Federal Tax Liens: Still Making Bankruptcy Attractive to Creditors

by

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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. Although other creditors' efforts to improve their position in the debtor's waning days by perfecting a security interest or obtaining a judgment lien can generally be undone in a subsequent bankruptcy case, when the IRS perfects its tax lien pre-bankruptcy, the effect of that perfection cannot be avoided thereafter, again creating an incentive for both the debtor and its other creditors to commence the 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.1 This provision is construed broadly so as to reach “every species of right or interest protected by the law and having an exchangeable value.”2 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.3 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.4

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.5 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.6 If the taxpayer is an individual, the lien is perfected against personal property by recordation in the office of the county recorder for the county in which the person resides.7

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1 26 U.S.C.A. § 6321 (West 2013). 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).

2 Drye v. United States, 528 U.S. 49 (1999) (Right to disclaim inheritance was property subject to Federal Tax Lien).


4 26 U.S.C.A. § 6334 (West 2013). 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”); compare, 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.A.§ 6334 (West 2013).

5 26 U.S.C.A. § 6323(a)(West 2013)


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.8 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.9

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.10

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.11 This can have significant consequences: secured 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.12


9 26 U.S.C.A. § 6323(f)(2)(B) (West 2013); 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 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., Inc.), 412 F3d. 653 (6th Cir. 2005); cert. den. 127 S.Ct. 41 (2006) (“Spearing Tool”). See generally, LoPucki, supra; Edwards, Joshua “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).

12 In Spearing Tool, supra, 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” for the purposes of Article 9, it sufficed to take priority under Federal Tax Lien law. 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
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. 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.13

Under the law prior to the Federal Tax Lien Act of 1966, the "choateness" doctrine was used to obtain this result.14 This doctrine gave the Federal Tax Lien priority over after-acquired property because the existing creditor's interest in such property was only "inchoate" when the security interest attached, and did not become "choate" until after the tax lien had attached.15

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 obtained after the tax lien was filed.16 The same result

person” thus requiring an exact name match and denying priority when the tax lien filing omitted “Civil” from the name “Crystal Cascades Civil, LLC”)

13 26 U.S.C.A. § 6323(h)(1)(A)(West 2013); United States v. McDermott (In re McDermott) 507 U.S. 447, 452-3 (1993); 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).

14 “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)


16 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”
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.\textsuperscript{17}

It should be noted than 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 although generally there must be additional performance before those rights can be enforced; contract rights will often be "in existence" before the tax lien is filed.\textsuperscript{18} 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.

\section*{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.

\textsuperscript{17} Tri-River Chemical Co. \textit{v.} TNT Farms (\textit{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, supra (finished goods); but see, Bloomfield State Bank, supra, discussed in Moratzka, Andrew “Security Interests vs. Federal Tax Liens and After-Acquired Property vs. Proceeds” 30 AM. BANKR. INST. J. 24 (Nov. 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.”

\textsuperscript{18} 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. \textit{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).
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 prefilling; (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.19

Of much more general practical significance is the provision which partially protects the holders of 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 45 days following the filing of the Federal Tax Lien.20 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.21

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.


20 Texas Oil & Gas v. United States, 466 F.2d 1040 (5th Cir. 1972) (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 & Associates v. American National Bank (In re Rallis & Associates, Inc., 114 B.R. 744, 746 (Bankr. W.D. Okla. 1990) (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 November 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 National Fin. Alternatives, Inc. 96 B.R. 844, 848-851 (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.”)

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.

C. STATUTORY THIRD-PARTY EXEMPTIONS

The IRS 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:

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);
9. Certain insurance contracts; and
10. Bank loans secured by savings deposits, if the bank had no notice of the tax lien.

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.

D. LENDER'S CHECKLIST

If the lender is engaged in purchase money financing or one of the handful of other exempted


23 “[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).
transactions, it need not attempt to check into whether a tax lien has been perfected against the borrower before funding.

If the lender is engaged in ordinary financing transactions (especially including floating lien financing), 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 on 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.24

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 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 a significant source of recovery, the lender can best protect that lien only by checking UCC 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 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.25

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

24 A Federal Tax Lien filing is effective for slightly more than 10 years. During that period, it remains effective regardless of changes in the taxpayer’s place of residence. To extend the effectiveness of the Federal Tax Lien and to preserve its lien priority beyond 10 years, the Federal Tax Lien must be refilled 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, Zennicker, supra, 63 TENN L. REV. at 590-592.

25 See, note 12, supra.
from subsequent avoidance as a preference under section 547(c)(6) of the Bankruptcy Code.\textsuperscript{26} Similarly, any prepetition sale under the lien is immune from avoidance.\textsuperscript{27} Finally, although the representative of the bankruptcy estate is treated as a \textit{bona fide} purchaser of real property for most purposes, it cannot use that status to defeat a Federal Tax Lien.\textsuperscript{28}

\textbf{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 $70,000. On March 10, the IRS files an $80,000 tax lien against Blackacre; the following day, the debtor files a bankruptcy case and sells Blackacre.\textsuperscript{29}

The debtor may avoid the judgment lien as a preference and preserve it for the benefit of the estate, thereby obtaining the first $70,000 of the proceeds of sale for the benefit of creditors generally.\textsuperscript{30} The tax lien cannot be avoided as a preference, so the IRS will get the remaining $30,000 from the proceeds of the sale.

Only if the IRS has seized but not yet sold tangible 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).\textsuperscript{31} 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 debt to the IRS because the levy itself operated to transfer ownership to the IRS, rendering the property immune to a subsequent turnover demand, but that argument has been rejected by the weight of authority.\textsuperscript{32}

\textsuperscript{26} 11 U.S.C.A. § 547(c)(6) West 2013); \textit{See, e.g., In re Rogers Refrigeration, Inc.}, 33 B.R. 59, 60 (Bankr. D. Or. 1983).

\textsuperscript{27} \textit{Rogers Refrigeration, Inc.}, 33 B.R. at 60; \textit{see also} 11 U.S.C.A. § 547(b)(5) (West 2013). 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. \textit{In re K & L Interiors, Inc.}, 34 B.R. 188 (Bankr. D. Or. 1982).

\textsuperscript{28} \textit{See} 11 U.S.C.A. § 545(c) (West 2013); \textit{United States v. Battley (In re Berg)} 188 B.R. 615 (B.A.P. 9th Cir. 1995).

\textsuperscript{29} In this article, “debtor” will often refer to the person in control of the bankruptcy case, whether a “debtor-in-possession” or a “trustee.”


\textsuperscript{32} The IRS’ contentions were initially adopted by some courts; \textit{see}, Altman \textit{v. Commissioner of Internal Revenue Service}, 83 B.R. 35 (D. Haw. 1988) (District court determined that ownership of cash was transferred to IRS upon prepetition levy; turnover motion denied, \textit{Whiting Pools} distinguished); \textit{In re Professional Technical Serv., Inc.}, 71 B.R. 946 (Bankr. E.D. Mo. 1987) (\textit{Whiting Pools} analyzed and
B. CASH COLLATERAL

The broad scope of the Federal Tax Lien, including within its reach all property of the taxpayer, clearly gives the IRS a lien against "cash collateral" and therefore entitles the IRS the protections afforded to creditors holding such liens.33 "Cash collateral" is defined in 363(a) of the Bankruptcy Code as cash, negotiable instruments, and other cash equivalents in which a creditor has a security interest. 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. In Chapter 11 reorganization cases, debtors routinely negotiate with the holders of floating liens for cash collateral orders through which the creditor permits the use of cash collateral in business operations in return for, among other things, a replacement lien on post-bankruptcy assets.

If a bankruptcy case is filed promptly after the recodarion 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.34 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 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

33 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.

34 See discussion in note 16, supra, but see, 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).
Federal Tax Lien on January 1.

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.

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 cash collateral order should be negotiated only with the IRS. The Bank is entitled to nothing with respect to the accounts receivable.

In addition to the types of remedies and protections ordinary lien creditors seek in negotiating consensual cash collateral orders in Chapter 11 cases, the IRS may seek provisions minimizing the danger of the accrual of (new) post-petition taxes, for example, through the imposition of a payroll service to insure payment of post-petition withholding taxes. On the other hand, the IRS may be barred from negotiating principal repayment provisions, since if the case is ultimately converted to Chapter 7, the tax lien will be automatically subordinated to various unsecured obligations.35

C. PROPERTY ACQUIRED POST-PETITION

The Federal Tax Lien probably does not extend to property acquired post-petition, although that result must be found in the definition of a secured claim, rather than in Section 552 of the Bankruptcy Code, the provision which ordinarily overrides after-acquired property clauses in the bankruptcy cases.36


Section 552 of the Bankruptcy Code does not prevent the Federal Tax Lien from attaching to property acquired post-petition. Section 552 generally frees property acquired post-petition from the effect of any lien resulting from a prepetition "security agreement." Since the Federal Tax Lien is nonconsensual and does not depend on a "security agreement," section 552 does not prevent the Federal Tax Lien from attaching to post-petition property.

Section 506 of the Bankruptcy Code, however, does prevent the IRS's secured claim from increasing based on post-petition accumulations. Under section 506, the IRS's secured claim is determined as of the commencement of the case. The Federal Tax Lien is ineffective to the extent that the IRS's claim is unsecured or undersecured as of the commencement of the case; section 506(d); and subsequent (post-petition) accumulations of property by the bankruptcy estate cannot thereafter increase the amount of the IRS's secured claim for bankruptcy purposes.

Section 506(d), however, comes into play only in the context of a judicial adjudication; if no section 506(d) action is commenced, does the Federal Tax Lien attach to post-petition property? Section 506(d) by its terms is inapplicable if "a party in interest has not requested that the court determine and allow or disallow such claim." The courts have therefore held that a tax lien is unaffected by bankruptcy unless an objection to claim or equivalent action is timely presented under section 506(d). On the other hand, attempts to confirm a Plan of Reorganization or even to make a distribution may be viewed as a de facto section 506 action.

Query: If the value of the IRS's collateral decreases during the bankruptcy case, will it be allowed to assert a lien against post-petition property to the extent necessary to secure the IRS's claim, determined as of the commencement of the bankruptcy case? Such a result is consistent with the foregoing section 506 analysis and provisions such as section 507(b).

D. EXEMPT PROPERTY

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


39 In re National Fin. Alternatives, Inc., 96 B.R. 844, 848 (Bankr. N.D. Ill. 1989); Dente/Pender supra, 60 B.R. at 165; 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).

40 Frost, supra, 19 B.R. at 808.

41 In re Tarnow, 749 F.2d 464, 465 (7th Cir. 1984); In re Simmons, 765 F.2d 547, 556 (5th Cir. 1985); In re Thomas, 883 F.2d 991, 996-98 (11th Cir. 1989).

42 See Frost, supra, 19 B.R. at 808 (attempt to confirm Chapter 13 Plan resulted in § 506(d) determination); Dente/Pender, supra, 60 B.R. at 165 (attempt to obtain approval of adequate protection stipulation with third party creditor led to § 506(d) determination of Federal Tax Lien).
Property exempt under state or bankruptcy law is not exempt from a Federal Tax Lien. As a consequence, the IRS may levy upon exempt property immediately after a discharge is entered.

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. 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."

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. The Ron Pair opinion is founded on a literal parsing of the language of section 506(b),

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43 See, footnote 4, supra.
44 11 U.S.C.A. § 522(c)(2)(B) (West 2013); 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))).
46 Prior to the decision of the United States Supreme Court in United States v. Energy Resources 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. 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).
47 Ron Pair, supra, 495 U.S. at 248-9.
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.48 Post-petition interest accrues at the statutory rate. 49

Penalties: Under the Bankruptcy Act, penalties were not allowed, even if secured, under the rule of Simonson v. Grandquist.50 Simonson was founded upon the language of section 57j of the Bankruptcy Act and a policy in favor of "the prohibitions 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."51

Under the Bankruptcy Code, prepetition penalties52 are generally allowed and enjoy the status of the underlying claim (i.e., secured, priority, or unsecured).53 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 Pair54 suggests that the language of the statute should be determinative of this analysis. Courts have routinely allowed penalties in Chapter 11 cases without discussion.55 Early attempts to equitably subordinate pre-petition penalties were

48 “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.”)


51 Id. At 40-41.

52 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 Construction Co., 886 F.2d 1101 (9th Cir.1989); In re Allied Mechanical, Inc., 885 F.2d 837 (11th Cir.1989); United States v. Friendship College, Inc., 737 F.2d 430 (4th Cir.1984); United States v. Flo-Lizer (In re Flo-Lizer, Inc.), 916 F.2d 363, 364-65 (6th Cir. 1990)

53 For secured penalties, see footnote 55, infra; for priority penalties, see 11 U.S.C.A. § 507(a)(8)(G) (West 2013); 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)

54 Ron Pair, 109 S. Ct. at 1030 (“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). 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’ ”).

55 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)
categorically rejected by the Supreme Court.56

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.57 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.58

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.

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. He must also pay interest on the tax lien from January 1 to date because the debt was oversecured, but he need not pay the post-bankruptcy penalty, pursuant to the Ron Pair decision.

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.59 A

56 Reorganized CF & I Fabricators, supra.

57 Compare 11 U.S.C.A. § 507(a)(7)(G) (West Supp. 1990), specifically affording priority status to the penalty associated with a priority tax claim, provided that the penalty is in compensation for actual pecuniary loss.

58 Ron Pair, 109 S. Ct. at 1030, see note 46, supra; Bondholders Committee v. Williamson County (In re Brentwood Outpatient, Ltd.), 43 F.3d 256, 263 (6th Cir. 1994) (“penalties which accrue postpetition 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); Matter of Johnson, 146 F.3d 252 (5th Cir. 1998; In re Cousins, 209 F.3d 38, 41 (1st Cir. 2000).

59 11 U.S.C.A. § 724(b) (West 2013). Under prior law, the Section 724(b) subordination explicitly applied to both Chapter 7 and failed Chapter 11 administrative claims; see Air Beds, supra (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., Inc.), 465 B.R. 218, 224 (Bankr. D.N.M. 2011). Giving effect to the asserted intent of the BAPCPA
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). 60

Claims for penalties, even if secured, are subordinated to all other (i.e., general unsecured) claims in a Chapter 7 liquidation. 61 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). 62 On the other hand, the possibility of a future 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. 63

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

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60 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”).


62 See 11 U.S.C.A. § 103(b) (West 2013); 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”); Reorganized CF & I Fabricators, supra.

63 Air Beds, supra (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 was ultimately converted).
treatment to the tax lien claim.\(^{64}\) That treatment requires payment in full, with interest at the statutory rate, within five years following the petition date, and treatment “not less favorable” that the treatment afforded the most favored general unsecured creditors.\(^{65}\) 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.\(^{66}\) 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.\(^{67}\)

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

The general 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.\(^{68}\) Payment of administrative and priority claims in full, together with some payment to an unsecured class, are generally preconditions to a confirmable Plan;\(^{69}\) if those preconditions can be met, an analysis of the best interests of creditors test in this regard 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. 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


\(^{69}\) 11 U.S.C.A. § 1129 (a)(9) (West 2013) 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 requires some distribution to a junior (i.e., general unsecured) class.
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.

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, 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 of confirmation. Even if the debtor could borrow $15,000 to fund these required payments,

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70 See, In re Colin, 44 B.R. 806 (S.D. N.Y. 1984) (Grappling with the problem that absent subordination of 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).

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 (potentially including unpaid administrative expenses of any previously unsuccessful Chapter 11 reorganization), and through 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.