

A Review of Federal Tax Lien Case Law in 2008

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The Federal Tax Lien Act, 26 U.S.C. §§6321-6237 (FTLA), was enacted in 1966 in part to “conform the lien provisions of the Internal Revenue Code to the concepts developed in the Uniform Commercial Code (UCC)” and “to provide some limited but specific relief from the harshness of the choateness rule.”¹ Somewhat conversely, in granting priorities for tax debt—in terms of payment and nondischargeability—in the Bankruptcy Code (Code) that were not found in the Bankruptcy Act, the drafters noted the paramount interests of government at all levels in collecting taxes.² In trumpeting these interests, Congress referred to the difference between “private voluntary creditors” and taxing authorities “who, if unpaid taxes exist, are also creditors in the [bankruptcy] proceeding.”³



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Interestingly, many courts interpreting the Code or the FTLA have adopted a reasoning base on the underlying purposes of the other. For example, courts faced with FTLA have ruled in favor of validity and/or priority of federal tax liens simply because the IRS is an “involuntary creditor,” and because tax collection is important to a stable government.⁴ These cases have

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stressed that the IRS prevails because of its status as a federal tax collector, which transcends its interest as a mere creditor: “The use of this power...is not the act of an ordinary creditor, but the exercise of a sovereign prerogative, incident to the power to enforce the obligations of the delinquent taxpayer himself and ultimately grounded in the constitutional mandate to lay and collect taxes.”⁵

By contrast, courts interpreting the treatment of federal tax liens under the Code have not employed the involuntary-creditor doctrine as a *deus ex machina* in granting rights and privileges to the IRS beyond the statutory text. For example, notwithstanding the IRS’s arguments to the contrary, courts have: (1) held that pursuant to 11 U.S.C. §542(a), property seized by the IRS before the petition

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date belongs to the bankruptcy estate,⁶ (2) interpreted 11 U.S.C. §§523(a)(1) and 507(a) to prevent postpetition interest on secured tax debt from being nondischargeable,⁷ and (3) determined that bankruptcy courts have the authority to direct the IRS to consider an offer to compromise a priority tax claim.⁸ The *Whiting Pools* court clarified that the IRS is not entitled to any special treatment other than that which is *expressly* provided by the Code.⁹

In 2008, courts considering cases involving interpretation of the FTLA, as well as issues of proposed special treatment for federal tax liens under the Code, have largely stayed within the bounds outlined above. This article focuses on a few of those cases and comments on the merits of their reasoning. This article also discusses whether healthy commercial and consumer lending markets are goals at least equally worthy as efficient tax collection—as evidenced by the fed-

eral government’s redirection of enormous sums of federal tax dollars back into the nation’s lending apparatus.

Hulett

In *Sullivan v. U.S. (In re Hulett Corp.)*,¹⁰ the Bankruptcy Court for the Northern District of Illinois twice considered the (almost) inconceivable issue of determining the priority in certain proceeds between a secured creditor and the IRS, that properly filed a UCC-1 financing statement and notice of federal tax lien (NOFTL), respectively, at exactly the same time.¹¹ The pertinent FTLA section provides that a federal tax lien shall not be valid as against any “holder of a security interest” until an NOFTL has been filed.¹² The FTLA and attendant regulations state that a “security interest” comes into existence when the collateral is in existence and the security interest has become protected under local law against a subsequent judgment lien and the secured creditor has parted with money or money’s worth.¹³ Eschewing the reasoning in a Fifth Circuit case con-

sidering the identical issue¹⁴—finding that the proceeds were to be divided evenly between the government and the secured creditor—the court held that the tie went to the IRS.¹⁵ It noted that the Supreme Court’s ruling in *McDermott* was on point.¹⁶

In *McDermott*, the Court addressed a priority dispute between a judgment lienor and the IRS in *after-acquired* property.¹⁷ In that case, the judgment creditor docketed a judgment lien before the IRS filed its NOFTL. However, the after-acquired property did not come into existence until months after notices of both liens were filed.¹⁸ In the Article 9 sense of “attachment,” this was consid-

¹⁰ 389 B.R. 610 (Bankr. N.D. Ill. 2008), *aff’d on reh’g*, No. 07-A-00917, 2008 WL 4058869 (Bankr. N.D. Ill. Aug. 25, 2008).

¹¹ *Id.* at 612.

¹² 26 U.S.C. §6323(a). This section is the basis for the doctrine that priority of federal tax liens is governed by the common law principle of “first in time is first in right.” *McDermott*, 507 U.S. at 449. *But cf. Southern Rock Inc. v. B&B Auto Supply, Sand Pit and Trucking Co.*, 711 F.2d 683, 689 (5th Cir. 1983) (noting that common law also dictated that simultaneously-perfected secured creditors were to share in collateral on *pro rata* basis).

¹³ Treas. Reg. §301.6323(h)-1(a)(1)(i)-(ii) (1976). “Section 6323 certainly was not enacted to decide dead heats among racing lien holders.” *Southern Rock*, 711 F.2d at 689.

¹⁴ *Southern Rock*, 711 F.2d at 689.

¹⁵ *Hulett*, 389 B.R. at 620.

¹⁶ *Id.*

¹⁷ *McDermott*, *supra*, 507 U.S. at 448-49.

¹⁸ *Id.*

¹ *U.S. v. Kimbell Foods Inc.*, 440 U.S. 715, 738 (1979). The FTLA “represents an effort to adjust the provisions of the internal revenue laws relating to the collection of taxes of delinquent persons to the more recent development in commercial practice (permitted and protected under [state law]). The [FTLA] represents the culmination of a project initiated approximately 10 years ago by those concerned with the relationship of the tax lien provisions to the interests of other creditors.” 1996 U.S.C.C.A.N. 3722, 3722-23.

² 1978 U.S.C.C.A.N. 5787, 5799-5800.

³ *Id.* (emphasis added). “Since tax authorities are creditors of practically every taxpayer...tax collection rules for bankruptcy cases have a direct impact on the integrity of the federal, state and local tax systems. To the extent that debtors in a bankruptcy are freed from paying their tax liabilities, the burden of making up the revenues thus lost must be shifted to other taxpayers.” *Id.* at 5800.

⁴ See, e.g., *U.S. v. Craft*, 535 U.S. 274, 288 (2002) (allowing federal tax lien to attach to nondebtor spouse’s interest in tenancy by entirety based on IRS’ status as federal tax collector); *U.S. ex rel. IRS v. McDermott*, 507 U.S. 447, 455 (1993) (holding strong “first to record” presumption in determining priority between simultaneously-attaching federal tax lien and state judgment lien in after-acquired property inappropriate because IRS “[could not] indulge the luxury of declining to hold the taxpayer liable for his taxes”); *U.S. v. Crestmark Bank (In re Spearling Tool & Manufacturing Inc.)*, 412 F.3d 653, 656-57 (6th Cir. 2005) (declining to apply UCC standard of identifying debtor with absolute precision to NOFTL because it would be unduly burdensome to government’s tax-collection efforts); *Haas v. U.S. (In re Haas)*, 31 F.3d 1081, 1088-89 (11th Cir. 1994) (notwithstanding IRS’s knowledge of mistakenly released mortgage, subsequently filed federal tax lien still prevailed because IRS was involuntary creditor).

⁵ *Schlossberg v. Barney*, 380 F.3d 174, 181 (4th Cir. 2004) (quoting *U.S. v. Rodgers*, 461 U.S. 677, 697 (1983)).

⁶ *U.S. v. Whiting Pools Inc.*, 462 U.S. 198, 209 (1983).

⁷ *U.S. v. Victor*, 121 F.3d 1383, 1388 (10th Cir. 1997).

⁸ *U.S. v. Macher (In re Macher)*, 303 B.R. 798, 805 (W.D. Va. 2003).

⁹ 462 U.S. at 209.

ered a case of simultaneous attachment, however the FTLA gave no *indicia* of a similar definition of “attachment.”¹⁹ In a 6-3 decision, the Court held that the filing of the NOFTL rendered the tax lien extant for “first in time” priority purposes regardless of whether it had yet attached to identifiable property.²⁰ In but-tressing that ruling, the Court stressed the government’s status as an involuntary creditor that did not have the luxury of declining to hold the taxpayer liable for its taxes.²¹

The *Hulett* court held that *McDermott* was directly controlling and declared that the reasoning behind giving priority to the government in cases of what it termed “simultaneous attachment”—*i.e.*, the IRS’ status as an involuntary creditor and the integrity of the tax system—was directly applicable to cases of “simultaneous perfection.”²² In so ruling, the *Hulett* court overlooked the fact that this situation was significantly different than *McDermott*. In that case, the IRS technically had filed its NOFTL before there was a judgment lien in existence for priority purposes.²³ The Court only asserted the “involuntary creditor” doctrine to support its reasoning that “the filing of notice renders the tax lien extant for first in time priority purposes regardless of whether it has yet attached to identifiable property.”²⁴ However, in *Hulett*, the NOFTL was *not* filed before the security interest attached to the collateral or before the security interest obtained its inviolable status under 26 U.S.C. §6323(a).²⁵ The *Hulett* court held that “public policy” accorded the federal tax lien priority solely because it was an involuntary creditor—thereby using the IRS’ status as an involuntary creditor as a legal justification in itself.²⁶

It is unclear if the NOFTL and financing statement were actually “filed” simultaneously. A financing statement is “filed” upon communication of a record to the filing office and tender of the filing fee.²⁷ “Communicate means... in the case of transmission of a record to...a filing office, to transmit a record by any means prescribed by filing-office

rule.”²⁸ There does not appear to be a rule that says that a financing statement is not “filed” until it is time-stamped by the clerk.²⁹ Even if the same “filed” definition applies to the NOFTL,³⁰ it seems unlikely that the NOFTL and financing statement could have actually gotten to the filing office at the same time (although it seems rather more probable that they could have been stamped “received” at the same time).

Johnson

In *Johnson v. IRS (In re Johnson)*,³¹ the Bankruptcy Court for the Western District of Pennsylvania held that a federal tax lien can be “stripped off” under 11 U.S.C. §506(a) and (d) in a chapter 11 case.³² The IRS “steadfastly maintained” that even if the court held that the Supreme Court’s holding in *Dewsnup v. Timm* did not apply to chapter 11 cases, the language of 26 U.S.C. §6321 prevented a chapter 11 debtor from avoiding a federal tax lien under §506

⁴⁴ U.S. Dept. of the Treasury: Initial §105(A) Troubled Asset Relief Program Report to Congress for the Period of Oct. 6, 2008, to Nov. 30, 2008, at 1 (Dec. 5, 2008), available at www.treas.gov/initiatives/eesa/congressionalreports.shtml (last visited Dec. 26, 2008).

because of the IRS’ special status as an involuntary creditor.³³ The Court noted that it would “operate from the presumption that the IRS lien should be treated the same as any other lien unless there is some contrary statutory law or provision of decisional law requiring different treatment.”³⁴

Relying on an opinion by the Bankruptcy Court for the Central District of California, the court held that the IRS being an involuntary creditor was inconsequential in determining whether a tax lien had special protection from avoidance under the Code.³⁵ The court noted that Congress had expressly delineated the preferred treatment it intended to bestow on the IRS under the Code—for example, 11 U.S.C. §§507(a)(7), 523(a)(1) and 1129(a)(9)(C)—and therefore, “[r]eading an IRS exception into §506 to prevent avoidance of the [federal tax] liens here

is unnecessary and inappropriate.”³⁶ The court also rejected the IRS’s position that a federal tax lien cannot be stripped off because of its “unitary nature.”³⁷

Other Cases in 2008

In several other cases, the courts declined to grant federal tax liens enhanced status under the Code. One court held that 11 U.S.C. §362(b)(9)(D) provided the IRS no specific authorization to assess taxes and file liens against estate property in the time between the petition date and the date of a reversion of a marital residence to the debtor, and therefore, its tax lien could be avoided pursuant to 11 U.S.C. §§549 and 550.³⁸ Another court held that a secured creditor had a property interest in accounts receivable that the debtor used to pay trust fund taxes, for which an NOFTL had been filed with the IRS, thereby supporting the secured creditor’s objection to the debtor’s discharge under 11 U.S.C. §523(a)(6).³⁹

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Interestingly, in a case interpreting and applying the provisions of the FTLA, a bankruptcy court departed from the earlier and easier standard enunciated in *Spearing Tool*.⁴⁰ In *Buenting v. Crystal Cascades Civil LLC (In re Crystal Cascades Civil LLC)*,⁴¹ the IRS filed an NOFTL on real property owned by a debtor-company named Crystal Cascades Civil LLC under the name “Crystal Cascades LLC.”⁴² The court held that the tax lien was invalid against a subsequently-filed deed of trust, since pursuant to 26 U.S.C. §6323(f) a “reasonable search” would not uncover the NOFTL.⁴³

Commentary

The public policy bestowing special privileges on federal tax liens because of the IRS’ status as an involuntary creditor should be circumscribed, as it is in interpretation of the Code, rather than

¹⁹ The term “attachment” is not defined in the FTLA and Treasury Regulations.

²⁰ 507 U.S. at 453. Interestingly, despite recognizing the Article 9 rules for attachment and perfection of security interests in after-acquired property, the Court went on to rule in spite of them. See *id.* (noting that Article 9 was nevertheless inapplicable to judgment liens).

²¹ *Id.*
²² *Hulett*, 389 B.R. at 619.

²³ *McDermott*, 507 U.S. at 453.

²⁴ *Id.* at 454-55.

²⁵ *Hulett*, 389 B.R. at 612.

²⁶ *Id.* at 619; accord, *Hulett*, 2008 WL 4058869 at *3 (“As a matter of public policy...[the] IRS takes priority in both cases because it is an involuntary creditor and the collection of tax revenue is essential to the functioning of the government.”).

²⁷ 810 Ill. Comp. Stat. 5/9-516 (2008).

²⁸ 810 Ill. Comp. Stat. 5/9-102 (2008).

²⁹ *Cf. Valio v. Bd. of Fire & Police Comm’rs*, 724 N.E.2d 1024, 1029 (Ill. App. Ct. 2000) (holding that ministerial tasks such as stamping pleading “filed” are unnecessary to perfect filing).

³⁰ Ambiguously, the treasury regulations state that “[t]he term ‘tax lien filing’ means the filing of notice of the lien imposed by §6321 in accordance with §301.6323(f)-1. Treas. Reg. §301.6323(h)-1(e) (1976). Presumably, this implies the same definition as under the UCC. See *Tracey v. U.S. (In re Tracey)*, 394 B.R. 635, 641 n.5 (B.A.P. 1st Cir. 2008).

³¹ 386 (Bankr. W.D. Pa. 2008).

³² *Id.* at 178-80.

³³ *Id.*

³⁴ *Id.* at 178.

³⁵ *Id.* (citing *In re Dever*, 164 B.R. 132, 145 (Bankr. C.D. Cal. 1994)

³⁶ *Id.* (quoting *Dever*, 164 B.R. at 145); *cf. Korbe v. HUD (In re Korbe)*, 386 B.R. 585, 589 (Bankr. W.D. Pa. 2008) (rejecting similar argument by HUD that chapter 13 debtor could not strip-off HUD lien because of its purported special status).

³⁷ *Johnson*, 386 B.R. at 179-80.

³⁸ *U.S. v. Owens*, 390 B.R. 808, 811 (W.D. Pa. 2008).

³⁹ *JP Morgan Chase Bank, N.A. v. Zwosta (In re Zwosta)*, 395 B.R. 378, 386 (B.A.P. 6th Cir. 2008).

⁴⁰ See generally, *Spearing supra*. Though they were somewhat different, as *Spearing Tool* concerned a personal property filing.

⁴¹ No. 06-10282 (BAM), --- B.R. ---, 2008 WL 5097701 (Bankr. D. Nev. Nov. 3, 2008).

⁴² *Id.* at *1.

⁴³ *Id.* at *9, *11.

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further expanded, as it is in cases under the FTLA. Although enactment of the FTLA was not meant to abrogate the priority of federal tax liens, the above cases discussed in this article support the notion that it is unnecessary—both practically and theoretically—to employ the involuntary-creditor doctrine to decide otherwise ambiguous legal issues in favor of the IRS.

Moreover, there is ample support for the proposition that a healthy commercial lending market is as important as tax collection in ensuring that our nation's economy runs smoothly. Indeed, in a report to Congress pursuant to the Troubled Asset Relief Program on Dec. 5, 2008, the Treasury Department noted that prior to the federal government's \$700 billion appropriation

of tax dollars for the benefit of major lending institutions, "financial markets were at a tipping point. Credit markets were largely frozen, and investor confidence was dangerously low. Had these conditions been allowed to persist, the turmoil in financial markets would have intensified with very serious spillovers on economic activity, employment, and incomes."⁴⁴ That recognition of the importance of private consumer and commercial lending renders the IRS's trump card over other secured creditors in arbitrary situations less justifiable, and it favors the reasoning employed by the *Hulett* court over the reasoning of the *Johnson* court. ■