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Priority Of Employment Taxes On Prebankruptcy Wages Under Section 64A Of The Bankruptcy Act

other than the immediate concerns of the petitioner,[130] it is urged that if all those interests are considered, residence requirements for divorce of limited duration will pass constitutional examination.

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PRIORITY OF EMPLOYMENT TAXES ON PRE-BANKRUPTCY WAGES UNDER SECTION 64a OF THE BANKRUPTCY ACT

While the congressional policy regarding the distribution of a bankrupt's assets has generally been one of equality of treatment among unsecured creditors,[1] the Bankruptcy Act has provided for certain exceptions.[2] One of the most significant of these exceptions is found in § 64a[3] which outlines a comprehensive scheme of priori-

[130]See note 121 *supra*.

[1]*E.g.*, H.R. REP. No. 686, 89th Cong., 1st Sess. 1-2 (1966); United States v. Embassy Restaurant, Inc., 359 U.S. 29, 31 (1959); Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941); Wurzel, *Taxation During Bankruptcy Liquidation*, 55 HARV. L. REV. 1141 (1942). *See also* 3 W. COLLIER, BANKRUPTCY ¶ 60.01, at 743 (14th ed. 1972) [hereinafter cited as COLLIER].

[2]One exception to the general principle of equality of distribution in bankruptcy is found in § 57d of the Bankruptcy Act, 11 U.S.C. § 93d (1970). This section requires that a claim must not only be provable under § 63 and proved and filed pursuant to § 57, but must also be allowed by the court in order to be entitled to a pro rata share upon distribution. In effect this incorporates equity considerations which may result in disallowance or subordination of certain claims.

[3]Bankruptcy Act § 64a, 11 U.S.C. § 104a (1970), reads in part as follows:

> The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the [actual and necessary costs and expenses] of preserving the estate subsequent to filing the petition . . . (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding . . . (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy . . . (5) debts other than for taxes owing to any person, including the United States . . . .

While the scheme of priorities of § 64a represents an exception to the principle of equality of distribution among the bankrupt's unsecured creditors, the scheme is consistent with the broader goal of achieving an equitable distribution of the bankrupt's estate. For example, giving first priority to costs and expenses of administration encourages efficient administration and protects both the bankrupt and the various unsecured creditors.

ties to be followed by the trustee in distributing the bankrupt's estate. This sytem of priorities, however, has not been applied without some difficulty and has required many changes to the basic priority provisions.[4] One of the frequently encountered problems which remains unresolved is the question of what priority, if any, is to be given withholding taxes[5] and employer excise taxes[6] due upon payment of pre-bankruptcy wage claims.[7]

Specifically, § 64a of the Bankruptcy Act lists five categories of claims to be paid by the trustee in bankruptcy before any payment

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[4]For a discussion of the legislative history of § 64a of the Bankruptcy Act, see 3A COLLIER ¶ 64.01, at 2046-63.

[5]INT. REV. CODE OF 1954, §§ 3102 and 3402 require the employer to withhold certain amounts from the employee's wages. Section 3102 provides that "[t]he tax imposed by section 3101 [Hospital insurance, old age, survivors and disability insurance] shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid." Similarly, § 3402, entitled INCOME TAX COLLECTED AT SOURCE, reads in part: "[e]very employer making payment of wages shall deduct and withhold upon such wages (except as otherwise provided in this section) a tax determined in accordance with the following tables."

[6]INT. REV. CODE OF 1954, § 3111 specifies that "[i]n addition to other taxes, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages . . . paid by him with respect to employment . . . ." This excise tax is more popularly known as the employer's contribution to the Social Security tax. Similarly, INT. REV. CODE OF 1954, § 3301 imposes an unemployment excise tax on the employer equal to 3.2% of total wages paid.

[7]Pre-bankruptcy wage claims are claims made against the bankrupt's estate by employees of the bankrupt for wages earned prior to the initiation of any bankruptcy proceedings. Since § 64a(2) of the Bankruptcy Act generally provides a second priority status for these wage claims, the question of priority is confined to the employment taxes related to the wage claims.

An issue preliminary to the question of priority is whether the trustee in bankruptcy is required to withhold taxes and to file the required forms pertaining to such withholdings as if he were the employer paying the wages. The overwhelming consensus of authority is that since the trustee "stands in the shoes of the bankrupt," and since the dividends paid as wage claims are wages, the trustee is required to make the withholdings and to file the records in question. *E.g.*, *In re* Freedomland, Inc., 480 F.2d 184 (2d Cir. 1973); *In re* Connecticut Motor Lines, Inc., 336 F.2d 96 (3d Cir. 1964); Lines v. California Dep't of Employment, 242 F.2d 201 (9th Cir.), *cert. denied*, 355 U.S. 857 (1957); United States v. Curtis, 178 F.2d 268 (6th Cir. 1949), *cert. denied*, 339 U.S. 965 (1950); United States v. Fogarty, 164 F.2d 26 (8th Cir. 1947). *See also In re* John Horne Co., 220 F.2d 33 (7th Cir. 1955). The employment forms required to be filed by the person paying the wages are described at note 23 *infra*.

The only disagreement has come from the referees themselves who argue that such requirements are an undue burden on the assets of the estate. *See* Hiller, *The Folly of the Fogarty Case*, 32 REF. J. 54 (1958); Oglebay, *Some Developments in Bankruptcy Law*, 23 REF. J. 12, 15 (1948); Oglebay, *Some Developments in Bankruptcy Law*, 22 REF. J. 82, 84 (1948).

of dividends to general creditors.[8] Three of these five categories have been considered by federal circuit courts as applicable to a determination of the priority of withholding and employer excise taxes payable on pre-bankruptcy wage claims. The applicable categories are first priority "costs and expenses of administration" of the bankrupt's estate,[9] second priority wage claims,[10] and fourth priority "taxes which became legally due and owing by the bankrupt."[11]

The question of priority of withholding and employer excise taxes due upon payment of pre-bankruptcy wage claims was first confronted in 1947 by the Eighth Circuit in *United States v. Fogarty*.[12] The court held that since such taxes were post-bankruptcy taxes in the sense that they were paid after bankruptcy proceedings had begun, they were by definition first priority expenses of administration.[13] Thus, the taxes were entitled to payment not only before all general claims but also before other claims of lesser priority.[14]

The second position adopted by the circuit courts as to the priority question of such taxes was set forth some seventeen years later by the Third Circuit in *In re Connecticut Motor Lines, Inc.*[15] The Third Circuit refused to follow the Eighth Circuit and determined that the various employment taxes on pre-bankruptcy wages were only entitled to a fourth priority status as taxes which became "legally due and owing by the bankrupt."[16]

The conflict among the circuits has been further complicated by the most recent development in this area of the law. In *In re Freedomland, Inc.*,[17] the Second Circuit rejected the positions of the Eighth and Third Circuits and determined that withholding taxes based on

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[8]Bankruptcy Act § 64a, 11 U.S.C. § 104a (1970).

[9]Bankruptcy Act § 64a(1), 11 U.S.C. § 104a(1) (1970).

[10]Bankruptcy Act § 64a(2), 11 U.S.C. § 104a(2) (1970).

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

[12]164 F.2d 26 (8th Cir. 1947).

[13]*Id.* at 33. The *Fogarty* rationale was subsequently adopted by the Ninth Circuit in Lines v. California Dep't of Employment, 242 F.2d 201 (9th Cir.), *cert. denied*, 355 U.S. 857 (1957).

[14]It is generally the rule that all claims share pro rata in the estate when the assets of the bankrupt are not sufficient to satisfy all claims of the same class. One exception to this general rule is outlined in § 64a(1) of the Bankruptcy Act, 11 U.S.C. § 104a(1) (1970), which provides that costs and expenses of administration of a superseding bankruptcy proceeding shall have priority over the costs and expenses of an earlier bankruptcy proceeding.

[15]336 F.2d 96 (3d Cir. 1964). The priority enunciated in *Connecticut Motor Lines* was followed in *In re* Erie Forge Steel Corp., No. 69-83 (W.D. Pa., filed Dec. 19, 1972).

[16]336 F.2d at 106.

[17]480 F.2d 184 (2d Cir. 1973), *cert. granted*, 42 U.S.L.W. 3415 (U.S. Jan. 22, 1974) (No. 375).

pre-bankruptcy wages should be aggregated with wage claims and accorded a second priority status.[18]

In *Freedomland*, the corporation had filed an arrangement petition[19] pursuant to Chapter XI of the Bankruptcy Act on September 15, 1964, and was adjudicated a bankrupt on August 30 of the following year. During the statutory period for filing claims[20] over four hundred claims of $600 or less,[21] totalling approximately $80,000, were filed by former employees of the bankrupt corporation for wages earned prior to the filing of the Chapter XI petition. No claims, however, were filed by the federal government or the City of New York for income and other employment taxes during the statutory period for filing claims.[22] On November 7, 1969, the trustee moved the referee for an order declaring that the trustee was not required to file any employment tax statements[23] relating to the payment of wage claims. The trustee also requested the referee to authorize the payment of such claims without allowance for any employment taxes. After the referee granted the order, an appeal from the order was brought by the federal and city governments in the district court.

The district court held that the trustee was required to file the appropriate employment tax forms and that federal withholding taxes must be paid, but only as fourth priority taxes legally due and owing by the bankrupt, and not as first priority administrative expenses as the federal government had contended.[24] In addition, the court determined that the city was not entitled to any withholding taxes since the city income tax law had not been enacted until after the

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[18]*Id.* at 190.

[19]Bankruptcy Act §§ 301-99, 11 U.S.C. §§ 701-99 (1970). Arrangement is broadly defined in § 306(1) of the Bankruptcy Act to mean "any plan of a debtor for the settlement, satisfaction, or extension of the time of payment of his unsecured debts, upon any terms."

[20]Bankruptcy Act § 57, 11 U.S.C. § 93 (1970), specifies the procedure for filing claims against the bankrupt's estate. Unless otherwise provided, claims must be filed within six months after the date of the first meeting of the creditors.

[21]Bankruptcy Act § 64a(2), 11 U.S.C. § 104a(2) (1970), specifies that wage claims of each individual claimant may not exceed $600.

[22]See notes 25, 26 and 47 *infra*.

[23]INT. REV. CODE OF 1954, § 6011 and § 6051 and the regulations thereunder require the employer to maintain and file certain employment-related forms and to provide employees with wage and tax information. Examples of such forms include the annual statement of social security and income tax withheld on wages, Form W-2, and the employer's quarterly tax returns, Form 940 for unemployment tax, and Form 941 for income tax and social security tax withheld. *See generally Treas. Reg.* § 31.6011(a)-1 *et seq.*

[24]341 F. Supp. 647 (S.D.N.Y. 1972).

wages had been earned.[25] On appeal, the Second Circuit held that while the trustee was required to file the tax forms, the federal and city withholding taxes were neither entitled to fourth priority as the lower court had decided nor first priority as the governments had contended. The court instead determined the withholding taxes were entitled to second priority status as part of the wage claims.[26]

In analyzing these various positions it should be noted that the *Fogarty* determination, that withholding and employer excise taxes on pre-bankruptcy wages are payable as costs and expenses of administration, has been severely criticized by both the courts[27] and the commentators.[28] As the Third Circuit pointed out in deciding *Connecticut Motor Lines*, "[t]he ultimate result in *Fogarty* rests on a number of cases which lend little support to the holding and, if anything, detract from the reasoning of the Eighth Circuit."[29] Specifi-

[25]The district court in *Freedomland* reasoned that since the city income tax had not been enacted until after the filing of the Chapter XI petition, the tax was not "computable" at the initiation of the bankruptcy proceeding. Since the tax was not computable, it could not be considered to have become legally due and owing at the time of the initiation of the bankruptcy proceedings and failed to qualify for fourth priority treatment. 341 F. Supp. at 658. For a discussion of the requirement of computability, see note 39 *infra* and accompanying text.

The Second Circuit avoided this statutory objection by including the city withholding taxes as part of wages and thus entitled to a second priority. 480 F.2d at 191. Because no vested rights were impaired, the Second Circuit found no constitutional barrier to this determination even though the wages on which the taxes were based were earned prior to the enactment of the city income tax law. For a discussion of the general effect of a retroactive tax on the distribution of a bankrupt's estate, see 3A COLLIER ¶ 64.405[1], at 2177 n.1. For a discussion of the constitutionality of a retroactive tax, see Welch v. Henry, 305 U.S. 134, 146-51 (1938); Milliken v. United States, 283 U.S. 15, 20-24 (1931); Kentucky Union Co. v. Kentucky, 219 U.S. 140, 152-53 (1911).

The district court in *Freedomland* also held that the federal government's claim was not barred because of failure to submit a proof of claim within the six month statutory period. 341 F. Supp. 657-58. For a contrary result see *In re* Connecticut Motor Lines, 336 F.2d 96, 107 (3d Cir. 1964). See note 47 *infra*.

[26]The Second Circuit also affirmed the district court's determination that the governments' claim was not barred because of failure to submit a timely claim under § 57 of the Act. 480 F.2d at 191.

[27]*E.g.*, *In re* Freedomland, Inc., 480 F.2d 184, 187 (2d Cir. 1973); *In re* Connecticut Motor Lines, Inc., 336 F.2d 96, 99 (3d Cir. 1964); *In re* John Horne Co., 220 F.2d 33 (7th Cir. 1955) (dictum).

[28]3A COLLIER § 64.202, at 2119; Comment, 63 MICH. L. REV. 1103 (1965); Comment, 40 N.Y.U.L. REV. 360 (1965). *See also* Note, *Bankruptcy Priority of Government's Claim to Withholding Taxes Arising from a Wage Distribution*: In re Connecticut Motor Lines, Inc., 19 RUTGERS L. REV. 546 (1965) [hereinafter cited as *Rutgers Bankruptcy Note*].

[29]336 F.2d at 99.

cally, the facts of the cases upon which *Fogarty* relied differed significantly from the facts of *Fogarty*.[30] In the cases relied on, all the withholding taxes were based on wages earned *subsequent* to some type of bankruptcy proceeding, while in *Fogarty* the labor involved was performed *prior* to the initiation of any bankruptcy proceeding.

The significance of this slight differentiation of facts is that in the cases in which the wages were earned subsequent to the bankruptcy proceeding, the wage expenses upon which the taxes were based were incurred in continuing the business of the debtor for the benefit of the creditors. Thus, taxes were related to the development, preservation, or distribution of the estate.[31] If, as has been suggested,[32] the true focus of congressional intent is to limit first priority expenses and costs of administration to those charges which are related to the development, preservation, or distribution of the bankrupt's estate, it seems proper to conclude that the employment taxes in the cases relied on by *Fogarty* were entitled to first priority status only because the wages were incurred in the furtherance of one of these functions. The mere fact that taxes are paid after bankruptcy proceedings have begun would not seem to provide adequate grounds for promoting them to a priority reserved for payments essential to the protection of creditors.[33]

Applying the proper interpretation of the cases relied upon by the court in *Fogarty* to the facts of that case, it would appear that employment taxes on wages earned before the bankruptcy proceedings were not entitled to first priority status as the Eighth Circuit had concluded. The taxes were based on wages for labor which had no relation to the development, preservation, or distribution of the assets in bankruptcy.[34] More importantly, giving withholding and ex-

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[30]*Id.* n.10.

[31]*Id.* at 99.

[32]Adair v. Bank of American Ass'n, 303 U.S. 350, 360-61 (1938); *In re* Connecticut Motor Lines, Inc., 336 F.2d 96, 101-02 (3d Cir. 1964).

[33]The conclusion that the employment taxes in the case cited in *Fogarty* were not first priority claims is reinforced by the fact that other courts have decided that some taxes and expenses paid after the date of bankruptcy were not first priority claims. *E.g.*, Denton & Anderson Co. v. Induction Heating Corp., 178 F.2d 841 (2d Cir. 1949) (commissions accruing after bankruptcy on goods ordered but not delivered prior thereto held not entitled to first priority status); *In re* Mt. Washington S.S. Co., 43 F. Supp. 176 (D.N.H. 1942) (state tax assessed against a vessel four days after bankruptcy petition was filed was not payable as a current expense of administration).

[34]Since the wage claims upon which the taxes were based were for labor performed prior to the initiation of any bankruptcy proceeding, the wage claims cannot be considered as related to the development, preservation, or distribution of the assets in bankruptcy. Therefore, the withholding taxes were not taxes on the distribution of the assets

cise taxes first priority would be contrary to the general congressional policy of subordinating taxes to wages,[35] since such a practice would reduce the amounts otherwise available for second priority wage claims.[36]

The alternative solution proposed by the Third Circuit in *Connecticut Motor Lines* also presents problems. By placing employment taxes in the fourth priority category under § 64a(4) of "taxes which became legally due and owning," the policy objections presented by the *Fogarty* approach were eliminated. However, § 64a(4) seems to dictate a different conclusion as to employment taxes by the plain meaning of its language.

Several objections based upon statutory construction of § 64a(4) can be made to a fourth priority status. The first arises from the requirement of that section that the taxes be legally due and owing by the *bankrupt*. It can be contended, as the Second Circuit did in *Freedomland*,[37] that withholding and excise taxes due on pre-bankruptcy wage claims were never legally due and owing by the bankrupt, but rather were owing only by the trustee in bankruptcy. This contention, however, is severely weakened by the established view among the courts that the trustee "stands in the shoes of the bankrupt" and succeeds to the obligations of the bankrupt.[38]

A second and more formidable statutory objection stems from the well-recognized rule that a tax does not become legally due and owing until it is certain in amount.[39] When, as in *Connecticut Motor Lines*, the amount of the tax depends upon the wages paid, it would seem the tax could not become legally due and owing at the time of the commencement of bankruptcy proceedings since it is unclear what amount of wage claims will actually be submitted and paid.

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in bankruptcy, but were taxes on the employment relationship existing prior to bankruptcy. *See* Comment, 40 N.Y.U.L. REV. 360, 361-62 (1965).

[35]See text accompanying note 40 *infra*.

[36]*In re* Connecticut Motor Lines, Inc., 336 F.2d 96, 102 (3d Cir. 1964); 3A COLLIER ¶ 64.201[2.2], at 2111.

[37]The Second Circuit in *Freedomland* rejected the fourth priority status on the basis that the employment taxes were never legally due and owing by the bankrupt. 480 F.2d at 190. The court reasoned that since the taxes were not due and owing until the wages were paid and since the bankrupt never paid any of the wages in question, the bankrupt never owed such taxes. *Id.*

[38]See note 7 *supra*.

[39]It is generally recognized that a tax becomes legally due and owing when all the facts necessary for its calculation are known. *E.g., In re* Ingersoll Co., 148 F.2d 282 (10th Cir. 1945); *In re* Int'l Match Corp., 79 F.2d 203 (2d Cir.), *cert. denied*, Delaware v. Irving Trust Co., 296 U.S. 652 (1935). *See also* 3A COLLIER ¶ 64.405[1], at 2178. This requirement is referred to as the "rule of computability." See note 25 *supra*.

Additionally, it has been argued that because Congress clearly intended that federal tax claims be given priority over general claims, employment taxes should be given a priority which effectuates that intent despite the fact that the language of § 64a(4) seems to conflict with congressional intention.[40] However, there is no clear congressional intent that *all* federal taxes should be given a fourth priority.[41] Thus, it would appear that, read literally, § 64a(4) must be recognized as a barrier to assigning fourth priority status to withholding and excise taxes.

In the most recent development on this point of law, the Second Circuit in *In re Freedomland, Inc.* determined that withholding taxes[42] based on pre-bankruptcy wage claims which were not related to the development, preservation, or distribution of the bankrupt's estate during bankruptcy should be accorded second priority status. The court held that such withholding taxes were "derived from the payments that will be made to the wage claimants," and should be conceptually treated as if they were wages.[43] In reaching this conclusion, the Second Circuit relied exclusively on *In re Quakertown Shopping Center, Inc.*,[44] which held that the Internal Revenue Service could levy upon the claim of a taxpayer-creditor of the bankrupt without approval of the bankruptcy court since the levy was merely an involuntary assignment by the creditor to the IRS. The court in *Freedomland* thus seemed to suggest that the withholding taxes should be treated as included in the wages paid to the claimants and contemporaneously assigned to the IRS at the time of payment. However appealing such an analysis may be, it seems inaccurate in light of the conceptual treatment which has been accorded withholding taxes in the Internal Revenue Code, a treatment relied upon by the Second Circuit in *Freedomland*.

As the *Freedomland* court noted, the withholding tax claims should be segregated by the employer, or the trustee in a bankruptcy proceeding, and held as trust funds consistent with § 7501(a) of the

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[40]Comment, 40 N.Y.U.L. REV. 360, 364 (1965). The writer apparently bases this proposition on the legislative history of § 64.

[41]The language of the Bankruptcy Act expressly provides that not all taxes should have fourth prioriy. Bankruptcy Act § 64a(4), 11 U.S.C. § 104a(4) (1970), states "that no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority."

[42]The court in *Freedomland* did not address itself to the question of what priority, if any, should be given excise taxes imposed on the employer by INT. REV. CODE OF 1954, §§ 3111 and 3301. 480 F.2d at 186. See text accompanying note 66 *infra*.

[43]480 F.2d at 190.

[44]366 F.2d 95 (3d Cir. 1966).

Internal Revenue Code.[45] This section provides for the creation of a trust fund in favor of the United States "whenever any person is required to collect or withhold any internal revenue tax from any other person . . . ." However, the treatment of withholding taxes as a trust means that conceptually the wage claimants never acquired any interest in the fund. The withholding tax fund remained with the trustee in bankruptcy for the special use of the United States. The wage claimants could not possibly have assigned such a fund to the United States as their creditor, either voluntarily or involuntarily, since the claimants had no rights in the trust fund.[46] Thus, reference to the creation of a trust under § 7501(a) appears to negate the involuntary assignment theory on which the Second Circuit seemed to rely in *Freedomland*.[47]

Such a conflict between the creation of a trust under § 7501(a) and the involuntary assignment theory does not conclusively answer the question of whether the Second Circuit correctly classified withholding taxes as second priority claims. The answer to this question seems ultimately to depend upon the scope of the term "wages" and the policy implications of treating withholding taxes as wages.

As to the scope of the term wages in the Bankruptcy Act,[48] the court in *Freedomland* did not cite any authority for the proposition that withholding taxes are included in wages. This is particularly distressing in light of the most recent Supreme Court case interpreting the parameters of wages, *United States v. Embassy Restaurant, Inc.*[49] In that case the Court held that contributions payable by the bankrupt employer to trustees of a union welfare fund pursuant to a

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[45]INT. REV. CODE OF 1954, § 7501(a) provides that:

> Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of the tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shal be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

[46]*Cf.* 2 A. SCOTT, TRUSTS §§ 132 and 147 (3d ed. 1967).

[47]The court in *Freedomland* appeared to rely on the trust fund theory merely to find that there was no necessity for the governments to file proof of claims under § 57 of the Bankruptcy Act and not to establish that withholding taxes should be given a second priority. 480 F.2d at 190-91. This limited reliance appears sound and would seem to compel a different conclusion than that reached in *Connecticut Motor Lines* with regard to the filing requirement. See notes 25 and 26 *supra*.

[48]There is no definition of the term "wages" in the Bankruptcy Act.

[49]359 U.S. 29 (1959).

collective bargaining agreement were not wages within the meaning of the Bankruptcy Act and were thus not entitled to second priority status. The Court reasoned that "[i]t is therefore evident that not all types of obligations due employees from their employers are regarded by Congress as being within the concept of wages, even though having some relation to employment."[50] The Court in *Embassy Restaurant* then enumerated several factors for determining whether a given payment by an employer is wages.

Among the factors suggested by the Court for determining the characterization of a payment by an employer were whether the workers had a legal interest in the fund and whether the workers considered such payments as wages. While it is unclear whether an employee considers withholding taxes as part of his wages,[51] it is clear that the wage claimants in *Freedomland* had no legal interest in the fund created by § 7501(a). They could neither exercise any control over such withholdings[52] nor could they be held liable for any funds withheld and misappropriated by the employer.[53] Thus, it would appear that the Supreme Court's interpretation of wages in *Embassy Restaurant* excludes withholding taxes from the scope of that term as it is used in the Bankruptcy Act, and the Second Circuit committed a serious error in failing to examine the definition of wages provided by that decision.[54]

The conclusion that withholding taxes are not part of wages is further supported by the 1966 amendments to the Bankruptcy Act.

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[50]*Id.* at 32.

[51]It has been suggested that in today's market place gross wages are merely an illusion of one's true earning power. B. BITTKER and L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 14 (4th ed. 1972).

[52]It is true that the employee can affect the amount of taxes withheld by changing the number of exemptions claimed. However, once the fund is collected the employee has no rights in the fund itself. See text accompanying notes 51-53 *supra*.

[53]INT. REV. CODE OF 1954, § 3403 provides that "[t]he employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment."

[54]There are cases holding that fringe benefits in the form of holiday or vacation pay are within the scope of the term wages as it is used in the Bankruptcy Act. *E.g.*, Sulmeyer v. Southern Cal. Pipe Trades Trust Fund, 301 F.2d 768 (9th Cir. 1962); United States v. Munro-Van Helms Co., 243 F.2d 10 (5th Cir. 1957); California Div. of Labor Law Enforcement v. Sampsell, 172 F.2d 400 (9th Cir. 1949). *See also* cases collected at 3A COLLIER ¶ 64.202, at 2117. These cases offer little support for the Second Circuit's conclusion that withholding taxes on pre-bankruptcy wages are themselves wages. In the fringe benefit cases there is a direct obligation of the employer to the employee while in the withholding tax cases the obligation is to the Government. *See* INT. REV. CODE OF 1954, §§ 3403, 7501(a). *See also* 3A COLLIER ¶ 64.202 [1], at 2117 n.1.

The amendments limited the priority accorded to taxes in the distribution of bankrupts' estates to those taxes which "became" legally due and owing by the bankrupt and "which were not released by a discharge in bankruptcy under § 17 of the Act."[55] At the same time, § 17a(1) was amended to conform to § 64a(4)[56] by borrowing the phrase "legally due and owing" from the latter section. The significance of these changes to a determination of the scope of the term wages is found in the fact that there is a provision under § 17a(1) which specifically states that a discharge in bankruptcy shall not release a bankrupt from any withholding taxes such as the ones in the *Freedomland* case. The structuring of the amended statute is strong evidence that Congress thought withholding taxes should be treated independently as taxes and not as wages. This proposition is reinforced by the fact that § 17a(5) provides in a separate category that certain wage claims are to be non-dischargable. Thus, if Congress meant that withholding taxes were to be aggregated with wages, it would seem that the legislature would refer to withholding taxes under § 17a(5) and not under § 17a(1). In addition, if withholding taxes are to be considered wages within the meaning of the Bankruptcy Act, then Congress, by structuring § 17 as it did would be stating redundantly that withholding taxes are nondischargable, first under § 17a(1) as withholding taxes and secondly under § 17a(5) as wages. It would seem that the Bankruptcy Act should be read to avoid such repetition by treating withholding taxes as distinct and separate from wages.[57]

The *Freedomland* court appeared to overlook another problem in assigning a second priority status to withholding taxes on pre-

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[55]Act of Oct. 3, 1966, Pub. L. No. 89-496, § 3, 80 Stat. 271, *amending* 11 U.S.C. § 104a(4) (1964).

[56]Act of Oct. 3, 1966, Pub. L. No. 89-496, § 3, 80 Stat. 271, *amending* 11 U.S.C. § 35 (1964). Prior to 1966, Bankruptcy Act § 17, 11 U.S.C. § 35a provided that: "[a] discharge in bankruptcy shall release a bankrupt from all his provable debts whether allowable in full or in part." Subsequent to the 1966 amendments, § 17 read in part as follows:

> (a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing . . . to the United States . . . within three years preceding bankruptcy: *Provided, however*, That a discharge in bankruptcy shall not release a bankrupt . . . . from any taxes . . . (e) which the bankrupt has collected or withheld from others as required by the laws of the United States . . . but has not paid over.

[57]*Cf.* 2A J. SUTHERLAND, *Statutory Construction* § 46.06, at 63 (Sands 4th ed. 1973).

bankruptcy wages. The language of § 64a(2) of the Act does not state that wages earned by all employees within the three month statutory period before the initiation of bankruptcy proceedings are second priority claims. Instead, it confines priority status to wage claims due to workmen, servants, clerks, or traveling or city salesmen.[58] In many instances the courts have determined that simply because a claim for wages was made by an employee of the bankrupt in compliance with the procedures outlined by the Act, the claim was not necessarily entitled to second priority status.[59] Even though § 64a(2) has been continually expanded to include other types of employees,[60] it cannot be said that every employee's wage claim is entitled to priority. Thus, the problem arises as to treatment of withholding taxes of employees who earned wages prior to bankruptcy proceedings but whose claims are not entitled to second priority status. It would appear that the Second Circuit would not hold that such taxes are second priority claims when the wages upon which they are based are not.[61] If this assumption is correct and the Second Circuit's formulation requires different treatment of withholding taxes depending upon the priority status of the wage claim itself, the formulation is open to additional criticism. For example, in an estate where assets are sufficient to pay only some priority creditors, the question of payment of the governments' claims for withholding taxes may depend entirely on the occupation of the employee. In this situation, the solution of the Second Circuit to the priority conflict has merely added more confusion and uncertainty than existed before *Freedomland*.

Another shortcoming of the Second Circuit's approach is evident when the policy of the wage priority section of the Bankruptcy Act is considered. The reasoning behind the grant of priority to wage claims by § 64a(2) was to protect the worker whose income was primarily in the form of wages and whose subsistence was dependent on such wages.[62] Assigning a second priority status to withholding taxes would

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[58]Bankruptcy Act § 64a(2), 11 U.S.C. § 104a(2) (1970).

[59]*E.g.*, Blessing v. Blanchard, 223 F. 35 (9th Cir. 1915) (claim of general manager of corporation not entitled to second priority); *In re* Crown Point Brush Co., 200 F. 882 (N.D.N.Y. 1912) (claim of president of company not entitled to second priority). *See also* cases collected at 3A COLLIER ¶ 64.204, at 2131.

[60]*E.g.*, United States v. Embassy Restaurant, Inc., 359 U.S. 29, 35 (1959) (Black, J., dissenting); 3A COLLIER ¶ 64.201, at 2110.

[61] 480 F.2d at 190.

[62]*E.g.*, Joint Indus. Bd. of Elec. Indus. v. United States, 391 U.S. 224 (1968); United States v. Embassy Restaurant, Inc., 359 U.S. 29 (1959); Local 140 Security Fund v. Hack, 242 F.2d 372 (2d Cir. 1957); Blessing v. Blanchard, 223 F. 35 (9th Cir. 1915). *See also* 3A COLLIER ¶ 64.201 [3], at 2112.

mean, however, that if the bankrupt's assets were insufficient to satisfy all the claims of § 64a(2), the wage claims and the tax claims would share pro rata in whatever payments were made.[63] Considering the significance of withholding taxes,[64] this would mean a smaller share available for wage claims.[65] Such a result clearly increases the hardship of employees who are primarily dependent on their wages and seems contrary to the congressional policy of protecting employees.

While the priority formulations of the Third and Eighth Circuits have several shortcomings, they do result in a determination of the treatment to be given both withholding taxes and the related excise taxes imposed on the employer. However, the Second Circuit's holding leaves unanswered the question of what priority, if any, should be given to the excise taxes.[66] Perhaps by expressly declining to address the priority of the employer's taxes, the Second Circuit impliedly agreed with the Third Circuit that these taxes became legally due and owing by the bankrupt and enjoyed fourth priority.

As previously mentioned, the Second Circuit relied on § 7501(a)

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[63]See note 14 *supra*.

[64]*Treas. Reg.* § 31.3402 *et seq.* (1971) provide tables for the determination of amounts to be withheld by the employer, but as suggested by the courts in *Fogarty* and *Freedomland*, the withholding taxes generally approach 25 percent of gross wages.

[65]An example of the diverse results of allowing withholding tax claims to share pro rata with other second priority claims in the total funds available for wage claims, as opposed to their treatment as fourth priority, can be illustrated as follows:

Assume there is $40,000 available for distribution after disposition of secured creditors and payment of first priority claims, that a total of $80,000 of allowable wage claims have been filed within the statutory period for filing claims, and that withholding taxes represent 25 percent of gross wages. If withholding tax claims are entitled to share pro rata in the fund as second priority items $10,000 would be immediately paid to the Government and $30,000 would be available for payment to wage claimants. If withholding tax claims are entitled to fourth priority, however, a very different result follows. Under INT. REV. CODE OF 1954, § 7501(a), 25 percent of all wages "paid" would be held in trust for the Government. The $10,000 would be held in trust for the Government and $30,000 would be available for payment to wage claimants. However, the $10,000 trust fund would not be payable to the Government until all second priority claims have been paid. Thus, the $10,000 fund would still be available for payment of second priority claims. Payment of additional wage claims, however, would again be subject to § 7501(a) and $2,500 of the $10,000 would be held as a trust fund for the United States. This trust fund could not be paid until after all second priority claims had been paid. The $2,500 would then be subject to § 7501(a). The process would continue until, in effect, the entire $40,000 was paid to the wage claimants.

[66]The Second Circuit based its conclusion that withholding taxes are entitled to second priority on the proposition that the taxes were part of gross wages of the employee. 480 F.2d at 190. It cannot, however, be said that the employer excise taxes are part of those gross wages.

of the Internal Revenue Code which provides for the creation of a trust in favor of the United States whenever any person is required to collect or withhold any internal revenue tax from any other person.[67] While the court did not base its second priority holding on this trust theory,[68] it did maintain that the creation of a trust under § 7501(a) was consistent with its holding. This position was based on an interpretation of the Supreme Court's decision in *United States v. Randall*.[69]

In the *Randall* case, the bankrupt was kept in possession of its business by court order but was required to open three bank accounts, one of which was for the employment taxes. After bankruptcy and upon discovery that the bankrupt had failed to maintain the separate tax account, the Government claimed that under § 7501(a) it was entitled to payment of employment taxes before any other claims, including first priority expenses of administration. The Supreme Court rejected the Government's argument and affirmed the district[70] and circuit court's[71] determination that the § 7501(a) trust was governed by § 64a of the Bankruptcy Act.

According to the Second Circuit in *Freedomland*, the rationale of *Randall* was merely that of upholding the Bankruptcy Act's policy of subordinating taxes to costs and expenses of administration. Thus, the treatment of withholding taxes as second priority was consistent with such policy. However, it must be pointed out that the *Randall* decision represented more than the mere honoring of the policy of subordinating taxes to costs and expenses of administration. That policy, as the Supreme Court suggested, is related to two other considerations—the overall policy of § 64a and the language of § 7501(a) of the Internal Revenue Code.

Specifically, the Supreme Court in *Randall* determined that the § 7501(a) trust fund was subordinate to § 64a(1) of the Bankruptcy Act. Apparently because that was the precise issue decided, the Second Circuit in *Freedomland* confined the holding to a conflict between a withholding tax claim based on § 7501(a) and a claim for

[67]See notes 45 and 47 *supra*.

[68]It has been suggested that a trust fund theory pursuant to INT. REV. CODE OF 1954, § 7501(a) should in itself lead to a second priority status for the withholding taxes under consideration. *Cf.* Comment, 40 N.Y.U.L. REV. 360 (1965); Comment, 63 MICH. L. REV. 1103 (1965); *Rutgers Bankruptcy Note, supra* note 28. Such a proposition, however, ignores the language of § 7501(a). See notes 74-78 and accompanying text *infra*.

[69]401 U.S. 513 (1971).

[70]*In re* Halo Metal Products, Inc., 302 F. Supp. 614 (N.D. Ill. 1968).

[71]*In re* Halo Metal Products, Inc., 419 F.2d 1068 (7th Cir. 1969).

first priority costs and expenses of administration.[72] Such a limitation, however, ignored the Supreme Court's statement in *Randall* that the entire Bankruptcy Act is an overriding statement of federal policy on the question of priorities.[73] Contrary to the Second Circuit's position, the holding in *Randall* should be interpreted to apply to all conflicts that arise between a claim under § 7501(a) of the Internal Revenue Code and any of the priorities of § 64a of the Bankruptcy Act.

In addition, the Supreme Court in *Randall* interpreted § 7501(a)[74] to mean that the payment of the trust fund is limited by the priority which § 64a would provide if such trust fund did not exist.[75] This made withholding taxes payable as a second priority item[76] only if they were entitled to second priority independent of any consideration of the § 7501(a) trust. Similarly, as the Supreme Court pointed out by citing *In re Green*[77] with approval, if such taxes were entitled to only a fourth priority independent of the trust under § 7501(a),

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[72]480 F.2d at 190.

[73]When the Supreme Court in *Randall* asserted that the Bankruptcy Act represents an overriding statement of federal policy on the question of priority, it apparently overruled several earlier cases which had held that other congressional provisions took precedence over the general provisions of § 64 of the Act. For example, in *In re* Airline-Arista Printing Corp., 156 F. Supp. 403 (S.D.N.Y. 1957), *aff'd per curiam*, 267 F.2d 333 (2d Cir. 1959), and in United States v. Sampsell, 193 F.2d 154 (9th Cir. 1951), the courts determined that INT. REV. CODE OF 1939, § 3661, now § 7501(a) of the 1954 Code, took precedence over § 64. Similarly, in City of New York v. Rassner, 127 F.2d 703 (2d Cir. 1942), the court held that 28 U.S.C. § 124(a) (1940), the earlier version of 28 U.S.C. § 959 (1970), took precedence over § 64. Section 124(a) subjected a trustee, receiver, or other similar court officer to local taxes as if the business such officer managed were conducted by an individual or a corporation. The local statute which precipitated the conflict with § 64a provided that a city sales tax should have status as a trust fund, similar to the theory of § 7501(a) of the Internal Revenue Code.

[74]The second sentence of the INT. REV. CODE OF 1954, § 7501(a), provides that "[t]he amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable to the taxes from which such fund arose."

[75]401 U.S. at 517.

[76]It should be noted that the Second Circuit in *Freedomland* determined that the withholding taxes in question were second priority items without reference to the trust fund theory. Note 47 *supra*. In this respect *Freedomland* is in accord with the holding of *Randall*.

[77]264 F. Supp. 849 (D. Colo. 1967). In *Green* the Government contended that prearrangement withholding taxes which were to be paid after confirmation of the arrangement proceeding, pursuant to an agreement between the Government and the debtor, were entitled to be paid as a trust under § 7501(a) before any other claims during the subsequent bankruptcy proceeding. The court rejected this argument and determined that the taxes were subject to the fourth priority they would have had in the absence of § 7501(a). *Id.* at 851.

even though the trust would theoretically arise at the time of payment of second priority wage claims, the taxes would be entitled to only a fourth priority. Thus, in *Freedomland*, where the holding that taxes are essentially second priority wages seems unsound, the trust fund theory provides no assistance. The theory cannot by itself give a claim a higher priority than the claim would have possessed apart from the creation of trust. Therefore, the question of what priority, if any, is to be given to withholding and employer excise taxes[78] remains unresolved even though there is a trust fund created by § 7501(a).

Evaluation of the several circuits' positions on the question of what priority is to be given to withholding and excise taxes on pre-bankruptcy wages indicates that each of the prescribed solutions has shortcomings.[79] Of the three formulations, the Third Circuit's holding of fourth priority appears least objectionable since it is consistent with the policies of the Bankruptcy Act.[80] This formulation, however, conflicts with the plain language of the statute. In light of the rule of construction applied to § 64a, that no priorities should be allowed except those expressly specified,[81] it appears that this position should also be rejected and withholding taxes on pre-bankruptcy wages not be given any priority under § 64a. This solution would not conflict with the policy of protecting the employee in a bankruptcy proceeding of his employer. The employee would not be liable for any amounts withheld but not remitted,[82] and also would receive payment of his wage claim in full.[83] In addition, excise taxes and withholding taxes would be given uniform treatment. Finally, if the legislative intent is in fact different from the literal language of § 17 and § 64a, Congress, prodded by the Internal Revenue Service, will be more

[78]The trust fund created by § 7501(a) has no application to the excise taxes on employers because these employers' taxes are not collected or withheld from another person. See language of § 7501(a) quoted at note 45 *supra*.

[79]Bankruptcy Act § 64a(5), 11 U.S.C. § 104a(5) (1970), provides that debts to the United States are to be entitled to fifth priority during the distribution procedure. This section, however, excludes all taxes from its scope and would offer no solution to the priority question of withholding or employer excise taxes.

[80]The Third Circuit's position is further supported by H.R. REP. No. 686, 89th Cong., 1st Sess. 11 (1966). This report specified that Bankruptcy Act § 64a(4), 11 U.S.C. § 104a(4) (1970), creates a priority for taxes. There was no recognition of the qualifying condition that the taxes must be "legally due and owing."

[81]Nathanson v. NLRB, 344 U.S. 25 (1952).

[82]INT. REV. CODE OF 1954, § 3403 specifies that the employer shall be liable for the taxes withheld. Note 53 *supra*. Section 17a(1)(e) also provides that such withholding taxes shall be nondischargeable. Note 56 *supra*.

[83]See text accompanyinging notes 60-62 *supra*.