

**“ULTIMATE FIGHTING”  
SECURED CREDITORS VS. FEDERAL TAX LIENS**

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## **“ULTIMATE FIGHTING” SECURED CREDITORS VS. FEDERAL TAX LIENS**

### **1. Birth of a Tax Lien – IRC §6321**

- Meant to Reach all Interests of Taxpayer (Compared to §541 of Bankruptcy Code, it is essentially the same)

Section 541 of the Bankruptcy Code defines property of the estate as “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. § 541(a)(1).

The Court determined that the IRS's power to attach a lien on all “property and rights to property” of any individual who failed to pay federal taxes was broad, clearly authorizing the IRS to attach a lien to all property and rights to the property a taxpayer may have, despite state law prohibiting otherwise.. United States v. Craft, 535 U.S. 274, 288 (2002).

Pursuant to Sections 6321 and 6322 of the Internal Revenue Code, federal tax liens arose at assessment on all property of Defendant. U.S. v. Frein, 2005 WL 518980, \*4 (M.D. Fla. 2005).

The commencement of a bankruptcy case creates an estate which is comprised of “all legal or equitable interests of the debtor in property.” 11 U.S.C. § 541(a)(1) (West 2001). Determination of whether a debtor's interest in property constitutes property of the estate is a question of federal law. “However, unless there is a strong countervailing federal interest, the actual existence of a debtor's right in property, including its nature and scope, is determined by looking at state law.” In re Greer, 242 B.R. 389, 394 (Bankr. N.D. Ohio 1999) (quoting Butner v. United States, 440 U.S. 48, 54-55, 99 (1979)). In re Wells, 259 B.R. 776, 779 (Bankr. M.D. Fla. 2001).

It is firmly established in case law that a “federal tax lien attaches to a then existing right to receive property in the future.” Wessel v. United States of America (In re Wessel), 161 B.R. 155 (Bankr. D.S.C. 1993).

- Generally, Tax Lien Arises on Date of Assessment (Self-Assessment, Tax Audit)
- Deficiency Notice (Amount and Intent to Levy) (Effective Date is Date of Assessment)

- Effective for Ten Years and Thirty Days (Renewable)
- IRS Files Form 668 (§6323(f)(2) – Liens Filed in Place Designated by Laws of Place of Residence or Principal Executive Office. A survey of filing locations for SE states is attached as Exhibit “A.”

## 2. **Federal Priority Statute (IRC §6323)**

- Priority Conflicts Matter of Federal Law

The validity and priority of a § 6321 lien as against certain third parties with subsequently arising interests in the property or interests in property to which the lien has attached is governed by 26 U.S.C. § 6323 (1976 ed. and Supp. IV). See also 26 U.S.C. § 6322 (period of lien); 26 U.S.C. § 6325 (1976 ed. and Supp. IV) (release of lien or discharge of property). U.S. v. Rodgers, 461 U.S. 677, 682, FN2 (1983).

Aquilino v. United States, 363 U.S. 509 (1960), and cases cited (attachment of federal lien depends on whether “property” or “rights to property” exist under state law; priority of federal lien depends on federal law).

“[O]nce the tax lien has attached to the taxpayer's state-created interests, we enter the province of federal law, which we have consistently held determines the priority of competing liens asserted against the taxpayer's ‘property’ or ‘rights to property.’” Aquilino v. U.S., 363 U.S. 509, 513-514 (1960). See also United States v. Vorreiter, 355 U.S. 15, 78 (1957); United States v. White Bear Brewing Co., 350 U.S. 1010 (1956); United States v. Colotta, 350 U.S. 808 (1955).

- “First In Time Is First In Right” (State Lien Must Be Specified and Perfected)

“Federal tax liens do not automatically have priority over all other liens. Absent provision to the contrary, priority for purposes of federal law is governed by the common-law principle that “the first in time is the first in right.”” U.S. By and Through I.R.S. v. McDermott, 507 U.S. 447, 449 (1993). See also United States v. New Britain, 347 U.S. 81 (1954); cf. Rankin v. Scott, 12 Wheat. 177 (1827) (Marshall, C.J.).

“Our cases deem a competing state lien to be in existence for “first in time” purposes only when it has been “perfected” in the sense that “the identity of the lienor, *the property subject to the lien*, and the amount of the lien are established.”” United States v. New Britain, 347 U.S.81, 84 (1954)(emphasis added).

“As against a record federal tax lien, the relative priority of a state lien is determined by the rule ‘first in time is the first in right,’ which in turn hinges upon whether, on the date the federal lien was recorded, the state lien was ‘specific and perfected.’ A state lien is specific and perfected when ‘there is nothing more to be done \* \* \*-when the identity of the lienor, the property, subject to the lien, and the amount of the lien are established.’” U.S. v. Equitable Life Assur. Soc. of U.S., 384 U.S. 323, 327-328 (D.C.N.J. 1966).

- Not Valid Against Competing Lien Holders Until Filed
- Security Interest Defined (IRC §6323(h)(1))

**3. Safe Harbor for Security Interests in “Qualified Property” (IRC §6323(c))**

- Limited Protection for Secured Lenders Collateralized by Inventory and A/R Acquired or Created After Lien Filed
- Earlier of 45 Days After Filing or Secured Lender’s Receipt of Notice or Knowledge of Tax Lien Filing

“In cases in which the priority of a security interest and a federal tax lien are contested, the Act identifies two distinct situations in which a security interest may have priority over a federal tax lien: when the security interest exists prior to the Internal Revenue Service's filing of notice of the tax lien, 26 U.S.C.A. § 6323(a), and when the security interest arises after the filing of the tax lien but within forty-six days of the date of filing, 26 U.S.C.A. § 6323(c).” Atlantic States Const., Inc. v. Hand, Arendall, Bedsole, Greaves and Johnston, 892 F.2d 1530, 1535 (11 Cir. 1990).

Protection for a security interest arising out of a commercial transactions financing agreement “is afforded only where the loan or purchase is made not later than 45 days after the tax lien filing (unless actual notice or knowledge of the filing is obtained sooner) and only where the inventory, accounts receivable, etc., are acquired before the 45 days have elapsed.” Rice Inv. Co. v. U.S., 625 F.2d 565, 569, FN 17 (C.A. Tex. 1980) (loans or purchases priority over a filed tax lien if the loans or purchases are made not later than 45 days after the tax lien filing and before the lender or purchaser has actual notice of the filing.)

U.S. v. Equitable Life Assur. Soc. of U.S., 384 U.S. 323 (D.C.N.J. 1966) (Where notice of federal tax lien had been recorded prior to default by the mortgagor, the federal tax lien was entitled to priority over the mortgagee's claim in foreclosure proceeding for the allowance of an attorney's fee provided by state court rule

fixing attorneys' fees as a percentage of the amount adjudicated in foreclosure proceeding.)

- Three Types of Written Security Agreements
  - Commercial Transactions Financing
    - (A/R is collateral (commercial paper, A/R, mortgage, notes, inventory) acquired in ordinary course of business and advances made without notice or knowledge prior to 46<sup>th</sup> day)
  - Real Property Construction or Improvement Agreement (§6323(c)(3)(a))
    - Basically, construction loan financing, but also includes (strangely) crop and livestock financing

Whiting-Turner/A.L. Johnson v. P.D.H. Development, Inc., 184 F.Supp.2d 1368 (M.D.Ga.,2000) (Secured creditor's interest in subcontractor's accounts receivable took priority over federal tax lien on those accounts to extent that accounts receivable were generated by services performed by subcontractor within 45 days following filing of tax lien, even though amount of money subject to creditor's security interest was subject to reduction or elimination in the future.).

- Obligatory Disbursement Agreement (§6323(c)(4)(a))
  - Irrevocable Letter of Credit
  - Surety Bond for Completion of Project
  - No time limit as long as agreement in place prior to tax lien filing
  - Also secured by after-acquired property directly traceable to contractual disbursement (e.g. imported goods paid by draw on documentary letter of credit)
- In all cases, secured party must be perfected under local law against rights of a lien creditor as of filing date of tax lien.

Payments under healthcare provider contracts become accounts when the services are rendered, and the contract created no choate right to payment prior to performance. Tax lien primed security interest in the provider contracts and accounts for services rendered to patients more than 45 days after filing of tax lien. American Investment Financial v. USA, 476 F.3d 810 (10<sup>th</sup> Cir. 2006)

#### 4. **Advances After Tax Lien Notice Filed (§6323(d))**

- Secured Lender can secure post-filing advances with pre-notice collateral before earlier of (a) Secured Lender's receipt of notice or knowledge of filing and (b) 46 days after filing of tax lien

Slodov v. U. S., 436 U.S. 238, 259, FN22 (1978)(when a security agreement exists and filing has occurred prior to the filing of a tax lien to secure advances made after the tax filing, perfection is, at the least, achieved when the secured party makes the advance. When that occurs after the tax lien has been filed, § 6323(d) protects the secured party from the federal tax lien if the advance is made not later than 45 days after the filing of the tax lien or upon receipt of actual notice of the tax lien filing, whichever is sooner.), *see also* Coogan, The Effect of the Federal Tax Lien Act of 1966 Upon Security Interests Created Under the Uniform Commercial Code, 81 Harv.L.Rev. 1369, 1403-1413 (1968).

#### 5. **Secured Creditor Recovery of Seized Collateral**

- Action For Wrongful Levy (26 U.S.C. §7426)

Texas Commerce Bank-Fort Worth, N.A. v. U.S., 896 F.2d 152 (5th Cir. 1990)(held that bank had right to institute wrongful levy action concerning check payable jointly to bank and taxpayer, and a return of bank account balance surrendered to the Internal Revenue Service, before surrendering the check, where the IRS had not yet filed a lawsuit to enforce its levy). Accord, Trust Co. of Columbus v. U.S., 735 F.2d 447 (Ga. App. 1984)(valid and senior security interest in the bank was wrongfully defeated by the government tax levy)

- Administrative Request (26 U.S.C. §6343(b))

#### 6. **Right of Setoff**

- Secured Creditor Must Have Security Interest in Deposit Accounts – Right of Setoff is not a Lien or Security Interest – IRS Lien defeats unexercised right of setoff (doctrine of choateness). *See* Virgin Islands Bureau of Internal Revenue v. Chase Manhattan Bank, 312 F.3d 131 (3d Cir. 2002)

U.S. v. Citizens and Southern Nat. Bank, 538 F.2d 1101 (5th Cir. 1976)(bank's right of setoff required some discreet act by the banks, and as neither bank performed such an act until after service of notice of levy, depositors retained property interests in the accounts subject to levy.)

Trust Co. of Columbus v. U.S., 565 F. Supp. 61, 63 (M.D. Ga. 1983)(Security interests acquired by third parties prior to the time when notice of a tax lien is filed by the IRS are *senior* to a federal tax lien.)

In re Nerland Oil, Inc., 303 F.3d 911 (8<sup>th</sup> Cir. 2002) concerned an attempted setoff being primed by a tax lien. Before bankruptcy, the debtor sold a truck stop to Purchaser, and Purchaser gave debtor a secured note. Debtor failed to remit credit card receivables to Purchaser. Purchaser attempted to set off the amount owed to debtor on the installment note. IRS, which had filed a tax lien against debtor well prior to bankruptcy filing, objected to setoff claiming that the amounts due by Purchaser under the note were subject to the tax lien. Court found that lien attached to note and that Purchaser had to pay the remaining purchase price to the IRS.

#### **7. Secured Creditor's Liability for Conversion of IRS Collateral - Liquidation of Collateral Subject to Prior Tax Lien**

In re NuMed Home Health Care, Inc., 323 B.R. 528 (Bankr. M.D. Fla. 2005)(judgment for government on government's claim against secured creditor, for tortiously converting receivables of debtor-taxpayer that were subject to its first priority tax lien by sweeping lock box accounts into which these receivables had been deposited)

US v. Standard State Bank, 905 F.2d 185 (8<sup>th</sup> Cir. 1990)(IRS released its lien in confirmed plan. Plan is not consummated, Bank gets stay relief and case is dismissed. Court holds that S349(b) order was a final order from which IRS did not appeal. Bank not liable for conversion)

- IRS Summons to Secured Creditor (Form 2039) (Testify and produce records)
- IRS Levy on Taxpayer's Account Debtors (Form 668)
- Purchasers of Accounts at Risk (Must check filing offices for personal property tax liens – may be doubt as to “principal executive office”)

#### **8. Foreclosure of Property with Tax Liens (IRC §7425)**

- 25-Day Prior Notice to IRS(unless tax lien filed within 30 days of foreclosure sale)

Southern Bank of Lauderdale County v. I.R.S., 770 F.2d 1001 (11th Cir. 1985)(held that failure of mortgagees to give statutory notice to Government before they conducted foreclosure sales and purchased property caused their mortgage liens to be extinguished and federal tax liens to be elevated from their junior status.)

“Section 7425(b) provides that a foreclosure sale is made *subject to* federal tax liens *unless* the United States is given the proper notice. If seen as an elevation of a tax lien to first position, it is a federally prescribed remedy.” USX Corp. v. Champlin, 992 F.2d 1380, 1386 (5th Cir. 1993)

- IRS Federal Rights of Redemption (longer of 120 days or time period allowed by state). A survey of statutory redemption periods for SE states is attached as Exhibit “B.”  
CAUTION: Under 28 U.S.C. §2410(d), the IRS Only Has To Reimburse the Purchaser For “the expenses necessarily incurred in connection with such property” (net of income from the property) plus the amount paid and 6% interest on that amount. This Amount May Be Less Than The Amounts Specified Under State Redemption Statutes.
- Removal of Tax Liens Prior To Expiration of Federal Redemption Period – If IRS Right of Redemption Is Valueless, Apply For A Release under §7425(d) (See IRS Publication 487).

## 9. Tax Liens and Bankruptcy

- a. IRS is Subject to Bankruptcy Court Orders (Turnover Seized Property) Just Like Any Secured Creditor. US v. Whiting Pools, 462 U.S. 198 (1983) (Debtor retained ownership interest until tax sale).
- IRS Liability for Preferences and Setoffs

U.S. v. Reynolds, 764 F.2d 1004 (4th Cir. 1985)(action of IRS in retaining debtors' tax refund was a setoff subject to the automatic stay and IRS violated the stay in retaining the funds). Accord, In re Mealey, 16 B.R. 800 (Bankr. E.D.Pa. 1982)(Retention by Internal Revenue Service of tax refund, which was due debtors, was a setoff in violation of automatic stay and appropriate fine would be levied against the IRS and costs imposed); In re Holden, 236 B.R. 156 (Bankr. D.Vt. 1999)( IRS had no setoff rights, and thus not permitted to place freeze on Chapter 13 debtor's federal income tax refund solely to ensure that tax debt was paid in accordance with terms of debtors' confirmed plan.); In re Rozel Industries, Inc., 120 B.R. 944 (Bankr. N.D. Ill. 1990)(IRS's act of withholding funds which it

admitted were owed to debtor as refund for overpayment constituted intentional setoff which was subject to automatic stay);

In re Borck, 81 B.R. 142 (Bankr. S.D. Fla. 1987)(debtor may not avoid tax lien and notice of levy pursuant to 11 USCA §§ 544 and 547(b) because federal tax lien is statutory lien). Accord, In re Wiles, 173 B.R. 92 (Bankr. M.D. Pa. 1994)(Federal tax lien may not be avoided as preference under 11 USCA § 547(b), where, pursuant to § 547(c)(6), lien is not type of statutory lien avoidable under 11 USCA § 545); In re J.B. Winchells, Inc., 106 B.R. 384 (Bankr. E.D. Pa. 1989)(Amount of IRS's tax lien which was both assessed and perfected by filing of notice prior to debtor's bankruptcy filing cannot be avoided as preference under 11 USCA § 547(c)(6), but to extent lien was unperfected on date of bankruptcy filing because notice had yet to be filed, it is avoidable); In re Riverfront Food and Beverage Corp., 29 B.R. 846 (Bankr. E.D. Mo. 1983)( Trustee cannot avoid fully valid federal tax lien as preferential transfer).

- Trustee Use of Tax Lien under §544

Schlossberg v. Barney, 380 F.3d 174 (4th Cir. 2004)(even if IRS was “creditor that extends credit,” its powers to enforce federal tax liens could not be invoked by trustee under Code's strong-arm provision.)

- Violation of Automatic Stay

U.S. v. Holden, 258 B.R. 323 (D.Vt. 2000)(Chapter 13 debtors were entitled to \$1,000 in general damages, \$7,000 in emotional damages, and attorney fees for IRS's violation of automatic stay and of plan confirmation order in placing administrative freeze on tax refund that became payable to Chapter 13 debtors post-confirmation). Accord, In re Lowthorp, 332 B.R. 656 (Bankr. M.D. Fla. 2005)(Sanctions award against IRS may include award of attorney fees consistent with the EAJA and non-bankruptcy law); In re Parker, 279 B.R. 596 (Bankr. S.D. Ala. 2002)(damages for IRS's “willful” violations of automatic stay include any reasonable out of pocket expenses); In re Craine, 206 B.R. 594 (Bankr. M.D. Fla. 1997)(IRS violation of stay willful, but debtors not injured by violation, so as to warrant damages); Hanna Coal Co., Inc. v. I.R.S., 218 B.R. 825 (W.D.Va. 1997)(Chapter 11 debtor entitled to damages of \$23,725, plus attorney fees and costs, for IRS' willful stay violation); In re Milto, 210 B.R. 687 (Bankr. D.Md. 1997)(IRS liable to Chapter 13 debtor for all consequential damages, including reasonable attorney fees, resulting from intentional violation of automatic stay by refusing to return funds levied upon post-petition); In re Davis, 201 B.R. 835 (Bankr. S.D. Ala. 1996)(IRS' willful automatic stay violation entitled debtors to recover compensatory damages).

- Treatment of Tax Liens in Plan of Reorganization

- Claims Process as Res Judicata of IRS Claims Against Secured Creditor