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BANKRUPTCY LAW

PRIORITY OF WITHHOLDING TAXES

In re Freedomland, Inc.

A Chapter XI bankruptcy proceeding is a voluntary action, initiated by a debtor in the form of a petition¹ before a bankruptcy court,² by which the debtor attempts to achieve financial rehabilitation. The court, while powerless to force the creditors' consent, may, at its discretion, agree to authorize an "arrangement"³ to continue the debtor's business and may, if necessary, postpone collection actions by creditors.⁴ It is not uncommon for the arrangement to fail and the debtor to then be declared a bankrupt.⁵

When an insolvent debtor is adjudicated bankrupt, certain unsecured creditors will receive priorities which allow them to share in the bankrupt's estate ahead of other general creditors, or creditors placed in a lower priority by the Bankruptcy Act.⁶

¹ The debtor must state in his petition that he is "insolvent or unable to pay his debts as they mature." Bankruptcy Act § 323, 11 U.S.C. § 723 (1970).

² Courts of bankruptcy are defined by the Bankruptcy Act as including "the United States district courts and the district courts of the Territories and possessions to which this title is or may hereafter be applicable." Bankruptcy Act, 11 U.S.C. § 1(10) (1970).

³ The goal of the arrangement is the "ultimate rehabilitation of the debtor." *Nicholas v. United States*, 384 U.S. 678, 687 (1966).

⁴ Bankruptcy Act § 314, 11 U.S.C. § 714 (1970). The court retains general supervisory powers over the arrangement plan. The referee, to whom the proceeding is usually referred by the court, may permit the debtor to continue the business as a "debtor in possession." However, he may instead appoint a receiver or allow a trustee, previously appointed in a bankruptcy proceeding concerning the company, to direct the business. Bankruptcy Act §§ 331-32, 342, 11 U.S.C. §§ 731-32, 742 (1970).

Moreover, the rights of all creditors with claims existing prior to the arrangement are preserved as of the date of the arrangement, rather than the date of a later petition in bankruptcy. *See* Bankruptcy Act §§ 302, 352, 378, 381(2), 11 U.S.C. §§ 702, 752, 778, 781(2) (1970).

⁵ After an adjudication of bankruptcy, the referee calls a meeting of creditors who, by a majority vote, attempt to appoint a trustee. If the creditors' efforts fail, the court will, usually through the referee, appoint the trustee. Bankruptcy Act §§ 44, 56, 11 U.S.C. §§ 72, 92 (1970).

⁶ Bankruptcy Act § 64, 11 U.S.C. § 104 (1970). The Act sets forth five priority groups, which are summarized generally as follows:

(1) costs and expenses of administration of the bankrupt's estate, including fees of trustees and attorneys;

(2) wage claims, not to exceed \$600, for a period of up to three months before bankruptcy, for each employee of the bankrupt;

(3) expenses of creditors in setting aside the confirmation of an arrangement or wage-earner plan for the now bankrupt debtor;

(4) federal, state, and local taxes which become legally due and owing by the bankrupt; and

(5) rent owing to a landlord for use and occupancy of premises which accrued within three months prior to the date of bankruptcy.

Frequently, among the claimants seeking a share of the bankrupt's estate are the taxing arms of the federal, state, and local governments. Although these authorities are granted a fourth-level priority for taxes which are legally "due and owing by the bankrupt," the Act is ambiguous with regard to payment of withholding taxes derived from wages earned by employees of the bankrupt when such wages are disbursed *after* adjudication. The Second Circuit, in *In re Freedomland*,⁷ held that such taxes are to be treated as conceptually equal to the wages from which they are derived, and thereby enjoy a number two priority as do the wage claims themselves. In making this determination, the court is in conflict with three other circuits.

Freedomland was an amusement park operated during the early 1960's in Bronx County, New York. It filed an arrangement petition on September 15, 1964, and was adjudicated bankrupt about eleven months later. Some 413 wage claims, each of \$600 or less, were filed for unpaid wages earned before the Chapter XI petition. Both the federal and city⁸ governments sought their derivative withholding taxes from the trustee as though he were then standing in the shoes of the employer.

The referee allowed payment of the wage claims, but without placing the burden of withholding and accounting upon the trustee, stating that such a time-consuming procedure would be "utterly inconsistent with the spirit and the letter of the Bankruptcy Act."⁹ The district court reversed, holding the trustee accountable to the governmental authorities, but put these tax claims in the fourth priority as though they were "legally due and owing by the bankrupt" before his adjudication.¹⁰ The Second Circuit, per Judge Oakes, affirmed the

⁷ 480 F.2d 184 (2d Cir. 1973), *petition for cert. filed*, 42 U.S.L.W. 3153 (U.S. Sept. 25, 1973) (No. 73-375).

⁸ The New York City tax claim was based on a wage withholding tax law which took effect *after* the wages were earned by the employees, but *before* the date of bankruptcy. N.Y.C. ADMIN. CODE § T46-51.0 (1967). Interestingly, a holding that the federal taxes were "due and owing" at the time of bankruptcy would by implication vitiate any City tax claim. Such a result ensues because the City's claim would not have matured at the time of the bankruptcy since the tax liability would have become fixed prior to the bankruptcy and hence prior to the effective date of the City's tax. Thus, no taxes could be said to have been "legally due and owing" to the City.

⁹ 480 F.2d at 186, *quoting* opinion of Referee Ryan (S.D.N.Y. Jan. 27, 1971).

¹⁰ *In re Freedomland*, 341 F. Supp. 647 (S.D.N.Y. 1972). The court very astutely noted that:

[i]f the taxes due on wages *actually paid* are entitled to only a fourth priority, why should the taxes on wages *earned but simply not paid* during that period be entitled to a higher priority? To assign a first priority to the later group of taxes would make those taxes payable ahead of the wages, themselves, which are entitled to only a second priority.

Id. at 655-56 (emphasis added).

district court's view of the duty imposed upon the trustee to assume the obligations of an employer with regard to withholding tax remittance,¹¹ but reversed on the issue of priority.

While it is generally agreed that the trustee has the duty to withhold, the question of which priority applies to these claims is unsettled. In *United States v. Fogarty*,¹² the Eighth Circuit thought it was significant that the taxes "were not payable at the time the petition was filed by the bankrupt," but accrued after the petition was filed and during the estate administration.¹³ This reasoning negated any inference that such withholding taxes were "legally due and owing" within the ambit of the fourth priority.¹⁴ Instead, the court held that since payment of the wages was made during the administration by a trustee, the consequential withholding taxes should properly be classified as an expense of administration and fall within the first priority grouping of the Act.¹⁵ The Ninth Circuit substantially followed the reasoning of *Fogarty* in *Lines v. California Department of Employment*.¹⁶ That court gave such claims a first priority as administrative expenses since they did not accrue until the wages were paid during the bankruptcy proceeding.¹⁷

The first major break from the *Fogarty* doctrine occurred in the Third Circuit case of *In re Connecticut Motor Lines, Inc.*¹⁸ The court examined the legislative history accompanying the formulation of the priority categories and found a congressional intent to indicate that those expenses which arise after bankruptcy, but "are unrelated to

¹¹ 480 F.2d at 189. See *United States v. Fogarty*, 164 F.2d 26 (8th Cir. 1947). The Eighth Circuit found support in "Section 402.227 of Treasury Regulations 106, which provide(d) that: 'Remuneration for employment . . . constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.'" *Id.* at 30.

The *Fogarty* court felt that the trustee's control over the payments as wages, rather than the employer-employee relationship, is significant. 164 F.2d at 32. Hence the trustee was deemed to stand "in the shoes of the bankrupt," *id.* at 33, as the one in control of the wage payments and must necessarily perform all attendant lawful functions. *Id.* See also *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.), *rehearing denied with opinion*, 246 F.2d 70 (9th Cir.), *cert. denied*, 355 U.S. 857 (1957); *United States v. Curtis*, 178 F.2d 268 (6th Cir.), *cert. denied*, 339 U.S. 659 (1949).

¹² 164 F.2d at 26 (8th Cir. 1947).

¹³ *Id.* at 33.

¹⁴ Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104(a)(4) (1970).

¹⁵ 164 F.2d at 33. See note 6 *supra*.

¹⁶ 246 F.2d 70 (9th Cir.), *petition for rehearing denied with opinion*, 242 F.2d 201 (9th Cir.), *cert. denied*, 355 U.S. 857 (1957).

¹⁷ The court remarked: "The employer's tax is not due or capable of ascertainment of amount until the wage is paid. There may very well not be any wages paid out of the bankrupt estate. The amount of the wage is uncertain until the bankrupt estate is fully determined." 246 F.2d at 72 (emphasis added).

¹⁸ 336 F.2d 96 (3d Cir. 1964).

development, preservation or distribution of the bankrupt's assets"¹⁹ have no place within the first priority grouping. The *Motor Lines* court held that withholding tax claims belonged in the fourth priority.²⁰ It reasoned that since the trustee was deemed to be in the shoes of the employer, he would become liable to the government for taxes on these wages as "legally due and owing" by the bankrupt.²¹

In *Freedomland*, Judge Oakes disagreed with the Third, Eighth and Ninth Circuits and took a novel approach conferring a second priority upon the withholding taxes.²² The court relied upon the reasoning of *Motor Lines* and the district court to reject the *Fogarty* rationale.²³ It concluded that it was anomalous to give a first priority status to the withholding taxes thereby allowing them to "take priority over the wages on which they were based."²⁴

¹⁹ *Id.* at 102. The *Motor Lines* court also took notice of prior changes in the law which had moved "taxes which became legally due and owing by the bankrupt" from a first priority down to the current fourth priority. For many years after the passage of the original bankruptcy act in 1800, Bankruptcy Act, ch. 19, 2 Stat. 19, there was no comprehensive bankruptcy plan for establishing priorities of payment. In 1867, however, a five category provision was devised and implemented, Bankruptcy Act, ch. 176, § 28, 14 Stat. 531, whereby taxes were accorded a second priority. In 1898, when another full-scale, comprehensive re-evaluation of the Act was undertaken, two basic priority groups for payment of debts were established. In group "A" were "all taxes due and owing . . . to the United States, State, county, district or municipality," and in group "B" were all other prior claims. Bankruptcy Act, ch. 541, § 64, 30 Stat. 563. Further changes occurred in 1926 and tax claims were relegated to a sixth priority. Bankruptcy Act of May 27, 1926, ch. 406, § 15, 44 Stat. 667-68. Finally, in 1938, taxes were accorded the fourth priority, where they remain today.

In this development Judge Forman recognized a "legislative disposition to remove taxes from a preferred status." 336 F.2d at 103. See also *United States v. Randall*, 401 U.S. 513, 517 (1971), wherein the Court noted the subordination of taxes to higher priorities of distribution and refused to impress a trust fund on wages held by the trustee to satisfy tax claims.

²⁰ 336 F.2d at 106; accord, *In re John Horne Co.*, 220 F.2d 33 (7th Cir. 1955). For an analysis and criticism of *Motor Lines* see 63 MICH. L. REV. 1103 (1965). See generally THE COLLIER BANKRUPTCY MANUAL, ¶ 64.404 at 785 (Kelliher ed. 1948), where it is stated "Only taxes which are 'legally due and owing' can be presented as prior claims under § 64(a)(4). . . . There is fairly general agreement that a tax becomes 'due and owing' at the date when all the facts necessary for its calculation are available. . . ." But see 40 N.Y.U.L. REV. 360 (1965), wherein the author, in criticizing the *Motor Lines* rationale, argued:

It is not clear, however, that the employer's taxes should be given fourth priority status, . . . since it is questionable whether they are legally due and owing at the date of bankruptcy. It is generally agreed that a tax is legally due and owing only when all of the facts necessary to calculate it—in this case, the number and amount of wage claims and the amount of funds available after payment of first priority expenses—are available. None of these facts are ascertainable at the date of bankruptcy, since wage claims may be filed up to six months after bankruptcy.

Id. at 363. The six-month claim request provision is found in Bankruptcy Act § 57(n), 11 U.S.C. § 93(n) (1970). The problems of finding an exact definition of "due and owing" are further illustrated in Plumb, *Federal Tax Liens and Priorities in Bankruptcy—Recent Developments*, 74 COMM. L.J. 225 (1969).

²¹ 336 F.2d at 106.

²² 480 F.2d at 190. See also 64 MICH. L. REV. 1103, 1108 (1965), in which the author calls for a similar conclusion.

²³ 480 F.2d at 189.

²⁴ *Id.*

However, the court did not share the belief of the Third Circuit in *Motor Lines* that the taxes were "legally due and owing" by the bankrupt. It felt instead that

[t]he taxes are by law calculable only when the wage claims are paid and not until then. . . . The taxes were never "due and owing by [the] bankrupt," which was *Freedomland*. When a tax "cannot be computed as of the date of the petition in bankruptcy," it is not "due and owing by [the] bankrupt."²⁵

However, the court did not develop its view of the conceptual meaning to be given the phrase "due and owing." Rather, it simply held that the payment of the wages is what incurs the concomitant obligation for payment of taxes and therefore the taxes must be considered in the same category as wages, *i.e.*, a second priority.²⁶ Additionally, the court held that the wage claims of the employees constituted a constructive claim for the withholding taxes due.²⁷

The Second Circuit's decision in *In re Freedomland* leaves open the question of which priority should be afforded a claim for withholding taxes on wages earned prior to, but paid after, the bankruptcy. Conflicts among the Eighth²⁸ and Ninth²⁹ Circuits, claiming first priority, and the Third³⁰ Circuit, claiming fourth priority, and now the Second Circuit, assigning second priority, indicate the need for further congressional or judicial clarification. By equating the priority to be accorded withholding tax claims to that given the wage claims themselves, *Freedomland* provides a logical solution to the problem because "the amounts claimed for wages include within them the amounts due to the taxing authorities."³¹ Hopefully the reasoning of *Freedomland* will be affirmed.³²

²⁵ *Id.* at 190, citing *In re International Match Corp.*, 79 F.2d 203 (2d Cir.), cert. denied, 296 U.S. 652 (1935).

Authority for this view is also found in the regulations of the Internal Revenue Service which provide that withholding taxes attach at the time wages are received by the employee and paid by the employer. See Treas. Reg. §§ 31.3101-3, 31.3111-3 (1954).

²⁶ 480 F.2d at 190. The court also held that the trustee could withhold on a 25% basis rather than computing and verifying each claim. *Id.* at 189.

²⁷ *Id.* at 191.

²⁸ *United States v. Fogarty*, 164 F.2d 26 (8th Cir. 1947).

²⁹ *Lines v. State Dep't of Employment*, 242 F.2d 201 (9th Cir. 1957).

³⁰ *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3d Cir. 1964).

³¹ 480 F.2d at 191. Moreover, consider the value of *Freedomland* in a situation where all priority claims have been satisfied and there are wage claims beyond those allowed within the second priority which fall into the general unsecured distribution class. If the withholding tax claims on these wages are given any priority, the trustee will be paying out taxes on wages before the wages themselves have been disbursed. Under *Freedomland* this anomaly is avoided and any withholding tax claims on those wages would be placed in the general unsecured category.

³² Cert. granted, 42 U.S.L.W. 3415 (U.S. Jan. 22, 1974) (No. 73-375).