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Among claims against a bankrupt estate were those for unpaid wages and vacation pay earned within three months of the bankruptcy of the employer. The referee ordered distribution of the amount of the claims, assigning them second priority, but he refused to authorize deduction of income withholding tax and social security taxes from these payments as requested by the Government.

* 336 F.2d 96 (3d Cir. 1964).

The district court reversed, holding the trustee in bankruptcy liable for the taxes as a first priority administrative expense.[1] On appeal, *held*, reversed. Taxes based on wage claims accruing prior to bankruptcy but paid during bankruptcy are section 64a(4) "taxes legally due and owing by the bankrupt."

In the principal case, the Third Circuit faced for the first time the troublesome situation in which wages earned prior to the filing of the petition in bankruptcy are paid by the trustee in the form of dividends to wage claimants. The assessment of income withholding tax[2] and social security tax[3] payments on these distributions has been a topic of extended controversy in the past, especially in relation to the priorities system of the Bankruptcy Act. Although the spirit of the act is equality of distribution among creditors,[4] section 64a provides for unsecured claims of certain creditors to be placed in one of five classes, each class taking precedence over those following.[5] Costs and expenses of administration of the bankrupt estate are accorded first priority, wage claims second priority, and taxes legally due and owing by the bankrupt fourth priority.[6] Payment of unsecured claims not within one of the five classes is postponed until those having priority have been paid in full.

It is clear that the bankrupt estate in the hands of the trustee in bankruptcy is not immune from taxation.[7] However, the priority section of the act does not in terms draw a distinction between pre-bankruptcy and post-bankruptcy taxes—that is, between taxes incurred by the bankrupt prior to bankruptcy and taxes incurred during the course of administration of the bankrupt estate.[8] The

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1. *In re* Connecticut Motor Lines, Inc., 223 F. Supp. 189 (E.D. Pa. 1963).

2. INT. REV. CODE OF 1954, §§ 3401-02.

3. INT. REV. CODE OF 1954, §§ 3101-02, 3111.

4. See United States v. Embassy Restaurant, Inc., 359 U.S. 29, 31 (1959); Wurzel, *Taxation During Bankruptcy Liquidation*, 55 HARV. L. REV. 1141 (1942).

5. Bankruptcy Act § 64(a), 30 Stat. 563, 11 U.S.C. § 104(a) (Supp. V, 1964). Claims secured by valid liens must be satisfied in full under the provisions of § 67(d) before § 64(a) becomes operative. See *In re* Quaker City Uniform Co., 238 F.2d 155 (3d Cir. 1956); Dunn v. Interstate Bond Co., 68 F.2d 364 (5th Cir. 1934).

6. Section 64(a) reads in part as follows: "The debts to have priority in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be . . .

"(1) the costs and expenses of administration including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition . . . ;

"(2) wages and commissions, not to exceed 600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding . . . ;

"(4) taxes legally due and owing by the bankrupt to the United States or any State or subdivision thereof . . . ."

Bankruptcy Act § 64(a), 30 Stat. 563, 11 U.S.C. § 104(a) (Supp. V, 1964).

7. Swarts v. Hammer, 194 U.S. 441 (1904). See 3 COLLIER, BANKRUPTCY § 62.14, at 1518 (14th ed. 1964).

8. See *In re* William F. Fisher & Co., 148 Fed. 907 (D.N.J. 1906). The Supreme Court has refrained from distinguishing between current and pre-bankruptcy tax

courts have nevertheless considered the date on which the petition in bankruptcy is filed as critical in determining the right to priority under section 64a.[9] Taxes which have accrued and can be computed as provable claims[10] at the time the petition is filed are within the fourth priority.[11] Taxes accruing subsequent to the filing date which arise out of carrying on the bankrupt's business are expenses of administration entitled to the first priority.[12]

The landmark case of *United States v. Fogarty*[13] held that the trustee stands in the shoes of the bankrupt employer when distributing dividends for pre-bankruptcy wages, and that the dividends are to be treated as actual wages, the trustee being required to withold the appropriate taxes due the United States. Since the taxes in *Fogarty* were not due and payable at the time the petition was filed but only when the "wages" were paid by the trustee,[14] the court classsified them as a first priority expense of administration.[15] Although ably and vigorously attacked by legal theoreticians on several occasions[16] and consistently ignored or rejected in decisions by the referees in bankruptcy, the *Fogarty* precept has endured in

claims. Arkansas Corp. Comm'r v. Thompson, 313 U.S. 132 (1941); Dayton v. Stanard, 241 U.S. 588 (1916). See Wurzel, *supra* note 4, at 1142.

9. See New Jersey v. Anderson, 203 U.S. 483 (1906); *In re* Lambertville Rubber Co., 111 F.2d 45 (3d Cir. 1940); 3 COLLIER, *op. cit. supra* note 7, § 64.01, at 2058.

10. It is the date of assessment or of an establishment of the liability for the tax, rather than the date of payment, that controls. New Jersey v. Anderson, *supra* note 9; *In re* International Match Corp., 79 F.2d 203 (2d Cir. 1935); *In re* Wells, 4 F. Supp. 329 (D. Md. 1933).

11. *In re* International Match Corp., *supra* note 10; *In re* Flynn, 134 Fed., 145 (D. Mass. 1905); *In re* Fago Constr. Corp., 162 F. Supp. 238 (W.D.N.Y. 1957).

12. Boteler v. Ingels, 308 U.S. 57 (1939); Michigan v. Michigan Trust Co., 286 U.S. 334 (1932); McColgan v. Maier Brewing Co., 134 F.2d 385 (9th Cir. 1943); *In re* Humeston, 83 F.2d 187 (2d Cir. 1936); *In re* Garfield Fire Clay Co., 46 F. Supp. 932 (W.D. Pa. 1942). *But cf. In re* Berkshire Hardware Co., 39 F. Supp. 663 (D. Mass. 1941). Thus, when business has been carried on by the trustee or debtor in possession, the courts have maintained the distinction set out in the text by holding that certain taxes, if incurred by the business in readily ascertainable amounts and reasonably apportionable over the period before and after bankruptcy, may constitute claims in part entitled to fourth priority and in part to first priority. This severability concept has been applied mainly to withholding taxes on wage payments. *In re* John Horne Co., 220 F.2d 33 (7th Cir. 1955); Pomper v. United States, 196 F.2d 211 (2d Cir. 1952); *In re* Fago Constr. Corp., 162 F. Supp. 238 (W.D.N.Y. 1957). *Contra, In re* Demos Cafe Inc., 5 CCH STAND. FED. TAX REP. ¶ 9223 (W.D. Mich. 1951). Where not severable, a payment of the entire tax by the trustee would necessarily be an expense of administration. *E.g.*, Michigan v. Michigan Trust Co., *supra*; Prudential Ins. Co. v. Liberdar Holding Co., 74 F.2d 50 (2d Cir. 1934); *In re* Portage Rubber Co., 288 Fed. 182 (6th Cir. 1923).

13. 164 F.2d 26 (8th Cir. 1947).

14. By statute, the amount of the tax is to be deducted from wages by the employer "as and when paid." INT. REV. CODE OF 1954, § 3102(a).

15. United States v. Fogarty, 164 F.2d 26, 33 (8th Cir. 1947).

16. See Hiller, *The Folly of the Fogarty Case*, 32 REF. J. 54 (1958); Seligson, *Creditors' Rights*, N.Y.U. ANN. SURVEY AM. L. 323, 336 (1957); Seligson, *Bankruptcy*, N.Y.U. ANN. SURVEY AM. L. 357, 371 (1955); 56 MICH. L. REV. 631 (1958); 23 REF. J. 14 (1948); 22 REF. J. 84 (1948); 2 U. FLA. L. REV. 133 (1949).

the appellate courts.[17] In the principal case, the Third Circuit clearly embraced the *Fogarty* position that the trustee is to be considered an employer making wage payments and thus is bound to collect and pay withholding taxes on wage claim dividends.[18] But the court repudiated the more controversial holding of *Fogarty* by dropping these tax claims from the first to the fourth priority. Expressly rejecting a definitional classification of *all* post-bankruptcy tax accruals as first priority, the court held that, whether pre-bankruptcy or post-bankruptcy in nature, only those taxes clearly related to the development, preservation, or distribution of the bankrupt's assets are entitled to the first priority.[19]

However, in adopting this more meaningful view of administrative expenses, the court failed to explain satisfactorily how the taxes could be assigned even a fourth priority. The court initially indicated that taxes accruing after the filing of the petition can be treated as provable claims entitled to the fourth priority.[20] But such treatment is contrary to well-established authority[21] and would do considerable violence to the well-considered distinction between pre-bankruptcy and post-bankruptcy taxes. The court subsequently hedged by ruling that withholding taxes can attach for purposes of the Bankruptcy Act *before* wages are paid and thus accrue prior to bankruptcy as normal fourth priority tax claims.[22] Despite the distortion of tax collection procedure which necessarily follows from this latter interpretation, the court refused to permit provisions of the Bankruptcy Act to be limited by conflicting provisions in other statutes, such as the Internal Revenue Code, which have incidental relationships to bankruptcy administration.[23]

In light of this position, it seems curious that this statutory independence was not maintained throughout by attempting to reject the *Fogarty* decision in its entirety. Under that portion of the *Fogarty* rationale which the court in the principal case clearly accepted, only by resorting to the Treasury Department definitions of "employer" and "wages" as adjuncts to the Bankruptcy Act can the trustee be required to collect this tax as a normal employer.[24]

17. See, *e.g.*, Lines v. California Dep't of Employment, 242 F.2d 201 (9th Cir. 1957). Several cases followed *Fogarty* to the extent of requiring the deductions, but refrained from classifying them as administrative expenses. See, *e.g.*, United States v. Curtis, 178 F.2d 268 (6th Cir. 1949). See also *In re* John Horne Co., 220 F.2d 33 (7th Cir. 1955).

18. 336 F.2d at 99 n.9.

19. *Id.* at 108.

20. *Id.* at 104.

21. See note 11 *supra* and accompanying text.

22. 336 F.2d at 105.

23. *Ibid.*

24. See United States v. Fogarty, 164 F.2d 26 (8th Cir. 1947). *Fogarty* relied on INT. REV. CODE OF 1954, § 3401(a), which defines "wages" as "all remuneration . . for services performed by an employee for his employer. . . ." Section 3041(d) defines

It is true that in most respects a trustee does stand in the position of the bankrupt.[25] For example, a trustee continuing a bankrupt enterprise is an employer required to withhold ordinary taxes from wage payments.[26] On the other hand, a trustee who, as in the principal case, is concerned solely with the liquidation and distribution of the bankrupt's assets cannot so easily be considered an "employer" of the bankrupt's former employees, with whom he has never established an employer-employee relationship. A payment by the latter trustee is a mere dividend—that is, a distribution of a fund among various claimants pursuant to court order.[27] The apposite provisions of the Internal Revenue Code make no reference to a trustee in bankruptcy, and the extension of a tax by implication to such a trustee has not been favored.[28] By a more effectual endorsement of the statutory independence of the Bankruptcy Act, a statute ostensibly equal in dignity to the Internal Revenue Code, the court in the principal case could have carried its logic to the point of rejecting *Fogarty* and priority claims for taxes on pre-bankruptcy wage dividends altogether. The court did not go this far, however, and it is questionable whether any worthwhile policy would be served by so doing.

The Court's argument that this tax is not a first priority expense related to the administration of the estate is persuasive and should effectively undermine the corresponding portion of *Fogarty*. But it is also clear that without a distortion of the Internal Revenue Code or a potentially dangerous departure from established bankruptcy policy, these withholding and social security taxes cannot be regarded as provable debts until the wages are actually paid. Since section 64a(4) by necessary implication and established judicial interpretation limits provable claims to those arising prior to the filing of the petition, the designation of this tax as a fourth priority claim is nearly as distortive of section 64a as would be a designation of the same tax as an administrative expense.[29]

"employer" as the person for whom the service is performed, except that if that person does not have "control" of payment of such wages then the term employer means the person having such control. This exception is "designed solely to meet unusual situations." Treas. Reg. § 31.3401(d)-1(g) (1964). See Century Indem. Co. v. Riddell, 317 F.2d 681 (9th Cir. 1963).

25. See *In re* B-F Building Corp. 284 F.2d 679 (6th Cir. 1960); Jones v. Dugan, 124 Md. 346, 92 Atl. 775 (1914).

26. Such taxes would be expenses of administration when paid. See, *e.g.*, McColgan v. Maier Brewing Co., 134 F.2d 385 (9th Cir. 1943); *In re* Garfield Fire Clay Co., 46 F. Supp. 932 (W.D. Pa. 1942).

27. See 56 MICH. L. REV. 631, 632 (1958); 23 REF. J .12, 14 (1948); 22 REF. J. 84 (1948). *Cf.* Seligson, *Creditors' Rights*, N.Y.U. ANN. SURVEY AM. LAW 323, 337 (1957).

28. See Michigan v. Michigan Trust Co., 286 U.S. 334 (1932); Reinecke v. Gardner, 277 U.S. 239 (1928). *Cf.* Shongut v. Golden, 270 F.2d 238 (2d Cir. 1959).

29. A few cases have assigned taxes accruing after bankruptcy to the fourth priority. *E.g.*, *In re* Berkshire Hardware Co., 39 F. Supp. 663 (D. Mass. 1941). Such treatment

Perhaps the court's holding was influenced by the fact that there were ample funds in the principal case to allow payments even to general creditors. But the court's solution leaves unanswered questions that would arise in the numerous cases in which distributions from the estate will not reach all classes of claimants. For example, suppose that the estate is sufficient to satisfy only first and second priorities and that the trustee is to pay a five hundred dollar wage claim, from which fifty dollars would normally be withheld for taxes. Should this fifty dollars be applied toward third priority claims, with any remainder applied to payment pro rata of tax claims of all kinds entitled to fourth priority? Or should it go directly to satisfy only the fourth priority tax claims arising by virtue of the wage payments? If the latter, a section 64a(4) claim would pre-empt a section 64a(3) claim and other fourth priority claims and be afforded what amounts to second priority treatment. If the former, a course the opinion seems to suggest, the employee's earnings will be used not to pay his taxes, but rather his employer's other liabilities. Both the employee and the government would be hurt by such a distribution. In either case the second priority wage dividend would be diminished by claims of an inferior status under the normal order of priorities. The more reasonable alternative would seem to be to treat the withholding taxes as a part of wages, entitled to priority under section 64a(2), and not as either a first or fourth priority. But difficulties will probably continue to surround this complex issue until explicit provisions are adopted in the Bankruptcy Act distinguishing between, and treating specifically, the various taxes accruing before and after bankruptcy.

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has been described as "completely inaccurate." 3 COLLIER, *op. cit. supra* note 7, § 62.14, at 1532.