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# Comments

## Allocation of Tax Payments Under Chapter 11 Reorganizations—Who Will Decide: IRS or Bankruptcy Courts?

### I. INTRODUCTION

A fundamental discord exists between the Internal Revenue Service and the Bankruptcy Court over which one of them has the final authority in determining how tax payments in bankruptcy reorganizations shall be applied. Specifically, this disagreement centers on whether a bankruptcy court can require the Internal Revenue Service to apply distributions under a plan of reorganization initially to trust fund tax liabilities.<sup>1</sup> At the heart of this controversy lies a dichotomy between payments made “voluntarily” or “involuntarily” by the taxpayer.<sup>2</sup> Traditionally under the common law, a debtor in a non-bankruptcy situation was always permitted to designate how voluntary payments would be allocated.<sup>3</sup>

Currently, there is a split among the federal circuit courts as to whether payments made under a reorganization plan are voluntary or involuntary, and as to whether such a distinction ends the inquiry.<sup>4</sup> Thus, this issue is ripe for determination by the United

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1. For a discussion of trust fund taxes, see *infra*, notes 6 to 13 and accompanying text.

2. See, e.g., *Amos v. Commissioner*, 47 T.C. 65 (1966). For a discussion of this case and the standard for determining whether payments under a reorganization plan are voluntary, see *infra*, notes 14 to 43 and accompanying text.

3. *Amos*, 47 T.C. at 68.

4. The Third, Sixth and Ninth Circuits, recognizing the traditional dichotomy, have ruled that tax payments made pursuant to a bankruptcy reorganization were involuntary, and thus, the Internal Revenue Service [hereinafter IRS or Service] was not obliged to apply such payments to trust fund liabilities first. See *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987); *In re DuCharmes & Co.*, 852 F.2d 194 (6th Cir. 1988)(*per curiam*); and, *In re Technical Knockout Graphics Inc.*, 833 F.2d 797 (9th Cir. 1987).

The First and Eleventh Circuits have looked beyond the traditional dichotomy. Having

States Supreme Court, and indeed, certiorari has been granted in *In re Energy Resources Co.*<sup>5</sup> This comment will focus on a brief description of trust fund taxes, the historical test for ascertaining when tax payments are voluntary or involuntary, an analysis of the federal decisional law applying such standard and case law departing from the historical test, and some thoughts on how the Supreme Court might resolve the controversy.

## II. TRUST FUND TAXES

Under the Internal Revenue Code, employers are required to withhold from employees' paychecks an amount of money equal to that portion of personal income taxes and social security (FICA)<sup>6</sup> taxes owed to the government by its employees.<sup>7</sup> Section 7501(a) of the Internal Revenue Code directs employers to place the amounts withheld from employees' paychecks in a special fund "in trust for the United States."<sup>8</sup> These taxes are commonly referred to as "trust fund" taxes.<sup>9</sup> In the event that employers fail to pay these "trust fund" taxes over to the government, section 6672 authorizes the Service to collect a commensurate sum directly from the employees or officers who are liable for their collection and payment.<sup>10</sup>

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concluded that the bankruptcy court can order the IRS to allocate "involuntary" payments to a debtor's trust fund liability first, these courts employ a balancing test, weighing the likelihood that such allocation will increase the reorganization plan's chances for success against the increased risk that the IRS may not collect the total tax liability. See *In re Energy Resources Co.*, 871 F.2d 223 (1st Cir. 1989), *cert. granted*, 110 S. Ct. 402 (U.S. Nov. 13, 1989) (No. 89-255); *In re A & B Heating & Air Conditioning, Inc.*, 823 F.2d 462 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, 108 S.Ct. 1724 (1988), *on remand*, 861 F.2d 1538 (11th Cir. 1988), *dismissed as moot*, 878 F.2d 1311 (11th Cir. 1989).

For a further discussion of these cases, see *infra*, notes 47 to 117 and accompanying text.

5. 110 S. Ct. 402 (U.S. Nov. 13, 1989) (No. 89-255). Oral argument on this issue has been scheduled for March 19, 1990.

6. FICA stands for Federal Insurance Contributions Act. See I.R.C. § 3101 (1989). The tax imposed under this section finances old-age, survivors, and disability insurance, commonly known as social security. I.R.C. § 7501(a) (1989).

7. INTERNAL REVENUE CODE OF 1986, I.R.C. §§ 3102(a), 3402(a) (1989).

8. I.R.C. § 7501(a) (1989). Section 7501(a) provides, in pertinent part: "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 tax so collected or withheld shall be held to be a special fund in trust for the United States." *Id.*

9. See *Slodov v. United States*, 436 U.S. 238, 242-43 (1978).

10. I.R.C. § 6672(a) (1989). Section 6672 states, in pertinent part:

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

These persons are usually referred to as "responsible" individuals.<sup>11</sup>

Thus, the effect of section 6672 is to make the "responsible" individuals personally liable for the unpaid "trust fund" taxes. This consequence takes on a special significance when the employer has incurred both trust fund and non-trust fund tax liabilities. In this situation, the policy of the Service is to allocate payments first to the outstanding non-trust fund taxes.<sup>12</sup> Then, if the employer has insufficient financial resources to pay off the trust fund taxes, the Service can tap the collateral source, namely, the responsible individuals, much to their discontent.<sup>13</sup>

### III. STANDARD FOR DETERMINING VOLUNTARY TAX PAYMENTS

The touchstone for ascertaining whether tax payments are involuntary is the frequently cited test in *Amos v. Commissioner*.<sup>14</sup> The taxpayers in *Amos* had a substantial outstanding tax liability for the tax year ending 1944.<sup>15</sup> To collect on this liability, the IRS served notices of levy on the taxpayers' bank and insurance company, both of whom complied with the levy.<sup>16</sup> Taxpayers attempted to have the payments from the bank and insurance company applied first to the accrued interest portion of the outstanding tax liability, so that they could receive a correspond-

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*Id.*

11. See *Slodov*, 436 U.S. at 244-45. There is no corresponding personal liability for non-trust fund taxes, such as corporate income taxes. In re *DuCharmes & Co.*, 852 F.2d 194, 196 (6th Cir. 1988).

12. See I.R.S. Policy Statement P-5-60, reprinted in 1 Administration, Internal Revenue Manual (CCH) 1305-15 (May 30, 1984). The position of the Service is reflected in the following excerpt from the Policy Statement:

In determining the amount of the 100-percent penalty to be assessed in connection with withheld income and employment taxes, any payment made on the corporate account involved is deemed to represent payment of the non-withheld portions of the liability (including assessed and accrued penalty and interest) unless there was some specific designation to the contrary by the taxpayer. The taxpayer, of course, has no right of designation in the case of collections resulting from enforced collection measures. To the extent partial payments exceed the non-withheld portion of the tax liability, they are considered as being applied against the trust fund portion of the assessment.

*Id.*

13. See *supra*, note 10.

14. 47 T.C. 65 (1966).

15. *Id.* at 66.

16. *Id.* at 66-67. Taxpayer husband held a group annuity contract with the John Hancock Mutual Life Insurance Company of Boston, Massachusetts, under which he was to receive monthly payments of \$523.40. *Id.* at 66.

ing interest deduction under section 163.<sup>17</sup> The Tax Court disallowed the interest deduction, ruling that the payments received from the bank and insurance company were involuntary.<sup>18</sup> In reaching its conclusion, the Tax Court looked initially to the common law derived from the debtor-creditor relationship.<sup>19</sup> The Tax Court stated the general principle that "when a debtor voluntarily makes a payment to a creditor, the payment will be applied as the debtor directs; and, if the debtor fails to make a timely application, the payment will be applied as the creditor directs."<sup>20</sup> Embellishing upon this common law principle, the Tax Court went on to hold that an involuntary payment includes any payment made to the IRS as a result of distraint or levy, or from a legal proceeding in which the Service is attempting to collect, or file a claim for, overdue taxes.<sup>21</sup>

Several years after the *Amos* decision, the Service issued Revenue Ruling 73-305,<sup>22</sup> officially taking the view that a taxpayer is free to allocate "voluntary" payments to taxes, penalties, and interest in any manner he prefers.<sup>23</sup> The Service also posited that where the taxpayer failed to make a designation, the payment would be applied to tax, penalty, and interest, in that order.<sup>24</sup>

Although Revenue Ruling 73-305 did not pertain to trust fund taxes, the Service extended its pronouncement to these taxes in Revenue Ruling 79-284.<sup>25</sup> In that ruling, the IRS permitted the designation of "voluntary" payments in accordance with the tax-

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17. *Id.* at 67-68. The taxpayers argued that they could direct how the payments should be applied, that is, to interest first and principal second. *Id.* at 68. In the case of involuntary payments, taxpayers alternatively argued that payments must be applied to interest first. *Id.*

18. *Id.* at 69-70.

19. *Id.* at 68.

20. *Id.* (citations omitted).

21. *Id.* at 69. The Tax Court was guided by the Tenth Circuit's opinion in *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964). The Court of Appeals in *O'Dell* acknowledged the general principle that a debtor who voluntarily pays his debts may direct to which items these payments are allocated. *Id.* at 456. However, the *O'Dell* Court held that the general principle did not apply where the payment was involuntarily made, such as in the case of an execution or judicial sale. *Id.*

22. Rev. Rul. 73-305, 1973-2 C.B. 43.

23. *Id.*

24. *Id.* The Service specifically excluded withheld employment taxes from this Revenue Ruling. *Id.* at 44.

25. Rev. Rul. 79-284, 1979-2 C.B. 83. Revenue Ruling 79-284 held, in pertinent part: "Rev. Rul. 73-305 applies to withheld employment taxes and collected excise taxes where the taxpayer provides specific written instructions for the application of a voluntary partial payment." *Id.*

payer's wishes, so long as the allocation was stated in writing by the taxpayer.<sup>26</sup> Revenue Ruling 79-284 further provided that where the taxpayer failed to make the required designation, the IRS was free to allocate such payments in accordance with its best interests.<sup>27</sup>

Thereafter, the Service attempted to treat any overdue payments made by the taxpayers as not voluntary.<sup>28</sup> However, in 1983, the Seventh Circuit decided *Muntwyler v. United States*,<sup>29</sup> which completely rejected the Service's treatment as involuntary the mere filing of a claim.<sup>30</sup> In *Muntwyler*, the taxpayer was an officer, director, and majority shareholder of a financially troubled airline.<sup>31</sup> Because of its failing financial posture, the airline failed to pay its trust fund and non-trust fund taxes.<sup>32</sup> The airline assigned the entirety of its assets to a trustee for the benefit of its creditors.<sup>33</sup> The IRS presented a claim to the trustee for unpaid trust fund and non-trust fund taxes.<sup>34</sup> A short time later, the trustee submitted three checks to the Service, directing that they be applied to the trust fund liability first.<sup>35</sup> Although it accepted the checks, the Service declined to follow the trustee's designation and applied the entire amount to the non-trust fund liability.<sup>36</sup>

The issue involved in *Muntwyler* was whether tax payments, made pursuant to a mere claim for overdue taxes by the IRS, were made voluntarily, such that the taxpayer was free to have those payments allocated first to his trust fund liability.<sup>37</sup> In concluding that the payments were voluntary, the Court of Appeals, relying on

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26. *Id.*

27. *Id.*

28. Falk, *Designating Employment Tax Payments in Bankruptcy Reorganizations*, 30 TAX MGMT. MEMO. 299 (1989). The author noted that the IRS was able to successfully persuade two district courts with its position: In re Hannan Trucking, Inc. v. United States, 17 Bankr. 475 (Bankr. N.D. Tex. 1981); and Hirsch v. United States, 396 F.Supp. 170 (S.D. Ohio 1975). Falk, *supra* at 301 n. 27. Referring to the district court's observation in *In re Hannan Trucking*, that "the power of designation, while absolute if timely, evaporates upon the expiration or [sic] the relevant period for filing a timely return," the author commented that the court's view was "extremely narrow and restrictive" and was "unnecessary, incorrect and unsupported." *Id.*

29. 703 F.2d 1030 (7th Cir. 1983).

30. *Id.* at 1033.

31. *Id.* at 1031.

32. *Id.*

33. *Id.* The trustee was appointed in a non-bankruptcy setting. *Id.* at 1033.

34. *Id.* at 1031.

35. *Id.*

36. *Id.*

37. *Id.* at 1032.

*Amos v. Commissioner*, focused on the requirement that court action or actual seizure is a prerequisite to a finding that the payment was involuntary.<sup>38</sup> To support its conclusion, the Court offered the Service's own policy statement<sup>39</sup> on the section 6672 one hundred percent penalty assessment,<sup>40</sup> which states: "The taxpayer, of course, has no right of designation in the case of collections resulting from *enforced collection measures*."<sup>41</sup> The *Muntwyler* Court interpreted "enforced collection measures" to mean that something more than the mere filing of a claim for back taxes is necessary to render a payment involuntary.<sup>42</sup>

Finally, the Seventh Circuit concluded in dicta that tax payments made under the auspices of the bankruptcy court were involuntary, since they involved court action.<sup>43</sup> The Tax Court's definition of involuntary payment in *Amos*, and the clarification provided in *Muntwyler*, have been relied on as established precedent in the context of a bankruptcy plan of reorganization, as will be shown below.

#### IV. JUDICIAL APPLICATION OF THE INVOLUNTARY STANDARD

Because of the personal liability imposed on responsible persons under section 6672, the voluntary requirement has generated significant litigation for trust fund tax payments.<sup>44</sup> From this litigation, two analytical approaches have evolved: a mechanical approach which simply looks at whether tax payments are voluntary or involuntary; and, a balancing approach which, after making a threshold determination that the payments are involuntary, weighs

38. *Id.* at 1032-33. The *Muntwyler* Court went on to explain that:

The distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual seizure of property or money as in a levy. No authorities support the proposition that a payment is involuntary whenever an agency takes even the slightest action to collect taxes, such as filing a claim or, as appears to be a logical extension of the Government's position, telephoning or writing the taxpayer to inform him of taxes due.

*Id.* at 1033.

39. See *supra*, note 12.

40. The one hundred percent penalty assessment refers to the total amount of the uncollected trust fund taxes for which the responsible persons are liable. I.R.C. § 6672(a) (1989). See *supra* note 10 for the text of this statute.

41. *Muntwyler*, 703 F.2d at 1033 (quoting I.R.S. Policy Statement P-5-60, *supra*, at note 12) (emphasis added).

42. *Id.*

43. *Id.*

44. Falk, *supra*, note 28, at 300.

the likelihood that the allocation will increase the reorganization plan's chances of success against the increased risk that the IRS may not collect total tax liability.<sup>45</sup> From a quantitative standpoint, the majority of jurisdictions faced with this issue have followed the mechanical approach.<sup>46</sup> As will be shown, however, the plain weight of numbers does not necessarily equate to the best argument.

The court of appeals which initially adopted the mechanical approach was the Third Circuit in *In re Ribs-R-Us, Inc.*<sup>47</sup> The issue in that case centered on whether the bankrupt's payment of taxes under a reorganization plan was voluntary.<sup>48</sup> The corporate taxpayer submitted a plan of reorganization under which it sought to allocate its payments of priority tax claims to the trust fund portion of its tax liability.<sup>49</sup> The Service objected to the reorganization plan, arguing that tax payments made pursuant to a bankruptcy proceeding were involuntary, and thus, the taxpayer could not designate how they were to be allocated.<sup>50</sup> On the other hand, the corporate taxpayer submitted that payments are involuntary only when they are made under enforced collections measures which result in an actual seizure of property, such as a levy.<sup>51</sup> Moreover, Ribs-R-Us argued that since it did not lose possession of the assets from which payments were to be made,<sup>52</sup> the tax payments under the reorganization plan were voluntary.<sup>53</sup>

Focusing on the bankruptcy court's intervention in the payment of creditors once a voluntary petition for reorganization has been

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45. See *supra*, note 4.

46. *Id.*

47. 828 F.2d 199 (3d Cir. 1987).

48. *Id.* at 201.

49. *Id.* at 200.

50. *Id.* at 201. The Third Circuit stated the Government's position as follows:

[T]he plan provision directing the application of tax payments initially to the trust fund portion of Ribs-R-Us' tax liability was intended to shield from potential personal liability principals of Ribs-R-Us, . . . who continued as the sole shareholders of the reorganized corporation, and that because this is in derogation of the purpose of section 6672 it is impermissible.

*Id.* at 201.

51. *Id.* at 202.

52. This reasoning follows from the fact that Ribs-R-Us remained as a debtor-in-possession, continuing to operate the restaurant throughout the course of the bankruptcy proceedings.

*Id.* at 199-200.

53. *Id.* at 202. Ribs-R-Us pointed out that under a Chapter 11 reorganization, the "debtor retains considerable flexibility in proposing and implementing a plan, including the amount and timing of payments." *Id.*



filed under Chapter 11 of the Bankruptcy Code,<sup>54</sup> the Third Circuit concluded that tax payments made pursuant to a plan of reorganization were involuntary.<sup>55</sup> In reaching this conclusion, the Third Circuit considered the precedent set forth in *Amos* and *Muntwyler*, and found the distinction between pre-petition and post-confirmation payments to be crucial.<sup>56</sup> In this regard, the Court stated that "following confirmation, the debtor is subject to an express judicial order in a proceeding concerning the obligation in which both the debtor and the United States are parties."<sup>57</sup>

The Third Circuit went on to hold that classifying payments made under a plan of reorganization as voluntary would fly in the face of the realities of bankruptcy.<sup>58</sup> The *Ribs-R-Us* Court reasoned that in exchange for the protection of the bankruptcy court, namely, to stay pending and future litigation and claims, and to discharge most pre-confirmation debts upon confirmation of the reorganization plan, the debtor loses any choice over how the payments under the plan will be allocated.<sup>59</sup>

The Third Circuit specifically rejected the position of the Eleventh Circuit in *In re A & B Heating & Air Conditioning, Inc.*,<sup>60</sup> which advocated leaving the allocation question to judicial discretion, to be decided on a case by case basis.<sup>61</sup> The Court of Appeals in *Ribs-R-Us* countered that whether tax payments made pursuant to a bankruptcy reorganization are voluntary is a question of law.<sup>62</sup> Motivated by an express concern for uniformity and reliability, the Third Circuit felt a uniform federal rule was preferable to debtors, creditors, and the IRS for guiding their decisions.<sup>63</sup>

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54. 11 U.S.C. § 1101 *et seq.* (1982, Supp. IV 1986 & Supp. V 1987).

55. 828 F.2d at 203.

56. *Id.* at 201, 203.

57. *Id.* at 203.

58. *Id.*

59. *Id.* at 203. The Third Circuit relied on the opinion of the dissenting judge in *In re Technical Knockout Graphics, Inc.*, who stated:

Debtors who file under *any* chapter of the bankruptcy code have few, if any, options.

As a practical matter, they file bankruptcy because it is a last chance for a relatively ordered financial liquidation or rehabilitation rather than the out-of-control financial debacle facing them on the eve of bankruptcy.

60 Bankr. 463, 469 (Bankr. 9th Cir. 1986) (Volinn, Bankr. J., dissenting), *rev'd*. 833 F.2d 797 (9th Cir. 1987).

61. 823 F.2d 462, 465 (11th Cir. 1987). For the subsequent history of this case, see *supra*, note 4.

62. *Ribs-R-Us*, 828 F.2d at 202. For a thorough discussion of *In re A & B Heating & Air Conditioning*, see *infra*, notes 78 to 97 and accompanying text.

63. *Id.*

Almost three months after the Third Circuit decided *In re Ribs-R-U's, Inc.*, the Ninth Circuit followed suit in *In re Technical Knockout Graphics, Inc.*<sup>64</sup> The question for the court in *TKO* was whether taxes paid after the debtor had filed for Chapter 11 bankruptcy, but prior to confirmation of the plan, were voluntarily made.<sup>65</sup> *TKO* advanced the position that the payments were voluntary for the reason that it had no duty to make any payments to any creditors before confirmation of the plan.<sup>66</sup> *TKO* further reasoned that since it made the payments without any obligation to do so, the payments were not the result of any enforced collection procedures and were prior to any intervention by the IRS in the bankruptcy.<sup>67</sup> The Service countered with the argument that because the payments were made during the pendency of the bankruptcy action, a judicial proceeding, the tax payments were involuntary.<sup>68</sup>

Relying on the precedent established in *Amos, Muntwyler*, and *In re Ribs-R-U's, Inc.*, the Ninth Circuit concluded that tax payments made after the initiation of the bankruptcy proceeding, but prior to the confirmation of the reorganization plan, were involuntary.<sup>69</sup> The Court held that *TKO*'s attempt to distinguish its case on the basis that it had no duty to make the payments when it did ignore the safeguards created by Congress for debtors under a "judicially supervised bankruptcy proceeding."<sup>70</sup> Indeed, the Ninth

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64. 833 F.2d 797 (9th Cir. 1987) [hereinafter *TKO*].

65. *Id.* at 801. The issue in *TKO* is slightly different than the question decided in *In re Ribs-R-U's, Inc.*, in that as to the latter, no payments of taxes had been made prior to the confirmation of the reorganization plan.

66. *Id.*

67. *Id.*

68. *Id.* The Government also contended that the bankruptcy court and bankruptcy appellate panel erred in holding that the bankruptcy court had the power under section 505 of the Bankruptcy Code, 11 U.S.C. § 505 (Supp. IV 1986), to allocate payments among various liabilities where equity demands, despite the involuntariness of the payments. *Id.* at 800-01. The Ninth Circuit in *TKO* agreed with the Service, finding that the Bankruptcy Court had misapplied section 505 of the Bankruptcy Code. *Id.* at 803.

69. *Id.* at 802.

70. *Id.* The Ninth Circuit delineated the protections afforded debtors under the Bankruptcy Code as follow:

Once a debtor files a bankruptcy petition, the property it then possesses, as well as funds acquired thereafter, become the property of the estate. The debtor-in-possession is not free to deal with this property as it chooses, but rather holds it in trust for the benefit of creditors, just as would a trustee. . . . By filing a bankruptcy petition, the debtor enjoys the protection of an injunction barring secured and unsecured creditors from pursuing the debtor without court intervention. A debtor-in-possession is required to obtain the court's permission to make payments other than in the ordinary course of business, and notice of this must be given to creditors. To approve a

Circuit found that TKO had abused the safeguards of a bankruptcy proceeding by attempting to designate payments in a manner that benefited only the responsible corporate officers outside of the probing eyes of the court or creditors.<sup>71</sup> Thus, the Ninth Circuit ruled that the IRS was entitled to allocate the payments received from TKO in accordance with the Service's best interests.<sup>72</sup>

The third court in the trilogy to follow a mechanical approach was the United States Court of Appeals for the Sixth Circuit in *In re DuCharmes & Co.*<sup>73</sup> Essentially, the Sixth Circuit adopted the positions of the Third and Ninth Circuits, in determining that payments made by a debtor in satisfaction of pre-petition tax liabilities, after the commencement of the bankruptcy proceeding, were involuntary.<sup>74</sup> In so holding, the Sixth Circuit rejected the position of the Eleventh Circuit in *In re A & B Heating & Air Conditioning, Inc.*<sup>75</sup>

Numerous bankruptcy and district courts have followed the mechanical approach employed by the Third, Sixth, and Ninth Circuits in determining that tax payments made in a bankruptcy proceeding are involuntary.<sup>76</sup> The lure of such a bright-line test should be approached with caution, however, as it ignores the purpose of a Chapter 11 reorganization, namely, the successful rehabilitation of the debtor corporation,<sup>77</sup> as well as whether the risk to

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reorganization plan, the court must find that the proposed plan is "fair and equitable," meaning that the payment priorities of the Bankruptcy Code are met. The debtor-in-possession is not free to pay whomever it chooses before the plan is confirmed, as this could defeat the priority scheme established by Congress.

*Id.* at 802-03. (citations omitted).

71. *Id.* at 803.

72. *Id.* The Ninth Circuit's decision in *TKO* has been followed by several bankruptcy courts within that circuit. See e.g., *In re Condel, Inc.*, 91 Bankr. 79 (Bankr. 9th Cir. 1988); *In re Stanmock, Inc.*, 103 Bankr. 228 (Bankr. 9th Cir. 1989); and, *In re Puget Sound Plywood, Inc.*, 1989-1 U.S. Tax Cas. (CCH) 9240 (Bankr. W.D. Wash. 1989).

73. 852 F.2d 194 (6th Cir. 1988).

74. *Id.* at 196.

75. *Id.* For a thorough discussion of the Eleventh Circuit's position in *In re A & B Heating & Air Conditioning, Inc.*, see *infra*, notes 78 to 97 and accompanying text.

76. See *In re Condel, Inc.*, *supra* note 70; *In re Stanmock, Inc.*, *supra* note 70; *In re Puget Sound Plywood, Inc.*, *supra* note 70; *In re 26 Trumbull Street, Inc.*, 96 Bankr. 419 (Bankr. D. Conn. 1989); *In re Professional Technical Services, Inc.*, 94 Bankr. 578 (Bankr. E.D. Mo. 1988); *In re Herald*, 66 Bankr. 169 (Bankr. E.D. N.C. 1986).

77. A finding of involuntariness, which thereby causes the payments to be allocated first to non-trust fund tax liabilities without a weighing of the interests, would negatively impact the rehabilitation of the debtor corporation, as well as the general unsecured creditors. The First Circuit illustrated how this would occur in *In re Energy Resources Co.* See *supra* note 4. Essentially, the court supposed that certain responsible individuals would be willing to advance the funds necessary to rehabilitate the corporation in exchange for an

the IRS of collection of tax liabilities will actually be increased. The balancing approach applied by the First and Eleventh Circuits provides such an equitable weighing of interests.

The Eleventh Circuit parted company with the Third, Sixth, and Ninth Circuits in *In re A & B Heating & Air Conditioning, Inc.*,<sup>78</sup> by applying a balancing approach to the issue of whether a taxpayer could designate how tax payments should be allocated under a bankruptcy reorganization plan.<sup>79</sup> The facts and issue in *In re A & B Heating & Air Conditioning, Inc.* were essentially the same as those contained in *In re Ribs-R-U's, Inc., TKO, and In re DuCharmes & Co.*, with one notable distinction: the IRS levied upon the assets of the corporation prior to commencement of the bankruptcy proceeding for failure to pay trust fund and non-trust fund taxes.<sup>80</sup> A & B Heating & Air Conditioning filed a petition for reorganization ten days later.<sup>81</sup>

In its reorganization plan, A & B Heating & Air Conditioning included a provision designating that the tax payments be allocated first to its trust fund liabilities.<sup>82</sup> The Service objected to the plan, contending that the tax payments made under a bankruptcy reorganization were involuntary, and thus, the debtor had no right to designate how the tax payments would be allocated.<sup>83</sup> The Eleventh Circuit, however, rejected the absolute rule that all tax payments made pursuant to a bankruptcy reorganization were involuntary.<sup>84</sup>

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assurance from the bankruptcy court that trust fund taxes would be paid first. 871 F.2d at 230. Although the responsible individuals would be released from personal liability under section 6672, the corporation would be kept afloat by the influx of capital, which would increase the likelihood of some payment to the general unsecured creditors. *Id.*

The Eleventh Circuit in *In re A & B Heating and Air Conditioning* also felt that "the failure to allow the debtor to allocate tax payments [was] detrimental to the reorganization plan," for the reason that if the responsible persons were forced to pay trust fund taxes out of their personal assets, the motivation to continue to successfully reorganize would be reduced. 823 F.2d at 465. In that event, the Eleventh Circuit believed there would be little probability that the general unsecured creditors would receive any payment. *Id.*

78. 823 F.2d 462 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, 103 S.Ct. 1724 (1988), *on remand*, 861 F.2d 1538 (11th Cir. 1988), *dismissed as moot*, 878 F.2d 1311 (11th Cir. 1989).

79. 823 F.2d at 465-66.

80. *Id.* at 463. The Eleventh Circuit appears to overlook the fact that a levy was placed on the assets in its analysis of whether the court involvement in a Chapter 11 reorganization rises to the level of court action equivalent to a seizure of property or money as in a levy. *Id.* at 464.

81. *Id.* at 463.

82. *Id.*

83. *Id.*

84. *Id.* at 465.

In its analysis, the Eleventh Circuit found weighty authority to support the position that tax payments made pursuant to a reorganization plan, as opposed to a straight liquidation, had elements of voluntariness.<sup>85</sup> In this regard, the Eleventh Circuit quoted from the opinion of the Bankruptcy Court in *In re A & B Heating & Air Conditioning, Inc.*, which noted that a debtor under a Chapter 11 reorganization had wide latitude in developing a plan, and had several options in determining how the IRS will be paid.<sup>86</sup> The Bankruptcy Court concluded that because the debtor had a certain "freedom" in propounding a plan, the payments made to the IRS under that plan were voluntary.<sup>87</sup> Moreover, the Eleventh Circuit cited precedent for the proposition that tax payments made pursuant to a *reorganization* plan did not rise to the level of court action which was the equivalent of "a levy, judicial order, execution or sale."<sup>88</sup>

The reason for the divergent opinions as to whether payments under a bankruptcy reorganization were voluntary was, in the Eleventh Circuit's opinion, due to a conflict between the public policies of the Bankruptcy Code and the Internal Revenue Code.<sup>89</sup> In the legislative history to the Bankruptcy Reform Act of 1978, Congress specifically recognized a conflict between the goals of rehabilitating debtors and treating private, voluntary creditors equally, and the interests of the taxing authorities, who are also creditors to the extent of unpaid taxes.<sup>90</sup>

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85. *Id.* at 464. *In re A & B Heating & Air Conditioning, Inc.*, was decided by the Eleventh Circuit without the benefit of the opinions of the Third, Sixth, and Ninth Circuits in *In re Ribs-R-U's, Inc.*, *In re DuCharmes & Co.*, and *TKO*, respectively. However, the Eleventh Circuit did have before it numerous bankruptcy court decisions supporting findings that the payments were both voluntary and involuntary. *Id.* at 463 n. 2.

86. *Id.* at 464 (quoting *In re A & B Heating & Air Conditioning, Inc.*, 53 Bankr. 54, 57 (Bankr. M.D. Fla. 1985), *aff'd.*, No. 85-1552-Civ-T-13 (M.D. Fla. May 7, 1986).

87. *Id.* (quoting *In re A & B Heating & Air Conditioning, Inc.*, *supra*, note 86).

88. *Id.* at 464 (quoting *In re Lifescape, Inc.*, 54 Bankr. 526, 529 (Bankr. D. Colo. 1985)).

89. *Id.* (footnote omitted).

90. S. REP. NO. 989, 95th Cong., 2d Sess. 13-14, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5799-800. The Senate's concerns were specifically stated as follows:

In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding.

...

A three-way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumulation of taxes for past years; (2) the debtor, whose "fresh start" should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law has restrained him from

Acknowledging the responsibility of the IRS to collect all taxes due, the Eleventh Circuit stated that public policy required that the Internal Revenue Code be construed in such a way as to maximize the public fisc.<sup>91</sup> In contrast, the Eleventh Circuit pointed out the intent of the Bankruptcy Code, which expressed a desire for reorganization rather than liquidation.<sup>92</sup> The Eleventh Circuit went on to note that a successful reorganization plan results in greater payments to the creditors, while preserving the economic vitality of the corporation.<sup>93</sup> The Eleventh Circuit held that allowing the IRS to decide how tax payments will be allocated in all Chapter 11 proceedings directly conflicts with the policy of the Bankruptcy Code.<sup>94</sup>

For lack of any express legislative intent that the Internal Revenue Code has priority over the Bankruptcy Code with regard to the designation of tax payments, the Eleventh Circuit declined to accept the position of the IRS, that all tax payments made pursuant to a reorganization plan were involuntary.<sup>95</sup> Instead, the Eleventh Circuit ruled that the determination of whether a taxpayer may allocate tax payments in a bankruptcy reorganization plan was best left to the discretion of the bankruptcy court, considering the plan as a whole and any equitable reasons for the allocation.<sup>96</sup> The Eleventh Circuit specifically ordered the bankruptcy court to ascertain whether the proposed plan was "merely a stop gap scheme" to prevent the allocation of the IRS while, in reality, little chance existed that the debtor would be able to meet its obligations under the plan.<sup>97</sup>

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collecting.

*Id.*

91. *In re A & B Heating & Air Conditioning, Inc.*, 823 F.2d at 465.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 465 n. 4 and 466. In particular, the Eleventh Circuit set forth the following equitable factors for the bankruptcy court to consider:

the history of the debtor, the absence or existence of prebankruptcy collection or "enforced collection measures" of the I.R.S. against the corporation and responsible corporate officers; the nature and contents of a Chapter 11 plan (e.g., last resort liquidation or reorganization); the presence, extent and nature of the administrative and/or court action; the presence of pre- or post-bankruptcy agreements between the debtor (or trustee) and the I.R.S.; and the existence of exceptional or special circumstances or equitable reasons warranting such allocation.

*Id.* at 466 (quoting *In re B & P Enterprises, Inc.*, 67 Bankr. 179, 184 (Bankr. W.D. Tenn. 1986)).

97. *Id.* at 466. The Eleventh Circuit's opinion was eventually dismissed as moot, be-

The other major precedent advocating a balancing approach was decided by the First Circuit in *In re Energy Resources Co.*<sup>98</sup> In that case, the First Circuit held that the Bankruptcy Court had the legal power to direct the IRS to apply tax payments to satisfy trust fund liabilities first, notwithstanding the fact that the payments were characterized as involuntary.<sup>99</sup> In reaching this conclusion, the First Circuit employed a two-pronged analysis.<sup>100</sup>

In the first part of its analysis, the First Circuit made a threshold inquiry as to whether tax payments made under a reorganization plan were properly characterized as involuntary.<sup>101</sup> In its opinion, the First Circuit felt that the characterization question was difficult, in that a reorganization proceeding had some features that made the tax payments appear to be voluntary,<sup>102</sup> and others

cause the taxpayer agreed to delete from the reorganization plan the provision which designated that tax payments would first be allocated to the trust fund liabilities. 878 F.2d 1311. The corporate officer personally liable for the payment of the trust fund taxes, who was not a party to the bankruptcy action, paid off this liability from his personal assets. 861 F.2d at 1539.

98. 871 F.2d 223 (1st Cir. 1989), *cert. granted*, 110 S. Ct. 402 (U.S. Nov. 13, 1989) (No. 89-255). This opinion addresses the consolidated appeal of two cases: *In re Energy Resources Co.*, 59 Bankr. 702 (Bankr. D. Mass. 1986); and, *In re Newport Offshore Ltd.*, 75 Bankr. 919 (Bankr. D. R.I. 1987).

Both cases involved reorganizations under Chapter 11 of the Bankruptcy Code. 871 F.2d at 225. Both corporations were indebted to the IRS for trust fund and non-trust fund tax liabilities. *Id.* The reorganization plan for each corporation applied the tax payments first to satisfy the trust fund liability. *Id.* The Service lodged its usual objection, that payments made pursuant to a reorganization plan were involuntary, and thus, only the IRS may designate how the payments were to be allocated. *Id.* at 225-26.

In *In re Energy Resources Co.*, the district court affirmed the decision of the bankruptcy court which permitted the debtor's allocation to trust fund liabilities first. *Id.* at 226. The district court in *In re Newport Offshore Ltd.* reversed the bankruptcy court's allocation of tax payments to trust fund liabilities. *Id.*

99. *Id.*

100. *Id.* at 227.

101. *Id.* The First Circuit reviewed all the relevant cases decided to date, including, *Amos, Muntwyler, In re Ribs-R-U's, Inc., TKO, In re DuCharmes & Co.*, and *In re A & B Heating & Air Conditioning, Inc.* *Id.* The First Circuit also considered Revenue Ruling 79-284, 1979-2 C.B. 83, as well as I.R.S. Policy Statement P-5-60. *In re Energy Resources Co.*, 871 F.2d at 227.

102. The First Circuit listed the following features which tended to characterize a payment as involuntary:

- (1) Once a debtor files for reorganization under Chapter 11 all its assets vest in the bankruptcy estate.
- (2) The debtor-in-possession (or other trustee) is no longer free to spend the debtor's money; rather, he must act as a "fiduciary" for the benefit of the creditor, and, he must act in accordance with orders the bankruptcy court may issue.
- (3) The bankruptcy court will determine the extent of the debtor's tax liability.
- (4) The debtor *must* produce a plan that will see that all tax claims . . . are paid in full "over a period not exceeding six years after the date of assessment of such claim[s]".
- (5) A bankruptcy court order confirming a plan is an order requiring the debtor (or

that made it look involuntary.<sup>103</sup> However, the First Circuit resolved the question in favor of the IRS, holding that deference must be given to an agency's own rules and regulations.<sup>104</sup> Since it could not say that the Service's view was clearly unreasonable, the First Circuit accepted the Service's characterization of the tax payments as involuntary.<sup>105</sup>

The second prong of the Court's analysis in *In re Energy Resources Co.* centered on the power of a bankruptcy court to direct the IRS to allocate involuntary tax payments first to trust fund liabilities.<sup>106</sup> In concluding that the bankruptcy court was vested with such authority, the First Circuit weighed the competing interests of the Bankruptcy Code and the Internal Revenue Code.<sup>107</sup> In addition to the factors weighed in *In re A & B Heating & Air Conditioning, Inc.*,<sup>108</sup> the First Circuit also considered the bankruptcy court's "broad equitable powers,"<sup>109</sup> as well as the legal power of the bankruptcy court.<sup>110</sup>

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trustee) to carry out the plan, including, of course, its payment schedule. (6) If the debtor fails to produce or comply, with such a plan, the bankruptcy court may convert the proceeding, against the debtor's wishes, into a Chapter 7 liquidation, which invariably will involve a bankruptcy court order requiring the debtor (or the trustee), to pay assets to the government to satisfy tax liabilities.

*Id.* at 228-29 (quoting *In re Ribs-R-U's, Inc.*, 828 F.2d at 202-03) (citations omitted).

103. According to the First Circuit, the following features tended to label a payment as voluntary:

(1) The debtor may choose "voluntarily" to enter a Chapter 11 reorganization proceeding. (2) The Chapter 11 proceeding offers the taxpayer *protection* from creditors, *including the IRS*. (3) Chapter 11 gives the debtor many "options" for structuring payment and considerable "latitude" as to "how and when the IRS will be paid." (4) [T]hird parties . . . provided the money used to pay the IRS; no law or any court order *required* these third parties to provide their money. . . (5) If a debtor fails to produce an acceptable Chapter 11 plan, the bankruptcy court need not convert the proceeding into a Chapter 7 liquidation; the court may decide simply to dismiss the proceeding, . . . leaving the debtor back where he started. (6) Under historic bankruptcy practice, a debtor can propose *which* of a creditor's several debts a particular payment shall satisfy.

*Id.* at 229 (citations omitted).

104. *Id.* at 229-30.

105. *Id.*

106. *Id.* at 230.

107. *Id.* at 230-33.

108. *See supra*, notes 89 to 94 and accompanying text.

109. The First Circuit described "broad equitable powers" to be "those powers 'expressly or by necessary implication conferred by Congress.'" 871 F.2d at 230 (citations omitted). The First Circuit also quoted from section 105 of the Bankruptcy Code: "The bankruptcy court may 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions' of the Bankruptcy Code." 11 U.S.C. § 105 (Supp. IV 1986) (emphasis added). *In re Energy Resources Co.*, 871 F.2d at 230.

110. The bankruptcy court's legal power consists of the right to "tell creditors against



Finally, the First Circuit gave consideration to the policy arguments of the IRS.<sup>111</sup> To this end, the First Circuit noted that the Service's policy of allocating payments first to non-trust fund liabilities was based on an internal policy and not pursuant to some statutory authority.<sup>112</sup> Yet, the IRS contended that section 6672, which reflects a strong congressional policy to collect trust fund taxes, would be frustrated if the bankruptcy court could tell the IRS how to apply the tax payments.<sup>113</sup> The First Circuit rejected this argument, responding that the Service's preference of allocating payments to non-trust fund liabilities first ensured that trust fund taxes were, in effect, paid last.<sup>114</sup> The First Circuit found this argument to be at odds with the purpose of section 6672.<sup>115</sup>

The First Circuit was unable to find any policy in any statute implying that Congress felt that bankruptcy courts must augment the probability that the IRS will receive its tax debt in toto, notwithstanding any other interests, particularly the Bankruptcy Code's preference for rehabilitation over liquidation.<sup>116</sup> After weighing the conflicting interests of the Bankruptcy Code and the Internal Revenue Code, the First Circuit found that whether an allocation under a reorganization plan, which applies tax payments first to satisfy trust fund liabilities, should be enforced, is a question to be resolved by the bankruptcy court on a case by case

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which of a debtor's several debts they are to apply a particular payment[.]” *Id.* at 231. (citation omitted). The First Circuit further noted: “‘A court applies involuntary payments according to principles of equity and justice, according to intrinsic justice or the equity of the case, according to the rights and priorities concerned, or ratably to all debts, and in such a way as will best maintain and protect the rights of all the parties.’ (citations omitted).” *Id.*

111. *Id.* at 232-33.

112. *Id.* at 232.

113. *Id.*

114. *Id.*

115. *Id.* With respect to the purpose of section 6672, the First Circuit noted, in particular:

In this way, the IRS's allocation policy gives ordinary, *non*-trust fund tax debts a special status; it places the payment of “trust fund” tax debts at risk; and it effectively forces the “responsible” persons to be liable for the *last* tax dollars due from the debtor, a liability which Congress did not say “responsible” persons ought to have.

*Id.*

116. *Id.* at 233. The First Circuit noted that legislation proposed by the House of Representatives in 1988 would amend section 505 of Title 11, United States Code, to read that “[p]ayments of taxes under this title to a governmental unit may be applied by the governmental unit in a manner that preserves alternative sources of collection, if any’”. *Id.* (quoting H.R. 3984, 100th Cong., 2d Sess. § 201 (1988)). However, that bill was never enacted into law. *In re Energy Resources Co.*, 871 F.2d at 233.

basis.<sup>117</sup>

The holding in *In re Energy Resources Co.* has been followed most recently by two bankruptcy courts within the Eleventh Circuit,<sup>118</sup> and one within the Eighth Circuit.<sup>119</sup>

## V. POSSIBLE RESOLUTION BY THE UNITED STATES SUPREME COURT

A just resolution of this controversy mandates an examination into the legal and equitable powers of a bankruptcy court. In deliberating this issue, the Supreme Court will need to define the scope of a bankruptcy court's power. As a starting point, the Supreme Court will probably look to sections 105 and 505 of Title 11, United States Code, and the legislative history behind those statutes.

Within the specific purview of Title 11, United States Code,<sup>120</sup> Congress has conferred relatively broad powers on the bankruptcy court to adjudicate all claims arising under Title 11. In this regard, section 105 of the Bankruptcy Code gives the bankruptcy court the power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [Title 11]."<sup>121</sup> Section 505 (a) of the Bankruptcy Code, which specifically delegates to the bankruptcy court the authority to ascertain the amount and the validity of any claims for unpaid taxes, fines, or penalties relating to a tax, which have not been previously adjudicated in a contested

117. *Id.* (citing *In re B & P Enterprises, Inc.*, *supra* at note 92). The First Circuit directed the bankruptcy court, on remand, to make the following inquiry:

[U]pon consideration of the reorganization plan as a whole, insofar [sic] as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, *i.e.*, increased likelihood of payment to creditors who might otherwise lose their money?

*Id.* at 234.

118. *In re Greenberg*, 105 Bankr. 691 (Bankr. M.D. Fla. 1989); *In re Gilley Consulting Engineers, Inc.*, 105 Bankr. 734 (Bankr. N.D. Ga. 1989).

119. *In re Educare Centers of Arkansas, Inc.*, 104 Bankr. 106 (W.D. Ark. 1989).

120. The scope of the bankruptcy court's subject matter jurisdiction is set forth in 28 U.S.C. § 157(b) (Supp. II 1984). Section 157 (b)(1) states in pertinent part:

Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of the title.

Included in the definition of a "core proceeding" is the confirmation of reorganization plans. 28 U.S.C. § 157 (b)(2)(L) (Supp. II 1984).

121. 11 U.S.C. § 105 (a) (1984).

proceeding,<sup>122</sup> does not necessarily address itself to allocations of tax payments. However, the authority of the bankruptcy court to confirm the plan of reorganization,<sup>123</sup> and the power conferred on it under section 1129 of the Bankruptcy Code,<sup>124</sup> may provide an alternative basis to the Supreme Court for affirming the decision of the First Circuit in *In re Energy Resources Co.*<sup>125</sup>

The Supreme Court is also likely to consider the competing interests of the Bankruptcy Code and the Internal Revenue Code. The lack of any express Congressional mandate elevating the Internal Revenue Code over the Bankruptcy Code, which was a significant factor in the decisions of the First and Eleventh Circuits, may also weigh heavily in the Supreme Court's ruling. In the past, the Supreme Court has recognized the necessity of granting broad, equitable powers to a bankruptcy court in order to rehabilitate a debtor, and has generally viewed the Service as any other creditor.<sup>126</sup>

## VI. CONCLUSION

Shortly, the United States Supreme Court will decide whether the bankruptcy and appellate courts must follow the bright-line, mechanical approach taken by the Third, Sixth, and Ninth Cir-

122. 11 U.S.C. § 505 (a) (1984). Section 505 (a) provides in relevant part:  
(a)(1) Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

(2) The court may not so determine—

(A) the amount or legality of a tax, fine, penalty, or addition to tax if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under this title; or

(B) any right of the estate to a tax refund, before the earlier of—

(i) 120 days after the trustee properly requests such refund from the governmental unit from which such refund is claimed; or

(ii) a determination by such governmental unit of such request.

11 U.S.C. § 505 (a) (1984). See also S. REP. NO. 989, 95th Cong., 2d Sess., reprinted in U.S. CODE CONG. & ADMIN. NEWS 5787, 6490.

123. 28 U.S.C. § 157 (b)(2)(L) (Supp. II 1984).

124. 11 U.S.C. § 1129 (1982, Supp. IV 1986 & Supp. V 1987). For a thorough discussion of the bankruptcy court's power under section 1129, see Note, *Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS*, 70 MINN. L. REV. 1279 (1986) (authored by Deborah A. Dyson).

125. See *supra*, note 4.

126. Falk, *supra*, note 28, at 304 (citing *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983)).

cuits for disallowing a Chapter 11 debtor's allocation of tax payments to his trust fund liabilities, or the more equitable, balancing of interests approach taken by the First and Eleventh Circuits. Should the Supreme Court choose the latter approach, its decision would be amply supported by the various authorities discussed in this comment. More importantly, such a result would effectively place the decision in the hands of the bankruptcy court, which is not only in the best position to adduce those facts pertinent to the feasibility and success of the reorganization plan, including the allocation of tax payments, but which also appears to have been vested with the power to do so.

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