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Bankruptcy Law

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BANKRUPTCY LAW

SUMMARY

SALES TAXES ARE NOT DISCHARGEABLE IN BANKRUPTCY

I. INTRODUCTION

In the bankruptcy case of *Shank v. Washington State Dept. of Revenue*¹ the Ninth Circuit held that sales taxes collected from third parties were not categorized as excise taxes but as trust fund taxes and thus were not dischargeable in bankruptcy.² The court reversed the decision of the district court finding that Congress intended to retain a distinction between the sales tax liability personally owed by the retailer and the sales taxes collected from customers, and held in trust for the state.³

II. FACTS

Debtor Darrel Shank operated a retail business in the State of Washington until 1979.⁴ When he discontinued his business, his total liability for sales taxes was in excess of \$45,000.⁵ In 1984, he filed for bankruptcy, and thereafter instituted a proceeding against the Washington Department of Revenue seeking a determination that the sales tax debt to the state was dis-

1. 792 F.2d 829 (9th Cir. 1986) (per Tang, J.; the other panel members were Wright, J. and Reinhardt, J., dissenting).

2. *Id.* at 832.

3. *Id.*

4. *Id.* at 830.

5. *Id.*

chargeable.⁶ The Bankruptcy Court granted summary judgment to the Revenue Department, upholding their claim that the sales taxes were "trust fund taxes" and not dischargeable.⁷ The district court overturned the Bankruptcy Court, concluding that all sales taxes owed by sellers, including those collected by retailers, were intended by Congress to be characterized as excise taxes and thus dischargeable after three years. The Revenue Department appealed.⁸

III. BACKGROUND

The Bankruptcy Act, in section 507(a)(6)(C), defines "trust fund taxes" as those "required to be collected," and it contains provisions regarding priority and non-dischargeability.⁹ Section 507(a)(6)(E) covers the dischargeability of excise taxes.¹⁰ An excise tax generally includes such federal, state or local taxes as sales tax, estate and gift taxes, gasoline and fuel taxes, and wagering taxes.¹¹ In addition, subsection (E) places a time limitation on the non-dischargeability of excise tax debts allowing the debtor to discharge any excise taxes more than three years old.¹²

6. *Id.*

7. *Id.* at 831.

8. *Id.*

9. *Id.* at 830. 11 U.S.C. § 507(a)(6)(C) provides:

(a) The following expenses and claims have priority in the following order:

.....

(6) Sixth, allowed unsecured claims of governmental units, to the extent that such claims are for

.....

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

.....

The recent amendment to the code adding a new priority caused § 507(c)(6) to be renumbered as § 507(a)(7). The original version governs resolution of this case. 11 U.S.C. § 507(a)(6)(C).

10. *Shank v. Washington State Dept. of Revenue*, 792 F.2d 829, 830. 11 U.S.C. § 507(a)(6)(E) provides:

(E) an excise tax on

(i) a transaction occurring before the date of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years immediately preceding the date of the filing of the petition 11 U.S.C. § 507(a)(6)(E).

11. *Shank*, 792 F.2d 829, 831.

12. 11 U.S.C. § 507(a)(6)(E). *See supra* text accompanying note 10. The parties in the case agreed that *Shank's* tax liability was dischargeable if sales taxes were determined to be excise taxes. *Id.* at 831.

IV. THE COURT'S ANALYSIS

A. THE MAJORITY

The issue before the Ninth Circuit was whether the "trust fund" or "excise" tax provisions would govern the sales tax liability.¹³ Acknowledging the Bankruptcy Act did not expressly refer to sales taxes when it excepted from discharge those taxes that the debtor had "collected or withheld from others," the Ninth Circuit panel turned to the legislative history accompanying the 1978 Bankruptcy Act.¹⁴

The House and Senate versions of the amendment to subsection (C) defining trust fund taxes differed markedly.¹⁵ The House version of the amendment stated that trust fund taxes encompassed those "withheld from wages, salaries, commissions, dividends, interest or other payments that were paid by the debtor."¹⁶ It also said they were non-dischargeable.¹⁷ In contrast, the Senate description of non-dischargeable taxes included those "required to be collected or withheld from others and for which the debtor is liable in any capacity."¹⁸ In the Senate version, this covered "trust fund" taxes described as income tax withholding, social security contributions, railroad retirement taxes, Federal Unemployment Insurance, and "excise taxes which a seller was required to collect from a buyer and pay to the taxing authority."¹⁹

The compromise ultimately enacted adopted the Senate version of subsection (C), deleting the reference to excise taxes.²⁰ This compromise stated that the debtor was liable for taxes that he was required to withhold or collect from others regardless of the age of the tax claims, and these so-called "trust fund" taxes included taxes withheld from income and employees' contribution to social security, railroad retirement taxes and Federal Un-

13. *Shank*, 792 F.2d 829, 830.

14. *Id.* at 831.

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.* at 831-32. (citing S. REP. NO. 989, 95th Cong., 2d Sess. 68-73 (1978).)

19. *Id.* at 831.

20. *Id.* at 832.

employment Insurance.²¹

Enactment of the House version of subsection (E) provided for the dischargeability of certain taxes.²² It called for dischargeability of excise taxes older than three years, but did not elaborate on the meaning of excise tax.²³ The House and Senate floor leaders issued a Joint Statement defining excise taxes to include "all Federal, State and local taxes generally considered by this category."²⁴

The Ninth Circuit recognized that the statutory language created an overlap between the provisions for trust fund and excise taxes,²⁵ and referred to the *DeChiaro v. New York Tax Commission* opinion that came to the same conclusion.²⁶ The *DeChiaro* court speculated that Congress could have intended to differentiate between taxes collected from third parties and taxes that were paid personally. Alternatively, Congress could have intended to differentiate between two categories of trust funds, i.e., sales taxes which are dischargeable and other collected taxes which are not dischargeable.²⁷

The Ninth Circuit concluded that Congress intended to retain a distinction between sales taxes owed personally and those collected from third parties.²⁸ Further, the court said it would need more evidence than the "intentional or unintentional deletion" of the Senate description of trust fund taxes to conclude that Congress did not intend to include sales taxes collected from third parties in the "trust fund" category.²⁹ It could find no evidence that Congress intended to treat retailers differently from employers regarding taxes collected from third parties. The court believed Congress would not have discharged either from

21. *Id.* (citing 124 CONG. REC. 32,416 (1978).)

22. *Id.*

23. *Id.* The House had proposed a one year time limit, but the three year limit was maintained. *Id.* at 832.

24. *Id.*

25. *Id.*

26. *Id.* at 829, 831 (citing *DeChiaro v. New York State Tax Commission*, 760 F.2d 432, 434 (2d Cir. 1985)) (Taxes collected by *DeChiaro* from third parties were not dischargeable in bankruptcy.)

27. *Shank v. Washington State Dept. of Revenue*, 792 F.2d 829, 832 (9th Cir. 1986).

28. *Id.*

29. *Id.* at 833.

their tax liabilities.³⁰ In making this decision, the court relied on similar findings in *DeChiaro* and *In re Rosenow* which characterized such sales taxes as trust fund taxes.³¹

The Ninth Circuit also noted that it was against public policy to provide the incentive to a failing retailer to default on sales tax liability by permitting him to wait three years to file bankruptcy, then discharge the liability.³²

B. THE DISSSENT

Judge Reinhardt dissented from the majority view. He believed the court erred in relying on the Senate Report as the legislative history.³³

Because the wording of section 507 (a)(6) was unclear, Judge Reinhardt agreed that it was proper to turn to the legislative history to determine Congressional intent.³⁴ However, according to Judge Reinhardt, the Joint Statement reflected the *only* legislative history of the Bankruptcy Code as enacted.³⁵ Thus, the panel's reliance on the Senate Report, obviously made prior to the amendment, did not reflect the final intent of both houses of Congress.³⁶

In Judge Reinhardt's opinion, the court should have relied on the Joint Statement which expressly stated that a sales tax is an excise tax and not a trust fund tax.³⁷ The Joint Statement also provided that trust fund taxes were income taxes which an employer is required to withhold from the pay of his employees

30. *Id.* at 832.

31. *Id.* at 831 (citing *Rosenow v. State of Illinois Dept. of Revenue*, 715 F.2d 277 (7th Cir. 1983)) (sales taxes collected by retailer were not different from withholding taxes collected by employers.)

32. *Shank*, 792 F.2d 829, 832.

33. *Id.* at 833.

34. *Id.*

35. *Id.* at 834. The differences between the House and Senate versions were so significant that it was decided not to have a conference committee. Instead, the floor managers of the proposed code, Senator DeConcini and Representative Edwards, with the assistance of some members of Congress, negotiated the amendment. The Joint Statement was presented to both houses prior to the vote to explain the compromise. *Id.* at 833.

36. *Id.* at 834.

37. *Id.*

and the employees' share of social security taxes.³⁸

The dissent also pointed out that the sentence including excise taxes as trust fund which appeared in the Senate version was omitted in the Joint Statement.³⁹ Judge Reinhardt argued that the omission demonstrated that sales taxes had been expressly dealt with as excise taxes under section 507(a)(6)(E).⁴⁰ Further, he contended that because subsections (C) and (E) were enacted at the same time, they must be construed with reference to, and in light of, each other.⁴¹

Judge Reinhardt also criticized the court's reliance on *DeChiaro* and *Rosenow* in helping to explain Congress' intent.⁴² The decisions in both cases were rendered after the enactment of the 1978 Bankruptcy Act.⁴³ Therefore, Congress did not take these cases into account, and they are not part of the legislative history.⁴⁴

Judge Reinhardt also challenged the court's public policy rationale. He preferred to leave the wisdom of tax policy to Congress and not the courts. He asserted that while the dischargeability of such excise taxes could encourage taxpayers to default, non-dischargeability could encourage taxing authorities to be lax in collection, harming other creditors of a debtor. He concluded it was better left to Congress to balance conflicting policies.⁴⁵

V. CONCLUSION

The majority found that a view of the entire history of the trust tax provision supported their conclusion that a sales tax collected from a third party was not dischargeable.⁴⁶ The court

38. *Id.*

39. *Id.* at 835.

40. *Id.*

41. *Id.* at 834.

42. *Id.* at 836.

43. *Id.* at 836. Prior to the revision, only two courts had held that sales taxes collected or withheld fell into the trust fund category, and commentators apparently believed the trust fund tax referred to income tax and social security withholding. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* at 833.

1987]

BANKRUPTCY LAW

7

held that the intentional or unintentional deletion of the express language did not by itself alter Congress' intent that sales taxes collected by third parties are to be considered trust fund taxes.⁴⁷

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47. *Id.*

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