Half an Answer to Placing Employment Taxes within the Priority Structure of Section 64(a) of the Bankruptcy Act - Otte v. United States

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HALF AN ANSWER TO PLACING EMPLOYMENT TAXES WITHIN THE PRIORITY STRUCTURE OF SECTION 64(a) OF THE BANKRUPTCY ACT—OTTE V. UNITED STATES

Codification of bankruptcy principles originated as an alternative to "grab law," the chaotic practice whereby the most aggressive creditors sliced up a debtor's assets.¹ Today the struggle among unsecured creditors for the assets of a bankrupt estate is resolved through a system of priorities established by the Bankruptcy Act.² Section 64(a) of the Act sets forth five categories of claims which are entitled to priority before distributions are made to general creditors.³ Only when a creditor estab-

1. At common law a person's property could be taken as satisfaction of a debt. This was done on a "first come, first served" basis; a creditor making the first seizure by execution or attachment took preference over another creditor perfecting a subsequent levy. 9 Am. Jur. 2d Bankruptcy §1 (1963). Insolvency and bankruptcy laws originated in Roman law and have been enforced in England for more than three centuries. See Continental Ill. Nat'l Bank & Trust Co. v. Chicago, R.I. & P. Ry., 294 U.S. 648 (1935). The Federal Constitution grants Congress power to enact bankruptcy legislation. U.S. Const. art. I, §8, cl. 4. Congress first exercised this power in 1800 when the first American Bankruptcy Act was passed. However, this Act was repealed in 1803 and the second Bankruptcy Act was not enacted until 1841. This Act was repealed in 1843. Again there was a period when no federal Bankruptcy Act was in force until the Bankruptcy Act of 1867. The 1867 Act was repealed in 1878 and another Act was not enacted until 1898 when the Act currently in force was passed. See Hanover Nat'l Bank v. Moyses, 186 U.S. 181 (1902). See generally C. Warren, Bankruptcy History in the United States (1935).


3. Not all creditors are treated equally in the distribution of the assets of a bankrupt estate. Secured creditors are generally paid before distribution of assets is made to the unsecured creditors. An unsecured creditor who has a right to priority, that is, one who falls within one of the classes of debts established by the priority structure of section 64(a), is entitled to payment before other claims in distribution of the remaining assets. See 3A W. Collier, Collier on Bankruptcy ¶ 64.02[1] (14th ed. 1975) [hereinafter cited as Collier]. Section 64(a) sets forth the following classes of debts in order of payment, which are summarized as follows:

(1) Costs and expenses of administration of the bankrupt's estate, including trustee's and attorney's fees.

(2) Wage claims, not to exceed $600, to each claimant, earned within three months before the date of commencement of the proceeding by certain employees.

(3) Costs and expenses incurred by creditors in opposing an arrangement, Chapter XIII plan or a discharge; and expenses in adducing evidence resulting in conviction under Chapter IX of Title 18.

(4) Taxes legally due and owing by the bankrupt to the United States or any state or political subdivision.

(5) Debts other than taxes owing to any person, including the United States,
lishes that his claim falls within one of these categories is it entitled to priority status. Claims by certain employees for wages earned prior to the bankruptcy proceeding are accorded second priority. However, a serious problem has plagued the courts for over 25 years. Is the bankrupt estate liable for payment of employment taxes arising out of these wage claims? If so, what priority, if any, should be given to these employment tax claims of the federal government under the Bankruptcy Act?

In attempting to reconcile the opposing objectives of tax collection and the equitable administration of bankrupt estates, most courts have failed to recognize that there are actually two different types of employment taxes: (1) withholding taxes deducted from an employee's gross pay and (2) employer taxes imposed only upon the employer. To...
clarify this distinction, assume an employer pays an employee a salary of $100. The employer must deduct 5.85% or $5.85 for payment of the employee's portion of the social security tax and also withhold approximately 20% or $20.00 for federal income tax purposes. The employee thus receives a check for $74.15. The $25.85 balance of the $100 gross salary constitutes withholding taxes. However, the employer's tax responsibility does not end when he withholds these taxes from the employee's gross pay. The employer must match dollar for dollar the social security tax withheld from the employee by paying 5.85% or $5.85 to the federal government as an expense of the company. In addition, the employer must pay another tax of 3.2% or $3.20 for unemployment tax purposes. Thus every time the employer pays his employee $100, the employer must pay out of his own pocket an additional $9.05 in employer taxes, so that the employer's total cost is $109.05 on a salary payment of $100.

Failure to recognize the distinction between withholding and employer taxes is perhaps a major reason for a split in the circuit court decisions, with different circuits placing employment taxes in either


10. Treas. Reg. §31.3101-2 (1976). A tax at the rate of 5.85% is presently imposed on amounts paid to employees up to a maximum of $15,300 (1976 wage base) per employee per year.

11. Employers are responsible for collecting the correct amount of income tax from wage payments. There are two conventional methods used, wage-bracket method and percentage method, both of which consider the number of exemptions an employee claims and total income earned. For purposes of simplification, this example uses a 20% withholding, although the actual percentage would vary from case to case. In bankruptcy, the Internal Revenue Service directives allow a trustee the option of using the exact calculation method or using a flat 25% withholding combining the employee portion of FICA tax and federal income tax. See Otte v. United States, 419 U.S. 43, 47 n.2 (1974); Flanagan, supra note 7, at 91.

12. Treas. Reg. §31.3111-2 (1976). A tax at the rate of 5.85% is presently imposed on the employer up to a maximum of $15,300 (wage base for 1976) paid to each employee per year.

13. Int. Rev. Code of 1954, §3301. The tax is equal to 3.2% of wages paid by the employer up to a maximum of $4,200 per year. However, a credit of up to 2.7% may be obtained by employers who are subject to state unemployment tax laws. See Int. Rev. Code of 1954, §3302. As to relative rights of federal and state governments, see United States v. New York, 315 U.S. 510 (1942).

14. Characteristic of the difficulties courts have had in segregating withholding taxes from employer taxes is the statement of the Supreme Court in Otte v. United States: "[T]he circuits are in disarray as to the priority to be accorded to withholding taxes on prebankruptcy wage claims." 419 U.S. 43, 47 (1974). The Court then cited the case of Lines v. California Dep't of Employment, 242 F.2d 201, aff'd on rehearing, 246 F.2d 70
the first, second or fourth priority. After 25 years of conflicting federal court decisions, in Otte v. United States the United States Supreme Court held that (1) claims for wages earned by employees before an employer's bankruptcy, but unpaid at the inception of bankruptcy proceedings, are subject to withholding taxes, and (2) withholding taxes are entitled to second priority since they are "carved out" of the wages themselves. Unfortunately, the liability of the bankrupt estate for employer taxes was not in issue in Otte and therefore remains the subject of dispute.

This Note will examine the rationale used in Otte to accord withholding taxes a second priority status and will then analyze the unre-

(9th Cir.), cert. denied, 355 U.S. 857 (1957), as one of the circuit court decisions split on the issue of withholding taxes. The Lines decision dealt solely with employer taxes. Another example of this problem is the decision in United States v. Fogarty, 164 F.2d 26 (8th Cir. 1947), which dealt with both withholding and employer taxes, but failed to distinguish between the employee and employer portions of social security tax, treating both portions as if they were one type of tax. See also note 50 infra.

15. The circuit courts are split between the following priorities on the issue of withholding taxes: United States v. Fogarty, 164 F.2d 26 (8th Cir. 1947) (first priority); In re Freedomland, Inc., 480 F.2d 184 (2d Cir. 1973) (second priority); In re Connecticut Motor Lines, Inc., 336 F.2d 96 (3d Cir. 1964) (fourth priority). "The third and fifth priorities clearly have no possible application to these taxes." Otte v. United States, 419 U.S. 43, 56 (1974). Tax claims obviously do not fall within the scope of third priority claims. See note 3 supra. Fifth priority is given to "debts other than taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority." Bankruptcy Act §64(a). The only law of the United States granting priority to "any person" is 31 U.S.C. §§191, 193 (1970), which grants priority only to the United States and sureties on bonds given to the United States by their principals. The words "other than for taxes" were inserted into fifth priority by an amendment in 1966 to prevent the apparent overlap between fourth and fifth priorities. Act of July 5, 1966, Pub. L. No. 89-495, §2, 80 Stat. 268. In addition, the fourth priority section was amended in 1966 to include the following new language: "no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority." Act of July 5, 1966, Pub. L. No. 89-496, §3, 80 Stat. 271. Thus taxes falling within fourth priority are not classified as debts owed the United States under section 64(a)(5) by means of the federal priority statute. The view that tax claims should have fifth priority as a non-tax debt owed to the United States by a collection agent has long been rejected by the courts. See United States v. New York, 315 U.S. 510, 513-16 (1942). See also 3A COLLIER ¶ 64.404[2.2].


17. Id. at 48-51.

18. Id. at 58.

19. This author has not been able to ascertain why the United States did not advance the argument that employer taxes were also to be paid on the wage claims in this case. In other cases, the United States government has asserted that employer taxes are to be paid as a first priority claim. See, e.g., United States v. Fogarty, 164 F.2d 26 (8th Cir. 1947); In re Connecticut Motor Lines, Inc., 336 F.2d 96 (3d Cir. 1964). See also text accompanying note 42 infra.
solved question of employer taxes in light of the *Otte* decision. Courts are forced to base their decisions on an antiquated priority structure contained in the present Bankruptcy Act. This has resulted in confusion and conflicts in court decisions. Congressional modification of the priority structure can best resolve the problem of employment taxes on pre-bankruptcy wage claims.20

THE RATIONALE OF OTTE

Background of the Case

Freedomland, Inc. operated an amusement park located in Bronx County, New York. On September 15, 1964, Freedomland filed a petition for an arrangement with its unsecured creditors under Chapter XI of the Bankruptcy Act.21 The rehabilitation effort failed, and 11 months later Freedomland was adjudicated a bankrupt. Former employees of Freedomland who had performed services for the company prior to its Chapter XI petition filed 413 wage claims, each for $600.00 or less, totalling approximately $80,000. William Otte, the trustee for the bankrupt Freedomland, requested relief from withholding and filing returns for income and social security taxes on these second priority wage claims. The bankruptcy judge granted the trustee’s request, ordering the wage claims to be paid without imposition of the withholding tax liability.22 The United States and the city of New York23 filed a petition for review and obtained a district court reversal24 of the bankruptcy judge’s order. The district court directed the trustee to withhold income and social security taxes from the wage claims and held that such taxes were to be allowed fourth priority status under section 64(a). On appeal,25 the Second Circuit agreed with the district court that with-

20. “Prebankruptcy wage claims” refers to wage claims by former employees for wages earned prior to the initiation of the bankruptcy proceedings, but paid after bankruptcy by the estate. The terms "prebankruptcy wage claims" and "second priority wage claims" will be used interchangeably through this Note.
23. New York City requires employers to withhold a tax from wages paid to employees. New York City, N.Y. Adm. Code §T46-51.0 (residents) and §U46-12.0 (non-residents) (1971). The rate of this tax is set forth at sections T46-3.0 and U46-2.0. However, in the principal case, the rate of tax was agreed upon as 1%. See *In re Freedomland, Inc.,* 480 F.2d 184, 187 n.3 (2d Cir. 1973). This tax is conceptually the same as the withholding of the federal income tax and will not be dealt with in this Note. It is to be noted, however, that in *Otte,* the United States government argued that withholding taxes should be entitled to first priority, while the city of New York advanced a second priority theory.
25. *In re Freedomland, Inc.,* 480 F.2d 184 (2d Cir. 1973).
holding taxes must be paid, but ruled that these taxes were entitled to second priority status. The United States Supreme Court granted certiorari\(^5\) (1) to review whether withholding taxes should be paid on pre-bankruptcy wages and (2) to resolve the split in the circuit courts as to which priority should be accorded these taxes under section 64(a).

**Withholding Taxes Must Be Paid on Prebankruptcy Wage Claims**

Every court of appeals, including the circuit court in *In re Freedomland*, which had faced the question of whether withholding taxes must be deducted from second priority wage claims had required the trustee to withhold these taxes.\(^27\) These decisions were severely criticized by bankruptcy judges who contended that wage claims were not wages but dividends, and thus there was no liability whatsoever for withholding taxes. The bankruptcy judges also argued that the trustee was not an employer, since the wage claimant did not perform services for the trustee and was not under the trustee's direction or control.\(^28\) The bankruptcy judges were not alone in their opinion, for even the Second Circuit in *In re Freedomland* had noted that on these issues they were not writing on a "clean slate."\(^29\) Therefore, before deciding whether withholding taxes were entitled to a priority under the Bankruptcy Act,


\(^{27}\) See *In re Freedomland, Inc.*, 480 F.2d 184 (2d Cir. 1973); *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3d Cir. 1964); United States v. Curtis, 178 F.2d 268 (6th Cir. 1949) (decision did not reach the priority issue, but did conclude that the trustee had the duty to withhold taxes on second priority wage claims); United States v. Fogarty, 164 F.2d 26 (8th Cir. 1947).

\(^{28}\) See Hiller, *The Folly of the Fogarty Case*, 34 Ref. J. 54 (1958); Oglebay, *Some Developments in Bankruptcy Law*, 23 Ref. J. 12, 15 (1948); Oglebay, *Some Developments in Bankruptcy Law*, 22 Ref. J. 82, 84 (1948). See also Bankruptcy Act §65, which provides the process for payment of claims and specifically defines these distributions as dividends. The opinion of the bankruptcy judges on this matter has not changed over the years. See, e.g., *In re Erie Forge & Steel Corp.*, No. 69-83 (W.D. Pa., Dec. 29, 1962) (unreported decision concluding that withholding taxes need not be deducted at all from wage claim distributions); *In re Freedomland, Inc.*, No. 64 B 727 (S.D.N.Y., Jan. 27, 1971).

\(^{29}\) In *Freedomland*, the court held that income and social security taxes should be withheld, finding themselves bound by precedent. However, the court noted that merit might be found in arguments to the contrary if the issue were faced afresh. *In re Freedomland, Inc.*, 480 F.2d 184, 187-88 (2d Cir. 1973). See also Jenkins, *Leading Case Commentary*, 48 Am. Bankr. L.J. 87, 96 (1974), where Bankruptcy Judge Jenkins' commentary on the Second Circuit's decision in *Freedomland* concludes:

The finding of an absolute duty to withhold and report in all cases great and small does not make sense. . . .

The clean slate is available. The Supreme Court needs but to write on it.
the Supreme Court dealt with the issues of whether prebankruptcy wage claims were wages or dividends and whether an employer was present.

The Court found that payment of wage claims as dividends in the distribution of assets of the bankrupt estate did not cause these payments to lose their identity as wages. The payment of wage claims was payment for services performed by employees prior to bankruptcy and thus fell within the broad definition of wages under the Internal Revenue Code.

The Court then had to determine whether an employer with the responsibility of complying with the applicable withholding and reporting provisions of federal law was present. Since withholding taxes include both social security taxes and federal income taxes, the Court looked to the social security and federal income tax withholding provisions of the Internal Revenue Code to find a definition of employer. Although the social security provisions do not define employer, the Court was not disturbed by this point for employer is defined for federal income tax withholding purposes. Without further inquiry the Court simply stated that the definition of employer is not to be construed more narrowly for social security withholding taxes than for federal income tax withholding.

30. The term "wages" is defined in both the federal income tax withholding and social security (FICA) tax provisions of the Internal Revenue Code. Int. Rev. Code of 1954, §3401(a) states: "Wages. For the purpose of this chapter [income tax withholding], the term 'wages' means all remuneration . . . for services performed by an employee for his employer . . . ." Int. Rev. Code of 1954, §3121 states: "Wages. For purposes of this chapter [FICA], the term 'wages' means all remuneration for employment . . . ."

31. The FICA provisions of the Int. Rev. Code of 1954, §3121(h) states: "American employer. For purposes of this chapter [FICA], the term 'American employer' means an employer . . . ." This is obviously a circular "non-definition."

32. Int. Rev. Code of 1954, §3401(d) states:

Employer. For purposes of this chapter, [income tax withholding] the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that —

1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' . . . means the person having control of the payment of such wages . . . .

33. The Court did not cite any authority for its decision. Previously, the FICA and income tax provisions of the Code were considered to be distinct and were not interpreted together. Otte has been cited as authority for the proposition that they now should be so interpreted. See United States v. Callahan, [1975-76 Transfer Binder] CCH Unempl. Ins. Rep. ¶ 14,265 (N.D. Tex. 1975), where a determination by the government that a person is an employer for income tax withholding purposes under the Internal Revenue Code precluded it from successfully asserting that the person is not an employer for FICA tax purposes.
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The federal income tax withholding provisions define employer as the person for whom services are performed. The definition further provides that if the party for whom the services are performed does not have control of the payment of wages, then employer refers to the one who has "control of the payment of such wages." The Court thus established that the responsibility for withholding taxes is on the one "at the point of control." In the instant case, the Court found an employer was present, but found it unnecessary to determine whether it was the trustee, the referee, the bankrupt estate, or the bankruptcy court who possessed the requisite control to qualify as the employer. It was sufficient that one of these parties possessed "control over payment of such wages" and was thus an employer with the duty to withhold or to order withholding of income and social security taxes.

The Court thus settled a long-standing debate between the federal courts and the bankruptcy judges by concluding that withholding taxes must be withheld from second priority wage claims. The Supreme Court was then faced with the problem of resolving the split in the circuit court decisions over which priority, if any, withholding taxes should be allowed under section 64(a) of the Bankruptcy Act.

The Priority Issue in Otte

Federal court decisions prior to Otte had distinguished between taxes on wage claims against the bankrupt accruing prior to bankruptcy and taxes on wage claims arising after the filing of the petition in bankruptcy. If an employer were short of money prior to filing a petition in bankruptcy, he might pay his employees their net wages or "take home pay" and neglect to remit to the government the taxes supposedly withheld from these payments. Courts held that the government's claim for

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34. See note 32 supra.
35. 419 U.S. at 50.
36. Control of payment of wage claims can be exercised in various forms by different parties in bankruptcy. The Supreme Court pointed out that the trustee, who has responsibilities under sections 47(a)(8) and 47(a)(11) of the Bankruptcy Act for making recommendations, could exercise control over the payment of wages. Section 47(a)(8) states that the trustee is to "examine all proofs of claim and object to the allowance of such claims as may be improper" and section 47(a)(11) provides that the trustee shall "pay dividends within ten days after they are declared by the referees." However, the bankruptcy judge could also have control by his supervision over the general administration of the bankrupt estate. The estate itself also may have an amount of control. Finally, the Court noted that there was no provision excepting a court from the requirement of withholding on amounts paid to an employee. 419 U.S. at 51 n.6, citing United States v. Fogarty, 164 F.2d 26, 32 (8th Cir. 1947).
these taxes was entitled to fourth priority status, since these taxes were "legally due and owing by the bankrupt." On the other hand, people were often hired by the trustee to perform services for the bankrupt estate after the petition in bankruptcy had been filed. Taxes on wages paid to these persons were held to be entitled to first priority as a cost and expense of administration. The critical point in time for determining the priority status of withholding taxes on wages is therefore the date of the filing of the petition in bankruptcy. Taxes on wages earned and paid prior to this date are entitled to fourth priority while taxes on wages earned and paid after this date are entitled to first priority. Confusion thus resulted from the hybrid situation present in Otte of wages earned prior, but paid after the instigation of the bankruptcy proceeding.

In resolving the conflict among the circuit courts as to the priority to be accorded withholding taxes, the Supreme Court rejected first priority. The Court refused to accept the concept that, merely because withholding taxes arose after bankruptcy, these taxes should automatically be entitled to first priority. In the Court's opinion, withholding taxes did not constitute "costs or expenses of doing business" and thus did not fall within the language defining first priority claims. Furthermore, the Court noted that liability for withholding taxes can accrue only when wages are actually paid. Since wage claims are second priority claims under section 64(a), the Court reasoned that it would be anomalous to accord withholding taxes a higher priority than the wage claims from which they were derived. To give such taxes first priority

37. In re John Horne Co., 220 F.2d 33 (7th Cir. 1955); Pomper v. United States, 196 F.2d 211 (2d Cir. 1952).
38. Missouri v. Gleick, 135 F.2d 134 (8th Cir. 1943); In re Lambertville Rubber Co., 111 F.2d 45 (3d Cir. 1940); United States v. Killoren, 119 F.2d 365 (8th Cir. 1941). If a debtor in possession under Chapter XI withholds income and social security taxes from wages of employees, but fails to pay this amount over to the United States, the government has the authority under the INT. REV. CODE OF 1954, §7501(a), to claim these taxes as a secured debt on a trust fund theory. If an identifiable trust fund can be established by reference to conventional trust fund doctrines of tracing and identification, creditors in bankruptcy will have no claim to the property held in trust. See 3A COLlier ¶ 64.02[3]. The Supreme Court has rejected this argument. See United States v. Randall, 401 U.S. 513 (1971); c.f. Nicholas v. United States, 384 U.S. 678 (1966). In Otte, the Court noted that the United States could not claim trust fund status because the trustee had paid the wage claims and set aside withholding tax pursuant to an agreement that the rights of the parties would not be affected. 419 U.S. at 55 n.11.
39. 419 U.S. at 56-57. For a discussion of the government’s first priority argument see generally Flanagan, supra note 7, at 81.
40. 419 U.S. at 57.
status would mean that the taxes would be paid before the duty to pay ever arose.

The Court also rejected fourth priority,\textsuperscript{42} taxes "legally due and owing by the bankrupt."\textsuperscript{43} Withholding taxes do not become due and owing until the actual payment of wages, because calculation of withholding taxes is based upon a percentage of wages actually paid and liability does not attach until wages are paid.\textsuperscript{44} Since Freedomland never paid the wages, taxes on these wages could never be due and owing by the bankrupt.

Having excluded both first and fourth priorities, the Court concluded that withholding taxes were entitled to second priority,\textsuperscript{45} as a deduction from gross wages. Consequently, as in the case of a monthly pay check,\textsuperscript{46} the wage claimant would actually receive a net amount as salary and constructively receive the withheld amount which is paid to the government against the wage claimant's ultimate income tax liability.\textsuperscript{47} Thus the wage claimants would not have the added burden of trying to pay and obtain proper credit for income and social security taxes when filing their individual tax returns.

The Court's rationale accorded withholding taxes a place within the priority structure that is consistent with both the federal tax laws and the Bankruptcy Act. This decision is compatible with the provisions of the Internal Revenue Code since liability for such taxes can accrue only upon actual payment of wages.\textsuperscript{48} Since the second priority wage claims were for gross wages containing within them the taxes to be withheld, proper notice would be provided to other creditors of the exact amount to be paid. This notice preserves the equitable principles underlying the Bankruptcy Act.\textsuperscript{49}

\textsuperscript{42} See In re Ingersoll Co., 148 F.2d 282 (10th Cir. 1945); In re International Match Corp., 79 F.2d 203 (2d Cir.), cert. denied, Delaware v. Irving Trust Co., 296 U.S. 652 (1935).

\textsuperscript{43} See In re DeSoto Crude Oil Purchasing Corp., 35 F. Supp. 1, 7 (W.D. La. 1940).

\textsuperscript{44} See In re Ingersoll Co., 148 F.2d 282 (10th Cir. 1945); In re International Match Corp., 79 F.2d 203 (2d Cir.), cert. denied, Delaware v. Irving Trust Co., 296 U.S. 652 (1935).

\textsuperscript{45} See In re DeSoto Crude Oil Purchasing Corp., 35 F. Supp. 1, 7 (W.D. La. 1940).

\textsuperscript{46} See In re DeSoto Crude Oil Purchasing Corp., 35 F. Supp. 1, 7 (W.D. La. 1940).

\textsuperscript{47} See In re DeSoto Crude Oil Purchasing Corp., 35 F. Supp. 1, 7 (W.D. La. 1940).

\textsuperscript{48} See In re DeSoto Crude Oil Purchasing Corp., 35 F. Supp. 1, 7 (W.D. La. 1940).

\textsuperscript{49} See In re DeSoto Crude Oil Purchasing Corp., 35 F. Supp. 1, 7 (W.D. La. 1940). See also Bankruptcy Act §§7, 55.
THE UNRESOLVED QUESTION: EMPLOYER TAXES

The decision in *Otte* resolved only part of the problem of employment taxes on second priority wage claims. The issue of employer taxes paid solely by the employer, such as federal unemployment taxes and the employer portion of social security taxes, was not before the Court in *Otte*. While lower federal courts have attempted to deal with the question of employer taxes, little attention has been paid to the distinction between withholding taxes and employer taxes. Moreover, these lower court decisions have frequently been unclear. The question of employer taxes is likely to continue to plague the federal courts, since the federal tax collector, in his quest for revenue, undoubtedly will continue to pursue claims for employer taxes on prebankruptcy wage claims. Therefore, it is important to give employer taxes a fresh analysis. The Supreme Court's approach to the problem of withholding taxes in *Otte* may also be used to examine employer taxes. The unresolved questions to be answered are (1) whether employer taxes must be paid by the estate, and if so, then (2) what priority, if any, these taxes are to be allowed under section 64(a).

Should Employer Taxes Be Paid on Prebankruptcy Wages?

As the Supreme Court noted in *Otte*, wage claims do not lose their character as wages merely because they are paid as part of the distribution of a bankrupt estate. Under the Internal Revenue Code, the definition of wages for employer tax purposes is essentially the same as the definition of wages for withholding tax purposes mentioned in *Otte*. In

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50. In *In re Connecticut Motor Lines, Inc.*, 223 F. Supp. 189 (E.D. Pa. 1963), the court allowed the government's claim for both withholding and employer taxes, yet ordered the trustee to withhold income and social security taxes from the wage claimant's distributions as a first priority matter. The court made no mention of the employer's excise tax. The confusion surrounding the district court's decision was pointed out by the court of appeals in *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 98 n.4 (3d Cir. 1964). *See also* cases cited in note 14 supra. *But see* Armadillo Corp. v. United States, BNA DAILY TAX REPORT, No. 59, Mar. 25, 1976, at H-1, and *In re Miller Ready Mix Concrete Corp.*, 348 F. Supp. 401 (D. Utah 1972), which recognized the distinction between employee and employer taxes. Nevertheless, most of *Miller* is devoted to a discussion for according withholding taxes priority status, and the analysis for employer taxes is rather weak. *See* note 55 and accompanying text infra.

51. *See* text accompanying note 31 supra.

52. The definition includes "all remuneration," with certain exceptions not applicable to the question of employment taxes in bankruptcy. *See* INT. REV. CODE OF 1954, §3401(a) (income tax withholding), §3121 (social security taxes), and §3306(b) (unemployment taxes) which define the term "wages."
addition, as in the case of withholding taxes, the liability for employer taxes attaches only when wages are actually paid by an employer. Therefore, it must first be determined whether the trustee has the responsibilities of an employer pursuant to the definition of employer established by the federal unemployment and social security taxing provisions.

The Federal Unemployment Act was amended in 1970 to significantly broaden the meaning of employer. Under the Act, an individual is an employer if (1) on each of some twenty days during the current or preceding calendar year he employs at least one individual for some portion of the day, or (2) he pays wages of $1,500 or more during any calendar quarter in the current or preceding calendar year. Since this definition has two alternative tests, the fact that the trustee would not have actually employed the wage claimants and would not meet the requirements of the first test is not important. The trustee would qualify as the employer under the second test if he pays wage claims which total $1,500 in the aggregate. Thus there would be an employer present under the Federal Unemployment Act and the bankruptcy trustee would be liable for payment of federal unemployment taxes on second priority wage claims.

Determining if the trustee would qualify as an employer under the Social Security Act is a more difficult task, since the Act does not provide a definition of employer. The social security excise tax is imposed on the employer "with respect to having individuals in his employ." The trustee would not employ the wage claimants; rather, this employer-employee relationship would exist between the bankrupt and the wage claimants. However, it is significant that the relationship of employer and employee need not exist at the time wages are paid in order for social security taxes to be imposed. Thus if a former employer makes a payment of wages to his former employees, he is liable for taxes on those payments of wages, even though he is no longer an employer.

55. From 1956-69 a person was an employer if on each of some twenty days during the taxable year, each day being in a different calendar week, he employed for some portion of a day four or more individuals. The trustee would not have been an employer under this prior definition. For history of the amendments to this section, see 1A CCH Unempl. Ins. Rep. ¶ 20,110-11.
56. See note 32 and accompanying text supra.
It is in this context that the Third and Eighth Circuit Courts of Appeal have reasoned that in paying wage claims the "trustee stands in the shoes of the employer-bankrupt and should be equally subject to these taxes as the employer."\(^59\) In the alternative, one could also take the approach of the Supreme Court in Otte and merely state that the fact that the Social Security Act does not define employer is insignificant, for employer is not to be construed more narrowly for social security tax purposes than for unemployment tax purposes.\(^60\) Thus it could be concluded that the trustee is an employer even under the non-definition of employer found in the Social Security Act.

**What Priority, If Any, Should Employer Taxes Be Allowed?**

Lower federal courts dealing with the priority issue for employer taxes on second priority wage claims have allowed these taxes either first priority or fourth priority status.\(^61\) No federal court has held that employer taxes are entitled to second priority in the payment scale under section 64(a); however, this priority will be considered to determine whether employer taxes, like the withholding taxes in Otte, may be given second priority.

Courts according employer taxes a first priority status as costs of administration have reasoned that employer taxes, unlike withholding taxes, are not part of the wage claim itself, but a tax on the act of distributing the assets of the estate.\(^62\) However, employer taxes do not arise due to the distribution of assets, but because of the payment of wage claims.\(^63\) Employer taxes cannot be paid ahead of the second priority wage claims, by analogy to the rationale used in the Otte decision. The computation base for employer taxes is the same as withhold-

\(^{59}\) United States v. Fogarty, 164 F.2d 26, 30 (8th Cir. 1947). See also In re Connecticut Motor Lines, Inc., 336 F.2d 96, 106 (3d Cir. 1964); Lines v. California Dep't of Employment, 242 F.2d 201 (9th Cir. 1957). Although the Third and Eighth Circuits agreed that the trustee steps into the shoes of the bankrupt, the courts reached different conclusions as to the priority to be accorded the employer taxes. See note 58 infra.

\(^{60}\) See note 35 and accompanying text supra.

\(^{61}\) In re Connecticut Motor Lines, Inc., 336 F.2d 96 (3d Cir. 1964); Lines v. California Dep’t of Employment, 242 F.2d 201 (9th Cir. 1957); United States v. Fogarty, 164 F.2d 26 (8th Cir. 1947) (first priority); In re Miller Ready Mix Koncrete Corp., 358 F. Supp. 401 (D. Utah 1972) (fourth priority).

\(^{62}\) See Lines v. California Dep’t of Employment, 242 F.2d at 203.

\(^{63}\) If the tax were on the distribution of the wage claim, the tax could be a valid expense of administration since distribution is part of administration; but the tax in question is not a tax on distribution, but a tax on wages paid.

ing taxes, the dollar amount of the wage claims. The liability for employer taxes, as in the case of withholding taxes, attaches only at the time of actual payment of the claims. Therefore, it would be inconsistent to pay employer taxes ahead of the wage claims which give rise to the duty to pay these taxes. If assets of the bankrupt estate were sufficient to pay only the first priority claims, allowing employer taxes a first priority would result in the payment of the tax, even though the wage claim on which it is based would never be paid. In addition, it is difficult to characterize employer taxes within the scope of first priority as necessary “costs or expenses of preserving the estate.”

Federal courts have granted employer taxes a fourth priority status upon the theory that Congressional intent was to grant tax claims a priority above general creditors.64 However, it is clear that not all taxes are entitled to this priority, but only those “legally due and owing by the bankrupt.”65 When the trustee fits within the definition of employer under the unemployment tax provisions, the tax would not be legally due and owing by the bankrupt, but by the trustee. Thus unemployment tax claims would not qualify for fourth priority status and would only share pro rata with general creditors.

On the other hand, since there is no statutory definition of employer for social security purposes, these tax claims might fit into the fourth priority category by use of the “trustee steps into the shoes of the bankrupt” rationale. This would allow employer social security taxes to be paid as a fourth priority claim, as due and owing by the bankrupt. Even this approach presents some problems. Payment of employer taxes as a fourth priority claim would mean that if funds were not available to pay all claims within this priority, social security taxes would be diverted to payment of other federal, state and local taxes. In addition, the rationale used to accord employer taxes a fourth priority is indeed strained. It provides the inconsistent result of allowing employer social security taxes fourth priority, while relegating unemployment taxes to the status of general unsecured claims. It is apparent that fourth priority does not provide an entirely adequate solution for employer taxes.

Likewise, second priority status for the employer’s portion of social security taxes and unemployment taxes cannot logically be advanced. Unlike the withholding taxes in Otte, employer taxes are not carved out of gross wages. Even though it might be argued that an employer pays

64. “By establishing a fourth priority dealing specifically with taxes, Congress apparently intended to express a general preference for tax claims over claims of general, non-priority creditors.” In re Miller Ready Mix Koncrete Corp., 358 F. Supp. at 406.
65. Bankruptcy Act §64(a)(4).
unemployment taxes and social security taxes so that the employees will ultimately be able to obtain unemployment or retirement benefits, it is unlikely employer tax contributions would be characterized as wages in light of Supreme Court decisions delineating the scope of wages under section 64(a). The Supreme Court has ruled that employer contributions do not possess the "customary attributes of wages" since they are not paid to the employees. Another reason for disallowing employer contributions the status of wages is that the amount available to pay the wage claimants would be reduced, since all claims within this class share on a pro rata basis. The Supreme Court reasoned that this would conflict with the intent behind allowing wages a second priority status, which is to alleviate in some degree the hardship on employees caused by sudden unemployment due to the employer's bankruptcy. Applying this analysis to employer taxes would result in these taxes being denied classification as wages under section 64(a), even though the employer might view these taxes as part of his total cost of employment. Therefore, employer taxes would not be entitled to second priority.

It is difficult to find a rationale for allowing employer taxes any priority whatsoever under the current Bankruptcy Act. Only fourth priority can logically be maintained, yet even this approach provides inconsistent and perplexing results. Strained rationales do not fulfill the need to


69. Id. at 32.

70. See Armadillo Corp. v. United States, BNA DAILY TAX REPORT, No. 59, Mar. 25, 1976, at H-1, holding that employer taxes are not entitled to any priority, but must share pro rata with general unsecured claims.
provide employer taxes a priority status. The present Bankruptcy Act provides no clear cut guidelines.

A LEGISLATIVE SOLUTION: THE PROPOSED BANKRUPTCY ACT

The confusion surrounding employment taxes on second priority wage claims centers around one fact; there is not a specific priority for employment taxes within the hierarchy of section 64(a). Congress has amended section 64(a) many times, yet failed to clarify the status of employment taxes.\(^1\) The problem has been left to the courts, resulting in innovative opinions which attempt to place withholding and employer taxes into one of the existing priorities. Legislative change in the structure of the priority system is needed, and only Congress has the appropriate fact-gathering facilities to gauge the impact of such a policy question.

Recognizing the need for reform, Congress created the Commission on the Bankruptcy Act.\(^2\) The Commission has reported its recommendations,\(^3\) which include a restructuring of the present section 64(a). This section would be replaced by section 4-405(a) of the Proposed Bankruptcy Act. Under the proposed section 4-405(a), priorities pertinent to this discussion and their order of payment include: (1) administrative expenses. . . . (3) claims for wages; (4) claims for fringe benefits; and (5) tax claims accruing within one year of the petition.\(^4\)

Under this proposal, the trustee is expressly required to withhold taxes from prebankruptcy wages, and withholding taxes are allowed the

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\(^{1}\) Congress's failure to provide a priority for employment taxes would be less disturbing if employment taxes were a relatively new concept. This is not the case. The Social Security Act was approved in 1935, Act of August 14, 1935, ch. 531, 49 Stat. 620. Federal income tax withholding began in 1943 with the withholding of a "Victory Tax" from wage and salary payments in that year. Act of Oct. 21, 1942, ch. 619, §465, 56 Stat. 884. In 1944 withholding was extended to the federal income tax itself. Act of June 9, 1943, ch. 120, §1622, 57 Stat. 128. Congress has amended section 64(a) eight times since 1938; however, none of these revisions have dealt with employment taxes. For the legislative history of section 64(a), see generally 3A COLLIER ¶ 64.01.


\(^{3}\) The Proposed Bankruptcy Act has been introduced in the 94th Congress, H.R. 31, 94th Cong., 1st Sess. (1975), as well as a proposed substitute bill drafted by the National Conference of Bankruptcy Judges, H.R. 32, 94th Cong., 1st Sess. (1975). Both bills are identical as far as the scope of proposed section 4-405 is concerned. Both are currently before the House Judiciary Subcommittee on Civil and Constitutional Rights. H.R. 31, 94th Cong., 2d Sess. (1976); H.R. 32, 94th Cong., 2d Sess. (1976).

\(^{4}\) Proposed Bankruptcy Act §4-405(a). The tax priority no longer includes the wording "legally due and owing by the bankrupt" which is currently found in section 64(a)(4) of the Bankruptcy Act. In addition, the period for accrual of taxes has been shortened from three years to one year.
same priority as the personal earnings from which they are withheld. The Otte decision is thus in harmony with this proposal. The Commission's proposal also provides that employer taxes attributable to wages earned prior to the petition, but paid afterwards from the estate, should enjoy only the priority status of taxes, rather than the higher status allowed by some of the federal courts. The proposed priority structure would result in employer taxes sharing pro rata with other state and local taxes that fall into the tax priority.

The proposal is not without some drawbacks. The Supreme Court in Otte noted that any one of the following parties might be classified as the employer: the trustee, the referee, the estate, or the court. However, the Commission's proposal specifically mentions only the trustee. Thus if the court is classified as the employer, the proposal provides no guidance as to whether taxes should be withheld or the priority they are to be allowed. The Proposed Act should provide a definition of employer to clarify this situation. While this proposed solution may not be the perfect answer, it has the virtue of recognizing the distinction between withholding and employer taxes and providing a separate rule for each type of tax.

75. Proposed Bankruptcy Act §4-405(a)(5)(C) and Note 11 of the Act. One must look both at the draft of the statute and the notes to determine that withholding taxes are entitled to the same priority as wages. From the draft of the statute itself, withholding taxes appear to be entitled to only a "tax priority." The notes indicate otherwise. The status of withholding taxes should be clearly delineated in the statute itself.

76. Id.
77. Proposed Bankruptcy Act §4-405(b).
78. See note 37 and accompanying text supra.
79. Proposed Bankruptcy Act §4-405(c).
80. The Treasury Department is opposed to the tax provisions of S. 236 recommended by the Bankruptcy Commission for revision of the bankruptcy laws. Dale S. Collinson, Deputy Tax Legislative Counsel for the Treasury, testified before the Subcommittee on Improvements in Judicial Machinery of the Senate Judiciary Committee on November 6, 1975 as follows:

We believe that the proposed priority and discharge provisions will have severe adverse consequences for the Federal tax system. The collection of taxes in bankruptcy proceedings would clearly be substantially reduced to unacceptable levels . . . .

Conclusion

The Proposed Bankruptcy Act is only a suggested solution and has yet to be enacted. At present, section 64(a) provides no clear cut priority in which to place employment taxes under the Bankruptcy Act. Even though the decision in Otte provided a rationale for according withholding taxes on prebankruptcy wages a second priority status within the priority structure, a state of indecision and confusion still exists as to the priority status of employer taxes. If a priority is to be accorded to employment taxes, creditors should be able to know that priority will be uniformly applied. This need for certainty is especially important when there are not enough funds to pay all competing creditors. More than 25 years elapsed before the Supreme Court finally resolved the priority to be accorded withholding taxes. This piecemeal approach to a solution might result in another 25 years of indecision regarding the priority to be accorded employer taxes. With our nation currently experiencing the largest number of bankruptcy filings in history, Congressional action is needed.81

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81. CCH Newsbureau Release of October 15, 1975 reports that total bankruptcy petitions filed in fiscal year ended June, 1975 reached a record high of 254,484. The previous high of 208,329 cases filed occurred in fiscal year 1967.