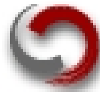
TAX BULLETIN  FEBRUARY 2001

PILLSBURY WINTHROP LLP

Federal and New York State Tax and Employer-Related Liens

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Summary and Highlights

Federal Tax Lien

Internal Revenue Code ("I.R.C.") section 6321 creates a lien in favor of the United States for assessed taxes (including interest, penalties and additional amounts). This federal tax lien automatically arises and attaches to all property and rights to property belonging to a taxpayer who fails to pay the assessed amount after notice and demand. The federal tax lien is deemed to arise on the assessment date (prior to notice and demand and nonpayment), and is automatically perfected, although filing is required to establish its priority.

The general rule is that a secured creditor with a perfected security interest[1] has priority over the federal tax lien as to credit extended prior to the time, and in collateral in which the borrower has an interest at the time, the federal tax lien is filed, whether or not such creditor knew of the existence of the federal tax lien. *See "The Federal Tax Lien–Priority of the Tax Lien Relative to a Security Interest or Lien."* However, the secured creditor is behind the federal tax lien as to credit extended, and in any collateral (**including proceeds**) acquired by the borrower, after the filing of the federal tax lien, subject to the exceptions discussed below.

The exceptions relate to credit extended, and collateral securing obligations, under the following four types of agreements:

- Commercial Transactions Financing Agreements (secured by property such as accounts receivable, mortgages on real property, inventory and paper of a kind ordinarily arising in commercial transactions (including negotiable instruments and securities)),
- Real Property Construction or Improvement Financing Agreements (generally secured by real

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[1] As used hereinafter, unless otherwise specified, "security interest" includes a "lien."

property mortgages (other than purchase money mortgages) and construction contracts),

- Obligatory Disbursement Agreements (generally concerning letters of credit and surety agreements) and
- Disbursement Agreements pursuant to which disbursements are made during a 45-day window after the tax lien filing.

Each exception has unique limitations on its coverage that are discussed in more detail below at "The Federal Tax Lien–Priority of the Tax Lien Relative to a Security Interest or Lien–Relief for Certain Security Interests or Liens after Notice Is Filed."

New York State Tax Liens

Each of New York State's corporation tax, business corporation tax and tax on banks and other financial institutions can become a lien in favor of New York State attaching to all real, personal and other property belonging to a taxpayer. *N.Y.Tax Law § 1092 (McKinney 1987 and Supp. 1999).* Under the New York law, New York State's rights are deemed to be those of a "lien creditor" as defined under section 9-301(3) of the Uniform Commercial Code. Accordingly, a secured lender's perfected security interest has priority over the New York State tax lien only to the extent that the perfected security interest secures either credit extended before the tax lien is filed or within 45 days thereafter, or credit extended without knowledge of the New York State tax lien or pursuant to a commitment entered into without knowledge of such tax lien. *See "New York Tax Lien."*

Liens Relating to Employee Benefit Plans

Section 4068 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), imposes a lien in favor of the Pension Benefit Guaranty Corporation ("PBGC") upon sponsors, and certain members of their controlled groups, of certain types of employee benefit plans, to secure amounts due the PBGC not in excess of 30 percent of the collective net worth of the plan sponsor and all controlled group members with positive individual net worths.

ERISA section 302(f) (and parallel Internal Revenue Code section 412(n)) impose a lien—that is not limited to a function of net worth—on any person, and members of its controlled group, who fails to satisfy the minimum funding standard for defined benefit plans if the unpaid balance of contributions due under ERISA section 302 is in excess of $1 million.

The relative priority of the PBGC lien both under ERISA section 4068 and under ERISA section 302(f) with respect to a competing security interest of a secured creditor is governed by Internal Revenue Code section 6321 which, as noted above, governs the relative priority of a federal tax lien. *See "The PBGC Lien," "Lien for Failure to Make Required Contributions" and "Multiemployer Plans."*

Lender Liability for Unpaid Employment and Withholding Taxes

Internal Revenue Code section 3505 imposes personal liability for unpaid employment taxes on a lender (i) who directly pays the wages of employees who are not employees of the lender, or (ii) who advances funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer while possessing actual notice or knowledge[2] that the employer does not intend to, or will not be able to, make a timely payment or deposit of the employment taxes. *See "Liability of Certain Lenders under Federal and New York Law for Employment and Employee Withholding Taxes Owed by the Borrower."*

New York State Lien for Unemployment Insurance

New York's Industrial Commissioner may issue a warrant which will, upon its filing, become a lien upon real and personal property of an employer who defaults in payments required to be made to the unemployment insurance fund. The warrant lien has priority as a docketed judgment, and in certain statutory proceedings is on a parity with other State and local tax liens, with exceptions. *See "New York State Lien for Unemployment Insurance."*

The Federal Tax Lien

The following discussion addresses the federal tax lien arising automatically after proper demand and nonpayment of the taxes assessed as due.[3]

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[2] *See* I.R.C. §§ 3505(b), 6323(i)(1); see also text accompanying note 39 for a discussion of the "actual notice or knowledge" standard.

[3] Generally, the Internal Revenue Service ("IRS") can collect due and unpaid taxes on the basis of either (i) a "judgment lien" arising from court proceedings or (ii) a lien created by Internal Revenue Code section 6321 that arises automatically after proper notice, demand and nonpayment.

Creation and Scope

Internal Revenue Code section 6321 creates a lien in favor of the United States against "all property and rights to property, whether real or personal" belonging to a taxpayer who "neglects or refuses" to pay any tax after assessment, notice and demand.

Although the lien is created by notice, demand and nonpayment,[4] it is deemed to arise and attach to the taxpayer's property as of the assessment date. *I.R.C. § 6322.* Because the lien relates back to this date of assessment, in general, all of the property owned as of that date and after is subject to the lien.[5]

The lien attaches to property owned by the delinquent taxpayer at any time during the lifetime of the lien (including after-acquired property), not merely property owned at the time the lien arises.[6]

State law defines the nature and extent of a taxpayer's property rights to which the federal tax lien may attach; however, federal law determines the extent to which the federal tax lien attaches to such property.[7] Thus, state exemption laws do not prevent the attachment of a federal tax lien.[8]

An assessment is made at the time an assessment officer signs a summary record of assessment.[9] Subject to the exceptions discussed under "–Priority of the Tax Lien Relative to a Security Interest or Lien" below, it is this date that is significant for determining the ultimate priority of the lien.[10]

The assessment may include all federal taxes imposed by the Internal Revenue Code and former internal revenue laws, including all taxes for which a return is required under the Internal Revenue Code, and interest, additional amounts, additions to tax and assessable penalties. *I.R.C. § 6201.* Specifically, these taxes include income taxes, the social security tax (FICA), the excise tax imposed under Internal Revenue Code section 4971 on an employer who fails to meet the minimum funding requirements for a pension plan or for a multiemployer plan on reorganization, and the excise tax imposed under Internal Revenue Code section 4975 on prohibited transactions entered into with respect to a qualified retirement plan.[11] Liability for any of these taxes can, therefore, cause a lien to be imposed.

The amount of the lien is the amount of taxes assessed (plus any interest, additional amount, addition to tax or assessable penalty, and any costs that accrue in addition thereto).[12]

Once an assessment has occurred, the IRS has 60 days to notify the taxpayer of the assessment and demand payment.[13]

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4 Generally, the notice and demand advises the taxpayer to remit the amount due within 30 days. The 30-day grace derives from a statutory prohibition on collection within 30 days after notice and demand. I.R.C. §§ 6203(a), 6320.

5 *See, e.g., U.S. v. New Britain,* 347 U.S. 81 (1954); *Rice Investment Co. v. U.S.,* 625 F.2d 565 (5th Cir. 1980).

6 Proc.& Admin.Regs. § 301.6321-1; *see also Municipal Trust and Savings Bank v. U.S.,* 114 F.3d 99 (7th Cir. 1997) (lien follows any property substituted for what the taxpayer owned, provided that the chain of substitution can be traced). Further, a taxpayer's "property" is limited to his equity in collateral that is the subject of a purchase money security interest, effectively rendering the purchase money security interest superior to a federal tax lien, whenever the lien is filed. *See Slodov v. U.S.,* 436 U.S. 238 (1978); Proc.& Admin.Regs. § 301.6323(c)-3(e) Example 1; Rev.Rul. 68-57, 1968-1 C.B. 553.

7 *Commissioner v. Bosch Est.,* 387 U.S. 456 (1967) (only property interest determinations by the highest state court bind the IRS); *Aquilino v. U.S.,* 363 U.S. 509 (1960).

8 *See U.S. v. Rodgers,* 461 U.S. 677 (1983) (state law exemption applicable to spouse's homestead interest does not prevent attachment of federal tax lien).

9 The IRS may make an assessment or commence a judicial action for the collection of the tax without assessment at any time after the tax became due and before the expiration of three years after the date on which the return was filed, but this period may be, and often is, extended by taxpayer consent when an audit is begun. I.R.C. §§ 6501(a), 6501(c)(4); *see* IRS Form 872 (Consent To Extend the Time to Assess Tax). The IRS must notify the taxpayer of his right to refuse to extend the period of limitation, or limit the extension to particular issues or periods of time. I.R.C. § 6501(c)(4). For purposes of this time limitation, all returns filed before the due date are considered to have been filed on the due date. I.R.C. §§ 6501(b)(1), (2).

10 Proc.& Admin.Regs. § 301.6203-1.

11 Internal Revenue Code section 6324 creates a separate additional lien for estate and gift taxes.

12 I.R.C. § 6321; Proc.& Admin.Regs. § 301.6321-1.

13 I.R.C. § 6303. However, failure to give notice within 60 days does not invalidate such notice. Proc.& Admin.Regs. § 301.6303-1.

Perfection and Filing of the Federal Tax Lien

After assessment, notice, demand and nonpayment, the federal tax lien is automatically perfected. The IRS does not have to take any further steps (including filing or notice) for its lien to be valid against the taxpayer and valid against (i) unsecured creditors of the taxpayer, (ii) holders of unperfected security interests and (iii) unrecorded real estate liens. Because the lien does not require notice for its perfection, it is often characterized as a "secret lien."

Although a federal tax lien is automatically perfected, it is restricted by statute from having priority over certain lenders whose security interest or lien is perfected until notice of the tax lien is filed.[14] These lenders include lenders who become perfected after the perfection of the federal tax lien, but before the federal tax lien is filed.[15] Therefore, the rights of those secured creditors will turn upon the filing of notice of the federal tax lien.[16] See "–Priority of the Tax Lien Relative to a Security Interest or Lien" for a discussion of priority.

The place for filing the notice of tax lien depends on the law of the state where the property is located.[17] In New York State generally, the place for filing the notice of a federal tax lien is, in the case of real property, the clerk's office in the county in which the property is situated. However, for Kings, Queens, New York and Bronx counties, the filing place is the office of the city register of The City of New York in such county. In the case of tangible or intangible personal property, the place for filing is the office of the Secretary of State if the lien is against a corporation or a partnership.[18] In all other cases (*i.e.*, individuals, trusts and estates), notices for liens upon tangible or intangible property should be filed in the office of the county clerk in the county where the debtor, if resident in New York State, resides at the time of filing, except that if the debtor lives in Kings, Queens, New York or Bronx counties, the filing place is the office of the city register of The City of New York in such county.[19]

In New York State, each of these offices (county clerk, city register and Secretary of State) keeps an index of federal liens so that lenders can inquire about the federal tax liens that may attach to their collateral. **Lender's counsel should note, however, that federal tax liens are filed separately from other liens and security interests, and therefore the records for federal tax liens must be searched separately.**

If a state fails to designate one office as the appropriate place for filing notices of tax lien, the IRS must file notice of the lien with the clerk of the United States District Court where the property is located. *I.R.C. § 6323(f)(1)(B).*

The federal tax lien continues until the liability for the amount assessed is paid or withdrawn,[20] or until the

[14] I.R.C. § 6323(a). After the notice has been filed, the taxpayer is entitled to request a hearing before the IRS Office of Appeals. I.R.C. § 6320(b); Proc.& Admin.Regs. § 301.6320-1T.

[15] *See* "–Priority of the Tax Lien Relative to a Security Interest or Lien–Generally."

[16] I.R.C. § 6323(a). Note however, that in *Adams v. U.S.,* 420 F.Supp. 27 (S.D.N.Y. 1976), a clerk's error in failing to record properly filed tax liens in the index did not prevent those liens from attaching to the subject property. The IRS did not know of the error and subsequent purchasers did not know of the liens. This decision was in part because Internal Revenue Code section 6323(a) uses the term "filed" and not "recorded," and in part because the failure to record properly occurred through no fault of the IRS. *See also Hanafy v. U.S.*, No. 3:96-CV-2957-X (N.D.Tex. 1998) ("A clerk's failure to comply with recording and indexing requirements should not affect the validity of the instrument filed, nor should it prejudice the rights of the instrument holder. Once a party files its instrument and obtains its file marked copy to prove it was filed, it has done all it could do. The party is not to blame if the clerk is derelict in his or her duty to index. The policy issue is who bears the burden to check for instruments yet to be indexed.").

[17] I.R.C. § 6323(f); Proc.& Admin.Regs. § 301.6323(f)-1.

[18] N.Y.Lien Law § 240. For this purpose, corporation and partnership are "as defined in the internal revenue law of The United States." N.Y.Lien Law § 240(2)(a). Presumably a limited liability company that is treated as a corporation or partnership for federal income tax purposes would be included in that definition. A limited liability company with a single member can also elect to be disregarded for federal income tax purposes, with the result that its assets would be deemed owned by its single member. In that case, the place for filing could either be based on the identity of the single member or on the default described in the text accompanying note 19.

[19] N.Y.Lien Law § 240(2)(b).

[20] The IRS can withdraw a tax lien notice prior to payment in full for certain reasons, including the best interests of the taxpayer, facilitation of collection, entrance into an installment payment agreement with the taxpayer, or a determination that the filing of notice was premature. The withdrawal is made by filing at the same office as the withdrawn notice, with a copy to the taxpayer. Upon request of the taxpayer, the IRS must make reasonable efforts to notify creditors, financial institutions and credit reporting agencies of the withdrawal. I.R.C. § 6323(j).

lien becomes unenforceable because of lapse of time, which is generally ten years from the date of assessment. *I.R.C. §§ 6322, 6502(a).* In many cases, chiefly by agreement between the taxpayer and the IRS or by reduction to judgment, the ten-year period can be extended.

To maintain continuous priority of its claim, the IRS must refile the notice of tax lien during the required refiling period, a one-year period ending ten years and thirty days after the original date of assessment (and thereafter during the one-year period ending ten years after the close of the previous required refiling period). *I.R.C. § 6323(g)(3).*

The place for refiling is the office where the original notice is on file unless the taxpayer has moved to another state and the IRS receives written information of this new address at least 90 days before the refiling date. In such a case, the notice of tax lien must also be refiled in the appropriate office in the state where the taxpayer then resides. *I.R.C. § 6323(g)(2)(B).* Therefore, a thorough file search probably should trace the borrower's residences for a period slightly longer than ten years, as the IRS should receive notice of the taxpayer's address at least annually through the filing of the tax return.

Priority of the Tax Lien Relative to a Security Interest or Lien

Generally

A secured creditor with a perfected security interest is an exception to the rule that a tax lien has priority from the assessment date.[21] To such a secured creditor, the date the tax lien is filed by the IRS is the relevant date for determining priority.

As noted under "Summary and Highlights–The Federal Tax Lien" above, the general rule is that a secured creditor's perfected security interest will have priority over the federal tax lien as to both credit extended and collateral acquired prior to the time the tax lien is filed, whether or not (i) the secured creditor's security interest arose or was perfected after the tax lien arose (*i.e.,* the assessment date) or (ii) the secured creditor had actual knowledge of the existence of a federal tax lien at the time its security interest arose or was perfected. Actual notice or knowledge of the unfiled tax lien on the part of the secured creditor is irrelevant for these purposes because the filing of the tax lien is the exclusive manner for the United States to establish priority of the tax lien over perfected security interests.[22] Once the tax lien is filed, the United States will have priority, except as noted below, as to both credit thereafter extended and collateral thereafter acquired.

The Internal Revenue Code defines the term "security interest" as any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or to indemnify against loss or liability. *I.R.C. § 6323(h)(1).* A security interest in property exists at any time if, at such time, (i) the property is in existence, (ii) the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation and (iii) to the extent the holder has parted with money or money's worth, but only to that extent.[23]

Thus, three requirements must be met for a security interest to be recognized under the Internal Revenue Code:

- The property subject to the security interest must exist;[24]

[21] A federal tax lien is not valid against a purchaser, secured creditor, judgment lien creditor or mechanic's lienor until the IRS files notice of the lien, whether or not such purchaser, lienor or creditor has actual knowledge of the tax lien. I.R.C. § 6323(a); Proc.& Admin.Regs. § 301.6323(a)-1(a). *See generally* Saltzman, IRS Practice and Procedure ¶ 16.03 (RIA 2000). Only the secured creditor's interest will be examined in detail here.

[22] *U.S. v. McCombs,* 30 F.3d 310 (2d Cir. 1994) ("After reviewing the case law, as well as the plan language and legislative history of section 6323, we are satisfied that record notice, as opposed to actual knowledge, of the tax lien is required to deprive a person of section 6323(a)'s protection.") Conversely, in states which have not adopted certain amendments to the Uniform Commercial Code made in 1972, some courts have held that the IRS' knowledge of the existence of an unperfected security interest causes the security interest to be perfected against the federal tax lien. *See, e.g., U.S. v. Kelley Grande Market, Inc.,* 75-2 USTC ¶ 9804 (E.D.Okla. 1975); *Richardson v. U.S.,* 358 F.Supp. 994 (D.Ark. 1973). Other courts, however, have held that a security interest must be protected against all hypothetical judgment lien creditors to trump the federal tax lien; therefore, the IRS' actual knowledge of the security interest is irrelevant. *See Dragstrem v. Obermeyer,* 549 F.2d 20 (7th Cir. 1977).

[23] I.R.C. § 6323(h)(1); Proc.& Admin.Regs. § 301.6323(h)-1(a).

[24] Proc.& Admin.Regs. § 301.6323(h)-1(a)(1)(i). This requirement has the effect of limiting a secured lender's protection under Internal Revenue Code section 6323(a) to the collateral belonging to the taxpayer as of the date of the tax lien filing, but not beyond. See the discussion below at "–Relief for Certain Security Interests or Liens after Notice Is Filed" for exceptions.

- The security interest must be protected under state law against a subsequent judgment lien arising out of an unsecured obligation;[25] and
- The holder must part with money or money's worth.[26]

Such a security interest will have priority over an unfiled federal tax lien, whether or not the secured creditor has knowledge of the existence of the federal tax lien. But note that the third requirement limits a secured lender's priority under Internal Revenue Code section 6323(a) to an amount equal to the total disbursements which have actually been advanced at the time of the tax lien filing and to collateral then in existence. That is to say, except under the special exceptions discussed below at "–Relief for Certain Security Interests or Liens after Notice Is Filed," in cases where a lender is obligated to make future advances under the terms of a loan agreement (or, for that matter, whenever there is any time delay between the file search and the advance of some portion of the loan proceeds) an intervening filing of notice of the federal tax lien cuts off the secured lender's priority as to the advanced funds and as to collateral acquired after the filing of the tax lien, despite the fact that such advances "relate back" to a financing arrangement antedating the tax lien filing.

The priority of the federal tax lien *vis a vis* a secured lender's perfected interest generally will be governed by the common law principle of "first in time, first in right."[27] Accordingly, the perfected security interest of a secured creditor will rank ahead of a federal tax lien as to credit extended and collateral existing at the time of the filing of the federal tax lien. However, a perfected security interest to the extent it secures subsequent extensions of credit will rank behind the filed federal tax lien. Also, because a security interest for this purpose is not deemed to be "perfected" in property until the borrower has an interest in that property, the secured creditor's security interest will also rank behind the tax lien as to collateral (including proceeds of pre-tax lien filing collateral) acquired after the filing of the tax lien.[28] Exceptions are discussed below.

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[25] Proc.& Admin.Regs. § 301.6323(h)-1(a)(2). A security interest is deemed to be protected against a subsequent judgment lien on the date on which all actions required under local law to establish the priority of a security interest against a subsequent judgment lien have been taken or (if later) the date on which those actions are deemed effective under local law to establish priority. These dates are determined without reference to any "relation back" rules under local law. Proc.& Admin.Regs. § 301.6323(h)-1(a)(2)(i); *see, e.g., Litton Industrial Automation Systems, Inc. v. Nationwide Power Corp.*, 106 F.3d 366 (11th Cir. 1997). However, temporary perfection, which becomes permanent with the passage of time or taking of additional steps, may not be treated as "relation back" and, therefore, may establish priority. Proc.& Admin.Regs. § 301.6323(h)-1(a)(2)(ii); *see Security Savings Bank v. U.S.*, 440 F.Supp. 444 (S.D.Iowa 1977) (priority lost if temporary perfection not made permanent). There is some uncertainty under New York law as to the ability of a creditor to perfect a security interest in a "deposit account," including a cash collateral account. Even if a creditor can perfect a security interest in such an account, by delivery, transfer, assignment or otherwise, the "choate lien" doctrine may defeat a secured creditor unless it exercises a right of set-off. *See U.S. v. McDermott*, 507 U.S. 447, 449-450 (1993) (a lien must be "choate" to take precedence over a later (or simultaneously) filed federal tax lien; for this purpose, "choateness" means generally that nothing more need be done to perfect the lien, *i.e.*, "the identity of the lienor, the property subject to the lien, and the amount of the lien are established"); *Jersey State Bank v. U.S.*, 926 F.2d 621 (7th Cir. 1991) (under Illinois law, bank security interest in demand deposit account was superior to judgment lien creditor but may not be "choate" until right of set-off exercised); *but see Jefferson Bank & Trust v. U.S.*, 894 F.2d 1241 (10th Cir. 1990) (under Colorado law, bank security interest in checking account was perfected and "choate" at the time federal tax lien notice filed); *cf. United States v. Sterling National Bank & Trust Co. of New York*, 494 F.2d 919 (2nd Cir. 1974)(under New York law, IRS levy superior to bank's unexercised right of set-off).

[26] Proc.& Admin.Regs. § 301.6323(h)-1(a)(1)(ii).

[27] *See U.S. v. New Britain, supra* note 5. The general rule of first-in-time, first-in-right cannot apply if a secured creditor's lien and the federal tax lien attach simultaneously, which can happen for after-acquired property. In that case, the Supreme Court has held under the "choate lien" doctrine that, if the secured creditor's lien does not attach to property until it is acquired, the federal tax lien is superior. *U.S. v. McDermott, supra* note 25; *see MDC Leasing v. New York Property Ins. Underwriting*, 450 F.Supp. 179 (S.D.N.Y. 1978), *aff'd without opinion*, 603 F.2d 203 (2d Cir. 1979). Although *McDermott* addressed a judgment lien, not a security interest, it has been extended to the relative priority of a perfected security interest and a tax lien. *See KPMG Peat Marwick v. Texas Commerce Bank*, 976 F.Supp. 623 (S.D.Tex. 1997).

[28] *See, e.g., Glass City Bank v. U.S.*, 326 U.S. 265 (1945); *Tri-River Chemical Co., Inc. v. TNT Farms*, 99-1 USTC ¶ 50,143 (Bankr.D.Ida. 1998) (under *McDermott*, tax lien prior to simultaneously attaching security interest in crop proceeds, which were "after acquired property"). For an exhaustive "proceeds" discussion, see Zinnecker, "When Worlds Collide: Resolving Priority Disputes between the IRS and the Article Nine Secured Creditor," 63 Tenn.L.Rev. 585, 672 (1996).

Relief for Certain Security Interests or Liens after Notice Is Filed

Internal Revenue Code section 6323 protects holders of certain security interests notwithstanding the filing of the federal tax lien.[29] Security interests securing three types of financing transactions have priority over the filed federal tax lien—not only as to existing extensions of credit and existing collateral, but also as to both future extensions of credit and after-acquired property:[30]

- commercial transaction financing agreements,
- real property construction or improvement financing agreements and
- obligatory disbursement agreements.

Each of these security interests has priority status over the filed federal tax lien, provided that the security interest is:

- in "qualified property," a term defined differently for each of these three types of security interests,[31]
- the subject of a written financing agreement that is entered into before the tax lien is filed and
- protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.[32]

Further, a fourth "catch-all" exception protects disbursements made during a 45-day window after the tax lien filing and before the secured lender has actual notice or knowledge of the tax lien filing.[33] This exception is similar to the other three exceptions but (i) it is not limited to any specific "qualified property" and (ii) it does not apply to after-acquired property.

Each of the four transactional types of security interests are discussed below.

Commercial Transaction Financing Agreement

The first exception applies to credit that is both (i) extended under a loan agreement that qualifies as a "commercial transaction financing agreement" and (ii) is secured by "commercial transaction financing security."[34]

In the case of a commercial transaction financing agreement, and assuming that the secured creditor's security interest is perfected, the general rule—that credit extended by a secured creditor with a perfected security interest before the filing of a federal tax lien has priority over that tax lien—is expanded to cover credit extended at any time before the earlier of (i) the 46th day after the filing of the tax lien and (ii) the time that the secured creditor received actual notice or knowledge of the tax lien.

29 In addition to holders of security interests described in the text, Internal Revenue Code section 6323(b) protects holders of security interests in motor vehicles, personal property purchased at retail or in a casual sale, personal property subject to a possessory lien, real property tax and special assessment liens, residential property subject to a mechanic's lien for certain repairs, attorneys' liens, certain insurance contracts, and passbook loans, none of which will be discussed further herein. See Proc.& Admin.Regs. § 301.6323(b)-1; *see generally* Saltzman, *supra* note 21 at ¶ 16.04. It also protects holders of security interests in "securities." The purchaser of or the holder of a security interest in "securities" has priority over the filed federal tax lien only if it did not have actual notice or knowledge of the existence of the tax lien at the time its interest came into existence. I.R.C. § 6323(b)(1). Further, a subsequent purchaser or security interest holder who acquires the securities from, or succeeds to a security interest of, the original protected holder would also take the securities or security interest in the securities free from any filed federal tax liens, even if the subsequent purchaser or holder has actual notice of the existence of the federal tax lien filed against the securities. Proc.& Admin.Regs. § 301.6323(b)-1(a)(2) Example 4. See *infra* text accompanying note 39 for a discussion of actual notice or knowledge. The IRS recognizes that an actual seizure of securities is likely the only route available to it to enforce a federal income tax claim. *See* Internal Revenue Manual § 334.4 (1-14-87) ("The best approach to a levy and seizure of intangibles is to do everything possible to constructively reduce the intangible to possession.") "Securities" include, *inter alia,* corporate or governmental bonds, debentures, notes, shares of stock, voting trust certificates, certificates of deposit, negotiable instruments and money. I.R.C. § 6323(h)(4).

30 I.R.C. § 6323(c)(1)(A).

31 *See* I.R.C. §§ 6323(c)(2)(B), (c)(3)(B), (d)(4)(B).

32 I.R.C. § 6323(c)(1)(B); see *infra* text accompanying note 36 for a discussion of Uniform Commercial Code section 9-301(4) in this context. These three categories (and the catch-all described in Internal Revenue Code section 6323(d)) are not mutually exclusive; a creditor may be protected by more than one.

33 I.R.C. § 6323(d).

34 I.R.C. §§ 6323(c)(1)(A)(i), (c)(2); Proc.& Admin.Regs. § 301.6323-1.

Similarly, the general rule—that a secured creditor with a perfected security interest has priority over a federal tax lien only with respect to property owned by the borrower at the time of the filing of that tax lien—is expanded to include property that qualifies as commercial transaction financing security and is collateral acquired before the 46th day after the filing of the tax lien, whether or not the secured creditor had actual notice or knowledge of the tax lien.[35]

The two expansions of the general rule for commercial transaction financings—as to credit extended within 45 days of the tax lien filing without knowledge and collateral acquired within 45 days of the tax lien filing—is significantly less generous than the protection accorded a prior perfected secured creditor as to future advances and after-acquired property under Uniform Commercial Code section 9-301(4).[36] Under that provision, a secured creditor with a perfected security interest has priority over a subsequent judgment lien creditor in four circumstances: (i) advances made by the secured creditor before the judgment creditor becomes a "lien creditor," as defined in Uniform Commercial Code section 9-301(3), (ii) advances made by the secured creditor within 45 days after the judgment creditor becomes a lien creditor (without any qualifications as to the secured creditor's knowledge), (iii) advances made by the secured creditor without knowledge of the lien of the judgment creditor and (iv) advances made by the secured creditor pursuant to a commitment entered into without knowledge of the lien of the judgment creditor (even if the advance occurs at a time when the secured creditor has knowledge). It appears that one reason for the 1972 addition of Uniform Commercial Code section 9-301(4) was to allow a secured creditor to satisfy the requirement in Internal Revenue Code sections 6323(c)(1)(B) and 6323(d)(2) that a secured creditor be "protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation." [37]

Actual notice or knowledge of a federal tax lien should not be implied from a tax lien filing.[38] An organization is deemed to have actual notice or knowledge of a particular fact from the time such fact is brought to the attention of the individual conducting the transaction, and in any event from the time such fact would have been brought to that individual's attention if the organization had exercised due diligence. An organization is deemed to exercise due diligence if it maintains reasonable routines for communicating significant information to the individual conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the information will materially affect the transaction.[39]

In effect, the two rules regarding credit extension and property ownership require a creditor to search for a federal tax lien at least every 45 days to ensure that unprotected disbursements are not made.

A "commercial transaction financing agreement" is an agreement entered into by a lender in the ordinary course of its trade or business to make loans secured by commercial financing security acquired by the borrower in the ordinary course of its trade or business.[40] The agreement qualifies whether or not the advances are discretionary.[41]

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[35] I.R.C. § 6323(c)(2)(B); Proc.& Admin.Regs. § 301.6323(c)-1(d).

[36] *See generally* Hawkland, Lord & Lewis, UCC Series § 9-301:8 (Art. 9).

[37] *See* N.Y.UCC § 9-301(4), Commentary (7); *see also* Saltzman, *supra* note 21 at ¶ 16.05[1].

[38] Congress stated explicitly that the purpose of the commercial financing transaction exception is to reduce the burden on lenders and factors in making future advances by requiring them to search for federal tax liens only every 45 days during the term of their financing to be assured of retaining their priority. *See* H.Rpt.No. 1884, 89th Cong., 2d Sess. (1966), reprinted at 1966-2 C.B. 815, 820. If actual notice or knowledge were implied by the fact of filing, this exception would be incoherent. *See also* N.Y.UCC § 8-105(e).

[39] I.R.C. § 6323(i)(1); Proc.& Admin.Regs. § 301.6323(i)-1.

[40] I.R.C. § 6323(c)(2)(A)(i). There are similar rules for factors. *See* I.R.C. § 6323(c)(2)(A)(ii). For purposes of this requirement, a loan is considered to have been made in the course of the lender's trade or business if the lender is in the business of financing commercial transactions (such as a bank) or if the agreement is incidental to the conduct of such person's trade or business (such as a manufacturer who finances the accounts receivable of its customers). Proc.& Admin.Regs. § 301.6323(c)-1(b).

[41] Rev.Rul. 72-290, 1972-1 C.B. 385.

As discussed below, "commercial financing security" is defined as accounts receivable, mortgages on real property, inventory (including raw materials, goods in process and finished goods held for sale) and paper of a kind ordinarily arising in commercial transactions.[42] In general, "paper of a kind ordinarily arising in commercial transactions" includes any written document customarily used in commercial transactions, such as paper giving contract rights, chattel paper, documents of title to personal property, negotiable instruments and securities. Although securities are included, the status of other items of "investment property," as defined in Uniform Commercial Code section 9-115(f), *i.e.*, securities entitlements, securities accounts, commodities contracts and commodities accounts, is not clear, but literally, at least, they are not included. It does not include general intangibles, such as patents or copyrights.[43] Further, a mortgage on real property (including a deed of trust, contract for sale, and similar instrument) is commercial financing security only if the secured party has an interest in the mortgage as a mortgagee or assignee, but not if the secured party is the mortgagor of the real property subject to the mortgage.[44]

Procedure and Administrative Regulations section 301.6323(c)-1 provides guidance for identifying commercial financing security and for determining the time when commercial financing security is acquired.

- An account receivable (defined as any right to payment for goods sold or leased or for services rendered that is not evidenced by an instrument or chattel paper) is acquired by a person at the time, and to the extent, that a right to payment is earned by performance.
- Inventory (including raw materials and goods in process as well as property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business) is acquired when title passes.
- Chattel paper, documents of title, negotiable instruments, securities, and mortgages on real estate are acquired when one obtains rights in the paper or mortgage.
- A contract right (defined as any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper, *i.e.*, **not** accounts receivable) is acquired when the contract is made.

Because accounts receivable are not "in existence" and are not acquired by the borrower until right of payment is earned by performance, a federal tax lien takes priority over all accounts receivable arising after the 45th day after the filing of the federal tax lien.[45]

Regulations promulgated under Internal Revenue Code section 6323 continue to refer to "contract rights," but the 1972 Uniform Commercial Code amendments eliminated the concept of "contract rights." For purposes of the federal tax lien, a "contract right" is in existence when the contract is made and before the taxpayer has earned the right to payment by completing performance, and, once performance has been rendered, the right to payment becomes an "account receivable."[46] Under the Uniform Commercial Code after the 1972 amendments, an "account" means a right to payment for goods sold or leased or for services rendered, not evidenced by an instrument, "whether or not it has been earned by performance." *UCC § 9-106*. The better view seems to be that accounts can be "in existence" prior to complete performance in a way that allows a secured creditor with a perfected security interest in "accounts" to trump a subsequently filed federal tax lien.[47]

Contrast the following situations. On June 1, secured creditor B perfects a security interest in X's contract to sell widgets to Y (B's security interest in that contract would be perfected under the Uniform Commercial Code if B perfected its security interest against X's "accounts"). On June 5, the IRS files a federal tax lien against X, and on August 5 (more than 45 days after the federal tax lien

[42] I.R.C. § 6323(c)(2)(C); Proc.& Admin.Regs. § 301.6323(c)-1(c)(1).

[43] Proc.& Admin.Regs. § 301.6323(c)-1(c)(1); *see* H.Rpt.No. 1884, 89th Cong., 2d Sess. 42 (1966), reprinted at 1966-2 C.B. 815, 844.

[44] Proc.& Admin.Regs. § 301.6323(c)-1(c)(1).

[45] *See generally Texas Oil & Gas v. U.S.*, 466 F.2d 1040 (5th Cir. 1972).

[46] Proc.& Admin.Regs. §§ 301.6323(c)-1(c)(2)(i), 301.6323(h)-1(a)(1).

[47] *See generally* Saltzman, *supra* note 21 at ¶ 16.03[2][a]; St. James, "The Federal Tax Lien in Bankruptcy," 46 Bus.Law. 157, 160 (Nov. 1990). *See, e.g., Atlantic States Constr., Inc. v. Hand et al.*, 892 F.2d 1530 (11th Cir. 1990); *Pine Builders, Inc. v. U.S.*, 413 F.Supp. 77 (E.D.Va. 1976); *Centex Constr. Co. v. Kennedy*, 332 F.Supp. 1213 (S.D.Tex. 1972).

filing), X sells the widgets to Y, creating an account receivable. On June 1, B has a perfected security interest in X's contract, which is an "account" under the Uniform Commercial Code and a "contract right" for federal income tax purposes. Consequently, B should have priority over the IRS as to the proceeds of the "account" or "contract right," *i.e.,* the account receivable arising on August 5. See the proceeds discussion below.

By contrast, on June 1, B perfects a security interest in all of X's assets other than inventory. On June 5, the IRS files a federal tax lien against X, and on August 5, X sells a widget from inventory to Y, creating an account receivable. The IRS has priority over B as to the account receivable.

Identifiable proceeds that arise **after** the 45-day period from the collection or disposition of commercial financing security acquired **prior to or during** the 45-day window are considered to be acquired at the time the original collateral is acquired, if the secured party has a continuously perfected security interest or lien in the proceeds under local law. "Proceeds" include "whatever is received when collateral is sold, exchanged, or collected;" however, "identifiable proceeds" do not include money, checks and the like that have been commingled with other cash proceeds.[48]

Note that—unlike the concept of "proceeds" under the Uniform Commercial Code—"proceeds" do not include "proceeds of proceeds." That is to say, property acquired by the expenditure of identifiable proceeds on or after the 46th day following the tax lien filing is not protected collateral. As a result, a secured creditor cannot preserve the priority of its security interest in rotating inventory.[49] Also note that, under existing Article 9 of the Uniform Commercial Code, dividends on shares of capital stock that are collateral are not "proceeds" under applicable case law. Courts have reached this conclusion because of an unnecessarily narrowed definition of the current Uniform Commercial Code definition of "proceeds," *i.e.,* "whatever is received when collateral is sold, exchanged or collected…."[50] Under Revised Article 9 of the Uniform Commercial Code, however, dividends are proceeds. In jurisdictions that have adopted Revised Article 9 (and New York has not yet done so), a secured creditor with a perfected security interest in shares of capital stock will, with respect to dividends on those shares, have priority over intervening Uniform Commercial Code lien creditors, but not the federal tax lien, if the federal definition of "proceeds"—which is identical with the existing Uniform Commercial Code definition—receives the same restrictive construction.

Real Property Construction or Improvement Financing Agreement

In general, the second exception protects liens and security interests securing credit extended under "real property construction or improvement financing agreements." A "real property construction or improvement financing agreement" is a written agreement to make cash disbursements (i) to finance construction or the improvement of real property if the agreement is secured by a lien on the real property with respect to which the construction or improvement has been or will be made or (ii) to finance a contract to construct on or improve real property if the agreement is secured by a security interest in the proceeds of the contract.[51]

If such an agreement is entered into before the filing of the tax lien, any credit extended by the secured creditor under that agreement at **any** time, whether before or after the federal tax lien is filed, will have priority over that tax lien, whether or not the secured creditor had knowledge of such tax lien at the time it entered into the agreement (so long as such knowledge would not cause the secured creditor to be junior to a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation) and whether or not the secured creditor has actual notice or knowledge of the tax lien filing at the time credit is extended.[52]

Note that the security interest in real property or proceeds has priority over the federal tax lien only to the extent of the specific real property with respect to which

48 Proc.& Admin.Regs. § 301.6323(c)-1(d).

49 *Id.; see* Proc.& Admin.Regs. § 301.6323(c)-1(f) Example 1(ii).

50 *See In Re Hastie,* 2 F.3d 1042 (10th Cir. 1993).

51 I.R.C. § 6323(c)(3); Proc.& Admin.Regs. § 301.6323(c)-2(b). The terms "construction" and "improvement" also include demolition. Proc.& Admin.Regs. § 301.6323(c)-2(b). Further, the term "real property" should also extend to the land on which a building is being constructed. *See* Proc.& Admin.Regs. § 301.6323(c)-2(d) Example 1. Real property construction or improvement financing agreements also include contracts to finance certain agricultural activities, which will not be considered further herein. I.R.C. § 6323(c)(3)(A)(iii).

52 Proc.& Admin.Regs. §§ 301.6323(c)-2(a), 301.6323(c)-2(d) Example 2. See *supra* text accompanying note 39 for a discussion of actual notice or knowledge.

the construction or improvement will be made with the credit extended, or, if a contract is financed, the proceeds of such contract.[53]

Obligatory Disbursement Agreement

The third exception protects credit extended under "obligatory disbursement agreements." An "obligatory disbursement agreement" is a written agreement by a lender to make payments on behalf of a borrower when the payments are due to a third party and includes, for example, a letter of credit and a surety agreement.[54] An obligatory disbursement agreement must be entered into by a person (*i.e.,* the lender) in the course of its trade or business, and must be secured by a security interest in "qualified property." For a lender's security interest to be protected, the agreement must be in writing and must have been entered into before the filing of the tax lien.

"Qualified property" in this case is limited to property existing at the time of the tax lien filing, together with property acquired after the lien filing that is directly traceable to the obligatory disbursements.[55] Accordingly, after-acquired property is protected no matter when acquired, but only to the extent it is directly traceable to the obligatory disbursements.[56]

There is no limitation as to the time disbursements may be made after the tax lien filing.[57] Actual notice or knowledge is not relevant with respect to any disbursement.[58]

Special rules are provided for surety agreements.[59]

[53] I.R.C. § 6323(c)(3)(B); Proc.& Admin.Regs. § 301.6323(c)-2(c).

[54] I.R.C. § 6323(c)(4). In general, the obligation to pay must be beyond the control of the obligor. Proc.& Admin.Regs. § 301.6323(c)-3(b).

[55] Internal Revenu} Code section 6323(c)(4)(B) limits qualified property to property subject to the tax lien at the time the tax lien is filed. Consequently, this exception protects security interests in property, which property is also "subject to" the tax lien, but only to the extent of property subject to the tax lien at the time it was filed, *i.e.,* existing at such time.

[56] I.R.C. § 6323(c)(4)(B); Proc.& Admin.Regs. § 301.6323(c)-3(c).

[57] *See* Proc.& Admin.Regs. § 301.6323(c)-3(c).

[58] Proc.& Admin.Regs. § 301.6323(c)-3(e) Example 3.

[59] Proc.& Admin.Regs. § 301.6323(c)-3(d).

"Catch-All" Exception

In addition to the three specific exceptions discussed above, Internal Revenue Code section 6323(d) provides for a general "catch-all." This fourth exception provides that a lender's security interest takes priority over a filed federal tax lien if it (i) secures credit extended under a written agreement entered into before the tax lien is filed and (ii) secures credit extended any time before the 46th day after the tax lien is filed, *provided that*, if credit is extended after the tax lien filing, the lender has not received actual notice or knowledge of the tax lien.[60] The credit extended must also be protected under local law against a judgment lien arising, as of the time of the tax lien filing, out of an unsecured obligation.[61]

The catch-all exception for disbursements before the 46th day is similar to the exception for commercial transaction financing agreements. *See "–Commercial Transaction Financing Agreement."* They both protect advances made within the 45-day window (without notice of knowledge), but there are three significant differences. First, "commercial financing security" is limited to accounts receivable, mortgages on real property, inventory and paper of a kind ordinarily arising in commercial transactions, but other property can be protected by the catch-all. Second, commercial financing security includes property acquired up to 46 days after the tax lien filing, but the catch-all includes only property in existence at the time of the tax lien filing.[62] Finally, the commercial transaction financing agreement exception protects only lenders engaged in the business of extending credit, but the catch-all protects all lenders.

It must be noted, however, that the catch-all exception of section 6323(d) protects only credit extended after the filing of a federal tax lien. It does not protect collateral acquired thereafter.

For purposes of this exception, it is immaterial that the agreement provides that disbursements are mandatory or at the option of the lender.[63]

[60] Proc.& Admin.Regs. § 301.6323(d)-1(a); see *supra* text accompanying note 39 for a discussion of actual notice or knowledge.

[61] I.R.C. § 6323(d)(2); see *supra* text accompanying note 36 for a discussion of Uniform Commercial Code section 9-301(4) in this context.

[62] Proc.& Admin.Regs. § 301.6323(d)-1(a)(1).

[63] Proc.& Admin.Regs. § 301.6323(d)-1(a).

New York State Tax Lien

Property of a taxpayer subject to the New York corporation tax (New York Tax Law Article 9) and the New York franchise tax on business corporations (New York Tax Law Article 9-A) is subject to two liens, one which arises when a warrant is issued after the taxpayer fails to pay the tax after notice and demand (the "Warrant Lien") and another which arises automatically on the date the tax is due (the "Automatic Lien").[64]

Warrant Lien

The Warrant Lien arises from the filing of a warrant and is in some ways similar in operation to the federal tax lien. If a taxpayer refuses to pay any of the taxes enumerated above (or any additions to tax, penalties or interest) within 21 days after notice and demand therefor is given (or a shorter period in certain cases), the Commissioner of the New York State Department of Taxation and Finance (the "Commissioner") may, within six years after the assessment of such taxes, issue a warrant. The warrant is delivered to any county sheriff or to any officer or employee of the New York State Department of Taxation and Finance (the "Department") and directs such person to levy upon and sell real, personal or other property of the taxpayer for the payment of the amounts assessed and the cost of executing the warrant. *N.Y. Tax Law § 1092(c).*

Within five days after receiving the warrant, the person to whom it is directed must file it with the appropriate county clerk, who will then enter the amount due, together with penalties and interest thereon, in the judgment docket.[65] Upon entry in the judgment docket, the amount becomes a lien on all real, personal and other property of the taxpayer to the same extent as other judgments docketed. The statute requires that a warrant on personal property also be filed with the New York Department of State. *N.Y. Tax Law § 1092(d).*

The judgment docket provides a record of Warrant Liens, so that a lender who seeks information about a borrower's Warrant Liens should examine the judgment docket. A search for judgment liens will also retrieve information about Warrant Liens. Such lien searches must be done separately from searches for federal tax liens or other security interests or liens. **Therefore, lender's counsel should be aware that services that do lien searches must be specifically directed to search for state tax liens such as the Warrant Lien (or, alternatively, directed to search for judgment liens).**

Upon the filing of the warrant, the Commissioner is deemed to have obtained a judgment against the taxpayer for the amount of the tax and other amounts due. *N.Y. Tax Law § 1092(e).* Within 60 days of receiving the warrant, the sheriff or officer must levy upon and sell the taxpayer's property and return to the Commissioner money collected by these actions. For a more complete discussion of the execution of the warrant, *see* New York Tax Law sections 1092(c) through (f). Special rules apply for collections against out-of-state property of non-New York corporations. *See N.Y. Tax Law § 1092(g).*

The Commissioner has authority to release any property of the taxpayer from the Warrant Lien "if it finds that the interests of the state will not thereby be jeopardized, and upon such conditions as it may require." *N.Y. Tax Law § 1092(i).*

Priority issues are discussed below at "–Relative Priority of New York State Tax Liens with Respect to a Security Interest or Lien."

Automatic Lien

In addition to the Warrant Lien, the Automatic Lien attaches to all real and personal property of the taxpayer (or a liable transferee) on the date on which the New York State tax return (for the taxes enumerated above) is required to be filed by the taxpayer (without regard to extensions).[66] *N.Y. Tax Law § 1092(j)(1).*

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64 Other New York taxes can similarly give rise to a warrant lien or an automatic lien, or both. In addition, a lender with a security interest in accounts receivable (or an assignment of a contract such as an equipment lease), the proceeds of which are paid into a "lock box," may be liable for New York State and local sales tax collected on the transactions underlying the accounts receivable (or other contract) and paid into the lock box. *See City of New York v. Advance Trading Corp.*, 202 Misc. 208 (1952); New York State Tax Commission Advisory Opinion, TSB-H-81(105)S (1981).

65 In the case of a foreign corporation or nonresident person, if the Commissioner determines that there is insufficient property in New York State, the warrant may be filed and the entry made in the County Clerk's office of Albany County. N.Y. Tax Law § 1092(g).

66 For a calendar year corporation the due date is March 15. For a fiscal year corporation it is two and one-half months after the end of the fiscal year. The taxes become a lien earlier if the taxpayer has ceased to be subject to the tax, ceased to exercise its franchise or ceased to do business in the state in a corporate or organized capacity.

There is no provision under New York State law for any procedure to be undertaken by the State for the filing, continuation or perfection of this lien. The only way for a lender to obtain information about Automatic Liens that may attach to property is to inquire at the Department of Collections for delinquent taxpayer information.

The Automatic Lien lapses after 20 years from the date it arose; but it lapses after ten years with respect to real estate in the hands of (i) owners who would be purchasers in good faith but for such tax lien and (ii) mortgage holders in good faith but for such tax lien, provided in each case that the transfer was not made with an intent to avoid taxes. *See N.Y. Tax Law § 1092(j)(3).* The Commissioner has authority to release real property from the lien provided adequate consideration is provided for the release. *N.Y. Tax Law § 1092(j)(2).*

Relative Priority of New York State Tax Liens with Respect to a Security Interest or Lien

The New York Tax Law does not contain a statutory provision analogous to Internal Revenue Code section 6323 providing to the holder of certain security interests or liens special protection against a New York State tax lien. Accordingly, the relative priority of a security interest or lien with respect to a New York State tax lien is governed by case law and by applicable Uniform Commercial Code provisions.

Perfected Security Interests

In general, a Warrant Lien has priority over a perfected security interest that attaches subsequently to property. However, the New York Uniform Commercial Code protects advances under an existing perfected security interest in collateral from the Warrant Lien to the extent of credit extended (i) up to 45 days after the Commissioner becomes a lien creditor (*i.e.*, the date the warrant is filed), and (ii) after 45 days if the credit is extended without knowledge of the Warrant Lien, or pursuant to a commitment entered into without knowledge of the Warrant Lien. *N.Y. UCC § 9-301(4).*[67] The protection for collateral thus secured is not limited to property acquired before the warrant is filed, but includes also property acquired at any time after the warrant is filed (provided that such property is adequately described so as to constitute collateral).[68]

An Automatic Lien, without more (*i.e.*, a warrant filing or judgment), is not afforded priority over a simultaneously or subsequently attaching perfected security interest or lien.[69]

Unperfected Security Interests or Liens

Under the Uniform Commercial Code, an unperfected security interest is subordinate to a security interest that is perfected, with the exception of certain purchase-money security interests. *N.Y. UCC §§ 9-301(1)(b), (2).* Thus, a New York State tax lien of either type generally has priority over an unperfected security interest, including any security interest which is perfected after the tax lien arises.

New York statutory law protects certain unperfected security interests or liens against the Automatic Lien. Most notably, the Automatic Lien is subject to the lien of certain mortgage indebtedness and is unenforceable against certain *bona fide* transferees.[70]

Specifically, the Automatic Lien is subject to the lien of any real property mortgage indebtedness existing previous to the time the tax became a lien and incurred in good faith and not given, directly or indirectly, to an officer or stockholder of the corporation owning such property. In addition, a mortgagee or purchaser is protected from an Automatic Lien even after such Automatic Lien has arisen provided that the mortgage or sale was made prior to the issuance of a notice of deficiency and either the purchaser is a *bona fide* purchaser for value or the mortgage must be incurred in good faith and not given, directly or indirectly, to an officer or stockholder of the corporation and certain other requirements are met.

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67 A holder of a Warrant Lien is a "lien creditor" as that term is used in New York Uniform Commercial Code section 9-301(4). *See Marine Midland Bank-Eastern National Association v. Conerty Pontiac-Buick, Inc. et al.*, 352 N.Y.S. 2d 953 (S.Ct.Albany, Spec.Term, 1974); *Chase Manhattan Bank (N.A.) v. State*, 367 N.Y.S.2d 580 (3d Dept. 1975), *aff'd* N.Y.S.2d 896 (1976).

68 *Marine Midland Bank-Eastern National Association v. Conerty Pontiac-Buick, Inc. et al.*, 352 N.Y.S.2d 953 (S.Ct.Albany, Spec.Term, 1974).

69 *E.g.*, *Security Trust Co. v. West*, 507 N.Y.S.2d 546 (3d Dept. 1986) (Warrant Lien held prior to general creditor's lien because attached simultaneously, inference that existing Automatic Lien did not have priority).

70 N.Y. Tax Law § 1092(j)(1). The Automatic Lien is also subject to liens for local taxes no matter when such local tax liens accrued.

An Automatic Lien for additional tax is also not enforceable at all against property in the hands of a transferee (including one who receives the property through foreclosure) if the taxpayer made the transfer (i) in good faith to a *bona fide* transferee and (ii) prior to the issuance of a notice of deficiency.

If proceedings have begun to foreclose a mortgage or local tax lien, the Automatic Lien may be further limited.

The PBGC Lien

ERISA section 4068(a) imposes a lien in favor of the PBGC upon "all property and rights to property, whether real or personal," belonging to a contributing plan sponsor and members of its controlled group, including controlled group members whose employees do not participate in the plan and members with no employees, when any such person refuses to pay, after demand, any liability to the PBGC arising under ERISA sections 4062, 4063 or 4064. The amount of the PBGC's lien generally equals the amount of the unpaid liability, but the lien cannot exceed 30 percent of the collective net worth of the contributing plan sponsor and members of its controlled group with positive individual net worth only, *i.e.,* there is no netting of controlled group members having negative net worth with members having positive net worth when calculating the 30 percent limit. *ERISA §§ 4062(a), 4062(d), 4068.*

ERISA Sections 4062, 4063, 4064

ERISA Section 4062

ERISA section 4062(a)(i) imposes liability to the PBGC upon contributing sponsors (as well as upon their controlled group members) who maintain a single-employer "defined benefit plan" that is terminated with insufficient assets to pay the plan's benefits. A "defined benefit plan" provides a definite formula under which the amount of a participant's annual or monthly retirement benefit is determined. The benefit formula is usually based on years of service. Certain formulas simply multiply the participant's years of service by a flat dollar amount (*e.g.,* the monthly retirement benefit equals $30 times the participant's years of service). Another common type of formula multiplies a participant's years of service by a percentage of his or her average pay (*e.g.,* the annual retirement benefit equals 2 percent times the participant's years of service times his or her final average pay). In defined benefit plans, the amount of the employer's contributions are actuarially determined each year based on such factors as the number and age of participants and the investment returns on plan assets.[71]

ERISA section 4062 only applies to single-employer defined benefit plans that are terminated: (i) in a distress termination under ERISA section 4041(c), which permits the plan sponsor, subject to the PBGC's approval, to terminate a plan in cases of extreme financial hardship such as bankruptcy, insolvency proceedings or other extreme financial difficulty or (ii) in termination proceedings instituted by the PBGC under ERISA section 4042, which similarly contemplates extraordinary circumstances that may indicate potential long-run losses to the PBGC if the plan is not terminated.

The liability imposed is equal to the amount by which the value of benefit liabilities under the plan, determined as of the termination date, exceeds the current value of plan assets as of the termination date together with interest on that amount calculated from the termination date. Plans must vest all contingent benefits upon termination, and benefit liabilities include all benefits to which plan participants and beneficiaries are entitled at the time of termination. The liability is generally due and payable as of the termination date, except for amounts that exceed 30 percent of the collective net worth of the plan sponsor and its controlled group members, which become due under commercially reasonable terms to be prescribed by the PBGC. Certain deferral provisions apply where neither the plan sponsor nor its controlled group members had any pretax profits for the fiscal year ending in the year the payment for liabilities exceeding 30 percent of their collective net worth is due. *ERISA § 4062(b)(2).*

ERISA Section 4063

ERISA section 4063 imposes liability on a contributing sponsor (and members of its controlled group) for withdrawal from a single-employer plan which has two or more contributing sponsors, at least two of which are not under common control in any plan year, when the sponsor constitutes a substantial employer. A

[71] Defined benefit plans can be contrasted with "defined contribution plans" such as 401(k) plans or profit-sharing plans, which provide an individual account for each participant to which the employer, the participant or both make contributions. A participant's benefit is determined solely by reference to the value of his or her account, which is based on the amount of contributions allocated to the account plus investment gains and less investment losses and expenses.

single-employer plan, with multiple participating employers, to which this section applies should be distinguished from a collectively bargained "multiemployer plan" which is not subject to ERISA section 4063. A multiemployer plan is a plan to which more than one employer is required to contribute, but which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and which satisfies such other requirements as the Secretary of Labor may prescribe by regulation. *ERISA § 4001(a)(3).*

The liability imposed upon the withdrawing sponsor is generally equal to the total liability which would have arisen under ERISA section 4062 if the plan were terminated on the date the sponsor withdrew, multiplied by a fraction, the numerator of which is the total amount required to be contributed to the plan by the withdrawing sponsor for the last five years before withdrawal and the denominator of which is the total amount required to be contributed by all contributing sponsors for the last five years. The PBGC may also determine liability, in addition to or in lieu of this method, on any other equitable basis that it may prescribe by regulation. In lieu of immediately paying its liability, the contributing sponsor alternatively may be required to furnish a bond in an amount not exceeding 150 percent of its liability. *ERISA §§ 4063(b), (c).* Liability payments, or any bond received by the PBGC, are held in escrow and are returnable after five years if the plan has not terminated. *Id.* The PBGC also has the authority to require that the plan be partitioned between the withdrawing employer and the contributing sponsors, in lieu of the imposition of liability as discussed above, and the requirements of these provisions may be waived if the PBGC determines that an adequate indemnity agreement is in effect among the contributing plan sponsors. *ERISA § 4063(e).*

ERISA Section 4064

ERISA section 4064 imposes liability when a single-employer plan which has two or more contributing sponsors, at least two of whom are not under common control at the time the plan is terminated, is terminated in a distress termination under ERISA section 4041(c) or by the PBGC under ERISA section 4042. Liability is imposed on all contributing sponsors who contributed to the plan at the time of termination, or at any time during the five plan years preceding the termination date, and members of each contributing sponsor's controlled group.

The amount of each sponsor's liability is generally determined in a manner consistent with ERISA section 4062, with the following exceptions. The total amount of unfunded benefit liabilities with respect to the plan, as of the termination date, is allocated under ERISA section 4064 to each controlled group by multiplying the total amount of unfunded benefit liabilities by a fraction, the numerator of which is the amount required to be contributed to the plan for the last five plan years ending prior to the termination date by persons in such controlled group as contributing sponsors, and the denominator of which is the total amount required to be contributed to the plan in the last five plan years by all contributing sponsors. The 30 percent of net worth limitation is applied separately to each controlled group. *ERISA § 4064(b).* The PBGC also has the discretion, under ERISA section 4064, to determine the liability of each contributing sponsor and member of its controlled group on any other equitable basis as it may prescribe in regulations.

When the PBGC Lien Arises and its Priority with Respect to a Security Interest

The PBGC lien arises on the date of termination of the plan. *ERISA § 4068(b).* If the plan is terminated on a voluntary basis by the plan administrator, the date of termination is the date established by the plan administrator and agreed to by the PBGC. If, on the other hand, the plan is involuntarily terminated by the PBGC, the date of termination is the date established by the PBGC and agreed to by the plan administrator. In either case, if no agreement can be reached as to the date of termination, the date will be established by a court. *ERISA § 4048.*

The amount of the PBGC lien can only be determined once the PBGC establishes the plan asset insufficiency (the amount, calculated as of the date of termination, by which guaranteed benefits exceed plan assets) and the collective net worth of all contributing plan sponsors and members of their controlled groups. The net worth of the contributing plan sponsors or members of their controlled group generally is determined as of the plan termination date, but the PBGC may use an earlier date, not more than 120 days prior to the termination, to prevent undue loss or abuse of the plan termination insurance program. *ERISA §§ 4062(d)(1), 4068; PBGC Regs. § 4062.5.*

Under PBGC regulations, once the PBGC has determined the amount of liability (including interest), it will notify the liable parties in writing of the amount and

request payment of the amount. Ordinarily the liable parties may appeal and obtain review by the PBGC of the decision in accordance with the PBGC Rules for Administrative Review of Agency decisions. *PBGC Regs. § 4068.3.* A demand letter will be issued to the employer at the time a final decision finding liability is reached by the PBGC. If the liability is not paid within the time specified in the letter, a lien in favor of the PBGC will arise which relates back to the date of termination of the plan. Notwithstanding the foregoing, the PBGC may, in any case where it believes that its ability to assert or to obtain payment for liability is in jeopardy, issue a demand letter immediately upon making the initial liability determination, thus foreclosing the employer's right to appeal the decision before a lien arises.

The PBGC lien continues until the PBGC liability is satisfied or becomes unenforceable by reason of lapse of time, which is generally six years. *ERISA §§ 4068(b), (d)(2).*

The relative priority of the PBGC lien with respect to a security interest is governed by the same rules that govern the relative priority of a tax lien with respect to a security interest. *ERISA § 4068(c)(1).* Thus, a PBGC lien is not "valid" against the holder of a security interest until filed, and even if filed protection against the PBGC lien is afforded to certain holders of security interests. *See "The Federal Tax Lien–Priority of the Tax Lien Relative to a Security Interest or Lien."*

Definition of Contributing Sponsor and its Controlled Group

Liability under ERISA sections 4062, 4063, and 4064 is imposed on a plan's contributing sponsor and members of its controlled group. Thus, the PBGC lien is imposed on assets not only of the employer maintaining the plan but also on the assets of any other corporations and other trades or businesses under common control with the employer, regardless of whether such other corporation or trade or business has any employees participating in the plan or even has any employees at all.

"Contributing sponsor" is defined as the employer responsible for making contributions to the plan. *ERISA § 4001(a)(13).* ERISA section 4001(a)(14) defines the "controlled group" of a person as "a group consisting of such person and all other persons under common control with such persons." The determination of whether persons are under "common control" is made in a manner consistent with regulations prescribed under Internal Revenue Code sections 414(b) and (c).

Internal Revenue Code section 414(b) and Income Tax Regulations section 1.414(b)-1 provide rules for determining whether a group of corporations constitutes a controlled group (largely by referring to Internal Revenue Code section 1563 and the regulations thereunder). Internal Revenue Code section 414(c) and Income Tax Regulations sections 1.414(c)-1 through -4 provide similar rules with respect to unincorporated trades or businesses, such as partnerships, trusts, estates and sole proprietorships. For ease of reference, the following discussion will refer only to the regulations under Internal Revenue Code section 414(c), which are broad enough to include corporations as well as unincorporated businesses.

Under the regulations, trades or businesses under common control include a parent-subsidiary group under common control, a brother-sister group under common control, or a combined group under common control. *Income Tax Regs. § 1.414(c)-2.*

A "parent-subsidiary group" is defined as one or more chains of organizations (corporations, sole proprietorships, partnerships, trusts and estates) conducting trades or businesses connected, through ownership of a controlling interest, with a common parent organization. *Income Tax Regs. § 1.414(c)-2(b).* A controlling interest of each organization, other than the common parent, must be owned by one or more of the other organizations. Furthermore, the common parent must own a controlling interest in at least one of the other organizations. A "controlling interest" is defined as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of a corporation, ownership of an actuarial interest of at least 80 percent of a trust or estate, ownership of at least 80 percent of the profits or capital interest of a partnership and ownership of 100 percent of a sole proprietorship. *Income Tax Regs. § 1.414(c)-2(b).*

A "brother-sister group" is defined as two or more organizations conducting trades or businesses if the same five or fewer persons (individuals, estates, or trusts) own a controlling interest of each organization (*i.e.,* satisfy one of the 80 percent tests described in the preceding paragraph) **and** if effective control of each organization exists. In determining whether effective control of each organization exists, the ownership of each person is taken into account only to the extent such ownership is identical with respect to each of the brother-sister organizations. *Income Tax Regs. § 1.414(c)-2(c)(1).* "Effective control" is

defined as an ownership interest of more than 50 percent (i) in the case of a corporation, of the total combined voting power of all classes of stock entitled to vote or of the total value of all classes of shares, (ii) in the case of a trust or estate, of an aggregate actuarial interest and (iii) in the case of a partnership, of the profits interest or capital interest. *Income Tax Regs. § 1.414(c)-2(c)(2).*

A combined group is defined as any group of three or more organizations if each organization is a member of either a parent-subsidiary group or a brother-sister group and at least one such organization is the common parent of a parent-subsidiary group and is also a member of a brother-sister group. *Income Tax Regs. § 1.414(c)-2(d).*

Under Income Tax Regulations section 1.414(c)-3, in determining a "controlling interest" or "effective control," certain interests and stock are excluded and treated as not outstanding. The purpose of such exclusion is to prevent persons from divesting themselves of sufficient ownership to avoid classification as a parent-subsidiary group or as a brother-sister group without divesting themselves, as a practical matter, of the benefits of the ownership of an organization. The constructive ownership rules under Income Tax Regulations section 1.414(c)-4, which, for example, attribute to a person ownership by a sufficiently related person or ownership of stock to persons who own options, apply in determining the ownership of an interest in an organization.

Lien for Failure to Make Required Contributions

ERISA section 302 imposes minimum funding standards on single-employer defined benefit pension plans (as such term is defined in "The PBGC Lien–ERISA Sections 4062, 4063, 4064–ERISA Section 4062") that have one or more participating employers.[72] These rules are designed to help ensure that plans have sufficient assets to satisfy their promised benefit liabilities. If such a plan has a funded liability percentage of less than 100 percent (*i.e.,* benefit liabilities exceed plan assets) for the prior plan year and the aggregate unpaid balance of all payments required under ERISA section 302 not paid before their due date (including interest) exceeds $1 million, ERISA section 302(f) imposes a lien in favor of the plan upon "all property and rights to property whether real or personal" belonging to any person and members of such person's controlled group (including controlled group members with no employees and members with employees who do not participate in the plan) when any such person fails to make a payment required to satisfy the minimum funding standards under ERISA section 302.

The amount of the lien equals the unpaid balance of all required payments not paid before their due date (including interest) for plan years beginning after 1987. *ERISA § 302(f)(3).* The lien arises on the date that the required payment is due and continues until the last day of the first plan year in which the unpaid balance no longer exceeds $1 million.[73] *ERISA § 302(f)(4)(B).* Any person satisfying the requirements for the imposition of a lien is obligated to notify the PBGC within 10 days of the due date of the missed payment. *ERISA § 302(f)(4)(A).*

The lien is similar to the lien imposed in favor of the PBGC, under ERISA section 4068, discussed in "The PBGC Lien." It is imposed on all members of the controlled group regardless of whether the member has any employees participating in the plan or even has any employees at all, see "The PBCG Lien–Definition of Contributing Sponsor and its Controlled Group," and the same rules that govern the relative priority of a tax lien with respect to a security interest govern the lien's relative priority with respect to a security interest. See "The Federal Tax Lien–Priority of the Tax Lien Relative to a Security Interest or Lien" and "The PBGC Lien–When the PBCG Lien Arises and its Priority with Respect to a Security Interest;" ERISA § 302(f)(4)(C).

Unlike the lien imposed under ERISA section 4068, the lien under ERISA section 302(f) technically is imposed in favor of the plan. It may be perfected and enforced, however, only by the PBGC or the contributing sponsor or any member of the controlled group of the contributing sponsor only at the direction of the PBGC. *ERISA*

[72] Internal Revenue Code section 412 contains a parallel minimum funding and lien provision.

[73] For example, assume an employer maintains a defined benefit plan on a calendar year basis, and further assume the plan has a funded liability percentage of 80 percent and the employer has recently failed to make $900,000 of required contributions. If the employer then fails to make an additional $300,000 required contribution due on April 15, 1995, the lien will be imposed as of that date in the amount of $1.2 million, *i.e.,* the entire unpaid balance of required payments. If the employer manages to make a contribution of $500,000 on July 15, 1995 (reducing the unpaid balance to below $1 million), the lien for $1.2 million nevertheless will continue to be imposed until December 31, 1995 at the earliest, the last day of the first plan year in which the unpaid balance ceases to exceed $1 million. Of course, if the employer fails to make additional required payments during 1995 and the unpaid balance again grows in excess of $1 million, the lien will continue into 1996.

§ 302(f)(5). In addition, the lien under ERISA section 302(f) is not capped at 30 percent of the collective net worth of the contributing sponsor and members of its controlled group with positive individual net worth. *See ERISA § 302(f).*

Multiemployer Plans

Liability to Plan

A multiemployer plan is a plan to which more than one employer is required to contribute, but which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and which satisfies such other requirements as the Secretary of Labor may prescribe by regulation. *ERISA § 4001(a)(3).*

An employer who is obligated to contribute to a multiemployer plan has withdrawal liability to the plan for its proportionate share of unfunded vested benefits when the employer withdraws from the plan in a "complete withdrawal" or a "partial withdrawal." *ERISA § 4201(a).* "Unfunded vested benefits" means an amount by which the value of nonforfeitable benefits under the plan exceeds the value of the assets of the plan. *ERISA § 4213(c).*

The calculation of withdrawal liability depends on whether the employer has completely or partially withdrawn from the plan. Generally, a complete withdrawal by an employer occurs when the employer permanently ceases to have an obligation to contribute to a multiemployer plan, or permanently ceases all covered operations under the plan. *ERISA § 4203(a).* There are special rules for determining complete withdrawals in the construction, entertainment, and trucking industries, presumably because the frequent initiation and cessation of projects in these industries would make the general rule unworkable and unfair. *See ERISA §§ 4203(b)-(d).*

An employer generally experiences a partial withdrawal when (i) the number of contribution base units (CBUs) with respect to which the employer is required to contribute to the plan declines by 70 percent or (ii) the employer's obligation to contribute to the plan partially ceases. *ERISA § 4205(a).* CBUs are typically measured in hours or weeks worked by employees, but may also include units of production. *See ERISA § 4001(a)(11).* A 70 percent decline is determined by comparing the number of CBUs in each of the last three years with the average of the number in the two highest years out of the five years preceding the three-year period. An employer's obligation to contribute to the plan partially ceases when (i) an employer permanently ceases to have an obligation to contribute under one or more but fewer than all collective bargaining agreements under which the employer has been obligated to contribute, but continues to perform the same type of work with respect to which contributions were required, either in the same area or in a new location or (ii) an employer ceases to have an obligation to contribute with respect to one or more but fewer than all of its facilities, but continues to perform work at the same type of facility for which the contribution obligation ceased. *ERISA § 4205(b).*

Disposition of the assets of a business can often constitute a complete or partial withdrawal from a multiemployer plan by the selling employer. However, it is possible to avoid having such transactions treated as a withdrawal if the purchaser assumes the seller's contribution obligations in the manner prescribed by ERISA section 4204, and certain other conditions imposed by that section are satisfied.

The statute calculates withdrawal liability as if a complete withdrawal had occurred, and then adjusts the result for partial withdrawals and other circumstances. An employer's withdrawal liability is calculated by first allocating its share of unfunded vested benefits. *ERISA § 4211.* The statute contains four different allocation methods, each of which attempts to ensure the allocation of substantially all of the plan's unfunded vested benefits among all employers who have an obligation to the plan. *Id.*

Under a mandatory *de minimis* rule, an employer's withdrawal liability is then reduced by the lesser of 0.75 percent of the withdrawal liability or $50,000. The *de minimis* reduction is phased out to the extent the employer's withdrawal liability exceeds $100,000. *ERISA § 4209.* A plan can be amended to provide for a more generous *de minimis* reduction which reduces withdrawal liability by the lesser of 0.75 percent of withdrawal liability or $100,000, and is phased out to the extent the employer's withdrawal liability exceeds $150,000. *ERISA § 4209(b).* For partial withdrawals, the withdrawal liability remaining after the *de minimis* reduction is then prorated to reflect roughly the proportion of contribution decline from the previous five years. *ERISA § 4206(a).*

If a withdrawing employer previously incurred liability for a partial withdrawal, its liability for a current complete or partial withdrawal is reduced by the amount of its liability for the previous partial withdrawal. *ERISA § 4206(b); PBGC Regs. § 4206.3.*

When an employer withdraws in connection with the sale of all or substantially all of its business assets, its withdrawal liability is limited to the greater of a portion of the liquidation value of the employer, calculated after the sale, or the liability directly attributable to the employees of the sold employer. *ERISA § 4225(a).* This ensures that withdrawal liability will not deplete the entire equity of a small- or medium-sized business. *ERISA § 4225; see, also, Cong.Rec. S10,117 (1980).*

Withdrawal liability is paid in annual payments equal to the product of the highest contributions made by the employer during any consecutive three-year period within the ten years prior to the withdrawal, and the highest contribution rate the employer was obligated to pay during those ten years. Such payments, however, are limited to 20 years, which may reduce overall liability. *ERISA § 4219(c).*

Slightly different rules apply if a multiemployer plan terminates due to the withdrawal of every employer from the plan (referred to as a "mass withdrawal"). Employers in a mass withdrawal lose the benefit of the *de minimis* reduction rule, and their payments can extend beyond 20 years. *ERISA §§ 4209(c), 4219(c)(1)(D).* These limitations ensure that the total unfunded vested benefits of the plan will be fully allocated among the employers. *ERISA § 4219(c); PBGC Regs. § 4219.1(b).* When a multiemployer plan terminates by mass withdrawal, the plan is amended to limit the payment of benefits to benefits which are nonforfeitable under the plan as of the date of termination. *ERISA § 4041A(c)(1).*

A plan is also considered terminated when a plan amendment (i) freezes accruals and vestings or (ii) converts the plan into an individual account plan (*e.g.*, a profit sharing plan). *ERISA § 4041A(a).* In this context, the employer incurs no withdrawal liability under ERISA section 4201, but must continue to make contributions to the plan at the highest contribution rate from the five years preceding the adoption or effective date of the amendment, unless the PBGC approves a reduction. *ERISA § 4041A(e).*

Notwithstanding these provisions, any transaction that formally avoids triggering withdrawal liability may be ignored if a principal purpose of the transaction is to evade liability. *ERISA § 4212(c).* The determination of whether the principal purpose is to evade and avoid liability depends on all the facts and circumstances of a transaction. *PBGC Op.Ltr. 85-29.* This "principal purpose" test appears to turn on the intent of the employer, regardless of the economic prospects of the transaction.[74] Since such intent can be shown only in extreme situations, such as when no other plausible explanation for the transaction exists, employers do not often face "evade and avoid" liability under ERISA section 4212(c). *Id.*

If the withdrawn employer is insolvent and undergoing liquidation or dissolution, it is always liable for the first 50 percent of its withdrawal liability, but its liability for the second 50 percent is limited to the liquidation or dissolution value of the employer. *ERISA § 4225(b).* This affords protection to creditors by preventing withdrawal liability from diluting the claims of other creditors.

An employer can request that a plan sponsor provide an estimate of the employer's potential withdrawal liability, but the employer must pay the reasonable cost of the estimate. Upon request, however, a plan sponsor must provide general information free of charge. *ERISA § 4221(e).* Thus, a lender who is concerned about the potential withdrawal liability of a borrowing employer who contributes to a multiemployer plan may wish to require that the borrower obtain such an estimate.

Definition of Employer

Although Title IV of ERISA does not define "employer" for purposes of the multiemployer plan rules, a group of trades of businesses under common control, whether or not incorporated, is treated as a single employer for purposes of employer liability under Title IV of ERISA.[75] Rules for determining whether "common control" exists are set forth in Internal Revenue Code section 414(c) and the regulations thereunder, which are discussed in "The PBGC Lien–Definition of Contributing Sponsor and its Controlled Group." *ERISA § 4001(b)(1); PBGC Regs. § 4001.3(a)(1).* Withdrawal by one member of the controlled group will not necessarily trigger withdrawal liability if another member contributes to the plan. Conversely, all members of the controlled group are jointly and severally liable for withdrawal liability incurred by any of them, so a plan sponsor that obtains a judgment against an employer for withdrawal liability can

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[74] *In re Consolidated Litigation Concerning International Harvester's Disposition of Wisconsin Steel,* 681 F.Supp. 512 (N.D.Ill. 1988).

[75] ERISA § 4001(b); PBGC Op.Ltr. 82-13; Senate Floor Explanation on date of passage of H.R. 3904 (Cong.Rec. S11,672, Aug. 26, 1980).

look to the assets of all members of the controlled group to satisfy that judgment. *PBGC Op.Ltr. 86-8; PBGC Op.Ltr. 86-10; PBGC Op.Ltr. 82-13.*

Default in Payment of Withdrawal Liability

If an employer defaults on a payment of withdrawal liability, the plan sponsor may require immediate payment of the balance of the employer's withdrawal liability plus any accrued interest thereon. *ERISA § 4219.* A default occurs when an employer fails to cure nonpayment of withdrawal liability within 60 days of receiving notice of the nonpayment from the plan, or if there is a substantial likelihood, as defined by rules adopted by the plan, that the employer will be unable to pay its withdrawal liability. *ERISA § 4219(c)(5).*

The plan sponsor may bring suit against the employer in either state or federal court to compel the employer to pay withdrawal liability. Although federal district courts have exclusive jurisdiction over actions brought with respect to multiemployer plans, state courts have concurrent jurisdiction over actions brought by a plan fiduciary to collect withdrawal liability. *ERISA § 4301(c).*

There is no provision of ERISA governing multiemployer plans which creates a lien in favor of the PBGC when an employer fails to pay liability for withdrawal from a multiemployer plan. Consequently, it appears that a plan sponsor can only enforce a claim for withdrawal liability against the assets of the employer by first obtaining a judgment against the employer.

Liability to the PBGC

A multiemployer plan can incur liability to the PBGC in one of two ways. First, a multiemployer plan is liable to the PBGC for any financial assistance that the PBGC provides to the plan because the plan is or will be insolvent and unable to pay basic benefits. *ERISA §§ 4245(f), 4261, 4281(d).* A plan receiving financial assistance is to repay the PBGC "on reasonable terms consistent with regulations prescribed by the [PBGC]." *ERISA § 4261(b)(2).*

Second, a multiemployer plan becomes liable to the PBGC if it transfers its liabilities to a single employer plan and the single employer plan is terminated within five years of the transfer without sufficient assets to pay benefits. *ERISA § 4232(c)(1).* This liability arises because, after the transfer to the single employer plan, the PBGC guarantees the payment of all nonforfeitable benefits under the plan. *ERISA § 4022.* The PBGC is authorized to "make equitable arrangements with multiemployer plans . . . for satisfaction of their liability." *ERISA § 4232(c)(4).*

Although neither provision explicitly imposes direct liability on a contributing employer for the plan's liability to the PBGC, "reasonable terms" or an "equitable arrangement" may involve a contributing employer. Neither provision, however, creates a lien in favor of the PBGC, either on the plan's assets or on the employer's assets.

Federal Tax Lien

Generally, multiemployer plans must meet minimum funding requirements through employer contributions. *ERISA § 302.* Financially troubled plans which satisfy the standard for "reorganization" status set out in ERISA section 4241 must meet more rigorous minimum contribution requirements. *ERISA §§ 4241, 4243, 4244.* If a contributing employer fails to meet these minimum funding requirements, a two-tier excise tax may be imposed on the employer. If the employer fails to cure the deficiency within a certain amount of time after the imposition of an initial tax equal to five percent of the accumulated funding deficiency, an additional tax equal to 100 percent of the deficiency is imposed. *I.R.C. §§ 4971(a), (b).* Payment of the excise tax does not relieve the employer from the requirement to make a contribution to correct the funding deficiency. *I.R.C. § 4971.* If the tax is not paid after notice and demand have been given, a federal tax lien will arise. *I.R.C. § 6321; see "The Federal Tax Lien."*

Liability of Certain Lenders under Federal and New York Law for Employment and Employee Withholding Taxes Owed by the Borrower

Two federal law provisions create liability for lenders for a borrower's unpaid employment and employee withholding taxes, and New York incorporates these provisions almost exactly in its own law.

Internal Revenue Code Section 3505

Internal Revenue Code section 3505 imposes personal liability for unpaid employment taxes on a lender (i) who directly pays the wages of employees who are not employees of the lender or (ii) who advances funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer while possessing actual notice or knowledge that the employer

does not intend to, or will not be able to, make a timely payment or deposit of the employment taxes.[76] The liability is incurred on the last day prescribed for filing the employer's federal employment tax return for the wages (determined without regard to any extensions). *Emp.Tax Regs. § 31.3505-1(f).*

In the case of direct payment of wages, the lender is liable for the entire amount of the taxes required to be deducted and withheld from the wages, plus interest from the due date of the employer's return relating to the employment taxes, for the period in which the wages were paid. *Emp.Tax Regs. § 31.3505-1(a)(1).* Where the lender only supplies the funds out of which the borrowing employer pays wages, the lender's total liability is limited to 25 percent of the amount supplied and actually used by the borrowing employer to pay wages. The 25 percent limitation applies to both the unpaid withholding taxes and prejudgment interest but not to post-judgment interest or penalties.[77]

If the lender pays wages directly, the lender is liable whether or not it was aware the employer could not or would not pay the employment taxes. *I.R.C. § 3505(a).* Where the lender merely supplies funds, liability is not so automatic; a jury trial may be had on the question of whether the lender had the ability or right to control the funds from which wage payments were made.[78]

In order for a lender to be found liable under Internal Revenue Code section 3505(b), it must be found both that the lender advanced the funds for the specific purpose of paying wages, and that at the time the funds were advanced the lender had actual notice or knowledge that the employer would not or could not pay the employment taxes. For example, in *Fidelity Bank,* the specific purpose to pay wages was found where checks honored in excess of a general line of credit were marked "payroll." Actual knowledge of the inability to pay employment taxes was inferred from the fact that the lender had control of the borrower's only source of income, which had been assigned to the lender to service the outstanding loan.

Special provisions apply to lenders who make a working capital loan. Such lenders will not incur liability under Internal Revenue Code section 3505(b) even though they know that a portion of the loan may be used to pay wages in the ordinary course of the borrowing employer's business. An ordinary working capital loan is defined as a loan made to enable the borrower to meet current obligations as they arise. Consequently, at the time of making an ordinary working capital loan, a lender is not obligated to determine the specific uses that will be made of the loan or the ability of the borrower to pay employment taxes.[79]

Nevertheless, if the lender has actual notice or knowledge at the time of making an advance pursuant to a working capital loan that the borrower will actually use all or part of the funds advanced to pay wages, the lender will be liable under Internal Revenue Code section 3505 for unpaid employment taxes even though the lender does not know the exact amount of the advance that will be so used.[80]

A facts and circumstances test will be applied in determining whether a lender knew only that funds advanced **might** be used to pay wages or whether the lender had actual notice or knowledge that the funds **would** be so used. The fact that a loan agreement sets forth a purpose other than the payment of wages will not save a lender with actual knowledge from liability.[81] In addition, if substantially all of an employer's operating expenses consist of salaries and wages and if the lender has actual notice or knowledge that the employment taxes will not be paid, the lender will be deemed to have actual knowledge that the funds **would** be used to pay salaries and wages. *Emp.Tax Regs. § 31.3505-1(b)(3).*

Internal Revenue Code Section 6672

Internal Revenue Code section 6672 imposes a penalty on any person required to collect, truthfully account for and pay over any tax, who willfully fails to do so. The amount of the penalty is equal to the amount of uncollected, unaccounted for and unpaid tax. *I.R.C. § 6672(a).* A person subject to this penalty tax is generally termed a "responsible person," and lenders have been found to be responsible persons. A "responsible person"

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[76] I.R.C. §§ 3505(a), (b). Actual notice or knowledge is defined as in Internal Revenue Code section 6323(i)(1). See *supra* text accompanying note 39.

[77] Emp.Tax Regs. § 31.3505-1(b); *see U.S. v. Intracontinental Industries, Inc.,* 635 F.2d 1215 (6th Cir. 1980); *Vaccarella v. U.S.,* 735 F.Supp. 1421 (S.D.Ind. 1990).

[78] *See U.S. v. Fred A. Arnold, Inc.,* 573 F.2d 605 (9th Cir. 1978); *Fidelity Bank N.A. v. U.S.,* 616 F.2d 1181 (10th Cir. 1980).

[79] Emp.Tax Regs. § 31.3505-1(b)(3).

[80] *See U.S. v. Intracontinental Industries, supra* note 77.

[81] *See* Emp.Tax Regs. § 31.3505-1(b)(3); *see also, U.S. v. Intracontinental Industries, supra* note 77.

is a person connected or associated with an employer in such a manner that he or she has the power to see that the taxes are paid.[82]

However, a lender will not be found to be a responsible person unless the lender exercises a minimum level of control over the affairs of the debtor. The most important indicia of control appears to be whether the lender has final or significant word as to which creditors of the borrower are to be paid and when.[83] Thus, a lender with check approval authority with respect to all disbursements made by the debtor pursuant to a security agreement has been found to be a responsible person, whereas a lender who did not initiate payment decisions or decide which creditors were to be paid but who merely honored checks in excess of the borrower's line of credit and who subsequently foreclosed on its security interest was not found to be a responsible person.[84]

If a lender is found to be a responsible person, it is a responsible person with respect to taxes withheld (but not paid) prior to the time it assumed control only to the extent that the taxes collected have not been dissipated or to the extent that other funds are available at the time the lender assumes control.[85] If funds are available the responsible person **must** pay the taxes.[86]

A lender will be found to have "willfully" failed to collect and pay over taxes if it "voluntarily, consciously, and intentionally" fails to do so. It is not necessary that the lender have an evil motive or specifically intend to deprive or defraud the government.[87]

New York Law Provisions

New York law includes provisions that nearly mirror the federal law provisions on lender liability.

New York Tax Law section 678 closely tracks the language of the federal tax law provision, Internal Revenue Code section 3505, and has been interpreted in parallel with it.[88] Therefore, it is likely that a New York court would look to federal law (discussed above) when interpreting the New York statute.[89]

Similarly, New York Tax Law section 685(g) closely tracks the language of Internal Revenue Code section 6672(a). While no reported New York case to date has held a lender liable under section 685(g), a New York court has looked to federal law under Internal Revenue Code section 6672 to determine who is a person required to collect and pay over tax.[90] Therefore, it is likely that a lender with sufficient control over a borrower to be liable under Internal Revenue Code section 6672(a) would also be liable under New York Tax Law section 685(g).

New York State Lien for Unemployment Insurance

Creation and Scope

If an employer defaults in any unemployment insurance payments required to be made to the New York State unemployment insurance fund and if no appeal or other proceeding for review brought pursuant to Article 8 of the New York Labor Law is pending, the Industrial Commissioner is empowered by New York Labor Law section 573(2) to issue a warrant directed to the county sheriff or to any officer or employee of the Department of Labor directing him to levy upon and sell all real and personal property of the defaulting employer. Within five days after receiving the warrant, the sheriff must file it with the county clerk who then will enter the amount due, together with interest and penalties thereon, in the judgment docket. Upon entry in the judgment docket, the amount becomes a lien upon the title to and interest in real property and chattels real of the employer in the same manner as a docketed judgment.

Priority of Lien in Certain Proceedings

In proceedings for the dissolution, insolvency, composition or assignment for the benefit of creditors of the employer, New York Labor Law section 574 places the claim of the Industrial Commissioner for unpaid

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[82] *See, e.g., U.S. v. Vaccarella, supra* note 77.

[83] *See, e.g., U.S. v. Vaccarella, supra* note 77; *Sawyer v. U.S.*, 831 F.2d 755, 758 (7th Cir. 1987); *Maggy v. U.S.*, 560 F.2d 1372 (9th Cir. 1977).

[84] *Compare First American Bank and Trust Company v. U.S.*, 1979-1 USTC ¶ 9205 (W.D.Okla. 1979), *with Fidelity Bank N.A., supra* note 78.

[85] *Slodov v. U.S., supra* note 6, at 259-60 (1978); *Louisville Credit Men's Association v. U.S.*, 73-2 USTC ¶ 9740 (E.D.Ky. 1970).

[86] *See, e.g., Pike v. U.S.*, 563 F. Supp. 428 (S.D.N.Y. 1983) (individual who became a responsible person on October 15 had a duty to pay taxes due October 31).

[87] *See First American Bank and Trust Co., supra* note 84.

[88] *See, e.g., In re Brandt-Airflex Corp.*, 843 F.2d 90 (2d Cir. 1988).

[89] *See In re Brandt-Airflex, supra* note 88; *see also Malkin v. Tully*, 65 App.Div.2d 228 (N.Y. 3d Dept. 1978).

[90] *See Malkin v. Tully, supra* note 89.

unemployment insurance payments on a parity with taxes (other than real property taxes), together with interest and penalties thereon, due to New York State or to any city in New York and gives the claim priority over all other claims, except for United States taxes due and wages owed for employment performed in the preceding three months. Note that the Industrial Commissioner is given parity or priority with respect to his claim for unemployment insurance payments only in statutory proceedings involving dissolution, insolvency, composition or assignment for the benefit of creditors. Thus, the mere fact that a debtor is insolvent in the sense that its assets are insufficient to pay its claims does not give rise to parity or priority for the Industrial Commissioner for unemployment insurance amounts under New York Labor Law Section 574.[91]

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[91] *Long Island Insurance Company v. S & L Delicatessen,* 424 N.Y.S.2d 849 (N.Y.Sup. Ct. 1980); *Flushing Federal Savings & Loan Association,* 133 N.Y.S.2d 187 (Sup.Ct. 1954).