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A LIEN LIKE NO OTHER: FEDERAL TAX LIENS BEFORE AND AFTER BANKRUPTCY

By Michael St. James[1]

I. Introduction

In many respects, both outside of bankruptcy and in the context of a bankruptcy case, the federal tax lien operates unlike any other secured claim, generating extraordinary and counterintuitive results and creating new incentives to commence bankruptcy cases. Although the rules regarding federal tax liens may seem to have an esoteric atmosphere, they have powerful everyday practical consequences.

The federal tax lien can "unseat" existing floating lien creditors, inexorably taking priority in "their" collateral with the passage of time. This may lead a bank holding a blanket lien to insist that the debtor quickly file a bankruptcy case in order to "freeze time," and with it, the bank's relative lien priority. Unlike other creditors, whose efforts to improve their position by perfecting a security interest or obtaining a judgment lien in the debtor's waning days can generally be undone as preferential in a subsequent bankruptcy case, when the IRS perfects its tax lien pre-bankruptcy, the effect of that perfection cannot be subsequently avoided. This also creates an incentive for both the debtor and its other creditors to commence a bankruptcy case as rapidly as possible in order to "freeze time" and prevent the IRS from gaining a last minute advantage.

This article will discuss the creation and scope of the federal tax lien and its effect on third party creditors prior to a bankruptcy filing. The article will analyze the principal issues which arise in all bankruptcy cases with respect to the tax lien, and will then address the individual components of the secured tax claim, such as interest and penalties, and the differing treatment of those components in Chapter 7 and Chapter 11 bankruptcy cases.

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II. Scope of the Federal Tax Lien

The federal tax lien attaches to "all property and rights to property, whether real or personal, belonging to" the taxpayer.[2] This provision is construed broadly so as to reach "every species of right or interest protected by the law and having an exchangeable value."[3] For example, the IRS was permitted to levy on all funds in a joint account (even though an ordinary creditor under state law could not) because the debtor had an unqualified right to withdraw those funds.[4] Similarly, the tax lien can extend to IRAs and pension plan interests, disability payments, and interests as a beneficiary in a spendthrift trust, even though these types of assets are generally protected from execution by other creditors. Nothing is exempt from the federal tax lien, although there are nominal exemptions from levy and sale.[5]

The federal tax lien attaches upon assessment of the tax, but is not enforceable against other creditors (or a trustee in bankruptcy) until it is perfected.[6] The tax lien is perfected against real property though recordation in the county recorder's office for the county in which the real property is located.[7] If the taxpayer is an individual, the lien is perfected against personal property by

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[2] 26 U.S.C. § 6321; Runkel v. United States, 527 F.2d 914, 916 (9th Cir. 1975) (federal tax lien attaches to buyer's equity in real estate contract of sale).

[3] Drye v. United States, 528 U.S. 49 (1999) (right to disclaim inheritance was property subject to federal tax lien).

[4] United States v. Nat'l Bank of Commerce, 472 U.S. 713 (1985).

[5] 26 U.S.C. § 6334. United States (Internal Revenue Service) v. Barbier, 896 F.2d 377, 380 (9th Cir. 1990) ("[T]he IRS's tax lien may be secured by property that is exempt from levy. . . ."); Bernstein v. Pavich (*In re* Pavich), 191 B.R. 838, 847 (Bankr. E.D. Cal. 1996) ("even though the Debtor is able to protect his homestead proceeds from judgment lien creditors, he loses it as against federal tax liens"); *cf. In re* Driscoll, 57 B.R. 322 (Bankr. W.D. Wis. 1986) (debtor may not avoid tax lien as impairing his exemption).

The exemptions from levy and sale are: (1) wearing apparel and school books, 2) fuel, provisions, furniture, and personal effects not exceeding $6,250 in value, (3) books and tools of trade, business, or profession not exceeding $3,125 in value, (4) unemployment benefits, (5) undelivered and unopened mail, (6) certain annuity and pension payments, (7) workmen's compensation, (8) so much of the taxpayer's income as is necessary to satisfy a judgment for support entered before the levy, and (9) a minimum amount of income from other sources (*e.g.*, G.I. benefits, public assistance payments). 26 U.S.C. § 6334.

[6] 26 U.S.C. § 6323(a).

[7] 26 U.S.C. § 6323(f)(1)(A)(i).

recordation in the office of the county recorder for the county in which the person resides.[8]

If the taxpayer is a corporation, the federal tax lien is perfected through recordation with the Secretary of State, generally in the same manner as a UCC–1 filing.[9] Notably, however, the federal tax lien must be filed in the state where "the principal executive office of the business is located" rather than the state of incorporation as contemplated by the current Article 9 of the UCC.[10]

The statute establishing the federal tax lien seeks only to provide other creditors with constructive notice, rather than actual notice, of the imposition and existence of the lien. As a District Judge explained in a seminal decision:

> The essential purpose of the filing of the lien is to give constructive notice of its existence. The test is not absolute perfection in compliance with the statutory requirements for filing the tax lien, but whether there is substantial compliance sufficient to give constructive notice and alert one of the government's claim.[11]

This relaxed standard is particularly problematic due to its conflict with the current Article 9 regime. In a lien priority dispute, the standard applied to determine whether an incorrect identification of the taxpayer/debtor is nonetheless effective to take priority is different for the purposes of the federal tax lien than under Article 9 of the UCC.[12] This can have significant consequences: secured

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[8] 26 U.S.C. § 6323(f)(1)(A)(ii) and (f)(2)(B).

[9] 26 U.S.C. § 6323(f)(1)(A)(ii).

[10] 26 U.S.C. § 6323(f)(2)(B); *see generally* Lynn M. LoPucki, *The Spearing Tool Filing System Disaster*, 68 OHIO ST. L.J. 281, 309 (2007) (complaining about the disconnect between current Article 9 and the rules for perfecting federal tax liens, noting that "one must search for IRS liens in states other than the state of incorporation.").

[11] United States v. Sirico, 247 F. Supp. 421, 422 (S.D.N.Y.1965) (footnotes omitted) (federal tax lien, not revealed in title search, had priority over subsequent first deed of trust recorded by bank).

[12] The current Article 9 requires strict accuracy in identifying the debtor's name, UCC § 9-503(a), rejecting a filing as ineffective if it is not disclosed in a standard search of the filing office's index using the debtor's correct name, UCC § 9-506(c), while a federal tax lien is effective unless the competing creditor failed to identify it when conducting "a reasonable and diligent search." United States v. Crestmark Bank (*In re* Spearing Tool and Mfg. Co.), 412 F.3d 653 (6th Cir. 2005), *cert. denied,* 127 S. Ct. 41 (2006). *See generally* LoPucki, *supra*; Joshua Edwards, *Meet the New Test, Same as the Old Test:* In re Spearing Tool's *Rejection of the Revised Article 9 Rules Means Secured Creditors Will Get Fooled Again*, 59 OKLA. L. REV. 657 (2006).

creditors may lose priority to the federal tax lien notwithstanding searches of the filings with the Secretary of State that would be sufficient for Article 9 purposes.[13]

A. Effect on Third Parties

As is the case with other perfected liens, a perfected federal tax lien takes priority over existing but unperfected security interests and subsequently perfected security interests and judgment liens.[14] Most unusually, however, the federal tax lien overrides after-acquired property clauses in existing security agreements and takes priority over existing liens in all property acquired after the tax lien is filed.[15]

Under the law prior to the Federal Tax Lien Act of 1966, the "choateness" doctrine was used to obtain this result.[16] This doctrine gave the federal tax lien priority over after-acquired property because the existing creditor's interest in

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[13] In *Spearing Tool*, the bank performed regular searches employing the debtor's correct name ("Spearing Tool and Manufacturing…") which did not disclose the tax lien filed under "Spearing Tool & Mfg…"). Although the tax lien identification would have been "seriously misleading"—and hence ineffective—for the purposes of Article 9, it sufficed to take priority under federal tax lien law, 412 F.3d 643. *But see* United States v. Buenting (*In re* Crystal Cascades Civil, LLC), 415 B.R. 403 (B.A.P. 9th Cir. 2009) (concluding that the federal tax lien must be apparent from a "reasonable inspection" performed by an "ordinary prudent person," thus requiring an exact name match and denying priority when the tax lien filing omitted "Civil" from the name "Crystal Cascades Civil, LLC").

[14] Different rules apply to determine priority between competing state and federal tax liens. Generally, priority is determined on the basis of "first in time, first in right," but measured by the date of assessment of the tax, rather than the date of perfection of the tax lien. Noriega & Alexander v. U.S., 859 F. Supp. 406, 409-12 (E.D. Cal. 1994); F.T.C. v. Crittenden, 823 F. Supp. 705 (C.D. Cal. 1993) (between competing tax liens, first assessment has priority). It is not clear that this approach to priority would be given effect in a bankruptcy case.

[15] 26 U.S.C. § 6323(h)(1)(A); United States v. McDermott (*In re* McDermott), 507 U.S. 447, 452-53 (1993) (after-acquired real property); Don King Prods., Inc. v. Thomas, 945 F.2d 529, 534 (2d Cir. 1991) (right to boxing prize purse did not come into existence until the match; prior assignment of revenues inferior to federal tax lien).

[16] "*Choate,* a back-formation from *inchoate,* is a misbegotten word, for the prefix in *inchoate* is intensive and not negative. . . . The word derives from the Latin verb *inchoare* 'to hitch with; to begin.' Yet, because it was misunderstood as being a negative (meaning 'incomplete'), someone invented a positive form for it, namely *choate* (meaning 'complete')." BRYAN GARNER, A DICTIONARY OF MODERN LEGAL USAGE 152 (2d ed. 1995) (quoted in Bloomfield State Bank v. United States, 644 F.3d 521, 523-24 (7th Cir. 2011)).

such property was only "inchoate" when the security interest attached, and did not become "choate" until after the tax lien had attached.[17]

Under current law, the priority of the federal tax lien is resolved largely on the basis of whether the property at issue was "in existence" before the tax lien was filed. Most significantly, accounts receivable which arise after the filing of the tax lien and inventory which was acquired after the filing of the tax lien were not previously "in existence," although they otherwise might be subject to the after-acquired property clause in a security agreement. As a consequence, apart from the 45-day safe harbor described below, the federal tax lien takes priority over all other security interests, including pre-existing duly perfected floating liens, with respect to all accounts receivable which arose and inventory which was obtained after the tax lien was filed.[18] The same result applies to agricultural crops grown after the perfection of the tax lien, to hotel revenues received after the perfection of the tax lien and to raw materials converted into finished goods after the perfection of the tax lien.[19]

It should be noted that in contrast to accounts receivable, which only come into existence after the taxpayer has completed performance, "contract rights" come into existence when the contract is entered into; thus, although generally there must be additional performance before those rights can be enforced, contract

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[17] *See*, e.g., United States v. Pioneer Am. Ins. Co., 374 U.S. 84 (1963); *see generally* Michael McCullough, *When First in Time is not First in Right: The Supreme Court Frustrates Judgment Creditors in* United States v. McDermott, 25 LOY. U. CHI. L.J. 405, 412-19 (1994).

[18] *See* Texas Oil & Gas v. United States, 466 F.2d 1040 (5th Cir.1972) (Lengthy analysis of prior law and the priority of the federal tax lien in connection with accounts receivable); Rice Inv. Co. v. United States, 625 F.2d 565, 572 (5th Cir. 1980) (federal tax lien takes priority over after-acquired inventory); *In re* May Reporting Servs., Inc., 115 B.R. 652, 660 (Bankr. D.S.D. 1990) (allocating priority to accounts receivables); Donald v. Madison Indus., Inc., 483 F.2d 837, 845 (10th Cir. 1973) (creditor had a security interest in raw materials owned as of the 45th day, but no right to the subsequent "value added" through parts or labor which converted the raw materials to finished goods after the 45th day); Banco Popular de Puerto Rico *v*. United States (*In re* Reitter Corp.), 475 B.R. 314, 321 (D.P.R. 2012) (accounts receivables created after 45th day); *see generally* Timothy R. Zinnecker, *When Worlds Collide: Resolving Priority Disputes Between the IRS and the Article Nine Secured Creditor*, 63 TENN. L. REV. 585, 688 (1996).

[19] Tri-River Chem. Co. v. TNT Farms (*In re* TNT Farms), 226 B.R. 436, 443 (Bankr. D. Idaho 1998) (crop lender is junior to IRS where tax lien filed before crops were planted); *Donald*, 483 F.2d 837 (finished goods); *but see Bloomfield State Bank*, 644 F.3d 521 (discussed in Andrew Moratzka, *Security Interests vs. Federal Tax Liens and After-Acquired Property vs. Proceeds*, 30 AM. BANKR. INST. J. 24 (2011)) (determining that rents from a lease of real property entered into after the federal tax lien was perfected nonetheless constituted collateral for the mortgage creditor rather than the IRS because "a month's rent is a receivable that matches the value of the real property [collateral] for that month.")

rights will often be "in existence" before the tax lien is filed.[20] Existing secured creditors, especially holders of blanket liens, may therefore attempt to characterize collateral as a "contract right" rather than an "account receivable" in order to preserve priority over an intervening tax lien.

B. The 45-Day Safe Harbor

The federal tax lien statute includes two provisions which defer the effect of the tax lien on other creditors for the first 45 days after its recordation, thereby somewhat moderating its impact on existing creditors: first, a provision intended to protect transactions which are pending when the lien is filed, and which are funded and close within the 45-day period, and second, of more general importance, a provision which protects and preserves the priority of existing floating liens for the first 45 days following the recordation of the tax lien.

A security interest perfected shortly after the filing of the federal tax lien is protected (and takes priority over the federal tax lien) if the following can be shown: (i) the security interest attached prefiling; (ii) the security interest could not be defeated by a judgment lien on the date of the filing of the tax lien; and (iii) the creditor's disbursement (financing) was made without notice of the federal tax lien and before the 46th day after the federal tax lien filing.[21]

Of much more general practical significance is the provision which partially protects the holders of existing floating liens for the first 45 days after the recordation of the tax lien. Ordinarily, pre-existing security interests lose priority to the federal tax lien with respect to all accounts receivable which come into existence and inventory which is acquired after the lien is perfected; a statutory safe harbor allows pre-existing floating liens to retain priority with respect to accounts receivable generated and inventory acquired during the first

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[20] The Tenth Circuit explained:

> A contract right is defined as "any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper." 26 C.F.R. § 301.6323(c)-1(c)(2)(i). An account receivable is "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper." *Id.* § 301.6323(c)-1(c)(2)(ii). Contract rights are acquired when a contract is made, while an account receivable is acquired when a right to payment is earned by performance.

Am. Inv. Fin. v. United States, 476 F.3d 810, 814 (10th Cir. 2006) (finding that the disputed cash was the proceeds of health care insurance accounts receivables stemming from services provided after the 45 day safe harbor had passed).

[21] 26 U.S.C. § 6323(c).

45 days following the filing of the federal tax lien.[22] After the expiration of the first 45 days, the pre-existing floating lien creditor has priority only in inventory and accounts receivable which were in existence as of the 45th day following the filing of the tax lien. The IRS has priority in all inventory, accounts receivable and cash which come into existence commencing on the 46th day.[23]

> *Example 1:* Debtor consistently maintains \$100,000 in accounts receivable; \$65,000 of which is collected within 30 days and \$35,000 of which is collected within 31 to 60 days. Bank has a blanket lien covering the accounts receivable. The IRS files a federal tax lien on January 1. Until February 15 (the 45th day following the filing of the tax lien), the Bank's rights in the accounts receivable will be unimpaired as a result of the 45-day safe harbor.
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> On March 18, the IRS will have a first priority security interest in \$65,000 in accounts receivable (those generated during the preceding 30 days following expiration of the 45-day safe harbor) and the Bank will have a first priority security interest in only the remaining \$35,000 (accounts receivable created during the safe harbor). On and after April 17, the IRS will have a first priority security interest in all accounts receivable, since they will all have been created after the expiration of the 45-day safe harbor.

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[22] *Texas Oil & Gas*, 466 F.2d 1040 (since the entire fund at issue represented accounts receivable which came into existence more than 46 days after the filing of the tax lien, the factor's lien was second in priority to the federal tax lien); Rallis & Assocs. v. Am. Nat'l Bank (*In re* Rallis & Assocs., Inc.), 114 B.R. 744, 746 (Bankr. W.D. Okla. 1990) (since all accounts receivables were invoiced after the conclusion of the 45 day safe harbor, IRS had priority); *In re* All Tool Rental, Inc., 40 B.R. 580, 583-85 (Bankr. S.D. Fla. 1984) (IRS held first priority with respect to "that \$700 of the inventory [which] was acquired after Nov. 9, 1980, or 45 days after the filing of the first… tax lien"); *In re* Schons, 54 B.R. 665, 667 (Bankr. W.D. Wash. 1985) ("To the extent that the Milk Diversion Program payments came into existence more than 45 days after the tax liens were filed, the Internal Revenue Service's interest is superior to [the Bank's]"). *But see In re* Nat'l Fin. Alternatives, Inc. 96 B.R. 844, 848-51 (Bankr. N.D. Ill. 1989). (In a careful analysis of the 45-day rule, the court concluded that accounts receivable which came into existence after the 45th day following the filing of the tax lien, but which themselves constituted proceeds of inventory which was acquired prior to the 45th day and therefore constituted the Bank's collateral, were also subject to the Bank's first priority lien notwithstanding the tax lien. "[T]he proceeds of "qualified property," are themselves qualified property, as long as these proceeds are not commingled or expended to acquire other property outside the 45–day period.")

[23] 26 U.S.C. § 6323(c)(2)(B).

C. Statutory Third-Party Exemptions

The Internal Revenue Code provides certain statutory exemptions from the effect of its tax lien, intended to protect parties who deal with the debtor, have no actual notice of the tax lien, and would not be expected to check for the filing of the tax lien. Those exempted transactions are: [24]

1. Purchased securities;

2. Purchased motor vehicles;

3. Personal property purchased at retail;

4. Casual sale of personal property for reasons other than resale, sold for less than $1,000;

5. Personal property subject to possessory liens (e.g., an automobile mechanic holding an automobile until the repair bill is paid);

6. Real property taxes and special assessments;

7. Residential property subject to mechanic's liens for small repairs and improvements (if the contract price is less than $5,000);

8. Attorney's liens (except on causes of action against the United States);[25]

9. Certain insurance contracts; and

10. Bank loans secured by savings deposits, if the bank had no notice of the tax lien.

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[24] 26 U.S.C. § 6323(b).

[25] California law holds "that if the parties intend that the attorney look directly to the settlement for payment, then a lien against that settlement is created in the attorney's favor." *In re* Pacific Far East Line, Inc., 654 F.2d 665, 668-69 (9th Cir. 1981). If the parties' intent is clear, "a lien may be created without the use of the word 'lien.'" *In re* Colt Eng'g, Inc., 288 B.R. 861, 873 (Bankr. C.D. Cal. 2003). An attorney's lien will ordinarily be inferior to a subsequent federal tax lien, however, because the tax lien attaches to the recovery as soon as it comes into being. *See*, note 14 *et seq.* and accompanying text; *see also Noriega,* 859 F. Supp. at 412-13 (federal tax lien superior to attorney's fee claim).

Finally, the language of the federal tax lien statute suggests that otherwise enforceable purchase-money security interests that arise after the tax lien is recorded will be subordinate to the tax lien. As a matter of policy, however, the IRS allows a properly perfected purchase money security interest to take priority over an existing tax lien.[26]

D. Lender's Checklist

If the lender is engaged in purchase money financing or one of the handful of other exempted transactions, it need not attempt to determine whether a tax lien has been perfected against the borrower before funding.

If the lender is engaged in floating lien financing transactions or otherwise relies on a security interest in inventory or accounts receivables, however, it must regularly attempt to determine whether a federal tax lien has been filed against its borrower. Unlike Article 9, if the borrower is an entity, the lender must search for lien filings in the state where the debtor's "principal executive office" is located; if there are multiple possible such states, the search should be made in all of them. Again unlike an Article 9 search, the lender must make a broad search of the UCC filings; the search should include all plausible variants of the debtor's name.

If the borrower is an individual, the search must be made in the recorder's office for the county in which the borrower resides. Note that if the federal tax lien is properly perfected in the county in which the taxpayer resides and the taxpayer thereafter relocates to a different county, the federal tax lien will remain enforceable and effective, notwithstanding the practical difficulties creditors might face in their efforts to discover it.[27]

In any event, the lender's credit agreement should require the borrower to covenant immediately to advise the lender (i) if it fails to pay taxes as they come

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[26] "[A] federal tax lien is subordinate to a purchase-money mortgagee's interest notwithstanding that the agreement is made and the security interest arises after notice of the tax lien…. Congress intended to preserve this priority… and the IRS has since formally accepted that position. Rev. Rul. 68-57, 1968-1 C.B. 553, Slodov v. U.S., 436 U.S. 238, 257-58 n.23 (1978).

[27] A federal tax lien filing is effective for 10 years following assessment of the tax. 26 U.S.C. § 6502(a)(1). During that period, it remains effective regardless of changes in the taxpayer's place of residence. To continue to collect on the tax beyond 10 years after assessment, including extending the effectiveness of the federal tax lien and preserving its lien priority, the IRS must file suit within the 10 years following assessment and obtain a judgment on the tax debt. 26 U.S.C. § 6502(a). If the IRS files suit in order to seek to collect beyond the 10 year period and wishes to preserve its lien priority, the federal tax lien must be refiled prior to its expiration in the original filing location and, if the IRS has been given notice of the taxpayer's change of address, in the new county of residence. *See* Zinnecker, *supra* note 18, 63 TENN. L. REV. at 590-92.

due; (ii) if a tax liability is assessed against it; and (iii) if a tax lien is recorded against it. Since a tax lien may not be recorded until 10 days have elapsed following assessment, the second provision should allow the holder of a blanket lien 55 days' notice before its collateral base began to diminish. Of course, these protections are only as strong as the borrower's sense of commitment to loan covenants.

Ultimately, if the lender's blanket lien against accounts receivable is significant source of recovery, the lender can best protect that lien only by checking for lien filings periodically after extending credit in order to ascertain whether a tax lien has been filed. If maintaining a first priority position on the accounts receivable or inventory is critical and the prospect of a tax lien is likely, the lender must check UCC filings every 45 days. Even so, if the taxing authority incorrectly identifies the taxpayer in its notice of lien, the lender may lose priority despite its best efforts.[28]

III. Scope of the Federal Tax Lien in Bankruptcy

A. Avoidance

The consequences of the perfection of the federal tax lien cannot thereafter be avoided as preferential by a trustee in bankruptcy. The "fixing" of the lien through perfection is immune from subsequent avoidance as a preference under section 547(c)(6) of the Bankruptcy Code.[29] Similarly, any prepetition sale under the lien is immune from avoidance.[30] Finally, although the representative of the bankruptcy estate is treated as a *bona fide* purchaser of real property for most purposes, it cannot use that status to defeat a federal tax lien.[31]

> *Example 2:* Debtor owns Blackacre, worth $100,000, free and clear of liens. On January 1, a creditor obtains an enforceable judgment lien against Blackacre for $30,000. On March 10, the IRS files an $80,000 tax lien against

[28] *See supra* note 12.

[29] 11 U.S.C. § 547(c)(6); *see, e.g., In re* Rogers Refrigeration, Inc., 33 B.R. 59, 60 (Bankr. D. Or. 1983).

[30] *Rogers Refrigeration,* 33 B.R. at 60; *see also* 11 U.S.C. § 547(b)(5). Of course, had the sale occurred under a levy prior to perfection of the lien, it would be subject to avoidance as a preferential payment to an unsecured creditor. *In re* K & L Interiors, Inc., 34 B.R. 188 (Bankr. D. Or. 1982).

[31] *See* 11 U.S.C. § 545(c); United States v. Battley (*In re* Berg), 188 B.R. 615 (B.A.P. 9th Cir. 1995).

> Blackacre; the following day, the debtor files a bankruptcy case and sells Blackacre.[32]
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> The debtor may avoid the judgment lien as a preference and preserve it for the benefit of the estate, thereby obtaining the first $30,000 of the proceeds of sale for the benefit of creditors generally.[33] The tax lien cannot be avoided as a preference, so the IRS will get the remaining $70,000 from the proceeds of the sale.

Only if the IRS has seized but not yet sold property at the time of a bankruptcy filing may a subsequent trustee require the IRS to turn over the property for administration in the bankruptcy case (but subject to the IRS's lien).[34] The IRS argued that turnover should not be available where the property subject to prepetition levy is intangible (e.g., cash and accounts receivable) and worth less than the tax debt because the levy itself operated to transfer ownership to the IRS, but that argument has been rejected by the weight of authority.[35]

B. Property Acquired Post-Petition

There is some confusion about whether the federal tax lien attaches to property acquired post-petition, largely due to negative inferences from section 552. The rule in the Ninth Circuit seems clear—the federal tax lien does not attach to property acquired post-petition—although the rationale for that rule is flawed. On the one hand, the consequence of that rule has little impact as a matter

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[32] In this article, "debtor" will often refer to the person in control of the bankruptcy case, whether a "debtor-in-possession" or a "trustee."

[33] *See* 11 U.S.C. §§ 547, 551.

[34] United States v. Whiting Pools, Inc. (*In re* Whiting Pools, Inc.), 462 U.S. 198, 209 (1983).

[35] The IRS' contentions were initially adopted by some courts; *see* Altman v. Comm'r of I.R.S., 83 B.R. 35 (D. Haw. 1988) (District court determined that ownership of cash was transferred to IRS upon prepetition levy; turnover motion denied, *Whiting Pools* distinguished); *In re* Prof'l Technical Serv., Inc., 71 B.R. 946 (Bankr. E.D. Mo. 1987) (*Whiting Pools* analyzed and distinguished in a careful opinion which denied turnover and held that the levy on accounts receivable transferred title to IRS prepetition). Current authorities generally reject the IRS' position, however; *see* United States v. Challenge Air Int'l, Inc. (*In re* Challenge Air Int'l, Inc.), 952 F.2d 384, 387 (11th Cir. 1992) (*Whiting Pools* turnover applies to tangible and intangible assets); Metro Press, Inc. v. United States (*In re* Metro Press, Inc.), 139 B.R. 763, 764 (Bankr. D. Mass. 1992) (following *Challenge Air* requiring turnover of cash); Stead v. United States, 419 F.3d 944, 948 (9th Cir. 2005) (mere levy does not transfer ownership or pay tax liability); *see generally* Kevin W. Coleman, *Pre-Petition IRS Levies on 'Cash Equivalents:' Why They Are Recoverable by the Estate Even Absent A Present Right to Collect*, 100 COM. L.J. 471 (1995).

of law, since it is clear that the IRS' allowed secured claim is fixed at the time of filing and cannot change based on subsequent changes in the collateral. On the other hand, in a business case in which the IRS' collateral has been dissipated or converted into unencumbered assets, the entitlement to an allowed secured claim may prove a cold comfort.

Section 552 generally governs the effect of pre-petition liens on after acquired property.[36] It provides the general rule that property acquired post-petition is free of pre-petition liens; section 552(a); but also provides the exception that a pre-petition lien continues in effect against post-petition proceeds; section 552(b). Section 552, however, is limited to "security agreements."[37] The federal tax lien is nonconsensual and does not depend on a "security agreement,"[38] so section 552 does not apply to it. Some courts have adopted the negative inference: since section 552(a) only prevents consensual pre-petition liens from attaching to post-petition assets, there is nothing to prevent the federal tax lien from attaching to post-petition property.[39]

In the Ninth Circuit, however, this approach has been rejected: in *Fuller,* the Bankruptcy Appellate Panel for the Ninth Circuit adopted the rule that the automatic stay prevents the tax lien from attaching to post-petition property.[40] It is submitted that *Fuller* is poorly reasoned: When an account receivable pledged as collateral for a consensual lien is converted into cash and the cash impressed

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[36] *See* 11 U.S.C. §§ 506, 552.

[37] *See, e.g., In re* Cross Baking Co., 818 F.2d 1027 (1st Cir. 1987).

[38] U.S. v. Ron Pair Enters., Inc. 489 U.S. 235, 241 (1989) (distinguishing the federal tax lien from liens that arise by agreement).

[39] They focus on the fact that the Bankruptcy Code has no mechanism comparable to Section 552 to prevent the post-petition attachment of non-consensual liens.

> A federal tax lien, which is a nonconsensual secured interest, attaches to property acquired by a debtor/taxpayer even subsequent to the filing of a bankruptcy petition, notwithstanding the provisions of § 552(a).

In re Commercial Millwright Serv. Corp*.,* 245 B.R. 585, 591 (Bankr. N.D. Iowa 1998) (collecting cases); *In re* Se. R.R. Contractors, Inc*.,* 235 B.R. 619, 622 (Bankr. E.D. Tenn. 1996) ("It is true, of course, that tax liens generally survive bankruptcy and, being nonconsensual, are not cut off by the operation of 11 U.S.C. § 552(a).").

[40] *In re* Fuller, 134 B.R. 945, 947 (B.A.P. 9th Cir. 1992). *Fuller* relied on a terse Bankruptcy Act precedent, *In re* Braund, 423 F.2d 718 (9th Cir. 1970), which held that a discharge of the underlying tax debt prevented application of the tax lien against the post-discharge property acquisitions of an individual (without mentioning any stay, automatic or otherwise). While *Braund* seems clearly correct in its context, it scarcely justifies either the result or explanation supplied in *Fuller.*

with the consensual lien as "proceeds," no "act" violating the automatic stay has apparently occurred; but when an account receivable subject to a tax lien is converted into cash and the cash impressed with the tax lien, *Fuller* claims that an "act" in violation of the automatic stay has occurred. *Fuller's* invocation of the automatic stay is unpersuasive and cannot be easily reconciled with the existence and application of section 552.

Rather than relying on the automatic stay to address the problem, it is submitted that a better approach would be to note that following the filing of a bankruptcy petition, property acquired post-petition is property of the estate and not of the debtor, and for that reason the tax lien does not attach to it. In Chapter 7 cases, courts readily conclude that the tax lien cannot attach to property of the estate.[41] In Chapter 11 cases, this requires accepting the teaching of *Bildisco* that the debtor in possession is, in fact, different from the debtor.[42]

The practical effect of preventing the tax lien from attaching to post-petition acquisitions is very different from its legal effect. The legal effect is straightforward: under section 506, the IRS's secured claim is determined as of the commencement of the case, and subsequent increases or diminutions in its collateral base are irrelevant.[43] As a practical matter, however, subsequent loss of collateral may have a significant effect on the IRS' ultimate recovery.

In a real estate case, absent significant fluctuations in market value, the collateral for the IRS' allowed secured claim is likely to remain stable. But in a business case, absent a replacement lien, the IRS' collateral is likely to vanish. On the first day of the case, the IRS holds a lien encumbering cash, accounts receivable and inventory. Absent some intervention, the cash is likely to be spent, the accounts receivables will be collected and spent and the inventory sold and the proceeds collected and spent. It is unclear whether the IRS has a lien on the

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[41] *See, e.g., Se. R.R. Contractors,* 235 B.R. at 622 (rejecting the claim that a preference recovery was subject to a federal tax lien, explaining "that a preference recovery by a trustee in a bankruptcy case can never be characterized as "belonging" to the debtor. At the time it comes into existence and first becomes anyone's property, it is property of the estate to be distributed only to the creditors in the case.").

[42] N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984).

[43] *Commercial Millwright,* 245 B.R. at 590 (Bankr. N.D. Iowa 1998) (determining tax lien claim as of the filing of the case, without regard to post-petition developments); *In re* National Fin. Alternatives, Inc., 96 B.R. 844, 848 (Bankr. N.D. Ill. 1989); *but see* United States v. Booth Tow Serv., 64 B.R. 539 (D. Mo. 1985) (Reversing Bankruptcy Court and allowing federal tax lien to attach to post-petition property by valuing IRS's claim substantially after the filing date).

proceeds of its collateral;[44] e.g., the cash proceeds of pre-petition accounts receivables; but even if it does, the rule is fairly clear that absent a replacement lien approved by the Court, the second generation of post-petition proceeds is free and clear of any pre-petition lien.[45] Thus, absent "adequate protection" in the form of a replacement lien, in a business case the IRS' collateral will evaporate over time.[46]

C. Adequate Protection / Cash Collateral

The federal tax lien includes within its reach all property of the taxpayer; in the absence of a senior lien in excess of the value of the debtor's assets, at the commencement of a bankruptcy case the IRS will hold an allowed secured claim entitled to "adequate protection" and "cash collateral"[47] protections.[48] For example, section 363(c) of the Bankruptcy Code provides that the debtor is prohibited from using cash collateral without the prior consent of the secured creditor or an order of the court providing the secured creditor "adequate protection" for the use of the cash.[49] In a business case, as discussed above, the

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[44] While current Article 9 of the Uniform Commercial Code expressly includes proceeds within the scope of collateral, the tax lien statute makes no mention of proceeds. *Compare*, Cal. Comm. Code § 9203(f) with 26 U.S.C. § 6321.

[45] *In re* Skagit Pac. Corp., 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004); Bruce H. White & William L. Medford, *Section 552's Hidden Threat to Secured Creditors: There Goes Your Equity Cushion*, 26 AM. BANKR. INST. J. 28 (2006) (concluding that "*Skagit Pacific* demonstrates the necessity and importance of replacement liens.")

[46] "The use of pre-petition collateral necessitates a replacement lien because allowing a debtor to use encumbered property to create unencumbered property harms the property interests of the secured party." Bruce H. White & William L. Medford, *Automatic Severance of After-Acquired Property Interests Under § 552 Are You Entitled to Adequate Protection for Debtor's Use of Cash Collateral?*, 25 AM. BANKR. INST. J., 36, 37 (2006).

[47] "Cash collateral" is defined in section 363(a) of the Bankruptcy Code as cash, negotiable instruments, and other cash equivalents in which a creditor has a security interest. 11 U.S.C. § 363(a).

[48] As is the case with a typical "blanket" lien—which results in unquestioned cash collateral rights—as of the commencement of the bankruptcy case, the federal tax lien encumbers all cash and cash equivalents and all assets that might, with the passage of time, become cash or cash equivalents.

Indeed, the IRS may have the *only* lien on cash, since the protection of the 45 day rule applies only to "identifiable proceeds," and that does not include commingled cash. 26 C.F.R. § 301.6323(c)-(1)(d) ("[T]he term 'identifiable proceeds' does not include money, checks and the like which have been commingled with other cash proceeds."); *see generally* Zinnecker, *supra* note 18.

[49] *See* 11 U.S.C. § 363(c).

collateral for the federal tax lien will predictably evaporate unless the IRS is afforded at least a replacement lien to protect its position.

In Chapter 11 reorganization cases, debtors routinely negotiate with the holders of floating liens for cash collateral orders through which the creditor consents to the use of cash collateral in business operations in return for various protections, notably including replacement liens. Such Orders can protect both the floating lien lender and the IRS, depending on their respective circumstances.

If a bankruptcy case is filed promptly after the filing of the tax lien, the IRS will be junior to pre-existing secured creditors with respect to each asset (through operation of the 45-day safe harbor). The cash collateral order might, therefore, provide a pre-existing secured creditor with a replacement floating lien which preserves that creditor's priority in post-bankruptcy property indefinitely.[50] Where the bankruptcy case is filed much later, however, the IRS may have a first priority lien with respect to cash and some accounts receivable and the pre-existing secured creditor may have a first priority lien against the balance of the accounts receivable and inventory. In those circumstances, the replacement lien provided under the cash collateral order should protect the interests of each party.

> *Example 1 Revisited.* Debtor consistently maintains \$100,000 in accounts receivable; \$65,000 of which is collected within 30 days and \$35,000 of which is collected within 31 to 60 days. Bank has a blanket lien covering the accounts receivable. The IRS files a federal tax lien on January 1.
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> Until February 15, the Bank's rights in the accounts receivable will be unimpaired, as a result of the 45-day safe harbor. If the bankruptcy case is filed during this period, the Bank should be able to obtain a cash collateral order which leaves it with a first priority replacement lien against post-bankruptcy accounts receivable, thereby freezing its relative property over the IRS.

[50] *See* discussion in note 21 and Example 1, *supra, but see* text following note 23; *In re* United Crane & Rigging, Inc., 93 B.R. 113 (Bankr. S.D. Tex. 1988) (Apparently ignoring the court's power to preserve the parties' relative positions even though petition was filed on the 46th day following the filing of the federal tax lien; as discussed below, section 506 would seem to preclude this result).

> On March 18, the IRS will have a first priority security interest in $65,000 in accounts receivable (those generated during the preceding 30 days following the expiration of the 45-day safe harbor), and the Bank will have a first priority security interest in only the remaining $35,000 (created during the safe harbor). If the bankruptcy case is filed now, the cash collateral order should preserve this relationship, perhaps by giving a first priority replacement lien against post-petition accounts receivable to the IRS and the Bank jointly, split between them on a 65% / 35% basis.
>
> On and after April 17, the IRS will have a first priority security interest in all accounts receivable, since they will all have been created after the expiration of the 45-day safe harbor. At this stage, the primary beneficiary of the cash collateral order is the IRS. If the IRS is owed more than the value of the company's assets, the Bank will have become completely unsecured by this juncture.

In the Ninth Circuit, the IRS often does not actively pursue cash collateral or adequate protection rights. [51] Thus, one might well face a situation in which the pre-petition creditor has been rendered unsecured as a result of the passage of time following the filing of the federal tax lien but prior to the bankruptcy filing, but the IRS has not sought a replacement lien post-petition and has also been rendered, as a practical matter, unsecured. The IRS' rights to an allowed secured claim as of the commencement of the case should not be affected, but the ability to marshal collateral to pay that claim could certainly be affected.

D. Exempt Property

Property exempt under state or bankruptcy law is not exempt from a federal tax lien.[52] As a consequence, the IRS may levy upon exempt property immediately after a discharge is entered.[53]

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[51] In practice in the Ninth Circuit, the IRS apparently only insists on post-petition compliance with reporting and the payment of post-petition taxes, and does not pursue broader cash collateral rights. In other jurisdictions, the IRS has apparently taken a more aggressive stance, e.g., seeking to negotiate cash collateral agreements that override the lien subordination provisions of section 724 in the event of a future conversion to Chapter 7. *Compare In re* Bino's Inc., 182 B.R. 784, 787 (Bankr. N.D. Ill. 1995) (prohibiting such an agreement), *with In re* Buzzworm, Inc., 178 B.R. 503, 512 (Bankr. D. Colo. 1994) (speculating that such an agreement might be permissible in an appropriate case).

[52] *See supra* note 4.

IV. The Claim Secured by the Federal Tax Lien and Its Treatment

A. Generally

Principal: If the collateral does not cover the full amount of the tax owed, the IRS will generally attempt to allocate its secured claim in bankruptcy cases so that it secures otherwise dischargeable taxes and leaves the priority or nondischargeable taxes unsecured.[54] The IRS bases its right to so allocate payments from a bankruptcy estate on the principle that it is entitled to allocate all "involuntary" payments, and payments made as part of a legal proceeding (*i.e*., a bankruptcy case) are by their nature involuntary. In *United States v. Energy Resources Co.,* however, the Supreme Court ruled that the bankruptcy court had the power to require the IRS to apply post-petition payments as the court designated, regardless of whether the payments were considered "voluntary" or "involuntary."[55] In practice, however, that power is rarely exercised,[56] because the Court must find that allocation is necessary in order to implement the reorganization in order to justify allocation.[57]

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53 11 U.S.C. § 522(c)(2)(B); *In re* Junes, 99 B.R. 978, 981 (B.A.P. 9th Cir. 1989) ("The discharge of [the debtors'] personal liability…to [the IRS] does not affect the right of [the IRS] to enforce its lien against the debtor's real [and personal] property once the automatic stay provided by [section] 362 [has] terminated." (*quoting In re* Work, 58 B.R. 868, 873 (Bankr. D. Or. 1986)). The automatic stay protecting exempt property terminates upon the entry of the discharge. *See* 11 U.S.C. § 362(c)(2)(C).

54 *See* 11 U.S.C. §§ 507(a)(7), 523(a)(1).

55 Prior to the decision in United States v. Energy Res. Co., 495 U.S. 595 (1990), there had been a split in the circuits regarding the bankruptcy court's power to allocate post-petition payments to the IRS. *See In re* Technical Knockout Graphics, Inc., 833 F.2d 797, 802 (9th Cir. 1987) (post-petition payments are involuntary, IRS may allocate them in any fashion it chooses), and *In re* A & B Heating & Air Conditioning, 823 F.2d 462, 465-66 (11th Cir. 1987) (rejecting "involuntary payment" analysis and leaving allocation to the discretion of the bankruptcy court). In *Energy Resources,* the Supreme Court held that the bankruptcy court had the power to compel the IRS to allocate payments first to "trust fund" obligations for which the debtor's officers were jointly liable. Presumably, the bankruptcy court has the power to allocate payments made on account of a federal tax lien as well.

56 In subsequent years, the power afforded by *Energy Resources* has been exercised with restraint; *see*, *e.g.,* United States v. Pepperman, 976 F.2d 123, 131 (3d Cir. 1992) (refusing to allocate payments in Chapter 7 context); *In re* Kaplan, 104 F.3d 589, 598 (3d Cir. 1997) (reversing allocation of payments); *In re* Kare Kemical, Inc., 935 F.2d 243, 244 (11th Cir. 1991) (allocation power limited to reorganizations; allocation under plan of liquidation reversed).

57 *Compare In re* GLK, Inc., 921 F.2d 967, 968 (9th Cir. 1990) (affirming bankruptcy court's refusal to allocate based on finding that allocation was not necessary to effectuate plan); *with In re* Deer Park, Inc., 10 F.3d 1478, 1482 (9th Cir. 1993) (affirming confirmation of plan that allocated payments to trust fund taxes based on finding that allocation was necessary to effectuate plan).

Post-Petition Interest: The Supreme Court's decision in *Ron Pair* concluded that section 506(b) permits the federal tax lien to accrue interest post-petition to the extent that the IRS's claim is oversecured; that is, to the extent that the value of the collateral exceeds the principal owed.[58] The *Ron Pair* opinion is founded on a literal parsing of the language of section 506(b), however, which should preclude accrual of any other "fees, costs, or charges" (i.e., post-petition penalties) in addition to interest, even if the tax lien is oversecured.[59] Post-petition interest accrues at the statutory rate. [60]

Penalties: Under the Bankruptcy Act, penalties were not allowed, even if secured, under the rule of *Simonson v. Grandquist.*[61] *Simonson* was founded upon the language of section 57j of the Bankruptcy Act and a policy in favor of "the prohibition of all tax penalties in bankruptcy" in order to avoid requiring "the general creditors of a bankrupt to suffer because of penalties designed to be inflicted upon the bankrupt himself."[62]

Under the Bankruptcy Code, prepetition penalties[63] are generally allowed and enjoy the status of the underlying claim (*i.e.,* secured, priority, or unsecured).[64] Although the policy underlying the *Simonson* decision remains applicable, the statutory basis (section 57j of the Bankruptcy Act) has been limited to Chapter 7 cases (section 726(a)(4) of the Bankruptcy Code) and the approach of the Supreme Court in *Ron Pair*[65] suggests that the language of the

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[58] *Ron Pair*, 495 U.S. at 248-49.

[59] "Therefore, in the absence of an agreement, postpetition interest is the only added recovery available [to the IRS]." *Ron Pair,* 495 U.S. at 245; Rushton v. State Bank of So. Utah (*In re* Gledhill), 164 F.3d 1338, 1342 (10th Cir. 1999) ("creditors holding oversecured nonconsensual claims may not recover attorney fees, costs, and other charges.").

[60] *See* 11 U.S.C. § 511.

[61] Simonson v. Grandquist, 369 U.S. 38 (1962).

[62] *Id.* at 40-41.

[63] Where the tax liability accrues post-petition and is thus entitled to administrative expense status, interest and penalties on that liability will also be entitled to administrative expense status. *See In re* Mark Anthony Constr. Co., 886 F.2d 1101 (9th Cir.1989); *In re* Allied Mech., Inc., 885 F.2d 837 (11th Cir.1989); United States v. Friendship Coll., Inc., 737 F.2d 430 (4th Cir.1984); United States v. Flo-Lizer Inc. (*In re* Flo-Lizer, Inc.), 916 F.2d 363, 364-65 (6th Cir. 1990).

[64] For secured penalties, *see infra* notes 65, 66*;* for priority penalties, *see* 11 U.S.C. § 507(a)(8)(G). Unsecured, non-priority pre-petition penalties are allowable as general unsecured claims. United States v. Reorganized CF & I Fabricators of Utah, Inc., 518 U.S. 213, 229 (1996).

[65] *Ron Pair,* 495 U.S. at 241 ("The task of resolving the dispute over the meaning of section 506(b) begins where all such inquiries must begin: with the language of the statute (cite omitted).

statute should be determinative of this analysis. Courts have routinely allowed penalties in Chapter 11 cases without discussion.[66] Attempts to equitably subordinate pre-petition penalties were categorically rejected by the Supreme Court.[67]

In conclusion, prepetition penalties and interest should be allowable in bankruptcy, and should be treated as a part of the debt secured by the federal tax lien.[68] Although post-petition interest is allowable, a penalty which arises post-petition on a pre-petition tax lien claim should not be allowable at all based on the language of section 506(b) and *Ron Pair.*[69]

> *Example 3:* Assume the IRS files a tax lien on January 1, securing a claim for $60,000 in taxes, $20,000 in interest, and $20,000 in penalties. On February 1, the debtor files a Chapter 11 case. On August 1, the IRS would ordinarily assess additional penalties on account of the tax obligations. On December 1, the trustee, having liquidated the estate for far more than what was owed on the tax lien, seeks to pay the tax debt.
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> The trustee must pay the full $100,000 pre-bankruptcy balance on the tax lien since the pre-bankruptcy penalty is part of the IRS's secured claim. The trustee must also pay interest on the tax lien from January 1 to date because the debt was oversecured, but s/he need not pay the post-bankruptcy penalty, pursuant to the *Ron Pair* decision.

In this case, it is also where the inquiry should end, for where, as here, the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms'").

[66] Murphy v. IRS (*In re* Murphy), 279 B.R. 163, 165 (Bankr. M.D. Pa. 2002) (allowing pre-petition interest and penalties as part of the tax lien claim); *In re* Wesley, 455 B.R. 383, 386 (Bankr. D.N.J. 2011) (same, collecting cases).

[67] *Reorganized CF & I Fabricators,* 518 U.S. 213.

[68] 11 U.S.C. § 507(a)(7)(G) (specifically affording priority status to the penalty associated with a priority tax claim, provided that the penalty is in compensation for actual pecuniary loss).

[69] *Ron Pair*, 495 U.S. at 241; Bondholders Comm. v. Williamson Cnty. (*In re* Brentwood Outpatient, Ltd.), 43 F.3d 256, 263 (6th Cir. 1994) ("penalties which accrue post-petition are not allowed to a nonconsensual oversecured claim in bankruptcy.") Of course, if the debtor is an individual, penalties continue to accrue on the debt against him individually (as opposed to the bankruptcy estate) and are not discharged by the bankruptcy; *In re* Hanna, 872 F.2d 829, 831-32 (8th Cir. 1989); *In re* Burns, 887 F.2d 1541, 1543 (11th Cir. 1989); *In re* Johnson, 146 F.3d 252 (5th Cir. 1998); *In re* Cousins, 209 F.3d 38, 41 (1st Cir. 2000).

B. Tax Lien in Chapter 7

The principal consequences of a liquidating bankruptcy under Chapter 7 as regards the federal tax lien are a partial subordination of the entire tax lien and a complete subordination of all penalties.

Tax liens in Chapter 7 cases are automatically subordinated to all administrative and priority claims, possibly including the administrative claims of a prior failed Chapter 11 case.[70] A Chapter 7 trustee may properly administer property in which the estate otherwise has no equity, solely in order to provide a recovery for administrative and priority claimants through the use of the subordination provisions of section 724(b).[71]

Claims for penalties, even if secured, are subordinated to all other (i.e., general unsecured) claims in a Chapter 7 liquidation.[72] Thus, a penalty which is secured by a tax lien is automatically demoted in a Chapter 7 case from the highest priority (secured by a blanket lien) to the lowest priority (payable only after general unsecured creditors are paid in full) through the operation of section 726(a)(4).

C. Tax Lien in Chapter 11

A Chapter 11 debtor-in-possession cannot require the subordination of tax liens and penalties which is available to a Chapter 7 trustee under section 724(b) and section 726(a)(4).[73] On the other hand, the possibility of a future

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[70] 11 U.S.C. § 724(b). Under prior law, the section 724(b) subordination explicitly applied to both Chapter 7 and failed Chapter 11 administrative claims; *see In re* Air Beds, Inc., 92 B.R. 419 (B.A.P. 9th Cir. 1988) (rent which accrued during failed Chapter 11 reorganization entitled to priority over federal tax lien). In 2005, the BAPCPA amendments apparently attempted to alter that result, limiting the subordination of tax liens to Chapter 7 (and not failed Chapter 11) administrative expenses, but the statutory references were incorrect, leading to further confusion. William F. Davis & Assocs. *v*. U.S. Trustee (*In re* J.R. Hale Contracting Co.), 465 B.R. 218, 224 (Bankr. D.N.M. 2011). Giving effect to the asserted intent of the BAPCPA legislation could yield the anomalous result of non-payment of a senior class of claims (failed Chapter 11 administrative claims) notwithstanding payment in full of a junior class of claims (priority pre-petition unsecured claims).

[71] *In re* K. C. Machine & Tool Co., 816 F.2d 238, 247 (6th Cir. 1987) ("We conclude that compelled abandonment is not available where administration promises a benefit to the estate. Administration promises a benefit in this case by virtue of § 724(b)").

[72] 11 U.S.C. §§ 724(a), 726(a)(4).

[73] *See* 11 U.S.C. § 103(b); *In re* Stack Steel & Supply Co., 28 B.R. 151, 155 (Bankr. W.D. Wash. 1983) ("Therefore, as long as this case remains in Chapter 11, this [c]ourt is constrained to allow the claim for penalties").

conversion—and consequent subordination of the tax lien—may be used prospectively in the Chapter 11 case to prevent interim payments on account of a secured tax lien claim, payments other than through a Plan of Reorganization.[74]

The principal issues in Chapter 11 cases regarding federal tax liens relate to the confirmation of a Plan of Reorganization; specifically, to the treatment of tax liens under the Plan and to the ability of a debtor to meet the "best interest of creditors" test for confirmation of a Plan of Reorganization in the face of the potential subordination of secured tax claims in Chapter 7 cases.

Treatment of the Lien: There is a slight lack of clarity regarding the proper treatment of the federal tax lien claim in a Plan of Reorganization. If the federal tax lien claim would be entitled to priority treatment if not secured, the Plan of Reorganization must provide priority treatment to the tax lien claim.[75] That treatment requires payment in full, with interest at the statutory rate, within five years following the petition date, and treatment "not less favorable" than the treatment afforded the most favored general unsecured creditors.[76] If the tax secured by the federal tax lien is not otherwise entitled to priority, there are no specific mandatory treatment provisions, so presumably it will be addressed in terms of the cram-down provisions governing secured debt generally.[77] On the other hand, it is likely that the IRS will generally be willing to accept the treatment mandated for priority tax claims.

In any event, post-confirmation interest under the Plan of Reorganization must be at the statutory rate applied by the IRS.[78]

Best Interests of Creditors Test: Can the proponent of the Plan of Reorganization meet the "best interest of creditors" test necessary to confirm the Plan under section 1129(a)(7)(A)(ii), in view of the potential subordination of tax liens and penalties in a Chapter 7 case? The best interests of creditors test

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[74] *Air Beds*, 92 B.R. 419 (Bankruptcy Court abused its discretion by allowing a distribution on account of a federal tax lien from the proceeds of sale of property of the bankruptcy estate, where landlord holding unpaid administrative rent claim objected, since IRS was not harmed by impounding instead of distributing funds and landlord would be entitled to receive payment before IRS if the case were ultimately converted).

[75] 11 U.S.C. § 1129(a)(9)(D).

[76] 11 U.S.C. § 1129(a)(9)(C).

[77] 11 U.S.C. § 1129(b)(2)(A).

[78] 11 U.S.C. § 511.

requires creditors to fare at least as well under the Plan of Reorganization as they would fare in a Chapter 7 liquidation.

The general but partial subordination of the tax lien under section 724(b) should not have a material impact, since the only beneficiaries of that subordination—administrative and priority claims—must be paid in full in any event (unless they agree to other treatment) in order to confirm a Plan of Reorganization.[79] Payment of administrative and priority claims in full, together with some payment to an unsecured class, are generally preconditions to a confirmable Plan;[80] if those preconditions can be met, an analysis of the best interests of creditors test in regard to the general partial subordination of the tax lien to administrative and priority claims is unnecessary.

The subordination of an otherwise secured tax penalty to all unsecured claims, mandated in Chapter 7 cases, however, may have a substantial impact on the payment received by unsecured creditors, as suggested by Example 4, below. Meeting the "best interest of creditors" test in the face of a substantial pre-bankruptcy penalty secured by a tax lien—treating creditors as well as if they had enjoyed subordination of the penalty in a Chapter 7 case—may require the Plan proponent to offer a large infusion of new cash, unless the reorganization or going concern value of the debtor outweighs the amount of the penalty.[81]

D. Comparison of the Tax Lien in Chapter 7 and Chapter 11

As previously noted, the treatment of the federal tax lien differs dramatically in Chapter 7 cases and Chapter 11 cases. The force of the difference can be seen best through an extended example.

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[79] 11 U.S.C. § 1129(a)(9).

[80] 11 U.S.C. § 1129(a)(9) mandates payment in full to administrative and priority claimants. Section 1129(a)(10) requires acceptance by at least one class of impaired claims without regard to the votes of insiders; presumably, this ordinarily will require some distribution to a junior (*i.e.*, general unsecured) class.

[81] *See In re* Colin, 44 B.R. 806 (S.D.N.Y. 1984) (grappling with the problem that absent subordination of the penalty, it may be impossible to meet the best interests of creditors test in order to confirm a Chapter 11 plan of reorganization). Prior decisions equitably subordinating penalty claims in liquidating Chapter 11 cases are consistent with this concern. *See, e.g., In re* Schultz Broadway Inn, Ltd., 89 B.R. 43 (Bankr. W.D. Mo. 1988); *In re* Airlift Int'l, 97 B.R. 664 (Bankr. S.D. Fla. 1989); *In re* Quality Sign Co., 51 B.R. 351 (Bankr. S.D. Ind. 1985).

Example 4: The debtor's property has a liquidation value of $320,000 and is encumbered by the following secured debts:

Bank	$150,000	
Tax Lien	$100,000	($40,000 in penalties)
Finance Co.	$60,000	

In addition, the debtor owes $15,000 in post-bankruptcy administrative expenses, $10,000 in pre-bankruptcy wages entitled to priority,[82] and $30,000 in general unsecured debts.

Upon sale of the property, the Bank and the Finance Company will be paid in full because the value of their collateral exceeds the amount they are owed.

In a Chapter 7 case, the portion of the federal tax lien which is for penalties ($40,000) is subordinated to all other claims. The remaining $60,000 in tax lien proceeds are paid first to administrative and priority claimants ($25,000) and then to the IRS ($35,000). Since $50,000 in proceeds will remain after the payment of liens, the IRS will receive the next $25,000 in proceeds to reimburse it for the payment to administrative and priority claims, satisfying its claim (exclusive of the penalty) completely. The remaining $25,000 in proceeds will be distributed to general unsecured creditors, generating a payment of nearly 85% on their claims.

Assume, on the other hand, the debtor wishes to accomplish the exact same liquidation in a Chapter 11 case through a Plan of Reorganization. The tax penalty is not subordinated in Chapter 11, so only $10,000 in proceeds of the sale will remain after payment of all secured debts (Bank, IRS, and Finance Company). This will be insufficient to pay either administrative expenses or priority claims in full, rendering the Plan of Reorganization unconfirmable since both must be paid in full as a condition

82 11 U.S.C. § 507(a)(4).

of confirmation.[83] Even if the debtor could borrow $15,000 to fund these required payments, general unsecured claims would face no payment at all in Chapter 11, instead of the 85% payment they might expect in Chapter 7. Thus, the Plan of Reorganization could not meet the "best interests of creditors" test.

V. Conclusion

Until a bankruptcy case is commenced, the federal tax lien is more potent than any other lien. Unlike consensual liens, it can override after-acquired property clauses in security agreements and take priority over the collateral base previously pledged to an existing floating lien creditor. Unlike other nonconsensual liens, the federal tax lien also encumbers property which otherwise would be exempt under applicable state law.

Following the commencement of a bankruptcy case, however, the federal tax lien loses much of its potency. The bankruptcy filing halts the otherwise inexorable increase in the collateral base of the federal tax lien, as it takes first priority in inventory and accounts receivable acquired after the lien is filed, displacing existing floating lien creditors. Unlike other secured creditors, the IRS may be barred from receiving any payment on its secured claim prior to confirmation of a Plan of Reorganization. More importantly, the effect of the federal tax lien is dramatically reduced in liquidating bankruptcy cases through provisions which subordinate the entire tax lien claim to the claims of (otherwise unsecured) administrative and priority creditors, and provisions which subordinate the penalty portion of the claim to all unsecured claims.

The substantial difference in the treatment of the federal tax liens pre-petition and post-petition creates an incentive for the debtor, its secured creditors, and its unsecured creditors to effect the commencement of a bankruptcy case quickly, before the IRS undertakes efforts to perfect or enforce its lien.

[83] 11 U.S.C. § 1129(a)(9).