

The Effect of Tax Liens on a Creditor's Secured Position

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A secured creditor's security interest in collateral may be effectively extinguished by the operation of any one of more than one hundred Federal and State statutes which authorize forfeiture, in many cases regardless of existing security interests, to government agencies. A Federal or State government agency may be able to prime a secured creditor's first priority position even if the secured creditor has taken all steps necessary under Article 9 of state law to perfect its interest in the subject collateral. Due to limited space, however, this paper will not analyze all of the more than one hundred Federal and State statutes which authorize forfeiture, but will instead focus on the mechanism by which Federal and State taxing agencies prime a secured creditor's priority position through the filing of a tax lien. Additionally, we will examine the attachment of liens for nonpayment of ad valorem county taxes to property and what effect this lien will have on the priority of a secured lender. Finally, we will discuss the recent changes in the law which unequivocally require a secured creditor to pay sales tax upon disposition of collateral.

- I. Federal or State Law May Defeat a Prior Perfected Security Interest.
 - A. Federal law may interfere with a secured creditor's ability to attach certain collateral or foreclose and sale the collateral under the security agreement.
 1. Secured creditors need to be aware of the multitude of Federal statutes which allow civil forfeiture where the property is connected with, or derived from, illegal activities.
 2. States have now jumped on the bandwagon and likewise enacted forfeiture statutes.
 - B. The number of Federal statutes which may operate to prime a secured prior perfected security interest in the collateral exceed one hundred. Some examples include:
 1. Federal law prevents a security interest being granted in a FCC broadcast license.
 2. Federal law prevents a security interest being granted in employment benefits.

3. A creditor may be prohibited from selling or transporting collateral of a debtor which was used or derived in violation of:
 - (a) Fair Labor Standards Act;
 - (b) Comprehensive Drug, Abuse, Prevention and Control Act of 1970;
 - (c) Money Laundering Control Act of 1986; and
 - (d) Racketeer, Influence and Corrupt Practices Act or ARICO.®
4. To a large degree, state statutory provisions often parallel Federal forfeiture statutes but in some cases offer more or less protection for secured creditors.

C. The Department of Justice has indicated that in most cases it will respect the rights of secured creditors absent unusual circumstances. However, the proliferation of forfeiture statutes suggests that a secured creditor must take precautions to protect its collateral.

1. Creditors should document pre-loan investigations of debtors.
2. Creditors should be wary if the debtor's source of income is not readily ascertainable.

D. While tax liens probably do not fall in the same sort of Acriminal activity@ discussed above, the most prevalent mechanism by which the Federal government seeks to trump a secured creditor's lien position in collateral is through the foreclosure and/or enforcement of Federal Tax Liens.

II. Federal Tax Liens.

- A. The Internal Revenue Service (AIRS@) has certain tools at their disposal to make a person or entity who has failed to pay taxes Apay up.®
- B. The most common of these tools is the lien and corresponding ANotice of Federal Tax Lien.®
- C. Typically, a lien is put into effect when the IRS has been repeatedly unable to collect a debt from a taxpayer or when the government agency decides that Amotivation@ is required to get the taxpayer's attention.
- D. Liens can be filed without prior warning and the purpose is to take the

taxpayer by total surprise.

- E. A lien gives the government a legal claim to the taxpayer's property as security for a tax debt thereby preventing an owner from being able to sell assets without authorization or relief from the taxing agency.
 - F. Generally, a lien will not be released unless the taxpayer comes to some kind of repayment agreement with the taxing authority.
 - 1. As a matter of practice, the IRS has agreed to release a lien while the taxpayer prepares and submits an offer in compromise.
 - 2. The IRS has agreed in some instances to a lien subordination which enables a taxpayer to secure financing for the purpose of making payment towards a Federal tax liability.
- III. Priority of Federal Tax Liens.
- A. The principal purpose for perfecting a Federal Tax Lien is to obtain priority with respect to certain competing interests.
 - B. In 1966, the Federal government enacted the Federal Tax Lien Act (the Act) which attempted to conform the law related to Federal Tax Liens to the treatment of creditors' liens under the Uniform Commercial Code.
 - C. Prior to 1966, all creditors with competing claims had to establish that their claims were choate to prevail against a Federal Tax Lien. Even judgment lien creditors, purchasers, pledgees and mortgagees had to pass this choateness test.
 - 1. The literal definition of a choate lien is a lien that requires no further action to be made enforceable.
 - 2. Choateness was only found when the lienor specifically established:
 - (a) The identity of the lienor;
 - (b) The property subject to the lien; and
 - (c) The amount of the lien.
 - 1. Prior to the Act, a competing claim not deemed choate was inferior to a Federal Tax Lien.
 - J. ' 6323 of the Internal Revenue Code was amended to clarify the confusion that resulted from the application of the choateness standard.

- E. The Act now divides creditors with claims competing into four (4) different classes:
1. Claims receive **priority status** if their interests are perfected before the filing of a Notice of Federal Tax Lien.
 2. Claims receive **Asemi-super priority@ status** when created pursuant to a written agreement entered into before the Notice of Federal Tax Lien is filed and protected under local law against subsequent judgment lien creditors.
 3. Some specific claims receive **Asuper priority@ status** which prevail over the Federal Tax Lien whether or not the Federal Tax Lien has been filed before the interest is perfected.
 4. Priority of claims as to Federal Tax Liens which are not in one of the preceding three (3) classes is judged under the old choateness standard.
- F. A bank's set off right is protected against a Federal Tax Lien if it is exercised before the Federal Tax Lien is filed.

IV. Priority Status.

- A. A tax lien is not valid against purchasers, holders of security interests, mechanic's lien holders or judgment lien creditors until the Notice of Federal Tax Lien is filed.
- B. Persons Entitled to Priority Status.
1. Purchasers. A purchaser who buys property for adequate and full consideration in money or money's worth acquires an interest in property which takes priority as to a Federal Tax Lien provided the purchase is completed and Aperfected@ prior to the filing of the Notice of Federal Tax Lien.
 - (a) Even actual notice of an unfiled tax lien does not cause a purchaser to lose priority.
 - (b) The purchase must be for adequate consideration.
 - (i) Money paid to satisfy pre-existing debt is not adequate consideration.
 - (ii) The assignment of the marital property rights is also

not deemed as an adequate consideration.

- (iii) The consideration must be reasonably or substantially equal to the value of the property surrendered or the consideration is deemed inadequate.
 - (iv) A purchaser's interest will not take priority as to a filed tax lien if a tax lien is filed between the date of the sale and the date the deed is recorded.
 - (v) Adequacy of consideration issues arises frequently in situations involving nominees or transferees.
- (c) A purchase from a taxpayer under an installment contract which is not completed prior to the making of all installment payments when the tax lien arises, if executed before the Notice of Federal Tax Lien is filed, will have priority over the tax lien even if all the payments under the contract have not been made.

EXAMPLE: ABC is in dire financial condition. ABC has not paid taxes for years and the IRS is beginning to take notice. ABC owes a substantial debt to XYZ. ABC approaches XYZ offering to sell a very valuable piece of equipment to XYZ in exchange for XYZ forgiving the debt and paying some additional cash to ABC. XYZ approaches the Bank to finance the equipment purchase, which Bank does. The Bank takes a security interest in the equipment and properly perfects its interest. Three days after the sale is completed, the IRS files a lien against ABC for unpaid taxes. XYZ defaults on payment to the Bank. The Bank repossesses the equipment and tries to liquidate. The IRS claims that the equipment is subject to the tax lien of ABC. Does the Bank have to pay the tax indebtedness? Possibly. The interest of XYZ, and the Bank, would only take priority if adequate consideration was paid. The issue here is whether the cash paid by XYZ was adequate consideration because we know forgiveness of existing debt is not adequate consideration in the eyes of the IRS.

2. Holders of Security Interest.

- (a) As will be discussed in great detail below, many types of security interests are entitled to Asemi-super priority@ over Federal Tax Liens even after a Notice of Federal Tax Lien has been filed.
- (b) If a security interest does not qualify for a Asemi-super priority@ status, the security interest must be perfected before the Notice of Federal Tax Lien is filed to obtain priority over the Federal Tax Lien. A security interest will

only be entitled to priority as to a subsequently filed Federal Tax Lien if all four of the following events occur before the IRS files the Notice of Federal Tax Lien:

- (i) A written contract securing payment or performance of an obligation has been executed or the secured creditor has taken possession of the property.
- (ii) The holder of the security interest has parted with money or money's worth.
 - (A) Past consideration can serve as money or money's worth.
 - (B) The following types of consideration are not sufficient to constitute money or money's worth:
 - (1) Relinquishment of marital rights;
 - (2) Love and affection;
 - (3) A promise of marriage;
 - (4) A promise not to prosecute;
- (iii) The property is in existence at the time the security interest arises; and
- (iv) The interest is protected under local law against a subsequently perfected judgment lien arising out of an unsecured obligation.

EXAMPLE: Suppose from the example above, Bank went to ABC and threatened to take legal action for an indebtedness owed. ABC offers additional security in the equipment in consideration of the Bank forbearing. Again, the tax lien is filed immediately after the Bank perfects its security interest. When ABC defaults will the tax lien be superior to the Bank's interest? Probably not. In the case of a secured creditor, past consideration can serve as money or money's worth.

V. Semi-Super Priority.

- A. The Act recognizes four (4) types of security interests which have semi-super priority over Federal Tax Liens even though the interests would normally not satisfy the traditional choateness criteria, i. e. not fully

completed.

B. The four (4) types of security interests included in the Asemi-super priority@ class are:

1. Real Property construction or improvement financing agreements;
2. Obligatory disbursement agreements;
3. Commercial transaction financing agreements; and
4. Security interests created by disbursements made within forty-five (45) days after the filing of the Notice of Federal Tax Lien and property existing at the time the Notice of Federal Tax Lien is filed.

C. Real property construction or improvement financing agreements.

1. The Act defines these agreements as any commitment to advance funds in connection with the construction or improvement of real property or for raising crops or livestock.
2. The rational behind granting Asemi-super priority@ status to these arrangements is that these types of advances typically enhance the value of the property subject to the Federal Tax Lien.
3. The agreement creating the interest must be a written agreement entered into without actual notice of an unfiled Notice of Federal Tax Lien and before a Notice of Federal Tax Lien is filed.
4. The security interest must be valid under local law against judgment lien arising out of unsecured obligations as of the date the Tax Lien is filed, i. e. perfected.
5. The written agreement must provide for:
 - (a) Cash disbursements to finance the construction or improvement of real property, or
 - (b) Distribution or furnishings of goods and services to finance the raising or harvesting of a farm crop or the raising of livestock or other animals.
 - (c) The Asemi-super priority@ status only applies to funds advanced pursuant to the contract for the improvement of the subject property or in use with livestock or crops and

does not extend to monies advanced under the agreement used for other properties or other means.

EXAMPLE: Bank makes crop financing to Farmer. Farmer has significant tax problems. Farmer takes draws from the crop financing and builds a much needed pool at his house. The IRS files a lien. Farmer defaults prior to harvest. Bank forecloses on crop. Will Bank have to pay lien of IRS to obtain free and clear title? Possibly, but only as to the amounts extended to Farmer in connection with the construction of the pool. The priority of the Bank will only extend to amounts actually used in connection with crop financing. The money advanced for the construction of the pool might not be protected.

D. Obligatory disbursement agreements.

1. Includes an agreement for which the secured creditor guarantees payment or performance of obligations to a third party.
2. The best examples of obligatory disbursement agreements include irrevocable letters of credit and surety agreements.
3. Protection with regard to obligatory disbursement agreements only applies to persons who enter into such agreements in the ordinary course of their business.

E. Commercial transactions financing agreements.

1. An agreement by which a person in the course of their business or trade agrees to:
 - (a) Make loans to the taxpayer in exchange for an interest in taxpayer's commercial financial security; or
 - (b) To purchase commercial financing security that the taxpayer acquires in the ordinary course of the taxpayer's trade or business.
2. A semi-super priority status is afforded to lenders who make advances based on the security of commercial paper, accounts and inventory.
 - (a) The purpose of providing this semi-super priority status to these lenders is to reduce the burden on lenders in making future advances by allowing them to search for Federal Tax Liens only every forty-five (45) days to be assured of retaining their priority.

- (b) In order to retain this priority:
 - (i) The agreement must be entered into before actual notice of or the filing of Notice of Federal Tax Lien.
 - (ii) The security interest arising from the agreement must be valid under local law against a judgment lien creditor as of the date the Notice of Federal Tax Lien is filed.
 - (iii) Must be entered into by creditors who make commercial transaction and financing agreements in the ordinary course of business.

F. Special rules with regard to security interests in inventory, proceeds and accounts receivable.

1. The Act imposes upon a lender an obligation to search the appropriate office of filing for Notice of Federal Tax Liens every forty-five (45) days to insure that no Federal Tax Liens are filed in order to maintain priority status in inventory, proceeds, and accounts receivables.
2. In most cases, this can be accomplished through monitoring Ascandal sheets@ which are circulated to lenders on a regular basis.
3. Failure to take action with regard to a security interest in inventory, proceeds, and accounts receivables within forty-five (45) days from the filing of a Notice of Federal Tax Lien may result in an extinguishment of the secured creditor's lien position in certain collateral.
4. Inventory.
 - (a) Inventory consists of raw materials, goods in process and property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business.
 - (b) A lender maintains a priority security position in all inventory acquired by the debtor up to forty-five (45) days following the filing of a Federal Tax Lien.
 - (c) The holder of a security interest in inventory has the burden of proving that the inventory was acquired by the taxpayer within the forty-five (45) day period following the filing of the Notice of Federal Tax Lien.

- (d) The secured creditor does not have to prove the exact date on which the taxpayer acquired each item of inventory but must only prove that the inventory was not acquired outside the forty-five (45) day period.

5. Proceeds.

- (a) Identifiable proceeds from the sale of inventory are protected if the secured creditor has a continually perfected security interest under local law.
- (b) Proceeds are deemed to exist as of the acquisition date of the underlying property.
- (c) Co-mingled cash proceeds are not considered to be identifiable and if identifiable cash proceeds are used to purchase additional property outside the protected forty-five (45) day period such additional property is not protected.

6. Accounts Receivables.

- (b) Refers to goods sold or leased or to services rendered by the debtor.
- (c) A secured creditor has priority in Accounts Receivables acquired prior to the filing of the Federal Tax Lien and up to forty five (45) days after the filing of the Federal Tax Lien.

EXAMPLE (1):

On February 1, ABC enters into financing agreement with Bank. Under the financing agreement, Bank will make advances to ABC in exchange for a security interest in all of ABC's inventory, presently owned and after acquired; accounts receivables; and all proceeds therefrom.

On February 10, IRS files tax lien against ABC.

On March 5, Bank advances \$100,000.00 to ABC to be used for the purchase of inventory. On March 17, ABC has \$50,000.00 in outstanding receivables. ABC defaults and Bank forecloses on its security interest in inventory and receivables. Will the Bank's lien in inventory and accounts be superior to the tax lien?

Yes, the advance and the acquisition for the inventory was made within forty five

days of the filing of the lien. The Bank's interest remains superior in this case. The same analysis would apply to the outstanding receivables. If the outstanding receivables were required within forty-five (45) days of filing of the Notice of Federal Tax Lien, the Bank's interest remains superior.

EXAMPLE (2): Changes facts where additional advances are made by Bank on May 1 for the purchase of inventory. The Bank's interest in this inventory is not superior because the inventory was acquired outside the forty-five (45) day period.

EXAMPLE (3): Suppose on March 18, ABC collects the accounts receivables and buys inventory with accounts receivables on April 10. Does the Bank have a superior interest to the IRS in that inventory which was purchased with proceeds? No, purchase of inventory was outside the forty-five (45) day period and is not protected even though with identifiable proceeds in which the Bank maintained a priority position.

VI. Super Priority Status.

- A. Certain interests are entitled to priority over Federal Tax Liens regardless of when the interest arises in relation to the creation or perfection of the Federal Tax Lien.
- B. The Act specifies ten (10) types of interests which qualify for Asuper priority@ status which include:
 1. Purchase or secured interest in securities.
 - (a) Purchasers or holders of a security interest in securities who do not have actual notice or knowledge of the existence of a Federal Tax Lien are entitled to Asuper priority@ status as to Federal Tax Lien.
 - (b) The rationalization of this category of Asuper priority@ is primarily because an interest in this property can typically only be perfected by possession.
 - (c) Securities include:
 - (i) Bonds;
 - (ii) Debentures;
 - (iii) Notes;
 - (iv) Stocks;
 - (v) Voting trust certificates;

- (vi) Certificates of participation or receipt;
 - (vii) Negotiable instruments; and
 - (viii) Money.
- (d) The term Asecurities@ does not include a bank's right of set off against the accounts receivable of a corporation.
2. Purchase of motor vehicles.
 3. Retail purchase of personal property.
 4. Casual sale of personal property.
 - (a) Sale in the ordinary course of seller's business;
 - (b) With a purchase price of less than \$1,000.00.
1. Possessory lien on personal property.
 2. Real property tax and special assessment liens.
 3. Mechanic's liens on residential property.
 4. Attorney's liens.
 5. Insurance contracts.
 6. Deposit secured loans.
 - (a) Banks and other savings institutions can obtain Asuper priority@ status for deposit secured loans or similar accounts in which the taxpayer's right of withdrawal is restricted.
 - (b) The Asuper priority@ status for banks extends only to the amount deposited in the restricted account and not to the amount of the loan.
 - (c) The account must be at the same savings institution which made the loan.
 - (d) The loan must be secured by such account, and the lender must have no actual knowledge of the existence of a

Federal Tax Lien at the time the loan is made.

- D. An eleventh (11th) category of Asuper priority@ status is afforded to purchase money security interests.
1. While not specifically mentioned in the Act, the legislative history of the Federal Tax Lien Act of 1966 reveals that Congress intended that purchase money security interests should have priority over previously filed Notice of Federal Tax Liens.
 2. The IRS has accepted the expression of the legislation intent and issued a ruling stating that a purchase money security interest has Asuper priority@ status if the interest is valid under local law.
 3. Perfection of the purchase money security interest under local law is the key to Asuper priority@ status.
- VII. Attachment of Ad Valorem Tax Liens to Property.
- A. An ad valorem tax lien attaches not only to the specific real property, but to all property of the debtor, including personal property.
- B. The Code sets forth specific priorities among the various taxing agencies and they are as follows:
1. Taxes due to the State,
 2. Taxes due to Counties of the State,
 3. Taxes due to school and other special tax districts of the State,
 4. Other special tax districts of the State,
 5. Taxes due to municipal corporations of the State.
- C. A lien for unpaid ad valorem taxes is not divested by a transfer of any kind, including a judicial sale.
1. Taxes will have to be paid upon foreclosure and/or repossession.
 2. All deeds or transfers made to avoid payment of taxes are void.
 3. Any transferee is liable for payment of taxes.
- D. The lien is superior to prior security deeds, except as to taxes on property other than that secured.

1. Security deed will be superior to the taxes assessed against the owner of property when the tax represents an assessment against other property not subject to the security deed of the owner.

E. Notice of tax sales.

1. County must provide twenty (20) days notice to holder of security deed before tax sale on real property.
2. Notice is not required prior to levy on personal property.

VIII. Liability of Secured Creditors to pay Sales Taxes Upon Disposition of Collateral.

- A. Prior to 2005, there was much confusion as to whether or not the sale of repossessed collateral was subject to sales tax in the same manner as the original sale.
- B. In 2005, the Department of Revenue Rules and Regulations for the State of Georgia (Chapter 560-12-1) was amended to specifically provide, "The subsequent sale of repossessed tangible personal property is subject to tax in the same manner as the original sale."
- C. The purpose of this enactment was to clarify the confusion which existed from county to county.
- D. The new rules go even further and provide that the retail sale of repossessed and other tangible personal property, leases and rentals of tangible personal property are subject to tax and that when an institution engages in such activities it must register as a dealer, collect and remit the tax.