

July 2013

Beware of the Federal Tax Lien

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Recommended Citation

Musicus, Raphael J. (2013) "Beware of the Federal Tax Lien," *St. John's Law Review*: Vol. 20 : No. 1 , Article 1.
Available at: <https://scholarship.law.stjohns.edu/lawreview/vol20/iss1/1>

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ST. JOHN'S LAW REVIEW

VOLUME XX

NOVEMBER, 1945

NUMBER 1

BEWARE OF THE FEDERAL TAX LIEN

LARGE financial losses have been sustained recently as a result of a misunderstanding of the extent and ramifications of the priority of federal tax claims and liens. Among the most troublesome problems with respect thereto have been the following:

1. The relative priority of federal tax claims which are not secured by a lien.
2. The relative priority of federal and state tax liens.
3. Whether a federal tax lien, which is unrecorded, has priority over the recorded lien of a mortgagee who acquired his mortgage for value, in good faith, and without knowledge of the tax lien.

I. RELATIVE PRIORITY OF FEDERAL TAX CLAIMS

As the United States has not adopted the common law, whatever right of priority the United States possesses over other creditors, in the payment of debts, exists because of some statute which confers it.¹ It does not exist independently of statute.

There are two federal statutes under which the Government's tax claims, not secured by a lien, may become entitled to a priority over the claims of a taxpayer's other creditors, namely, Section 3466 of the Revised Statutes, and Section 64(a) of the Bankruptcy Act of 1938. Although the two statutes involve the same subject, where one is applicable the

¹ United States v. Oklahoma, 261 U. S. 253, 67 L. ed. 638 (1923); *In re* Wm. Akers, Jr., Co., Inc., 121 F. (2d) 846 (C. C. A. 3rd, 1941).

other is not.² Section 64(a) of the Bankruptcy Act of 1938, as amended, applies exclusively where the taxpayer has been adjudicated a bankrupt. Conversely, the bankruptcy priority does not affect the status of tax claims in proceedings not under the Bankruptcy Act, such as in equity receiverships.

The Federal Government's priority in the collection of its tax claims, not secured by a lien, is derived solely from these two statutes and, therefore, unless a case comes under the express coverage of the two statutes, there is no priority on behalf of the Government.

Section 3466 of the Revised Statutes³ provides:

Priority established. 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.

A literal reading of the statute, as quoted above, would appear to indicate that the first portion extends priority solely upon the insolvency of a taxpayer and that the second portion, starting after the semi-colon, adds an additional priority whenever one of the acts specified therein is committed. However, the courts have not followed this literal interpretation. In *United States v. Oklahoma*,⁴ the Supreme Court stated:

Mere inability of the debtor to pay all his debts in ordinary course of business is not insolvency within the meaning of the act, but it must be manifested in one of the modes pointed out in the latter part of the statute which defines or explains the meaning of insolvency referred to in the earlier part.

On the basis of the court's decision, no priority attaches in favor of the Government's tax claim unless there exists

² *In re Jacobson*, 263 Fed. 883 (C. C. A. 7th, 1920).

³ 31 U. S. C. A. § 191.

⁴ 261 U. S. 253, 43 Sup. Ct. 295, 67 L. ed. 638 (1923).

an inability of the taxpayer to pay his debts with all his property, plus one of the "manifestations" of insolvency stated in the statute, *viz.*, (1) a voluntary assignment of assets, (2) an attachment by process of law of the estate and effects of an absconding, concealed, or absent debtor, or (3) commission of an act of bankruptcy.⁵

A marked distinction is made, however, between living and deceased debtors. In the case of a deceased debtor, the "manifestations" of insolvency discussed above, are not required; the section expressly provides that the United States shall have priority whenever the estate in the hands of the executor or administrator "is insufficient to pay all the debts due to the United States."⁶

Interpretations by the courts⁷ have now clearly established the following rules with respect to Section 3466:

1. This section does not give the United States a lien upon its debtor's property, but only a right to priority of payment out of the same in certain cases.⁸

2. The priority established can never attach while the debtor continues the owner and in possession of the property, though he may be unable to pay all his debts.

3. No evidence can be received of the insolvency of a living debtor until he has been divested of his property in one of the modes stated.

4. Whenever the debtor is thus divested of his property, the person who becomes invested with the title is thereby made a trustee for the United States, and is bound to pay the debt first out of the proceeds of the debtor's property.

Since the priority established by Section 3466 does not amount to a lien, a valid mortgage which has been executed

⁵ *Davis v. Miller-Link Lumber Co.*, 296 Fed. 649 (C. C. A. Tex. 1924).

⁶ *Equitable Trust Co. v. Connecticut Brass, etc., Corp.*, 290 Fed. 712 (C. C. A. Conn. 1923).

⁷ *Beaston v. Farmers' Bank*, 12 Pet. 102, 132, 9 L. ed. 1017 (Md. 1838); *In re Baltimore Pearl Hominy Co.*, 294 Fed. 921 (D. C. Md. 1923), *rev'd on other grounds*, 5 F. (2d) 553 (C. C. A. 1925).

⁸ *United States v. Eggleston*, Fed. Cas. No. 15,027 (C. C. Or. 1877); *Same v. Griswold*, 8 Fed. 496 (C. C. Or. 1881).

by a taxpayer before his insolvency, and recorded by the mortgagee, is superior to the priority granted the Government. Moreover, regardless of the existence of the mortgage, the mortgaged property becomes an asset out of which claims against the debtor may be paid, only to the extent of the debtor's equity of redemption therein, if any.

The position of the Government's priority with respect to the lien of such mortgages is stated in *North River Coal and Wharf Co. v. McWilliams Bros.*⁹ as follows:

The Supreme Court appears to have given priority to the government under section 3466 . . . in all cases except where the legal title of the taxpayer has been in some measure divested before the tax or other indebtedness became due.

As previously mentioned, the second of the two statutes conferring priority on claims of the Federal Government, namely, Section 64(a) of the Bankruptcy Act of 1938, applies only when the taxpayer has been adjudicated a bankrupt. The Act states that "all taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality"¹⁰ shall have priority, except with respect to certain necessary expenses of administration of the deceased's estate.

An examination of this provision reveals that Section 64(a) of the Bankruptcy Act embraces all taxes owing by the bankrupt, and makes no mention of the relative priority of federal taxes as compared with state and local taxes. Since the Federal Government has the power to accord itself such priority, as it has done in the case of Section 3466 of the Revised Statutes, the absence of such provision is significant. In view of its omission, Section 64(a) lends itself to the construction that no such priority was intended; that all taxing bodies are to share on a *pro rata* basis. This construction was placed upon it by the court in *In re Maryland Coal Co. of West Virginia*,¹¹ where claims filed by the United States, State of West Virginia, and the sheriff of Taylor

⁹ 59 F. (2d) 979, 981 (C. C. A. 2d, 1932), *aff'd sub. nom.*, *New York v. Maclay*, 288 U. S. 290 (1933).

¹⁰ 10 U. S. C. A. § 104.

¹¹ 36 F. Supp. 142 (1941).

County, West Virginia, were held to be entitled to share equally.¹²

II. RELATIVE PRIORITY OF FEDERAL AND STATE TAX LIENS

Questions of priority and of lien for taxes are closely related and may arise in the same case; however, for the purpose of this article, the question of priority of federal taxes, not based upon a lien, has been discussed in the preceding section and the question of priority of federal taxes in so far as such priority is based upon a lien will be covered in this section.

As in the case of priority of federal tax claims, federal tax liens are statutory. The statute imposing a lien for federal taxes generally is set forth in Section 3670 of the Internal Revenue Code.¹³ In addition to this lien imposed for federal taxes generally, special liens are provided for the federal tax on distilled spirits,¹⁴ the federal estate tax,¹⁵ and the federal gift tax.¹⁶

Section 3670 of the Internal Revenue Code provides:

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

To create a lien for taxes, under this section, there must be a previous ascertainment of the sum due by means of an assessment by the assessor¹⁷ or a demand for payment.¹⁸ However, after levy has been made, the United States tax lien relates back to the time when the taxes became due and payable.¹⁹

¹² Also see *In re Wyley Co.*, 292 Fed. 900 (1923); *In re A. E. Fountain, Inc.*, 295 Fed. 873 (1924).

¹³ 53 STAT. 448, 26 U. S. C. A. § 3670.

¹⁴ 26 U. S. C. A. § 2800(e).

¹⁵ 26 U. S. C. A. § 827.

¹⁶ 26 U. S. C. A. § 1009.

¹⁷ *United States v. Pacific R. R.*, 1 Fed. 97, 100 (1800).

¹⁸ *In re Baltimore Pearl Hominy Co.*, 294 Fed. 921 (D. C. Md. 1923), *rev'd on other grounds*, 5 F. (2d) 553 (C. C. A. 1925).

¹⁹ *The River Queen*, 8 F. (2d) 426 (D. C. Va. 1925).

On the other hand, many states have statutes declaring certain taxes to be liens upon the property involved, from and after a specified date, without any further affirmative action on the part of the state in reducing the tax account to a specific figure or enforcing the granted lien by levy. When the Federal Government subsequently obtains a lien under Section 3670 of the Internal Revenue Code, a conflict arises as to which tax takes precedence.

The courts have uniformly held that unless the state lien is perfected against specific property prior to the attachment of the federal lien, the latter is paramount. Thus, where a New York franchise tax claim was declared a lien from the date of assessment, it was held inferior to a federal lien attaching after such date since the State of New York had never procured a specific lien by levy.²⁰

In the case of *United States v. Reese*,²¹ a similar situation arose with respect to the Illinois real estate tax, which by statute is made a lien on the taxed property from April first of the year in which the tax was levied. Levies were made in 1930 and 1931, before the federal assessment list had been received by the collector, but the exact amount to be paid and secured by the state lien was not determined until after the lien of the United States arose. The court held the federal lien superior on the ground that it took precedence over an existing inchoate lien, not liquidated or fixed in amount until after the federal tax lien had attached.

Thus, the problem of relative priority of liens requires a determination as to which lien has been perfected or made specific first, for as illustrated above, a lien of an inchoate or unperfected character will not be given preference over a perfected lien even though the latter may have been created subsequently. However, this general rule is subject to an important exception, in the case of the federal estate tax lien, which will be considered in the next section.

²⁰ Gerson, Beesley & Hampton, Inc. v. Shubert Theatre Corp. *et al.*, 7 F. Supp. 399 (1934).

²¹ 131 F. (2d) 466 (1942).

III. RELATIVE PRIORITY OF UNRECORDED FEDERAL TAX LIENS AND RECORDED MORTGAGES.

Before 1913, a federal tax lien was valid as against subsequent purchasers and encumbrances without notice, although no notice of the lien was filed or recorded. Thus, in *United States v. Curry*,²² a lien to secure the payment of an oleomargarine tax for which formal demand had not been made before the taxpayer's conveyance of property to *bona fide* purchasers was held valid as against such purchasers, the court saying:

When the requirements of the assessment and the demand have been complied with, the lien of the government is superior to that of anyone acquiring any interests in the property after the date of demand. The government's lien is unaffected by the fact that a subsequent encumbrancer or purchaser became such without knowledge that the government had any interest in the property or claim upon it.

This harsh rule was modified in 1913²³ by a provision similar to that presently in effect in the form of Section 3672 of the Internal Revenue Code, which provides:

Validity against mortgagees, pledgees, purchasers, and judgment creditors.—(a) Invalidity of lien without notice.—Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector

As a result of this revision, a mortgage or other lien which attaches to property of the taxpayer before filing of notice is now rightly held entitled to priority over the tax lien. Thus, in *Ormsbee v. United States*,²⁴ the lien of a mortgage was held superior to a lien for federal income tax, where the mortgage was properly recorded prior to the filing of notice of the tax lien. And in *Ferris v. Chic-Mint Gum Co.*,²⁵ where notice of a lien of the United States for taxes was never filed as required by statute, such tax lien was held to be inferior to the lien of a recorded mortgage, in respect of taxes for which an assessment list was received by the

²² 201 Fed. 371 (1912).

²³ Act of March 4, 1913, Rev. Stat. § 3186.

²⁴ 23 F. (2d) 926 (1928).

²⁵ 14 Del. Ch. 232, 124 A. 577, retrial in 14 Del. Ch. 270, 125 A. 343 (1924).

collector both before and after the recording of the mortgage, although the mortgage was given for an antecedent debt.

Unfortunately, however, the courts have restricted this revision, requiring the filing of federal tax liens, to the general liens created in Section 3670 of the Internal Revenue Code and have not seen fit to extend this line of reasoning to the special lien provided for the federal estate tax.

As a result, the former harsh rule, which existed with respect to the general lien, still exists with respect to the federal estate tax lien, Section 827 of the Internal Revenue Code, which provides as follows:

Lien for tax.

(a) Upon gross estate. Unless the tax is sooner paid in full, it shall be a lien for ten years upon the gross estate of the decedent

(b) Liability of transferee, etc. If the tax herein imposed is not paid when due, then the . . . transferee . . . who receives, or has on the date of the decedent's death, property included in the gross estate . . . , to the extent of the value, at the time of decedent's death, of such property, shall be personally liable for such tax. Any part of such property sold by such . . . transferee . . . to a *bona fide* purchaser for an adequate and full consideration in money or money's worth shall be divested of the lien provided in section 827(a) and a like lien shall then attach to all the property of such . . . transferee . . . except any part sold to a *bona fide* purchaser for an adequate and full consideration in money or money's worth.

*Detroit Bank v. United States*²⁶ is the leading recent United States Supreme Court case interpreting the provisions of Section 827. The question there presented was whether the federal estate tax lien is required to be recorded in order to give it superiority over the lien of a mortgagee who acquired his mortgage in good faith without knowledge of the tax lien.

The Government brought the suit to foreclose an asserted lien for estate taxes assessed upon certain parcels of real estate. The real estate had been owned at the time of his death by the decedent and his wife as tenants by the entirety. Following his death the real estate was not included as part

²⁶ 317 U. S. 329, 63 Sup. Ct. 297, 87 L. ed. 304 (1943).

of his estate in computing the federal estate tax. Prior to assessment or payment of the tax, the parcels of real estate in question were mortgaged by his children to petitioner (Detroit Bank) who acted without notice of the Government's asserted lien or claim for taxes.

The Supreme Court reviewed the provisions of Section 827 with respect to the estate tax lien and distinguished between its effect on transfers made *inter vivos* in contemplation of death and transfers made after the decedent's death (note the similarity of this distinction and that made by the court in the case of Section 3466 of the Revised Statutes, *supra*). As to the former, no lien attaches against innocent purchasers of property which a decedent has transferred *inter vivos* in contemplation of death. As to the latter, however, the estate tax lien attaches as of the date of decedent's death as against all persons, including innocent purchasers and mortgagees. Furthermore, inasmuch as Section 827 makes no reference to any requirement for recording notice of the lien, no recording is necessary.

In view of the foregoing, the Supreme Court decided that the Government's estate tax lien, though unrecorded, was superior to the lien of the mortgagee despite the fact that the latter had acquired his mortgage in good faith, for full value, and without knowledge of the tax lien.

As a result of this decision, unless the Government has expressly released the property from the estate tax lien (as it may if the individual case warrants), it is now essential to exercise extraordinary care in all cases of mortgage, pledge or sale, whenever it appears that the property in question was includible in a decedent's estate within the preceding ten years.

Thus, at present we have a situation with respect to the estate tax lien which is similar to that which existed prior to 1913 with respect to the general tax lien. A revision of the present estate tax lien statute, Section 827, to conform to the current provisions of Section 3672 is, therefore, highly desirable in order to guard the innocent purchaser or mortgagee of property against the menace of unrecorded federal estate tax liens.

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