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A Review and Improvement of the Tax Priority System in Bankruptcy Liquidation Proceedings

Jing Zhang [1,*], Jingchao Zhu [1] and Fulian Hou [1]

[1] Department of Law, School of Public Administration, Southwest Jiaotong University, Chengdu, Sichuan, 610031, China
* Correspondence: Jing Zhang, Department of Law, School of Public Administration, Southwest Jiaotong University, Chengdu, Sichuan, 610031, China

Abstract: This paper analyzes the tax priority system in bankruptcy liquidation proceedings from both theoretical and empirical perspectives, exploring its theoretical foundations and practical issues while proposing corresponding improvements. First, the paper examines the connotation of the tax priority system, the nature of tax legal relationships, and the specific manifestations of this system in bankruptcy liquidation proceedings, revealing the influences of the tax power theory, the debt relationship theory, and the dualistic theory on tax priority. Subsequently, through empirical research, the paper reviews real-world challenges concerning the order of repayment between tax claims and secured claims, whether tax delinquency fees, tax penalties, and tax advances should enjoy priority, and other related issues. Furthermore, the paper dissects the legal conflicts between the "Tax Collection and Administration Law" and the "Enterprise Bankruptcy Law" in terms of legal application. Based on this analysis, the paper proposes several recommendations for improving the tax priority system in bankruptcy liquidation proceedings. Specifically, it advocates for the clarification of principles such as balancing interests, prioritizing compensatory claims over punitive claims, and the ability-to-pay principle in tax-related bankruptcy liquidation. Additionally, it calls for the coordination of the "Enterprise Bankruptcy Law" and the "Tax Collection and Administration Law" and a reasonable limitation on the scope of tax priority to balance state tax interests with the rights of other creditors, optimize the functioning of bankruptcy proceedings, and promote the high-quality development of the market economy.

Keywords: bankruptcy liquidation; tax priority; legal coordination; interest balance

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1. Introduction

With the vigorous development of the market economy, the number of corporate bankruptcy cases has been rising annually. The implementation of the "Enterprise Bankruptcy Law" has established a standardized legal framework for the orderly exit of market participants, with its core objective being the fair and reasonable settlement of debts to safeguard the legitimate rights and interests of both creditors and debtors, thereby maintaining the operational order of the socialist market economy. Meanwhile, as the cornerstone of national fiscal revenue [1], tax law grants tax claims a certain degree of priority in bankruptcy liquidation proceedings. Since the enactment of the "Enterprise Bankruptcy Law," despite its clear legislative intent, its practical implementation has encountered numerous challenges. These issues primarily stem from the lagging concept of bankruptcy legal governance, the lack of supporting mechanisms, and insufficient attention to bankruptcy law within the field of tax law. Particularly in the critical stages of bankruptcy liquidation, the application of the tax priority system has long been a heated topic of discussion in both academic and practical circles. The initial purpose of this system was to safeguard national tax security and prevent tax revenue losses. However, with the advancement of socio-economic conditions and the growing characteristics of a welfare state, scholars have increasingly questioned the reasonableness of this system. The unsatisfactory implementation of the tax priority system and the tax-related issues arising in bankruptcy liquidation proceedings appear to stem from legislative conflicts and deficiencies on the surface. In essence, however, the deeper causes lie in the conflicting legal nature and philosophies of the two major legal domains, as well as procedural obstacles.

2. Theoretical Foundations of the Tax Priority System in Bankruptcy Liquidation Proceedings

2.1. The Concept of the Tax Priority System

Taxation is a means by which the state secures fiscal revenue through the exercise of political authority, collecting funds from citizens, legal entities, and other organizations in accordance with statutory standards without compensation. Tax priority refers to the legal system whereby tax claims take precedence over other ordinary claims in the order of repayment. The purpose of this system is to prevent the loss of tax revenue, stabilize tax sources, and ensure the stability of national fiscal revenue. According to Article 45 of China's "Tax Collection and Administration Law", tax claims enjoy priority under specific circumstances. However, since the implementation of the "Enterprise Bankruptcy Law," this provision has become a focal point of debate due to conflicts in the application of departmental laws, which will be further analyzed below.

2.2. The Nature of Tax Legal Relationships

Both the "Enterprise Bankruptcy Law" and the "Tax Collection and Administration Law" regulate tax priority primarily through the lens of tax legal relationships. Tax legal relationships are social relationships involving rights and obligations formed between parties in the course of national tax activities, as defined and regulated by tax law [2]. The nature of tax legal relationships remains a subject of debate, with academic discourse focusing on whether tax legal relationships should be characterized as a "power relationship" or a "debt relationship".

2.2.1. Tax Power Theory

The tax power theory was first proposed by the German administrative law scholar Mayer.Otto.It argues that tax legal relationships represent a hierarchical relationship in which the state's taxation authority dominates taxpayers. Taxation is thus classified as a specific administrative act, similar to administrative penalties and administrative permits, and is an embodiment of public power in the financial sphere, falling under the domain of administrative law. This perspective led to the establishment of the tax priority system, which asserts that the interests of general creditors should yield to those of the state. Before China's reform and opening-up, the country adopted this power relationship approach in understanding tax legal relationships.

2.2.2. Tax Debt Theory

The tax debt theory originated from the enactment of Germany's 1919 Tax Code. German jurist Albert Hensel argued that tax legal relationships should be defined as the state's claim against taxpayers for fulfilling their tax obligations [3] This perspective views the state and taxpayers as creditor and debtor, respectively, akin to civil law relationships, where taxes are treated as debts. Since taxation is regarded as a debt, it falls within the scope of civil and commercial law and should adhere to the principle of equality under these legal domains. Consequently, the state's tax claims should be on equal footing with those of general creditors, without precedence. With the development of the tax debt theory, it has gradually gained acceptance in academic circles. As a result, the tax priority system derived from the power relationship theory has gradually declined, with countries such as Germany and Australia abolishing tax priority system.

2.2.3. Dualistic Tax Relationship Theory

Unlike the power or debt theories, the dualistic tax relationship theory posits that taxation constitutes a state-enforced claim on taxpayers. Renowned Japanese tax law scholar Hiroshi Kaneko contended that tax legal relationships encompass both power and debt aspects, though the primary focus remains on the debt relationship, characterizing taxation as a "public law debt." [4]. Substantively, taxation is a relationship of debt-credit, yet procedurally, tax collection embodies the exercise of state authority. Overall, the tax relationship is a debt-credit relationship with public power attributes. This perspective has gained considerable recognition among Chinese scholars in recent years. Based on this understanding, the tax priority system in bankruptcy liquidation proceedings must strike a balance between safeguarding state authority and protecting the private rights of other creditors, ensuring that tax priority remains within a reasonable scope to reflect the principle of "taxation for the people."

2.3. The Tax Priority System in Bankruptcy Liquidation Procedures

The tax priority system in bankruptcy liquidation procedures is the concrete manifestation of tax priority in the bankruptcy domain. According to the provisions of China's Enterprise Bankruptcy Law, tax claims fall under the second-ranking category of special claims. After the priority settlement of bankruptcy expenses and common benefit debts, bankruptcy assets should first be used to settle the first-ranking employee claims and social insurance claims, followed by the settlement of tax claims, and lastly, the settlement of ordinary claims. Meanwhile, secured claims, as exclusionary rights, enjoy priority over the value of the collateral. Unlike the Tax Collection and Administration Law, which places tax claims at an extremely high priority level, the Enterprise Bankruptcy Law only prioritizes tax claims over ordinary claims while subordinating them to several other types of claims. The significant difference in ranking due to varying legal perspectives has led to multiple practical issues concerning the application of law and the order of settlement.

3. Review of Practical Issues in the Tax Priority System in Bankruptcy Liquidation Procedures

Since the promulgation of the Enterprise Bankruptcy Law in 2006, China's bankruptcy system has undergone more than a decade of reform and has gradually improved. However, with the severe economic impact of the post-pandemic era requiring urgent recovery and the rising number of corporate bankruptcies, numerous issues have emerged in bankruptcy liquidation practice. In particular, a series of practical problems arising from the tax priority system in bankruptcy liquidation procedures have become increasingly prominent. Due to the special nature of corporate bankruptcy, corporate capital is often insufficient to repay all debts, necessitating the joint participation of tax claims and other claims in the distribution of remaining corporate assets. Through an empirical research approach, the author retrieved civil cases with the cause of action related to "bankruptcy-related disputes" from the China Judgments Online and PKU Law database. Using "bankruptcy," "liquidation," "tax," and "priority" as search keywords, a total of 21 relevant cases were identified. After summarizing the common dispute focal points, the findings are as follows Table 1:

Table 1. Analysis of Typical Legal Cases Related to Tax Priority in Bankruptcy Liquidation Procedures.

Case Number	Disputed Issue Summarized by the Court	Summary of Court Ruling
(2016) Zhe 0603 Minchu No.10874	Between the plaintiff's mortgage-backed claim against the defendant and the third party's tax claim against the same defendant, which claim should have a higher priority for repayment.	1. The occurrence time of a tax claim should be determined based on the time when the taxpayer's tax obligation arises. 2. The law should uphold special arrangements that grant tax claims priority over secured claims under certain circumstances.
(2017) Zhe 06 Minzhong No.1119	The order of repayment from the liquidation proceeds of collateral in bankruptcy between a mortgage-backed claim held by the plaintiff and a tax claim asserted by a third party.	A mortgage-backed claim should take priority over a tax claim with respect to the collateral, regardless of the chronological order in which the tax claim arises and the mortgage right is established.
(2017) Zhe 03 Minzhong No.4844	The order of repayment from the liquidation proceeds of collateral between the appellant's tax claim and the secured claim of the third party in the original trial.	The order of repayment in bankruptcy proceedings should follow the provisions of the Enterprise Bankruptcy Law.
(2017) Lu 10 Minchu No,453	Whether the late payment interest on outstanding taxes owed by the defendant should be classified as an ordinary bankruptcy claim.	According to the Enterprise Bankruptcy Law, late payment interest on unpaid taxes incurred before the acceptance of the bankruptcy case is recognized as an ordinary bankruptcy claim and does not enjoy tax priority. However, any tax-related late payment interest accrued after the acceptance of the bankruptcy petition should not be regarded as a bankruptcy claim.
(2018) Qian 26 Minchu No,32	1. Whether the late payment interest claimed by the plaintiff enjoys priority. 2. Whether the tax penalty claimed by the plaintiff constitutes a bankruptcy claim, and if so, whether it qualifies as a priority claim.	1. Late payment interest on unpaid taxes incurred before the bankruptcy liquidation date constitutes an ordinary bankruptcy claim, while any subsequent portion does not qualify as a bankruptcy claim. 2. Tax penalties do not constitute bankruptcy claims and therefore cannot enjoy priority.
(2022) Gan 1023 Minchu No,773	Whether the various tax liabilities and late payment interest declared by the plaintiff should be recognized as bankruptcy claims.	1. If the taxpayer's failure to pay or underpayment of taxes is due to the tax authority's responsibility, the taxpayer has the right to refuse payment of taxes beyond the retroactive collection period. 2. Late payment interest on unpaid taxes incurred by the bankrupt enterprise before the acceptance of the bankruptcy case constitutes an ordinary bankruptcy claim.

(2023) Lu 10 Min-zhong No.354	Whether the plaintiff's claim for tax payments advanced on behalf of the defendant enjoys priority.	The plaintiff, being different in status from the tax authority, does not enjoy the priority status accorded to tax claims held by the tax authority.

Based on the above table, it is evident that the current issues exposed by the tax priority system in bankruptcy liquidation procedures include the order of repayment between tax claims and secured claims, whether tax penalties and fines should be classified as priority claims, and whether the claims for advanced tax payments should enjoy priority. A detailed review of these issues is as follows.

3.1. The Issue of Repayment Order between Tax Claims and Secured Claims in Bankruptcy Liquidation Procedures

According to Article 45 of the Tax Collection and Administration Law, if a taxpayer owes taxes before setting up a mortgage, pledge, or before their property is subjected to lien, the tax claim should take precedence over the mortgage, pledge, or lien in execution. However, Articles 109 and 132 of the Enterprise Bankruptcy Law explicitly state that secured claims enjoy priority in bankruptcy proceedings. Specifically, the property corresponding to secured claims is excluded from the bankrupt estate, and secured claims are repaid before tax claims. This creates a conflict regarding the order of repayment between the two in the bankruptcy liquidation process. By summarizing relevant cases, it is evident that, with a few exceptions, most courts tend to prioritize the repayment of secured claims over tax claims, reflecting a conflict between the Enterprise Bankruptcy Law and the Tax Collection and Administration Law.

First, in terms of legal status and nature, both the Tax Collection and Administration Law and the Enterprise Bankruptcy Law are departmental laws formulated by the Standing Committee of the National People's Congress, giving them the same legal rank. According to Article 92 of the Legislative Law of the People's Republic of China, "When a law formulated by the same authority contains special provisions that conflict with general provisions, the special provisions shall apply." General provisions are broad legal norms designed to regulate specific types of social relations, while special provisions are narrower legal norms tailored to regulate particular social relations [5]. To analyze which provisions are special and which are general in the context of tax claim repayment in bankruptcy liquidation, it is necessary to examine the scope of regulation of each law.

Second, in terms of the scope of legal regulation, the Tax Collection and Administration Law and the Enterprise Bankruptcy Law represent a distinction between public and private law: the Tax Collection and Administration Law governs tax collection and management matters affecting all taxpayers, which concern public interests; the Enterprise Bankruptcy Law regulates the liquidation or reorganization of enterprises meeting bankruptcy criteria, focusing on maintaining bankruptcy procedures and balancing the interests of specific creditors.

From the perspective of bankruptcy liquidation, the mainstream view is that the tax collection matters regulated by the Tax Collection and Administration Law cover both normal and bankrupt enterprises, while the Enterprise Bankruptcy Law only applies to bankrupt enterprises. Therefore, the scope of the Enterprise Bankruptcy Law is narrower than that of the Tax Collection and Administration Law. Hence, the provision in the Enterprise Bankruptcy Law that secured claims take precedence over tax claims is a special provision and should be applied. However, some argue that the Tax Collection and Administration Law itself is a special provision regulating tax collection matters, and in the context of bankruptcy liquidation, tax claims are considered part of tax collection matters, thereby favoring the application of the Tax Collection and Administration Law and prioritizing tax claims over secured claims.

3.2. The Applicability of Tax Priority to Tax Late Fees and Tax Fines in Bankruptcy Liquidation Procedures

The Reply of the Supreme People's Court on Whether to Accept the Creditor's Rights Confirmation Lawsuit Filed by the Tax Authority Regarding Late Fees Arising from a Bankrupt Enterprise's Unpaid Taxes explicitly clarifies that late fees accrued due to unpaid taxes before the acceptance of a bankruptcy case are considered ordinary bankruptcy claims. In contrast, late fees arising after the acceptance of the bankruptcy case are not classified as bankruptcy claims. From this reply and empirical case analyses, it can be concluded that tax late fees accumulated before the acceptance of the bankruptcy case are treated as general bankruptcy claims and do not enjoy priority in repayment. Conversely, tax late fees incurred after the commencement of bankruptcy liquidation are not considered part of the bankruptcy claims and are thus not subject to bankruptcy liquidation procedures. Additionally, tax fines are also not classified as bankruptcy claims. Based on this distinction, neither tax late fees nor tax fines fall within the scope of the tax priority system.

However, in examining whether tax late fees and tax fines should be granted priority, it is necessary to first clarify and distinguish their nature. Tax fines, as the term suggests, are punitive measures imposed on enterprises for failing to pay taxes. Tax late fees, on the other hand, not only serve as a penalty for delayed tax payments but also compensate for the interest that should have accrued on the tax principal owed to the state [6]. Excluding purely punitive tax fines from the tax priority system in bankruptcy liquidation is justifiable. However, a blanket exclusion of tax late fees without considering their compensatory nature—thus denying them priority in repayment—remains open to debate.

3.3. Whether Creditors Enjoy Priority for Tax Claims Arising from Tax Advances in Bankruptcy Liquidation Procedures

Among the cases analyzed, one involved a unique situation regarding the advance payment of taxes. In this case, the claimant argued that their creditor's rights stemmed from paying the bankrupt enterprise's tax obligations on its behalf, which served to protect the state's tax interests. The claimant contended that after advancing the taxes, they should legally assume the tax authority's rights against the debtor and thus enjoy priority in repayment. However, the court ultimately rejected this argument, reasoning that the claimant did not hold the same legal status as the tax authority.

Despite this judicial ruling, the issue remains unaddressed in existing legislation. While current legal provisions grant third parties who advance employee wages the same priority as employee claims, such rules are based on the principle that the parties involved either hold equal legal status or that the advancing party has a superior standing to the creditor. These principles cannot be automatically extended to disputes over tax advances. Therefore, it is necessary to fill this legislative gap to clarify the rights of creditors advancing taxes on behalf of bankrupt enterprises.

4. Conclusion

The practical issues surrounding the tax priority system in bankruptcy liquidation involve multiple laws, including the Tax Collection and Administration Law, the Enterprise Bankruptcy Law, and the Civil Code. On one hand, these issues arise from the differences in the nature of these laws and the conflicts among the various interests they seek to protect. On the other hand, they reflect the competing interests between general creditors and tax authorities over the distribution of a bankrupt enterprise's remaining assets. Therefore, effectively coordinating the legal framework governing tax collection in bankruptcy liquidation and balancing the interests of all parties is essential to improving the tax priority system.

4.1. Clarifying the Fundamental Principles of the Tax Priority System in Bankruptcy Liquidation Procedures

4.1.1. Principle of Interest Balance

In bankruptcy liquidation, the interests of various stakeholders often conflict, necessitating the application of the principle of interest balance. This principle requires safeguarding the state's tax revenue while also considering the legitimate rights of other creditors to ensure fairness and justice in the bankruptcy process. When determining the relationship between tax claims and other bankruptcy claims, all parties' interests should be fully considered to prevent excessive emphasis on one party's claims at the expense of others. The priority of tax claims should not unreasonably squeeze out the rights of ordinary creditors.

4.1.2. Principle of Compensation over Punishment

The establishment of the tax priority system primarily aims to protect state tax revenues, making its nature compensatory rather than punitive. Tax penalties, which serve a punitive function, should be treated as subordinated claims to avoid excessive punishment that would harm the rights of other creditors. In bankruptcy liquidation, the handling of tax late fees and penalties should be clearly defined. The compensatory portion of tax late fees may be treated as priority claims to some extent, while tax penalties should be classified as subordinated claims that do not enjoy priority.

4.1.3. Principle of Taxation Based on Ability to Pay

The principle of taxation based on the ability to pay is both a fundamental fiscal and tax concept and an underlying logic that cannot be overlooked in tax law across various domains [7]. Its core idea is that taxes should be levied based on a taxpayer's actual financial capacity and should be adjusted accordingly as that capacity changes. When a taxpayer is no longer capable of paying taxes—particularly in cases where a bankrupt enterprise is already insolvent and undergoing liquidation—applying the same tax standards as in normal circumstances is generally impractical. Even if taxes are forcibly collected, this would severely disrupt the bankruptcy liquidation process and make it difficult to balance the interests of all creditors.

4.2. Coordination Between the Enterprise Bankruptcy Law and the Tax Collection and Administration Law

First, the distinction between the two laws must be clarified. The Tax Collection and Administration Law establishes three levels of tax claim priority:

Tax claims take precedence over unsecured claims.

Tax claims take precedence over security interests established after the tax obligation arises.

Unpaid taxes take precedence over administrative penalties and confiscation of illegal gains imposed for the same tax obligation.

In contrast, the Enterprise Bankruptcy Law ranks tax claims third in the order of priority in bankruptcy liquidation. Tax claims are subordinate to secured claims (which enjoy exemption right), bankruptcy expenses, and common benefit debts (first priority), as well as employee wages and social security claims (second priority). However, tax claims are superior to general unsecured claims (fourth priority), regardless of when they were established.

From a legal perspective, the scope of the Tax Collection and Administration Law is evidently broader than that of the Enterprise Bankruptcy Law, making it a general provision. The Enterprise Bankruptcy Law, by affirming that secured claims take precedence over tax claims, serves to balance the interests of creditors while aligning with the tax law's principle of taxation based on ability to pay. Therefore, the Enterprise Bankruptcy Law should be regarded as the special provision governing tax priority in bankruptcy liquidation. In practice, tax claims should be satisfied before general unsecured claims but after secured claims, employee wages, and social security claims [8]. Security interests, as exemption rights, should take priority over all other claims, including tax claims.

4.3. Reasonable Restriction of the Scope of Tax Priority in Bankruptcy Liquidation

Broadly speaking, taxes include regular tax, tax late fees, and tax penalties. The regular tax constitute the core content of the tax priority system and are undisputed. However, tax penalties, given their punitive nature, should be excluded from tax priority, following the principle that compensatory claims take precedence over punitive claims. Tax penalties should even be classified as subordinated claims, receiving payment only after all other claims have been satisfied.

Tax late fees, due to their dual nature—both compensatory and punitive—should be assessed separately. The portion of the tax late payment penalty equivalent to the interest rate on regular tax deposits should be considered as the tax interest that the state should have enjoyed, which constitutes compensation to the state， and should enjoy the same priority as the principal tax debt. The remaining portion, which serves as a penalty for delayed tax payment, should not be granted priority status.

Furthermore, the priority status of claims arising from third-party tax payments on behalf of the bankrupt entity should be determined based on multiple factors, including the identity of the payer, their intent, and the actual consequences of the payment. To address legal uncertainties, judicial interpretations should be issued to clarify these issues and fill existing legislative gaps.

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