*, 35 Tenn. App. 225, 244 S.W.2d 176 (1951).

42. Act of Aug. 16, 1954, ch. 736, 68A Stat. 733 (codified at INT. REV. CODE OF 1954, § 6012(b)(3)) (emphasis added).

43. H.R. REP. No. 1337, 83d Cong., 2d Sess. A396 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 563 (1954).

Congress had not been "advised of any such sweeping substantive change."⁴⁴ Therefore, he concluded that "the statutory words must be construed narrowly in a procedural sense [in order] to avoid an unintended change in the substantive law."⁴⁵ A nonoperating trustee, he determined, is required to file a return that "need only list his receipts with notation for informational purposes that they arose from non-operating activity and therefore do not comprise taxable income"⁴⁶—despite the plain terms of the law that the trustee, if subject to the law at all, must file, not an incomplete return, but a return "in the same manner and form as corporations are required to make such returns."⁴⁷

In concluding that the nonoperating trustee still need not *pay* tax on income of the estate, even though some form of return is now required of him, the referee noted⁴⁸ that the 1954 amendment, section 6012(b)(3), deleted the sentence of section 52(a) of the 1939 Code (and of corresponding provisions back to 1916) that provided that "[a]ny tax due on the basis of such returns made by receivers, trustees, or assignees [should] be collected in the same manner as if collected from the corporations of whose business or property they have custody or control." That deletion, however, merely reflected a restructuring of the procedural and administrative provisions of the tax law,⁴⁹ whereby provisions that had formerly been grouped in the income tax chapter under the heading, "Returns and Payment of Tax,"⁵⁰ were redistributed, together with parallel provisions relating to other taxes, under "Chapter 61—Information and Returns" (IRC §§ 6001-110)—and "Chapter 62—Time and Place for Payment of Tax" (IRC §§ 6151-67). Therefore, whereas section 52(a) of the 1939 Code had dealt with both returns and payments, IRC § 6012(b)(3) referred only to returns, and a general provision was made in IRC § 6151(a) that (with an exception not pertinent)

44. *In re Statmaster Corp.*, 332 F. Supp. 1248, 1258 (S.D. Fla. 1971) (referee opinion), *revd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *affd.*, 465 F.2d 978 (5th Cir. 1972). Since the preparation of this paper, the referee's opinion in *Statmaster* has been followed by a district court. *In re I.J. Knight Realty Corp.*, 366 F. Supp. 450 (E.D. Pa. 1973). Comments herein on the *Statmaster* opinion apply equally to that in *Knight*.

45. 332 F. Supp. at 1261.

46. 332 F. Supp. at 1261.

47. INT. REV. CODE OF 1954, § 6012(b)(3). See *State ex rel. Gibson v. American Bonding & Cas. Co.*, 225 Iowa 638, 281 N.W. 172 (1938).

48. 332 F. Supp. at 1254.

49. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 99 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 133 (1954).

50. INT. REV. CODE OF 1939, ch. 1, §§ 51-60, 53 Stat. 27.

"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 to the internal revenue officer with whom the return is filed"⁵¹

Nevertheless, the referee refused to apply section 6151(a) because, in his view, "the legislative history of § 6012(b)(3) . . . gave Congress no notice that this coupling of these two new sections was intended to dramatically change the substantive law relating to taxation of trustees in bankruptcy."⁵² Therefore, he concluded that Congress "did *not* intend to overrule and change the well-established substantive principle of both statutory and case law to the effect that a nonoperating trustee in bankruptcy is not subject to federal income taxes."⁵³ However, when Congress has stated its intention in unmistakable terms addressed to the specific question, the fact that the committee reports describe the amendment as "clarifying" cannot be taken as confirming and making applicable to the amended law those interpretations of prior law that were to the contrary.⁵⁴ Even if the committee reports were thought to give Congress "no notice" of the wording of the statute it was enacting, "an uncertain guess at Congress' intent provides dubious ground for disregarding its plain language."⁵⁵

51. INT. REV. CODE OF 1954, § 7701(a)(1) defines "person" to "mean and include an individual, a trust, estate, partnership, association, company or corporation" and does not mention "trustee in bankruptcy" in so many words, *In re I.J. Knight Realty Corp.*, 366 F. Supp. 450, 454 (E.D. Pa. 1973), although the word "includes" is not exclusive, INT. REV. CODE OF 1954, § 7701(b), and a fiduciary required to file a return "for" a corporation, INT. REV. CODE OF 1954, § 6012(b)(3), would seem to be as much obligated as the executor who is required to file "for" an estate. *See* Treas. Reg. § 301.7701-1(a) (1960), which expressly includes a trustee in bankruptcy in the definition of "persons."

52. 332 F. Supp. at 1260.

53. 332 F. Supp. at 1260-61 (emphasis original).

54. *Commissioner v. Bilder*, 369 U.S. 499, 502-03 (1962); *United States v. Manufacturers Natl. Bank*, 198 F. Supp. 157 (N.D.N.Y. 1961).

55. *Segal v. Rochelle*, 382 U.S. 375, 383 (1966). *Cf.* *Albert L. Dougherty*, 60 T.C. 917, 925 (1973). The court in *In re I.J. Knight Realty Corp.*, 366 F. Supp. 450, 458 & n.23 (E.D. Pa. 1973), thought that language in INT. REV. CODE OF 1954, § 6011(e) (redesignated as (f) in 1971, Act of Dec. 10, 1971, Pub. L. No. 92-178, § 504(a), 85 Stat. 550), which reads "For requirement that returns of income, estate, and gift taxes be made *whether or not there is a tax liability*, see sections 6012 to 6019," (emphasis added by court), was in conflict with the government's interpretation of INT. REV. CODE OF 1954, § 6151(a). Aside from the fact that cross references in the Code are "made only for convenience and shall be given no legal effect," INT. REV. CODE OF 1954, § 7806(a), the reference to section 6012 plainly relates to the fact that "every corporation" is required to file whether or not it has gross or net income on which a tax might be imposed and that others must file if they have a certain gross income even if no net taxable income results. No inference should result that a trustee who *does* show a net taxable income on a return that is required by section 6012 to be filed "whether or not such property or business is being operated" need not pay the resulting tax pursuant to section 6151(a).

In the view of the referee,⁵⁶ the obligation of the trustee to pay tax on the return he was admittedly required by the Code to file must still be found, not in the tax payment provisions of the tax law, but in 28 U.S.C. § 960, which states (emphasis added): "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 a corporation." The referee followed the holding of the district court in *In re F. P. Newport Corp.*⁵⁷ that the failure of Congress in 1954 to amend section 960 to extend the liability for payment of tax to others than those "conducting any business" meant that nonoperating trustees were still not required to pay taxes even though they were obliged to file returns. The *Newport* case, however, had been reversed by the Ninth Circuit in *United States v. Sampsell*,⁵⁸ which held that section 6151 of the Code imposed the liability for tax on returns required by section 6012. The Ninth Circuit declared, "It is not likely that Congress, in passing the 1954 I.R.C. would make the income tax liability dependent on a part of the Judiciary and Judicial Procedure Code."⁵⁹ It is true that Congress has on occasion placed substantive tax provisions in nontax legislation, notably in certain provisions⁶⁰ of the Chandler Act of 1938, where state as well as federal tax liabilities are affected by the provision, just as they are by 28 U.S.C. § 960. But the latter statute, the purpose and effect of which have been described above, is merely permissive and in itself neither imposes nor restrains the imposition of any tax.⁶¹ It certainly does not withdraw from Congress, which enacted it, the power to impose any tax, whether or not within its scope, and, since the 1954 amendment dealt only with *federal* taxation, there was no occasion to broaden the permissive terms of 28 U.S.C. § 960.

The referee in the *Statmaster* case, however, did not find authoritative the holding of *Sampsell* that IRC §§ 6012 and 6151 were the determinative provisions and that 28 U.S.C. § 960 had no limiting effect. In the referee's view, what the Ninth Circuit said in that connection was unnecessary to its decision since the court (in the

56. 332 F. Supp. at 1261.

57. 144 F. Supp. 507, 509 (S.D. Cal. 1956), *revd. sub nom. United States v. Sampsell*, 266 F.2d 631 (9th Cir. 1959).

58. 266 F.2d 631 (9th Cir. 1959).

59. 266 F.2d at 635.

60. Bankruptcy Act §§ 268-71, 395-97, 520-23, 679-80, 11 U.S.C. §§ 668-71, 795-97, 920-23, 1079-80 (1970).

61. See text accompanying notes 11-20 *supra*.

part of the decision relating to pre-1954 Code years) had already held that the trustee's activities constituted "operating the bankrupt's business—a conclusion that would subject him to tax liability in any event."⁶²

The referee, citing "myriad unresolved questions of deductions, procedures, etc." and "some very practical, difficult administrative problems . . . which would affect the handling of bankruptcy estates if a trustee were required to file returns and pay taxes for 'income' realized from liquidating activities,"⁶³ declared that the courts "have not been averse to ruling that conflicting provisions of the tax laws must on occasion bow to the strong social and economic policies underlying the Bankruptcy Act."⁶⁴ Congress is the final arbiter of the conflict between tax law and practical bankruptcy administration, however, and the bankruptcy courts have no power to override express tax and other statutes that they find inconvenient for trustee compliance.⁶⁵ The four cases relied on by the referee are not to the contrary. In *United States v. Randall*,⁶⁶ the Court declined to accord the government a "trust fund" priority (ahead of administration expenses) for taxes withheld from employees by a debtor in possession under Chapter XI, where there was no traceable fund into which the withholdings had been paid. In so holding, the Court applied the same tracing requirement that was applicable under IRC § 7501 to taxes required to be withheld prior to bankruptcy⁶⁷ and cited the Congressional policy to preserve administration expense funds, not as a ground for overriding the tax law, but as a ground for not waiving in bankruptcy the general requirement thereof. In *City of New York v. Saper*,⁶⁸ the Court found that the statutory interest on taxes⁶⁹ was subject, like other prescriptions for interest, to the general rule of bankruptcy law that interest does not run against the estate while payment of the principal is delayed

62. 332 F. Supp. at 1257.

63. 332 F. Supp. at 1258-59.

64. 332 F. Supp. at 1261.

65. *United States v. Key*, 397 U.S. 322, 326-27 (1970); *Nicholas v. United States*, 384 U.S. 678, 692-95 (1966); *Bruning v. United States*, 376 U.S. 358, 361 (1964). See also quotation from *Swarts v. Hammer*, 194 U.S. 441, 444 (1904), in text accompanying note 9 *supra*.

66. 401 U.S. 513 (1971).

67. The leading case on this requirement is *In re Frank*, 25 F. Supp. 1005 (S.D.N.Y. 1939).

68. 336 U.S. 328 (1949).

69. Under present law, interest on federal taxes is prescribed by INT. REV. CODE OF 1954, § 6601(a).

by the pendency of bankruptcy.⁷⁰ The third case cited by the referee, *Reinecke v. Gardner*,⁷¹ held the trustee in bankruptcy of a corporation not to be subject to an excess profits tax imposed on "corporations," in the absence of a provision (such as IRC § 6012(b)(3)) that expressly extended such tax to trustees in bankruptcy; however, the Court did not question the effectiveness of the predecessor of § 6012(b)(3) in requiring the trustee to pay the basic *income tax* imposed on corporations. The remaining cited decision, *In re Johnson Electrical Corp.*,⁷² had applied the bankruptcy court's notion of fairness to the debtor to preclude collection of postpetition interest from the debtor's later free assets when the principal of the tax liability had been fully paid under Chapter XI; that decision was later reversed,⁷³ in reliance on the Supreme Court's opinion in *Bruning v. United States*.⁷⁴

It seems clear, therefore, that, notwithstanding the referee's views in *Statmaster* (not discussed by the reviewing courts, which went off on procedural grounds), present law requires the trustee to file returns and pay corporate income tax, whether he is operating the business or merely liquidating.

b. *Tax identity of the fiduciary and the corporation.* Another much mooted point is whether section 6012(b)(3) continues the corporate taxable entity in the person of the trustee in bankruptcy and thus requires him to file a return "for such corporation" in the place of the corporate officers, or whether the trustee becomes a new and separate taxable entity subject to tax "in the same manner" as the corporation. It has been argued, following the rationale of *Reinecke v. Gardner*,⁷⁵ that "the income taxable is not *that of the corporation*, but *that of the Trustee*"⁷⁶ and that the "trustee in

70. Although the Bankruptcy Act did not expressly deal with interest on tax claims, the Court relied on the principles of the English bankruptcy system, on which our law was modeled. 336 U.S. at 330, citing *Sexton v. Dreyfus*, 219 U.S. 339, 344 (1911). Cf. Bankruptcy Act §§ 63a(1), (5), 11 U.S.C. §§ 103a(1), (5) (1970), which stop interest on judgments and written instruments.

71. 277 U.S. 239 (1928), discussed in text accompanying notes 28-30 *supra*.

72. 312 F. Supp. 840 (S.D.N.Y. 1970), *revd.*, 442 F.2d 281 (2d Cir. 1971).

73. *In re Johnson Elec. Corp.*, 442 F.2d 281 (2d Cir. 1971). *Accord*, *Hugh H. Eby Co. v. United States*, 456 F.2d 923 (3d Cir. 1972).

74. 376 U.S. 358 (1964), which held undischarged postpetition interest on *unpaid* taxes collectible from the debtor's after-acquired assets since the tax law "demonstrates congressional judgment that certain problems—*e.g.*, those of financing government—override" general bankruptcy policies. 376 U.S. at 361.

75. 277 U.S. 239 (1928), discussed in text accompanying notes 28-30 *supra*.

76. *In re F.P. Newport Corp.*, 144 F. Supp. 507, 509 n.1 (S.D. Cal. 1956), *revd. sub nom.* *United States v. Sampsell*, 266 F.2d 631 (9th Cir. 1959) (emphasis original).

bankruptcy of a corporate bankrupt simply does not own or control the corporation involved [but] is vested only with title to its assets.”⁷⁷

The Service’s position to the contrary is embodied in the Income Tax Regulations under the 1954 Code, which declare that “[t]he estate of . . . an individual or corporation in receivership or a corporation 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. See section 6012(b)(2) and (3) for provisions relating to the obligation of the fiduciary with respect to the returns of such persons.”⁷⁸

Whatever “conceptual problem” may arise from the fact that the trustee has title to the corporate property but does not control the corporation,⁷⁹ it is surely within the power of Congress, which vested title in him, to impose on him the obligations of reporting as if he were the corporation to whose property he succeeded and of paying the resulting tax from the estate. Congress appears to have done so, in fact, in specifying in section 6012(b)(3) that the trustee shall make the return “for such corporation”—that is, not for the estate in bankruptcy as a distinct entity. There is nothing to the

77. *In re Statmaster Corp.*, 332 F. Supp. 1248, 1258 (S.D. Fla. 1971) (referee opinion), *revd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *affd.*, 465 F.2d 978 (5th Cir. 1972) (emphasis original). In *415 South Taylor Bldg. Corp. v. Commissioner*, 2 T.C. 184 (1943), the corporation was in reorganization under former section 77B of the Bankruptcy Act (now Bankruptcy Act ch. X, 11 U.S.C. §§ 501-676 (1970)) during 1935, but the property was reconveyed to the debtor pursuant to the reorganization plan before the income tax return for 1935 became due. The trustee filed no return, and the corporation filed only a statement that, by reason of the proceeding, it had had no operations during the year. The Service attempted to assess tax for 1935 against the corporation, on the ground that, while the trustee stood in its place during the proceeding, the real and beneficial ownership was at all times in the corporation, which received the economic benefit of the operation. The Tax Court, however, leaving open what remedies might exist against the trustee, or against the corporation as transferee of the estate, held that, under *Reinecke v. Gardner*, 277 U.S. 239 (1928), the title to the property and income, and hence the primary liability for the tax, was the estate’s and not the corporation’s. While the precise issue in the *415 South Taylor* case has been otherwise resolved by provisions (Bankruptcy Act §§ 271, 397, 523, 11 U.S.C. §§ 671, 797, 923 (1970)) of the Chandler Act of 1938 that expressly permit assessment against the debtor or successor corporation for tax liabilities incurred during a rehabilitative proceeding, see *C.C. Bradley & Co. v. Commissioner*, 2 T.C. 564 (1943), the decision may still be pertinent in straight bankruptcy cases, as evidence of the separate taxable entity of the bankrupt estate. However, the Service indicated by nonacquiescence, 1943 CUM. BULL. 31, that it would not accept the decision as a precedent.

78. Treas. Reg. § 1.641(b)-2(b), T.D. 6580, 1961-2 CUM. BULL. 123.

79. *In re Statmaster Corp.*, 332 F. Supp. 1248, 1258 (S.D. Fla. 1971) (referee opinion), *revd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *affd.*, 465 F.2d 978 (5th Cir. 1972). The Commission’s substitutes—COMMISSION REPORT, *supra* note 3, §§ 4-601(a), 7-202—for Bankruptcy Act § 70a, 11 U.S.C. § 110(a) (1970), abandon the “confusing and erroneous concept” of “vesting title” in the trustee” and state instead that certain property is “property of the estate.” See COMMISSION REPORT, *supra*, § 7-201, note 1.

contrary in *Reinecke v. Gardner*,⁸⁰ which relied on the trustee's title in holding the trustee not subject to excess profits tax as a corporation *in the absence* of any applicable provision comparable to section 6012(b)(3). With respect to the corporate income tax, the Court *upheld* the liability imposed on the trustee by the predecessor of that provision⁸¹ but had no occasion to consider whether its effect was to make the estate a separate taxable entity or (for tax purposes) a continuation of the corporation.

The intent of Congress that the trustee assume the obligations of the bankrupt in this regard seems to be underscored by section 6903(a),⁸² which provides:

Upon notice to the Secretary or his delegate that 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 by this title (except as otherwise specifically provided and except that the tax shall be collected from the estate of such other person), until notice is given that the fiduciary capacity has terminated.

Despite the suggestion by Krause and Kapiloff⁸³ that section 6903(a) does not apply to a trustee in bankruptcy, who is generally elected by and administers the estate for the benefit of the creditors and, hence, is not "acting for" the bankrupt, the trustee does act in a fiduciary capacity for the bankrupt, at least in applying property to its debts and returning the residue, if any.⁸⁴ In any event, the report on the Revenue Act of 1926, in which the provision originated, makes it clear that the trustee in bankruptcy was meant to be covered.⁸⁵

80. 277 U.S. 239 (1928).

81. Act of Sept. 8, 1916, ch. 463, § 13(c), 39 Stat. 71. This section is quoted in text accompanying note 26 *supra*.

82. The Tax Court, however, drew the opposite inference from the predecessor provision in 415 South Taylor Bldg. Corp. v. Commissioner, 2 T.C. 184, 191 (1943).

83. Krause & Kapiloff, *The Bankrupt Estate, Taxable Income and the Trustee in Bankruptcy*, 34 FORDHAM L. REV. 401, 402-03 (1966).

84. See *B & L Farms Co. v. United States*, 238 F. Supp. 407, 410 (S.D. Fla. 1965), *aff'd.*, 368 F.2d 571 (5th Cir. 1966), *cert. denied*, 389 U.S. 835 (1967). See also 9 AM. JUR. 2d *Bankruptcy* § 637 (1963).

85. S. REP. NO. 52, 69th Cong., 1st Sess. 30 (1926). The report expresses the concern of the Congress "that there . . . be some individual to whom notice may be mailed and upon whom demand may be made, in the case of, for example, an incompetent, a decedent's estate, or an estate in the hands of a receiver or trustee in bankruptcy." (Emphasis added.) Although the report's only express reference is to the mailing of deficiency notices and demands to the fiduciary, the provision has the further effect of fixing on the trustee the bankrupt's duty to pay the tax (limited to the amount in the estate). Cf. *Fletcher Trust Co. v. Commissioner*, 141 F.2d 36, 40 (7th Cir. 1944) (involving the trustee of a gift in trust). While, on its face, the obligation under

Treatment of the estate of a bankrupt corporation as a continuation of the corporate taxable entity is consistent with the treatment of a liquidating trustee for a corporation that is not in bankruptcy. It has long been established that the conveyance of corporate assets to a trustee in dissolution or liquidation for the purpose of disposing of the assets and discharging the corporate debts does not terminate the existence of the corporation for tax purposes. The trustee is deemed to hold the assets, not as a representative of the shareholders, but as agent for the corporation, until its debts have been paid and the residue distributed.⁸⁶ It makes no difference that the state law finally terminates the corporate existence upon the transfer to the trustee⁸⁷ or that the trust instrument expressly disclaims representation of the corporation.⁸⁸ While it is not legally im-

INT. REV. CODE OF 1954, § 6903(a), is conditional upon the fiduciary's having given notice to the government, it has been held that the assumption of such tax responsibility is not optional with the fiduciary. *Fidelity Trust Co. v. Commissioner*, 141 F.2d 54, 57-58 (3d Cir. 1944). In any event, the notice required to be given to the district director of internal revenue by the clerk of the court under section 58e of the Bankruptcy Act, 11 U.S.C. § 94(e) (1970), suffices for purposes of section 6903(a). *Treas. Reg.* §§ 301.6036-1(a)(1), (c) (1960).

86. *United States v. Loo*, 248 F.2d 765 (9th Cir. 1957), *cert. denied*, 356 U.S. 928 (1958); *J. Ungar, Inc. v. Commissioner*, 244 F.2d 90, 93 (2d Cir. 1957); *First Natl. Bank v. United States*, 86 F.2d 938 (10th Cir. 1936); *Hellebush v. Commissioner*, 65 F.2d 902 (6th Cir. 1933); *Taylor Oil & Gas Co. v. Commissioner*, 47 F.2d 108 (5th Cir.), *cert. denied*, 283 U.S. 862 (1931); *National Metropolitan Bank v. United States*, 345 F.2d 823 (Ct. Cl. 1965); *Mrs. Grant Smith*, 26 B.T.A. 1178 (1932). Liquidation cases that arose before the 1954 Code placed some reliance on long-standing regulations that declared:

When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes . . . Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss . . .

E.g., *Treas. Reg.* 118, § 39.22(a)-20 (1953); *Treas. Reg.* 45, art. 547 (1919). That provision disappeared when the regulations were reissued under the 1954 Code and was replaced by a more limited statement that "gain or loss is recognized to a corporation [in liquidation] on all sales by it, whether directly or indirectly (as through trustees or a receiver)," with an exception not here pertinent. *Treas. Reg.* § 1.336-1 (1955). The current regulation has been relied on, however, in reaching the same result as under prior law. *Hersloff v. United States*, 310 F.2d 947, 950 (Ct. Cl. 1962). Furthermore, present *Treas. Reg.* § 1.6012-3(b)(4), T.D. 6628, 1963-1 CUM. BULL. 272, 273 links the requirement of filing by a "trustee in dissolution" to the statutorily prescribed filing by "a receiver, trustee in bankruptcy or assignee," INT. REV. CODE OF 1954, § 6012(b)(3), and that statute was relied on in finding continuity between a corporation and its liquidating trustee in *National Metropolitan Bank v. United States*, 345 F.2d 823, 825 (Ct. Cl. 1965). *See also* *Treas. Reg.* § 1.6012-2(a)(2) (1959) ("A corporation does not go out of existence if it is turned over to receivers or trustees who continue to operate it.").

87. *United States v. Loo*, 248 F.2d 765, 767 (9th Cir. 1957), *cert. denied*, 356 U.S. 928 (1958).

88. *Whitney Realty Co. v. Commissioner*, 80 F.2d 429, 431 (6th Cir. 1935), *cert. denied*, 298 U.S. 668 (1936).

possible to sever the corporation's tax connection with later transactions by a clear-cut distribution to shareholders, even if they appoint a trustee to act for them,⁸⁹ trustees who were charged, not merely with disposing of property and paying over the proceeds to shareholders, but with winding up the affairs of the corporation and paying its debts, were not permitted to deny their representation of the corporation.⁹⁰ Such functions, of course, are performed by a bankruptcy trustee.

Aside from affecting the availability of the corporation's loss carryovers to the trustee, the principal practical difference between the two points of view discussed above is that the Service position requires the trustee to file a return that includes the portion of the year before he took title.⁹¹ In nonbankruptcy corporate liquidation cases, which are governed by the same regulation on returns as that which governs corporate bankrupts,⁹² it has been held that there is but one taxable period in the year in which the corporate assets are transferred to the liquidating trustee.⁹³ One possible distinction between the bankruptcy and nonbankruptcy situations, however, is that the bankrupt corporation, instead of passing out of existence, may obtain a discharge and resume business under the same charter with fresh capital, as is permitted by section 14a of the Bankruptcy Act.⁹⁴ The fact that this permissible, if relatively rare, occurrence

89. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950); *United States v. Cummins Distilleries Corp.*, 166 F.2d 17 (6th Cir. 1948); *Amos L. Beaty & Co.*, 14 T.C. 52 (1950); *Acampo Winery & Distilleries, Inc.*, 7 T.C. 629 (1946).

90. See note 86 *supra* and accompanying text.

The same principle has been applied to an assignment by a corporation for the benefit of creditors. See *Louisville Property Co. v. Commissioner*, 140 F.2d 547 (6th Cir.), *cert. denied*, 322 U.S. 755 (1944). The court held that the assignee, although he held legal title, was conducting not his own business but that of the corporation and rejected as "fanciful" the argument "that the beneficial owners were the creditors and stockholders." 140 F.2d at 549. *But cf. Standard Oil Co. v. Apex Oil Co.*, 35 Tenn. App. 225, 244 S.W.2d 176 (1951), which held that a receiver in a general creditor's suit was not taxable under the predecessor of INT. REV. CODE OF 1954, § 6012(b)(3), in part because the income was deemed to belong not to the corporation but to its creditors and shareholders.

91. G.C.M. 12207, XII-2 CUM. BULL. 83, 85 (1933), *declared obsolete* by Rev. Rul. 71-498, 1971-2 CUM. BULL. 434. The declaration of obsolescence presumably refers to the consolidated return issues dealt with in the ruling, since there has been no pertinent change in the law on the present point.

92. See note 86 *supra*.

93. *National Metropolitan Bank v. United States*, 345 F.2d 823, 827 (Ct. Cl. 1965); *Mrs. Grant Smith*, 26 B.T.A. 1178, 1187 (1932).

94. 11 U.S.C. § 32(a) (1970). See *Theobald-Jansen Elec. Co. v. Harry I. Wood Engr. Co.*, 285 F. 29 (6th Cir. 1922); *In re Marshall Paper Co.*, 102 F. 872 (1st Cir. 1900); *In re Hargadine-McKittrick Dry Goods Co.*, 239 F. 155 (E.D. Mo. 1917), *rev'd*, 244 F. 719 (8th Cir.), *cert. denied*, 245 U.S. 667 (1917). The Commission has recommended denying the owners of the bankrupt corporation the option to obtain a discharge and re-

might result in two entities with the same tax identity if the government's position were sustained has been cited as a reason for judicial narrowing of the application of section 6012(b)(3) of the Code and for the view, expressed by the referees, that the trustee, if required to file at all, should report only the income from the estate's own operations and the corporation should file its own return covering the prebankruptcy portion of the year (as well as the period thereafter if the corporation resumes operations after discharge).⁹⁵ Krause and Kapiloff, on the other hand, accept the Service position that, in general, the trustee continues the identity of the corporate bankrupt for tax purposes, but they would make an exception for the unusual case where the discharged corporation resumes business activity. In such a situation, they say, the trustee should not file corporate returns for the estate in his hands but should file fiduciary (estate) returns in the same manner as the trustee of a bankrupt individual or partnership, since the discharge severs the corporation from the estate.⁹⁶

The referee in the *Statmaster* case⁹⁷ declared that the Supreme Court, in *Nicholas v. United States*,⁹⁸ "took pains to negate any implication that its decision extended to the filing of tax returns by the trustee for pre-petition periods." The referee, however, misread the *Nicholas* case, in which the Court, in holding a trustee for a bankrupt corporation subject to civil penalties for failure to file withholding, social security, and cabaret tax returns that came due after his appointment but covered periods while the debtor was in possession under a Chapter XI arrangement, stressed "the continuity of interest between the debtor in possession and the trustee as officers of the bankruptcy court"⁹⁹ and stated that "nothing said in this opinion may be taken as imposing any obligations upon a trustee

activate the corporate shell. COMMISSION REPORT, *supra* note 3, § 4-505(a) & note 3 thereto.

95. *In re Statmaster Corp.*, 332 F. Supp. 1248, 1258, 1261 (S.D. Fla. 1971) (referee opinion), *revd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *affd.*, 465 F.2d 978 (5th Cir. 1972); *In re Town Crier Bottling Co.*, 123 F. Supp. 588, 592 (E.D. Mo. 1954).

96. Krause & Kapiloff, *supra* note 83, at 405-06, 415. Perhaps that view can be reconciled with the terms of INT. REV. CODE OF 1954, § 6012(b)(3), on the theory that, at least from the time the corporation acquires new assets, the trustee no longer "has possession of or holds title to *all or substantially all* the property or business of [the] corporation." (Emphasis added.) Concerning the taxation of the estate of an individual or partnership as a separate entity, see text accompanying notes 106-34 *infra*.

97. 332 F. Supp. at 1259.

98. 384 U.S. 678, 693 n.27 (1966).

99. 384 U.S. at 693 n. 27.

in bankruptcy to file returns for taxes incurred before the initiation of proceedings under the Act."¹⁰⁰ The Court cited¹⁰¹ I.T. 3959,¹⁰² which holds that a trustee is not authorized to file an income tax return for the prebankruptcy period of an *individual*. In the case of individuals, however, there is no express statute, such as section 6012(b)(3), that requires the trustee to "make the return of income for the corporation";¹⁰³ nor was that provision relevant or given consideration in *Nicholas*, since the statute relates only to corporate income taxes, which were not there involved.

I submit, therefore, that present law requires the trustee in bankruptcy to file income tax returns as and for the corporate bankrupt, without break in the accounting period of the corporation and without becoming a new and separate taxable entity.¹⁰⁴

2. *Individual and Partnership Bankruptcies*

Whereas section 6012(b)(3), whatever its conceptual and practical inadequacies, at least undertakes to regulate the tax duties of corporate bankrupts and their fiduciaries, the tax law with respect to trustees for bankrupt individuals and partnerships is a virtual vacuum. The taxing authorities and the courts, therefore, have had to improvise and apply rules not framed with the bankruptcy situation in mind.¹⁰⁵

Since an individual bankrupt, after the transfer of his assets to the trustee, may obtain new employment or new assets from which he will derive income independent of that which the trustee may simultaneously derive from the assets transferred to him, it has been the "long-established practice" of the Service to treat the estate

100. 384 U.S. at 693 n.27.

101. 384 U.S. at 693 n.27.

102. 1949-1 CUM. BULL. 90.

103. See text accompanying notes 105-06 *infra*.

104. There appears to be no room to question the proposition that, whatever might be the general conclusion with respect to trustees, a *receiver* (of all or substantially all of a corporate debtor's property), appointed under the Bankruptcy Act and having only possession and not title (Bankruptcy Act § 2a(3), 11 U.S.C. § 11(a)(3) (1970); *Imperial Assur. Co. v. Livingston*, 49 F.2d 745, 749 (8th Cir. 1931)), stands completely in the shoes of the debtor in filing returns "for such corporation," rather than becoming a distinct taxable entity. INT. REV. CODE OF 1954, § 6012(b)(3); Treas. Reg. § 1.6012-3(b)(4), T.D. 6628, 1963-1 CUM. BULL. 272, 273; Treas. Reg. § 1.641(b)-2(b), T.D. 6580, 1961-2 CUM. BULL. 123. Therefore, losses of the debtor may be used on the return, *In re Kepp Elec. & Mfg. Co.*, 98 F. Supp. 51, 53 (D. Minn. 1951), and the receiver files for the full unbroken accounting year of the corporation, including the period before the receiver took control. Rev. Rul. 69-600, 1969-2 CUM. BULL. 241. If the property is restored to the debtor, the debtor files for the full year, including the period the receiver was in charge. Rev. Rul. 69-641, 1969-2 CUM. BULL. 241.

105. See Henry C. Mueller, 60 T.C. 36, 44-45 (1973).

in the hands of a trustee for a bankrupt individual (in contrast to the rule asserted in corporate bankruptcies) as a taxable entity separate from the individual.¹⁰⁶ The Service holds the trustee taxable under section 641 of the Code, which imposes a tax on "the taxable income of estates or of any kind of property held in trust," although the *nonexclusive*¹⁰⁷ list of specific examples that follows that general language refers to no "estates" other than "estates of deceased persons,"¹⁰⁸ and the Service undercuts its case by perversely holding that not all the tax provisions applicable to "estates" apply to estates in bankruptcy.¹⁰⁹

Knowledge of that "long-established practice" apparently escaped the draftsmen of the first regulations promulgated under the 1954 Code. It was provided in the 1956 version of Treas. Reg. § 1.641(b)-2(b) that

[t]he estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or 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. See section 6012(b)(2) and (3) for provisions relating to the obligation of the fiduciary with respect to returns of such persons.¹¹⁰

Relying on that regulation, the court in *In re Kirby*¹¹¹ held that the trustee in bankruptcy of an individual is not subject to income tax and added that, if Congress had meant to impose the tax, it would have done so expressly, as it had done with respect to corporations. The "estates" subjected to tax by section 641 were held to be confined to decedents' estates. While the case was pending, the Treasury hastily amended the regulation. The words immediately following "in general" in the old regulation were amended

106. G.C.M. 24617, 1945 CUM. BULL. 235; Rev. Rul. 72-387, 1972-2 CUM. BULL. 632, 632. See Krause & Kapiloff, *supra* note 83, at 405.

107. See INT. REV. CODE OF 1954, § 7701(b) ("The terms 'includes' and 'including' when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined."). See *Groman v. Commissioner*, 302 U.S. 82, 86 (1937).

108. INT. REV. CODE OF 1954, § 641(a)(3).

109. Rev. Rul. 66-266, 1966-2 CUM. BULL. 356, discussed in note 112 *infra*; Rev. Rul. 68-48, 1968-1 CUM. BULL. 301, 303, discussed in text accompanying note 220 *infra*. See Henry C. Mueller, 60 T.C. 36, 45 (1973).

110. T.D. 6217, 1956-2 CUM. BULL. 336, 344. INT. REV. CODE OF 1954, § 6012(b)(2), referred to in the regulation, requires an agent, committee, guardian, or fiduciary to file returns for an individual under disability. INT. REV. CODE OF 1954, § 6012(b)(3), which relates to fiduciaries for corporations, has been discussed in the text accompanying notes 75-104 *supra*.

111. 62-2 U.S. Tax Cas. ¶ 9752 (S.D. Tex. 1962).

to declare that the estate "of an individual or corporation in receivership or a corporation in bankruptcy [the reference to a bankrupt individual was deleted] is not a taxable entity separate from the person for whom the fiduciary is acting"¹¹² The *Kirby* case was then settled for \$140,000.00, out of a claimed \$575,644.18 in tax and penalty, and the government dismissed its appeal.¹¹³

Although the *Kirby* case remains the only reported decision that has held a liquidating trustee for a bankrupt individual immune from income tax, the two reported cases to the contrary¹¹⁴ are less than satisfactory in their reasoning. Both relied on 28 U.S.C. § 960 and broadly construed the statutory term, "conduct[ing] any business," to embrace "any activity or operation in connection with the handling or management of the bankrupt estate";¹¹⁵ the later case added that, in any event, "§960 does not purport to exclude a liquidating Trustee from paying tax on income received."¹¹⁶ But, having neutralized section 960, which neither imposes nor inhibits

112. T.D. 6580, 1961-2 CUM. BULL. 123, 123. The confusion in the Service concerning the status of a bankrupt estate continued, however. In construing INT. REV. CODE OF 1954, § 1371(a)(2), under which a so-called "small business corporation," the income of which (if so elected) is taxed to its shareholders and is immune from corporate tax, is disqualified for such treatment if it has any shareholders other than individuals and "estates[s]," the Service ruled that disqualification occurs if a shareholder becomes bankrupt and a trustee in bankruptcy takes title to his shares. Rev. Rul. 65-90, 1965-1 CUM. BULL. 428. Citing the above-quoted regulation as it had read before the amendment four years earlier, see text accompanying note 110 *supra*, the ruling stated that "the estate of a decedent is the only estate which may be recognized as a taxable entity." Rev. Rul. 65-90, 1965-1 CUM. BULL. 428, 429. That generalization, as well as the reference to the regulation, was deleted when the ruling was revised and superseded by Rev. Rul. 66-266, 1966-2 CUM. BULL. 356. But it was nevertheless concluded, Rev. Rul. 66-266, 1966-2 CUM. BULL. 356, 357 (emphasis added), that "an 'estate,' within the meaning of section 1371 of the Code, includes only the estate of a decedent," without explaining why the meaning was different for that purpose than for others. Cf. Rev. Rul. 74-9, 1974 INT. REV. BULL. No. 1, at 17, which holds that an individual debtor in possession under chapter XII is neither an individual nor an estate for the purpose of section 1371.

113. *United States v. Kerr*, 64-1 U.S. Tax Cas. ¶ 9184 (5th Cir. 1963). Although it has been said that the "precedential value of the *Kirby* case was undermined substantially" by the compromise pending its appeal, *Krause & Kapiloff*, *supra* note 83, at 410, the view of the Tax Court in similar circumstances is that such a settlement "does not affect the vitality of the opinion as an expression of the Tax Court's views on the issue involved." *Cosmopolitan Credit Corp.*, 31 CCH Tax Ct. Mem. 404, 414 n.4 (1972).

114. *In re Steck*, 62-2 U.S. Tax Cas. ¶ 9702 (S.D. Ill. 1962) (referee opinion) (taxing farm income pending sale of farm); *In re Loehr*, 98 F. Supp. 402 (E.D. Wis. 1950) (taxing gain on sale of bankrupt's property).

115. *In re Steck*, 62-2 U.S. Tax Cas. ¶ 9702, at 85,839 (S.D. Ill. 1962) (referee opinion), quoting *In re Mid America*, 31 F. Supp. 601, 606 (S.D. Ill. 1939); *In re Loehr*, 98 F. Supp. 402, 403 (E.D. Wis. 1950), quoting *In re Mid America Co.*, 31 F. Supp. 601, 606 (S.D. Ill. 1939).

116. *In re Steck*, 62-2 U.S. Tax Cas. ¶ 9702, at 85,839 (S.D. Ill. 1962) (referee opinion).

the imposition of a federal tax,¹¹⁷ the decisions fail to address themselves to the affirmative basis for liability.¹¹⁸

The *Kirby* referee, like the referee in *Statmaster* on the corporate side of the same issue,¹¹⁹ based his finding of the absence of such an affirmative basis on the principle that "[t]he extension of a tax by implication is not favored."¹²⁰ That principle stems ultimately, at least in the federal income tax field, from *Gould v. Gould*,¹²¹ a 1917 case, in which the Supreme Court said, "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen." So far as the *Gould* case may require construing all doubts against the government, however, such a requirement "is no longer the law,"¹²² in view of a later declaration of the Supreme Court:

We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of the courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be.¹²³

Although *Gould* is, nevertheless, still relied on,¹²⁴ its role is clearly limited to the interpretation of provisions *levying* taxes.¹²⁵ When the tax-levying provisions extend, as they do here, to "all income from whatever source derived,"¹²⁶ including "the taxable income of estates or of any kind of property held in trust,"¹²⁷ and thus evidence

117. See text accompanying notes 18-20 *supra*.

118. This criticism is noted in Krause & Kapiloff, *supra* note 83, at 409.

119. *In re Statmaster Corp.*, 332 F. Supp. 1248, 1259-60 (S.D. Fla.) (referee opinion), *rev'd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *aff'd.*, 465 F.2d 978 (5th Cir. 1972). See text accompanying notes 44-74 *supra*.

120. 62-2 U.S. Tax Cas. at 86,050, *quoting* *Reinecke v. Gardner*, 277 U.S. 239, 244 (1928).

121. 245 U.S. 151, 153 (1917).

122. *Endler v. United States*, 110 F. Supp. 945, 949 (D.N.J. 1953). *But cf.* *Busse v. Commissioner*, 479 F.2d 1147, 1151 (7th Cir. 1973).

123. *White v. United States*, 305 U.S. 281, 292 (1938).

124. *E.g.*, *Tandy Leather Co. v. United States*, 347 F.2d 693, 694 (5th Cir. 1965).

125. See *Parker Pen Co. v. O'Day*, 234 F.2d 607, 609 (7th Cir. 1956).

126. INT. REV. CODE OF 1954, § 61(a).

127. INT. REV. CODE OF 1954, § 641(a).

the purpose of Congress "to use the full measure of its taxing power,"¹²⁸ the applicable principles are that "those who seek an exemption from a tax must rest it on more than a doubt or ambiguity [since] [e]xemptions from taxation cannot rest upon mere implication,"¹²⁹ and that even express exemptions from a generally imposed tax "are to be strictly construed."¹³⁰

Partnerships are not themselves taxable under the federal income tax law but are treated as conduits, the partners being directly taxable in accordance with their distributive shares of the income determined at the partnership level.¹³¹ A partnership may, however, become bankrupt, either separately or jointly with one or more or all of its general partners.¹³² Originally, it was ruled that a bankrupt partnership was no more a taxable entity than the partnership itself and that the trustee should file the regular partnership information return Form 1065 on behalf of the partnership, which was considered to continue in existence as such during its dissolution by the trustee; the distributive shares were ruled to be taxable to the trustees for the bankrupt partners (and directly to any partners not in bankruptcy).¹³³ That ruling was subsequently reconsidered, however, in light of the asserted inconsistency in treatment of trustees for partnerships and trustees for individuals. It was then determined that the trustee for a bankrupt partnership, like the trustee for an individual, should be taxed under section 641 of the Code as an estate, separate from both the partnership and the partners.¹³⁴

No separate taxable entity results, however, if a receiver, rather than a trustee, holds all, or substantially all, the property of an individual¹³⁵ or a partnership.¹³⁶ The law provides that "[i]f an in-

128. *Helvering v. Clifford*, 309 U.S. 331, 334 (1940); *Blassie v. Commissioner*, 394 F.2d 628, 630 (8th Cir. 1968).

129. *United States v. Stewart*, 311 U.S. 60, 71 (1940).

130. *Helvering v. Northwest Steel Rolling Mills, Inc.*, 311 U.S. 46, 49 (1940). *Accord*, *Bingler v. Johnson*, 394 U.S. 741, 751-52 (1969).

131. INT. REV. CODE OF 1954, §§ 701-04; *United States v. Basye*, 410 U.S. 441, 448 (1973).

132. Bankruptcy Act § 5a, 11 U.S.C. § 23(a) (1970). To the same effect, see COMMISSION REPORT, *supra* note 3, §§ 1-102(34), 4-201, -204, -206, -305.

133. G.C.M. 8488, X-1 CUM. BULL. 270 (1931).

134. G.C.M. 24617, 1945 CUM. BULL. 235; Rev. Rul. 68-48, 1968-1 CUM. BULL. 301. Not only does this treatment (which has been tested in no reported case) subject the bankrupt estate to the highest individual rate schedule (INT. REV. CODE OF 1954, § 1(d)), but also the lumping of the interests of all the partners into a single entity taxable at graduated individual rates may place the estate in a substantially higher tax bracket than its members.

135. Treas. Reg. § 1.641(b)-2(b), T.D. 6580, 1961-2 CUM. BULL. 123.

136. See text accompanying note 140 *infra*.

dividual is unable to make a return . . . , the return of such individual shall be made by . . . his . . . fiduciary or other person charged with the care of the person or property of such individual," with an express exception in the case of a receiver of "only a part of the property of an individual."¹³⁷ The regulation thereunder specifies that "[a] receiver who stands in the place of an individual *must* make the return of income required in respect of such individual," but an individual only a part of whose property is held by a receiver "must make his own return."¹³⁸ The Tax Court has held,¹³⁹ however, that an individual whose property is held by a receiver is not necessarily "unable to make a return," as the statute provides, and that the receiver may discharge his obligation by seeing that the taxpayer himself files a return. Whether filed by the receiver or the individual, the return is that of the individual and may be joined in by the debtor's spouse, in order to take advantage of the lower rates applicable to joint returns—a privilege that is unavailable to a trustee in bankruptcy. With respect to partnerships, there was for many years a regulation that stated that a receiver in charge of the business of a partnership should file the partnership information return Form 1065 rather than filing as an estate, as a trustee for a bankrupt partnership must do.¹⁴⁰ While that provision disappeared from the regulations after 1954, the rule no doubt remains the same.¹⁴¹

3. Reorganization and Rehabilitation Proceedings

In reorganization and rehabilitation proceedings of the kind embraced in Chapters X, XI, and XII, whether involving corporations, partnerships, or individuals, and whether administered by a trustee or receiver or by the debtor in possession, the present Bankruptcy Act provides that "all taxes which may become owing to the United States or any State^[142] from a receiver or trustee of a

137. INT. REV. CODE OF 1954, § 6012(b)(2).

138. Treas. Reg. § 1.6012-3(b)(5) (1960) (emphasis added).

139. Selma Heasley, 45 T.C. 448, 460-62 (1966).

140. E.g., Treas. Reg. 45, art. 424 (1919); Treas. Reg. 118, § 39.142-4 (1953).

141. The reasons for stating this are that (1) while neither section 142 of the 1939 Code (on which the former regulation purported to rest) nor section 6012 of the 1954 Code directly deals with receivers for partnerships, there is nothing in the latter section or elsewhere in the 1954 Code to indicate that the prior interpretation was changed or undermined, and (2) the old regulation and the author's conclusion as to the present law are consistent with the principle that a receiver is in effect a custodian that does not take title and hence is not a new taxable entity.

142. The Commission would add "or any subdivision thereof," for clarification. COMMISSION REPORT, *supra* note 3, § 7-315(e).

debtor or from a debtor in possession, *shall* be assessed against, *may* be collected from, and *shall* be paid by the debtor or the corporation organized or made use of for effectuating a plan or arrangement under one of those chapters.”¹⁴³ The italicized words indicate that, while the obligation to file returns falls upon the receiver or trustee, if one is appointed and holds all, or substantially all, the property of the debtor,¹⁴⁴ and while the taxes “become owing” from the fiduciary, the debtor is viewed as the actual taxpayer, even during administration (resulting in continuity of the taxable year and availability of the debtor’s loss carryovers),¹⁴⁵ since the taxes “shall” be assessed against and “shall” be paid by the debtor (or his successor). While the taxes “may” be collected from the debtor, they may also be collected from the estate, with the priority of administration expenses.¹⁴⁶

C. Legislative Alternatives

1. Complete or Partial Exemption of the Trustee from Tax

Under the proposals of the Commission, the trustee in straight bankruptcy, whether of an individual, a partnership, or a corporation, and whether or not operating or conducting the business of the debtor, would be relieved of any obligation to file returns or pay any federal, state, or local tax upon or measured by income of the estate. However, in order to avoid a windfall to the debtor in the unusual case where the property available for distribution exceeds the aggregate amount of allowable claims, the taxes for the entire period of administration would have to be computed on returns to be made by the trustee before approval of his final account, and the taxes would then be paid ratably from and to the extent of the amount otherwise distributable to the debtor. The running of the statute of limitations on assessment and collection of administra-

143. Bankruptcy Act §§ 271, 397, 523, 11 U.S.C. §§ 671, 797, 923 (1970) (emphasis added). The Commission, which would merge such procedures into one procedure called “reorganization” (even when an individual is involved), would carry forward the substance of those provisions (simplified to state that the taxes “may be assessed against and collected from” the debtor or successor) in proposed section 7-315(c) and would extend them to railroad reorganizations (on which the law has heretofore been silent in this respect) in proposed section 9-101.

144. INT. REV. CODE OF 1954, §§ 6012(b)(2), (3).

145. *In re Lister*, 177 F. Supp. 372, 373 (E.D. Va. 1959); *Stoller v. United States*, 320 F.2d 340, 341-42 (Ct. Cl. 1963). The Service, however, has ruled that an individual debtor in possession, at least under chapter XII, is a taxable entity distinct from the debtor himself. Rev. Rul. 74-9, 1974 INT. REV. BULL. No. 1, at 17.

146. *Berryhill v. Gerstel*, 196 F.2d 304 (5th Cir. 1952); *In re Gates*, 256 F. Supp. 1 (E.D. Wis. 1966).

tive taxes would be suspended until the date of approval of such account, and any deficiency later determined would be collectible from the debtor by transferee proceedings¹⁴⁷ to the extent of any distribution he received.¹⁴⁸

The proposal to exempt the trustee from tax is not a new one, and the arguments for it are perhaps adequately summarized in Judge Yankwich's dictum that, "Historically, income taxes are levied on the *profits of the owners of a successful enterprise*, not on the dividends paid to the creditors on the 'winding-up' or 'closing-out' of a defaulted and bankrupt business."¹⁴⁹ For purposes of analysis, it is necessary to deal with the two parts of that statement separately.

First, it is not strictly true that, either "historically" or under current law, only "the profits of the owners of a successful enterprise" are subject to the income tax. Income taxes are determined on an annual basis and reflect the income and deductions of a taxable year; the profitability or unprofitability of the taxpayer's aggregate business over a period of years is relevant only as specific statutory provisions, such as those for loss carryovers, make it so.¹⁵⁰ If, in the application of those provisions, a net income does develop, "[p]rofits made in the business of liquidation are taxable in the same way and to the same extent as if made in an expanding business,"¹⁵¹ and, except in so far as carryover provisions may be applicable, "[t]he fact that it might prove that when the business was fully liquidated the profits . . . were offset by heavy loss of [other] years is immaterial."¹⁵²

The second part of Judge Yankwich's statement assumes that the tax is imposed upon the "dividend" to creditors. The tax is not, of course, imposed upon their receipt of payment of their debts (although they may be independently taxable if the payments reflect recovery of previously untaxed income, rather than of capital). The

147. See INT. REV. CODE OF 1954, § 6901.

148. COMMISSION REPORT, *supra* note 3, § 5-104(a).

149. *In re F.P. Newport Corp.*, 144 F. Supp. 507, 510 (S.D. Cal. 1956), *rev'd. sub nom.* *United States v. Sampsell*, 266 F.2d 631 (9th Cir. 1959) (emphasis original). The Commission merely "rests on the premise that estates undergoing liquidation in bankruptcy and the officers administering them should be relieved from filing returns and paying income taxes so long as the payment of such taxes on income earned during the administration of the estate would diminish the assets of the estate necessary for the full payment of all its creditors." COMMISSION REPORT, *supra* note 3, § 5-104, note 1.

150. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *United States v. Rexach*, 482 F.2d 10, 22-23 (1st Cir. 1973), *cert. denied*, 42 U.S.L.W. 3306 (U.S., Nov. 20, 1973).

151. *Heiner v. Mellon*, 304 U.S. 271, 275 (1938).

152. *Heiner v. Mellon*, 304 U.S. 271, 276 (1938).

tax is on the bankrupt estate (whether deemed to be a continuation of the identity of a bankrupt corporation or, in other circumstances, a separately taxable estate). The special circumstance of the trustee's realization of income and appreciation in value accrued before bankruptcy is left aside for later discussion.¹⁵³ In general, the other forms of income (interest, royalties, rent, or income from the conduct of business) that may be taxed to the bankrupt estate involve increments in the amount of assets that were available to creditors at the date of bankruptcy, and while, to the creditors, the greater amount thereby recovered from the estate merely constitutes a reduction of their loss, it is to the trustee—as it would have been to the bankrupt if he had continued to be the owner of the source—an accession to income.¹⁵⁴ The fact that it was earned by an insolvent estate under judicial supervision (hence, “*in custodia legis*”) affords no more reason for exempting such income than it would for relieving the income of a decedent's estate, a guardianship, or the like. To paraphrase the Supreme Court's response to a comparable argument that judicial custody precluded property taxation, “the transfer to the trustee [gives] no mysterious or peculiar ownership or qualities . . . to the property [and does not] withdraw it from the necessity of protection by the [United States].”¹⁵⁵

Essentially, the argument of Judge Yankwich comes down to what later courts have described as the “manifest inequity” of imposing any tax *on the insolvent estate* when “its burden would fall upon the creditors by further reducing what at best is only a partial recovery of amounts owing to them from the bankrupt,”¹⁵⁶ so that, “[i]n effect, the creditors would . . . be asked to pay a tax on their loss.”¹⁵⁷ That argument, as the reviser of Collier has pointed out, “implies a limitation on the taxing power that may appeal to the emotion, but has little justification in law.”¹⁵⁸ The argument may be relevant to the “negative income” resulting to the bankrupt through the reduction of his liabilities, which results in no increment in available assets—a form of income for which, in conse-

153. See text accompanying notes 242-72, 336-85 *infra*.

154. *In re Steck*, 62-2 U.S. Tax Cas. ¶ 9702 (S.D. Ill. 1962) (referee opinion).

155. *Swarts v. Hammer*, 194 U.S. 441, 444 (1904). The actual quotation is found in the text accompanying note 9 *supra*.

156. *In re Kirby*, 62-2 U.S. Tax Cas. ¶ 9752, at 86,051 (S.D. Tex. 1962).

157. *In re Statmaster Corp.*, 332 F. Supp. 1248, 1260 (S.D. Fla.) (referee opinion), *rev'd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *aff'd.*, 465 F.2d 978 (5th Cir. 1972).

158. 3A COLLIER ON BANKRUPTCY ¶ 62.14[3] (rev. 14th ed. J. Moore 1972). See note 187 *infra*.

quence, a conditional exemption has been expressly provided.¹⁵⁹ At least in so far, however, as the income in question reflects an actual increment in the amount available to creditors, there is no inequity in charging such increment first with the "price" exacted from all citizens for the protection afforded by the government, just as it is charged with the expenses directly incurred in its production. The equity of charging that increment with the tax thereon is further evidenced by the fact that, if the creditors had been paid on the date of bankruptcy, they would have received only the principal amount of assets then in the estate, without the later increment, and, if they had then invested the proceeds and earned interest or other income therefrom, they would surely have been taxed on that income, notwithstanding their prior unrecovered loss on the debt from the bankrupt.¹⁶⁰

The creditors' loss is properly reflected, for tax purposes, not in exemption of the estate from tax on its income, but in the creditors' own deductions for bad debts (or, in some circumstances, in their not being taxable in the first instance on amounts that they fail to collect). It may be asked why it would not be simpler, then, to dispense with the trouble of collecting a tax from the trustee and to make up the difference through the greater taxable recoveries or lesser deductions resulting to the creditors. The effect of the two treatments is not identical, however, as may be evidenced by an example: Suppose the bankrupt, with 250,000 dollars of assets, has a single creditor to whom he owes 500,000 dollars. During administration, the estate earns 12,000 dollars net of expenses. Under present law, as interpreted in the preceding discussion, the trustee would pay, say, 2,600 dollars of tax. The creditor recovers 259,400 dollars (250,000 dollars plus 12,000 dollars less 2,600 dollars) and claims a bad debt deduction of 240,600 dollars, which reduces his tax (assuming a forty-eight per cent rate) by 115,488 dollars. If the proposed exemption were adopted, the trustee would pay no tax, the creditor would recover 262,000 dollars (250,000 plus 12,000 dollars), the bad debt deduction would be 238,000 dollars, and the creditor's tax would be reduced by 114,240 dollars. In the former case, the creditor's loss, net of tax saving, is 125,112 dollars; in the latter, it is 123,760 dollars. The difference reflects the fact that, to the extent of the 2,600-dollar tax that the interest or other income would have

159. Bankruptcy Act §§ 268, 270, 395-96, 520, 522, 679, 11 U.S.C. §§ 668, 670, 795-96, 920, 922, 1079 (1970). See also text accompanying notes 247-59 *infra*.

160. Cf. *Allen v. Trust Co.*, 180 F.2d 527 (5th Cir.), *cert. denied*, 340 U.S. 814 (1950). See also text accompanying notes 256-59 *infra*.

borne if earned directly by either the debtor or the creditor, the government, in effect, rebates the creditor's loss rather than bearing only a fraction thereof through an augmented bad debt deduction.

If, as argued by Krause and Kapiloff, "[i]t is reasonable for the Government to absorb a share of the rehabilitation process" by forgiving the tax on current income of the estate unless all other creditors have been satisfied in full¹⁶¹—thus, in effect, placing such taxes on a priority level below general creditors—it would be at least equally reasonable to do the same with respect to unpaid taxes on income of past years. The argument expressed by one referee, that "[t]axing authorities and collectors are not responsible for a dollar's worth of goods on any bankrupt's shelves or for one single fixture in his store and every penny paid in tax priorities is at the expense of the general creditors,"¹⁶² is more appropriately addressed (and in fact was addressed) to past taxes, which are a dead weight on the estate, rather than to current taxes, which, in general, take only a share of the increment and are the price exacted for current governmental protection of the estate.¹⁶³ Yet, Congress has not heretofore been willing to forego priority over general creditors for past taxes unless the tax collector has had at least three years before bankruptcy in which to attempt to collect them,¹⁶⁴ and it is not recommended even by the Commission that such priority be relinquished if less than one year has elapsed since the tax fell due.¹⁶⁵ Even "stale" taxes are not disallowed or subordinated but stand on a parity with general creditors and thus encroach upon the latter's recovery.¹⁶⁶ Since there has, of course, been no prior opportunity to collect the tax on income earned during administration, there would seem to be even less reason for the government to yield its place to other creditors with respect to current taxes than with respect to those incurred before bankruptcy.

It has been urged that section 7507 of the Code affords a precedent for relieving the bankrupt estate from tax on income earned during administration if payment would diminish the assets neces-

161. Krause & Kapiloff, *supra* note 83, at 416.

162. *In re Raffowitz*, 43 Am. Bankr. Rep. (n.s.) 358, 361 (D. Conn. 1940) (referee opinion), *revd.*, 37 F. Supp. 202 (D. Conn. 1941).

163. See *Swarts v. Hammer*, 194 U.S. 441, 444 (1944).

164. Bankruptcy Act § 64a(4), 11 U.S.C. § 104(a)(4) (1970).

165. COMMISSION REPORT, *supra* note 3, § 4-405(a)(5)(A), to be discussed in part I(B)(2)(c) of Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Priority and Dischargeability of Tax Claims*, 59 CORNELL L. REV. — (1974).

166. *In re Autorama Tool & Die Co.*, 412 F.2d 369, 373 (6th Cir. 1969), *cert. denied*, 397 U.S. 1043 (1970).

sary for full payment of all creditors. That provision, first enacted in 1879,¹⁶⁷ in general bars the assessment or collection of tax on any insolvent bank or trust company if the result would be to diminish the assets available for full payment of depositors. If the precedent were valid at all, it would support subordination of past, as well as current, taxes to all other creditors. In fact, however, it reflects no concern for creditors generally, but only the special concern of Congress for bank depositors as a class peculiarly in need of protection.¹⁶⁸

The further argument has been advanced¹⁶⁹ that requiring trustees to prepare returns puts an unwarranted financial burden on estates and tends to defeat the prime objective of economical bankruptcy administration. Nevertheless, that consideration has not motivated Congress to relax the trustee's obligation to account to the bankruptcy court,¹⁷⁰ and it may be questioned whether any "legitimate interest would be served by permitting the trustee to escape the unburdensome [further] responsibility of merely filing the returns and thereby notifying the United States of the taxes that are due."¹⁷¹ The Commission had before it, however, unpublished statistics purporting to show that the net return to the Treasury is simply not worth the trouble and expense imposed on bankruptcy administration, since the aggregate federal taxes paid on current income of bankrupt estates, at least in the year covered by the study, is quite small and even that small recovery is offset to a significant

167. Act of March 1, 1879, ch. 125, § 22, 20 Stat. 351.

168. See Treas. Reg. § 301.7507-9(b) (1957). In some circumstances, other creditors may unavoidably benefit as well where state law places them on a parity with depositors. Treas. Reg. § 301.7507-9(b) (1957); Rev. Rul. 73-294, 1973 INT. REV. BULL. No. 27, at 17.

169. COMMISSION REPORT, *supra* note 3, pt. I, at 277-78.

170. Bankruptcy Act §§ 47a(5), (12), (13), 11 U.S.C. §§ 75(a)(5), (12), (13) (1970), now superseded by BANKR. R. 218.

171. See *Nicholas v. United States*, 384 U.S. 678, 695 (1966). It is acknowledged that the Court's reference to an "unburdensome responsibility" was directed to taxes other than the income tax, but a more suitable approach to the peculiar problems raised by income tax returns might be through tax simplification, return simplification, and expanded taxpayer assistance directed at all taxpayers including trustees, rather than through exempting one class from the burden because compliance is troublesome. The bankruptcy trustee's special problems in ascertaining the gain on property acquired from the bankrupt and in including in his return the prebankruptcy portion of the taxable year of a bankrupt corporation are dealt with in text accompanying notes 230-39, 273-95 *infra*. In a related connection, the Commission itself has discounted the alarms of two referees, quoted in *In re Freedomland, Inc.*, 341 F. Supp. 647, 650-54 (S.D.N.Y. 1972), *rev'd*, 480 F.2d 184 (2d Cir. 1973), *cert. granted*, 42 U.S.L.W. 3415 (U.S., Jan. 21, 1974) (No. 73-374), that bankruptcy administration would be unduly burdened by having to withhold taxes on wage dividends to employees and to report such withholdings. See COMMISSION REPORT, *supra* note 3, § 4-405, note 10.

extent by the fact that such tax payments and the trustee's expenses of compliance reduce the amount otherwise available for federal claims of lower priority.¹⁷² But statistical summaries, especially when confined to a single year, tend to obscure individual cases in which the escape from tax would be far in excess of the relatively nominal amounts indicated by the averages,¹⁷³ as illustrated by the \$384,484.52 in tax (covering twenty-seven years in straight bankruptcy, during which no returns were filed) that was involved in *In re Kirby*,¹⁷⁴ and the \$492,150.33 in income that was involved (for just two of the nineteen years that the estate was in straight bankruptcy) in *United States v. Metcalf*.¹⁷⁵

Unconditional exemption, therefore, may not be the most appropriate means of relieving the burden on bankruptcy administration. A large part of that burden might be relieved simply by altering the rule—although it is a rule apparently more honored in the breach than the observance¹⁷⁶—that requires trustees to file returns even when it is obvious that no tax liability will result. The law (construed as heretofore discussed) now requires the trustee for every corporate bankrupt to file an annual income tax return even when the estate has neither gross nor net income¹⁷⁷ and requires the trustee for a bankrupt individual or partnership to file if the estate has as much as 600 dollars in gross income, whether or not there is any net income.¹⁷⁸ This reflects the general unwillingness of Congress to leave it to the taxpayer, when his *gross* income exceeds the minimum *net* income on which a tax would be incurred, to determine privately, without setting out his claimed deductions in a return, that his net income is insufficient to produce a tax liability. In view of the judicial supervision of the trustee's accounts¹⁷⁹ and the fact that, as recommended by the Commission, many estates in the future may

172. To the extent that such other taxes, if owed by individuals, are not dischargeable under Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (1970), however, the depletion of the amount available for their satisfaction from the estate may not be a true measure of the ultimate offsetting loss to the government.

173. A critical analysis of the statistics is found at pages 48-51 of this writer's report on *Federal Income Tax Returns and Liabilities in Bankruptcy*, in which the Commission did not concur but which it published in part III of its Report. COMMISSION REPORT, *supra* note 3, pt. III, at 48-51.

174. 62-2 U.S. Tax. Cas. ¶ 9752 (S.D. Tex. 1962).

175. 131 F.2d 677 (9th Cir. 1942), *cert. denied*, 318 U.S. 769 (1943).

176. COMMISSION REPORT, *supra* note 3, pt. I, at 277-78.

177. INT. REV. CODE OF 1954, §§ 6012(a)(2), (b)(3); Treas. Reg. § 1.6012-2(a)(2) (1958); Treas. Reg. § 1.6012-3(b)(4), T.D. 6628, 1963-1 CUM. BULL. 272, 273.

178. INT. REV. CODE OF 1954, § 6012(a)(3); Treas. Reg. § 1.6012-3(a)(1)(i) (1959). *See* text accompanying notes 106-09 *supra*.

179. Bankruptcy Act §§ 47a, 62a(1), 11 U.S.C. §§ 75(a), 102(a)(1) (1970).

be administered by government-employed professionals,¹⁸⁰ Congress might be willing to make an exception and dispense with the filing of returns by bankruptcy trustees when there is no *net* taxable income—although, once the trustee has made the calculations necessary to negate a tax liability, it may be no more of a burden to embody the calculations in a return. A further salutary step might be to allow exemption from tax (and from return filing) on some minimum amount of otherwise taxable income, the amount to be determined by Congress pragmatically in light of the expense of the trustee's preparation of returns and the fact that some part (but not all) of the lost tax will, in any event, be made up from the creditors through reduction of their bad debt deductions, or more directly in some cases through greater recovery on lower priority tax claims.

Whatever the merits of complete exemption from return filing and tax payment when incidental income is derived in the course of liquidation, it seems more difficult to justify the Commission's proposal in so far as it relieves a trustee in straight bankruptcy from payment of tax on the regular operations of a business,¹⁸¹ which, in some instances, have been known to go on for years even without formal authorization.¹⁸² The proposal is, in this regard, a significant departure from the policy firmly established by Congress for federal income tax purposes ever since 1916;¹⁸³ that policy was strongly affirmed, with respect to state taxes, in 1934, when Congress, in enacting the predecessor of 28 U.S.C. § 960, declared: "No good reason is perceived why a receiver should be permitted to operate under such an advantage as against his competitors not in receiver-

180. Unless the creditors choose to elect a trustee, COMMISSION REPORT, *supra* note 3, § 5-101, civil service employees of the United States Bankruptcy Administration would perform the functions of the trustee in liquidating bankruptcies. *Id.* §§ 3-102(c), 4-301, 5-101(c).

181. *Id.* § 5-104(a), which exempts the trustee, does not distinguish, under *id.* § 3-303(a), which expands the investment mandate of Bankruptcy Act § 47a(2), 11 U.S.C. § 75(a)(2) (1970), between income from the mere investment of funds awaiting distribution and the income from business operations, which may be authorized by the court under BANKR. R. 216 "for such time and on such conditions as may be in the best interest of the estate and consistent with orderly liquidation thereof." The bankruptcy administrator, when acting as trustee under the proposed legislation, will be neither equipped nor authorized to operate the ongoing business of the bankrupt, COMMISSION REPORT, *supra* note 3, § 3-202, note 7, other than as an incident to winding up, *id.* § 3-202(b)(3), but the proposal contemplates that the court may, in such cases, direct the administrator to designate a receiver to operate the business. *Id.* § 4-302(a). Although the proposed tax exemption extends only to the "trustee" and not to a receiver, the latter would probably share the exemption as an agency of the trustee.

182. *E.g.*, *United States v. Metcalf*, 131 F.2d 677 (9th Cir. 1942), *cert. denied*, 318 U.S. 769 (1943).

183. See text accompanying note 26 *supra*.

ship."¹⁸⁴ In more recent provisions, which relate to businesses owned by charitable, educational, and religious organizations, Congress has further evidenced its strong concern about the unfair competitive advantage gained when a business is conducted under the shelter of an income tax exemption and is thus enabled to expand or to engage in price-cutting at the expense of others whose profit margin is eroded by taxes.¹⁸⁵ While a business that is in bankruptcy or undergoing reorganization or rehabilitation is subject to a severe economic disadvantage, the practical effect of income tax exemption is felt only when the estate has realized profits (and, in the case of a corporate bankrupt, sufficient profits to absorb loss carryovers available from the preceding five years). "No good reason is perceived" why at that point, merely on the ground that the creditors—in effect the equitable owners of the estate under administration¹⁸⁶—have not recovered their stake in the enterprise, the estate should be favored over the owners of other enterprises, which are subjected to tax on their current income whether or not their invested capital is impaired.¹⁸⁷ Therefore, any exemption (other than of a relatively nominal amount of income) that Congress may determine to provide should at least except cases where the trustee is "operating" or "conducting" a business.¹⁸⁸

The Commission, in effect, acknowledged that principle in part by not extending the proposed exemption to the operating income (as distinguished from income from sales out of the ordinary course of business¹⁸⁹) of estates in reorganization and rehabilitation pro-

184. H.R. REP. NO. 1138, 73d Cong., 2d Sess. 1 (1934); S. REP. NO. 1372, 73d Cong., 2d Sess. 1 (1934).

185. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 36 (1950); S. REP. NO. 2375, 81st Cong., 2d Sess. 28 (1950). See also U.S. TREASURY DEPT., REPORT ON PRIVATE FOUNDATIONS [TO THE SENATE COMM. ON FINANCE, 89TH CONG., 1ST SESS.] 31-42 (Comm. Print 1965), which recites numerous instances in which taxable businesses were "placed at a serious competitive disadvantage" that led Congress to tighten substantially the corrective provisions, INT. REV. CODE OF 1954, §§ 511-14, in the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. For the view that "the arguments about unfair competition [that results from tax exemption of businesses owned by charities, cooperatives, and mutuals] are based on economic theory that is at best naive and incomplete and is most likely just plain wrong," Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 61 (1972), see *id.* at 59-68. However, the premises of Professor Klein's argument rest on the peculiar nature of those entities and would not appear to be applicable where both competitors are private business corporations.

186. See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 183-84 (1942).

187. Except in the cancellation-of-indebtedness area, the existing solvency or insolvency of the taxpayer has no bearing on the taxability of income actually realized. *Home Builders Lumber Co. v. Commissioner*, 165 F.2d 1009, 1011 (5th Cir. 1948); *Parkford v. Commissioner*, 133 F.2d 249, 251 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943).

188. Cf. text accompanying notes 12, 26 *supra*.

189. See text accompanying notes 242-72 *infra*.

ceedings. It wisely ignored the recent ill-considered resolution of the National Bankruptcy Conference that, while likewise leaving such estates taxable on operating income, would have relieved the trustees of any obligation to file income tax returns.¹⁹⁰ Exemption from filing returns is supportable in circumstances in which tax is not to be imposed at all, but it seems impossible to justify abrogation of the return requirement where ordinary business operations are intended to remain taxable. It is unclear who, if anyone, would be expected, under the Conference proposal, to make formal disclosure of such operating profits. It is hardly to be supposed that the debtor, divorced from his funds, business, personnel, and books, could prepare and verify a return of the trustee's operations.¹⁹¹ It must have been contemplated by the Conference, therefore, that the Service, in order to determine whether the estate had net income subject to tax, would be required to delve directly into the books and records of the estate without the aid of a verified declaration by the fiduciary conducting the operation. A fundamental characteristic of the income tax system, however, is that the tax is "self-assessed" in the first instance and that (except in cases of unlawful failure to file returns) the starting point for an audit is the taxpayer's own declaration of his income and deductions.¹⁹²

2. Deductions Allowable to the Trustee

One referee has referred to the "myriad of unresolved questions of deductions" as one reason why Congress could never have intended to subject nonoperating bankrupt estates to the burden of filing income tax returns.¹⁹³ The proper remedy for such uncertainties, however, would seem to be, not to exempt the trustee from tax (except in the case of estates with minimal income), but to direct attention to removal of the uncertainties. Even if the Commission's

190. National Bankruptcy Conference, Summary of Proceedings, Oct. 26-28, 1972, at 5 (Resolution No. 3) [copy is on file with the *Michigan Law Review*].

191. Although the referee in *In re Town Crier Bottling Co.*, 123 F. Supp. 588, 592 (E.D. Mo. 1954), expressed the view that "the government has the legal right to compel corporate officers to file the returns," that seems an unrealistic view. See text accompanying notes 230-35 *infra*. In any event, that was a straight bankruptcy case and involved returns for periods before the proceeding.

192. *In re Statmaster Corp.*, 465 F.2d 978, 980-81 (5th Cir. 1972). See *Commissioner v. Lane-Wells Co.*, 321 U.S. 219, 223 (1944). Cf. *United States v. Harrison*, 72-2 U.S. Tax Cas. ¶ 9573 (E.D.N.Y.), *affd. per curiam*, 73-1 U.S. Tax Cas. ¶ 9295 (2d Cir. 1972), *cert. denied*, 411 U.S. 965 (1973) (holding a taxpayer criminally responsible for failure to file a return, despite his claim that the Service could have reconstructed his taxable income from a mass of data available to it).

193. *In re Statmaster Corp.*, 332 F. Supp. 1248, 1258-59 (S.D. Fla.) (referee opinion), *rev'd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *affd.*, 465 F.2d 978 (5th Cir. 1972).

exemption proposal is adopted, these ambiguities will remain a problem in those situations (reorganization, rehabilitation, and solvent straight bankruptcy cases) where tax is still to be imposed; the Commission, however, made no recommendations on this matter.¹⁹⁴

a. *Administration expenses.* The estate of a bankrupt individual or partnership, like a decedent's estate or a trust, is entitled, under section 641(b) of the Code, to the same deductions that are provided for individuals (with some differences expressly provided for).¹⁹⁵ Such deductions include "all the ordinary and necessary expenses . . . in carrying on any trade or business" (section 162(a)) and "all the ordinary and necessary expenses . . . (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax" (section 212).

The first regulation under the predecessor of section 212 was enacted in 1942 and provided:

The ordinary expenditures incurred in a receivership or bankruptcy proceeding *are not deductible*. Such expenditures include expenditures of administration incurred in the performance of the ordinary duties of a receiver or trustee in bankruptcy, as, for example, fees paid to the attorney for the petitioning creditors, fees paid to the appraisers, and disbursements which are made in connection with the proceeding and which look toward the collection of assets and their preservation pending ultimate distribution to the parties entitled thereto.¹⁹⁶

In *Trust of Bingham v. Commissioner*,¹⁹⁷ however, the Supreme Court held that expenses incurred in connection with the distribution of a trust at its termination were just as much a part of the management of the income-producing property of the trust as those directly concerned with production of the income. Thereupon, the above quoted paragraph of the regulation and others equally inconsistent with the *Bingham* rationale were stricken out and the following was substituted:

Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fidu-

194. The Commission's recommendation concerning the trustee's use of the debtor's loss carryovers is discussed in text accompanying notes 484-93 *infra*.

195. Treas. Reg. § 1.641(b), T.D. 7177, 1971-2 CUM. BULL. 5, 56.

196. Treas. Reg. 103, § 19.23(a)-15(b), T.D. 5196, 1942-2 CUM. BULL. 96, 99 (emphasis added); Treas. Reg. 111, § 29.23(a)-15(b) (1943) (emphasis added).

197. 325 U.S. 365, 372-75 (1945).

ciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under this section, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income.¹⁹⁸

In Revenue Ruling 68-48, it was declared that, where a trustee in bankruptcy of a partnership does not operate the business, the trustee may deduct under section 212 the estate's payments for compensation of the referee, the trustee, the trustee's attorneys and accountants, the bankrupt's attorney, and the attorneys for the petitioning creditors, as well as the trustee's bond premium, charges of court reporting and transcripts, and the filing costs of petitioning creditors, "*if and to the extent that, they are paid for services rendered for the production and collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax for the estate in bankruptcy.*"¹⁹⁹ The italicized qualification of the generality of the ruling, while following the language of the statute, drains the ruling of practical utility to the trustees in determining the circumstances in which the enumerated items of expenditures are deemed to be made for the purposes stated. There have been disturbing indications, in fact, that the Service has been reverting to the strict position it took in I.T. 2004,²⁰⁰ an ancient ruling the substance of which had been embodied in the 1942 regulation²⁰¹ that was repudiated in the *Bingham* decision and expunged in 1946.²⁰²

While the present regulation denies deduction of the portion of administration expenses allocable to exempt income (as section 265

198. Treas. Reg. 111, § 29.23(a)-15(b), T.D. 5513, 1946-1 CUM. BULL. 61, 61-62. Treas. Reg. § 1.212-1(i) (1957) reaches the same result.

199. 1968-1 CUM. BULL. 301, 302 (emphasis added).

200. III-1 CUM. BULL. 292 (1924). The ruling held that administrative expenses of a receiver, including fees paid to the appraiser, the attorney for the petitioning creditors, and the attorney for the receiver, unless related to the conduct of the bankrupt's business, were not deductible.

201. See text accompanying note 196 *supra*.

202. The Chief of the General Litigation Division of the Internal Revenue Chief Counsel's Office, who is responsible for bankruptcy matters and the putative father of Rev. Rul. 68-48, after expounding on the ruling in a talk to the National Conference of Referees in Bankruptcy soon after its promulgation, added cryptically, "However, limitations may exist as indicated in I.T. 2004." Feigenbaum, *supra* note 33, at 77. In addition, a very recent decision, although it involved a corporate bankrupt and hence arose under section 162 rather than section 212, viewed I.T. 2004 as viable authority. See *Narragansett Wire Co. v. Commissioner*, 74-1 U.S. Tax Cas. ¶ 9234 (1st Cir. 1974).

of the Code prescribes), neither that regulation nor any decision that has been found prescribes that the property of the estate be income-producing at all—although this prescription may be implicit from section 212, on which the regulation rests.²⁰³ Like many decedents' estates, a bankrupt estate may consist primarily or entirely of a residence, an automobile, and nonexempt personal effects, and very little of the trustee's commissions and expenses may be attributable to interest earned on time deposits, gains on sales of property, or the like, which may be the estate's only gross income. Nevertheless, every asset in the bankrupt estate, of whatever nature, is held for the purpose of sale or other realization for the benefit of creditors—for whom the trustee acts, as well as for the bankrupt²⁰⁴—with the object either of collecting the taxable income from their transactions with the bankrupt or of minimizing their bad debt losses.²⁰⁵ It is true that the bankrupt himself could not convert an asset in personal use into one held for income production merely by ceasing to use it and putting it up for sale.²⁰⁶ But the trustee for a bankrupt individual is a separate taxable entity, and the purpose of his holding must be judged independently of the manner in which the property was held by the bankrupt.²⁰⁷

The task of the trustee for a noncorporate bankrupt in determining his tax liability would be eased by declaring I.T. 2004 obsolete²⁰⁸ and by striking out the meaningless qualification italicized in the above quotation²⁰⁹ from Revenue Ruling 68-48. These actions would be supported by the present regulation, which appears to have determined unqualifiedly that the statutory requirements are inherently satisfied by expenses that are reasonable, ordinary, and necessary in connection with the performance of the duties of administration of an estate.²¹⁰ If changes in the rulings are not made, amendment of the statute may be in order.

203. Cf. *Whittemore v. United States*, 383 F.2d 824, 830 (8th Cir. 1967); *Alfred I. duPont Testamentary Trust*, [1974 Transfer Binder] P-H TAX CR. REP. ¶ 62.6.

204. *Mascot Stove Co. v. Commissioner*, 120 F.2d 153, 156 (6th Cir. 1941), *cert. denied*, 315 U.S. 802 (1942); *Imperial Assurance Co. v. Livingston*, 49 F.2d 745, 748-49 (8th Cir. 1931).

205. The minimization of a deductible loss is a purpose recognized as income-producing under INT. REV. CODE OF 1954, § 212. Treas. Reg. § 1.212-1(b) (1957).

206. *May v. Commissioner*, 299 F.2d 725 (4th Cir. 1962); *Frank A. Newcombe*, 54 T.C. 1298 (1970).

207. Cf. *Acro Mfg. Co. v. Commissioner*, 334 F.2d 40, 43 (6th Cir.), *cert. denied*, 379 U.S. 887 (1964); *Estate of Jacques Ferber*, 22 T.C. 261 (1954).

208. The program of reviewing old rulings to identify those that are no longer determinative because of changes in law, regulations, or court decisions is described in Rev. Proc. 67-6, 1967-1 CUM. BULL. 576.

209. See text accompanying note 199 *supra*.

210. See text accompanying note 198 *supra*.

The trustee for a corporate bankrupt is subject to the tax provisions applicable to corporations,²¹¹ to which section 212 of the Code, the *Bingham* decision, and the *Bingham*-inspired regulation²¹² do not apply. Therefore, such a trustee's expense deductions, apart from such items as taxes and interest, which are specially treated, must qualify under section 162 as "ordinary and necessary expenses . . . in carrying on any trade or business." The First Circuit has recently held, therefore, in a case involving a receivership that was engaged, not in "carrying on," but only in liquidating the corporate business, that the expenses of the receivership cannot be deducted.²¹³ Yet, it has long been settled that the final "ordinary and necessary" step in the carrying on of a corporate business is its liquidation and that the expenses thereof are properly deductible under section 162.²¹⁴ Since the trustee for a corporation is not a distinct taxable entity but stands in the shoes of the corporation,²¹⁵ he should have the same right to deduct liquidation expenses as the corporation would have in the absence of bankruptcy.²¹⁶

b. *Deduction for distributions to creditors.* The trustee in bankruptcy for an individual or a partnership, as we have seen, is taxed as an "estate" under section 641.²¹⁷ In general, an estate has always been treated as a conduit for tax purposes, in that it is allowed a deduction for certain distributions that are taxed to its beneficiaries.²¹⁸ With the enactment of sections 661 and 662 of the Internal Revenue Code of 1954, all distributions (with exceptions in section 663 that

211. See text accompanying notes 26-104 *supra*.

212. See text accompanying note 198 *supra*.

213. *Narragansett Wire Co. v. Commissioner*, 74-1 U.S. Tax Cas. ¶ 9234 (1st Cir. 1974), which relied on I.T. 2004, III-1 CUM. BULL. 292 (1924). See note 200 *supra*.

214. *Commissioner v. Wayne Coal Mining Co.*, 209 F.2d 152 (3d Cir. 1954); *Pacific Coast Biscuit Co.*, 32 B.T.A. 39 (1935), *acquiesced in*, 1954-1 CUM. BULL. 6. Direct expenses of sales of assets, however, would ordinarily be offset against the proceeds. See cases reviewed in *Of Course, Inc.*, 59 T.C. 146 (1972).

215. See text accompanying notes 75-104 *supra*.

216. Concerning the trustee's right to deduct expenses paid by him but incurred before bankruptcy, see text accompanying notes 226-29 *infra*.

217. See text accompanying notes 105-34 *supra*.

218. In G.C.M. 24617, 1945-1 CUM. BULL. 235, however, it was ruled that a bankrupt estate was not entitled to a deduction for distributions to creditors "because such distributions represent[ed] capital payments," which were not deductible under section 162 of the Internal Revenue Code of 1939; authority for the ruling was *Helvering v. Pardee* [sic; actual name—*Helvering v. Butterworth*], 290 U.S. 365, 370 (1933), which held that an annuity payable without regard to the availability of income was not a distribution of income within the meaning of a corresponding provision of earlier law. The *Pardee* principle, however, was totally abandoned with the enactment of sections 661 and 662 of the Internal Revenue Code of 1954. See text accompanying note 219 *infra*. The specific application of the principle that was involved in the *Pardee* case had earlier been repudiated by section 110 of the Revenue Act of 1942, ch. 619, § 110, 56 Stat. 808.

are not pertinent) were to be deductible by the estate and taxable to the beneficiaries, to the extent that the estate had distributable net income, even if the distribution came from the corpus and had no relation to the beneficiary's interest in income of the estate.²¹⁹ Nevertheless, Revenue Ruling 68-48²²⁰ rules that a bankruptcy trustee's distributions are not deductible under section 661 because that section applies only to distributions to "beneficiaries," and creditors are not deemed to be such. In support of that conclusion, the ruling cites *Thomas Lonergan Trust*,²²¹ which had so held under earlier terms of the law,²²² and section 643(c), which provides that "the term 'beneficiary' includes heir, legatee, devisee"; it notes that creditors "do not fall within this definition," even though the law further provides that the word "includes" does not "exclude other things otherwise within the meaning of the term defined."²²³ Nevertheless, while it might be argued that the only "beneficiaries" of a bankrupt estate are the creditors, they may say a silent prayer of thanksgiving that they are not so treated. The distortions reflected in *Harkness v. United States*,²²⁴ which arose from disproportionate distributions by a decedent's estate and which might be mirrored in the case of a bankrupt estate if priorities or late filing of claims caused disproportionate distributions among creditors, as well as the possibility of double taxation of income or income taxation of capital recoveries,²²⁵ are reason enough for such thanks.

A crucial unanswered question, however, is whether the estate of a bankrupt individual or partnership is entitled to deduct its payments to the bankrupt's creditors of expenses and similar obligations that accrued or had their origin before bankruptcy but that had not theretofore become deductible under the bankrupt's accounting method. Walter Feigenbaum has stated that deductions "probably would be allowed to the trustee" for distributions allocable to obligations that would have been deductible if paid by the

219. See *Harkness v. United States*, 469 F.2d 310 (Ct. Cl. 1972), *cert. denied*, 414 U.S. 820 (1973).

220. 1968-1 CUM. BULL. 301, 303.

221. 1968-1 CUM. BULL. at 303, *citing* 6 T.C. 715 (1946).

222. At that time, only distributions out of income were taxable to beneficiaries. See note 218 *supra*.

223. INT. REV. CODE OF 1954, § 7701(b).

224. 469 F.2d 310 (Ct. Cl. 1972), *cert. denied*, 414 U.S. 820 (1973). In *Harkness*, corpus distributions to the widow, out of proportion to her testamentary share in the income of the estate, caused her to be taxed on more of the estate's income than she was entitled to receive.

225. As envisioned in Krause & Kapiloff, *supra* note 83, at 410-12.

bankrupt,²²⁶ but he cites no authorities, and those that exist suggest the contrary. The above-cited rulings, which deem distributions to creditors to be nondeductible "capital payments," relate only to distributions of "the amount by which the estate's income exceeds its expenses" and fail to define what expenses may be allowable to the trustee.²²⁷ The bankrupt estate, although succeeding to the business of the individual or partnership, is, nevertheless, a distinct taxable entity,²²⁸ and analogous precedents treating as nondeductible capital expenditures (in the absence of express statutory provision for their deductibility) the payment of a predecessor's expenses by transferees, even after tax-free transactions, cast doubt on the trustee's right to deductions in this situation.²²⁹

3. Taxable Year of the Corporate Bankrupt

We have seen that, at least in the view of the Service, the taxable year during which a corporation becomes bankrupt is deemed to be one unbroken accounting period,²³⁰ so that the trustee, having assumed the responsibilities of management before the end of the period, must reconstruct—often from the disordered books and records of a failing corporation—the taxable income or loss arising before he assumed control.²³¹ Referees have expressed the view that

226. Feigenbaum, *supra* note 33, at 77. See note 202 *supra*.

227. G.C.M. 24617, 1945-1 CUM. BULL. 235, 236; Rev. Rul. 68-48, 1968-1 CUM. BULL. 301, 303.

228. See text accompanying notes 106-34 *supra*.

229. Corporate transferees in tax-free transactions were denied deductions for such expense payments in *Birmingham Business College v. Commissioner*, 276 F.2d 476, 481 (5th Cir. 1960); *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946); *Commissioner v. Breyer*, 151 F.2d 267, 272 (3d Cir. 1945); *Merchants Bank Bldg. Co. v. Helvering*, 84 F.2d 478 (8th Cir. 1936); *Falk Corp. v. Commissioner*, 60 F.2d 204 (7th Cir. 1932). Succession to such deductions is now provided in the case of certain intercorporate transfers. INT. REV. CODE OF 1954, §§ 381(c)(4), (16); Treas. Reg. §§ 1.381(c)(4)-1(a)(1)(ii), 1.381(c)(16)-1(a)(2) (1964). The estate of a decedent (to which the bankrupt estate is analogized, see text accompanying notes 106-09 *supra*) was denied deduction for the decedent's expenses paid after death in *John M. Brown*, 11 B.T.A. 1203 (1928), before such succession was expressly provided for by INT. REV. CODE OF 1954, § 691(b) (which is confined to estates of decedents).

However, it will be suggested hereafter, in connection with the calculation of the bankrupt's own tax liabilities, that it may be more appropriate to take amounts paid by the trustee, and not theretofore deductible by the bankrupt, into account in the bankrupt's own tax for the period terminating with bankruptcy, rather than to allow such deductions in computing the estate's own tax liability, if any; such action will result either in a loss carryover to be used by the estate or in the reduction of a claim for prebankruptcy tax liability. See text accompanying notes 386-441 *infra*.

230. See text accompanying notes 91-104 *supra*.

231. More often than not, of course, a loss will be discovered and the trustee may be motivated to reconstruct the figures if there were any recent profitable years against which to carry the loss back. Nevertheless, sales of assets before bankruptcy might have resulted in a taxable income.

the trustee should not be required to sign, under the penalties of perjury,²³² a return embracing a period concerning which he has no personal knowledge and that the court may instead order the corporation or "the principals of the corporation" to prepare and file a return for that period;²³³ this seems to overlook the fact that the corporate officers and accounting personnel will no longer be on the payroll, unless on that of the trustee, and that, while they may be required to give information, they can hardly be expected to undertake without compensation the task of preparing a return that, by law, is not their obligation but that of their former employer. Congress has elected to charge the trustee, as one of his duties, with the obligation to prepare the return "for such corporation,"²³⁴ and, since the trustee will have or can get possession of the books and records,²³⁵ such as they are, and will be employing the personnel who remain connected with the business, he is the only one in a position to make a return covering that period. The trustee's possible ignorance of the results of the pre-bankruptcy period is no greater than that of, for example, the administrator of a decedent's estate, and he will not be penalized if he bases an honest report on the information available to him or obtainable through the processes of the bankruptcy court.

The Commission, however, has taken the pragmatic view that there will too rarely be a tax liability resulting from operations of the last months of a corporation's plunge toward bankruptcy to warrant imposing on the trustee the administrative burden of preparing a return for that period. Therefore, in addition to relieving the trustee in a straight bankruptcy case both of filing returns and of paying tax (in most circumstances) for the period of the bankruptcy, the Commission would relieve him of filing returns for the bankrupt corporation itself for any period.²³⁶ It would, however, terminate the corporation's taxable year at the date of bankruptcy²³⁷ and thus permit the Service, if it believes the results may repay the

232. INT. REV. CODE OF 1954, §§ 6062, 6065; Treas. Reg. § 1.6065-1(a) (1960).

233. *In re Statmaster Corp.*, 332 F. Supp. 1248, 1259, 1261 (S.D. Fla.) (referee opinion), *revd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *affd.*, 465 F.2d 978 (5th Cir. 1972). *Cf. In re Town Crier Bottling Co.*, 123 F. Supp. 588, 592 (E.D. Mo. 1954).

234. INT. REV. CODE OF 1954, § 6012(b)(3).

235. BANKR. R. 108, 205, 402; Bankruptcy Act § 14c, 11 U.S.C. § 32(c) (1970); COMMISSION REPORT, *supra* note 3, §§ 4-313, -502, -505. *See* *Dier v. Banton*, 262 U.S. 147 (1923); *Ex parte Fuller*, 262 U.S. 91 (1923); *Kaufman v. Hurwitz*, 176 F.2d 210 (4th Cir. 1949).

236. COMMISSION REPORT, *supra* note 3, § 5-104(a).

237. *Id.* § 5-104(b).

effort, to audit the prebankruptcy period unaided by a return²³⁸ and to make claim for any tax it may determine.²³⁹

If the Commission's proposal to exempt the bankrupt estate from tax is not adopted, the proposed division of the taxable year of the debtor corporation, however convenient it may be for the trustee who is relieved of responsibility for the earlier period, should also be reconsidered. If the estate later enjoys taxable income against which the loss carryovers of the debtor might be offset, the division of the year of bankruptcy into two taxable periods would impose an unwarranted penalty, since each such short period is considered a "taxable year," and the normal period of five "taxable years" during which the debtor's loss carryovers may be availed of would be reduced by one year.²⁴⁰

A similar question of dividing the taxable year arises in non-corporate cases but, since that has no effect on the obligations of the trustee, it will be considered at a later point.²⁴¹

4. Gains and Losses on Sales of the Bankrupt's Property

a. *Exemption of gains and denial of losses.* The Commission, while not extending to trustees, receivers, and debtors in possession in reorganization and similar proceedings the same qualified exemption from all taxation of income that it would provide in straight bankruptcy cases, proposes that, subject to recoupment of the tax saving for the benefit of the Government if an equity is ultimately found to exist for the debtor or the shareholders, such fiduciaries and debtors be exempt from federal, state, or local tax on gains from sales of property made during the pendency of the proceeding or pursuant to the plan, other than in the ordinary course of business.²⁴² Except perhaps in a prolonged proceeding, such gains would gen-

238. Cf. text accompanying note 192 *supra*.

239. A salutary effect of the Commission's proposal to close the corporation's taxable year at bankruptcy is that it would rectify the existing rule, formulated in *Florida Natl. Bank v. United States*, 87 F.2d 896 (5th Cir. 1937), that the tax (if any is incurred) for the entire year becomes an administration expense allowable on a parity with expenses incurred by the trustee and ahead of wages and state and local taxes, even though the part attributable to prebankruptcy transactions is as much "rooted in the pre-bankruptcy past," see text accompanying note 462 *infra*, as any fourth priority tax. This effect will be discussed, along with other priority questions, in part I(B)(2)(a) of Plumb, *supra* note 165.

240. See Treas. Reg. § 1.172-4(a)(2) (1956). Cf. the illustration in Treas. Reg. § 1.381(c)(1)-1(e)(3) (1960). The tax for the full year should nevertheless be divided for priority purposes. See note 239 *supra*.

241. See text accompanying notes 319-35 *infra*.

242. COMMISSION REPORT, *supra* note 3, § 7-315(c). Losses on such sales would also be disallowed.

erally result from appreciation in value that occurred prior to the proceeding or from a low basis that reflected depreciation or depletion deductions previously taken by the debtor,²⁴³ and it is regarded as inequitable to deplete the proceeds available for satisfaction of creditors by a tax on such gains.

Although the question before the referee in *In re Statmaster Corp.*²⁴⁴ concerned only the taxability of a liquidating trustee for a corporate bankrupt on interest earned during the proceeding, the referee's extended discussion of the "dramatic change" that would result in the substantive law if the trustee were subjected to income tax at all²⁴⁵ included an expression of the rationale for exemption from tax on gains on sales:

[I]n cases of sale of tangible assets by a liquidating trustee where a capital gain would occur because of a low basis stemming from the time when the bankrupt acquired the property . . . [taxation of the gain to the trustee] is highly inequitable, inasmuch as the creditors would have incurred no such tax burden if the bankrupt had simply transferred the assets directly to them. A creditor who has supplied goods and is not paid in full for them has suffered a capital loss [and taxation of the estate's gain] could lead to the spectacle of the general creditors of the bankrupt indirectly paying a capital gains tax upon their capital loss!²⁴⁶

Actually, of course, the creditors themselves incur no tax (except in so far as their claims include previously untaxed income), whether the property is sold pursuant to a proceeding under the Bankruptcy Act or the debtor simply transfers his property directly to the creditors. Whether the imposition of tax is "inequitable" in the former circumstance—or any more "inequitable" than the general priority of tax claims over unsecured creditors—depends, therefore, on the validity of the premise that taxing the trustee causes a greater erosion of assets available to creditors than would have resulted from a direct transfer. That requires consideration of (1) whether a direct transfer by the debtor would have been taxable; (2) whether the debtor's loss carryovers, if unavailable to the trustee, would have minimized the tax, if any, payable by the debtor; and (3) whether

243. Trustees for both corporate and individual bankrupts use the same asset basis as the debtor. See text accompanying notes 273-80 *infra*. In fact, in the case of debtor relief and reorganization proceedings, whether corporate or individual, the debtor continues to be the taxpayer against whom the tax is assessed. See notes 142-46 *supra* and accompanying text.

244. 332 F. Supp. 1248, 1250-62 (S.D. Fla.) (referee opinion), *revd. on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *aff'd*, 465 F.2d 978 (5th Cir. 1972).

245. See text accompanying notes 44-55 *supra*.

246. 332 F. Supp. at 1260.

the creditors might, in effect, have enjoyed a preference over any tax payable by the debtor.

(1) As a general rule, it is well established that one who transfers property to his creditor in satisfaction of an obligation is taxable, or realizes a loss, on the difference between the value of the property and its basis, exactly as if he had sold the property and used the proceeds to pay his debt.²⁴⁷ Ordinarily, the fact that a person is insolvent and still has a negative net worth after realizing certain income does not affect the income's taxability.²⁴⁸ Logically, the taxability of the quasisale with which we are here concerned should no more be affected by the insolvency of the debtor than if the insolvent had first sold the property and then assigned the proceeds to his creditors, a transaction that was held taxable in *Home Builders Lumber Co. v. Commissioner*, where the court said, "Both the solvent and the insolvent may receive profits and be liable for the tax thereon . . . [I]t is immaterial whether or not the proceeds of the sale were sufficient to pay the indebtedness of the taxpayer in full."²⁴⁹ In one exceptional situation, the solvency of the taxpayer has a direct bearing on the taxability of income. When an indebtedness of the taxpayer is forgiven in whole or in part, he may be taxed thereon (in the absence of an applicable exemption) on the ground that he has "improved his net worth,"²⁵⁰ and, if he repurchases a bond or other obligation for less than he had received upon its issuance, he is taxed because the transaction "made available . . . assets previously offset by the obligation . . . now extinct."²⁵¹ But if the taxpayer is insolvent after, as well as before, such transaction, there is no improvement in net worth, and no net assets are freed from the claims of creditors, so the justification for taxability is deemed not to exist. Whatever advantage the taxpayer may have enjoyed, by the initial receipt of funds, property, or services for which he need no longer pay, has already vanished with his insolvency.²⁵² To the extent, however, that actual, existing property

247. *United States v. Davis*, 370 U.S. 65 (1962); *United States v. General Shoe Corp.*, 282 F.2d 9, 12 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961); *Lutz & Schramm Co.*, 1 T.C. 682, 688-89 (1943); *Carlisle Packing Co.*, 29 B.T.A. 514 (1933).

248. *Parkford v. Commissioner*, 133 F.2d 249, 251 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943) (compensation taxed to earner although collected by his trustee in bankruptcy).

249. 165 F.2d 1009, 1011 (5th Cir. 1948).

250. *Commissioner v. Jacobson*, 336 U.S. 28, 38 (1949).

251. *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931).

252. See *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934); *Commissioner v. Simmons Gin Co.*, 43 F.2d 327 (10th Cir. 1930); Rev. Rul. 58-600, 1958-2 CUM. BULL. 29.

values—not vanished values—are applied toward the debt, no forgiveness or cancellation of indebtedness is involved, and the insolvency of the debtor should be irrelevant to taxability of the resulting gain.²⁵³ In *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*,²⁵⁴ the insolvent taxpayer had transferred property to its creditor in return for cancellation of indebtedness. The taxpayer had conceded in the trial court²⁵⁵ that it was taxable on the difference between its basis and the actual fair market value of the property applied in satisfaction of its debt, and it was only the excess of the indebtedness over such value (which was forgiven, not satisfied) that was held nontaxable because of the taxpayer's insolvency. On the other hand, in *Main Properties, Inc.*,²⁵⁶ in which the Commissioner acquiesced,²⁵⁷ the insolvent taxpayer was not taxed on any gain on its transfer of a building and leaseholds, with a value of \$260,256.72 and a basis of \$212,182.02, in return for the cancellation of \$600,000 in bonds. Under the foregoing reasoning, there should have been a taxable gain of \$48,074.70, and the Court's failure to tax any gain might be deemed a rejection of such analysis. But the Court's attention was fixed on the Commissioner's claim that the entire excess of the \$600,000 debt over the basis of the property was taxable, and the Court did not address itself to the possibility that a lesser amount might be taxed on a different theory. Therefore, neither the decision nor the Commissioner's acquiescence therein can be regarded as authority that the insolvency rule would exempt from tax the actual appreciation in value of property applied by the debtor himself in satisfaction of his debts, or as supporting the argument that the trustee should, accordingly, also be exempted.²⁵⁸ "Questions which merely lurk in the record, neither brought to the

253. Cf. *J.K. McAlpine Land & Dev. Co.*, 43 B.T.A. 520, 526-27 (1941), *affd. on other issues*, 126 F.2d 163 (9th Cir. 1942).

254. 70 F.2d 95 (5th Cir. 1934).

255. 27 B.T.A. 651, 656 (1933).

256. 4 T.C. 364, 383 (1944).

257. 1945 CUM. BULL. 5.

258. Although *Texas Gas Distrib. Co.*, 3 T.C. 57 (1944), has also been cited on this question, it is not authority thereon. That taxpayer conveyed its assets, subject to a \$400,000 lien, for \$14,610 in cash (concededly taxable) and the assumption of other liabilities of \$108,649. Since the aggregate of the cash and liabilities exceeded the taxpayer's cost of \$455,155.82 by \$68,103.18, the Commissioner sought to tax that amount as gain. The Tax Court held the taxpayer nontaxable on its relief from indebtedness that exceeded the value of its assets. However, since the court also found such value to be only \$235,000, which was less than the taxpayer's cost, the question whether insolvency would have relieved it from tax if the value had been as great as the Commissioner contended was not resolved.

attention of the court nor ruled upon, are not to be considered as having been so decided as to constitute precedents."²⁵⁹

(2) Krause and Kapiloff, on whom the *Statmaster* referee relied in asserting inequity to creditors,²⁶⁰ actually made no claim that the debtor would not have been taxable if he had transferred appreciated assets to creditors. Rather, they pointed out that, if the bankrupt is an individual or a partnership (rather than a corporation, as in *Statmaster*, where their argument was misapplied), the trustee's tax may be greater than the debtor's would have been because of the unavailability to the trustee of the debtor's loss carryovers,²⁶¹ a deficiency in the law that is more appropriately dealt with by making such carryovers available to the trustee than by wholly exempting the gain.²⁶²

(3) A further, but generally unspoken, practical difference is that, if the debtor, without making provision for payment of tax on the gain, had simply transferred *all* his nonexempt property to his creditors, the tax he incurred on the resulting gain would have gone unsatisfied, and the creditors would have received correspondingly more than they receive in bankruptcy. That difference, however, reflects only the unpleasant fact of life that the occurrence of bankruptcy precludes preferences and requires that the debtor's obligations be satisfied in the prescribed order of priority;²⁶³ while the creditors might have escaped with their preference if events had taken a different course,²⁶⁴ they can hardly complain of inequity when bankruptcy forestalls them.

259. *Webster v. Fall*, 266 U.S. 507, 511 (1925).

260. 332 F. Supp. at 1260, citing Krause & Kapiloff, *supra* note 83, at 417-18.

261. "While the debtor would not have to pay the tax *because he could use his business losses to offset the income*, the bankrupt estate [of an individual] 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." Krause & Kapiloff, *supra* note 83, at 417-18 (emphasis added).

262. See text accompanying notes 484-93 *infra*. Although Krause & Kapiloff, on broader grounds, urged total exemption of the trustee from tax, their alternative, if full exemption were denied, was, not to exempt the gain on the sale as such, but to allow the trustee "all of the tax benefits to be derived from a debtor's pre-bankruptcy history of operating losses." Krause & Kapiloff, *supra* note 83, at 418. Actually, even where the debtor is an individual, in the rehabilitation cases with which we are here concerned the estate is not considered a taxable entity separate from the debtor, see text accompanying notes 142-46 *supra*, and the inequity envisioned by those authors would not arise.

263. See, e.g., Bankruptcy Act §§ 60, 64, 11 U.S.C. §§ 96, 104 (1970). Cf. *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941).

264. See, e.g., *Hartman v. Lauchli*, 238 F.2d 881, 886-88 (8th Cir. 1956), *cert. denied*, 353 U.S. 965 (1957).

The unsoundness of the proposal is underscored by the fact that there is complete continuity for tax purposes between the debtor, the estate, and the corporation (if any) that is "organized or made use of for effectuating a plan." The trustee (or debtor in possession) stands in the tax shoes of the debtor, whether corporate or individual, and the law expressly directs that all taxes that become owing during administration shall be assessed against and paid by the debtor or the successor.²⁶⁵ Both the estate²⁶⁶ and the successor corporation²⁶⁷ have the same asset basis as the debtor, the premise being that the creditors step into the shoes of the shareholders in the ownership of the reorganized or rehabilitated corporation.²⁶⁸ The anomalous result of the proposal would be that, if the debtor sold assets out of the ordinary course of business before the proceeding began, or if the creditor-controlled successor (or continuing corporation) sold the same assets under like circumstances after consummation of the plan, a taxable gain, measured by the debtor's original basis (adjusted for depreciation, etc.), would be realized, but the identical gain would be tax-free if the sale were made by the estate, standing in the shoes of the debtor, in the interval between the petition and the consummation. The effect would be to place a premium on maximum liquidation of assets in a proceeding designed, not for liquidation, but for rehabilitation of the business.

Moreover, there is no conflict between the taxation of these gains realized during administration and the policy declared in

265. Bankruptcy Act §§ 271, 397, 523, 11 U.S.C. §§ 671, 797, 923 (1970). COMMISSION REPORT, *supra* note 3, § 7-315(e), is in accord. In corporate cases, this reaffirms the tax identity established by INT. REV. CODE OF 1954, § 6012(b)(3). See text accompanying notes 75-104 *supra*. In individual rehabilitations, unlike liquidating bankruptcies where the debtor is severed from his properties and obligations and goes his separate way, tax identity is established by sections 397 and 523 of the Bankruptcy Act, 11 U.S.C. §§ 797, 923 (1970). See text accompanying notes 142-46 *supra*.

266. See text accompanying notes 273-80 *infra*. Cf. *United States v. Sampsell*, 266 F.2d 631, 635 (9th Cir. 1959).

267. INT. REV. CODE OF 1954, §§ 372(a), 374(b). Those provisions relate to a corporate or railroad reorganization under the Bankruptcy Act, as well as under a receivership, foreclosure, or "similar proceeding," but probably do not embrace a chapter XI proceeding in which a successor corporation is utilized. See Tillinghast & Gardner, *Acquisitive Reorganizations and Chapter X and XI of the Bankruptcy Act*, 26 TAX L. REV. 663, 688-89 (1971); *Practical Techniques for Handling Tax Problems in Bankruptcy: A Panel Discussion*, N.Y.U. 27TH INST. ON FED. TAX. 1115, 1129-30 (1969). In some chapter XI and XII cases, however, the general provision for inheritance of basis, INT. REV. CODE OF 1954, § 362, would be satisfied when a corporation succeeds to the property of a corporate or individual debtor. The Commission would bring all forms of reorganization and rehabilitation proceedings in bankruptcy under the basis provisions of INT. REV. CODE OF 1954, § 372, but with an adjustment for certain reductions of indebtedness. See note 270 *infra*.

268. Treas. Reg. § 1.371-1(a)(4) (1955). Cf. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 183-84 (1942).

sections 268, 395, and 520 of the Bankruptcy Act,²⁶⁹ by which no taxable income or gain results from the modification or cancellation of indebtedness pursuant to a Chapter X plan or a Chapter XI or Chapter XII arrangement. The rationale on which such relief from tax may be supported is that, in the typical case, the equitable ownership of the business has passed to the creditors and it would truly be making them "pay a tax on their loss" if the business were saddled with a tax on income measured by what the creditors *gave up*—values that have either disappeared or been contributed to the corporation by the creditor-owners themselves.²⁷⁰ On the other hand, when the trustee in a reorganization or similar case sells assets for more than their basis, the gain reflects, not values that no longer exist or values contributed to capital by the creditors, but an increment in the value of the assets of the debtor, an increment that is thereby made available either for satisfaction of the debtor's obligations or for other purposes.

The argument that the depletion of the sum available to creditors through the imposition of a tax on the estate's realization of accumulated appreciation requires the creditors to "pay a tax on their loss" is essentially the same contention that is advanced for complete exemption of the insolvent liquidating estate from income tax, and the answer is the same. There is no inequity in first charging the realized appreciation with the "price" exacted from all citizens for the protection afforded by government,²⁷¹ *provided* that the erosion of the value available for creditors is the same whether the sale or application of the property on debts occurs before, during, after, or in the absence of the proceeding in bankruptcy. That condition is met in the case of reorganization and debtor relief proceedings, individual or corporate, as well as in corporate liquidating bank-

269. 11 U.S.C. §§ 668, 795, 920 (1970).

270. Where the indebtedness reduced was not owed to a creditor who acquires an equity, the tax on the debtor is (with some exceptions) merely postponed through an adjustment to the basis of property for future gain or loss or depreciation, Bankruptcy Act §§ 270, 396, 522, 11 U.S.C. §§ 670, 796, 922 (1970), and the Commission would confirm that treatment and make it more uniform. COMMISSION REPORT, *supra* note 3, §§ 7-315(d), 9-101; *id.* at 296 (proposed amendment to INT. REV. CODE OF 1954, § 372(a)). But such basis adjustment is and would continue to be inapplicable where an equity security is substituted for the debt. This important distinction will be explored in depth in Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Reorganizations, Carryovers, and the Effects of Debt Reduction*, 29 TAX L. REV. — (1974).

271. See text accompanying notes 149-68 *supra*. However, for reasons discussed in the text accompanying notes 442-51 *infra*, it would be more appropriate to recognize the gain (or loss) in computing the tax of the debtor (allowable as a claim against the estate) than the tax of the estate.

ruptcies. It is not met in the case of noncorporate liquidating bankruptcies, but the remedy for the inequity in those cases is not tax exemption, but allowance to the trustee of the benefit of the bankrupt's carryovers.²⁷²

b. *Treatment of gain or loss if not exempted.* If, as here recommended, exemption of gains on sales of assets in reorganization and debtor relief proceedings is not to be provided for, and if the bankrupt estate in other situations is not to be exempted from tax, certain other matters should be considered.

(1) *Proof of asset basis.* One of the difficulties confronted by trustees in bankruptcy in filing returns is the establishment of the basis of property of the estate. As a general rule, the estate's basis is the same as that of the bankrupt or the debtor. In the case of a corporate bankruptcy, or any debtor relief or reorganization proceeding, this follows from the premise that the trustee stands in the tax shoes of the bankrupt or the debtor, without change in the taxable entity.²⁷³ But the same conclusion has been reached in the case of individual and partnership bankruptcies, despite the fact that the trustee is there regarded as a taxable entity distinct from the bankrupt.²⁷⁴

Although the courts have been singularly remiss in discussing, or even identifying, the statutory foundation for so holding in noncorporate cases, the Service, in Revenue Ruling 68-48,²⁷⁵ relied on section 1012 of the Code, which prescribes that the basis of property shall be its cost, unless otherwise provided. But the "cost" of property is not ordinarily considered to be what was paid by *someone else*, a distinct taxable entity.²⁷⁶ On the contrary, before express provisions of law made applicable a basis other than cost, the "cost" to one who acquired property by gift or to a corporation that succeeded to the property of another corporation with the same shareholders was held to be, not the *transferor's* cost, but the fair market value at the time the taxpayer acquired the property.²⁷⁷ Rather, the applicable provision appears to be section 1015(b), which prescribes that

272. See text accompanying notes 484-93 *infra*.

273. See *United States v. Sampson*, 266 F.2d 631, 635 (9th Cir. 1959). See text accompanying notes 75-104, 142-46 *supra*.

274. *In re Loehr*, 98 F. Supp. 402 (E.D. Wis. 1950); *Homer A. Martin, Jr.*, 56 T.C. 1294, 1299 (1971); *Norris Bloomfield*, 52 T.C. 745, 750 (1969), *motion denied*, 54 T.C. 554, 556 (1970); Rev. Rul. 68-48, 1968-1 CUM. BULL. 301, 303. See text accompanying notes 105-34 *supra*.

275. 1968-1 CUM. BULL. 301.

276. See *Hartley v. Commissioner*, 295 U.S. 216, 219 (1935).

277. Treas. Reg. 45, art. 1562 (1919) (gift); *Maltine Co.*, 5 T.C. 1265, 1271-72 (1945) (reincorporation).

the basis of property "acquired . . . by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) . . . shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer," although a technical objection to its application might be made on the ground that the bankrupt estate, for other tax purposes, has been viewed, not as a trust, but as an estate.²⁷⁸ Since it has been held that a bankrupt realizes no gain or loss upon the transfer of his property to the trustee in connection with the discharge of his debts,²⁷⁹ the trustee inherits the bankrupt's basis without adjustment, and it is the estate, not the bankrupt, that realizes, on subsequent sales by the trustee, the taxable gain or deductible loss that was inherent in the bankrupt's property.²⁸⁰

The possibility exists that the information on basis may be unobtainable by the trustee, or obtainable only at excessive cost, particularly if the bankrupt's records have been poorly maintained. The problem parallels that of the donee of property, who is required to use as his basis the basis of the property in the hands of the donor or of the last preceding owner by whom it was not acquired by gift (or, in the case of a loss, the lesser of such amount or the value at the date of the gift).²⁸¹ The law provides that, if the facts concerning such previous owner's basis are unknown to the donee, the Service shall itself, if possible, obtain the facts from the previous owner or any other person; if that is impossible, the basis is to be the fair market value as found by the Service as of the approximate time when such previous owner acquired the property, according to the best information the Service is able to obtain.²⁸² That provision in effect places the burden of investigating the facts upon the Service, which has inquisitorial powers,²⁸³ as well as access to past returns in which such basis may have been pertinent, although the Service might still try to disallow any basis if it is unable to find the necessary evidence.²⁸⁴ The situation of the trustee (whether treated as a separate taxpayer or as acting for a bankrupt corporation or debtor in a re-

278. See text accompanying notes 106-34 *supra*.

279. *Homer A. Martin, Jr.*, 56 T.C. 1294, 1299 (1971).

280. *Schilder v. United States*, 71-2 U.S. Tax Cas. ¶ 9595 (N.D. Cal. 1971); *Norris Bloomfield*, 52 T.C. 745, 750 (1969).

281. INT. REV. CODE OF 1954, § 1015(a).

282. INT. REV. CODE OF 1954, § 1015(a).

283. INT. REV. CODE OF 1954, §§ 7402, 7602-05; *Donaldson v. United States*, 400 U.S. 517 (1971).

284. See, e.g., *James E. Caldwell & Co.*, 24 T.C. 597, 613, 621 (1955), *revd.*, 234 F.2d 660 (6th Cir. 1956).

organization or similar proceeding) is comparable to that of the donee, in the sense that the information needed to determine the basis may be in the possession of others. But the trustee's position differs from that of the donee in that, through the Bankruptcy Act²⁸⁵ and Rules,²⁸⁶ the trustee may avail himself of inquisitorial powers comparable to those available to the Service²⁸⁷ and, as statutory successor to the bankrupt, may demand access to the Service's files of the bankrupt's past returns.²⁸⁸ Therefore, any proposal to impose on the Service the burden of ascertaining basis, as is done under section 1015(a), must be based not on need, but on economy of bankruptcy administration. In any event, it does not appear that the possibility of difficulty of proof in some cases in itself affords any justification for exempting the gains from tax when a gain is found to have been realized.

(2) *Character of the gain or loss.* The Revenue Service, in Revenue Ruling 68-48, has taken the following position:

The tax treatment of the gain or loss on the sale or exchange of each asset depends upon the nature of the asset in the hands of the bankrupt. For example, if the bankrupt held certain assets for sale to customers in the ordinary course of business, the sale of these assets by the trustee would give rise to ordinary income or loss. Conversely, the sale of assets which were capital assets in the bankrupt's hands would generate capital gain or loss income when sold by the trustee in bankruptcy.²⁸⁹

That principle is sound enough in the case of a corporate bankrupt (which was not involved in the ruling), and it would be sound as applied to individual bankrupts if, as hereafter proposed,²⁹⁰ the gain or loss were treated as if realized by the individual. In general, the fact that a sale is made in liquidation does not convert property to a capital asset when it has been theretofore held for sale to customers, with no interim period of holding for some other purpose.²⁹¹ Nor, conversely, does the fact that property, formerly held for investment or for use in business, is sold in the course of orderly liquidation convert such property into an ordinary income asset held for

285. Bankruptcy Act § 14c, 11 U.S.C. § 32(c) (1970).

286. BANKR. R. 205; COMMISSION REPORT, *supra* note 3, § 4-310.

287. See text accompanying notes 230-35 *supra*.

288. Treas. Reg. §§ 301.6103(a)-1(c)(1)(ii)(d), (iii)(d), (iv)(d), (vii)(d) (1961).

289. 1968-1 CUM. BULL. 301, 302-03.

290. See text accompanying note 417 *infra*.

291. E.g., *Estate of Freeland v. Commissioner*, 393 F.2d 573, 583-84 (9th Cir.), *cert. denied*, 393 U.S. 845 (1968); *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963); *Donald J. Lawrie*, 36 T.C. 1117 (1961).

sale to customers.²⁹² However, when a sale is made by a trustee for a noncorporate bankrupt, which is a distinct taxpayer, analogous precedents determine the character of the asset exclusively by the activities of the seller with respect thereto, without regard to how it was held by the previous owner. In *Estate of Jacques Ferber*,²⁹³ an executor who was liquidating a decedent's stock of goods was deemed not to be holding them for sale to customers, even though the decedent had so held them and could not himself have changed their character by making a bulk sale. Similarly, the character of assets received in liquidation of a corporation is judged exclusively by the recipient's use of them,²⁹⁴ even when the recipient succeeds to the corporation's asset basis.²⁹⁵

If the proposal to exempt gains realized by the estate is not adopted, it may be desirable to confirm by legislation the result indicated by Revenue Ruling 68-48, which makes more sense than the rule of the cases last described.

(3) *Priority status.* To the extent that gains on sales made during a proceeding under the Bankruptcy Act are taxable, either generally, as here recommended, or limited to sales in the ordinary course of business, consideration should be given to the impropriety of according top priority, as an expense of administration, to taxes attributable to the realization by the estate of appreciation in value arising before the proceeding commenced.²⁹⁶

5. *Personal Holding Company Tax*

The federal tax law imposes a special tax at a prohibitive seventy per cent rate on the undistributed income of a personal holding company (which, in brief, is a closely held corporation with predominantly passive investment income).²⁹⁷ The object is to force such companies to distribute their income to shareholders so that the income will be subjected to individual tax rates and will not enjoy the shelter of the generally lower corporate rates. In a recent case,²⁹⁸ the Service attempted to impose the personal holding company tax

292. *Heller Trust v. Commissioner*, 382 F.2d 675 (9th Cir. 1967).

293. 22 T.C. 261 (1954).

294. *E.g.*, *Greenspon v. Commissioner*, 229 F.2d 947 (8th Cir. 1956); *C. Frederick Frick*, 31 CCH Tax Ct. Mem. 286 (1972). *But cf.* *Heller Trust v. Commissioner*, 382 F.2d 675 (9th Cir. 1967).

295. *Acro Mfg. Co. v. Commissioner*, 334 F.2d 40, 43 (6th Cir.), *cert. denied*, 379 U.S. 887 (1964).

296. *See* note 239 *supra*.

297. INT. REV. CODE OF 1954, §§ 541-47.

298. *In re I.J. Knight Realty Corp.*, 366 F. Supp. 450 (E.D. Pa. 1973).

on a corporation in bankruptcy, which had primarily interest income, but the court concluded, in reliance on the referee's opinion in *Statmaster*,²⁹⁹ that the estate was not taxable at all; thus, it did not reach the question whether, if taxable, a bankrupt estate could be a personal holding company.³⁰⁰ If, as here urged, the bankrupt estate is subjected to income tax, the law should make clear that the personal holding tax, the purpose of which is wholly foreign to the bankruptcy situation, is not to be imposed.

II. INCOME TAX LIABILITIES OF THE DEBTOR

The Commission recommends that bankruptcy not be regarded as involving a premature disposition of the bankrupt's property, causing him to incur the burden of "recapture" of investment credits previously allowed to him.³⁰¹ The Commission further proposes that the tax liability, if any, of an individual bankrupt, computed to the date of bankruptcy, be made allowable as a claim against the estate, rather than leaving the full year's tax as an obligation collectible only from his exempt and after-acquired property;³⁰² it stops short of the full relief that could result from lumping into that allowable amount the tax attributable to sums earned by the bankrupt before the petition and collected thereafter by the estate (although taxed to the earner as postbankruptcy income) and from reducing such tax by allowing deductions for expenses incurred by him and satisfied by the trustee from his assets and declines to treat the occurrence of bankruptcy as the event at which gain or loss on the assets dedicated to the bankrupt's debts is realized.³⁰³

A. *Investment Credit Recapture*

In order to stimulate investment in tangible personal property for productive use in business, the federal tax law allows an "investment credit," to be applied in reduction of income tax otherwise payable, in an amount generally (omitting many refinements) equal to seven per cent of the qualified investment in such property.³⁰⁴ To prevent excessive benefit being derived from credits based on purchases of assets expected to be replaced within a short time, the law

299. 366 F. Supp. at 459-60, citing 332 F. Supp. at 1250-62. See text accompanying notes 44-74 *supra*.

300. See 366 F. Supp. at 460 n.25.

301. COMMISSION REPORT, *supra* note 3, at 293 (proposed INT. REV. CODE OF 1954, § 47(d)).

302. COMMISSION REPORT, *supra* note 3, § 5-104(b).

303. See text accompanying notes 336-451 *infra*.

304. INT. REV. CODE OF 1954, §§ 38, 46-50.

allows no credit if the expected useful life of the property to the taxpayer is under three years and bases the credits on graduated percentages of the investment if the useful life is three to seven years.³⁰⁵ Since the life estimated at the outset may differ from the facts as they actually develop, provision is made for the "recapture" of excessive investment credits previously allowed if the property is disposed of prematurely, other than by reason of death or of certain tax-free intercorporate transfers or by reason of "a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as [qualified] property and the taxpayer retains a substantial interest in such trade or business."³⁰⁶

Since the trustee for an individual bankrupt, unlike the trustee for a corporation, is considered an entity distinct from the debtor for tax purposes,³⁰⁷ and since the debtor is considered to have retained no "substantial interest" in the business in the hands of the estate, bankruptcy becomes the occasion for imposing on the distressed debtor an obligation to disgorge tax benefits enjoyed by him in palmier days.³⁰⁸ Although imposed as an "increase" in the income tax for the year of such disposition, it is payable even if the return for that period shows a substantial loss.³⁰⁹ And since that period, under present law, is unbroken at bankruptcy, the tax for the year is deemed a postbankruptcy obligation burdening the debtor's exempt and after-acquired property.³¹⁰ The Commission would afford relief from that burden on the individual, consistently with the general principle of not taxing him on his relief from debts that he is unable to pay,³¹¹ by amending the Internal Revenue Code to make clear that the transfer of title to a trustee in bankruptcy is not, in itself, to be deemed a disposition of the property causing recapture of investment credits.³¹² While the trustee's own

305. INT. REV. CODE OF 1954, §§ 46(c)(2), 48(a).

306. INT. REV. CODE OF 1954, § 47.

307. See text accompanying notes 75-113 *supra*.

308. Henry C. Mueller, 60 T.C. 36, 46-47 (1973).

309. INT. REV. CODE OF 1954, § 47(a)(1); Treas. Reg. § 1.47-1(b)(1) (1967).

310. See text accompanying notes 319-35 *infra*. In contrast, in the case of a corporate bankrupt, there is no "disposition" unless and until the trustee liquidates the property, and the resulting liability then falls on the estate. See text accompanying notes 75-104 *supra*.

311. Treas. Reg. § 1.61-12(b) (1957).

312. COMMISSION REPORT, *supra* note 3, at 293 (proposed INT. REV. CODE OF 1954, § 47(d)). Using the reasoning employed by the Tax Court in Henry C. Mueller, 60 T.C. 36, 46-47 (1973), one could conclude that bankruptcy of an individual would cause deferred gains on installment sales previously made by him to become taxable under

subsequent sale of the property would be such a disposition, the proposal to relieve the trustee of all income taxes in liquidation cases³¹³ would preclude recapture of the credit from the estate.

Recapture of investment credits may also result, *as if* the property had been partially disposed of, when "the basis (or cost) of [qualified] property is reduced, for example, as a result of a refund of part of the cost of the property" ³¹⁴ A further provision of the Commission's proposed amendment would preclude misapplication of that principle to cause recapture of investment credits when the basis of property is reduced, not as a result of renegotiation of the price, but merely as a convenient device adopted by Congress to postpone the liability for tax on income otherwise resulting from an adjustment of indebtedness,³¹⁵ whether in Bankruptcy Act cases or otherwise.³¹⁶ Since the freedom of debtors in straight bankruptcy from tax on their relief from indebtedness³¹⁷ is not conditioned upon reduction of the basis of any property,³¹⁸ this phase of the proposal would not affect tax liabilities of the bankrupt in such cases.

B. *Allocating Income, Deductions, and Tax Liability Before and After Bankruptcy*

1. *Closing the Individual's Taxable Year at Bankruptcy*

The taxable period of an individual bankrupt, like that of a corporation,³¹⁹ continues without interruption at the date of bank-

section 453(d)(1) of the Code when the obligation is "disposed of" to the trustee. Although the Commission does not deal directly with this matter, the inequity would be relieved by its general proposal to cut off the debtor's taxable year at bankruptcy for the purpose of making the tax computed to that date allowable as a claim against the estate rather than a postbankruptcy obligation of the debtor. *See* text accompanying notes 319-35 *infra*.

313. *See* text accompanying notes 147-92 *supra*.

314. Treas. Reg. § 1.47-2(c)(1) (1967).

315. *See* Commissioner v. Jacobson, 336 U.S. 28, 39, 45-56 (1949).

316. The Service has ruled that recapture of investment credits occurs in a non-bankruptcy situation where basis is electively reduced under section 1017 of the Code as an alternative to immediate taxability of income derived by a debtor from repurchase of his bonds below face. Rev. Rul. 1974-17, 1974 INT. REV. BULL. No. 17, at 6. But the same principle might be applied where basis is adjusted to reflect debt reductions under the reorganization and rehabilitation provisions of the Bankruptcy Act—§§ 270, 396, 522, 11 U.S.C. §§ 670, 796, 922 (1970). *See* Tillinghast & Gardner, *supra* note 267, at 701.

317. Treas. Reg. § 1.61-12(b) (1957).

318. INT. REV. CODE OF 1954, § 1017, reduces basis only where the debt adjustment would otherwise have been taxable. Retail Properties, Inc., 23 CCH Tax Ct. Mem. 1463, 1474-75 (1964).

319. *See* text accompanying notes 75-104 *supra*.

ruptcy.³²⁰ But, in the case of an individual, it is not the trustee but the individual himself who files a return for the unbroken taxable year,³²¹ while the trustee (under existing law) files independently for the estate to reflect its transactions during the period of administration.³²² Although it is generally assumed that the bankrupt will have a loss for the immediate prebankruptcy period, it is entirely possible that he will have a net taxable income. His misfortune may have resulted from extravagance in personal, non-deductible expenditures; he may have sold property for more than its depreciated cost; or, being on the cash basis of accounting, he may have had taxable receipts in excess of the business expenses he was in a position to pay³²³—and he gets no credit for their subsequent payment by the trustee out of his assets³²⁴ or for the losses the trustee may sustain on the sale thereof.³²⁵ Since his tax liability is not determinable until the end of the year, it has been held³²⁶ that no part of the tax for the year in which bankruptcy occurs can be collected from the estate as a tax “legally due and owing” at bankruptcy and that, even though the benefits of prebankruptcy transactions that gave rise to the tax liability may have passed to the trustee, the tax is collectible, if at all, only from the bankrupt’s

320. *Homer A. Martin*, 56 T.C. 1294, 1298 (1971); *Norris Bloomfield*, 52 T.C. 745, 749 n.5 (1969).

321. Rev. Rul. 72-387, 1972-2 Cum. BULL. 632.

322. See text accompanying notes 106-34 *supra*.

323. Such was the situation in *Henry C. Mueller*, 60 T.C. 36, 43 (1973), where a prebankruptcy taxable income of 60,000 dollars resulted from the debtor’s inability to pay and qualify for deduction of expense obligations that were in a greater amount. See text accompanying notes 400-21 *infra*. Cf. *F.R. Humpage*, 17 T.C. 1625, 1631-32, 1640 (1952), in which a corporation, although rendered insolvent by its guaranty of its subsidiary’s bonds that it was unable to meet (and hence could not deduct), nevertheless had over 2 million dollars surplus in its earnings and profits account for tax purposes.

324. Cf. *Henry C. Mueller*, 60 T.C. 36, 43 (1973).

325. *Schilder v. United States*, 71-2 U.S. Tax Cas. ¶ 9595 (N.D. Cal. 1971); *Norris Bloomfield*, 52 T.C. 745 (1969).

326. *In re Cooney*, 35 Am. Bankr. R. (n.s.) 247 (N.D.N.Y. 1938) (referee opinion). See *Frances M. Parkford*, 45 B.T.A. 461, 466 (1941), *aff’d.*, 133 F.2d 249 (9th Cir. 1943). Cf. *In re International Match Co.*, 79 F.2d 203 (2d Cir. 1935). The referee in the *Cooney* case adverted to the fact that no attempt had been made by the Commissioner to terminate the individual’s taxable year at the date of bankruptcy under the predecessor of section 6851 of the Code, which permits such action in order to enable immediate assessment and collection when the taxpayer “designs . . . to do any . . . act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the income tax for the current . . . taxable year unless such proceedings be brought without delay.” The inference that the result of the *Cooney* case would have been altered if that had occurred, however, seems unfounded. The termination of the taxable year is merely a provisional remedy, and the tax is to be redetermined and adjusted on the basis of the full taxable year after completion of such period, *Irving v. Gray*, 479 F.2d 20 (2d Cir. 1973); *Ludwig Littauer & Co.*, 37 B.T.A. 840 (1938); hence, the liability for the year would still be a postbankruptcy obligation.

exempt and after-acquired property.³²⁷ That effect might be avoided if the courts were to give a broad construction to the words "debts" and "claims,"³²⁸ unencumbered by the concept of "legally due and owing," which appears only in the provision³²⁹ that establishes priority, not in the provisions with regard to provability and allowability.³³⁰ The part of the bankrupt's income tax attributable to the prebankruptcy portion of the year should be viewed as a contingent claim against the estate, readily determinable when the taxable year ends a few months after the filing of the petition and, hence, provable and allowable under sections 57d and 63a(8) of the Bankruptcy Act.³³¹ At the date of bankruptcy, the inchoate tax liability, while subject to modification by events later in the year, exists as a claim against the bankrupt as surely as the inchoate right to a carryback refund (when a loss was sustained in that period) existed as an asset of the bankrupt in *Segal v. Rochelle*,³³² and it is as surely "rooted in the prebankruptcy past." It is doubtful, however, that this equitable result can be assured without legislation.

The Commission proposes, therefore, that the taxable year of an individual bankrupt be tentatively closed at the date of filing, solely for the purpose of making the income tax, computed to that date, an allowable claim against the estate.³³³ If the actual tax for the full taxable year proves to be greater, the excess would be a postbankruptcy obligation of the debtor, neither collectible from the estate nor dischargeable; if less, only the actual tax liability would be allowed against the estate.³³⁴ Since the taxable period would

327. In contrast, a corporate tax for the year in which bankruptcy occurs not only is collectible from the estate but also ranks as an administration expense and thus raises an entirely different set of problems. See note 239 *supra*.

328. See, e.g., *In re Plankinton Bldg. Co.*, 135 F.2d 273, 275 (7th Cir. 1943).

329. Bankruptcy Act § 64a(4), 11 U.S.C. § 104(a)(4) (1970).

330. Cf. *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 102-06 (3d Cir. 1964), which held employment and withholding taxes incurred during the proceeding, with respect to payments of prebankruptcy wages, to be provable debts or claims rather than administration expenses but then (by dictum) stretched the general understanding of "legally due and owing" to hold the taxes to be fourth priority items. The Commission's proposals abandon the "legally due and owing" concept, even for priority purposes, COMMISSION REPORT, *supra* note 3, § 4-405(a)(5), but still determine the existence of allowable nonadministrative claims as of the date of filing of the petition. COMMISSION REPORT, *supra*, § 4-403(b).

331. 11 U.S.C. §§ 93(d), 103(a)(8) (1970). See *Coclin Tobacco Co. v. Griswold*, 408 F.2d 1338, 1341 n. 6 (1st Cir.), *cert. denied*, 396 U.S. 940 (1969).

332. 382 U.S. 375 (1966). See text accompanying notes 455-67 *infra*.

333. COMMISSION REPORT, *supra* note 3, § 5-104(b). The device of tentatively closing the taxable year, subject to final calculation on a full-year basis, has precedent in INT. REV. CODE OF 1954, § 6851. See note 326 *supra*.

334. The proposal in these respects does rough, rather than exact, justice to the bankrupt. In the rare cases in which the bankrupt's income spans a significant range

be divided only for this limited purpose, there would be no injection of short "taxable years" with resultant curtailment of the aggregate period in which loss carryovers may be used.³³⁵

2. *Income Earned Before, but Deemed Realized After, Bankruptcy*

Merely dividing the individual bankrupt's taxable year, as proposed by the Commission, would only begin to resolve the inequity, for many items of income that would fall into the debtor's post-bankruptcy taxable period under the rules of tax accounting would nevertheless become assets of the bankrupt estate.

Under the bankruptcy law, the trustee takes title to the bankrupt's nonexempt and transferable or leivable claims for compensation for services rendered before bankruptcy,³³⁶ including compensation for uncompleted services if the contract is divisible,³³⁷ although the bankrupt retains the right to the full compensation for then uncompleted work if no part is payable in the absence of further performance of services.³³⁸ The trustee's title is not affected by the fact that the amount payable is determined only by later resolution of a dispute³³⁹ or that it is contingent upon future profits or other subsequent events, provided the bankrupt has done before bankruptcy all that he is required to do to entitle him to payment.³⁴⁰ Any other causes of action, which may be productive of taxable income, also pass to the trustee.³⁴¹ The trustee, of course, also acquires the right to accrued rents, interest, and dividends from the bankrupt's property, as well as his right to the proceeds of sales previously made by him.

of tax brackets, the higher applicable brackets, rather than an average, will be applied to his income for the postbankruptcy portion of the year. If he has net income for the early part of the year and suffers a net loss after bankruptcy, the loss, which his future resources must bear, reduces a prebankruptcy liability rather than being available to offset his future taxable income.

335. See text accompanying note 240 *supra*.

336. *In re Aveni*, 458 F.2d 972 (6th Cir. 1972); *Kolb v. Berlin*, 356 F.2d 269 (5th Cir. 1966). The Commission would delete the requirement that the property be transferable or subject to seizure under state law. COMMISSION REPORT, *supra* note 3, § 4-601, notes 1-2.

337. *In re Brown*, 4 F.2d 806 (2d Cir. 1924). *But cf. Fischer v. Liberty Natl. Bank & Trust Co.*, 61 F.2d 757, 759 (2d Cir. 1932), *cert. denied*, 288 U.S. 611 (1933).

338. *In re Leibowitt*, 93 F.2d 333 (3d Cir. 1937), *cert. denied*, 303 U.S. 652 (1938); *In re Coleman*, 87 F.2d 753 (2d Cir. 1937); *In re Furness*, 75 F.2d 965 (2d Cir. 1935).

339. *In re Evans*, 253 F. 276 (W.D. Tenn. 1918).

340. *Hudson v. Wylie*, 242 F.2d 435 (9th Cir. 1957); *In re Wright*, 157 F. 544 (2d Cir. 1907). See *Lockhart v. Mittleman*, 123 F.2d 703, 704 (2d Cir. 1941); *In re Leibowitt*, 93 F.2d 333, 335 (3d Cir. 1937).

341. *Gochenour v. Cleveland Terminals Bldg. Co.*, 118 F.2d 89, 93 (6th Cir. 1941).

Among the basic principles of tax law are the principles that the one rendering services is taxable on the income therefrom,³⁴² that the one owning property is taxable on interest or dividends accruing while he owns it,³⁴³ and that the seller of property is taxable on the profit from the sale³⁴⁴—even though the amount is never collected by him but is applied directly to “procure a satisfaction that can be obtained only by the expenditure of money or property,” whether that is the nonmaterial satisfaction involved in a family gift³⁴⁵ or the payment of one’s debts.³⁴⁶ The fact that the amount payable is in dispute at the time of the transfer³⁴⁷ or is dependent upon future events³⁴⁸ affects the timing, but not the existence, of the earner’s liability for tax.³⁴⁹ Those principles are controlling even where the application of the payment on the taxpayer’s debts is involuntary, by attachment or other levy,³⁵⁰ and they have been held equally applicable in bankruptcy, notwithstanding that the debtor would have been discharged of his debts whether or not the creditors realized anything.³⁵¹

In principle, there can be no quarrel with the holdings that income earned by the bankrupt before bankruptcy should be taxable *to him*, whether or not the event fixing the *time* of taxability under his accounting method has yet occurred.³⁵² To the bankrupt

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

343. *United States v. Joliet & Chicago R. R.*, 315 U.S. 44 (1942); *Helvering v. Horst*, 311 U.S. 112 (1940); *Austin v. Commissioner*, 161 F.2d 666 (6th Cir. 1947).

344. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Wood Harmon Corp. v. United States*, 311 F.2d 918 (2d Cir. 1963); *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952). Concerning the taxability of deferred gains on installment sales upon the occurrence of bankruptcy, see note 312 *supra*.

345. *Helvering v. Horst*, 311 U.S. 112, 117 (1940).

346. *Commissioner v. Hansen*, 360 U.S. 446, 465-66 (1959); *Steckel v. Commissioner*, 253 F.2d 267 (6th Cir. 1958).

347. *Wood Harmon Corp. v. United States*, 311 F.2d 918, 924 (2d Cir. 1963).

348. *J. Ungar, Inc. v. Commissioner*, 244 F.2d 90 (2d Cir. 1957).

349. *But cf. Jones v. Commissioner*, 306 F.2d 292, 301 (5th Cir. 1962).

350. *Ward v. Commissioner*, 224 F.2d 547, 552-53 (9th Cir. 1955).

351. *Parkford v. Commissioner*, 133 F.2d 249, 251 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943). *Parkford* happened to involve a taxpayer on the accrual basis, who would, in any event, have been immediately taxable on his compensation when earned, irrespective of its later disposition, and the Tax Court for this reason had felt it unnecessary to rely on the foregoing line of cases. *Frances M. Parkford*, 45 B.T.A. 461, 470 (1941). But the Ninth Circuit squarely relied on those principles, in taxing the bankrupt not only on amounts fully earned before bankruptcy but also on compensation that was contingent on the subsequent results of his prebankruptcy services. The Tax Court itself has applied those principles to a bankrupt using the cash basis, in *Charles E. Cooney*, 1 CCH Tax Ct. Mem. 264 (1942), *remanded pursuant to settlement*, (2d Cir., May 29, 1944). *Cf. Orval C. Walker*, 32 CCH Tax Ct. Mem. 690, 692 (1973) (under chapter XIII).

352. See note 351 *supra*.

estate, the money is not income (as interest earned during administration would be) but the collection of capital in the form of an account receivable that came to the estate as property of the bankrupt under section 70a of the Bankruptcy Act.³⁵³ "It is idle to contend it is inequitable to tax [the bankrupt] upon it because [he] did not personally receive it. All of it was used to pay [his] debts, and, if equities were to be weighed, it would be far more inequitable to the fiscus to permit the income to escape taxation altogether."³⁵⁴ What is wrong with this application of the rule is that, although the trustee collected the earnings as prebankruptcy property, the tax incurred by the bankrupt thereon was a postbankruptcy item that, in the bankruptcy proceedings, was held not to be a provable claim against the estate. The purpose of the Bankruptcy Act to give the bankrupt "an unencumbered fresh start,"³⁵⁵ "'a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt,'"³⁵⁶ is frustrated when the mechanical application of rules of tax law causes income earned before bankruptcy and appropriated by the trustee to be taxed to the individual bankrupt in periods ending after bankruptcy, for which the tax liability is not chargeable against the estate. The bankrupt's "fresh start" is, of course, inevitably "encumbered" by nondischargeable taxes that the assets in the estate are *insufficient* to satisfy, but it is wholly inconsistent with the "fresh start" principle to burden the bankrupt with continuing liability for a tax on prebankruptcy earnings that are paid over to the trustee and that the estate, including the amount of that income, would have been adequate to satisfy at the fourth priority level.

That merely dividing the taxable year at the date of bankruptcy would not remove the inequity is evident from the fact that, under the principles discussed above, a taxpayer on the cash basis becomes taxable only at the time his earnings are collected by his assignee, rather than at the time of the transfer.³⁵⁷ Although an exception is

353. 11 U.S.C. § 110(a) (1970). Cf. *Nichols v. United States*, 64 Ct. Cl. 241 (1927), *cert. denied*, 277 U.S. 584 (1928); *William C. Frank*, 6 B.T.A. 1071 (1927) (which, before Congress dealt expressly with the subject, *see* text accompanying notes 366-72 *infra*, held that a decedent's estate received the decedent's uncollected and untaxed compensation and interest earnings as corpus of the estate and was not subject to income tax thereon).

354. *Frances M. Parkford*, 45 B.T.A. 461, 470 (1941), *aff'd.*, 133 F.2d 249 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943).

355. *Segal v. Rochelle*, 382 U.S. 375, 380 (1966).

356. *Lines v. Frederick*, 400 U.S. 18, 19 (1970), *quoting* *Local Loan Co. v. Hunt*, 292 U.S. 234, 244-45 (1934).

357. *Jones v. United States*, 395 F.2d 938, 943 (6th Cir. 1968); *Sol C. Siegel Prods.*,

recognized in cases where the transfer is made for a present consideration,³⁵⁸ the prevailing view is that the transfer to the trustee of assets from which the bankrupt's liabilities will ultimately be satisfied or discharged is not, in itself, such a transfer for a consideration.³⁵⁹ In any event, and even if the bankrupt uses the accrual basis of accounting, taxability would be postponed to the individual's postbankruptcy period if the amount were contingent, since it cannot be known how much of the bankrupt's debts will be satisfied from the assigned income right until the contingency is resolved. It seems desirable, therefore, to devise a way to make postbankruptcy taxes, to the extent attributable to prebankruptcy earnings appropriated by the trustee, allowable against the estate.

The way to accomplish that purpose would be to make taxable in the period ending with the date of bankruptcy all items of theretofore untaxed income that pass to the trustee, whether or not they would yet have been taxable under the bankrupt's method of accounting. There is precedent for such action in cases involving the liquidation of corporations. Under section 446(b) of the Code and predecessor provisions, when a taxpayer's regular method of accounting "does not clearly reflect income," it must be computed "under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income." In order to prevent the permanent escape of tax on earned income that at the time of liquidation had not yet become taxable under methods of accounting that took earnings into taxable income only when received in cash or its equivalent or when contracts were completed, the courts have sustained findings by the Service that income can be clearly reflected in the final year only by modifying the accounting method to pick up all accrued income or a percentage of the income on uncompleted contracts.³⁶⁰ That precedent is deficient, however, in that it does not reach items of income that, while fully earned, are still contingent in amount at the crucial date and, therefore, would not be

Inc., 46 T.C. 15, 23-25 (1966); *Estate of Florence E. Carr*, 37 T.C. 1173 (1962); Rev. Rul. 72-312, 1972-1 CUM. BULL. 22.

358. *E.g.*, *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973).

359. *Homer A. Martin*, 56 T.C. 1294, 1299 (1971). *But cf.* *Charles R. Stuart*, 38 B.T.A. 1147, 1151 (1938).

360. *Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962); *Idaho First Natl. Bank v. United States*, 265 F.2d 6 (9th Cir. 1959); *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946).

taxable in that final period under *any* recognized method of accounting.³⁶¹

A more effectual precedent is found in section 42 of the Revenue Acts of 1934,³⁶² 1936,³⁶³ and 1938³⁶⁴ and of the Internal Revenue Code of 1939³⁶⁵ as originally enacted. As a result of court decisions that held a decedent's estate not taxable on the collection of income that had not previously been taxed to the decedent,³⁶⁶ Congress enacted the following: "In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includable in respect of such period or a prior period." The Supreme Court, in *Helvering v. Enright*,³⁶⁷ broadly construed the term "amounts accrued" in order to effectuate the legislative purpose that no income should escape taxation as a result of death. The Court, therefore, taxed in the decedent's final return his share of fees from unfinished business of his law partnership. In other cases it was held that the amounts so taxable include executors' and trustees' commissions that would have become fixed and payable only upon final settlement and that would not have been accruable by a living taxpayer before that time.³⁶⁸

Under that provision, the courts also struggled with the treatment of dividends, which may be declared on one date, payable at a later date, to those who were shareholders at some intermediate record date. In *Estate of Putnam v. Commissioner*,³⁶⁹ it was determined that a dividend declared before death, payable to shareholders of record on a date after death, was not "accrued" income taxable to the decedent. Although declaration of the dividend creates an obligation to the shareholders, the Court concluded that

361. See, e.g., *Telephone Directory Advertising Co. v. United States*, 142 F. Supp. 884 (Ct. Cl. 1956).

362. Ch. 277, § 42, 48 Stat. 694.

363. Ch. 690, § 42, 49 Stat. 1666.

364. Ch. 389, § 42, 52 Stat. 472.

365. Ch. 1, § 42, 53 Stat. 24.

366. *Nichols v. United States*, 64 Ct. Cl. 241 (1927), *cert. denied*, 277 U.S. 584 (1928); *William G. Frank*, 6 B.T.A. 1071 (1927).

367. 312 U.S. 636 (1941).

368. *Helvering v. McGlue's Estate*, 119 F.2d 167 (4th Cir. 1941); *Estate of Lewis Cass Ledyard, Jr.*, 44 B.T.A. 1056, 1064 (1941), *affd. on this issue sub nom. Commissioner v. United States Trust Co.*, 143 F.2d 243, 244 (2d Cir.), *cert. denied*, 323 U.S. 727 (1944).

369. 324 U.S. 393 (1945).

it "leaves the identity of the recipient at large."³⁷⁰ The Court noted that, unlike the situation in the *Enright* line of cases, the income would not go untaxed if not made taxable to the decedent, since a dividend on stock owned by the estate on the record date would be taxable to it.³⁷¹ Even though the stock, in which the earnings and the right to the declared dividend inhere, comes to the estate as capital, the scheme of the tax law is to treat the *severance* of earnings from the stock and from the corporation as the event giving rise to taxable income to the shareholder.³⁷²

Following the pattern of that provision, it might be provided that income that had been earned by the bankrupt's services or property prior to bankruptcy should continue to be taxable to him but should be deemed income of the short taxable period ending with his bankruptcy (if not properly reportable in an earlier period). With respect to income from services, from certain causes of action, and from other nonproperty-connected income, the standard applied should be whether the right to the income passes to the trustee.³⁷³ If it does, the taxability of the income to the individual should be accelerated into the prebankruptcy taxable period—irrespective of whether the income has technically "accrued," even by the broader standard of the *Enright* case—since the purpose is to make the tax a claim against the estate if the estate collects the income; if the right to the income is dependent upon further action by the bankrupt, so that the estate does not become entitled to it, the tax thereon should not be a claim against the estate but should be imposed on the individual in the postbankruptcy period in which the income would be taxable under his regular accounting method. In the case of income from property that passes to the estate, that line of demarcation could not be used, since the trustee will acquire the right to such income whether it accrues before or after bankruptcy; therefore, the test in this instance should be, as under former section 42, whether the income had "accrued" at the date of bankruptcy.

This proposal, of course, raises a problem of reporting the income and establishing a claim for the tax. The individual, in filing his return for the short period, will be unable to anticipate what recoveries may be made by the trustee on theretofore uncollected

370. 324 U.S. at 400.

371. 324 U.S. at 396-97. This is still the situation today. Treas. Reg. § 1.61-9(c) (1957).

372. *United States v. Phellis*, 257 U.S. 156, 171-72 (1921).

373. See text accompanying notes 336-41 *supra*.

items, particularly those that may be contingent. Therefore, his obligation to file a return should be deemed satisfied if he determines his income on his regular basis of accounting. If a tax is shown on such return, or if (with or without a filed return) the Service determines a tax on that basis, claim for so much thereof as is allowable against the estate should be filed in the usual manner. There should be no requirement to file a claim, however, with respect to the tax on additional collections, of which the trustee would have firsthand knowledge. A claim, if required, would necessarily be based on information furnished by the trustee himself, since the income giving rise to the claim would be received during administration. It would, in any event, be impossible to file the claim within the time prescribed by section 57n of the Bankruptcy Act;³⁷⁴ moreover, while the claim timely filed with respect to the original return could be amended after the time for filing to increase the amount,³⁷⁵ there might have been no original claim if there were no tax or only a nominal tax shown on such return (if filed).

In lieu of requiring a claim, the trustee should be made responsible for reporting such additional income taxable in the bankrupt's final prebankruptcy period by amending either the bankrupt's return or the calculations reflected in the government's claim. If there has been no claim, the trustee's responsibility should be deemed discharged if his report of additional income and tax starts from a base of zero (although, if the bankrupt had a loss, it would be in the estate's interest to ascertain that fact and reflect it in the calculations). Such reporting might be required either annually or at such times as dividends on priority tax (or lower-ranking) claims are to be distributed.

No prejudice to the administration should result from the existence of an open-ended priority claim for which no claim need be filed. Each increase in the liability will reflect a correspondingly greater increment in the estate, from which the amount of the anticipated tax liability may be reserved without reducing the amounts projected to be available for other creditors. The administration would not be prolonged thereby, since the estate would presumably be kept open in any event so long as significant amounts of the bankrupt's earnings remain to be collected. If the trustee

374. 11 U.S.C. § 93(n) (1970); BANKR. R. 302(e). See COMMISSION REPORT, *supra* note 3, § 4-401(a). Cf. *In re Freedomland, Inc.*, 480 F.2d 184, 191 (2d Cir. 1973), *cert. granted*, 42 U.S.L.W. 3415 (U.S., Jan. 21, 1974) (No. 73-374).

375. See *Menick v. Hoffman*, 205 F.2d 365 (9th Cir. 1953).

sells the right in order to close the estate, the proceeds will be the final amount taxable. If he abandons a contingent or disputed claim to the bankrupt in order to save further expense of administration,³⁷⁶ the bankrupt would be taxable on subsequent collections, if any, as if the right had never vested in the trustee.

One advantage of making the trustee responsible for reporting such income, without need for a claim, is that such a requirement avoids the inequity that may result if the government neglects or chooses to refrain from filing a claim and thus causes the estate to be disbursed to creditors whose claims, if unsatisfied, would have been discharged, while the tax that could have been satisfied as a priority claim out of the assets of the estate survives as an unsatisfied and undischarged obligation of the individual.³⁷⁷

It should be noted, in connection with the precedent cited above for this proposal, that Congress soon abandoned taxation of "accrued" earnings in a decedent's final return, on the ground that the ad hoc change of his accounting method caused hardship when income that in the usual course might have been taxable over a period of years was bunched into a single year at higher rates.³⁷⁸ Therefore, Congress instead prescribed,³⁷⁹ in what has since become section 691(a) of the Code, that income of a decedent not properly includible during his lifetime under his accounting method should be taxed as income of his estate or of its beneficiaries. Despite the argument that the amounts passed to them as capital, it was held constitutional to tax them on what would have been income if received by the decedent.³⁸⁰ In view of the trustee's representation of the bankrupt as well as of the creditors,³⁸¹ it would presumably be equally valid to treat like income as taxable to the bankrupt estate if that should be the legislative choice.

376. Abandonment is provided for in BANKR. R. 608 and COMMISSION REPORT, *supra* note 3, § 4-611. See *First Natl. Bank v. Lasater*, 196 U.S. 115, 118-19 (1905); *In re Kokoszka*, 479 F.2d 990 (2d Cir. 1973), *cert. granted*, 42 U.S.L.W. 3352 (U.S., Dec. 10, 1973) (No. 73-5265).

377. See *Newberg v. United States*, 187 F. Supp. 158 (S.D.N.Y. 1960), *affd.*, 296 F.2d 152 (2d Cir. 1961). Cf. *In re Curtis*, 69-1 U.S. Tax Cas. ¶ 9433 (W.D. Mich. 1969) (referee opinion), which refers to previous legislative proposals to correct this inequity. COMMISSION REPORT, *supra* note 3, § 4-401(c), like the recently adopted BANKR. R. 303, entitles the debtor or the trustee to file a tax claim on the creditor's behalf, in order to avoid this result; the claim would be of no avail where the potential existence of the claim is unknown at the time proof thereof must be filed.

378. H.R. REP. NO. 2333, 77th Cong., 2d Sess. 83 (1942); S. REP. NO. 1631, 77th Cong., 2d Sess. 100 (1942).

379. Int. Rev. Code of 1939, ch. 619, § 134(e), 56 Stat. 831 (1942).

380. *Richardson v. United States*, 294 F.2d 593 (6th Cir. 1961), *cert. denied*, 369 U.S. 802 (1962). Cf. *Taft v. Bowers*, 278 U.S. 470 (1929); text accompanying note 353 *supra*.

381. See, e.g., *B & L Farms Co. v. United States*, 238 F. Supp. 407, 410 (S.D. Fla. 1965), *affd. per curiam*, 368 F.2d 571 (5th Cir. 1966), *cert. denied*, 389 U.S. 835 (1967).

Taxing the trustee rather than the individual permits imposing the tax for the years of actual receipt rather than bunching the income in one taxable period. But it is doubtful that, in the bankruptcy situation, there would be many cases in which the bunching of income in the individual's return would cause tax in very high brackets, and, if such situations were to arise, relief is now available to individuals under the provisions for five-year averaging of income,³⁸² which were not in the law in 1942, when Congress retreated from taxing the decedent rather than his estate. Therefore, the determination of whether the tax ought to be imposed on the bankrupt or the trustee (in either event, collectible from the estate) may rest on other considerations.

One objection to imposing the tax on the estate, rather than on the individual, is that, if the estate, even as augmented by such recoveries, is insufficient to pay all taxes, including the tax on such items, the liability will be uncollectible from anyone, whereas, if the tax is imposed on the bankrupt, the unpaid balance would remain as a nondischargeable liability. Such tax liability would be nondischargeable if the income had been realized shortly before bankruptcy, and there appears to be no good reason why the fact that prebankruptcy earnings of the bankrupt happen to be collected after, rather than before, bankruptcy should relieve the individual of the tax thereon if it cannot be collected from the aggregate assets of the estate. It should be enough that he is relieved of the existing inequity of having the tax on his uncollected prebankruptcy earnings charged *entirely* against his exempt and after-acquired property, rather than *first* against the estate into which those earnings were paid.

It seems clear, in any event, that the tax on prebankruptcy earnings collected by the trustee after bankruptcy, should remain at the individual level (although made collectible as a claim against the estate) if the Commission's proposal to exempt the trustee entirely from tax in most situations is adopted, since the trustee's collections of income earned by the bankrupt are in no sense administrative income, and since the fortuity that such earnings are collected after, rather than before, the date of bankruptcy and that the bankrupt had used the cash basis of accounting (or that the claim was contingent) should not alter its taxability to *someone*.³⁸³

382. INT. REV. CODE OF 1954, §§ 1301-05. The higher tax rates applicable to estates, as contrasted with either married or single individuals, *compare* section 1(d) *with* sections 1(a)-(c), might well nullify any remaining advantage from avoiding bunching of income in the bankrupt's return.

383. *See* text accompanying notes 147-88 *supra*.

Further, even if the trustee remains a taxable entity, such earnings ought, in any event, to be taxable at the individual level *unless* (a) the bankrupt's loss carryovers are made available to the trustee (as the Commission has proposed), so that they may offset the trustee's taxable income reflecting such prebankruptcy earnings;³⁸⁴ and (b) the trustee's tax liability is made apportionable, so that the portion of the tax attributable to such prebankruptcy earnings, earnings that reflect collections of capital of the estate rather than increments therein, would not enjoy the priority status of an administration expense.³⁸⁵

While the foregoing discussion has focused on individual bankruptcies, the same treatment ought to be applied in corporate cases if the trustee is granted exemption from tax, since there is no justification for exempting prior corporate earnings merely because they are collected after bankruptcy. There would be less need to apply it to corporate bankruptcies if the estate remains a taxpaying entity, since corporations are not subject to the inequity suffered by individuals who now incur a postbankruptcy tax on income that is taken by the trustee. But if the estate of a corporate bankrupt is to remain taxable on such income, the tax should be apportioned, as above suggested, so that the amount attributable to prior earnings will not enjoy the priority of an administration expense.

3. *Deductions for Expenses Incurred Before Bankruptcy*

The foregoing problem has its analogue on the deduction side, in situations where the individual bankrupt had incurred expenses of a deductible nature but his right to deduct them had not matured before bankruptcy, either because the amount was not yet fixed³⁸⁶ or because the bankrupt, being on the cash basis of accounting, had not made payment.³⁸⁷

In the early case of *Charles R. Stuart*,³⁸⁸ the bankrupt was a corporate director against whom a judgment for over 7 million dollars had been entered shortly before he filed a voluntary petition in bankruptcy. He claimed on his individual return a deduction for a loss, equal to the cost basis of property turned over to the

384. See text accompanying notes 473-79 *infra*.

385. The impropriety of treating as an administration expense a tax attributable to prebankruptcy income will be discussed in part I(B)(2)(a) of Plumb, *supra* note 165.

386. *E.g.*, *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944); *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *Commissioner v. Fifth Ave. Coach Lines*, 281 F.2d 556 (2d Cir. 1960), *cert. denied*, 366 U.S. 964 (1961).

387. *Helvering v. Price*, 309 U.S. 409 (1940).

388. 38 B.T.A. 1147 (1938).

trustee. The Service, declaring that no loss is sustained upon the transfer of one's property to a trustee in bankruptcy,³⁸⁹ although conceding that the judgment itself would have resulted in a deductible loss if the bankrupt had been using the accrual method of accounting,³⁹⁰ denied the deduction. The court, however, unanimously rejected the view that taxpayers using the cash basis could be permanently deprived of deductions to which they would have been entitled if they were using the accrual basis and declared that "[t]he only difference in treatment countenanced by the income tax law is the year of deduction."³⁹¹

In *B & L Farms Co. v. United States*,³⁹² the facts generally paralleled those of the *Stuart* case, except that the bankrupt was a corporation. The bankrupt, which used the cash basis of accounting, had over 2.4 million dollars of unpaid and undeducted trade accounts, which its trustees paid in the year following bankruptcy. Seeking to avail itself of a loss carryback to its last profitable year, three years before the year of bankruptcy, the bankrupt (through its trustees) claimed deduction of those expenses as if they were satisfied in the year title was transferred to the trustees, rather than in the subsequent year, when they were actually paid.³⁹³ The district court held that the accounts were not satisfied by the transfer of the accounts to the trustees, who represented the interests of the bankrupt as well as of his creditors and who did not, at that time, have "any fixed duty to pay over any specific amounts to any particular creditors."³⁹⁴ The court initially distinguished *Stuart* as involving "a specific deductible loss, arising from a court judgment"³⁹⁵—although a hundred trade accounts are surely as "specific" as one judgment—and then, on rehearing, rejected *Stuart* outright as "directly contrary to the overwhelming weight of authority on this point."³⁹⁶ (The court was re-

389. It relied on I.T. 2898, XIV-1 CUM. BULL. 70 (1935).

390. On the accrual basis, the extreme unlikelihood that an otherwise deductible item will ever be paid by a failing or insolvent debtor is not a ground for denying or deferring a deduction therefor. *Fahs v. Martin*, 224 F.2d 387 (5th Cir. 1955); *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011 (8th Cir. 1942); *Edward L. Cohen*, 21 T.C. 855 (1954), *acquiesced in*, 1954-2 CUM. BULL. 4; Rev. Rul. 70-367, 1970-2 CUM. BULL. 37.

391. 38 B.T.A. at 1151.

392. 238 F. Supp. 407 (S.D. Fla. 1965), *affd. per curiam*, 368 F.2d 571 (5th Cir. 1966), *cert. denied*, 389 U.S. 835 (1967).

393. A three-year carryback, INT. REV. CODE OF 1954, § 172(b)(1)(A), from the year of payment by the trustee would not have reached the last profitable year.

394. 238 F. Supp. at 410.

395. 238 F. Supp. at 411.

396. 238 F. Supp. at 414.

ferring³⁹⁷ to cases that hold that "payment" of expenses by a cash-basis taxpayer must be made in cash or its equivalent, and not merely by changing the form of the obligation.) The Fifth Circuit affirmed without opinion, approving "the conclusions" of the district court over the dissent of Judge Brown, who argued in vain that upon adjudication the bankrupt "lost irrevocably control over the use or disposition of corporation assets," that "[b]y every realistic standard the creditors were 'paid' at the moment the Trustee came into possession and control of the Bankrupt's assets under the inescapable obligation to hold and distribute them (or their proceeds) to creditors,"³⁹⁸ and that "the Trustee's obligation, first, foremost, and always, is to the creditors" and only incidentally to the bankrupt.³⁹⁹

In the recent case of *Henry C. Mueller*,⁴⁰⁰ the Tax Court, without referring to *Stuart*, held *B & L Farms* equally applicable to individual bankrupts. Because of his inability to pay \$100,000 of offsetting expenses, \$43,702.31 of which was, in fact, paid two years later by the trustee from the proceeds of his assets, Mueller was found to have taxable net income of \$60,000 to the date of his bankruptcy. No deduction was allowed to the bankrupt either in the year of bankruptcy or by way of carryback from the later taxable year of the estate,⁴⁰¹ which, as a distinct taxpayer, lacked income to offset the expenses.⁴⁰² The Tax Court felt that the rationale of the district court opinion in *B & L Farms*, in effect approved by the Fifth Circuit to which *Mueller* would go on appeal,⁴⁰³ left no room for distinguish-

397. 238 F. Supp. at 410-11, citing *Helvering v. Price*, 309 U.S. 409 (1940); *Doggett v. Commissioner*, 275 F.2d 823 (4th Cir. 1960); *P.G. Lake, Inc. v. Commissioner*, 148 F.2d 898 (5th Cir. 1945); *Citizens Natl. Trust & Sav. Bank v. Welch*, 119 F.2d 717 (9th Cir. 1941); *Arthur Kniffen*, 39 T.C. 553 (1962); *Vander Poel v. Commissioner*, 8 T.C. 407 (1947).

398. 368 F.2d at 571.

399. 368 F.2d at 572.

400. 60 T.C. 36, 44 (1973).

401. Concerning carryovers or carrybacks of losses between the trustee and the individual, see text accompanying notes 484-517 *infra*.

402. It is open to question whether the trustee, as a distinct taxpayer from the one who incurred the expense, would have been entitled to the deductions in any event. See text accompanying notes 226-29 *supra*. No claim was made that the bankrupt himself might deduct the expenses in the year of payment by the trustee. In some circumstances, the payment of one's expenses by another may entitle the obligor to a deduction. *Leward Cotton Mills, Inc. v. Commissioner*, 245 F.2d 314 (4th Cir. 1957); *Norman Cooledge*, 40 B.T.A. 1325 (1939). But cf. *Arthur L. Kniffen*, 39 T.C. 553, 566-67 (1962); *Hanna Furnace Corp. v. Kavanagh*, 50-2 U.S. Tax Cas. ¶ 9443 (E.D. Mich. 1950). However, the fact that the debtor would meanwhile have been discharged of his obligations might be an impediment in this instance.

403. The Tax Court, although a court of nationwide jurisdiction, considers itself bound by a decision of the court to which the particular case would go on appeal. *Jack E. Golsen*, 54 T.C. 742, 756-58 (1970), *affd. on other grounds*, 445 F.2d 985 (10th

ing individual from corporate cases. It ignored the very real difference that a trustee for a corporate bankrupt is taxed under section 6012(b)(3) as a continuation of the taxable entity of the corporation so that the transfer of title to the trustee in such a case involves payment to the taxpayer's alter ego⁴⁰⁴ and denial of the deduction at that time to the cash-basis corporation affects only the timing, not the ultimate allowability, of that taxpayer's deduction.⁴⁰⁵ The individual bankrupt, in contrast, passes his property to a distinct taxable entity at the date of bankruptcy,⁴⁰⁶ and a deduction denied to him then, although incurred and accrued in his business, is lost to him forever, solely because of his choice of accounting method.

Five judges, dissenting in *Mueller*, declared that the effect of that decision was to tax a cash-basis bankrupt on his gross receipts and that "this disparity in result as between a cash basis taxpayer and an accrual basis taxpayer . . . [cannot] be allowed to stand."⁴⁰⁷ They referred to *Bongiovanni v. Commissioner*,⁴⁰⁸ in which, in another connection, the Second Circuit had stated, "There is no justification for making an accounting method inadvertently chosen by the taxpayer determinative of the tax benefits . . . of that taxpayer."⁴⁰⁹ Unfortunately, however, the Second Circuit was stating an ideal rather than reflecting reality, since such discriminations are not uncommon in our tax system.⁴¹⁰ Three judges who concurred in the prevailing decision in *Mueller* although they viewed its results as "unfortunate" were perhaps more realistic in recognizing the problem as calling for a legislative, rather than a judicial, solution.⁴¹¹

In considering the appropriate legislative solution, we must first clear away some underbrush, reflected in the prevailing opinion in *Mueller*, which, in partial justification for denying the bankrupt the benefit of deductions attributable to expenses paid from the proceeds of his assets, declared:

Cir.), *cert. denied*, 404 U.S. 940 (1971). It was not precluded, however, from finding a relevant appellate decision to be distinguishable, *cf.* *Estate of George I. Speer*, 57 T.C. 804, 812 (1972), particularly as the Fifth Circuit had endorsed only the "conclusions" below.

404. See text accompanying notes 75-112 *supra*.

405. See text accompanying note 391 *supra*.

406. See text accompanying notes 106-34 *supra*.

407. 60 T.C. at 48.

408. 60 T.C. at 48, citing 470 F.2d 921 (2d Cir. 1972).

409. 470 F.2d at 924.

410. *E.g.*, *United States v. Catto*, 384 U.S. 102, 113-17 (1966); *United States v. Rexach*, 482 F.2d 10, 20 (1st Cir.), *cert. denied*, 42 U.S.L.W. 3306 (U.S., Nov. 20, 1973); *Willging v. United States*, 474 F.2d 12 (9th Cir. 1973).

411. 60 T.C. at 47-48.

A bankrupt taxpayer does not have a diminished interest in his bankrupt estate because of expenses or losses incurred by the estate, but rather his creditors receive a lesser amount. In fact, through the bankruptcy proceedings, the bankrupt taxpayer is discharged from liabilities which here were (and usually are) greatly in excess of the basis in the property which he turned over, and is also relieved from any income from cancellation of indebtedness as well.⁴¹²

Four points in that statement require comment.

First, the court's statements about the amounts that were cancelled were gratuitous, since the issue concerned not the tax treatment of amounts that went unpaid, but the deductibility of amounts that the bankrupt's assets sufficed to pay. There is no necessary relationship in any given case between the amount of otherwise deductible debts in fact paid from such assets and the amount of capital obligations or other nondeductible items that go unpaid and result in at least a theoretical benefit to the discharged debtor, a benefit that, under long-standing judicial and administrative policy, is relieved from tax.⁴¹³ If the policy of exempting the latter is unsound, one should attack it directly, rather than enforce a "trade-off" by denying deductions for actual payments that may be greater or less than the benefit derived from relief from obligations that go unpaid.⁴¹⁴

Second, the court's remark⁴¹⁵ about the discharged debts' being in excess of the basis of the debtor's property, while uncalled for in the particular case (in which the debtor sought to deduct no more than the adjusted basis of the property applied to his debts), does point to the fact that a logical, and perhaps necessary, corollary to treating the transfer to the trustee as satisfaction of the individual's obligations would be to treat such transfer as realizing gain or loss equal to the difference between the adjusted basis and the value of the property so applied,⁴¹⁶ contrary to the Tax Court's view that no taxable disposition occurs at such time.⁴¹⁷

412. 60 T.C. at 45.

413. Treas. Reg. § 1.61-12(b) (1957). Cf. text accompanying note 269 *supra*.

414. Cf. quotation from Tillinghast & Gardner, *supra* note 267, at 714, in note 508 *infra*. The Commission has proposed that, except where the creditor involved succeeds to an equity interest in the debtor, the debtor's carryovers and other deductions for periods ending after the discharge should be adjusted to exclude the effect of obligations that will never have to be paid. COMMISSION REPORT, *supra* note 3, § 7-315(b); *id.* at 293 (proposed INT. REV. CODE OF 1954, § 172(d)(7)). See Plumb, *supra* note 270.

415. 60 T.C. at 43.

416. See text accompanying notes 442-51 *infra*. Such is the rule in the absence of bankruptcy. See note 446 *infra*. Mueller's deduction of only the amount of the adjusted basis of the property transferred was a shortcut to a similar result, although it could differ if, for example, the gain was capital and the expense was ordinary.

417. Homer A. Martin, 56 T.C. 1294, 1299 (1971).

Third, while it was true in *Mueller* that the allowance of the deduction that reduced tax liability for the year in which bankruptcy occurred would have benefited the discharged bankrupt rather than his unsatisfied creditors, that would no longer be true under the Commission's proposal to make the bankrupt's tax, computed to the date of bankruptcy, an allowable priority claim against the estate,⁴¹⁸ since any deduction permitted against such liability would make more assets available for creditors.⁴¹⁹

Fourth, despite the preachments of the opinion against allowing deductions even for satisfied obligations when others have been discharged, the Tax Court has not in this generation questioned the axiom that an *accrual-basis* taxpayer may deduct even expenses that he is patently unable to pay and does not pay;⁴²⁰ moreover, it seems clear that, even on the cash basis, the trustee for a *corporate* bankrupt, standing in the debtor's shoes, may deduct and carry back to pre-bankruptcy years the expense claims actually paid from the estate.⁴²¹

Clearly, an unwarranted penalty is imposed if, in a bankruptcy situation, a tax is, in effect, imposed on gross income or gross receipts of a noncorporate cash-basis taxpayer and otherwise allowable deductions are lost forever as a result of the intervention of the trustee as a technically separate taxpayer. It is no answer to allow the deductions to the trustee,⁴²² even if (contrary to the Commission's recommendation) the estate remains subject to tax, for such treatment may separate the deductions from the income to which they relate⁴²³ and there is a high probability that the estate will have insufficient gross income during the period of administration to offset an accumulation of the bankrupt's previously unpaid expenses. Nor would it be appropriate

418. See text accompanying notes 319-35 *supra*.

419. If, instead of net income, the bankrupt had had a net operating loss for the year of bankruptcy and had had net income in past years against which to offset it, the benefit of the deduction would have been enjoyed by the creditors, whether under present law, *Segal v. Rochelle*, 382 U.S. 375 (1966), or under the proposed legislation. See text accompanying notes 455-67 *infra*.

420. See note 390 *supra*. In an earlier day, the Tax Court stood firm against such deductions only to have the government concede the case on appeal. *Millar Brainard*, 7 T.C. 1180 (1946).

421. Cf. text accompanying notes 75-104 *supra*. The government's position in *B & L Farms Co. v. United States*, 238 F. Supp. 407 (S.D. Fla. 1965), *affd. per curiam*, 368 F.2d 571 (5th Cir. 1966), *cert. denied*, 389 U.S. 835 (1967), was not that expense payments by a corporate bankrupt could not be deducted, but that, on the cash basis, the corporation, represented by the trustee, could not deduct them until payment by the trustee.

422. Concerning present law, see text accompanying notes 226-29 *supra*.

423. This occurred in the *Mueller* case. See text accompanying notes 400-02 *supra*. While the matching of income with the related deductions is an ideal not invariably achieved in the tax law, see, e.g., *Schlude v. Commissioner*, 372 U.S. 128 (1963); *Heaven Hill Distilleries, Inc. v. United States*, 476 F.2d 1327, 1336-37 (Ct. Cl. 1973), such matching in the hands of the same taxpayer is a desirable legislative goal.

to allow the expenses to the individual bankrupt in any period ending after the filing of the petition and, thereby, supplement his "fresh start" with postbankruptcy tax savings that are "rooted in the pre-bankruptcy past."⁴²⁴ Since the deductible items, so far as satisfied at all, are paid from the estate and deplete the assets available for other creditors, the appropriate legislative solution would be to allow the individual to deduct *at the time of bankruptcy* all otherwise deductible obligations that are, in fact, ultimately satisfied in the proceeding.⁴²⁵ In this manner, the deductions either would reduce a tax that (under the Commission's proposal) would be allowable as a claim against the estate⁴²⁶ or would become available for carryback or carryover for the benefit of the estate.⁴²⁷ The deductions would also be matched against the yet uncollected income, which, under my preceding proposal, would be taxed in the same period.⁴²⁸

In support of this recommendation, I turn again to the precedent of the 1934, 1936, and 1938 Revenue Acts and the 1939 Code as originally enacted, by section 43 of which the "accrued" deductions of a decedent were allowed in his final return, regardless of his accounting method, in a manner similar to the treatment of accrued income items under section 42, discussed above.⁴²⁹ The Board of Tax Appeals (predecessor of the Tax Court) held that section 43, like section 42, dispensed with the usual requirement that, in order to have "accrued," an item must have been fixed or determined in amount (that is, not contingent or in contest) within the taxable period,⁴³⁰ but that decision was reversed by the Second Circuit.⁴³¹ The legislation here suggested should make clear that, consistently with its purpose, any deductible items constituting

424. Cf. *Segal v. Rochelle*, 382 U.S. 375 (1966).

425. The Tax Court in *Mueller*, 60 T.C. at 44 n.6, protested that "[o]bviously, allocation of percentage receipts between business and nonbusiness creditors would pose many problems." Yet, the allowance by the court of discrete claims makes the apportionment far simpler than, for example, the task, which the Tax Court has not shunned, see *Sidney Merians*, 60 T.C. 187 (1973), of apportioning a lump sum legal fee among services of a deductible and nondeductible nature. Cf. Rev. Rul. 72-545, 1972-2 CUM. BULL. 179.

426. See text accompanying notes 319-35 *supra*.

427. Under present law and the Commission's proposal, refunds of individual taxes resulting from carrybacks from the period in which bankruptcy occurs become assets of the estate, and the Commission would also make carryovers from such period allowable to the estate, if it is taxable at all. See text accompanying notes 452-535 *infra*.

428. See text accompanying notes 336-85 *supra*.

429. See *id.*

430. *Estate of Lewis Cass Ledyard*, 44 B.T.A. 1056, 1066-67 (1941), *revd. sub. nom. Commissioner v. United States Trust Co.*, 143 F.2d 243 (2d Cir. 1944).

431. *Commissioner v. United States Trust Co.*, 143 F.2d 243, 245 (1944).

allowable claims against the estate, whether or not fixed in amount before bankruptcy, should be accumulated in the tax computation for the debtor's final prebankruptcy period, which would be held open for the purpose.⁴³²

In corporate bankruptcies, provided the estate is not exempted from tax,⁴³³ there may be less need to accelerate the deduction of expenses into the period preceding bankruptcy, since the estate continues the tax identity of the bankrupt,⁴³⁴ and the creditors, through the estate, will theoretically get the same benefit whether the deductions are allowed in one year or another. As the *B & L Farms* case⁴³⁵ illustrates, however, in a bankruptcy situation a deduction deferred will very likely be a deduction lost, for the delay pending liquidation of assets and payment of debts may well make it impossible for losses during administration to be carried back as far as the corporation's last profitable period. To avoid penalizing creditors for the law's delays,⁴³⁶ as well as to lessen the discrimination against cash-basis taxpayers, I suggest that this proposal be applied to corporations, as well as to individual bankrupts. In addition, while somewhat different considerations apply, the treatment adopted for expense items should be applied consistently to income.

It may be noted that the foregoing proposal would not eliminate the discrimination between cash- and accrual-basis taxpayers (or their creditors, who would indirectly benefit from their deductions), since the tax liabilities of those on the *accrual* basis will have been reduced, not merely by the deduction of obligations that are satisfied in the proceeding, but also by the deduction of those obligations that it proves impossible to pay from the assets of the estate. One might suppose that the better way to equalize cash- and accrual-basis taxpayers in this respect would be to undo the prior accrual of expenses to the extent that it is established in bankruptcy that

432. The reporting procedure described above, *see* text accompanying notes 374-76 *supra*, should be followed.

433. If the Commission's exemption proposal is adopted, there is strong reason to accelerate the deductions for expenses attributable to the prebankruptcy period, since these expenses have nothing to do with administration and should not be wasted merely because payment was deferred.

434. *See* text accompanying notes 75-104 *supra*.

435. *See* text accompanying notes 392-99 *supra*.

436. *Cf. American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266 (1914), in which, in stopping interest from running during bankruptcy, the Court said, "As this delay was the act of the law, no one should thereby gain an advantage or suffer a loss."

they will never be paid,⁴³⁷ rather than to give the cash-basis taxpayer an equal right to an unearned deduction for unpaid expenses.⁴³⁸ There would be merit in that view if the deductions might benefit the debtor. But to deny the deductions against taxes that are collectible from the estate or to deny resulting carrybacks or carryovers from which the estate might benefit depletes the very funds that might otherwise be available to pay the defaulted obligations and make them deductible.⁴³⁹ It would be just to give the unsatisfied creditors, in effect, a preference over so much of the bankrupt's tax liability as is incurred solely by reason of his inability to satisfy other creditors, by allowing deductions to cash-basis taxpayers, individual or corporate, for accrued expenses unpaid at the time of bankruptcy for the purpose of computing the tax claim allowable against the estate and any resulting carrybacks or carryovers, but not for the purpose of computing the debtor's nondischargeable liability for such tax or any carryover from which he may benefit.⁴⁴⁰ I submit that this suggestion is not inconsistent with the substance of the Commission's proposal, which I support, to reduce the debtor's (or a successor's) loss carryovers by the amount of deductions attributable to obligations that go unpaid as a result of a proceeding in bankruptcy.⁴⁴¹ That proposal is designed to prevent the debtor, or creditors other than those who suffered the loss, from gaining a benefit from such deductions, but it is not meant to deprive the unpaid creditors of such benefit, as is evidenced by the fact that the disallowance is expressly made inapplicable to unpaid obligations for which a creditor receives an equity security and thus retains a stake in the resulting tax benefit.

437. The tax consequences of debt reduction in bankruptcy will be more fully discussed in Plumb, *supra* note 270.

438. The Service resists efforts by cash-basis insolvents to change to the accrual basis in order to avail themselves of deductions for expenses they cannot pay. See *Transamerica Ins. Co. v. Womack, Inc.*, 73-1 U.S. Tax Cas. ¶ 9146 (E.D. Va. 1972), *affd. on another issue*, 74-1 U.S. Tax Cas. ¶ 9326 (4th Cir. 1974). Cf. *Millar Brainard*, 7 T.C. 1180, 1182-83 (1946).

439. See Wurzel, *Taxation During Bankruptcy Liquidation*, 55 HARV. L. REV. 1141, 1149 (1942). Cf. *United States v. Rochelle*, 384 F.2d 748 (5th Cir. 1967), *cert. denied*, 390 U.S. 946 (1968) (funds of bankrupt confidence man exhausted by claim for taxes on his ill-gotten gains, to exclusion of obligation to repay victims); *Irving v. Gray*, 344 F. Supp. 567, 573 (S.D.N.Y. 1972), *affd.*, 479 F.2d 20 (2d Cir. 1973).

440. The Commission would deny an individual any carryover of prebankruptcy losses against his postbankruptcy income. See text accompanying notes 503-10 *infra*.

441. COMMISSION REPORT, *supra* note 3, at 293 (proposed INT. REV. CODE OF 1954, § 172(d)(7)). See Plumb, *supra* note 270.

4. Gain or Loss on the Bankrupt's Property Applied to His Debts

It has been urged above⁴⁴² that there is no justification for exempting from taxation the gains on sales by the trustee of property of the bankrupt or for denying deductions for losses on such sales, but it does not follow that the trustee is the proper party to whom such gains and losses should be recognized. I suggest that it would be more appropriate to treat the occurrence of bankruptcy as the event by which gain or loss is realized, not by the trustee but by the debtor, as if he had then applied the property, to the extent of its value, in satisfaction of his debts.⁴⁴³ While it may be argued that the surrender of the debtor's property to the trustee does not *per se* discharge his debts,⁴⁴⁴ the application of the property to the partial satisfaction of the debts is certainly the contemplated result of the series of transactions initiated by the petition, and the intervention of the trustee as the instrument for liquidation and payment may properly be ignored.⁴⁴⁵ The suggested treatment is, furthermore, the logical concomitant of the preceding proposal to treat bankruptcy as the event giving rise to deduction by the debtor of his previously undeducted expenses.⁴⁴⁶

Where losses would result from disposition of the property, as is likely when the bankrupt's property is obsolete or in poor condition, treatment of the occurrence of bankruptcy as the loss-realizing event would provide greater flexibility in absorption of the loss deductions against income. The estate, if exempted from tax, would itself have no use for the deduction of losses on its subsequent sales and, if taxable, could use them only against the (probably) limited income of the period of administration. While the bankrupt, too, may, during the three full years before bankruptcy, have had little net income against which a loss might be offset (with result-

442. See text accompanying notes 242-72 *supra*.

443. Under present law, the bankrupt's surrender of his property to the trustee, although it results in discharge of his debts, is not a transaction resulting in gain or loss to him. *Homer A. Martin*, 56 T.C. 1294, 1299 (1971); *Norris Bloomfield*, 52 T.C. 745, 749 (1969); *Frances M. Parkford*, 45 B.T.A. 461, 471 (1941), *aff'd.*, 133 F.2d 249, 251 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943). *Cf.* I.T. 2898, XIV-1 Cum. BULL. 70 (1935).

444. See *Henry C. Mueller*, 60 T.C. 36, 43-44 (1973), discussed in text accompanying notes 400-21 *supra*.

445. *Cf. Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184-85 (1942).

446. In general, the application of property to the satisfaction of deductible obligations results in realization of gain or loss, in addition to the deduction. *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961); *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943). *Cf. United States v. Davis*, 370 U.S. 65 (1962).

ing benefit to the estate through tax refunds),⁴⁴⁷ the chance that the loss may be absorbed against income of the debtor or of the estate at some time in the carryback or carryover period is enhanced. It is assumed, of course, that this suggested treatment will be coupled with adoption of the Commission's proposal to allow the trustee to utilize carryovers of any individual losses on the estate's returns,⁴⁴⁸ so that turning the loss into an individual one will not make it unavailable to the estate to the extent that it is not absorbed against past income of the debtor.

Where gains would result, creditors would, of course, be better off if the gain were deemed realized by the estate, assuming adoption of the proposed exemption. Nevertheless, I submit that the prebankruptcy values thus realized are not income incident to administration of the estate and should not enjoy the exemption. If the estate remains taxable, *some* creditors (preferred wage claimants and state and local governments) may prefer the treatment here suggested, which would reduce the resulting tax from its present inappropriate priority status as an expense of administration. If the tax is not satisfied from assets of the estate, the suggested treatment would leave it outstanding as a nondischargeable obligation of the debtor, whereas, at present, it can be satisfied only from the estate. That effect is regarded by Krause and Kapiloff as an undesirable one, which "would frustrate the theory of rehabilitation of giving the debtor a fresh start."⁴⁴⁹ So long as Congress has seen fit, however, to "frustrate" that theory to the extent of making certain taxes nondischargeable, it is difficult to see why any different treatment should be given to the tax on appreciation realized and made available for satisfaction of the bankrupt's debts, whether the property is sold before or after the occurrence of bankruptcy. In many cases, the effect of this proposal on the bankrupt may be neutral, since the consequence of treating the tax on the trustee's gain as an administration expense, as at present, may be to leave other nondischargeable outstanding taxes unsatisfied; it would also be neutral, of course, if assets, including the appreciation on which the tax is imposed, suffice to pay both first and fourth priority items.

As a matter of strict principle, only the tax that would have been incurred on a sale at fair market value at the date of the petition should be treated as proposed, since the tax on any further

447. See *Segal v. Rochelle*, 382 U.S. 375 (1966), discussed in text accompanying notes 458-67 *infra*.

448. See text accompanying notes 484-92 *infra*.

449. Krause & Kapiloff, *supra* note 83, at 417.

increment in the gain may be regarded as an incident to administration. To split the gain and the resulting tax, however, would require the expense of an appraisal at the date of the petition, and the chance that realizable values in a bankruptcy sale (unless possibly in the case of a mineral strike or a prolonged administration in an inflationary period) would exceed the fair market values at the date of bankruptcy seems too remote to justify imposing such a requirement.⁴⁵⁰ Therefore, I suggest that the *measurement* of the gain or loss should be deferred until sale by the trustee, even though the taxable event is deemed to be the transfer from the bankrupt to the trustee.⁴⁵¹ This deferral of determination of the gain also permits eliminating from taxability the appreciation on any property that is returned to the bankrupt without sale, either as exempt property or as property in excess of debts.

III. ALLOCATION OF CARRYOVERS AND CARRYBACKS BETWEEN THE ESTATE AND THE INDIVIDUAL DEBTOR

The Commission would confirm the present rule that the trustee for an individual bankrupt is entitled to recover for the estate any refunds that result from the carryback of losses incurred before bankruptcy and would preclude the dilution of such carrybacks by income the debtor may realize in the postbankruptcy portion of the year in which bankruptcy occurs.⁴⁵² In addition, carryovers of such losses to postbankruptcy years would, in all cases, be denied to an individual bankrupt and would be made available to offset income of the estate in those unusual situations in which, by reason of the ultimate solvency of the estate, the estate's income would remain taxable.⁴⁵³ No provision is proposed to be made, however, for the trustee, in such cases, to step into the shoes of the bankrupt

450. Nevertheless, it may be appropriate to charge the administration with so much of the gain as equals depreciation and depletion deductions taken on the property during administration, at least so far as the deductions resulted in tax benefit to the estate.

451. While this would make the amount of the priority claim uncertain until disposition of the property, it should not interfere with normal administration, since the contingent priority claim cannot exceed the proceeds of the unsold property, which itself should suffice as provision therefor. *See* text preceding note 376 *supra*. In the rare case in which the sale proceeds exceed the value at the date of bankruptcy while the nondischargeable tax imposed on the bankrupt under this proposal remains unsatisfied from assets of the estate, it may be appropriate to relieve the bankrupt to the extent that the unsatisfied amount exceeds what his tax would have been if measured by the value of date of bankruptcy.

452. COMMISSION REPORT, *supra* note 3, § 5-104(c). However, certain cash equivalents, including tax refunds, would be exempt to an aggregate amount of 500 dollars. *Id.* § 4-503(c)(3).

453. *Id.* § 5-104(c).

individual with respect to miscellaneous carryovers, accounting methods, application of the tax benefit rule, and the like.⁴⁵⁴

A. *Net Operating and Capital Losses*

1. *Carrybacks*

In the typical case, a business bankruptcy will have been preceded by a period of net operating losses that extended to the date when the trustee took over the business and property. Such losses, for federal income tax purposes, may ordinarily be carried back to offset any net income the debtor may have had in the three years preceding the taxable year of the loss and thus result in refunds of taxes previously paid.⁴⁵⁵ Since the trustee in bankruptcy of an individual does not succeed to the tax identity of the bankrupt and the individual's taxable year is not interrupted by the occurrence of bankruptcy,⁴⁵⁶ the courts at one time supposed that refunds that resulted from the carryback of losses for the year of bankruptcy were postbankruptcy assets that did not pass to the trustee.⁴⁵⁷ In *Segal v. Rochelle*,⁴⁵⁸ however, the Supreme Court held that the right to refunds, so far as they are based on the carryback of the portion of the bankrupt's net operating loss that had been incurred before bankruptcy, is an asset that existed at the date of bankruptcy and passed to the trustee, under section 70a(5) of the Bankruptcy Act,⁴⁵⁹ as "property, including rights of action, which prior to the filing of the petition he could by any means have transferred" The Court declared that the "main thrust" of that provision is "to secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition,"⁴⁶⁰ that it was equitable to give the creditors the benefit of the carryback because "the very losses generating the refunds often help precipitate the bankruptcy and injury to the creditors,"⁴⁶¹ and that the refund is

454. See text accompanying notes 536-43 *infra*.

455. INT. REV. CODE OF 1954, § 172(b)(1)(A).

456. See text accompanying notes 106, 319-22 *supra*.

457. *Fournier v. Rosenblum*, 318 F.2d 525 (1st Cir. 1963); *In re Sussman*, 289 F.2d 76 (3d Cir. 1961). No similar question arose in corporate cases or in individual rehabilitation proceedings, where the estate steps into the tax shoes of the debtor. See text accompanying notes 75-104, 142-46 *supra*. Concerning the possible exception when a corporation in straight bankruptcy obtains a discharge and resumes business, see notes 94-96 *supra*.

458. 382 U.S. 375 (1966).

459. 11 U.S.C. § 110(a)(5) (1970).

460. 382 U.S. at 379.

461. 382 U.S. at 378, *citing* the misgivings of the courts in the earlier adverse decisions cited in note 457 *supra*. Although the debtor, too, has lost his stake as a result

"sufficiently rooted in the prebankruptcy past and so little entangled with the bankrupt's ability to make an unencumbered fresh start that it should be regarded as 'property' under § 70a(5)."⁴⁶² The contingency that "earnings by the bankrupt after filing the petition might diminish or eliminate the loss-carryback refund claim"⁴⁶³ did not negate its character as property under the Act, since "an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed."⁴⁶⁴ The argument that the rights were property that the bankrupt could not "by any means have transferred" was rejected on the ground that, while assignments of claims against the United States, before their allowance, are by law made "absolutely null and void,"⁴⁶⁵ that provision voids a transfer only as against the government and does not affect its validity between the parties to the assignment.⁴⁶⁶ The Commission would confirm and codify the *Segal* rule by prescribing that, notwithstanding any federal or state law to the contrary, "[t]he right to any refund of taxes paid by the debtor, resulting from the carryback of net losses sustained before the date of the petition, shall be vested in the trustee and may be recovered as property of the debtor."⁴⁶⁷

Since the trustee is not entitled to file a return for the individual, the approved procedure for his obtaining the benefit of the carryback refunds is to file a claim for refund in his capacity as representative of the bankrupt.⁴⁶⁸ If the bankrupt improperly obtains

of his operating losses, it is the creditors who are entitled first to be made whole out of the assets existing at bankruptcy.

462. 382 U.S. at 380.

463. 382 U.S. at 380.

464. 382 U.S. at 379.

465. 31 U.S.C. § 203 (1970).

466. *Segal v. Rochelle*, 382 U.S. 375, 384 (1966), citing *Martin v. National Surety Co.*, 300 U.S. 588, 596 (1937). Matured income tax refund claims had earlier been held to pass to the trustee, *Chandler v. Nathans*, 6 F.2d 725 (3d Cir. 1925), and to be transferable to a receiver in a chapter XI arrangement. *In re Kepp Elec. & Mfg. Co.*, 98 F. Supp. 51 (D. Minn. 1951). The requirement of alienability would in any event, under COMMISSION REPORT, *supra* note 3, § 4-601, no longer be a condition to the passing of property to the estate.

467. *Id.* § 5-104(c). In prescribing a federal set of standards for exemptions, in lieu of those established by state law and section 6 of the present Bankruptcy Act, 11 U.S.C. § 24 (1970), the Commission would exempt certain cash equivalents, including tax refunds, in the aggregate amount of 500 dollars plus the excess of the debtor's "homestead" exemption (5000 dollars plus 500 dollars for each dependent) over the value of the equity in his home. COMMISSION REPORT, *supra* note 3, § 4-503(b)(2), (c)(3). But such exempt property would vest in the trustee for the purpose of collection and administration. *Id.* §§ 4-601(a)(1), -503 n.1.

468. Rev. Rul. 72-387, 1972-2 CUM. BULL. 632. The requisites for refund claims

the refund in his own right (for example, by accompanying his return filed after bankruptcy with an application for a "quickie" refund for the earlier years⁴⁶⁹), the bankruptcy court may order the bankrupt to turn over the amount recovered to the trustee.⁴⁷⁰ Sometimes, however, the carryback will result, not in a refund, but in reduction of a proposed deficiency for the earlier years to which the loss is carried, a reduction that the trustee may assert as a defense to a tax claim filed by the government in the bankruptcy proceeding. If, before bankruptcy, the bankrupt had filed a petition in the Tax Court contesting the deficiency, the Tax Court retains jurisdiction concurrent with the bankruptcy court, and the amount of the liability will be settled by the first court that reaches a decision.⁴⁷¹ The trustee may make himself a party to the Tax Court case and assert the bankrupt's defenses.⁴⁷²

by trustees in their representative capacity are set out in Treas. Reg. § 301.6402-2(e) (1955). A claim by the bankrupt himself is improper even if the estate has been closed. *Brangan v. United States*, 74-1 U.S. Tax Cas. ¶ 9214 (E.D. Va. 1973).

469. Refunds based on loss carrybacks are required to be paid within 90 days after application therefor (made after filing of the return for the loss year), subject to subsequent audit. INT. REV. CODE OF 1954, § 6411; Treas. Reg. § 1.6411-1, T.D. 6950, 1968-1 CUM. BULL. 528, 538.

470. This procedure was followed in *Fournier v. Rosenblum*, 318 F.2d 525 (1st Cir. 1963), although (since the case arose prior to the *Segal* decision) the First Circuit vacated the order of the district court inasmuch as it felt that it was not improper for the bankrupt to claim the carryback refund.

471. *In re Fotochrome, Inc.*, 346 F. Supp. 958 (E.D.N.Y. 1972); *Fotochrome, Inc.*, 57 T.C. 842 (1972). See INT. REV. CODE OF 1954, § 6871. The Commission's proposal to permit removal to the bankruptcy court of "any civil action" pending on the date of the petition, COMMISSION REPORT, *supra* note 3, § 2-202, would not apply to a Tax Court case since it relates only to actions "in a state or federal district court."

472. Treas. Reg. § 301.6871(b)-1(a), T.D. 6425, 1959-2 CUM. BULL. 384, 413. See BANKR. R. 610. If the carryback exceeds the income determined for the earlier year, the Tax Court may find an overpayment. INT. REV. CODE OF 1954, § 6512(b). The Tax Court seems clearly in error in holding, in *Norris Bloomfield*, 52 T.C. 745 (1969), *motion denied*, 54 T.C. 554 (1970), that, since the trustee and the bankrupt are separate taxpayers and the carryback, under the *Segal* rule, belongs to the trustee, the carryback cannot be allowed in a case instituted by the bankrupt, even if the trustee is made a party. The carryback, on the contrary, belongs to the trustee, not as a taxpayer, but as one to whom an asset of the bankrupt has passed by operation of law. It originates as an inchoate right before the estate comes into existence, *Segal v. Rochelle*, 382 U.S. 375, 380 (1966), and is measured by income and deductions of the individual, not of the estate; there will be a refund only if, taking the carryback into account, the bankrupt has overpaid his tax for the earlier year. While the Tax Court correctly, see *United States ex rel. Girard Trust Co. v. Helvering*, 301 U.S. 540, 542 (1937), pointed out, 52 T.C. at 750 n.7, that it had no power to order payment of the refund to the trustee, it improperly abdicated its statutory, INT. REV. CODE OF 1954, § 6512(b), function of determining by how much, considering the carryback, the individual taxpayer had overpaid his tax. The *Bloomfield* decision apparently puts the estate to the further trouble, expense, and delay of separately litigating the carryback issue in the bankruptcy court in defense to the government's claim for the deficiency found by the Tax Court, a defense that would not be barred by res judicata if, as *Bloomfield* holds, the Tax Court had no jurisdiction to pass on the issue. INT. REV. CODE OF 1954, § 6511(d)(2)(B)(i); *Hanson Clutch & Mach. Co. v. United States*, 72-1 U.S. Tax Cas.

2. *Offset of the Debtor's Income for the Balance of the Year*

For two reasons, the present structure of the federal tax law does not permit carrying the *Segal* rationale to its logical conclusion. The first is that, because the individual debtor's taxable year is unbroken at bankruptcy, any loss he may suffer in the prebankruptcy portion will first be offset by his earnings, if any, during the balance of the year, thereby reducing the amount available to produce carryback refunds for the benefit of the estate⁴⁷³ and giving the debtor a windfall in the form of tax-free treatment of income that is unavailable to his creditors.⁴⁷⁴ This problem would be resolved by the Commission's proposal (applicable to state and local, as well as federal, taxes) that the loss for the prebankruptcy portion of the year be made available for carryback for the benefit of the estate, unreduced by postbankruptcy income, on which the debtor would be subject to tax.⁴⁷⁵

3. *Carryovers*

The second impediment to giving full effect to the equitable principle of the *Segal* case is that frequently the bankrupt will have had insufficient net income in the three preceding years to absorb the losses and produce maximum refunds for the benefit of the estate; the unabsorbed operating losses—to which are added excess capital losses, which can be carried only forward and not back⁴⁷⁶—may then become available to reduce the taxes that would otherwise have been incurred by the discharged debtor on his income for five postbankruptcy years.⁴⁷⁷

¶ 9303 (N.D. Ohio 1972). So far as the carryback offsets the deficiency determined by the Tax Court, it will be barred if not raised as a defense in the bankruptcy court. *Cohen v. United States*, 115 F.2d 505 (1st Cir. 1940). But if a net overpayment results from the carryback, the trustee would apparently have to fragment the case still further by filing first a claim for refund and then a plenary suit, since the bankruptcy court would have no power to grant affirmative relief against the United States. *In re Vista Liner Coach & Trailer, Inc.*, 447 F.2d 497 (10th Cir. 1971), *cert. denied*, 405 U.S. 954 (1972). The Commission's proposal to permit the trustee to proceed in the bankruptcy court to collect claims on behalf of the estate, COMMISSION REPORT, *supra* note 3, § 2-201(a), including claims against the United States, *id.* § 1-104, would make unnecessary the third stage of fragmentation, the plenary suit. The *Bloomfield* jurisdictional aberration is not otherwise dealt with and, unless Congress takes the initiative, must be left to the Tax Court's power of self-correction.

473. INT. REV. CODE OF 1954, § 172(c).

474. On the other hand, if the bankrupt suffers a further loss during the balance of the year, it appears that the refunds resulting from the carryback of the loss for the full year are to be apportioned between the estate and the individual. *See Segal v. Rochelle*, 382 U.S. 375, 380 n.5 (1966).

475. COMMISSION REPORT, *supra* note 3, § 5-104(c). This legislative solution had been suggested in *Fournier v. Rosenblum*, 318 F.2d 525, 527 n.3 (1st Cir. 1963). *See also* Seidman, *Some Implications of Segal v. Rochelle*, 40 REF. J. 107, 108 (1966).

476. INT. REV. CODE OF 1954, § 1212(b).

477. INT. REV. CODE OF 1954, § 172(b)(1)(B).

The *Segal* decision left open, but implied a negative answer to, the question whether the estate might recoup the tax savings enjoyed by the debtor from carrying the unabsorbed loss forward to succeeding years.⁴⁷⁸ The loss could, in any event, not be used against income of the estate as a taxable entity, since loss carryovers, in the absence of an express statutory provision, may not ordinarily be offset against income of another taxpayer.⁴⁷⁹ Theoretically, on the other hand, the estate should be as entitled to recoup the tax saved by the individual through his use of the prebankruptcy losses to offset his future income as it is to recover the refunds of past taxes resulting from carryback of those losses. The individual's tax savings through carryovers to later years are as much "rooted in the prebankruptcy past" as the refunds resulting from carrybacks, and the bankrupt's right to an "unencumbered fresh start" does not require that he enjoy freedom from income tax on his subsequent earnings by reason of carryovers of prebankruptcy losses, the burden of which fell on his creditors. Loss carryovers and carrybacks are essentially averaging devices, "designed to permit a taxpayer to set off [his] lean years against [his] lush years, and to strike something like an average taxable income computed over a period of longer than one year."⁴⁸⁰ Congress could as easily have provided for the loss to go back eight years, in which case the entire benefit of the losses would belong to the trustee under the *Segal* principle. The fact that Congress elected for practical reasons to have the loss carried three years back and five years forward⁴⁸¹ does not alter the equities.

The Court in *Segal*, however, suggested⁴⁸² a conceptual impediment to such an extension of the principle: Whereas the *carryback* refund reflects the offset of income earned by the individual in the past against a loss already sustained and is contingent only on the possibility that his earnings later in the year of bankruptcy will deplete the loss, the tax saving from *carryovers* is subject to the further contingency that the individual have future earnings against which the loss may be offset. The Court also took note of the practical impediment that the estate might have to be held open for a number of years awaiting the realization of sufficient earnings by the bankrupt to offset the earlier losses.⁴⁸³ It might also have observed

478. *Segal v. Rochelle*, 382 U.S. 375, 381 (1966).

479. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934). Cf. *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 385-86 (1957).

480. *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957).

481. INT. REV. CODE OF 1954, §§ 172(b)(1)(A)(i), (1)(B). Longer periods for carryback and carryover are provided in section 172(b) for special situations.

482. 382 U.S. at 381.

483. 382 U.S. at 381.

that, since the carryover results, not in a claim for tax refund, but in a reduction of the bankrupt's tax bill, the trustee would have to recover the difference by proceeding against the bankrupt himself for the amount saved.

An alternative to incurring the practical difficulties of policing the debtor's later tax situation and of keeping the estate open during the five-year carryover period⁴⁸⁴ (or of reopening the estate for unadministered assets, if necessary⁴⁸⁵), in order to reclaim later tax savings from the debtor, would be to make the debtor's loss carryovers available directly to the estate as a taxable entity, to be offset against any net income realized by the estate during administration.⁴⁸⁶ There is legislative precedent for transferring loss carryovers to a different taxable entity where there is sufficient continuity of beneficial interest (as there is here, under the *Segal* rationale, between the individual in his prebankruptcy period and the trustee as representative of the creditors, who bore the burden of the loss). The unused operating and capital losses of an estate or trust, after its termination, are made available, by section 642(h)(1) of the Code, for use against income of the "beneficiaries succeeding to the property of the estate or trust," a phrase that the regulations interpret to mean "those beneficiaries . . . who bear the burden of any loss for which a carryover is allowed."⁴⁸⁷ And such loss carryovers of one corporation are made available by sections 381(c)(1) and (3) to offset income of another corporation, if the latter succeeds to all or substantially all of the former's assets in certain tax-free transactions, subject to certain restrictions⁴⁸⁸ on the transferability of the benefit of the loss carryovers to new owners who did not bear the burden of the losses. Although the present situation is unusual in that the individual taxpayer in whose returns the losses originated continues to exist, whereas under section 642(h)(1) and in most cases under section 381 the transferor's existence is terminated, there is precedent for such a case as this. In certain corporate reorganizations within the scope of section 381 it is permissible for the

484. In the case of capital losses, the carryover period may last for the taxpayer's lifetime. INT. REV. CODE OF 1954, § 1212(b).

485. Bankruptcy Act § 2a(8), 11 U.S.C. § 11(a)(8) (1970). Cf. *Brangan v. United States*, 74-1 U.S. Tax Cas. ¶ 9214 (E.D. Va. 1973). See J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 307, at 366 (1956).

486. See Krause & Kapiloff, *supra* note 83, at 417-18, who urge, as an alternative to their preferred course of exempting the estate entirely from income tax, that "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."

487. Treas. Reg. § 1.642(h)-3(a) (1956).

488. INT. REV. CODE OF 1954, §§ 382-83.

transferor to continue in existence,⁴⁸⁹ although the transferee succeeds to the transferor's loss carryovers,⁴⁹⁰ and the transferor makes a fresh tax start.⁴⁹¹

Therefore, in lieu of making the discharged debtor's tax savings through carryovers recoverable by the trustee for the benefit of the estate, the Commission has proposed that prebankruptcy losses of an individual in straight bankruptcy (so far as they are not carried back against the debtor's income and made available to the estate under the *Segal* principle) "shall not be allowed [as carryovers] to the debtor but shall be allowed to the estate in the computation of any [federal, state, or local] taxes on or measured by income of the estate in the same manner and for the same periods in which such carryovers would have been allowable by law to the debtor."⁴⁹²

The transfer of the debtor's loss carryovers to the estate will, in most cases, be a futile gesture, so far as creditors are concerned, if Congress adopts the Commission's companion proposal to exempt estates in straight bankruptcy from any taxation of their income, except in the unusual cases in which all debts can be paid and there remains a surplus for the debtor.⁴⁹³ But even if the estate remains subject to income taxation, it may have little administrative net income against which to absorb the loss carryovers and, in fact, may itself suffer an operating loss, particularly if the expenses incurred by a debtor on the cash basis, paid from the proceeds of liquidation, are not accumulated as deductions in the debtor's last prebankruptcy return (as I have urged above⁴⁹⁴) but are considered expenses of the estate. The question then arises whether the estate's own unused losses and those it inherits from the bankrupt might be availed of by the creditors on their own tax returns. Reference has been made above to section 642(h), by which unused loss carryovers of an estate or trust are made available to the "beneficiaries

489. Rev. Rul. 68-358, 1968-2 CUM. BULL. 156, which holds that a reorganization described in INT. REV. CODE OF 1954, § 368(a)(1)(C) (the acquisition by one corporation, solely in exchange for all or part of its own or its parent's voting stock, of substantially all the properties of another corporation) may exist even if the transferor retains the stock received in exchange and continues to exist as a holding company.

490. *World Serv. Life Ins. Co. v. United States*, 471 F.2d 247 (8th Cir. 1973); Treas. Reg. § 1.382(b)-1(b)(2) (1962). Although the government attempted (unsuccessfully) to deny the carryovers in the cited case, the attempt was on the basis of its interpretation of restrictive language in section 382(b) of the Code, which there would be no occasion to make applicable to the present situation.

491. Treas. Reg. § 1.381(b)-1(c) (1960).

492. COMMISSION REPORT, *supra* note 3, § 5-104(c). The final clause is intended to ensure that the period during which the carryovers will remain available will not be shortened as a result of the injection of an additional "taxable year" when the carryovers pass from the debtor to the estate. See text accompanying note 240 *supra*.

493. See text accompanying notes 147-88 *supra*.

494. See text accompanying notes 386-441.

succeeding to the property," whose shares were diminished as a result of the losses.⁴⁹⁵ The Tax Court, in denying the inheritance of the estate's unused losses to the debtor himself, has declared that it is not he but the creditors who "receive a lesser amount" when the estate has suffered a loss.⁴⁹⁶ The court has also ruled, however, that the estate of an individual bankrupt, even though the only basis on which it has been held a taxable entity is that it is an "estate" within the meaning of the revenue law,⁴⁹⁷ is not an "estate" for purposes of section 642(h).⁴⁹⁸ In any event, the creditors receive their distributions, not as "beneficiaries" in the sense commonly understood, but as payees of obligations.⁴⁹⁹

The practical difficulties of making the unused losses deductible directly by the creditors argue strongly against adopting that expedient, and the Commission has not recommended any amendment toward that end. It would be impracticable to apportion the benefit of the loss among a mass of creditors with different priorities, even if they found it feasible to calculate the losses sustained in the absence of any returns by the trustee. Furthermore, since the only equitable ground on which the creditors might be entitled to such a benefit would be that it enables them to recoup a portion of their uncollected claims,⁵⁰⁰ logic would require that the amount of any ultimate tax saving they personally enjoy should itself be taxed to them as a recovery on their previously deducted bad debts⁵⁰¹ or on claims they had not theretofore taken into income.⁵⁰²

In my opinion, the Commission erred in recommending⁵⁰³ that the individual debtor himself be deprived of the right to use his own loss carryovers, even when the estate is unable to utilize them. In justification of its position, the Commission states: "Nor should the bankrupt have the benefit in future years of loss carryovers when the very debts reflecting the losses have been cancelled and the loss has been sustained not by the bankrupt but by his creditors. The bankruptcy law is designed to give the bankrupt a 'fresh start'—not a 'head start.'"⁵⁰⁴ I submit, however, that the unqualified denial

495. See note 487 *supra*.

496. Henry C. Mueller, 60 T.C. 36, 45 (1973).

497. See text accompanying notes 106-18 *supra*.

498. Henry C. Mueller, 60 T.C. 36, 45 (1973).

499. Rev. Rul. 68-48, 1968-1 CUM. BULL. 301, 303. See text accompanying notes 217-25 *supra*. Cf. Greggar P. Sletteland, 43 T.C. 602, 610 (1965).

500. Cf. Segal v. Rochelle, 382 U.S. 375 (1966).

501. See First Natl. Bank of Lawrence County, 16 T.C. 147, 153 (1951). Cf. INT. REV. CODE OF 1954, § 111.

502. See Clifton Mfg. Co. v. Commissioner, 137 F.2d 290, 292 (4th Cir. 1943).

503. COMMISSION REPORT, *supra* note 3, § 5-104(c).

504. *Id.*, pt. I, at 280. Although the verbal flourish in the second sentence is ap-

to the debtor of any benefit from his unabsorbed loss carryovers represents a meat-ax approach to a problem to which the Commission has elsewhere properly applied a scalpel. The amount of the carryovers may differ substantially from the amount of unpaid debts and may not even include any such unpaid debts if the debtor had used the cash basis of accounting and was entitled to deduct only the expenses he had paid.⁵⁰⁵ The proper remedy for any undue advantage to the debtor that results from inclusion in the carryover of accrued but unpaid obligations is not to deny the carryovers absolutely, but to *reduce* the carryovers to the extent that they reflect deductible obligations that are cancelled or reduced in the proceeding, thereby confining the carryovers to the actual economic loss suffered by the debtor. Curiously, the Commission recognized that principle in a companion recommendation by which carryovers generally would be so reduced.⁵⁰⁶ In reorganization and rehabilitation proceedings, that is the only adjustment that would or should be made.⁵⁰⁷ To deny the individual discharged in straight bankruptcy the benefit of his own unabsorbed carryovers, properly so adjusted, is not only unjust discrimination, but unsound tax law.⁵⁰⁸

parently derived from the dissent in *Lines v. Frederick*, 400 U.S. 18, 21 (1970) (Harlan, J., dissenting), that case involved a very different issue (the debtor's right to receive, free of the claims of creditors, vacation pay that he had earned before bankruptcy). The Commission's viewpoint, however, accords with that of the prevailing opinion (but not of a clear majority) in *Henry C. Mueller*, 60 T.C. 36, 45 (1973), discussed in text accompanying notes 400-21 *supra*, although the carryover denied there was based, not on expenses paid by the debtor before bankruptcy, but on expenses of the debtor's business paid from his assets by the trustee as a distinct taxable entity.

505. In fact, the proposed forfeiture of past carryovers would apply even if every dollar of the debtor's previously unsatisfied debts is paid by the trustee from his assets. Cf. *Henry C. Mueller*, 60 T.C. 36, 48 (1973) (Quealy, J., dissenting).

506. COMMISSION REPORT, *supra* note 3, at 293 (proposed INT. REV. CODE OF 1954, § 172(d)(7)). See also text accompanying note 441 *supra*.

507. It would not be made in such cases if the creditor received an equity security for the debt and thus became a participant in the continuing enterprise by which the carryover is to be utilized. For the same reason, no such adjustment should be made in the carrybacks and carryovers so far as they benefit the estate rather than the debtor. Cf. text accompanying notes 437-41 *supra*.

508. A similar case of "overkill" is reflected in the reasoning of *Willingham v. United States*, 289 F.2d 283 (5th Cir.), *cert. denied*, 368 U.S. 828 (1961), where, among other grounds for denying loss carryovers following a bankruptcy reorganization, the court referred to the purpose of the carryover provision to enable a taxpayer to "set off its lean years against its lush years," and declared that "[t]his loss taxpayer 'set off its lean years' by having them wiped out in the reorganization proceedings." 289 F.2d at 287, quoting *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 385 (1957). It has been pointed out:

Willingham fatally oversimplifies a most complex situation. There is at best an uncertain relationship between the benefits of a discharge of indebtedness and the detriment of eliminating net operating losses [T]here is no necessary relationship between the amount of debt discharged and the amount of the existing net operating loss This analysis suggests that if there are unjustifiable tax windfalls growing out of a Chapter X or XI proceeding, they should not be dealt with by an arbitrary denial of net operating loss—they should be

Unquestionably, the tax benefit to be derived from the debtor's loss carryovers, even when they reflect actual cash expenditures by him, is something of value that is "rooted in the prebankruptcy past" and should be subjected so far as practicable to the superior equity of the creditors.⁵⁰⁹ Provision has properly been made in the Commission's recommendation for the use of such carryovers by the trustee in so far as they can be availed of, and, practical considerations aside, it would be appropriate to entitle the trustee to reach the debtor's own tax savings from use of the unabsorbed carryovers.⁵¹⁰ However, the superiority of the creditors' unexercised equitable right detracts nothing from the subordinate, but nonetheless real, equitable right of the debtor himself to utilize losses arising from his assets and business, with proper adjustment for deductions attributable to unpaid expenses. When the creditors have had all the benefit they can practically derive from the carryovers as an asset of the debtor, that asset ought, in effect, to be abandoned to the debtor rather than forfeited to the taxing authorities.

For the same reason, I submit that the unabsorbed losses sustained by the estate itself, when the creditors, through the estate, have gained all the advantage that it is practicable to give them, should be made available to the debtor to reduce his postbankruptcy taxes. The losses of the estate, although it is a legally distinct taxpayer, derive from the trustee's payment of deductible items with the bankrupt's assets, from the realization by the trustee of declines in the value of the bankrupt's assets below his cost, and from the administration of the bankrupt's assets for the satisfaction of his debts. Such losses do not differ qualitatively from the debtor's own losses; the former and latter together, with due adjustment for unpaid items, reflect the debtor's economic loss.

No doubt the Commission's proposal to relieve the trustee of filing any returns will, if adopted, raise a practical impediment to the determination of the estate's tax losses, as well as of the amount of the individual's prebankruptcy carryovers that would have been absorbed by income of the estate if it had been taxable. But an expedient adopted for convenience in bankruptcy administration should not be made to penalize the debtor. The amount of the estate's losses or income can presumably be reconstructed from the accounts required to be filed with the court, and, if the debtor under-

remedied through modification of the cancellation of indebtedness and basis adjustment rules.

Tillinghast & Gardner, *supra* note 267, at 714.

509. Cf. *Segal v. Rochelle*, 382 U.S. 375, 379 (1966). See text accompanying notes 478-81 *supra*.

510. But see text accompanying notes 482-85 *supra*.

takes such a reconstruction, he should be entitled to the benefit of the losses.

If those losses are to be made available to the debtor, consideration must be given to the taxable years to which they should be carried. If the pattern of section 642(h) were followed, the losses would be carried first to the taxable year of the bankrupt that is in progress when the administration terminates and then forward to succeeding years.⁵¹¹ Application of that principle, however, would greatly restrict the period within which the carryovers of net operating losses may be absorbed. The customary three-year carryback would not be available at all,⁵¹² and the five-year carryover period would be constricted into as few as three calendar years by the rule that each short taxable period is considered a "taxable year" for this purpose.⁵¹³ The twelve-month period in which bankruptcy occurs and the trustee succeeds to the bankrupt's carryovers would embrace two such periods,⁵¹⁴ and two more "taxable years" of availability would be embraced in the twelve-month period in which the proceeding ends and the carryovers revert to the bankrupt.⁵¹⁵ To illustrate: *A*, who files returns on the calendar-year basis, becomes bankrupt on July 1, 1974, having suffered a net operating loss for the period ending on that date, much of which remains unabsorbed by carryback against income of earlier years. The trustee, who also reports on the calendar-year basis, terminates the administration on November 30, 1975, leaving part of the loss still unabsorbed. Under the foregoing principles, the "taxable years" in which the loss carryover may be used would be (1) the estate's six-month period ending December 31, 1974; (2) the estate's eleven-month period ending November 30, 1975; and the bankrupt's calendar years (3) 1975, (4) 1976, and (5) 1977.⁵¹⁶ Absent bankruptcy, a loss sustained in 1974 could have been utilized in years through 1979. In the interest of equity, as well as of rehabilitation of the bankrupt, a device adopted to make the debtor's losses available to the estate for the

511. See Treas. Reg. § 1.642(h)-1(b), T.D. 6828, 1965-2 CUM. BULL. 264, 265-66.

512. The unused losses of an estate or trust, under INT. REV. CODE OF 1954, § 642(h), may be carried only forward, not backward, by the beneficiaries. Treas. Reg. § 1.642(h)-5(b) (1956). Although not observed by the court, which was right for the wrong reasons, the debtor in *Henry C. Mueller*, 60 T.C. 36, 43 (1973), relying on INT. REV. CODE OF 1954, § 642(h), erroneously sought to use the bankrupt estate's unused net operating loss, in part, by carryback to a year earlier than that in which it was sustained.

513. Treas. Reg. § 1.172-4(a)(2) (1956).

514. Cf. Treas. Reg. § 1.381(c)(1)-1(e)(3) (1960). See note 240 *supra*.

515. Treas. Reg. § 1.642(h)-1(b) (1965).

516. The trustee's selection of a taxable year ending with a different month from the bankrupt's could vary the details, but the effect would generally be the same following the reversion of the carryovers to the bankrupt.

benefit of his creditors to the extent needed should not be permitted to reduce the period in which he may utilize the amount the trustee does not need. I suggest, therefore, that the losses not consumed by income of the estate during the full period of administration be made retroactively available to the bankrupt, to be used by him for years during and after bankruptcy as if bankruptcy had not occurred.⁵¹⁷

4. *Losses on Partnership and Joint Returns*

a. *Partnerships.* The dual status of a partnership creates special complications in dealing with carrybacks and carryovers in bankruptcy. The Bankruptcy Act marshals partnership assets first against partnership debts and individual assets first against individual debts.⁵¹⁸ But since the income tax law treats the individual partners, before bankruptcy, as liable for tax on the partnership income and entitled to deduct its losses,⁵¹⁹ it is the individual bankrupt estates from which the tax on any prebankruptcy income is to be collected,⁵²⁰ and to which, under the normal operation of the *Segal* rule, the refunds attributable to carrybacks of partnership losses would flow.⁵²¹ The Commission properly proposes that the amount of any refunds of individual taxes that is fairly apportionable to the carryback of partnership losses (unless such losses were reimbursed by the partner) shall become assets of the estate of the partnership, whose creditors suffered the burden of those losses.⁵²²

Following bankruptcy, the partnership estate is no longer treated for tax purposes as a mere conduit of income to the partners or their estates but is treated as a distinct taxpayer.⁵²³ The Commission's proposal would assure that, to the extent that such estate may remain taxable, it would be entitled, to the exclusion of the individual estates, to deduct the individual loss carryovers fairly apportionable to partnership losses.

517. This detail is consistent with the principle of the Commission's more limited recommendation that the bankrupt's carryovers be allowable to the estate "in the same manner and for the same periods in which such carryovers would have been allowable by law to the debtor." COMMISSION REPORT, *supra* note 3, § 5-104(c).

518. Bankruptcy Act § 5g, 11 U.S.C. § 23(g) (1970). The Commission would modify this rule to permit partnership creditors to share in the partners' estates on a parity with individual creditors but would still subordinate individual creditors in partnership assets. COMMISSION REPORT, *supra* note 3, § 4-405(f) & n.14.

519. INT. REV. CODE OF 1954, §§ 701-04; *United States v. Basye*, 410 U.S. 441, 448 (1973).

520. *Cf. United States v. Kaufman*, 267 U.S. 408 (1925). The Commission's remedy for this problem will be dealt with in part I(B)(2)(c) of Plumb, *supra* note 165.

521. This question was inherent in the fact situation in *Segal*, where the bankrupts were a partnership and its partners, but was not the subject of the litigation.

522. COMMISSION REPORT, *supra* note 3, § 5-104(d).

523. *See* text accompanying notes 133-34 *supra*.

If a partnership becomes bankrupt but one or more of its partners does not,⁵²⁴ the nonbankrupt partners' rights to refunds based on the *carryback* of their shares of the partnership's losses would nevertheless, under the proposal, vest in the partnership estate,⁵²⁵ but the *carryovers* of such losses would remain available to them and would not be allowable to the partnership estate.⁵²⁶ Such treatment is beneficial to the creditors, however, since the partnership estate, unless solvent, would be nontaxable anyway under the Commission's proposal and could gain no benefit from the carryovers, while the nonbankrupt partners, not having the benefit of a discharge, would enhance by use of the carryovers their future assets, which partnership creditors may reach.⁵²⁷

b. *Joint returns.* Where the bankrupt had filed joint returns with his or her spouse, losses may be apportioned between them for the purpose of giving the trustee the benefit of the carrybacks.⁵²⁸ If the year to which the losses are carried back is also a joint return year, it may be claimed, in certain states where rights to money may be so held, that the refund right belongs to the husband and wife as tenants by the entirety,⁵²⁹ exempt from creditors of either spouse under state law and hence unreachable by the trustee under the present Bankruptcy Act⁵³⁰ (unless the nonbankrupt spouse dies within six months after the filing of the petition).⁵³¹ In an effort to make uniform the exemptions applicable in bankruptcy (heretofore governed by widely varying state laws), the Commission proposes⁵³²

524. See Bankruptcy Act § 5a, 11 U.S.C. § 23(a) (1970); *Liberty Natl. Bank v. Bear*, 276 U.S. 215 (1928).

525. COMMISSION REPORT, *supra* note 3, § 5-104(d) entitles the partnership estate to any refunds "of a partner's tax" attributable to partnership losses and is not confined to bankrupt partners.

526. Under *id.*, § 5-104(d), only carryovers "allowable to the estate of a partner in accordance with [§ 5-104(c)]" become allowable to the partnership estate to the extent attributable to partnership losses and are disallowed to the "debtor." Such language can refer only to a partner who is himself bankrupt.

527. Bankruptcy Act § 5j, 11 U.S.C. § 23(j) (1970). Cf. *Francis v. McNeal*, 228 U.S. 695 (1913).

528. Cf. Treas. Reg. § 1.172-7(d) (1956), concerning apportionment of joint return losses carried to separate returns.

529. See *In re Sussman*, 188 F. Supp. 320, 323-24 (E.D. Pa. 1960), *aff'd.*, 289 F.2d 76 (3d Cir. 1961), in which the district court referred to but did not rely upon the referee's conclusion to that effect. But the court in *In re Wetteroff*, 453 F.2d 544 (8th Cir. 1972), *cert. denied*, 409 U.S. 934 (1972), found no such intention manifested by mere joinder in a single tax return in order to use the more favorable tax rates applicable thereto.

530. Cf. *Hayes v. Schaefer*, 399 F.2d 300 (6th Cir. 1968) (similar argument made by bankrupt not accepted by court due to interpretation of state law); *Reid v. Richardson*, 304 F.2d 351 (4th Cir. 1962) (dictum).

531. See Bankruptcy Act § 70a, 11 U.S.C. § 110(a) (1970).

532. COMMISSION REPORT, *supra* note 3, § 4-601(b). Since the bankrupt spouse's interest is not an outright half interest but is subject to mutual survivorship rights,

to make available to the trustee the bankrupt spouse's interest in property held by the entirety, an effort that may prove ineffective if the courts adhere to the view⁵³³ that the immunity of entirety property results, not from an exemption, but from a constitutionally protected right of the nonindebted spouse to the enjoyment of the whole property, shared only with the spouse. But even if that provision is not enacted or is ineffective, it would be only the *carryback* refunds that the immunity would affect, and the use of *carryovers* of the bankrupt spouse's losses could validly be made available to the trustee; the carryovers are not a property right of the spouses but exist by grace of Congress,⁵³⁴ and what Congress gives it can take away or confer upon another (the trustee).⁵³⁵

B. Other "Tax Attributes"

Although attention is generally focused on loss carryovers, there are numerous other "tax attributes," including such matters as accounting and depreciation methods, carryovers of excess charitable contributions and pension plan deductions, investment credits, and the like, the carryover of which may be of concern in any business succession. Congress, in section 381(c) of the Code, has identified twenty-two such tax attributes, in addition to losses, that it has concluded ought to follow the business into the hands of successors in certain intercorporate transfers, and there may be as many more not expressly dealt with.⁵³⁶ In the case of a corporate bankruptcy, the trustee's succession to such tax attributes is assured, since the law places the trustee in the tax shoes of the corporation as if there had been no transfer.⁵³⁷ But, because the survival of the individual as a taxpaying entity, although divorced from his business and most of

it appears that the nonbankrupt spouse would be paid the actuarial value of his or her interest in the proceeds of the claim. *See id.* § 5-203(c).

533. *See, e.g., United States v. Hutcherson*, 188 F.2d 326 (8th Cir. 1951). *See Plumb, Federal Liens and Priorities—Agenda for the Next Decade II*, 77 YALE L.J. 605, 634-40 (1968).

534. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

535. The resulting anomaly that the bankrupt and his spouse would then enjoy the benefit of the prebankruptcy loss to the extent that he and his spouse had prebankruptcy income to offset it and that the creditors would benefit only from what they are unable to absorb in that manner must be blamed, not on the legislative proposal, but on the anachronism of property law.

536. *See Reese, Reorganization Transfers and Survival of Tax Attributes*, 16 TAX L. REV. 207, 208 (1961). Their inheritance in intercorporate transfers is left to the ill-defined "common law" of taxation. Treas. Reg. § 1.381(a)-1(b)(3)(i) (1960); Rev. Rul. 68-350, 1968-2 CUM. BULL. 159.

537. The further right to carry over tax attributes from a debtor corporation or its estate to a successor in a reorganization, a right that is doubtful under present law, would be provided for by the Commission in proposed amendments to sections 381 and 382 of the Code. COMMISSION REPORT, *supra* note 3, at 296-97. *See Plumb, supra* note 270.

his assets, necessitates treating the estate of a noncorporate bankrupt as a new and distinct taxpayer, it is unlikely that the tax attributes follow the business in such cases.

Among other questions in this area, it is uncertain whether the estate, if required to repay an amount on which the bankrupt had been taxed when he received it erroneously but under claim of right,⁵³⁸ would be permitted, as the bankrupt would have been,⁵³⁹ to relate the repayment back to the year of receipt and thus to recover an amount equal to the tax the bankrupt had paid thereon for that year.⁵⁴⁰ It is also doubtful that the trustee would be entitled to exclude from taxable income of the estate a recovery of a bad debt or of an overpayment of a tax or expense that the bankrupt had deducted in a loss year without enjoying any tax benefit from the deduction,⁵⁴¹ although the bankrupt himself would not have been taxable on such recovery.⁵⁴² It is also unlikely that the trustee would succeed to, or be bound by, the established methods of accounting, inventory, and depreciation of the bankrupt individual or partnership whose assets and business he assumed.⁵⁴³

The Commission made no recommendation on these matters, perhaps because, under its proposal, the estate will rarely be a taxpayer (although that did not deter the Commission from dealing with the transfer of loss carryovers in such circumstances). At least if estates in bankruptcy are to remain generally taxable, Congress ought to provide that the trustee for a bankrupt individual or partnership, even though deemed a new taxable entity, should, nevertheless, succeed to those and other tax attributes of the business he has taken over, in the same manner that a trustee for a bankrupt corporation would do.

538. See, e.g., *United States v. Lewis*, 340 U.S. 590 (1951).

539. INT. REV. CODE OF 1954, § 1341.

540. The Service holds such relief unavailable to a decedent's estate when death intervenes between the receipt and the repayment. Rev. Rul. 67-355, 1967-2 CUM. BULL. 296. *Contra*, *Estate of Good v. United States*, 208 F. Supp. 521 (E.D. Mich. 1962) (rejected by Rev. Rul. 67-355). See *Estate of Samuel Stein*, 37 T.C. 945, 958 (1962), *computations aff'd.*, 40 T.C. 275 (1963).

541. Cf. *Michael Carpenter Co. v. Commissioner*, 136 F.2d 51 (7th Cir. 1943) (dictum); *National Bank of Commerce of Seattle*, 12 T.C. 717 (1949). *But cf.* *Ridge Realization Corp.*, 45 T.C. 508, 523-26 (1966), *not acquiesced in*, 1972-2 CUM. BULL. 4. In certain intercorporate transactions, the successor now steps into the predecessor's shoes for this purpose. INT. REV. CODE OF 1954, § 381(c)(12).

542. INT. REV. CODE OF 1954, § 111; Treas. Reg. § 1.111-1(a) (1956).

543. Cf. *Textile Apron Co.*, 21 T.C. 147 (1953) (involves LIFO inventory method, following a tax-free transfer to a controlled corporation). The trustee may also be regarded as a new taxpayer for the purpose of the adjustments required by INT. REV. CODE OF 1954, § 481, if the estate adopts or is obliged to adopt a method different from the bankrupt's. Cf. *Ezo Prods. Co.*, 37 T.C. 385 (1961); *Frank G. Wikstrom & Sons, Inc.*, 20 T.C. 359 (1953). Congress has provided for continuity of such methods following intercorporate transfers in INT. REV. CODE OF 1954, §§ 381(c)(4), (5), (6).