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OFFICIAL TRANSCRIPT
PROCEEDINGS BEFORE

THE SUPREME COURT
OF THE
UNITED STATES

CAPTION: HARRY P. BEGIER, JR., ETC.. Petitioner V.
INTERNAL REVENUE SERVICE

CASE NO: 89-393

PLACE: Washington, D.C.

DATE: March 27, 1990

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IN THE SUPREME COURT OF THE UNITED STATES

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HARRY P. BEGIER, JR., ETC., :
Petitioner :
v. : No. 89-393
INTERNAL REVENUE SERVICE :

-----x
Washington, D.C.
Tuesday, March 27, 1990

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 12:59 a.m.

APPEARANCES:

PAUL J. WINTERHALTER, ESQ., Philadelphia, Pennsylvania; on behalf of the Petitioner.
BRIAN J. MARTIN, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Respondent.

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C O N T E N T S

ORAL ARGUMENT OF:

PAGE

PAUL J. WINTERHALTER, ESQ.

On behalf of the Petitioner

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BRIAN J. MARTIN, ESQ.

On behalf of the Respondent

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REBUTTAL ARGUMENT OF:

PAUL J. WINTERHALTER, ESQ.

On behalf of the Petitioner

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P R O C E E D I N G S

(12:59 p.m.)

1
2
3 CHIEF JUSTICE REHNQUIST: We'll hear argument
4 now on No. 89-393, Harry P. Begier v. Internal Revenue
5 Service.

6 Mr. Winterhalter.

7 ORAL ARGUMENT OF PAUL J. WINTERHALTER

8 ON BEHALF OF THE PETITIONER

9 MR. WINTERHALTER: Thank you, Your Honor. Mr.
10 Chief Justice, and may it please the Court:

11 Good afternoon. The third case before the Court
12 today involves whether a debtor's pre-bankruptcy payment
13 alone from its general operating account for trust fund
14 tax obligations excludes that property from a bankruptcy
15 estate subject to avoidance as preferential transfers
16 under Section 547. For the reasons which I shall present
17 to this Court, I would respectfully present that such
18 transfers are, in fact, avoidable.

19 The Petitioner in this case is the court-
20 appointed Chapter 11 bankruptcy trustee in the matter of
21 American International Airways. The debtor was a
22 commercial airline carrier that provided scheduled
23 passenger and air cargo service throughout the eastern and
24 central United States.

25 As a carrier, the debtor had many employees and

1 was required to pay wages to those employees and was
2 further required to withhold taxes from those employees'
3 wages, was required to withhold individual income taxes,
4 the employer's -- the employee's share of Federal
5 Insurance Corporation taxes, and was further required to
6 retain certain excise taxes which it collected from the
7 passengers' tickets.

8 By the first quarter of 1984, the debtor had
9 become -- had experienced financial difficulties in the
10 payments of its -- of its debt -- of its debts. Similar
11 to many companies in this type of situation, the debtor
12 failed to file and pay its tax returns on a timely basis.
13 The debtor funded only net payroll.

14 The IRS imposed extraordinary remedies for the
15 enforcement of the collect -- for the enforcement of these
16 taxes. It issued a notice changing the debtor's tax
17 filing requirements from a quarterly basis to a monthly
18 basis. It also required the debtor to make deposits into
19 a certain designated depository.

20 The debtor followed these guidelines and on
21 April 30th transferred two checks to the government, one
22 out of the specially designated account and the second
23 check in the amount of \$734,797 from the debtor's general
24 operating account. The debtor and the IRS agreed to
25 specific application of these funds.

1 Two further payments were made out of the
2 general operating account just prior to the bankruptcy.
3 One for \$200,000, which was applied to 941 withholding
4 taxes and the second in the amount of \$11,636 which was
5 applied to Federal unemployment taxes and also to Form 11
6 taxes for the year 1982.

7 QUESTION: All the payments you've described,
8 Mr. Winterhalter, were within the preferential period?

9 MR. WINTERHALTER: That is correct, Your Honor.
10 The debtor's financial difficulties continued, whereby on
11 July 19th, 1984, the debtor filed its petition under
12 Chapter 11. Problems persisted and a trustee was
13 appointed two months later.

14 During the administration of the bankruptcy
15 proceeding, the trustee instituted this instant action,
16 seeking to avoid the three transfers made out of the
17 debtor's general operating account.

18 Following a trial, the bankruptcy court ruled
19 that the trustee was entitled to avoid \$700,410. The
20 District Court affirmed. On subsequent appeal to the
21 Third Circuit, the United States Court of Appeals for the
22 Third Circuit reversed the bankruptcy court and district
23 court findings.

24 The Third Circuit, relying principally on the
25 dissenting opinion of the D.C. Circuit in Drabkin v. The

1 District of Columbia, found the ability of the debtor to
2 make the pre-petition payment of withholding taxes
3 regardless of the source of those funds impressed those
4 funds with trust characteristics, removing the property
5 from the debtor's estate.

6 QUESTION: What particular funds was the court
7 of appeals talking about?

8 MR. WINTERHALTER: Your Honor, I'm not certain I
9 understand your question. The funds -- the funds which
10 the court of appeals was discussing were the funds that
11 the debtor used to pay the Internal Revenue Service.

12 QUESTION: Simply money drawn on its general
13 operating account?

14 MR. WINTERHALTER: That is correct. They were
15 written on a regular check that the -- that the debtor
16 would pay any other creditor.

17 It is respectfully presented that the holding of
18 the Third Circuit is incorrect and should be reversed.
19 The circuit's reasoning is wrong on four specific points.

20 First, the court relies on the wrong legislative
21 history to support its contention that Congress intended
22 to preclude the avoidability of tax withholding payments.

23 QUESTION: Well, what about the language of the
24 statute?

25 MR. WINTERHALTER: My second point would be that

1 the clear language of the statute --

2 QUESTION: Well, you had better start with that,
3 hadn't you?

4 (Laughter.)

5 MR. WINTERHALTER: I would believe, Your Honor,
6 that the clear language -- the plain wording of the
7 statute expressly requires that for this trust to be
8 created the taxes must be withheld or collected. In this
9 situation, we did not have that situation.

10 QUESTION: Well, what does it -- doesn't the --
11 doesn't the law say that these withheld taxes are to be
12 held as a trust fund?

13 MR. WINTERHALTER: Yes, it does. Section 7501
14 of the Internal Revenue Code --

15 QUESTION: Yes.

16 MR. WINTERHALTER: -- provides that --

17 QUESTION: Yes.

18 MR. WINTERHALTER: -- Justice White, provides
19 that any taxes which are collected and withheld shall be
20 held in trust. The wording of the statute -- the plain
21 wording of the statute expressly indicates that the --
22 expressly indicates and is written in the past tense that
23 the funds must be collected and withheld. There must be
24 some type of segregation. This segregation does not --

25 QUESTION: Well, it doesn't really say that,

1 does it? It says, the amount of tax so collected or
2 withheld shall be held to be a special fund in trust.

3 MR. WINTERHALTER: That --

4 QUESTION: It -- it provides automatically by
5 statute that whatever amount is withheld for these taxes
6 is automatically in trust for the government. Isn't that
7 what it says?

8 MR. WINTERHALTER: The statute says expressly
9 that, Justice O'Connor. I would represent --

10 QUESTION: So why does it have to be segregated
11 to comply with the statute?

12 MR. WINTERHALTER: I would represent to the
13 Court, as has this Court on other occasions, that there
14 must be a trust raised for a trust to be established.
15 There must be something there. If -- here the government
16 suggests that they need do nothing, that payment alone is
17 a sufficient designation to establish this trust. But
18 there is no trust existence.

19 QUESTION: You're -- you're not now saying that
20 it has to be segregated. You're just saying that it has
21 to exist, that when somebody pays an employee \$80 and
22 fails to withhold the \$10 or put that aside for the
23 government, there -- there is no \$10 to -- for the trust
24 to attach to.

25 MR. WINTERHALTER: That is exactly correct.

1 QUESTION: Now, that would be different for a
2 sales tax, I suppose. If you collect a sales tax and it's
3 provided that the sales tax shall be held in trust, you
4 would actually get the sales tax and that could be held in
5 trust.

6 MR. WINTERHALTER: That is exactly correct.

7 QUESTION: But with the withholding of -- of
8 wages there's --

9 MR. WINTERHALTER: The property is --

10 QUESTION: -- there's nothing to identify.

11 MR. WINTERHALTER: That is correct.

12 QUESTION: You just paid him -- paid him 80.
13 You were supposed to put 10 aside, but there is no 10 that
14 we know of that's an identifiable 10.

15 QUESTION: Well, obviously there was money
16 though, because they paid him.

17 MR. WINTERHALTER: Yes, there is money. But
18 there is no --

19 QUESTION: Well, whatever the law says -- that
20 -- that amount is going be held in trust, and the money
21 was there to be held in trust.

22 MR. WINTERHALTER: Not necessarily so.

23 QUESTION: Well, it was paid.

24 MR. WINTERHALTER: Yes, it was paid.

25 QUESTION: Mr. Winterhalter, let's go back to

1 that second clause of 7501 that Justice O'Connor referred
2 to. The amount of tax so collected or withheld shall be
3 held to be a special fund in trust for the United States.
4 Now, certainly Congress can legislate in a way that says a
5 -- a particular fund shall be treated in a particular way
6 even though under the classic law of trusts there might
7 not be any res, can't it?

8 MR. WINTERHALTER: Yes, it can. But --

9 QUESTION: You -- don't you think that's --
10 might be what it intended here?

11 MR. WINTERHALTER: No, I do not believe it did.
12 I believe the -- when Congress enacted Section 7501, which
13 was back in 1934, it had contemplated providing some
14 protections for the government in the collection of their
15 taxes. They have provided other statutes which expressly
16 empower the government to enforce its collection efforts.
17 Section 6672 would be an example.

18 QUESTION: Well, suppose what the company did in
19 this case with respect to monies that was paid from the
20 general account, drew one check to the general account and
21 then immediately -- pardon me -- drew one check from the
22 general check to the special account --

23 MR. WINTERHALTER: Yes.

24 QUESTION: -- then a second check special
25 account to the government. Does that create the trust?

1 MR. WINTERHALTER: Absolutely. I think there is
2 the act of the segregation itself.

3 QUESTION: And -- and you couldn't set it aside
4 as a preference that putting it in the trust was a
5 preference? I mean, how would that would be any different
6 from the argument you're making now?

7 MR. WINTERHALTER: Well, I think in the
8 situation which you have raised in your hypothetical,
9 there is the -- there is the designation. There is the
10 creation of the trust res which allows it to come into
11 existence.

12 There is oftentimes suggested that the normal
13 business operates properly --

14 QUESTION: But it's not -- it's not a preference
15 to create a trust res?

16 MR. WINTERHALTER: No, I do not --

17 QUESTION: But it -- but it -- but it is -- but
18 it is a preference to directly to pay the IRS?

19 MR. WINTERHALTER: Let me correct that
20 statement.

21 QUESTION: That -- that doesn't make sense.

22 MR. WINTERHALTER: I believe that it would be a
23 preference to create a trust res for any party. But I
24 believe under Section 7501 Congress had enacted a
25 provision which gives the IRS special treatment under

1 certain circumstances. And that is when the trust money
2 is properly withheld.

3 QUESTION: Mr. -- Mr. Winterhalter, it -- it
4 seems to me -- I don't -- I don't understand why you say
5 -- why you say that there has to be a res in order for a
6 trust to be created. But if the statute, as the Chief
7 Justice pointed out -- if it says it shall be created, the
8 Federal Government can make it happen.

9 I should think that -- that the problem here is
10 not whether it's created, but how you identify it, that
11 when the government says in this statute that it will be a
12 special fund in trust, you don't know what the res is.
13 You don't know whether it's the bank accounts or the
14 corporate -- the corporation's real property or any of the
15 other assets of the corporation.

16 And, therefore, when it comes to -- to
17 identifying something that -- that is subject to this
18 special privilege, you can't identify it. It isn't that
19 it couldn't be created, it's that it's not identifiable
20 later. Isn't that your -- your point?

21 MR. WINTERHALTER: My point is, Justice Scalia,
22 that there must be some act, some separation. It does not
23 have to be the deposit into the designated account. It
24 does not have to be the deposit into the approved tax
25 depository in the normal business sense. But there must

1 be something. The -- for the, for the trust to be
2 created, there must be something to set aside. It can't
3 just -- it's not an abstract, as the government suggested
4 in their brief. There must be the creation that the --

5 QUESTION: It could be created in the abstract,
6 but you can't give it effect in the abstract. Unless you
7 can identify a res, you can't identify the trust corpus.

8 MR. WINTERHALTER: I don't believe I disagree
9 with that.

10 QUESTION: But when must it be created? I'm not
11 sure I understand your position on that. Supposing 30
12 days before bankruptcy they have \$1,000 payroll and \$200
13 withholding obligation. They have \$1,200 in the bank and
14 they pay \$1,000 to the -- to the employees and don't do
15 anything to with the two hundred until after the
16 bankruptcy. Or they pay the 200. Would that be -- would
17 that be a preference?

18 MR. WINTERHALTER: If they held the 200 in their
19 general operating account?

20 QUESTION: Yes.

21 MR. WINTERHALTER: And then paid it directly to
22 the government?

23 QUESTION: Yeah, a week later, but still within
24 the preference period.

25 MR. WINTERHALTER: Presuming that the other

1 elements of a preference have been satisfied, I would
2 believe that that -- I would believe that that would be a
3 preference. I believe that's the situation here.

4 We have funds being used which were in the
5 account, but no connection being made between the \$200 in
6 your hypothetical and the \$700,000 in this hypothetical
7 which would connect the monies collected with the trust
8 being created.

9 QUESTION: Other than the fact that they did use
10 the money to pay the government? That's not enough, of
11 course.

12 MR. WINTERHALTER: That is -- that is correct.

13 QUESTION: Well, what do they -- they have to
14 put it -- you're -- they have to put in a separate account
15 before the -- in -- in -- before the preference period
16 begins.

17 MR. WINTERHALTER: I'm -- I'm not saying to
18 create the segregation itself or to create the designation
19 it has to be placed in a separate account. Again, many
20 businesses operate under a three bank account system.
21 They have their general operating account which they
22 collect their revenues. They then have their payroll
23 account and they have their tax account.

24 They would collect revenues from the normal
25 operation of their business, place them in their -- place

1 them -- place those monies into their general operating
2 account. Use the general operating account to pay their
3 normal expenses, which would include their payroll and
4 their wages. And once they provide gross wages into the
5 payroll account, they then, in turn, would transmit the
6 requisite funds to satisfy the withholding tax
7 obligations. Upon doing that, I think the 7501 would come
8 into effect.

9 QUESTION: Well, what if the statute -- this
10 clause we've been talking about -- said any paid amount of
11 tax so collected or withheld shall become the property of
12 the United States?

13 MR. WINTERHALTER: I -- I still don't believe
14 you have reached that threshold of identifying the trust
15 res. There is -- the statute does not say --

16 QUESTION: But this statute would not have --
17 the statute I'm talking about says nothing about a trust.
18 It simply says the money that was withheld shall become
19 the property of the United States.

20 MR. WINTERHALTER: If there has been no
21 withholding, Mr. Chief Justice, I do not believe that the
22 trust -- well, you're -- instead of putting the property
23 in trust, you're creating a statute which would in effect
24 transfer title to the property directly to the
25 government --

1 QUESTION: Yes.

2 MR. WINTERHALTER: -- upon the operation of the
3 statute. I'm not certain how that would work, Mr. Chief
4 Justice. I would believe that if -- if Congress
5 specifically enacted that statute and expressly stated
6 such in a statute, then, in fact, that would be
7 controlling.

8 QUESTION: Well, I -- I have the feeling that
9 the statute Congress did enact is not far different
10 from --

11 MR. WINTERHALTER: I would respectfully disagree
12 with Your Honor.

13 QUESTION: I'm sure you do.

14 (Laughter.)

15 QUESTION: Mr. Winterhalter, it's -- it's my
16 understanding of trust law that if you declare yourself to
17 be a trustee of a res which is not in existence at the
18 time, but later declare the res, it is effective. That
19 is, if I tell my nephew I am putting in trust \$500 for you
20 and in fact I don't, but several weeks later I set aside
21 the \$500 and I say this is the -- this is the trust corpus
22 for my nephew, that's effective. So, you can do it later.
23 Right?

24 MR. WINTERHALTER: I believe that Hornbook trust
25 law would -- would look to the intent to the trustee in

1 that situation.

2 QUESTION: Well, that's right. But I can do it
3 later.

4 MR. WINTERHALTER: Yes.

5 QUESTION: I don't have to do it at the moment
6 that it's created.

7 MR. WINTERHALTER: Yes. That is correct.

8 QUESTION: Now why isn't it -- and it's also
9 Hornbook trust law, as I understand it, that you can
10 declare in trust a portion of a fungible account. So you
11 can say \$500 of this bank account is held in trust for my
12 nephew.

13 MR. WINTERHALTER: Yes, you can.

14 QUESTION: Okay. Now, when you put those
15 principles -- two principles together, why is it not the
16 case that as soon as the corporation wrote out this check
17 to the United States it identified a portion of that bank
18 account as being the trust corpus that was owed to the
19 government before it was transmitted to the government.

20 MR. WINTERHALTER: You would be talking -- I --
21 my -- my response to that would be it would not be a trust
22 because you would be transferring title to the funds to
23 the government on that time.

24 QUESTION: I'm not using it as check. I'm not
25 using it for its conveyance purposes. I'm using it for

1 its declaration of what is the corpus of the trust. As
2 soon as you sign that check you have effectively expressed
3 your intention that this is indeed the portion that
4 belongs to the United States.

5 MR. WINTERHALTER: What in effect as --

6 QUESTION: As opposed to my real estate. I
7 agree with you, before that we have no idea what portion
8 of the corporation's assets belong to the United States.
9 We don't know that it was a real estate or whatever and
10 I'm sure the government would use whatever -- whatever was
11 convenient at the time. But once the -- once the
12 corporation signs that check, the corporation has
13 acknowledged a particular corpus.

14 MR. WINTERHALTER: Mr. Justice Scalia, I would
15 present to you that the trust which is required to be
16 created in order for 7501 to be attached -- to attach,
17 this trust to be created, must relate to the funds
18 collected from employees' wages. If these funds are
19 dissipated -- if the bank account goes down to zero, then
20 you cannot take funds unrelated to the employees' wages
21 and recreate them in a trust. Those funds will never be
22 affected with the trust characteristics if in fact they
23 came from funds which were not generated from employees'
24 wages.

25 QUESTION: There is no -- there's no -- how do

1 you identify -- look the statute applies not only to -- to
2 funds collected but also to funds withheld. There is no
3 identifiable dollar withheld. When I pay you \$80 and
4 withhold \$10 for Federal income tax, what identifiable
5 dollar is that? It's no identifiable dollar. It is money
6 I have not paid you.

7 MR. WINTERHALTER: But this is --

8 QUESTION: So, you have to rely on my
9 declaration of a fund later, it seems to me.

10 MR. WINTERHALTER: I would respectfully
11 disagree.

12 QUESTION: That's for a sales tax. Yes. When I
13 get the tax, you say that's it, that's what the trust
14 attached to. But not for a withholding tax. The
15 withholding tax never exists. There -- there is no dollar
16 it -- it ever attaches to. It's just money I do not pay
17 you.

18 MR. WINTERHALTER: The trust language, Mr.
19 Justice Scalia, under 7501 does not suggest that the trust
20 attaches to monies collected and which should have been
21 collected. It only says that the trust attaches to monies
22 which were collected.

23 QUESTION: Or withheld.

24 MR. WINTERHALTER: -- or withheld.

25 QUESTION: (Inaudible) the problem?

1 MR. WINTERHALTER: But if we fund only net
2 payroll, if the employer pays only net payroll while the
3 -- the employee takes the advantage of the tax credit, the
4 employer does not pay it. He does not fund gross payroll.
5 He does not withhold the monies.

6 QUESTION: Well, he withholds by the act of
7 paying the employee only the net, I would think. Withhold
8 means deduct.

9 MR. WINTERHALTER: Yes. I agree.

10 QUESTION: So, he is with -- if I -- if I hire
11 you for \$100 a week and your gross is \$100 and your net is
12 \$80, when I pay you \$80, I have by definition withheld
13 \$20, even though I don't have the \$20.

14 MR. WINTERHALTER: That's correct. But, Mr.
15 Chief Justice, if you don't have the \$20, then how can the
16 trust attach to those funds?

17 QUESTION: Well, if you're looking for something
18 that meets all the requirements of Bogurt on trusts, I
19 agree that it can't. I -- my view is that this statute
20 does not require those.

21 QUESTION: It cannot attach immediately, but I
22 thought you conceded before that -- that the res does not
23 have to be in existence at the time. You can establish
24 the res later. And why didn't that happen when the check
25 was written, even using Bogurt?

1 MR. WINTERHALTER: Because there's been no
2 connection between the funds withheld from the employees
3 and the trust funds paid to the government.

4 QUESTION: There doesn't have to be a
5 connection.

6 MR. WINTERHALTER: I believe that there does.

7 QUESTION: The res was created later.

8 QUESTION: But you acknowledge that you can put
9 it into a special account and that that creates a trust
10 without a preference. And I just don't see how that
11 follows from your argument.

12 MR. WINTERHALTER: I would represent to Your
13 Honor that if there is the designation -- if you -- if you
14 go through the steps to establish the existence of a trust
15 res --

16 QUESTION: But -- but why isn't the payment to
17 the government the designation?

18 MR. WINTERHALTER: Because --

19 QUESTION: Why -- why is doing something
20 directly less of a designation than doing it indirectly?

21 MR. WINTERHALTER: Because in the payment to the
22 government you are transferring title to the property.
23 What the government wants to say is allow us to be
24 preferred over every other creditor. We should be
25 preferred. We should have some loophole.

1 If that is what Congress intended when it
2 enacted the Bankruptcy Code, it should have expressly
3 stated so. But it didn't state that. It stated that the
4 -- that the IRS, that the government was going to be
5 subject to the preference laws. It was going to be
6 subject to the -- a trustee in bankruptcy or the debtor
7 himself from avoiding payments to the government.

8 QUESTION: Well, the Congress set up a scheme
9 whereby avoidance could be had for items that were
10 property of the debtor. These monies weren't property of
11 the debtor. They were the property of the United States
12 the minute they are withheld. It doesn't belong to the
13 debtor anymore.

14 MR. WINTERHALTER: I would respectfully
15 disagree.

16 QUESTION: Well, that's the statutory scheme.

17 MR. WINTERHALTER: But there is no nexus between
18 the funds collected and the monies paid to the government.
19 There is no -- in this case, there is absolutely no proof
20 that the funds used to pay the Federal Government were
21 those funds collected from the employees' wages.

22 QUESTION: Well, there is no tracing problem
23 here. Once the check is drawn, that solves that. They've
24 set it aside.

25 MR. WINTERHALTER: At that time they transfer

1 title. They don't establish the trust. What you are
2 enabling by such a ruling would be for the -- for the
3 principals of the corporation to in effect -- to in effect
4 avoid 6672, 100 percent penalty liability. You are, in
5 effect, carving out an exception that does not exist in
6 the statute -- while it may have existed in the proposed
7 Senate statute, it does not exist in the statute as
8 enacted to allow a debtor corporation to avoid 100 percent
9 penalty payments, to allow the Internal Revenue Service to
10 be preferred over other creditors.

11 This Court stated in United States v. Whiting
12 Pools that the government should be treated no
13 differently. That -- it stated in United States v. Slodov
14 that there must be a connection -- there must be some
15 nexus when discussing this trust. If the Court finds in
16 favor of the government of today, it would be reversing
17 the principles established by this Court in those two
18 cases. It would be obviating the need for the government
19 to impose any tracing whatsoever. It would just say that
20 the trust arises by operation of law without anything
21 further.

22 The legislative history -- the statute itself
23 does not describe either way whether the government can or
24 cannot avoid transfers of property. Several courts have
25 attempted to interpret whether Congress intended when

1 enacting the Bankruptcy Code to permit the government to
2 do just this, whether a bankruptcy trustee can avoid a
3 transfers of the government to a governmental authority if
4 the property was properly withheld.

5 Each of the courts have looked to the statute
6 and said it's not clear and referred to the legislative
7 history. The legislative history was -- as this Court has
8 recognized, was a long time in making. The statute
9 involved 10 years of congressional debate.

10 QUESTION: This is the Bankruptcy Code you're
11 referring to?

12 MR. WINTERHALTER: That is correct. That is
13 correct. And this -- that is correct.

14 The -- when -- when the statute was enacted, the
15 House originally proposed House Resolution 8200. The
16 House resolution was approved by the House Judiciary
17 Committee, voted out of committee and a report was filed.
18 The language in the report is the language referred by the
19 Third Circuit in their opinion. The House bill was sent
20 to the House floor, subject to several amendments and
21 passed. It was then sent to the Senate.

22 The Senate at the time was considering their own
23 legislation, Senate Bill 2266. Senate Bill 2266 would
24 have specifically authorized -- would have specifically
25 carved out an exception that the government desires today,

1 that preference payments to the government are not
2 avoidable.

3 The Senate Bill was approved by the Senate
4 Judiciary Committee. What they did, though, is they took
5 -- they tabled the bill, Senate 2266, put their language
6 into House Resolution 8200 and sent it back to the House.
7 Because of the lateness of the term, the two parties --
8 the -- the managers, the House leader and the Senate
9 leaders, got together and, in lieu of formal committee,
10 came up with this new statute, came up with a -- with a
11 hybrid which imputed parts of the Senate bill and parts of
12 the House bill.

13 This hybrid bill is reflected in the conference
14 committee report, which is also attached to the
15 legislative history. That -- that language specifically
16 references the fact that the provision in the Senate bill
17 which allowed the government to have the ability to avoid
18 taxes was specifically excluded.

19 Senator DeConcini's statements stated that
20 Section 547 -- 547(b)(2) of the House amendment adopts a
21 provision contained in the House bill and rejects the
22 alternative contained in the Senate amendment relating to
23 the avoidance of preferential transfers, that is, the
24 payment of a tax claim owing to a government unit.

25 What in effect this says is that the -- what the

1 Senate proposed and what the government is proposing today
2 was expressly not adopted.

3 QUESTION: Of course, Congress could have
4 rejected that because it would have extended to state and
5 local government units, too, the way you have expressed
6 it, couldn't it?

7 MR. WINTERHALTER: That is correct. In Section
8 -- but what Congress did do in enacting the Bankruptcy
9 Code in its final text, it provided under Section 106,
10 which is sovereign immunity section, clear language that
11 the government would be subject to the avoidance of
12 preferential transfers.

13 In this case, if the Court adopts the position
14 as espoused by the government, you would in effect be
15 overruling what Congress had expressed in the legislative
16 history.

17 QUESTION: Only as to the extent of trust funds,
18 though. It wouldn't be as to all tax obligations --
19 corporate -- income tax, for example.

20 MR WINTERHALTER: Yes. That is correct. There
21 -- there is a difference in those taxes, Mr. Justice
22 Stevens. The problem, however, is that there was no
23 express exclusion in the statute for the non-avoidability
24 of even trust fund taxes. And certainly Congress was
25 cognizant of that fact by its -- by its protection of

1 those -- by the protection of those taxes in both Section
2 507, which is the priority section, and Section 523, which
3 is the discharge section.

4 What Congress said there is that we want to
5 protect both taxes which were collected and which should
6 have been collected.

7 QUESTION: Well, on that basis it wouldn't do
8 you any good to segregate these funds that you've
9 withheld.

10 MR. WINTERHALTER: Under the Section 507 or 523
11 analysis?

12 QUESTION: Well, I thought you said a while ago
13 if you actually segregated these withheld funds, they
14 would not become property of the estate.

15 MR. WINTERHALTER: That is correct.

16 QUESTION: And there could be no avoidance.

17 MR. WINTERHALTER: That is correct.

18 QUESTION: Well, but the argument you've just
19 made from that other provision of the law on the
20 preference I would think it would -- I would think that
21 would cover the withheld funds that are segregated also.

22 MR. WINTERHALTER: Mr. Justice White, under
23 those sections they clearly had contemplated taxes which
24 should have been collected and which were not collected.
25 In the final draft of the -- of the statute as enacted

1 under 547, they did not include this type of reference and
2 in the legislative history they equally did not include
3 such a reference.

4 Justice Marshall noted in the case in -- in this
5 Court that under 6672 they do in fact recognize taxes
6 which were collected or which should have been collected.
7 Under 547 and 7501 they do not.

8 If the Court has no further questions, I will
9 reserve my remaining time for rebuttal.

10 QUESTION: Very well, Mr. Winterhalter.

11 Mr. Martin.

12 ORAL ARGUMENT OF BRIAN J. MARTIN

13 ON BEHALF OF THE RESPONDENT

14 MR. MARTIN: Thank you, Mr. Chief Justice, and
15 may it please the Court:

16 I'd like to begin where Mr. Winterhalter left
17 off. In fact, Congress did pass the House version of
18 Section 547, the Preference Bill, H.R. 8200. It rejected
19 the Senate version which would have made all tax payments
20 non-avoidable. It did that to reach corporate income
21 taxes, unemployment taxes.

22 It's plain that taxes held in trust and turned
23 over to the government cannot be a preference. Every
24 court has recognized that. The joint floor statements
25 recognize that. So, the question in this case is whether

1 a trust was created and maybe whether a trust was
2 dissipated.

3 The petitioner has argued that no trust was ever
4 created. He has not contended that one was created and
5 somehow spent and -- and rendered unavailable. His
6 argument has been that there was withheld taxes placed in
7 a segregated account.

8 In the first place, it's -- it's plain that
9 taxes were withheld. At trial IRS Forms 940 which detail
10 the amounts of withholding were placed into evidence. And
11 it's roughly about \$350,000 withheld each month of -- of
12 the relevant months in questions.

13 On the question of whether taxes --

14 QUESTION: May I -- may I interrupt you right
15 there?

16 MR. MARTIN: Yes.

17 QUESTION: Those forms proved that that's the
18 amount that should have been --

19 MR. MARTIN: No.

20 QUESTION: -- set aside?

21 MR. MARTIN: No. It's -- it's a statement of
22 these were withheld. It's not --

23 QUESTION: But where were they withheld? Were
24 they -- could you -- were they actually -- there were
25 actually funds there that were placed in a bank account?

1 MR. MARTIN: There were no funds placed in a
2 bank account. They were net wages in other words.

3 QUESTION: I know, but when you have a -- when
4 you file a form that says gross wages X --

5 MR. MARTIN: Uh-huh.

6 QUESTION: -- and net wages X minus the tax,
7 that isn't proof that the amount withheld was actually
8 withheld. It's just a proof they filed a piece of paper
9 that said they were doing it.

10 MR. MARTIN: The filing a piece of paper their
11 identifying it court as genuine, and the document says --

12 QUESTION: It's genuine.

13 MR. MARTIN: And it says -- it says we did it.
14 It says we withheld. It doesn't say we were required to
15 withhold it. It said we did withhold it.

16 QUESTION: Well, withhold means simply not paid.

17 MR. MARTIN: Exactly.

18 QUESTION: Well, okay.

19 QUESTION: That doesn't suggest the existence
20 that they've put a deposit of monies --

21 MR. MARTIN: Not at all.

22 QUESTION: -- just that they did not paid that
23 amount.

24 MR. MARTIN: Not at all. I'm just saying if you
25 had an employer -- not AIA, but another employer who paid

1 -- who paid gross wages, so there was no withholding in
2 the first place, then we would have trouble reaching --
3 finding a trust under 7501.

4 QUESTION: Oh, I see.

5 MR. MARTIN: But when there is a withholding,
6 that's my simple point.

7 QUESTION: (Inaudible).

8 MR. MARTIN: Right.

9 QUESTION: I still don't -- maybe I'm stupid.
10 Say, they have enough money to pay net wages and they file
11 a return that says we withheld the difference between net
12 wages and gross wages. Would that be -- but they actually
13 didn't have any money. They have -- it's a no-asset
14 business. It's a sales operation of some kind, and all
15 the money they had in -- available to them they used to
16 pay net wages, but they filed the return suggesting that
17 we withheld this amount and we recognize an obligation to
18 pay it when we get the money.

19 MR. MARTIN: There has been a withholding in
20 that case. If --

21 QUESTION: What has been withheld?

22 MR. MARTIN: Well, they've have had to pay less
23 -- they've have had to pay less than they would have paid
24 -- they had to reduce -- they cannot pay gross wages. In
25 other words, if they only have enough money, they have to

1 make payroll, and they have to deduct on the forms at
2 least from the paycheck. A person's paycheck -- the stub
3 would say withholding of \$105. The government cannot go
4 after that \$105 with respect to that taxpayer if there's
5 been that much of a withholding. Maybe the individual
6 would have a claim for wages against its employer.

7 QUESTION: But there is no asset representing
8 the amount withheld?

9 MR. MARTIN: Well, that's right. On -- on the
10 books, they didn't have to borrow the money either.
11 Perhaps they could borrow the money if you wanted to find
12 an asset. Withholding is just a deduction from gross
13 wages. That's all it means.

14 QUESTION: You just mean not paid.

15 MR. MARTIN: Not paid is all I mean.

16 QUESTION: All right. So, the trust consists --
17 the trust res consists of a liability?

18 (Laughter.)

19 QUESTION: That's what you've said.

20 MR. MARTIN: That's basically right. And this
21 is the liability that if the law is followed, will be
22 satisfied usually within about three to five days by a
23 check to the IRS. It wasn't --

24 QUESTION: You're -- you're not suggesting that
25 in the strict sense of trust law, the filing of a

1 withholding -- a return showing tax withheld creates any
2 sort of a res, are you?

3 MR. MARTIN: No. No. I -- I'm saying under
4 7501 whenever a trust is created and the amount of tax
5 withheld -- the amount of tax withheld shall be held to be
6 a special fund in trust for the United States. It's a
7 statutory trust. The trust is created by operation of
8 law. It's in the amount of not paid. It's in the amount
9 of withheld.

10 QUESTION: Mr. Martin, I'm -- I'm willing to
11 concede that you can create a trust by law. You can just
12 say by law there is a trust.

13 MR. MARTIN: Right.

14 QUESTION: But you -- you know, you can't make
15 black white by law. You can't pass a law that makes black
16 white. And what you're trying to do is to enforce a trust
17 and -- and -- and that is an objective reality. You are
18 trying to move on some corpus.

19 MR. MARTIN: Uh-huh.

20 QUESTION: And you can't decree the existence of
21 a corpus by law.

22 MR. MARTIN: I agree.

23 QUESTION: So, we -- we -- we have to find some
24 corpus to identify for the legal consequences that you
25 want to attach.

1 MR. MARTIN: I agree.

2 QUESTION: Now, at -- until the check was
3 written at least, that corpus could have been anything.
4 It could have been the company's plant. It could have
5 been any asset whatever of the company. I wouldn't know
6 how to apply a trust law theory to that kind of a
7 situation.

8 MR. MARTIN: And with that --

9 QUESTION: But you -- you would apply it even
10 before the check was written. You -- you would say that
11 somehow you would have a preference on the corporation's
12 assets even before there was any identification.

13 MR. MARTIN: Yes. I think that we would --
14 wherever we found -- found in the commingled accounts of
15 the withholder the amount of tax withheld, that that would
16 be the trust.

17 QUESTION: Wow, boy, that --

18 QUESTION: We don't have to decide that in this
19 case.

20 MR. MARTIN: But you don't have to decide that -
21 - fortunately.

22 (Laughter.)

23 MR. MARTIN: But let me just -- you know, there
24 is evidence that Congress thought that too in 1978. The
25 joint floor statements addressed the question of

1 commingled accounts and said that the IRS could use
2 reasonable assumptions, with one such assumption being any
3 amount remaining in commingled accounts is the IRS' money.

4 QUESTION: I -- I assume that what you assert
5 the Federal Government can do by using the device of trust
6 law, you are willing to acknowledge that state governments
7 can do as well.

8 MR. MARTIN: Absolutely.

9 QUESTION: So, a state government could say,
10 henceforward, any taxes owed to the state shall be a trust
11 and they would -- they -- they would acquire a preference
12 under bankruptcy law. You think about that for a minute.

13 MR. MARTIN: If -- if they have a parallel
14 system, sure. I mean, if -- if a trust is created under
15 law, under private instrument, whatever it is, payments of
16 trust funds cannot be preferences because they're not
17 properties of the debtor. That's right.

18 Let me go back to the question you asked about
19 -- okay, a trust has been created, but how do we know that
20 the payments are payments of trust fund taxes. Well, we
21 know in this case because of the black letter law that a
22 trustee may designate any funds, its personal funds, its
23 corporate funds, whatever it wants to, as trust funds
24 taxes or -- as the trust property. If they wrongfully
25 dissipated the trust, they can restore it with any funds

1 they want.

2 So when they write a check that clears, as in
3 this case, that's sufficient to identify the -- the trust.
4 And I think that's what Congress contemplated in the House
5 report which this Court has viewed as authoritative of
6 Congress' intent in 1978. When it said, in the House
7 report -- and this is at page 26 of our brief -- that the
8 payment of withholding taxes will not be a preference if
9 they have been properly held for payment, as they
10 will have been if the debtor is able to make the payments.
11 So, we think that Congress thinks that if the debtor is
12 able to make the payments, if the tax withholder can make
13 the payments, the checks clear, that no further connection
14 is required.

15 Now, there may be cases if -- where trust fund
16 taxes are not paid over, they file for bankruptcy, when
17 the IRS wants to identify the funds. In that type of
18 case, we would be entitled to use reasonable assumptions.
19 One of the assumptions is that any -- any amounts
20 remaining in commingled accounts are the taxes.

21 But here we have more than that. We know that
22 there were amounts remaining. The checks cleared. And we
23 also have the identification of the payments as trust fund
24 taxes by the trustee -- in this case, AIA.

25 QUESTION: What other purpose is 7501 used for?

1 I mean, it -- it seems to me it might be possible to read
2 the first sentence of 7501(a) as -- as its whole purpose
3 is simply to -- to lay the basis for the second sentence.
4 That is, the -- the only reality that this fund has in the
5 world is to enable the assessment, collection and payment
6 in the same manner as the taxes out of which it arose.

7 MR. MARTIN: Well, that's -- that's not what
8 Congress was doing in '34. Until 1934, this liability was
9 just a tax debt and had to be treated as such. And
10 Congress wanted to -- to say no, once the withholding has
11 occurred, it's our money. There can be no higher secured
12 interest. You know, if it's -- it's secured, creditors
13 can't take the money. It's our money. You can use trust
14 concepts to segregate and collect. I think that's clear.

15 QUESTION: There was no withholding in 1934.
16 That must have been added later, wasn't it?

17 MR. MARTIN: Yeah, in '34 -- it dealt with the
18 excise taxes only and said that -- that money was held in
19 trust. It was added -- I think it was '39 or '40.
20 Whenever withholding began is when it was -- 7501 was
21 amended to apply to withholdings in addition to excise
22 taxes.

23 I think the last sentence of 7501(a) just means
24 that the that the IRS can use the notice and assessment
25 and levy and lien provisions with respect to trust fund

1 obligations if it wants to. And we have to in many cases.

2 So, just to summarize our position, we think a
3 trust is created when there is a withholding, when -- when
4 net wages are paid. No segregation is required. We can
5 require it under Section 7512 of the Code if there has
6 been a poor performance by the employer. But we don't
7 have to require a segregated account.

8 QUESTION: Mr. Martin, in -- in the case of the
9 special fund that is created that is a separate earmarked
10 bank account, if the employer coming upon hard times
11 decides to change his mind or its mind and takes the money
12 back, is -- is there some kind of criminal liability?

13 MR. MARTIN: Yes. Yes. 6672 is the 100 percent
14 penalty provision for every responsible officer, and I
15 think there would be a 100 percent liability there. And
16 there is also a criminal penalty for willfully violating
17 the trust fund obligations. And I think that would fall
18 within that. It's a -- I believe it's a misdemeanor
19 punishable up to one year.

20 QUESTION: And -- but that -- but that special
21 liability, that special criminal liability doesn't apply
22 if there is simply a failure to earmark funds that are in
23 the general account and those funds would then disappear
24 or what?

25 MR. MARTIN: It could apply for willful --

1 QUESTION: If it's a trust in either event --

2 MR. MARTIN: Right. No, it could apply in this
3 -- in this type of case as well. If -- if -- the IRS
4 policy is to use the 100 percent civil penalty before it
5 would use the criminal penalty. But there are criminal
6 penalties for the failure to turn over the amounts of
7 withholdings to the IRS.

8 QUESTION: But -- but is the gravamen of the
9 offense the invasion of an identified trust corpus?

10 MR. MARTIN: No. No. It's not.

11 QUESTION: In other words, it's just failure to
12 withhold?

13 MR. MARTIN: Failure to turn -- to deposit --

14 QUESTION: Failure to deposit.

15 MR. MARTIN: -- into the U.S. Treasury the
16 amounts of withholding.

17 If there are no further questions --

18 QUESTION: Very well, Mr. Martin.

19 Mr. Winterhalter, do you have rebuttal?

20 REBUTTAL ARGUMENT OF PAUL J. WINTERHALTER

21 ON BEHALF OF THE PETITIONER

22 MR. WINTERHALTER: I do, Your Honor.

23 The government suggested that the record before
24 the bankruptcy court reflected that in fact deposits or
25 tax payments were made and referred to Form 940 returns.

1 Form 940 returns would reflect Federal unemployment tax
2 obligations. That is not at issue in this case.

3 What is at issue in this case is 941 taxes which
4 would be reflected on the 941 returns. Government
5 Exhibits Number 11 and Number 12, which were attached to
6 the supplemental brief filed with the Third Circuit,
7 clearly indicated that while the tax liability of the
8 debtor corporation was identified, there were no tax
9 deposits made during this time period.

10 In addition, the record, the joint appendix,
11 which has attached to it a copy of the record, clearly
12 indicates when the Internal Revenue Service, Mr. Alan
13 Zlatkin, the Revenue Officer, was being questioned at the
14 trial, he clearly indicated --

15 QUESTION: Thank you, Mr. Winterhalter.

16 MR. WINTERHALTER: Thank you.

17 CHIEF JUSTICE REHNQUIST: The case is submitted.

18 (Whereupon, at 1:42 p.m., the case in the above-
19 entitled matter was submitted.)

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CERTIFICATION

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No. 89-393 - HARRY P. BEGIER, JR., ETC., Petitioner V. INTERNAL REVENUE SERVI

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BY *Lona M. May*

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