Enforced Collection of Tax Debts

Internal Revenue Service, USA

Introduction

The enforced collection of tax debts is a highly visible and dynamic function of tax administration. The mission of a collection function is twofold: 1) the efficient collection of the tax debt (protection of the government's interest), and 2) the protection of the rights of all the taxpayers. When the mission is carried out in a quality fashion there is an increase in confidence and compliance with the system.

The Internal Revenue Service (IRS) administers the Internal Revenue Code (IRC) as enacted by the Congress and signed by the President of the United States. The IRS participates in the creation of law only to the extent that Congress seeks assistance in determining the ramifications of proposed legislation. The enforced collection of a tax debt is an area which has received recent attention by the government of the United States. This article will show some of the steps taken to implement new laws, as well as efforts undertaken to increase the overall effectiveness in administering the IRC. The common method used in accomplishing this is the creative utilization of technology in areas which are traditionally labor intensive.

There are seven sub-titles that make up our discussion of "Enforced Collection of Tax Debts." They are: 1) Direct enforced collection by the tax administration or transfer of collection to private agencies; 2) Design, development, and updating of the delinquent taxpayer file; 3) Judicial intervention in the process, advantages and inconveniences; 4) Guarantees, powers and rights of the parties in the enforced collection process and objections which may be made by taxpayers; 5) Transfer of fiscal responsibilities of the company's net worth to the net worth of partners and/or administrators; 6) Intervention (levy) of bank accounts, and; 7) Priority of tax credit (lien). Each will be addressed in order of listing.

Direct Enforced Collection: by Tax Administration or by Private Agency

Discussions on this subject center around two broad areas of consideration: practical and philosophical.

The authority to tax is an inherent governmental power, which is a critical test of a state's sovereignty. It is arguably the most pervasive form of law enforcement a government exercises. The tax laws not only affect every individual in a society, but have a direct impact on every sector of the economy. As such, a high degree of accountability must be maintained.

Enforced collection of an outstanding tax debt has historically been reserved to government officials in order to maintain direct accountability and because such activity ultimately hinges on two questions: 1) Is the amount owed correct? and 2) Can it be collected (without hardship)? These concerns, coupled with a need to ensure taxpayers' rights, constitute the mission of tax administration. Our experience has demonstrated that consolidating these responsibilities within one agency results in the most efficient method of administration. To do otherwise could lead to an adversarial environment resulting in judicial review. Few would argue with the fact that such reviews are both expensive and time consuming.

The main argument used in advocating collection by private agencies is efficiency; the assumption is the private sector is more efficient than the public. Private collection agencies, on the average, charge a 25-30% fee for the dollars they collect. In fiscal year 1988 (FY88) the Internal Revenue Service (IRS) brought in $8 for every $1 expended in enforced collections. This is a "fee" of 12.5%. The technology used by both sectors is basically the same; although the government does retain unto itself greater authority in this area than a private agency could exercise. Private agencies can be hired to provide valuable services at an economical price to **assist** governmental agencies in the collection of debts. One such task is locator services. When the tax administrator fails to locate a delinquent taxpayer at the address of record, private enterprises may provide a low cost finder's service. A major portion of the work done in a collection office involves locating the taxpayer and his/her assets. In this area it has been found to be beneficial to contract with private agencies.

The obvious reason for this discrepancy in "fees" is the need for the private agency to make a profit. Although this should be the driving force for the private sector, in tax collection other issues supersede this consideration. If this were not

so, the result would be an abuse of authority and infringements on the rights of taxpayers (the only recourse being to more expensive judicial review). In light of the fact that the IRS is empowered with authority beyond what a private agency may undertake in collecting, that both sectors utilize the same technology, and that tax administrators need not make a profit, it would appear, not only in philosophical terms, but also in practical terms of efficiency, that enforced collection remain in the hands of government officials.

Design, Development, and Updating of the Delinquent Taxpayer File

A taxpayer identifying number (TIN) is crucial to the success of retrieval of taxpayer files and data. Computer storage and access is vital to the efficient operation of tax administration and the use of a TIN is the basis for this system of storage and access. Routine files (master files), containing account data and other information, categorized by the source and type of data will contain the history of a taxpayer's account, and, as needed, can be easily accessed by TIN and correlated for enforcement activities.

Delinquent taxpayer files would then be created when a taxpayer fails to comply with some aspect of the tax law. The criteria for creation of a delinquent account file would include an automated analysis of available files for the given taxpayer. That is, the relevant files need to be correlated for a given TIN, the data analyzed, and an extract of summary data compiled for creation of a delinquent taxpayer account. A sample of the data which is analyzed might include information from third parties on interest paid, wages paid, and large dollar transactions. In addition, there may be information that is received from other taxing authorities that would cause the generation of an inquiry. The account is then sent to a file for the compliance functions to prioritize and pursue. Computer programs are instrumental in accomplishing the necessary analysis to ascertain whether an inquiry is warranted.

As the compliance functions take actions and create history items, data is transmitted back to the master files as record updates. Errors need to be corrected and new data needs to be added, with an audit trail, and other system safeguards. Ideally, one request for taxpayer data would access all relevant master files and return a taxpayer's complete record and history.

Some third party sources which can be used to add to a file are: credit bureaus, telephone directories, motor vehicle departments or similar agency,

employment departments, county recorders (real and personal property), Secretary of State (for corporate records and required filings regarding business transactions), utility companies, various state agencies (such as licensing and taxing authorities), and cross directories (listing by address and phone number). The increased use of computers to interact with one another for the purpose of data extraction greatly increases effectiveness and efficiency.

In general terms, the increased ability to use technology in areas traditionally requiring labor intensive tasks results in significant productivity gains. As a result, many of the areas of advancement in collection are centered around creative utilization of technology.

Judicial Intervention in the Process Advantages and Inconveniences

Congress in enacting the Internal Revenue Code (IRC) gave the Internal Revenue Service (IRS) broad administrative authority for the collection of taxes. Although such processes are responsible for a majority of the delinquent tax accounts collected, considerable credit for such success lies in the ability of the IRS to utilize, when the need arises, the aid of the courts to insure collection of the tax.

Between the two collection processes, administrative and judicial, the administrative process is far less expensive and time consuming; therefore, in the absence of unusual circumstances, judicial proceedings are used only as a last resort. However, once the decision is made to proceed by way of a court action, you should move quickly and thoroughly to insure its success. Because of the publicity that generally accompanies a court proceeding, the success of such an action cannot be measured solely in the dollar amount of the tax collected.

The expense and time of a successful judicial proceeding gives the tax administrator access to methods of collection offering many benefits. A suit to foreclose a tax lien and a suit to reduce a lien to judgment are two examples that will be discussed.

A suit to foreclose a tax lien may be instituted for the purpose of resolving questions of priority or title prior to sale or to eliminate the right of redemption available to the taxpayer. The aim of each is to increase the sale price. If a business is involved, the court may forbid the taxpayer from competing with the purchaser in the same business, and/or area, after sale. This could greatly increase the value of the seized property.

A suit to reduce a lien claim to judgment is another method used to enforce collection. At present there may be no assets subject to levy. The judgment extends the limitations period otherwise applicable to the collection of the tax liability. If the suit is successful the government has the option of levying, proceeding to enforce the judgment or instituting judicial foreclosure of its tax lien.

The judgment achieved through the courts can result in very significant benefits accruing to the winning party. The odds of achieving the desired results and the benefits of these results must be weighed against the increased expense in time and money needed to obtain such a judgment in order to justify instituting the suit. In broad terms: the primary advantages usually sought in the judicial process are an increase in value of property being sold to satisfy a tax debt and securing an extended amount of time to settle the tax debt; the inconveniences which accompany these advantages are the added time and money necessary to carry on a successful suit.

Guarantees, Powers and Rights of the Parties in the Enforced Collection Process and Objections which may be made by Taxpayers

In a majority of instances there are three parties involved when enforced collection action is taken. They are: the Government, a third party in possession of property belonging to the taxpayer, and the taxpayer. Each party has rights and obligations which must be observed as enforced collection occurs.

Government

Once the lien exists, and the taxpayer fails to render full payment within 30 days (absent jeopardy) of a notice of intent to levy, the Government has the authority to seek payment through enforced collection procedures. Prior to taking enforced collection action the Government has an obligation to serve the taxpayer with a 30 day notice of intent to levy. This notice has to be (a) given in person, or (b) left at the dwelling or usual place of business of the taxpayer, or (c) sent by certified or registered mail to such person's last known address.

Once a levy is made, the government has a general obligation to preserve and protect such property during the period of custody. The government must protect the property, if it is within its power to do so.

Third Party

The third party in possession of property of a taxpayer has two competing concerns to address. On the one hand they realize the necessity of complying with federal law as it pertains to levy. On the other hand there exists a concern over an obligation or liability to the taxpayer. The Internal Revenue Code (IRC) makes it clear that where a person levied upon honors a levy and surrenders to the government property or rights to property with respect to which the levy is made, he/she is discharged from any obligation or liability to the taxpayer with respect to the property surrendered. Similarly, where a person becomes personally liable for failing or refusing to surrender property or rights to property subject to levy, and subsequently pays this liability, he/she, too, is discharged from any obligation or liability to the delinquent taxpayer with respect to such property or rights to property arising from such payment. The IRC does not relieve from liability any person who mistakenly surrenders to the government property or rights to property belonging to a third party. The owners of mistakenly surrendered property may secure administrative relief or may bring suit to recover their property under the IRC.

Taxpayer

On November 10, 1988, the Omnibus Taxpayer Bill of Rights (Bill) was signed into law. The Bill was the product of close consultation between Congress and the Internal Revenue Service (IRS). The major objective of the Bill was to place more emphasis on the individual rights of the taxpayer. It codified many policies of the Service and therefore did not have a drastic effect on how the Service conducts business. The protection of the rights of taxpayers should always be an integral part of the mission of the IRS.

The Bill contains numerous provisions dealing with collection issues. Some of the areas covered are: advising taxpayers of their rights; procedures involving taxpayer interviews; taxpayers may rely on written advice of the IRS; taxpayer assistance orders; basis for evaluation of IRS employees; installment payment of tax liabilities; levy and distraint; administrative appeal of liens; awarding of costs and certain fees in administrative and civil actions; civil causes of action for damages sustained due to certain unauthorized action by the IRS; and jurisdiction to review certain sales of seized property.

Disclosure of Rights of Taxpayer

This provision requires the IRS to give a written statement of the rights of the taxpayer and the obligations of the Service at the beginning of the collection process. Part of the mission of the Service is to collect the correct amount of tax. Under a voluntary system of tax administration this can be accomplished only if the public is well informed of its rights and obligations.

Procedures Involving Taxpayer Interviews

This codified IRS procedures for the audio recording of interviews with taxpayers. Either party may record if advance notice is given to the other. Also, absent a summons, the taxpayer may terminate an interview at any time; although repeated and unjustified terminations may result in enforcement action. In addition, the place and time of an interview dealing with the determination or collection of a tax liability must be reasonable. Finally, taxpayers may be represented by certain third parties who have been given written powers-of-attorney. Taxpayers must personally appear in response to an administrative summons.

Taxpayer Assistance Orders

The provision gives the Taxpayer Ombudsman (or designee) the authority to intervene in certain administrative situations. A taxpayer assistance order (TAO) can be issued that directs the compliance function to take certain action if it is determined that the taxpayer is suffering, or is about to suffer, a significant hardship. Significant hardship is defined as a serious privation caused or about to be caused to the taxpayer as the result of the particular manner in which the internal revenue laws are being administered by the IRS. It means more than an inconvenience to the taxpayer. TAOs cannot be ignored by any function. Withdrawal or modification of the TAC can only be done by the issuing authority or their superior.

Basis for Evaluation of IRS Employees

The provision states that the IRS will not use tax enforcement records for purposes of evaluating either employees directly involved in enforcement activities nor their immediate managers. Additionally, these records may not be used to impose or suggest production quotas. A tracking system to ensure compliance with this provision is essential to success.

Although not precisely a right of the taxpayer, the existence of the provision is essential to maintain the necessary equilibrium when collection and ensuring taxpayer's rights are concurrent goals.

Installment Payment of Tax Liability

This provision provides the IRS with statutory authority to enter into a written installment payment agreement if the Service determines that such an agreement will facilitate collection of tax. The agreement will remain in effect as long as the taxpayer makes the required payments, files returns and pays subsequent tax liabilities, provides supplemental financial information when requested, and collection of the tax is not in jeopardy. The agreement is void if based on false information. The taxpayer, absent jeopardy, has the right to a 30 day notification of the termination, alteration or modification of an agreement based on an IRS determination of change in financial condition.

Levy and Distraint

Due to the effect, and intrusive nature, of levy and distraint actions, extensive guidelines have been provided to the IRS in this area.

The IRS (absent jeopardy) must wait 30 days before taking enforcement action after notifying the taxpayer of intent to levy. This provides a reasonable time frame for the taxpayer to prepare his/her response.

The notice of intent to levy includes in brief, non-technical, language the following: a) a description of the process and procedures involved in levy actions, b) an explanation of the appeals process and procedures, c) an explanation of the alternative remedies available to satisfy the liability (including installment agreements), and d) an explanation of the redemption of property and release of lien provisions of the IRC.

The dollar criteria was modified for exempting certain property from levy as well as adding types of property to this category. The dollar criteria dealt with exempting amounts of books, tools of the trade, fuel, and provisions. The types added were: a) public assistance payments, b) job training benefits, and c) personal residence, unless prior written approval of the district director or assistant district director is secured, or jeopardy exists.

In addition to exempt properties, levies are, in certain instances, prohibited. No levy may be made on the date of appearance in response to an administrative summons unless collection is endangered. A levy cannot be made on any property if the cost of the levy exceeds the **fair market value** of the property at the time of levy.

An attachment on a bank account freezes funds on deposit for 21 days from the date of levy receipt. The funds, along with interest on the amount attached, not exceeding the total amount owed, will then be sent to the IRS.

Levies will be released when the underlying liability is satisfied; is no longer legally collectible; when release will facilitate the collection of the liability, or; if the fair market value of the property exceeds the liability owed and a partial release would not hinder collection of the liability.

Taxpayers are entitled to an expedited review of a levy involving personal assets essential to the maintenance of a business. The review will determine whether a release under the provisions of the preceding paragraph is applicable. A taxpayer may also request that seized property be sold within 60 days of seizure. The sale must be held pursuant to this request unless it is in the Government's best interest to delay the sale.

Administrative Appeal of Liens

For notices of lien filed by the IRS an administrative review procedure must be in place to permit the release of notices filed in error. The procedure would apply if the liability was satisfied prior to filing of notice, or the taxpayer is in bankruptcy and subject to the automatic stay, or a deficiency assessment was improperly made. This section cannot be used to challenge the validity of the underlying liability. If it is determined that the filing is erroneous, a release must be issued within 14 days of the determination, to the extent practicable. The release must contain a statement that the filing was erroneous.

Civil Cause of Action

A number of provisions exist which provide the taxpayer avenues for seeking relief and recovery from actions taken by the IRS. The Government waives its right of sovereign immunity. Employees who are performing their assigned duties are immune from suit.

Taxpayers may recover reasonable litigation and administrative costs in instances where the IRS' position was not substantially justified. The burden of proof, however, still lies with the taxpayer. Additionally, the IRS may settle claims for administrative and litigation costs prior to commencement of a civil action.

A second section allows the taxpayer to sue the federal government for damages if the IRS **knowingly** or **negligently** fails to release a lien when release should be made. The taxpayer, if successful, will be compensated for actual, direct, economic damages plus the cost of the action. Before bringing suit, the taxpayer must first request that the IRS release the lien and release does not occur.

The third section of the Bill dealing with civil actions provides that a taxpayer may sue the federal government for damages, if any officer or employee of the IRS "**recklessly** or **intentionally** disregards" any provisions of the IRC or associated regulations. Negligence or carelessness by an IRS employee would not give rise to a cause of action. Damages are limited to the lesser of $100,000 or actual direct economic damages suffered by the plaintiff plus costs of the action. Limitations on the suit are: a) all administrative remedies must be exhausted by the taxpayer, b) damages will be reduced by the amount that could have been reasonably mitigated by the plaintiff, and c) the suit must be brought within two years after the date the right of action arose. The government may be awarded up to $10,000 if the taxpayer's suit is found to be frivolous or groundless. The IRS would assess and collect the damages awarded.

Transfer of Fiscal Responsibilities of the Company's Net Worth to the Net Worth of Partners and/or Administrators

The IRC provides for many ways of collecting the liability of a corporation that cannot meet its tax obligations. The appropriate method depends on the facts of the case and the type of tax(es) involved.

A comprehensive example would be if the taxes involved included trust fund taxes. Trust fund taxes are those which are collected from a third party and held in trust for payment to the government. The investigating officer might pursue collection (if the facts are supported) by way of the 100 percent penalty (for the trust fund portion), a transferee/nominee procedure, and/or collection under the alter ego doctrine.

The 100 percent penalty requires the officer to determine which person(s) were responsible for paying over the trust fund taxes and willfully failed to do so. A responsible person is one who has the duty to perform or the power to direct the act of collecting, accounting for, and paying over these trust fund monies. A willful act in this case does not imply a bad motive or evil intent. All that needs to be shown is the responsible party was aware of the outstanding taxes and declined to pay them over or had knowledge they were not being paid. In other words, he/she intentionally and knowingly caused the delinquency in payment of trust fund taxes. This is the essence of the responsible officer's personal liability. The term "100 percent penalty" refers to the amount of the unpaid trust fund that will be assessed. Whatever this unpaid amount is determined to be, 100 percent of it is the penalty assessed against all persons found to be responsible and willful.

The "alter ego" doctrine, in commercial law, states that the obligations of a corporation will be recognized as those of another person, and vice versa, where it appears that the corporation is not only influenced and governed by that person, but there is such a unity of interest and ownership that the individuality/ separateness of the person and of the corporation has ceased. Also the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote an injustice. Briefly stated these two elements of the alter ego doctrine are: a) unity of interest and ownership, and b) fraud or inequity would result from the failure to disregard the corporate entity.

The feasibility of using the administrative process of a jeopardy transferee assessment, emergency lien foreclosure action or emergency transferee or fraudulent conveyance suit should be explored before filing a notice of lien in the name of an alter ego. Even though the foregoing actions may not be feasible, a lien in the name of an alter ego should not be filed without legal review, advice, and written direction as to the need for a supplemental assessment, a new notice and demand, and the language to be incorporated in the notice of lien and levy.

Our Government may reach assets which are disposed of by the taxpayer prior to assessment and which are not subject to the tax lien. The three principal methods by which the Government may proceed in instances where assets have been transferred in fraud of creditors are: a) suit to set aside fraudulent conveyances, b) transferee liability by civil law suit, and c) transferee liability by statutory notice. Of these methods, assessments which can be obtained administratively are pursued first.

Investigators encounter situations in which the taxpayer transfers property which, under the circumstances, indicates either actual or constructive fraud is involved in the transfer. In other cases, property may have been acquired in the name of another person or entity (a nominee) but the taxpayer exercises dominion and control over the property to such an extent that it is clear the title holder is possessed of nothing more than the "color of title."

In cases where property has been transferred to or acquired in the name of a third party with the taxpayer's funds, a notice of transferee lien may be used to subject the property to the Government's lien. In some jurisdictions, local law may not recognize a transferee lien without judicial process or it may not be possible to show that title to the property was derived from or through the taxpayer. Where a transferee lien is not feasible but a combination of facts and circumstances support a conclusion that the taxpayer clearly treats the property as his/her own, a notice of nominee lien may be filed. In such a case development, circumstances to be considered should be the taxpayer paying maintenance expenses, using the property as collateral for loans and paying state and local taxes on the property.

Caution should be exercised in the use of notices of lien and levy predicated on transferee or nominee theory. Such action should not be initiated without approval of legal counsel. Once approval is secured, subsequent collection action is within the administrative discretion of collection officials.

In determining what additional enforcement measures to pursue after filing a notice of transferee or nominee lien, consideration should be given to the likelihood that confusion in the chain of title and potential redemption rights may depress the sale of property sold administratively under either transferee or nominee theory. A judicial lien foreclosure or seizure followed by suit to foreclose the lien will generally bring a greater sale price, particularly for real property. However, the more expedient administrative seizure and sale may be desirable if there is a need for prompt action to protect and preserve the Government's interest in the property.

Intervention (Levy) of Bank Accounts

A levy is an administrative means of collecting taxes by seizure of eligible property to satisfy delinquent taxes. A levy is an administrative method of compelling payment of a delinquent tax liability.

There is no statutory requirement for the sequence to be followed in levying, but it is generally more effective to levy on funds in possession of third parties. A bank levy is one of the most efficient sources available in terms of cost and effectiveness. The term "bank" includes: credit unions, trust companies, savings and loan associations, and similar institutions.

State law defines property. Once defined, federal law controls and a bank must honor a notice of levy regardless of state laws or by-laws of the bank providing that the amount on deposit shall not be paid except upon presentation of the passbook. We believe the courts would also strike down a bank's defense to a suit for failure to honor a levy that a properly drawn check made by the depositor had to be presented as a condition precedent to payment of the amount in a checking account to the IRS.

A bank must hold funds on deposit for 21 days before sending the attached amount, plus interest (not to exceed the total amount due), to the IRS. The levy does not reach money deposited in the taxpayer's account after the levy is received. The levy attaches to: certificates of deposit (regardless of maturity date), joint bank accounts (as long as the taxpayer can withdraw money without the consent of the other depositor), and to funds which have been deposited but are not yet available for withdrawal. Mailing a bank levy is usually the most efficient method of service. Field investigators deliver notices of levy to banks when the facts of the case warrant. The mailing of levies is most efficient, and most often, accomplished by systemic levies. A systemic levy is one where the accessing of information for, and the preparation of, the levy is accomplished by computer.

The interest a bank pays equals the amount the taxpayer earns, on the attached funds, up to date of surrender. However, in no case will the bank pay over more than the total amount due on the levy. The date the bank credits interest to depositors' accounts has no bearing on their obligation to pay interest on the attached funds.

Bank information is secured from various sources. The most efficient source is the taxpayer. If the taxpayer is uncooperative, there are a variety of third party sources we use. Under current procedures banking institutions must file annual information documents with the Internal Revenue Service (IRS) for interest credited to accounts. This information can be secured through internal means, reducing cost and increasing efficiency. Through an additional expenditure of resources, bank information can be secured by checking public records in search of lien holders. Information that the lien holder possesses is usually valuable in light of the taxpayer's desire to substantiate their solvency for the lien holder.

As is the case with all third party levy action, the bank is relieved of liability or obligation to the taxpayer in relation to the property levied upon.

In most instances a branch bank is to be considered as an agent of the main bank and not a separate and distinct institution. It is the position of the IRS that a notice of levy served upon the main bank reaches an account in a branch bank. However, where it is believed that the taxpayer has an account in a branch bank, it may be advisable to serve a notice of levy on the main bank at the same time a notice of levy is served on the branch bank.

A bank account of the taxpayer may be designated "special account," but in the absence of evidence that a trust was created a bank must honor a levy served upon it as to the "special account." Quite often a savings account may be standing in the name of the taxpayer in trust for another party (Totten Trust). A trust is nothing more than another means of disposing of property by the party establishing the trust (settlor). Usually, the deposit in a "Totten Trust" is held to be that of the settlor-trustee during the period he/she maintains control over the account with the freedom to make deposits and withdrawals at will. However, the "Totten Trust" becomes a true trust with title of the beneficiary becoming indefeasible upon delivery of the passbook to the other party, unequivocal notification given to the beneficiary that the trust has been created for his/her benefit, or upon the death of the depositor without having revoked the trust. Thus, whether a levy will reach such a trust depends upon who the taxpayer is (depositor or beneficiary) and whether or not an irrevocable trust was established.

Trying to prove whether a bank deposit is a true trust or not will present difficulties which are not limited to "Totten Trusts." It would be advantageous in most cases to ascertain who has the property in a trust account before serving a notice of levy upon the bank.

Two areas of interest arise with respect to outstanding checks and the serving of a notice of levy.

The first is when the taxpayer draws checks on an account prior to levy, but the checks are not presented to the debtor bank until after the notice of levy is served, or are honored before the service of levy but the amounts so paid have not been charged on the bank's books to the depositor's account. In the latter case a bank was held not to be in possession of any property or rights to property of the taxpayer-depositor with respect to checks honored before service of notice of levy, notwithstanding the fact that at the time of levy, the checks paid had not been charged on the bank's books to the taxpayer's accounts. On the basis of this

decision, if the checks had not been presented for payment prior to levy, or had been presented, but not honored, the bank would have had property of the taxpayer subject to levy. As an aside, it is also clear that the bank is required to pay over the funds actually on hand at the time the notice of levy is served, not the amount indicated by the bank in its acknowledgment of service.

The second problem area arises when a taxpayer deposits checks to his/her account drawn by a party having an account in the same bank and the maker delivers to the bank a stop-payment order after acceptance of the deposit by the bank, but before the bank's books reflected the charge against the maker's account. In this situation, the Government was held to be entitled to the money in the taxpayer's account reflecting the balance remaining from the deposit of the accepted checks, notwithstanding a stop-payment order by the maker before appropriate book entries were made by the bank and before the notice of levy was served upon the bank. The tests are whether and at what time the bank accepts checks for deposit in relation to a stop-order.

Priority of Tax Credit (Lien)

The United States Federal Tax Lien (FTL) serves two intertwining functions. The first is to serve as a collection tool. The existence of the FTL, or the possibility of it arising, encourages the delinquent taxpayer to discharge his liability. The second function is to preserve the Government's priority against third parties. It is this function which we now address.

The United States Government has a responsibility to ensure that everyone pays their fair share under the Internal Revenue Code (IRC). In addition, the Government has the responsibility to act in a manner which does not unduly disrupt the economy. It is within this context that the Federal Tax Lien Act of 1966 became law, and within which the FTL operates today.

Under the IRC a FTL arises when the delinquency is assessed and after the taxpayer neglects or refuses to pay (within 10 days) after demand has been made. The demand must be made within 60 days of assessment. The FTL is effective as of the date of assessment and attaches to all property, and rights to property, belonging to the taxpayer, or property and rights to property acquired thereafter. At this point the public has no notice of the FTL. In spite of this lack of public notice, the FTL is valid and has priority over all but subsequent purchasers, judgment lien creditors, mechanics' lienors, holders of security interests, and a

trustee in bankruptcy. In order to be valid in relation to these classes of creditors the FTL must be filed. Once filed, priority is determined by the first-in-time, first-in-right doctrine.

Even though a notice of federal tax lien (NFTL) has been filed, and priority protected under the first-in-time doctrine, the FTL is still not valid as against certain interests. These so called "superpriorities," are: (1) securities, (2) motor vehicles, (3) personal property purchased at retail, (4) personal property purchased in casual sale, (5) personal property subject to possessory lien, (6) real property tax and special assessment liens, (7) residential property subject to a mechanic's lien for certain repairs and improvements, (8) attorney's liens, (9) certain insurance contracts, and (10) passbook loans. The NFTL is not valid against a superpriority unless they had actual notice or knowledge of the existence of the lien (in most cases). The notice must be actual and not constructive. It falls to the Government to prove the existence of notice or knowledge. The particulars of each superpriority will now be dealt with.

Securities

The FTL is not valid against the purchaser or the holder of a security interest in a security, i.e., share of stock, who did not have actual notice of the existence of the FTL at the time of purchase. A subsequent holder of a security interest is also protected if the prior holder did not have actual notice at the time the security interest came into existence.

Motor Vehicles

A FTL is not valid against the purchaser of a motor vehicle if, at the time of sale, the purchaser did not know of the existence of the FTL, and; before the purchaser has actual notice or knowledge, takes possession of the motor vehicle and does not relinquish it to the seller or his/her agent.

Personal Property Purchased at Retail

The purchaser of tangible personal property purchased at a retail sale is protected unless at the time of purchase the purchaser intends the purchase to (or knows the purchase will) hinder, evade or defeat the collection of the federal tax. In any other set of circumstances the purchaser takes possession free of the lien; whether or not notice or knowledge of the lien exists.

"Retail sale" means a sale made in the ordinary course of the seller's trade or business of tangible personal property of which the seller is the owner. It includes a sale in the customary retail quantities by a seller who is going out of business. It does not include a bulk sale or an auction sale in which goods are offered in quantities substantially greater than are customary in the ordinary course of the seller's trade or business or an auction sale where the owner is not in the business of selling such goods.

Personal Property Purchased in Casual Sale

The FTL is not valid against a purchaser of household goods, personal effects, or other tangible personal property purchased (not for resale) in a casual sale for less than $250. A casual sale is a sale not made in the ordinary course of the seller's trade or business. Protection is afforded only if the purchaser does not have actual notice or knowledge of the existence of the FTL, or that this sale is one of a series of sales.

Personal Property Subject to Possessory Lien

The FTL is not valid with respect to tangible personal property subject to a lien under local law securing the reasonable price of the repair or improvement of such property. The holder of such a lien must continuously have possession of such property from the time his/her lien arose. If local law gives an automobile mechanic a lien for the repair bill and the right to retain possession of an automobile he/she has repaired as security for payment of the repair bill, and the mechanic retains continuous possession of the automobile, a FTL which has attached to the automobile is not valid to the extent of the repair bill.

Real Property Tax and Special Assessment Liens

Even though a notice of lien is filed, the FTL is not valid with respect to real property, as against a holder of a lien upon such property, if such lien is entitled under local law to priority over security interests in such property which are prior in time, and such lien secures payment of: (a) tax of general application levied by any taxing authority based upon the value of such property; (b) a special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the cost of any public improvement; or (c) charges for utilities or public services furnished to such property by the United States, a state or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

If real estate taxes (whenever they accrue) are ahead of mortgages under local law, they will also be ahead of the FTL. The same result will ensue if a special assessment lien arises after the FTL is in existence. The same priorities apply in the case of charges for utilities or public services.

Residential Property Subject to a Mechanic's Lien for Certain Repairs and Improvements

This "superpriority" also includes real property, but the property must be a personal residence containing not more than four dwelling units with the owner occupying one of the units and the total contract price must be $1,000 or less to be eligible for the absolute priority which is afforded the mechanic's lienor.

Even though a mechanic lienor may not be entitled to a superpriority because the contract price is in excess of $1,000, it is possible that he/she will prevail over a FTL against a contractor or subcontractor as to the contract proceeds, since by the failure to pay laborers and material suppliers, the taxpayer may be deemed to have no property right in the proceeds to which the FTL could attach.

Attorney's Liens

In certain instances attorneys who have lien claims may prevail over the FTL. This claim must be valid under local law and relate to a judgment or settlement of a claim/cause in action. However, an attorney's claim against the Government is treated differently. The Government offsets judgments against any liability a taxpayer owes the Government. Even in those cases where the attorney's lien enjoys the priority over the FTL, it is limited to reasonable compensation. Generally, reasonable compensation means the amount customarily allowed under local law for an attorney's services for litigating or settling a similar case or administrative claim. Nevertheless, reasonable compensation shall be determined on the basis of the facts and circumstances of each individual case. The priority does not apply to an attorney's lien which may arise from the defense of a claim or cause of action against a taxpayer, except to the extent such a lien is held upon a judgment or other amount arising from the adjudication or settlement of a counterclaim in favor of the taxpayer.

Certain Insurance Contracts

An insurer under a life insurance, endowment or annuity contract with a taxpayer is protected under the following situations: (a) if an insurer makes a so-called policy loan on a life insurance policy after a notice of lien has been filed with respect to the property of the insured, the insurer is protected as against the tax lien if such insurer did not have actual notice or knowledge of the existence of the tax lien at the time the policy loan was made; (b) the insurer, after actual notice or knowledge of a FTL, will still have priority but only with respect to advances (including contractual interest) required to be made under an agreement entered into prior to such actual notice or knowledge; although an insurer will not have priority for so-called policy loans made after the insurer has actual notice or knowledge that the policy is subject to a tax lien, the insurer may nevertheless continue to make so-called automatic premium loans to maintain the contract in force and have priority over the FTL with respect to such loans, if the agreement to make the automatic premium loans was entered into before the insurer had actual notice or knowledge.

Passbook Loans

This superpriority is intended to protect a bank or building and loan association with regard to a passbook loan only to the extent that the loan is secured by an account with the bank or association and the institution in fact retains the passbook in its possession until the loan is completely paid off. This protection is available only for passbook loans made before the bank or association has actual notice or knowledge of the existence of the tax lien. Where a passbook loan is made before this knowledge and the bank or association subsequently obtains knowledge, this protection does not attach to any additional loans made after the knowledge is acquired even if the bank continues to retain the passbook from the preceding, protected, passbook loan. The term "passbook" includes any tangible evidence of a savings deposit, share or other account or procedure or system, such as an automatic data processing system, which prevents the withdrawal from the account to the extent of the loan balance.

FTL Priority & Purpose

The filing of the notice of the FTL is in no sense a step required to give rise to the lien or to perfect the lien. The act of filing has no purpose or significance other than to protect the Government's right of priority as against a purchaser, holder of a security interest, mechanic's lienor or judgment lien creditor. The FTL

is not valid against persons falling within these categories until notice thereof has been properly filed. Even after filing, the priority of the FTL can be superseded if a transaction occurs within the parameters of the "superpriorities." The Government's prioritization of claims reflects the dual responsibilities it must carry out. The first is to ensure payment under the law; the other, to act in a manner which does not hinder, and indeed enhances, the performance of the economy. Due to the dynamics of the local and world economy the priority of the tax lien must constantly be reviewed in order to ensure that it allows the Government to successfully carry out these responsibilities. Ideally the system of priorities would address the present and anticipate the future.

Conclusion

The effective administration of a tax system requires the support of those being taxed. This support is developed and enhanced when the people perceive a high degree of integrity and proficiency in the operation of the system. These expectations are met when the system actively pursues its mission in an evenhanded manner that recognizes the equality of all aspects of that mission (the protection of the Government's and the taxpayer's interests).

Each area discussed in this article reflects an effort on the part of the Internal Revenue Service to effectively and efficiently administer the Internal Revenue Code in a manner that warrants public confidence. In an area as highly intrusive as enforced collection the necessity of ongoing scrutiny and development cannot be over emphasized. In fact, it is a natural result of the dynamics used in carrying out the two-part mission of a collection function in tax administration. If you are to protect the taxpayer's interest, you must anticipate the effect of the tax laws and how they are administered.