

Tax Recommendations of the Commission on the Bankruptcy Laws-Priority and Dischargeability of Tax Claims

William T. Plumb Jr.

Follow this and additional works at: <http://scholarship.law.cornell.edu/clr>

 Part of the [Law Commons](#)

Recommended Citation

William T. Plumb Jr., *Tax Recommendations of the Commission on the Bankruptcy Laws-Priority and Dischargeability of Tax Claims*, 59 Cornell L. Rev. 991 (1974)
Available at: <http://scholarship.law.cornell.edu/clr/vol59/iss6/1>

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

CORNELL LAW REVIEW

Volume 59

August 1974

Number 6

THE TAX RECOMMENDATIONS OF THE COMMISSION ON THE BANKRUPTCY LAWS—PRIORITY AND DISCHARGEABILITY OF TAX CLAIMS

William T. Plumb, Jr.†

Table of Contents

I. PRIORITY OF TAX LIENS AND CLAIMS	992
A. <i>Statutory Liens for Taxes</i>	993
1. <i>Current Law</i>	993
2. <i>The Commission's Proposals</i>	1003
B. <i>Priority of Nonlien Tax Claims and Other Claims</i> ...	1008
1. <i>Current Law</i>	1008
2. <i>The Commission's Proposals</i>	1016
a. <i>Administrative Taxes</i>	1016
b. <i>Priorities Superior to Prebankruptcy Tax Claims</i>	1022
c. <i>Tax Claims Antedating Administration</i>	1025
d. <i>Interest on Taxes</i>	1035
e. <i>Tax Penalties</i>	1037
C. <i>Insolvency Priorities Contrasted</i>	1045
II. DISCHARGE OF TAX OBLIGATIONS	1049
A. <i>Current Law</i>	1050
B. <i>The Commission's Proposals</i>	1054
C. <i>An Alternative Suggestion</i>	1060

The Commission on the Bankruptcy Laws of the United States (hereinafter called "the Commission"), pursuant to congressional

† Member, District of Columbia Bar; A.B. 1936, University of Rochester; LL.B. 1939, Cornell University; consultant to the Commission on Bankruptcy Laws of the United States. The views expressed herein are the author's and not necessarily those of the Commission or its staff.

mandate,¹ has reported its recommendations for the first comprehensive revision of the bankruptcy laws since the Chandler Act of 1938.² This Article deals with the proposed revision of the provisions relating to priority and dischargeability of tax claims in cases under the Bankruptcy Act.³

I

PRIORITY OF TAX LIENS AND CLAIMS

The Commission proposed major changes in the priority status of tax liens and claims in bankruptcy. Under the proposed act, statutory liens for taxes, other than *ad valorem* property taxes and special assessments, are no longer recognized as against the trustee.⁴ Income taxes and employment taxes, other than taxes withheld from wages, for periods before the filing of the bankruptcy petition rank only as general claims unless the due date of the tax return falls after or within one year preceding the petition date, regardless of whether the debtor makes a legitimate or fraudulent return.⁵ Older taxes for which an extension of time for payment had been granted retain their priority except as to payments more than one year in arrears.⁶ Employment taxes imposed on the debtor with respect to wages earned before but paid after filing the petition are deemed prebankruptcy taxes for priority purposes, but amounts required to be withheld from such wages share the priority status of those wages.⁷ The amount available for tax claims is further reduced by liberalization of the superior priority for wages and by addition of a new priority for pension plans and similar contributions.⁸ Federal nontax claims do not enjoy any priority in bankruptcy under the new proposal. Penalties and postbankruptcy interest are no longer disallowed, but are

¹ S.J. Res. of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

² Act of June 22, 1938, ch. 575, 52 Stat. 840.

³ Bankruptcy Act §§ 17a, 64a, 11 U.S.C. §§ 35(a), 104(a) (1970).

⁴ COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT, PART II (PROPOSED BANKRUPTCY ACT), H.R. DOC. NO. 137, 93d Cong., 1st Sess. § 4-606 (1973) [hereinafter cited as PROPOSED BANKRUPTCY ACT]. The proposed legislation has been introduced in Congress as H.R. 10792 and S. 2565, 93d Cong., 1st Sess. (1973).

⁵ This is true regardless of whether assessment of a tax deficiency was restrained at the time.

⁶ PROPOSED BANKRUPTCY ACT § 4-405(a)(5). Priorities of other forms of taxes would be even further restricted, as detailed hereafter.

⁷ PROPOSED BANKRUPTCY ACT § 4-405(c).

⁸ *Id.* §§ 4-405(a)(3), (4).

subordinated to general claims.⁹ These rules of priority also apply in reorganization cases; the present principle of absolute federal priority is discarded.¹⁰

A. *Statutory Liens for Taxes*

1. *Current Law*

Although the Constitution empowers Congress to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States,"¹¹ the regulation of insolvencies was left, during most of the nineteenth century, to the states, subject only to congressional insistence that "the debts due to the United States shall be first satisfied."¹² Nevertheless, during that century three depression-born but short-lived federal bankruptcy acts were adopted.¹³ The first of these, enacted in 1800 and repealed in 1803, decreed that, subject only to the overriding federal priority,¹⁴ all creditors should be paid proportionately, irrespective of any security they might have "by judgment, statute, recognizance, or speciality."¹⁵ All subsequent federal bankruptcy legislation, however, from the abortive acts of 1841¹⁶ and 1867¹⁷ to the permanent system established in 1898, has "traditionally recognized that a lien is a valid property right which must be satisfied out of the assets to which it attaches before any part of those assets becomes available for distribution to unsecured creditors,"¹⁸ subject only to excep-

⁹ *Id.* §§ 4-405(a)(8), (9).

¹⁰ *Id.* § 7-303(2).

¹¹ U.S. CONST. art. I, § 8, cl. 4.

¹² REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1970) (originating in substantially its present form in Act of March 3, 1797, ch. 20, § 5, 1 Stat. 515).

¹³ See *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 581-82 (1935). See generally C. WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* (1935).

¹⁴ Act of April 4, 1800, ch. 19, § 62, 2 Stat. 36, *repealed*, Act of Dec. 19, 1803, ch. 6, 2 Stat. 248.

¹⁵ *Id.* § 31, 2 Stat. 30. See also *id.* § 62, 2 Stat. 36.

¹⁶ Act of Aug. 19, 1841, ch. 9, § 2, 5 Stat. 442 (repealed 1843) (construed in *Peck v. Jenness*, 48 U.S. (7 How.) 612 (1849)).

¹⁷ Act of March 2, 1867, ch. 176, §§ 14, 20, 14 Stat. 522-26 (repealed 1878) (construed in *Yeatman v. New Orleans Sav. Institution*, 95 U.S. 764, 766 (1878); *Doe v. Childress*, 88 U.S. (21 Wall.) 642 (1875)).

¹⁸ S. REP. NO. 1159, 89th Cong., 2d Sess. 2 (1966) [hereinafter cited as SENATE REPORT], quoting H.R. REP. NO. 686, 89th Cong., 1st Sess. 2 (1965) [hereinafter cited as HOUSE REPORT]; accord, *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 135 (1962) ("[p]roperty interests in a fund not owned by a bankrupt at the time of adjudication, whether complete or partial, legal or equitable, mortgages, liens, or simple priority of rights are . . . not a part of the bankrupt's property and do not vest in the trustee"). See also *Oppenheimer v. Oldham*, 178 F.2d 386, 389 (5th Cir. 1969).

tions designed: (1) to exclude preferential and fraudulent transactions¹⁹ and disguised rules of priority,²⁰ and (2) to place the trustee in at least as favorable a position as an execution creditor.²¹

Although none of the acts before 1938 referred expressly to *statutory* liens, as distinguished from those arising by agreement or obtained by judicial acts or proceedings, it was well established that, if duly perfected and not otherwise invalidated, statutory liens shared in the recognition which the acts gave generally to "liens."²² The Chandler Act of 1938 made it explicit not only that "statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or any State or subdivision thereof" were valid in bankruptcy, but also that they could not be voidable as preferences "even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition." Such a lien arising before bankruptcy might be perfected thereafter, within the time permitted by applicable law.²³ That congressional action, coupled with the Act's deletion of the former blanket recognition of any priority provided by state law,²⁴ triggered a movement to convert state law priorities into statutory liens, thus defeating the congressional purpose to make priorities in bankruptcy "uniform . . . throughout the United States."²⁵ Concluding that "[l]iens on personal property unaccompanied by possession . . . are of the nature of 'floating liens,' which attach to all a debtor's personalty, although the property he owns is com-

¹⁹ Fraudulent and preferential liens were dealt with in the Act of Aug. 19, 1841 (ch. 9, § 2, 5 Stat. 442), the first act that recognized liens at all. See Bankruptcy Act §§ 60, 67a, 11 U.S.C. §§ 96, 107(a) (1970).

²⁰ See notes 30-35 and accompanying text *infra*.

²¹ The Act of July 1, 1898 (ch. 541, § 67a, 30 Stat. 564), first imposed the express condition that "[c]laims which for want of record or for other reasons would not have been valid liens as against the claims of the creditors of the bankrupt shall not be liens against his estate." That provision was fortified by the Act of June 25, 1910 (ch. 412, § 8, 36 Stat. 840), giving the trustee, in effect, the rights that a creditor holding an execution or other lien by legal or equitable proceedings would have. See *United States v. Speers*, 382 U.S. 266, 271-72 (1965); *Lewis v. Manufacturers Nat'l Bank*, 364 U.S. 603 (1961).

²² *Richmond v. Bird*, 249 U.S. 174 (1919); *Henderson v. Mayer*, 225 U.S. 631 (1912); *In re Knox-Powell-Stockton Co.*, 100 F.2d 979 (9th Cir. 1939); *In re Brannon*, 62 F.2d 959 (5th Cir. 1933).

²³ Act of June 22, 1938, ch. 575 § 67b, 52 Stat. 876-77.

²⁴ Act of May 27, 1926, ch. 406, § 15, 44 Stat. 666-67. The incorporation of state law priorities had originated in the Act of March 2, 1867 (ch. 176, § 28, 14 Stat. 531).

²⁵ U.S. CONST. art. I, § 8, cl. 4. The Supreme Court, with reference to the earlier laws, had declared that constitutional uniformity was not lacking "when the trustee takes in each State whatever would have been available to the creditors if the bankrupt law had not been passed." *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 190 (1902).

monly changing from day to day,"²⁶ Congress, in 1952, declared invalid against the trustee "statutory liens created or recognized by the laws of any State for debts owing to any person, including any State or any subdivision thereof, on personal property not accompanied by possession of, or by levy upon or by sequestration or distraint of, such property," unless such liens had been enforced by sale before the filing of the petition.²⁷ Certain nonpossessory and unenforced statutory liens on personal property, nevertheless, were not invalidated but continued to be postponed in payment to the two most favored priority classes—administration expenses and wages.²⁸ Among the statutory liens which were merely postponed but not invalidated were those created by federal law, including "liens for taxes and debts owing to the United States." Despite some ambiguity resulting from an overlap in the terms of the invalidation and postponement provisions, liens for taxes owing to states and their subdivisions were held to be subject merely to postponement.²⁹

In 1966, Congress reexamined the problem of overcoming "the distortion of the Federal Order of distribution by the creation of spurious statutory liens," and concluded that "neither the standard of possession nor the distinction between real and personal property is an entirely satisfactory criterion," since "[s]ome lines [*sic*] which are genuine property rights are affected and others which were essentially State-created priorities escape."³⁰ Therefore, "[t]o insure the supremacy of the order of distribution provided in the Bankruptcy Act insofar as it is consistent with the continued recognition of genuine lien interests,"³¹ the 1966 legislation³² invalidated in bankruptcy: (1) every statutory lien, whether on real or personal property, "which first becomes effective upon the insol-

²⁶ H. REP. NO. 2320, 82d Cong., 2d Sess. 13 (1952). See also S. REP. NO. 1395, 82d Cong., 2d Sess. 7 (1952).

²⁷ Act of July 7, 1952, ch. 579, § 21, 66 Stat. 428 (amending Bankruptcy Act § 67c).

²⁸ *Id.* In order to minimize the consumption in satisfaction of liens of funds needed for those most favored priorities, wage claims of limited amount having been elevated above federal nontax debts in 1898 and over unsecured tax claims in 1926, the Chandler Act had postponed to such priorities the satisfaction of all nonpossessory and unenforced statutory liens on personalty, including those which Congress in 1952 determined wholly to invalidate. Act of June 22, 1938, ch. 575, § 67c, 52 Stat. 876-77.

²⁹ *Rochelle v. Dallas*, 264 F.2d 166 (5th Cir.), *cert. denied*, 361 U.S. 827 (1959); *In re Baron*, 165 F. Supp. 186 (D. Conn. 1958). See *In re Century Vault Co.*, 416 F.2d 1035, 1038 (3d Cir. 1969).

³⁰ SENATE REPORT 6, quoting HOUSE REPORT 5.

³¹ *Id.*

³² Act of July 5, 1966, Pub. L. No. 89-495, § 4; 80 Stat. 268, amending Bankruptcy Act § 67c(1), 11 U.S.C. § 107(c)(1) (1964) (codified at 11 U.S.C. § 107(c)(1) (1970)).

veny of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor," such a "lien" being viewed as merely determining the order of distribution rather than representing "a specific property right which may be asserted independently of a general distribution and regardless of the transfer of the property";³³ and (2) every statutory lien on real or personal property which is not perfected at the date of bankruptcy against one acquiring the rights of a bona fide purchaser³⁴ on that date, such a lien being viewed as "so tenuous" that the "holders of such liens have reason to know that their security is extremely vulnerable."³⁵ The invalidation of the second category of liens was qualified, however, by a proviso: if a statutory lien is sufficiently perfected at the date of bankruptcy to prevail over a judicial lien creditor,³⁶ but further action is still required to perfect the lien against a "subsequent" bona fide purchaser, the lien is nevertheless valid against the trustee even if the latter action is taken after bankruptcy but within the time permitted by the lien statute. Notice to the bankruptcy court was substituted for seizure if the latter was the prescribed perfecting action.³⁷

The proviso contains two ambiguities. One results from the failure of the statute to establish a time reference for the word "subsequent." Leading bankruptcy commentators have construed it to mean that postbankruptcy action which perfects the lien against persons purchasing *subsequent to such perfection* is sufficient. Professor King concluded that the effect thereof on bankruptcy administration "could become chaotic" in cases where applicable lien law sets no time limit on such perfection;³⁸ and Professor Marsh

³³ SENATE REPORT 6-7, quoting HOUSE REPORT 5-6.

³⁴ The term "bona fide purchaser" is defined to "include a bona-fide encumbrancer or pledgee and the transferee, immediate or mediate, of any of them." Bankruptcy Act, § 1(5), 11 U.S.C. § 1(5) (1970).

³⁵ SENATE REPORT 7, quoting HOUSE REPORT 6. In addition, certain liens for rent, with which we are not here concerned, were invalidated as liens but recognized as junior priorities, next above general creditors. Bankruptcy Act § 67(c)(1)(C), 11 U.S.C. § 107(c)(1)(C) (1970).

³⁶ The reference is to Bankruptcy Act § 70c, 11 U.S.C. § 110(c) (1970). The trustee receives the rights of "a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy," as well as of "a creditor who upon the date of bankruptcy obtained an execution returned unsatisfied against the bankrupt" and of one "who upon the date of bankruptcy obtained a lien by legal or equitable proceedings. . . ." *Id.*

³⁷ *Id.* § 67c(1)(B), 11 U.S.C. § 107(c)(1)(B) (1970).

³⁸ King, *Statutory Liens Under New § 67c of the Bankruptcy Act*, 42 REF. J. 11, 14 (1968). Professor King has suggested that the bankruptcy court utilize bar orders, under its general equitable powers, to cut short the time for perfection in such cases. King, *Post-Bankruptcy Perfection of Statutory Liens*, 72 COM. L.J. 346 (1967).

stated that the proviso makes the bona fide purchaser test mean, "for all practical purposes, nothing," because "a lien which cannot by any means be perfected as against a bona fide purchaser, not even by seizure of the property subject to the lien, is virtually inconceivable."³⁹

A construction which makes any provision of a statute a dead letter is to be avoided if at all possible.⁴⁰ With all the trepidation and some of the deference a tax man should feel in jousting with the bankruptcy experts on their home grounds, I suggest that another construction of the proviso enables the statute to make sense and carries out the declared intention of Congress to strike "at a lien which is so tenuous that it can be defeated by transfer to a bona fide purchaser."⁴¹ I submit that the only relevant time to which the word "subsequent" could reasonably refer is *the time of bankruptcy*. At that point, the trustee acquires title and, for this limited purpose, steps into the shoes of a bona fide purchaser.⁴² The only postbankruptcy action that will relieve the lienor is one which relates back and protects him against such an intervening bona fide purchaser—*e.g.*, a mechanic's lienor typically is protected against a bona fide purchaser subsequent to commencement of the work, provided he files notice within a prescribed period after completion.⁴³ This construction also appears to conform to the

³⁹ Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 722-23 (1967). Professor Marsh subsequently served as Chairman of the Commission on the Bankruptcy Laws.

In an effort to save the provision from being totally nugatory, as envisioned by Professor Marsh, the First Circuit concluded that notice to the court, as a substitute for seizure, will not meet the requirement for postbankruptcy perfection where seizure is provided by the lien law only as a means of enforcement and not of perfection. *In re J.R. Nieves & Co.*, 446 F.2d 188, 193 (1st Cir. 1971). *Contra*, *In re Trahan*, 283 F. Supp. 620, 627 (W.D. La.), *aff'd per curiam*, 402 F.2d 796 (5th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969). The First Circuit's view in making this one provision meaningful seems, however, to render meaningless the other provision for notice as a substitute for seizure, because it is difficult to conceive of a statutory lien for which seizure is provided as a means merely of perfection rather than of enforcement.

⁴⁰ *Gemsco, Inc. v. Walling*, 324 U.S. 244, 255 (1945); *General Motors Acceptance Corp. v. Whisnant*, 387 F.2d 774, 778 (5th Cir. 1968); *Jennings v. United States*, 168 F. Supp. 781 (Ct. Cl. 1958).

⁴¹ SENATE REPORT 7, quoting HOUSE REPORT 6.

Moreover, this construction may be made without the "tortuous reasoning" King has said such an interpretation would require. See King, *Post-Bankruptcy Perfection of Statutory Liens*, 72 COM. L.J. 346-47 (1967).

⁴² See Seligson, *Treatment of Statutory Liens in Bankruptcy—The 1966 Amendments of Section 67b and c*, 27 FED. B.J. 111, 116-17 (1967).

⁴³ The proviso was properly applied to protect a mechanic's lienor who commenced work before, but filed after, bankruptcy, pursuant to N.Y. LIEN LAW § 13(5) (McKinney 1966). *In re Chesterfield Developers, Inc.*, 285 F. Supp. 689 (S.D.N.Y. 1968). Since any lien

congressional intent merely to clarify the postbankruptcy perfection provision of the Chandler Act,⁴⁴ which had been viewed as not permitting perfection if, *at the date of bankruptcy*, the lien failed the applicable standard of validity against a judicial lien.⁴⁵

The second ambiguity in the proviso concerns whether the hypothetical bona fide purchaser into whose shoes the trustee steps includes one with some special additional attribute, since the rights of all bona fide purchasers are not identical, entitling him to protection not accorded purchasers generally. For example, it has been held that a mechanic's lien for work commenced before bankruptcy, filed thereafter within the time prescribed by state law for perfection against interim purchasers, is valid in bankruptcy even though *one class* of purchasers—those who obtained a covenant that the seller would hold the proceeds in trust for mechanic's lienors—could have taken free of the lien.⁴⁶ One questionable decision has gone so far as to hold that a lien which is valid against a subsequent purchaser who fails to take possession is valid in bankruptcy, although by merely taking possession a hypothetical purchaser could have prevailed.⁴⁷ A better reasoned opinion held, on similar facts, that the law placed the trustee in the shoes of a hypothetical purchaser in possession, saying that Congress "contemplated a full-blooded, not an anemic, purchaser."⁴⁸

Similar, although perhaps distinguishable, language was found in section 60a of the Chandler Act, making certain transfers, including security interests, voidable as preferences unless "*no bona-fide purchaser*" from the debtor could have acquired, within

law that permits *retroactive* perfection against purchasers would surely set a time limit, King's concern about open-ended perfectibility would be satisfied by this interpretation.

⁴⁴ Note 23 *supra*; see SENATE REPORT 13; HOUSE REPORT 11-12.

⁴⁵ *United States v. Speers*, 382 U.S. 266, 278 (1965); see 4 W. COLLIER, BANKRUPTCY ¶ 67.26 (14th ed. 1971). Collier views § 70c, which gives the trustee the rights of a judicial lien creditor at the date of bankruptcy, as predominant over § 67b, which permits postbankruptcy perfection in other respects, such as fixing by levy the amount of a property tax that had theretofore become an inchoate lien of sufficient force to prevail over judicial liens at the date of bankruptcy. See *De Laney v. City & County of Denver*, 185 F.2d 246, 252-53 (10th Cir. 1950). The 1966 amendment made it express that § 70c could not be overcome by postbankruptcy perfection. It would be consistent with the construction of the prior provision, which construction was merely "clarified," to conclude that the new test of perfection against bona fide purchasers refers to those who become such on the date of bankruptcy. Act of July 5, 1966, Pub. L. No. 89-495, § 5, 80 Stat. 269-70, amending Bankruptcy Act § 70c, 11 U.S.C. 110(c) (1964) (codified at 11 U.S.C. § 110(c) (1970)).

⁴⁶ *In re Chesterfield Developers, Inc.*, 285 F. Supp. 689 (S.D.N.Y. 1968).

⁴⁷ *In re Trahan*, 283 F. Supp. 620 (W.D. La.), *aff'd per curiam*, 402 F.2d 796 (5th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969).

⁴⁸ *In re J.R. Nieves & Co.*, 446 F.2d 188, 192 (1st Cir. 1971). See Countryman, *The Use of State Law in Bankruptcy Cases* (pt. II), 47 N.Y.U.L. Rev. 631, 640-45 (1972).

the four months before bankruptcy, rights in the property superior to the transferee's rights.⁴⁹ The Supreme Court construed this language to render voidable a security assignment of accounts receivable which, because of failure to comply with state law requiring notification of the account debtors, was subject to defeat by a subsequent bona fide assignee who did give such notice, although not by one who failed to do so.⁵⁰ And even where such a security assignment was valid under state law against a later purchaser of the accounts without need for notification of the account debtors, one court nevertheless held the assignment voidable in bankruptcy because it might be defeated by a later purchaser if he obtained payment or a novation from or judgment against the debtors.⁵¹ Another decision, however, rejected that view on the ground that the first assignment in such a case is vulnerable not to the second assignee's *status* as a bona fide purchaser but to the purchaser's later activities.⁵² A district court held, under former section 60a, that a trust receipt transaction, of which notice was duly filed sufficient to protect against a later security interest in or bulk sale of the goods in derogation of the security, nevertheless constituted a voidable preference because, at the time of bankruptcy, purchasers *in the ordinary course of business* could have taken free of the security interest. In reversing on other grounds, the Fourth Circuit expressed the strong view that a distinction should be drawn between a bona fide purchaser and a buyer in the ordinary course of trade, and that the Act was never intended to upset a transfer that involved a lien duly placed on public record.⁵³

One of the statutory liens affected by the foregoing rules of bankruptcy law is the federal tax lien. For over a century it has

⁴⁹ Section 60a of the Bankruptcy Act (now codified at 11 U.S.C. § 96(a) (1970) (emphasis added)) as amended by the Chandler Act (Act of June 22, 1938, ch. 575, § 60, 52 Stat. 869), used absolute terms in prescribing that *no* bona fide purchasers be able to acquire superior rights. However, present § 67c(1)(B) (11 U.S.C. § 107(c)(1)(B) (1970)), in speaking of "one acquiring the rights of a bona fide purchaser," may leave the courts more room for choosing the variety of bona fide purchaser referred to.

⁵⁰ *Corn Exchange Nat'l Bank & Trust Co. v. Klauder*, 318 U.S. 434 (1943). As a result of that decision, the bona fide purchaser test of perfection for preference purposes was later abandoned in favor of a judicial lien test. Act of March 18, 1950, ch. 70, § 1, 64 Stat. 24, amending Bankruptcy Act § 60a, 11 U.S.C. § 96(a) (1952) (codified at 11 U.S.C. § 96(a) (1970)).

⁵¹ *In re Vardaman Shoe Co.*, 52 F. Supp. 562 (E.D. Mo. 1943).

⁵² *In re Rosen*, 157 F.2d 997 (3d Cir. 1946), *cert. denied*, 330 U.S. 835 (1947).

⁵³ *Coin Machine Acceptance Corp. v. O'Donnell*, 192 F.2d 773 (4th Cir. 1951), *rev'g In re Harvey Distrib. Co.*, 88 F. Supp. 466 (E.D. Va. 1950). The Fourth Circuit's view of the matter was dictum, since the decision actually rested upon the intervening retroactive amendment abandoning the bona fide purchaser test. See note 50 *supra*.

been the view of the Congress that it is not enough to rely, for the collection of taxes, on a mere right of priority, however absolute, in the assets remaining in an insolvent estate.⁵⁴ Congress has felt the need for a lien that exists regardless of insolvency and follows the property even into the hands of third parties acquiring interests between the time when the tax is assessed and the time when the enforcement machinery can be brought to bear. The law provides, therefore, that a lien on all the property of the taxpayer, real and personal, tangible and intangible, shall automatically arise when any federal tax is assessed, if the tax is not paid on demand.⁵⁵ Against many forms of competing liens, the federal tax lien is effective as a secret encumbrance, without need for notice of any kind.⁵⁶ Originally, the secret lien was valid even against bona fide purchasers,⁵⁷ but later legislation has provided progressively greater protection for purchasers, holders of security interests, mechanic's lienors, and judgment lien creditors, unless notice of the tax lien has been duly filed in the office designated by law.⁵⁸ Since the tax lien attaches automatically to additional property whenever the taxpayer acquires it,⁵⁹ Marsh has characterized it as "a general, floating lien."⁶⁰ It differs markedly from the typical floating lien, however, in that, although the federal tax lien may float *onto* after-acquired property, one that is duly perfected never floats *off*, but, except in very limited circumstances, follows the property even into the hands of an innocent, albeit negligent, purchaser.⁶¹ Since it is enforceable against third parties apart from any insolvency or liquidation proceeding, a perfected federal tax lien, as well as those state tax liens which are imposed in similar terms,⁶² clearly has the characteristics of "genuine property rights," rather than of those "spurious statutory liens . . . which were in reality priorities" that Congress has heretofore invalidated in bankruptcy.⁶³

⁵⁴ Note 12 *supra*; see notes 339-74 and accompanying text *infra*.

⁵⁵ INT. REV. CODE OF 1954, §§ 6321-22 (originally enacted as Act of July 13, 1866, ch. 184, § 9, 14 Stat. 107).

⁵⁶ *United States v. City of New Britain*, 347 U.S. 81 (1954).

⁵⁷ *United States v. Snyder*, 149 U.S. 210 (1893).

⁵⁸ INT. REV. CODE OF 1954, § 6323. See generally W. PLUMB, FEDERAL TAX LIENS, chs. 2-5 (3d ed. 1972).

⁵⁹ *Glass City Bank v. United States*, 326 U.S. 265 (1945).

⁶⁰ Marsh, *supra* note 39, at 710.

⁶¹ *Pipola v. Chicco*, 274 F.2d 909 (2d Cir. 1960); *United States v. Stutsman County Implement Co.*, 274 F.2d 733 (8th Cir. 1960).

⁶² See, e.g., *United States v. Vermont*, 377 U.S. 351 (1964).

⁶³ See note 30 *supra*. The federal tax lien "is as binding as a mortgage, and has the same

Under present law, therefore, a federal tax lien duly filed before bankruptcy, or a state tax lien with equivalent characteristics, is valid against judgment lien creditors and, under normal circumstances, against bona fide purchasers.⁶⁴ It also enjoys lien status in the distribution of the estate subject to postponement in favor of administration expenses and preferred wage claims, so far as the liens attach to personal property.⁶⁵ On the other hand, if the lien is not so filed, it is invalid against the trustee in his "judgment creditor" capacity and therefore is not saved by the fact that postbankruptcy filing would perfect it against subsequent bona fide purchasers.⁶⁶ Hence, taxes secured only by unfiled liens are collectible in bankruptcy only as unsecured claims, which may or may not enjoy priority over general creditors.⁶⁷ In some circumstances even a duly filed tax lien may be denied lien status in bankruptcy on the ground that, although it is valid against judgment creditors, there is no means, short of seizure under levy, by which it may be perfected against certain bona fide purchasers. A filed federal tax lien attaching to securities, for example, is unconditionally invalid against bona fide purchasers for full value,⁶⁸ and such a lien on a motor vehicle is invalid against a purchaser who obtains possession before gaining actual notice or knowledge of the lien and who does not thereafter relinquish possession to the seller.⁶⁹ A filed federal tax lien on inventory is invalid against purchasers at retail in the ordinary course of the seller's business,⁷⁰ but is protected against other purchasers. Also, a filed federal tax lien on household goods, personal effects, and similar articles is invalid under certain conditions against a bona fide purchaser "in a casual sale for less than \$250."⁷¹ In any of these situations, the lien is perfectible under the tax law by seizure as against purchasers subsequent to the seizure.

capacity to hold the land [or other property] so long as the statute preserves it in force." *United States v. City of New Britain*, 347 U.S. 81, 84 (1954), quoting *Rankin v. Scott*, 25 U.S. (12 Wheat.) 104-05 (1827).

⁶⁴ INT. REV. CODE OF 1954, §§ 6321, 6333(a).

⁶⁵ See notes 28-29 *supra*.

⁶⁶ Postbankruptcy perfection against purchasers suffices only where there has been prebankruptcy perfection against judgment creditors. See notes 36-37 and accompanying text *supra*.

⁶⁷ *In re Autorama Tool & Die Co.*, 412 F.2d 369 (6th Cir. 1969), cert. denied, 397 U.S. 1043 (1970); see notes 126-33 and accompanying text *infra*.

⁶⁸ INT. REV. CODE OF 1954, § 6323(b)(1)(A). "Securities" include stock, bonds, negotiable instruments, and the like. *Id.* § 6323(h)(4).

⁶⁹ *Id.* § 6323(b)(2).

⁷⁰ *Id.* § 6323(b)(3).

⁷¹ *Id.* § 6323(b)(4).

Hence, it could be retroactively validated as a lien in bankruptcy by later notice to the bankruptcy court, if Marsh and King are correct that that kind of perfectibility meets the requirement of the Bankruptcy Act—and thus makes it mean, “for all practical purposes, nothing.”⁷² Even if their interpretation is not accepted,⁷³ the lien on motor vehicles may nevertheless be valid in bankruptcy if, as one court has held but another has denied, perfection against a purchaser *who fails to obtain possession* satisfies the requirement of the Act even though the lien is ineffective against a purchaser with possession.⁷⁴ Moreover, the lien on inventory and on household goods and personal effects may be valid if the Act means that perfection against purchasers *in general* suffices even though purchasers in particular circumstances could take free of the lien.⁷⁵

Tax liens antedating bankruptcy compete with other liens and security interests on substantially the same terms as if bankruptcy had not occurred.⁷⁶ It is entirely possible, therefore, that a tax lien that is invalid in bankruptcy because unfiled, or perhaps because not perfectible against bona fide purchasers, may nevertheless enjoy priority over some other lien or security interest that is valid in bankruptcy but against which the tax lien is effective without filing. Circuity of liens would result: the tax lien is superior to the other lien or security interest; the other lien or security interest is in turn superior to the trustee; and the trustee is superior to the tax lien. Neither the tax collector nor the junior lienor or secured party may ordinarily benefit from this circuity, however, since the trustee is entitled to have the invalidated tax lien preserved for the benefit of the estate. The estate thereby takes advantage of the tax lien's priority over the junior lien or interest and the trustee's priority over the tax lien.⁷⁷ Circuity may also result when the tax collector files a lien on, but does not take possession of, personal property which is subjected to a *later* security interest or indefeasible nontax lien or of which another tax lienor takes possession thereafter but before bankruptcy. In such situations, the junior

⁷² See notes 36-39 and accompanying text *supra*.

⁷³ See notes 40-45 and accompanying text *supra*.

⁷⁴ See notes 47-48 *supra*.

⁷⁵ See note 53 *supra*.

⁷⁶ *In re Thriftway Auto Rental Corp.*, 457 F.2d 409 (2d Cir. 1972); *United States v. First Nat'l Bank & Trust Co.*, 386 F.2d 646 (8th Cir. 1967); *Dallas v. United States*, 369 F.2d 645 (5th Cir. 1966).

⁷⁷ Bankruptcy Act § 67c(2), 11 U.S.C. § 107(c)(2) (1970). However, if for any reason the invalidated tax lien is not so preserved, the junior liens are promoted at the expense of the tax claim. *Id.*

lienor has rights superior to general administration expenses and wage claims, but inferior to those of the tax collector, whose lien, however, is postponed to administration and wage claims.⁷⁸ In this type of case the Bankruptcy Act adopts a different solution to the circuitry problem: an amount equal to the superior tax lien is first set aside and the junior lien is satisfied from what remains; then, administration expenses and wage claims are paid from the amount set aside for the tax lien; the unsatisfied portion of the tax then becomes an unsecured claim.⁷⁹

2. *The Commission's Proposals*

Departing sharply from Congress's historic policy, the Commission proposes to invalidate in bankruptcy, including reorganization and rehabilitation proceedings as well as straight liquidations, every common law or statutory lien⁸⁰ with the exception of (1) a lien securing a debt for the repair, preservation, shipment, storage, manufacture, or improvement of the lien property, (2) a lien securing a general *ad valorem* tax on such property, (3) a lien securing a special assessment to defray the cost of a public improvement, or (4) a lien for expenses and fees of an attorney in obtaining a judgment or settlement.⁸¹ With those exceptions, regardless of whether a particular lien is created by federal or state law, whether it attaches to real or personal property, or even whether it had been so far perfected that neither a judgment creditor nor a bona fide purchaser could have acquired superior rights at the date of the petition, the Commission views it as a mere right of priority which must yield to the priority scheme of the Bankruptcy Act.

The Commission's position reflects its chairman's expressed

⁷⁸ See notes 28-29 *supra*.

⁷⁹ Bankruptcy Act § 67c(3), 11 U.S.C. § 107(c)(3) (1970). Adopted in 1966, this provision confirmed the judicial solution adopted in *California State Dep't of Employment v. United States*, 210 F.2d 242 (9th Cir. 1954).

⁸⁰ The definition of "statutory lien" (Bankruptcy Act § 1(29a), 11 U.S.C. § 1(29a) (1970)) is refined to make clear that "a lien resulting from a judicial act or proceeding" is not included therein. PROPOSED BANKRUPTCY ACT § 1-102(45).

⁸¹ PROPOSED BANKRUPTCY ACT § 4-606(a). The excepted liens would be valid only if perfected against judicial liens at the date of the petition (*id.* § 4-604(a), *restating* Bankruptcy Act § 70c, 11 U.S.C. § 110(c) (1970)) and if either the lien is a matter of public record as against the specific property or notice of the lien is given to the trustee within 30 days after the lien claimant learns of the filing of the petition. PROPOSED BANKRUPTCY ACT § 4-606(c). The further requirement of perfection against bona fide purchasers, which the Commission (citing its chairman, Marsh, *supra* note 39, at 721-23) regards as virtually meaningless, would be abandoned.

disenchantment with several inept legislative attempts to draw the line between those statutory liens that are true property rights, justifiably relied upon as security against all the world, and those that merely determine, in contravention of the purpose of the Bankruptcy Act, the order of distribution of whatever assets the debtor possesses when the roof falls in.⁸² The Commission would abandon the effort to draw such a distinction and would throw the baby out with the bath water. The present distinction, based on whether the lien would follow the property into the hands of a bona fide purchaser, would be perfectly sound were it not for an apparent "last-minute drafting bobble"⁸³ introducing an ambiguous time reference into a provision that makes sense only if it means that the trustee prevails over any statutory lien that is not, and cannot retroactively be, perfected against one becoming a bona fide purchaser *on the date of bankruptcy*.⁸⁴ This logical time reference should not be too difficult to express in the law now that attention has been focused on the ambiguity. Such an amendment would be preferable to the Commission's proposal. The test should be further refined to make clear whether the hypothetical bona fide purchaser in whose shoes the trustee is placed includes one with "special additional attributes such as possession, a special contract of purchase . . . or the status of a buyer in ordinary course of business."⁸⁵ The trustee should be in the position of a "full-blooded, not an anemic, purchaser"⁸⁶—*i.e.*, one who has done everything that an encumbrancer or bulk purchaser could do to perfect his interest, such as taking possession, but not one who is a member of a special class of purchasers, such as retail purchasers, whose characteristics are not shared by the trustee and the creditors he represents.⁸⁷

⁸² Marsh, *supra* note 39, at 732-34. The Commission's notes to Proposed § 4-606 echo Marsh's hyperbole that section 67c(1)(B) invalidates only "liens on ambulatory houses in Pennsylvania and the get of bulls, rams and boars in Colorado." Marsh, *supra* note 39, at 722-23 n. 94. The text of its report states that "recognition [of statutory liens] substantially frustrates the goals of equality and uniformity, and it has generated a substantial amount of litigation and made the Act considerably more complex." COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT, PART I, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 212 (1973) [hereinafter cited as BANKRUPTCY COMM'N REPORT].

⁸³ See Countryman, *supra* note 48, at 641.

⁸⁴ See notes 37-45 and accompanying text *supra*.

⁸⁵ Countryman, *supra* note 48, at 644. See notes 46-53 and accompanying text *supra*.

⁸⁶ Countryman, *supra* note 48, at 643.

⁸⁷ Cf. Bankruptcy Act § 60a(4), 11 U.S.C. §96(a)(4) (1970). That provision declares that the judicial lien against which a transfer must be perfected in order to avoid treatment as a preference "does not include liens which under applicable law are given a special priority over other liens which are prior in time." This language has no counterpart in Proposed

With respect to tax liens, other than those for *ad valorem* taxes and special assessments, Chairman Marsh has conceded that they may be "necessary outside of bankruptcy for the efficient collection of the revenue and for the purpose of protecting the Government against subsequent purchasers and secured parties,"⁸⁸ as well as for providing a convenient reference point in the race of diligence. He insists, however, that "none of this is relevant" in insolvency proceedings because the "[p]riorities [then] are established by the statute" and "the Government no longer needs any collection procedure or any protection against subsequent parties."⁸⁹ On the contrary, there is as much need for protection against creditors generally, represented by the trustee, at this point as there is at an earlier stage against creditors obtaining judgment liens. Whether the "priorities are established by the statute" depends upon the resolution of the point in issue—*i.e.*, whether the tax for which a lien has been perfected qualifies as a secured or unsecured claim.

Marsh declares further that "[t]o say that an income tax claim should be entitled to the super priority of a secured debt simply because it has been assessed the day before bankruptcy, but that the same claim should be demoted to a fourth priority if it is assessed the day after bankruptcy is irrational," since "[t]his factor has nothing to do either with the equities of the situation or with the needs of the fisc."⁹⁰ It has much to do with "the needs of the fisc," however, in that vendors, hospitals, landlords, and other holders of statutory liens have the alternative of demanding and perfecting *contractual* security interests as a means of protecting themselves against the trustee, while the Government's only practical means of protection if collection cannot be effected within the proposed time limitations on priority⁹¹ is to perfect the statutory lien which Congress for a century has provided for its security.⁹² As for the equities of the unsecured creditors, those who "supplied the bankrupt with goods and funds during the period immediately

§ 4-607(g)(6), which the Commission considers a "simplified version [that] says all that is needed." PROPOSED BANKRUPTCY ACT § 4-607 Note 27.

⁸⁸ Marsh, *supra* note 39, at 728.

⁸⁹ *Id.*

⁹⁰ *Id.* A similar proposal, limited to the invalidation of tax liens on personal property, was advanced by the National Bankruptcy Conference a quarter century ago. Moore & Tone, *Proposed Bankruptcy Amendments: Improvement or Retrogression?*, 57 YALE L.J. 683, 701 (1948); Olive, *Taxes in Bankruptcy Proceedings*, 25 TAXES 5, 7 (1947). But that feature was deleted from the proposal long before a much modified version was finally enacted in 1966. See note 126 *infra*.

⁹¹ See notes 224-56 and accompanying text *infra*.

⁹² See notes 54-63 and accompanying text *supra*.

prior to bankruptcy," which may constitute the bulk of his remaining assets,⁹³ may have just cause for complaint if a last-minute tax lien consumes those assets. But a tax lien that has been on file for three months, for instance, gives the last minute supplier of goods or funds as much warning as a duly filed security interest; he has no cause for complaint if he failed to make a proper credit check. Such equities may justify treatment of the perfection of a tax lien against an insolvent debtor within three months before the petition as a voidable preference,⁹⁴ but not the invalidation of a lien perfected earlier or during solvency.

The Commission argues that the tax lien priority is not needed:

Data submitted to the Commission by the Treasury Department establishes that the total amount collected by the Federal Government as a result of all its liens and priorities in bankruptcy proceedings is insignificant in the total federal budget. It is the view of the Commission that it is unseemly for the Federal Government to insist upon collecting its taxes at the expense of other creditors of the taxpayer, and that the only possible justification for this would be a plea of necessity in order to keep the government functioning. As indicated above, such a plea would be totally without foundation in fact.⁹⁵

The Commission could with equal reason contend that there is no justification for preferring filed tax liens over general creditors *outside* of bankruptcy since the amount of tax collected by lien enforcement is a mere drop in the federal budgetary bucket—or that policemen need not carry guns because the occasions for their use are infrequent. The removal of the threat of the collection weapon, however, might well cause delinquencies to skyrocket; the opportunity for creditors to thwart filed tax liens by throwing the debtor into bankruptcy would surely greatly increase the number

⁹³ See Olive, *supra* note 90, at 6.

⁹⁴ Under Proposed § 4-607(a), a "transfer" made "to pay or secure" an antecedent debt, if made within three months before the petition and while the debtor was insolvent, whether or not the creditor had reasonable cause to believe that he was, is a voidable preference. Proposed § 1-102(46) defines "transfer" to include the fixing of a lien on property. Proposed § 1-104, abrogating the former rule that the sovereign is not bound by the Bankruptcy Act unless a provision is expressly made applicable to it (*United States v. Herron*, 87 U.S. (20 Wall.) 251 (1874)), makes *all* provisions applicable to the United States, the states, and their subdivisions unless expressly provided otherwise. Moreover, Proposed § 1-102(17) defines "debt" broadly enough to embrace taxes. It would seem, therefore, that a tax lien perfected under those circumstances would be voidable, even if tax liens were not generally invalidated.

⁹⁵ BANKRUPTCY COMM'N REPORT 22. The annual amount collected in bankruptcy on liens and priorities is estimated by the Treasury at about \$44,000,000. *Id.* 234.

of bankruptcies and the amount of federal taxes involved therein. This conclusion is reinforced by the Commission's proposals to eliminate the present requirement of an act of bankruptcy before involuntary bankruptcy can be sought.⁹⁶

The new proposal, like present law, entitles the trustee to ask the court to preserve an invalidated lien for the benefit of the estate; hence, unsecured creditors, rather than holders of junior liens valid in bankruptcy, would profit from the invalidation of the otherwise senior statutory lien.⁹⁷

The debasement of the once favored statutory liens, including tax liens, is carried so far that any amounts paid or property transferred within three months before the petition, in voluntary or involuntary satisfaction of the obligation secured by the invalidated lien, is unconditionally recoverable by the trustee, even if the debtor was solvent at the time of the transfer.⁹⁸ This provision goes even further than the Commission's broadened attack on preferences generally, which make preferential payments and transfers with respect to antecedent debts *not* secured voidable if the debtor was insolvent at the time, whether or not the preferred creditor had reasonable cause to believe that insolvency existed, and raises a rebuttable presumption that the debtor was insolvent throughout the three-month period preceding the petition.⁹⁹ The odd result is that a federal tax promptly paid within the applicable period by a demonstrably solvent taxpayer, before a lien arises, is *not* a recoverable preference. But if the tax is not paid within the ten days usually allowed, thus causing a lien to arise,¹⁰⁰ a payment made any time thereafter is recoverable by the trustee and thrown into the pot for distribution in accordance with the priorities.¹⁰¹

⁹⁶ Proposed Bankruptcy Act § 4-205(c) permits maintenance of an involuntary petition upon a mere showing that the debtor "will be generally unable" or "has generally failed" to pay his debts as they become due.

⁹⁷ PROPOSED BANKRUPTCY ACT § 4-610. This provision restates, *inter alia*, Bankruptcy Act § 67c(2) (11 U.S.C. § 107(c)(2) (1970)) and applies to a transfer voidable under Proposed § 4-606. Since tax liens would no longer be recognized at all, the current provision for postponing tax liens on personalty to administration expenses and certain wages is deleted. See note 29 *supra*.

⁹⁸ PROPOSED BANKRUPTCY ACT § 4-606(b).

⁹⁹ *Id.* §§ 4-607(a), (f). Compare Bankruptcy Act § 60b, 11 U.S.C. § 96(b) (1970). Preferences occurring within one year would be made voidable if the creditor occupied one of certain close relationships to the bankrupt; but in this case the trustee would still be required to show that the creditor had reasonable cause to believe the debtor insolvent. PROPOSED BANKRUPTCY ACT § 4-607(a)(2).

¹⁰⁰ INT. REV. CODE OF 1954, §§ 6155, 6321, 6331(a).

¹⁰¹ Concerning subjection of the sovereign to the recovery of preferences, see note 94 *supra*.

B. Priority of Nonlien Tax Claims and Other Claims

1. Current Law

Although the earliest federal bankruptcy laws incorporated the principle of absolute priority of federal claims,¹⁰² subsequent acts have moved progressively toward "a reasonable classification of claims as entitled to priority because of superior equities,"¹⁰³ as the "demands of social, economic, and political policy . . . resulted in deviations from a strict rule of equality among creditors."¹⁰⁴ Wage claims, limited in amount, first gained recognition as a priority class in 1841¹⁰⁵ and steadily improved in position, being elevated in 1898 above federal and state claims for other than taxes.¹⁰⁶ They continued to be inferior to all tax claims¹⁰⁷ until 1926, when they were moved ahead of taxes and the amount entitled to priority was increased to \$600 for each claimant, earned within three months before bankruptcy.¹⁰⁸ Since 1938, wages have enjoyed the highest priority among unsecured claims, subject only to administration expenses,¹⁰⁹ and the portion of the bankrupt estate available for preferred wage claims has been further enhanced by the subordination of tax liens on personalty, even though otherwise valid and fully perfected, whenever such liens are not accompanied by possession or enforced by sale before bankruptcy.¹¹⁰ Unlike the rule

¹⁰² *United States v. Fisher*, 6 U.S. (2 Cranch) 358 (1804). The pertinent provisions of the 1800, 1841, and 1867 Acts are quoted in *United States v. Anderson*, 334 F.2d 111, 114-15 (5th Cir.), cert. denied, 379 U.S. 879 (1964).

¹⁰³ See *Carpenter v. Wabash Ry.*, 309 U.S. 23, 28 (1940).

¹⁰⁴ SENATE REPORT 2, quoting HOUSE REPORT 2.

¹⁰⁵ Act of Aug. 19, 1841, ch. 9, § 5, 5 Stat. 444. This Act limited claims to \$25 earned within six months. This was increased to \$50 by the Act of March 2, 1867, ch. 176, § 28, 14 Stat. 531. Both laws were short-lived. See notes 16-17 *supra*.

¹⁰⁶ *Guarantee Title & Trust Co. v. Title Guar. & Sur. Co.*, 224 U.S. 152 (1912); Act of July 1, 1898, ch. 541, § 64b(4), 30 Stat. 563. The amount of wages entitled to priority was then \$300 earned within three months.

¹⁰⁷ *Oliver v. United States*, 268 U.S. 1 (1925); Act of July 1, 1898, ch. 541, § 64a, 30 Stat. 563.

¹⁰⁸ 11 U.S.C. § 104 (1970). The Act of May 27, 1926, ch. 406, § 15, 44 Stat. 667, amended §§ 64a and 64h(5)-(6) of the original Act to accomplish this aim. The \$600 limit has remained constant despite nearly 50 years of deterioration in the value of the dollar.

¹⁰⁹ The last remaining higher priority, for certain expenses of creditors, was demoted below wages by the Chandler Act. 11 U.S.C. §§ 104(a)(2)-(3) (1970).

¹¹⁰ Subject to the conditions stated, the Chandler Act (Act of June 22, 1938, ch. 575, 52 Stat. 875) thus subordinated statutory liens. The 1952 amendments (Act of July 7, 1952, ch. 579, § 21, 66 Stat. 427) continued the subordination of tax liens and invalidated other statutory liens. Later law (Act of July 5, 1966, Pub. L. No. 89-495, § 4, 80 Stat. 268 (1966)) restored certain statutory liens to secured status in bankruptcy and continued the subordination of tax liens. See Bankruptcy Act §§ 67c(3), (5), 11 U.S.C. §§ 107(c)(3), (5) (1970).

under some state laws,¹¹¹ however, the federal bankruptcy law does not extend the wage priority to unpaid contributions to pension¹¹² and welfare funds,¹¹³ although the priority does extend, within applicable limits, to accrued vacation pay¹¹⁴ and vacation fund contributions,¹¹⁵ back pay awards,¹¹⁶ and dismissal or severance pay.¹¹⁷

Debts and taxes owing to a state enjoyed no priority in bankruptcy until the 1867 Act; thereafter their priority was junior to all federal claims and was confined to claims of the state in which the proceeding was pending.¹¹⁸ The permanent bankruptcy legislation of 1898 placed all unsecured federal, state, and local taxes, whether or not of the home jurisdiction, on a parity¹¹⁹ which they have continued to experience under later Acts.¹²⁰ The top priority then enjoyed has been steadily eroded, first in the 1926 and 1938 legislation seeking to improve the position of wage-earners,¹²¹ and ultimately, but only in a limited way, for the benefit of general creditors.

More than a quarter century ago, a movement developed in the American Bar Association¹²² and the National Bankruptcy Conference to restrict the priority of federal and other taxes which, unknown to creditors who finance the taxpayer's operations, often accumulate over an extended period and, when bankruptcy finally occurs, are likely to consume all or the greater part of the estate. Initially, the proposal sought to reduce to general creditor status every claim for taxes, whether or not supported by a lien, if the last day of the period for which the tax is incurred is

¹¹¹ See, e.g., N.Y. DEBT. & CRED. LAW § 22 (McKinney Supp. 1973); Dunlop v. Tremayne, 62 Cal. 2d 427, 398 P.2d 774, 42 Cal. Rptr. 438 (1965).

¹¹² Joint Indus. Bd. v. United States, 391 U.S. 224 (1968).

¹¹³ United States v. Embassy Restaurant, Inc., 359 U.S. 29 (1959).

¹¹⁴ *In re* Ad Serv. Engraving Co., 338 F.2d 41 (6th Cir. 1964).

¹¹⁵ *In re* E.V. Moore of Cal., Inc., 447 F.2d 1106 (9th Cir. 1971).

¹¹⁶ NLRB v. Killoren, 122 F.2d 609 (8th Cir.), *cert. denied*, 314 U.S. 696 (1941); *cf.* Nathanson v. NLRB, 344 U.S. 25 (1952).

¹¹⁷ McCloskey v. Division of Labor Law Enforcement, 200 F.2d 402 (9th Cir. 1952); *In re* Public Ledger, 161 F.2d 762, 773 (3d Cir. 1947). *But cf.* *In re* Ad Serv. Engraving Co., 338 F.2d 41, 43-44 (6th Cir. 1964).

¹¹⁸ Act of March 2, 1867, ch. 176, § 28, 14 Stat. 531.

¹¹⁹ Act of July 1, 1898, ch. 541, § 64a, 30 Stat. 563 (codified in substantially modified form at 11 U.S.C. § 104(a) (1970)); *New Jersey v. Anderson*, 203 U.S. 483, 489 (1906).

¹²⁰ See *Missouri v. Ross*, 299 U.S. 72, 74-75 (1936).

¹²¹ See notes 108 & 110 *supra*.

¹²² It appears to have originated in 1946 with the Committee on Bankruptcy Law of the American Bar Association Section of Corporation, Banking, and Commercial Law. See J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY 102 (1956); Olive, *supra* note 90, at 6.

more than one year before bankruptcy.¹²³ That proposal was criticized for its failure to take account of the differences in the complexities of different types of taxes and the possibility that controversy over the amount payable might often preclude collection action within the year following the tax period.¹²⁴

As enacted in 1966, the law¹²⁵ leaves the status of perfected tax liens undisturbed, but provides that priority status is denied for nonlien taxes that "became legally due and owing" more than *three* years before bankruptcy.¹²⁶ The three year period corresponds to the basic period of limitations for the determination of federal taxes¹²⁷ and, therefore, was considered to afford ample opportunity not only to assess any tax but also to collect it or to protect it by filing notice of a lien.¹²⁸ The phrase, "became legally due and owing," has been in the priority section since 1898 in order to distinguish provable prebankruptcy tax claims from those accruing during bankruptcy. It has long been held that a tax becomes "legally due and owing" when the event occurs which fixes the liability for tax, even though a return is not yet due and the tax is not collectible until a later date.¹²⁹ But the 1966 legislative history indicates that, for the purpose of measuring the "staleness" of a tax claim, the time runs from the date prescribed for payment of the

¹²³ The original American Bar Association version of the proposal is described in Olive, *supra* note 90, at 6-8. The original National Bankruptcy Conference version would have excepted taxes secured by a lien of the kind not subject to postponement under Bankruptcy Act § 67c—*i.e.*, a lien on realty or a lien on personalty not reduced to possession or enforced by sale. Moore & Tone, *supra* note 90, at 701. The proposal was first introduced in Congress as H.R. 5829, 80th Cong., 2d Sess. § 3 (1948).

¹²⁴ J. MacLACHLAN, *supra* note 122, at 102; Moore & Tone, *supra* note 90, at 702-03.

¹²⁵ For a detailed discussion of the terms of and the defects in the law, see Plumb, *Federal Liens and Priorities—Agenda for the Next Decade I*, 77 YALE L.J. 228, 263-72 (1967).

¹²⁶ The priority provision, § 64a(4) of the Bankruptcy Act (11 U.S.C. § 104(a)(4) (1970)), merely excludes from the fourth-priority level taxes "which are not released by a discharge in bankruptcy," making it necessary to refer to the discharge provision, § 17a(1) (11 U.S.C. § 35(a)(1) (1970)), for the applicable rules.

¹²⁷ INT. REV. CODE OF 1954, § 6501(a).

¹²⁸ S. REP. NO. 1158, 89th Cong., 2d Sess. 2-3 (1966); H.R. REP. NO. 687, 89th Cong., 1st Sess. 2 (1965).

¹²⁹ *New Jersey v. Anderson*, 203 U.S. 483, 494 (1906). By this standard, a tax based on income becomes "legally due and owing" at the close of the taxable year. *In re International Match Co.*, 79 F.2d 203 (2d Cir. 1935); *In re Cooney*, 35 Am. Bankr. Rep. (n.s.) 247 (N.D.N.Y. 1938). An employment or excise tax becomes "legally due and owing" as each wage payment is made or taxable transaction occurs. *In re Freedomland, Inc.*, 480 F.2d 184, 190 (2d Cir. 1973), *cert. granted sub nom. Otte v. United States*, 414 U.S. 1156 (1974); *In re John Horne Co.*, 220 F.2d 33 (7th Cir. 1955). *But cf. In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 98 (3d Cir. 1964) (making cutoff even earlier).

tax, rather than from any earlier date,¹³⁰ and the courts so far have accepted that view.¹³¹

In partial recognition of the practicalities of tax administration, the 1966 statute provides four exceptions to the three-year cutoff: (1) where the bankrupt has failed to make a return required by law, if the tax was not assessed or was assessed within one year before bankruptcy; (2) where the tax liability was not reported on the return made by the bankrupt and was not assessed before bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt;¹³² (3) where the bankrupt had made a false or fraudulent return, or willfully attempted in any manner to evade or defeat the tax; and (4) where the amount was collected or withheld by the bankrupt from others, such as his employees, and was not paid over.¹³³

Federal claims for items other than taxes, which shared with taxes the top priority under earlier acts, were not expressly mentioned in the Act of 1898, although it was provided generally therein that debts owing to any "person," if entitled to priority under any federal or state law, should occupy the priority level next above general claims.¹³⁴ In 1925, the Supreme Court, holding that the United States is not a "person," concluded that the general

¹³⁰ 112 CONG. REC. 13,814 (1966); *cf.* S. REP. NO. 1158, *supra* note 128, at 3.

¹³¹ *In re Kopf*, 299 F. Supp. 182 (E.D.N.Y. 1969); *In re Reeves*, 70-1 U.S. Tax Cas. ¶ 9314 (D. Colo. 1969).

¹³² Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (1970) (made applicable by *id.* § 64a(4), 11 U.S.C. § 104(a)(4) (1970)). In enacting this exception, Congress particularly had in mind federal income tax deficiencies which normally cannot be assessed and collected until the taxpayer has first been issued a deficiency notice and given an opportunity to contest the liability in the Tax Court (INT. REV. CODE OF 1954, § 6213(a)), although the fact that jeopardy assessments may be made in appropriate circumstances (such as approaching bankruptcy) makes the prohibition less than absolute (*id.* § 6861). The exception extends to any *undetermined* income tax deficiency, whether or not a Tax Court proceeding had been instituted before bankruptcy, and whether the deficiency results from undisclosed income or unallowable deductions. *In re Michaud*, 458 F.2d 953 (3d Cir.), *cert. denied*, 409 U.S. 876 (1972); *In re Indian Lake Estates, Inc.*, 428 F.2d 319 (5th Cir.), *cert. denied*, 400 U.S. 964 (1970). Once the controversy is resolved and the tax assessed, however, and if the basic three year period since the due date has then expired, the tax instantly becomes subject to dischargeability and loss of priority if bankruptcy then occurs. No grace period is allowed for collection efforts. *See Plumh, supra* note 125, at 266-68.

¹³³ Bankruptcy Act §§ 17a(1)(a)-(e), 11 U.S.C. §§ 35(a)(1)(a)-(e) (1970). These provisions also are applicable to the determination of priorities. *Id.* § 64a(4), 11 U.S.C. § 104(a)(4) (1970).

¹³⁴ Act of July 1, 1898, ch. 541, § 64a(5), 30 Stat. 563.

federal insolvency priority statute¹³⁵ was not thereby made applicable in bankruptcy, and relegated federal nontax claims to the status of general debts without priority.¹³⁶ Justice Holmes's dictum that "[p]ublic opinion as to the peculiar rights and preferences due to the sovereign has changed"¹³⁷ proved premature, however, since Congress, without so much as an explanatory word in the legislative history, restored the government's nontax priority in bankruptcy one year later, although placing it behind taxes and wages and on the same level as any other claims to which state or federal law might give priority.¹³⁸ Since the Chandler Act of 1938 eliminated the recognition of all state law priorities except those of landlords, federal nontax claims stand equal to landlords' claims on the lowest priority level above general claims; nontax claims of the states, often favored under their own laws, enjoy no priority in bankruptcy.¹³⁹

The foregoing priority rules, established by section 64a of the Bankruptcy Act, are also made applicable in debtor relief proceedings under Chapters XI and XIII.¹⁴⁰ Their application is expressly precluded, however, in corporate reorganizations under Chapter X unless the reorganization fails and straight bankruptcy follows.¹⁴¹ In Chapter X proceedings, the rules of priority in equity receiverships are controlling,¹⁴² cardinal among which is the ancient federal statute¹⁴³ requiring that, if the estate is insolvent, the United States must not only enjoy first priority, perhaps even ahead of otherwise senior secured obligations,¹⁴⁴ but also must be paid *first*

¹³⁵ See note 12 *supra*.

¹³⁶ *Davis v. Pringle*, 268 U.S. 315 (1925).

¹³⁷ *Id.* at 318.

¹³⁸ Act of May 27, 1926, ch. 406, § 15, 44 Stat. 666 (amending Bankruptcy Act § 64a(7)). The 1926 amendment included the United States in the definition of the term "person."

¹³⁹ Bankruptcy Act § 64(a)(5), 11 U.S.C. § 104(a)(5) (1970).

¹⁴⁰ *In re Belkin*, 358 F.2d 378 (6th Cir. 1966); *In re Chicago Express, Inc.*, 332 F.2d 276 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964), Bankruptcy Act §§ 302, 337(2), 602, 659(6), 11 U.S.C. §§ 702, 737(2), 1002, 1059(6) (1970). Whether § 64a is incorporated into the provisions relating to real property arrangements (Chapter XII) is unclear from the Act's language. Bankruptcy Act § 402, 11 U.S.C. § 802 (1970). See T. FINLETTER, *THE LAW OF BANKRUPTCY REORGANIZATION* 345-46 (1939).

¹⁴¹ Bankruptcy Act § 102, 11 U.S.C. § 502 (1970).

¹⁴² *United States v. Key*, 397 U.S. 322, 329-32 (1970); *United States v. Anderson*, 334 F.2d 111, 115-16 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964).

¹⁴³ REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1970); see note 12 *supra*.

¹⁴⁴ On its face, the federal insolvency priority is absolute and admits of no exceptions. See *United States v. Vermont*, 377 U.S. 351, 357 (1964). The Supreme Court has pointedly left open the question whether the most specific and perfected of liens (see *United States v. Gilbert Assoc.*, 345 U.S. 361, 365 (1953)), or even a prior mortgage (see *New York v. Maclay*,

in time.¹⁴⁵ In railroad reorganizations under section 77, section 64a rules also seem clearly to be made inapplicable¹⁴⁶ by section 77(b) of the Act,¹⁴⁷ which adopts the equity receivership rules of priority and which has, therefore, been held to incorporate the statutory requirement of first payment of federal claims, if the railroad is insolvent.¹⁴⁸ Even when the insolvency priority statute is inapplicable—*i.e.*, when the debtor is not insolvent in the “balance sheet” sense of having an excess of liabilities over debts¹⁴⁹—section 77 prescribes that no plan of reorganization of a railroad or other corporation can be confirmed if it fails to provide for full payment, not necessarily first in time, of federal taxes and customs duties, unless the Treasury agrees to accept a lesser amount.¹⁵⁰

Among the rules of priority applicable in equity receiverships is the so-called “six-month rule.” This rule is a judicial doctrine under which liabilities for supplies, materials, and services necessary for operating railroads and certain other public service businesses, within a limited period, usually six months, before the commencement of the proceeding, enjoy priority over general creditors and, in limited circumstances, even over mortgagees.¹⁵¹

288 U.S. 290, 294 (1933)) could prevail over the federal priority. Lower courts, however, have recognized the superiority of both mortgages (*Exchange Bank & Trust Co. v. Tubbs Mfg. Co.*, 246 F.2d 141, 143 (5th Cir.), *cert. denied*, 355 U.S. 868 (1957)) and “choate” liens (*United States v. Atlantic Municipal Corp.*, 212 F.2d 709 (5th Cir. 1954)), subject to a most exacting test of “choateness.” *United States v. Gilbert Assoc.*, *supra*. In any event, even if not absolutely preferred, federal taxes for which liens have been perfected enjoy secured status in the reorganization (*United States v. Harris*, 287 F.2d 491 (9th Cir. 1961), *rev'd on other grounds*, 369 U.S. 38 (1962)), free of the subordination effect of § 67c(3) of the Act (11 U.S.C. § 107(c)(3) (1970); see notes 28-29 *supra*) because that section is made inapplicable in Chapter X cases by § 67c(5) (11 U.S.C. § 107(c)(5) (1970)).

¹⁴⁵ *United States v. Key*, 397 U.S. 322, 327-28 (1970) (disapproving plan providing for installment payment of federal taxes concurrently with other debts).

¹⁴⁶ Declarations in some decisions that “Section 64 . . . is applicable to a proceeding under Section 77” (*e.g.*, *In re New York, O. & W. Ry.*, 25 F. Supp. 709, 713 (S.D.N.Y. 1937)), refer not to the system of priorities, but to a jurisdictional proviso that has since been relocated in § 2a(2A) of the Act (11 U.S.C. § 11(a)(2A) (1970)) by the Act of July 5, 1966 (Pub. L. No. 89-496, § 1, 80 Stat. 270). See Plumb, *The Federal Priority in Insolvency: Proposals for Reform*, 70 MICH. L. REV. 1, 15-16 n.81 (1971).

¹⁴⁷ 11 U.S.C. § 205(b) (1970).

¹⁴⁸ *In re Tennessee Cent. Ry.*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972); see *United States v. Key*, 397 U.S. 322, 329-30 (1970).

¹⁴⁹ *United States v. Oklahoma*, 261 U.S. 253 (1923) (holding REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1970), inapplicable where there is insolvency only in “equity” sense of inability to pay debts as they mature in ordinary course of business). There may be a § 77 or Chapter X proceeding even though there is insolvency only in the “equity” sense. Bankruptcy Act §§ 77(a), 131(1), 11 U.S.C. §§ 205(a), 530(1) (1970).

¹⁵⁰ Bankruptcy Act §§ 77(e) (3d ¶), 199, 11 U.S.C. §§ 205(e) (3d ¶), 599 (1970); see *United States v. Key*, 397 U.S. 322, 327-29 (1970). See also Plumb, *supra* note 146, at 16-19.

¹⁵¹ *Fosdick v. Schall*, 99 U.S. 235 (1878). For a summary of the extent to which

The objective of the rule is "to encourage the extension of credit to corporations delivering important public services at a time when they are financially weak," and thus "to prevent the interruption of services to the public and to preserve the value of the corporate assets for the other creditors."¹⁵² On rare occasions, it has been applied even to private businesses whose inability to operate would have caused loss to creditors but not to the public.¹⁵³ But the better view, when the public interest is not involved, is to refrain from imposing a preference upon senior creditors "for their own good" if they have not consented thereto.¹⁵⁴

In Chapter XI proceedings and others governed by section 64a, the express enumeration of certain priorities precludes recognition of others, such as those which would otherwise be allowable under the six-month rule.¹⁵⁵ On the other hand, section 77(b) of the Act, directing that "unsecured claims, *which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed* by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors,"¹⁵⁶ was unquestionably designed to make the six-month rule applicable

"six-month" claims may prevail over mortgagees, a matter on which there is substantial division of authority, see Plumb, *supra* note 146, at 46 n.241.

¹⁵² *In re Hallmark Medical Serv., Inc.*, 475 F.2d 801, 803 (5th Cir. 1973) (holding nursing home sufficiently involved with public interest to come within the rule). The rule has been applied to other public service businesses providing gas, light, telephones, heating, transportation, and irrigation. *In re Madison Rys.*, 115 F.2d 586 (7th Cir. 1940); *Crane Co. v. Fidelity Trust Co.*, 238 F. 693 (9th Cir. 1916), *cert. denied*, 244 U.S. 658 (1917); *Pennsylvania Steel Co. v. New York City Ry.*, 216 F. 458 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915); *Louisville & Nashville R.R. v. Memphis Gaslight Co.*, 125 F. 97 (6th Cir. 1903); *Keelyn v. Carolina Mut. Tel. & Tel. Co.*, 90 F. 29 (C.C.D. S.C. 1898); *Atlantic Trust Co. v. Woodbridge Canal & Irrigation Co.*, 79 F. 39 (C.C.N.D. Cal. 1897); see FitzGibbon, *The Present Status of the Six Months' Rule*, 34 COLUM. L. REV. 230, 233 n.8 (1934). *But see In re Richards*, 43 F. Supp. 733, 734 (M.D. Pa. 1942) (holding rule inapplicable to motor carrier since service could be duplicated without resort to power of eminent domain).

¹⁵³ *Dudley v. Mealey*, 147 F.2d 268 (2d Cir.), *cert. denied*, 325 U.S. 873 (1945) (using language broader than case required); *L'Hote v. Boyet*, 85 Miss. 636, 38 So. 1 (1905); *Drennen v. Mercantile Trust & Deposit Co.*, 115 Ala. 592, 23 So. 164 (1897); see Jacobson, *Shall the Six Month Priority Rule Be Applied to Hotel Receiverships?*, 40 COM. L.J. 568 (1935).

¹⁵⁴ *In re Yale Express Sys., Inc.*, 342 F. Supp. 972 (S.D.N.Y. 1972); *In re North Atlantic & Gulf S.S. Co.*, 200 F. Supp. 818 (S.D.N.Y.), *aff'd on other grounds sub nom. Schilling v. McAllister Bros., Inc.*, 310 F.2d 123 (2d Cir. 1962); *Snively v. Loomis Coal Co.*, 69 F. 204 (C.C.E.D. Mo. 1895); see *Wood v. Guarantee Trust Co.*, 128 U.S. 416, 421 (1888); *In re Pusey & Jones Corp.*, 192 F. Supp. 233 (D. Del.), *aff'd*, 295 F.2d 479 (3d Cir. 1961).

¹⁵⁵ *In re Chicago Express, Inc.*, 332 F.2d 276 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964); *In re Pusey & Jones Corp.*, 295 F.2d 479 (3d Cir. 1961); *Wheeling Elec. Co. v. Mead*, 177 F.2d 718 (4th Cir. 1949); *Kavanis v. Mead*, 171 F.2d 195 (4th Cir. 1948) (holding that six-month rule cannot enlarge wage priority granted by Bankruptcy Act).

¹⁵⁶ 11 U.S.C. § 205(b) (1970) (emphasis added).

to railroad reorganizations under the Act.¹⁵⁷ Former section 77B(b)(10),¹⁵⁸ relating to the reorganization of corporations other than railroads, contained similar language, which was omitted when section 77B was revised and re-enacted as Chapter X by the Chandler Act of 1938. Nevertheless, the power of the court to exercise all the powers it would have, had it appointed a receiver in equity,¹⁵⁹ has been regarded as reserving a discretionary power in the court to apply the six-month rule under Chapter X in appropriate cases.¹⁶⁰ It has even been suggested that Chapter X evidences such congressional concern for the survival of purely private businesses that the reasons for excluding such entities from the operation of the rule may no longer apply.¹⁶¹ On the other hand, many practical difficulties have been envisioned in enlarging the administration expense priority to embrace expenditures not made under the scrutiny of the fiduciary and in introducing "an undesirable imponderable into the already complicated techniques of long term bond and mortgage financing."¹⁶² Moreover, the Securities and Exchange Commission has opposed allowance of priority for six-month claims, pointing out that the omission of the language of former section 77B(b)(10) when the Chandler Act was enacted was no mere oversight but a deliberate congressional decision.¹⁶³ In any event, even in reorganization proceedings to which the six-month rule may apply, it yields, as does the general priority for wages,¹⁶⁴ to the overriding force of the federal insolvency priority statute.¹⁶⁵

¹⁵⁷ *Southern Ry. v. Flournoy*, 301 F.2d 847, 850 (4th Cir. 1962); see 5 W. COLLIER, BANKRUPTCY ¶ 77.21 (1964).

¹⁵⁸ Act of June 7, 1934, ch. 424, § 1, 48 Stat. 914.

¹⁵⁹ Bankruptcy Act § 115, 11 U.S.C. § 515 (1970).

¹⁶⁰ *In re Hallmark Medical Serv., Inc.*, 475 F.2d 801 (5th Cir. 1973); *Dudley v. Mealey*, 147 F.2d 268 (2d Cir.), cert. denied, 325 U.S. 873 (1945); see *In re Chicago Express Co.*, 332 F.2d 276, 278 (2d Cir.), cert. denied, 379 U.S. 879 (1964); *In re North Atlantic & Gulf S.S. Co.*, 200 F. Supp. 818, 821 (S.D.N.Y.), aff'd on other grounds sub nom. *Schilling v. McAllister Bros., Inc.*, 310 F.2d 123 (2d Cir. 1962). See also 6A W. COLLIER, Bankruptcy ¶ 9.13[5] (1965); Gerdes, *Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act*, 52 HARV. L. REV. 1, 28-29 (1938).

¹⁶¹ T. FINLETTER, *supra* note 140, at 383-84.

¹⁶² See *In re Pusey & Jones Corp.*, 192 F. Supp. 233, 235-36 & n.13 (D. Del.), aff'd, 295 F.2d 479 (3d Cir. 1961).

¹⁶³ See *In re Yale Express Sys., Inc.*, 342 F. Supp. 972, 974 (S.D.N.Y. 1972); HOUSE COMM. ON THE JUDICIARY, 74TH CONG., 2D SESS., ANALYSIS OF H.R. 12889 CONTAINING AMENDMENTS PROPOSED BY THE NAT'L BANKRUPTCY CONFERENCE 74 (Comm. Print 1936).

¹⁶⁴ Cf. *United States v. Emory*, 314 U.S. 423 (1941) (equity receivership case; policy of Congress to favor wages in straight bankruptcies signifies no change of position in cases still governed by REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1970)).

¹⁶⁵ *In re Tennessee Cent. Ry.*, 463 F.2d 73 (6th Cir.), cert. denied, 409 U.S. 893 (1972).

2. *The Commission's Proposals*

a. *Administrative Taxes.* Taxes incurred after the filing of a bankruptcy petition at present are treated as expenses of administration¹⁶⁶ entitled to the highest priority, except as against certain liens that are neither invalidated nor postponed in bankruptcy.¹⁶⁷ They are on an equal footing with the essential costs and expenses of development, preservation, and distribution of the debtor's assets.¹⁶⁸ The Commission's proposals exclude from the administration expense priority certain taxes which are now arbitrarily included therein by application of the principle that a tax is classifiable as a prebankruptcy claim only if on the date of bankruptcy the facts necessary to compute the tax are known or available.¹⁶⁹

Under the federal corporate income tax, and no doubt under some state income and franchise taxes framed in similar terms, the taxable year of the debtor is unbroken at the date of bankruptcy.¹⁷⁰ The trustee steps into the shoes of the bankrupt and, at least in the view of the IRS, is required to file a return for the corporation for the full taxable year.¹⁷¹ Since any income or profit the debtor may have earned in the prebankruptcy portion of the year might be cancelled through later losses, no fixed or determinable tax li-

The contrary view expressed in 5 W. COLLIER, *supra* note 157, at ¶ 77.21, is not supported by the referee's decision on which it relies (*In re Missouri Pac. R.R.*, CCH BANKR. L. REP. ¶ 3780 (E.D. Mo. 1935), *aff'd on other grounds sub nom. J.P. Morgan & Co. v. Missouri Pac. R.R.*, 85 F.2d 351 (8th Cir.), *cert. denied*, 299 U.S. 604 (1936)); that decision merely divided creditors into classes and declared the ranking to be "provisional." See Plumb, *supra* note 146, at 46 n.242.

¹⁶⁶ *Security-First Nat'l Bank v. United States*, 153 F.2d 563 (9th Cir. 1946); *In re Fonda, J. & G. R.R.*, 126 F.2d 604, 606 (2d Cir. 1942).

¹⁶⁷ See notes 26-37 and accompanying text *supra*.

¹⁶⁸ *In re Killoren*, 119 F.2d 364 (8th Cir. 1941); *In re Lambertville Rubber Co.*, 111 F.2d 45, 49-50 (3d Cir. 1940).

¹⁶⁹ *United States v. Fogarty*, 164 F.2d 26, 33 (8th Cir. 1947); *In re International Match Corp.*, 79 F.2d 203 (2d Cir.), *cert. denied*, 296 U.S. 652 (1935); 3A W. COLLIER, BANKRUPTCY ¶ 64.405[1] (1972).

¹⁷⁰ Treas. Reg. § 1.641(b)-2(b), T.D. 6580, 1961-2 CUM. BULL. 123; G.C.M. 12,207, XII-2 CUM. BULL. 83, 85 (1933) (declared obsolete by Rev. Rul. 71-498, 1971-2 CUM. BULL. 434). A declaration of obsolescence, where there has been no change in the law, may mean only that the ruling is deemed "unnecessary because the issue has been covered by regulations." Rev. Proc. 67-6, 1967-1 CUM. BULL. 576, 577.

¹⁷¹ INT. REV. CODE OF 1954, § 6012(b)(3); Treas. Reg. § 1.6012-3(b)(4) (1958). *Contra, In re Statmaster Corp.*, 332 F. Supp. 1250, 1258-59 (S.D. Fla.), *rev'd on other grounds*, 332 F. Supp. 1248 (S.D. Fla. 1971), *aff'd*, 465 F.2d 978 (5th Cir. 1972); *In re Town Crier Bottling Co.*, 123 F. Supp. 588, 592 (E.D. Mo. 1954). The trustee's obligation is discussed at length in part 1-B-1 of Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Income Tax Liabilities of the Estate and the Debtor*, 72 MICH. L. REV. 935, 940 (1974).

ability is considered to have been incurred until the year ends.¹⁷² Therefore, any tax incurred for the period of that return apparently occupies the priority position of an administration expense,¹⁷³ even though the portion of the tax resulting from transactions prior to bankruptcy is no more meritorious a claim than the tax for a period that had ended before bankruptcy. Both are wholly "unrelated to development, preservation or distribution of the bankrupt's assets."¹⁷⁴

The Commission proposes that estates in straight bankruptcy be exempted from tax on income earned during the proceeding, unless there ultimately proves to be a surplus for the debtor.¹⁷⁵ The Commission also proposes that the taxable period of the debtor be terminated at the date of the petition and that the tax for such period be allowed as a claim against the estate.¹⁷⁶ Whatever the merit of the exemption proposal, which this writer has else-

¹⁷² Cf. *Fournier v. Rosenblum*, 318 F.2d 525, 527 (1st Cir. 1963); *Ludwig Littauer & Co.*, 37 B.T.A. 840, 843 (1938). However, the *Fournier* case, which denied the trustee's right to obtain the refund resulting from the carryback of a net operating loss sustained by an individual for the year in which bankruptcy occurred, so far as such loss was attributable to the prebankruptcy portion of the year, has been overruled by the Supreme Court. *Segal v. Rochelle*, 382 U.S. 375 (1966). Although the amount of loss could not be determined until the year ended after bankruptcy, the Supreme Court held that the inchoate right was a contingent asset at the date of the petition and passed to the trustee under Bankruptcy Act § 70a(5) (11 U.S.C. § 110(a)(5) (1970)). It could be argued, therefore, that any tax liability of the corporation attributable to the same prior period, although not yet determinable, is a prebankruptcy contingent claim provable under Bankruptcy Act §§ 57d and 63a(8) (11 U.S.C. §§ 93(d), 103(a)(8) (1970)). Cf. *Coclin Tobacco Co. v. Griswold*, 408 F.2d 1338, 1341 (1st Cir.), *cert. denied*, 396 U.S. 940 (1969).

¹⁷³ *Florida Nat'l Bank v. United States*, 87 F.2d 896 (5th Cir. 1937).

¹⁷⁴ Flanagan, *The Determination and Payment of Federal Taxes in Bankruptcy*, 47 AM. BANKR. L.J. 81, 90 (1973); cf. *In re Freedomland, Inc.*, 480 F.2d 184, 189 (2d Cir. 1973), *cert. granted sub nom. Otte v. United States*, 414 U.S. 1156 (1974); *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 102 (3d Cir. 1964). In support of the proposition that administration expenses should generally be for such purposes, see *Adair v. Bank of America Nat'l Trust & Sav. Ass'n*, 303 U.S. 350, 360-61 (1938); cf. *Reading Co. v. Brown*, 391 U.S. 471 (1968).

Harold Flanagan has scouted the applicability of the tripartite test to the classification of taxes as administration expenses, on the grounds that "it is difficult to perceive how, except in the most remote manner, taxes, other than franchise and some excise taxes, contribute to the 'development, preservation or distribution of the bankruptcy assets'" and that it would "be very difficult to force the income tax imposed on an estate under [Internal Revenue Code] Section 6012 into one of these pigeon holes except by the most fanciful legal imagination." Flanagan, *supra*. As a generalization, this statement seems incorrect, since it is a basic premise of the taxation system that governmental services and protection contribute to the production of a taxpayer's income, including any increments to a bankrupt estate. See *Swarts v. Hammer*, 194 U.S. 441, 444 (1904). However, it is true that by no fanciful stretch of the legal imagination could tax attributable to *prebankruptcy* income so qualify.

¹⁷⁵ PROPOSED BANKRUPTCY ACT § 5-104(a).

¹⁷⁶ *Id.* § 5-104(b).

where criticized at some length,¹⁷⁷ the related termination proposal has the salutary effect of denying administration expense status to the tax, if any, for the prebankruptcy portion of the year, since the liability for the period closing at bankruptcy would be finally determinable at that time.¹⁷⁸ If the Commission's proposal to exempt the estate from tax is not adopted, the priority anomaly should nevertheless be dealt with by treating so much of the tax for the year of bankruptcy as does not exceed the tax computed to the date of the petition as a prebankruptcy claim, and only the balance, if any, as an administration expense.¹⁷⁹

A comparable distortion of the administration expense priority occurs under present law upon conversion into cash of the value of assets acquired by the trustee from either an individual or a corporate bankrupt. The conversion results in taxable gains mea-

¹⁷⁷ See part I-C of Plumb, *supra* note 171, at 960.

¹⁷⁸ Although the exemption and termination provisions would not be applicable in reorganization and rehabilitation proceedings (PROPOSED BANKRUPTCY ACT §§ 7-315, 9-101), this may be of no consequence, because a plan in such cases cannot be confirmed unless it "provide[s] for the payment or securing" of *all* levels of priority claims, without distinction between administration expenses and immediate prebankruptcy taxes. *Id.* §§ 7-303(2), 9-503(d)(3) (derived from but quite different in effect from Bankruptcy Act §§ 199, 77(e), 11 U.S.C. §§ 599, 205(e) (1970)). See notes 272-76 and accompanying text *infra*.

A somewhat similar problem, although not affecting priorities, exists in the case of an individual bankrupt whose taxable year is also, at present, unbroken at the date of the petition. Homer A. Martin, 56 T.C. 1294, 1298 (1971). But the consequences in an individual case are different from those affecting a corporation because the individual makes a return for the year of bankruptcy on his own behalf and the trustee is expected to file as a distinct taxable entity, reporting only the postpetition income of the estate. Rev. Rul. 72-387, 1972-2 CUM. BULL. 632; see part I-B-2 of Plumb, *supra* note 171, at 954. The tax, if any, incurred by the individual for the full year, having become a fixed and determinable liability only after bankruptcy, is then not allowable against the estate at all, but is collectible only from the bankrupt's exempt and after-acquired property. *In re Cooney*, 35 Am. Bankr. Rep. (n.s.) 247 (N.D.N.Y. 1938); see Frances M. Parkford, 45 B.T.A. 461 (1941), *aff'd*, 133 F.2d 249 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943). This result occurs even though the right to the prebankruptcy earnings on which the individual is taxed passes to the trustee. *In re Aveni*, 458 F.2d 972 (6th Cir. 1972); *Kolb v. Berlin*, 356 F.2d 269 (5th Cir. 1966). The Commission's proposal to compute and allow the tax as of the date of bankruptcy would ameliorate, but not resolve, this inequity. See part II-B of Plumb, *supra* note 171, at 990.

¹⁷⁹ In this event, however, it would be desirable to divide the tax only for priority purposes and not to treat the pre- and postbankruptcy segments as separate taxable periods. If the estate later enjoys taxable income against which the loss carryovers of the debtor might be offset, the division of the year would impose an unwarranted penalty, since each such period would be considered a "taxable year," and the normal period of five "taxable years" during which carryovers may be availed of would be shortened by one calendar year. Treas. Reg. § 1.172-4(a)(2) (1956); *cf.* Treas. Reg. § 1.381(c)(1)-1(e)(3) (1960) (illustrating similar effect upon nonbankruptcy reorganization). A like penalty would result if the trustee sustained losses which could be carried back three taxable years to offset past profits of the debtor corporation.

sured by the debtor's basis for the assets.¹⁸⁰ Gains from such conversions, except in the probably unusual case where the sale by the trustee realizes more than the value of the property at the date of the petition, or where depreciation deductions during administration have outpaced the decline in realizable value, are usually "rooted in the prebankruptcy past" and the tax thereon is in no sense a cost attributable to the administration of the estate. There is no justification for favoring the tax on such appreciation over wages and prebankruptcy taxes, or for placing such tax on a parity with the trustee's expenses merely because the property is sold after, rather than before, the date of the petition. There is likewise no justification for the other extreme, which, as the Commission proposes, wholly exempts gains on sales during administration,¹⁸¹ whereas realization of the same appreciation by the debtor before the proceeding or by the debtor or a successor thereafter would result in tax liability. I suggest, therefore, that gains on sales during administration remain taxable,¹⁸² but that the portion of the estate's tax liability that is attributable thereto be classified, for priority purposes, as a tax accruing as of the date of bankruptcy.¹⁸³

In contrast to annual taxes based on income, unemployment

¹⁸⁰ *United States v. Sampsell*, 266 F.2d 631, 635 (9th Cir. 1959); *Homer A. Martin*, 56 T.C. 1294, 1299 (1971); *Rev. Rul. 68-48*, 1968-1 CUM. BULL. 301, 303.

¹⁸¹ Sales in straight bankruptcy are exempted as an incident to the exemption of the trustee from all income taxes (PROPOSED BANKRUPTCY ACT § 5-104(a)), and sales in reorganization and rehabilitation proceedings are disregarded in determining the tax to which such estates would be subject. *Id.* §§ 7-315(c), 9-101.

¹⁸² The Commission's proposal to exempt gains realized during the proceeding is criticized in part 1-C-4 of *Plumb*, *supra* note 171, at 977.

¹⁸³ Proof of claim should not be required, however, since the transaction giving rise to the tax occurs during bankruptcy—perhaps even after the time for claims has expired—and is known to the trustee, who should have the obligation to inform the tax collector of it rather than the reverse. *Cf. In re Freedomland, Inc.*, 480 F.2d 184, 191 (2d Cir. 1973), *cert. granted sub. nom. Otte v. United States*, 414 U.S. 1156 (1974). As a matter of strict principle, only the tax on the gain that would have been incurred on a sale at the date of the petition should be treated as a prebankruptcy item, because the tax on any further increment in the gain might be regarded as an incident to administration. To split the gain and the resulting tax, however, would require the expense of an appraisal at the date of the petition, and the chance that realizable values in a bankruptcy sale would exceed the fair market values at the date of bankruptcy seem too remote to warrant imposing such a requirement. Nevertheless, it may be appropriate to charge the administration with so much of the gain as equals depreciation and depletion deductions taken on the property during administration, so far as the deductions resulted in a tax benefit and thus reduced tax liabilities that would have been chargeable as administration expenses. *Cf. INT. REV. CODE OF 1954*, §§ 1245(a)(3), 1250(b)(3); *Treas. Reg. § 1.1245-2(a)(7)* (1965), T.D. 7141, 1971-2 CUM. BULL. 304; *Treas. Reg. § 1.1250-2(d)(4)* (1971) (imposing ordinary income tax on gains reflecting recovery of prior depreciation deductions, but only so far as tax benefit resulted therefrom).

and old age taxes imposed on employers with respect to the payment of wages have long been recognized as apportionable. The tax attributable to wages paid by the debtor before bankruptcy is deemed a prebankruptcy obligation even though the taxable period ends and the tax becomes payable during the administration.¹⁸⁴ The tax attributable to wages paid for services rendered to the bankrupt estate itself, however, is deemed an expense of administration.¹⁸⁵ The Commission, without disturbing those principles, resolves a conflict of decisions concerning an intermediate situation by providing that employment taxes attributable to wages earned before the petition but paid thereafter from the estate should enjoy only the priority status of prebankruptcy taxes,¹⁸⁶ rather than the higher standing of administration expenses accorded them by some courts.¹⁸⁷ The mere technicality that the tax on the payment of wages owed by the debtor is neither incurred nor determinable until distribution to the employees by the trustee is an inadequate reason for treating such a tax as an expense of administration, outranking even the wages themselves,¹⁸⁸ for the wages with respect to which the tax is imposed "are unrelated to development, preservation or distribution of the bankrupt's assets."¹⁸⁹ Nevertheless, it is questionable whether the proposal should go so far as to rank the trustee's tax liability behind, rather than equal to, the prebankruptcy wage claims, with the result that the full amount of the wage claims is payable before any part of the tax on such payment.¹⁹⁰ In any event, the proposal ought to be modified to relieve the tax collector of the needless formality of filing a proof of claim for such taxes, which must necessarily be estimated arbitrarily on the assumption that the

¹⁸⁴ *In re John Horne Co.*, 220 F.2d 33 (7th Cir. 1955); *Pomper v. United States*, 196 F.2d 211 (2d Cir. 1952).

¹⁸⁵ *Missouri v. Gleick*, 135 F.2d 134 (8th Cir. 1943); *In re Lambertville Rubber Co.*, 111 F.2d 45, 49-50 (3d Cir. 1940).

¹⁸⁶ PROPOSED BANKRUPTCY ACT § 4-405(c); see *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3d Cir. 1964).

¹⁸⁷ *Lines v. California Dep't of Employment*, 242 F.2d 201, 203 (9th Cir.), *rehearing denied*, 246 F.2d 70 (9th Cir.), *cert. denied*, 355 U.S. 857 (1957); *United States v. Fogarty*, 164 F.2d 26, 33 (8th Cir. 1947).

¹⁸⁸ See *In re Freedomland, Inc.*, 480 F.2d 184, 189 (2d Cir. 1973), *cert. granted sub. nom. Otte v. United States*, 414 U.S. 1156 (1974).

¹⁸⁹ *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 102 (3d Cir. 1964); see *Plumb*, *supra* note 125, at 274-75. For a contrary view, see *Flanagan*, *supra* note 174, at 84-90.

¹⁹⁰ In contrast, with respect to taxes imposed on the employees and required to be withheld from wage payments by the trustee, the proposal would require pro rata payment of wages and taxes. See note 196 and accompanying text *infra*.

maximum amount of wages will be paid,¹⁹¹ and which thus conveys less useful information than will be obtainable by the trustee by simple arithmetic when he actually pays the wages and incurs the tax.¹⁹²

The Commission also resolves an existing three-way conflict of authority on whether income and social security taxes, imposed on the employees but required to be withheld from amounts paid to them by the trustee on account of prebankruptcy wages, rank as administration expenses,¹⁹³ as prebankruptcy taxes,¹⁹⁴ or as part of the wage claims.¹⁹⁵ The Commission's proposal quite properly requires the trustee to deduct the withholdings from his payments on account of prebankruptcy wages and pay the amount over to the tax collector, thus in effect giving the tax the same priority the wage payments enjoy and dispensing with the need for filing a claim therefor.¹⁹⁶ Since the proposal is confined to wage withholdings, the status of amounts which some laws require to be withheld from interest and other payments, particularly those made to certain nonresidents,¹⁹⁷ is left in doubt.

Although administration expenses, including taxes properly attributable to the proceeding, generally rank on a parity among themselves,¹⁹⁸ the law since 1952 has provided that, if a liquidating bankruptcy supersedes a proceeding under another chapter of the Bankruptcy Act and if there are insufficient funds for all administration expenses, the expenses of the superseding bankruptcy shall have priority over the unpaid expenses of the antecedent proceeding, including, of course, any taxes incurred therein.¹⁹⁹ Since the

¹⁹¹ *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 105-06 (3d Cir. 1964). Although the Second Circuit held proof of claim unnecessary with respect to *withheld* taxes, because it viewed them as embraced in the employees' claims for the gross wages from which the tax is to be deducted, the rationale of the decision would be inapplicable to the tax on the employer, which was not involved in the case before the court. *In re Freedomland, Inc.*, 480 F.2d 184, 191 (2d Cir. 1973), *cert. granted sub. nom.* *Otte v. United States*, 414 U.S. 1156 (1974).

¹⁹² See *Plumb*, *supra* note 125, at 279.

¹⁹³ *United States v. Fogarty*, 164 F.2d 26, 30 (8th Cir. 1947).

¹⁹⁴ *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 103 (3d Cir. 1964).

¹⁹⁵ *In re Freedomland, Inc.*, 480 F.2d 184 (2d Cir. 1973), *cert. granted sub. nom.* *Otte v. United States*, 414 U.S. 1156 (1974).

¹⁹⁶ PROPOSED BANKRUPTCY ACT § 4-405(c); see *Plumb*, *supra* note 125, at 275, 278.

¹⁹⁷ See, e.g., *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940); INT. REV. CODE OF 1954, §§ 1441-42.

¹⁹⁸ See note 168 *supra*.

¹⁹⁹ Bankruptcy Act § 64a(1), 11 U.S.C. § 104(a)(1) (1970). Before Act of July 7, 1952 (ch. 579, § 19, 66 Stat. 426), expenses of both proceedings ranked equally. *In re Killoren*, 119 F.2d 364 (8th Cir. 1941).

Act refers only to prior proceedings under other chapters, it appears that expenses and taxes incurred during a prior assignment for creditors might be entitled to a prior lien or charge on the property brought into the bankruptcy court.²⁰⁰ The Commission proposes to make clear that whether or not the superseded proceeding is one under the Act, its unpaid expenses, including taxes, are junior to those of the ultimate liquidation.²⁰¹

b. *Priorities Superior to Prebankruptcy Tax Claims.* The Commission proposes to raise the amount entitled to priority in certain claims for compensation for services.²⁰² The present \$600 limitation on the priority amount allowable is increased to \$1,200 per claimant, earned no more than three months before the earlier of the date of filing the petition or the time of cessation of the debtor's business.²⁰³ Fully as important in the long run as the doubling of the amount of the priority is the further proposal for adjustment of the amount, as often as biennially, by administrative

²⁰⁰ *Randolph v. Scruggs*, 190 U.S. 533, 538-39 (1903); see 3A W. COLLIER, BANKRUPTCY ¶ 64.102[2] (1967).

²⁰¹ PROPOSED BANKRUPTCY ACT §§ 4-405(b), 4-403 Note 17.

²⁰² *Id.* § 4-405(a)(3). A new priority class, composed of those dealing with the debtor in the ordinary course of business or entering into transactions with him with the authorization of the bankruptcy administrator in the interval between the time of an involuntary petition and the order granting relief, is injected between administration expenses and wage claims. *Id.* §§ 4-208(c), 4-405(a)(2). In addition, certain expenses of creditors, which in 1938 were made junior in priority to wage claims (note 109 *supra*), would be advanced to administration expense status. *Id.* §§ 4-403(a)(2), (10).

²⁰³ The modification of the three-month rule would partially eliminate an inequity existing under present law when bankruptcy supersedes a nonbankruptcy proceeding. For example, if an assignment for creditors or receivership occurs on July 1, the employees might be entitled under state law to priority for wages earned since April 1. But if bankruptcy supervenes on September 28, their state law priority is voided as to wages earned between April 1 and June 28. *In re Ko-Ed Tavern*, 129 F.2d 806, 810 (3d Cir. 1942); *Strom v. Peikes*, 123 F.2d 1003 (2d Cir. 1941); *contra*, *Manly v. Hood*, 37 F.2d 212 (4th Cir. 1930). This situation would arise even though the prior custody of the law may have been just as effective as bankruptcy itself in precluding normal collection of payment for the earlier services. *Manly v. Hood*, *supra* at 214. The proposal would relieve the employees of the loss of priority if business ceases during the prior proceeding, but not if the business continues—e.g., in receivership—although the employees' hands are just as surely tied with respect to earlier wages unless their economic power is such that they are able to force payment under the "necessity of payment" principle. *Gregg v. Metropolitan Trust Co.*, 197 U.S. 183, 187 (1905); *Moore v. Donahoo*, 217 F. 177, 182-83 (9th Cir. 1914), *cert. denied*, 237 U.S. 706 (1915); *United States v. Wisconsin Valley Trust Co.*, 233 F. Supp. 73, 79 (W.D. Wis. 1964); *Plumb*, *supra* note 146, at 48-50. At least those employees who are laid off by the receiver may receive nothing under the "necessity" principle, yet their priority would be eroded day by day as the receivership continues operations prior to bankruptcy. If, on the other hand, a proceeding is initiated under one chapter of the Bankruptcy Act and later converted to another, the three months would be measured from the initial filing of a petition under the Act. PROPOSED BANKRUPTCY ACT § 4-312. In either event, wages earned during the bankruptcy or nonbankruptcy proceeding would rank as administration expenses.

action whenever there is an increase or decrease of ten percent or more in the cost of living index since the last previous adjustment,²⁰⁴ so that we may not again see the figure frozen at an unrealistic level for half a century.²⁰⁵

The priority at present is confined to wages and commissions due to "workmen, servants, clerks, or traveling, or city salesmen,"²⁰⁶ on the theory that protection is required only for subordinate employees "who could not be expected to know anything of the credit of their employer, but must accept a job as it comes,"²⁰⁷ and "who generally have no substantial savings or other reserves to fall back on in case of adversity and therefore cannot afford to lose."²⁰⁸ The Commission expands the priority to cover claims for any form of compensation earned by any individual as an employee or independent contractor,²⁰⁹ excluding only the principal officers, directors, certain substantial stockholders,²¹⁰ and members of the immediate family of any of them,²¹¹ whose claims, secured or unsecured, are not only denied priority but are subordinated to general creditors.²¹² No doubt the present section 64a(2) is ambiguous, inadequate, and in need of revision, for the teacher now denied priority as a "professional"²¹³ may be as much in need of protection in today's economy as the janitor, who has priority. But are middle management employees, scientists, and engineers employed by a bankrupt corporation—or, with due deference, its lawyers and certified public accountants if unincorporated—entitled to or in need of priority over other creditors and a share in the funds available for wage-earners, merely because they too provide services rather than goods or money?

²⁰⁴ PROPOSED BANKRUPTCY ACT § 1-105. This is an oversimplified statement of the rule. The details of its operation are set out in the Commission's notes to the proposed provision.

²⁰⁵ See note 108 and accompanying text *supra*.

²⁰⁶ Bankruptcy Act § 64a(2), 11 U.S.C. § 104(a)(2) (1970).

²⁰⁷ *In re Lawsam Elec. Co.*, 300 F. 736 (S.D.N.Y. 1924).

²⁰⁸ *In re Estey*, 6 F. Supp. 570 (S.D.N.Y. 1934); see BANKRUPTCY COMM'N REPORT 214. See also *Guarantee Title & Trust Co. v. Title Guar. & Sur. Co.*, 224 U.S. 152, 160 (1912); *Blessing v. Blanchard*, 223 F. 35, 37 (9th Cir. 1915).

²⁰⁹ PROPOSED BANKRUPTCY ACT § 4-405(a)(3).

²¹⁰ The word used here is "affiliate," which is defined to include "a person who directly or indirectly owns, controls, or holds with power to vote, 20 per cent or more of the outstanding voting securities of the debtor." *Id.* § 1-102(4).

²¹¹ A "member of the immediate family" means a "spouse, parent, spouse of a parent, child, spouse of a child, brother, or sister, and includes a person in a step or adoptive relationship." *Id.* § 1-102(32).

²¹² *Id.* § 4-406(a)(2). Although claims of close relatives of officers, etc., of a corporate debtor are thus subordinated, claims of relatives of individuals are not. *Id.*

²¹³ See *In re Estey*, 6 F. Supp. 570 (S.D.N.Y. 1934).

The Commission concurs with present judicial opinion²¹⁴ that vacation, severance, and sick leave pay are includible in the priority as compensation for personal services.²¹⁵ The Commission, however, creates a new priority level for "contributions to pension, insurance, or similar employee benefit plans to the extent that the claims arise from services rendered within one year before the date of the petition or the cessation of the debtor's business, whichever is earlier."²¹⁶ In order to avoid encroachment of obligations for such contributions upon the funds available for direct payment of compensation, the contribution claims are made a priority class immediately behind such compensation. The amount of unpaid contribution allowable with priority with respect to any individual cannot exceed the *lesser* of (1) \$300 or (2) the excess of \$1,200 over the amount paid on his priority claim for wages.²¹⁷

Under the proposed act, the bankruptcy system of priorities for the first time is made applicable to corporate reorganizations of the type now embraced in Chapter X.²¹⁸ The federal insolvency priority statute is superseded in such cases and, within specified limitations, compensation and fringe benefit claims must be provided for.²¹⁹ The intent of the Commission, however, is to preclude application of the nonstatutory six-month rule, in any non-railroad case,²²⁰ no matter how important to the public interest it may seem to keep the enterprise functioning while it is en route to the reorganization court.²²¹ The bankruptcy system of priorities is also extended to railroad reorganizations, but claims for current operating expenses during the six months immediately preceding

²¹⁴ See notes 114-17 and accompanying text *supra*.

²¹⁵ PROPOSED BANKRUPTCY ACT § 4-405(a)(3). The Commission's Note 3 to that provision states that "the three-month limitation is made inapplicable to severance and vacation pay," since those benefits accrue over longer periods. In the proposed statute, however, there is no express provision for relief from the limitation.

²¹⁶ *Id.* § 4-405(a)(4). This provision overrules the cases cited in notes 112-13 *supra*.

²¹⁷ PROPOSED BANKRUPTCY ACT § 4-405(a)(4). It is unclear how the limitations are to be applied when contributions to a plan are not allocated to particular employees or related to their compensation—*e.g.*, flat periodic payments, or payments based on production.

²¹⁸ Cases now embraced in Chapters X, XI, and XII of the Bankruptcy Act would all be covered by a unified procedure under Proposed Chapter VII.

²¹⁹ PROPOSED BANKRUPTCY ACT § 7-303(2); see notes 272-76 and accompanying text *infra*.

²²⁰ See note 155 *supra*. The Commission's Note 4 to Proposed Bankruptcy Act § 7-303 states its purpose to overrule *In re Hallmark Medical Serv., Inc.*, 475 F.2d 801 (5th Cir. 1973), and *Dudley v. Mealey*, 147 F.2d 268 (2d Cir. 1945).

²²¹ See note 152 and accompanying text *supra*. The Commission's view is that earlier resort to the rehabilitation or reorganization provisions of the Act, under which priority obligations may be created for continued operation, will suffice to maintain essential services. BANKRUPTCY COMM'N REPORT 219-20.

the filing of the petition must be provided for,²²² and claims for personal injury to any person, whether occurring after or at any time before the date of the petition, shall be paid as administration expenses.²²³

c. *Tax Claims Antedating Administration.* Certain federal, state, and local claims for prebankruptcy taxes occupy, under both present law and the proposed revision, the priority level just below the expanded preference for compensation and fringe benefits claims. But the proposed tax priority is contracted to embrace only the most current taxes.²²⁴ The weasel words, "legally due and owing,"²²⁵ are abandoned in favor of a forthright declaration of the crucial date applicable to almost every conceivable form of tax.²²⁶

According to the proposal, taxes upon or measured by income, for any period ending on or prior to the date of the petition,²²⁷ enjoy priority over general creditors if the due date for filing the return or the extended due date is within one year before the

²²² PROPOSED BANKRUPTCY ACT § 9-503(d)(3). Because six months is expressly mentioned, the present flexibility of the courts to embrace more than six months' expenses in the priority would apparently be denied. *Southern Ry. v. Carnegie Steel Co.*, 176 U.S. 257, 292-93 (1900); see *In re Chicago, R.I. & P. Ry.*, 90 F.2d 312, 315 (7th Cir. 1937).

²²³ PROPOSED BANKRUPTCY ACT § 9-501. This section expands upon Bankruptcy Act § 77(n) (11 U.S.C. § 205(n) (1970)), which now so treats claims for personal injuries to employees, whether or not occurring within the preceding six months. *Thompson v. Siratt*, 95 F.2d 214 (8th Cir. 1938). But present law makes no such provision for injuries to passengers and others. *In re New York, New Haven & Hartford R.R.*, 92 F.2d 428 (2d Cir. 1937). Inexplicably omitted from the proposal are wrongful death claims, which are now expressly covered in the case of employees. Also omitted from the proposal are the present provisions for unsecured claims of sureties or supersedeas, appeal, attachment, and garnishment bonds. See *In re Chicago, R.I. & P. Ry.*, 90 F.2d 312 (7th Cir. 1937). The proposal also omits the extension of the priority rule to federal equity receiverships. *Carpenter v. Wabash Ry.*, 309 U.S. 23 (1940). The two last-mentioned of these neglected provisions may perhaps have outlived their usefulness. Like present law the proposal fails as well to provide similar priority for persons injured by *intrastate* railroads, which will be subject to proposed Chapter VII (now Chapter X) rather than to the railroad reorganization provisions. See *Augus v. Stichman*, 273 F.2d 707 (2d Cir.), *cert. denied*, 362 U.S. 988 (1960).

²²⁴ PROPOSED BANKRUPTCY ACT § 4-405(a)(5).

²²⁵ See notes 126-31 and accompanying text *supra*.

²²⁶ "Taxes are either (1) capitation or poll taxes, (2) taxes on property, or (3) excise taxes." I T. COOLEY, *TAXATION* § 38 (4th ed. 1924). The proposal fails to refer to capitation or poll taxes, which may still be levied even though not made a condition to voting. See *Harper v. Virginia Bd. of Elections*, 383 U.S. 663, 668-69 (1966). Property taxes include both *ad valorem* taxes and specific taxes, that is, by the number, weight, size, etc., of certain objects owned, without reference to value. I T. COOLEY, *supra* at § 52. The proposal mentions only *ad valorem* taxes. Neither poll taxes nor specific property taxes, however, appear to be so significant that the resulting denial of priority for them would be material.

²²⁷ For a discussion of the status of taxes for periods ending thereafter, see notes 170-79 and accompanying text *supra*.

petition or has not yet arrived.²²⁸ For example, if an individual becomes bankrupt on March 1, 1975, the priority extends to the taxes for 1973, the return for which is due April 15, 1974, less than a year before bankruptcy, and to those for 1974, the return for which is not due until after bankruptcy, and for the short period ending March 1, 1975.²²⁹ But if bankruptcy occurs on or after April 16, 1975, and no extension of the time for filing the return has been granted, only the taxes for 1974 and the short period in 1975 enjoy priority. For taxable years within that limited span—the ones in which the debtor is least likely to have incurred an income tax—the priority extends not only to taxes shown on the debtor's return, if any, but to deficiencies subsequently determined and assessed, whether before or after the filing of the petition.

For any earlier taxable year, the proposed act gives priority to the original tax or deficiencies only in unusual circumstances, even if the delay in assessment or collection is justifiable. If the tax has been assessed, whether on an original return or as a deficiency, any uncollected amount thereof is denied priority; it is of no avail to the taxing government that a lien for such obligation has been duly perfected since statutory tax liens are wholly invalidated by the proposed legislation.²³⁰ Even if the tax has not been assessed because the debtor's failure to file a return or his filing of a false or fraudulent return made prompt detection of his tax delinquency more difficult, or if the amount of tax shown on the debtor's return is erroneous and the tax collector is restrained by law from assessing and collecting the deficiency by normal procedures until the debtor is afforded an opportunity to contest his liability, the tax priority nevertheless is denied. The 1966 legislation, which attempted to accommodate the needs of practical tax administration by maintaining the government's priority where the delay is thus justified,²³¹ was unquestionably ineptly drafted and in need of

²²⁸ PROPOSED BANKRUPTCY ACT § 4-405(a)(5)(A).

²²⁹ Under present law, the taxable year would not end at bankruptcy, and no part of the tax for 1975 would be provable against the estate. Instead, the entire tax for the year would be a postbankruptcy obligation, collectible only from the exempt and after-acquired property of the debtor, even though the taxed income had passed to the trustee. The Commission's proposal makes the tax computed on the income of the short period an allowable claim. See note 178 *supra*.

²³⁰ See notes 80-82 and accompanying text *supra*. Even if the tax had been collected, it would be recoverable by the trustee if (1) the assessment had first given rise to a lien and (2) collection had occurred within three months before bankruptcy, so the period in which the Government is permitted to collect its tax without loss of priority is three months less than superficially may appear. See notes 100-01 and accompanying text *supra*.

²³¹ See notes 132-33 and accompanying text *supra*.

amendment.²³² But, instead of making the effort consistent with their purpose to make those provisions understandable and rationally workable, the Commission wholly abandons the accommodations that ultimately won congressional approval of the 1966 reforms in the face of nearly two decades of bitter Treasury opposition.²³³

In proposing what amounts to a "no-fault" standard for denying the priority of noncurrent tax liabilities, the Commission states, in effect, that the tax collector is no more meritorious a creditor than those who provide the unsecured credit that keeps the business going. As the Commission's Chairman Marsh earlier wrote:

Should tax claims be granted priority in bankruptcy? Does the traditional rule which has granted priority to all tax claims, at least over all general, non-priority creditors, rest upon anything more than a naked assertion of power based upon the fact that this particular creditor happens to be writing the rules of distribution? It is possible that in a simpler day the priority given to tax claims in insolvency proceedings was of some real consequence in gathering together enough funds to keep the government running. There can be no doubt today that whatever amount the government is able to collect as a result of such a priority over what it would receive without it is insignificant; its sacrifice would go completely unnoticed in the vast federal bureaucracy. It is difficult to see how the government, absent a plea of necessity, has any equities superior to the other creditors of an insolvent.²³⁴

Chairman Marsh anticipates the argument that, if the dollars involved are so insignificant as to mean little to the government, it is equally true that little is added to the typically small recovery of each creditor. He responds that it is important that the government both be fair and appear to be fair in its dealings with its citizens, and that, "[i]f there is no equitable basis for the Government's claiming such a priority, its assertion is viewed merely as an exercise of arbitrary power; [hence,] to say that any one of the victims is really hurt very little is irrelevant."²³⁵

²³² See Marsh, *supra* note 39, at 689-97. For suggested statutory amendments to deal with the problem areas, see Plumb, *Federal Tax Liens and Priorities in Bankruptcy—Recent Developments*, 43 REF. J. 37, 43-46 (1969).

²³³ See notes 132-33 and accompanying text *supra*.

²³⁴ Marsh, *supra* note 39, at 729 (footnote omitted). The footnote cites 1966 statistics indicating that tax claims probably received substantially less than \$43,000,000 in bankruptcy liquidations, despite their liens and priorities.

²³⁵ Marsh, *supra* note 39, at 729-30; see H.R. REP. NO. 687, *supra* note 128, at 4. The House Judiciary Committee stated that it had received "hundreds of letters from business firms all over the country complaining about [the] situation" (Marsh, *supra* note 39, at 730

A proponent of the original American Bar Association recommendation, to which the Commission's proposal is a throw-back,²³⁶ cited a reason why, at least in many business bankruptcies, the federal tax priority results in inequities:

General unsecured creditors in most cases have supplied the bankrupt with goods and funds during the period immediately prior to bankruptcy, and what remains of such goods and funds usually constitutes the bulk of the assets of the bankrupt. The result is that new, general, and unsecured creditors often furnish the wherewithal out of which are paid the expenses of administration and taxes, and it frequently happens that tax claims disclose old and large liabilities of which the general unsecured creditor had no knowledge or means of ascertaining.²³⁷

Although I am not prepared to concede the validity of that argument in support of the Commission's proposal to invalidate tax liens that have been a matter of record for three months or more before bankruptcy,²³⁸ it is persuasive as applied to tax liabilities which, for whatever good reason, remain undetermined and undiscoverable by those extending credit.

A dilemma results, however, from the policy tension between priority and dischargeability of tax claims. If a tax claim is denied priority, the probability that it will not be paid out of the estate is enhanced; if the same claim is nondischargeable, the consequence of its lack of priority is to enlarge the overhanging burden of debt that will impede the debtor's "fresh start."²³⁹ Accordingly, the 1966 legislation preserved the Government's priority for every tax for which Congress for any reason denied the debtor a discharge.²⁴⁰ The Commission partially severs the priority and discharge issues by relieving innocent creditors of the burden of the Government's priority for noncurrent taxes for which the debtor filed a fraudu-

n.105) which was thereafter only ineffectually remedied by the 1966 legislation. Marsh views these complaints as evidence of "a widespread and deep-seated resentment in the business community at the government's claiming the lion's share of every bankrupt estate." Marsh, *supra* note 39, at 730.

²³⁶ See note 122 and accompanying text *supra*.

²³⁷ Olive, *supra* note 90, at 6. With less restraint, a referee has expressed the view that "[t]axing authorities and collectors are not responsible for a dollar's worth of goods on any bankrupt's shelves or for one single fixture in his store and every penny paid in tax priorities is at the expense of the general creditors." *In re Rafiowitz*, 43 Am. Bankr. Rep. (n.s.) 358, 361 (D. Conn. 1940), *rev'd*, 37 F. Supp. 202 (D. Conn. 1941).

²³⁸ See notes 93-94 and accompanying text *supra*.

²³⁹ Moore & Tone, *supra* note 90, at 704.

²⁴⁰ Act of July 5, 1966, Pub. L. No. 89-496, 80 Stat. 27 (1966), *amending* Bankruptcy Act §§ 17a(1), 64a(4), 11 U.S.C. §§ 35(a)(1), 104(a)(4) (1964) (codified at 11 U.S.C. §§ 35(a)(1), 104(a)(4) (1970)).

lent return or no return, but retaining the denial of a discharge in such cases. The burden of the debtor's misconduct or default is thus placed upon the debtor and the Government rather than upon the creditors. But, in further relieving the unknowing creditors of the existing priority consequences of a debtor's *nonfraudulent* understatement of his tax liability, the Commission felt obliged also to grant the debtor a discharge.²⁴¹ There are nevertheless very persuasive reasons why Congress may be unwilling to follow the Commission's lead in permitting even a nonfraudulent taxpayer, by declaring bankruptcy as early as a year and a day after filing his return, to escape liability for the tax he failed to disclose on his return.²⁴² Unfortunately for innocent creditors, unaware of the tax liabilities that may accumulate while the controversy remains unresolved, the reasons for denying discharge in such circumstances are necessarily also reasons against denying the priority of the claim unless Congress is prepared to sever the issues completely, in effect penalizing the nonfraudulent debtor for contesting his tax liability, by denying discharge thereof yet making priority funds in his estate unavailable for its satisfaction.

In one circumstance, the Commission's concern for the innocent creditors who extend credit in ignorance of the debtor's tax liabilities is overcome by a greater concern for the debtor himself. Under its general power to compromise tax liabilities,²⁴³ the Government may enter into a deferred payment agreement with a hard-pressed taxpayer who appears able to work himself out of his difficulties if given time.²⁴⁴ In connection therewith it also may refrain from filing notice of its lien or may release a lien already filed, in order that the taxpayer who is conscientiously meeting his deferred payments may deal freely with his property and obtain credit, unhampered by a notice of lien filed against all his assets. One of the objections raised by the Treasury against the 1966 legislation was that it would make the tax collector reluctant to enter into such arrangements, and would force him to "crack down" on the distressed taxpayer by seizing his home or other

²⁴¹ See text accompanying note 403 *infra*.

²⁴² See text accompanying notes 392-95 & 439-43 *infra*.

²⁴³ INT. REV. CODE OF 1954, § 7122.

²⁴⁴ In general, federal law limits extensions of the time for payments of income tax to six months from the due date, in the case of tax shown on the return (INT. REV. CODE OF 1954, § 6161(a)(1)) and to 18 months in the case of deficiencies (*id.* § 6161(b)(1)); further extensions, however, limited only by the discretion of the tax collector, may be granted once the collection process begins. *United States v. Wolper*, 86 F.2d 715 (2d Cir. 1936); *Treas. Reg.* § 301.6343-1(a)(2), T.D. 7180, 1972-1 CUM. BULL. 386, 393.

assets, because if bankruptcy occurred after the then three-year limitation period, the Government would lose its priority and suffer discharge of the liability for the deferred payments.²⁴⁵ Although the objection went unheeded by Congress at the time, the proposed shortening of the limitation on priority and nondischargeability to one year moved the Commission to propose an exception whereby, if an extension of the time for payment of any form of tax has been granted, the priority and nondischargeability of the tax claim is preserved with respect to any installments that, under the terms of the extension, were payable after or within one year before the date of the petition.²⁴⁶ Although such consideration for the debtor is commendable,²⁴⁷ the proposal partially negates the intended protection for creditors, since it exposes them to priority claims which may include taxes for a number of years past and for which there may be no recorded notice of lien. It is impossible, of course, to satisfy everyone in a bankruptcy situation in which someone necessarily must lose. But a better balancing of the equities of the parties might be achieved if, while making the deferred tax nondischargeable as proposed and thus assuring the tax collector that the taxpayer cannot walk away from the arrangement made for his accommodation, priority were nevertheless denied in the absence of public notice of the liability. In this way, creditors would be protected against an undue accumulation of taxes of which they had no warning. Although this suggestion could result in a greater ultimate burden on the debtor if bankruptcy ensues and the loss of priority causes less of the tax to be collectible from the estate, it is not an unfair burden to impose when the delay in collection and the nonfiling of the lien are for the accommodation of the debtor and at his request. If the Government's priority is to be preserved in such cases, consideration should be given to providing for filing notice of the payment arrangement, which would warn creditors but which would not have the effect of a filed notice of lien except as against the trustee if bankruptcy ensues.²⁴⁸

²⁴⁵ H.R. REP. NO. 687, *supra* note 128, at 6 (Treasury Department statement).

²⁴⁶ PROPOSED BANKRUPTCY ACT § 4-405(a)(5)(F); *see* BANKRUPTCY COMM'N REPORT 216.

²⁴⁷ According to Marsh,

[a]ny rule denying priority to tax claims purely upon the basis of age tends to put pressure on the Internal Revenue Service to "crack down" on delinquent taxpayers, regardless of their degree of fault. Surely, any humanity which may have insinuated itself into the heartless process of tax collection is not something to be discouraged.

Marsh, *supra* note 39, at 730.

²⁴⁸ This was proposed by the Treasury Department and the Senate Finance Committee as an amendment to one of the 1966 bankruptcy bills. S. REP. NO. 999, 89th Cong., 2d Sess.

The Commission's proposal perpetuates a serious aberration in the interpretation of present law. If a taxpayer, on the road to bankruptcy, suffers a net operating loss, the loss may in general be carried back to offset income reported in the three preceding years.²⁴⁹ In order to provide needed funds without delay to one who has suffered such a loss, the Internal Revenue Code permits the taxpayer to file an application for a tentative refund of the tax overpayment for the prior year resulting from application of the carryback. Furthermore, it requires that the refund be paid within ninety days, with a minimum of checking for obvious errors, subject to full examination at a later date.²⁵⁰ If, for example, a loss for 1972 is carried back to 1969 and a tentative refund is allowed on June 1, 1973, a later audit of the 1972 return may result in reduction of the claimed loss and consequent liability to repay part of the refund allowed for 1969. In the Fifth Circuit's view, under the present Bankruptcy Act the liability is a tax "legally due and owing" for 1969, and was already more than three years old on the day the tentative refund was made. Hence it would be a dischargeable and nonpriority claim, even if bankruptcy occurred immediately, despite the fact that until that moment the tax for 1969 was not underpaid at all.²⁵¹ A district court in New York has disagreed on the ground that the tax could not have become "legally due and owing" until the events giving rise to the liability occurred.²⁵² But the ground would be cut from under the latter decision by the proposed abandonment of the "legally due and owing" phraseology. Since the liability is one for a tax "upon or measured by income" for the year to which the loss was carried back, it would be difficult to argue that the liability to repay the excessive carryback refund is not a dischargeable nonpriority claim from the moment of its birth. The proposal should be amended to make clear that in such a case the one year limitation is measured from the date of the refund which for the first time results in the debtor's liability to repay.

6, 13 (1966). It was apparently acceptable in principle to at least one representative of the National Bankruptcy Conference, Professor MacLachlan. See *Hearings on S. 976 (H.R. 3438) and S. 1912 (H.R. 136) Before the Senate Comm. on Finance, 89th Cong., 1st Sess. 9, 54 (1965)*. But it fell with the defeat of the rest of the Treasury Department substitute for the Judiciary Committee's bills. See Plumb, *supra* note 125, at 271.

²⁴⁹ INT. REV. CODE OF 1954, § 172(b)(1)(A)(i).

²⁵⁰ *Id.* § 6411.

²⁵¹ *In re Able Roofing & Sheet Metal Co.*, 425 F.2d 699 (5th Cir. 1970); see Plumb, *Federal Tax Priorities in Bankruptcy and Insolvency*, 78 Com. L.J. 309, 312 (1973).

²⁵² *In re Laytan Jewelers, Inc.*, 332 F. Supp. 1153 (S.D.N.Y. 1971).

The one-year cutoff of the tax priority is applied, with some variations, to taxes other than those imposed upon or measured by income. In the case of claims for *ad valorem* property taxes, priority over general claims is allowed if the tax was last payable without penalty within one year before the date of the petition.²⁵³ However, in view of the widespread, if not universal, practice of impressing a lien for *ad valorem* taxes which would normally attach automatically long before a year after the last day for payment without penalty, and in view of the proposal to recognize statutory liens for *ad valorem* taxes,²⁵⁴ only in rare cases would such a tax, regardless of age, not qualify for either lien or priority status.

Under the Commission's proposal, customs duties and excises, other than excises measured by income or by wages paid, enjoy priority only to the extent that they are imposed on *transactions occurring* within one year prior to the date of the petition, even though the reporting of liability might be required on a return due less than a year before the petition.²⁵⁵ Employment taxes—*i.e.*, those imposed on the debtor as an employer—based on wages earned before the date of the petition enjoy priority over general claims only if the return is required to be filed within one year prior to the petition or thereafter.²⁵⁶ On the other hand, income and social security taxes imposed on the employee but required to be withheld by the debtor from wages paid before bankruptcy enjoy priority, as tax claims, over general creditors of the debtor, no matter how many years' accumulation of such claims there may be.²⁵⁷ The proposal thus conforms with the present law.²⁵⁸ It

²⁵³ PROPOSED BANKRUPTCY ACT § 4-405(a)(5)(B). Whereas the income and employment tax priority provisions (*id.* §§ 4-405(a)(5)(A) & (D)) use the phrase "within one year prior to the petition or thereafter" (emphasis added), the *ad valorem* tax provision does not. Its omission of the words "or thereafter" is disturbing. When a property tax is incurred before bankruptcy, and hence should not rank as an administration expense, the fact that payment without penalty is still permissible at the date of the petition should not cause it to lose even the priority that a somewhat older claim for such a tax would enjoy.

²⁵⁴ PROPOSED BANKRUPTCY ACT § 4-606(a)(2); *see* note 81 *supra*.

²⁵⁵ PROPOSED BANKRUPTCY ACT § 4-405(a)(5)(E).

²⁵⁶ *Id.* §§ 4-405(a)(5)(D), 4-405(c). This priority applies regardless of whether the wages are paid or unpaid and whether the tax is incurred before or after the date of the petition. The proposed change in the law respecting the tax on wages earned before but paid during the proceeding is discussed in notes 186-92 and accompanying text *supra*.

²⁵⁷ PROPOSED BANKRUPTCY ACT § 4-405(a)(5)(C). For a discussion of the proposed treatment of tax withholdings from wages earned before but paid during the proceeding, *see* notes 193-97 and accompanying text *supra*.

²⁵⁸ Bankruptcy Act §§ 17a(1)(e), 64a(4), 11 U.S.C. §§ 35(a)(1)(e), 104(a)(4) (1970). The unlimited priority and nondischargeability of liabilities for taxes "which the bankrupt has collected or withheld from others" is construed to include not only the employer's own liability but also the 100% "penalty" imposed by § 6672 of the Internal Revenue Code on the

reflects the peculiar sanctity of withheld taxes, which are viewed as trust funds,²⁵⁹ although in fact the question of priority would arise only if the debtor had dissipated the trust.²⁶⁰ The debtor's default and dissipation of the trust fund are much more readily subject to prompt detection and remedial action by the tax collector than, for example, his underpayment of income taxes;²⁶¹ unpaid withholdings are more likely than stale income taxes to be a heavy burden on general creditors in bankruptcy.²⁶² It therefore seems difficult to justify exempting such claims from the proposed one-year limitation on priority, if the limitation is supportable at all.

Proposed changes in the law respecting partnership bankruptcies also affect priorities. Partnerships occupy a dual status under the federal tax law as well as under any state or local tax laws cast in similar terms. For certain purposes, they are treated as business entities and are liable as such for withholding, social security, and excise taxes in the same manner as a corporate or individual operator of the business would be.²⁶³ For federal income tax purposes, however, a partnership is not taxed as such but is treated in effect as a conduit: the partners are directly taxable on the partnership's income in accordance with their distributive shares.²⁶⁴ A partnership, as such, may become bankrupt, either separately or jointly with one or more of its general partners.²⁶⁵ The present bankruptcy law adopts the rule of marshalling assets by which the net proceeds of partnership property are first ap-

officer or other person responsible for the failure to protect the funds collected or withheld. *Westenborg v. United States*, 285 F. Supp. 915 (D. Ariz. 1968); *Sherwood v. United States*, 228 F. Supp. 247 (E.D.N.Y. 1964); *In re Serignese*, 214 F. Supp. 917 (D. Conn. 1963), *aff'd sub nom. Goring v. United States*, 330 F.2d 960 (2d Cir. 1964). The Commission similarly construes its proposal. PROPOSED BANKRUPTCY ACT § 4-406 Note 6.

²⁵⁹ INT. REV. CODE OF 1954, § 7501(a).

²⁶⁰ If the fund is traceable, the Government can claim it as its own property, free of the bankruptcy administration. *In re States Motors, Inc.*, 168 F. Supp. 82 (E.D. Mich. 1958). If not, the claim is viewed for priority purposes as a tax liability of the employer. *United States v. New York*, 315 U.S. 510, 513-16 (1942); *In re Gregory Mobile Homes, Inc.*, 347 F. Supp. 528 (M.D. Ga. 1972).

²⁶¹ See Moore & Tone, *supra* note 90, at 703-04, suggesting that the period for which priority claims should be allowed to accumulate should be *shortest* for withheld taxes, which are simple to compute, required to be paid promptly, and rarely disputable, while a longer period should be allowed for income taxes, which involve complexities in determination.

²⁶² See Marsh, *supra* note 39, at 694; *cf. In re Gregory Mobile Homes, Inc.*, 72-2 U.S. Tax Cas. ¶ 9564 (M.D. Ga.), *rev'd*, 347 F. Supp. 528 (M.D. Ga. 1972).

²⁶³ *Adler v. Nicholas*, 166 F.2d 674, 679 (10th Cir. 1948).

²⁶⁴ *United States v. Bayse*, 410 U.S. 441, 448 (1973); INT. REV. CODE OF 1954, §§ 701-04.

²⁶⁵ Bankruptcy Act § 5a, 11 U.S.C. § 23(a) (1970). To the same effect, see PROPOSED BANKRUPTCY ACT §§ 1-102(34), 4-201, 4-204, 4-206, 4-305.

propriated to partnership debts, and the net proceeds of individual assets are applied first to individual debts of the members of the partnership.²⁶⁶ If a business tax is duly assessed against the partnership as such before bankruptcy, and notice of lien is duly filed, such tax will enjoy lien status in the estates of *both* the partnership and its members, since the members are liable for partnership debts and the marshalling rule does not affect liens.²⁶⁷ However, if no lien is perfected, the tax is collectible as either a priority or a general claim against the partnership estate, but is collectible from the individual estates only in subordination to all their personal general creditors. On the other hand, the income tax incurred by the individual partners on partnership income, which may have been retained in the partnership or expended for its benefit, enjoys priority or general status only in the members' personal estates and, if not collectible from them, is subordinated in the partnership estate to all partnership debts.²⁶⁸

The Commission proposal substantially modifies those rules in both respects. On the one hand, the marshalling rule is altered, as has long been urged,²⁶⁹ so that partnership creditors, including claimants for taxes which are partnership debts, share in the assets of the individual estates in the same manner as individual creditors, and are no longer subordinated in such assets.²⁷⁰ On the other hand, while the generally superior rights of partnership creditors in assets of the partnership continue, any income tax liability incurred at the individual level that is fairly apportionable to a partner's taxable share of partnership earnings not withdrawn by him before bankruptcy is classified as a partnership obligation. As a result, it is collectible from partnership, as well as individual, assets, with the priority, if any, to which the age of the liability entitles it, but in any event without being subordinated to firm creditors.²⁷¹

In the case of railroad and corporate reorganizations under

²⁶⁶ Bankruptcy Act § 5g, 11 U.S.C. § 23(g) (1970). This is in accord with the general rules expressed in UNIFORM PARTNERSHIP ACT §§ 40(h)-(i).

²⁶⁷ *In re Crockett*, 150 F. Supp. 352 (N.D. Cal. 1957).

²⁶⁸ *United States v. Kaufman*, 267 U.S. 408 (1925).

²⁶⁹ J. MACLACHLAN, *supra* note 122, at 423-25; Kennedy, *A New Deal for Partnership Bankruptcy*, 60 COLUM. L. REV. 610, 630-32 (1960) (reporting efforts of National Bankruptcy Conference to change rule).

²⁷⁰ PROPOSED BANKRUPTCY ACT § 4-405(f). Principles of marshalling would no doubt require that such tax claims first exhaust partnership assets.

²⁷¹ *Id.* § 5-104(d). This provision reinstates, so far as it may have been impaired by the *Kaufman* decision (*United States v. Kaufman*, 267 U.S. 408 (1925)) the equitable rule of *In re Brezin*, 297 F. 300, 306-07 (D.N.J. 1924).

the Bankruptcy Act, the prescription of present law that no plan shall be confirmed which does not provide for full payment of federal taxes and customs duties, unless the Treasury agrees to accept a lesser amount,²⁷² is replaced by a requirement that provision be made "for the payment or securing" of those claims entitled to priority under the foregoing proposed rules.²⁷³ Thus, the Treasury's existing veto power is largely abrogated since, in general, taxes more than a year old need not be provided for unless there is an equity remaining for them. In addition, even if the estate is insolvent, it is the declared intention of the Commission that the ancient insolvency priority statute²⁷⁴ no longer be applicable in such reorganizations,²⁷⁵ so that even those federal claims entitled to priority need only be properly secured, but need not necessarily be paid first in time, as under present law.²⁷⁶

d. *Interest on Taxes.* As a general rule, interest is not recoverable in bankruptcy beyond the date of the petition, whether the claim is for a private debt²⁷⁷ or for a tax.²⁷⁸ This rule applies in reorganization and rehabilitation proceedings²⁷⁹ as well as in straight bankruptcy. It is not completely accurate, however, to say that interest stops running at the date of the petition, because interest accruing afterward is collectible from the debtor himself if

²⁷² See notes 149-50 and accompanying text *supra*.

²⁷³ PROPOSED BANKRUPTCY ACT §§ 7-303(2), 9-503(d)(3). State and local taxes, so far as they are entitled to priority, are thus for the first time brought within the protection of this requirement.

²⁷⁴ REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1970).

²⁷⁵ PROPOSED BANKRUPTCY ACT § 7-303 Note 4. The past reluctance of the courts to imply amendments to the insolvency priority statute from amendments to related laws warns, however, that the intention ought to be spelled out in the statute itself, or in unmistakable legislative history. See *United States v. Emory*, 314 U.S. 423 (1941); *H.B. Agsten & Sons, Inc. v. Huntington Trust & Sav. Bank*, 388 F.2d 156, 160 (4th Cir. 1967), *cert. denied*, 390 U.S. 1025 (1968). *But cf.* *United States v. Gargill*, 218 F.2d 556, 558-59 (1st Cir. 1955).

²⁷⁶ *United States v. Key*, 397 U.S. 322 (1970). See notes 141-48 and accompanying text *supra*.

²⁷⁷ *Sexton v. Dreyfus*, 219 U.S. 339, 344 (1911).

²⁷⁸ *City of New York v. Saper*, 336 U.S. 328 (1949). The rule applies even when the tax is secured by a perfected general lien. *In re Kerber Packing Co.*, 276 F.2d 245 (7th Cir. 1960); *United States v. Bass*, 271 F.2d 129 (9th Cir. 1959); *United States v. Harrington*, 269 F.2d 719 (4th Cir. 1959); Rev. Rul. 68-574, 1968-2 CUM. BULL. 595. Interest stops even if the Government has made a levy, but has not collected, before bankruptcy. *In re Quakertown Shopping Center, Inc.*, 366 F.2d 95, 98 (3d Cir. 1966).

²⁷⁹ *United States v. Edens*, 189 F.2d 876 (4th Cir. 1951) (involving a Chapter X proceeding); *United States v. General Eng'r & Mfg. Co.*, 188 F.2d 80 (8th Cir. 1951) (involving a Chapter XI proceeding, *both aff'd*, 342 U.S. 912 (1952)); *In re Tennessee Cent. Ry.*, 316 F. Supp. 1103, 1114 (M.D. Tenn. 1970), *rev'd on other grounds*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972) (involving a railroad reorganization proceeding).

the underlying obligation is not discharged,²⁸⁰ and is collectible from the value of the specific security in excess of the principal of the debt.²⁸¹ Since the relief from postpetition interest is granted not out of compassion for the debtor²⁸² but to prevent creditors from profiting or suffering loss through the effect of interest accruing during a delay that is "the act of the law,"²⁸³ such interest may be allowed out of assets of the estate when there is a surplus over the principal of allowed claims.²⁸⁴ The Commission proposal, in effect, confirms this rule by providing that interest on allowed claims, other than subordinate claims,²⁸⁵ shall be paid next after general nonpriority claims.²⁸⁶

Nevertheless, the Supreme Court has said, in a considered dictum, that interest is allowable on those taxes that are incurred *during* the proceeding and constitute administration expenses.²⁸⁷

²⁸⁰ *Bruning v. United States*, 376 U.S. 358 (1964); *Hugh H. Eby Co. v. United States*, 456 F.2d 923 (3d Cir. 1972); *In re Johnson Elec. Corp.*, 442 F.2d 281 (2d Cir. 1971).

²⁸¹ *In re Black Ranches, Inc.*, 362 F.2d 8, 15 (8th Cir. 1966); *In re Macomb Trailer Coach, Inc.*, 200 F.2d 611 (6th Cir.), *cert. denied*, 345 U.S. 958 (1953); see *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 164 (1946) (*compound* interest denied in bankruptcy even when security would cover it; *simple* interest allowed only if security worth more than sum of principal and interest due (emphasis added)). The Commission, although stating perversely that "judicial rules concerning postpetition interest and penalties are not disturbed," indicates its disapproval of these decisions (which it fails to cite) by stating the existing rule to be that "[p]ostpetition interest is not allowable on any claim, whether or not dischargeable or fully secured by an indefeasible lien." PROPOSED BANKRUPTCY ACT § 4-506 Note 4. The Commission cites *City of New York v. Saper*, 336 U.S. 328 (1949), and *Sword Line v. Industrial Comm'r*, 212 F.2d 865 (2d Cir.), *cert. denied*, 348 U.S. 830 (1954), neither of which involved a secured claim, although the *Sword Line* court, without expressing an opinion even by dictum, did raise the question whether "in pursuance of an overriding policy the Court may ultimately think it not desirable to allow any [exceptions] at all." 212 F.2d at 869. The principle of the *Black Ranches* and *Macomb* cases, *supra*, has not been extended by the courts to cases where a tax creditor has a general lien on all the debtor's property. See note 278 *supra*.

²⁸² See *Bruning v. United States*, 317 F.2d 229, 231 (9th Cir. 1963), *aff'd* 376 U.S. 358 (1964).

²⁸³ *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266 (1914).

²⁸⁴ *Brown v. Leo*, 34 F.2d 127 (2d Cir. 1929); *Johnson v. Norris*, 190 F. 459 (5th Cir. 1911); see *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266-67 (1914).

²⁸⁵ See notes 299-302 and accompanying text *infra*.

²⁸⁶ PROPOSED BANKRUPTCY ACT § 4-405(a)(8). Although the proposed provision states generally that "interest on claims" shall occupy this position in the hierarchy of distribution, it is evident that only postpetition interest is meant to be thus subordinated. See *id.* § 4-405 Note 6. Prepetition interest would itself be a claim, since "claims" are determined as of the date of the petition. *Id.* § 4-403(b).

²⁸⁷ In *Nicholas v. United States*, 384 U.S. 678, 682-90 (1966), the Court concluded that "[a] tax incurred within any one of these three periods [the pre-arrangement period, the period of an attempted Chapter XI arrangement, and the liquidating bankruptcy period] would, we think, be entitled to bear interest against the bankrupt estate until, but not

Although the Commission's purpose with respect to such interest is unclear, it appears that interest on such taxes continues to be allowable at the expense of other creditors.²⁸⁸ Yet, as an earlier court of appeals opinion to the contrary had aptly said,

[w]hether the tax accrued before bankruptcy or subsequent thereto, the evil propagated by continually accruing interest remains the same. In neither case is it logical to charge a bankrupt estate a fee for the use of money—when it is the force of law which prevents the return of the principal to the creditor, rather than the desire of the debtor to retain its use.²⁸⁹

Congress should consider whether to extend the subordination of interest to claims incurred during the proceeding, other than on funds borrowed for the purposes of administration.²⁹⁰ On the other hand, since there may be cases where payment of taxes is delayed with no better excuse than that the tax money has been put to work for the rehabilitation of the debtor and the enhancement of the return to the creditors, it might be advisable to give the court discretion to allow interest without subordination.²⁹¹

e. *Tax Penalties.* Penalties which accrue on taxes and other governmental claims before the filing of the petition have long been expressly disallowed in bankruptcy, except to the extent that they compensate for actual pecuniary losses sustained.²⁹² This

beyond, the close of the period in which it was incurred." *Id.* at 686. That conclusion is dictum for present purposes since the tax was incurred during the arrangement period, but the interest accrued only in the liquidating period, and was disallowed.

²⁸⁸ The ambiguity of the Commission's position may be due to a typographical error in the proposed bill. The interest that is proposed to be subordinated to general claims is "interest on claims allowed under section 4-402(b)." PROPOSED BANKRUPTCY ACT § 4-405(a)(8). Since § 4-402(b) relates to the allowance of secured and partially secured claims, it is probable that the intended reference is to § 4-403(b), relating to the allowability of claims for *other than* administration expenses (which are dealt with in § 4-403(a)). PROPOSED BANKRUPTCY ACT §§ 4-402(b), 4-403(a), (b).

²⁸⁹ *United States v. Kalishman*, 346 F.2d 514, 520 (8th Cir. 1965), *cert. denied*, 384 U.S. 1003 (1966).

²⁹⁰ See *Plumb*, *supra* note 125, at 284-85. It was said in *Nicholas v. United States*, 384 U.S. 678, 687 (1966), that the allowance of interest on debts incurred *during* the proceeding promotes the availability of capital to the estate—an end which, however, could readily be served by permitting the court or the administrator to approve contracts for the payment of interest on funds borrowed by or on credit extended to the estate (*cf.* PROPOSED BANKRUPTCY ACT § 7-106), without subjecting the estate to interest on administrative tax claims.

²⁹¹ *Cf.* *Nicholas v. United States*, 384 U.S. 678, 684-86 (1966); *Sexton v. Dreyfus*, 219 U.S. 339, 346 (1911); *Beecher v. Leavenworth State Bank*, 192 F.2d 10, 14 (9th Cir. 1951).

²⁹² Bankruptcy Act § 57j, 11 U.S.C. § 93(j) (1970). Thus, fraud and delinquency penalties are essentially punishments and are disallowed, although to some extent they compensate the government for enforcement costs. See *Helvering v. Mitchell*, 303 U.S. 391, 401 (1938). But the 100% "penalty" imposed by § 6672 of the Internal Revenue Code on a corporate officer or other responsible person for failure to protect "trust funds" of taxes

policy, which applies even to penalties secured by lien,²⁹³ judgment,²⁹⁴ or levy,²⁹⁵ reflects the view that

[t]ax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors.²⁹⁶

The penalty remains collectible against the bankrupt's exempt and after-acquired assets²⁹⁷ unless the tax liability to which the penalty relates is itself discharged.²⁹⁸

The Commission's proposal continues to protect the estate against erosion by penalties not reflecting pecuniary loss,²⁹⁹ and extends that policy to embrace private claims in the nature of penalties or forfeitures.³⁰⁰ However, instead of disallowing penal claims, whether governmental or private, the Commission proposal subordinates them to all other claims, including postpetition interest thereon, except certain rescission claims of security holders and obligations to certain insiders, which stand equal to penalties when there is available surplus in the estate.³⁰¹ The practical effect

withheld or collected is designed to make good a loss and is not disallowed. See note 258 *supra*. Nor is a "penalty" charge in the nature of interest to compensate for a prebankruptcy delay in payment ordinarily denied. Compare *New York v. Jersawit*, 263 U.S. 493 (1924) with *United States v. Childs*, 266 U.S. 304 (1924).

²⁹³ *Simonson v. Granquist*, 369 U.S. 38 (1962).

²⁹⁴ *In re Abramson*, 210 F. 878 (2d Cir. 1914).

²⁹⁵ *In re Brewster-Raymond Co.*, 344 F.2d 903, 910 (6th Cir. 1965).

²⁹⁶ *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962) (footnote omitted). The same disallowance applies in bankruptcy reorganizations. *Simonson v. Granquist*, *supra*, *rev'd* *United States v. Harris*, 287 F.2d 491 (9th Cir. 1961) (involving a Chapter X proceeding); *In re Tennessee Cent. Ry.*, 316 F. Supp. 1103, 1113-14 (M.D. Tenn. 1970), *rev'd on other grounds*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972) (involving a railroad reorganization). Moreover, it applies to Chapter XI arrangements also. *California State Bd. of Equalization v. Goggin*, 183 F.2d 489, 493 (9th Cir.), *cert. denied*, 340 U.S. 891 (1950).

²⁹⁷ *World Scope Publishers, Inc. v. United States*, 348 F.2d 640 (2d Cir. 1965); *Custom Wood Prods., Inc. v. United States*, 338 F. Supp. 337 (W.D. Mich. 1971).

²⁹⁸ Rev. Rul. 68-574, 1968-2 CUM. BULL. 595.

²⁹⁹ PROPOSED BANKRUPTCY ACT § 4-406(a)(3). Although the Commission's Note 6 to that section states that the "pecuniary loss" test is to continue to be applicable, it inexplicably deletes the existing exception (note 292 *supra*) from the statutory text, and no definition of "penalty" incorporating that test is provided.

³⁰⁰ This includes multiple, punitive, or exemplary damages. PROPOSED BANKRUPTCY ACT § 4-406(a)(3).

³⁰¹ Although further stratification of claims is probably undesirable, particularly since there may rarely be funds enough to reach this level, it may be questioned whether the claims of defrauded security holders for rescission may not be more meritorious than claims designed to punish management misconduct, and whether such penalties, in turn, may not be more deserving of satisfaction than the claims, at least, of those insiders who participated in the wrongs.

of the substitution of subordination for disallowance is that, if the estate proves solvent, it enables collection of the penalty in the bankruptcy proceeding itself rather than necessitating a separate proceeding or, if the penalty is dischargeable, giving the debtor a windfall through distribution of the surplus to him free of the claim.³⁰²

The proposal codifies the interpretation of present law as disallowing or subordinating penalty claims "whether secured or unsecured."³⁰³ It further provides that any lien or trust securing a subordinated penalty claim shall pass to the trustee for the benefit of unsubordinated claimants.³⁰⁴ While the lien preservation proposal is in line with numerous existing provisions for preserving voidable preferences, invalidated liens, and similar devices for the benefit of the estate,³⁰⁵ it reverses the express determination by Congress in 1966 that "[w]here a penalty [that is] not allowable . . . is secured by a lien, the portion of the lien securing such penalty shall not be eligible for preservation. . . ."³⁰⁶ The 1966 legislative history is silent on the reason for this restriction, but some indication appears in the reports concerning identical language in a bill that was passed in 1960 but vetoed by the President.³⁰⁷ Congress then took the position that "a lien preserved for the estate benefits only unsecured creditors" and that "there is no reason in the policy of the act why junior lien holders should be bypassed in these circumstances"³⁰⁸—*i.e.*, where penalties are disallowed.

The policy reason now divined by the Commission for reversing that position and extending the lien preservation rule to claims for penalties is that the provision "is necessary to determine the ranking of lien interests that in the application of [the provisions

³⁰² PROPOSED BANKRUPTCY ACT § 4-406 Note 4.

³⁰³ See notes 293-95 and accompanying text *supra*.

³⁰⁴ PROPOSED BANKRUPTCY ACT § 4-406(b).

³⁰⁵ Bankruptcy Act §§ 60b, 67a(3), 67c(2), 67d(6), 70(e)(2), 11 U.S.C. §§ 96(b), 107(a)(3), 107(c)(2), 107(d)(6), 110(e)(2) (1970) (consolidated in PROPOSED BANKRUPTCY ACT § 4-610).

³⁰⁶ Act of July 5, 1966, Pub. L. No. 89-495, 80 Stat. 268-69, adding Bankruptcy Act § 67c(4), 11 U.S.C. § 107(c)(4) (1970).

³⁰⁷ H.R. 7242, 86th Cong., 2d Sess. (1960). The reports on that vetoed bill had been relied upon by the Supreme Court as evidence of the meaning of the law even before Congress finally succeeded in enacting it in 1966. *United States v. Speers*, 382 U.S. 266, 274-75 (1965). Reports on unenacted legislation that was later enacted in similar form (without fresh explanation) have been relied upon in *Portage Plastics Co. v. United States*, 486 F.2d 632, 636-37 (7th Cir. 1973), and in *Shores Realty Co. v. United States*, 468 F.2d 572, 575 (5th Cir. 1972).

³⁰⁸ S. REP. No. 1871, 86th Cong., 2d Sess. 14 (1960), quoting H.R. REP. No. 745, 86th Cong., 1st Sess. 12 (1959).

subordinating certain claims even when secured] might otherwise appear to be circular."³⁰⁹ Circuity results, for example, if a duly perfected lien for a penalty is superior to the rights of an intervening purchaser, secured lender, or mechanic's lienor, whose rights are effective against the trustee, who in turn takes free of the lien for the penalty. By preserving the lien, the trustee gains for the benefit of general creditors a position superior to that of the intervening party, without actually impairing the latter's relative rights in the assets. But, if avoidance of circuity is the object, it could equally be accomplished by invalidating the lien for the penalty not only against the trustee but also against all liens that are valid in bankruptcy, thereby "promoting" the position of valid liens rather than enhancing the fund for unsecured creditors.³¹⁰ A better reason is required, therefore, for reversal of the 1966 policy determination not to "bypass" junior liens—and purchasers—in this particular circumstance.

In reaching its previous conclusion, Congress may have been influenced by the fact that the claim for a nonpecuniary-loss penalty, heretofore having been wholly disallowed in bankruptcy as well as deprived of any lien status, takes nothing from the general estate. In contrast, the invalidation of an attachment lien or an unperfected tax lien leaves the underlying claim to be satisfied from the general assets, while the liened property, if allowed to pass to or be retained by the junior lienor or purchaser free of the invalidated lien, depletes the property from which the claim might have been satisfied and the general estate exonerated *pro tanto*. It is necessary in the latter type of case, therefore, to preserve the lien in order to make the general estate whole and not give a windfall to the junior lienor or purchaser at the expense of general creditors.³¹¹ Under the Commission's proposal, of course, claims for penalties become allowable, but the substance of their treatment does not change: the penalty claimant, being subordinated, will not share with general creditors but will be paid only if and when they have been fully satisfied, with interest.

³⁰⁹ PROPOSED BANKRUPTCY ACT § 4-406 Note 7.

³¹⁰ Cf. Bankruptcy Act § 67c(2), 11 U.S.C. § 107(c)(2) (1970). If an invalidated lien is not preserved for the benefit of the estate, the lien "shall be invalid as against all liens indefeasible in bankruptcy, so as to have the effect of promoting liens indefeasible in bankruptcy which would otherwise be subordinate to such invalidated lien." *Id.* That provision (which does not appear in Proposed § 4-610) was enacted to avoid "the compound confusion of circuity" in cases where no preservation action is taken. SENATE REPORT 7-8, quoting HOUSE REPORT 6-7.

³¹¹ Cf. *First Nat'l Bank v. Staake*, 202 U.S. 141 (1906); *Egyptian Supply Co. v. Boyd*, 117 F.2d 608 (6th Cir. 1941).

The Commission's proposal for preservation of penalty liens seems supportable, however, on another ground. Although no depletion of the general estate is involved, there is nevertheless, if preservation is not provided, a windfall to the intervening purchaser or junior lienor, for whose benefit the statutory invalidation of liens for penalties was never intended.³¹² A purchaser who acquired property from the debtor or a lender who extended secured credit to him when there was a lien already duly filed for tax and penalty would have been subject thereto in the absence of bankruptcy, and presumably took the lien into account in fixing the price or assessing the risk to his security. Even if he failed, through negligence or deception, to discover and allow for the lien, whatever legal or equitable claim he may have to be made whole is surely of no higher dignity than a general claim. He would have a superior equity only if the invalidated lien, for want of filing or otherwise, would have been ineffective against him in the absence of bankruptcy. Inequity can be avoided in such situations by construing the preservation statute—or, better, by making the language or the legislative history clear beyond a doubt³¹³—to place the trustee in no higher position against innocent third parties than the holder of the invalidated lien would have occupied.³¹⁴

When a penalty is incurred in the course of the proceeding, the general policy against saddling the estate with penalties is held inapplicable under present law.³¹⁵ Because the trustee or debtor in

³¹² The statutory invalidation of liens for penalties was never intended to benefit intervening purchasers or junior lienors. The objective of making "as equitable a distribution of assets as is consistent with the type of claims involved" (*Simonson v. Granquist*, 369 U.S. 38, 40 (1962)) is better served by "pro rata participation of all of the bankrupt's creditors" (*Egyptian Supply Co. v. Boyd*, 117 F.2d 608, 611 (6th Cir. 1941)) than by giving the primary benefit of the penalty disallowance to a lien creditor or purchaser.

³¹³ For a discussion of some problems of construction of the present law, see Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419, 1434-39 (1967).

³¹⁴ *In re Grave's Estate*, 27 F. Supp. 717 (W.D. Ky. 1939); see *Egyptian Supply Co. v. Boyd*, 117 F.2d 608, 610 (6th Cir. 1941).

³¹⁵ This is true regardless of whether the penalty results from the negligence or misconduct of the trustee or debtor in possession or from the restraints imposed by the proceeding itself. *Nicholas v. United States*, 384 U.S. 678, 692-95 (1966) (failure of trustee to file return, soon after taking office); *Boteler v. Ingels*, 308 U.S. 57 (1939) (delinquency in paying vehicle license fees where uncertain that estate would be sufficient to pay all expenses entitled to share equally); *In re Samuel Chapman, Inc.*, 394 F.2d 340 (2d Cir. 1968); *In re Chicago & N.W. Ry.*, 119 F.2d 971 (7th Cir. 1941); cf. *California State Bd. of Equalization v. Goggin*, 183 F.2d 489 (9th Cir.), cert. denied, 340 U.S. 891 (1950). But cf. *In re New York, New Haven & Hartford R.R.*, 304 F. Supp. 1121, 1135 (D. Conn. 1969) (refusing to impose delinquency penalties on taxes of railroad trustee where payment of tax had been deferred by court order as only way to keep railroad operating in public interest).

possession is acting for the benefit of the creditors and is subject to their selection, and in some degree to their supervision,³¹⁶ the otherwise "innocent creditors" are made to suffer the punishment which the law prescribes for the acts or defaults of their "agent," unless—if a trustee is involved—the circumstances of his act and his financial condition are such that they can recoup their loss through a surcharge.³¹⁷ The rationale is that if a tax is payable by the estate, the Government should not "be denied the traditional and almost universal method of enforcing" compliance.³¹⁸ Yet the trustee or debtor in possession is also an officer of the court,³¹⁹ and "[t]he control of the bankruptcy court should be a satisfactory guaranty that tax law will be complied with as strictly as circumstances may permit."³²⁰ Surely,

if it is unlawful to penalize the creditors for the [prebankruptcy] delinquencies of the debtor, it is hard to see why they should be held accountable for an omission on the part of the trustee [or debtor in possession] who in every act of his administration is under the direct surveillance of the court, and is not subject to the creditors' instructions.³²¹

The Commission evidently proposes no relief in this regard,³²² despite the fact that under its proposal the functions of the trustee are, in most cases, to be performed by a government agency.³²³ Congress ought to consider whether it would not be better to rely

³¹⁶ Compare *In re Samuel Chapman, Inc.*, 394 F.2d 340, 342 (2d Cir. 1968), with *In re Samuel Chapman, Inc.*, 67-1 U.S. Tax Cas. ¶ 9209 (S.D.N.Y.), *aff'd* 270 F. Supp. 1021, 1023 (S.D.N.Y. 1967).

³¹⁷ See *Delaware v. Irving Trust Co.*, 92 F.2d 17, 19 (2d Cir.), *cert. denied*, 302 U.S. 754 (1937); *In re Samuel Chapman, Inc.*, 67-1 U.S. Tax Cas. ¶ 9209 (S.D.N.Y.), *aff'd*, 270 F. Supp. 1021 (S.D.N.Y. 1967), *rev'd*, 394 F.2d 340 (2d Cir. 1968). But see BANKRUPTCY COMM'N REPORT 103-06 (discussion of "myth of creditor control").

³¹⁸ *Boteler v. Ingels*, 308 U.S. 57, 61 (1939). See also *Nicholas v. United States*, 384 U.S. 678, 694 (1966).

³¹⁹ See *Urban Properties Corp. v. Benson, Inc.*, 116 F.2d 321 (9th Cir. 1940).

³²⁰ *Wurzel, Taxation During Bankruptcy Liquidation*, 55 HARV. L. REV. 1141, 1176 (1942).

³²¹ *Id.* at 1167-68.

³²² Proposed § 4-403(a) describes administration expenses as "claims," and § 4-406(a)(3) subordinates "any claim" for a penalty, which action might indicate an intent to subordinate penalties incurred during administration. But the operative section governing the order of distribution, § 4-405, gives first priority to "administrative claims allowed under section 4-402(a)" without qualification (PROPOSED BANKRUPTCY ACT § 4-405(a)(1)), and reduces to ninth place only "claims allowed under section 4-402(b) and subordinated in payment." (Emphasis added.) If, as surmised (note 288 *supra*), the references to § 4-402 are erroneous and are intended to be to § 4-403, only those penalties which fall under § 4-403(b), which excludes administrative claims, would be subordinated.

³²³ Under Proposed Bankruptcy Act § 5-501, a federal agency, the United States Bankruptcy Administration, would hereafter serve as trustee in liquidation cases unless the creditors choose to elect a private trustee.

upon the procedures and disciplinary powers of the bankruptcy court, rather than upon the "almost universal method" of enforcing compliance by taxpayers who are not thus subject to court control and supervision.

One liability of a penal nature that may be incurred during administration is the increase in liability for federal unemployment tax imposed when the related contribution to the state fund is tardily paid. The federal tax was enacted primarily not as a means of raising revenue, but rather as a means of encouraging the states to enact tax-supported unemployment compensation systems.³²⁴ The liability for the 3.2 percent federal tax, therefore, may be abated up to a maximum of 2.7 percent of taxable wages³²⁵ by a credit for payments by the employer to the state fund. If the employer's payment of the state tax is delayed beyond the due date of the federal return, for whatever reason, the credit for state tax payments ultimately made is reduced to ninety percent of the amount otherwise allowable—*i.e.*, to a maximum of 2.43 percent³²⁶—thus increasing the net federal liability from 0.5 percent to 0.77 percent. This fifty-four percent increase for late payment is as penal in effect as any delinquency penalty.³²⁷ It is sheer euphemism to say, as some bankruptcy courts have, that the denial of the credit is not a penalty imposed for late payment but reflects the failure of the taxpayer to qualify for a reward in the form of a tax reduction which was tendered in order to encourage timely payment.³²⁸

Although the Supreme Court has agreed that the additional federal tax resulting from denial of the credit was not a penalty disallowable in bankruptcy, the case before it was not one involving merely a delayed payment, but one in which the state tax for which credit was denied could not be paid at all.³²⁹ Congress may have

³²⁴ See *Steward Mach. Co. v. Davis*, 301 U.S. 548, 585-90 (1937).

³²⁵ Originally the federal tax was 3% and the maximum credit was 90% thereof. The basic federal rate is now 3.2% (INT. REV. CODE OF 1954, § 3301), but the maximum credit is frozen at 90% of 3%. INT. REV. CODE OF 1954, §§ 3302(c)(1) & (d)(1). The remaining 0.5% is used for the federal government's expenses of administration of the system, for assistance to the states in their administrative costs, and for advances to the states to meet unusual needs for unemployment benefits. 42 U.S.C. §§ 1101-05, 1321 (1970).

³²⁶ INT. REV. CODE OF 1954, § 3302(a)(3).

³²⁷ Cf. *New York v. Jersawit*, 263 U.S. 493, 496 (1924).

³²⁸ *In re Illinois Art Indus., Inc.*, 27 F. Supp. 334, 335 (W.D. Mich. 1939); *In re Richmaid Creameries, Inc.*, 27 F. Supp. 828, 829 (S.D. Cal. 1937), *rev'd on stip. sub nom. Boteler v. Rogan*, 97 F.2d 992 (9th Cir. 1938). *Contra, In re Hy-Grade Meat & Grocery Co.*, 26 F. Supp. 294, 295 (D.N.J. 1938); *In re Standard Composition Co.*, 23 F. Supp. 391, 395 (E.D. Mich. 1938). See generally Annot., 1 A.L.R. Fed. 657, 670 (1969).

³²⁹ *United States v. New York*, 315 U.S. 510, 516-17 (1942). For the monstrous

had this type of case in mind when, in 1939, it sought to "set at rest the question involved by expressly providing that no part" of the federal unemployment tax shall be deemed a penalty for purposes of the Bankruptcy Act.³³⁰ It provided in the same legislation that no loss or reduction of credit should occur merely because of lateness of payment if the

taxpayer's assets, at any time during the period from [the] last day for filing a return for such year to June 30 next following such last day, both dates inclusive, are in the custody or control of a receiver, trustee, or other fiduciary appointed by, or under the control of, a court of competent jurisdiction.³³¹

Congress, however, eliminated that relief provision in 1943, declaring that it "does not appear to be warranted" in view of a further amendment then made which provided that the credit was no longer wholly forfeited for late payment and that ninety percent of it could be earned by payment at any time.³³² But it is doubtful that a relatively small penalty for a delay that is "necessitated by law if the courts are properly to preserve and protect the estate for the benefit of all interests involved"³³³ is any more warranted than a large one.

The trustee or debtor in possession may incur this penalty with respect to unemployment taxes which are (1) payable after the petition on wages paid prior thereto, (2) payable on wages paid after the petition but earned prior thereto, or (3) payable on wages earned during the administration. In any of these cases, the trustee may risk surcharge if, in order to spare the estate the burden of the penalty, he makes timely payment and the assets later prove insufficient to satisfy claims of equal or higher priority.³³⁴ The Commission proposal recognizes the inequity of reducing the

algebraic device by which the federal government, supposedly standing on a parity with the state under Bankruptcy Act § 64a(4) (11 U.S.C. § 104(a)(4) (1970)), actually gets not only a greater proportion of the fund available for unemployment tax but often a greater *dollar amount*, the smaller the fund may be, see Plumb, *supra* note 203, at 72-73. Draft remedial legislation also is set out, although it is not discussed herein since the Commission has made no proposal in that regard. *Id.* at 103-04, 105-07.

³³⁰ S. REP. NO. 734, 76th Cong., 1st Sess. 91 (1939) (describing § 902(i) of the Social Security Act Amendments of 1939, ch. 666, 53 Stat. 1400).

³³¹ Social Security Act Amendments of 1939, ch. 666, § 609, 53 Stat. 1387.

³³² H.R. REP. NO. 871, 78th Cong., 1st Sess. 73 (1943) (referring to § 601 of the Revenue Act of 1943, ch. 63, 58 Stat. 21).

³³³ See *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946).

³³⁴ *In re Lambertville Rubber Co.*, 111 F.2d 45 (3d Cir. 1940) (taxes paid on wages earned and paid both before and after, where funds ultimately proved inadequate for administration expenses).

credit in such circumstances and provides that, "[n]otwithstanding any other law, *such taxes* on an employer paid by the trustee or debtor shall be computed without reduction in the amount of any applicable credit due to late payment."³³⁵ Unfortunately, an ambiguity is introduced by the use of the term "such taxes," because the reference is to a preceding sentence which deals not with unemployment taxes in general, but with "taxes imposed on an employer with respect to the payment of compensation for personal services *earned but unpaid prior to the filing of the petition.*"³³⁶ Read narrowly, the provision grants relief only in the second of the three situations referred to above. The provision ought to apply, and probably was meant to apply, to all three situations since all involve an increase in taxes occasioned by delay necessitated by the bankruptcy administration.³³⁷ Furthermore, the relief ought to be made applicable is still a fourth situation, where the debtor employer had already forfeited a portion of the credit by his own tax delinquency occurring before the administration began; such a penalty ought to be remitted just as other penalties for the debtor's past defaults are remitted in favor of the estate when bankruptcy follows.³³⁸

C. *Insolvency Priorities Contrasted*

There is another federal statute, applicable generally to insolvencies not governed by the Bankruptcy Act, which prescribes that "the debts due the United States shall be first satisfied."³³⁹ The

³³⁵ PROPOSED BANKRUPTCY ACT § 4-405(c) (emphasis added).

³³⁶ *Id.* (emphasis added).

³³⁷ On the other hand, the Commission's granting of relief in one or all of these situations is difficult to reconcile with its unwillingness to relieve the estate of other penalties incurred during administration on account of delays necessitated thereby. See *Boteler v. Ingels*, 308 U.S. 57 (1939); notes 315 & 322 *supra*.

³³⁸ In accordance with the Commission's new approach to penalties (note 301 *supra*), the differential in the credit might appropriately be merely subordinated, rather than forgiven. In that event, the amount of the differential might, consistently with the treatment of penalties, be made a nondischargeable obligation of the debtor if the tax itself is nondischargeable (see notes 425-33 *infra*). On the other hand, because the additional tax is incurred regardless of fault, for failures occurring on the road toward bankruptcy, such treatment of the debtor may be unduly harsh.

³³⁹ Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1970).

statute, never substantially amended since 1797,³⁴⁰ "on its face permits no exception whatever" to the priority in favor of federal claims.³⁴¹ In proceedings to which the statute applies, all federal claims, whether arising from taxes,³⁴² penalties,³⁴³ contracts,³⁴⁴ direct government loans,³⁴⁵ or defaulted guaranteed loans,³⁴⁶ enjoy absolute priority over all unsecured claims, including wages³⁴⁷ and state and local taxes,³⁴⁸ as well as over most antecedent liens,³⁴⁹ including mechanics' liens³⁵⁰ and possibly even mortgages.³⁵¹ Although the earliest bankruptcy laws incorporated this absolute federal priority,³⁵² the Act of 1898 began the process of downgrading the federal priority in bankruptcy.³⁵³ The Commission's proposals eliminate the last remaining areas in which the ancient federal insolvency priority statute is applied in bankruptcy proceedings by deleting the present fifth level of priority, which federal nontax claims now share with certain claims of

³⁴⁰ The law assumed substantially its present form in the Act of March 3, 1797 (ch. 20, § 5, 1 Stat. 496, 515), although a provision of more limited application had been enacted by the first Congress in 1789 (Act of July 31, 1789, ch. 5, § 21, 1 Stat. 24, 42).

³⁴¹ See *United States v. Vermont*, 377 U.S. 351, 357 (1964).

³⁴² *Price v. United States*, 269 U.S. 492, 501 (1926).

³⁴³ *Spokane County v. United States*, 279 U.S. 80, 93 (1929); *Johbers Credit Ass'n v. United States*, 164 F. Supp. 22 (E.D.N.Y. 1958).

³⁴⁴ *United States v. Knott*, 298 U.S. 544, 548 (1936).

³⁴⁵ *Small Business Admin. v. McClellan*, 364 U.S. 446 (1960); *United States v. Remund*, 330 U.S. 539 (1947).

³⁴⁶ *United States v. Emory*, 314 U.S. 423 (1941).

³⁴⁷ *Id.* at 426.

³⁴⁸ *Spokane County v. United States*, 279 U.S. 80 (1929).

³⁴⁹ Liens are subordinated to the federal insolvency priority unless they meet a standard of "choateness" so exacting that no case which has ever come before the Supreme Court has satisfied it. The Court, therefore, has reserved the question whether even a "choate" lien could prevail. See *United States v. Gilbert Assoc.*, 345 U.S. 361, 365 (1953). To be "choate" in this sense, not only must the identity of the lienor, the amount of the lien, and the property subject to the lien be fixed beyond possibility of change or dispute (*Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362, 370-76 (1946)), but, at least in the case of personalty, the debtor must have been divested of either title or possession, if not both. *United States v. Gilbert Assoc.*, *supra* at 366.

³⁵⁰ *H.B. Agsten & Sons, Inc. v. Huntington Trust & Sav. Bank*, 388 F.2d 156 (4th Cir. 1967), *cert. denied*, 390 U.S. 1025 (1968); *cf. W.T. Jones & Co. v. Foodco Realty Co.*, 318 F.2d 881 (4th Cir. 1963).

³⁵¹ The Supreme Court pointedly left this question open. See *New York v. Maclay*, 288 U.S. 290, 294 (1933). But lower courts have consistently recognized prior mortgages in insolvency. *Exchange Bank & Trust Co. v. Tubbs Mfg. Co.*, 246 F.2d 141, 143 (5th Cir.), *cert. denied*, 355 U.S. 868 (1957); *United States v. Guaranty Trust Co.*, 33 F.2d 533, 537 (8th Cir. 1929), *aff'd on other grounds*, 280 U.S. 478 (1930); *Evans v. Stewart*, 245 Iowa 1268, 66 N.W.2d 442 (1954).

³⁵² See note 102 *supra*.

³⁵³ See notes 106-39 and accompanying text *supra*.

landlords,³⁵⁴ and by making the bankruptcy system of priorities controlling for the first time in railroad and corporate reorganizations.³⁵⁵

The federal insolvency priority statute, however, continues to be applicable in cases of general assignments for the benefit of creditors³⁵⁶ and in equity receiverships,³⁵⁷ and possibly in cases in which an act of bankruptcy is committed but neither bankruptcy nor any other collective proceeding actually follows.³⁵⁸ The Commission proposal discards the statutory term "act of bankruptcy" in the Bankruptcy Act, which may force the courts in insolvency cases to reapply the general concepts of such acts, which they had applied during most of the first century under the insolvency priority statute.³⁵⁹ The Commission's proposed substitute, however, making the debtor's general failure or inability "to pay his current liabilities as they become due" the "basis for relief" in a creditor's petition for bankruptcy,³⁶⁰ might be construed as making

³⁵⁴ Compare Bankruptcy Act § 64a(5), 11 U.S.C. § 104(a)(5) (1970), with PROPOSED BANKRUPTCY ACT § 4-405(a), which has no comparable provision.

³⁵⁵ See notes 271-75 and accompanying text *supra*.

³⁵⁶ See, e.g., *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353 (1945).

³⁵⁷ See, e.g., *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362, 368-69 (1946).

³⁵⁸ The Supreme Court repeatedly has generalized in dicta that the insolvency priority was intended to apply only "when the possession and control of the estate of the insolvent is given to any person charged with the duty of applying it to the payment of the debts of the insolvent, as the rights and priorities of creditors may be made to appear." *Bramwell v. United States Fid. & Guar. Co.*, 269 U.S. 483, 490 (1926). See also *King v. United States*, 379 U.S. 329, 336 (1964); *United States v. Knott*, 298 U.S. 544, 552 (1936); *United States v. Oklahoma*, 261 U.S. 253, 260 (1923). Nevertheless, lower courts, taking literally the statutory language (see note 339 *supra*) making the priority applicable in "cases in which an act of bankruptcy is committed," have enforced it where there has been a preferential transfer, whether or not within four months. *Lakeshore Apts. Inc. v. United States*, 351 F.2d 349, 353 (9th Cir. 1965); *United States v. Caldwell*, 74 F. Supp. 114 (M.D. Tenn. 1947). Priority has also been applied where there was a fraudulent conveyance. *United States v. Mr. Hamburg Bronx Corp.*, 228 F. Supp. 115, 120-21 (S.D.N.Y. 1964). Furthermore, insolvency priority has attached where a creditor secured a lien by legal proceedings not duly vacated or discharged. *W.T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881, 885-86 (4th Cir. 1963); see Bankruptcy Act § 3a, 11 U.S.C. § 21(a) (1970) (defining acts of bankruptcy). The courts have generally interpreted the term "act of bankruptcy" in the insolvency statute by reference to the changing meanings thereof in the Bankruptcy Act. *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362, 368 (1946); *United States v. Oklahoma*, 261 U.S. 253, 262 (1923). The Commission's proposal to abandon, in bankruptcy, the concept of an "act of bankruptcy" (see PROPOSED BANKRUPTCY ACT § 4-205 Note 5) may preclude the foregoing events from acting as triggers for the insolvency priority.

³⁵⁹ There was no federal bankruptcy law when the insolvency priority statute was enacted, or during much of the nineteenth century, but the courts were able to identify acts of bankruptcy for this purpose. See *Prince v. Bartlett*, 12 U.S. (8 Cranch) 431, 433 (1874).

³⁶⁰ PROPOSED BANKRUPTCY ACT §§ 4-205(c)(1), (2); see BANKRUPTCY COMM'N REPORT 187-91.

the existence of that condition the equivalent of an act of bankruptcy for the purpose of invoking the insolvency statute when bankruptcy does not follow, thus in effect removing one of the conditions precedent and giving the statute a potential breadth of application that it never had before.³⁶¹

In most such cases, creditors may be able to protect themselves by petitioning for a proceeding under the Bankruptcy Act, but that choice is not always available.³⁶² No such option exists, or will exist under the Commission's proposals, if the debtor is already deceased³⁶³ or is a state bank,³⁶⁴ a savings and loan association,³⁶⁵ an insurance company,³⁶⁶ or a farmer.³⁶⁷ The bankruptcy option is also unavailable under present law if the debtor owes less than \$1,000,³⁶⁸ of which an aggregate of \$500 is owed to petitioning creditors, or if less than three of a total of twelve or more creditors

³⁶¹ For the insolvency statute to apply, there must not only be an act of bankruptcy—which, if the above test is applied, would be present whenever there is insolvency in the "equity" sense—but the debtor must also be insolvent in the "bankruptcy" sense of an excess of liabilities over assets. *United States v. Oklahoma*, 261 U.S. 253 (1923). But, despite some opinion to the contrary, insolvency in the latter sense arising at any time before distribution will make the insolvency priority apply. *Compare* Comm. on Relative Priority of Government and Private Liens, *Report*, 4 REAL PROP., PROBATE & TRUST J. 413, 419-20 (1969), *with* Plumb, *supra* note 203, at 21-31.

³⁶² See *Krauth v. Mid-Ohio Indus., Inc.*, 72-2 U.S. Tax Cas. ¶ 9512 (Ohio App. 1972) (inability of wage-earners to convert receivership into bankruptcy cost them priority over federal claims).

³⁶³ See *In re Fackelman*, 248 F. 565, 568 (S.D. Cal. 1918). The insolvency priority statute applies to decedents' estates. *Viles v. Commissioner*, 233 F.2d 376, 379 (6th Cir. 1956); *In re Shoptaw's Estate*, 54 Wash. 2d 602, 343 P.2d 740 (1959). The Commission considered, but rejected, extension of bankruptcy administration to insolvent decedents' estates. BANKRUPTCY COMM'N REPORT 184-85. But that should not preclude making applicable a uniform system of priorities among creditors whether the debtor is alive or dead. Plumb, *supra* note 203, at 60-61.

³⁶⁴ A bank cannot become bankrupt. Bankruptcy Act § 4, 11 U.S.C. § 22 (1970); PROPOSED BANKRUPTCY ACT §§ 4-201, -204. The insolvency priority statute applies to bank liquidations. *Bramwell v. United States Fid. & Guar. Co.*, 269 U.S. 483, 489-90 (1926). It is, however, made inapplicable to national banks. *Cook County Nat'l Bank v. United States*, 107 U.S. 445 (1883); 12 U.S.C. § 194 (1970).

³⁶⁵ Bankruptcy Act § 4, 11 U.S.C. § 22 (1970); PROPOSED BANKRUPTCY ACT §§ 4-201, -204.

³⁶⁶ An insurance company cannot become bankrupt, but the insolvency statute applies to it. *United States v. Knott*, 298 U.S. 544 (1936); Bankruptcy Act § 4, 11 U.S.C. § 22 (1970); PROPOSED BANKRUPTCY ACT §§ 4-201, -204.

³⁶⁷ Involuntary bankruptcy proceedings may not be brought against a farmer. Bankruptcy Act § 4b, 11 U.S.C. § 22(b) (1970); PROPOSED BANKRUPTCY ACT § 4-204. "Wage earners" working for less than \$1,500 a year are now also excluded. Bankruptcy Act §§ 1(32), 4b, 11 U.S.C. §§ 1(32), 22(b) (1970). But the Commission proposal drops that exclusion. PROPOSED BANKRUPTCY ACT § 4-204 Note.

³⁶⁸ Bankruptcy Act § 4b, 11 U.S.C. § 22(b) (1970).

are willing to join.³⁶⁹ In place of these requirements, the Commission substitutes a single standard: the petitioning creditors must hold in the aggregate at least \$2,500 of noncontingent claims in excess of their security.³⁷⁰ Even when bankruptcy is a legally available alternative, it may involve greater costs of administration than a simple assignment for the benefit of creditors,³⁷¹ and in a small estate these costs may nullify the priority advantage.

The American Bar Association has proposed legislation designed to bring the federal insolvency priority statute into the twentieth century and generally to conform it to the lien priority and bankruptcy laws as they now exist.³⁷² The bill is not without its faults,³⁷³ and it will obviously need a major overhaul to bring it into alignment with the Commission's bankruptcy proposals. The Commission's proposals accentuate the disparities between the outmoded priority rules in nonbankruptcy insolvencies and those under the Bankruptcy Act. The reform of the archaic insolvency priority should be effected, if not by amendment of the Commission's own bill, at least by coordinated action before interest in the whole subject is allowed to cool.³⁷⁴

II

DISCHARGE OF TAX OBLIGATIONS

The Commission proposes that taxes which are denied priority under the one-year rule described above shall be dischargeable in

³⁶⁹ *Id.* § 59b, 11 U.S.C. § 95(b) (1970).

³⁷⁰ PROPOSED BANKRUPTCY ACT § 4-205(a). For a proceeding under proposed Chapter VII, the successor to present Chapters X, XI, and XII, the petitioning creditors would have to hold \$10,000 of noncontingent claims. *Id.* § 4-205(b). Like other dollar amounts specified in the proposed Act (*see* note 204 and accompanying text *supra*), these minimum requirements would automatically be adjusted periodically to reflect changes in the cost of living index. PROPOSED BANKRUPTCY ACT § 1-105.

³⁷¹ *See* BANKRUPTCY COMM'N REPORT 64-65. It is the hope of the Commission that its proposals will achieve a substantial reduction of expenses in bankruptcy. *Id.* at 214.

³⁷² The A.B.A. proposal is set out in Comm. on Relative Priority of Government and Private Liens, *supra* note 361, and was, with minor changes, introduced "by request" in the 92d Congress by Senator Quentin Burdick for the purpose of inviting public comment. S. 2197, 92d Cong., 1st Sess. (1971).

³⁷³ For a critical but friendly analysis and a proposed revision, see Plumb, *supra* note 203.

³⁷⁴ The adverse effects of the insolvency priority rule on wage earners, business creditors, and state and local governments, respectively, are described by the writer in three other articles. Plumb, *The Relative Priority of Federal and Business Claims: Yesterday, Today and Tomorrow*, 27 BUS. LAWYER 1195 (1972); *The Relative Priority of Claims of Workingmen and of the Federal Government in Insolvency*, 23 LAB. L.J. 259 (1972); *The Priorities of Federal Taxes over State and Local Taxes—Revisited*, 25 NAT'L TAX J. 133 (1972).

bankruptcy unless a tax return, if required, is not filed more than one year before the date of the petition, or if filed is false or fraudulent.³⁷⁵ Penalties and postbankruptcy interest are dischargeable if the underlying tax liability is discharged.³⁷⁶

A. *Current Law*

The purpose of the Bankruptcy Act is not solely to collect and marshal the debtors' assets for the benefit of creditors. It is also to relieve the honest but unfortunate debtor of burdensome debts so he can make a fresh start.³⁷⁷ Until 1966, however, Congress's competing concern for the collection of the taxes upon which government depends for its support caused it to make all tax liabilities nondischargeable.³⁷⁸ Although the House version of the Chandler Act would have made taxes dischargeable like other debts, the Senate, at the instance of the Treasury Department, restored total nondischargeability on the ground that "if federal taxes were made dischargeable, it would open the door to evasion."³⁷⁹ Thereafter, at least as early as 1946, the American Bar Association and the bankruptcy bar began a prolonged drive to make dischargeable all tax claims except those that had accrued within one year before bankruptcy.³⁸⁰ The discharge proposal, extensively modified in an effort to accommodate Treasury objections, was finally enacted in 1966, when Congress concluded, upon rebalancing the equities of the debtors and the needs of government, that "the enormous increase in the tax burden during recent years and the consequent impact on both the distribution of a

³⁷⁵ PROPOSED BANKRUPTCY ACT § 4-506(a)(1).

³⁷⁶ *Id.* § 4-506 Notes 4 & 18-20.

³⁷⁷ *Lines v. Frederick*, 400 U.S. 18, 19 (1970); *Local Loan Co. v. Hunt*, 292 U.S. 234, 244-45 (1934); *Shelby v. Texas Improvement Loan Co.*, 280 F.2d 349, 355 (5th Cir. 1960); see S. REP. NO. 1158, *supra* note 128, at 2; BANKRUPTCY COMM'N REPORT 62-65.

³⁷⁸ Act of July 1, 1898, ch. 541, § 17a(1), 30 Stat. 550, as amended, Act of June 22, 1938, ch. 575, § 1, 52 Stat. 851. Although the nineteenth century bankruptcy laws, other than the Act of April 4, 1800 (ch. 19, § 62, 2 Stat. 36), had failed expressly to except federal claims from discharge, the intervening acts were construed not to discharge such claims, on the theory that the sovereign is not affected unless named. *United States v. Herron*, 87 U.S. (20 Wall.) 251 (1874). When the 1898 Act expressly excepted taxes from discharge, however, it was concluded that the omission to refer to *other* federal claims as well indicated an intent that such other claims be dischargeable. *McPhee v. United States*, 64 Colo. 421, 174 P. 808, 812-13 (1918); cf. *Guarantee Title & Trust Co. v. Title Guar. & Sur. Co.*, 224 U.S. 152, 159-60 (1912). In the case of state and local taxes, § 17 of the 1898 Act preserved from discharge only taxes imposed by the jurisdictions within which the debtor resided, but § 1 of the Chandler Act of 1938 extended the immunity from discharge to those of "any State, county, district or municipality." (Emphasis added.)

³⁷⁹ 83 CONG. REC. 9106 (1938) (explanation by Rep. Chandler).

³⁸⁰ See *Olive*, *supra* note 90, at 8-9; *Moore & Tone*, *supra* note 90, at 701-05.

bankrupt's estate and his financial rehabilitation, require a modification of that status."³⁸¹

The 1966 amendment, still in effect, provides for discharge of the tax liabilities, federal, state, or local, which are denied priority and ranked with general creditors' claims by its related provisions heretofore described³⁸²—*i.e.*, tax liabilities which become "legally due and owing" more than *three* years before bankruptcy. Exceptions are provided for instances of fraud or nonfiling of returns, for taxes withheld or collected, and for taxes the assessment of which was restrained pending exhaustion of remedies for review. The law contains two provisos. The first specifies that the discharge of a tax liability shall not bar any remedies available under applicable law against property set apart to the bankrupt as exempt. Therefore, the niggardly exemptions provided by the Internal Revenue Code³⁸³ are exclusively applicable³⁸⁴ to federal tax liabilities even in bankruptcy.³⁸⁵ The second proviso, that a discharge "shall not release or discharge any tax lien," has resulted in much litigation. The Government construed it to mean that, since the general federal tax lien³⁸⁶ by its nature attaches to after-acquired property,³⁸⁷ the "discharged" tax liability continued to be collectible by enforcement of the lien against property the bankrupt might thereafter acquire—a position the courts have quite properly rejected.³⁸⁸

The present tax discharge provision, apart from its am-

³⁸¹ S. REP. NO. 1158, *supra* note 128, at 2; H.R. REP. NO. 687, *supra* note 128, at 2. The enactment took the form of Act of July 5, 1966, Pub. L. No. 89-496, 80 Stat. 270, amending Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (1964) (codified at 11 U.S.C. § 35(a)(1) (1970)).

³⁸² See notes 125-33 and accompanying text *supra*.

³⁸³ INT. REV. CODE OF 1954, § 6334(a).

³⁸⁴ *Id.* § 6334(c): "Notwithstanding any other law of the United States, no property or rights to property shall be exempt from levy other than the property specifically made exempt by subsection (a)."

³⁸⁵ *United States v. Heffron*, 158 F.2d 657 (9th Cir.), *cert. denied*, 331 U.S. 831 (1947).

³⁸⁶ See notes 54-63 and accompanying text *supra*.

³⁸⁷ *Glass City Bank v. United States*, 326 U.S. 265 (1945).

³⁸⁸ *United States v. Sanabria*, 424 F.2d 1121 (7th Cir. 1970); *In re Braund*, 423 F.2d 718 (9th Cir.), *cert. denied*, 400 U.S. 823 (1970). Although Congress's choice to legislate on tax priorities (Bankruptcy Act § 64a(4), 11 U.S.C. § 104(a)(4) (1970)) by cross reference to the discharge section (Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (1970)) caused the lien-preservation proviso to be incorporated into the provision dealing with discharge, it seems clear that the proviso was not germane to discharge at all but was designed to assure, by cross-reference, that the loss of priority of dischargeable taxes should not affect their collectibility from property of the estate ahead of unsecured claims, to the extent that liens on such property had arisen and were valid in bankruptcy and not postponed. See *Marsh*, *supra* note 39, at 710-12; *Plumb*, *supra* note 125, at 270-71.

biguities of draftsmanship,³⁸⁹ is subject to substantive criticism both for continuing the inequity to creditors in certain situations, and for unnecessarily opening the door to evasion by debtors. The inequities result from tying the conditions under which a discharge is permitted to those under which priority will be denied. The apparent policy reason for this connection is that the denial of priority for a nondischargeable tax may enhance the amount of the tax claim that is uncollectible from the estate and thus unduly enlarge the burden left overhanging the debtor.³⁹⁰ In other respects, however, the policy considerations are not the same. Although a taxpayer should not reap a benefit, through discharge, from a delay in assessment that occurred for his own accommodation, the present denial of discharge in such circumstances may be accompanied by preservation of the priority of taxes accumulated over an excessive number of years, to the detriment of creditors who have no knowledge of the accumulation and no responsibility for the delay. Further, if a taxpayer fails to file a return, files a false or fraudulent return, or otherwise willfully attempts to evade or defeat a tax, there is justice in denying him a discharge, but gross inequity in penalizing his innocent creditors by subjecting them to the priority of an unlimited accumulation of such tax liabilities.³⁹¹

The evasion possibilities created by the 1966 amendments are underscored in a recent report by the Comptroller General to the Joint Committee on Internal Revenue Taxation.³⁹² The Comptroller General urged amendment of the Bankruptcy Act to measure the three-year period for determining dischargeability from the *date of assessment*, instead of the *due date of the return*, because

[t]axpayers with high incomes have avoided paying taxes by taking advantage of the Bankruptcy Act Further, because of delays inherent in auditing returns, in assessing deficiencies, and in going through legal processes, IRS in all cases is not permitted sufficient time to collect the taxes before they are discharged through bankruptcy. Although the number of cases does not appear to be large, the dollar amounts in the individual cases are material.³⁹³

The Comptroller General also noted that, because collection efforts

³⁸⁹ See notes 126-31 and accompanying text *supra*.

³⁹⁰ See notes 239-40 and accompanying text *supra*.

³⁹¹ See Plumb, *supra* note 125, at 268-69.

³⁹² COMP. GEN., REPORT TO JOINT COMM. ON INTERNAL REVENUE TAXATION, COLLECTION OF TAXPAYERS' DELINQUENT ACCOUNTS BY THE IRS (Aug. 9, 1973) (Dep't of Treas. B-137762).

³⁹³ *Id.* at 25.

are not instituted until a tax is assessed, the IRS frequently has less than three years in which to collect a tax before it becomes dischargeable. Moreover, the taxpayer, by exercising his various rights of appeal and by making settlement offers, can easily delay collection beyond the applicable three-year period and, having dissipated the earnings on which he failed to pay tax, can be adjudicated bankrupt and free his future earning power from the obligation.³⁹⁴ The Comptroller General concluded:

It is difficult for IRS personnel to decide how aggressively to pursue collection efforts against delinquent taxpayers whose financial condition makes them eligible to have their debts discharged through bankruptcy. If they forgo enforcing collection

³⁹⁴ An instance was cited in which a physician filed delinquent returns for 1953 through 1965, on which tax was assessed in November 1966. Pending consideration of an offer in compromise, the revenue officers suspended collection efforts, with the result that more than one year elapsed following the assessment. The physician, who had meanwhile earned, and apparently spent, \$131,000 in 1966 and 1967, then withdrew the offer in compromise, went bankrupt, and thus freed his future substantial earning power of the liability. Another instance was cited in which an entertainer, earning \$15,000 a week from performances at a hotel, contested in the Tax Court federal tax liabilities aggregating to \$277,797. All of his liabilities were more than three years old when the taxpayer agreed to the deficiencies, thereby terminating the restriction on assessment that would have prevented discharge if he had gone bankrupt while the Tax Court case was pending, and filed a bankruptcy petition three days later, before the Service had had any real opportunity to collect the dischargeable tax. *Id.* at 26-28.

The facts stated by the Comptroller General have been simplified for clarity. It is recited that, in the actual case on the latter facts, another creditor had contested the taxpayer's right to a discharge on unspecified grounds under Bankruptcy Act § 14c (11 U.S.C. § 32(c) (1970)), and that the question whether he might make good his escape from his liabilities was still undetermined. COMP. GEN., REPORT, *supra* note 392, at 28.

When there is a failure to file a return, if an assessment nevertheless is made, as in the case of the physician, *supra*, the time within which a tax remains nondischargeable is three years from the due date or one year from the assessment, whichever is longer. Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (1970). On facts comparable to those of the physician, a taxpayer's effort to escape was frustrated because he misjudged the date of the assessment and filed a petition three days before the year expired. *In re O'Leary*, 72-1 U.S. Tax Cas. ¶ 9287 (W.D. Wis. 1972).

With respect to the entertainer's case, Bankruptcy Act § 17a(1)(c) (11 U.S.C. § 35(a)(1)(c) (1970)) excepts from discharge any taxes, regardless of age, "which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt." This precludes discharge of deficiencies not yet finally determined at the date of bankruptcy, whether resulting from omission of income or improper deductions. *In re Michaud*, 458 F.2d 953 (3d Cir.), *cert. denied*, 409 U.S. 876 (1972); *In re Indian Lake Estates*, 428 F.2d 319 (5th Cir.), *cert. denied*, 400 U.S. 964 (1970). But no grace period at all is allowed following the expiration of the restriction on assessment resulting from pendency of a Tax Court contest, so that the tax then immediately becomes dischargeable if the basic three-year period has expired. See Plumb, *supra* note 125, at 267. The Treasury anticipated this eventuality in a letter to the House Judiciary Committee, set out in HOUSE REPORT 6.

in hopes that the taxpayer's financial condition may improve in the future, they risk allowing the taxes to become more than 3 years old and subject to discharge through bankruptcy. However, if they take collection action immediately, they may cause undue hardship or precipitate the taxpayer's bankruptcy.³⁹⁵

B. *The Commission's Proposals*

Rather than undertaking to rectify the defects in the compromise legislation of 1966,³⁹⁶ the Commission has thrown down the gage to the Treasury Department—and by implication to the Comptroller General and the Senate Finance Committee, who have supported the Treasury position³⁹⁷—by resurrecting the substance of the original, far-reaching American Bar Association recommendation. All taxes other than those withheld by the debtor from wage payments and those for which he failed to file a required return or filed a false or fraudulent return, or which he otherwise willfully attempted to evade or defeat, are dischargeable if the petition is filed more than one year from the later of

(1) the date when a return is actually filed, if a return for such tax is required by law;³⁹⁸

(2) whichever of the following is applicable:

(a) the due date or extended due date of the return, in the case of taxes upon or measured by income, as well as employment taxes;

(b) the last date on which payment might be made without penalty, in the case of *ad valorem* taxes; or

(c) the date of the taxable transaction, in the case of customs duties and excise taxes.³⁹⁹

If a three-year limitation poses problems for the tax collector under existing law, the proposed one-year cutoff presents obvious impossibilities. With nearly three million delinquent federal tax accounts to dispose of each year involving over three and a half billion dollars,⁴⁰⁰ there will necessarily be many in which the collection officers will be unable to complete in time the process of

³⁹⁵ COMP. GEN., REPORT, *supra* note 392, at 28.

³⁹⁶ For a draft of amendments designed to overcome the deficiencies in the 1966 Act without departing from its essential purpose, see Plumb, *supra* note 232, at 45-46.

³⁹⁷ S. REP. NO. 999, 89th Cong., 2d Sess. (1966); COMP. GEN., REPORT, *supra* note 392.

³⁹⁸ PROPOSED BANKRUPTCY ACT § 4-506(a)(1)(B).

³⁹⁹ *Id.* § 4-506(a)(1)(A). This provision incorporates by reference the priority rules of Proposed § 4-405(a)(5). Notes 227-62 and accompanying text *supra*. Whereas present law sets out the rules in the discharge provision (Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (1970)) and adopts them by cross-reference in the priority provision (*Id.* § 64a(4), 11 U.S.C. § 104(a)(4) (1970)), the proposed statute reverses that procedure.

⁴⁰⁰ COMM'R OF INT. REV. ANN. REP. 25 (FY 1971).

discovering the delinquency, attempting to obtain voluntary payment, considering compromise offers, and locating and levying on assets.⁴⁰¹ The Commission, anticipating the criticism that the short cut-off period will preclude IRS leniency which might facilitate the debtor's recovery without bankruptcy, adds a provision that, if an extension of time for payment is granted, apparently either before or after the initial one-year period expires, dischargeability is limited to the unpaid installments that become payable under the extension agreement more than one year prior to the filing of the petition.⁴⁰² This provision, however, affords no protection for the Treasury where the tax collector, in continuing beyond the initial year to seek assets from which to collect, is unable to extract an installment payment agreement from the debtor or is unwilling to tie his own hands by agreeing to an extension of time for payment. The provision likewise fails to protect the Government in the case, now proposed for the first time to be made subject to one-year dischargeability, where the debtor's liability does not appear on the face of the return because the taxpayer has nonfraudulently resolved in his favor any doubtful issues of income and deductions and the conflict cannot be settled within the applicable one-year period.⁴⁰³

The provision for nondischargeability of taxes which the debtor has "willfully attempted in any manner to evade or defeat" may possibly serve, in extreme situations, to frustrate taxpayers who file honest returns and then stall the collection process to escape the admitted liability by filing in bankruptcy a year and a day after the return is filed. In criminal cases, our Dickensian aversion to imprisonment for debt makes it all but impossible to convict a high-living taxpayer who duly discloses but does not pay his tax liability, even for the offense of "willfully fail[ing] to pay,"⁴⁰⁴ let alone for the more aggravated offense of "willfully attempt[ing]

⁴⁰¹ Although cases closed in 1971 approximately matched new cases opened, the carryover at the end of the fiscal year was 759,000 cases involving \$1,899,804,000 in taxes. The periods for which they had been outstanding are not indicated in the report. *Id.*

⁴⁰² PROPOSED BANKRUPTCY ACT § 4-506(a)(1)(A), *incorporating id.* § 4-405(a)(5)(F). The latter section similarly denies priority only to the part of the claim the deferred payments on which have been delinquent to that extent. For a discussion of the resulting exposure of creditors to an accumulation of unknown noncurrent tax claims, see notes 243-48 and accompanying text *supra*.

⁴⁰³ The present law is set out in note 394 *supra*.

⁴⁰⁴ INT. REV. CODE OF 1954, § 7203; *see* United States v. Palermo, 259 F.2d 872 (3d Cir. 1958). A conviction was sustained in United States v. Andros, 484 F.2d 531 (9th Cir. 1973), on evidence that the taxpayer had sufficient funds, which he deposited under a fictitious name.

in any manner to evade or defeat" the tax.⁴⁰⁵ Nevertheless, the added element of affirmative acts calculated to cause collection to be deferred until the liability becomes dischargeable may supply the essential evidence of "attempt . . . to evade or defeat,"⁴⁰⁶ particularly since the words may be construed more broadly when only civil sanctions, in this instance the denial of a discharge, are invoked.⁴⁰⁷ Nevertheless, it probably is better to deal with the problem directly. In analogous circumstances, the Commission proposes to deny discharge of private debts voluntarily incurred, without the intention to repay,⁴⁰⁸ in a spending spree in anticipation of bankruptcy. It seems appropriate to make comparable express provision denying or conditioning discharge when the debtor, in anticipation of bankruptcy, has affirmatively contributed to delay in collection of his taxes.

In situations where the delay in collection is caused by the debtor's fraud or delinquency in the return itself, the Commission retains in substance the present nondischargeability provision,⁴⁰⁹ although it relieves other creditors of the effect of priority of taxes even in such cases—if the claims are over one year old.⁴¹⁰ The Commission justifiably departs from the policy pursued in the 1966 legislation of completely coordinating the priority and discharge rules.⁴¹¹ The proposal reflects an effort to balance the interests of the Government, when it lacks a proper return on which to base timely action against the erring taxpayer, and the creditors who arguably should not bear a greater accumulation of superior claims merely by reason of the debtor's delinquency or wrongdoing. In this respect, the proposal is consistent with the long-standing policy of the bankruptcy law denying discharge of certain debts with respect to which the debtor has been guilty of wrongdoing or

⁴⁰⁵ INT. REV. CODE OF 1954, § 7201. To constitute the felony of willfully attempting to evade a tax, there must be in addition to willful nonpayment some affirmative actions directed toward escaping the tax. *Spies v. United States*, 317 U.S. 492, 496-500 (1943).

⁴⁰⁶ The purpose in this instance is assumed to be not merely postponement of payment, but its ultimate escape, which constitutes evasion. *See Edwards v. United States*, 375 F.2d 862, 866-67 (9th Cir. 1967).

⁴⁰⁷ *See United States v. Murdock*, 290 U.S. 389, 394 (1933); *Monday v. United States*, 421 F.2d 1210, 1215-16 (7th Cir.), *cert. denied*, 400 U.S. 821 (1970).

⁴⁰⁸ PROPOSED BANKRUPTCY ACT § 4-506(a)(3); *see* BANKRUPTCY COMM'N REPORT 176.

⁴⁰⁹ PROPOSED BANKRUPTCY ACT §§ 4-506(a)(1)(B), (C). In denying discharge in the case of nonfraudulent failure to file a return, the proposal is more stringent than present law, which allows discharge if the tax liability, despite such failure, has been discovered *and assessed* more than a year before bankruptcy. Bankruptcy Act §§ 17a(1)(a), (b), 11 U.S.C. §§ 35(a)(1)(a), (b) (1970).

⁴¹⁰ PROPOSED BANKRUPTCY ACT § 4-405(a)(5).

⁴¹¹ *See* notes 239-40, 390 and accompanying text *supra*.

nondisclosure, although the claims enjoy no corresponding priority.⁴¹²

Departure from the policy of coordination may, however, be unduly harsh to the debtor who merely fails to file on time because of some reasonable excuse, such as illness, absence from the country, casualty, or reliance on expert advice that a return was not required,⁴¹³ or who files a timely return but inadvertently fails to sign it.⁴¹⁴ Even more insupportable is the fact that, at least in excise tax cases, nondischargeability may be accompanied by loss of priority, with consequent increase in the burden on the debtor's later assets and earnings, in some instances in which the return was not delinquent at all, as a result of the proposal to start the one-year period for loss of priority at the date of the taxable transaction and the one-year period for dischargeability at the date the return is filed.⁴¹⁵

The two controversial provisos in the present discharge provision, preserving the taxing authority's rights in exempt property and in property subject to lien,⁴¹⁶ are eliminated by the Commission: it recommends that tax claims no longer be collectible from the exempt property of a discharged bankrupt⁴¹⁷ and that statutory liens no longer be generally recognized against the bankrupt estate.⁴¹⁸

⁴¹² Bankruptcy Act §§ 17a(2), (3), (4), (8), 11 U.S.C. §§ 35(a)(2), (3), (4), (8) (1970). The proposal also is consistent with the policy of relieving the bankrupt estate, and hence the creditors, of monetary penalties for the debtor's prebankruptcy fraud or delinquency (Bankruptcy Act § 57j, 11 U.S.C. § 93(j) (1970); see notes 292-98 and accompanying text *supra*), while leaving the debtor undischarged therefrom (Bankruptcy Act § 17a(1)(d), 11 U.S.C. § 35(a)(1)(d) (1970); see notes 421-26 and accompanying text *infra*). See Plumb, *supra* note 125, at 268-69.

⁴¹³ Unlike the provision imposing a penalty for failure to file a return (INT. REV. CODE OF 1954, § 6651(a)), the proposal denies discharge irrespective of whether the nonfiling or late filing is excused by reasonable cause. PROPOSED BANKRUPTCY ACT § 4-506(a)(1)(B).

⁴¹⁴ An unsigned or otherwise incomplete return is considered no return at all. Vaira v. Commissioner, 444 F.2d 770, 777-78 (3d Cir. 1971); Plunkett v. Commissioner, 118 F.2d 644, 649-50 (1st Cir. 1941).

⁴¹⁵ For example, if a transaction subject to excise tax occurs on December 14, 1974, a return is timely filed on February 28, 1975, and bankruptcy occurs on February 1, 1976, the tax claim will be denied priority (PROPOSED BANKRUPTCY ACT § 4-405(a)(5)(E)), but the unsatisfied claim will be nondischargeable. PROPOSED BANKRUPTCY ACT § 4-506(a)(1)(B); see notes 255 and accompanying text *supra*.

⁴¹⁶ See notes 383-88 and accompanying text *supra*.

⁴¹⁷ PROPOSED BANKRUPTCY ACT § 4-503(a); *id.* Note 2.

⁴¹⁸ See notes 80-101 and accompanying text *supra*. Although statutory liens for *ad valorem* taxes and special assessments would continue to be recognized against property of the estate (PROPOSED BANKRUPTCY ACT §§ 4-606(a)(2), (3)), there is no occasion to refer to such liens in the proposed discharge provision, which would no longer serve, by cross-reference, to set priorities in the estate. See note 399 *supra*.

Like present law, the proposal is silent concerning the dischargeability of postpetition interest on tax claims.⁴¹⁹ The Commission states that it does not intend to disturb the existing judicial rule that the liability for such interest survives if the tax itself is not discharged.⁴²⁰

The present law is also silent on the dischargeability of liabilities for tax penalties. Only "provable debts" are discharged;⁴²¹ but the law, although making certain penalties *nonallowable*, except to the extent of the pecuniary loss sustained by the wrongful act,⁴²² does not expressly state that they are *not provable*. Courts generally take the position, however, that such penalties survive a discharge in bankruptcy.⁴²³ These holdings are sometimes predicated upon the questionable theory that the penalties are in effect nonprovable.⁴²⁴ A better justification, however, is that the penalties, at least under federal law, are "assessed and collected in the same manner as taxes" and are treated in all respects as taxes.⁴²⁵ The latter theory preserves the penalty from discharge only if the underlying tax liability is itself non-dischargeable.⁴²⁶

⁴¹⁹ For a discussion of the allowability of such interest and its subordination to general claims against property of the estate, see notes 277-86 and accompanying text *supra*.

⁴²⁰ PROPOSED BANKRUPTCY ACT § 4-506 Note 4; see note 280 and accompanying text *supra*.

⁴²¹ Bankruptcy Act § 17a, 11 U.S.C. § 35(a) (1970).

⁴²² *Id.* § 57j, 11 U.S.C. § 93(j) (1970).

⁴²³ *World Scope Publishers, Inc. v. United States*, 348 F.2d 640 (2d Cir. 1965). *Contra*, *United States v. Mighell*, 273 F.2d 682 (10th Cir. 1959).

⁴²⁴ *Custom Wood Prods. Inc. v. United States*, 338 F. Supp. 337 (W.D. Mich. 1971); *In re Steckler*, 195 F. Supp. 879 (S.D. Ind. 1961); *cf. In re Abramson*, 210 F. 878 (2d Cir. 1914).

⁴²⁵ *Sherwood v. United States*, 228 F. Supp. 247, 250-51 (E.D.N.Y. 1964) (relying on INT. REV. CODE OF 1954, § 6671); *accord*, *Westenberg v. United States*, 285 F. Supp. 915, 917 (D. Ariz. 1968); *Lynn v. Scanlon*, 234 F. Supp. 140 (E.D.N.Y. 1964). The cases involved a penalty on a corporate officer for not paying over withheld taxes (INT. REV. CODE OF 1954, § 6672), a "pecuniary loss" penalty which was clearly provable and allowable, and hence dischargeable (Bankruptcy Act § 17a, 11 U.S.C. § 35(a)(1970)) unless excepted as a tax. Similar language assimilating nonpecuniary loss penalties for fraud and delinquency into the taxes to which they relate is found in § 6659 of the Internal Revenue Code.

Although *United States v. Mighell*, 273 F.2d 682, 684-85 (10th Cir. 1959), rejected a similar argument with respect to income tax penalties, the most comparable language of the 1939 Internal Revenue Code (§§ 291, 293) was not considered by the court, and the case has in any event been discredited by its being overruled on the closely related question of dischargeability of postbankruptcy interest. *Bruning v. United States*, 376 U.S. 358 (1964); *cf. Jeanne Hamar*, 42 T.C. 867, 878-79 (1964).

⁴²⁶ The IRS has announced that it will not claim penalties against after-acquired property of the debtor unless the taxes to which the penalties relate are themselves nondischargeable. Rev. Rul. 68-574, 1968-2 CUM. BULL. 595, 597. A proposal by the Treasury and the Senate Finance Committee expressly to inject this decision into the 1966 amendments to the Bankruptcy Act was not adopted. See *Plumb, supra* note 125, at 272.

The Commission states its intention to "clarify and rationalize" the dischargeability status of penalties.⁴²⁷ It abandons the concept of "provability," and makes all claims, whether allowable or not, dischargeable unless excepted.⁴²⁸ Fines imposed for the benefit of a federal, state, or local government are expressly excepted from discharge.⁴²⁹ Civil penalties are not mentioned and therefore are dischargeable, even though subordinated in the estate to virtually all other claims,⁴³⁰ unless embraced in some other specific category of excepted claims.⁴³¹ The Commission states its intention that "prepetition" tax penalties, presumably those incurred before the proceeding, whenever determined, are dischargeable "if and to the extent that the tax debt . . . giv[ing] rise to the penalty is dischargeable," but that if the tax debt is itself nondischargeable—*e.g.*, because the debtor filed a fraudulent return or no return at all, the penalty too is nondischargeable.⁴³² The Commission's note adds a cryptic statement that a "postpetition penalty is a nondischargeable liability of the debtor only if the tax liability from which it arises is nondischargeable,"⁴³³ although it is difficult to imagine a "postpetition" liability that would ever be anything but "nondischargeable."⁴³⁴

⁴²⁷ See PROPOSED BANKRUPTCY ACT § 4-506 Note 18.

⁴²⁸ *Id.* § 4-506(a); *id.* Note 19.

⁴²⁹ *Id.* § 4-506(a)(9).

⁴³⁰ See notes 299-302 and accompanying text *supra*.

⁴³¹ PROPOSED BANKRUPTCY ACT § 4-506 Note 19.

⁴³² *Id.* Note 20. If that semi-official legislative history is accepted as controlling (see *Western Pac. R.R. v. Western Pac. R.R.*, 345 U.S. 247, 254-55 (1953); *King v. United States*, 390 F.2d 894, 913 (Ct. Cl. 1968); *Associates Investment Co.*, 59 T.C. 441, 445 (1972)), or if it is restated in the congressional committee reports, it will give a firmer statutory base to the rule of the cases discussed in note 425 *supra*, and will sustain the extension of the rule to taxes of state and local government which may lack laws expressly assimilating penalties into the tax liabilities to which they relate.

⁴³³ PROPOSED BANKRUPTCY ACT § 4-506 Note 20. Presumably a "postpetition penalty" is one incurred during the proceeding. *Nicholas v. United States*, 384 U.S. 678, 692-95 (1966).

⁴³⁴ Since only tax liabilities incurred at least a year before the petition will be dischargeable, it is unlikely that, during the proceeding, the estate would incur any penalties with respect thereto. In reorganizations and rehabilitative proceedings, taxes becoming payable in the course thereof attach to the debtor following consummation (Bankruptcy Act §§ 271, 397, 523, 11 U.S.C. §§ 671, 797, 923 (1970); PROPOSED BANKRUPTCY ACT § 7-315(e)) and are not discharged. In straight bankruptcies, any tax liabilities and resulting penalties arising during the proceeding would be those of the estate, not of the debtor, except in the case of corporate income taxes, regarding which § 6012(b)(3) of the Internal Revenue Code treats the corporation as the continuing taxable entity, but regarding which the Commission proposes in any event (1) to eliminate liability for such income tax in most circumstances (PROPOSED BANKRUPTCY ACT § 7-315(b)) and (2) to make corporate bankrupts ineligible for discharge (*id.* § 4-505; *id.* Note 3). See *Plumb, supra* note 171, at 937-38, 988.

C. *An Alternative Suggestion*

The 1966 amendment to the Bankruptcy Act was accepted by the Congress on the basis of assurances from the House and Senate Judiciary Committees that the three-year minimum period that must elapse before any tax becomes dischargeable thereunder would allow ample time to audit returns and assess and collect deficiencies and would "serve to discourage recourse to bankruptcy as a facile device for evading tax obligations."⁴³⁵ The Commission, however, makes no attempt to support its assertion that the proposed one-year period will "give the Treasury adequate time to collect taxes."⁴³⁶ The Commission's only stated justification for its one-year proposal and for its failure to deal adequately with even the aggravated situations described above is found in its view that "the amount of revenue [involved in bankruptcy cases] is insignificant to the federal government."⁴³⁷

The effect on the revenue might be magnified, however, if, as has been predicted, a bankruptcy "explosion" should result from the proposed simplification of procedure and liberalization of provisions for the debtor's "fresh start."⁴³⁸ Furthermore, because the federal tax system is largely dependent upon voluntary self-assessment, taxpayers' awareness of even relatively isolated situations in which "smart" taxpayers have found ways to escape paying their share impairs the willingness of others to cooperate in the self-assessment process,⁴³⁹ wholly apart from the perhaps limited incentive for more taxpayers to avail themselves of this particular means of avoidance. With this problem in mind, the Senate Fi-

⁴³⁵ S. REP. NO. 1158, *supra* note 128, at 3; H.R. REP. NO. 687, *supra* note 128, at 2-3. See also 112 CONG. REC. 13,821 (1966).

⁴³⁶ BANKRUPTCY COMM'N REPORT 216.

⁴³⁷ *Id.* at 216. See also notes 82-95 *supra*. "[A] taxing authority is . . . unlikely to be affected substantially by the bankruptcy process because only a minute percentage of almost any population of debtors obtains relief under the Act." BANKRUPTCY COMM'N REPORT 78. The statements are all addressed to the reduction of the Government's priority standing, rather than to the question of discharge, but the Commission clearly views the questions as interdependent.

⁴³⁸ Twinem, *Bankruptcy Report: Some Limitations on Creditors' Rights*, 29 BUS. LAWYER 353-54 (1974).

⁴³⁹ See S. REP. NO. 552, 91st Cong., 1st Sess. 13 (1969) (regarding the Tax Reform Act of 1969 (codified in scattered sections of 26 U.S.C.)). Not many taxpayers, for example, hold public papers they could give away at a tax saving, and the aggregate revenue loss from this and a number of other charitable deduction loopholes was estimated at a mere five to twenty million dollars. *Id.* at 80-81, 95. Yet there can be little doubt that recent revelations concerning the earlier use of such devices have produced a more cynical taxpayer attitude toward tax obligations generally, which will not be easily repaired.

nance Committee vainly urged in 1966 that the more limited discharge provision then under consideration, which was enacted over its opposition, be qualified by requiring that a limited percentage of the debtor's future after-tax earnings be charged with his prebankruptcy tax liabilities.⁴⁴⁰ The Committee declared that

[a] discharge provision which relieves the bankrupt of his tax liabilities could materially harm taxpayer morale in this country and thereby adversely affect the self-assessment revenue system. Of particular concern would be those cases where, shortly after bankruptcy and discharge, an individual earns large sums of income but would be under no responsibility to pay any of his remaining prebankruptcy tax liabilities. To provide such an individual with this type of tax forgiveness while most citizens are paying their fair share of our Nation's revenue needs, is in the view of this committee, both inequitable and likely to undermine the morale of our tax system. Additionally, in view of the substantial increase in voluntary bankruptcies which has been occurring in recent years, it does not seem prudent to provide potential bankrupts with the additional incentive of avoiding unpaid tax liabilities.⁴⁴¹

The Commission itself, in recommending safeguards against abuse of discharge provisions in the cases of consumer and student debts,⁴⁴² states that although "[t]he Commission is not aware of any evidence that suggests these are significant problems numerically, . . . such abuses discredit the system and cause disrespect for the law and those charged with its administration."⁴⁴³ At least equal concern should be shown for preserving whatever may remain of taxpayer confidence in the working of the tax system.

In order to give greater relief to debtors overburdened by tax liabilities, without opening the door to complete escape from taxes which the government will have had inadequate opportunity to determine and collect, consideration should be given to an amalgam of the discharge provisions of the 1966 legislation, the 1966 counterproposal of the Senate Finance Committee, and the

⁴⁴⁰ Although giving qualified approval to the principle that after a certain time taxes should be *denied priority* over general creditors, the Treasury and the Senate Finance Committee both opposed the *discharge* of older taxes, proposing instead to limit the portion of an individual's subsequent earnings which he would be required to devote to payment of prebankruptcy taxes had he not been guilty of specified misconduct or omissions. S. REP. NO. 999, *supra* note 397, at 8-10, 14-16. The proposal was defeated on the Senate floor. 112 CONG. REC. 13, 815-23 (1966).

⁴⁴¹ S. REP. NO. 999, *supra* note 397, at 9. See also 112 CONG. REC. 13,816-17 (1966).

⁴⁴² PROPOSED BANKRUPTCY ACT §§ 4-506(a)(3), (8).

⁴⁴³ BANKRUPTCY COMM'N REPORT 170.

Commission's one-year principle. I would not propose to turn back the clock by undoing the firm determination of Congress in 1966 to discharge, with certain exceptions, those tax liabilities which are more than three years old at the date of bankruptcy and which the tax collector has not been restrained from collecting.⁴⁴⁴ But for tax liabilities of intermediate age—*i.e.*, those which would not be discharged under present law but would be discharged under the Commission's one-year proposal—I suggest, in lieu of discharge, a system of limited deferred payments, adapted from the Finance Committee proposal. The debtor would be required to make annual postbankruptcy payments on account of such intermediate-aged federal taxes in an amount not in excess of ten percent of his after-tax taxable income for the preceding year,⁴⁴⁵ and another five percent would be required to be applied proportionately to intermediate-aged state and local taxes, unless in either case the bankruptcy court ordered satisfaction of the obligation at a faster rate.⁴⁴⁶

CONCLUSION

There is much that is commendable in the Commission's proposals concerning the priority and discharge of claims. Especially sound are the proposals for modernizing and making more flexible the priority of wage claims and the proposed elimination, in reorganizations as well as in straight bankruptcy, of the priority for nontax—and generally consensual—federal claims. I submit, however, that more injury to the revenue than the Commission

⁴⁴⁴ There are, however, technical deficiencies in the law that should be corrected. *See* note 396 *supra*.

⁴⁴⁵ The Finance Committee proposal would have reduced the base income to which the percentage was applied by the amount paid on such back federal taxes and by current federal income and self-employment taxes. There is no apparent reason why self-employment taxes should be excluded from base income unless Social Security (FICA) deductions from the wages of employed persons are also excluded. Reduction of base income by state income taxes might also be justified, but this raises the question of where to stop.

⁴⁴⁶ S. REP. No. 999, *supra* note 397, at 14-16. As under the Commission's proposal, no relief would be granted in the case of tax liabilities with respect to which the debtor had filed a false or fraudulent return or no return at all, or which he had willfully attempted to evade or defeat, nor would relief be granted with respect to taxes collected or withheld from others but diverted from payment by the debtor. In addition, the Finance Committee would add a category of nondeferrable taxes where the debtor had nonfraudulently failed to disclose in his return gross income exceeding 25% of the amount reported therein. But mere lateness in filing a return, extending to within one year before bankruptcy, which would cause denial of a discharge under the Commission's proposal (*see* notes 413-14 and accompanying text *supra*), would not deprive the debtor of the benefit of deferral.

imagines may result from its proposals to deny priority for, and to permit the debtor to obtain a discharge from, tax claims for which it allows grossly inadequate time for determination and collection. I therefore urge upon the Congress that serious consideration be given to the alternative approaches suggested herein.