

In the

Supreme Court of the United States

WILLIAM OTTE, TRUSTEE IN BANKRUPTCY
OF FREEDOMLAND, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA and
THE CITY OF NEW YORK,

Respondents.

No. 73-375

Washington, D. C.
October 15, 1974

Pages 1 thru 43

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Washington, D. C.,

Tuesday, October 15, 1974.

The above-entitled matter came on for argument at
11:47 o'clock, a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

HOWARD KARASIK, ESQ., 1290 Avenue of the Americas,
New York, New York 10019; for the Petitioner.

KEITH A. JONES, ESQ., Assistant to the Solicitor
General, Department of Justice, Washington, D. C.
20530; for Respondent United States.

SAMUEL J. WARMS, ESQ., Office of Corporation Counsel
of the City of New York, Municipal Building, New
York, New York 10007; for Respondent City of New York

C O N T E N T S

<u>ORAL ARGUMENT OF:</u>	<u>PAGE</u>
Howard Karasik, Esq., for the Petitioner.	3
Keith A. Jones, Esq., for Respondent United States.	22
Samuel J. Warms, Esq., for Respondent City of New York.	36

[Afternoon session - pg. 13]

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in No. 73-375, Otte against the United States.

Mr. Karasik, you may proceed whenever you're ready.

ORAL ARGUMENT OF HOWARD KARASIK, ESQ.,

ON BEHALF OF THE PETITIONER

MR. KARASIK: Thank you.

Mr. Chief Justice, and may it please the Court:

I represent William Otte, the Trustee in Bankruptcy of Freedomland, the Petitioner before the Court today.

This case is here on a writ of certiorari to the Court of Appeals for the Second Circuit.

The facts of this case are relatively simple. Freedomland filed a petition under Chapter XI of the Bankruptcy Act. It was subsequently adjudicated a bankrupt.

413 priority wage claimants filed proofs of claim for priority wage claims in the Bankruptcy proceeding during the six-month period during which claims could be filed.

The United States Government and the City of New York did not file any claims for withholding taxes or related taxes in connection with those priority wage claims.

As a matter of fact, they did not file any proofs of claim pursuant to the "bar order" entered in the proceeding, which directed the taxing authorities to file proofs of claim if they had any claims for withholding or related taxes.

During the course of the proceeding the bankruptcy judge entered an order authorizing the bankruptcy trustee to make a priority wage claim distribution without the necessity for withholding taxes.

This order was appealed to the District Court, and the District Court held that it was incumbent upon the bankruptcy trustee to withhold taxes and that the withheld taxes were subject to the fourth priority of Section 64a of the Bankruptcy Act.

On further appeal to the Court of Appeals, the Court of Appeals held that the withheld taxes were subject to the second priority under Section 64a of the Bankruptcy Act.

Now, the issues before the Court are:

First, whether a bankruptcy trustee is required to withhold taxes in connection with a priority wage claim distribution;

Second, whether those withheld taxes are entitled to a priority;

Third, whether the ruling of the bankruptcy judge that it was not incumbent upon a bankruptcy trustee to prepare the W-2 forms and related forms because it was inconsistent with the general rule that a bankruptcy trustee need not incur unnecessary expenses in connection with the administration of an estate, whether that ruling was clearly erroneous; and

Fourth, whether it was incumbent upon the taxing authorities to file proofs of claim in this proceeding or be barred from asserting their claim in the proceeding.

Essential, absolutely crucial to an understanding of this case, is that it is a bankruptcy case, it is not a tax case. Every appellate court that has dealt with the issues before the Court today has viewed the issues in terms of the Internal Revenue Code and has viewed the cases before them as tax cases.

I submit to the Court that this is a bankruptcy case, and that if this Court recognizes that it's a bankruptcy case, that it will overrule all of the appellate courts that have dealt with the issues before the Court and will overrule the court below.

Section 64a(2) of the Bankruptcy Act establishes a priority wage claim for wage earners.

QUESTION: Where is that printed?

MR. KARASIK: It's in the Appendix, Your Honor, ---

QUESTION: Not in your brief?

MR. KARASIK: No, it's not in the brief; it's in the Appendix. And it's at 94a and 95.

Now, this Court has dealt with Section 64a(2) in two significant cases. The Embassy Restaurant case and the Joint Industry Board case.

This Court ruled, decided that Congress, when it

passed Section 64a(2), attempted to establish an economic cushion for wage earners who lost their jobs as a result of their employer's bankruptcy.

Now, I ask this Court, in light of the obvious congressional purpose related to Section 64a(2), whether withholding taxes in connection with a priority wage claim distribution would fulfill that purpose. I say that it would not.

Moreover, in interpreting Section 64a(2), this Court has said that it was incumbent upon a bankruptcy trustee to make a prompt distribution of the priority wage claim dividends. Yet if a bankruptcy trustee is required to work out the computations and prepare the W-2's and the 941's and the related forms, it is inevitable that there will be a delay in the distribution, and again I say that any requirement that would cause a bankruptcy trustee to delay a distribution would not fulfill the congressional purpose. And that brings us --

QUESTION: Under your theory, Mr. Karasik, would the employees be nonetheless credited with having paid the withheld taxes?

MR. KARASIK: No, Your Honor. The -- my theory is this: they would receive their money. If they owe money to the government on account of taxes at the end of the year, they would pay the government.

There would be clerical costs associated with the

preparation of the W-2 forms and the related forms. I don't know how much there would be, and obviously it would vary from case to case. But it would cost something, some clerical personnel would have to be hired, some accountants would have to review the computations.

The amount of money that's spent might very well eat into the amount of money available for purposes of paying out the priority wage claim dividend.

QUESTION: You mean that every time a tax return is filed, an accountant has to be employed? Do you do that for your personal one?

MR. KARASIK: I retain an accountant in my personal case, and in this particular case, Your Honor, --

QUESTION: Do you think all taxpayers do?

MR. KARASIK: No, all taxpayers do not. But most bankruptcy trustees do. In this particular case we have an accountant. The accountant testified in the court below that he would ordinarily review the work product of the junior accountants and any clerical staff that would prepare the computations and the related forms.

QUESTION: So now you have not only an accountant but junior accountants also?

MR. KARASIK: Well, the District Court --

QUESTION: Suppose there were just one employee here. Still an accountant?

MR. KARASIK: It might not have to be an accountant. But, nevertheless, there would be an expense. And it's possible, under some circumstances, that the expense would eat into the amount of money available for the priority wage claim dividend.

QUESTION: That's true of any cost of administration, though, isn't it?

MR. KARASIK: That's correct. But this would be an unnecessary cost of administration, because if no deduction were made, if the taxpayer, the recipient, the wage earner actually owed taxes at the end of the year, he would pay it. Just like every other businessman who happens to receive a dividend in a bankruptcy proceeding. There's no deduction for that businessman.

QUESTION: Well, if that were so, why do we have withholding?

MR. KARASIK: Withholding applies to the on-going relationship between an employer and an employee. The government wants to collect money at the source, on a pay-as-you-go basis.

QUESTION: You think that's the only reason for withholding?

MR. KARASIK: I think that's the primary reason for withholding. Unless the government assumes that the ordinary wage earner is going to default and not make the payment. And I don't believe that's a valid assumption, because --

QUESTION: Well, now that you have to assume that, can't you assume that a recognizable proportion will, not the ordinary one? Wasn't the delinquency of accounts a reason for withholding as well as currency at the time?

MR. KARASIK: That may be, but in this particular type of situation, that suggestion would be inapplicable, because all of the priority wage claimants would have filed proofs of claim in the proceeding. The government would be completely aware of which people are receiving dividends, and if these people do not pay taxes, if taxes turn out to be due -- and they may very well not turn out to be due, because, after all, you're dealing with wage claimants who receive a meager amount of money, \$600. If a man who's earning \$600 loses his job, perhaps by the end of the year he may or may not have gotten a new job. There may have been a hiatus. At the end of the year he may owe no taxes whatsoever.

And I submit that it's unfair to deduct taxes when he receives a priority wage claim dividend. It's unfair to him, and it serves no valid purpose.

The Brookings Institute report, in its study, indicates that taxes collected in connection with bankruptcy proceedings have a miniscule effect on the treasury; absolutely miniscule. But a very significant effect on the dividends that are paid out in bankruptcy proceedings.

Moreover, as I indicated before, the taxpayer, the

wage earner, when he receives money, it's incumbent upon him to pay a tax if he owes a tax at the end of the year. And I submit that the government would lose no money if that procedure were followed in this particular type of case.

QUESTION: I'm not sure that I follow the theory behind your comparison that it doesn't hurt the government very much, but it does hurt the creditors a great deal.

What's -- how is that relevant to the issues here?

MR. KARASIK: Well, any -- I'm just talking generally, in terms of the Brookings report. The Brookings report indicated that taxes, as a general proposition, collected in bankruptcy proceedings have a miniscule effect on the treasury.

QUESTION: That's simply because we have a three or four hundred billion -- I've forgotten what it is now -- three or four hundred billion dollar budget. But what's that got to do with the creditor? Creditors would vary from small creditors to large, many creditors to few creditors.

MR. KARASIK: Well, I was just suggesting that as a general policy. The revision, the proposed revision of the Bankruptcy Act suggested by the Brookings Institute, that the amount of taxes collected as miniscule, suggested to them that priority taxes in general should be abolished, in bankruptcy proceedings.

I'm further submitting that the government will not really be hurt in this particular case if we follow the

suggestion that the trustee is making, that no money be withheld. And that the wage earner, at the end of the year, if he owes a tax, pays a tax.

Now, the government has recognized that the trustee might have some difficulty computing the deduction and accordingly they've established a bureaucratic practice that, as far as I'm concerned, has no basis in law, and not subject to any particular regulation. But there is some kind of practice that the bankruptcy trustee take 25 percent off the top.

Well, the withholding tax statutes run from 14 percent on upwards. And I submit that in the kind of cases we're talking about, where there are wage earners -- and you're not talking about principals of business or businesses or salaried personnel, but just wage earners -- that 25 percent is excessive.

QUESTION: Doesn't that include Social Security as well as income tax deduction?

MR. KARASIK: That's correct. That's the practice.

But even including Social Security at five percent, you end up with 20 percent as the total deduction. And I submit that the kind of people we're talking about might not pay 20 percent, certainly they're not going to be paying 25 percent.

In this particular case you've got 413 people, many

of whom are simple day laborers. They need their money and they need their money quickly. And to deduct 25 percent off the top, or any specific amount off the top, is detrimental to them and does not fulfill the congressional purpose which was to establish an economic cushion for these people.

Now, the court below spoke in terms of control. That is, that the bankruptcy trustee control the wage claim --

MR. CHIEF JUSTICE BURGER: We'll resume there right after lunch.

[Whereupon, at 12:00 noon, the Court was recessed, to reconvene at 1:00 p.m., the same day.]

AFTERNOON SESSION

[1:02 p.m.]

MR. CHIEF JUSTICE BURGER: You may continue, Mr. Karasik.

ORAL ARGUMENT OF HOWARD KARASIK, ESQ.,

ON BEHALF OF THE PETITIONER -- Resumed

MR. KARASIK: In order for the Court of Appeals for the Second Circuit to reach the conclusion that a bankruptcy trustee was required to withhold taxes, it had to conclude that the bankruptcy trustee was in control of the wage claim dividends. Much like the other appellate courts, the court below simply ignored the bankruptcy context of this case.

In point of fact, the bankruptcy trustee does not control the distribution of wage claim dividends. It's the bankruptcy judge. The bankruptcy judge appoints the trustee, the bankruptcy judge has the right in certain instances to remove the trustee; the bankruptcy judge declares the dividends; the bankruptcy judge must countersign the checks; and the bankruptcy judge mails out the checks.

So it is not the bankruptcy trustee who is in control, it's the bankruptcy judge.

The government says, Well, if it's the bankruptcy judge, then perhaps the bankruptcy judge should withhold the taxes and prepare the W-2's and the related forms.

I say that this is ludicrous, that Congress never intended the withholding tax statutes to apply to bankruptcy judges, and that the government is merely trying to force the issue, as I will show in connection with the priorities.

Each court that --

QUESTION: Why would that be any more true of a bankruptcy judge than a receiver, for example, in either a federal or a State proceeding, trustee in bankruptcy? Why would it be any more true of the bankruptcy judge? I don't quite get your argument on that.

MR. KARASIK: Well, the bankruptcy judge -- under the Internal Revenue Code, it is only the person who is in control of the payment who is deemed to be the employer, and it is only the employer who must withhold the tax and prepare the W-2 forms and the related forms.

QUESTION: But there are certain derivative responsibilities that follow the funds, are there not?

MR. KARASIK: No. The Internal Revenue Code speaks in terms of the parties, not the funds. It's only the employer, and the employer who is the one who withholds. That has nothing to do with the money that's withheld.

Each of the appellate courts dealing with the issues before the Court has come up with -- well, I shouldn't say each of them. There have been divergent opinions as to what is to be done to the taxes that are to be withheld.

The government contends that the withheld taxes, taxes withheld on a second priority are bootstrap to the first priority. This is illogical.

And, in addition to that, it's not only illogical, but it's contrary to the holding of this Court in the Adair case.

The withheld funds are taxes that are withheld from the employees, they are not expenses of the estate. And it's only the expenses of the estate that can be deemed to be administration expenses and would entitle the government to priority.

The City of New York says, as did the court below, that the withheld taxes are entitled to a second priority, because they are, quote, "carved out of the wages."

Yet this Court, in the Embassy Restaurant case, said that if anything is paid to a third party, to someone other than the wage claimant, that the moneys that are paid are not wages for purposes of the Bankruptcy Act.

So you cannot conclude that withheld taxes paid to the government can fall into the second priority.

The Connecticut Motor Lines case says that the withheld taxes fall into the fourth priority.

Well, the taxes here are not the taxes of the bankrupt, and the fourth priority only relates to taxes of the bankrupt.

Now, the petitioner does not concede that any taxes should be withheld at all. But if taxes are withheld, and if the taxes do not fall within the priority category of Section 64a(4), then perhaps they fall into the proviso that follows Section 64a(4), which says that if a tax is not entitled to a priority, that it falls into the general unsecured claim category.

QUESTION: What proviso is that?

MR. KARASIK: That's the proviso that follows the priority section under 64a(4) of the Bankruptcy Act.

QUESTION: I don't find it in the Act.

QUESTION: It's in the Appendix, is it?

MR. KARASIK: It's in the Appendix at page 95a. It says, "Provided, however, that no priority over general unsecured claims shall pertain to" --

MR. CHIEF JUSTICE BURGER: Well, counsel, hold up a minute until we find the place here.

MR. KARASIK: Yes. Excuse me.

QUESTION: The bottom three lines.

QUESTION: Yes.

MR. KARASIK: That's correct.

QUESTION: Thank you.

QUESTION: Counsel, as I understand it, it's your position that the wages should be paid in gross?

MR. KARASIK: That's correct.

They are not wages, Your Honor, they're wage claim dividends. There's a significant difference.

QUESTION: I don't care what you call them. But, anyway, you want them paid in gross?

MR. KARASIK: That's correct.

But if there is to be a withholding, then, at best, the taxes should fall into the unsecured category.

The government will argue that this constitutes a windfall for the unsecured creditors. But I submit to the Court that this is what the statute says. The Congress, when it promulgated this particular statute, expected a certain, quote, "windfall", close quote, to unsecured creditors.

At the risk of being repetitious, I say to this Court that we're dealing with a bankruptcy case and not a tax case. When this Court dealt, in the Randall case, with a conflict between the Internal Revenue Code and the Bankruptcy Act, this Court ruled that in the event of a conflict the Bankruptcy Act takes precedence.

And I submit that in this particular case, if the Court finds that the Bankruptcy Act does take precedence -- and I submit that it should find that it takes precedence -- that it will also find the bankruptcy trustee need not withhold any taxes in connection with priority wage claim dividends.

QUESTION: Do you have any authority supporting

your position flatly at all?

MR. KARASIK: No.

QUESTION: You have an array of cases internally inconsistent, first, second, and fourth; but none of them support your position at this point, do they?

MR. KARASIK: Well, only indirectly. The Connecticut Motor Lines case said that if the government failed to file a proof of claim, that the withheld taxes would be entitled to a fourth priority, but by virtue of the failure to file a proof of claim that the taxes would fall into the general unsecured category.

But for the general proposition that a bankruptcy trustee is not required to withhold taxes, I have no authority at all, except the Bankruptcy Act. And I request, and respectfully submit to this Court, that all of those appellate decisions which ruled that a bankruptcy trustee should withhold taxes should be overruled.

QUESTION: Well, what -- do you think that if you said this tax claim was fourth priority, or unsecured at all, or not secured at all, or no priority at all, would it necessarily follow that the trustee would not have to file a withholding tax return?

MR. KARASIK: Well, if there were no wages paid, --

QUESTION: Yes?

MR. KARASIK: -- then the trustee would not have to

file any returns. These would not constitute wages.

QUESTION: Yes, but when he paid them?

MR. KARASIK: These would be wage claim dividends, there's --

QUESTION: Well, I know, but he's going to be paying wages, he's going to be paying the \$600.

MR. KARASIK: He's going to be paying \$600, but these are not wages. He's not an employer. The recipients are not his employees.

QUESTION: Well, I know, but it still could be held that he's paying wages. And then --

MR. KARASIK: If it is held that he's paying wages, --

QUESTION: Yes?

MR. KARASIK: -- then I would assume that it would -- that he would have to prepare the appropriate forms.

QUESTION: Well, I know, but the people to whom wages are owed, were owed by the bankrupt, up to \$600 are going to be paid, aren't they?

MR. KARASIK: That's correct.

QUESTION: The trustee is going to pay them, isn't he?

MR. KARASIK: Well, the trustee in connection with the --

QUESTION: With the judge.

MR. KARASIK: -- bankruptcy judge. Yes.

QUESTION: Well, so those distributions are going to be made.

MR. KARASIK: That's correct.

QUESTION: And I suppose you could say that the trustee can withhold them, can withhold the money.

MR. KARASIK: Well, if -- there are several threshold questions -- if we're talking about a wage, and if you're saying that the bankruptcy trustee is the one in control, then -- and if you're further saying that the Internal Revenue Code comes into play at this point --

QUESTION: Well, certainly the claims that are going to be filed and paid are wage claims.

MR. KARASIK: The claims are wage claims. What is paid is a wage claim dividend.

QUESTION: Yes, and it's --

MR. KARASIK: And there's a difference, I submit respectfully, between a wage claim dividend and a wage.

QUESTION: Well, if all a fellow was owed was \$599 and he gets it all, I suppose he thinks he's collected his wages?

MR. KARASIK: Well, if he got it several years after the event, I don't know what he would consider it. He might consider it a windfall. I don't know, Your Honor.

QUESTION: Well, don't you usually pay wages, wage claims pretty fast?

MR. KARASIK: We attempt to do it. In this particular case there was a hiatus between the date of adjudication and the date of payment.

The reason for that is that, first, the estate must be liquidated. Second, as in this particular case, there were liens that had to be invalidated. And third, in this particular case, the attorney who was handling the case took ill. He was ill for several years, and then died, unfortunately.

QUESTION: But if you're right that these wage claims, that these tax claims might be -- have no priority at all, what the trustee would do is to withhold the money and it would go into the unsecured --

MR. KARASIK: That's correct.

QUESTION: -- unsecured creditor --

MR. KARASIK: And that's illogical, Your Honor.

QUESTION: Well, that's your claim, though.

MR. KARASIK: Well, it's not my claim. The illogicality of that, and the fact that you have so many divergent opinions as to what is to be done with the withheld taxes demonstrates to me, and I hope to the Court, that Congress never contemplated that withholding taxes would be applicable in a situation such as the one at bar.

If there are no further questions, I respectfully reserve my time for rebuttal.

MR. CHIEF JUSTICE BURGER: Very well.

Mr. Jones.

ORAL ARGUMENT OF KEITH A. JONES, ESQ.,

ON BEHALF OF THE RESPONDENT UNITED STATES

MR. JONES: Mr. Chief Justice and may it please the Court:

I represent the United States in this case. Mr. Warns, who will follow me, represents the City of New York.

Three related questions are presented here:

First, whether a trustee in bankruptcy must withhold income and Social Security taxes on the distribution of wage claims.

Second, whether the taxing authorities must file formal proofs of claims with respect to these withholding taxes.

And third, whether such taxes are entitled to first priority of payment or payable in some other manner under the Bankruptcy Act.

As to the first question, the trustee's duty to withhold, notwithstanding the trustee's arguments here, the law is quite clear. The Internal Revenue Code squarely requires the trustee in bankruptcy to withhold federal income and Social Security taxes on all wage claim distributions, and to prepare and submit appropriate information returns and reports to the Internal Revenue Service and to the wage

claimants.

The evidence in this case shows that, contrary to the petitioner's position, the cost of complying with these withholding and reporting requirements are trivial; and, in any event, even if the costs were more substantial, they would not justify the trustee's failure to perform his statutory duty.

Our arguments to this effect are set forth in our brief, and, if there are no questions on this point, in the interest of time, I will go on to the other questions in this case.

As to the second question in this case, the filings of proofs of claims, we believe that it is also clear that no filings of proofs of claims are required with respect to withholding taxes that arise after bankruptcy, as in this case.

The Bankruptcy Act requires the filing of formal proofs of claims only with respect to debts for which the bankrupt is or may be liable, and the bankrupt will never become liable for the withholding taxes in this case.

These taxes arise only after bankruptcy and they are obligations incurred by the estate in the course of administration, and not by the bankrupt.

In this respect, they are just like the expenses incurred by the trustee in employing clerical assistants to help administer the estate. Indeed, they are just like the

costs incurred by the trustee in conducting this litigation. Withholding taxes, like other expenses incurred in the course of administration, are obligations of the State, which -- as I say, which are incurred in the course of the administration, and the Bankruptcy Act does not require the filing of proofs of claims with respect to such debts of the estate, as distinguished from debts of the bankrupt.

Moreover, the purpose of filing proofs of claims is simply to inform the bankruptcy court, the trustee, and the other creditors of the total amount of claims outstanding against the bankrupt.

Proofs of claims of withholding taxes here in question would not serve that purpose. These withholding taxes do not add to the total amount of claims against the bankrupt or the estate, they arise only when the wage claims are paid out. They're deducted from the wage claims, paid over to the United States, and they don't reduce the fund remaining for payment to other creditors.

Therefore, filing proofs of claims would serve no purpose under the Bankruptcy Act.

Moreover, any filing requirement of that kind for the government would be impracticable. As we showed in our brief, the Bankruptcy Act requires proofs of claims to be filed as to debts of the bankrupt within six months of the first date set for the first meeting of creditors.

No taxing authority could comply fully with that requirement.

Until the expiration of the six-month period, it would be impossible to know just how much wage claims in fact were to be payable out of the estate.

Moreover, the actual amount of the tax that would be due cannot be known until the actual amount of wages has been calculated and distributed. Because withholding rates fluctuate over time, and the effective withholding rates at the time of bankruptcy may be very different from those that are in effect at the time of the distribution of the wage claims.

Therefore, for all these reasons, we believe it's clear that Congress did not intend to require the filings of proofs of claims with respect to these withholding taxes.

With that in mind, I now turn to what we believe is the most important and substantial question in this case, and that is the priority to which the United States is entitled or, more generally, the manner in which these withholding taxes are to be paid over to the United States.

Under Section 7501 of the Internal Revenue Code, an obligation is imposed upon all persons responsible for collecting taxes to hold those taxes in a special fund in trust for the United States. Under that provision, withholding taxes of the kind here in question, or, indeed, any other

withholding taxes, are directly payable to the United States as a trust fund, without regard to the provisions of the Bankruptcy Act.

However, the trustee in this case has not complied with Section 7501. And we recognize that under this Court's holding in United States v. Randall the trustee's duty to pay over cannot be enforced as against third-party creditors. The issue that arises in this case, therefore, is to what priority of payment, if any, the United States is entitled, when the trustee defaults on his duty to pay over the withholding taxes as a trust fund.

And I turn now to that question.

Our position, simply put, is that the United States is entitled to payment of these withholding taxes as first priority administrative costs and expenses. We reach this conclusion both because such withholding taxes analytically fall within the category of administrative expenses, and also because they don't fit within any other priority or, indeed, non-priority category.

QUESTION: In your argument, you're supporting the judgment below?

MR. JONES: We're supporting the judgment below in the sense that we're supporting the distribution of assets ordered by the court in its judgment. We're not supporting the express holding that these wage claims are -- excuse me,

that these withholding taxes --

QUESTION: But if you -- if you --

MR. JONES: -- are distributable as second priority items.

QUESTION: If you won -- if we accept your argument, the result below might be different? I mean in terms of who gets what.

MR. JONES: That's true. And what you're saying, I assume, --

QUESTION: So you really want to secure more than you got out of the judgment below?

MR. JONES: Yes and no. We want --

QUESTION: Well, did you petition, or not?

MR. JONES: We didn't petition, but, as we pointed out in our brief, the question of first priority was opened up by the petitioner in his petition. The question presented in the petition -- and I will read it to the Court -- is whether -- this is Question No. 2 at page 2 of the petition:

"Assuming arguendo that such a distribution is subject to the withholding tax and reporting requirements of the Internal Revenue Code", et cetera, "should the monies withheld in connection with the distribution be accorded fourth priority 'tax claim' status ..., first priority 'administration claim' status ..., second priority 'wage claim' status ..., or 'trust fund' status".

QUESTION: Well, of course, it goes further than that, doesn't it, Mr. Jones, it isn't just a question of what may be raised here, but it's a question of whether, if you want to get a more favorable result than the Second Circuit gave you, whether you don't have to cross-petition?

MR. JONES: Well, I don't think that's true in this case, Mr. Justice Rehnquist. On that point I would say that since the question in this case is how the moneys are distributable, necessarily the Court has to consider whether the taxes are first priority items.

Now, I would say that if the question were not properly before the Court, were not presented by the petitioner, then we would be entitled, at most, to an affirmance of the judgment below; although we might also be entitled to a ruling that, as a matter of law, such taxes are first priority claims.

QUESTION: Sub dicta --

MR. JONES: In other words, you could, if you saw fit, determine that as a matter of law these withholding taxes are first priority items. But that, in the absence of a cross-petition, we were entitled only to an affirmance of the judgment below.

In this case we would be perfectly satisfied by such an affirmance, because the distribution of assets in this case is the same, whether it's a first priority or a second

priority item.

That is, as I say, I think that in this case, under the peculiar circumstances where the question necessarily is presented to the Court in the petition, by the question raised by the petitioner, that it's open to the Court to consider it and dispose of it.

QUESTION: Well, I don't know, but he says you're not only not entitled to administration expenses, but you're not entitled to the priority you got.

And so I don't know that he is in a very good position to -- or you're in a very good position to say that he is raising the issue. That relieves you of the necessity to cross-petition.

MR. JONES: I think, analytically, there are two separate questions. The first is whether the issue is properly before the Court; and the second separable question is the -- is whether this Court can modify the judgment of the court below in favor of the respondent.

And as to the first question, I think it's clear that this issue is before the Court.

As to the second question, I'm less clear, in the circumstances of this case, whether we really are entitled to modification of the judgment --

QUESTION: And you're suggesting that surely we're not required by the failure of the government to cross-

petition to affirm the -- what we think is an erroneous holding of the Court of Appeals? If we thought it was erroneous.

MR. JONES: That's correct.

QUESTION: Mr. Jones, to over-simplify, suppose you got a judgment for \$15,000 in the Court of Appeals, and the other side brought it up and you didn't cross-petition, would we be right in giving you 25,000?

MR. JONES: I'm sorry, what was the last question -- would we be right in --?

QUESTION: You got an affirmed judgment of \$15,000 for damages.

MR. JONES: I see, and --

QUESTION: And the other side appealed, and we say you should have gotten 25.

MR. JONES: Well then, we don't cross-appeal or cross-petition --

QUESTION: Right.

MR. JONES: -- but we present an argument which, if accepted, logically would entitle us to a judgment of \$25,000.

QUESTION: You'd get it -- we'd give it to you?

MR. JONES: No. And we have spelled out our position at greater length on this point.

QUESTION: Yeah, I know.

MR. JONES: In our reply brief in the Western

Addition case, which was filed last week.

QUESTION: Well, the fact is, if you look at the petition for certiorari in this question, Question 2 does embrace the question that you've raised.

MR. JONES: That's correct. And it was in reliance upon that that we acquiesced in this petition.

QUESTION: And we granted certiorari across the board.

MR. JONES: That's correct.

QUESTION: -- implicitly accepting the proposition that these questions were raised.

MR. JONES: And for that reason we believe that this case really doesn't even present the issue that we discuss in our reply brief in Western Addition. Because we think that this issue is before the Court and can be adjudicated in our favor, and the judgment modified -- the judgment below modified.

QUESTION: The two basic questions are, Are these wage claim dividends subject to -- does the trustee have the duty to withhold at all? And, secondly, if he does, what priority, if any, do they fall into?

MR. JONES: That's correct.

QUESTION: Would you expand for me the government's theory as to why they should be first priority?

MR. JONES: Yes, Mr. Justice Blackmun, I would be delighted to do that.

As I've already indicated --

QUESTION: As contrasted with the Second Circuit's conclusion that they would derive from wages and therefore would belong in the second priority.

MR. JONES: That's right.

Well, in the first place, this is, as I've already indicated, an expense that's incurred by the estate in the course of administration. And it seems clear to us that such expenses are administrative expenses, entitled to first priority.

QUESTION: Now, why is that? What is the estate for it, as contrasted, say, with the trustee's fees or something of this kind?

MR. JONES: Well, these are very much like the expenses of hiring secretaries to mail out the wage distributions, the estate really doesn't get anything for it, it's just an obligation that it incurs in the course of the administration.

QUESTION: Well, I'll buy the obligation part, but I wonder why it is a cost of administration.

MR. JONES: Why, if it's an obligation and it's incurred, I'm not sure why it wouldn't be cost.

QUESTION: I think the first priority originated in the Eighth Circuit Fogarty case, did it not?

MR. JONES: That's correct.

QUESTION: And I look at this, this was a tag-end issue, because there were other primary issues there, such as the validity of --

MR. JONES: That's right. The court, of course, did not devote much time to this issue.

QUESTION: -- the tax, and all that I see that Judge Woodruff said is that the taxes should be allowed and classified as an expense of administration having priority; they were not payable at the time the petition was filed by the bankrupt and only accrued as and when paid. That is, on the actual payment of 25 percent of the wage claims during the administration of the estate, pursuant to the orders of the bankruptcy court.

Well, I don't find much reasoning in that. It merely says that it was paid pursuant to an order of the Court, therefore it's a cost of administration.

MR. JONES: Well, we're not relying necessarily upon the reasoning as set forth in the Fogarty opinion.

QUESTION: I would just like to know what reasoning, then, you are relying on?

MR. JONES: Well, I'm not sure exactly what your question is, Mr. Justice Blackmun. You're distinguishing between cost and taxes, it seems to me, and it's clear that the taxes incurred in the course of administration are first priority items, whether or not they are of any substantial

value to the estate.

I would quote, with regard to that, from Collier on Bankruptcy, paragraph 62.14[3], and I quote:

"To the extent to which a receiver or trustee is under a duty to pay taxes, his expenses or tax liabilities are to be classified as necessary to the cost of operation, preservation, or administration, and within the first priority."

In other words, these are items, expense items, taxes, however you describe them, they are obligations that are incurred in the course of administration.

QUESTION: Is that Collier speaking, or are there some cases to support it?

MR. JONES: That's Collier speaking. There are many cases to support it. He addresses -- he's there addressing the question of whether administration expenses have to be preservation costs, and he points out that clearly they do not, that what you're concerned about in the first priority administration expenses are the broad category of expenditures that are made by the trustee without regard to whether they may be directly related to the preservation or development of the estate.

QUESTION: That statement is also directed at taxes which accrue during the administration, --

MR. JONES: Like this tax.

QUESTION: Well, yes, but this tax happens to be related to wages earned before bankruptcy.

MR. JONES: Well, if the taxes --

QUESTION: And, arguably, these taxes or these withholdings ought to be treated like real property taxes that were due and owing at the time of bankruptcy.

MR. JONES: No, Mr. Justice White, they can't be treated in that way, because they were not legally due and owing before bankruptcy.

QUESTION: Yes, I understand that.

MR. JONES: And they were not legally due and owing by the bankrupt, --

QUESTION: That's right.

MR. JONES: -- otherwise after bankruptcy, and they are due and owing by the estate. You can't fit that into the fourth priority.

QUESTION: Well, I didn't say I would fit it into the fourth priority. I just said I wouldn't put it in the administration expenses.

MR. JONES: Well --.

QUESTION: And I was also saying that the bankrupt -- that Collier was directed to taxes incurred in the operation of the business.

MR. JONES: Oh, no, he was speaking more generally --

QUESTION: And the receiver.

MR. JONES: He was speaking more generally of taxes.

QUESTION: Well, and there weren't a lot of cases holding it then, to support that statement.

MR. JONES: Well, of course, this Court had the --

QUESTION: If there were, then we probably wouldn't be here.

MR. JONES: That's correct.

QUESTION: Yes.

MR. JONES: My time has expired, and I turn over the remaining appellees' time to Mr. Warms.

MR. CHIEF JUSTICE BURGER: Mr. Warms.

ORAL ARGUMENT OF SAMUEL J. WARMS, ESQ.,

ON BEHALF OF RESPONDENT, THE CITY OF NEW YORK

MR. WARMS: Mr. Chief Justice, and may it please the Court:

I shall confine my argument to the priorities question, and support the holding of the court below, which held that the withholding tax claims in question were wage claims.

Now, while the United States Government's argument suits our book as well, we would fare just as well, the distribution would be precisely that which was ordered by the court below, we feel that the court's position, which was our position there and is our position here, is the more logical

and it also better answers the arguments of the trustee against any priority status.

QUESTION: In some other case would it make a difference whether it was administration expense or second class?

MR. WARMS: I can conceive none under the way we rationalize --

QUESTION: Well, the government must have some reason for making this argument.

MR. WARMS: I beg pardon?

QUESTION: I should have asked the government this question. They must have some reason to be making the argument.

MR. WARMS: Yes, they do, Mr. Justice White, and they do because they are afraid that in a case where, after the payment of administration expenses other than these, --

QUESTION: Yes.

MR. WARMS: -- there will not -- where there's not enough left to --

QUESTION: There wouldn't be enough to pay wage claims.

MR. WARMS: -- pay in full, that there will be a diminution in the amount of tax claims.

Now, they set that forth in a very complicated example on page 40 and page 41 of their brief.

QUESTION: So wherever there's not enough assets to pay the wage claims, they would suffer, too, if the Court of Appeals had --

MR. WARMS: I don't believe so, Your Honor.

QUESTION: Well, that's what their claim is.

MR. WARMS: That's their claim, but I've analyzed the argument and I've analyzed the example.

What they say is this, if in a State where there is \$40,000 worth of wage claims, there are only \$20,000 to pay them, they would be paid in this way.

QUESTION: Yes. Well, let me -- you would say that as far as you can see it doesn't make that much difference to the State, or to the city?

MR. WARMS: I would say it doesn't make any difference, because in such a case the residue would be paid, if we assume 25 percent as the rate, 75 percent to the wage earner and 25 percent, on his behalf, to the government; not half of 25 percent, as they argue in their brief.

QUESTION: I see.

QUESTION: But, nonetheless, it's 25 percent of a smaller amount than the total wages claimed, isn't it?

MR. WARMS: Well, that would be true in any case, Your Honor.

QUESTION: In other words, you tax only what is paid out.

MR. WARMS: That's correct, sir. The withholding is based on the actual gross amount of the wage distribution.

QUESTION: But so far as net receipts to the treasury is concerned, if you pay \$100,000 on \$100,000 wage claim and subtract 25 percent for tax, the government is getting more money than it would if you pay \$50,000 on \$100,000 wage claim and paid twelve-five to the government.

MR. WARMS: That's absolutely correct, Mr. Justice Rehnquist. Because the wage claimants are getting half, the wage claimants are getting less than the \$50,000.

QUESTION: Well, in his last example, the only thing that would be administration expense would be 25 percent of \$50,000.

MR. WARMS: That is correct, Your Honor.

QUESTION: And so it wouldn't -- and you say that wouldn't make -- so it wouldn't make any difference.

MR. WARMS: It wouldn't make the slightest bit of difference.

You see, the government's example indicates that that 25 percent of the \$50,000 would be cut in half, because it's a 50 percent dividend. It wouldn't be, it would be calculated on the amount of each wage paid.

Now, another reason why we prefer our argument is that it avoids the trustee's argument that an administration expense must be in preservation of the estate or in connection

with the acquisition of assets. We don't have to argue against that in presenting it as a second wage -- a second priority wage claim.

Now, I'd like to advert to some of Mr. Justice Blackmun's questioning concerning the Fogarty case, because that was the leading case, and that was the case from which sprung this notion of administration expense priority.

Actually, I'm not sure that the Fogarty case wasn't correct. Because, in the Fogarty case, there was no withholding, as far as we can see. I believe the wage distributions were made without any withholding of tax. And that the taxes were actually satisfied by offsetting them against the claim which the bankrupt had against the government for some ships it had built.

Now, that means, probably, that they were rightly decided to be administration expenses, because they weren't carved out of the wages. The wages went 100 percent to the wage claimants. The other came out of the estate.

And so, although the case was followed in Lines v. California and in the Curtis case in the Ninth and Sixth Circuits, which both held that administration expense status was accorded these claims, I think we should bear in mind that Fogarty, which was the father of all of these cases, is perhaps reconcilable with our view in this case.

Now, we say that the wage claim status depends on

this. Withholding taxes are derived from and carved out of the actual wages paid to an employee and the wage distribution paid to a wage claimant.

?

There is if there were an inevisam assignment by the wage claimant to the governments involved, of that part of his wages which might reasonably be assumed to cover his taxes. The minute these taxes are withheld he gets a credit on the books of the governments for these withholdings.

If he in other respects has satisfied his tax indebtedness, if, for example, he's made estimates, he'll get those withholdings back in the form of a refund; so he will ultimately realize, in that case, what are essentially his wages. He's required to include them in his gross income, in his income tax return, and this shows, too, that the amount of the withholding is part of his salary and therefore are wages.

QUESTION: Mr. Warms, this second priority theory, which I think emerged for the first time in this case in the Second Circuit, was this your argument below or did the court pick it up on its own theorizing or --

MR. WARMS: I'm sorry to say that it was my argument. I say that because it makes me appear to be very vain to try to support it in the case where I need not necessarily do so.

But it was, indeed, my argument, and the court was

very kind in flattering me about it.

Part of that argument also was that if proper segregation were made of these funds, they would also enjoy a trust fund status within the second -- within the range of the second priority.

Now, I've spoken about what I consider to be the unfounded fears of the federal government in the event that second priority status is accorded to these wage claims.

Finally, I think I should point out that there is an anomaly in computing them, if they're to be considered administration expenses, because administration expenses have to be computed before you can determine how much money is left in an estate to pay wage claims.

And it's only after you've determined how many -- how much you will have left for wage claims that you can compute the taxes on them.

QUESTION: Mr. Warms, have you ever studied calculus or differential equations?

MR. WARMS: No, Your Honor, I haven't, and I was wondering whether this was a case of a multiple variable -- I've heard that term.

QUESTION: Well, it just seems to me here you have two dependent variables with one constant, which you've forgotten, to wit, the amount of money.

MR. WARMS: That's correct.

QUESTION: And I think it's a routine problem in either differential equations or calculus, integral calculus, if you wish; so I don't go along with this argument, I'll be frank to say, that it is capable of solution, I'm sure.

MR. WARMS: Oh, just as the problem of the employer who pays the income tax on the employee's income is capable of solution.

QUESTION: Sure.

MR. WARMS: In a similar manner, I think.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you very much.

You have a few minutes left, do you have anything further?

MR. KARASIK: If there are no further questions, I will waive my time.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.
The case is submitted.

[Whereupon, at 1:39 p.m., the case in the above-entitled matter was submitted.]

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