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Two Valid Approaches for Determining Whether "Taxes" Get Priority in Bankruptcy Cases

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INTRODUCTION

In bankruptcies, tax status often effects whether claims are entitled to priority.[1] Thus, debates about whether charges are penalties or taxes date back to the early twentieth century.[2] In 1930, the Supreme Court established that courts are not bound to the characterization given to a charge by the municipality that created it.[3] Rather, courts have a duty to consider the "real nature" and "effect" of the charge.[4] Accordingly, different circuits have implemented different approaches to make these determinations.[5]

This Article examines the ambiguity among circuits regarding charges' "tax" status and resulting priority entitlement.[6] Part I outlines *In re Lorber*'s multi-factor test in the Ninth Circuit.[7] Part II outlines *In re Peete*'s functional examination test in the Seventh Circuit.[8] Part III examines the tests' similarities and differences. The Article concludes by contextualizing the concurrent validity of both approaches.

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[1] *See* 11 U.S.C. § 507(a)(8)(B) (2018); 11 U.S.C. § 64(a)(4) (2018).
[2] *See* Galveston, H. & S. A. Ry. Co. v. Texas, 210 U.S. 217, 223–24 (1908).
[3] *See* Carpenter v. Shaw, 280 U.S. 363, 367–68 (1930).
[4] *Id.*
[5] *Compare In re* Peete, 642 B.R. 299 (Bankr. E.D. Wis. 2022), *with In re* Lorber Indus. Cal., Inc., 675 F.2d 1062 (9th Cir. 1982).
[6] *See* 11 U.S.C. § 507(a)(8)(B); *In re Peete*, 642 B.R. at 306.
[7] 675 F.2d at 1062.
[8] 642 B.R. at 311–12.

DISCUSSION

I. *In re Lorber* Creates a Bright Line Multi-Factor Test for Determining Whether Charges Are Taxes or Penalties

In 1982, the Ninth Circuit decided *In re Lorber*.[9] The issue was whether section 104(a)(2) of title 11 of the United States Code (the "Bankruptcy Code") entitled the creditor (the "District"), to priority status in receiving "user fees" from its debtor ("Lorber").[10] The Bankruptcy Code provides that "taxes which became legally due and owing by the bankrupt . . . which are not released by a discharge" have priority status.[11] Accordingly, the District contended that the charges were taxes owed by Lorber and thus entitled to priority status. In response, Lorber objected to the District's claim "contending that the charges constituted a general unsecured claim."[12]

The Ninth Circuit held that the purpose of the Bankruptcy Code is "to bring about an equitable distribution of the debtor's estate" and that "[t]he priority provisions of section 64(a) run counter to that purpose."[13] The court reasoned that charges must satisfy two requirements to be taxes entitled to priority under the Bankruptcy Code.[14] First, the charge must be a "tax" as defined by federal law.[15] Second, the charge's "classification as a priority claim[] must be consistent with the terms and purposes of section 64(a) and other provisions of the act."[16]

To analyze whether a charge is a "tax," the *Lorber* court adopted the multi-factor test developed in *In re Farmers Frozen Food Co.*[17] *Lorber's* test established that an exaction is a tax if it is: "(a) An involuntary pecuniary burden, regardless of name, laid upon individuals or

[9] 675 F.2d at 1065–66.
[10] *Id.*
[11] 11 U.S.C. § 104(a)(4).
[12] *In re Lorber*, 675 F.2d at 1065.
[13] *Id.* at 1066.
[14] *Id.*
[15] *Id.* (citing New York v. Feiring, 313 U.S. 283, 285 (1941)).
[16] *Id.* (citing the same).
[17] *See* 221 F. Supp. 385 (N.D. Cal. 1963), *aff'd*, 332 F.2d 793 (9th Cir. 1964); *In re Lorber*, 675 F.2d at 1066.

property; (b) Imposed by, or under authority of the legislature; (c) For public purposes, including the purposes of defraying expenses of government or undertakings authorized by it; [and] (d) Under the police or taxing power of the state."[18] Courts look to any one of the dispositive factors in their penalty or tax determination.[19]

The "involuntary pecuniary burden" requirement anchored the *Lorber* court's analysis.[20] Holding the requirement must be read consistent with *New Jersey v. Anderson*, the court opined that "if Lorber's use of the system was voluntary, . . . we are not free to consider the practical and economic factors which constrained Lorber to make the choices it did."[21] In determining voluntariness "[t]he focus is not upon Lorber's motivation, but on the inherent characteristics of the charges."[22] Since the usage fee arose from Lorber's acts, it falls within the non-tax fee classification defined by the Supreme Court in *Nat'l Cable Television Ass'n v. United States*.[23] Because the fees arose from Lorber's increased wastewater, which was a voluntary act not shared by others, the court found it to be a non-tax.[24]

II. *In re Peete* Creates a Balancing Functional Examination Test for Determining Whether Charges Are Taxes or Penalties

In June of 2022, the Bankruptcy Court of the Eastern District of Wisconsin decided whether section 507(a)(8)(B) of the Bankruptcy Code entitled the creditor (the "City") to priority status in receiving "special charges" from its debtor ("Peete").[25] The Bankruptcy Code states that certain expenses and claims have priority status including "unsecured claims of governmental

[18] *In re Lorber*, 675 F.2d at 1066.
[19] *Id.*
[20] *Id.*
[21] *Id.* (citing New Jersey v. Anderson, 203 U.S. 483, 491 (1906)).
[22] *In re Lorber*, 675 F.2d at 1066.
[23] 415 U.S. 336, 340–41 (1974) ("A fee, [] is incident to a voluntary act . . . . The public agency performing [the applicable services] normally may exact a fee for a grant which, presumably, bestows a benefit on the applicant, not shared by other members of society."); *In re* Lorber, 675 F.2d at 107.
[24] *In re Lorber*, 675 F.2d at 1066.
[25] *In re* Peete, 642 B.R. 299, 310–12 (Bankr. E.D. Wis. 2022).

units, only to the extent that such claims are for . . . a property tax."[26] Accordingly, the City contended that the charges were property taxes and thus entitled to priority status, whereas Peete objected to the City's claim alleging the charges in question were "not property taxes and should be treated like other general unsecured claims."[27]

The court found that the City "failed to explain the nature or purpose" of the charges, and thus, it was "not apparent" whether the charges were assessed to collect funds for public benefit (indicating a tax) or to compensate for service(s) provided to the individual (indicating a penalty).[28] The court reached its decision for two reasons.[29] First, "the party seeking to establish a priority claim bears the burden of proving that the claim is entitled to priority treatment," and the City failed to meet this burden.[30] Second, because the Bankruptcy Code defines neither "tax" nor "property tax," courts must "conduct a 'functional examination' of whether any particular charge should be considered a property tax."[31]

Said functional examination must determine "whether the charges generate revenue for general public purposes, or for the regulation and benefit of the parties upon whom the fees are imposed."[32] The former indicates a tax, and the latter indicates a penalty.[33] The court held that "the only material distinction [between taxes and fees] is between exactions designed to generate revenue—taxes, whatever the state calls them . . . —and exactions designed [] to punish (fines, in

[26] 11 U.S.C. § 507(a)(8)(B).
[27] *In re Peete*, 642 B.R. at 300.
[28] *Id.* at 302.
[29] *Id.*
[30] *Id.* at 309 (citing *In re* Alewelt, 520 B.R. 704, 708–10 (Bankr. C.D. Ill. 2014) (concluding that the creditor had the burden to prove by the preponderance of evidence that his claim was entitled to priority treatment)).
[31] *Id.* at 305.
[32] *Id.* at 311.
[33] *Id.*

a broad sense)."[34] Rather than look to one of multiple factors, courts balance the overall nature of the charge.[35]

In re Peete made five such determinations.[36] First, it determined that certain "special charges" were penalties rather than taxes because the City failed to meet its burden of proof.[37] Second, it determined that other "special charges" were penalties rather than taxes because the charges were "meant to *discourage* unwanted conduct" and "defray the City's costs in providing services to *specific* property owners."[38] Third, it determined that the "penalties" from "interest and penalties" were penalties because the City failed to meet its burden of proof.[39] Fourth, it determined that the tax principal was a tax.[40] Fifth, it determined that the portion of the prepetition interest attributable to the principal tax was a tax.[41] In total, all charges but the tax principal and prepetition interest were deemed penalties and thus not entitled to priority.[42]

III. Both Tests Remain Viable to Determine Whether Charges Are Penalties or Taxes Under Bankruptcy Law

The main differences between the tests lie in their construction.[43] While the *Lorber* multi-factor test presents a bright line catch-all for what constitutes a tax, the *In re Peete* functional examination test presents a balancing analysis for determining the same.[44] Initially, the tests seem to fall on different sides of the formalism to functionalism spectrum.[45] However, *In re Lorber*'s extended analysis of the "voluntary pecuniary burden" element produced conflicting

[34] *Id.* at 310.
[35] *Id.*
[36] *Id.* at 311–312.
[37] *Id.* at 311.
[38] *Id.* at 311–12.
[39] *Id.* at 309, 312 ("The City [] offered no viable argument that any of the penalty charges [were] entitled to priority.").
[40] *Id.* at 312.
[41] *Id.*
[42] *Id.*
[43] *Compare In re* Lorber, 675 F.2d 1062, 1066 (9th Cir. 1982), *with In re* Peete, 642 B.R. at 305.
[44] *See In re Lorber*, 675 F.2d at 1066; *but see In re Peete*, 642 B.R. at 305.
[45] *See generally In re Lorber*, 675 F.2d at 1062 (functional examination test); *In re Peete*, 642 B.R. at 306 (multi-factor test).

"well-reasoned opinions" reducing the first prong of the otherwise formalist multi-factor test to a balancing question—deciding between the multiple opinions "[o]n balance.[46] Irrespective of their construction, the tests' substantive similarities and differences highlight how future courts may arrive at identical or opposite conclusions.

At their core, the tests are similar because they both weigh the overall purpose of the Bankruptcy Code.[47] Additionally, they both weigh whether a charge defrays a municipality's costs.[48] Further, they both acknowledge the importance of a charge's scope.[49]

However, the tests' differences outline the basis for opposite rulings. While, *In re Lorber* presents four elements to determine a charge's priority status, *In re Peete* held that "the *only* material distinction" between taxes and fees were that taxes are "exactions designed to generate revenue" whereas fees are "exactions designed to punish . . . or to compensate for a service."[50] Additionally, while *In re Peete* focused on the nature of the charge in its determination, *In re Lorber* focused largely on voluntariness.[51] These discrepancies can yield different results begging the question of which test to apply.

Since its decision, *In re Lorber* has received mixed treatment. While it has received some positive treatment from every circuit, it has also been criticized by the First, Third, Sixth, and Tenth Circuits.[52]

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[46] *In re Lorber*, 675 F.2d at 1067.
[47] *See id.*; *In re Peete*, 642 B.R. at 311.
[48] *See In re Lorber*, 675 F.2d at 1066 (holding the third factor in the test weighs "defraying expenses of government"); *In re Peete*, 642 B.R. at 311 (holding some charges were penalties because they meant to "defray the City's costs in providing services to property owners").
[49] *See In re Lorber*, 675 F.2d at 1067 (holding the charge was not a tax because the services were "provided to the industrial users, rather than to the general local population"); *In re Peete*, 642 B.R. at 311 (holding charges were not taxes because they were neither "imposed on all property owners in [the] community, nor . . . generate[d] revenue to benefit the general public").
[50] *See In re Lorber*, 675 F.2d at 1067; *In re Peete*, 642 B.R. at 310.
[51] *In re Lorber*, 675 F.2d at 1066 ("Taxes are not equivalent to debts, which are voluntary obligations based on express or implied contracts. Taxes are levied without consent or voluntary action of the taxpayer.").
[52] *See* Workers' Comp. Trust Fund v. Saunders, 234 B.R. 555, 562–64 (D. Mass. 1999) (first circuit) ("Given the problems with the *Lorber* test, the court agrees . . . that it would not be appropriate to apply that test in the context of

Multiple courts criticize *In re Lorber*'s four factor test for being "too broad."[53] Critics of the *Lorber* test's breadth highlight how the authority and power referenced in the second and fourth factors describe "virtually every government program."[54] The third factor is similarly all-encompassing because "all money collected by the Government goes toward defraying its expenses, and is used for public purposes . . . [o]r so [the Government] say[s]."[55] By having some public purpose including, but not limited to, defraying government expense, the government need only prove voluntariness to "automatically win[] priority for all money any debtor owes it."[56]

Despite being decided in June of 2022, *In re Peete* has already received favorable treatment.[57] However, the *In re Peete* test itself has yet to be either adopted or criticized.[58]

While the *Lorber* test is older, it is also widely criticized.[59] While the *Peete* test has not been criticized, it has also not been adopted.[60] Although the functional examination test from *In re Peete* analyzed a chapter 13 claim and the multi-factor test from *In re Lorber* analyzed a

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the workers' compensation reimbursement claim here."); *In re* Marcucci, 256 B.R. 685, 694 (D.N.J. 2000) (third circuit) ("Because it appears that the Supreme Court has declined to adopt the reasoning employed in *Lorber* and because of the valid concerns voiced by other Courts about the *Lorber* test's overbreadth, this Court declines to follow *Lorber* in deciding whether the subject surcharges are taxes for bankruptcy purposes."); *In re* Suburban Motor Freight, 998 F.2d 338, 341 (6th Cir. 1993) (sixth circuit) ("The threat of the *Lorber* reasoning, then, is that the Government automatically wins priority for all money any debtor owes it, regardless of the nature of the payments."); *In re* Freymiller Trucking, 194 B.R. 914, 916 (Bankr. W.D. Okla. 1996) (tenth circuit) ("I find, however, two problems with the analysis of *Lorber*.").

[53] *In re* Marcucci, 256 B.R. at 694.

[54] *In re* Suburban Motor Freight, 998 F.2d at 341.

[55] *Id.* at 341 n.4.

[56] *Id.* at 341.

[57] *See In re* Harris, No. 21-23864-kmp, 2022 WL 4389318 at *3 (Bankr. E.D. Wis. September 22, 2022) (quoting *In re Peete* in holding that creditors bear the burden of proving a charge's priority status when asserting the charge is a tax rather than a penalty).

[58] *See generally In re* Peete, 642 B.R. 299, 306 (Bankr. E.D. Wis. 2022).

[59] *See* Workers' Comp. Trust Fund v. Saunders, 234 B.R. 555, 562–64 (D. Mass. 1999); *In re* Marcucci, 256 B.R. 685, 694 (D.N.J. 2000); *In re* Suburban Motor Freight, 998 F.2d at 341; *In re* Freymiller Trucking, 194 B.R. 914, 916 (Bankr. W.D. Okla. 1996).

[60] *See generally In re* Peete, 642 B.R. at 306.

chapter 11 claim, the *In re Peete* court did not comment as to whether the chapter of the Bankruptcy Code had any bearing on its different analysis.[61]

CONCLUSION

In re Peete legitimized a second test for determining whether charges are taxes or penalties in bankruptcy proceedings.[62] By distinguishing from *In re Lorber* rather than rejecting it, the court left future cases open to either the multi-factor test or the functional analysis test.[63] As a result, debtors and creditors must be aware of both tests and the distinguishing factors between them.

[61] *Id.* at 311.
[62] *Id.*
[63] *Id.*