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Tax Superiority in Bankruptcy—A Study of Business Bankruptcy Distributions in the Southern and Western Districts of New York

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TAX SUPERIORITY IN BANKRUPTCY—A STUDY OF BUSINESS BANKRUPTCY DISTRIBUTIONS IN THE SOUTHERN AND WESTERN DISTRICTS OF NEW YORK

The superiority accorded federal tax claims in bankruptcy proceedings has led to criticism that the federal government is too formidable a competitor for the assets of a bankrupt and receives more than an equitable share of distributions.[1] The effects of this superiority, however, have not been well documented.[2] This study of a sample of the actual bankruptcy distributions of two federal courts, the Southern and Western Districts of New York, lends support to the critics by showing that the portion remaining in bankrupt estates after taxing authorities have taken their share is indeed small.

I. INTRODUCTION—THE FEDERAL TAX SUPERIORITY

Creditors' claims against a bankrupt generally fall within three categories that determine which and how much of a bankrupt's debts are to be paid. In the order of superiority, a claim may be (1) secured by a valid lien,[3] (2) unsecured, but given a priority over ordinary unsecured claims,[4] or (3) unsecured and on a parity with ordinary unsecured claims. Under the Internal Revenue Code, the federal government can perfect a lien for its unpaid taxes.[5] If this is accomplished, the government's claim will be placed in the first category. Furthermore, the Bankruptcy Act gives the government advantages with respect to even its unsecured tax claims: all

1. Plumb, *Federal Tax Priorities in Bankruptcy and Insolvency*, 78 COM. L.J. 309 (1973).

2. However, some useful data has been compiled. *See, e.g.*, REPORT OF THE COMMISION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PT. 1, H.R. DOC. No. 93-137, 93d Cong., 1st Sess. 234-35 nn. 228 & 232 (1973) [hereinafter cited as COMMISSION REPORT]; D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM (1971); Babitt & Freiman, *The Priority of Federal Claims: Selected Problems and Theoretical Considerations*, 24 CASE W. RES. L. REV. 521, 551 n.170 (1973).

3. Section 67(b) of the Bankruptcy Act, 11 U.S.C. § 107(b) (1970), recognizes the validity of statutory tax liens as qualified by section 61(c)(3), 11 U.S.C. § 107(c)(3) (1970).

4. *See* Bankruptcy Act § 64(a), 11 U.S.C. § 104(a) (1970); text accompanying notes 18-21 *infra*.

5. I.R.C. §§ 6321-6323.

except dischargeable claims[6] receive a priority over the claims of general unsecured creditors.[7]

A. *Secured Claims—Creation and Status of Tax Liens*

When a federal tax is demanded and not paid, section 6321 of the Internal Revenue Code creates "a lien in favor of the United States upon all [the debtor's] property and rights to property, whether real or personal."[8] Such a lien arises at the time of assessment,[9] although it is invalid against certain creditors, including bankruptcy trustees, until proper notice is filed.[10]

Choate liens that arise before a valid tax lien are superior to it.[11] Furthermore, section 6323 of the Internal Revenue Code protects the interests of certain creditors from all federal tax liens,[12] and section 67 of the Bankruptcy Act protects bona fide purchasers.[13] On the other hand, a federal tax lien on real property, as well as a tax lien on personal property in the government's possession,[14] is superior to liens that arise later in time, and to inchoate and general liens irrespective of when they arise.[15]

Where the tax lien is on personal property and is unaccompanied by possession of such property, it is subordinated not only to superior liens, but also to claims for administrative expenses and wages.[16] Moreover, only the difference between the amount of the tax lien and claims for administrative expenses and wages will be

6. *See* text accompanying notes 21–25 *infra*.

7. Bankruptcy Act § 64 (a), U.S.C. § 104 (a) (1970).

8. I.R.C. § 6321.

9. *Id.* § 6322.

10. *Id.* § 6323 (a). A trustee in bankruptcy has at least the rights of a judgment creditor under section 70 (c) of the Bankruptcy Act, 11 U.S.C. § 110 (c) (1970). *See* United States v. Speers, 382 U.S. 266 (1965).

11. United States v. City of New Britain, 347 U.S. 81 (1954), defines a lien as sufficiently choate if "the identity of the lienor, the property subject to the lien, and the amount of the lien are established." *Id.* at 84; United States v. Vermont, 377 U.S. 351, 358 (1964), *aff'g* 317 F.2d 446 (2d Cir. 1963).

12. I.R.C. § 6323 (b)–(e).

13. Bankruptcy Act § 67 (c) (1) (B), 11 U.S.C. § 107 (c) (1) (B) (1970).

14. "Constructive possession" has been held to be sufficient. Phelps v. United States, 421 U.S. 330 (1975). Phelps held that "notice of levy and demand are equivalent to seizure." *Id.* at 337.

15. 4 COLLIER ON BANKRUPTCY ¶ 67.24, at 339 (14th ed., 1975) [hereinafter cited as COLLIER] (citing United States v. Security Trust & Sav. Bank, 340 U.S. 47 (1950)).

16. *See* Bankruptcy Act § 67 (c) (3), 11 U.S.C. § 107 (c) (3) (1970). Section 64 (a) (1), 11 U.S.C. § 104 (a) (1) (1970), gives a priority for administrative expenses and section 64 (a) (2), 11 U.S.C. § 104 (a) (2) (1970), gives a priority to claims for wages.

The reason for the subordination is explained in H. R. REP. No. 686, 89th Cong., 1st Sess. 1965 [hereinafter cited as HOUSE REPORT], with which the Senate Judiciary Committee

paid before junior liens are satisfied.[17]

B. *Priority Claims*[18]

Even when it is not secured by a lien—because of negligence or failure to comply with the statutory requirements[19]—a non-dis-

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agreed. *See* S. REP. No. 1159, 89th Cong., 2d Sess. 1 (1966), *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 2442.

> Although new section 67c establishes more effective standards for the treatment of statutory liens, the new section 67c (1) (B), which permits perfection by notice filing rather than possession, may nevertheless result in the consuming of assets otherwise available for paying administrative costs and wages. This is an especially acute problem in view of the continuing increase in the tax burden at all levels of government. The committee believes that if the policy of the Chandler Act to protect the costs of administration and wages is to be given effect, it is necessary to postpone to the costs of administration and wages at least those tax liens which are on personal property and are unaccompanied by possession. It would be grossly unfair for the bankruptcy court and the attorneys who have labored to wind up the bankrupt's affairs and to accumulate an estate for distribution to receive nothing for this labor. It is also socially desirable that the claims of the wage earner who is normally entirely dependent upon his wages for the necessity of life should be paid to the extent of the restriction in section 64a (2) before the estate is subject to the heavy burden of all tax liens.

4 COLLIER, *supra* note 15, ¶ 67.24, at 313 (quoting HOUSE REPORT, *supra*, at 7).

Given the above policy, why are only those tax liens which are on personal property that is not accompanied by possession subordinated to the costs of administration and wages? Why should the rationale for subordination—increasingly heavy tax burdens—not be applicable as well to the claims of general unsecured creditors? *See* text accompanying notes 46 & 47 *infra*.

17. *See* Bankruptcy Act § 67 (c) (3), 11 U.S.C. § 107 (c) (3) (1970). The 1966 amendment of section 67 (c) (3) has resolved the "circuity" problem that arose when a federal tax lien that was on personal property and was unaccompanied by possession, although subordinated to other debts, was "superior to another lien on the same property arising out of contract, common law, or judicial proceedings." 4 COLLIER, *supra* note 15, ¶ 67.27, at 383.

To illustrate, when you subordinate a valid tax lien to a section 64 (a) (1) or (2) priority, what do you do with a nonsubordinated lien junior to the subordinated tax lien but superior to the section 64 priority? *See id.* at 382–94. *See generally* HOUSE REPORT, *supra* note 16. This circuity problem was especially highlighted in In re Quaker City Uniform Co., 238 F.2d 155 (3d Cir. 1956), *cert. denied*, 352 U.S. 1030 (1957).

18.

> Considerable confusion exists in bankruptcy administration because of a failure to distinguish clearly between a valid lien and a right to prior payment from unencumbered assets. The former entails a right to enforcement independent of bankruptcy; it may be created by agreement or statute, or by judgment of a court. The latter is a narrow right to payment at a certain relative point in the distribution of a bankrupt debtor's property, naked of any power of levy or attachment; it is a creature of the Bankruptcy Act. Quite different consequences in bankruptcy are appended to each. A valid lien, subject to the qualifications and restrictions previously stated, is a charge against assets which must be met before distribution to unsecured creditors begins. A right to priority accords an unsecured claim a particular precedence over other claims in the distribution of the bankrupt's remaining assets.

3A COLLIER, *supra* note 15, ¶ 64.02, at 2068 (footnote omitted).

19. *See* 3A COLLIER, *supra* note 15, ¶ 64.02, at 2068–69.

chargeable tax claim is to be paid before the claims of general unsecured creditors.[20] In the scheme of section 64(a) of the Bankruptcy Act, which establishes priorities among unsecured claims, non-dischargeable tax claims stand just fourth in line, behind expenses of administration (first priority), claims for wages (second priority), and expenses of certain kinds of successful opposition proceedings (third priority).[21]

In general, federal tax claims that have become legally due and owing during the three-year period immediately preceding bankruptcy are non-dischargeable; conversely, taxes that became legally due and owing prior to that period are dischargeable.[22] And be-

20. *See* United States v. Speers, 382 U.S. 266 (1965). The court in In re Autorama Tool & Die Co. v. United States, 412 F.2d 369 (6th Cir. 1969), *cert. denied*, 397 U.S. 1043 (1970), noted that "[t]he Supreme Court in *Speers* specifically stated that the Government retained its priority under § 64 (a) (4) even though it had no lien because of failure to timely file notice of tax lien." *Id.* at 371.

21. Opposition proceedings accorded a third priority exist

> where the confirmation of an arrangement or wage earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under chapter 9 of Title 18, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence.

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

To qualify for a priority, a federal claim must be a "tax," and it must be "legally due and owing by the bankrupt." Bankruptcy Act § 64 (a) (4), 11 U.S.C. § 104 (a) (4) (1970). According to the leading bankruptcy treatise, priority as a "tax" has been given to almost any statutory governmental imposition, including assessments under marketing orders, capital stock tax, club dues taxes, gasoline taxes, income taxes, local assessments, personal as well as real property taxes, sales taxes, unemployment compensation contributions, and water rents. 3A COLLIER, *supra* note 15, ¶ 64.404, at 2172–74. In general, a tax is considered "legally due and owing" upon assessment or at the time when the obligation to pay accrues, not at the time when the obligation is dischargeable by payment. *See* New Jersey v. Anderson, 203 U.S. 483 (1906). Moreover, the tax must be one that is legally due and owing by the bankrupt. *See, e.g.*, Philadelphia Co. v. Dipple, 312 U.S. 168 (1941) (debtor-lessee does not have to pay as a priority taxes of lessor which lessee agreed to pay as part of leasing agreement; such taxes are part of the consideration for the lease and are treated in the same way as other debts owed to the lessor). Whether a tax is "legally due and owing" and whether it is legally due and owing "by the bankrupt" are federal questions. *See* New York v. Feiring, 313 U.S. 283, 285 (1941); New Jersey v. Anderson, 203 U.S. at 491.

22. Bankruptcy Act § 17 (a) (1), 11 U.S.C. § 35 (a) (1) (1970). "Taxes that are dischargeable under Section 17a (1) are to be paid on a parity with general unsecured claims after all [liens and] the priorities in Section 64a have been satisfied." 3A COLLIER *supra* note 15, ¶ 64.402, at 2160. Federal tax claims that are not dischargeable

> are placed on an equal footing within § 64, and no preference may be given to federal over state taxes, or to state over municipal taxes; if the estate is insufficient to pay all taxes in full, a *pro rata* distribution is contemplated. Taxes due the United States would be entitled to priority in bankruptcy distribution even if § 64 made no provision for their payment, since taxes are debts due the United States and entitled to priority under 31 U.S.C. § 191 [§ 3466, Rev. Stat.]; but § 64 exclusively establishes priorities in bankruptcy, and gives a fourth priority to *all*

cause they are considered an administrative expense, taxes that accrue after bankruptcy receive a first priority,[23] unless they are withholding taxes, in which case they receive a second priority.[24] Furthermore, claims arising from penalties[25] and claims composed of interest[26] are dischargeable regardless of when they arise.

II. Actual Effects

By now the upper hand of the federal government should be evident.[27] But for the interests protected by section 6323 of the Internal Revenue Code and first-in-time, choate, non-federal liens, a federal tax lien on real property or on personal property in the government's possession is the first claim satisfied in a bankruptcy proceeding. Federal tax liens on personal property not in the government's possession are partly satisfied before junior liens. Non-dischargeable tax claims receive a fourth priority among unsecured

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non-dischargeable tax claims.

Id. ¶ 64.401, at 2151–53. *See also* Missouri v. Ross, 299 U.S. 72 (1936); Guarantee Title & Trust Co. v. Title Guar. & Sur. Co., 224 U.S. 152 (1912). "In only two instances do the laws of the United States give such priority. The two instances are [§ 64(a)(4)] and 31 U.S.C. § 191." In re Jonker Corp., 385 F. Supp. 327, 333 (D. Md. 1974).

> Thus, dischargeable taxes are to be paid on the same basis as unsecured claims not falling within any of the priorities and being paid after *all* of the priorities have been satisfied. This provision makes certain that such taxes will not be classified as debts so as to fall within the fifth priority (§ 64a(5)), and prevents an assertion by the Government that a tax claim, even though dischargeable, is entitled to priority by virtue of 31 U.S.C. § 191 (Rev. Stat. § 3466). The proviso also evidences an intent by Congress that taxes not granted a priority may still be proved as general unsecured claims.

3A Collier, *supra* note 15, ¶ 64.404, at 2176–77.

> 23. Generally, taxes accruing after bankruptcy are
> considered a proper expense of administration of the [bankruptcy] proceeding, entitled to a first priority under [section 64(a)] of the Act. They are taxes incurred while the property of the debtor was *in custodia legis* under the administration of the bankruptcy court, and thus are clearly expenses of administration as that term has long been understood.

United States v. Kalishman, 346 F.2d 514, 517 (8th Cir. 1965), *cert. denied,* 384 U.S. 1003 (1966); *see* Dayton v. Stanard, 241 U.S. 588 (1916); United States v. Sampsell, 266 F.2d 631 (9th Cir. 1959); Missouri v. Gleick, 135 F.2d 134 (8th Cir. 1943). *See also* 3A Collier, *supra* note 15, ¶ 64.105, at 2088.

24. The theory is that the withholding taxes arise when the wages are paid. Otte v. United States, 419 U.S. 43 (1974), *aff'g* In re Freedomland, Inc., 480 F.2d 184 (2d Cir. 1973). Wages themselves are given a second priority under section 64(a)(2), 11 U.S.C. § 104(a)(2) (1970).

25. *See* Simonson v. Granquist, 369 U.S. 38 (1962), *rev'g* 287 F.2d 489 (9th Cir. 1961) *and* United States v. Harris, 287 F.2d 491 (9th Cir. 1961).

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

27. Compare the treatment of the federal governments claims in insolvency proceedings under section 3466 of the Revenue Act of 1797, 31 U.S.C. § 191 (1970). *See* W. Plumb, Federal Tax Liens 191–201 (3d ed. 1972).

claims. Finally, dischargeable tax claims share on a parity with the claims of general unsecured creditors.

But what effect does all this have on actual bankruptcy distributions? To be more precise, which of the competing claimants lose and how much better off would they have been had the federal government been treated as an unsecured creditor? By compiling data of actual distributions, this study aims to contribute to the process of discovering answers to these questions, and to suggest avenues for further research.

A. *Methodology*

Clearly, the most valuable study would be a comprehensive one covering bankruptcy distribution in all of the federal courts. Limited resources, however, have compelled a less ambitious project here. Two courts, the Southern and Western Districts of New York, have been chosen, solely because of their convenient location. Furthermore, sheer volume dictated three additional restrictions. First, the study is limited to cases terminating as straight bankruptcies[28] between April 1, 1975 and March 31, 1976. Second, while data from all of the Western District cases terminating during that period are included, the study is limited to only a sample of the Southern District cases.[29] Third, because of the large number of personal bankruptcy cases, and because such cases tend to involve small estates with few tax problems, only business bankruptcies have been studied.

Distinguishing business bankruptcies from personal bankruptcies presents a problem because Form J.S. 19, on which every asset and nominal asset bankruptcy case terminating as a straight bankruptcy is reported, does not so distinguish, but merely provides a space, captioned "In re," for the name of the bankrupt.[30] For purposes of this study, therefore, a case was classified a "Business Bank-

28. "Straight bankruptcy" is "[a] colloquialism not found in the Bankruptcy Act, but referring to the type of proceeding in which the bankrupt's distributable assets (if any) are divided among creditors who have proved claims and the bankrupt may receive a discharge." D. STANLEY & M. GIRTH, *supra* note 2, inside cover. An "asset case" is "[a] case in which the proceeds of nonexempt assets are sufficient to pay administrative expenses and make some distribution to creditors." *Id.* A "nominal-asset case" is "[a] case in which proceeds of nonexempt assets are consumed by payment of administrative expenses, leaving nothing to be distributed to creditors." *Id.*

29. Two bankruptcy court judges of the Southern District of New York were randomly selected. All cases assigned to them which terminated as straight bankruptcies between April 1, 1975 and March 31, 1976 are included.

30. Forms J.S. 19 are compiled by the Administrative Office of the United States Courts, D.I.S. Operations Branch.

ruptcy" if the name was either (1) clearly that of a business, or (2) the name of a natural person a/k/a business. A case was classified as a "Non-Business Bankruptcy" if the name was that of a natural person only.[31]

The tables on pages 721 through 724 present the aggregate data of 159 cases, 76 from the Western District and 83 from the Southern District. In an attempt to improve upon Form J.S. 19, claims have been classified in Table I, page 721, as either: (1) secured non-tax claims; (2) secured tax claims (*i.e.,* tax liens); (3) administration expenses; (4) priority tax claims; (5) priority non-tax claims; or (6) general unsecured claims.[32] Tables II and III, pages 722 and 723, classify tax claims according to taxing authority.

Each table contains five columns, "A" through "E." For each class of claims, these columns present "A," the aggregate amount of such claims that was *allowed,*[33] and "B," the aggregate amount of such claims that was eventually *paid.* Of the aggregate amount of such claims *allowed,* "C," the *fraction* that was eventually *paid,* is easily determined by dividing "A" by "B."

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31. An alternative scheme might have been employed. In addition to cases in which the name of the bankrupt was clearly that of a business, the study might have included all cases in which obligations of the bankrupt were greater than $15,000 as "Possible Business-Related Bankruptcies." The reliability of such a scheme, however, would be somewhat suspect. To aid future research, form J.S. 19 should distinguish between business and non-business bankruptcies.

32. Form J.S. 19 classifies the "Obligations of Bankrupt" as either: (1) Priority, (2) Secured, or (3) Unsecured. Thus, to subdivide these classes, and those for "amounts paid," it was necessary to study the worksheets attached to each form, and in many cases, particularly in the Southern District, the dockets and case files. Because of the inherent lack of clarity in worksheets to all but the maker, classification of claims into the six categories mentioned in the text to this footnote may in some cases have been inaccurate, although every attempt to assure accuracy was made, including many confrontations with the makers. Without asserting that the classifications of data used in this study are all necessary for the general purpose of form J.S. 19—or, on the other hand, that they are sufficient—a further breakdown of the classifications now made on the form is recommended.

A more serious problem is that the amounts reported as "Obligations of Bankrupt" were, although primarily the amounts allowed, sometimes the amount scheduled by the bankrupt, and sometimes the amounts filed by the creditors. This inconsistency existed not only between different forms, but also among the three classes noted above on a single form. For this study, only the amounts "allowed" were considered.

To eliminate this inconsistency and add useful information, form J.S. 19 should be amended to include for each class of obligation: (1) the amount scheduled by the bankrupt, (2) the amount filed by creditors, and (3) the amount ultimately allowed.

33. *See* D. STANLEY & M. GIRTH, *supra* note 2, at 15, 127–28. The authors explain that bankruptcy proceedings are presided over by a referee who will rule on objections made to claims submitted by creditors. Most objections are raised by the trustees; many creditors never bother to prove their claims at all and of the claims that are filed, many are not fully allowed by the referee. *Id.* Section 7403(a) of the Internal Revenue Code permits the government to bring actions to enforce its liens in federal district court. I.R.C. § 7403(a); *see* W. PLUMB, *supra* note 27, at 254.

For any particular class of claims, "D" is the ratio:

$$\frac{\text{aggregate of claims of } \textit{that particular class} \text{ allowed}}{\text{aggregate of } \textit{all} \text{ claims allowed}}$$

The aggregate of all claims allowed is equal to the sum of column A. Similarly, "E" is the ratio:

$$\frac{\text{aggregate of claims of } \textit{that particular class} \text{ eventually paid}}{\text{aggregate of } \textit{all} \text{ claims eventually paid}}$$

The aggregate of all claims eventually paid is equal to the sum of column B. Of course, this sum is also equal to the total amount available for distribution from the bankrupt estates.

B. *Conclusions*

The tables indicate that taxing authorities receive a substantial amount of the funds available for distribution from bankrupt estates. Moreover, the fraction of their allowed claims that is eventually paid is much greater than that of unsecured creditors' allowed claims.

As indicated in Table I, only secured non-tax claims allowed and administration expenses were fully satisfied. Moreover, while totalling just over 2% of the aggregate amount of claims allowed, together these claims received slightly more than 41% of the total amount available for distribution from bankrupt estates; administration expenses received 30.70% and secured non-tax claims received 10.64%.[34]

Slightly over 17% of the tax liens and almost 20% of the tax priority claims allowed were satisfied. Together, they accounted for about 6% of the claims allowed, yet they received almost 23% of the distribution. Whereas virtually all tax liens are federal (Table II), about half of the priority claims are not (Table III). Most of the non-federal priority claims are those of New York State (Table III); most of the state priority claims are probably sales tax claims (Table IV).[35]

General unsecured creditors clearly fared the worst. Only 1.83% of their allowed claims were satisfied, and while represent-

34. Secured non-tax claims constituted a substantially higher proportion of those paid in the Western District (20%) than in the Southern District (9%).

35. The data in Table IV is of the Western District only. There is, of course, a possibility that in the Southern District sales tax claims constitute a smaller fraction of state priority claims.

TABLE I

ALL CLAIMS

AGGREGATE AMOUNTS ALLOWED AND PAID BY TYPE OF CLAIM

District	Type of Claim	A Aggregate Amount Allowed	B Aggregate Amount Paid	C Fraction of Amount Allowed That Was Paid	D Ratio to All Claims Allowed	E Ratio to All Claims Paid
Western and Southern Combined	Secured Non-tax	$ 191,551	$ 191,551	1.0000	.0054	.1064
	Secured Tax	512,168	87,382	.1706	.0144	.0486
	Admin. Expenses	552,508	552,508	1.0000	.0156	.3070
	Priority Tax	1,633,917	325,872	.1994	.0461	.1811
	Priority Non-tax**	1,285,885	70,546	.0549	.0363	.0392
	General Unsecured	31,291,871	571,695	.0183	.8823	.3177
	TOTAL	$35,467,900	$1,799,554***			
Western	Secured Non-tax	$ 53,435	$ 53,435	1.0000	.0073	.1993
	Secured Tax	226,263	23,475	.1038	.0311	.0876
	Admin. Expenses	81,632	81,632	1.0000	.0112	.3045
	Priority Tax	397,991	54,057	.1358	.0547	.2016
	Priority Non-tax**	178,892	9,531	.0533	.0246	.0355
	General Unsecured	6,331,884	45,972	.0073	.8709	.1715
	TOTAL	$ 7,270,097	$ 268,102			
*Southern**	Secured Non-tax	$ 138,116	$ 138,116	1.0000	.0049	.0902
	Secured Tax	470,876	63,907	.2235	.0101	.0417
	Admin. Expenses	285,905	470,876	1.0000	.0167	.3075
	Priority Tax	1,235,926	271,815	.2199	.0438	.1775
	Priority Non-tax**	1,106,993	61,015	.0551	.0393	.0398
	General Unsecured	24,959,987	525,723	.0211	.8852	.3433
	TOTAL	$28,197,803	$1,531,452			

* Only a sample of the bankruptcy cases filed in the Southern District is included. *See* note 29 *supra*.
** The debt in this category is primarily outstanding Small Business Administration loans.
***This figure also equals the total amount available for distribution from the bankrupt estates.

TABLE II

GOVERNMENT LIENS
AGGREGATE AMOUNTS ALLOWED AND PAID
BY TAXING AUTHORITY

District	Taxing Authority	A Aggregate Amount Allowed	B Aggregate Amount Paid	C Fraction of Amount Allowed That Was Paid	D Ratio to All Liens Allowed	E Ratio to All Liens Paid
Western and Southern Combined	Federal	$510,483	$86,950	.1703	.9967	.9951
	N.Y.S.	479	120	.2505	.0009	.0014
	N.Y.C.	0	0	—	—	—
	Other*	1,206	312	.2587	.0024	.0036
	TOTAL	$512,168	$87,382			
Western	Federal	$225,784	$23,355	.1034	.9979	.9949
	N.Y.S.	479	120	.2505	.0021	.0051
	Other	0	0	—	—	—
	TOTAL	$226,263	$23,475			
Southern	Federal	$284,699	$63,595	.2234	.9958	.9951
	N.Y.S.	0	0	—	—	—
	N.Y.C.	0	0	—	—	—
	Other	1,206	312	.2587	.0042	.0049
	TOTAL	$285,905	$63,907			

* Includes taxes allowed and paid in other jurisdictions and those unidentified as to jurisdiction.

TABLE III

GOVERNMENT PRIORITY CLAIMS
AGGREGATE AMOUNTS ALLOWED AND PAID
BY TAXING AUTHORITY

District	Taxing Authority	A Aggregate Amount Allowed	B Aggregate Amount Paid	C Fraction of Amount Allowed That Was Paid	D Ratio to All Priority Claims Allowed	E Ratio to All Priority Claims Paid
Western and Southern Combined	Federal	$ 825,026	$186,181	.2257	.5050	.5713
	N.Y.S.	527,672	88,781	.1683	.3229	.2724
	N.Y.C.	124,777	22,957	.1840	.0764	.0704
	Other	156,442	27,953	.1787	.0957	.0858
	TOTAL	$1,633,917	$325,872			
Western	Federal	$ 92,801	$ 17,095	.1842	.2332	.3162
	N.Y.S.	282,680	25,314	.0896	.7103	.4683
	Other	22,510	11,648	.5175	.0566	.2155
	TOTAL	$ 397,991	$ 54,057			
Southern	Federal	$ 732,225	$169,086	.2309	.5925	.6221
	N.Y.S.	224,992	63,467	.2591	.1982	.2335
	N.Y.C.	124,777	22,957	.1840	.1010	.0845
	Other	133,932	16,305	.1217	.1084	.0600
	TOTAL	$1,235,926	$271,815			

TABLE IV

NEW YORK STATE TAX PRIORITY CLAIMS IN WESTERN DISTRICT*
AGGREGATE AMOUNTS ALLOWED AND PAID BY TYPE OF TAX

Type of Tax	A Aggregate Amounts Allowed	B Aggregate Amounts Paid	C Fraction of Amount Allowed That was Paid	D Ratio to All N.Y.S. Tax Priority Claims Allowed	E Ratio to All N.Y.S. Tax Priority Claims Paid
Unemployment	$ 32,832	$ 4,248	.1294	.1161	.1678
Sales	146,223	18,870	.1290	.5173	.7454
Income	10,458	1,422	.1360	.0370	.0562
Withholding**	75,340	18	.0002	.2665	.0007
Franchise	17,822	756	.0424	.0630	.0299
TOTAL	$282,675	$25,314			

* A similar breakdown of state taxes in the Southern District of New York was not possible due to the absence of reasonably accessible information.

** Withholding tax claims were filed in only two of the 76 cases analyzed in the Western District.

ing about 88% of the total claims allowed, they received slightly less than 32% of the proceeds distributed.

III. Proffered Rationales and Possible Solutions

Why should federal tax claims be entitled to a superiority in bankruptcy distributions?[36] Of the several rationales that have been offered, perhaps the least convincing is the notion of sovereign priority since it is bottomed on power, not policy.[37]

Another rationale often asserted is the superiority's revenue-raising function.[38] Nowadays, however, a business may incur federal tax debts that are much larger than the debts usually incurred when this rationale was first offered. Thus, for private creditors "the federal priority can very often mean the difference between a reduced recovery and no recovery at all."[39] Some of these private creditors may not survive if they do not recover the debt. And while the amount recovered by the federal government in its bankruptcy claims is substantial from the point of view of the unsecured

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36. State and city governments may be able to justify the superiority of their claims on the ground that they cannot absorb these losses as easily as the federal government can.

37.

> The idea of sovereign priority is of ancient lineage—the Magna Carta provides, "The king's debtor dying, the king shall first be paid"—and is perhaps originally traceable to no more profound policy than might makes right. Although it is said that the government of the United States has no priority as a matter of common law, and it is difficult to give a convincing reason why it should, federal priority in fact took early root in federal legislation and has been developed by the courts in recent years to a point where the government has priority exceeding anything enjoyed by the English crown.

Lacy, *The Effect of Federal Priority and Tax Lien Legislation on Creditors of Vendors and Purchasers,* 50 Oregon L. Rev. 621, 622 (1971) (footnotes omitted). *See also* D. Stanley & M. Girth, *supra* note 2, at 209.

38.

> Taxes are a necesssity of government, and their prompt and certain availability is an imperious need. The tax lien, which is an exercise of Congress' constitutional power "to lay and collect taxes," is essential to the fulfillment of this governmental need. Consequently, private and local interests should not be permitted to undermine the exercise of this power by means of competing liens which are uncertain in amount and which attach at an indefinite or arbitrary time to unascertained property.

Note, *Choateness and the 1966 Federal Tax Lien Act,* 52 Minn. L. Rev. 198, 218 (1967) (footnote omitted) (citing Bull v. United States, 295 U.S. 247, 259–60 (1965)). *See* Comment, 14 Hastings L.J. 52 (1962) (citing United States v. Emory, 314 U.S. 423) (1941). *See also* Babitt & Freiman, *supra* note 2, at 552.

39. Plumb, *Federal Liens and Priorities—Agenda for the Nex Decade,* 77 Yale L.J. 228, 244 (1967).

In 66 of the 159 cases reported in Table I, tax claims were paid in full or in part while unsecured claims of general creditors were paid nothing. *See also* cases cited note 19 *supra.*

creditors, it is insignificant in comparison to the total revenue collected by the government.[40]

A third argument in support of the superiority is that the government in its status as tax collector cannot choose its debtors and therefore needs the protection afforded by the priority. However, in our economy of easy credit, private creditors may be under competitive pressure to extend credit, placing them in a position comparable with the government with respect to their freedom in choosing debtors.[41]

Finally, note that "[t]he actual advantage the government secures from its liens and priorities is the collection of claims and obligations from those who did not incur them";[42] or, put more prosaically, it tends to "rob Peter to pay Paul's taxes."[43] Moreover, since the government draws its revenue from the entire population, it is in a better position than any particular creditor to bear the losses incurred in bankruptcies and perhaps should rank even after unsecured creditors.[44]

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40. *See* COMMISSION REPORT, *supra* note 2, at 234–35 nn.228 & 232; D. STANLEY & M. GIRTH, *supra* note 2, at 130–31.

Indeed the amount involved is irrelevant. The Government must "appear to be fair" in its dealings with others, and absent an equitable basis for such a priority, "its assertion is viewed merely as an exercise of arbitrary power." Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 730 (1967).

41. Consider the following comments of the Canadian Study Committee on Bankruptcy Legislation:

> It is, we believe, important to re-examine the public policy in respect of the Crown priority. It must be determined whether such a priority is justified in a modern society. Certainly, it is not necessary for the financial stability of the government. The argument that the Crown cannot choose its own debtor has some relevance in claims for taxes, but not, as regards contractual claims. In this respect, it should be pointed out that individuals claiming damages do not choose their debtors either; and yet, they do not benefit by a priority of rank. One wonders whether, in our economy of easy credit, the businessman has always the economic freedom to choose his debtor or whether he is not bound, to a certain point, to give credit to the same extent as do his closest competitors. It could even be argued that the government should rank after ordinary creditors, as the public treasury, is, in fact, in a better position than anyone to bear the inevitable losses. The government can, in effect, divide the burden of tax left unpaid by the bankrupt among all the tax-paying public. It would be more logical for the government to do this, than to take advantage of the bankruptcy of an insolvent taxpayer to reimburse itself, at the expense of the creditors who have already suffered losses. Certainly, there can be no rational explanation for the government to attempt to obtain payment of the tax due by a bankrupt from his creditors. *Such a proposition offends one's sense of justice.*

COMMISSION REPORT, *supra* note 2, at 216–17 (quoting STUDY ON BANKRUPTCY AND INSOLVENCY LEGISLATION—CANADA 122–23 (1970)).

42. *See* Comment, *supra* note 38, at 52.

43. Plumb, *Federal Tax Collection and Lien Problems* (pt. 2), 13 TAX L. REV. 459, 459 (1958).

44. *See* COMMISSION REPORT, *supra* note 2. *See also* Plumb, *supra* note 39.

As this study has shown, not only do federal tax claims, as well as claims of other taxing authorities, divert a substantial amount of the funds available for distribution from the bankrupt's estate out of the hands of general unsecured creditors, but the advantage given to tax claims by the Bankruptcy Act results in virtually no return to unsecured creditors. While the system may have once been justified, the superiority given to federal tax claims is no longer tolerable.[45]

Two possible reforms should be considered. Congress should either terminate the superior status given governmental tax liens and claims or, as suggested by the Canadian Study Committee on Bankruptcy Legislation, subordinate such liens and claims to the claims of unsecured creditors.[46]

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45. *But see* Babbit & Freiman, *supra* note 2, at 551–54. Based in part upon their research, *id.* at 551, n.170, Babitt and Freiman conclude that it is a misimpression that the government dominates the distribution. They support the priority based upon its revenue raising function bolstered by (1) a sanction and deterrent function that stresses the difficulty the government would have collecting debts from third parties who gain possession of the debtor's property without special legislation, and (2) a ceremonial function whereby the sovereign's priority serves the psychological purpose of maintaining the level of respect necessary for a tax system based on self-assessment to work.

However, compare Babitt and Freiman's findings with the findings of this study. It would appear that their findings support this study's conclusions that the government receives a substantial part of the distribution of the bankrupt's assets and that its claims are satisfied to a much greater degree than are claims of unsecured creditors. Moreover, neither the "ceremonial function," nor the "deterrent function" seem convincing rationales in support of the government's priority.

46. *See* note 41 *supra.*