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Bankruptcy - Priorities - Internal Revenue Code Provision Making Withheld Taxes a Trust for Government Held Not to Supersede Bankruptcy Act Priorities Which Give All Costs of Administration Pro Rata First Priority

Eugene J. Jeka

BANKRUPTCY—PRIORITIES—Internal Revenue Code Provision Making Withheld Taxes a Trust for Government Held Not to Supersede Bankruptcy Act Priorities Which Give All Costs of Administration Pro Rata First Priority

On August 18, 1967, Halo Metal Products, Inc., filed a petition for an arrangement in the United States District Court for the Northern District of Illinois[1] under Chapter XI of the Bankruptcy Act.[2] Pursuant to the plan of arrangement, Halo was allowed to remain in possession of its assets under the supervision of the court. Halo was to file monthly reports with the court, keep separate books and records of its operations as of the date the petition was filed, and maintain separate bank accounts for its general, payroll, and tax indebtedness, making necessary disbursements from those accounts as the debts matured.

On November 22, 1967, Halo was adjudicated a bankrupt, and its assets were sold. During the approximately three month period in which Halo operated as a debtor-in-possession under the Chapter XI arrangement, it had failed to file the monthly reports and to set up the separate bank accounts. Income and social security taxes withheld from employees by Halo were neither paid over to the government nor set aside as required.

The United States sought to have a trust imposed in its favor on $1,075.02 from the bankrupt's estate, this amount representing the money the government claims was withheld from employees' wages but not paid over to the United States. The basis for the government's trust theory is Section 7501 (a) of the Internal Revenue Code of 1954[3] which states:

> General Rule—Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

1. The Chapter XI arrangement is a bankruptcy procedure whereby an insolvent debtor is given an opportunity to resolve his financial difficulties. Upon the agreement of the majority of his creditors to a plan of arrangement the debtor is allowed to remain in the possession of his assets under the supervision and control of the bankruptcy court.
2. 11 U.S.C.A. § 701 et seq. (1964).
3. 26 U.S.C.A. § 7501(a) (1964).

It is the government's contention that by virtue of Section 7501 (a) the trustee in bankruptcy takes the assets of the bankrupt subject to a trust in the amount of tax money withheld and must make payment of the trust property prior to any distribution under the Bankruptcy Act.

The trustee, on the other hand, seeks to have the government's claim for taxes share pro rata first priority with other administrative expenses incurred during the Chapter XI arrangement.[4] Section 64 (a)(1) of the Bankruptcy Act, establishes priorities in bankruptcy and gives first priority to costs of administration.[5]

Substantially all of the funds remaining in the bankrupt's estate were derived from the court ordered sale of Halo's assets. Full payment of the government's tax claim would leave only a few hundred dollars in the estate and as a result the other administrative expense claims would remain substantially unpaid.

Thus the basic issue which the Seventh Circuit Court of Appeals in *United States v. Randall*[6] confronted is whether the United States is entitled to a "super-priority"[7] over other costs of administration by virtue of Section 7501 of the Internal Revenue Code.

HELD: The United States is not entitled to a super-priority over other

4. Debts incurred by a trustee in bankruptcy or by a debtor-in-possession under an arrangement while operating the business under the supervision of the bankruptcy court are costs of administration. Thus taxes assessed against the business after the filing of the petition are included among claims having first priority under § 64(a)(1). Missouri v. Earhart, 111 F.2d 992 (8th Cir. 1940).

5. 11 U.S.C.A. § 104(a) (1964):

> Debts which have priority.
>
> (a) The debts to have priority, in advance, of the payment of dividends to creditors, and to be paid in full out of the bankrupt estates, and the order of payment shall be (1) the costs and expenses of administration. . . . Where an order is entered in a proceeding under any Chapter of this title directing that bankruptcy be proceeded with, the costs and expenses of ad-administration incurred in the ensuing bankruptcy proceeding . . . shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any; . . . .

6. United States v. Randall, 419 F.2d 1068 (7th Cir. 1969).

7. The term "super-priority" was used by the *Randall* court. It is submitted that the term does not clearly describe the relationship between the tax trust and the § 64(a) priorities under the government's theory.

A valid trust creates a prior right to payment independent of the Bankruptcy Act. A "priority" in bankruptcy refers to the order of precedence established by the Bankruptcy Act for the distribution of the bankrupt's remaining assets. Thus, what the government sought was preferred payment independent of the priorities established in the Bankruptcy Act, not a super-priority in the technical sense. Use of the term does suggest the court's ultimate conclusion, that the statutorily created trust was not recognizable in bankruptcy so as to create a priority not intended by the Bankruptcy Act. Similarly, in cases reaching an opposite conclusion, discussed *infra*, those courts refer to the payment as "direct restitution", a term which is equally non-technical and suggestive of their ultimate conclusion.

administrative expense claims for tax money withheld but not paid over to the government. Taxes incurred during the Chapter XI arrangement, including money withheld from employees for income and social security taxes not turned over to the government, share a pro rata first priority with all other administrative expenses under the terms of Section 64 (a)(1) of the Bankruptcy Act. The court determined: 1.) That the second sentence of Section 7501 (a) which requires tax trust be ". . . assessed, collected, and paid in the same manner and subject to the same provisions and limitations" as the taxes from which it arose, makes the trust fund subject to the priorities established by Section 64 (a)(1) of the Bankruptcy Act; and 2.) Even if Section 7501 was not so construed, the priority which it establishes is overridden by the strong policies of the Bankruptcy Act, which Act is controlling in matters regarding bankruptcy.

The Seventh Circuit Court of Appeals thus took a position contrary to the decisions of three other United States courts of appeals on facts substantially identical to the instant case.[8] The court discussed the ample line of authority which has upheld the government's tax trust theory in similar situations and then stated its basis for taking an opposing view.

The first decision upholding a statutory tax trust was *City of New York v. Rassner*.[9] In *Rassner*, a debtor-in-possession under a Chapter XI arrangement collected a New York City sales tax from its customers but commingled the funds. When the debtor became bankrupt, the only substantial assets remaining were funds derived from the trustee's invalidation of a chattel mortgage. A city sales tax law made a vendor a "trustee" for sales tax money collected from vendees. The city asked for payment in full of all post-bankruptcy taxes collected, while the trustee sought a pro rata distribution for all administrative expense claims, including such taxes, pursuant to Section 64(a)(1) of the Bankruptcy Act.

The referee had ruled the city must share pro rata with other administrative expenses because the funds left in the estate were the result of the trustee's efforts and not derived from the collection of sales tax and because the city was not able to trace the trust fund. The district court in *Rassner* affirmed for both reasons, and added that the city's

8. City of New York v. Rassner, 127 F.2d 703 (2nd Cir. 1942); United States v. Sampsell, 193 F.2d 154 (9th Cir. 1951); Hercules Service Parts Corp. v. United States, 202 F.2d 938 (6th Cir. 1953); In re Airline Arista Printing Corp., 156 F. Supp. 403 (S.D.N.Y. 1957), *aff'd. per curiam*, 267 F.2d 333 (2nd Cir. 1959).

9. 127 F.2d 703 (2nd Cir. 1942).

claim was for taxes, not a trust fund, and thus the Bankruptcy Act priorities should apply.

The Court of Appeals for the Second Circuit reversed. While the question of proper distribution is federal, state law determines when a trust relationship exists. Admitting that a strong policy of the Bankruptcy Act would override state law, the court determined that "the generalities of § 64, subd. a (1)"[10] did not override the general application of state law regarding the existence of and the preference accorded a trust.

In regard to the necessity of tracing trust property, the court conceded that a beneficiary must trace funds where mingling takes place prior to bankruptcy. However, it distinguished that situation from one where the trust arose subsequent to an arrangement proceeding. When the debtor filed his petition and was granted leave by the court to continue in possession, he was thereafter acting as an officer of the bankruptcy court[11] and was subject to the control of that court. If the debtor commingled trust property under these circumstances, the court's control would be a defense in an action by the city against him for breach of his fiduciary duty as trustee. The court's conclusion was that:

> If we hold that the city must now trace the funds, we state in effect that any beneficiary of a trust which is handled by an officer of a bankruptcy court must always protect himself by petitioning in advance for proper administration of the trust. Thus stated, it can be seen that we would be condoning improper action by a trustee so long as he could successfully get away with it. As a court of equity, a court can hardly proceed on this assumption. It is the duty of the bankruptcy court in distributing an estate to do so equitably.[12]

In *United States v. Sampsell*,[13] the Ninth Circuit Court of Appeals considered a similar claim by the United States for direct restitution of money withheld from employees as income and social security tax by a debtor-in-possession under an arrangement. The statute invoked was Section 3661 of the Internal Revenue Code of 1938 which contained the same provisions as Section 7501 (a) of the 1954 Code. The only issue the court discussed was whether the government's inability to trace trust property would be fatal to its claim.[14] The Ninth Circuit followed *New York City v. Rassner* in finding that the necessity of tracing does

10. 127 F.2d at 707.
11. 11 U.S.C.A. § 742, 743 (1964).
12. 127 F.2d at 706.
13. 193 F.2d 154 (9th Cir. 1951).
14. The Referee had disallowed the government's claim on this ground and the district court affirmed.

not arise where the commingling debtor is an officer of the court.[15]

The Sixth Circuit Court of Appeals also adopted the *Rassner* rationale in *Hercules Service Parts Corp. v. United States.*[16] The pertinent facts in *Hercules* are substantially identical to those in *Sampsell* and *Randall.* Unlike *Sampsell,* however, the court was confronted with a second issue, whether acceptance of the government's claim nullifies Section 64(a)(1) of the Bankruptcy Act. In regard to the issue of tracing, the court repeated the *Rassner* and *Sampsell* rationales. The court dismissed the trustee's second contention, stating: "We agree with the Second Circuit in the *Rassner* case, supra, that the allowing of a priority to the government here does not violate the 'generalities' of Section 64 of the Bankruptcy Act."[17]

In re Airline Arista Printing Corp.[18] reaffirmed *Rassner* in the Second Circuit and applied it to a Section 7501 trust of withholding taxes. The trustee in *Airline Arista* relied on the 1952 amendment to Section 64(a)(1) which gives the administrative expenses of an ensuing bankruptcy proceeding priority over administrative expenses incurred during a superseded arrangement. On the basis of this amendment, the trustee moved for an order directing that expenses of administration incurred in the bankruptcy proceeding be paid prior to administrative expenses of the superseded Chapter XI arrangement, including claims for taxes. The district court held, and the Second Circuit affirmed, that the amendment to 64(a)(1) did not control the disposition of property in bankruptcy pursuant to a trust; and the amendment did not evidence an overriding policy which would alter the *Rassner* rationale.

Having set out the decisions from other circuits in which cases of almost identical factual content were confronted, the Seventh Circuit Court of Appeals in *United States v. Randall*[19] determined not to follow their reasoning. It is worthy of note, however, that none of the cases which followed *City of New York v. Rassner* and applied its holding to the trust created by Section 7501 (a) of the Internal Revenue Code or its predecessor, confronted the issue which the *Randall* court felt was conclusive of the case. The second sentence of 7501 (a), cited earlier, states: "The amount of such [trust] fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with re-

15. 193 F.2d at 156.
16. 202 F.2d 938 (6th Cir. 1953).
17. 202 F.2d at 941.
18. 156 F. Supp. 403 (S.D.N.Y. 1957), *aff'd per curiam,* 267 F.2d 333 (2nd Cir. 1959).
19. 419 F.2d at 1070-1071.

spect to the taxes from which such fund arose." The court considered whether that sentence in Section 7501 limits the trust created by the prior sentence to the same status as a tax in bankruptcy. If that limitation is imposed on Section 7501 (a), then the government's superpriority must fail, for as the court suggested earlier in its opinion, "It is well settled that, absent such a trust, taxes incurred during a Chapter XI arrangement enjoy only a pro rata first priority with all other administrative expenses under Section 64(a)(1) of the Bankruptcy Act."[20]

It is not difficult to imagine how the previous cases failed to reach this issue. *City of New York v. Rassner*,[21] the leading case, dealt with a law which was not limited in this manner. The cases which followed cited *Rassner* as being factually indistinguishable, although they dealt with Section 7501 or its predecessor. The factual similarity of those cases to *Rassner* may have caused those courts to overlook this essential difference.

The Third Circuit recognized this limitation on the government's trust theory imposed by the second sentence of Section 7501 (a) in *In re Connecticut Motor Lines, Inc.*[22] In that case the government sought to have the tax money withheld on wages earned prior to bankruptcy, but paid subsequent to the filing of bankruptcy, declared a first priority claim as an expense of administration, rather than a fourth priority claim as "taxes legally due and owing" under 64(a)(4) of the Bankruptcy Act. The court held that the taxes were not costs of administration. In the alternative, the government argued, the tax claim was entitled to a preferred position by virtue of Section 7501. The *Connecticut Motor Lines* court said that contention was defeated by the very language of Section 7501.

> Thus, though such collections are considered by law to be held in trust, that trust is subject to the same limitations as are the taxes from which the trust arose. Here, that limitation is the structure of the Bankruptcy Act, the fact that such trust fund can only be collected in the instant case as a fourth priority matter.[23]

The *Randall* court also cited a district court case which has upset the government's trust theory. *In re Green*[24] involved substantially the same facts as *Randall*. The *Green* decision also noted the authorities supporting the government, but chose to follow the *Connecticut Motor*

20. 419 F.2d at 1070, *citing* Missouri v. Earhart, 111 F.2d 992, 995 (8th Cir. 1949) and cases cited therein.
21. 127 F.2d 703 (8th Cir. 1940).
22. 336 F.2d 96 (3rd Cir. 1964).
23. 336 F.2d at 107-108.
24. 264 F. Supp. 849 (D. Col. 1967).

Lines construction of Section 7501. The court noted: "So construed there is no conflict between § 7501 (a) and § 64 (a) of the Bankruptcy Act".[25]

In *Nicholas v. United States*[26] the Supreme Court was called upon to decide whether the United States was entitled to post-bankruptcy interest on taxes withheld during a superseded arrangement. After having noted that the general rule has been to suspend interest on taxes after the filing of a petition in bankruptcy, the Court did not feel compelled by Section 7501 (a) to alter that result. While specifically limiting its holding to the *interest* on the withheld tax money (assets in the estate were sufficient to pay all costs of administration) the Court's language seems to favor the *Randall* conclusion with regard to the *principal* of the taxes.

> The second sentence of § 7501 (a) specifically provides that interest on such a trust fund is collectible in the same manner as the taxes from which the fund arose. Since we have already determined that no interest on any of the taxes here in question accrues beyond the period of the arrangement proceeding, no interest could accumulate on a trust fund composed of the withholding and cabaret taxes.[27]

In further support of the *Randall* conclusion as to the scope of Section 7501 (a), it is helpful to examine the circumstances which existed when the predecessor to that section was enacted. Section 7501 (a) is derived unchanged from an Act of May 10, 1934,[28] and was carried over in the 1938 Code as 26 U.S.C.A. § 3661, and in the 1954 Internal Revenue Code as 26 U.S.C.A. § 7501. In *Nolte v. Hudson Navigation Co.*,[29] decided in 1925, the Second Circuit held that the government's claim against a navigation company for transportation taxes collected by it was not a tax claim but rather an ordinary debt since the debtor acted as a mere conduit for payment. As a result of this conclusion, the government's claim was not entitled to the priority in bankruptcy afforded a "tax", nor was the government able to avail itself of the procedures established for the creation of a tax lien. It was not until the late 1930's that the Supreme Court recognized the dual liability inherent in such taxes and began reversing decisions which followed *Nolte*.[30]

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25. 264 F. Supp. at 851.
26. 384 U.S. 678 (1966).
27. 384 U.S. at 691.
28. Act of May 10, 1934, c 277, § 607, 48 STAT. 768.
29. 8 F.2d 859 (2d Cir. 1925).
30. New York City v. Goldstein, 299 U.S. 522 (1937). United States v. Feiring, 313 U.S. 283 (1941). The basic argument for calling the amount of tax money collected or withheld a debt rather than a tax in the hands of the collecting agent was that the individual from whom the tax was collected or withheld was the taxpayer,

It, thus, follows that the intention of the legislature in its 1934 enactment of the predecessor to Section 7501 (a) was to give taxes withheld or collected the status of a "tax" in the hands of the collection agent. The Senate and House Committee reports cited in *Randall* confirm this position.[31] The *Randall* application of Section 7501 resolves the conflict in the two statutes by leaving undisturbed the favorable collection procedures provided for by Section 7501, while giving deference to "the policy decision of Congress reflected in Section 64 as to the relative merits of various claims upon the bankrupt estate."[32]

While determination of this issue was conclusive of the case, the *Randall* court proceeded to a second ground for its decision. If the conflict between Section 7501 of the Internal Revenue Code and 64(a)(1) of the Bankruptcy Act was not resolved by construction, the priorities established by the Bankruptcy Act would still prevail. In *New York v. Saper*[33] the Supreme Court said:

> [The Bankruptcy Act] was early held to take into consideration 'the whole range of indebtedness of the bankrupt, national, state, and individual,' *Guarantee Co. v. Title Guaranty Co.*, 224 U.S. 152, 160, and to have been passed 'with the United States in the mind of Congress;' *Davis v. Pringle*, 268 U.S. 315, 317. We do not believe the Revenue Act of 1924 and similar enactments were intended to amend the comprehensive scheme of the Bankruptcy Act . . .[34]

The *Randall* court cited an ample line of authority suggesting that in bankruptcy matters the Bankruptcy Act supersedes all other legislation and its priorities should control.[35] In *City of New York v. Rass-*

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and the collecting or withholding party was simply an agent for collection, thus a debtor in regard to taxes collected. The Supreme Court in *Feiring* noted that if the seller in that case had failed to collect the tax, he would remain liable for the amount of the tax. Thus, that amount is a tax owed to the city from the seller's standpoint as well as the buyer's. The buyer is primarily liable for the tax and the seller secondarily liable. The decisions giving amounts collected or withheld tax status, however, occurred after the predecessor to § 7501 had used other means to obtain tax status for those payments.

31. Senate Committee Report, S. REP. No. 558, 73rd Cong., 2d Sess., p. 53 (1934), provides:

> Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he cannot be treated as a trustee or proceeded against by distraint. Section [7501(a)] . . . impresses the amount of taxes withheld or collected with a trust and makes applicable for the enforcement of the Government's claim the administrative provisions for assessment and collection of taxes.

See also H.R. CONF. REP. No. 1385, 73d Cong., 2d Sess. p.32 (1934).

In subsequent revisions of the Internal Revenue Code the tax trust provision was carried over without comment.

32. 419 F.2d at 1072.

33. 336 U.S. 328 (1949).

34. 336 U.S. at 340-341 n.18.

35. 419 F.2d at 1072 *citing* Guarantee Title & Trust Co. v. Guaranty & Surety Co., 224 U.S. 152 (1912); Davis v. Pringle, 268 U.S. 315 (1925); Missouri v. Ross, 299 U.S.

ner[36], however, the court found that the generalities of Section 64(a)(1) did not reflect an overriding policy of the Bankruptcy Act.

Nevertheless, in *Nicholas v. United States*, cited earlier, the Supreme Court, while withholding determination of the issue confronted in *Randall*, suggested that the policies inherent in Section 64(a)(1) were more than mere generalities:

> We need not here determine whether, with regard to the *principal* of those taxes, the general language of § 7501 (a) overrides the strong policy of § 64 a (1) of the Bankruptcy Act, which establishes a sharply defined priority that places all expenses of administration on a parity, including claims for taxes.[37]

Despite the strong line of authority which gives Section 64(a) and the Bankruptcy Act, in general, a preferential status in bankruptcy matters, it is not necessary to assume that *Rassner* misread Section 64(a). The distinction which *Rassner* draws upon is the status of the statutory trust in bankruptcy. While Section 64(a) sets out the priorities accorded in bankruptcy, other claims may be entitled to satisfaction prior to and without regard to those priorities. A valid lien, subject to restrictions, will receive payment before distribution in bankruptcy occurs. While Congress has the power to terminate or limit this preference under the Bankruptcy Act, and in fact has limited it, absent such restrictions, a lien will be paid prior to expenses of administration.[38]

In a similar fashion, property which a bankrupt holds in trust for another goes directly to the beneficiary and is not subject to distribution to creditors.[39] The reason is that while the bankrupt held legal title to the property, he did not possess the beneficial interest in the property and thus the property equitably should not be considered a part of his estate upon bankruptcy. The trustee takes legal title subject to the beneficiary's interest. As the *Rassner* court noted, an overriding policy of the Bankruptcy Act could make even trust property subject to the priorities of Section 64(a). However, that court saw no such policy evidenced by the terms of Section 64(a). In regard to a common law trust, that observation is beyond dispute. The *Randall* decision, in this writer's opinion, does not compel subordination of the common law trust. However, both *Rassner* and *Randall* dealt with a statutory trust, a trust created not by the relationship of the parties but by statu-

72, 76 (1936); United States v. Key, 407 F.2d 635, 638 (7th Cir. 1969); and United States v. Kalishman, 346 F.2d 514, 517 (8th Cir. 1965).

36. *See* note 8, *supra.*

37. 384 U.S. at 691.

38. 3A COLLIER ON BANKRUPTCY ¶ 64.02 at 2068 (14th ed. 1969).

39. 3A COLLIER ON BANKRUPTCY ¶ 64.02 at 2069 (1969) and 4A COLLIER ON BANKRUPTCY ¶ 70.25 at 342 (1969).

tory enactment. While the *Randall* court did not expressly differentiate, that distinction can, and perhaps should, be viewed as the basis for the *Randall* decision.[40]

The preference accorded a common law trust in bankruptcy distribution has had long-standing application.[41] However, where the trust is not created by the relationship of the parties but by statutory enactment it must come under more careful scrutiny. Where the trust is not based upon established trust principles, but upon legislative enactment, the possibility exists that it may be a mere device to obtain a priority not intended by the provisions of the Bankruptcy Act. If that is the case, then preferred distribution of the trust might be held to be against the clear policy of the Bankruptcy Act.[42] Collier on Bankruptcy advocates this treatment of the statutory trust:

> In view of the elimination of all state-created priorities but one in § 64 a (5) and the avowed purpose in § 67 c to implement the policy of § 64 a by striking at statutory liens indistinguishable from priorities, there is reason for treating the statutory trust in the same way as its functional equivalent, the statutory lien, so far as bankruptcy is concerned.[43]

Unlike *Rassner*, where the statute creating the trust was a city law, the *Randall* court had to determine whether Section 7501 (a) or Section 64(a) more clearly reflected the policy of Congress since both were federal laws (assuming arguendo, as the court did, that the two statutes were in conflict). In addition to the rule of construction which gives the Bankruptcy Act priority in bankruptcy matters, the *Randall* court relied on the trend of legislative enactments involving the Bankruptcy Act as reflecting the strong policy of the Act to place all costs of administration, whether for taxes or for other administrative expenses, on a parity. The court traced the development of the Bankruptcy Act since 1926, noting that Congress has continually and systematically reduced the priority afforded federal tax claims while raising the priority of administrative expense claims.

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40. The *Randall* court displayed cognizance of the objections to the statutory trust by citing 3A COLLIER ON BANKRUPTCY 2070, 2071 n.27 where those objections were discussed.

41. 4A COLLIER, *supra* note 39, at ¶ 70.25 at 339, 340 n.3.

42. Another approach would be to hold that a trust never existed where the trust is a mere device, despite the fact a particular statute calls it a trust. The problem, as the *Rassner* court noted, is that decisions have generally applied state law to determine whether or not a trust existed. Thus, a federal bankruptcy court could not "go behind the trust" if state law controls and a state statute calls a particular relationship a trust. However, for arguments against applying state law, *see* 4A COLLIER, *supra* note 39, at ¶ 67.25 at 351 (14th ed. 1969).

43. 4 COLLIER *supra* note 39, at 351. *See also* H.R. REP. No. 2320, 82d Cong., 2d Sess. (1952), p.13.

Reasons for the legislative preference accorded costs of administration over other claims can be discerned in the Senate Report on the 1952 Amendment to Section 64(a)(1),[44] which gave costs of administration of an ensuing bankruptcy proceeding priority over costs of administration of a superseded proceeding:

> Unless provision is made for payment of the costs and expenses necessary to liquidate, administer and close the estate in the ensuing bankruptcy proceeding, ahead of all prior incurred and unpaid administration costs and expenses, there is always danger of a breakdown of administration. There should be assurance to the trustee in the ensuing proceeding that the costs and expenses incurred by him, such as bond and insurance premiums, costs of conducting a public sale and compensation for his services and for the services of his attorney, will be paid out of the assets liquidated and administered by him ahead of the prior unpaid costs and expenses.[45]

Thus, the policy of 64(a)(1) is premised on a strong factual reality: if the ability of the trustee to recover his costs in administering the bankrupt's estate is compromised, there is a danger that the efficient administration of the bankruptcy proceeding will be inhibited. Furthermore, on equitable principles alone, it would seem that the service the trustee performs for all creditors in administering the estate should be compensated for, at least to the extent of funds expended. The statutorily created trust, when coupled with the liberal tracing requirements imposed by *Rassner* and subsequent cases, often produces an equitable anomaly. For example, where none of the trust assets are present in the estate at bankruptcy and the sole assets in the estate are the product of the trustee's activity (*i.e.*, by selling the debtor's chattels or invalidating a mortgage), the trustee under the *Rassner* line of decisions may not be able to recoup the expenses of the sale.[46] Part of the difficulty involves the relaxation in *Rassner* of the general requirement that the beneficiary must trace trust property in the debtor's assets.[47]

> Once the trust relationship has been established, one claiming as a *cestui que trust* thereunder must identify the trust as property in the bankrupt estate, and if such fund or property has been mingled with the general property of the bankrupt, sufficiently trace the trust property.[48]

Rassner made an exception to this requirement where the mingling

44. SEN. REP. No. 1395 on S. 2234, 82d Cong., 2d Sess. (1952).
45. *Id.* at p. 5.
46. *See* In re S.T. Foods, Inc., 202 F. Supp. 37 (S.D.N.Y. 1962).
47. *Randall* did not deal with this issue because its determination that the Section 7501 tax trust did not create a super-priority precluded that discussion.
48. 4A COLLIER, *supra* note 39, at ¶ 70.25, p. 354 n.44 for cases cited.

took place during an arrangement, since the bankrupt was acting as an officer of court and subject to the control of the court. This would seem to be a valid equitable approach with regard to the common law forms of trusts. However, here again it seems that a distinction should have been made with regard to a statutory trust. The statutory trust bears even less resemblance to the traditionally accepted trust forms where there has never been a distinguishable trust res. Where the trust is composed of taxes "withheld" from employees, often no res ever existed. Frequently, the employer facing bankruptcy makes payments to his employees by deducting the amount of taxes and paying the net amount without ever having had funds to cover the gross amount paid. Tax money is not "withheld" in the true sense when, in fact, it never was in existence. This is distinguishable from the case where a trust res existed and was commingled by the trustee. Even apart from the tracing requirements, it might be argued in the former example that a valid trust never existed because of the absence of a trust res.[49] A more fundamental argument, however, (which may have been implicit in *Randall*), is that where the statutory trust relationship, considering all the facts, bears so little resemblance to the ordinary trust relationship that it can be termed a mere device to obtain a priority not provided for by the Bankruptcy Act, that trust is contrary to the policies of the Act. This approach would require a case-by-case analysis of the trust in question. If the particular facts of a given situation indicate that a trust created by statute bears little resemblance to other trust relationships, it would be held to be inapplicable in bankruptcy as contrary to the policy of the Bankruptcy Act.

In summary, the Seventh Circuit Court of Appeals in *United States v. Randall* held that the United States was not entitled to a super-priority in bankruptcy by virtue of Section 7501 of the Internal Revenue Code. The court decided that the second sentence of Section 7501 makes the tax trust subject to the same limitations as the taxes from which it arose, and therefore, the trust would be subject to the priorities of Section 64(a) of the Bankruptcy Act which gives taxes incurred during a Chapter XI arrangement only a pro rata first priority with other administrative expenses. The court also decided that even if Section 7501 were not so limited by its language, its preference would be overridden by the strong policy underlying Section 64(a) of the Bankrupty Act.

The first ground of the *Randall* decision is noteworthy in that the

49. *See* note 42, *supra*, for difficulties inherent in that argument.

Seventh Circuit's decision on the construction of Section 7501 is in conflict with the decisions of three other circuits. However, the second ground in *Randall*, taken in its broadest application, could have a far greater significance.

It may be argued that the second ground for the *Randall* decision is a mere resolution of an inconsistency between two federal statutes, Section 64(a) of the Bankruptcy Act and Section 7501 of the Internal Revenue Code, and that it should be limited in its future application to cases involving Section 7501. In that event the court's discussion of the second ground would add nothing to the scope of its decision and would have been unnecessary. However, the court's emphasis upon the strong policy of the Bankruptcy Act and the Act's supremacy in bankruptcy, and its rejection of the *Rassner* rationale, even though the *Rassner* decision did not involve a federal tax statute, seems to indicate a broader application than merely cases involving Section 7501. It seems likely that *Randall* is authority in the Seventh Circuit for the rejection of any statutory trust device, either federal or state, which creates priorities contrary to those established in Section 64(a) of the Bankruptcy Act. Taken in this light, the *Randall* decision is very significant in that it establishes a court created limitation on the application of a statutory trust in bankruptcy. The decision could be the stepping stone for judicial limitations upon the statutory trust device, similar to the legislative limitations imposed upon the statutory lien by Sections 64(a)(5) and 67(c) of the Bankruptcy Act.[50]

The Supreme Court may be called upon to resolve this conflict between the circuits. In light of its dicta in *Nicholas v. United States*,[51] it is submitted that the Supreme Court is likely to concur with the Seventh Circuit's construction of Section 7501. The court, thus, would not be compelled to consider whether the policy of Section 64(a)(1) of the Bankruptcy Act precludes the creation of contrary priorities by means of a statutory trust. It would thereby tacitly defer to Congress to clarify the status of the statutory trust in bankruptcy.

EUGENE J. JEKA

50. § 64(a)(5) of the Bankruptcy Act, 11 U.S.C.A. § 104(a)(5) (1964), eliminated all state-created priorities with one exception (rent). § 67(c)(2), 11 U.S.C.A. § 107(c)(2), invalidated statutory liens where the property was not levied upon or in the possession of the creditor before the filing of the petition in bankruptcy. "The adoption of § 64(a)(5) and § 67c of the Bankruptcy Act was intended to make clear that state rules of priority of distribution must yield in bankruptcy cases to that prescribed by the Act." Elliot v. Bumb, 356 F.2d 749, 754 (9th Cir. 1966).

51. 384 U.S. at 690-691.