Property of the Estate
Earned Income Credit

In re John Richard Ott

Civil No. 94-6355-HO
Bankr. No. 694-60243-psh7

2/6/95 Hogan, J. reversing PSH Unpublished

The District Court (Judge Hogan) determined that a federal earned income credit (EIC) accrues to the recipient at the end of the tax year to which the credit relates rather than at the time a tax return is filed and the government determines that the recipient is entitled to a credit. Since the debtor was entitled to EIC's for 1992 and 1993 when he filed his Chapter 7 petition on 1/25/94, the EIC's were property of the estate, even though 1992 and 1993 returns had not yet been filed.

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DISTRICT OF OREGON
EUGENE, OREGON
BY

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

In re

JOHN RICHARD OTT,

Debtor.

Civil No. 94-6355-HO

JUDGMENT

The order on trustee's objection to debtor's claimed exemption #13 is reversed. This case is remanded to the bankruptcy court for further proceedings.

Dated: February 6, 1995.

Donald M. Cinnamond, Clerk

by Lea Force
Lea Force, Deputy

JUDGMENT **DOCUMENT NO: _____**

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DISTRICT OF OREGON
EUGENE, OREGON
BY

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

In re	)	
	)	Civil No. 94-6355
JOHN RICHARD OTT,	)	Bankruptcy No.
	)	694-60243-psh7
Debtor.	)	
	)	ORDER
	)	

This bankruptcy appeal arises from a Chapter 7 bankruptcy petition filed on January 25, 1994. At the time of this filing, the debtor had not yet filed his federal and state income tax returns for 1992 and 1993. The debtor claimed exemptions for earned income credit (EIC) for tax years 1992 and 1993 in the bankruptcy proceeding. The trustee objected to these claimed exemptions. At an April 19, 1994 hearing in the bankruptcy court, debtor conceded that there was not a sufficient basis for an exemption, but asked the court to find that the EIC claim is not property of the estate. The bankruptcy court overruled the trustee's objection and found that the EIC claim was not property of the estate. The trustee appeals that decision.

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DISCUSSION

Bankruptcy Code 11 U.S.C. §541(a)(1) provides that "property of the estate" includes all legal or equitable interests of the debtor in property, wherever located and by whomever held at the commencement of the case. The bankruptcy judge found that the EIC claim was not property of the estate, because it was not sufficiently rooted in the bankruptcy past. The determinative factors were that the government had not decided that the debtor qualified for the EIC prior to the filing of the bankruptcy petition, and the funds did not belong to the debtor until that decision has been made. (Transcript of April 19, 1994 Hearing (#23) at 10).

One key issue is whether case law construing "property" under Section 70a(5) of the Bankruptcy Act should continue to apply. One goal of that section was to "secure for creditors everything of value the bankrupt may possess in alienable or leviable form" when the bankruptcy petition is filed. Segal v. Rochelle, 382 U.S. 375, 379 (1966). One limitation, however, was the intent to leave the bankrupt free after the date of the petition to accumulate new wealth in the future. Id. The Supreme Court held in Segal that a company's potential claims for loss-carry back tax refunds were property of the bankruptcy estate, because they were "sufficiently rooted in the pre-bankruptcy past" and "so little entangled with the bankrupts' ability to make an unencumbered fresh start." Id. at 380. See

also Kokoszka v. Belford, 417 U.S. 642 (1974). The legislative history of the Bankruptcy Code, 11 U.S.C. §541(a)(1) states that "[t]he result of Segal v. Rochelle, 382 U.S. 375 (1966), is followed, and the right to a refund is property of the estate."

One court held that the portion of a tax refund attributable to earned income credit was not property of the estate under the Bankruptcy Act. In Re Searles, 445 F.Supp. 749 (D. Conn. 1978). In that case, the Connecticut court considered whether the policy of the Bankruptcy Act which affords bankrupts a "fresh start" and allows them to accumulate new wealth requires that the EIC portion of a tax refund be treated differently from the portion attributable to excess withholding tax. The court found that the EIC is a social welfare program designed to benefit only working low income taxpayers with dependent children. While the credit is given effect through the income tax return and contemplates a payment of funds belonging to the government, it is not an income tax refund, because it does not represent a return of funds withheld from the debtor's wages. Id. at 752. The court reasoned that the credit is only "rooted in the pre-bankruptcy past" to the extent that a person must have earned income in the tax year to receive it, and the amount received as wages determines the amount of the credit. Id. However, the EIC is meant to supplement future wages and provide a "fresh start" in the post-bankruptcy period. Id. at 753.

Since the adoption of the Bankruptcy Code, courts have split over the question whether an EIC is property of the estate. Several courts have found that an EIC is property of the estate under 11 U.S.C. §541(a)(1). See In re Davis, 136 B.R. 203 (S.D. Iowa 1991); In re Buchanan, 139 B.R. 721 (D. Idaho 1992). The debtor argues that in cases such as these, courts have found that an EIC is exempt under a specific state law. It is undisputed that there is no exemption under Oregon state law. This, however, does not control the issue of whether an EIC is estate property under bankruptcy law.

One court has found that an EIC is not property of the estate under 11 U.S.C. §541, because it is not an income tax refund or return of funds withheld from a debtor's past wages, and it includes funds belonging to the government, citing In re Searles. In re Hurles, 31 B.R. 179, 180 (S.D. Ohio 1983). However, the Ohio court in Hurles failed to consider that 11 U.S.C. §541(a)(1) was intended to encompass all property of the estate, even that needed to ensure a fresh start in the post-bankruptcy period, unlike its predecessor. See S. Rep. No. 989, 95th Cong., 2d Sess. 82 (1978). The precedential value of Searles is questionable in light of this change. The focus is whether the debtor's interest in the property accrued before the filing of the bankruptcy petition. The fact that an EIC is a program intended to supplement future wages, rather than a tax refund based on past withheld wages is, therefore, not

determinative.

The key issue identified by the bankruptcy court here was: when does a debtor's legal or equitable interest to an EIC accrue? Under the definition of property of the estate in 11 U.S.C. §541(a), an EIC accruing to a debtor before the filing of a petition is property in which the debtor holds "legal or equitable interests . . . as of the commencement of the case." In re Buchanan, 139 B.R. 721 (D. Idaho 1992). Certain cases have discussed accrual of claims to tax refunds, excluding EIC's. The bankruptcy judge, in effect, found these cases distinguishable on the accrual issue, because the source of funds for the EIC is the government and the source for the income tax refund is the debtor, based on past withheld wages. In other words, the debtor does not have any interest in funds belonging to the government until the government decides the debtor has a right to an EIC. The judge acknowledged that had the debtor filed the tax returns prior to the bankruptcy petition and established a right to an EIC, the amount due would be estate property. The difficulty with this analysis is that 11 U.S.C. §541 is broad enough to include legal and equitable interests in any property the debtor owns, claims or possesses, "wherever located and by whomever held." A debtor could have an interest in funds belonging to the government.

An EIC operates through a tax return and the amount is determined, in part, by the debtor's past wages. The individual

receives the excess of the amount of the EIC entitlement over the tax liability. Sorenson v. Secretary of Treasury, 475 U.S. 851, 859 (1986). The Internal Revenue Code defines this as an overpayment and provides the tax refund as the mechanism for disbursing overpayments. Id. The refundability of the EIC is inseparable from the tax refund process. Under these circumstances, legal authority deciding the accrual of claims to tax refunds generally also applies to a proceeding involving refunds based on EIC's.

The right to a tax refund arises at the end of the tax year to which the refund relates. See Segal v. Rochelle, 382 U.S. 375 (1966). Again, in Segal the debtor received a "loss carryback" refund for losses suffered during the tax year in which the bankruptcy case was filed. The Supreme Court held that the refund was property of the estate even though the amount of the refund did not become fixed until the end of the tax year, after the date of filing. The Court rejected the argument that the right to the refund could not arise before the claim had been filed, stating that "postponed enjoyment does not disqualify an interest as 'property.'" Id. at 379. See also In re Doan, 672 F.2d 831 (11th Cir. 1982). If an individual meets the eligibility requirements in 26 U.S.C. §32, they may file a tax return to recover an EIC. This is sufficient to create an interest in the credit. In re Davis, 136 B.R. 203 (S.D. Iowa 1991).

In the present proceeding, the debtor filed the bankruptcy petition on January 25, 1994. He had not yet filed his federal and state income tax returns for 1992 and 1993. However, he claimed exemptions for earned income credit in 1992 and 1993. At the April 19, 1994 hearing, Judge Higdon asked the debtor's attorney whether "there was an earned income credit arising out of both the '92 and '93 tax returns." The attorney responded affirmatively and stated that the tax returns had not been filed because the "Federal V.A. has a debt against him on a home loan default of around thirty grand, and he was afraid if he filed that they would take those funds . . . I think he has a claim; I don't think there's any dispute he has a claim [for an EIC]." Transcript of April 19, 1994 hearing (#23) at 2-3. The debtor's interest in the EIC accrued at the end of 1992 and 1993, prior to the filing of the bankruptcy petition, and is property of the estate. It is not necessary to decide whether the EIC is a tax attribute passing to the estate under 11 U.S.C. §§ 346(i), 1398(g).

CONCLUSION

The Order on Trustee's Objection to Debtor's Claimed Exemption (#13) is reversed. This case is remanded to the bankruptcy court for further proceedings.

DATED this 3rd day of Feb., 1995.

Michael R. Hogan
UNITED STATES DISTRICT JUDGE