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Bankruptcy-Federal Tax Claims-Accrual of Post-Petition Interest

Robert Lane
University of Michigan Law School

RECENT DECISIONS

BANKRUPTCY—FEDERAL TAX CLAIMS—ACCRUAL OF POST-PETITION INTEREST—In 1953 taxpayer filed a petition and was discharged in bankruptcy owing federal withholding and social security taxes for 1951. In 1958 taxpayer became entitled to a refund on his 1953-1954 taxes. The Commissioner applied a portion of this refund against the balance of the tax for the year 1951, plus accrued interest to 1958. Taxpayer claimed that he was not liable for the interest which had accrued during the period between the date of petition in bankruptcy and the date of refund. When the Commissioner disallowed his claim, the taxpayer brought an action in district court to recover the disputed portion of the interest. *Held,* complaint dismissed. Interest on delinquent taxes will accrue against a taxpayer after the filing of a petition in bankruptcy. *Bruning v. United States,* 192 F. Supp. 826 (S.D. Cal. 1961).

As a general rule, interest on claims against a bankruptcy estate ceases to accrue once a petition in bankruptcy has been filed.[1] The policy behind the rule is twofold. One consideration is the protection of the general creditors from the further depletion of the bankruptcy estate by interest accruing on priority claims. The other is the preservation of each creditor's proportional interest in the bankruptcy estate as it stood at the date of the filing of the petition.[2] Although the common law "cut-off" rule has been held to be applicable to interest on delinquent federal tax claims,[3] in three exceptional situations the foregoing policy considerations are not present and post-petition interest has been held to accrue against the bankruptcy estate. These exceptions arise when the estate becomes solvent,[4] when property upon which there is a specific lien produces income after the date of bankruptcy,[5] or when the proceeds from the sale of property upon which there is a specific lien is sufficient to pay both the principal and the interest.[6]

1 This rule was derived from the English bankruptcy law. See Sexton v. Dreyfus, 219 U.S. 339 (1911).

2 American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U.S. 261, 266 (1914); Thomas v. Western Car Co., 149 U.S. 95, 117 (1893).

3 City of New York v. Saper, 336 U.S. 328 (1949). The holding in this case has been extended in the following cases: United States v. Edens, 342 U.S. 912 (1952), *affirming* 189 F.2d 876 (4th Cir. 1951) (interest on tax claims in reorganization proceeding); United States v. General Eng'r & Mfg. Co., 342 U.S. 912 (1952), *affirming* 188 F.2d 80 (8th Cir. 1951) (interest on tax claims in arrangement proceedings); United States v. Bass, 271 F.2d 129 (9th Cir. 1959); United States v. Harrington, 269 F.2d 719 (4th Cir. 1959) (interest on tax claims secured by pre-bankruptcy liens). *Contra,* Matter of Ridgecrest Dev. Co., 129 F. Supp. 708 (S.D. Cal. 1950).

4 United States v. Bass, *supra* note 3; United States v. Harrington, *supra* note 3.

5 *Ibid.*

6 United States v. Bass, 271 F.2d 129, 130 (9th Cir. 1959). *But see* United States v. Harrington, 269 F.2d 719, 722 (4th Cir. 1959). The last two exceptions have generally been denied to pre-bankruptcy liens on federal tax claims because these liens

The policy considerations which led to the use of the "cut-off" rule are likewise inapplicable to a claim for post-petition interest against a taxpayer discharged in bankruptcy.[7] The Government's claim for taxes may not be discharged in the bankruptcy proceedings.[8] Consequently, that claim may be viewed both as a claim against the assets of the taxpayer's bankruptcy estate and as a personal claim against the taxpayer. The personal claim will survive the bankruptcy proceedings to the extent it is not satisfied in the distribution of the bankruptcy estate. Thus, it is only necessary to terminate the accruing of interest against the estate in order to give effect to the considerations which justify the "cut-off" rule. Relying on this distinction, the court in the principal case has created a new inroad into the application of the "cut-off" rule by holding that interest on delinquent taxes may accrue against the taxpayer. The court felt that this conclusion, which is in accord with the Treasury Regulations,[9] was compelled by its construction of the Internal Revenue Code, which provides that interest shall be treated as a part of the delinquent tax;[10] and of the Bankruptcy Act which expressly exempts tax obligations from discharge.[11]

The circuits, however, have not been in accord with this analysis. In *United States v. Mighell*[12] the Tenth Circuit held that post-petition interest did not accrue against a taxpayer discharged in bankruptcy. However, this decision was based solely upon *United States v. Bass*,[13] and *United States v. Harrington*,[14] in which the issue concerned post-petition interest sought to be allowed against the bankruptcy estate, not against the taxpayer. On the other hand, the Second Circuit has denied the Government's claims for post-petition interest against reorganized corporations following arrangement proceedings under chapter XI of the Bankruptcy Act,[15] because the court felt that such claims should not be used to harass the resulting corporations.[16] Although a reorganized corporation is similar to

are created by statute rather than contract and are not liens on specific property. United States v. Bass, *supra*; United States v. Harrington, *supra*. *Contra*, In Matter of Parchem, 166 F. Supp. 724 (D. Minn. 1958).

7 American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U.S. 261, 266 (1914) (dictum); Johnson v. Norris, 190 Fed. 459, 463 (5th Cir. 1911) (dictum). *Contra*, Matter of Young, 171 F. Supp. 317, 320 (W.D. Wis. 1959) (dictum).

8 Bankruptcy Act § 17, 52 Stat. 851 (1938), 11 U.S.C. § 35 (1958).

9 Treas. Reg. § 301.6873-1 (1957). *Accord*, Rev. Rul. 162, 1956-1 CUM. BULL. 652.

10 Int. Rev. Code of 1939, ch. 9, § 1420(b), 53 Stat. 176 [now INT. REV. CODE OF 1954, §§ 6601(a), (f) (1)].

11 § 17, 52 Stat. 851 (1938), 11 U.S.C. § 35 (1958).

12 273 F.2d 682 (10th Cir. 1959).

13 271 F.2d 129 (9th Cir. 1959).

14 269 F.2d 719 (4th Cir. 1959).

15 52 Stat. 905 (1938), 11 U.S.C. §§ 701-99 (1958).

16 National Foundry Co. v. Director, 229 F.2d 149 (2d Cir. 1956); Swordline v. Industrial Comm'r, 212 F.2d 865 (2d Cir. 1954).

a taxpayer discharged in bankruptcy to the extent that the corporation's debts have been reduced, it is also similar to the bankruptcy estate because the old creditor still must look to the corporation for the satisfaction of that portion of his claim left undisturbed by the arrangement proceedings. It would seem, therefore, that the Second Circuit would have difficulty in making any distinction between the estate and the taxpayer in applying the "cut-off" rule. Their reasoning, however, could apply equally to an individual seeking relief from overburdensome debts.[17] It must be noted that this consideration did not induce Congress to allow taxes to be discharged in bankruptcy.

At present there is no specific legislation on the point in question. Since most courts have dealt only with claims for post-petition interest against the estate, it will be difficult to predict how they will handle the new approach put forth by the Commissioner and adopted by the court in the principal case. However, if a court looks for guidance to those cases which dealt with claims against the bankruptcy estate, it should take notice of the fact that the "cut-off" rule was applied in those cases primarily to protect the interest of the creditors and not the interest of the taxpayer.

Robert Lane

17 United States v. Mighell, 273 F.2d 682, 685 (10th Cir. 1959).