Federal Tax Lien Priority: An Injustice to Creditors

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FEDERAL TAX LIEN PRIORITY: AN INJUSTICE TO CREDITORS

By THOMAS C. McNALLY III*

FEDERAL tax lien priority is a prominent issue among legal scholars as well as practicing attorneys. Much has been written on the subject to date,¹ and more will be written concerning it in the near future. The reason for this is the large number of adverse decisions which favor the government lien over that of the individual creditor although the creditor’s lien be considered valid and enforceable under state law. A remedy for this injustice to the individual lienholder has not, as yet, been granted either by judicial decisions or Congress. Until such remedial action is taken the issue will be kept in the foreground.

Article I, section 8 of the Federal Constitution allows the establishment of a tax lien by Congress as an exercise of its constitutional power “to lay and collect taxes.”² This tax lien is established by federal law under sections 6321 and 6322 of the Internal Revenue Code of 1954. The controversy does not exist because of this tax lien, but because of the priority given it by Revised Statutes section 3466, of 1875,³ stating that debts due to the United States shall first be satisfied in the case of a debtor’s insolvency.

The rationale for this priority is said to be founded upon motives of a public policy to secure adequate revenue to sustain public burdens and discharge public debts.⁴ The actual advantage the government secures from its liens and priorities is the collection of claims and obligations from those who did not incur them. The government tends to “rob Peter to pay Paul’s taxes.”⁵ This advantage serves as an injustice to all creditors, both secured and unsecured.

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² United States v. Snyder, 149 U.S. 210 (1893).

³ 31 U.S.C. § 191. The application of this section to tax claims was set down in Price v. United States 269 U.S. 492 (1926). The obligation to pay any penalty imposed by the United States constitutes a debt due the United States within the meaning of this section. (Set out in 41 U.S.C. § 108(d) ). Bankruptcy proceedings are not included under this section. Priorities in Bankruptcy are contained in 11 U.S.C. § 104.

⁴ United States v. Emory, 314 U.S. 423 (1941).

Development of the Federal Priority

In one of the earlier cases decided under Revised Statutes section 3466, Thelusson v. Smith, it was determined that a general judgment lien upon the lands of an insolvent debtor does not take precedence over claims of the United States unless execution of the judgment has proceeded far enough to take the land out of the possession of the debtor. In effect, there must be "a change of title or possession." This test was clarified in Conrad v. Atlantic Insurance Co. where it was stated that "the judgment creditor in the Thelusson case received no title to the proceeds of the land because he had not 'perfected his title by an execution and levy.'" From these two early cases, it can be established that unless a judgment creditor had his debtor's property in his hands at the time the federal lien arose he had no chance of obtaining it in the future. This gross injustice was recognized by the federal government and partially alleviated by the enactment of section 6323(a) of the Internal Revenue Code. The present situation can be summarized as follows:

A federal tax lien asserted against a taxpayer's property under sections 6321-6322 of the Internal Revenue Code of 1954 prevails over all other claims against such property except (1) those specifically protected by section 6323(a); (2) those which attach and become "choate" before the federal lien attaches.

Application of Section 6323(a)

Until 1913 no third parties were protected from Revised Statutes section 3466; but in 1913, as a result of United States v. Snyder, three classes—purchasers, mortgagees and judgment creditors—were held exempt until notice of the federal lien had been filed. In 1939 pledgees became the fourth class of exempt creditors under this section.

Whether a person comes under one of these protected classes, enu-

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7 Id. at 426.
8 26 U.S. (1 Pet.) 386 (1828).
9 Id. at 442.
11 149 U.S. 210 (1893). In this case it was decided that the United States is not subject to the recording laws of a state. Although Louisiana had such a law the assessment was never filed. A corporation purchased the property for full value, in good faith and in ignorance of the alleged assessment. (It took the Congress many years, however, before positive action was taken.)
12 Act of March 4, 1913, ch. 166, 37 Stat. 1016 (now INT. REV. CODE of 1954 § 6323(a)). The filing requirement is contained in INT. REV. CODE of 1954 § 6323(a) 1&2.
merated in section 6323(a) of the code, depends on the facts in a given case rather than the technical definition of the class.14

In the leading case of United States v. Gilbert15 it was said that the term “judgment creditor” should have the same application in all states, and that in section 6323(a) the words “judgment creditor” are used in the usual conventional sense of a judgment of a court of record, since all states have such courts.16

To come within the class of purchasers set out in section 6323(a) the lienholder must be one who acquired title for a valuable consideration in manner of vendor and vendee.17

In United States v. Ball Construction Co.18 it was held that assignment made by a subcontractor to his performance bond surety of all sums to become due for performance of the subcontract, as security for any indebtedness or liability thereafter incurred by the sub-contractor to surety, did not constitute the surety a mortgagee of those sums within meaning of section 6323(a).

From these cases and others concerned with pledgees,19 it can be noted that the classes in this section are restricted. “[E]mphasis is placed upon the narrow letter rather than the spirit and purpose of the excepting clause.”20

Another exception which came about as a result of United States v. Rosenfield21 was in the cases of “securities.”22 This exception is strictly limited to items enumerated in section 6323(c)23 and therefore does

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15 345 U.S. 361 (1953).
16 Id. at 364. New Hampshire assessment was in the nature of a judgment, enforced by warrant instead of execution; see United States v. Record Pub. Co., 60 F. Supp. 194, (N.D.C. 1945). Creditor not entitled to prior lien as judgment creditor by merely giving notice “to withhold” recovering judgment before government filed notice. See also United States v. Waddill, Holland and Flinn, Inc., 323 U.S. 353 (1945).
19 E.g., United States v. Toys of the World Club, Inc., 170 F. Supp. 450 (S.D.N.Y. 1959) (An artisan’s lien cannot be denominated a “pledge” within context of section 6323(a)).
21 26 F. Supp. 433 (E.D. Mich. 1938). A tax lien duly filed before the sale of securities survives the sale; a bona fide purchaser for value without actual notice of the lien took title subject to the lien.
22 Rev. Act of 1939, ch. 247, §247(b), 53 Stat. 882 (now INT. REV. CODE of 1954, §6323(c)).
23 Securities are defined under the code as “any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation with interest coupons or in regi-
not refer to intangibles generally, such as accounts receivable and life insurance policies, nor does it extend to tangible personal property.24

**Application of the Concept of Choateness**

Holders of liens other than those exempted by section 6323(a) are wholly unprotected, but may secure priority over federal liens on the theory that their lien was *specific* and *perfected* before the federal lien attached. The genesis of the doctrine of the inchoate and general lien is attributed to *Spokane County v. United States,*25 a proceeding wherein the federal tax claims of the United States were given priority over county tax claims because there was no distraint nor any other procedure taken by the county to render its claims a specific lien.

The doctrine of the inchoate lien was not actually applied by the Supreme Court until twenty-one years later in *United States v. Security Trust and Savings Bank of San Diego.*26 This case involved the relative priorities of a tax lien of the United States and an attachment lien filed in California, where the tax lien was recorded subsequent to the date of the attachment but prior to the date the attaching creditor received judgment. The court relied on the "inchoate nature" of California's attachment lien. It was defined as "merely lis pendens notice that a right to perfect the lien exists."27 A lien of a garnishee was subject to the same fate in *United States v. Liverpool and London and Globe Insurance Company Ltd.*28

Since *Spokane County,* the requirement that the lien be specific and perfected has been extended to cases where this has contradicted the applicable state lien law. Although a state court's classification of a lien as "specific and perfected" is entitled to weight, it is subject to re-examination in the United States Supreme Court, *specificity* and *perfection* being federal questions.29

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25 279 U.S. 80 (1929).
A lien, in order that it be deemed “choate,” must pass the three-fold test set down by the Supreme Court in **People of State of Illinois ex rel Gordon v. Campbell**.\(^{30}\) (1) identity of the lienor, (2) amount of the lien, and (3) the property to which it attaches. It was held that when these three elements were established the lien would be considered “choate” in the federal sense. This test, however, is subject to such strict interpretation that few creditors’ liens have passed it.\(^{31}\) In **United States v. Gilbert**,\(^{32}\) a case in which these requirements were fulfilled, the court said that there was an additional requirement of transfer of title or possession and it therefore held the lien to be a general, unperfected lien.

In **United States v. City of New Britain**,\(^{33}\) involving liens for municipal real property taxes and water rents, it was stated that the controlling principle is “the first in time is the first in right.”\(^{34}\) Priority is determined by the time at which competing liens “attached to the property and became choate.”\(^{35}\) This was the first case to find a lien, which had not been enforced by taking possession or title, to be choate in the federal sense. The **New Britain** case aroused anticipation of a more liberal interpretation in favor of individual liens, but its value is doubtful because of later decisions.\(^{36}\)

In one of these later decisions, **United States v. White Bear**, Justice Douglas, in his dissent, stated:\(^{37}\)

The court apparently holds that under 26 U.S.C. section 3670 [now 26 U.S.C. section 6321], a lien that is specific and choate under state law, no matter how diligently enforced, can never prevail against a subsequent tax lien, short of reducing the lien to final judgment. That is a new doctrine, not warranted by our decisions and supportable only if the New Britain case was overruled.

The **New Britain** case, however, has not to date been overruled. The deciding principle of “first in time is first in right” has been applied in most later cases concerned with federal priority. The principle has not been a determining factor for many judgments, the courts still being

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\(^{30}\) 329 U.S. 362 (1946). The lien in this case did not pass the test; for “all personal property used in the business” was said to be too vague. However, miscalculation as to the amount of the lien was not sufficient, in itself, to make the lien inchoate.


\(^{32}\) 345 U.S. 361 (1953).


\(^{34}\) Id. at 85.

\(^{35}\) Id. at 86.


\(^{37}\) 350 U.S. 1010 at 1011 (dissent).
nebulously tied up with "choateness." The lien must first be deemed choate in the federal sense before this principle will be applied.38

**Determination of the Status of the Property**

State law determines the nature of the legal interest which a taxpayer possesses in the property sought to be reached by the federal government in asserting its tax lien. Section 6321 of the Internal Revenue Code of 1954 creates no property rights but merely attaches consequences, federally defined, to rights created under state law.39

Recent Supreme Court decisions, *United States v. Durham*40 and *Acquilino v. United States,*41 recognized the so-called "no property" rule. In each of these cases, under their respective state laws (North Carolina and New York), a federal tax lien against a contractor was said to attach only to the residue or net amount of the unpaid balance to which the contractor was entitled after settlement with his subcontractors. The subcontractors have the right of direct payment and were not defeated by the federal liens. Government tax liens cannot prevail if, at the time of the assessment, the property against which the lien is asserted does not belong to the taxpayer.

**Conclusion**

In a recent Circuit Court decision,42 the court mentions the "choate lien test" as requiring that the state-created liens be specific to the point that nothing further need be done to make the lien enforceable. This is a 1960 case, but how does it differ from a case decided thirty-one year prior—*Spokane County v. United States.*43 There is actually no difference in their holdings of "choateness."

In the last thirty-two years nothing has been done to improve the position of the individual lienholder. The principle set out in the *New Britain* case was really nothing more than a reiteration of *Rankin v. Scott.*44 In that case the court stated:45

"The principle is believed universal, that a prior lien gives a prior claim, which is entitled to prior satisfaction, out of the subject it binds, unless the lien be intrinsically defective, or be displaced by some act of the

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43 279 U.S. 80 (1929).
45 Id. at 179.
party holding it, which shall postpone him in a court of law or equity to a subsequent claimant.

Although judicial decisions have not proved adequate in protecting the individual creditor, they are capable of doing so by liberal interpretation of the classes protected under Section 6323(a), and by establishing a reasonable test whereby a lien will, upon inspection, promptly qualify as being either choate or inchoate.

We should also turn to Congress for the enactment of a statute, similar to section 6323(a) of the Internal Revenue Code, exempting other classes of lienholders.

Another solution would be to enact a bill amending those sections of the Internal Revenue Code which deal with the priority of federal tax liens. The American Bar Association has sponsored such a bill, presently pending in Congress. It is designated “Federal Liens Priorities and Procedures Act of 1961.” This act, inter alia, would amend section 6323 of the Internal Revenue Code by striking out “validity against mortgagees, pledgees, purchasers and judgment creditors” and inserting, in lieu thereof, “validity against security interests, liens and transfers.” This bill also would amend 31 U.S.C. section 191 which provides exceptions to the federal priority. These exceptions include: (1) administrative expenses, (2) funeral expenses, (3) wage claims, (4) state and local taxes and (5) claims for rent. This bill, which is a thorough analysis of the entire field of federal priorities, was presented for the purpose of protecting persons entering into business transactions against federal lien claims of which they have no knowledge and, in many instances, no means of discovering. This bill is the proper remedial action, and its enactment may serve as a major step in repairing the wrong which has been done to the individual lienholder.

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