Insolvency Law Committee - Business Law Section of the State Bar of California

Bankruptcy e-Bulletin

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Dear constituency list members of the Insolvency Law Committee, the following is a recent case update:

The United States Bankruptcy Appellate Panel of the Ninth Circuit recently held that a corporate officer's "responsible person" liability for California unemployment insurance taxes was dischargeable because such taxes were not "trust fund" taxes, that is, taxes to be collected from a third party. See State of California Emp. Dev. Dept. v. Hansen, et. al. (In re Hansen) (9th Cir. BAP, April 18, 2012). To read this decision, click: In re Hansen

Factual Background:
California unemployment insurance taxes ("UIT") are collected from employers to fund unemployment benefits to California residents. The UIT rate for any given employer is determined by a formula that takes into account the employer's paid UIT (referred to as "contributions"), the benefits charged to the employer (for former employees who seek unemployment benefits) and the employer's average base payroll. Application of this formula results in substantially different UIT rates for different employers, and that is where our story begins.

The Debtor was president of a group of affiliated companies collectively referred to as "Onvoi". Onvoi had a UIT rate of 4.79%. In December 2002, Onvoi purchased Birdcage Travel ("Birdcage"), an entity with a UIT rate of 0.9%. Seizing on an opportunity to engage in some tax rate arbitrage, shortly after the acquisition Onvoi transferred all of its employees from Onvoi's EDD employer account to Birdcage's EDD employer account. The "arbitrage" purported to save Onvoi approximately $2.8 million in UIT. But the EDD had not yet spoken.

The EDD spoke in March 2004, and it was not favorable: the EDD issued the Debtor, as the responsible person for Onvoi, an assessment for approximately $4.8 million, representing the difference between taxes payable under the Onvoi UIT rate and the Birdcage UIT rate, with penalties and interest.

The EDD and Debtor entered into an installment agreement which allowed the Debtor to pay in monthly installments significantly less than the full amount assessed, but preserved the EDD's right to seek the entire assessment in the event of a default. The Debtor paid more than $1 million under the arrangement, but ultimately defaulted and filed for Chapter 7 relief. The EDD filed a complaint to have the full amount of the unpaid assessment determined to be nondischargeable.

The Debtor admitted both liability and the amount of the EDD claim. The only issue before the BAP was whether the UIT was dischargeable.

The BAP Ruling:
Bankruptcy Code Section 523(a)(1)(A) excepts from discharge a debt for a tax "of the kind and for the periods specified in … Section 507(a)(8) of this title". The relevant provision of Section 507(a)(8) is subsection (C), which specifies a "tax required to be collected or withheld and for which the debtor is liable in whatever capacity." So if the tax is one covered by Section 507(a)(8)(C), it will be determined to be nondischargeable under Section 523((a)(1)(A), and the Debtor will have to deal with the EDD for presumably a very long time. The only question, therefore, was whether the UIT was a "tax required to be collected or withheld".

The text of Section 507(a)(8)(C) speaks only about taxes "required to be collected or withheld," and is not limited to taxes collected or withheld **from third parties**. Thus, the issue before the BAP was whether the scope of Section 507(a)(8)(C) extends only to taxes to be collected from third parties (i.e. the classic trust tax liabilities for sales, excise and income withholding tax responsibilities), or something more.

Determining that the statutory language itself did not definitively answer the question, the BAP turned to the legislative history. The Court concluded that the legislative history evidenced that a "tax required to be collected" must be a tax collected from a third party. Since UIT is not collected from a third party, it is beyond of the scope of Section 507(a)(8)(C). Because UIT is beyond the scope of Section 507(a)(8)(C), UIT is not a tax encompassed within Section 523(a)(1), and the tax liability was discharged.

Author's Commentary:
The result is correct, but bankruptcy practioners might question whether the BAP had to find the statutory language ambiguous to reach the result. The "plain meaning" approach to statutory construction requires a court to first analyze the statutory language – which is the final statement of the legislative intent – before attempting to go beyond the statutory language to antecedent sources. But a "plain meaning" analysis should include a rigorous and principled analysis of both the meaning and necessary implications of the language enacted. Such an analysis might have been sufficient to reach the right result without finding the statutory language to be ambiguous.

A taxpayer is required to pay its taxes, but it does not collect or withhold its taxes from itself in order to pay it over to the tax authority. Accordingly, the use of the phrases "collected" or "withheld" necessarily requires a third party; the taxpayer can only collect or withhold from a third party. UIT is simply a tax required to be paid by a California employer; the employer does not "collect" or "withhold" the tax from anyone, and it cannot be said that the employer collects or withholds the tax from itself before paying it over to the taxing authority. Similarly, the Debtor was liable for the unpaid taxes as a "responsible person", but he was not required to collect or withhold the taxes from Onvoi. Thus, while each may have had an obligation to "pay" these

taxes, neither Onvoi nor the Debtor were required to “collect” or “withhold” these taxes. The BAP did briefly articulate this line of reasoning, but it was subsumed as part of its analysis of the legislative intent rather than as a “plain meaning” analysis of the statutory language.

These materials were prepared by Patrick M. Costello of Vectis Law Group in Palo Alto, California, with editorial contributions from Uzzi O. Raanan, of Danning, Gill, Diamond & Kollitz, LLP, of Los Angeles, California. Mr. Costello is a member of the Insolvency Law Committee.

Thank you for your continued support of the Committee.

Best regards,

Insolvency Law Committee

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