FEDERAL TAX LIENS: A GUIDE TO THE PRIORITY SYSTEM OF SECTION 6323 OF THE INTERNAL REVENUE CODE

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This article presents an analysis of the system of priorities for federal tax liens contained in section 6323 of the Internal Revenue Code (IRC),[1] which is intersected by the priority system contained in the Uniform Commercial Code (UCC).[2] The article begins with a general introduction of federal tax liens, proceeds to discuss the problems posed by the "choate lien" and "no property" doctrines, relates the purposes and functions of the Federal Tax Lien Act of 1966 (the Act),[3] and analyzes the system of priorities under the Act, with references to the more noteworthy of the proposed regulations published by the Treasury Department.[4]

I. INTRODUCTION

The federal tax lien is a secret lien arising at the time the tax is assessed. IRC section 6321[5] provides:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount [with interest, penalty and costs] shall be a lien in favor of the United States on all property and rights to property, whether real or personal, belonging to such person.[6]

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[1] Int. Rev. Code of 1954, § 6323.

[2] Uniform Commercial Code § 301 et seq. Although mentioned in passing, there is included no detailed explanation of the priority afforded claims owing to the United States by 31 U.S.C. § 191 (1970), popularly termed "section 3466," under which certain types of insolvency proceedings are invoked.

[3] Act of Nov. 2, 1966, Pub. L. No. 89-719 § 101(a).

[4] Among the additional materials concerning federal tax liens are: W. Plumb, Jr., Federal Tax Liens (3d ed. 1972) (the most comprehensive treatment); Babitt & Freiman, The Priority of Federal Claims: Selected Problems and Theoretical Considerations, 24 Case W. Res. L. Rev. 521 (1973); Coogan, The Effect of the Federal Tax Lien Act of 1966 Upon Security Interests Created Under the Uniform Commercial Code, 81 Harv. L. Rev. 1369 (1968); Creedon, Assignments for Security and Federal Tax Liens, 37 Fordham L. Rev. 535 (1969); Kennedy, From Spokane to Vermont: The Campaign of the Federal Government Against the Inchoate Lien, 50 Iowa L. Rev. 724 (1965); Kennedy, The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien, 63 Yale L.J. 905 (1954); Mellinkoff, The Language of the Uniform Commercial Code, 77 Yale L.J. 185 (1967); Plumb, Federal Tax Liens and Priorities—Agenda for the Next Decade, 77 Yale L.J. 228 (1967); Young, Priority of the Federal Tax Lien, 34 U. Chi. L. Rev. 723 (1967).

[5] Int. Rev. Code of 1954, § 6321.

[6] Id.

The lien continues to encumber the present and after-acquired property of the taxpayer until the tax liability is satisfied or becomes unenforceable because of the lapse of time.[7]

An assessment that is based upon admitted liability set forth in a tax return and that is in excess of the amount paid is made by the recording of the liability on a schedule maintained in the office of the District Director of the Internal Revenue Service.[8] In the case of an understatement of liability, the amount of understatement is assessed and recorded when the tax return is processed and the understatement discovered. In either case, the Government then makes formal demand for payment upon the taxpayer either by personal service or by mail. Although the tax lien attaches as of the time of assessment, it cannot be enforced until demand is made upon the taxpayer.

The tax lien is effective against the taxpayer and most unsecured creditors without filing. A public notice of tax lien, however, must be filed to make the lien effective against prior purchasers, holders of security interests, mechanic's lienors, or judgment lien creditors.[9] IRC section 6323(f) provides for filing of a notice of a tax lien: (1) in the case of real property, in the office designated by the state in which the realty is located; and (2) in the case of personal property, whether tangible or intangible, in the office designated by the state in which the property is situated.[10] Personal property is deemed situated in the state of the taxpayer's residence rather than in the state of his domicile. If a state fails to designate an office for filing or if it designates more than one office for filing, the notice of lien is to be filed in the office of the Clerk of the United States District Court for the district in which the property is situated.[11]

In order to make a tax lien effective against certain third party interests, a notice must be filed. To keep the lien effective against these third party interests beyond the initial six year period,[12] the Government must refile its notice of lien within the one year period ending six years and thirty days after the date of the assessment. Further extensions are possible and require similar refiling during each successive six year interval affected. The notice must be refiled in the office of the original filing and, if the taxpayer has moved, in the office designated by the state in which the taxpayer resides at the time of the required refiling.[13] However, if the Government refiles

[7] See Glass City Bank v. United States, 326 U.S. 265 (1945).
[8] Int. Rev. Code of 1954, § 6203.
[9] Id. § 6323(a).
[10] Id. § 6323(f).
[11] See United States v. Estate of Donnelly, 397 U.S. 286 (1970).
[12] Int. Rev. Code of 1954, § 6502. See text at note 9 supra.
[13] Int. Rev. Code of 1954, § 6323(g).

after the one year period ending six years and thirty days after the date of assessment, the late refiling is considered a new filing which may be subordinate to third party interests arising after the original filing.[14]

IRC section 6322[15] provides that the tax lien continues until the liability for the amount assessed, or a judgment against the taxpayer arising from such liability, is satisfied or becomes unenforceable by reason of lapse of time.[16] The statutory lapse of time is the period of six years from the date of assessment of the tax or such extension of time as may be agreed upon by the Government and the taxpayer.[17] In addition to the taxpayer's agreement to prolong the period of collection, the running of the statute of limitations may be suspended during the period that assets of the taxpayer are in control or custody of a court, and during the period in which the taxpayer is outside of the United States for six or more consecutive months.[18] The Government's filing of a lawsuit against the taxpayer may also toll the statute of limitations. If the Government obtains a judgment, the period for collection may remain open indefinitely.[19]

II. Tax Liens Prior to the Federal Tax Lien Act of 1966

A discussion of some of the important pre-1966 tax lien cases and the choate lien doctrine is essential to an understanding of the Act's system of priorities. For the past twenty years the federal tax lien has held the upper hand in its battle with competing liens. Under the tax lien law as it developed for insolvent taxpayer-debtors, a lien competing with the federal tax lien was required to be "choate" and perfected. The court-created concept of choateness required that the lienholder establish the identity of the lienor, the property subject to the lien, and the fixed amount of the lien.

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[14] For example, the Government makes a tax assessment against A on February 1, 1967. On April 1, 1967, the Government files a notice of tax lien in the appropriate state office. On June 1, 1972, A agrees to a three-year extension of the collection period to February 1, 1976. On March 1, 1973, A grants a security interest in all of its equipment to B, who has no knowledge of the agreement extending the collection period. On April 1, 1973, the Government refiles a tax lien notice against A in the appropriate state office. B's security interests will take priority over the tax lien because the Government failed to refile within six years and thirty days after the date of the tax assessment against A. Consequently, the Government's refiling is treated as an original filing. If the Government had refiled on March 1, 1973, the tax lien would have priority over B's security interest.

[15] Int. Rev. Code of 1954, § 6322.

[16] Id.

[17] Id. § 6502.

[18] Id. § 6503(b).

[19] See United States v. Overman, 424 F.2d 1142 (9th Cir. 1970). But see United States v. Home Beneficial Life Ins. Co., 73-1 CCH U.S. Tax Cas. ¶ 9345, at 80747 (E.D. Tenn. 1973).

A. *Choate Lien Doctrine*

The choate lien doctrine was developed by the Supreme Court for the purpose of determining the priority rules for tax liens. Prior to its 1950 decision in *United States v. Security Trust & Savings Bank*,[20] the Court had developed a doctrine concerning the priority granted to a federal tax lien in situations where the taxpayer-debtor was insolvent. This doctrine relied upon the general federal priority provisions contained in what is popularly termed, "section 3466":[21]

> Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.[22]

Thus, in *Spokane County v. United States*,[23] a pre-1950 decision, the Supreme Court held that federal priority under section 3466 prevailed over local tax liens which antedated the event (receivership) which triggered the application of section 3466.[24] This result followed because the local liens were not, at the relevant point in time, "specific," "perfected," or "complete" under state law. Something more had to be done before the local liens achieved a degree of specificity or perfection which would entitle them to prevail over the federal lien arising subsequently.[25]

The first case in which this choate lien doctrine was applied to a priority dispute under the Federal Tax Lien Act was *United States v. Security Trust & Savings Bank*.[26] That case, decided in 1950, involved the priority between an attachment lien and a subsequently arising federal tax lien. Because the attachment lien was subject to certain contingencies which could prevent its enforceability, the lien was considered inchoate and thus inferior to the federal tax lien.[27] The Court in *Security Trust* relied on cases under the federal

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[20] 340 U.S. 47 (1950).
[21] 31 U.S.C. § 191 (1970).
[22] Id.
[23] 279 U.S. 80 (1929).
[24] Id. at 85-95.
[25] Id. at 93-94.
[26] 340 U.S. 47 (1950).
[27] Id. at 51.

priority provisions of section 3466.[28] Consequently, it remained uncertain for some time whether the Federal Tax Lien Act standard of choateness was as stringent as the standard applied under the federal priority provision of section 3466. In *United States v. Gilbert Associates, Inc.*,[29] the circumstances permitted the United States to claim a tax lien and a section 3466 priority. In holding that the section 3466 lien had priority because the competing lienholder had not gained title or possession of the disputed property, the Supreme Court chose to rely solely on section 3466.[30] This suggested that, in the Court's view, the tax lien statute had a weaker priority and that the choateness test of the tax lien statute was less stringent than the section 3466 test.[31]

This suggestion appeared to be confirmed in *United States v. New Britain*,[32] where the Court held that under Connecticut law, a municipal tax lien assessed and filed prior to a later assessed federal lien was sufficiently choate to prevail because it attached to specific parcels of real estate.[33] The municipal lien was considered perfected in the sense that there was "nothing more to be done to have a choate lien [since] the identity of the lienor, the property subject to the lien and the amount of the lien [was] established."[34] The Court indicated, however, that the municipal lien would not have prevailed over a subsequently arising section 3466 lien upon the property of an insolvent.[35]

As a result of the Supreme Court's 1956 decision in *United States v. White Bear Brewing Co.*,[36] however, the test of choateness of a lien competing with a federal tax lien, appeared to be more stringent than previously suggested. There the Court held that a federal tax lien was prior to a statutory mechanic's lien, even though the mechanic's lien was specific, prior in time, perfected in the sense that everything possible under the state law had been done to make it choate, and despite the fact that the mechanic's lien was being enforced before the federal tax lien arose.[37] In that case, before the assessment of the federal tax, certain mechanics completed their work on a building, recorded their lien and sued to enforce their lien in a local court. Although the only step lacking to

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[28] Id.
[29] 345 U.S. 361 (1953).
[30] Id. at 365.
[31] Id. at 366.
[32] 347 U.S. 81 (1954).
[33] Id. at 84.
[34] Id.
[35] Id. at 85.
[36] 350 U.S. 1010 (1956) (per curiam).
[37] Id.

settle the amount owing to the mechanics was a final judgment, the Court held that the mechanic's lien was inchoate.[38] The Court did not indicate whether it relied on section 3466 or IRC section 6323 for finding federal priority.

After the *White Bear Brewing* decision, however, the Supreme Court helped to clarify the law of federal tax liens by confirming its previous intimation that the choateness test was not as severe for liens arising under IRC section 6321 as it was for liens arising under section 3466.[39] In its 1964 decision in *United States v. Vermont,*[40] the Court found a competing state tax lien sufficiently choate, even where the state lien covered all of the debtor's property.[41] In that case the ingenious Vermont legislature adopted the provisions of the federal tax lien statute as its state statute for the collection of state taxes. After Vermont had made a tax assessment against a solvent taxpayer, the United States made an assessment. The Court held that the antecedent state lien was sufficiently choate to obtain priority over the later federal tax lien.[42]

Until 1958, the choate lien doctrine had never been applied to defeat consensual security interests. Government counsel had acquiesced in the priority of such interests and instead attacked statutory, judicial and other non-consensual liens. However, in *United States v. R.F. Ball Construction Co.*,[43] the Supreme Court applied the theory of the inchoate lien to a consensual security interest. In that case, Ball, the principal contractor in a Texas housing project, subcontracted some of the work to Jacobs, the taxpayer.[44] Ball required Jacobs to obtain a performance bond from a surety company. Jacobs assigned to the surety all rights to sums becoming due to Jacobs under the Texas housing project. The bond was executed on July 23, 1951, but the surety never filed under the Texas accounts receivable statute.[45] On April 4, 1952, Jacobs entered into a similar arrangement with the same surety covering a second project in Kentucky. On April 30, 1953, the sum of $13,228 became due to Jacobs from the Texas project. Ball did not pay Jacobs because Jacobs had not paid his material men. In late 1953, and early 1954, Jacobs defaulted on the Kentucky project and the surety was required to pay $12,979. In March and May of 1953, federal taxes were assessed against Jacobs and notices of liens were filed in May,

[38] See id. at 1011 (dissenting opinion).
[39] United States v. Vermont, 377 U.S. 351 (1964).
[40] 377 U.S. 351 (1964).
[41] Id. at 358.
[42] Id. at 359.
[43] 355 U.S. 587 (1958) (per curiam).
[44] Id. at 588.
[45] Texas Rev. Civ. Stat. Ann. art. 260-1.

June and September 1953. Ball filed an interpleader to determine whom it should pay.[46] The Supreme Court held that the instrument representing the surety's lien was inchoate and unperfected and thus subordinate to the federal tax lien.[47]

This decision placed in serious doubt the ability of a security device to compete with a federal tax lien filed before the secured property was acquired or before a future advance was actually made. In a number of cases after the *Ball* decision, various security interests were subordinated to federal tax liens.[48] It appeared that any security interest which was indefinite at any point as to the precise amount of the debt secured, or the identity of the collateral, was inchoate and subordinate.[49]

Some comfort, however, was given to secured parties by the Supreme Court's 1961 decision in *United States v. Crest Finance Co.*[50] In that case, Twin Excavating Company (Twin), a subcontractor, had contracted with Standard-Crowley-Jackson (Standard), the principal contractor, to supply labor and materials for the construction of the Illinois Toll Road.[51] From March through June, 1958, Crest Finance Company (Crest) loaned $67,722 to Twin, secured by an assignment of the accounts receivable from Standard. Standard was notified of the assignment and made some payments to Crest. Under the Illinois accounts receivable statute, this assignment was perfected when made and no filing was required.[52] In August and November, 1958, federal tax liens were assessed against Twin and a notice of tax lien was filed on October 9, 1958. At that time, Standard's debt to Twin was not definitely determined. The United States argued that the assignment of the accounts receivable was inchoate because the exact amount of the accounts receivable was unknown.[53] In affirming the district court, the Seventh Circuit held that the case was controlled by the *Ball* decision and that the assignment was inchoate.[54]

After Crest petitioned the Supreme Court for certiorari, the Solicitor General submitted a memorandum to the Court conceding

[46] 355 U.S. at 589.

[47] Id. at 587.

[48] See, e.g., United States v. Chapman, 281 F.2d 862 (10th Cir. 1965); Bankhead v. Maryland Cas. Co., 197 F. Supp. 879 (D. La. 1961); Arthur Co. v. Chicago Paints, Inc., 175 F. Supp. 50 (D. Minn. 1959); First State Bank v. United States, 166 F. Supp. 204 (D. Minn. 1958).

[49] See Comment, Federal Tax Liens and Assignees of Accounts Receivable: Priority Without Reason, 29 U. Chi. L. Rev. 548 (1962); Note, Applicability of the "General and Unperfected Lien" Doctrine to Contractual Liens, 43 Minn. L. Rev. 755 (1959).

[50] 368 U.S. 347 (1961).

[51] United States v. Crest Fin. Co., 291 F.2d 1, 2 (7th Cir. 1960).

[52] Ill. Rev. Stat. ch. 121 ½, § 220(c) (1959).

[53] 291 F.2d at 3.

[54] Id.

that if under Illinois law the assignment of the accounts receivable need not be recorded, the assignment was a choate lien under the principles set forth in *United States v. New Britain*. The Supreme Court concurred with the Solicitor General's opinion and in a per curiam opinion vacated the judgment and remanded the case to the Seventh Circuit.[55] The Seventh Circuit then held that Crest's lien was perfected under Illinois law without filing and was entitled to priority over subsequent tax liens.[56]

Following the *Crest* decision, the Supreme Court indicated in *United States v. Pioneer American Insurance Co.*[57] that consensual liens must meet the same standards of choateness as non-consensual liens.[58] In that case two Arkansas taxpayers assumed a note and a deed of trust obligating them to pay a reasonable attorney's fee in the event of default on the note. The taxpayer subsequently defaulted and the mortgagee brought suit to foreclose the deed of trust. The local chancery court fixed the attorney's fee at $1,250 and awarded the mortgagee's claim for attorney's fees priority over a tax lien filed after the commencement of the foreclosure suit but before the entry of the foreclosure decree.[59] The Supreme Court held that the federal tax lien was entitled to priority because the mortgagee's claim for attorney's fees was inchoate when the tax lien was filed.[60] The Court reasoned that at that time the amount of the attorney's fee was uncertain and that there was no showing that the mortgagee had become obligated to pay and had paid any attorney's fee at that time.[61]

This decision appeared to ignore the clear language of pre-1966 section 6323, which provided that a tax lien was not valid against any mortgagee until the notice of lien was filed.[62] Under that section, mortgagees were in a special class distinct from other lienhold-

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[55] 347 U.S. 81 (1954) (per curiam).

[56] United States v. Crest Fin. Co., 302 F.2d 568, 570 (7th Cir. 1962). A similar result was reached in Hammes v. Tucson Newspapers, Inc., 324 F.2d 101 (9th Cir. 1963), where a debtor-taxpayer assigned certain installment payments to be received under a real property sales contract. Although the assigned installment in controversy did not become due until after the federal tax lien was filed, the court held that the assignment was valid. Id. at 102. The court deemed the lien choate because it represented an "unconditional" present right to receive money in the future. Id. at 103. See also United States v. Ray Thomas Gravel Co., 373 S.W.2d 333 (Tex. Civ. App. 1963), rev'd on other grounds, 380 S.W.2d 576 (Tex. Sup. Ct. 1964).

[57] 374 U.S. 84 (1963).

[58] See id. at 88-91.

[59] Id. at 86.

[60] Id. at 89.

[61] Id. at 90.

[62] Prior to 1966, § 6323(c)(1) read, in part: "[a] lien shall not be valid . . . as against any mortgagee . . . if at the time of such mortgage . . . such mortgagee is without notice or knowledge of the existence of such lien." Int. Rev. Code of 1954, § 6323(c)(1).

ers. The requirement that a mortgagee's lien become choate before notice of the federal tax lien was filed removed any uniqueness previously accorded to mortgagees under section 6323 and placed mortgagees in the same category as other lienholders. Thus, the mortgage has to meet the *New Britain* requirements of choateness before the federal tax lien notice was filed.

B. *"No Property" Doctrine*

Among the noteworthy pre-1966 tax lien cases are the "no property" line of cases decided after the *Ball* decision. The "no property" decisions held that because the federal tax lien attached to all "property and rights of property belonging to" the taxpayer, the lien did not attach to property belonging to someone other than the taxpayer.[63] The federal tax lien could only attach to that interest of a taxpayer which existed under applicable state law. The first case in which the "no property" doctrine was applied to limit the effectiveness of a tax lien was *United States v. Bess*.[64] There, the Supreme Court stated that the taxpayer's property interests in a life insurance policy was to be determined by state law.[65] Applying state law, the Court held that the federal tax lien attached only to the proceeds which represented the cash surrender value.[66] The taxpayer's "property" was only a right to receive the cash surrender value of the policy, not the full insurance proceeds payable upon his death.

The *Bess* decision was relied upon in *Aquilino v. United States*[67] and in *United States v. Durham Lumber Co.*,[68] where the Supreme Court applied the no-property doctrine and refused to give a fund to the government because under state law, the taxpayer had never acquired any property rights in the fund.[69] Both cases involved money owing to subcontractors and the Court concluded that since under state law the taxpayer-general contractor did not have any property interest in the money due him under the contract to the extent that the subcontractors remained unpaid, the federal tax lien could not attach to any money.[70]

Shortly after the Supreme Court rendered the *Aquilino* decision, the Third Circuit decided *In re Halprin*.[71] In that case,

[63] United States v. Bess, 357 U.S. 51 (1958); United States v. Durham Lumber Co., 363 U.S. 522 (1960); Aquilino v. United States, 363 U.S. 509 (1960).

[64] 357 U.S. 51 (1958).

[65] Id. at 56.

[66] Id.

[67] 363 U.S. 509 (1960).

[68] 363 U.S. 522 (1960).

[69] *Aquilino*, 363 U.S. at 513; *Durham Lumber*, 363 U.S. at 525-26.

[70] Id.

[71] 280 F.2d 407 (3d Cir. 1960).

Halprin had been engaged by Doniger, a garment manufacturer, to sew and complete jackets. Under the contract, Halprin would receive a fixed sum upon delivery of the jackets to Doniger. The United States filed a tax lien notice against Halprin after the contract was made. Halprin then borrowed from a finance company in order to meet his payroll and irrevocably assigned to the finance company, as security for the loan, all sums to become due under his contract with Doniger. Thereafter, Halprin delivered some completed jackets to Doniger. In Halprin's bankruptcy proceeding, the United States and the finance company both claimed the money owed by Doniger. The Third Circuit held that the federal tax lien did not attach to a contingent or conditional right.[72] Accordingly, Doniger's conditional promise to pay did not constitute "property belonging to" Halprin so as to be subject to the tax lien. The Court also emphasized that the loan from the finance company was used to finance Halprin's contract with Doniger, so that the finance company was in a position similar to a purchase money mortgagee.[73]

The *Halprin* case was clear authority for the application of the no-property doctrine to assignments of collateral. Except for the purchase money aspects, the decision was a difficult precedent for the Government, because it allowed a taxpayer to assign future monies effectively, even after a notice of tax lien had been filed.[74]

III. Purpose of the Federal Tax Lien Act

The Federal Tax Lien Act of 1966 was the first comprehensive revision of those internal revenue laws which concern the relationship of federal tax liens to the interests of creditors other than the United States. The main purpose of the Act was to conform the relevant provisions of the Internal Revenue Code to the concepts promulgated in the UCC. Because the UCC evolved from business practices requiring the protection of secured creditors, Congress thought it desirable to conform federal tax liens with the recent developments in commercial practice under the UCC.[75]

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[72] Id. at 410.

[73] Id.

[74] There is some authority contrary to the *Halprin* decision. In United States v. L.R. Foy Constr. Co., 300 F.2d 207 (10th Cir. 1962), The Tenth Circuit rejected the "no property" doctrine but held for the assignee on the theory that its lien was choate. Id. at 211. In that case, prior to the filing of the notice of tax lien, an assignment was made to secure the taxpayer's indebtedness to a bank. Some of the indebtedness was acquired after the date of filing of the federal tax lien. Id. at 209. The bank argued that the "no property" doctrine protected the full indebtedness against the tax lien. The Tenth Circuit held, however, that the assignment was similar to a mortgage and that the taxpayer's "property" was its equity of redemption. Id. at 211. Consequently, the bank's assignment was entitled to priority only to the extent that it was choate on the date of filing of the tax lien. See discussion in Creedon, Assignments for Security and Federal Tax Liens, 37 Fordham L. Rev. 535, 549 (1969).

[75] See S. Rep. No. 1708, 89th Cong., 2d Sess. (1966).

Prior to 1966, purchasers and certain secured creditors had priority over federal tax liens until a notice of the tax lien was filed in a designated office. The category of secured creditors entitled to priority basically was limited to mortgagees, pledgees, purchasers and judgment creditors, with extra protection allowed pledgees of securities and purchasers of motor vehicles. The dominant effect of the Act was to improve the position of secured creditors by: (1) extending protection against unfiled tax liens to mechanic's lienors;[76] (2) providing a clear definition of certain classes of secured creditors already protected regardless of choateness at the time notice of the tax lien was filed;[77] (3) broadly increasing the classes of creditors holding property interests for whom superpriority was to be given even against a noticed tax lien;[78] (4) giving priority status to certain interests created after filing of a tax lien if they arose under specified types of financing agreements entered into before filing of the tax lien;[79] and (5) providing a time period up to 45 days for further protection of some interests after filing of notice of the tax lien.[80] In addition, the Act codified much of the choateness doctrine, although it did not use the familiar language "general and inchoate lien."[81]

IV. Property Covered by the Federal Tax Lien

Section 6321 imposes a lien upon "all property and rights to property, whether real or personal" belonging to the taxpayer.[82] Thus, the initial question is whether a taxpayer had "property" or "rights to property" to which the lien could attach. This question must be answered by the applicable state law which controls the nature of the taxpayer's interest in property.[83] The Act does not create any property rights but merely attaches federally defined consequences to rights existing under state law.[84] For example, if

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[76] Int. Rev. Code of 1954, § 6323(a).

[77] Id.

[78] Id. §§ 6323(b)(1)-(9).

[79] Id. § 6323(c).

[80] Id. § 6323(d).

[81] The House Report accompanying the bill which became the Act stated:

> Under decisions of the Supreme Court a mortgagee, pledgee, or judgment creditor is protected at the time notice of the tax lien is filed if the identity of the lienor, the property subject to the lien, and the amount of the lien are all established at such time . . . . Except as otherwise provided, subsection (a) of new Section 6323 retains this basic rule of Federal law . . . . The holder of a security interest has priority over a Federal tax lien if, at the time notice of the tax lien was filed, the security interest exists within the meaning of Section 6323 (h)(1) . . . .

H.R. Rep. No. 1884, 89th Cong., 2d Sess. 9 (1966).

[82] Int. Rev. Code of 1954, § 6321.

[83] See Aquilino v. United States, 363 U.S. 509, 513 (1960).

[84] See United States v. Bess, 357 U.S. 51 (1958). But see Commissioner v. Estate of Bosch, 387 U.S. 456 (1967).

under the applicable state law, an irrevocable assignment of a life insurance policy by a husband to a wife is bona fide and not in fraud of creditors, that policy could not be reached by a tax lien on the husband's property.[85]

The federal tax lien is not limited to tangible property but is a broad, comprehensive lien which attaches to all of the taxpayer's property except certain exempt property. The exempt property includes wearing apparel, school books, fuels, provisions, furniture and personal effects, books and tools of the trade or profession, unemployment benefits, undelivered mail, certain annuity and pension payments, and workmen's compensation.[86] The federal tax lien even attaches to property which is exempt from creditors' claims under state law[87] and to property acquired by the taxpayer after the time the tax lien arises.[88] It also attaches to a taxpayer's right to certain property which is conditional upon the taxpayer taking certain action,[89] to a taxpayer's interest in property even though that interest is terminable,[90] and to property which the taxpayer is not unconditionally free to transfer.[91]

It now appears that the federal tax lien attaches to a taxpayer's accounts receivable previously collaterally assigned to a third party. In 1972 in *United States v. Trigg*,[92] the no-property doctrine was defeated with respect to such assigned accounts receivable. In that case, a contractor assigned its accounts receivable to a bank. The bank failed to perfect its security interest under the UCC by the filing of a financing statement.[93] The Government served notice of levy upon the contractor's account debtors and received payment for work performed by the contractor. The bank brought an action claiming priority over the tax lien. In awarding priority to the bank, the district court had determined that the contractor's assignment of accounts receivable divested the contractor of any property interest in payments from its account debtors.[94] Therefore, the contractor held no property interest in the progress payments upon which the Government could attach by a tax lien. This result was based on the

[85] See United States v. Burgo, 175 F.2d 196 (3d Cir. 1949).

[86] See Bennsinger v. Davidson, 147 F. Supp. 240 (S.D. Cal. 1956).

[87] See United States v. Heasley, 283 F.2d 422, 429 (8th Cir. 1960) (notwithstanding state homestead exemption, tax lien attached to taxpayer's home); Freed v. New York Life Ins. Co., 241 F.2d 504, 507 (2d Cir. 1959) (tax lien attached to disability insurance proceeds); Campbell v. Campbell, 88 N.J. Super. 63, 67, 210 A.2d 644, 646 (1965) (tax lien attached to alimony payments).

[88] See Glass City Bank v. United States, 326 U.S. 265, 268 (1945).

[89] See United States v. Sullivan, 333 F.2d 100, 110 (3d Cir. 1964).

[90] See Avco Delta Corp. v. United States, 459 F.2d 436, 440 (7th Cir. 1972).

[91] See Leuschner v. First W. Bank & Trust Co., 261 F.2d 705, 708 (9th Cir. 1958).

[92] 465 F.2d 1264 (8th Cir. 1972), cert. denied, 410 U.S. 909 (1973).

[93] Uniform Commercial Code § 9-302.

[94] 465 F.2d at 1267.

Aquilino line of cases,[95] which held that the federal tax lien statute created no property rights but merely attached consequences to rights created under state law.[96]

In reversing the district court's decision, the Eighth Circuit emphasized that the UCC does not classify a debtor's interest in the collateral securing the debt as "property" or "rights of property," the terms used in the *Aquilino* line of cases.[97] The rights and duties of the parties are stated in the UCC without reference to the location of title to the collateral. Since the bank's security interest was unperfected, it was vulnerable to a lien creditor which, as indicated in UCC 9-301, could reach property securing an unperfected interest in accounts receivable. Thus, the court held that the federal tax lien could attach to the accounts receivable.[98] The court then applied the basic federal priority standard, "first in time is first in right," to hold that the federal tax lien took priority over the bank's security-interest, because the bank's security interest was not specific and perfected before the tax lien arose.[99]

A purchase money security interest normally is protected whether or not it arises after a filing of a notice of tax lien. This result is based on the theory that only the taxpayer's equity can be reached by the tax lien. In a general explanation of the Act, a House of Representatives report states:

> Although so-called purchase money mortgages are not specifically referred to under present law, it has generally been held that these interests are protected whenever they arise. This is based on the concept that the taxpayer has acquired property or a right to property only to the extent that the value of the whole property or right exceeds the amount of the purchase money mortgage. This concept is not affected by the Bill.[100]

V. PRIORITIES

Section 6323(a) protects third party interests of certain purchasers, holders of security interests, mechanic's lienors and judgment

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[95] United States v. Durham Lumber Co., 363 U.S. 522 (1960); United States v. Bess, 357 U.S. 51 (1958).

[96] E.g., Aquilino v. United States, 363 U.S. 509, 513 (1960).

[97] 465 F.2d at 1269.

[98] Id.

[99] Id. at 1270. The no property doctrine was similarly defeated in the recent case of United States v. Sterling Nat'l Bank & Trust Co., 494 F.2d 919, 922 (2d Cir. 1974), where the court held that a bank account pledged by a depositor was "property" of the taxpayer. Id. at 922.

[100] H.R. Rep. No. 1884, 89th Cong., 2d Sess. 817 (1966). Rev. Rul. 68-57, 1968-1 Cum.

lien creditors if the interests arose before notice of the tax lien is filed.[101] Even if a filing is made, the tax lien will not prevail against certain subsequently arising interests entitled to so-called superpriority. This superpriority status is given to certain persons without actual notice or knowledge of the filing of the tax lien notice. This category includes purchasers of securities, motor vehicles and properties sold at retail in the ordinary course of business.[102] Priority is also given to certain security interests covered by commercial transaction financing agreements, real property or construction or improvement financing agreements, and obligatory disbursement agreements.[103]

Under the basic federal priority standard, "first in time is first in right," if none of the special rules analyzed below apply, a federal tax lien takes priority over a state-created lien unless the state lien is specific and perfected before the federal tax lien arises.[104] In order to discuss the exceptions to this general rule, it is necessary to turn to some of the definitions contained in the Act.

A. *Definitions*

1. *Security Interests*

IRC section 6323(h)(1) sets forth the following definition of a security interest:

> The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation and (B) to the extent that, at such time, the holder has parted with money or money's worth.[105]

This IRC definition includes security devices not covered by the UCC, such as real estate mortgages and deeds of trust. It is broader than the definition of security interest contained in UCC section 1-201(37), in that it describes the amount of collateral cov-

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Bull. 553, also supports this theory. It states that the Internal Revenue Service will consider a purchase money security interest or mortgage valid under local law to be protected even though it arose after a notice of federal tax lien was filed.

[101] Int. Rev. Code of 1954, § 6323(a).

[102] Int. Rev. Code of 1954, § 6323(b).

[103] Id. § 6323(c).

[104] See United States v. Equitable Life Assurance Soc'y, 384 U.S. 323, 327 (1966).

[105] Int. Rev. Code of 1954, § 6323(h)(1).

ered, measures the extent of the secured party's interest, and requires that the interest be protected against a subsequent judgment lien. The amount of collateral covered, however, is limited to "property . . . in existence" at the time the notice of tax lien is filed.[106]

The security interest exists "to the extent that at the time the [secured party] has parted with money or money's worth."[107] Under the treasury's proposed regulations, the term "money or money's worth" includes money, securities, tangible or intangible property and services.[108] It does not include a relinquishing of dower, curtesy, or other marital rights or any other consideration not reducible to a money value.[109]

2. *Mechanic's Lienor*

According to the Internal Revenue Code, the term "mechanic's lienor" is any person who, under local law, has a lien on real property, or on the proceeds of a contract relating to real property, for services, labor, or materials furnished in connection with the construction or improvement of the real property.[110] The mechanic's lien arises either on the date on which the lien first became valid under local law against subsequent purchasers without actual notice, or on the date on which the mechanic begins to furnish labor, services or materials, whichever date is the more recent.[111]

3. *Purchaser*

A purchaser is defined by the Act as one who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien), in property which is valid under local law against subsequent purchasers without actual knowledge.[112] An interest in property includes a lease of property, a written executory contract to purchase or lease property, an option to purchase or lease property and any interest therein, and an option to renew or extend a lease of property.[113] The term "adequate and full consideration in money or money's worth" means a consideration in money or money's worth having a reasonable relationship to the true value of the interest in the property acquired. This may include the consideration in a bona fide bargain purchase or the consideration in

[106] This language is qualified by Int. Rev. Code of 1954, § 6323(c), which concerns commercial financing agreements.

[107] Int. Rev. Code of 1954, § 6323(h)(1).

[108] Proposed Treas. Reg. § 301.6323(h)-1(a)(3), 38 Fed. Reg. 798 (1973).

[109] Id.

[110] Int. Rev. Code of 1954, § 6323(h)(2).

[111] Id.

[112] Id. § 6323(h)(3).

[113] Id.

an installment purchase contract, even though the purchaser has not completed the installment payments.[114] For example, A enters into a contract for the purchase of a house and lot from B. Under the terms of the contract, A makes a down payment and is to pay the balance of the purchase price in 120 monthly installments. After payment of the last installment, A is to receive a deed to the property. A enters into possession, which under local law protects his interest in the property against subsequent purchasers without actual notice. After A has paid five monthly installments, a notice of tax lien is filed against B. Since the contract is an executory contract to purchase property and is valid under local law against subsequent purchasers without actual notice, A qualifies as a purchaser.

4. *Actual Notice or Knowledge*

Under the Act, an organization is deemed to have actual notice or knowledge of a fact from the time the fact is brought to the attention of the individual in the organization conducting the transaction or from the time the fact would have been brought to his attention if the organization had exercised due diligence.[115] Due diligence requires reasonable routines for communicating significant information to the person conducting the transaction and reasonable compliance with these routines. It does not require an individual acting for the organization to communicate information unless it is part of his regular duties or he has reason to know of the transaction and the material facts of the transaction.[116]

5. *Subrogation*

Where under local law one person is subrogated to the rights of another in a lien or interest, he is subrogated to such rights for purposes of a federal tax lien. Thus, if a tax lien is not valid with respect to a bank's security interest, then the tax lien is not valid with respect to the assignee of the bank's security interest.[117]

B. *Priorities in Financing Agreements*

1. *Commercial Transactions Financing Agreements*

a. *General Requirements for Priority*—Security interests are protected, under commercial transaction financing agreements entered into before a notice of federal tax lien was filed, provided: (1) the disbursement of consideration for the security interests was made and the security acquired not later than 45 days after the filing

[114] See Proposed Treas. Reg. § 301.6323(h)(1)(f), 38 Fed. Reg. 794 (1973).
[115] Int. Rev. Code of 1954, § 6323(i)(1).
[116] Id.
[117] Id. § 6323(i)(2).

of notice of the tax lien; (2) at the time of such disbursements the creditor had no actual notice or knowledge of the tax lien; and (3) the security interest was perfected under local law as against a judgment lien arising as of the time of filing of notice of the tax lien.[118] Thus, the extent of the priority of the creditor's security interest over the tax lien is the amount of his disbursement made before the 46th day after the date of filing of the notice of tax lien or made before the day on which the creditor has actual notice or knowledge of the filing.

With respect to the property covered by the creditor's security interest, however, the creditor's priority extends to property acquired by the borrower after the creditor received actual knowledge of the filing but before the 46th day after the filing.[119] Although the receipt of actual knowledge of the filing of the tax lien notice terminates the period within which protected disbursements may be made to the borrower, the creditor's priority extends to commercial financing security acquired by the borrower after the creditor's receipt of such knowledge and before such 46th day. Thus, the commercial financing exception permits a secured creditor to add or substitute security not owned by the borrower at or before the filing of the tax lien, but acquired by the borrower within 45 days after the notice was filed.[120]

A commercial transaction financing agreement is defined as an agreement to make loans secured by commercial financing security, or an agreement to purchase commercial financing security other than inventory.[121] In either case, the security must be acquired by the borrower in the ordinary course of its business. The lender need not be a lending institution; it may be a customer financing its supplier of goods or a distributor financing its customers on the security of their receivables.[122]

The term "commercial financing security" is defined as paper of a kind ordinarily arising in commercial transactions, accounts receivable, mortgages on real property, and inventory.[123] Paper of a kind ordinarily arising in commercial transactions include "contract rights," "chattel paper," "instruments," and "documents" as defined in the UCC.[124] Intangibles, such as copyrights and patents, are not included.[125]

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[118] Id. § 6323(c).
[119] Id. § 6323(c)(2)(B).
[120] Id.
[121] Id. § 6323(c)(2)(A).
[122] See H.R. Rep. No. 1884, 89th Cong., 2d Sess. 41 (1966).
[123] Int. Rev. Code of 1954, § 6323(c)(2)(C).
[124] Uniform Commercial Code §§ 1-201, 9-105.
[125] See H.R. Rep. No. 1884, 89th Cong., 2d Sess. 35 (1966).

If the conditions for this exception are met, the secured commercial lender need search for tax liens only at the outset of the transaction when the financing statement is filed, and at 45-day intervals thereafter. Actual knowledge or notice of the tax lien will shorten the 45-day grace period. The lender must terminate substitution of collateral within the 45-day period after the notice of tax lien is filed, and must terminate disbursements to or for the borrower upon actual notice or knowledge of the tax lien in order to preserve his priority over the tax lien.[126] As a practical precaution, every lender should condition its obligation to make future advances to the borrower upon the non-existence of a federal tax lien and require the borrower to give notice of the existence of any such lien as well as notice of the filing of a federal tax lien.

The same conditions apply to a factor purchasing commercial financing security other than inventory, such as receivables. In that case, the factor is protected to the same extent and under the same rules as a commercial lender. According to the proposed regulations, a bona fide purchase at a discount may be protected to the extent of the full amount of the security purchased rather than only to the extent of the purchaser's payment.[127]

b. *Choate Lien Doctrine*[128]—One aspect of the commercial transaction financing priority requires further discussion: the application of the choate lien doctrine. The Act has not resolved the choate lien problem. As stated in the House Report, except as otherwise provided the specificity requirements of the choate lien doctrine continue to apply under section 6323(a).[129] Thus, unless otherwise provided in the Act, a lien must be specific as to: (1) the identity of the lien; (2) the amount of the lien; and (3) the property subject to the lien. The first decision under the Act was based on pre-1966 cases and reached a debatable conclusion which reaffirmed the choate lien test. In *Continental Finance Inc. v. Cambridge Lee Metal Co.*,[130] Continental obtained a perfected security interest in an executory contract of Centre Trucking Company (Centre), prior to a federal tax lien filing against Centre.[131] Certain accounts receivable arose under the contract but were not earned until the 45-day period after the filing of the notice of tax lien. Instead of examining the new provisions of the Act to determine whether contract rights were a proper subject for a security interest, the lower

[126] See Peninsula State Bank v. United States, 211 So. 2d 3 (Fla. 1968).
[127] Proposed Treas. Reg. § 301.6323(c)-1(c), 38 Fed. Reg. 788 (1973).
[128] See text at note 12 supra.
[129] H.R. Rep. No. 1884, 89th Cong., 2d Sess. 35 (1966).
[130] 100 N.J. Super. 324, 241 A.2d 853 (1968).
[131] Id. at 325, 241 A.2d at 855.

court analyzed prior law and held that Continental's security interest in contract rights was inchoate.[132] Accordingly, Continental's security interest was subordinate to the federal tax lien. The New Jersey appellate court affirmed the lower court's decision.[133]

In essence, the *Continental* decision held that contract rights, a term now embodied within the definition of "accounts" in the revised UCC,[134] cannot be the subject of an effective security interest. Arguably, this holding ignores the inclusion of contract rights in the definition of "commercial financing security" and the decision of the Second Circuit in *Rockmore v. Lehman.*[135] In that case, the Second Circuit held that an assignment of rights under an existing contract did not constitute an assignment of after-acquired property.[136] The transfer was construed to be a single transfer of the rights under a contract which had taken place more than four months before the bankruptcy of the assignor. The transfer was deemed to take place at the time the assignment was made without regard to the time the payments were received under the contract.[137]

Nevertheless, in *Texas Oil & Gas Corp. v. United States*[138] the Fifth Circuit followed the rationale of the court in *Continental Finance.* In *Texas Oil,* the Pecos Bank entered into a security agreement with the taxpayer-debtor on March 25, 1967, and perfected its security interest in accounts receivable on March 29, 1967.[139] Pursuant to that security agreement the bank agreed to advance money at various times to the taxpayer, and the taxpayer agreed to factor his accounts receivable with the bank as soon as they arose. On February 27, 1970, the Government filed a tax lien notice and attempted to levy on the proceeds of a contract between the taxpayer and Texas Oil & Gas. That contract was entered into in September 1970 and the taxpayer completed his services for Texas Oil & Gas during the months of September, October and November of 1970. The bank first became aware of the tax lien on October 22, 1970, and shortly thereafter served notice on Texas Oil & Gas that it also claimed all of the taxpayer's accounts receivable.[140]

The Fifth Circuit found that the accounts receivable were not

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[132] Id. at 335, 241 A.2d at 861.

[133] Continental Fin. Inc. v. Cambridge Lee Metal Co., 105 N.J. Super. 406, 252 A.2d 417 (Super. Ct. App. Div. 1970) (per curiam).

[134] Uniform Commercial Code § 9-103(3).

[135] 128 F.2d 564, 565-66 (2d Cir. 1942), cert. denied, 317 U.S. 700 (1943).

[136] 128 F.2d at 564-66.

[137] Id. at 567.

[138] 466 F.2d 1040 (5th Cir. 1972).

[139] Id. at 1044.

[140] Id.

"acquired" within 45 days of the filing of the tax lien because the work was not performed for Texas Oil & Gas until after that period.[141] Accordingly, because the final transaction creating the accounts receivable had not occurred, the court held that the bank's security interest was inchoate, and emphasized that both the transactions of lending to the taxpayer and acquiring of the collateral by the taxpayer must be completed within the 45-day period.[142]

2. *Real Property Construction and Improvement Financing Agreements*

IRC section 6323(c)(3) gives a special priority to property interests under real estate construction or improvement financing agreements.[143] These property interests have priority over a filed tax lien even though the cash disbursements are made after filing. However, in this case, the priority is provided without regard to whether the disbursements occur within 45 days of the filing of the notice of tax lien. The disbursements are also protected although made with knowledge of the tax lien. Although no time limit applies to cash disbursements under this type of agreement, a 45-day time limit applies to additional security put up by the borrower. Such security only has priority with respect to advances made before or within 45 days after the filing of the tax lien notice and before the lender has actual notice or knowledge of the tax lien.[144] If the borrower is required to place his share of the construction costs in escrow, that share may be viewed as additional security for the construction loan. In such a case, a lender should consider requiring that the amount escrowed by the borrower be the first money expended on the construction process.[145]

The types of financing agreements covered are basically agreements covering cash disbursements paid: (1) to an owner of real property for construction or improvement of the property; (2) to a builder operating under a contract to construct or improve real property; and (3) to a borrower for raising or harvesting farm crops or raising livestock.[146] This special priority is limited to interests arising from cash disbursements, except in the case of financing livestock and farm crops where the disbursements may arise in the form of goods and services.[147] The protection afforded by this

[141] Id. at 1051.
[142] Id.
[143] Int. Rev. Code of 1954, § 6323(c)(3).
[144] Id. § 6323(b).
[145] See W. Plumb, Jr., Federal Tax Liens 98 (3d ed. 1972).
[146] Int. Rev. Code of 1954, § 6323(c)(3).
[147] See H.R. Rep. No. 1884, 89th Cong., 2d Sess. 43 (1966); Willstead v. Johnson Feed Serv., Inc., 73-1 CCH U.S. Tax Cas. ¶ 9329, at 80708 (Ill. Cir. Ct. 1972) (landlord's security interest in crops held protected as securing payment for services).

special priority is further limited to real property security, in the case of advances made to the owner, and to the proceeds of the contract, in the case of advances to the contractor.[148]

The rationale for this special priority is that the disbursements generally enhance the value of the property. Completion of the construction or the improvement of real property or the completion of the raising of crops or livestock normally increases the value of the property by more than the amount of the disbursement.[149] In addition, terminating this type of loan upon the discovery of a tax lien may be impractical. A lender who has made substantial advances to a construction project often can recover his investment only if the project is completed. As with all types of financing agreements accorded special priority under IRC section 6323(c), the agreement must be in writing and must be executed before the filing of the tax lien. In addition, the security interest created by the agreement must have priority under local law against a judgment lien creditor as of the time of the filing of the tax lien.[150]

3. *Security Interests Under Obligatory Disbursement Agreements*

The general exception permitting a 45-day grace period following the perfection of a security interest would not provide much comfort to a lender who has obligated himself to make future advances upon the happening of an event outside of his control. Accordingly, the interest of a lender created by advancements under a written, obligatory disbursement agreement is given priority if the agreement is entered into before the tax lien is filed and in the ordinary course of the lender's business.[151]

An "obligatory disbursement agreement" is defined as

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[148] See Plumb, supra note 145, at 97.

[149] See H.R. Rep. No. 1884, 89th Cong., 2d Sess. 82 (1966).

[150] The following example illustrates the priority provisions of § 6323(c):

A, in order to finance the construction of a dwelling on a lot owned by him, mortgages the property to B. The mortgage, executed January 4, 1971, includes an agreement that B will make cash disbursements to A as the construction progresses. On February 1, 1971, a notice of tax lien is filed against A. A continues the construction and B makes cash disbursements on June 10, 1971 and December 10, 1971. Under local law, B's security interest, arising by virtue of the disbursements, is protected against a judgment lien arising February 1, 1971 (the date of tax lien filing). Because B is the holder of a security interest coming into existence by reason of cash disbursements made pursuant to a written agreement, entered into before tax lien filing, to make cash disbursements to finance the construction of real property, and because B's security interest is protected under local law against a judgment lien arising as of the time of tax lien filing, B's security interest has priority over the tax lien.

Proposed Treas. Reg. § 301.6323(c) and (d), 38 Fed. Reg. 788, 789 (1973).

[151] See Int. Rev. Code of 1954, § 6323(c)(4).

> [a]n agreement [entered into by a person in the course of his trade or business] to make disbursements, but such an agreement shall be treated as coming within the term only to the extent of disbursements which are required to be made by reason of the intervention of the rights of a person other than the taxpayer.[152]

As with all special priorities accorded to financing agreements under IRC section 6323(c), the written obligatory disbursement agreement must be entered into, and the security interest created thereunder must be perfected, prior to the filing of the notice of the tax lien. In addition, the obligatory disbursement agreement must be made in the course of trade or business of the disburser. Thus, accommodation endorsers are not protected unless the accommodation is incidental to the operation of a trade or business.[153]

To acquire special priority, the disbursements must be made as a result of the exercise of the rights of a party other than the taxpayer and upon the happening of an event beyond the lender's control. Thus, if the taxpayer-borrower can require the lender to make future disbursements, this special priority does not apply. The lender is then relegated to the general priority rule which provides protection only for disbursements made within 45 days of the filing of the tax lien and without notice or knowledge of the tax lien. In this case, a lender should negotiate an escape clause relieving him from his obligation to make future disbursements if a notice of tax lien is filed. Tax lien searches must then be made at no less than 45-day intervals. A lender should also consider the possibility of using letters of credit so that rights of third parties are injected into his commitments.[154]

No time limit is placed upon the disbursements which may be made under the shelter of this priority where the third party has the right to demand the disbursement. Knowledge of the tax lien will not vitiate the priority. The priority applies to the extent of property on hand at the time of the tax lien filing and, if the financing agreement so provides, the priority extends to other property where the acquisition of such property is directly traceable to the disbursements.[155] For example, assume that pursuant to a written

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[152] Id. § 6323(c)(4)(A). An example of such an agreement is an irrevocable letter of credit where a bank issuing the letter must honor a demand for payment by a third party who advances credit in reliance upon the bank's letter of credit. Another example would be a surety's agreement to finance the completion of a contract entered into by the taxpayer. See H.R. Rep. No. 1884, 89th Cong., 2d Sess. 9 (1966).

[153] See Proposed Treas. Reg. § 301.6323(c)-3(b), 38 Fed. Reg. 788 (1973).

[154] See Plumb, supra note 145, at 94.

[155] Id.

agreement, ABC Bank issues an irrevocable letter of credit to T for the purpose of financing T's purchase of refrigerators. After the filing of the notice of tax lien against T, the ABC Bank honors a demand for payment on its letter of credit. Assuming that the general requirements applicable to all types of financing agreements under IRC section 6323(c) have been fulfilled, ABC Bank will have priority over the tax lien with respect to the refrigerators purchased by T and to property directly traceable to its cash disbursements, such as the proceeds from the sale of the refrigerators.

If an effort is made to foreclose on a tax lien before all of the potential obligations under an obligatory disbursement are met, an amount sufficient to cover the potential obligations is usually set aside. Only after the obligations have been met is any remainder available for the satisfaction of the tax lien.[156]

The Federal Tax Lien Act also sets forth special rules for surety agreements:

> Where the obligatory disbursement agreement is an agreement insuring the performance of a contract between the taxpayer and another person, the security interest entitled to special priority may be in the proceeds of the insured contract. If the insured contract is a contract to construct or improve real property, to produce goods or to furnish services, the security interest may be in any tangible personal property used in the performance of the contract.[157]

For example, on July 1, 1974, C is awarded a contract to construct an office building. B executes a written agreement to ensure the performance of the contract. The agreement provides that in the event B must complete the job as a result of a default by C, B will be entitled to the proceeds of the contract. In addition, the agreement provides that B will have a security interest in all of C's property. On December 1, 1974, prior to the completion of the building, C defaults. On the same day, a notice of tax lien is filed against C. B completes the building on July 1, 1975. Under local law, B's security interest in the proceeds of the contract and in C's property are entitled to priority over a judgment lien arising December 1, 1974 (date of tax lien filing). B's security interest in the proceeds of the contract has priority over the tax lien, even though the notice of tax lien was filed before B's security interest arose. B's security interest in any of C's tangible personal property used in performance of the contract also has priority over the tax lien.

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[156] See H.R. Rep. No. 1884, 89th Cong., 2d Sess. 9 (1966).
[157] Int. Rev. Code of 1954, § 6323(c)(4).

C. *Priority Rule for 45-Day Period for Disbursements with Respect to Security Interests Generally*

In addition to the priorities for financing agreements, the Act also provides priority generally with respect to those security interests in property, held by the taxpayer before the tax lien filing, which arise as a result of disbursements made within 45 days after the filing of a tax lien notice.[158] This grace period, however, will end when the lender obtains actual notice or knowledge of the filing of the tax lien. For the priority to exist, a written security agreement must be entered into before the date of tax lien filing and the security interests created thereunder must be protected against a judgment lien arising as of the time of tax filing.[159]

As in the case of commercial transactions financing agreements, this priority is designed to make it unnecessary for the secured lender to search the tax lien records more often than once every 45 days where one or more disbursements are to be made by him.[160]

D. *Priority for Interest and Expenses*

The Act also provides a priority for the interest with respect to and for certain costs of, preserving property to which is attached a lien or security interest entitled to priority over a federal tax lien.[161] This priority exists only to the extent local law provides for the same priority for interest and expenses as the lien or security interest to which it relates.[162]

E. *Superpriorities*

Certain third party interests in property are accorded a higher status than a federal tax lien, even if the interests arise after the filing of the tax lien notice. Prior to the Act the federal tax lien law

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[158] Id. § 6323(d).

[159] Id.

[160] See H.R. Rep. No. 1884, 89th Cong., 2d Sess. 45 (1966).

[161] Int. Rev. Code of 1954, § 6323(c).

[162] The types of items referred to here are:

(1) interest or carrying charges (including finance and services charges) on the obligation secured by a lien or security interest;

(2) reasonable expenses of an indenture trustee (such as a trustee under a deed of trust) or agent holding a security interest;

(3) reasonable expenses incurred in collecting and enforcing a secured obligation (including reasonable attorney's fees);

(4) reasonable costs of insuring, preserving or repairing the property subject to the lien or security interest;

(5) reasonable costs of insuring payment of the obligation (such as mortgage insurance); and

(6) amounts paid by the holder of a lien or security interest to satisfy another lien on the property where this other lien has priority over the Federal tax lien.

H.R. Rep. No. 1884, 89th Cong., 2d Sess. 46 (1966). See Int. Rev. Code of 1954, § 6323(c).

accorded this special protection to mortgagees, pledgees, purchasers of securities, and certain purchasers of motor vehicles, provided they did not have knowledge of the filed tax lien.[163] The Act retained this special protection and added additional categories of interests entitled to this "superpriority" protection.[164]

1. *Security Interest in Securities*

Superpriority is accorded to: (1) a purchaser of a security who, at the time of purchase, did not have actual notice or knowledge of the tax lien; and (2) a holder of a security interest in a security who had no actual knowledge or notice of a tax lien at the time the security interest came into being.[165] Since the test is whether the holder of a security interest had notice or knowledge of the tax lien, the transfer of a security interest in a security from a person with knowledge of the tax lien to a transferee without such knowledge will protect the transferee from the tax lien. On the other hand, the transfer from a holder of such a security interest with knowledge of the tax lien to a transferee with knowledge bars superpriority for the holder of that security interest.

In addition, if a person without knowledge of the tax lien acquires a security interest in a security interest in securities (for example, a security interest in notes secured by a security), he may not be considered a holder of a security interest in the security and may not be accorded superpriority. Therefore, lending institutions may be advised to consider purchasing notes secured by securities rather than securing loans with such notes.[166]

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[163] See text at notes 75, 76 supra.

[164] Int. Rev. Code of 1954, § 6323(b).

[165] Int. Rev. Code of 1954, § 6323(h)(4) defines the term "security" as:

> [A]ny bond, debenture, note or certificate or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest, coupons or in registered form, share of stock, voting trust certificate, or any certificate of interest or participating in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

[166] Proposed Treas. Reg. § 301.6323(b)-1(a), 38 Fed. Reg. 782 (1973), contain the following example of this superpriority:

> On July 1, 1970, a notice of tax lien is filed against E. E owns 100 $1,000 bonds issued by the Y Company. On July 5, 1970, E borrows $4,000 from F and delivers the bonds to F as collateral for the loan. At the time the loan is made, F has actual knowledge of the existence of the tax lien and, therefore, holds the security interest in the bonds. G does not have actual notice or knowledge of the existence of the lien on July 10, 1970. Because G became the holder of a security interest in a security interest after notice of lien was filed and does not directly have a security interest in a security, the security interest held by G is not entitled to a priority over the tax lien.

See Plumb, supra note 145, at 78-79.

2. *Security Interest in Motor Vehicles*

Even though a notice of tax lien is filed, the lien is not valid as against the purchaser of a motor vehicle if: (1) at the time of the purchase, the purchaser did not have actual notice or knowledge of the lien; and (2) he obtains possession of the vehicle before he had notice and knowledge of the tax lien and does not thereafter relinquish possession to the seller or his agent.[167]

Although a purchaser of a motor vehicle is accorded superpriority to the extent he purchases without knowledge or notice of the lien, no special priority is given to security interests in motor vehicles. Consequently, a lender contemplating securing of a loan with a motor vehicle should search for federal tax liens. State laws requiring the notation of lien on the title certificate do not bind the Government.[168]

3. *Loans Secured by Insurance Policies*

An insurance company is protected in making a loan on a policy, even though a notice of tax lien has been filed.[169] However, this priority is provided only where the company has no actual notice or knowledge of the lien. Thus, an insurance company need not search for tax liens before making a policy loan. The rationale for this priority is that the company is making a prepayment of its obligation under the insurance policy rather than providing a loan to a policyholder.[170] Moreover, the insurance company will have priority with respect to automatic premium loans required by a preexisting agreement to maintain the policy in force even where it has notice or knowledge of the tax lien filing.[171]

If a tax levy on an insurance contract is satisfied by the insurance company, the company will have priority for any subsequent loans until the Government delivers to the company a new notification of tax lien on the policy. This requirement avoids the necessity of the insurance company checking on the payment of tax liability in each case where levy has been previously made on the policy.[172]

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[167] Int. Rev. Code of 1954, § 6323(b)(2).

[168] See Merchants Loan Co. v. United States, 169 F. Supp. 227, 228 (D. Ariz. 1957).

[169] Int. Rev. Code of 1954, § 6323(b)(9).

[170] See United States v. Sullivan, 333 F.2d 100, 112 (3d Cir. 1964).

[171] Int. Rev. Code of 1954, § 6323(b)(9)(B). An example of the workings of this superpriority provision is as follows: On June 2, 1973, a notice of tax lien is filed against D. On July 2, 1973, D executes an assignment of his rights, as the insured, under an insurance contract to M Bank as security for a loan. M Bank's security interest is subject to the tax lien because the bank is not an insurer entitled to protection under IRC section 6323(b)(9) and did not become a secured party prior to the filing of the notice of tax lien.

[172] Id.

4. *Passbook Loans*

Banks, savings and loan associations, and similar institutions often make loans to their savings account depositors. Those loans often are secured by the borrower's account with the institution, evidenced by a passbook. Superpriority status is granted to such an institution if it has no actual notice or knowledge of a tax lien and if the institution retains possession of the passbook until the loan is paid off.[173] The loan must be secured by an account at the institution making the loan, and the institution must be either a bank or savings institution of the type described in IRC section 581 or 591.[174] Superpriority status will not attach to any loans made after the date knowledge of the tax lien is acquired.[175]

5. *Purchase of Personal Property at Retail and Casual Sales*

Purchasers of tangible personal property sold at retail in the ordinary course of the seller's trade or business are given superpriority status unless the purchaser intends to interfere with the collection of the federal tax or knows that the purchase would so interfere.[176] Household goods, personal effects or certain other personal property purchased in a casual sale for less than $250 are also protected if the purchaser has no knowledge of the existence of the tax lien.[177]

6. *Possessory Liens*

Where local law provides a repairman or similar person holding continuous possession of personal property, with a lien securing payment of the repairman's charge, the repairman is protected against the tax lien even if he has knowledge of the tax lien before he undertakes the work.[178] The rationale for this superpriority is that the repairman's work enhances the value of the property and,

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[173] Id. § 6323(b)(10).

[174] Id.

[175] Proposed Treas. Reg. § 301.6323(b)-1(F), 38 Fed. Reg. 782 (1973) provides the following example of passbook loan priority:

> On June 2, 1970, a notice of lien is filed against A. A owns a savings account at the M Bank with a balance of $1,000. On June 10, 1970, A borrows $300 from the M Bank, using the savings account as security. The M Bank is continuously in possession of the passbook from the time the loan is made and does not have actual notice or knowledge of the lien at the time of the loan. The tax lien is not valid against M Bank with respect to the passbook loan of $300 and accrued interest and expenses. Upon service of a notice of levy, the M Bank must pay over the savings account balance in excess of the amount of its protected interest in the account as determined on the date of levy.

[176] Int. Rev. Code of 1954, § 6323(b)(3).

[177] Id. § 6323(b)(4).

[178] Id. § 6323(b)(5).

as a result, the value of the tax lien. The superpriority is limited to the reasonable price of the repairs or improvements.

7. *Real Property, Taxes and Special Assessments*

Where state and local government liens covering real property taxes and special assessments have priority under local law as against holders of security interests, such liens are granted superpriority status.[179]

8. *Repairs and Improvements to Real Property*

Superpriority status is also given to persons who under local law are granted a non-possessory mechanic's lien for repairs and improvements to real property. The lien must arise as the result of work on a personal residence containing not more than four dwelling units. Additional requirements are that the property must be occupied by the owner and the contract charges must not exceed $1,000.[180]

9. *Attorney's Lien*

Where pursuant to local law an attorney is afforded a lien against any fund his efforts create for his client, or where the attorney holds a contract enforceable against such a fund, the attorney is accorded superpriority to the extent of his reasonable compensation.[181] "Reasonable" compensation has been construed as the amount normally allowed under local law for attorney's services in litigating or settling a similar claim.[182]

F. *Circuity of Priority*

Because the Act imposes a second priority system upon a state priority system, the "first-in-time, first-in-right" rule occasionally causes circular priority problems. For example, B and C have liens against A's equipment. Thereafter, the Government files a notice of tax lien against A's property. Under state law, B's lien is superior to C's lien. If C's lien is choate but B's lien is not, the tax lien would be entitled to priority over B's lien, but not to priority over C's lien.

In *United States v. New Britain,*[183] the Supreme Court resolved this circular priority problem in a two-step process. First, the federal law of priorities was applied. An amount equal to the interest taking priority over the tax lien was set aside to be distri-

[179] Id. § 6323(b)(6).
[180] Id. § 6323(b)(7).
[181] Id. § 6323(b)(8).
[182] See Jackson Mfg. Co. v. United States, 69-1 CCH U.S. Tax Cas. ¶ 9383, at 84590 (N.D. Miss. 1969), rev'd on other grounds, 434 F.2d 1027 (5th Cir. 1970).
[183] 347 U.S. 81 (1954).

buted according to state law priority.[184] In the example above, if C's lien is choate and prior to the tax lien, the amount of C's lien would be set aside. However, since B's lien has priority under state law, B's lien would be first satisfied and any surplus would be applied to the satisfaction of the tax lien. Any surplus remaining after the satisfaction of the tax lien would be distributed to satisfy C's lien.

G. *Subordination of the Tax Lien*

IRC section 6323(b)(3) permits the Internal Revenue Service to subordinate an otherwise superior federal tax lien to another lien or interest.[185] There are two conditions under which the Service is authorized to issue a certificate of subordination: (1) there is paid to the Service an amout equal to the amount of the lien or interest to which the tax lien is subordinated; or (2) the Service believes that such subordination will improve the chance of ultimate collection of the tax by the Government.

VI. CONCLUSION

The foregoing discussion is an attempt to arrange the priority system of IRC section 6323 in a clear format. Applying the Act is a formidable task. The choate lien problem is not resolved, and the "no property" doctrine remains amorphous. Only conjecture will reveal any thread of consistency. Since the legislative history of the Act clearly discloses an intent to conform the priority systems of the Act to the priority system of the UCC, reference to that body of state law will continue to throw light upon the workings of the Act. If promulgated, the proposed treasury regulations will also aid in the clarification of this complex priority system.

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[184] Id. at 88.

[185] Int. Rev. Code of 1954, § 6323(b)(3).

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