

In re Island Hardware, In re Mid-Pacific Construction Co. Inc.

Supreme Court, Trial Division (Pon.)
King C.J.
15 August 1988

Creditors' remedies—lien in favour of government re unpaid taxes—whether lien should extend to interest and penalties.

Taxation—statutory lien in favour of government re unpaid taxes—whether lien should include interest and penalties on unpaid taxes.

10 *Taxation—whether taxation statute should be construed as penal and thus subject to strict construction.*

Facts:

Previous litigation (see *In re Mid-Pacific Construction*, page 88 *supra*) established common law or equitable priorities between judgment creditors, including the Government as tax collector. The Government's liens re unpaid taxes were recognized as superior to execution and judgment creditors. Such unpaid taxes attract both penalties and interest. Left unresolved in that litigation was whether such penalties and interest were embraced by the government liens, thus taking priority over execution creditors.

20 **HELD:**

- (1) A statutory penalty imposed on tardy taxpayer is penal, not remedial, and should be strictly construed against the Government.
- (2) The statutory penalties and interest owing on unpaid taxes are not protected by the statutory liens. The only "penalty" in this matter would be imposed on other creditors, not the defaulting taxpayer.

Other cases referred to in judgment:

Baltimore Trust Co. v. Interocean Oil Co. 30 F. Supp. 560 (D. Md. 1939)

California v. Hisey 84 F. 2d. 802 (9th. Circ. 1936)

Gould v. Gould 245 U.S. 151, 38 S. Ct. 53, 62 L. Ed. 211 (1915)

30 *Northern Finance Corp. v. Byrnes* 5 F. 2d. 11 (8th. Circ. 1925)

Legislation referred to in judgment:

54 F.S.M.C., sections 135, 153, 155, 803-806, and 902

Other sources referred to in judgment:

3 Sands, *Sutherland's Statutory Construction* (4th. ed. 1974)

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KING C.J.

Judgment:

Previous opinions in this litigation deferred consideration of the question whether statutory penalties and interest payable for overdue wage and salary taxes, or gross revenue taxes, are enforceable as liens against the taxpayer's property pursuant to 54
 50 F.S.M.C., sections 135(2) and 153. That issue is the subject of this opinion.

I.

Analysis begins with the statutory language itself. Both lien provisions refer only to "the amount of the tax imposed or authorized" or "taxes". Neither section creating a lien refers directly to interest or penalties.

Section 135. *Employer's responsibility for withheld taxes*

(2) If any employer shall fail, neglect, or refuse to deduct and withhold from the compensation paid to an employee, or to pay over, the amount of the tax imposed by this chapter, such employer shall, moreover, be liable to pay to
 60 the Government the amount of the tax, which amount shall (whether or not tax withholdings constituting trust funds have been commingled with said employer's assets) form a lien on the employer's entire assets, having priority over all other claims and liens.

Section 153. *Lien on property.*—All taxes imposed or authorized under this chapter shall be a lien upon any property of the person or business obligated to pay said taxes and may be collected by levy upon such property in the same manner as the levy of an execution.

The language itself, then, seems to provide lien rights only for the taxes themselves, and not for penalties and interest which may be added to the tax under 54 F.S.M.C.
 70 sections 155 and 902.

II.

The Government gives several reasons why it nevertheless believes penalties and interest should be regarded as part of the tax for lien right purposes.

A.

The Government's first contention is that including penalties and interest within the Government's rights would further the statutory purpose of public law 3-32, to "improve the collection and enforcement of the tax laws by providing criminal and administrative penalties for failure to pay the taxes which the Congress assesses"

(S.C.R.E.P. No. 13, Senate J. of 1st Cong., 3rd. Reg. Sess. 407 (1967)).

80 However, the provisions adopted in Public Law 3-32 to implement those congressional purposes appear at 54 F.S.M.C. sections 803-806 and 901-902. None of those provisions, nor any others contained in the tax laws, specify that penalties and interest shall be regarded as part of the tax for purposes of lien rights under 54 F.S.M.C., sections 135(2) and 153. The implication is that the Congress of Micronesia did not view the general purpose of penalizing failure to pay taxes as requiring extension of lien treatment to penalties and interest.

90 Indeed, there is ample reason to question whether the Government's interpretation would have the effect of supporting the purpose announced in S.C.R.E.P. 13. Resolution of this tax lien issue will have little, if any, impact on the relationship between the Government and the typical taxpayer. The penalties and interest provided in 54 F.S.M.C. sections 155 and 902 may be assessed by the Government against the taxpayer without regard to 54 F.S.M.C., sections 135(2) and 153. There is no question as to the ability of the Government to require payment of penalties and interest by a solvent taxpayer. Even without the liens provided by sections 135(2) and 153, the Government may press its claims to judgment against a recalcitrant taxpayer, then obtain a writ of execution, and force payment through sale of the taxpayer's assets.

100 Existence or non-existence of tax liens will likely be pivotal only in cases like the instant ones, where numerous creditors have claims and there are inadequate assets to satisfy all claims. Under these circumstances, the insolvent taxpayer has little at stake for it is a foregone conclusion that the taxpayer's non-exempt assets will be employed to satisfy the claims of one or another of the creditors. The key struggle is among the various creditors.

110 This tax lien issue, then, is important to the Government and to the taxpayer's other creditors, but is of little import to the taxpayer. To the extent the Government obtains greater lien rights, "penalties" will be inflicted upon other creditors, not the debtor who failed to pay taxes. Thus, acceptance of the Government's interpretation would not further appreciably the purpose of providing "penalties for failure to pay the taxes".

Indeed, the result could be ironic. Acceptance of the Government's position could retard tax enforcement by diminishing Government incentive to require prompt payment of taxes. Assured of full lien rights for not only the tax itself but also for interest and penalties, the Government would have little reason to act quickly to enforce tax claims, so long as the taxpayer retains sufficient assets to satisfy all tax, penalty, and interest claims.

B.

The Government also contends that a law creating a lien is remedial and should be read liberally to give full effect to the remedy.

120 Tax laws are not generally regarded as remedial. It has been called a "fundamental precept" and a "settled rule" that tax laws are strictly construed against the State and in favour of citizens (3 C. Sands, *Sutherland Statutory Construction*, 66.01 (4th. ed. 1974); *Gould v. Gould* 245 U.S. 151, 38 S. Ct. 53, 62 L. Ed. 211 (1915)).

There appears no reason to apply a different rule in this case. Admittedly the lien rights sought here would increase the Government's tax enforcement capabilities by providing an additional remedy to enforce Government claims under 54 F.S.M.C.,

sections 155 and 902. In that broad sense, the lien provisions are remedial.

130 However, the remedy would enforce provisions which are themselves penal. Sections 155 and 902 both have the word "penalty" in their codified titles and both obviously are designed primarily as penalties to encourage or force taxpayers to comply with the law.¹ See 54 F.S.M.C., section 155(1) (adding 1% of the tax for each thirty days or fraction thereof for late filing); section 155(2) (\$5.00 penalty for employer failure to file written statement); section 155(3) (25% of the tax assessed for failure to file return upon demand); section 155(4) (penalty of 50% of the tax assessed for fraud); section 902 (penalty of 10% of the tax per month for delayed payment, up to 100% of the tax).

140 These civil penalty provisions, 54 F.S.M.C., sections 155 and 902, are not remedial, then, but are penal. It follows that enforcement of such penalties will have a penal effect. Accordingly, in approaching the question whether the liens referred to in 54 F.S.M.C., sections 135(2) and 153 may be used to enforce amounts owing under sections 155 and 902, the Court must strictly construe the statutory language.

The Government also points out that courts in some cases have regarded interest and penalties payable with respect to a tax as part of the tax itself for tax lien purposes. See *California v. Hisey* 84 F. 2d. 802, 805 (9th. Circ. 1936); *Northern Finance Corp. v. Byrnes* 5 F. 2d. 11, 12 (8th. Circ. 1925); *Baltimore Trust Co. v. Interocean Oil Co.* 30 F. Supp. 560, 562 (D. Md. 1939).

Those courts did not reach that conclusion, however, on the basis of any general legal principle but upon careful analysis of the particular statutes under consideration.

150 III.

This Court then must place primary emphasis upon the statutory language, and the overall structure of the tax law, to determine whether interest and penalties qualify for lien treatment. In so doing the Court should construe the language strictly and uphold the lien claim only if the statute itself provides a sound reason for doing so.² It is therefore quite significant that neither lien provision at issue here says anything about interest or penalties.

160 The Government points to provisions calling for penalties and interest to be "added to" or "in addition to" other amounts to be collected under the tax lien.³ The argument is that these phrases demonstrate legislative intent that the penalties and interest be effectively attached to the applicable tax.

While it may be possible to read such words as suggesting that the penalty amount is to be regarded as part of the tax itself, the same words are equally amenable to an interpretation that the penalties and interest are separate and discrete from taxes, but must be added to the taxes to calculate the entire amount due. The tax statutes are devoid of any direct statement, or clear implication, that penalties and interest

1 The heading for 54 F.S.M.C. 155 is "Civil penalties" and for 54 F.S.M.C. 902 is "Monthly penalty upon unpaid taxes and fees".

2 For example, the United States statute leaves no doubt that United States tax lien rights extend to interest and penalties: "Lien for taxes. If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person" (26 U.S.C.S. 6321).

3 See 54 F.S.M.C., sections 155(1), (3), and (4), and 902.

are to be considered merged with the tax for lien or other purposes.

IV.

The Court concludes that amounts owing for penalties and interest under 54 F.S.M.C., sections 155 and 902 do not qualify for lien treatment under 54 F.S.M.C., sections 135(2) or 153.