Florida Law Review

Volume 42 | Issue 4 Article 4

September 1990

Reasonable Assumptions, Reasonable Persons and Invisible Boomerangs: Payments of Trust Fund Liabilities in and Before Bankruptcy

Allen J. Littman

Follow this and additional works at: https://scholarship.law.ufl.edu/flr

Part of the Law Commons

Recommended Citation
Allen J. Littman, *Reasonable Assumptions, Reasonable Persons and Invisible Boomerangs: Payments of Trust Fund Liabilities in and Before Bankruptcy*, 42 Fla. L. Rev. 711 (1990).
Available at: https://scholarship.law.ufl.edu/flr/vol42/iss4/4

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Law Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact kaleita@law.ufl.edu.

REASONABLE ASSUMPTIONS, RESPONSIBLE PERSONS AND INVISIBLE BOOMERANGS: PAYMENTS OF TRUST FUND LIABILITIES IN AND BEFORE BANKRUPTCY

*Allen J. Littman**

I. INTRODUCTION 711
II. TAX AND BANKRUPTCY LAWS GENERALLY APPLICABLE TO TRUST FUND LIABILITY AND TO THE ONE HUNDRED PERCENT PENALTY 714
A. *Tax Law* 714
B. *Bankruptcy Law* 720
III. PREBANKRUPTCY VOLUNTARY PAYMENTS OF TRUST FUNDS 724
A. *Judicial Solutions* 724
B. *Critique of Judicial Solutions and Approaches* . . 726
IV. DESIGNATION OF PAYMENTS TO TRUST FUND LIABILITIES IN CHAPTER 11 729
A. *Judicial Solutions* 729
B. *Critique of Judicial Solutions and Approaches* . . 737
V. INTERACTION BETWEEN TRUST FUND TRACING AND DESIGNATION ISSUES 744
VI. CONCLUSION 746

I. INTRODUCTION

The Internal Revenue Code (I.R.C.) requires a corporate employer to deduct and withhold federal income taxes[1] and social security taxes[2] from its employees' wages. The corporate employer is liable for pay-

---

©1991, Allen J. Littman. All rights reserved.

*J.D., 1984, University of Miami; LL.M. (Taxation), 1990, University of Florida. Allen J. Littman practices law with the firm of Roberts & Holland, New York, New York and Washington, D.C.

1. I.R.C. § 3402(a)(1) (1988) (unless otherwise indicated, all references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended and in effect for 1988). The requirement extends to all employers, not just corporations, but since the subject matter discussed herein pertains predominantly to corporations, corporations will be largely referenced.

2. I.R.C. § 3102(a).

Published by UF Law Scholarship Repository, 1990

ment of those taxes to the Internal Revenue Service (the Service or IRS).[3] The I.R.C. requires these funds to be held as "special fund[s] in trust for the United States."[4] These funds are often referred to as "trust funds." Predictably, some corporate employers may fail to satisfy this trust fund requirement or may abuse the trust fund. One possible scenario is an employer in financial difficulty using the trust fund as a source of financial first aid.[5] In another scenario, an employer may have only sufficient funds to pay employees their wages net of withholding taxes, and lack the funds to set aside withholding taxes for the trust fund. In such cases, the individual persons who are required to collect, account for or pay over the trust fund taxes are liable for a penalty (referred to herein as the "one hundred percent penalty") equal to the amount of tax evaded, not collected, or not accounted for and paid over.[6] These individual persons, known as "responsible persons," may include officers, employees or other persons controlling the corporate employer.[7]

A corporation experiencing financial difficulty, such as in the above examples, probably will be unable to rescue itself by the described actions, which amount to simply exchanging one creditor for another. Eventually, the corporation could be forced to seek protection from its creditors, including the IRS, under the reorganization provisions contained in chapter 11 of the Bankruptcy Code.[8] Using the trust funds to maintain the business or paying a "net payroll" is likely to be a last resort for the employer, due to the one hundred percent penalty as well as potential criminal liability.[9] Therefore, it is possible that the corporation would have other substantial liabilities to the IRS, including regular corporate income taxes[10] and the corporation's own one-half share of the social security taxes.[11] The corporate debtor in a chapter 11 proceeding may wish to relieve the responsible persons of their liability for the trust fund taxes and the one hundred percent

---

3. I.R.C. § 3403 (income taxes); I.R.C. § 3102(b) (social security).
4. I.R.C. § 7501(a).
5. Slodov v. United States, 436 U.S. 238, 243 (1978).
6. I.R.C. § 6672(a) (West Supp. 1990). *See Slodov*, 436 U.S. at 245.
7. I.R.C. § 6671(b).
8. 11 U.S.C. § 1101-1146 (1988). Under chapter 11, a debtor may continue to operate its business and its debts may be adjusted or paid under a plan of reorganization, which is voted on by its creditors and approved by the bankruptcy court in a complex confirmation process. *Id.*
9. I.R.C. § 7202.
10. *See* I.R.C. § 11 (imposing corporate income taxes).
11. I.R.C. § 3111. These are actually excise taxes, imposed upon employers, based upon the employees' wages. They are imposed at the same rates as the social security taxes imposed upon the employees. *See* I.R.C. § 3101.

Littman: Reasonable Assumptions, Reasonable Persons and Invisible Boomeran

penalty. In order to do this, the debtor may designate, within or without its plan of reorganization, that its payments to the IRS of prebankruptcy tax debts will be applied first to its liability for trust fund taxes. The IRS has objected uniformly to these designations, since they increase the risk of nonpayment of non-trust fund taxes.[12] The increased risk arises because, while the IRS can turn to the responsible persons for payments of the trust fund taxes, the IRS has no collateral source for payment of non-trust fund taxes analogous to the responsible persons. The ensuing litigation has produced a kaleidoscope of judicial opinions, results and rationales. The Supreme Court decided the issue in the combined cases of *United States v. Energy Resources Co.* and *United States v. Newport Offshore, Ltd.*[13] *Energy Resources* holds that a bankruptcy court has the authority to order the IRS to apply a payment to trust fund liabilities if the designation is "necessary for the success of a reorganization plan."[14]

A related issue arises when the corporation initially fails to collect or pay over to the IRS the trust fund taxes, but later pays the trust fund taxes within ninety days before filing a bankruptcy petition. In such circumstances, the issue is whether the payment is a preference which a bankruptcy trustee or debtor in possession in the bankruptcy proceedings may recover from the Service.[15] If the payment is not recovered, then it will serve to reduce the liability of the responsible person commensurately. The Supreme Court also recently decided this issue in *Begier v. Internal Revenue Service*,[16] which holds that a voluntary prebankruptcy payment to the IRS, designated by the corporation as a payment of trust fund taxes, cannot be recovered from the Service as a preference.[17]

Taken together, *Energy Resources* and *Begier* offer a debtor approaching bankruptcy the flexibility to relieve the responsible person of the trust fund liability, either prior to bankruptcy, as in *Begier*, or through a reorganization, as in *Energy Resources*. However, in *Energy Resources*, the Supreme Court allowed special priority treatment for trust fund liabilities in a chapter 11 case,[18] a result which is inconsistent

12. United States v. Energy Resources Co., 110 S. Ct. 2139, 2141 (1990).
13. *Id.* at 2139.
14. *Id.* at 2140.
15. *See* 11 U.S.C. § 547 (1988) (governing preferences and permitting a bankruptcy trustee or debtor in possession to avoid and recover a transfer made to a creditor on the eve of bankruptcy if the effect of the transfer is to give that creditor a larger distribution than the creditor would have otherwise received through bankruptcy liquidation proceedings).
16. 110 S. Ct. 2258 (1990).
17. *Id.* at 2267.
18. *Energy Resources*, 110 S. Ct. at 2140.

Published by UF Law Scholarship Repository, 1990

with the longstanding bankruptcy law principle that equal priority claims must be treated alike.[19] Moreover, given the holding of *Energy Resources*, which permits designation in a chapter 11 plan, *Begier* could have the ultimate effect of reducing the total revenue the IRS collects. This is because a voluntary prebankruptcy payment of trust fund taxes by the corporation will eliminate or reduce the Service's alternative source of collection, the responsible person.

The balance of this article will address the issues raised by the various judicial opinions and the litigants' positions in these cases. First, the generally applicable tax and bankruptcy law will be reviewed. Second, the article will address the various judicial approaches to the problems and criticize them where appropriate. Third, the article will offer alternative solutions which the government, the taxpayers, and the courts to date, including the Supreme Court, have overlooked. Finally, the article will discuss the interaction, sometimes unexpected, between the designation and preference issues.

II. Tax and Bankruptcy Laws Generally Applicable to Trust Fund Liability and to the One Hundred Percent Penalty

A. *Tax Law*

I.R.C. section 3402(a) requires an employer to deduct and withhold from its employees' wages the employees' income taxes attributable to those wages.[20] I.R.C. section 3102(a) imposes a similar obligation upon an employer with respect to employees' social security and medicare taxes imposed under I.R.C. section 3101.[21] Sections 3403 and 3102(b) create employer liability for the employees' income, social security, and medicare taxes which the I.R.C. requires the employer to deduct and withhold.[22] These taxes, when collected or withheld, are "held to be a special fund in trust for the United States," pursuant to I.R.C. section 7501(a).[23] No general requirement exists that requires these taxes be held in a segregated bank account.[24]

---

19. *See* 11 U.S.C. § 1123(a)(4) (1988); G. Treister, J. Trost, L. Forman, K. Klee & R. Levin, Fundamentals of Bankruptcy Law § 9.03(b) (2d ed. 1988).

20. I.R.C. § 3402(a).

21. I.R.C. § 3102(a).

22. I.R.C. §§ 3403, 3102(b).

23. I.R.C. § 7501(a). The history of those provisions is straightforward. I.R.C. §§ 1622(a), 1623 (1939) (withheld income taxes) (current versions at I.R.C. §§ 3402(a), 3403), were enacted by the Current Tax Payment Act of 1943, ch. 120, § 2(a), 57 Stat. 126, 128, 137. I.R.C. § 1401 (1939) (social security taxes) (current version at I.R.C. § 3102, was originally enacted by the Social Security Act of 1935, ch. 531, § 802(a), 49 Stat. 636).

Beyond the employer's liability, I.R.C. section 6672(a) imposes a penalty upon "persons" who willfully fail to collect these trust fund taxes, willfully fail to account truthfully for and pay over these taxes, or willfully attempt to evade or defeat these taxes.[25] The penalty imposed is equal to the total amount of the tax evaded, not collected, or not accounted for and paid over.[26] Further, section 6671 makes it clear that the IRS assesses and collects the penalty in the same manner as a tax.[27]

The "responsible persons" referred to in section 6672 include officers and corporate employees.[28] The responsible person concept had its genesis in the Revenue Act of 1918, section 1308(a),[29] in substantially the same form as it exists in current section 6672(a).[30] As a final

---

I.R.C. § 7501 was first enacted, in substantially current form, in the Act of May 10, 1934, ch. 277, § 607, 48 Stat. 768. The legislative history to § 607 of the Act of May 10, 1934 indicates that the provision imposes the amount of taxes withheld or collected with a trust and makes applicable for the enforcement of the government's claim the administrative provisions for assessment and collection of taxes. S. REP. No. 558, 73d Cong., 2d Sess. 53 (1934).

24. *Begier*, 110 S. Ct. at 2264. *See* I.R.C. § 7512 (requiring the employer to deposit trust funds in a segregated bank account upon demand by the Service) (added by Pub. L. No. 85-321, 72 Stat. 5 (1958)).

25. I.R.C. § 6672(a) (West Supp. 1990).

26. *Id.*

27. I.R.C. § 6671(a).

28. I.R.C. § 6671(b).

29. The Revenue Act of 1918, ch. 18, § 1308(a), 40 Stat. 1143.

30. I.R.C. § 6672(a) (West Supp. 1990). The Revenue Act of 1918, ch. 18, § 1308(a), 40 Stat. 1143, referred to other types of taxes required to be collected by a third party and paid to the government, such as certain taxes on transportation, cigars and cigarettes, and admission tickets. The Revenue Act of 1924, ch. 234, § 1017(d), 43 Stat. 344, strengthened the provision by changing the "willfully refuses" language to "willfully fails."

The Social Security Act of 1935, ch. 531, § 807(c), 49 Stat. 638, made the responsible person penalty, as well as the "trust fund" provision, applicable to the social security taxes withheld from employees. The Int. Rev. Code of 1939 contained the same 100% penalty within the respective substantive law titles relating to admissions and dues, Int. Rev. Code of 1939, § 1718(c), 53 Stat. 193, documents and playing cards, Int. Rev. Code of 1939, § 1821(a)(3), 53 Stat. 202, narcotics, Int. Rev. Code of 1939, § 2557(b)(4), 53 Stat. 275, and handguns, Int. Rev. Code of 1939, § 2707(a), 53 Stat. 290. Int. Rev. Code of 1939, § 1430, 53 Stat. 178, made the 100% penalties contained in Int. Rev. Code of 1939, §§ 1821(a), 2707(a), 53 Stat. 202, 290, applicable to employment taxes. When federal income tax withholding was enacted in 1943, *see supra* note 17, Current Tax Payment Act of 1943, § 1627, 57 Stat. 138, was added to make all laws applicable to withheld taxes, including penalties, which applied to the social security taxes, including the penalties referenced by the Internal Revenue Code of 1939, § 1430, 53 Stat. 178. When the Code was recodified in 1954, I.R.C. § 6672(a) (1954) (amended 1978, 1989), simply continued the 100% penalty imposed by existing law.

It is, therefore, apparent that congressional policy underlying the 100% penalty and the "trust fund" nature of these taxes has been longstanding and consistent. The force of these statutes is justified by the fact that the United States credits the employees' tax liabilities even

major component of the enforcement system, I.R.C. section 7202 imposes criminal penalties upon responsible persons for failure to collect or truthfully account for and pay over trust fund taxes.[31]

Despite the section 6671(a) prescription that the Service assess and collect the one hundred percent penalty in the same manner as a tax, nothing in the Code actually prohibits the collection of the one hundred percent penalty from responsible persons in addition to collection of the actual tax liability from the employer. Nevertheless, the IRS's policy is to use the one hundred percent penalty "only as a collection device . . . [and that] the withheld income and employment taxes or collected excise taxes will be collected only once, whether from the corporation, from one or more of its responsible persons, or from the corporation and one or more of its responsible persons."[32]

The Service is somewhat less generous in its application of corporate payments to trust fund liabilities. Generally, the policy of the Service is to honor a taxpayer's designation of a payment to a particular tax if the payment is "voluntary."[33] If trust fund liabilities are involved, the Service considers any payment made on the corporate account to represent payment of the employer (non-trust fund) portions of the

---

if the employer fails to pay their taxes required to be withheld. *In re* Technical Knockout Graphics, Inc., 833 F.2d 797, 799 (9th Cir. 1987); United States v. Huckabee Auto Co., 783 F.2d 1546, 1548 (11th Cir. 1986). Although this article focuses on employment taxes and employees' income taxes withheld, it applies equally to all other "trust fund" taxes.

31. I.R.C. § 7202. This penalty was initially enacted as a maximum penalty of $1,000 or one year imprisonment. Revenue Act of Oct. 3, 1917, ch. 63, § 1004, 40 Stat. 325-26. The monetary penalty was increased to $10,000 by the Revenue Act of 1918, ch. 18, § 1308(b), 40 Stat. 1143, and was later made a felony punishable by imprisonment of up to five years by the Revenue Act of 1924, ch. 234, § 1017(b), 43 Stat. 344. Interestingly, despite inflation, the monetary penalty today remains at $10,000.

32. 100-Percent Penalty Assessments, 1 Int. Rev. Man. (Admin.) (CCH) ¶ P-5-60, at 1305-14 (May 30, 1984). To ensure that it will be able either to retain funds collected from a responsible person or that the statute of limitations on collection against the corporation will not expire, the Service will generally continue to pursue collection against the corporation until the expiration of the period for filing a claim for refund by the person or persons from whom the 100% penalty was collected. *Id.* When that statute of limitations expires, the tax assessment against the corporation will be abated. *Id.* In addition, the IRS will abate the 100% penalty to the extent that further trust fund taxes are collected from the corporation. Abatements, 2 Int. Rev. Man. (Admin.) (CCH) ¶ 5638.1(2), at 6321 (Nov. 21, 1989). *See In re* A & B Heating & Air Conditioning, 861 F.2d 1538 (11th Cir. 1988) (because responsible person may still file for a refund, IRS may not ignore designation provision in chapter 11 plan even though currently the 100% penalty has been paid), *dismissed as moot*, 878 F.2d 1311 (11th Cir. 1989); *In re* Ribs-R-Us, Inc., 828 F.2d 199 (3d Cir. 1987) (responsible person may be assessed without collection action against employer).

33. Rev. Rul. 79-284, 1979-2 C.B. 83, modifying Rev. Rul. 73-305, 1973-2 C.B. 43; *see* Rev. Proc. 84-58, 1984-2 C.B. 501.

liability, unless it is a voluntary payment and the taxpayer designates a different application of the payment.[34] In the latter case, the Service follows the taxpayer's designation.[35]

The term "voluntary," when applied to a taxpayer's payment, means not "involuntary." The IRS Manual defines an "involuntary" payment as one made "when the taxpayer has no immediate control over its source."[36] The Manual offers three examples of involuntary payment, two of which are relevant here: "(a) distraint action by Service personnel (notice of levy, levy, etc.)" and "(b) distribution of proceeds resulting from a court order pursuant to a claim or other legal action to which the United States is a party."[37] Payments received from a bankruptcy proceeding are considered to be involuntary[38] and are, therefore, applied to attain the "maximum benefit for the United States" unless there is specific statutory direction.[39] Thus, the Service consistently has maintained the position that it, and not a court, has the sole power to designate the application of an involuntary payment.

The Service's logic that it alone has the power to designate the application of involuntary payments for the United States's benefit prevailed in the seminal case of *Amos v. Commissioner*.[40] *Amos* was a nonbankruptcy case in which the debtor argued that a payment collected by levy and distraint, which the parties agreed was involuntary, must be applied as a matter of law first to interest, rather than principal.[41] The Tax Court, however, held that the payment must be applied as the Service elected, to principal first, as a matter of administrative necessity and convenience.[42] Significantly, although the Tax Court found that a creditor's right to direct the application of an

---

34. 100-Percent Penalty Assessments, 1 Int. Rev. Man. (Admin.) (CCH) ¶ P-5-60, at 1305-14 (May 30, 1984); Employer (Corporate) Payments, 2 Int. Rev. Man. (Admin.) (CCH) ¶ 56(18)3.1(1)(a), at 6910 (Nov. 21, 1989).

35. Voluntary Payment, 2 Int. Rev. Man. (Admin.) (CCH) ¶ 56(18)6.1(1), at 6911 (Oct. 21, 1988). In the absence of taxpayer designation, a voluntary payment will be applied by the Service "in a manner serving its best interest." Rev. Rul. 79-284, 1979-2 C.B. 83, modifying Rev. Rul. 73-305, 1973-2 C.B. 43. Courts approve of this. *See* Liddon v. United States, 448 F.2d 509, 513 (5th Cir. 1971), *cert. denied*, 406 U.S. 918 (1972).

36. Involuntary Payments, 2 Int. Rev. Man. (Admin.) (CCH) ¶ 56(18)6.2(1), at 6911-3 (Nov. 15, 1985).

37. *Id.*

38. Application of Payments Received From Proceedings, 2 Int. Rev. Man. (Admin.) (CCH) ¶ 57(13)4.3, at 7451-3 (Dec. 7, 1988).

39. Involuntary Payments, 2 Int. Rev. Man. (Admin.) (CCH) ¶ 56(18)6.2(2), at 6911-3 (Nov. 15, 1985).

40. 47 T.C. 65 (1966).

41. *Id.* at 68.

42. *Id.* at 70 (citing O'Dell v. United States, 326 F.2d 451, 456 (10th Cir. 1964)).

involuntary payment was a minority common law view,[43] it favorably cited an earlier case which "emphasized that the relationship between the United States and a delinquent taxpayer is not that of an ordinary debtor and creditor,"[44] and refused to follow the majority general debtor-creditor rule.

In *Amos*, the Tax Court apparently accepted in full the Service's definition of "involuntary payment."[45] The *Amos* court relied heavily on *O'Dell v. United States*,[46] a bankruptcy liquidation case decided under the Bankruptcy Act of 1898. *O'Dell* held that the bankruptcy court had no power or jurisdiction to direct the application of funds held in the registry of the bankruptcy court which resulted from the liquidation of property by judicial sale.[47] By adopting the second prong of the Service's definition of "involuntary payment" as one resulting "from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor,"[48] however, *Amos* may have extended *O'Dell* beyond its holding. The mortgage foreclosure and the seizure and sale of property held by the bankrupt created the fund in *O'Dell*.[49] Thus, the operative fact in *O'Dell* may have been the judicial foreclosure sale and the seizure and sale by the IRS, rather than the fact that the sale proceeds, placed in the registry of the bankruptcy court, were subject to the government's claim in that legal proceeding.[50] Furthermore, the government had neither brought a legal proceeding to collect taxes in *Amos* nor filed a claim. More importantly, however, *O'Dell* involved a liquidation bankruptcy, not a reorganization, and *Amos* was a nonbankruptcy case. Therefore, any direct application of *O'Dell* or *Amos* to a reorganization is questionable.

Muntwyler v. United States[51] applied the *Amos* and *O'Dell* holdings in the context of the one hundred percent penalty. In *Muntwyler*, a corporation owing both trust fund and non-trust fund taxes assigned

---

43. *Id.* at 69.

44. *Id.* at 70 (citing Standard Oil Co. v. United States, 5 F. Supp. 976 (Ct. Cl.), *cert. denied*, 293 U.S. 599 (1934)).

45. *See supra* text accompanying notes 36-37.

46. 326 F.2d 451 (10th Cir. 1964).

47. *Id.* at 456.

48. *Amos*, 47 T.C. at 69.

49. *O'Dell*, 326 F.2d at 454.

50. The *O'Dell* court's brief explanation supports this view: "As a general rule, a debtor voluntarily paying his debt may direct the application of his money to such items or demands as he chooses. But, such is not the case where, as here, the payment is made involuntarily as in an execution or judicial sale." *Id.* at 456 (citations omitted).

51. 703 F.2d 1030 (7th Cir. 1983).

all of its assets to a common law trustee (assignee) for the benefit of creditors. The court authorized the trustee to sell company assets and pay claims.[52] The IRS filed a claim for both trust fund and non-trust fund taxes with the trustee. The trustee made a partial payment to the IRS and directed that it be applied to the trust fund liability.[53] The IRS refused to honor the trustee's instructions and instead allocated the entire amount to the non-trust fund liability.[54] Accordingly, the IRS assessed the trust fund liability against Muntwyler, who was a responsible person under I.R.C. section 6672.[55]

The *Muntwyler* court recognized and accepted as sensible tax policy both the voluntary-involuntary distinction and the Service's sole power to allocate an involuntary payment, stating that the rule had been "uniformly followed by the courts."[56] The sole question was whether or not the trustee's payment was voluntary. The Service contended that its submission of a claim to the trustee was an administrative action, like a levy, sufficient to meet the *Amos* definition of an involuntary payment.[57] The court rejected the Service's contention. It stated that the presence of court action or administrative action resulting in actual seizure of property was necessary to render a payment involuntary.[58] No seizure of property or enforced collection measures were taken in *Muntwyler*. The court distinguished prior cases in which actual court action was involved.[59]

---

52. *Id.* at 1031.
53. *Id.*
54. *Id.*
55. *Id.* at 1031-32.
56. *Id.* at 1032. *See also* Arnone v. United States, 79-1 U.S. Tax Cas. (CCH) ¶ 9356 (N.D. Ohio 1979) (holding that the Service properly exercised its power to allocate involuntary payments); United States v. DeBeradinis, 395 F. Supp. 944, 952 (D. Conn. 1975) (finding that the Service properly allocated involuntary payments, and citing cases supporting that proposition), *aff'd mem.*, 538 F.2d 315 (2d Cir. 1976); Amos v. Commissioner, 47 T.C. 65 (1966) (discussed *supra* text accompanying notes 40-51). *But see* cases cited *infra* note 59.
57. *Muntwyler*, 703 F.2d at 1032.
58. *Id.* at 1033.
59. *Id.* In *In re* Hart's Transfer & Storage, Inc., 6 Kan. App. 2d 579, 631 P.2d 258 (1981), the debtor had made a voluntary bulk sale of assets. The sale proceeds were deposited into the registry of the court by the auctioneer, who filed an interpleader action. *Id.* at 579, 631 P.2d at 259. The government filed a claim in the interpleader action. *Id.* at 579, 631 P.2d at 260. Citing *O'Dell* and *Amos*, the court held that the payments were involuntary due to the fact that the court had the power to decide the amount due each creditor and the priority of payments as among creditors. *Id.* at 582-84, 631 P.2d at 261-62. Because the payments were involuntary, the court had no power to instruct the IRS how to apply the payment as between trust fund and non-trust fund liability. *Id.* at 583-84, 631 P.2d at 262.

Muntwyler aptly demonstrates how the voluntary-involuntary dichotomy can become the focal point of litigants' arguments with regard to the application of payments to trust fund liabilities by the IRS. By making a "voluntary" payment, a debtor can designate its payment to be applied to trust fund liabilities, thus reducing the responsible person's liability for the one hundred percent penalty under section 6672. If the payment is deemed involuntary, then neither the debtor nor a court can order the IRS to apply the payment in any particular manner, at least in the absence of a "specific statutory directive" to the contrary.[60] However, initiation of bankruptcy proceedings alters these governing principles.

B. *Bankruptcy Law*

The Bankruptcy Code[61] contains liquidation provisions (chapter 7),[62] reorganization provisions (chapter 11),[63] and provisions common to both.[64] The commencement of any bankruptcy case creates an estate, which consists of "all legal or equitable interests of the debtor in property . . . wherever located and by whomever held."[65] The estate includes "[a]ny interest in property that the estate acquires after the commencement of the case,"[66] but excludes "[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and

---

In *First Nat'l City Bank v. Kline*, the court took the opposing view that payments in bankruptcy were involuntary because they are made under judicial order, and, therefore, the *court* had exclusive authority to apply the funds as "equity and justice require." First Nat'l City Bank v. Kline, 439 F. Supp. 726, 729 (S.D.N.Y. 1977). The "equitable solution" was "to apply repayments ratably, to all the debts." *Id.* The *Muntwyler* court distinguished *First Nat'l* on the grounds that *First Nat'l* involved court action. *Muntwyler*, 703 F.2d at 1033. However, *First Nat'l* is better distinguished from *Muntwyler* because *First Nat'l* did not involve tax debts, and therefore, the rationale of *Amos* and *O'Dell* (adopting the minority view as to taxes) did not apply in *First Nat'l*, and the general common law did apply. Moreover, neither *Muntwyler* nor *First Nat'l* involved a reorganization. The *Muntwyler* court did state as dicta that the "Government might have been correct in its claim [that the payment was involuntary] if the corporation had been in bankruptcy, which it was not." *Muntwyler*, 703 F.2d at 1034 n.2.

60. Involuntary Payments, 2 Int. Rev. Man. (Admin.) (CCH) ¶ 56(18)6.2(2), at 6911-3 (Nov. 15, 1985).

61. 11 U.S.C. §§ 101-1330 (1988).

62. 11 U.S.C. §§ 701-728 (1988).

63. 11 U.S.C. §§ 1101-1146 (1988).

64. Chapters 1, 3 and 5 of title 11, United States Code apply in a case under chapter 7 (liquidation) or chapter 11 (reorganization). 11 U.S.C. § 103(a) (1988).

65. 11 U.S.C. § 541(a)(1) (1988). *See* United States v. Whiting Pools, Inc., 462 U.S. 198, 208-09 (1983) (estate includes property of the debtor seized by the IRS prior to bankruptcy).

66. 11 U.S.C. § 541(a)(7) (1988).

not an equitable interest. . . ."[67] Consequently, the bankruptcy estate will not include the beneficial interest in property the debtor holds in trust for another.

In chapter 7, a trustee administers the bankruptcy estate,[68] while in chapter 11, the debtor generally administers the estate,[69] unless a trustee has been appointed.[70] In either chapter 7 or chapter 11, however, the bankruptcy trustee or debtor in possession may recover certain prebankruptcy[71] or postbankruptcy transfers[72] of the debtor's property for the benefit of the estate.[73] A preference, one of these avoidable prebankruptcy transfers, is a transfer of the debtor's property to or for the benefit of a creditor[74] on account of an antecedent debt,[75] made while the debtor is insolvent[76] and within ninety days before the date of the filing of the bankruptcy petition,[77] which enables the creditor to receive more than it would otherwise receive in a chapter 7 distribution.[78]

A preferential transfer, therefore, must consist of the "property of the debtor," which is "that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings."[79] Consequently, if the debtor holds property in trust for another and transfers that property to the beneficiary (even if the beneficiary is also a creditor), it is axiomatic that the property transferred is not the debtor's property under bankruptcy law because it would not have been "property of the estate" had it not been transferred. Therefore, the beneficiary did not receive a preferential transfer.[80]

In chapter 7, the trustee collects and sells the property of the estate and distributes the funds to creditors according to a priority

---

67. 11 U.S.C. § 541(d) (1988).

68. 11 U.S.C. § 704 (1988).

69. Known as the debtor in possession. 11 U.S.C. § 1107(a) (1988).

70. 11 U.S.C. § 1104(a) (1988).

71. 11 U.S.C. §§ 544, 545, 547, 548 (1988).

72. 11 U.S.C. § 549 (1988).

73. 11 U.S.C. §§ 550(a), 551 (1988).

74. 11 U.S.C. § 547(b)(1) (1988).

75. 11 U.S.C. § 547(b)(2) (1988). The regular, timely payment of any tax cannot be "on account of" an antecedent debt and, therefore, is not a preference because a tax is not deemed incurred until the last day the tax is payable without penalty. 11 U.S.C. § 547(a)(4) (1988).

76. 11 U.S.C. § 547(b)(3) (1988). Insolvency is presumed during the 90 days immediately preceding the date of the filing of the bankruptcy petition. 11 U.S.C. § 547(f) (1988).

77. 11 U.S.C. § 547(b)(4)(A) (1988).

78. 11 U.S.C. § 547(b)(5) (1988).

79. *Begier*, 110 S. Ct. at 2263.

80. *Id.*

scheme set forth in both chapter 7 and chapter 5.[81] Generally, in chapter 7, the trustee pays priority claims listed in chapter 5 before general unsecured claims.[82] The Bankruptcy Code establishes seven levels of priority claims, and the trustee must pay each claim of a certain priority before any claim of a lower priority is paid.[83] The Bankruptcy Code reserves seventh priority for income taxes due within three years before the commencement of the bankruptcy case,[84] trust fund taxes payable by either the employer or by a responsible person,[85] employment taxes (employer's share) due within three years before the commencement of the bankruptcy case,[86] and certain other taxes not relevant here.[87] If sufficient funds are not available to satisfy all claims within a priority category, then the trustee must make payments pro rata among claims within that priority category.[88]

In chapter 11, the debtor, or a trustee if one has been appointed, continues to operate the business.[89] The debtor generally has the exclusive right to file a plan of reorganization within the first 120 days

---

81. *See* 11 U.S.C. § 726 (1988); 11 U.S.C. § 507(a) (1988). One of the functions of the preference provisions is to protect the statutory priorities of 11 U.S.C. § 507(a) and to ensure equitable distribution of the estate. *See Begier*, 110 S. Ct. at 2263; Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1355 (5th Cir. 1986); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 177-78 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6138.

82. 11 U.S.C. § 726(a)(1) (1988).

83. 11 U.S.C. § 507(a) (1988).

84. 11 U.S.C. § 507(a)(7)(A) (1988).

85. "[A] tax required to be collected or withheld and for which the debtor is liable in whatever capacity." 11 U.S.C. § 507(a)(7)(C) (1988). This priority includes the 100% penalty in a bankruptcy proceeding of the responsible person. *See* United States v. Sotelo, 436 U.S. 268 (1978). Withheld taxes on wages earned, but not paid, within 90 days of bankruptcy receive third priority along with the wages. *See* Otte v. United States, 419 U.S. 43 (1974); 11 U.S.C. § 507(a)(3) (1988).

86. 11 U.S.C. § 507(a)(7)(D) (1988).

87. *See* 11 U.S.C. § 507(a)(7)(A), (B), (E), (F), (G) (1988).

88. 11 U.S.C. § 726(b) (1988). The clear statutory directive of 11 U.S.C. § 726(b) overrides the voluntary-involuntary distinction. *See supra* note 60 and accompanying text. It is odd, indeed, that cases confronting this very fact pattern have not focused upon U.S.C. § 726(b). *See In re* Vermont Fiberglass, Inc., 88 Bankr. 41 (D. Vt. 1988) (payment involuntary if in chapter 7); *In re* Office Dynamics, Inc., 39 Bankr. 760 (Bankr. N.D. Ga. 1984) (chapter 7 liquidation is sufficient judicial action to render debtor's payment involuntary); *see also In re* Leonard, 112 Bankr. 67 (Bankr. D. Conn. 1990) (recognizing effect of 11 U.S.C. § 726(b) on IRS allocation, and citing *Vermont Fiberglass* and *Office Dynamics*, *supra*, but failing to recognize the erroneous absence of 11 U.S.C. § 726(b) in the two cases). *But see In re* Leonard, 1990 Bankr. LEXIS 2174 (Bankr. D. Conn. 1990) (in later proceeding court ruled that 11 U.S.C. § 726(b) "may not apply" if there is only one creditor, even if that creditor has more than one claim).

89. 11 U.S.C. § 1108 (1988); 11 U.S.C. § 1104(a) (1988) (appointment of trustee).

after the commencement of the bankruptcy case.[90] Thus, the debtor is generally, at least initially, in control of both the business of the debtor and the legal proceedings. The plan proposes the treatment of various claims or classes of claims and holders of claims or interests vote on the plan.[91] The bankruptcy court will confirm the plan if it meets certain minimum requirements.[92] One of the requirements is that a holder of a seventh priority tax claim must receive "deferred cash payments" of the entire amount of the claim, plus interest, over a period not exceeding six years after the date of assessment of the claim.[93] No provisions in the Bankruptcy Code specifically address the application of prebankruptcy or chapter 11 tax payments between trust fund and non-trust fund liabilities.[94] Consequently, the courts have attempted to address the issue of payment application, and as might be expected, have arrived at a variety of conclusions.

---

90. 11 U.S.C. § 1121(a)-(b) (1988). A creditor may file a plan of reorganization if a trustee has been appointed or if the debtor fails to propose a plan. 11 U.S.C. § 1121(c) (1988).

91. *See* 11 U.S.C. §§ 1123, 1126 (1988). Generally a class of claims has accepted the plan if the claimants accepting the plan hold claims totaling at least two-thirds of the value of the class' claims and more than one-half of the number of total claims in the class. 11 U.S.C. § 1126(c) (1988).

92. 11 U.S.C. § 1129 (1988). Creditors holding secured non-priority claims or general unsecured claims whose classes have not accepted the plan and whose contract rights are not reinstated and who are not paid off in cash in full immediately upon confirmation of the plan may have certain of their legal rights altered under the plan. *See* 11 U.S.C. § 1129(b) (1988).

93. 11 U.S.C. § 1129(a)(9)(C) (1988). Seventh priority tax claims are listed in 11 U.S.C. § 507(a)(7) and in *supra* text accompanying notes 84-87. If the tax has not yet been assessed at the time of the commencement of the bankruptcy case, assessment, as well as the commencement or continuation of a proceeding in Tax Court, is automatically stayed. 11 U.S.C. § 362 (a)(6), (8) (1988). However, the Service may file a claim in the bankruptcy case despite the pendency of a tax court case, I.R.C. § 6871(c)(1), and the bankruptcy court may determine a tax. *See* 11 U.S.C. § 505(a) (1988). After the bankruptcy court has determined the tax, the Service may assess the tax despite the automatic stay and irrespective of the restrictions on assessments under I.R.C. § 6213(a). 11 U.S.C. § 505(c) (1988); I.R.C. § 6871(b)(2). Thus, the maximum stretchout of payments from the time of confirmation of a plan of reorganization may be somewhat less than six years if the tax is assessed before the commencement of the bankruptcy case or before the confirmation of the plan, and somewhat more than six years if the tax is not assessed until after the plan is confirmed by the court.

94. Proposed H.R. 3984, 100th Cong., 2d Sess. § 201 (1988), which would have added 11 U.S.C. § 505(d), provided 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." The bill, of course, would have permitted the IRS to apply all funds received in a chapter 11 bankruptcy proceeding to non-trust fund liabilities in order to preserve the liability of any responsible persons. It is not clear what effect the bill would have had upon the specific statutory requirement of pro rata distribution of equal priority taxes under 11 U.S.C. § 726(b) (1988).

III. PREBANKRUPTCY VOLUNTARY PAYMENTS OF TRUST FUNDS

A. *Judicial Solutions*

Prior to the enactment of the Bankruptcy Code in 1978, the case law regarding payment of trust funds[95] to the IRS in the ninety-day period prior to bankruptcy wavered between two alternatives. One group of cases overrode the trust provisions of I.R.C. section 7501(a) in favor of the statutory bankruptcy priorities.[96] The other group of cases recognized the trust, but required strict tracing of the funds either to a segregated account[97] or to an account containing general funds commingled with trust funds.[98]

Post-1978 case law remained divided on whether the preference (and therefore the priority) provisions overrode the trust provisions of I.R.C. section 7501(a) and to what extent, if any, tracing was required. The leading cases relaxed the pre-Code standard. However, they differ on the degree of relaxation of the tracing burden.[99]

The Supreme Court reduced the uncertainty in this area in *Begier.*[100] In *Begier*, the IRS required the debtor, which had fallen behind in its trust fund tax payments, to deposit all future trust fund taxes in a separate bank account.[101] The debtor did not deposit sufficient

95. All of the cases cited in *infra* notes 96-98 addressed the issue of whether withheld tax funds could be traced to property held by the debtor after bankruptcy — in other words, whether funds were property of the estate under pre-Code law or were deemed held in trust. They are not preference cases. However, since the concept of "property of the estate" enlightens the preference provisions, they are relevant in that context as well. *See supra* notes 79-80 and accompanying text.

96. *See* United States v. Randall, 401 U.S. 513 (1971); *In re* Shakesteers Coffee Shops, 546 F.2d 821 (9th Cir. 1976), *cert. denied*, 431 U.S. 974 (1977); *In re* Tamasha Town & Country Club, 483 F.2d 1377 (9th Cir. 1973).

97. *See* United States v. Randall, 401 U.S. 513 (1971) (cited for both propositions); *In re* Glynn Wholesale Bldg. Materials, Inc., 78-1 U.S. Tax Cas. (CCH) ¶ 9469 (S.D. Ga. 1978); *In re* Progress Tech Colleges, Inc., 78-2 U.S. Tax Cas. (CCH) ¶ 9555 (S.D. Ohio 1977); *In re* Rohar Assocs., Inc., 375 F. Supp. 637 (S.D.N.Y. 1974).

98. Lusk Corp. v. Arizona State Tax Comm'n, 462 F.2d 187 (9th Cir. 1972).

99. *Compare* Begier v. Internal Revenue Serv., 878 F.2d 762, 766 (1st Cir. 1989) (significant relaxation), *aff'd*, 110 S. Ct. 2258 (1990) *with* Drabkin v. District of Columbia, 824 F.2d 1102, 1106 (D.C. Cir. 1987) (moderate relaxation). *See also In re* Malmart Mortgage Co., 109 Bankr. 1 (Bankr. D. Mass. 1989); *In re* Olympic Foundry Co., 63 Bankr. 324 (Bankr. W.D. Wash. 1986), *rev'd on other grounds*, 71 Bankr. 216 (Bankr. 9th Cir. 1987); United States v. Air Fla. Sys., Inc., 50 Bankr. 653 (Bankr. S.D. Fla.), *aff'd*, 56 Bankr. 732 (S.D. Fla. 1985), *opinion withdrawn*, 68 Bankr. 134 (S.D. Fla. 1986); *In re* Rodriguez, 50 Bankr. 576 (Bankr. E.D.N.Y. 1985); *In re* Razorback Ready-Mix Concrete Co., 45 Bankr. 917 (Bankr. E.D. Ark. 1984).

100. *Begier*, 110 S. Ct. at 2258.

101. *Id.* at 2261. *See supra* note 24.

Littman: Reasonable Assumptions, Reasonable Persons and Invisible Boomeran

funds into the new account to cover its trust fund liabilities. However, the debtor became current on these trust fund taxes by making voluntary payments to the Service both from the new, separate account and from its general funds.[102] The debtor filed a chapter 11 petition within ninety days of the transfers.[103] The case was subsequently converted to a chapter 7 case. Begier, the chapter 7 trustee, sought to recover the tax payments from the Service as preferences.[104] The lower courts in *Begier* agreed that the bankruptcy trustee could not avoid the transfers of funds from the separate account because the debtor held those funds in trust for the benefit of the IRS.[105] The lower courts disagreed about the prebankruptcy payments from the debtor's general accounts.[106]

The Supreme Court framed the issue as whether the money "transferred from its general operating accounts to the IRS was property that [the debtor] had held in trust for the IRS."[107] First, the Court examined the language of I.R.C. section 7501 and determined that the debtor created the statutory trust at the time the wages were paid, even if specific funds were neither sent to the IRS with the relevant return nor placed in a segregated fund.[108] Next, the Court described the section 7501 trust as one "radically different" from "a common-law trust, in which the settlor sets aside particular property as the trust res."[109] A section 7501 trust, in contrast, created a trust in an abstract "amount" not tied to particular assets.[110] Consequently, common law tracing rules would not apply to a section 7501 trust.[111]

Instead, the appropriate rules to determine whether trust fund taxes not segregated in a separate account were held in trust, or were property of the estate at the commencement of a bankruptcy case,

---

102. *Begier*, 110 S. Ct. at 2261. It is not clear from the Court's opinion whether the debtor became current on all its trust fund taxes or simply remained current on its trust fund taxes due after the IRS required their segregation.

103. *Id.*

104. *Id.* at 2262. Despite the conversion to chapter 7, the 90-day preference period continues to begin to run 90 days before the filing of the original chapter 11 petition. 11 U.S.C. § 348(a) (1988).

105. *Begier*, 110 S. Ct. at 2262.

106. *Id.* The bankruptcy court and, on appeal, the district court, permitted the trustee to avoid most of the payments made from the debtor's general accounts. *Id.* The Supreme Court affirmed the Third Circuit's reversal of the district court. *Id.*

107. *Id.* at 2263.

108. *Id.* at 2263-64. *See also supra* note 24.

109. *Begier*, 110 S. Ct. at 2265.

110. *Id.*

111. *Id.*

were "reasonable assumptions."[112] The same "reasonable assumptions" applied for preference purposes to determine whether a prepetition payment consisted of funds in trust or of the debtor's property.[113] These "reasonable assumptions" would assist the Service in demonstrating that the withheld taxes were still in the debtor's possession at the commencement of the case.[114]

Drawing on the House Report to the Bankruptcy Code, the Court identified the appropriate "reasonable assumption" as being that the debtor's voluntary payment, albeit from general funds, established the requisite nexus between the "amount" held in trust and the funds paid.[115] Simply put, under *Begier*, any voluntary prepetition payment to the IRS which the debtor designates as a payment of trust fund taxes is automatically deemed to consist of funds held in trust under I.R.C. section 7501(a). Therefore, such a transfer of the debtor's property does not constitute a preference.

B. *Critique of Judicial Solutions and Approaches*

In *Begier*, the Supreme Court created a new form of trust, a trust not requiring a trust res, but instead tied to an abstract dollar figure. Although freeing up the trust from the res requirement permitted the court to jettison common law tracing rules, it is not at all clear that Congress intended to create this new form of trust in 1934, when it enacted the statutory predecessor to I.R.C. section 7501.[116] If Congress meant to create a new form of trust,[117] one would expect that Congress would have explained somewhere that the common law tracing rules would not apply, particularly since the obvious purpose for creating

---

112. *Id.* at 2266 (quoting 124 CONG. REC. 32,417 (1978) (statement of Rep. Edwards) and 124 CONG. REC. 32,017 (1978) (statement of Sen. DeConcini), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6501, 6570). The "reasonable assumptions" overruled the strict (or no) tracing rule of *Randall*, 401 U.S. at 513. *See supra* notes 96-97.

113. *Begier*, 110 S. Ct. at 2267.

114. *Id. See* legislative history cited in *supra* note 112.

115. *Begier*, 110 S. Ct. at 2267. The House Report stated:

> A payment of withholding taxes constitutes a payment of money held in trust under [the] Internal Revenue Code § 7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments.

H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 373, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 5787, 6329.

116. *See supra* note 23.

117. The Court stated that "[t]he common law of trusts is not binding on Congress." *Begier*, 110 S. Ct. at 2265 n.4.

that trust in the first place was to provide a vehicle for tracing funds collected or withheld. Instead, to construe I.R.C. section 7501(a) as permitting a trust without a res, the Court relied upon the House Report to the Bankruptcy Code, and upon statements made by the House floor manager for the bill that enacted the Bankruptcy Code some forty-four years later.[118]

The Court completely failed to address its own conflicting precedent which interpreted section 7501 as requiring a res. In *Slodov v. United States*,[119] the IRS attempted to impose the one hundred percent penalty upon the purchaser of all of the stock of a corporation which owed trust fund taxes, on the ground that he failed to pay the trust fund taxes with funds acquired by the corporation after he acquired control.[120] The IRS contended that section 7501 impressed a trust upon all after-acquired cash of the corporation.[121] In rejecting the Service's claim, the *Slodov* Court discussed the relationship between I.R.C. sections 6672 and 7501. The Court compared the language of section 7501, which limited the trust to "the amount of taxes *withheld* or *collected*," with the language of section 6672, which imposed "liability for a willful failure to *collect* as well as failure to pay over."[122] The Court concluded that section 7501 required "a nexus between the funds collected and the trust created . . . consistent with the accepted principle of trust law requiring tracing of misappropriated trust funds into the trustee's estate in order for an impressed trust to arise."[123] This passage clearly defined a section 7501 trust as one subject to the common law tracing rules traditionally used to identify the trust res.[124]

Slodov also identified and discussed the dilemma faced by secured creditors whose interests might be overtaken by a trust imposed upon funds untraceable under the established common law principles.[125] Be-

---

118. This approach was criticized by the concurring opinion in *Begier*, 110 S. Ct. at 2267-69 (Scalia, J., concurring). The majority interpretation arguably was rejected by the Congress considering the Bankruptcy Code when it failed to enact the Senate version of 11 U.S.C. § 541(b)(3), which would have expressly exempted all withheld taxes from "property of the estate" and superseded *Randall*, 401 U.S. at 513. *See supra* notes 96-97 and accompanying text; S. REP. NO. 95-1106, 95th Cong., 2d Sess. 33, *reprinted in* Resnick & Wypyski, *Bankruptcy Reform Act of 1978: A Legislative History*, DOCUMENT 54 (1979).

119. 436 U.S. 238 (1978).

120. *Id.* at 241.

121. *Id.* at 255-56.

122. *Id.* at 256 (emphasis by the Court).

123. *Id.*

124. *Accord In re* Malmart Mortgage Co., 109 Bankr. 1, 6 (Bankr. D. Mass. 1989).

125. *Slodov*, 436 U.S. at 256-60. *See also Malmart*, 109 Bankr. at 7 (trust consisting of untraceable funds is secret, floating lien).

cause the *Begier* Court failed even to spot the issue, *Begier* offers the courts no guidance on the issue concerning a direct conflict between the IRS as beneficiary of a section 7501 trust and a secured creditor asserting an interest in the same funds. This issue arises if a debtor makes a voluntary payment of trust fund taxes from a bank account which contains no traceable trust funds, but which is collateral subject to a creditor's perfected security interest.[126] If the debtor paid the wages to which the trust fund taxes relate prior to the perfection of the security interest, the "springing" trust *Begier* created could attach at the time the debtor paid the related wages. The trust could be impressed upon the cash the creditor relied on for the security interest. Of course, the creditor's due diligence could prevent this situation from arising.

A more significant problem *Begier* presents is the extent of the new tracing burden. Under the traditional common law tracing rules alluded to in *Slodov* and rejected by *Begier*, the debtor had to trace funds in a commingled account back to the trust in order for the trust to attach to those funds.[127] If the debtor could trace trust funds into a commingled account, the burden was on the wrongdoer (here, the debtor) to show how much of the commingled account was not in trust.[128] If the amount remaining in the commingled account was less than the amount of the trust funds originally commingled, all funds in the account were deemed to be trust funds.[129] However, if the debtor replenished the commingled account, the "lowest intermediate balance" rule required that "the trust fund [was] thereby dissipated, and [could not] be treated as reappearing in sums subsequently deposited to the credit of the same account."[130] An exception to this rule permitted trust restoration if actual intent existed to place the funds in trust.[131]

The *Begier* Court rejected these established common law principles in favor of "reasonable assumptions."[132] In addition to establishing the

---

126. *See, e.g.*, U.C.C. § 9-306(3) (1987) (cash proceeds of collateral are subject to security interest for 10 days; identifiable cash proceeds of collateral are subject to security interest indefinitely).

127. *See In re* Air Fla. Sys., Inc., 50 Bankr. 653, 659 (Bankr. S.D. Fla.), *aff'd*, 56 Bankr. 732 (S.D. Fla. 1985), *opinion withdrawn*, 68 Bankr. 134 (S.D. Fla. 1986); D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES 424-26 (1973) (cited approvingly by *Slodov*, 436 U.S. at 256).

128. D. DOBBS, *supra* note 127, at 425.

129. *Id.*

130. Schuyler v. Littlefield, 232 U.S. 707, 710 (1914); D. DOBBS, *supra* note 116, at 425-26.

131. D. DOBBS, *supra* note 127, at 425. Such a transfer to a trust from general funds, if made during the 90-day preference period, would itself be preferential under the common law tracing principles.

132. *See Begier*, 110 S. Ct. at 2258.

automatic "springing" trust assumption, the *Begier* Court favorably cited legislative history that states "where the debtor had commingled that amount of withheld taxes in his general checking account, it might be reasonable to assume that any remaining amounts in that account on the commencement of the case are the withheld taxes."[133] Although it was unnecessary in *Begier* for the Court to clarify the extent of this "postpetition reasonable assumption," the assumption could replace the lowest intermediate balance rule. All the Service would need to do at the commencement of a bankruptcy case is to trace any amount of withheld funds to a commingled account in order to reach the *entire* amount of the account to the extent of the withheld funds originally commingled.[134] Fluctuations in the balance of the account after the commingling of the withheld taxes and before the commencement of the bankruptcy case would be irrelevant under this reading of *Begier*.[135] However, with respect to prepetition payments, *Begier* took the "reasonable assumption" one step further by failing to require any tracing of withheld taxes to the general fund.[136]

IV. Designation of Payments to Trust Fund Liabilities in Chapter 11

A. *Judicial Solutions*

There are three main judicial responses to chapter 11 debtors' attempts to designate payments made from property of the estate to trust fund liabilities. First, some cases hold that a tax payment re-

---

133. 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards) and 124 Cong. Rec. 34,017 (1978) (statement of Sen. DeConcini), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6501, 6570.

134. *See supra* note 130 and accompanying text.

135. The legislative history, *supra* note 133, makes clear that the determination is made as of the date the bankruptcy case is commenced. *See* 11 U.S.C. § 541(a)(1), (7) (1988); *see also* Whiting Pools, Inc. v. United States, 462 U.S. 198, 205 n.10 (1983) (dicta, suggesting the possibility that trust funds may be traced to tangible assets held by the debtor prior to bankruptcy).

136. *Begier*, 110 S. Ct. at 2267. It has been reported that the IRS will "purse [sic] the question" of whether the *Begier* rule applies to involuntary payments of trust fund taxes. *IRS Troubled By Rulings Subordinating Tax Penalty, Claims, Official Says*, Daily Tax Report (BNA) G-5 (Oct. 29, 1990) (comments of IRS Deputy Assistant Chief Counsel, General Litigation Division, made on Oct. 26, 1990). One might also expect the Service to attempt to apply the result in *Begier* to the postpetition situation if the debtor has made a prepetition partial payment of trust fund taxes. The Service might argue that the prepetition voluntary payment of trust fund taxes identified the account from which it was drawn as one containing all of the trust funds due at the commencement of the case, in other words, that the "*Begier* payment" sufficiently met the tracing requirements with regard to the entire account.

ceived from a chapter 11 debtor in a proceeding initiated by the debtor is not received through court or administrative action resulting in the actual seizure of property. Therefore, the payment is voluntary as a matter of law.[137] These cases distinguish *Amos* and *O'Dell*,[138] and analogize the voluntary assignment for the benefit of creditors in *Muntwyler*.[139] The cases hold that the fact that the debtor must make payments pursuant to a plan of reorganization which complies with Bankruptcy Code requirements does not constitute court action equivalent to a levy, judicial order, execution sale or judicial sale,[140] largely because the debtor in a voluntary chapter 11 case has a certain degree of latitude as to how and when to pay the IRS.[141] This approach overlooks or misinterprets a portion of the original, universally accepted definition of involuntary payment which was set out as the second prong of *Amos*. *Amos* stated that involuntary payments included ones "received . . . from a legal proceeding in which the Government [was] seeking to collect its delinquent taxes or file a claim therefor."[142] While this portion of the *Amos* definition of involuntary payment may be mere dicta, erroneous or inapplicable to the chapter 11 situation, these cases nonetheless fail to apply it.[143]

On the opposite end of the voluntary-involuntary continuum are the cases which hold that a payment made by a debtor in a chapter 11 proceeding is involuntary as a matter of law. In *In re Ribs-R-Us, Inc.*,[144] the Court of Appeals for the Third Circuit rejected the debtor's contention, based upon the first prong of *Amos*, that only payments resulting from enforced collection measures leading to an actual seizure

---

137. *See, e.g.*, *In re* Lifescape, Inc., 54 Bankr. 526 (Bankr. D. Colo. 1985); *In re* Tom LeDuc Enters., Inc., 47 Bankr. 900 (W.D. Mo. 1984).

138. *See supra* notes 40-51 and accompanying text.

139. *See supra* notes 51-59 and accompanying text.

140. *Lifescape*, 54 Bankr. at 529.

141. *Id.*

142. *Amos*, 47 T.C. at 69. In *Muntwyler*, of course, the government was seeking to file a claim, but it was not in a legal proceeding at the time. *Muntwyler*, 703 F.2d at 1031-34. Therefore, the *Amos* definition of involuntary was not met.

143. *See also In re* Hartley Plumbing Co., 32 Bankr. 8 (Bankr. M.D. Ala. 1983) (a chapter 11 case which relied on *In re* Frost, 19 Bankr. 804, 808-09 (Bankr. D. Kan. 1982), *rev'd*, 47 Bankr. 961 (D. Kan. 1985)). The bankruptcy court in *Frost* had held that payments in a chapter 13 case (in which a wage earner pays his debts over three years under a plan) were voluntary because a chapter 13 petition can be filed only by a debtor and can be dismissed at any time without notice to creditors. *Frost*, 19 Bankr. at 809. The district court reversed, correctly applying the *Amos-Muntwyler* definition. *Frost*, 47 Bankr. at 964-65. Amazingly, the court in *Lifescape* specifically criticized the district court in *Frost* for failing to follow *Muntwyler*, in the process misreading the *Amos-Muntwyler* definition. *Lifescape*, 54 Bankr. at 529.

144. 828 F.2d 199 (3d Cir. 1987).

of property, such as a levy, are involuntary.[145] The court instead examined the Bankruptcy Code restrictions imposed upon a chapter 11 debtor. It then concluded that, despite the chapter 11 debtor's right to operate the business and to dispose of property in the ordinary course of its business, the debtor must act as a fiduciary for the benefit of its creditors.[146] Further, the court recognized that the debtor must follow the terms of a confirmed plan, including payment of all seventh priority tax claims within six years.[147] However, the court focused on the fact that any bankruptcy proceeding was the last chance of a debtor for a relatively ordered financial liquidation or rehabilitation rather than an out-of-control financial debacle; therefore, to interpret any payment made pursuant to a plan of reorganization as voluntary would be inconsistent with the realities of bankruptcy.[148]

Ribs-R-Us, the debtor, argued that the provision of the Bankruptcy Code giving a debtor six years to pay seventh priority taxes, 11 U.S.C. section 1129(a)(9)(C), created a federal policy which subordinated the competing federal policy of protecting the revenue as set forth by I.R.C section 6672.[149] However, the court could find no legislative history to support that view, nor could it find any specific Bankruptcy Code provision permitting either a debtor or a court to direct application of payments in a manner to preclude recourse against responsible persons.[150]

On the other hand, the court found that there was a federal policy of protecting the revenue inherent in I.R.C. section 6672 in the context of a chapter 11 reorganization.[151]Cases holding that a bankruptcy court lacks jurisdiction or authority to enjoin the IRS from pursuing the one hundred percent penalty against responsible persons who were not the debtors in the proceeding evidence this policy.[152] Consequently, the congressional policy of protecting the government's tax revenues prevailed over any lesser bankruptcy policy, and there was no obstacle to the IRS's sole power to allocate the involuntary chapter 11 payments

145. *Id.* at 202-03.

146. *Id.* at 203 (citing Wolf v. Weinstein, 372 U.S. 633, 649-50 (1963)).

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.* at 203-04. The court specifically rejected the use of 11 U.S.C. § 505(a)(1), which permits a bankruptcy court to determine a tax, as authority for the court to allocate the payments in derogation of the policy underlying I.R.C. § 6672. *Ribs-R-Us*, 828 F.2d at 204 n.4.

151. *Ribs-R-Us*, 828 F.2d at 203-04.

152. *Id.* at 204 (citing to United States v. Huckabee Auto Co., 783 F.2d 1546 (11th Cir. 1986)). In *Huckabee*, the debtor claimed that the responsible person would contribute the amount of the 100% penalty to fund the reorganization absent the penalty. *Huckabee*, 783 F.2d at 1547.

Florida Law Review, Vol. 42, Iss. 4 [1990], Art. 4

to non-trust fund liabilities.[153] Both the Ninth and Sixth Circuits subsequently adopted the "per se involuntary" holding and reasoning of *Ribs-R-Us*.[154]

Within the continuum lie cases which hold that voluntariness is a question of fact.[155] In *In re A & B Heating & Air Conditioning*,[156] the Eleventh Circuit recognized the voluntary-involuntary distinction and the conflicting precedent. The court attributed the conflicting decisions to a policy conflict between the Internal Revenue Code and the Bankruptcy Code.[157] The Internal Revenue Code, on the one hand, imposes liability upon employers and responsible persons and imposes a trust upon withheld taxes to facilitate their collection. The policy of the

---

The debtor contended that the funds were necessary to a reorganization. *Id.*; *see also* Quattrone Accountants, Inc. v. Internal Revenue Serv., 895 F.2d 921, 924-27 (3d Cir. 1990) (determination of I.R.C. § 6672 liability of nondebtor does not pass jurisdictional test of being "related" to bankruptcy); *In re* Brandt-Airflex Corp., 843 F.2d 90, 94-96 (2d Cir. 1988) (11 U.S.C. § 505 does not authorize the bankruptcy court to determine the tax liability of nondebtors); *In re* LaSalle Rolling Mills, Inc., 832 F.2d 390 (7th Cir. 1987) (anti-injunction provision of I.R.C. § 7421 prevents bankruptcy court from enjoining IRS assessment of 100% penalty against non-debtors).

153. *Ribs-R-Us*, 828 F.2d at 204. Because the court decided the payments were involuntary as a matter of law, it refused to consider whether the corporate principals were committed to finance the reorganization only if the debtor were allowed to designate the payments. *Id.*

154. *See In re* Technical Knockout Graphics, Inc., 833 F.2d 797 (9th Cir. 1987). In *Technical Knockout*, the debtor attempted to designate, pursuant to motion, preconfirmation payments. *Id.* at 799. The court held that the bankruptcy court did not have "equitable jurisdiction" to order the IRS to apply the payment because to do so "could defeat the priority scheme established by Congress." *Id.* at 803. The court failed to indicate how the proposed designation related to the priority scheme or how designation could defeat the scheme.

In *DuCharmes*, the Sixth Circuit simply agreed with *Ribs-R-Us* and *Technical Knockout* without detailed discussion. *In re* DuCharmes & Co., 852 F.2d 194, 196 (6th Cir. 1988).

See also In re Avildsen Tools & Machine, Inc., 794 F.2d 1248, 1254 (7th Cir. 1986) (Ripple, J., concurring) (stating that payments made under the bankruptcy court's supervision were involuntary); *In re* Professional Technical Servs., Inc., 94 Bankr. 578 (E.D. Mo. 1988) (adopting the *Ribs-R-Us* holding and reasoning); *In re* Frost, 47 Bankr. 961 (D. Kan. 1985) (debtor's payments to IRS pursuant to chapter 13 plan held to be involuntary); *In re* Mister Marvins, Inc., 48 Bankr. 279 (E.D. Mich. 1984) (court ordered payment to IRS under chapter 11 held to be involuntary).

155. *In re* Energy Resources Co., 871 F.2d 223, 233 (1st Cir. 1989), *aff'd*, 110 S. Ct. 2139 (1990); *In re* A & B Heating & Air Conditioning, 823 F.2d 462, 465 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, 108 S. Ct. 1724 (1988), *held not moot on remand*, 861 F.2d 1538 (11th Cir.), *dismissed as moot*, 878 F.2d 1311 (11th Cir. 1989); *In re* Kare Kemical, Inc., 112 Bankr. 38, 40 (S.D. Fla. 1989); *In re* Hineline, 72 Bankr. 642, 644 (N.D. Ohio 1987); *In re* B & P Enters., Inc., 67 Bankr. 179, 183 (Bankr. W.D. Tenn. 1986). *See In re* Franklin Press, Inc., 52 Bankr. 151 (Bankr. S.D. Fla. 1985).

156. 823 F.2d 462 (11th Cir. 1987).

157. *Id.* at 463-64.

Internal Revenue Code is the collection of taxes and the maximization of the public fisc.[158] On the other hand, the Bankruptcy Code expresses a preference for reorganization over liquidation because creditors are likely to receive a larger distribution in a reorganization and reorganization preserves the entity's economic life.[159] The court found that the failure to allow a debtor to designate payments to trust fund liabilities is detrimental to a reorganization because the corporate officers (who are responsible persons), who control the corporation, will prefer a corporate liquidation in chapter 7 to a chapter 11 because the corporation will likely pay all priority taxes in full.[160]

Consequently, according to the *A & B Heating* court, the designation question in a chapter 11 case should be decided on a case-by-case basis.[161] The court identified a number of factors which the lower court was instructed to consider in determining whether the payment was voluntary or involuntary.[162] Among the factors were whether prebankruptcy collection measures had been taken, whether the case was a liquidation or a reorganization, whether there were special circumstances, and most importantly, "whether the proposed plan [was] merely a stopgap scheme to hold the taxing authority at bay with little chance that the debtor [would] fulfill its obligation under the plan."[163] Interestingly, the *A & B Heating* court did not mention the reorganization's dependence upon the participation of the responsible persons, the only factor directly related to the Bankruptcy Code policy of encouraging reorganizations, as a factor for the lower court to consider.

The First Circuit Court of Appeals in *Energy Resources* also held that the designation issue was a question of fact. In reaching that conclusion, the court borrowed from both *Ribs-R-Us* and *A & B Heating*.[164] First, the court found that the IRS could call a chapter 11 tax

---

158. *Id.* at 465.

159. *Id.*

160. *Id.* (quoting Note, *Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS*, 70 MINN. L. REV. 1279, 1299-1300 (1986)).

161. *Id.* (quoting *B & P Enters.*, 67 Bankr. at 183).

162. *Id.*

163. *Id.* at 466. The court adopted the case-by-case analysis of factors proposed in *B & P Enters.*, 67 Bankr. at 184. *Id.* at 465-66. The court refused to adopt *B & P Enters.*' restrictive test, which placed the burden of proof upon the debtor to show special circumstances warranting the allocation. *Id.* at 465 n.4. Instead, the court instructed the lower court to consider the plan as a whole. *Id.* at 465-66. In the light of the court's recognition that the bankruptcy judge previously had considered and passed upon the feasibility of the plan, as he was required to do under 11 U.S.C. § 1129(a)(11) (1988), *see A & B Heating*, 823 F.2d at 466, it is unclear what, if anything, the "most important" factor adds to the plan confirmation criteria.

164. *Energy Resources*, 871 F.2d at 227, 233.

payment involuntary for the purpose of applying its own rules or regulations.[165] It reached that finding by identifying those characteristics of a chapter 11 proceeding which would make a related tax payment involuntary, as noted in *Ribs-R-Us*.[166] The court next identified those characteristics favoring application of a voluntary label.[167] However, the First Circuit in *Energy Resources* did not find it necessary to weigh the voluntary-involuntary characteristics because it did not find the Service's view or its internal rules to be clearly unreasonable.[168] Therefore, the court held that the payments were involuntary, and that the debtor could not dictate the application of payments to the Service.[169]

This did not end the analysis. Having decided that the payments were involuntary, the court ruled that a bankruptcy court has the power to order the IRS to override its own internal rules and policies of payment application.[170] The court gave six reasons. First, a bankruptcy court has the power to issue any order appropriate to carry out the provisions of the Bankruptcy Code.[171] Permitting the bankruptcy court the power to assure the responsible persons that the trust fund debt (and thus their liability) would be extinguished first might diminish the IRS's chances of being paid in full on all its claims. However, it would increase the possibility that the reorganization would be successful by ensuring the cooperation, and perhaps the financial assistance, of the responsible persons.[172] Second, bankruptcy courts can apply payments among particular claims of the same creditor outside of the tax context, and *Amos* specifically refrained from deciding whether the IRS would have the same rights to apply payments if the reorganization might affect other creditors.[173] Third, the court could find nothing in the Bankruptcy Code which would limit the court's power to allocate a tax payment, considering the "compromise nature of chapter 11's tax debt policy."[174] Fourth, the bankruptcy court was better fit to apply the court's balancing test on a case-by-case basis than was the IRS.[175] Fifth, the IRS could not over-

165. *Id.* at 227-30.
166. *Id.* at 228-29. *See supra* text accompanying notes 146-48 for a discussion of factors.
167. *Energy Resources*, 871 F.2d at 229.
168. *Id.* at 230. The court found this to be the applicable standard. *Id.*
169. *Id.*
170. *Id.*
171. *Id.* (quoting 11 U.S.C. § 105 (1988)).
172. *Id.* at 230-31.
173. *Id.* at 231; *Amos*, 47 T.C. at 70 n.5.
174. *Energy Resources*, 871 F.2d at 231.
175. *Id.*

ride by an internal rule the bankruptcy court's powers.[176] Sixth, the IRS's allocation policy, according to the court, ensured that the trust funds would be paid last and thus represented an attempt to use the one hundred percent penalty to collect total tax debts, not merely trust fund taxes.[177] In contrast, under the debtor's view, the IRS would release the responsible person only to the extent that the trust fund taxes were paid, and the IRS would be no worse off with regard to the remaining non-trust fund debt than if the entire debt had been of non-trust fund nature.[178]

Having found that the bankruptcy court had the power to allocate the payments, the court required the bankruptcy courts to consider the plan as a whole, and to justify the increased risk that the IRS would not collect the total tax debt against the offsetting increased likelihood of rehabilitation (payment to general creditors who otherwise might not receive payment in a liquidation).[179] In both of the cases involved in *Energy Resources*, the First Circuit found that a third party's infusion of capital was funding and facilitating the plan of reorganization, and therefore, the likelihood of rehabilitation justified the increased risk to the IRS.[180]

The Supreme Court affirmed the ruling of the First Circuit in *Energy Resources*, adopting much of the same general reasoning, but with several significant differences.[181] First, the Court stated that the bankruptcy court has the authority to order a designation of payments to trust fund liabilities whether or not the payments are involuntary.[182]

---

176. *Id.* at 232.

177. *Id.*

178. *Id.* at 233.

179. *Id.* at 234.

180. *Id. See also Franklin Press*, 52 Bankr. at 152 (establishing voluntariness of payment from a voluntary, third party guarantee in securing financing for a reorganization). The court in *Franklin Press* relied on *In re* Hartley Plumbing Co., 32 Bankr. 8 (Bankr. M.D. Ala. 1983). *Id. Hartley Plumbing* relied on another case which was later reversed. *Hartley Plumbing*, 32 Bankr. at 8 (citing to *In re* Frost, 19 Bankr. 804 (Bankr. D. Kan. 1982), *rev'd*, 47 Bankr. 961 (D. Kan. 1985)). *See supra* note 143.

The court in *Kare Kemical* went even further by finding that the bankruptcy court could adopt the debtor's proposed allocation to trust fund taxes in a liquidating chapter 11 case where no general creditors would receive any payments. *Kare Kemical*, 112 Bankr. at 41. The court in *Kare Kemical* affirmed the bankruptcy court's finding that the responsible person's actions in attempting to maximize the value of the debtor's assets for the benefit of the IRS made the payments voluntary. *Id.* at 40-41.

181. *Energy Resources*, 110 S. Ct. at 2141-42.

182. *Id.* Because the Court, unlike the First Circuit, did not even consider whether the payments were voluntary or involuntary, in a proper case, a bankruptcy court might be able to override a chapter 11 debtor's "voluntary" designation, if it is still possible to make a voluntary designation.

Second, the Court found the trust fund designation appropriate under the bankruptcy court's authority both to permit the inclusion in a plan of "any . . . appropriate provision not inconsistent with the applicable provisions of this title," and to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code.[183] Third, the Court rejected the government's claims that the designation provision violated the Bankruptcy Code's priority and non-discharge provisions.[184] The Court found nothing in the Bankruptcy Code which would specifically protect the IRS from the risk of plan failure.[185] Finally, the Court briefly examined the policy underlying I.R.C. section 6672 to provide an additional source for the collection of taxes and determined that the designation orders were, in fact, in accord with that policy because the debtor would pay trust fund taxes first.[186]

On its face, the Supreme Court appears to have narrowed the legal standard for permitting designation from that of "increased likelihood of rehabilitation"[187] to one of "necessary to the success of a reorganization plan."[188] Because the Court simply affirmed the First Circuit without any further discussion of the apparent new standard,[189] it is unclear whether the Court actually adopted a new standard or believed that the two standards were identical in practice. However, the facts of one of the two consolidated cases in *Energy Resources* suggest that the results under the two standards are identical.

In *United States v. Energy Resources Co.*, the bankruptcy court confirmed a reorganization plan which placed all of the debtor's assets, except for one division, into a special liquidating trust to pay its debts, including taxes, over five years.[190] More than one year after the plan was confirmed, the trustee of the liquidating trust asked the bankruptcy court to order the Service to apply his $280,000 tax payment to trust fund liabilities.[191] The trustee negotiated this arrangement with a former officer in return for a $14,000 payment by that officer to the liquidating trust.[192] While the bankruptcy court ruled that the

183. *Id.* at 2142 (quoting 11 U.S.C. §§ 1123(b)(5), 105(a) (1988)).

184. *Id.*; *see* 11 U.S.C. §§ 507(a), 726, 1129(a) (1988); *see also supra* notes 81-88, 93 and accompanying text.

185. *Energy Resources*, 110 S. Ct. at 2142-43. Apparently the feasibility test of 11 U.S.C. § 1129(a)(11) is the only protection against plan failure. *See supra* note 163 and accompanying text.

186. *Energy Resources*, 110 S. Ct. at 2143.

187. *See Energy Resources*, 871 F.2d at 234.

188. *Energy Resources*, 110 S. Ct. at 2142.

189. *See id.* at 2142-43.

190. *See Energy Resources*, 871 F.2d at 226-27.

191. *In re* Energy Resources Co., 59 Bankr. 702, 704 (Bankr. D. Mass. 1986).

192. *Id.*

trustee was entitled to designate the payment to trust fund taxes because the payment was voluntary,[193] it is difficult to see how the designation met the Supreme Court's "necessary to the success of a reorganization" standard. The estate was benefited only by the amount of the officer's contribution, $14,000, a relatively insignificant amount in that multimillion dollar bankruptcy case. Moreover, the designation occurred long after the reorganization plan had been negotiated and confirmed by the bankruptcy court. It appears, therefore, that the Supreme Court treated its new "necessary" standard as identical to the standard of "increased likelihood of rehabilitation."

B. *Critique of Judicial Solutions and Approaches*

Both the judicial solutions and approaches, and the rationale of the litigants, are subject to criticism. As pointed out above, the "per se voluntary" rule overlooks a significant portion of the definition of involuntary set forth in *Amos* and *Muntwyler*, and thus is without firm judicial precedent.[194] The "per se involuntary" rule of *Ribs-R-Us*[195] and its progeny was defective as well, for it disregarded the independent role of the bankruptcy courts to adjust debtor-creditor relationships, including those with the IRS. Therefore, the rule reduced the role of the court to enforcing the Service's designation.

The Supreme Court cut through the strict voluntary-involuntary dichotomy by adopting the First Circuit's approach of focusing upon the bankruptcy court's power to override the internal rules of the IRS. In doing so, the Court resolved the apparent policy conflict between the Bankruptcy Code and the Internal Revenue Code in favor of the Bankruptcy Code, the debtor and the responsible persons. In most cases, the "necessary to a successful reorganization" test will result in confirmation of a plan containing a trust fund designation provision. A third party's voluntary contribution to fund a reorganization must be contingent upon the inclusion of a designation provision in a plan, and the contribution must be necessary to the success of the plan. Thus, in practice, the results of the case-by-case approach of *Energy Resources* will likely closely resemble those of the "per se voluntary" rule, except that the ultimate power to designate now resides in the bankruptcy court.[196]

---

193. *Id.* at 706.

194. *See supra* notes 137-43 and accompanying text.

195. *See supra* notes 144-54 and accompanying text.

196. *See Energy Resources*, 110 S. Ct. at 2142. If the designation provision is necessary to a successful reorganization, it appears that it would be an abuse of discretion for a bankruptcy court not to approve the provision. *See id.*

The concept that a designation provision can facilitate a chapter 11 reorganization is difficult to fault. A responsible person in control of a chapter 11 debtor through stock ownership could be willing to inject cash into the enterprise in lieu of simply paying the funds to the IRS, if a designation provision eliminates the person's risk of ultimate one hundred percent penalty liability. In effect, a cash contribution under those circumstances serves double duty: it funds the reorganization and thus increases the value of stock in the corporate debtor, and through the designation provision, it provides relief of some of the risk of responsible person liability. Thus, the responsible person is willing to make a larger contribution to fund the reorganization due to the presence of the designation provision. The same holds true if a third party provides the cash to the debtor. Presumably, the responsible person/shareholder would give up to the third party a larger share of equity in the corporate debtor in return for the designation provision proposed by the debtor, increasing the third party's willingness to risk its funds in the reorganization.[197]

However, in another sense, a designation of tax payments to trust fund liability also burdens the reorganization of a chapter 11 debtor by decreasing the likelihood that the responsible person will ultimately bear the economic burden for the trust fund taxes. If no designation provision existed and if the payments were involuntary (*i.e.*, trust fund taxes were to be paid last in time), then the government could collect from the responsible persons (and the statute of limitations on refunds might have run) before the trust fund taxes were payable under the plan, and the Service would abate those taxes imposed upon the corporate debtor.[198] Thus, the presence of a designation provision

---

197. There would seem to be no reason why a responsible person who is not a shareholder or creditor of a corporate debtor would have anything proper to offer a third party in return for a designation provision. In such a case, a bankruptcy court might examine the designation provision in the light of 11 U.S.C. § 1129(a)(3) (1988) (the plan must be proposed in good faith and not by any means forbidden by law), or might simply find that, under the facts and circumstances, the designation provision is not "necessary to a successful reorganization."

198. *See supra* note 32. The weight of authority holds that a responsible person who pays the 100% penalty has no right to recover the amount of his payment from the employer. *See* Sinder v. United States, 655 F.2d 729, 732 (6th Cir. 1981); *In re* All-Star Sports, Inc., 78 Bankr. 281 (Bankr. D. Nev. 1987); *In re* Ace Finance Co., 59 Bankr. 667, 670 (Bankr. N.D. Ohio 1986); *In re* Windsor Communications Group, Inc., 45 Bankr. 770 (Bankr. E.D. Pa. 1985); Rebelle v. United States, 588 F. Supp. 49, 51 (M.D. La. 1984); Rice v. Pearce, 574 F. Supp. 23 (S.D. Iowa 1983); Moats v. United States, 564 F. Supp. 1330, 1341-42 (W.D. Mo. 1983); Hanhauser v. United States, 85 F.R.D. 89, 91-92 (M.D. Pa. 1979); Spivak v. United States, 254 F. Supp. 517, 524 n.9 (S.D.N.Y. 1966), *aff'd*, 370 F.2d 612 (2d Cir.), *cert. denied*, 387 U.S. 908 (1967). *But see* Reid v. United States, 558 F. Supp. 686 (N.D. Miss. 1983).

in a confirmed plan could actually increase the reorganized debtor's total tax burden.

Another difficulty with the Supreme Court's approach is that it tends to reduce the designation issue to a mere accounting entry on the government's "books." The Supreme Court determined that the designation orders protected trust fund revenues by requiring that the trust fund taxes be credited first, at the risk of the later nonreceipt of total tax debts.[199] This argument fails to recognize the damage to the public fisc — someone must make up a shortfall in revenues, whether trust fund or non-trust fund. The Court focused only on the policy underlying I.R.C. section 6672 and failed to give weight to the complex interlocking statutory scheme and underlying policy regarding collection of trust fund liabilities. The Court should have considered section 6672 as a tool for enforcing compliance with the employer's obligation to deduct and withhold its employees' income and social security taxes,[200] together with section 7501, which imposes a trust upon these funds,[201] section 7202, which imposes criminal liability upon persons who fail to comply with these provisions,[202] and the fact that a claim in bankruptcy against a debtor based upon the one hundred percent penalty is a seventh priority claim which is nondischargeable.[203] The Supreme Court in *Energy Resources* simply glossed over this statutory scheme.

Assuming a bankruptcy court's determination that a designation provision is necessary to the success of a particular reorganization, the mechanical issues raised above beg the public policy question which the Supreme Court failed to directly address: should the court permit the responsible person and the chapter 11 debtor (and perhaps a third party) to make this arrangement in the light of the strong congressional tax collection policy, given that the government is forced to be a creditor in the proceeding and is not a willing participant to the arrangement? Since the Court's implicit answer to this question is yes, any change in the law now clearly will have to come from Congress.[204]

---

199. *See Energy Resources*, 110 S. Ct. at 2142-43; *Energy Resources*, 871 F.2d at 232.

200. I.R.C. § 6672.

201. I.R.C. § 7501.

202. I.R.C. § 7202.

203. 11 U.S.C. §§ 507(a)(7)(C), 523(a)(1)(A) (1988). *See* Comment, *Favoring Collection of Taxes Over Bankruptcy Discharge in Section 6672 Actions*, 25 WILLAMETTE L. REV. 633 (1989); *see also* United States v. Sotelo, 436 U.S. 268, 282 (1978) (liability under I.R.C. § 6672 held to be nondischargeable under the Bankruptcy Act).

204. *See supra* note 94 for a discussion of proposed legislation to the Bankruptcy Code to permit the government to preserve alternative sources of collection.

More fundamentally, now a need for congressional intervention exists to prevent the next round of inevitable litigation over the issue of when a designation provision is "necessary" to the success of a reorganization. The Court offered no clear guidelines to assist the lower courts in making this determination. A compromise legislative approach which would create needed certainty in this area is proposed below.

The underlying economic issue in these cases is the identification of the appropriate person to bear the risk of plan failure — the government or the responsible person. The responsible person, and therefore the plan proponent, desires an early exoneration from the one hundred percent penalty. Conversely, the government wants to keep the responsible person liable until the debtor makes all tax payments in the reorganization. No court has ever considered any solution to this deadlock other than a complete victory for one litigant or another. Apparently, none of the parties to litigation of this issue has proposed an intermediate solution. Therefore, it is not surprising that the Supreme Court awarded total victory to the debtor.[205]

However, there are provisions contained in the Bankruptcy Code, its legislative history, and case law which dictate a different result from that found by the Supreme Court or put forth by the parties in the litigated cases.[206] At least two separate lines of reasoning support

---

205. *Energy Resources*, 110 S. Ct. at 2143. Some additional arguments not addressed by the cases are:

a. 11 U.S.C. § 1129(d) forbids a court from confirming a plan if the principal purpose of the plan is tax avoidance. 11 U.S.C. § 1129(d) (1988). The government has the burden of proof. *Id.* While it would be difficult for the government to prevail on this theory in most instances, in part due to the burden of proof, this provision might be successful in attacking certain cases where other arguments have failed. *See, e.g., Kare Kemical*, 112 Bankr. at 38, in which a corporation liquidating under chapter 11 was permitted to designate its seventh priority tax payment to trust fund liabilities, despite having insufficient funds to pay the IRS in full or to pay anything to creditors junior to the IRS. It is at least arguable that under these facts and circumstances, there was no "successful reorganization," (or, for that matter, any "reorganization") and, therefore, that the designation provision could not have been "necessary to a successful reorganization."

b. If the responsible person is not a shareholder or creditor of the debtor, the plan might not be proposed in good faith. *See* 11 U.S.C. § 1129(a)(3) (1988) (requiring that the plan has been proposed in good faith); *see also supra* note 197.

206. Since these provisions are inconsistent with a designation provision in a plan, the designation provisions are not permissible under either 11 U.S.C. § 1123(b) or 11 U.S.C. § 105(a), cited by the Court. *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (power of § 105 must be exercised within confines of Code); *In re* Morristown & E.R.R., 885 F.2d 98, 100 (3d Cir. 1989) (§ 105 cannot create new substantive rights); *In re* NWFX, Inc., 864 F.2d 593 (8th Cir. 1989) (in accord); *In re* Kelly, 841 F.2d 908 (9th Cir. 1988) (in accord);

the conclusion that each payment of taxes of seventh priority made pursuant to a chapter 11 plan must consist of a ratable share of trust fund and non-trust fund taxes, in proportion to the ratio of aggregate trust fund liabilities to aggregate non-trust fund liabilities.

The first line of reasoning is based on treatment of priority claims in bankruptcies. Unlike general unsecured claims and secured claims, which must be grouped into classes for purposes of voting upon a chapter 11 plan,[207] seventh priority tax claims may not be classified in a plan. Instead, the debtor must pay these claims in accordance with Bankruptcy Code section 1129(a)(9)(C). The section specifies that the holder of a claim must receive "deferred cash payments," including interest, over a period not exceeding six years after assessment. The legislative history of the Bankruptcy Code clarifies that a governmental unit may have more than one claim within the same priority.[208] Consequently, claims for the trust fund taxes and non-trust fund taxes may constitute at least two separate claims.[209]

The effect of a provision designating that trust fund taxes be deemed paid before non-trust fund taxes is judicially to establish a priority within a priority for the trust fund taxes.[210] Substantial, longstanding authority exists under the bankruptcy law that the courts must strictly construe the statutory bankruptcy priorities Congress

---

United States v. Sutton, 786 F.2d 1305 (5th Cir. 1986) (in accord); Johnson v. First Nat'l Bank, 719 F.2d 270, 273 (8th Cir. 1983) (§ 105 must be exercised in a manner consistent with the Bankruptcy Code), *cert. denied*, 465 U.S. 1012 (1984). *See also supra* note 183 and accompanying text.

207. 11 U.S.C. § 1123(a)(1) (1988). *See* 11 U.S.C. § 1126(c) (1988) (acceptance of plan determined by classes). Claims in the same class must be treated alike. 11 U.S.C. § 1123(a)(4) (1988). *See also infra* note 213.

208. "Tax claims entitled to priority under section 507(a)(6) of different govenmental units may not be contained in one class although all claims of one such unit may be combined. . . ." 124 CONG. REC. 32,406 (1978) (statement of Rep. Edwards) and 124 CONG. REC. 34,006 (1978) (statement of Sen. DeConcini), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6472, 6542.

209. There might, in fact, be more than two claims. If the existence of separate claims is determined by the different subparagraphs of § 507(a)(7), there might be separate claims for income taxes due within three years, § 507(a)(7)(A), trust fund taxes, § 507(a)(7)(C), and the employer's share of social security taxes due within three years, § 507(a)(7)(D). 11 U.S.C. § 507(a)(7)(A), (C), (D) (1988). Alternatively, there could be a separate claim for each separate Internal Revenue Code provision giving rise to a claim. For purposes of this analysis, it is unnecessary to consider whether there are more than two separate seventh priority claims, one for trust fund taxes, and one for non-trust fund taxes.

210. Similarly, permitting the IRS to designate involuntary payments in chapter 11 under prior law as non-trust fund taxes establishes a priority within a priority for non-trust fund taxes.

established[211] and that the courts may not set priorities without clear statutory authority.[212] A bankruptcy court, therefore, has no authority to fix different priorities for two different claims of the same priority classification.[213] All claims which fall within the seventh priority must be accorded the same treatment, including claims of state taxing authorities and the IRS.[214] The designation provision approved by the Supreme Court contravenes this longstanding authority.

If the IRS combines the trust fund and non-trust fund tax claims into one claim,[215] then the court must treat them alike. If a designation provision requires that the payments of non-trust fund taxes be commenced after completion of the payments of trust fund taxes, one is led to the conclusion that the two claims have been combined. Whether

---

211. Nathanson v. NLRB, 344 U.S. 25, 29 (1952); *In re* Amarex, Inc., 853 F.2d 1526, 1530 (10th Cir. 1988); Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc., 789 F.2d 98 (2d Cir. 1986); *In re* Pulaski Highway Express, Inc., 57 Bankr. 502 (Bankr. M.D. Tenn. 1986); *In re* American Anthracite & Bituminous Coal Corp., 171 F. Supp. 377 (S.D.N.Y. 1959), *aff'd*, 280 F.2d 119 (2d Cir. 1960).

212. United States v. Embassy Restaurant, Inc., 359 U.S. 29 (1959); *In re* Lorber Indus., Inc., 675 F.2d 1062 (9th Cir. 1982); *In re* Mammoth Mart, Inc., 536 F.2d 950 (1st Cir. 1976); Standard Oil v. Kurtz, 330 F.2d 178 (8th Cir. 1964); *In re* Great Northeastern Lumber & Millwork Corp., 64 Bankr. 426 (Bankr. E.D. Pa. 1986); *In re* Pierce Coal & Constr., Inc., 65 Bankr. 521 (Bankr. N.D. W. Va. 1986); *In re* FCX, Inc., 54 Bankr. 833 (Bankr. E.D.N.C. 1985); *In re* P.J. Nee Co., 36 Bankr. 609 (Bankr. D. Md. 1983).

213. *See* United States v. Kalishman, 346 F.2d 514 (8th Cir.), *cert. denied*, 384 U.S. 1003 (1965); *In re* Columbia Ribbon Co., 117 F.2d 999 (3d Cir. 1941); United States v. Killoren, 119 F.2d 364 (8th Cir.), *cert. denied*, 314 U.S. 640 (1941); *In re* Grosso, 51 Bankr. 266 (Bankr. D.N.M. 1984); *In re* Wilnor Drilling, Inc., 29 Bankr. 727 (S.D. Ill. 1982); *In re* Wil-Low Cafeterias, 35 F. Supp. 965 (S.D.N.Y. 1940). There is limited authority permitting a court to alter the timing of priority claims if necessary for equitable public policy reasons. *See In re* Jewish Memorial Hosp., 13 Bankr. 417 (Bankr. S.D.N.Y. 1981) (court permitted delay of payments of priority expenses where hospital, which was essential to health and safety of community, otherwise would be forced to close its doors). In *Jewish Memorial Hosp.*, it was not clear whether the payment of all claims of the same priority were delayed, but at least some other claimants in addition to the complaining claimant were delayed. *Jewish Memorial Hosp.*, 13 Bankr. at 418. The standard in *Jewish Memorial Hosp.* is clearly much more restrictive than that announced by the Supreme Court in *Energy Resources*, 110 S. Ct. at 2139, and appears to be reserved for extraordinary cases.

214. *See* Missouri v. Ross, 299 U.S. 72 (1936) (under former Bankruptcy Act, all taxes, whether of the United States, state, county, district or municipality, were placed on a parity); *In re* Revco, D.S., Inc., 91 Bankr. 777, 781 (Bankr. N.D. Ohio 1988) (to pay seventh priority state trust fund taxes prior to confirmation of a plan of reorganization would prejudice other claimants holding seventh priority claims, as well as creditors holding claims of higher priority); *In re* Penn-Mahoning Mining, Inc., 45 Bankr. 51 (Bankr. M.D. Pa. 1984) (no separate priorities exist within § 507(a)(7)).

215. *See supra* note 208.

the claims are combined or separate, the court must treat them alike. Therefore, each deferred cash payment of seventh priority taxes must consist of a proportionate share of trust fund and non-trust fund taxes.[216]

The second line of reasoning is based upon cases which require that the debtor make the "deferred cash payments" by periodic payments of principal and interest.[217] Although the legislative history requires payment of the seventh priority taxes "in installments over a period not to exceed 6 years . . . ,"[218] it is not clear whether the debtor must make equal installments or if the installments must be made monthly. Most of the cases considering this question have required equal monthly payments with the possibility of a longer payment interval if the debtor demonstrates special or unusual facts.[219]

Given a requirement of equal periodic payments for seventh priority claims, it is clear that a designation provision deviates by permitting the non-trust fund payments to begin in mid-plan. The non-trust fund payments would begin, for example, in year three of a six-year-plan, and would, therefore, fail the periodic installment test.[220] Under this analysis as well, each equal payment should consist of a proportionate share of the trust fund and non-trust fund claims.[221]

---

216. *See also In re* Parker, 21 Bankr. 692, 694 (E.D. Tenn. 1982) (" '[D]eferred' [in chapter 13] means after the effective date of the plan, not postponed until after the payment of any other claims covered by the plan.").

217. *In re* Arrow Air, Inc., 101 Bankr. 332, 335 (S.D. Fla. 1989); *In re* Mahoney, 80 Bankr. 197 (Bankr. S.D. Cal. 1987); *In re* Inventive Packaging Corp., 81 Bankr. 74 (Bankr. D. Colo. 1987); *In re* Mason & Dixon Lines, Inc., 71 Bankr. 300 (Bankr. M.D.N.C. 1987).

218. 124 CONG. REC. 32,418 (1978) (statement of Rep. Edwards) and 124 CONG. REC. 34,017 (1978) (statement of Sen. DeConcini), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6502, 6572.

219. *See supra* note 217. *But see In re* Snowden's Landscaping Co., 110 Bankr. 56 (Bankr. S.D. Ala. 1990). In *Snowden,* the court permitted quarterly rather than monthly payments, undoubtedly within the court's discretion. *Id.* at 61. More significantly, however, *Snowden* permitted the debtor to pay all seventh priority tax claims over 5 years in graduated installments of 5% in year 1, 15% in year 2, and 26% in each of years 3, 4 and 5. *Id.* at 59. While *Snowden* certainly rejects the previously well understood definition of "deferred cash payments" as equal payments, the case does not undercut the concept of equal treatment for equal priority claims. All of the seventh priority claims, as well as the junior general unsecured claims, were treated alike. *Id.* at 59-60. Interestingly, *Snowden* also adopted the general approach of allowing the special treatment because it was necessary to a successful reorganization. *See id.* at 61.

220. *See supra* note 217. The *Snowden* court would not save the provision because the timing of payment of claims in the hypothetical plan would be different. *Snowden,* 110 Bankr. at 56. *See supra* note 219.

221. *Cf.* 11 U.S.C. § 726(b) (1988) (requiring that claims within a particular class be paid pro rata in a chapter 7 liquidation case if there are inadequate funds to pay the holders of claims

V. Interaction Between Trust Fund Tracing and Designation Issues

The implication of *Begier*'s "reasonable assumptions"[222] at the commencement of a chapter 11 case probably limits the designation of payments to trust fund liabilities, permitted under *Energy Resources*. A chapter 11 debtor in possession or a trustee is not free to designate the payment within a plan of funds which are not property of the estate. According to *Begier*, the IRS may have a right to the funds traced to a trust under the "reasonable assumption" that funds in the debtor's accounts are withheld taxes belonging to the trust fund. Consequently, the designation issue addressed in *Energy Resources* may only arise to the extent that funds deemed held in trust under "reasonable assumptions" are insufficient to satisfy the debtor's trust fund liability.

On the other hand, *Energy Resources* and *Begier*, in tandem, do afford a debtor in chapter 11 considerable flexibility in benefiting the responsible person. The debtor can make a non-avoidable payment prior to bankruptcy, or alternatively can designate that tax payments first be applied to trust fund liabilities.[223] In fact, because a debtor is likely to have an immediate need for working capital, the well-counseled potential chapter 11 debtor will probably find a voluntary pre-bankruptcy payment of trust funds, like that made in *Begier*, to be highly undesirable. Consequently, *Begier* is best understood as a chapter 7 case. In effect, *Begier* permits a corporate debtor on the eve of filing for chapter 7 liquidation to designate a payment to trust fund liabilities simply by the act of payment alone. Such a payment will, of course, commensurately relieve the responsible person of liability for the one hundred percent penalty, and override the priorities of chapter 7.[224] In fact, such a course of action could be so attractive to a corporate debtor that it might attempt to liquidate its tangible assets

---

of a particular class in full). *See supra* note 88. The theory behind this provision certainly should be adopted in a chapter 11 liquidation. *See also* 11 U.S.C. § 1129(a)(7) (1988) (requiring each claimant to receive property with a value of at least what would have been realized under chapter 7).

222. *Begier*, 110 S. Ct. at 2258. *See supra* notes 133-35 and accompanying text.

223. In a chapter 11 case, the debtor will generally wish to prevent the impressing of a trust on its accounts in order to preserve its designation option. Even under "reasonable assumptions," a debtor may easily, intentionally or unintentionally, manage its cash in such a manner as to avoid the tracing of withheld funds to a commingled account existing at the time the bankruptcy case commences. *See supra* notes 133-35 and accompanying text.

224. *See supra* notes 81-88 and accompanying text.

to the extent necessary to satisfy its trust fund liabilities for the benefit of the responsible person.

The Service, conversely, probably would not wish to apply such a payment to trust fund liabilities, but would have no choice under its own declared policy of honoring taxpayers' designations of voluntary payments[225] and under the established principles of *Muntwyler*.[226] Similarly, after commencement of a chapter 7 case, the Service would probably not wish to have a trust imposed under "reasonable assumptions" upon monies in the debtor's general accounts, since to do so would relieve the responsible person from his statutory guaranty under I.R.C. section 6672 and would leave the IRS with a noncollectible claim for non-trust fund liabilities. The corporate debtor and responsible person, of course, probably would wish to see the trust imposed. Given the Supreme Court's decision in *Energy Resources*, therefore, it is painfully clear that the IRS lost, not won, in *Begier*.

The recent decisions have further potential implications in the area of IRS collection activities. If the Service seizes a bank account of a debtor who has both trust fund and non-trust fund liabilities, traditional principles would appear to dictate that the "payment" is involuntary, and the IRS will apply the funds in the account to non-trust fund liabilities.[227] If, however, the debtor can trace the funds in the account by "reasonable assumptions" to trust funds, the court may force the IRS to reapply the payment to trust fund liabilities when bankruptcy is later filed, preventing a potential preference. Although the facts of *Begier* concerned a prepetition voluntary payment, since the same "reasonable assumptions" apply both prepetition and postpetition,[228] any funds held in a commingled account are trust funds to the extent of the original trust funds which can be traced into the account. Thus, it is at least arguable that *Begier* changed the common law tracing rule as to involuntary payments (i.e., seizures) as well as to voluntary payments of trust fund liabilities.[229] Moreover, in cases where other creditors have significant claims ahead of the IRS in priority, the Service may wish to apply all involuntary payments to trust fund liabilities, regardless of tracing, where bankruptcy is imminent.[230] Thus, the distinction between the IRS treatment of voluntary

---

225. *See supra* notes 33-34 and accompanying text.

226. *See supra* notes 51-59 and accompanying text.

227. *See supra* notes 36-37 and accompanying text.

228. *See Begier*, 110 S. Ct. at 2266.

229. *See, e.g., In re* R & T Roofing Structures & Commercial Framing, Inc., 887 F.2d 981, 987 (9th Cir. 1989) (rejecting the arguments finally adopted in *Begier* and relying on the common law of trusts, which was rejected in *Begier*).

230. *See supra* note 136.

and involuntary payments prior to bankruptcy may begin to evaporate. The ultimate effect of *Energy Resources* and *Begier* may be the evisceration of the voluntary-involuntary distinction in the bankruptcy context.

VI. Conclusion

Given the likelihood of further litigation in the designation area, particularly with regard to the standard of "necessary to the success of a reorganization plan," it is unfortunate that the Supreme Court in *Energy Resources* left the application of the "necessity" standard somewhat vague. Although the Court discarded the unfruitful voluntary-involuntary analysis in the bankruptcy context, it failed to address the established bankruptcy law requiring a proportionate payment of claims, in this case trust fund and non-trust fund taxes, within the same bankruptcy priority.[231]

Congress should address the choice between the pro rata alternative or the new status quo. However, it should be recognized that the Bankruptcy Code already balances the policies behind payment of these tax claims in a detailed and certain manner.[232] At this stage, congressional affirmation of this fact will eliminate the unseemly use of responsible person liability as a "bargaining chip" in reorganization negotiations by an individual who may have broken the criminal tax law. Congress should enact legislation clarifying the proportionate payment of equal priority tax claims in order to return the balance lost by *Energy Resources*. Such legislation is a workable compromise between the apparently per se "necessity" rule of *Energy Resources* and the previously proposed legislation (which would permit a government to apply payments of taxes in bankruptcy as it saw fit).[233]

With regard to the voluntary payment of "trust funds" prior to bankruptcy, the Supreme Court's decision in *Begier* questionably used the legislative history of the 1978 Bankruptcy Code to interpret I.R.C. section 7501, originally enacted in 1934, creating a new form of "trust" free of the common law rules of tracing. While on the surface *Begier* appears to be a major victory in this area for the Service, in fact, due to the impact of *Energy Resources*, *Begier*'s application will generally be confined to chapter 7 cases, where it will be used to minimize the liability of responsible persons for the one hundred percent penalty.

---

231. *Energy Resources*, 110 S. Ct. at 2139.
232. 11 U.S.C. §§ 101-1330.
233. *See supra* note 94.

Begier will "invisibly boomerang"[234] to the detriment of the Service and the public fisc.

The real "winner" in *Begier* was, again, the responsible person. While both *Begier* and *Energy Resources* undercut the one hundred percent penalty by permitting its use as a collection device to be circumvented, the real "loser" in these cases was probably the traditional voluntary-involuntary distinction. The practical effect of these cases may be the elimination of that dichotomy in the bankruptcy context, with the courts directing the application of payments made in bankruptcy and the debtor effectively designating the application of prebankruptcy "payments" arising as a result of the involuntary seizure of its property.

---

234. *See* Arrowsmith v. Commissioner, 344 U.S. 6, 12 (1952) (Jackson, J., dissenting) ("[the Court's] sporadic omnipotence in a field beset with invisible boomerangs").