DISCHARGE OF TAXES IN BANKRUPTCY

1637-6

HEARING

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

EIGHTY-NINTH CONGRESS

FIRST SESSION

ON

S. 976 (H.R. 3438)

TO AMEND THE BANKRUPTCY ACT WITH RESPECT TO LIMITING THE PRIORITY AND NONDISCHARGEABILITY OF TAXES IN BANKRUPTCY

S. 1912 (H.R. 136)

TO AMEND SECTIONS 1, 17a, 57j, 64a(5), 67b, 67c, AND 70c OF THE BANKRUPTCY ACT, AND FOR OTHER PURPOSES

THURSDAY, AUGUST 5, 1965

Printed for the use of the Committee on Finance

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DISCHARGE OF TAXES IN BANKRUPTCY

THURSDAY, AUGUST 5, 1965

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:15 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Long, Talmadge, Williams, Carlson, and Curtis.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The hearing will come to order.

This hearing is on two bankruptcy bills which have been reported favorably by the Committee on the Judiciary of the Senate. They are comparable to bills which have passed the House of Representatives. Each of these bills contain provisions which affect the Federal income tax laws and collections. For that reason the Finance Committee is considering the tax implications of these bills. Similar bills have been referred to this committee in past Congresses after having passed the House and considered favorably by the Judiciary Committee of the Senate. In each instance, however, the bills have come to us too late to act on before adjournment. An executive session of the committee is set for tomorrow to consider these bills after the hearing is concluded.

(The bills referred to follow:)

[S. 976, 89th Cong., 1st sess.]

A BILL To amend the Bankruptcy Act with respect to limiting the priority and nondischargeability of taxes in bankruptcy

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subdivision (a) of section 2 of the Bankruptcy Act, as amended (11 U.S.C. 11), is amended by inserting after paragraph (2) the following new paragraph:

"(2A) Hear and determine, or cause to be heard and determined, any question arising as to the amount or legality of any unpaid tax, whether or not previously assessed, which has not prior to bankruptcy been contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction, and in respect to any tax, whether or not paid, when any such question has been contested and adjudicated by a judicial or administrative tribunal of competent jurisdiction and the time for appeal or review has not expired, to authorize the receiver or the trustee to prosecute such appeal or review;".

SEC. 2. Clause (1) of subdivision a of section 17 of such Act, as amended (11 U.S.C. 35), is amended to read as follows:

"(1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: *Provided, however*, That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law,

(b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law, (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, ~~or~~ (d) with respect to which the bankrupt made a false or fraudulent return, or willfully attempted in any manner to evade or defeat; *or* (*e*) *which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over;* but a discharge shall not be a bar to any remedies available under applicable law to the United States or to any State or any subdivision thereof, against the exemption of the bankrupt allowed by law and duly set apart to him under this Act: *And provided further*, That a discharge in bankruptcy shall not release or affect any tax lien."

SEC. 3. Clause (4) of subdivision a of section 64 of such Act, as amended (11 U.S.C. 104), is amended to read as follows:

"(4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however*, That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further*, That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court;".

SEC. 4. If any provision of this Act, or any amendment made by it, or the application thereof to any person or circumstance is held invalid, such invalidity shall not affect other provisions of this Act, or other amendments made by it, or applications thereof which can be given effect without the invalid provision or application.

SEC. 5. (a) Nothing in this Act, or in the amendments made by it, shall operate to release or extinguish any penalty, forfeiture, or liability incurred under the Bankruptcy Act before the effective date of this Act.

(b) The amendments made by this Act shall govern proceedings so far as applicable in cases pending when it takes effect.

SEC. 6. This Act shall take effect on the ninetieth day after the date of its enactment.

[H.R. 3438, 89th Cong., 1st sess.]

AN ACT To amend the Bankruptcy Act with respect to limiting the priority and nondischargeability of taxes in bankruptcy

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subdivision (a) of section 2 of the Bankruptcy Act, as amended (11 U.S.C. 11), is amended by inserting after paragraph (2) the following new paragraph:

"(2A) Hear and determine, or cause to be heard and determined, any question arising as to the amount or legality of any unpaid tax, whether or not previously assessed, which has not prior to bankruptcy been contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction, and in respect to any tax, whether or not paid, when any such question has been contested and adjudicated by a judicial or administrative tribunal of competent jurisdiction and the time for appeal or review has not expired, to authorize the receiver or the trustee to prosecute such appeal or review;".

SEC. 2. Clause (1) of subdivision a of section 17 of such Act, as amended (11 U.S.C. 35), is amended to read as follows:

"(1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: *Provided, however*, That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law, (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law, (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, (d) with respect to which the bankrupt made

a false or fradulent return, or willfully attempted in any manner to evade or defeat, or (e) which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over; but a discharge shall not be a bar to any remedies available under applicable law to the United States or to any State or any subdivision thereof, against the exemption of the bankrupt allowed by law and duly set apart to him under this Act: *And provided further*, That a discharge in bankruptcy shall not release or affect any tax lien."

SEC. 3. Clause (4) of subdivision a of section 64 of such Act, as amended (11 U.S.C. 104), is amended to read as follows:

"(4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however*, That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further*, That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court;".

SEC. 4. If any provision of this Act, or any amendment made by it, or the application thereof to any person or circumstance is held invalid, such invalidity shall not affect other provisions of this Act, or other amendments made by it or applications thereof which can be given effect without the invalid provision or application.

SEC. 5. (a) Nothing in this Act, or in the amendments made by it, shall operate to release or extinguish any penalty, forfeiture, or liability incurred under the Bankruptcy Act before the effective date of this Act.

(b) The amendments made by this Act shall govern proceedings so far as applicable in cases pending when it takes effect.

SEC. 6. This Act shall take effect on the ninetieth day after the date of its enactment.

Passed the House of Representatives August 2, 1965.

Attest:

RALPH R. ROBERTS,
Clerk.

[S. 1912, 89th Cong., 1st sess.]

A BILL To amend sections 1, 17a, 57j, 64a(5), 67(b), 67c, and 70c of the Bankruptcy Act, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 1 (11 U.S.C. 1) of the Bankruptcy Act approved July 1, 1898, as amended, is amended by inserting after paragraph 29 the following new paragraph:

"(29a) 'Statutory lien' shall mean a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute and whether or not the agreement or lien is made fully effective by statute."

SEC. 2. Clause (1) of subsection a of section 17 of said Act (11 U.S.C. 35) is amended to read as follows:

"(1) are due as a tax, penalty, or forfeiture to the United States, or any State, county, district, or municipality;"

SEC. 3. Clause (5) of subsection a of section 64 of said Act (11 U.S.C. 104(a)) is amended to read as follows:

"(5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision c of section 67 of this Act: *Provided, however*, That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy."

SEC. 4. Subsection b of section 67 of said Act (11 U.S.C. 107(b)) is amended to read as follows:

"b. The provisions of section 60 of this Act to the contrary notwithstanding and except as otherwise provided in subdivision c of this section, statutory liens

in favor of employees, contractors, mechanics, or any other class of persons, and statutory liens for taxes and debts owing to the United States or to any State or any subdivision thereof, created or recognized by the laws of the United States or any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this Act by or against him."

SEC. 5. Subsection c of section 67 of said Act (11 U.S.C. 107 (c)) is amended to read as follows:

"c. (1) The following liens shall be invalid against the trustee:

"(A) every statutory lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor;

"(B) every statutory lien which is not perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide purchaser from the debtor on that date, whether or not such purchaser exists: *Provided*, That where a statutory lien is not invalid at the date of bankruptcy against the trustee under subdivision c of section 70 of this Act and is required by applicable lien law to be perfected in order to be valid against a subsequent bona fide purchaser, such a lien may nevertheless be valid under this subdivision if perfected within the time permitted by and in accordance with the requirements of such law: *And provided further*, That if applicable lien law requires a lien valid against the trustee under section 70, subdivision c, to be perfected by the seizure of property, it shall instead be perfected as permitted by this subdivision c of section 67 by filing notice thereof with the court;

"(C) every statutory lien for rent and every lien of distress for rent, whether statutory or not. A right of distress for rent which creates a security interest in property shall be deemed a lien for the purposes of this subdivision c.

"(2) The court may, on due notice, order any of the aforesaid liens invalidated against the trustee to be preserved for the benefit of the estate and in that event the lien shall pass to the trustee. A lien not preserved for the benefit of the estate but invalidated against the trustee shall be invalid as against all liens indefeasible in bankruptcy, so as to have the effect of promoting liens indefeasible in bankruptcy which would otherwise be subordinate to such invalidated lien. Claims for wages, taxes, and rent secured by liens hereby invalidated or preserved shall be respectively allowable with priority and restricted as are debts therefor entitled to priority under clauses (2), (4), and (5) of subdivision a of section 64 of this Act, even though not otherwise granted priority.

"(3) Every tax lien on personal property not accompanied by possession shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. Where such a tax lien is prior in right to liens indefeasible in bankruptcy, the court shall order payment from the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual cost of that sale, of an amount not in excess of the tax lien, to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. If the amount realized from the sale exceeds the total of such debts, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act and the amount of the tax lien, is to be paid to the holder of the tax lien.

"(4) Where a penalty not allowable under subdivision j of section 57 is secured by a lien, the portion of the lien securing such penalty shall not be eligible for preservation under this subdivision c.

"(5) This subdivision c shall not apply to liens enforced by sale before the filing of the petition, nor to liens against property set aside to the bankrupt as exempt, nor to liens against property abandoned by the trustee or unadministered in bankruptcy for any reason and shall not apply in proceedings under section 77 of this Act, nor in proceedings under chapter X of this Act unless an order has been entered directing that bankruptcy be proceeded with."

SEC. 6. Subsection c of section 70 of said Act (11 U.S.C. 110(c)) is amended to read as follows:

"c. The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the

bankrupt after bankruptcy shall not bind the trustee. The trustee shall have as of the date of bankruptcy the rights and powers of: (1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained an execution returned unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceeding upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists. If a transfer is valid in part against cerditors whose rights and powers are conferred upon the trustee under this subdivision, it shall be valid to a like extent against the trustee. In cases where repugnancy or inconsistency exists with reference to the rights and powers in this subdivision conferred, the trustee may elect which rights and powers to exercise with reference to a particular party, a particular remedy, or a particular transaction, without prejudice to his right to maintain a different position with reference to a different party, a different remedy, or a different transaction."

[H.R. 136, 89th Cong., 1st sess.]

AN ACT To amend sections 1, 17a, 64a(5), 67(b), 67c, and 70c of the Bankruptcy Act, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 1 (11 U.S.C. 1) of the Bankruptcy Act approved July 1, 1898, as amended, is amended by inserting after paragraph 29 the following new paragraph:

"(29a) 'Statutory lien' shall mean a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute and whether or not the agreement or lien is made fully effective by statute."

SEC. 2. Clause (1) of subsection a of section 17 of said Act (11 U.S.C. 35) is amended to read as follows:

"(1) are due as a tax, penalty, or forfeiture to the United States, or any State, county, district, or municipality;"

SEC. 3. Clause (5) of subsection a of section 64 of said Act (11 U.S.C. 104(a)) is amended to read as follows:

"(5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision c of section 67 of this Act: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy."

SEC. 4. Subsection b of section 67 of said Act (11 U.S.C. 107(b)), is amended to read as follows:

"b. The provisions of section 60 of this Act to the contrary notwithstanding and except as otherwise provided in subdivision c of this section, statutory liens in favor of employees, contractors, mechanics, or any other class of persons, and statutory liens for taxes and debts owing to the United States or to any State or any subdivision thereof, created or recognized by the laws of the United States or any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this Act by or against him."

SEC. 5. Subsection c of section 67 of said Act (11 U.S.C. 107(c)) is amended to read as follows:

"c. (1) The following liens shall be invalid against the trustee:

"(A) every statutory lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor;

"(B) every statutory lien which is not perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide purchaser from the debtor on that date, whether or not such purchaser exists: *Provided,*

That where a statutory lien is not invalid at the date of bankruptcy against the trustee under subdivision c of section 70 of this Act and is required by applicable lien law to be perfected in order to be valid against a subsequent bona fide purchaser, such a lien may nevertheless be valid under this subdivision if perfected within the time permitted by and in accordance with the requirements of such law: *And provided further*, That if applicable lien law requires a lien valid against the trustee under section 70, subdivision c, to be perfected by the seizure of property, it shall instead be perfected as permitted by this subdivision c of section 67 by filing notice thereof with the court;

"(C) every statutory lien for rent and every lien of distress for rent, whether statutory or not. A right of distress for rent which creates a security interest in property shall be deemed a lien for the purposes of this subdivision c.

"(2) The court may, on due notice, order any of the aforesaid liens invalidated against the trustee to be preserved for the benefit of the estate and in that event the lien shall pass to the trustee. A lien not preserved for the benefit of the estate but invalidated against the trustee shall be invalid as against all liens indefeasible in bankruptcy, so as to have the effect of promoting liens indefeasible in bankruptcy which would otherwise be subordinate to such invalidated lien. Claims for wages, taxes, and rent secured by liens hereby invalidated or preserved shall be respectively allowable with priority and restricted as are debts therefor entitled to priority under clauses (2), (4), and (5) of subdivision a of section 64 of this Act, even though not otherwise granted priority.

"(3) Every tax lien on personal property not accompanied by possession shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. Where such a tax lien is prior in right to liens indefeasible in bankruptcy, the court shall order payment from the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual cost of that sale, of an amount not in excess of the tax lien, to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. If the amount realized from the sale exceeds the total of such debts, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act and the amount of the tax lien, is to be paid to the holder of the tax lien.

"(4) Where a penalty not allowable under subdivision j of section 57 is secured by a lien, the portion of the lien securing such penalty shall not be eligible for preservation under this subdivision c.

"(5) This subdivision c shall not apply to liens enforced by sale before the filing of the petition, nor to liens against property set aside to the bankrupt as exempt, nor to liens against property abandoned by the trustee or unadministered in bankruptcy for any reason and shall not apply in proceedings under section 77 of this Act, nor in proceedings under chapter X of this Act unless an order has been entered directing that bankruptcy be proceeded with."

SEC. 6. Subsection c of section 70 of said Act (11 U.S.C. 110(c)) is amended to read as follows:

"c. The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee shall have as of the date of bankruptcy the rights and powers of: (1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained an execution returned unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists. If a transfer is valid in part against creditors whose rights and powers are conferred upon the trustee under this subdivision, it shall be valid to a like extent against the trustee. In cases where repugnancy or inconsistency exists with reference to the rights and powers in this subdivision conferred, the trustee may elect which rights and powers to exercise with reference to a par-

ticular party, a particular remedy, or a particular transaction, without prejudice to his right to maintain a different position with reference to a different party, a different remedy, or a different transaction."

Passed the House of Representatives August 2, 1965.

Attest: RALPH R. ROBERTS, *Clerk.*

The CHAIRMAN. With the consent of the distinguished Senator from North Carolina, Senator Ervin, Mr. Lawrence Stone will be the first witness.

STATEMENT OF LAWRENCE M. STONE, TAX LEGISLATIVE COUNSEL, TREASURY DEPARTMENT

Mr. STONE. My name is Lawrence M. Stone. I am the tax legislative counsel of the Treasury Department.

Mr. Chairman and members of the committee, the Treasury Department appreciates this opportunity to appear before your committee to state its views on H.R. 3438 (identical to S. 976) and H.R. 136 (identical to S. 1912), at a public hearing.

The first of these bills attempts to prescribe new limitations upon the collection of Federal tax liabilities in and after bankruptcy proceedings. The second contains provisions designed to compel early filing of public notice by the Commissioner of Federal tax liens. The Treasury Department has opposed both bills vigorously in previous Congresses. The Department is of the view that their adoption could occasion serious disruption of the present balanced procedures for the orderly settlement, adjudication, and disposition of tax disputes. Both of the bills, also, contain serious technical deficiencies; both contain provisions giving rise to considerable interpretive difficulties; and both appear very likely to lead to substantial controversy and litigation as to their meaning.

Mr. Chairman, at the outset, I would like to make clear that the Treasury's position on these bills is not one of blind and complete opposition. The Department recognizes with considerable sympathy the problems with which these bills are concerned. It has stood ready—and now stands ready—to explore at any time with interested parties legislative or administrative measures to alleviate these problems. However, any such solution would have to take into account and balance the various competing interests involved—those of taxpayers generally, those of creditors, and those of the general public in insuring adequate collection of tax revenues. The Department is confident I might say that satisfactory legislative or administrative solutions can be developed to accommodate these competing interests. Neither of the present bills, however, unfortunately represent such a solution.

Let me turn to the first bill, H.R. 136, which is the same as Senate bill 1912.

H.R. 136 concerns the problem of whether or not the tax claims of the Government should, in bankruptcy proceedings, be treated the same as the claims of secured creditors.

The Internal Revenue Code now subjects all of a taxpayer's assets to a lien for assessed and unpaid taxes. This security interest of the United States is not valid against mortgagees, pledgees, purchasers, or judgment creditors whose rights arise prior to the filing by the

United States of public notice of the Government lien. The present bill would not alter that situation in any way.

Except against these four classes of preferred creditors, the tax lien becomes fully effective immediately upon assessment. Hence, with respect to all other categories of creditors, the Government is entitled to the status of a secured claimant. The Government's position is that this status applies equally against a trustee in bankruptcy. The Government's view on this matter has been sustained by the U.S. Courts of Appeals for the Second, Third, and Ninth Circuits. However, the Court of Appeals for the Sixth Circuit has recently reached a contrary result. *In Re Kurtz Roofing Co.*, 64–2 U.S.T.C. 9678 (6th Cir. 1964), certiorari granted January 18, 1965. The sixth circuit decision is presently awaiting review by the Supreme Court of the United States and has been set for argument early in the fall term.

H.R. 136 deals with precisely the question facing the Supreme Court in this case. The bill would reverse the rule established by the second, third, and ninth circuits: it would subordinate to the claim of the trustee in bankruptcy, all U.S. tax liens which have not been filed publicly prior to the initiation of bankruptcy proceedings. This rule could reduce significantly or in fact eliminate entirely the Government's recovery from the assets of a bankrupt taxpayer. As a practical consequence adoption of the rule would necessitate rapid, broad, and undiscriminating use of the public filing procedure by the Internal Revenue Service. To illustrate, in 1964 the Service had roughly 3,065,000 new delinquent tax accounts. In only 239,000 cases did the Service actually file a public notice of the tax lien. Plainly, the rule provided by the proposed bill would compel a very substantial increase in the number of such public filings.

The Treasury Department believes that such a result, namely, an increase in the number of public filings of tax liens, would be most unfortunate. The filing of a tax lien frequently has exceedingly serious financial consequences for a taxpayer. It can destroy a taxpayer's credit standing in the community; it can make the conduct of his business affairs impossible; and it can thereby precipitate his financial ruin. All of this may occur where the taxpayer would have been able to continue his business, pay off his liabilities, and rehabilitate his financial situation if the public notice of the lien had not been filed. Recognizing the devastating effect which a sudden and severe restriction of credit can have upon a business, the Internal Revenue Service has continually used its lien filing powers with appropriate restraint. We believe that Congress intended that this power be exercised with judgment and prudence. If not, Congress could have required automatic filing for every delinquent tax account. The proposed bill would compel indirectly precisely the result which Congress has not provided directly. This fundamental objection to the bill overshadows all of the numerous technical defects which we have repeatedly pointed out in our reports of past years to the Judiciary Committees of both Houses of Congress.

I would like to turn to the second bill that is before the committee, H.R. 3438, which is the same as S. 976.

Under present law, the treatment of U.S. tax in bankruptcy proceedings does not depend upon the year to which the tax relates. Like-

wise, under present law unsatisfied tax liabilities survive bankruptcy without regard to the year to which they relate.

The intent of H.R. 3438 would appear to be to alter both of these results. For both purposes, the bill would establish a distinction between tax claims relating to the 3 years preceding bankruptcy and those relating to prior years. It would permit preferred treatment to continue only for liabilities of the 3 most recent years. That is the apparent intent of the authors of the bill.

The present form of the bill, however, contains a variety of defects which make its interpretation difficult and its operation highly uncertain. We have met twice recently with representatives of the National Bankruptcy Conference which, I believe, is the principal sponsor of the bill. On both occasions, different members of the conference have presented to me and my staff different—and conflicting—interpretations of key provisions of the bill. Some of these interpretations differ substantially from the constructions which the Department of Justice and the Treasury Department have long placed on the bill. I do not intend these remarks in any way to be critical of the members of the National Bankruptcy Conference or anyone else who may have prepared the bill. The confusion arises, and it is confusion, because of the extreme difficulty of correlating two highly complex and intricate areas of the law—the Bankruptcy Act and the Internal Revenue Code.

Whatever the source, however, the defects of the bill are extremely critical. It is, for example, not clear whether the crucial 3-year period is to be measured from the due date of the tax return or the date of assessment of the tax. The difference here could be any number of years. It is, again, not clear whether the bill applies to unassessed tax liabilities, regardless of the year to which they relate. Conversely, it is not clear whether the bill applies to any tax claims which have been assessed. It is also not clear what effect—if any—the bill has on tax liens not satisfied in the bankruptcy proceeding. In short, Mr. Chairman, it is our sincere belief, it is far from clear whether the bill has any effect whatsoever.

This is not to say that the Treasury Department is unsympathetic to the bill's objectives. On the contrary, the Department believes that the problems with which the bill is concerned warrant active examination. Because of that belief, as I have said, we stand ready to work with the National Bankruptcy Conference, the American Bar Association, other interested groups, and the staff of the Joint Committee on Internal Revenue Taxation, to explore these problems and to attempt to develop solutions for them.

The willingness of the Treasury Department to appraise and adjust the Government's tax priorities and collection machinery has been amply demonstrated by the part which the Treasury Department has played in the preparation of the Federal tax lien bill (H.R. 12545, 88th Cong.).

That bill, introduced in the last Congress by both Chairman Mills and Congressman Byrnes of the Committee on Ways and Means of the House of Representatives resulted from a joint and cooperative effort on the part of the American Bar Association's Special Committee on Federal Liens and the staffs of the Treasury Department, the Internal Revenue Service, and the Joint Committee on Internal Revenue Taxa-

tion. The bill significantly modernizes the law of tax liens, accommodating its provisions to the needs of the present-day business world. We would expect that a similar cooperative effort could likewise result in appropriate and fruitful solutions of the problems with which the proposed bills are concerned.

The views of the Treasury Department and the Department of Justice that the proposed bills should not be enacted in their present form are shared by the chairmen of two committees of the American Bar Association concerned with this area, Mr. Laurens Williams, chairman of the association's special committee on Federal liens and Mr. John E. Scheifly, chairman of the committee on Federal tax liens and collection proceedings of the section on taxation. They have not had time to contact their committees so these are their individual views.

I have here copies of letters which I have received from both of these gentlemen which I could make available to the committee, and which I will now give to the clerk.

Senator CURTIS. Mr. Stone, is your letter a copy of the letter Mr. Williams wrote to me?

Mr. STONE. It is a copy of that letter.

Senator CURTIS. When my turn comes I expect to go into it.

Mr. STONE. I do have a letter in the form of a telegram——

Senator LONG. Why don't you put them in the record now and you can talk about them later.

Senator CURTIS. It does not matter, either way.

The CHAIRMAN. Without objection the material referred to will be inserted in the record at this point.

(The documents referred to follows:)

SUTHERLAND, ASBILL & BRENNAN,
Washington, D.C., August 4, 1965.

Re S. 976 and S. 1912.

Hon. CARL T. CURTIS,
U.S. Senator, New Senate Office Building, Washington, D.C.

DEAR SENATOR CURTIS: I know of your longstanding interest in Federal tax liens and their impact on the business community. Similarly, you know of my long-continued efforts to help try to bring about amendments which would modernize the portions of the Internal Revenue Code dealing with Federal tax liens (and related procedural provisions). Therefore, I should express to you my deep concern about portions of the above bills.

Several facets of the bills disturb me. In the first place, it seems to me that they well may have a highly undesirable impact on present tax procedures, which might be quite adverse to many taxpayers. For example, situations frequently arise in which the filing of notice of a Federal tax lien would seriously impair a tax-debtor's ability to conduct his business operations. Under current law, district directors of Internal Revenue typically agree to a reasonable program of installment payments of a tax debt, without filing notice of the Federal tax lien. How this jeopardizes other creditors is difficutl to see: they have full opportunity, before extending credit, to obtain financial statements showing the tax liability (and if the tax-debtor gives a false financial statement, his discharge in bankruptcy would be denied). In contradistinction, if these bills are enacted in their present form, it seems to me that district directors of Internal Revenue would have little choice but to file notice of a tax lien in such situations.

In the second place, the bills do not seem to me to have been correlated with tax procedures. For example, examine section 2 of S. 976. This amendment would except from discharge in bankruptcy "taxes which became legally due and owing * * * within three years preceding bankruptcy." I take it that in the usual income, estate, or gift tax matter, the date on which a tax becomes "legally due and owing" is the due date of the return. Any tax disclosed by the return

is, of course, immediately assessed. However, a deficiency in reported tax liability typically is not assessed until several years later, often more than 3 years later. Thus, under the bill, a deficiency in tax which, because the taxpayer has been pursuing his administrative or judicial remedies, is not assessed until more than 3 years after the original due date of the tax, would be discharged in a bankruptcy proceeding commenced the following day—before the district director had any opportunity to file notice of the Federal tax lien. Indeed, as I read it, this section would mean that if a deficiency on a tax return due more than 3 years before bankruptcy will be discharged if it is assessed the day before bankruptcy, whereas, if it is not assessed until the day after bankruptcy, it will not be discharged.

Moreover, I respectfully suggest that it is not appropriate to have the "3 years preceding bankruptcy" (or whatever time period is thought appropriate) run from the date the tax "became legally due and owing." Rather, I suggest, it should run from date of assessment. Indeed, as to deficiencies assessed more than 3 years after original due date, the committee might well find it possible to provide a shorter period than 3 years if it were thought wise to do so as a matter of tax policy.

In the very short time I have been able to give to an analysis of these bills, I have noted several other serious ambiguities, the impact of which are not at all clear to me, but perhaps what I have specifically said above will suffice for the present.

So far as I can determine, the hearing which your committee is to hold tomorrow morning will be the first public hearing held on these bills. The short time between announcement of the hearing and the date of the hearing has made it impossible for me to circulate copies of the bills and related data to the members of the Special Committee on Federal Liens of the American Bar Association, of which I am chairman, to obtain their views and comments. Accordingly, I want to make it perfectly clear that this letter is written entirely in my individual capacity, not as a communication from or of the American Bar Association.

However, it seems clear to me that the bills, as drafted, will cause serious changes in current administrative procedures and policies in the administration of our revenue rules, adverse to taxpayers—at least some of which, it seems to me, could be avoided by changes which would not significantly interfere with the major objectives of the sponsors of the bills. I therefore urge that, before taking final action on the bills, your committee refer them to Dr. Woodworth and his staff for complete analysis, to determine whether the portions of them which seem ambiguous and unclear in their import and application, and which seem so certain to hurt, rather than help, many delinquent taxpayers, can be revised in a manner which will accommodate both to the needs of delinquent taxpayers and the proper needs of the revenue.

Respectfully,

LAURENS WILLIAMS.

[Telegram]

LOS ANGELES, CALIF., *August 5, 1965.*

Re S. 976, S. 1912.

LAWRENCE M. STONE,
Tax Regional Counsel, U.S. Treasury Department, Main Treasury Building, Washington, D.C.

DEAR LARRY: I am writing you to express my deep concern over certain aspects included in the provisions of the above-numbered bills.

While the effect of the bills in the specific instances to which they were directed is clear, I believe they have serious (and unintended) consequences of a detrimental nature for the normal tax situation. For example, section 2 of S. 976 would seem to require the Government to at least issue a 90-day letter within 3 years after the due date of the tax even though the taxpayer was utilizing the administrative procedures provided or the resolution of tax controversies. One effect of this would seem to badly cripple the normal administrative process by throwing upon the machinery of the Tax Court cases which might appropriately be resolved at a lower level for which machinery is already provided. There are other examples, all of which bear further investigation.

During the forthcoming year I intend to ask the Committee on Collections and Limitations of the section of taxation of the American Bar Association (of

which I am the chairman) to study these proposals in depth so that we may be informed of their many ramifications. We will, of course, make our materials available to you on an informal basis. In the meantime, I do hope that action upon these measures will be delayed pending better information as to their implications.

Sincerely,

JOHN E. SCHEIFLY.

Mr. STONE. In conclusion, Mr. Chairman, the Treasury Department must strongly oppose the adoption of these two bills in their present form. On the other hand, at the risk of being redudant, I would like to reiterate that the Department is sympathetic to the aims of the propopents of these bills and is confident that appropriate resolutions of these problems can be achieved.

Thank you.

The CHAIRMAN. Any questions?

Senator WILLIAMS. Mr. Stone, do I understand that the Department feels there is an area here in which something should be done?

Mr. STONE. Yes, sir; that is correct.

Senator WILLIAMS. As I understand it these bills or similar bills have been before us for the last 3 to 4 years; have they not?

Mr. STONE. This is the first public hearing, I believe, on both of these bills.

Senator WILLIAMS. That is true, but the bills have been introduced some time ago.

Mr. STONE. The bills have been introduced and passed on several ocassions by the House, and reported out by the Senate Judiciary Committee. We have reported on them a number of times, but we have never been asked to work out solutions, to my knowledge.

Senator WILLIAMS. Well, the point I am raising is that if it is recognized that there is an area here which needs our attention, I am wondering what steps the Department has taken toward solving that problem. Do you have any suggestions as to how this bill could be improved to carry out the objectives that you think should be achieved but which you do not believe the bill accomplishes in its present form?

Mr. STONE. In the first place, Senator Williams, let me repeat that we have done a lot of work in the area of modernizing tax lien and collection procedures in connection with the Federal tax lien bill project on which two of my lawyers have worked for the last 3 years, and which we hope will be enacted.

As to these two bills here, we met with National Bankruptcy Conference in May; I spent a good deal of time with them. I explained our problems to them; I offered to work with them. I never heard from them again.

We have been willing to work on this thing. Now, if the committee would like, we would undertake the development of solutions to these problems.

Senator WILLIAMS. Well, under the existing law how far back can you go in claiming priority on a tax lien?

Mr. STONE. There is no limit so long as the claim is not barred by the statute of limitations on assessment or collections.

Senator WILLIAMS. You can go all the way back, no limit.

Do you not think that is unfair? I ask that question as one who has expressed quite an interest in your collecting other taxes. But

where this might run for an unlimited time are not those in private industry who are doing business with these people, without any possible knowledge that there are accrued tax liability or the possibility of tax liability, are they not placed at somewhat of a disadvantage?

Mr. STONE. Well, I think there is some room to cut off old tax liabilities at some point. Now, this bill does in a way which we, frankly, do not understand, and I hesitate at this time to indicate any proposed solution. But I am confident, having done enough thinking about it, that we could at some point cut off tax liabilities in such a way as to give some recognition to the problems of creditors without, at the same time, jeopardizing the normal tax procedures that are of benefit to taxpayers.

I am not really interested primarily in the collection of taxes here so much as I am in not cutting off the orderly tax procedures that we have worked out for adjudicating tax cases.

Senator WILLIAMS. Well, filing a tax lien certainly does restrict the available credit of the individual, and it does have its hardships. But that same thing is true when the banker files his mortgage, particularly if he files a chattel mortgage, is it not?

Mr. STONE. I do not think so. I think the Federal tax lien has quite a different effect.

Senator WILLIAMS. It does have a different effect. But nevertheless, as one who has been in business, we always regretted to see liens filed.

Mr. STONE. Senator, I can give you an example from personal experience. I have been in private practice myself for a number of years. On several occasions I have represented responsible taxpayers who found themselves in situations where they could not satify their full tax liabilities because of an adverse turn of the liquidity of their business.

I have negotiated with the Internal Revenue Service arrangements to pay off very substantial liabilities in a way that worked out satisfactorily to the taxpayers and to the Government and everybody concerned.

These businessmen were not ruined; no lien was filed. Because the Government had discretion, it had adequate time to look into the matter, to see whether it was necessary to file a lien agaist this man, and see whether it was necessary to take the chance of ruining him.

After looking into it, they decided that they could reasonably take a chance with him; they did take a chance, and I believe it is in the national interest that we continue to let people rehabilitate themselves if we can.

In all of these situations the Government was paid every penny. I think the Government acted very wisely. It could have put on its tax lien. It probably would have collected all or most of its money by selling the man's assets at liquidation value. But in this way nobody was harmed, and the matter was worked out very satisfactorily.

What we are objecting to is the necessity to file the lien without thinking. In other words, if we know that if we do not file that lien as soon as a $100,000 tax liability is assessed that the Government may lose rights, the Commissioner does not have the opportunity to ask for a balance sheet, to talk to the man and to investigate to see what his chances are. He has got to file that lien immediately.

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Senator ERVIN. Mr. Stone, if you will pardon me, you do not have to do anything the minute the tax lien is assessed. You have 3 years to file that lien.

Mr. STONE. That is not correct, Senator, I am sorry.

Senator ERVIN. Well, it is.

Senator WILLIAMS. Those are the points we would like to clean up.

Mr. STONE. It is not correct. If the tax is assessed on the morning of January 1, and that afternoon the man goes into bankruptcy, voluntary or involuntary, the Government's lien is invalid against the trustee in bankruptcy unless it has been filed, so it would have to be filed at the earliest possible moment. There is not 1 day's delay given to the Commissioner.

Senator WILLIAMS. That would be due to the fact that in some States these liens have to be filed a certain number of days prior to filing bankruptcy. But that would also be true with respect to liens that would be filed by the private individual, would it not? They would not take a prior position. If the bankruptcy took place prior to a stated——

Mr. STONE. I am sorry, I did not hear that.

Senator WILLIAMS. The conditions that you outlined, for instance, if you did not file your lien today and they were to go into bankruptcy tomorrow you would have no preferred position: that is also true as to a lien filed by a bank or any other creditor, is it not?

Mr. STONE. That is correct. A responsible creditor puts its mortgage on record knowing that if it does not put it on record it will lose its secured rights.

Senator WILLIAMS. I do not disagree with you entirely. I agree with the situation you described, and I think the Department is right in giving the man a chance when you think there is a chance. But bankers and private business people likewise give these creditors similar chances when they think it is better. Rather than filing a lien immediately they will give him a chance, and they withhold filing the lien.

Mr. STONE. Yes.

Senator WILLIAMS. But the creditor takes a chance, that they will lose a position when they give this man a chance. The point that disturbs me is should the Government be put in a prior position. I do not think the bill would preclude you from doing what you have just said.

Mr. STONE. Well, Senator, you place yourself in a position of an Internal Revenue Service tax collector somewhere out in a district. A matter comes across his desk, a bill that is 20 days old for $100,000 owed by Joe Jones. This tax collector knows that if Joe Jones goes bankrupt the next morning, the Government will lose its tax lien——

Senator WILLIAMS. Yes.

Mr. STONE (continuing). And he will be blamed. What does the collection official do under these circumstances? Does he negotiate carefully, investigate the affairs of Joe Jones or does he say, "I had better file that tax lien this afternoon." That is the problem.

Senator WILLIAMS. I recognize your problem, and I do not want to handicap you from collecting taxes. But the point that disturbs me——

Mr. STONE. Today he is not under that pressure.

Senator WILLIAMS. I have examined those cases. In some instances where the taxpayer is an outright crook and deliberately is trying to defraud the Government, and everybody else, I have found far too often that you failed to file the lien, and the man has transferred all of his assets. When you get around to filing, there is nothing you can do about it. I mentioned to one of your people in the Department the other day an incident that I think is taking place right now where that is going on, and still you do not file your lien. You sit back and let this individual transfer all of his assets and get them out of his name. If you were a little more diligent in those areas I think it would solve some of your problems. As you well know, those instances, those cases, have happened where you have carried on for years, and ultimately you have collected nothing or settled for just a fraction of the total liability. I certainly would not want to support a bill that would unduly handicap you. But at the same time I think there is some responsibility on the part of the Department to file these liens. As I understand this bill, it will still give you a 3-year period. If you think it does not give a 3-year period and these sponsors of the bill say that it does couldn't you come up with language to make sure?

Mr. STONE. The 3-year period relates to the other bill. That is on a question of whether or not old tax liabilities lose their preferred status and whether there is a discharge.

Senator WILLIAMS. Perhaps I am confused. Do you endorse this other bill?

Mr. STONE. But the tax filing bill does not have any 3-year period.

Senator WILLIAMS. There are two bills before us on this subject.

Mr. STONE. What I am suggesting, Senator, is that this bill, the filing of the lien bill, does not cause the Government to lose any rights, because the Government can protect itself by filing its lien.

Senator WILLIAMS. And you have no objection?

Mr. STONE. Yes, we do have objection. The Commissioner can protect his own interest by filing. The people who are harmed are the 250,000 or more businessmen that we might ruin every year through the indiscriminate filing of the tax lien.

I think that the solution is somewhere inbetween and would give the Commissioner adequate opportunity to investigate and determine whether or not a lien ought to be filed, and if after a reasonable period of time he does not file it then perhaps, it might be reasonable to cut back on the status of an unfiled lien. But the loss of status should not be something that can happen in the next second after assessment.

Senator WILLIAMS. I do not want to delay this further. I will only close with this comment. Since it is recognized that there is a problem here, and personally I think there is one that we should deal with, I would strongly recommend that the Department come up with its recommendations quickly, because if the Department does not solve it Congress might.

Mr. STONE. We fully intend to.

Senator WILLIAMS. Fine.

Mr. STONE. We fully intend to.

The CHAIRMAN. Senator Talmadge.

Senator TALMADGE. No questions.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. Mr. Stone, it seems to me that what we are faced with here is that there are some problems in this whole field of liens, but these two proposals, S. 976 particularly, create a lot of other problems, too, do they not?

Mr. STONE. Yes, sir.

Senator CURTIS. One of the things that disturbs me is this 30-day limit for this committee, because this bill has to be reworked by people who have spent more or less full time in tax law. I am convinced of that.

I am not quarreling with the fine objectives of the proponents, but I find myself in accord with the Treasury's position.

You mentioned in your statement the general bill on Federal liens of all kinds. That has been the result of a great many years of work, has it not?

Mr. STONE. Three to four years; yes, sir; a large number of people.

Senator CURTIS. Yes. I have sponsored that in the Senate for several years. I have had a great many cosponsors because banks, businessmen, the Treasury, and everybody are vitally interested, and it is a much-needed area for legislation.

It is my understanding that now that some of this other legislation is out of the way, Chairman Mills expects soon to start that bill on its way through the Congress. Of course, no one can predict what will happen with it.

Will it clarify any of the problems involved in this legislation before us? We do not need to enumerate them at length, but will it have any bearing on this field if that bill were to be enacted?

Mr. STONE. These bills relate primarily to bankruptcy, and that bill is not really concerned with bankruptcy.

Senator CURTIS. No. But it does harmonize a lot of things that have grown up in the matter of liens, isn't that right?

Mr. STONE. Yes, sir. It certainly is in a clearly related area.

Senator CURTIS. Now, a Federal tax lien that is filed is not comparable at all to either a chattel or a real estate mortgage, is it, in its effect, because the mortgage is pinpointed to describe certain property, isn't that right?

Mr. STONE. It is a normal transaction.

Senator CURTIS. Well, what I mean——

Mr. STONE. Yes.

Senator CURTIS. The property mortgaged has to be specifically described.

Mr. STONE. That is correct.

Senator CURTIS. As a matter of fact, a mortgage would probably be regarded as invalid if it were so vague that you could not tell exactly what property it was.

Mr. STONE. Whereas the Federal tax lien applies to all assets and property rights of the taxpayers.

Senator CURTIS. Yes.

Senator WILLIAMS. Will the Senator yield? It is more in the form of a judgment note.

Senator CURTIS. It has a considerable aspect of the judgment. I thought of that when the distinguished Senator from Delaware was speaking.

If a bank loans money to buy machines, the machines are described in the mortgage.

Mr. STONE. Yes.

Senator CURTIS. Or if it is growing crops this is described; or if it is livestock, it is described; or if it is real property, that is described. To be a valid mortgage the property has to be described so that it is not vague, and it is notice to the world.

A Federal tax lien, once it is filed, blankets everything, does it not?

Mr. STONE. It does.

Senator CURTIS. And it stops the machinery, doesn't it?

Mr. STONE. It has a broad effect.

Senator CURTIS. And it stops the machinery and everything, is that right?

Mr. STONE. Yes, sir; it can do that.

Senator CURTIS. This letter of Mr. Williams has been placed in the record in full, as I understand it. I might comment on one or two paragraphs here. He said:

> Therefore, I should express to you my deep concern about portions of the above bills.
>
> Several facets of the bills disturb me. In the first place, it seems to me that they well may have a highly undesirable impact on the present tax procedures, which might be quite adverse to many taxpayers. For example, situations frequently arise in which the filing of notice of a Federal tax lien would seriously impair a tax-debtor's ability to conduct his business operations. Under current law, District Directors of Internal Revenue typically agree to a reasonable program of installment payments of a tax debt, without filing notice of the Federal tax lien. How this jeopardizes other creditors is difficult to see: They have full opportunity, before extending credit, to obtain financial statements showing the tax liability (and if the tax-debtor gives a false financial statement, his discharge in bankruptcy would be denied). In contradistinction, if these bills are enacted in their present form, it seems to me that the District Directors of Internal Revenue would have little choice but to file notice of a tax lien in such situations.

Isn't that correct?

Mr. STONE. That is correct.

Senator CURTIS (reading):

> In the second place, the bills do not seem to me to have been correlated with tax procedures. For example, examine section 2 of S. 976. This amendment would except from discharge in bankruptcy "taxes which became legally due and owing * * * within three years preceding bankruptcy." I take it that in the usual income, estate, or gift tax matter, the date on which a tax becomes "legally due and owing" is the due date of the return. Any tax disclosed by the return is, of course, immediately assessed. However, a deficiency in reported tax liability typically is not assessed until several years later, often more than 3 years later.

Is that a fair statement of fact?

Mr. STONE. That is correct. In any tax case involving a substantial amount of money and a substantial legal dispute, the period will often run, in fact normally runs, more than 3 years.

Senator CURTIS (reading):

> Thus, under the bill, a deficiency in tax which, because the taxpayer has been pursuing his administrative or judicial remedies, is not assessed until more than 3 years after the original due date of the tax, would be discharged in a bankruptcy proceeding commenced the following day—before the district director had any opportunity to file notice of the Federal tax lien.

If this bill were passed that would be true, would it not?

Mr. STONE. That could be the result, but again because of the confusion in the manner in which the bills are drafted, I am not quite sure that that is the definite result. It could be the result when the two bills are considered together.

Senator CURTIS. Well, when they became due and owing, if something was in litigation, or he was making appeals, procedural appeals, and it took a long time to determine whether it was due and owing, it might well happen, might it not?

Mr. STONE. It depends on the interpretation of the bill. I think that certainly is probably what the drafters intended.

Senator CURTIS. Yes. (Reading on:)

> Indeed, as I read it, this section would mean that if a deficiency on a tax return due more than 3 years before bankruptcy will be discharged if it is assessed the day before bankruptcy, whereas, if it is not assessed until the day after bankruptcy, it will not be discharged.

Do you have any comment on that?

Mr. STONE. Well, that again is a possible interpretation of the effect of the bill. We do interpret the bill to mean that the tax would not be discharged if assessed the day after the bankruptcy begins.

Senator CURTIS (reading):

> Moreover, I respectfully suggest that it is not appropriate to have the "three years preceding bankruptcy" (or whatever time period is thought appropriate) run from the date the tax "became legally due and owing." Rather, I suggest, it should run from date of assessment. Indeed, as to deficiencies assessed more than 3 years after original due date, the committee might well find it possible to provide a shorter period than 3 years if it were thought wise to do so as a matter of tax policy.

Then Mr. Williams goes on to point out, and he did not know until I talked to him this morning that we were under a 30-day instruction, that these were his individual views. He has not had time to contact the Special Committee on Federal Liens of the American Bar Association of which he happens to be the chairman, so he is speaking as an individual, and we want that clear.

He goes on to say:

> However, it seems clear to me that the bills, as drafted, will cause serious changes in current administrative procedures and policies in the administration of our revenue rules, adverse to taxpayers—at least some of which, it seems to me, could be avoided by changes which would not significantly interfere with the major objectives of the sponsors of the bills. I therefore urge that, before taking final action on the bills, your committee refer them to Dr. Woodworth and his staff for complete analysis, to determine whether the portions of them which seem ambiguous and unclear in their import and application, and which seem so certain to hurt, rather than help, many delinquent taxpayers, can be revised in a manner which will accommodate both to the needs of delinquent taxpayers and the proper needs of the revenue.

I know you do not want to tell this committee how to proceed, but if our staff were asked to go into this bill and see what could be done to reach the objectives sought by the sponsors, but still correct some of these ambiguities, might we have the assistance of the Treasury in that?

Mr. STONE. You certainly would, yes. I think that there are two things involved. I think we have got to correct some of these ambiguities, and I think also that somewhere there has got to be a compromising of the competing interests. In other words, the matter

may have swung too far one way today in the protection of the Government's tax rights and in the protection of the rights of taxpayers who are disputing the Government's claims. However, we do not want it to swing too far in the protection afforded creditors.

Senator CURTIS. There may have been some policy determined by Congress in that regard. But would you say, is it your view, that a little more work should be done on the language so that both policy decisions could be submitted to this committee as well as to the Judiciary Committee?

Mr. STONE. Definitely, yes. I am confident that there are ways of working out these problems.

Senator CURTIS. I realize that sometimes things get slowed down, and there is really quite an urge to push them fast. I hope that something can be done in reference to the order for the 30-day procedure here, because the bill will not die at the adjournment of this session, so that it might be reworked, and thus enable the Congress to make whatever policy decisions ought to be made in bringing together the conflicting views here.

Mr. STONE. I would say that it is important that we not hurry since there are other significant groups who should be given the opportunity to comment on whatever is to be done, such as these American Bar Association groups, and that could not be done overnight. There would be great difficulty in doing this within a 30-day period.

Senator CURTIS. I have been called back to my office, and I won't proceed any further. I do want the record to show that I have no hostility whatever toward the people interested in the passage of this legislation and the objective they seek. I think the very fact that it was referred to two committees indicates the problem.

The problem I referred to is that those practitioners in bankruptcy have a viewpoint that should be taken into account. Those who are familiar with and have spent long hours in tax practice have a viewpoint that should be taken into account, and if it is not done, the passage of this bill will not clarify the situation very much. Don't you think that is correct?

Mr. STONE. That is correct. I do not think the bills will clarify much. I think I can illustrate your point. Yesterday I had a meeting with the two witnesses from the National Bankruptcy Conference, and it was quite clear at that meeting that until that time they did not fully understand how our tax procedures worked. At the same time, I think it was quite clear that we did not have a full understanding of the Bankruptcy Act, and so I think this is where the confusion comes from.

Senator CURTIS. Yes. I think if something can be done on the Senate floor in reference to this 30-day deadline, and we call upon the available talent in and out of Government here, that in a matter of not too many weeks some real improvements might be made in reference to this legislation which would not interfere with what appears to be the objective of the sponsors of the legislation; isn't that true?

Mr. STONE. I think that is so. I think a substantial part of their objectives can be accomplished.

Senator WILLIAMS. If the Senator will yield I would like to join him in his expression, because, as I stated earlier, I think there is a

problem that we should solve, but I think to do it too hastily we may create a greater problem either for the Treasury or for those interested in this legislation. I did not know we were under a 30-day time limitation, but I think we can get that changed. As he said, we will be here next year, and we can continue. In the meantime we can have the benefit of your recommendations and the recommendations of other interested parties on the outside.

I have just one question here: These bills would be prospective, would they not? There is nothing retroactive in them?

Mr. STONE. They are prospective.

Senator WILLIAMS. Prospective; then, therefore, they would not affect any existing cases at all.

Mr. STONE. That is correct; yes, sir.

Senator WILLIAMS. And we are in agreement that any action that we take should be prospective in nature.

Mr. STONE. Yes; I think the proponents have not attempted to make it retroactive.

Senator WILLIAMS. That is my understanding, too.

Thank you.

The CHAIRMAN. Thank you.

The next witness is the distinguished Senator from North Carolina, Senator Ervin.

The Chair would like the record to show that Senator Ervin requested to appear second.

Senator ERVIN. Yes, Mr. Chairman.

The CHAIRMAN. We are delighted to have you.

STATEMENT OF HON. SAM J. ERVIN, U.S. SENATOR FROM THE STATE OF NORTH CAROLINA

Senator ERVIN. Mr. Chairman and gentlemen. I have been very much intrigued by the suggestion that there has not been enough time taken on these bills, in studying these bills. One of the bills has passed the House the last five Congresses. It has been passed by the House Judiciary Committee, I am informed by Congressman Whitener of the House, without opposition on all those occasions.

It has been reported favorably on every occasion it has been referred to the Senate Judiciary Committee without opposition.

I am also intrigued by the suggestion that the Department of Treasury is willing to discuss this matter with the National Bankruptcy Conference.

Senator CARLSON. Mr. Chairman, would the Senator yield at that point?

Could I inquire if the House Ways and Means considered the tax angles as we are requested to do on the Senate side?

Senator ERVIN. No; the House considered the bill just as a bill to deal with priorities in bankruptcy. But Congressman Whitener informs me that Wilbur Mills was aware of the existence of the bill and acquainted with its substance.

Now, the Treasury has been willing to talk to the National Bankruptcy Conference about the bill. That is a group of lawyers who practice in the banyruptcy courts, and the trustees in bankruptcy. They never offered to talk with the proponents of the bill, so far as I know.

The have suggested to me that after the 10-year delay and dawdling we should delay it some more so that they can confer with the National Bankruptcy Conference some more.

You have a letter from an attorney in Washington, Mr. Williams. I understand, and I am not certain about this, that Williams is a member of the ABA committee, but there has been a telegram sent to this Finance Committee, and to my attention, from Miami, Fla., on the 3d of August this year, as follows:

American Bar Association has heretofore approved the bill to correct the *Quaker City Uniform* case, which is now S. 1912, and the bill to unit priority of tax claims in bankruptcy which is now S. 976, and urges adoption of said bills.

It is signed by Sydney Krausl, chairman of Commercial Bankruptcy Committee of Section on Corporation Banking and Business Law of ABA.

I think I could bring you virtually every lawyer who is engaged in looking up titles to inform a prospective creditor as to whether he can safely advance money to a debtor, and virtually every one would advocate the passage of this bill. The bill is backed by American Credit Association, it is backed by banks, trust companies, because it recognizes some tax problems, and it recognizes problems of other people in business, and it reconciles the two, I think, in about as fair a way as can be.

I was much intrigued by the suggestion that there are a lot of ambiguities in this bill. I would like to say with respect to Congressman Whitener's bill—he is my Congressman, incidentally, and I am glad to brag on this—that this is about the simplest piece of legislation, and as free from ambiguities as any bill that has been introduced in the Congress since I came to the Senate 11 years ago.

All it does is this: Under existing law, Federal taxes take priority. Whether anybody knew about them or not, they take priority; and Federal taxes are not dischargeable in bankruptcy, which causes a gross discrimination against an individual who goes into bankruptcy, in favor of a corporation which goes into bankruptcy.

When a corporation gos into bankruptcy, unless it is reorganized in some way, it goes out of existence, and while theoretically its liability for Federal taxes continues, as a practical matter they can never be collected because the corporate debtor is dead. It no longer has a breath of life in its legal nostrils.

But the individual who goes into bankruptcy is saddled with a continued liability for those taxes until the last lingering echo of Gabriel's horn trembles into ultimate silence.

Now, the law should not discriminate in favor of the corporate debtor and against the individual debtor, but that is the way it is, and you are not losing any corporate taxes. If General Motors would go into bankruptcy, it would not lose anything because it would dissolve and rid itself of its tax debts and liabilities.

Now, I may have misunderstood Mr. Stone a while ago, but I did not agree with him. He said that if you assessed the tax, you had to immediately file, and I contradict that. You have 3 years after a tax becomes due, according to law under Congressman Whitener's bill, in which you do not have to file a claim. In other words, the only time you have to start to file a claim, is when the Government and the Treasury Department is so negligent in collecting taxes that it allows

a man to get to the point where he lacks only 1 day of having his 4-year tax due that it has not collected.

This bill does not affect taxes. In the first place, the bill of Congressman Whitener, which is H.R. 3438, and which has been passed by the House for five Congresses, provides in substance two things: It does not affect any tax lien that is filed and made a public record. If the Treasury Department files a tax lien and gives notice to the public that a man owes money to the Government, it does not affect the claim of the Federal Government at all.

But it does provide, first, that a discharge in bankruptcy will relieve a debtor of all taxes becoming due more than 3 years before bankruptcy unless the Government has reduced those taxes to a tax lien—that is, given a public notice of them; and all the Government has to do to give that public notice is to write a letter. In North Carolina, it would be to the register of deeds' office to notify them that the Government claims a tax lien against this individual in such and such amount, and it is made public knowledge.

Now, the other thing which Congressman Whitener's bill does is limit the priority of Federal taxes to those becoming due—that is, where there is no lien filed—to those becoming due within 3 years before bankruptcy.

The bankruptcy law was intended to do two things, as I see it: (1) to give debtors a chance to rehabilitate themselves; therefore, it grants them a discharge in bankruptcy, and (2) to arrange for an equitable distribution of the assets among the creditors.

The bankruptcy law proceeds upon the idea that, first, liens on property shall be paid first out of the property to which they attach, and then the next stage of payments or use of the taxpayer's estate is to be in the area of priorities.

In other words, you can divide a taxpayer's estate into the property that is subject to liens, which goes toward the satisfaction of those liens, then the priorities, and then the general fund to general creditors.

Now, the priorities are these under the bankruptcy law: First, the cost of administration; second, wages for certain limited periods of time prior to bankruptcy; then, taxes, that is, taxes that have not been reduced to liens, just taxes that are due but have not been reduced to liens, and then certain rents, and then general funds.

This does not do away with, except to the extent of the discharge after bankruptcy, any debtor's taxes, but it merely says that creditors are entitled to some protection.

Under the present law, the matter of taxes is a confidential matter between the Department of Justice, Internal Revenue, and the taxpayer. Nobody else can find out the amount of the Federal tax except from the debtor, and a debtor, when he gets into straits, is tempted to minimize his taxes. Further, in many cases there is a dispute between him and the Federal Government as to the amount of his taxes that nobody knows about, and he is not going to admit, in drafting a statement for a creditor, taxes which he denies he owes, as being a debt.

So, there is nobody in the world who can find out the amount of Federal tax liens which have not been made public.

This bill says that the Federal Government's position is not to be disturbed in the least with respect to taxes which have accrued during 3 years preceding bankruptcy. The Department even says there is an ambiguity about when a tax becomes due.

I think most every American citizen knows when a tax becomes due. The law fixes it.

You can employ the best lawyer in the world under existing law, and that is what this bill is intended to correct—you can employ the best lawyer in the world, and this lawyer can truthfully say that he searched every title that is available to him—that he has made all the inquiries from all sources of information that are available to him, and can inform his client that he can certainly advance this credit to this debtor; and yet this debtor can owe the Federal Government thousands of dollars of unpaid taxes. There is no record available to the public to disclose them. This bill says the Federal Government can still come in and have priority, if it will file a tax lien; and the bill says this man owes it, just as we have to file chattel mortgages, real estate mortgages, and deeds of trust, to disclose to the world our claim. The Federal Government can come in and it can file this tax lien before the debt gets to be more than 3 years old, and it remains in effect, as far as the law is concerned, forever.

That gives the Federal Government 3 years in which to take action.

Why should the Federal Government want to dilly-dally with a taxpayer who is in arrears for 4, 5, 6, 7 years in payment of taxes, and to rehabilitate him when they put it within his power to defraud all the people? They have 3 years to act, under Congressman Whitener's bill, which has passed the House five times, and is the clearest, most unambiguous bill I have ever seen.

Now, with reference to the other bill, Congressman Poff's bill, it is free from ambiguity I respectfully submit. I am not going into all the intricacies of liens, except the tax part of it.

We have a decision in Pennsylvania under which a man took a chattel mortgage and recorded it for all the world to see; and then after he put that chattel mortgage on record, the Federal taxes accrued, which were not disclosed to anybody. The man who executed the chattel mortgage went into bankruptcy, and the Federal courts having jurisdiction of the Pennsylvania area held that this tax lien, which was for taxes not even due until subsequent to the recording of the chattel mortgage, came ahead of the chattel mortgage. That is not just.

Congressman Poff's bill, which has passed the House several times and has been under study for years, merely takes and straightens out the priorities. The only thing it does to Federal taxes, as I construe it, and I have studied it at great length, is to say the trustee in bankruptcy shall prevail against an unrecorded Federal tax lien.

Now, in this case, the Federal Government can file a lien and protect itself fully. What does it mean that the trustee shall prevail against him? It merely means this: the trustee takes the money for the benefit of all of the creditors, and if the assets are subject to specific liens, he pays the specific liens; then, he uses the remainder in the order of priority; and I respectfully submit that under this bill the Federal tax lien then, although unrecorded, would come under the third order of priority.

I will admit if you start reading all of the sections of the bankruptcy law that you reach a state of great intellectual confusion. But when you analyze these bills and see what they do, in my judgment they are free from ambiguity.

Now, Mr. Stone said that if a man went into bankruptcy that the Federal Government would immediately have to file a claim. Sure it would. Every other person who has any claim against the bankrupt has to file his claim.

I was struck with the criticism of the lawyer who wrote concerning what would happen after a man went into bankruptcy. The bankruptcy laws do not have anything to do with events that occur after the man goes into bankruptcy. All of the rights of the parties are fixed as of the date of the bankruptcy, so that is not a valid argument.

I respectfully submit that people who deal with debtors ought to be allowed to employ lawyers to look up the title to the property—that those who make loans or extend credit should be allowed to look at public records with confidence of full discovery. Under Congressman Whitener's bill, a concession is made to the Federal Government, that notwithstanding there is no public record, they can go back for 3 years as to taxes that nobody knows about except the debtor and the Treasury Department, and which no one can learn from the Treasury Department, because, under the law, it is a confidential matter.

So it seems to me this bill protects the Federal Government. Why should the Treasury Department—I have never seen any inclination on their part to give me 3 or 4 years to pay my taxes—why should they jeopardize their claim by allowing taxes to accrue up to 4 or 5 or 6 years?

These bills are very simple. They won't upset the administration of the tax laws. They would merely protect businessmen against possible acts of debtors aided and abetted by the secrecy of the Internal Revenue laws up to the time of the filing of the tax lien.

I would like for Congressman Whitener to make a statement, unless some members of the committee desire to ask any questions.

(The prepared statement of Senator Ervin, together with the attachments follow:)

STATEMENT OF HON. SAM J. ERVIN, JR., U.S. SENATOR FROM THE STATE OF NORTH CAROLINA, BEFORE SENATE COMMITTEE ON FINANCE IN SUPPORT OF H.R. 136 AND H.R. 3438 TO AMEND THE BANKRUPTCY ACT, AUGUST 5, 1965

Mr. Chairman and members of the Finance Committee, I am most grateful for the opportunity of appearing before this committee today in support of H.R. 136 and H.R. 3438. My colleagues, Senator Hruska and Representative Basil Whitener, and I have spent not just months but years in an effort to bring this vitally important legislation to enactment. I cannot overemphasize the necessity and basic fairness of favorable action by this committee. This legislation is long overdue and your courteous consideration of it is to be commended.

I have two brief statement setting forth the technical explanation and the need for each of the bills. I shall not take the committee's time by reading these here today; however, I would like to summarize a few of the more important reasons for enacting H.R. 3438.

This bill was reported favorably by the Senate Judiciary Committee earlier this year for the third straight Congress. It passed the House in the 85th, 86th, 87th, and 88th Congresses. Its sole purpose is to clarify and regulate the priority of claims in bankruptcy proceedings. Any tax aspects inherent in the measure are purely ancillary to the basic purpose, which is the reform of our bankruptcy law; and the bill is in no way a revenue raising measure. This is clear since the bill has never been referred to the Ways and Means Committee of the House.

Its enactment would help cure the unfair discrimination against the private unincorporated businessman which exists in the present law. A corporation normally ceases to exist upon bankruptcy and unsatisfied tax claims, as well as other unsatisfied claims, have no recourse even though the enterprise may continue in a new corporate firm. However, the nondischargeability of taxes follows the individual businessman to his grave.

Under existing law, Federal taxes have a priority which is unlimited as to the time prior to bankruptcy in which they accrued, and they are also not dischargeable in bankruptcy regardless of the length of the period over which they accrued. H.R. 3438 would put a 3-year limit on both the priority and nondischargeability of tax claims in bankruptcy proceedings except in the case of those claims which have been reduced to liens.

Further, the undisclosed and undiscoverable Federal tax claims can rob the most cautious businessman of any substantial recompense because of their size and priority over his claim. Consequently, the present law is manifestly unjust to persons dealing with a bankrupt prior to bankruptcy. The finest lawyer cannot uncover evidence of Federal tax claims not reduced to liens.

I would like to add that Senator B. Everett Jordan shares my views on this matter.

Again, I thank you for the opportunity to appear; and again, I solicit your early and favorable consideration of these measures.

STATEMENT RE H.R. 3438

This bill has two closely related purposes: (1) to make taxes dischargeable in bankruptcy if they became due over 3 years before bankruptcy, and (2) to limit the priority of taxes in bankruptcy distributions to those becoming due within 3 years before bankruptcy.

The bill accordingly amends section 17 of the Bankruptcy Act, which presently makes taxes nondischargeable without limitation, and section 64 of the act, which gives tax claims priority without limitation as to amount. Section 2 would also be amended to define the jurisdiction of courts of bankruptcy to determine questions as to the amount or legality of tax claims. This provision is simply a clarifying elaboration of a clause now included in section 64a(2) but more appropriately placed in section 2.

The nondischargeability of taxes provided by section 17 is a matter of little or no concern to corporate bankrupts since liquidation in bankruptcy effectively terminates their existence as taxpayers. The policy of section 17 thus operates with discriminatory impact on unincorporated taxpayers. The inability of individuals to get any degree of relief in bankruptcy from the burden of accumulated tax debts constitutes an increasingly serious impairment of the purpose of bankruptcy to rehabilitate debtors for return to the community as able and willing contributors to the economy.

The bill carefully restricts release from tax liability in the cases of bankrupts who failed to make returns required by law, made false or fraudulent returns, or willfully attempted to evade or defeat tax liability. Liability for taxes collected or withheld from others remains nondischargeable. Finally, tax liability of property set apart as exempt in the bankruptcy proceeding and of property subject to valid tax liens remains unaffected by any discharge.

The priority accorded to taxes by section 64 relates only to taxes not secured by liens. The present lack of any limitation on this priority, along with the absence of any qualification of the nondischargeability of taxes, has encouraged tax collectors to allow such claims to accumulate for inordinately long periods and to inordinately large amounts. As a result sizable estates may yield nothing for general creditors. The proposed amendment of the priority section is correlated to the amendment dealing with dischargeability; i.e., only taxes not dischargeable would be entitled to priority. Other tax claims would share pari passu with general creditors.

The 3-year limit placed on dischargeability and priority of taxes coincides with the 3-year statute of limitations for Federal income tax assessments. It allows a fair opportunity to tax authorities to audit returns and assess deficiencies. It will encourage authorities to keep unpaid taxes from accumulating beyond 3 years. Treasury representatives have suggested the limit will not only stimulate earlier enforcement of tax claims but will precipitate bankruptcies that might have been avoided. The point made ignores the probability that persons owing more than 3 years' taxes will not recover finan-

cial health without bankruptcy relief, and that a more diligent tax collection policy will not only minimize losses by both Government and private creditors but may be conducive to financial adjustments by debtors before their financial condition becomes inextricable.

STATEMENT RE H.R. 136

The principal purpose of this bill is to rationalize the treatment of statutory liens in bankruptcy. The governing provisions of the Bankruptcy Act are confusing and have led to conflicting rulings and to results subversive of sound bankruptcy administration.

The most important of the changes proposed are embodied in the proposed revision of section 67c of the Bankruptcy Act. This subdivision now overlaps and by implication and circumlocution overrules in large part section 67b. The latter subdivision purports to validate all statutory liens against the trustee in bankruptcy, but section 67c postpones, restricts, and invalidates certain of these liens. These provisions are so difficult to understand and to apply that the courts not only disagree with each other as to their meaning but unwittingly disregard their own prior rulings in point.

A particular difficulty is that as interpreted section 67c creates a circuity of priority among liens without providing any guide to solution. The proposed revision provides a solution (in the new sec. 67c(3)) that is consistent with the better considered opinions dealing with the problem as it has arisen under the present language of the act. The subdivision is also revised to eliminate unwarranted discrimination against statutory liens perfected by public recordation or filing, as distinguished from possession, and against statutory liens on personality as contrasted with statutory liens on realty. The other changes in this subdivision are essentially clarifying. The amendments of sections 64a(5) and 67b are corollary to the changes in section 67c and are probably noncontroversial.

The amendment of section 70c is intended to spell out more clearly than the subdivision presently does the extent of the powers of the trustee in bankruptcy under the so-called strong-arm clause. Some unfortunate implications of changes in this clause made in 1950 and 1952 would be overcome by its adoption.

The proposed amendment of section 17a and some of the phraseology of the amendment of section 67c have been added at the request of representatives of the Treasury Department. It is understood that the Department still objects to the fact that under the bill the trustee would be able to defeat a Federal tax lien that is not perfected by the filing of a notice before bankruptcy. That the trustee should be able to prevail against all secret liens that are ineffective against judgment creditors outside of bankruptcy accords with long-established bankruptcy policy and seems to be entirely consistent with the congressional policy embodied in the Federal tax lien statute (Internal Revenue Code sec. 6323). See *In re Kurtz Roofing Co.*, 335 F. 2d 311 (6th Cir. 1964), cert. granted sub nom. *United States* v. *Speers*, 33 U.S.L. Week 3245 (1965). In requiring Federal tax liens to be filed in order to be perfected against the trustee in bankruptcy, the bill resolves a conflict that has developed among the circuits and eliminates an unwarranted anomaly in the law of the circuits that uphold the secret tax lien in bankruptcy. The Treasury Department's argument that notice filing is onerous on the Government and detrimental to the interest of a debtor trying to avoid bankruptcy is the same argument that secured creditors have made for 400 years against the imposition of notice-filing requirements as a condition of validity of their liens against other creditors.

In any event, the bill recognizes that the Government can protect its tax lien on real estate against the trustee in bankruptcy as well as purchasers, mortgagees, and judgment creditors by filing notice. It can protect its tax lien on personalty only by taking possession, but that has been the law for more than 25 years. It retains its priority under section 64a and the immunity of its tax claims from discharge so far as this bill is concerned. It thus will share as a priority claimant in the proceeds of such enlargement of bankrupt estates as may result from enactment of these amendments. It may be difficult to demonstrate that the receipts of the Government from bankrupt estates would be increased by the bill, but it is clear that no loss would necessarily result from its enactment. In view of the widely acknowledged benefits ac-

cruing to bankruptcy administration from adoption of these amendments, the doubts raised by the Treasury Department as to possible impacts on the revenue appear insubstantial grounds for objecting to the bill's passage.

Senator WILLIAMS. I would like to ask one question of the Senator.

Senator LONG. Let me see if I understand this. What you are saying, Senator Ervin, is that the Government should not be in position of having a large tax claim which no other creditor knew about, and then come in with this tax claim and taking a priority over all these other people who would not have advanced credit to the man if they had known that the Government had this claim to advance?

Senator ERVIN. Yes, that is, prior to the 3 years.

In other words, for 3 years we allow Government claims to remain secret and still have effect.

Senator LONG. Let me see if I understand the law now, because I am not sure I do, and I would like to have you explain it to me. How would the Government stand as against other creditors when this person does declare in bankruptcy? Let us say the Government has a claim which has been building up for 7 or 8 years, and the Government then proceeds to come in and make its claim. As I understand it, the Government would come in behind mortgagees, pledgees, purchasers, or judgment creditors?

Senator ERVIN. Yes, they would come in in priority for taxes, which is the third priority.

Senator WILLIAMS. Is that existing law or is that——

Senator LONG. Is that existing law?

Senator ERVIN. Yes. In other words existing law divides the debtor's property into three classifications. Roughly, the first is used to satisfy the liens; then, you have the orders of priority, which is the cost of the administration of the bankruptcy estate, that is, the bankruptcy court; then, wages for a certain limited period of time for personal services rendered to the bankrupt, and then taxes, the third priority; and then your rent, in some States, and then general creditors.

Senator LONG. I see.

Senator ERVIN. Now, this, of course, would——

Senator LONG. What you are saying in effect is that for the protection of the general creditors, that they should not be in a position of advancing credit completely in the dark, because of the fact that the Government has a large tax claim against this person.

Senator ERVIN. That is right. When this law was originally passed, it did not make much difference, because Federal income taxes were comparatively small. But now Federal income taxes have become so large in amount that it results often in the Federal Government coming in and taking the entire estate even though the Federal Government may have held back, collecting taxes for an unlimited period of time, 8 or 9 or 10 years in the past—taxes which no person had any knowledge of.

Senator LONG. I had some dear friend who had the duty of withholding taxes for his employees, and apparently he did some withholding all right, but I guess the exigencies of his business were such that he needed it for his own activities, and he did not remit it to the Government.

When the Government came in for the money, this was more money than he had any hope of paying over, and the only hope of the Government for ever getting its full amount or the creditors getting anything would be for him to stay in business, and if he went into bankruptcy there would be no possibility of the private creditors, general creditors, getting anything out of the business.

Senator WILLIAMS. But in that particular instance, if the Senator will yield, that is money which the employer withholds from his employees, and is money which he is supposed to hold as a trustee. He has no right to use it for his own business, and the Government should have taken action very promptly in that case.

Senator LONG. I agree with you.

Senator ERVIN. Under Congressman Whitener's bill, he would not be discharged.

Senator WILLIAMS. There is no reason if he has withheld for 2 or 3 years for the Government's not having taken action against him because it is not his property.

Senator ERVIN. Yes.

Senator LONG. I think the Government did pretty well. They were working on the theory that you cannot squeeze blood out of a turnip. The Government got about what it could.

Senator ERVIN. I used to practice law, and I used to have clients come in and ask me to investigate records. I was always afraid to ever tell them that I could assure them of a clear record. I said the records are clear, but I cannot tell you what undisclosed claim the Treasury Department may have against this man for taxes, and there is no way to find it out.

Senator TALMADGE. Will the Senator yield at that point?

As I understand, what you are telling this committee, Senator Ervin, is that a creditor could not deal with a businessman in a normal account except at his own peril. In other words, the only way he could be adequately protected against the Government's lien would be to secure some type of mortgage, either on real estate or goods, and record it; otherwise, the Government would come in and take priority over a normal businessman's assets?

Senator ERVIN. Unfortunately, they held in the *Quaker State* case in Pennsylvania that even though he takes security—in that case, it was a chattel mortgage—before the year for which the tax accrued, that the tax came in ahead of him.

Senator TALMADGE. Even though the Government's lien was not recorded?

Senator ERVIN. That is right.

Senator TALMADGE. So, he could not even secure a mortgage then under that decision except at his own peril.

Senator ERVIN. Yes, sir.

Now, Congressman Poff's bill goes into some other lien aspects of the law that do not affect the Federal Government, and so I did not explain that. But from my study of Congressman Poff's bill, it clarifies the whole situation, and it makes it so that the assets of the bankrupt are to be disbursed in accordance with the Federal Law, free from a lot of conflicting State laws. It clarifies existing law instead of making it more ambiguous.

Senator WILLIAMS. I am not quite as clear on this.

You are searching the records for a client, and you list that Mr. X has a certain mortgage or certain mortgages against his real estate or, we will say judgments, but notes that are entered. You give him that list of mortgages and entries of judgments that have been made against the property. Do I understand that at some future date the Government could come in and record a tax lien which would go back and take priority over those recorded judgments and mortgages?

Senator ERVIN. They are not supposed to, as I construe the bankruptcy law, it is a very technical thing, but owing to the phraseology of an amendment that was made at the time of the Chandler Act, the courts in Pennsylvania held that very thing in the *Quaker State* case.

Senator WILLIAMS. Would the Treasury care to comment on that?

Senator ERVIN. That was a chattel mortgage. There are other courts that hold to the contrary. Instead of these bills making that more ambiguous, they clear up the ambiguity, making it more uniform.

Senator WILLIAMS. I think we ought to get this point clear. As one of the sponsors of the bill would you object if it should be the decision of the committee that we nullify this 30-day requirement and let this bill go over until the early part of next year so we could get these various reports in?

I say that as one who is very sympathetic with the problem you are trying to get at here, but I want to be sure that we do it right. This would give the Treasury and also all these other interested parties a chance to come in with their recommendations. I was wondering if you would object to this limited delay.

Senator ERVIN. I would rather stand by the 30-day requirement. I might as well be frank about it, I would rather stand on the 30 days, because I have had to work on the legislation every year for 10 years.

Senator WILLIAMS. Of course, but I am hoping 30 days from now we shall be approaching the end of the session. It has been our experience that good suggestions get defeated in the rush of adjournment.

Senator ERVIN. Senator Curtis was basing his objection on the letter from Laurens Williams, who, I understand, is a member of Mr. Sydney Krausl's committee. Mr. Sydney Krausl says that the American Bar Association is in favor of both of these bills. I think the bills are in as good shape as they can be put in. I think the proper balance is struck of Federal interest as against those of the business world. The Government has never shown me any inclination to give me more than 3 years to pay my taxes, and I do not see why they worry about somebody who has not paid taxes for 4, 5, 6, 7, or 8 years.

Senator TALMADGE. Will the Senator yield at that point?

Senator ERVIN. Yes.

Senator TALMADGE. You heard Mr. Stone's testimony, I believe, in which he stated that there were some 3,065,000 new delinquent tax accounts, and only 239,000 cases were cases where the Service actually filed a notice, a public notice, of the tax lien. Of course, the Senator is aware of his testimony and has common knowledge of the fact that when a tax lien is filed it greatly jeopardize the financial standing of the taxpayer in the community. Every citizen is then alerted to the fact that in dealing with him financially only at his peril.

What comment would you make on this business that if they had to start filing these tax liens promiscuously that it might ruin lots of businessmen who, through no fault of their own, sometimes do get into

arrears on taxes, and ultimately pay them and rehabilitate themselves financially?

Senator ERVIN. Well, with the exception of income taxes and possibly gift taxes, every tax that a person owes is now a matter of public record in this country, and I do not know that that plunges a lot of them in ruin. I do agree that Federal income taxes are greater than other taxes.

I think that the Federal Government ought to collect a tax from a man in 3 years, or file, make public, their claims which antedate the 3 years.

If they do that, it might jeopardize some business of some men, but it might save thousands and millions of other people who are losing property unjustly when they have done everything they could to protect themselves by searching the records. I do not think you ought to give a man more than 3 years to pay taxes.

Senator TALMADGE. Mr. Stone, may I ask you a question?

You cannot go back now and recover taxes beyond 3 years except in case of a fraud, can you?

Mr. STONE. Well, we can collect an assessed tax for 6 years, we have 6 years in which to collect an assessed tax.

Senator TALMADGE. One that has previously been assessed?

Mr. STONE. Yes; that is, either where the taxpayer agrees and reports he owes the tax or where there has been a final adjudication in the courts or a final determination where the taxpayer does not go to the Tax Court that he owes the tax. We have 6 years then in which to collect after such assessment.

In terms of assessing taxes, we have 3 years from the due date of the taxpayer's return in which to assess a tax, or rather to determine a deficiency. That period can be extended, and frequently is extended in complicated cases such as excess profits cases which may run for 10 or 15 years, by the Government and the taxpayer if they both agree together to waive the statute of limitations. That period is also extended by statute if the taxpayer files a petition in the Tax Court of the United States, and then the period runs indefinitely until the matter has been finally adjudicated by the courts.

Incidentally, I am sorry to have to disagree with Senator Ervin but there is no 3-year period in H.R. 136 or S. 1912. The Government's tax lien, if unfiled, can lose out regardless of when the tax is assessed. The tax can be assessed if reported on the taxpayer's return voluntarily on April 15, and if the taxpayer does not pay his tax with that return, we have an unpaid claim for assessed taxes. If the taxpayer goes bankrupt the next day, and the Government's lien has not been filed, the lien would then not be valid against the trustee in bankruptcy. This would be a 1-day period. There is no 3-year period in H.R. 136 whatever.

Senator ERVIN. Yes; but the other bill would give you the 3-year period, because you have priority.

Mr. STONE. H.R. 136 is the bill which I say would force the Commissioner, if he is exercising his responsibility to collect taxes, to file the lien in the case of any substantial unpaid tax immediately, and there is no 3-year period.

Senator ERVIN. No; but he would have priority in taxes under the other bill, for 3 years. All it does is to say that an unrecorded—that is, undisclosed——

Mr. STONE. The Commissioner would have priority if he has a lien, but the unfiled lien would be invalid as against the trustee in bankruptcy under the other bill.

Senator ERVIN. That is right. The Federal Government would have to take their chance as a prior creditor.

Mr. STONE. That could mean the difference between collecting $100,000 and zero.

Senator ERVIN. Yes. And the present law could be the difference between the Government collecting 100 percent and everybody else collecting zero, except costs of administration and wages, which only go back for 90 days.

Senator TALMADGE. Senator Ervin, what you are trying to say is if a man is operating a restaurant supply business in North Carolina, and he extends credit to a restaurant, and the man sells his food to customers and collects the money, that the man who extended the credit in selling the food ought to be on the same status as the Government of the United States.

Senator ERVIN. That is, after 3 years he ought to be on the same status as the Government. Up to a 3-year period, the Government would have a preferred claim, because that man would come in as a general creditor, and he would be the one to lose in the hypothetical case stated by Mr. Stone.

Senator WILLIAMS. Since the able lawyers who sponsor the bill and the able lawyers from the Treasury Department all agree that there should be a 3-year period but they disagree that this bill provides for a 3-year period, would you suggest that some of we laymen provide the proper language.

Senator ERVIN. I will tell you, I think laymen can write laws much better than lawyers. I was bragging about my Congressman's bill because it was one I could understand without spending days and days on it. But most of the laws I read written by lawyers in legal gobbledygook have at least one case of incurable mental indigestion in each sentence. I would like to have Congressman Whitener make a statement.

The CHAIRMAN. Thank you very much.

STATEMENT OF HON. BASIL L. WHITENER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. WHITENER. Mr. Chairman and members of the committee, before making my statement, I would like to relate to the committee a request of my colleague, Congressman Richard Poff, of Virginia, who could not be here today because of an important committee meeting, asking for permission to file a statement in support of both of the bills which you have before the committee.

The CHAIRMAN. Without objection.

(The statement referred to follows:)

STATEMENT OF HON. RICHARD POFF BEFORE THE SENATE FINANCE COMMITTEE IN SUPPORT OF H.R. 136

Mr. Chairman, I appear today in support of my bill, H.R. 136, which amends the Bankruptcy Act in order to assure a greater degree of uniformity and equity in the administration and distribution of a bankrupt estate. The bill would amend certain sections of the Bankruptcy Act wherein there have been a variety

of conflicting judicial interpretations concerning the appropriate order of distribution. This measure is designed to eliminate the considerable amount of uncertainty in the commercial world as to the strength of secured credit.

Similar measures have passed the House in the 87th and 88th Congresses, but failed of enactment in the Senate. On Monday of this week, the House once again passed this measure.

The problems in the administration and distribution of a bankrupt's estate to which this legislation is addressed are two: First is the problem of preserving the recognized interests of security holders; and second is the problem of clearly defining the nature and scope of the powers of the trustee.

Essentially, then, this measure deals with issues which are fundamentally problems of the bankruptcy law. The so-called tax aspects of this measure are incidental. The purpose, and I believe the effect, of the bill is to present a clearer and more precise and complete expression of basic Federal bankruptcy policy.

The following discussion of this bill is drawn from the report of the Committee on the Judiciary on this measure (H. Rept. 686, 89th Cong.):

"One of the fundamental purposes of the Bankruptcy Act is to assure an equitable distribution of the bankrupt's assets. Ideally, this would be accomplished by giving each creditor a pro rata share of the estate. However, the demands of social, economic, and political policy have resulted in deviations from a strict rule of equality among creditors. Through the creation of priorities and the recognition of security interests, favored treatment has been accorded to certain classes of creditors. Thus, the Bankruptcy Act has traditionally recognized that a lien is a valid property right which must be satisfied out of the assets to which it attaches before any part of those assets becomes available for distribution to unsecured creditors. Among unsecured creditors, the act established an order of payment which favors the costs of administering the estate, wages, taxes, and rent over general creditors.

"As a result of these prior payments to lienholders and priority claimants, the amount available for distribution to general creditors is considerably diminished and often entirely consumed. To increase their share of the estate, various classes of general creditors at first sought priority status under State law. However, in 1938, in the interest of national uniformity in distributions, the Chandler Act eliminated the recognition of State priorities in bankruptcy proceedings, except for a limited priority for landlords, which was placed on the lowest of five rungs of the priority ladder erected by section 64. The act also gave explicit recognition for the first time to the general validity of statutory liens. Thus, if a class of creditors could obtain State legislation transforming their debts into liens, they would then be in a position superior not only to all other general creditors but to priority claimants as well. This would be the result not only in the case of liens creating a noncontingent property interest in a specific asset but also in the case of liens which became effective only in the event of inslovency or which did not attach to any particular asset. These spurious liens were in reality disguised priorities and the effect of their recognition in bankruptcy would be to distort the federally ordered scheme of distribution by depressing the position of priority claimants.

"The problem was intensified by the contemporary development of a proliferation of taxes at all levels of government. With little formality and frequently without any of the normal attributes of a lien interest, these claims were raised to the dignity of statutory liens.

"It became obvious that if all statutory liens, regardless of what they were in substance, were to be treated as liens in bankrupty the order of federally created priorities would be completely disrupted. In an attempt to protect what it considered to be the most important of the priorities, Congress in the Chandler Act subordinated the most transparent liens to the priorities for costs of administration and wage claims. Thus, section 67c of the Bankruptcy Act provided that statutory liens on personal property not accompanied by possession were to be postponed in payment to the debts specified in clauses (1) and (2), if subdivision a of section 64, namely costs of administration and wages. In addition, section 67c postponed liens of distress for rent whether statutory or not and whether or not accompanied by possession. Here, too, the purpose was to protect costs of administration and wages from a type of claim which frequently consumed all of the assets especially in the smaller estates. Section 67c also limited postponed liens for wages and rent to the same extent as they were restricted as to priority in section 64. In the case of rent, this meant only the

liability for actual occupancy accruing within 3 months prior to bankruptcy. For wages it meant not more than $600 to each claimant earned within 3 months before bankruptcy.

"The purpose of restricting these liens was to protect unsecured creditors rather than junior lienholders. The Chandler Act therefore prescribed that liens should be restricted "except as against other liens." Unfortunately the effect of this exception was to produce unanticipated results where, as a result of the fortuitous intervention of a junior lien, the rent or wage lien became unrestricted at the expense of the general creditors (*In re Eakin Lumber Co.* 39 F. Supp. 787 (N.D. W. Va. 1941), *aff'd sub nom. R.F.C.* v. *Sun Lumber Co.*, 126 F. 2d 731 (4th Cir. 1942)).

"The problem raised in the *Eakin* decision had its legislative repercussion when Congress in 1952 amended the Bankruptcy Act by deleting this exception and adding a provision subrogating the trustee to the amount of the lien in excess of the priority restriction. The position of the general creditors was additionally buttressed by the invalidation as against the trustee of all statutory liens created or recognized by State law on personal property not accompanied by possession, levy, sequestration, or distraint. By this amendment, which became section 67c(2), Congress sought further to implement the established policy of preventing State liens which were essentially priorities from frustrating the order of distribution established by the Bankruptcy Act.

"However, the invalidating provision of section 67c(2) was simply tacked on to the postponement provision in section 67c(1) with a resulting overlap which raised substantial difficulties in statutory interpretation. This is especially acute insofar as State taxes and rent are concerned. For example, do statutory liens for debts owing to a State include liens for taxes? If so, the lien is invalidated; if not, it is merely postponed. The question was considered sufficiently troublesome to precipitate the introduction of clarifying legislation in the 83d Congress at the request of State tax authorities (H.R. 5786, 83d Cong., 2d sess. (1954)). The question was finally litigated in *Rochelle* v. *City of Dallas* (264 F. 2d 166 (1959)), where the fifth circuit held that "debts" do not include taxes.

"The legislative report that accompanied the bill amending the Bankruptcy Act in 1952 observed that the exception "as against other liens" made it difficult to avoid a construction which would introduce circuity of liens (H. Rept. 2320, 82d Cong., 2d sess., p. 14 (1952)). Circuity of liens results when lien B is subordinate to lien A but prior in right to lien C, which, however, is in turn entitled to priority over lien A. Although the 1952 amendments eliminated the circuity problem insofar as it arose from the restriction of wage and rent liens, there was a failure to anticipate the possibility of a circuity problem arising where State law places a lien postponed under the Bankruptcy Act in a position senior to liens unaffected by postponement. The problem thus created has been characterized as "a first rate legal puzzle insoluble on any known legal principles."

"In 1955, the problem was brought to a head by the decision in *In re Quaker City Uniform Company* (134 F. Supp. 596 (E.D. Pa.)). In that case a bank and another creditor had advanced money to the debtor long before bankruptcy. As security they had taken chattel mortgages which they promptly recorded. When the debtor went into bankruptcy there were four claims upon the proceeds from the sale of property which was subject to the chattel mortgages. They were—

"(1) Chattel mortgages, which were prior in time to all other claims;

"(2) Costs of administering the estate;

"(3) Rent owing to the landlord who had distrained but had not caused any of the property to be sold under the distraint;

"(4) Wage claims.

Under Pennsylvania law a lien of distraint for rent is superior to a chattel mortgage even though the chattel mortgage is prior in time.

"In a series of decisions demonstrative of the difficulties inherent in section 67c the referee, district court, and court of appeals all arrived at different and conflicting orders of distribution. The referee held that the chattel mortgages were not postponed and that they should be paid first followed by the cost of administration, wages, and the rent lien. The district court rejected this order of distribution and held that although the chattel mortgages should be paid first, they were under Pennsylvania law subordinated to the rent lien and therefore the landlord should be paid out of the amount set aside for the chattel mortgages. After recalling a decision in which it held the chattel mortgages to be a statutory

lien, the court of appeals held (238 F. 2d 155 (3d Cir. 1956)) that the proceeds from the sale of the mortgaged property was to be distributed in the following order:

"(1) Costs of administration;

"(2) Wage claims;

"(3) Rent;

"(4) Chattel mortgages.

The costs of administration and wage claims having consumed the estate, neither the landlord nor the chattel mortgagees received anything. The court reached this result upon the theory "that Congress did not intend by section 67c, to disturb the priority of liens established by State law." Since section 67c postponed the lien for rent to costs of administration and wage claims, and since Pennsylvania law subordinated the chattel mortgages to the landlord's lien, the court concluded that the chattel mortgages must also be subordinated not only to the landlord's lien but also to the costs of administration and wages. The rule of the *Quaker City* case was adhered to in *In Re Einhorn Bros., Inc.* (272 F. 2d 434 (3d Cir. 1959)).

"Although the effect of section 67c appears settled in the third circuit, the conflicting conclusions reached in other circuits emphasizes the uncertainty which plagues any application of section 67c. In *New Orleans* v. *Harrell* (134 F. 2d 399 (5th Cir. 1943)), the fifth circuit held that since chattel mortgages were unaffected by the postponement provision of section 67c(1), they should be paid first and then the costs of administration, wages, and the city's tax lien. This disposition was rejected by the ninth circuit in *California State Department of Employment* v. *United States* (210 F. 2d 242 (1954)). In that case it was held that an amount should first be set aside equal to the claim of the lien which was senior outside of bankruptcy but was subordinated by section 67c. Out of this sum the costs of administration were to be paid. The unsubordinated lienor would then have the right to be satisfied first out of the remainder of the estate, if any.

"The overall effect of these decisions on the commercial world has been to create considerable uncertainty as to the strength of secured credit. As a result of the *Quaker City* decision, particularly, the problem has become serious in the entire field of secured financing. By destroying the position of valid consensual liens solely because of the fortuitous intervention of a postponed lien, the *Quaker City* doctrine can only result in either the curtailment of credit or an increase in interest rates. This is especially so in the case of the marginal businessman who was able to get secured credit at a reasonable rate but will be unable to do so if security is made meaningless.

"However, aside from the merits or shortcomings of these decisions, the simple fact that a section of law is susceptible to a seemingly unlimited variety of interpretations is reason enough for its amendment.

"To overcome the problems created by subdivision c of section 67, section 6 of this bill completely revises that subdivision. New standards are established for the invalidation of statutory liens and the circuity potential in the present section is eliminated.

"Since the effect of section 67c is limited to statutory liens and does not include consensual liens, it is essental that the term "statutory lien" be clearly defined. The Bankruptcy Act nowhere defines that term. Therefore, section 1 of the bill provides that a statutory lien shall mean a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute, and whether or not the agreement or lien is made fully effective by statute.

"The definition is directed at preventing a recurrence of the misapplication which appeared in the first decision in the *Quaker City* case. There the court held that since the chattel mortgage depended upon the Pennsylvania recording statute for its effectiveness against subsequent transferees, the chattel mortgage was a statutory lien. The purpose of section 1 is to specifically embody the meaning which Congress originally intended in the act and thus to assure that consensual securities are not subjected to any of the tests of validity prescribed by the new section 67c.

"It will be recalled that one of the major objectives of the Chandler Act was to overcome the distortion of the Federal order of distribution by the creation of spurious statutory liens. To upset these liens which were in reality priorities, the authors of the Chandler Act decided that if statutory liens on personal prop-

erty, unaccompanied by possession were postponed to wages and costs of administration, the most serious effects of these liens could be overcome. This provision was strengthened in 1952 when most liens of this nature were completely invalidated. However, a recent reexamination of State lien statutes has shown that neither the standard of possession nor the distinction between real and personal propery is an entirely satisfactory criterion. Some lines which are genuine property rights are affected and others which were essentially State-created priorities escape.

"To insure the supremancy of the order of distribution provided in the Bankruptcy Act insofar as it is consistent with the continued recognition of genuine lien interests, this bill would eliminate lack of possession of personal property as the standard for upsetting liens and would instead invalidate as against the trustee every lien which falls within any of the following categories:

"(1) Every statutory lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property or upon execution against his property levied at the instance of one other than the lienor.

"(2) Every statutory lien not perfected at the date of bankruptcy as against a subsequent bona fide purchaser from the debtor on that date.

"(3) Every statutory lien for rent and every lien of distress for rent.

"The first of these provisions strikes at liens which merely determine the order of distribution upon insolvency or liquidation. This kind of lien is not a specific property right which may be asserted independently of a general distribution and regardless of the transfer of the property. This is clearly a disguised priority.

"The second provision strikes at a lien which is so tenuous that it can be defeated by transfer to a bona fide purchaser. The holders of such liens have reason to know that their security is extremely vulnerable. It would seem that if, apart from bankruptcy, a lien is not good against a bona fide purchaser, then it should not be valid against the trustee. However, it should be noted that under the proviso to the new section 67c(1) (B), the substance of which is now found in section 67b, a lien that is valid against the creditors described in section 70c (and therefore against the trustee) may thereafter be perfected against bona fide purchasers and therefore against the trustee by filing notice with the bankruptcy court.

"The new section 67c(1) (C) invalidates statutory liens for rent and liens of distress for rent, whether statutory or not. Under present law, statutory liens for rent unaccompanied by possession or distraint are likewise invalidated, but common law and statutory liens of distress for rent are postponed and restricted where accompanied by an actual levy of distraint or possession in the lienor. Section 64a(5), as proposed in this bill, would specifically give a restricted priority to debts for rent owing to a landlord who is entitled to a priority by applicable State law or who is entitled to priority by section 67c(2). The proposed section 67c(2) provides that invalidated rent liens should be allowable with a restricted priority, 'even though not otherwise granted priority.' Thus, although a priority for rent heretofore has been recognized only if State laws granted the priority, the new section 67c(2) accords priority to the holder of an invalidated rent lien, even though no State law otherwise grants priority to such a landlord. Through recognizing State priorities for rent and in granting a priority status to invalidated rent liens, the bill respects a policy widespread among the States of granting a preferred status to landlords' claims, but brings it within the scheme of distribution of the Bankruptcy Act.

"It is believed that these amendments, in addition to implementing the distributive scheme of the Bankruptcy Act, will provide a standard which is clear and more easily applicable than exists under present law.

"The compound confusion of circuity demonstrated in the *Quaker City* case discussed above is dealt with in the new section 67c(2) which is found in section 5 of the bill as reported. That subdivision provides that any lien which is invalidated against the trustee shall be invalid against all liens indefeasible in bankruptcy. Thus under this bill the chattel mortgage in the *Quaker City* case, which was a lien indefeasible in bankruptcy, would not be subordinated to the landlord's lien. While this provision may in some cases result in a ranking of liens in bankruptcy different from what it would be apart from bankruptcy, this is necessary if the paramount order of distribution created in the Bankruptcy Act is to prevail.

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

"The amendment to section 67c in this bill retains the provision of existing law which postpones a tax lien on personal property not accompanied by possession to the debts specified in clauses (1) and (2) of subdivision (a) of section 64. However, the treatment of the circuity problem here is somewhat different from that in the bill which passed both Houses in the 86th Congress. In that bill, H.R. 7242, the recurrence of circuity confusion was prevented by specifically providing that postponement shall be not only to the debts specified in section 64(a) (1) and (2) but also to all liens indefeasible in bankruptcy. While this language would effectively prevent the circuity which occurred in the *Quaker City* case, the Treasury Department, after passage by the House, objected to this approach on the ground that it would result in a windfall to secured claims recorded after the filing of notice of a tax lien.

"In order to avoid this result, the proposed section 67c(3) in this bill provides that where a postponed tax lien is prior in right to liens indefeasible in bankruptcy, the court shall order payment from the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual cost of that sale, of an amount not excess of the tax lien, to the debts specified in clauses (1) and (2) of subdivision (a) of section 64 of this act. If the amount realized from the sale exceeds the total of such debts, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the debts specified in clauses (1) and (2) of subdivision (a) of section 64 of this act and the amount of the tax lien, is to be paid to the holder of the tax lien.

"This approach adopts the solution which three courts have already innovated under the existing language of section 67c. See *California State Department of Employment* v. *United States* (210 F. 2d 242 (9th Cir. 1954)); *In re American Zyloptic Co., Inc.* (181 F. Supp. 77 (E.D.N.Y. 1960)); *In re Empire Granite Co.* (42 F. Supp. 450 (M.D. Ga. 1942)).

"In order to compare the different results which would occur under the various rules of distribution which have been discussed, let us assume the following hypothetical situation:

Chattel mortgage No. 1, recorded Jan. 1, 1963	$7,000
Tax lien on personal property, unaccompanied by possession, recorded Feb. 1, 1963	8,000
Chattel mortgage No. 2, recorded Mar. 1, 1963	4,000
Costs of administration	1,000
Wage claims	2,000

"Assume further that the bankrupt estate is $15,000.

"Under the principle of the *Quaker City* decision the estate would be distributed as follows:

Costs of administration	$1,000
Wage claims	2,000
Tax lien	8,000
Chattel mortgage No. 1	4,000
Chattel mortgage No. 2	0

"It will be noted that under this distribution chattel mortgage No. 1, which was recorded prior to the tax lien, received only $4,000 of the $7,000 due it, whereas the subsequent tax lien was paid in full.

"Under H.R. 7242 in the 86th Congress the distribution would be as follows:

Chattel mortgage No. 1	$7,000
Chattel mortgage No. 2	4,000
Costs of administration	1,000
Wage claims	2,000
Tax lien	1,000

Under this distribution, chattel mortgage No. 2, which is junior to the tax lien, is paid in full but the tax lien receives only $1,000.

"Finally, under the amendment to section 67c in H.R. 186, the estate would be distributed as follows:

Chattel mortgage No. 1	$7,000
The amount of the tax lien, $8,000, to be paid as follows:	
Costs of administration	1,000
Wage claims	2,000
Tax lien	5,000
Chattel mortgage No. 2	0

This solution would prevent the subordination of the tax lien to chattel mortgage No. 2, a subsequent consensual lien. It would also assure priority over the tax lien of chattel mortgage No. 1, a lien which is prior to the tax lien.

"This solution thus avoids the situation where the fortuitous intercession of a subsequent tax lien may result in little or nothing being left for the secured creditor as accrued in *Quaker City*. At the same time, it prevents a lienor who has a lien subsequent to a tax lien from receiving more than he would get if bankruptcy had not occurred.

"It should be noted, too, that in a case where there is not enough to pay the tax lien in full, any deficiency remains a claim which, under section 64a(4), is entitled to a priority on the unsecured assets of the estate. In addition, under present law, tax debts are not dischargeable, and any deficiency remains a claim against the debtor even after bankruptcy.

"In respect to the relation between new sections 67c(1) and 67c(3), it is the intention of the committee that a statutory tax lien on personal property not accompanied by possession shall first be tested by the standards of section 67c(1). Section 67c(3) is then to be applied to those liens which have not been invalidated by section 67c(1).

"The second major problem with which this bill is concerned arises from the application of section 70 of the Bankruptcy Act. Section 70 is the 'title' section of the act and provides many of the legal tools for assembling the bankrupt's estate. It defines the rights and remedies of the trustee in this process. This bill deals only with the second sentence of section 70c which is derived from the 'strong arm' amendment of 1910. That sentence gives the trustee the position of hypothetical judicial lien creditor as of the date of bankruptcy. The question arises, however, as to whether this standard includes that of a judgment creditor. The answer to that question is particularly important because section 6323 of the Internal Revenue Code provides that a Federal tax lien is not valid 'against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed' in the appropriate office.

"As a result of several recent decisions, it would appear that the courts are of the view that the trustee does not have the status of a judgment creditor for purposes of section 6323. The direction of judicial thinking is discernible from the decisions in *United States* v. *Gilbert Associates, Inc.* (345 U.S. 361 (1953)) and *United States* v. *Acri* (348 U.S. 211 (1955)). In *Gilbert*, the court upheld the validity of the Federal tax lien against a prior lien which, under New Hampshire law, was given the status of a judgment. In *Acri* the court similarly upheld the Federal tax lien against a prior attachment lien which, under the law of Ohio, was deemed to be 'and execution in advance.' The rationale of the court's decisions is that a uniform application of the Federal tax law required that the term 'judgment creditor' be defined in the 'usual conventional sense of a judgment of a court of record' which is common to all States (*United States* v. *Gilbert*, supra at 364).

"Although these cases did not involve the interrelationship of the Internal Revenue Code with the Bankruptcy Act, the limitation of the term 'judgment creditor' to one holding a judgment of a court of record was subsequently extended to the application of section 70c. In 1960, the issue came before the third circuit in *In the matter of Fidelity Tube Corp.* (278 F. 2d 776). After

hearing the case reargued twice, the court in a 5-to-2 decision held that the trustee was not a judgment creditor for purposes of the Internal Revenue Code. The court declared that its ruling turned in large part upon its interpretation of *Gilbert*

"In *Brust* v. *Sturr* (237 F. 2d 135 (1956)), the second circuit, also on the basis of the *Gilbert* case, reversed the position which it had previously taken in *United States* v. *Sands* (174 F. 2d 384 (1949)), and held that the trustee we not a judgment creditor within section 3672 of the Revised Statutes (now sec. 6323 of the Internal Revenue Code). This view had already been taken by the sixth circuit in *Re in Taylorcraft Aviation Corporation* (168 F. 2d 808 (1948)), and by the ninth circuit in *United States* v. *England* (226 F. 2d 205 (1955)).

"The effect of these decisions is that the Federal Government's unrecorded tax lien prevails over the rights of the trustee under section 70c. This would appear to be contrary to the legislative purpose which gave the trustee all the rights of an ideal judicial lien creditor. Prior to 1950, the trustee was given the status of a judicial lien creditor as to all property coming into the possession of the bankruptcy court. As to all other property, he was given the rights of a judgment creditor holding an execution returned unsatisfied. In 1950, the distinction which turned on possession was eliminated and the trustee was simply given the rights of a judicial lien creditor. The House report which accompanied the bill indicates that the purpose of Congress was not to contract but rather to expand the rights of the trustee under section 70c. The report states that the amendment to section 70c 'has been placed in the bill for the protection of trustees in bankruptcy as correlative to the amendment to section 60, and also to simplify, and to some extent expand, the general expression of the rights of trustees in bankruptcy' (H. Rept. 1293, 81st Cong., 2d sess., p. 7 (1949)).

"As a matter of general law, the holder of a lien by legal proceedings has greater rights than a judgment creditor who usually has no rights in the personal property of the debtor by virtue of his judgment. Even as to real property it is frequently necessary for the judgment creditor to take further action after judgment to create a lien. It would seem anomalous to allow judgment creditors to prevail over secret tax liens and to deny that right to a judicial lienholder. As against liens and transfers other than Federal tax liens, it has generally been held that a trustee in bankruptcy does have the rights of a judgment creditor. See, e.g., *McKay* v. *Trusco Finance Co.* (198 F. 2d 431 (5th Cir. 1952)); *Sampsell* v. *Straub* (194 F. 2d 228 (9th Cir. 1951)), cert. denied, 343 U.S. 927 (1952).

"The need for forthright congressional action in this matter was underscored by the decision in *Fidelity Tube*, supra. There the court pointed to the fact that legislation clarifying the status of the judgment creditor was pending before Congress and further declared that it considered the enactment of such legislation necessary if the trustee was to have the status of a judgment creditor vis-a-vis the Federal tax lien.

"In order to assure the trustee of this status, section 6 of H.R. 136, as reported, specifically provides that a trustee shall have the rights and powers of 'a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists.'

"The question of whether the higher standing given the trustee by the 1950 amendment includes lesser rights has been raised in another context. Prior to 1950, the trustee specifically had the rights of a judgment creditor holding an execution returned unsatisfied insofar as property not coming within the custody of the court was concerned. It is now feared, however, that the trustee may be denied remedies which, under State law, are available only to creditors holding executions returned unsatisfied. Since the trustee often gains title to property the extent and location of which is unknown to him, he may wish to resort to discovery proceedings. Yet, in some States, if the trustee does not have the rights of a judgment creditor holding an execution returned unsatisfied, such proceedings are not available to him under State law. In order to assure that the trustee is given the rights and powers of a judgment creditor holding an execution returned unsatisfied, section 6 of this bill specifically grants those rights and powers to him.

"If a security transaction or other transfer involving a debtor's property is valid in part against creditors whose rights and powers are conferred upon the trustee by the proposed amendment, it seems clear that it should be valid to the same extent against the trustee. While nothing in the proposed or existing legis-

lation empowers the trustee to invade interests that no creditor described in the new version of the 'strong arm' clause could have reached, it has been thought advisable not to leave this limitation in the realm of inference. Thus, a security transaction involving property located in more than one county or State may be perfected against creditors having the rights conferred upon the trustee by the proposed subdivision, only in respect to the property located in one of the jurisdictions. The security transfer would remain valid against the trustee under the proposed section 70c insofar as property in the one jurisdiction is covered. In like manner, a security transaction duly perfected as to one kind of property but not as to another, or valid to the extent of only a part of the consideration given, would remain valid pro tanto against the trustee so far as this subdivision would apply.

"Section 70c expressly confers upon the trustee a variety of legal positions. Related to State and Federal law these positions carry with them a substantial number of rights. To exercise an effective general levy upon the property of the bankrupt, the trustee must be allowed to bring to bear upon each party or transaction whichever of his rights may be necessary. However, it would seem improper to allow him to occupy inconsistent or repugnant positions with reference to a particular party or transaction. Nevertheless, having chosen a position with respect to one set of circumstances, the trustee as a representative of all of the creditors of the bankrupt should not be barred from asserting a different position in other circumstances. The proposed section 70c therefore contains what has been called a chameleon clause, safeguarding the trustee's right to take inconsistent positions with respect to different parties, remedies, or transactions.

"As rewritten in H.R. 136, section 70c presents a clearer and more complete expression of basic bankruptcy policy.

"In the course of remedying the major problems to which this bill is directed, a number of clarifying amendments were made to involved and related sections of the act. A brief explanation of these may be helpful.

"(1) Section 64a(5). In amending section 64a(5) the word 'debts' was modified by the phrase 'other than for taxes.' Section 64a(4) expressly creates a priority for taxes. Since the term 'debts,' apart from any consideration of legislative purpose in a particular context, includes all liabilities, there is an apparent overlap between sections 64a(4) and 64a(5). By modifying the term 'debts' to exclude taxes, the ambiguity is eliminated.

"(2) Section 67b expresses the general policy in bankruptcy of recognizing the validity of statutory liens. This policy is, of course, qualified by section 67c which invalidates liens that are essentially disguised priorities. In order to clarify the interrelationship between the two subdivisions, the language 'and except as otherwise provided in subdivision c of this section' is inserted in the first sentence of present section 67b. Since landlords' liens are expressly invalidated under the proposed section 67c, the term 'landlords' has been deleted from among the enumerated liens in 67b. In the interest of clarity the substance of the last sentence of subdivision b has been deleted and instead inserted as a proviso in section 67c(1)(B)."

Mr. Chairman, I believe that this bill represents an effective and equitable solution to a number of problems which are creating undesirable conditions in the commercial community. I urge favorable consideration of this measure.

STATEMENT OF HON. RICHARD POFF BEFORE THE SENATE FINANCE COMMITTEE IN SUPPORT OF H.R. 3438

Mr. Chairman, I wish to briefly express my support for the bill, H.R. 3438, which limits the priority and nondischargeability of tax claims in bankruptcy proceedings.

This measure has passed the House on numerous occasions but has consistently failed of enactment in the Senate. This measure has had bipartisan support since its initial introduction. That support was most recently expressed on Monday of this week when the House once again passed the bill.

H.R. 3438 would remove an inequity in the administration and distribution of a bankrupt's estate which is so obvious it is difficult to percieve why it was permitted to exist in the first place. If Federal bankruptcy policy is intended to serve a humane purpose (which is clearly one of its fundamental objectives), then it utterly fails in allowing unlimited priority and nondischargeability of tax claims.

The inequity of the present law is vividly demonstrated by examining the difference in treatment between an individual and a corporate bankrupt. Only the individual bankrupt remains burdened with undischarged taxes. The corporate bankrupt, while not discharged, may go out of existence—if continued, it may reestablish itself in a new corporate form, free of past tax liability. Thus, the existing provision in the Bankruptcy Act providing that taxes shall not be discharged is seriously discriminatory and unfair to the individual taxpayer.

By establishing a 3-year period on the nondischargeability of taxes and by limiting the priority of taxes to those which became due and payable within 3 years prior to bankruptcy, H.R. 3438 would promote both the financial rehabilitation of the bankrupt, and the equitable distribution of a bankrupt's estate. It would thus secure the fundamental objectives of Federal bankruptcy policy.

I urge that the committee give favorable consideration to this measure.

Mr. WHITENER. I would like to thank also the members of the committee for giving me an opportunity to appear here in support of H.R. 3438 of which I am the author. Senator Ervin is the author of a similar bill in the Senate.

I am sure that anything that I might say after your hearing from such a distinguished lawyer as Senator Ervin, would be of little effect, but I would like to associate myself with him in the remarks that he has made, and point out that similar bills have passed the House of Representatives in now five Congresses. Just a few days ago we again passed it in the House on the consent calendar after a unanimous approval for the fifth time by the Committee on the Judiciary, of which I am a member.

Under existing law, debts for taxes survive a bankrupt's discharge and are entitled to a priority of payment without limitation in advance of the payment of any dividends to general creditors.

H.R. 3438 would make dischargeable in bankruptcy debts for taxes which became legally due and owing more than 3 years preceding bankruptcy. It would also limit the priority accorded to taxes in the distribution of bankrupt estates to those taxes which became legally due and owing within 3 years preceding bankruptcy.

When originally introduced by me, this bill provided for a limitation of the priority of taxes under section 64a of the Bankruptcy Act to those which became due and owing within 1 year before bankruptcy. However, to meet objections raised by the Treasury Department, the bill was amended to its present form which provides that section 17 of the Bankruptcy Act shall be amended to discharge a bankrupt from all liability for taxes except those which became legally due and owing by the bankrupt within 3 years preceding bankruptcy except—and I think these are important exceptions:

(1) Where the tax was not assessed within the normal time because of a failure to file a return; or

(2) Where the return was false or fraudulent; or

(3) Where no return was filed with intent to evade the tax, or

(4) Where the bankrupt has collected or withheld from others as required by Federal, State, or local law, but has not paid over those collections to the taxing authority.

These safeguards are designed to assure that the bill's objectives are realized and to prevent abuses.

Another section of the bill limits the priority accorded taxes by section 64 of the act to those which became legally due and owning by the bankrupt within 3 years before bankruptcy. The net effect of the bill is that all taxes which became legally due and owing within 3

years prior to bankruptcy are entitled to priority payment and are not dischargeable; that all taxes which antedate the 3-year period rank merely as general claims on a parity with those of other creditors and are discharged by the discharge of the bankrupt.

This measure deals with a problem which is fundamentally a bankruptcy problem. The basic policy of the Bankruptcy Act, as this committee knows, is to provide a means for both the effective rehabilitation of the bankrupt, and the equitable distribution of the bankrupt's assets among his creditors. These basic considerations are involved in the problem to which this bill is addressed.

There are two aspects to the problem. One involves the nondischargeability of taxes under section 17a(1) of the present law. The other involves the equitable distribution of the assets of the bankrupt's estate among creditors. H.R. 3438 establishes a 3-year period on the nondischargeability of taxes. It is important, as Senator Ervin has pointed out, to realize that it is only the individual bankrupt who remains burdened with undischarged taxes, while the corporate bankrupt, while not discharged, may cease to exist upon an adjudication in bankruptcy, and the enterprise, if continued, is reestablished in a new corporate form, free of tax liability. Thus, the existing statutory provision of section 17 of the Bankruptcy Act providing that taxes shall not be dischargeable is grossly discriminatory and unfair to the individual taxpayer. A further consideration is that rehabilitation of honest but unfortunate debtors (which is a primary purpose of the Bankruptcy Act) is in many cases impossible because of the undischarged tax burden.

Senator LONG. Let me ask a question of Treasury at that point.

Does Treasury have any serious objection to letting these people be discharged of tax liabilities that run back more than 3 years when they go through, when an individual goes through, bankruptcy?

Are your people in position to take a stand on that, Mr. Stone?

Mr. STONE. It would depend upon when the 3 years run from, surely. If the Commissioner never had a chance to collect the tax, for example, because the tax had never been assessed, we would, of course, object.

If we were talking about a period that ran from the date of assessment, then I think our position might be different, but we do not have a definite position on that.

Senator LONG. Why don't you see if you can come up with a position, something that you think you can live with.

Mr. STONE. We will. We think there is some point at which discharge should be available to bankrupts, and we are not unwilling to consider that.

Senator LONG. It seems to me as though you ought to. I think he is right on that point. I am not in a position to say just at what point the 3 years ought to run from, but it seems to me as though 3 years is a fair period, that you do not go back more than 3 years after a man goes through bankruptcy, assessing him with something after that.

Mr. STONE. That is correct, but depending upon when the 3 years run from.

Senator TALMADGE. May I ask a question on that point?

Senator LONG. What is your reaction, Congressman?

Mr. WHITENER. May I point out with respect to what Mr. Stone said, there is no reason why, if this bill becomes law, the Treasury Department cannot protect itself unless it is guilty of negligence and laches, because of the exceptions that the bill sets forth, which I pointed out earlier, that if the taxpayer has not filed a return, if the taxpayer has filed a fraudulent return, if the taxpayer has collected withholding money and has not remitted it, or if no return was filed with intent to evade taxes, then this bill would not become applicable.

So, what the Treasury Department is saying, I gather from Mr. Stone's statement, is that they should have longer than 3 years to do the normal evaluation of tax returns and a determination of tax liability. I submit to you that when the First National Bank of your home city seeks to extend credit to some individual, they make the decision in a very short time, in very short order, and they have to go to the courthouse and look at what records are there.

As Senator Ervin has said, in our State, the only thing that the Revenue Service has to do is write a letter to the Register of Deeds saying that Joe Jones owes $1,000 for 1963 taxes, which he has not paid. They have a form letter to use. Thereupon, the Register of Deeds enters that into a book called the Federal Tax Lien Book, alphabetically listed, and it is a lien which takes priority from that date.

So, there is a lot of difference between the tax folks getting a lien on the books and a bank getting a mortgage on. They do not have to check titles or do anything else. They just have to write a form letter and type in the amount.

Senator TALMADGE. May I ask you a question at that point, Congressman Whitener?

Do these two bills affect tax lien status of cities and counties and States?

Mr. WHITENER. I would prefer not to go into Mr. Poff's bill, because I have not gone into it recently. But the bill would deal with local, State, and Federal taxes in the same way.

Senator TALMADGE. Do you know whether or not their comments have been solicited and heard?

Mr. WHITENER. We have had no objection whatever from any State taxing authority, and it has been taken up with some of the States by members of the Judiciary Committee, particularly one of our members, Mr. Rogers of Colorado.

Senator TALMADGE. I wonder if any of the States have laws similar to the one you are proposing here?

Do you know, Senator Ervin?

Mr. WHITENER. I do not know.

Senator ERVIN. I will have to confess I do not. It has never been so much a problem with the State laws, because in most State, like mine people were wise enough to write into the constitution that the income tax could not exceed certain limits, and the highest is 7 percent.

The Poff bill, as I construe it, would protect a lien of the Federal Government, if the Federal Government has made a public filing of the Federal tax lien, or the State government has made a public filing of the State tax lien. They would both be standing in the same situation, and they would have a priority. They would have not only a priority, but they would come under the lien classification.

Mr. WHITENER. I do not know that our State has a similar provision, but I believe that under the general law of our State, unless they did make their lien public by recording, that the 3-year statute of limitations would run in North Carolina against the State, would it not?

Senator ERVIN. I am not sure, but our law does provide for the State filing liens, just as it authorizes the filing of Federal liens.

Mr. WHITENER. It not only authorizes that but it authorizes the issuance of an execution without any further ado. All the State tax authority has to do is to go out and levy.

Senator TALMADGE. And go out and levy. The same situation exists in Georgia.

Mr. WHITENER. We who support this measure, H.R. 3438, believe it is inconsistent with the policy of the Bankruptcy Act that an honest individual who, through no fault of his own, becomes bankrupt, should be unable to make a fresh start unburdened by liability for accumulated taxes.

The imposition of some time limitation upon the extent of taxes exempt from discharge is essential to assure both a more equitable distribution of a bankrupt's assets and the financial rehabilitation of the bankrupt.

In addition to establishing a 3-year period on the nondischargeability of taxes, the bill would limit the priority of taxes to those which become due and payable within 3 years before bankruptcy. We do not believe this will impose an unrealistic or unfair burden upon the tax authorities. The 3-year period coincides with the 3-year statute of limitations for assessment in Federal income tax cases. Moreover, the fact that tax claims for the 3 years preceding bankruptcy will not be discharged should discourage recourse to bankruptcy by those who would evade their tax obligations. At the same time it will permit an industrious debtor to reestablish himself as a productive and taxpaying member of society.

While, under this bill, unsecured tax claims due and owing more than 3 years prior to bankruptcy would be dischargeable, there is no intention to place any time limit on otherwise valid tax liens. As with other secured claims like mortgages and conditional sales contracts, the purpose of the lien is to give the creditor a property interest which is indefeasible in bankruptcy. Thus, to the extent that the tax authorities may satisfy their claims out of the security they hold, they will be unaffected by the discharge regardless of the fact that the underlying debt may include taxes for years prior to the 3-year period preceding bankruptcy.

What has been the effect of the present provision granting unlimited priority to tax claims? Experience has shown that some of the taxing authorities are dilatory in collecting the amounts due them. Taxes are often allowed to accumulate over a period of years. The amount of accumulated and unpaid taxes is not known and is unascertainable by those from whom the bankrupt makes purchases on credit.

Over the years, our House Judiciary Committee has received hundreds of letters from business firms all over the country complaining about this situation. Although a creditor can protect himself to some degree by requiring periodic financial statements from the bankrupt, there are cases in which the true extent of tax liability may not be known, even to the debtor, as where there are unsettled accounting or

legal questions. Nor is the creditor protected from a dishonest debtor who issues a false statement of his tax liability. While this may result in barring the debtor's discharge, the Government still has a tax priority which may be large enough to preclude the creditor's participation in the distribution of the debtor's assets.

The effect of the enactment of this measure would be to challenge the taxing authorities to greater diligence in pursuing their remedies.

The contention by the Treasury Department that this bill will compel the Government to refuse leniency to hard-pressed taxpayers and even force taxpayers into bankruptcy who otherwise might have had a chance to rehabilitate themselves, is unpersuasive. It may also be argued that the present unlimited tax priority often puts pressure on general creditors to curtail credit and to precipitate bankruptcy in order to stop the accumulation of tax claims which may exhaust all of the debtor's assets. Trade creditors and taxing authorities would both benefit more in the long run if they work together rather than in competition for the assets of the bankrupt's estate.

It is also important, I think, to dispute the contention of the Treasury Department that this bill counters the social policy of this Nation by relieving bankrupts of tax debts. The unlimited priority now enjoyed by taxes in bankruptcy proceedings in the United States is inconsistent, and I would add, less enlightened than the social policy in most commercial countries. Thus, several Western commercial nations limit the priority of tax claims in bankruptcy; for example, England, 1 year; Australia, 1 year; France, 2 years; Germany, 1 year; Belgium, 1 year.

In conclusion, I would emphasize again that this is a modest bill. There are no dire consequences to revenue collections here if it is enacted. We have approached this problem in a spirit of accommodation. Over the years, this measure has been amended to meet many of the Treasury Department's criticisms. As I mentioned earlier the original 1-year priority for taxes was extended to 3 years; in addition, explicit safeguards, which I have already mentioned, are incorporated in the measure to protect against abuses.

Fundamentally, the bill deals with bankruptcy problems, the resolution of which should be within the framework and policy of the Bankruptcy Act. That policy seeks to provide an effective means of rehabilitating the bankrupt, and to assure an orderly and equitable distribution of the bankrupt's assets among his creditors.

I wish to suggest to the committee that H.R. 3438 presents a most desirable and necessary resolution between the demands of the public revenue on the one hand and the underlying purposes of the Bankruptcy Act on the other.

Thank you very much.

The CHAIRMAN. The Chair desires to insert in the record a letter from the American Bankers Association in support of H.R. 136 and H.R. 3438; also a statement received from James W. Roberts of Norfolk, Va., on behalf of the National Association of Wholesalers, endorsing H.R. 3438.

(The documents referred to follow:)

THE AMERICAN BANKERS ASSOCIATION,
Washington, D.C., August 4, 1965.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Old Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: The American Bankers Association takes this opportunity to express its support for H.R. 136 and H.R. 3438.

H.R. 136 (S. 1912)

The provisions of H.R. 136 are needed to correct inequities and remove confusion concerning the status of chattel mortgages and other contractual financing arrangements in which collateral is left in possession of the debtor. Confusion and inequities that have resulted from court decisions are of concern to banks and other lenders because of their adverse effect on the extension of credit secured by personal property. It should be noted that these decisions have not only cast doubt upon the validity of chattel mortgages but also upon factors liens, trust receipts, assignment of accounts receivable, conditional sales, and other forms of security device in which collateral is left in the hands of the debtors. Unless this situation is remedied, prospective borrowers who have only personal property to offer as security may find that they are unable to obtain credit even though their collateral would otherwise be acceptable to lenders.

In a letter dated September 8, 1961, the Treasury Department set forth several objections to tax features of the legislation which, in our opinion, have been effectively answered in Senate Report 277. We will merely comment on the requirement that notice of a tax lien must be filed in order for it to be valid against the trustee in bankruptcy. The American Bankers Association believes that this provision is a vital part of the legislation and should be retained.

Creditors should be protected against secret liens arising from taxes or otherwise. The damage inflicted by an unfiled tax lien is as great as that resulting from any other type of secret lien. The Treasury points out that filing of notice of a tax lien may have the effect of curtailing the extension of credit to the taxpayer. It is certainly true that creditors may be less likely to advance credit to a debtor who has not been able to pay his taxes. However, it seems only just that before making credit decisions a lender or seller should be alerted to the real financial position of the borrower or purchaser. Generally, creditors (who cannot receive dividends in bankruptcy proceedings until taxes are paid in full) will be benefited by H.R. 136 which will encourage the Federal Government, like other secured creditors, to divulge information concerning their liens. It is difficult to see how H.R. 136 could have any appreciable effect on revenue and as indicated, this amendment would be of great benefit in administering the estate of bankrupts.

H.R. 3438 (S. 976)

H.R. 3438 would make dischargeable in bankruptcy debts for taxes which became legally due and owing more than 3 years preceding bankruptcy. It would also limit the priority accorded to taxes in the distribution of a bankrupt's estate to those taxes which became legally due and owing within 3 years preceding bankruptcy.

The present unlimited priority of tax claims encourages the tax collecting authorities to be dilatory in making collection of amounts due them since the priority makes it unnecessary for them to determine and assess taxes which have been due for many years before bankruptcy intervenes. The result is that the taxes which have accumulated over a period of years are paid out of amounts that would otherwise go to general creditors who had no way of determining the amount of unpaid taxes.

Under existing law all tax claims, Federal, State and local, survive a bankruptcy discharge. These undischarged taxes in some cases may prevent the rehabilitation of honest but unfortunate debtors.

We would appreciate it if this statement were included as part of the hearing record.

Sincerely yours,

CHARLES R. MCNEILL.

STATEMENT OF JAMES W. ROBERTS ON BEHALF OF NATIONAL ASSOCIATION OF WHOLESALERS

My name is James W. Roberts, of Norfolk, Va. I am chairman of the board, Henry B. Gilpin Co., a wholesale drug firm with establishments in Norfolk, Baltimore, Washington, D.C., and Dover, Del. Today, I am appearing on behalf of the National Association of Wholesalers in my capacity as chairman of the association's committee on government relations. The National Association of Wholesalers wishes to endorse S. 976 and urges this committee to approve the legislation. We note that a similar bill, H.R. 3438, was approved by the House of Representatives on August 2, 1965.

The National Association of Wholesalers is composed of 44 national commodity line wholesale associations which are comprised of over 18,000 wholesale distribution firms. Wholesalers purchase goods and commodities in bulk quantities and resell them to retailers and business users such as building contractors, service establishments, institutions, hotels, and other businesses. To facilitate the sale of these commodities we wholesalers usually extend short-term credit. Outstanding credit extended by merchant wholesalers now stands at over $16 billion, which is slightly in excess of 1 month's sales by the industry.

It is our understanding that S. 976 would limit the priority accorded to taxes in the disrtibution of the assets of bankrupt persons and corporations to those taxes which became legally due and owing within 3 years preceding the bankruptcy. Under current law, all taxes, irrespective of the time of delinquency, are afforded priority over the other debt claims.

The laws on bankruptcy were enacted to achieve two basic purposes: (1) to rehabilitate economically the bankrupt, and (2) to provide an orderly and just distribution of the remaining assets to all the creditors.

All creditors have an obligation to extend credit judiciously and to collect accounts when due and payable. Tax collecting authorities have the same responsibility and should protect revenues through prompt collection and not through an unlimited priority over other creditors.

If the bankrupt is rehabilitated, the taxes collected on the revised operation will more than offset the tax loss due to the provisions of this bill.

Today, the world of business moves on credit. Literally, millions of retail merchants and business purchasers now receive credit from wholesale-distributors. Generally, this credit is extended for from 30 to 60 days. In addition, credit is frequently extended for longer periods to meet seasonal peaks, or special circumtances, as when credit is extended to a building contractor until completion of a particular project. Through the proper control of outstanding credit we wholesale-distributors have tried to minimize our risks and subsequent losses.

However, debtors do go bankrupt, and the wholesaler who may be the principal creditor, finds that his accounts, which may be delinquent less than 6 months at the time of bankruptcy, become a total loss due to the unlimited priority afforded to delinquent taxes. Unlike many sales at retail, wholesale sales are not made under a conditional sales contract, and the debt is not secured through title to the products sold. Because wholesalers sell for resale or for business use, conditional sales contracts cannot generally be effectively used in making sales at wholesale.

We realize that the Treasury Department has opposed enactment of similar legislation passed by the House of Representatives. We respect their efforts to safeguard the taxes due to Federal, State, and local governments. But this legislation as now approved by the Senate Committee on the Judiciary and now before the Senate Committee on Finance contains many safeguards. Among these are:

1. Taxes which were not assessed because the bankrupt failed to make a return required by law. A discharge in bankruptcy would not release a bankrupt from such taxes due.

2. Taxes which were not assessed due to the bankrupt filing a false or fraudulent return. The bankrupt would still be liable for such taxes.

3. Taxes which the bankrupt had collected or withheld from others, as required by law, but did not forward to proper authorities. Under the provisions of S. 976, a discharge in bankruptcy would not release a bankrupt from such taxes.

These foregoing provisions of the bill would prevent any debtor from using the benefits of S. 976 for false or fraudulent purposes. We believe they are adequate safeguards to the Treasury's responsibility for collecting delinquent taxes. S. 976 would give 3 years' priority to delinquent taxes over all other debts.

This appears to be more than ample time for tax collection authorities to take the administrative and legal steps necessary to collect delinquent taxes.

Certainly, if the Government permits a long accumulation of tax liability, it should share the risks involved, and not prescribe the assets needed to satisfy the claims of all other creditors. When wholesalers extend credit, they do not know the total tax liability of the debtor, for such liability is not public information. In fact, it would be reasonable to assume that tax authorities would not permit a delinquency to extend even for 3 years.

We believe that the Government should share some of the burden imposed by businesses which go bankrupt. By continuing the priority for taxes delinquent less than 3 years, the tax loss should be negligible. Delinquencies which extend more than 3 years are, to a great extent, due to the failure of tax authorities to act in a timely manner. Other creditors should not be penalized because the Government has delayed discharging its responsibility for the collection of taxes when due.

We are hopeful that legislation to achieve a more equitable distribution of the remaining assets of a bankrupt firm can be enacted in this session of the Congress.

Senator ERVIN. We appreciate the patient hearing we have been accorded.

The CHAIRMAN. I am sorry to have delayed you.

Senator Hruska, scheduled to testify, had to go to another meeting. In lieu of appearing, he has submitted written statements endorsing both of these bills, and the statements will be inserted in the record.

(The documents referred to follow:)

STATEMENT BY SENATOR ROMAN L. HRUSKA, OF NEBRASKA, ON H.R. 3438 AND S. 976, LIMITATION ON THE PRIORITY AND NONDISCHARGEABILITY OF TAXES IN BANKRUPTCY

Mr. Chairman, this bill will limit the priority and nondischargeability of taxes in bankruptcy. Existing law affords priority of payment to taxes without limitation in advance of the payment of any portion to general creditors.

Present law prevents an honest debtor from making a fresh start unburdened by what may be an overwhelming liability for accumulated taxes. The rehabilitory purpose of the Bankruptcy Act is frustrated when long overdue taxes continue after bankruptcy. In practice this feature discriminates against the individual debtor since corporations which enter bankruptcy go out of existence having the practical effect of discharging all debts including taxes.

The rehabilitory purpose of the Bankruptcy Act is frustrated when long overdue taxes continue after bankruptcy. This bill would not absolve all tax liability in bankruptcy but rather would limit the dischargeability to taxes which became legally due and owning more than 3 years preceding bankruptcy.

This 3-year limitation provides adequate opportunity for tax collectors to audit returns and assess deficiencies if they are to do so. Incidentally, this period coincides with the 3-year statute of limitations for assessments in Federal income tax cases. The chances for the individual to reestablish himself as a productive and taxpaying member of society are enhanced by preventing him from working himself into an inextricable situation. The bill would not permit discharge where fraudulent means are used to bring discharge.

The revenue which would be derived by the Treasury Department from the continued operation of a business by a solvent debtor would be greater than the amount which may be salvaged by the occasional collection of undischarged tax claims following bankruptcy, and every dollar diverted from the general creditors reduces the amount of their own tax liabilities.

A second aspect of this bill deals with the equitable distribution of the assets of the bankrupt estate among creditors. Under the Bankruptcy Act priority claimants are provided including administrative expenses, wage claims, taxes, and rent claims. Wages claims and rent claims have time or amount limitations but taxes are given unlimited priority. This allows tax collectors to accumulate tax claims without the possibility of discharge in bankruptcy. A financially unsound business thus may continue for many years with accumulated taxes leaving general creditors with nothing. This is particularly unjust since it is often difficult or impossible for a creditor to determine tax liability of a debtor. If the debtor is dishonest in stating his tax liability the creditor has no recourse.

Experience has shown that some of the taxing authorities are dilatory in making collection of the amounts due them. Income taxes and sales taxes are often allowed to accumulate over a period of years with no attempt to enforce the taxes until bankruptcy ensues. At that moment, the taxing authorities descend upon the remains of the bankrupt estate with an accumulated claim for taxes extending back over many years. In many cases, this completely exhausts the assets in the estate and leaves nothing for general creditors. The amount of the accumulated and unpaid taxes is not ascertainable by those from whom the bankrupt makes purchases on credit.

The effect of the enactment of this bill will be to challenge the taxing authorities to greater diligence in pursuing their remedies thereby protecting the remedies of other creditors. If they shrug this duty only taxes which became due and owing within the preceding 3 years will be entitled to preferential payment.

This does not mean that taxing authorities can only collect the amount which became due and owing within the preceding 3 years, only that taxing authorities will receive priority treatment for just 3 years' taxes with the remaining balance being a general claim and entitled to a pro rata share with other creditors. The principle is supported by the laws of most other commercial countries of the world.

A business which is unable to meet tax obligations extending back more than 3 years is unlikey to recover financial viability. The continued failure to protect the Government's tax interest by instituting liens or distraint warrants generally results only in compounding the loss suffered by general creditors and the Government as well. The effect of forcing the financial issue may in some cases be to save the debtor before his position becomes helpless.

If the Internal Revenue is forced to simply bring the tax liability into the open, much of the unfairness of the present practice will be removed. Sufficient powers are present in the Treasury Department to subsequently compromise a taxpayer's liability if the enforcement of the lien seems too harsh. At least the creditors will be apprised and in a position to protect themselves.

There is a policy decision to be made as to whether the Government as a creditor should bear part of the economic burden of business failures through the loss of some of its tax claims. Part of this decision must weigh the fact that the tax authorities have allowed accumulation of the claim over a long period of years. This legislation will induce tax authorities to act to prevent large accumulations of tax claims to safeguard the public's interest in the collection of revenues which are timely due and enforceable.

The decision to be made in this bill is well defined. This bill provides a rational and fair solution to a situation which in some cases is almost intolerable. I urge the committee to report this legislation.

STATEMENT BY SENATOR ROMAN L. HRUSKA, OF NEBRASKA, ON H.R. 136 AND S. 1912, LIENS IN BANKRUPTCY

Mr. Chairman, this legislation is needed to remedy a number of problems which have occurred in bankruptcy proceedings. I shall limit my discussion to the tax aspects of this bill since that is the interest of this committee.

Experience with the administration of bankruptcy proceedings indicates the need for a redefinition of powers vested in the trustee. In particular, the provisions of section 70(c), the "strong arm" amendment of 1950, which gives the trustee the position of a judicial lien creditor as of the date of the bankruptcy, need revision. The interpretation of the legal position of the trustee is crucial, hinging upon whether he is held to be a judgment creditor since section 6323 of the Internal Revenue Code provides that a Federal tax lien is not valid against a judgment creditor (among others) until notice thereof has been filed in the appropriate office. In *U.S. v. Gilbert Associates, Inc.* (345 U.S. 361 (1953)), and *U.S. v. Acri* (348 U.S. 211 (1955)), the court used the rationale that the uniform application of the Federal tax law required the term "judgment creditor" be defined in the "usual conventional sense of a judgment of a court of record" which is common to all States. Although these cases were not applicable to the Bankruptcy Act the rationale was extended to the application of section 70c *in the Matter of Fidelity Tube Corp.* (278 F. 2d 776). There it was held that the trustee was not a judgment creditor for purposes of the Internal Revenue Code. Subsequent decisions in *Brust v. Sturr* (237 F. 2d 135 (1956)), *In re Taylorcraft Aviation Corporation* (168 F. 2d 808 (1948)), and *U.S. v. Eng-*

land (226 F. 2d 205 (1955)) followed this reasoning. The effect of these decisions is that the Federal Government's unrecorded tax lien prevails over the rights of the trustee under section 70c. From the legislative history of the 1950 amendment the purpose of giving the trustee the rights of a judicial lien creditor was to expand his powers. As the House report on this bill pointed out:

"As a matter of general law, the holder of a lien by legal proceedings has greater rights than a judgment creditor who usually has no rights in the personal property of the debtor by virtue of his judgment. Even as to real property, it is frequently necessary for the judgment creditor to take further action after judgment to create a lien. It would seem anomalous to allow judgment creditors to prevail over secret tax liens and to deny that right to a judicial lien holder. As against liens and transfers other than Federal tax liens, it has generally been held that a trustee in bankruptcy does have the rights of a judgment creditor" (*McKay v. Trusco Finance Co.* (198 F. 2d 431 (5th Cir. 1952)).

The need for legislation was specifically pointed out in *Fidelity Tube, supra* wherein the court declared that it considered the enactment of such legislation necessary to create the status of a judgment creditor for the trustee vis-a-vis the Federal tax lien.

Experience with the administration of bankruptcy proceedings indicates that the powers vested in the trustee need to be diversified to adequately protect the assets of the bankrupt estate and to more efficiently handle the estate. In this regard, under present law, the trustee is precluded from assuming inconsistent or repugnant positions with reference to a particular party of transaction. Nevertheless, having chosen a position with respect to one set of circumstances, the trustee as a representative of all the creditors of the bankrupt should not be barred from asserting a different position in other circumstances.

This legislation will shore up the glaring weaknesses which have evidenced themselves in the courts and in the experience of bankruptcy administration on this question as well as a number of others not related to taxes.

Since the policy of the Chandler Act is to protect the costs of administration and wages, it is necessary to postpone to the costs of administration and wages at least these tax liens which are on personal property and are unaccompanied by possession. It is socially desirable to protect those adding to the proceeds of the estate or collecting and protecting the proceeds to be paid for their efforts. In light of this policy section 67c in this bill retains the provision of existing law which postpones a tax lien on personal property not accompanied by possession, to the debts specified in section 64a clauses (1) and (2).

Since the Treasury Department had objected to the language of previous bills on this point the proposed section 67c(3) provides that where a postponed tax lien is prior in right to liens indefeasible in bankruptcy, the court shall order payment from the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual cost of that sale, of an amount not in excess of the tax lien, to the debts specified in clauses (1) and (2) of section 64a of this act. If the amount realized from the sale exceeds the total of such debts, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the debts specified in clauses (1) and (2) of section 64a of this act and the amount of the tax lien, is to be paid to the holder of the tax lien. This approach adopts the solution which three courts have already innovated under the existing language of section 67c. (See *California State Department of Employment v. U.S.* 210 F. 242 (1954); *In re American Zyloptic Co., Inc.* (181 F. Supp. 77 (1960)); *In re Empire Granite Co.* (42 F. Supp. 450 (1942)).)

It is the intention of this legislation that a statutory tax lien on personal property not accompanied by possession shall be first tested by the standards of section 67c(1). Then, section 67c(3) is then to be applied to those liens which have not been invalidated by section 67c(1).

The second major problem met by this legislation concerns the powers of the trustee. Since section 70 of the Bankruptcy Act provides the legal tools for the administration of a bankrupt estate, section 6 of this bill would meet the problems previously outlined concerning the narrow construction of the powers of the trustee.

Specifically, it is provided that the trustee shall have the rights and powers of a "creditor who obtained a judgment against the bankrupt on the date of bankruptcy whether or not such a creditor exists." This provision further sets out specifically the powers which the trustee is to have. By these terms the trustee would be included within the language of section 6323 of the Internal Revenue Code.

These sections of the bill would clarify the status of taxes in bankruptcy cases. The Congress has a constitutional duty under article I, section 8, to establish uniform laws on the subject of bankruptcies. The courts administer these laws but it is for Congress to decide the policy which should be established. The courts are in conflict on a number of the problems to which this bill is directed. Sound solutions are presented in this legislation.

In view of the rising number of bankruptcies and the great increase in the availability of credit which has occurred over the last few years, it is important that the rights of creditors be protected. By giving the trustee the necessary powers, this can be achieved. Tax revenues will not be unduly diminished so long as tax authorities effectively and conscientiously carry out their responsibilities.

I urge the committee to favorably report this legislation.

The CHAIRMAN. The next witness is Mr. Frank R. Kennedy, of the National Bankruptcy Conference.

STATEMENT OF FRANK R. KENNEDY, NATIONAL BANKRUPTCY CONFERENCE

Mr. KENNEDY. The time is very short.

I am Frank Kennedy from the University of Michigan. I teach bankruptcy and creditors' rights at the University of Michigan Law School, and have been teaching the subject since 1940.

During a good part of my professional career I worked on this problem of trying to straighten out the statutory lien problem in the Bankruptcy Act.

The bill I want to discuss is S. 1912, and H.R. 136, the bill which deals with the record of the statutory lien, including the tax lien.

I do not want to go into the measure. I want to say that the Senate has passed this bill, that it has been passed several times by the House. It was vetoed by former President Eisenhower, and, may I say with due deference, that the reason for his veto, as given in his veto message, was that it did not change existing law. The bill included a provision which is already in the law, and he said the reason for vetoing it was that it did not change a certain result which the law now requires already and which would remain in effect.

This bill has been the subject of numerous conferences between me and other members of the National Bankruptcy Conference and the gentlemen of the Treasury.

The two main points that Mr. Stone made about the tax lien bill this morning were these: (1) that there are technical difficulties, ambiguities, that need to be resolved. Mr. Surrey, the Assistant Secretary, apparently tried to resolve these ambiguities in a draft that appears in the Senate Report No. 277, and I make a comment on that in an immediately following letter that the suggested revision makes no sense at all. It could not be applied so as to have any meaning.

This provision that we have now in the tax lien bill has been thoroughly considered with the members of the Treasury Department and there are no ambiguities they have brought out that could be improved by any language that they have ever suggested.

With respect to the suggestion that this bill will require filing in hundreds of thousands of cases where there is no filing now, I should like to say that the argument that the Treasury Department is making is that the trustee in bankruptcy should not be protected as a judgment creditor.

The philosophy of the tax lien law that is now on the books, that would be amended by the bill that the gentlemen of the Treasury here this morning apparently think is a good bill, would require notice filing immediately as against judgment creditors, and there is nothing more fundamental in bankruptcy law than that the trustee in bankruptcy steps into the shoes of the creditors. The creditors are barred from collecting. The trustee is a judgment creditor; he has been a judgment creditor for years and years and years; and until 1950 nobody supposed that the trustee in bankruptcy was not fully protected against the unfiled Federal tax lien.

Only since decisions for the Government since 1950 has anybody supposed that the trustee would not prevail under tax lien law and the Bankruptcy Act as against the unfiled Federal tax lien.

Furthermore, let me point out we are talking only about tax liens against real estate. The law, the Bankruptcy Act, now already makes clear that unless the Federal Government has perfected its tax lien as against personalty by taking possession before bankruptcy, the tax lien must yield to the trustee in bankruptcy.

So, the Government would be moved to make more filings only if it found that debtors had real estate, because mere filing would not protect the Government as against tax liens against personalty, because possession must be taken.

If it is suggested that filing Federal tax liens will precipitate bankruptcies needlessly, the suggestion is that creditors should not know about all of the facts of the debtor's liability; that if the creditors knew about all of the measure of the tax liability, they would precipitate bankruptcy. If creditors believed that the man should be allowed to continue, they are not likely to put him into bankruptcy just because the Federal tax lien has been filed.

The philosophy of the Federal tax lien law and the philosophy of the Bankruptcy Act is that creditors are entitled to have full disclosure, and when the argument is that the Government should not be called upon to make this disclosure because creditors will invoke bankruptcy, the suggestion is that bankruptcy is too freely available, and that is another problem.

I do not believe that the risk that is involved is serious as to the taxpayer.

If the Government says that the measure would now require the Government to go out and file many tax liens contrary to their present practice, they ought to go out now and seize the property. They would go out and seize the property of a personal nature now before bankruptcy, because they now run the risk if they do not seize personal property before bankruptcy that they will lose out to the trustee in bankruptcy; but they have not done that.

This has been the law since 1938, and I submit before 1950 the law was generally understood that an unfiled Federal tax lien is no good against a trustee in bankruptcy; yet the Federal Government did not promiscuously, indiscriminately, slap tax liens on the record. They exercised discretion then, and they would exercise discretion now, it seems to me.

The law that would be put into effect by this bill has recently declared by the sixth circuit to be the law now, as Mr. Stone pointed out—the sixth circuit has already ruled exactly the way this bill pro-

vides. We are restoring the law to the situation as it was universally understood in 1950.

I think that that aspect of the present bankruptcy law was surely not understood by Mr. Laurens Williams who wrote the letter that was referred to today when he said that this bill would affect the procedures significantly. It could not affect the procedures significantly because the Federal Government would already be seizing personal property in this country, would be filing tax liens promiscuously under the sixth circuit decision, and would have been promiscuously filing tax liens when the law was understood to be the same as now proposed—from 1910 to 1950, yes, all the time up to 1950, when this was the universal understanding.

These are the points that seem to me relevant to the discussion which has preceded me.

This measure has been very fully considered and reported on in the Senate report, and I think it answers all of the other questions.

The CHAIRMAN. Thank you.

The next witness is Mr. James A. MacLachlan, who will testify on S. 1912 and H.R. 136.

Mr. MacLachlan represents the National Bankruptcy Conference.

STATEMENT OF JAMES A. MacLACHLAN, NATIONAL BANKRUPTCY CONFERENCE

Mr. MACLACHLAN. I am scheduled to testify here, I take it, as a member of the National Bankruptcy Conference.

Mr. Montgomery, and Referee Olney now retired, and Referee Fribolin, and I are the only four living members of the original group who came together in 1932 and later took on the name of the National Bankruptcy Conference. We were the drafters of the Chandler Act.

I am the author of the West Publishing Co. "Hornbook on Bankruptcy," and I wrote some articles in the field of Federal liens and priorities starting in the 1950's.

I might say that the suggestion made from the bench that this controversy is, at least, 5 years old is certainly a conservative understatement, because ever since World War II this thing has been under fire as far as the National Bankruptcy Conference is concerned.

When I say this thing, what is this thing? Well, this thing is the fact that the functioning of the credit process in the United States is very much impeded by the fear and the fact that if anyone fails the Government takes everything.

This bill that I am specifically talking about (S. 976) is only one of three directed at different aspects of that problem.

Mr. Kennedy talked about the bill in relation to section 67c and 70 of the Bankruptcy Act, and several other sections (S. 1912). Focusing upon the financial and tax aspects of the discussion has related to the provision that the tax lien ought to be and must be filed under this bill before the petition in bankruptcy if the trustee is not to prevail over the lienholder and, as he (Mr. Kennedy) was pointing out, that was clear, and always has been the correct law, in our estimation. It clearly was the law from the 1910, when the Bankruptcy Act was amended to give the trustee in bankruptcy the status of a judgment creditor, until the 1950's, and the trouble comes because of recent

extravagant constructions of the Supreme Court in favor of Federal liens and priorities.

The U.S. Supreme Court has cast doubt upon the proposition that the words "judgment creditors" and the rights of judgment creditors are to be construed in anything except a very narrow and technical sense.

So, this is a bill to make clear what we have always supposed was the fact, that the trustee is more than a judgment creditor, because he is the holder of a lien by legal proceedings, a status he cannot reach without judgment, but he will be specifically named a judgment creditor simply to dispense with this doubt that has been cast by the Supreme Court upon the relative status of other creditors as against the rights of the Government.

Now, I think this thing ought to be put in perspective. The Treasury does not even claim that this is materially going to affect the revenue. There is chickenfeed involved here. All priorities in bankruptcy amounted to a collection of $11.5 million in the last fiscal year. I have the statistics here.

Now, that includes not only tax priorities, it includes other Government priorities. It includes priorities in favor of State governments, and there is no exact way of figuring out by these statistics how much the Government is collecting by the priority provisions now in question, but it does not amount to one one-hundredth or one one-thousandths of 1 percent of the revenue they are collecting, and if you can improve the climate of credit, remove the doubts that are hanging around about the extension of credit due to the fear that the Government comes in and takes everything in case there is an insolvency, then you are going to have more net earnings.

I submit that this bill is going to increase the net revenue accruing to the Government. Congress knocks 4 percent off the corporate income tax, and it turns out that they are not giving away nearly as much as they thought they were giving away, because it stimulates business.

Now, if the Treasury should lose something, it would not be 4 percent, it would not be 1 percent, it would be a tenth of a percent, it would not be one one-hundredth of a percent. It is chickenfeed that is involved, as far as money is concerned.

Now, the important thing is the orderly processes, they say. They have some fear that their routine would be upset. They naturally have their problems. They live in the Federal income tax world. We, to some extent, have lived in our bankruptcy world.

I am not a bankruptcy practitioner. Bankruptcy is only 1 of 18 legal courses that I have taught, and when I regard bankruptcy, I like to think of bankruptcy as being useful in connection with its repercussions upon the credit structure.

What is happening here is that the Government, in order to save a small amount of money and to avoid upsetting its convenience and its routine, is throwing sand into the gearbox and making it very difficult for credit to be extended on any intelligent basis.

Now, they say there are ambiguities in the bill. They have been introduced to try to answer some of the objections of the Treasury Department.

If you will look back at the record and see the letters that have been written by the Treasury over Mr. Surrey's signature, you will find the most gross misunderstanding of what the entire situation is from the bankruptcy point of view.

The Treasury says well, a person can get out of his taxes by the simple expedient of filing a petition of bankruptcy. It is not true that you can get out of paying taxes by the simple expedient of filing a petition in bankruptcy, and Mr. Stone made no such asinine statement, but it has been made by the Treasury Department.

In its long history of obstructing this bill, and, as Mr. Kennedy points out, the only time one of these bills got through to the President's desk, the Treasury managed to bend the President's ear, and the President vetoed it, and got out an opinion justifying the veto, which showed he completely failed to understand what was involved.

Now, as far as the ambiguities in this bill (S. 976) are concerned, there are a couple of them that are at least arguable. One of them relates to the statement that the limitation upon the priority shall not affect any lien, and the Treasury says, as I understand it, that when a person makes a tax return showing a tax, that that constitutes an automatic assessment, and there is no difficulty there.

As far as the lien is concerned, you have got a floating lien. As one of the Senators pointed out, it certainly is true that the Federal lien is not like the ordinary strict mortgage lien because of its floating character. It is very much more like the floating liens under the Uniform Commission Code, which has now been enacted in 41 States, and it is not like the old-fashioned law narrowly and strictly describing the subject matter. It is possible to have a floating lien on inventory and stock in trade.

However, if this Federal lien is not going to be defeated by a discharge in bankruptcy, the policy of the bill, insofar as it relates to the protection of the discharged bankrupt against an accumulation of property over 3 years, can be defeated. The proviso that has been put in there in an effort to placate the income tax people would very largely defeat the policy of relieving the debtor.

This language could be construed as saying that the effectiveness of the lien shall stop as of the date of bankruptcy. But if the Federal Government is going to continue to have a lien on all property that the bankrupt gets and all his earnings after bankruptcy, then, of course, he does not get any relief at all.

If this bill is kept under consideration by the committee, the first suggestion that I would make would be to make it clear that the lien is saved only as to the earnings and property of the bankrupt up to the date of bankruptcy.

Now, as for a change, if you are making changes, which might benefit the Treasury Department, it seems to me they have a couple of points that are worthy of consideration. I do not think the sponsors of this bill or the National Bankruptcy Conference would be upset by an amendment in situations where the Treasury faces a situation and enters into an extension agreement with a debtor; if they act within 3 years and get an extension agreement lined up, then it seems to me that the statute of limitations might very well be tolled. I am talking about the relation to the priority and the discharge; I am not talking with reference to the lien. Mr. Stone is completely correct in saying

the 3 years relate to this bill having to do with the priorities and discharge. It has nothing to do with the filing of the Federal tax lien.

The answer on the filing of the Federal tax lien, Mr. Kennedy has already given. The Federal Government, in days when it was perfectly clear they had to file, did not go around slapping on liens.

Now, it can well be that they might slap on a little bit more, because the situation is getting more acute all the time. The reason something has got to be done is that taxes keep getting bigger. The old taxes are augmented by new taxes. The priorities are not limited to tax priorities. The fact that the Income Tax Division of the Treasury was the only one that objected, has tended to throw things all out of focus. Although the income tax is very important, this bill relates to all sorts of Government priorities, and it also relates to discharge on a much broader front than just the Federal income tax field.

But coming back and trying to meet the Federal income tax people on their own ground, I would say that in addition to the fact that they think it ought to be possible to provide for an extension agreement without losing their priority and their right, I think it ought to be made possible.

Also, they say that if a debtor exhausts his administrative remedies they cannot assess and if their rights are going to be dated from an assessment, then they are whipsawed by the time they get into bankruptcy court, by it being too late because they have been held up for more than 3 years someplace else.

If, however, you date it (the 3 years) from the due date, then clause c that is in there (S. 976, sec. 2) protects them, and the National Bankruptcy Conference and the credit people are not getting what they want out of the bill. Well, as far as our not getting what we want out of the bill is concerned, our answer is: "Yes, this bill has been very much weakened in some respects out of deference to the Treasury."

However, the U.S. Treasury is not the only person involved. The governmental priorities that come in here involve claims of the Federal Government that are not tax claims. They involve claims for State taxes, which are growing even faster than the Federal taxes.

The history of the last few years has been that the State budgets have been mounting more steeply than the Federal Government, notwithstanding all the money that the Federal Government has to spend and all the money that it sees fit to spend, whether it has to spend it or not; the Federal Government may be bad from the point of view of being extravagant, but it is not mounting its expenses to the extent the States are.

So, the position of the National Bankruptcy Conference is, if the Treasury is right, and this bill realy does not achieve anything much with reference to the 3 years priority and the limitation of the discharge of Federal income taxes, it is much better to go ahead and have the bill the way it is than to not have it at all. It is going to accomplish something in the Federal income tax field. It will accomplish very much more in relation to other priority claims.

The CHAIRMAN. Thank you very much.

The National Association of Credit Management, New York, has submitted for the record two letters endorsing both of the bankruptcy bills discussed today, and they will be inserted in the record.

(The documents referred to follow:)

NATIONAL ASSOCIATION OF CREDIT MANAGEMENT,
New York, N.Y., August 3, 1965.

Re amendment 372 to H.R. 7502 (S. 976); A bill to amend the Bankruptcy Act with respect to limiting the priority and nondischargeability of taxes.

FINANCE COMMITTEE,
U.S. Senate,
Washington, D.C.

GENTLEMEN: This association, which comprises a membership of more than 30,000 manufacturers, bankers, and wholesalers in all parts of the United States, takes this opportunity to reiterate its support for the above numbered bill.

A full statement by the association appears in Senate Report No. 114 on S. 976 and will not be repeated here. We sincerely trust that this bill, which is regarded by the business community as of great importance, may have your favorable consideration.

Respectfully yours,

ELMER T. SIVERTSEN, *Legislative Director.*

LEGISLATIVELY SPEAKING

NATIONAL ASSOCIATION OF CREDIT MANAGEMENT,
New York, N.Y., February 18, 1965.

To all: Legislative chairmen and executive vice presidents and managers.
Subject: Tax priorities in bankruptcy, S. 976 (Ervin).

ACTION REQUEST

Objective: To place a 3-year limit on the now unlimited priorities given to unsecured Federal, State, and local taxes in bankruptcy, and to assist any honest and worthy debtor toward successful rehabilitation by permitting the discharge of tax debts older than 3 years.

The means: By obtaining early Senate consideration and approval of tax priority limitation bill, S. 976.

Status: Introduced in the Senate February 3, 1965, by Senator Sam J. Ervin, of North Carolina, and referred to the Senate Judiciary Committee. (An identical bill, H.R. 3438, by Representative Whitener, of North Carolina, is also before the House.) We understand that upon approval by the Senate Judiciary Committee the bill will be referred to the Senate Finance Committee.

NACM position: NACM has repeatedly placed itself on record by convention resolution and by statements before congressional committees that priorities granted tax claims should be allowed only for those taxes against the debtor which have arisen no more than 3 years before bankruptcy and all taxes for earlier years should be dischargeable. Enactment of S. 976 would accomplish this objective.

Arguments: Bill's enactment, by its fairer treatment of creditor interests, would provide sounder basis than now exists for future credit extensions, would assure a healthier credit and business climate generally, would bring our bankruptcy law into closer accord with the insolvency laws of other major commercial countries, and through its dischargeability provision would make it possible for many businesses (now written off as a total economic loss) to serve their communities and the economy on a sound, taxpaying basis.

How you can help: Write your two Senators today, with indicated copies to Hon. James O. Eastland, chairman, Senate Judiciary Committee and Hon. Harry F. Byrd, chairman, Senate Finance Committee (both Senate Office Building, Washington, D.C.). The rosters of the Senate Judiciary Committee and the Senate Finance Committee are attached.

Sincerely,

M. F. PRICE,
Chairman, National Legislative Committee.

NATIONAL ASSOCIATION OF CREDIT MANAGEMENT,
New York, N.Y., August 3, 1965.

Re amendment 373 to H.R. 7502 (S. 1912): To amend the Bankruptcy Act to define the term "statutory lien" and to establish the priority of liens in bankruptcy.

FINANCE COMMITTEE,
United States Senate,
Senate Office Building,
Washington, D.C.

GENTLEMEN: For the reasons set forth in the report of Prof. Frank R. Kennedy, chairman of the Drafting Committee of the National Bankruptcy Conference, appearing at pages 21–27 of Senate Report No. 1183 on H.R. 394 (S. 1912) we wish to express our support for this proposed legislation and the hope that it may have your favorable consideration.

The National Association of Credit Management is one of the largest business organizations in the United States with a membership of more than 30,000 bankers, manufacturers, and wholesalers. We regard the enactment of the above numbered bill as a matter of first priority.

Respectfully yours,

ELMER T. SIVERTSEN, *Legislative Director.*

The CHAIRMAN. The committee will adjourn until tomorrow morning at 10 o'clock, when it will meet in executive session.

By direction of the chairman, the following is made a part of the record:

ADMINISTRATIVE OFFICE OF THE U.S. COURTS,
Washington, D.C., August 5, 1965.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: This letter relates to H.R. 136 and S. 1912, identical bills, to amend sections 1, 17a, 64a(5), 67b, 67c, and 70c of the Bankruptcy Act, and for other purposes, which bills are pending before your committee for consideration. These bills would preserve the position of the costs of administration and of wages in the distribution of the assets of a bankrupt and, at the same time, would enable valid contractual liens such as chattel mortgages, conditional sales contracts, trust receipts, and the like, to retain their position ahead of statutory liens on personal property unaccompanied by possession.

The proposals contained in H.R. 136 and S. 1912 of the present 89th Congress were embodied in H.R. 394 of the 88th Congress, which proposals were approved by the Judicial Conference of the United States. The latest action of the Conference thereon was at its September 1963 session when it reaffirmed its approval of the proposals contained in H.R. 394 of the 88th Congress. Accordingly, you are advised that the Judicial Conference of the United States has approved the proposals now contained in H.R. 136 and S. 1912.

Sincerely yours,

WILLIAM R. SWEENEY, *Acting Director.*

INDEPENDENT BANKERS ASSOCIATION OF AMERICA,
Grafton, Wis., August 10, 1965.

Re S. 1912.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: The Independent Bankers Association of America, comprising 6,300 banks in 40 States, supports the amendments to the Bankruptcy Act contained in this bill. These long-delayed amendments are urgently needed to restore confidence in chattel mortgage loans where possession is left with the debtor.

Our member banks are largely located in smaller communities and rural areas where a great deal of credit is extended upon many types of fiancial arrangements in which collateral is left with the borrower.

Loans based upon such security are traditionally made upon the understanding by the bank and the borrower that the bank is fully secured and will have priority in the event of bankruptcy. However, recent court decisions have interpreted the Bankruptcy Act in such a manner that they are subordinated to landlords' liens, costs of administration, and wages. Thus, what both parties to the loan agreement assume to be the law turns out to be an illusion, at least in the third circuit. Other circuit courts have held differently, causing confusion and inequities. The confusion would be reason enough to clarify the Bankruptcy Act by these amendments.

These decisions create doubt not only upon the secured position of chattel mortgages but also factor's liens, trust receipts, warehouse receipts, assignments of accounts receivable, conditional sales, and other forms using personal property as security to a loan where such property is left in the hands of the borrower.

We plead for uniformity and clarity in the priorities sections of the Bankruptcy Act, particularly where personal property is used as security. One of the great purposes of our system of law in this country is to give assurance that private parties entering into a transaction can do so with certainty as to the intended result. When the act of Congress is vague and the courts interpret it in unlimited ways, it is time to clarify the law. Unless this is done customers of banks who have only personal property to offer as security may find that they cannot get loans, even though the collateral might otherwise be acceptable to the bank.

We understand that the chief objector to these amendments is the Treasury Department which apparently does not wish to be put to the burden of filing notice of lien. Under present law a Federal tax lien is valid against the trustee in bankruptcy without requiring such filing. In effect, this gives the Federal Government a secret lien which cannot be discovered by a bank or other lender, but which can be prior to the lender's lien under present law. The result of secret tax liens may be to given a borrower more credit than would be available to him if the lien were filed, and lenders may unwittingly permit the borrower's condition to deteriorate seriously before taking action to secure payment or obtaining other forms of security. We think that the same Government that should give dependable assurances under law for private transactions should be required in the same spirit to file notice of its tax liens.

We feel that S. 1912 is preferable to S. 976 since it provides more clarity and protection for banks. It must be kept in mind that about 90 percent of the money loaned by banks is derived from deposits of the public. Thus the more protection that can be afforded to loans secured by personal property is in the public interest.

Our association joins with the American Bankers Association and the National Bankruptcy Conference in urging early enactment of this bill by Congress.

Sincerely yours,

RALPH L. ZAUN.

(Whereupon, at 12:20 p.m., the committee adjourned.)