'TRUST FUND' TAXES

The Dischargeability of Sales Taxes

By Henry M. Karwowski

More than 200 years ago, Benjamin Franklin wrote: "In this world nothing is certain but death and taxes." Were he alive today, Mr. Franklin might feel compelled to qualify his statement, at least with respect to the treatment of certain prepetition sales taxes in bankruptcy.

Although a clear majority of courts have held that sales taxes constitute "trust fund" taxes, generally nondischargeable in bankruptcy, a minority has held that these taxes constitute excise taxes, generally dischargeable if "stale." Further, another minority of courts has held that certain sales taxes constitute "gross receipt" taxes, also generally dischargeable if stale.

Bankruptcy Code § 523(a)(1)(A) provides in relevant part that "[a] discharge under §§ 727, 1141, 1128(a), 1128(b) or 1328(b) of this title does not discharge an individual debtor from any debt for a tax ... of the kind and for the periods specified in § 507(a)(8) of this title."

Sec. 507(a)(8) accords priority to claims for certain taxes. For the purposes of this article, three subsections are relevant. Subsection (C) applies to "a tax required to be collected or withheld and for which the debtor is liable in whatever capacity." Subsection (E) applies to an "excise" tax on a transaction occurring less than three years prior to the filing of the bankruptcy petition. Subsection (A) applies to a tax "on or measured by ... gross receipts" due within three years of the filing of the bankruptcy petition. Thus, while "trust fund" taxes covered by subsection (C) are generally nondischargeable, "excise" taxes covered by subsection (E) and "gross receipts" taxes covered by subsection (A) are generally dischargeable if sufficiently "stale."

Majority View: Sales Taxes Constitute 'Trust Fund' Taxes

Generally, sales taxes are imposed on purchasers of goods or services and collected by the vendor of the goods or the furnisher of the services under the authority of the state. A typical sales tax statute provides that "[a]n excise is hereby imposed upon sales at retail in the commonwealth, by any vendor, of tangible personal property or of services performed in the commonwealth at the rate of five percent of the gross receipts of the vendor from all such sales of such property or services." Mass. Gen. Laws Ann. ch. 64H, § 2 (West 2001). For the purposes of this article, the term "sales tax" encompasses only debts arising from the collection of sales taxes by a vendor of goods or a furnisher of services; it does not encompass debts arising from the purchase of goods or services.

As noted, a majority of courts, including several U.S. Circuit Courts of Appeals, have held that sales taxes constitute nondischargeable "trust fund" taxes within the meaning of subsection (C). See, e.g., *Shank v. Washington State Dept. of Revenue (In re Shank)*, 792 F.2d 829, 832-33 (9th Cir. 1986); *DeChiaro v. N.Y. State Tax Comm'n*, 760 F.2d 432, 435-36 (2d Cir. 1985); *Western Sur. Co. v. Waite (In re Waite)*, 698 F.2d 1177, 1179 (11th Cir.), *reh'g denied*, 703 F.2d 582 (11th Cir. 1983).

In reaching its determination, each of these courts noted that, in its version of subsection (C), the Senate intended to include "taxes which a seller of goods or services is required to collect from a buyer and pay over to a taxing authority." See, e.g., *Shank*, 792 F.2d at 831 (quoting S.Rep. No. 989, 95th Cong., 2d Sess. 68-73 (1978)).

Minority View: Sales Taxes Constitute 'Excise' Taxes

Nevertheless, in several cases courts have held that sales taxes constitute "excise" taxes within the meaning of subsection (E). See *George v. California State Board of Equalization (In re George)*, 95 B.R. 718, 720 n.4 (B.A.P. 9th Cir. 1989) (affirming bankruptcy court's determination that California sales tax constitutes an "excise tax" under predecessor of § 507(a)(8)(E) rather than a "gross receipts" tax under predecessor of § 507(a)(8)(A)); *City of Phoenix v. A.J. Bayless Mkts. (In re A.J. Bayless Mkts., Inc.)*, 108 B.R. 721, 728 n.7 (Bankr. D. Ariz. 1989) (holding that recently incurred sales tax debt was nondischargeable pursuant to predecessor of § 507(a)(8)(E)); *In re Boyd*, 25 B.R. 1003, 1004 (Bankr. S.D. Ohio 1982) (finding that "sales tax liability falls within the category of 'excise taxes' as stated in [predecessor of § 507(a)(8)(E)]"); *Tapp v. Fairbanks North Star Borough (In re Tapp)*, 16 B.R. 315, 322-23 (Bankr. D. Alaska 1981) (finding that "the priority, and through § 523(a)(1)(A), dischargeability, of [a] retail sales tax claim is governed not by [subsection (C)], but rather by [subsection (E)]").

A number of these cases are of dubious precedential value, however. For instance, the Ninth Circuit overruled the basis for the holding in *Tapp*. See *Shank*, *supra*. Second, an appellate panel questioned the decision in *George*. See *George*, *supra*. Third, the holding in *Bayless* constitutes mere dicta. See *Bayless*, *supra*. See also *Groetken v. State of Illinois (In re Groetken)*, 843 F.2d 1007 (7th Cir. 1988) (finding that Illinois Occupation Tax "appears" to fall within subsection (E)'s scope).

The most persuasive and comprehensive opinion in support of this view appears in a dissent in *Shank*. See *Shank*, 792 F.2d 833-36 (Reinhardt, J., dissenting). Judge Reinhardt premised his determination, primarily, on an analysis of the legislative history of the section. He noted that the floor managers of the proposed Bankruptcy Code had viewed the predecessor of § 507(a)(8) in its final form as a compromise between the House and Senate versions. "Of particular importance," he asserted, "is [subsection (E)] which expressly makes excise taxes dischargeable and which was included as a part of the joint amendment although no comparable provision had been contained in [the Senate version]." *Id.* "The majority, by relying only on the legislative history prior to the joint amendment, fails to give effect to the compromise reached by the floor managers of the Code."

Judge Reinhardt observed that the

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Representing a Debtor With a 'Stale' Obligation

Attorneys representing a debtor possessing a "stale" prepetition sales tax obligation are advised to investigate the possibility of making two arguments with respect to the treatment of the obligation. First, they should ascertain the treatment of sales taxes in bankruptcy cases in the circuit in which the debtor has filed. If a higher court has not held that sales taxes constitute "trust fund" taxes under § 507(a)(8)(C) or a predecessor of that section, they should argue that the sales tax obligation constitutes a dischargeable excise tax under § 507 (a)(8)(E), on the basis of the cases cited supra.

Alternatively, or in addition, they should determine whether the statute on which the obligation is based, like the statutes in *Groetken* and *Raiman*, imposes the tax directly on retailers. If so, they should argue that the sales tax constitutes a dischargeable "gross receipts" tax under § 507(a)(8)(A).

joint statement of the floor managers "makes it quite clear" that a sales tax constitutes an "excise tax" and not a "tax required to be collected or withheld." The joint statement provides that "the category of taxes required to be collected or withheld 'covers the so-called "trust fund" taxes, that is, income taxes which an employer is required to withhold from the pay of his employees' share of Social Security taxes.'" *Id.* (quoting 124 Cong.Rec. 34015, 124 Cong.Rec. 32415). With respect to excise taxes, it provides that "[a]ll Federal State or local taxes generally considered or expressly treated as excises are covered by this category, including sales taxes, estate and gift taxes, gasoline and special fuel taxes, and wagering and truck taxes." *Id.* (quoting 124 Cong.Rec. 34016, 124 Cong.Rec. 32416).

Judge Reinhardt observed further that "[t]he decision by the floor managers to adopt the House version of [the predecessor of § 507(a)(8)] insofar as it made excise taxes, including sales taxes, dischargeable...and to incorporate that agreement in section E, explains why, when they also decided to use the Senate language regarding 'taxes required to be collected' in subsection C, it was necessary to delete a [certain] sentence from the original Senate explanation of the purpose of effect of subsection (C)." *Id.* at 835. That sentence is the very sentence on which the majority based its decision: "This category also includes excise taxes which a seller of goods and services is required to collect from a buyer and pay over to a taxing authority." *Id.* (quoting S.Rep. No. 989, 95th Cong., 2nd Sess. 71). Judge Reinhardt noted that "[t]he floor managers, after they reached their compromise, retained nearly identical language in their explanation of subsection (C) except that they omitted [that] sentence." *Id.* "It is apparent," he concluded, "that their reason for doing so was the agreement to make excise taxes (including sales taxes) dischargeable, as evidenced by the inclusion in § 507 of subsection (E) which deals expressly with excise taxes and provides for their dischargeability and the Joint Statement's definition of excise taxes as 'including sales taxes.'"

Minority View: Sales Taxes Constitute 'Gross Receipts' Taxes

Some courts have held that certain sales taxes constitute "gross receipts" taxes within the meaning of subsection (A). See, e.g., *Groetken*, 843 F.2d at 1007. For a number of reasons, however, these cases may be limited in their application. First, the relevant statute in each of these cases imposed the sales tax directly on retailers. In *Groetken*, for instance, the statute in question, the Illinois Occupation Tax Act, "impose[d] a tax...upon persons engaged in the business of selling tangible personal property at retail at the rate of 5 percent of the gross receipts from such sales of tangible personal property made in the course of such business." *Groetken*, 843 F.2d at 1010 (quoting Ill.Rev.Stat. ch. 120 ¶ 441 (1985)). The Seventh Circuit found that because it was imposed directly on retailers, the occupation tax did not constitute a "trust fund" tax under subsection (C). "Rather," it concluded, "as a tax on the retailers themselves that is 'on or measured by gross receipts,' the Occupation Tax [fell] squarely under Section A."

Similarly, in a case in which the parties agreed that subsection (A) was applicable, the statute in question, § 6051 of the California R & T Code, provided: "For the privilege of selling tangible personal property at retail a tax is hereby imposed upon all retailers at the rate of 2-1/2 percent of the gross receipts of any retailer from the sale of all tangible personal property sold at retail in this state." *Raiman v. State Board of Equalization (In re Raiman)*, 172 B.R. 933, 937 (B.A.P. 9th Cir. 1994) (quoting Cal.Rev. & Tax. Code § 6051 (West 1987 & Supp. 1994)).

Moreover, a "gross-receipts"-type sales tax statute might have a companion use tax statute, pursuant to which retailers are required to collect a use tax from purchasers, to wit, a "trust fund" type of tax implicated under subsection (C). For instance, in Illinois, the Occupation Tax Act is complimented by the Use Tax Act, providing that retailers must collect a use tax "upon the privilege of using in this State tangible personal property purchased at retail from a retailer." 35 Ill. Comp. Stat. 105/3 (West 2000). If a debtor fails to pay the occupation tax, it remains liable for the use tax obligation. See *Rosenow v. State of Illinois*, 715 F.2d 277, 282 (7th Cir. 1983). Thus, courts have found an occupation tax arrearage due more than three years before the bankruptcy petition nondischargeable, on the grounds that the arrearage qualifies as a use tax obligation entitled to priority under subsection (C). See, e.g., *In re Jansen*, 162 B.R. 530, 533 (S.D. Ill. 1994).

Finally, while courts in other cases have found that sales taxes fall under subsection (A), these cases, like several cited in connection with subsection (E), bear little precedential value. For instance, in *In re Bowen*, 116 B.R. 477, 480 (Bankr. S.D. W. Va. 1990), the court deemed certain West Virginia consumer sales and tax liability dischargeable pursuant to subsection (A); it failed to explain the basis for its decision, however.

Further, in *Ernst v. Iowa Dep't of Revenue (In re Hubs Repair Shop Inc.)*, 28 B.R. 858, 870 n. 18 (Bankr. N.D. Iowa 1983), the court asserted, only in dicta and without explanation, that "[subsection (A)] allows a tax claim priority for prepetition taxes measured by gross receipts, such as the Iowa retail sales tax."

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