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## Bankruptcy - Priorities - Priority Status of Tax on Wages Earned But Unpaid at Time of Bankruptcy

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## RECENT DECISIONS

**BANKRUPTCY—PRIORITIES—PRIORITY STATUS OF TAX ON WAGES EARNED BUT UNPAID AT TIME OF BANKRUPTCY**—The State of California demanded that a trustee in bankruptcy pay the employer's tax due on wages earned by the employees of the bankrupt. The wages were earned within the three-month period prior to the petition in bankruptcy but had not been paid prior to bankruptcy. The trustee did not continue the operation of the bankrupt's business. The United States district court reversed the Referee and ordered the trustee to pay the tax claim.<sup>1</sup> The court of appeals affirmed.<sup>2</sup> On rehearing, *held*, affirmed. Since the tax is not due until the wages are actually paid, the tax accrues during the administration of the estate and is consequently an expense of administration entitled to the first priority within section 64 (a) of the Bankruptcy Act.<sup>3</sup> *Lines v. State of California Dept. of Employment*, (9th Cir. 1957) 246 F. (2d) 70.

The Bankruptcy Act provides for priority in the payment of debts and designates five classes of priority claims, each of which is given precedence in payment over succeeding classes.<sup>4</sup> Wages are within the second priority, tax claims within the fourth, and expenses of administration within the first. Since the estate of the bankrupt in the principal case was not adequate to pay the entire wage claim, a determination that the tax claim in question was an expense of administration within the first priority partially defeats the wage claims which normally would be preferred to taxes. A tax claim which has not accrued at the time of bankruptcy, however, is not a provable debt and therefore not within the fourth priority;<sup>5</sup> but if such tax accrues during bankruptcy in relation to administering the estate or to the conducting of business during bankruptcy it is within the first priority.<sup>6</sup> The following taxes have been held to be within the first priority when they have accrued after the date of the filing of the petition: property taxes;<sup>7</sup> social security taxes accruing while the debtor was allowed

<sup>1</sup> In re Blackwood, (D.C. Cal. 1956) 147 F. Supp. 93.

<sup>2</sup> *Lines v. California Dept. of Employment*, (9th Cir. 1957) 242 F. (2d) 201, cert. den. 26 U.S. Law Week 3129 (1957).

<sup>3</sup> 30 Stat. 563 (1898), as amended, 11 U.S.C. (Supp. IV, 1957) §104(a).

<sup>4</sup> *Ibid*.

<sup>5</sup> In re Intl. Match Corp., (2d Cir. 1935) 79 F. (2d) 203. 2 REMINGTON, BANKRUPTCY §799 (1956); 3 COLLIER, BANKRUPTCY §63.26 (1941). *Contra*, In re Berkshire Hardware Co., (D.C. Mass. 1941) 39 F. Supp. 663.

<sup>6</sup> *Pomper v. United States*, (2d Cir. 1952) 196 F. (2d) 211. 3 COLLIER, BANKRUPTCY §62.14 (1941); MACLACHLAN, BANKRUPTCY 146 (1956); Wurzell, "Taxation During Bankruptcy Liquidation," 55 HARV. L. REV. 1141 at 1173 (1942).

<sup>7</sup> The trustee must pay property taxes accruing during bankruptcy regardless of whether he is operating the property as a business. It has been suggested that this is because the property enjoys government protection whether in the hands of the bankrupt or the trustee. *Swarts v. Hammer*, 194 U.S. 441 (1904). 3 COLLIER, BANKRUPTCY §62.14 (1941).

to remain in possession;<sup>8</sup> franchise taxes accruing while a receiver was operating the business;<sup>9</sup> and wages and unemployment insurance taxes accruing while the trustee operated the business.<sup>10</sup> To be within the fourth priority a tax must be "due and owing" at the time of bankruptcy.<sup>11</sup> A tax becomes due and owing when all the facts necessary for its calculation are available even though it may be payable at some later date.<sup>12</sup> A franchise tax payable at the end of the year, partly on the basis of changes in capital structure during the year, was not divisible, and no part was due and owing at any time other than the end of the year.<sup>13</sup> Unemployment taxes payable at the end of the year, however, have been held apportionable between wages paid before and after bankruptcy, the tax on wages paid before bankruptcy being placed within the fourth priority.<sup>14</sup> The principal case, however, concerned a tax on wages which were earned but unpaid at the time of bankruptcy. Such a tax was held to be an expense of administration by the Eighth Circuit in *United States v. Fogarty*,<sup>15</sup> where the court held that a dividend on a wage claim was a payment of wages and that, since the tax was on the payment of wages, it accrued during the bankruptcy proceedings and was therefore an expense of administration. The decisions in the *Fogarty* case and in the principal case are subject to forceful criticism. If the tax were on the distribution of the wage claim, the tax could be a valid expense of administration since distribution is a part of administration; but the tax in question is not a tax on distribution but a tax on wages paid. A distribution in bankruptcy should be categorized as a distribution alone and not as a payment of wages.<sup>16</sup> Secondly, expenses of administration should be restricted to such items as court costs and the costs of actually operating the business during the bankruptcy proceeding.<sup>17</sup> Furthermore, the purpose of the California Unemployment Insurance Code is to provide "benefits for persons unemployed through no fault of their own, and to reduce involuntary unemployment and the suffering caused thereby to a minimum."<sup>18</sup> It also states that employers' taxes "shall not be deducted in

<sup>8</sup> *United States v. Killoren*, (8th Cir. 1941) 119 F. (2d) 364; *In re Wil-Low Cafeterias, Inc.*, (D.C. N.Y. 1940) 35 F. Supp. 965.

<sup>9</sup> *McColgan v. Maier Brewing Co.*, (9th Cir. 1943) 134 F. (2d) 385, cert. den. 320 U.S. 737 (1943).

<sup>10</sup> *In re John Horne Co.*, (7th Cir. 1955) 220 F. (2d) 33; *Pomper v. United States*, note 6 supra.

<sup>11</sup> *In re Intl. Match Corp.*, note 5 supra.

<sup>12</sup> *In re John Horne Co.*, note 10 supra. 3 COLLIER, BANKRUPTCY §64.405 (1941).

<sup>13</sup> *In re Intl. Match Corp.*, note 5 supra.

<sup>14</sup> *In re John Horne Co.*, note 10 supra; *Pomper v. United States*, note 6 supra, noted in 52 COL. L. REV. 932 (1952).

<sup>15</sup> (8th Cir. 1947) 164 F. (2d) 26.

<sup>16</sup> MACLACHLAN, BANKRUPTCY 149, n. 19 (1956); 22 REF. J. 84 (1948); 2 FLA. L. REV. 133 (1949).

<sup>17</sup> MACLACHLAN, BANKRUPTCY 149, n. 19 (1956); 22 REF. J. 84 (1948).

<sup>18</sup> Cal. Unemployment Ins. Code §100.

whole or in part from the wages of individuals in his employ."<sup>19</sup> The policy of the Bankruptcy Act is to give wage claims priority over tax claims. The policies of both acts are far from realized in the principal case where dividends which otherwise would go to wage earners are depleted by tax payments to the unemployment insurance fund. Two alternatives more desirable than the result reached in the principal case are open to the court.<sup>20</sup> A determination that the state had a valid tax claim but that it accrued after bankruptcy and was not an expense of administration would allow the state later to assess the tax claim against after acquired property of the bankrupt, since a claim accruing after the filing of the petition is not discharged by bankruptcy proceedings.<sup>21</sup> This solution would be more in accord with the spirit of the Bankruptcy Act and of the California Unemployment Insurance Code than the result reached in the principal case. An alternative solution would be to find that the tax claim was within the fourth priority reserved for taxes accruing before bankruptcy. Tax claims within the fourth priority normally relate to matters which occurred prior to the petition in bankruptcy;<sup>22</sup> the tax in the principal case related to wages earned prior to bankruptcy. Liability to the tax accrues as wages are earned. If wages of a specified amount have been earned and are not contingent,<sup>23</sup> then the tax liability is fixed and will be reduced only if assets of the estate are not adequate to pay wages in full. To be within the fourth priority a tax must be "due and owing" at the time of bankruptcy,<sup>24</sup> and it becomes "due and owing" when all the facts necessary for its calculation are available even though it may be payable at some later date.<sup>25</sup> Construing "due and owing" as broad enough to cover a tax claim that has accrued, but is subject to the limited possibility of reduction as in the principal case, is no greater extension of the fourth priority than a determination that accrued taxes payable in the future are "due and owing" within the meaning of the statute.<sup>26</sup> Such a

<sup>19</sup> *Id.*, §976.

<sup>20</sup> It would be impossible to fit the tax into the second priority as wages. Two cases have held that employer contributions to Union Welfare Funds were actually wages assigned by the Union to the Welfare Fund. The contributions were held to be wages since paid under a collective bargaining agreement. *Matter of Otto*, (D.C. Cal. 1956) 146 F. Supp. 786; *Matter of Embassy Restaurant, Inc.*, (D.C. Pa. 1957) 154 F. Supp. 141. Two cases have held that such contributions were not wages. *In re Brassel*, (D.C. N.Y. 1955) 135 F. Supp. 827; *In the Matter of Sleep Products, Inc.*, (D.C. N.Y. 1956) 141 F. Supp. 463. For a discussion of these cases, see 62 *COMM. L. J.* 321 (1957); 66 *YALE L. J.* 449 (1957).

<sup>21</sup> All tax claims are specifically exempt from discharge in bankruptcy. 30 *Stat.* 550 (1898), as amended, 11 *U.S.C.* (1952) §35(a)(1). *California Bd. of Equalization v. Coast Radio Prod.*, (9th Cir. 1955) 228 F. (2d) 520. See *MacLachlan, Bankruptcy* 101 (1956).

<sup>22</sup> *In re California Pea Products*, (D.C. Cal. 1941) 37 F. Supp. 658.

<sup>23</sup> *Reich v. Industrial Commissioner of New York*, (2d Cir. 1944) 145 F. (2d) 759.

<sup>24</sup> *In re Intl. Match Corp.*, note 5 *supra*.

<sup>25</sup> *In re John Horne Co.*, note 10 *supra*. 3 *COLLIER, BANKRUPTCY* §64.405 (1941).

<sup>26</sup> The suggested solution may have been precluded in the principal case since the California Unemployment Insurance Code §976 says the tax shall "accrue and become payable by every employer for each calendar year with respect to wages paid for em-

construction restricts first priority expenses of administration to their proper narrow sphere, furthers the stated purpose of the California Unemployment Insurance Code, and is in accord with the policy of the Bankruptcy Act that established a system of priorities. By endorsing the *Fogarty* case the principal case thwarts these desirable results.

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ployment." However, at the first hearing of the principal case the court said that §976 covers only the normal operation of a going business and not the situation of bankruptcy.