

# THE ORANGE COUNTY BANKRUPTCY FORUM

presents its June 29, 2017 "Brown Bag"\* Program:

## DEBTORS, LOOK BEFORE YOU LEAP!

### SECTION 724 DECODED; A PRIMER FOR CHAPTER 7 TRUSTEES AND ATTORNEYS

This program will address a powerful and dangerous provision of the Bankruptcy Code which authorizes both avoidance as well as subordination of tax liens. *Every Chapter 7 Trustee or attorney representing Chapter 7 debtors must be familiar with this section.* The panelists will provide an overview of 11 U.S.C. 724, and will also provide factual scenarios and cases bearing upon this important section.

#### Panelists:

Jolene Tanner, U.S. Attorney's Office

David Wood, Marshack Hays LLP

Sean A. O'Keefe, O'Keefe & Associates Law Corporation

Donald W. Sieveke, Moderator

Date: June 29, 2017

Time: 12:00 p.m. *sharp* until 1:00. *Be sure to allow extra time for parking*

Place: United States Courthouse, Santa Ana, CA Pro Bono Room (2<sup>nd</sup> floor)

\*Despite its name "Brown Bag", no food or beverages will be allowed in the Meeting Room.

## 11 U.S.C. §724 and Tax Liens

### 1. 724(a) – Tax Lien Avoidance

- A. Tax liens securing a “fine, penalty or forfeiture” may be avoided by a trustee under §724(a).
- B. Proofs of Claim filed by taxing authorities typically provide a breakdown of principal, interest and penalties for each tax assessed. If not, they will provide breakdowns.
- C. Effect of avoided lien under §551.
- D. Determining if lien avoidance will result in sufficient funds to warrant a sale of property under §363.
- E. Trustees argue where a tax lien secures a penalty, a bona fide dispute over the validity of the tax lien exists justifying a sale free and clear under §363(f)(4); however, case law supports argument that this is not a bona fide dispute for purposes of section 363(f)(4). *See e.g. Matter of Stroud Wholesale, Inc.*, 47 B.R. 999, 1002 (E.D.N.C. 1985), *aff’d sub nom. Richardsan v. Pitt Cty.*, 983 F.2d 1057 (4th Cir. 1986).
- F. Multiple tax agencies holding liens: priority based upon assessment date instead of date of recordation of tax lien. *See* 26 U.S.C. §6321; 6323.
- G. 26 U.S.C. §6321 – the IRS secret lien. *See* §544(a)(3).

### 2. 724(b) – Distribution of Property of the Estate Where Tax Liens are Present

- A. §724(b) provides rules for distribution that differ from §726.
- B. Subject to exhaustion of assets under §724(e), certain priority and administrative claims, not just professional fees, are paid before tax liens, unsecured claims and the debtor’s homestead.
- C. What is the priority scheme for distribution where senior tax liens are not avoided, but junior tax liens are avoided?
  1. If the estate does not exhaust the avoided liens by paying priority and administrative claims, §724(b) does not apply and senior tax liens are paid in order of priority.
  2. If the estate’s assets are exhausted by payment of priority and administrative claims and priority or administrative claims remain unpaid, then priority and administrative claims are paid from the remaining sale proceeds before any tax lien is paid.
  3. When does the debtor’s homestead get paid?

724(a) Avoidance of Penalties

Agency	Tax Period	Assessment Date	Recording Date	Total Balance Due	Tax + Interest on Tax	Penalty + Interest on Penalties
IRS	2006	5/31/2010	6/23/2010	\$ 120,000.00	\$ 100,000.00	\$ 20,000.00
IRS	2008	11/23/2009	6/23/2010	\$ 40,000.00	\$ 30,000.00	\$ 10,000.00
				\$ 160,000.00	\$ 130,000.00	\$ 30,000.00
Avoided and Preserved for estate - 724(a) & 551				\$ 30,000.00		
Remainder of Tax Lien to Be Paid from Sale				\$ 130,000.00		
				\$ 160,000.00		

724(b) Waterfall

\$1,000,000.00	Sale Price				
\$500,000.00	1st TD				
\$350,000.00	2nd TD				
\$ 30,000.00	Penalties Preserved for Estate from IRS/FTB Liens - 724(a)				
\$ 100,000.00	Subordinated Tax Lien Available for Admin Expenses 507(a)(1)-(7)				
\$20,000.00	Remainder for Distribution to Next Lienholder				
\$ 20,000.00	Payment to IRS on Remainder of 6/23/2010 Lien				
\$ 30,000.00	Total Preserved for Estate				
\$ 100,000.00	Total for Admin Expenses under 507(a)(1)-(7)				

<b>Section 724(b) Waterfall Example</b>		
Net Sales Proceeds		\$500,000.00
First DOT		\$250,000.00
	subtotal:	\$250,000.00
First Priority Tax Lien		\$140,000.00
Second DOT		\$105,000.00
Aggregate 507(a)(1) - 507(a)(7) expenses		\$100,000.00
<b><u>The remaining \$250,000 in proceeds is distributed as follows:</u></b>		
First 724(b)(2): to the Trustee for 507(a)(1)-507(a)(7) claims:		\$100,000.00
Second 724(b)(3): the remaining amount owed to the taxing authority for its tax lien:		\$40,000.00
Third 724(b)(4): payment to the Second DOT:		\$105,000.00
Fourth 724(b)(5): remaining proceeds to the taxing authority for subordinated lien:		<u>\$5,000.00</u>
	Remaining Balance:	<u>\$0.00</u>

Material prepared by David Wood, Esq.

*In re Bolden*, 327 B.R. 657 (Bankr. C.D. Cal. 2005): The Chapter 7 trustee listed the debtor's residence for sale. The debtor had claimed a \$50,000 homestead exemption. The residence was subject to eight (8) total liens by the IRS totaling approximately \$1.3 million, among other encumbrances held by the California EDD. The debtor did not cooperate with the Trustee, and the debtor filed a motion to abandon. The Court denied the motion to abandon holding that the residence could confer a substantial benefit to the bankruptcy estate, as the Trustee could avoid and preserve the tax penalties and interest on the tax penalties pursuant to the interplay of 11 U.S.C. §§ 724(a), 726(a)(4), and 551. The court held that such a sale would allow the estate to pay administrative claimants and unsecured priority claimants under 11 U.S.C. § 507(a)(8), thus "Unsecured, as well as secured creditors would receive payment from the proceeds of the sale." As to the homestead, the Court found that under 11 U.S.C. § 522(c)(2), exempt property: ". . . remains liable for debts secured by a lien that is not avoided or for which a notice of such things as a federal tax lien has been filed. . . . a [state] homestead exemption does not erect a barrier around a taxpayer's home sturdy enough to keep out the Commissioner of Internal Revenue." *Id.*, at 663 citing *United States v. Estes*, 450 F.2d 62, 65 (5<sup>th</sup> Cir. 1971).

*In re Laredo*, 334 B.R. 401 (Bankr. N.D. Ill. 2005): The Chapter 7 trustee commenced an adversary to determine the priority of liens to disburse the proceeds of the sale of the debtor's residence. The residence was subject to two (2) mortgage liens, an IRS tax lien in the amount of \$114,843, and an IRS unsecured priority claim. The Trustee argued, and the court agreed that debtor's homestead exemption could not be paid until the IRS tax lien was satisfied in full. The court held that by virtue of 11 U.S.C. § 522(c)(2)(B), a properly noticed tax lien is superior to a state created homestead exemption. *Id.*, 410-411. The Court then turned to 11 U.S.C. § 724(b), which provides that a tax lien is subordinated up to the amount of the lien, to the rights of 11 U.S.C. § 507(a)(1)-(a)(7). Essentially, the court held ". . . the existence of the IRS lien rendered the Property beneficial to the estate and not susceptible to abandonment, notwithstanding a lack of equity in the Property, because the provisions of § 724(b) can be invoked to satisfy administrative expenses." *Id.*, at 415.

*In re Fearing*, 2008 WL 4690967 \*1 (Bankr. C.D. Cal. Oct. 21, 2008). In *Fearing*, the District Court affirmed the Bankruptcy Court's holding that the debtors were not entitled to any proceeds from the settlement of certain litigation, which the debtors claimed as exempt that was subject to a tax lien. Notably, the Bankruptcy Court in *Fearing* adopted the rationale of *In re Bolden*, and *In re Laredo* in determining the 11 U.S.C. § 522(c)(2)(B) issue. The District Court affirmed and found that the Bankruptcy "correctly and without error applied the law and reached the conclusion" that the confluence of 11 U.S.C. §§ 724(b) & 522(c)(2)(B) mandates a finding that "whether or not the secured tax claims are paid first or the administrative expenses are paid first, there is nothing remaining to which the [Debtors] are entitled." *Id.*, \*3-4.

Congressional Intent in enacting 11 U.S.C. 724(b): Courts have explained that “. . . the legislative history indicate that Congress made a policy decision to favor the claims of wage earners, the costs of administration of the estate, and other priority claims over tax liens.” *In re Bino’s*, 182 B.R. 784, 787-790 (Bankr. N.D. Ill. 1995) (citing H.R. Rep. No. 686, 89<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1965), U.S. Code & Admin. News at 2442, 2462). Such

Congressional intent is instructive as courts around the nation have held that “so long as the amount of the avoided tax lien exceeds the administrative costs of carrying and disposing of the property, the property has value to the estate and the trustee is justified in selling the property and avoiding the tax lien.” 6-724 Collier on Bankruptcy P 724.03 (16th 2016) (citing *In re K.C. Machine & Tool Co.*, 816 F.2d 238 (6th Cir. 1987) (“[a]dministration promises a benefit in this case by virtue of § 724(b)”); *In re Riker Indus., Inc.*, 122 B.R. 964 (Bankr. N.D. Ohio 1990); *In re Quality Health Care*, 215 B.R. 543 (Bankr. N.D. Ind. 1997); see also *Wurst v. City of New York (In re Packard Properties, Inc.)*, 112 B.R 154, 158-59 (Bank. N.D. Tex.) (holding that “[t]ax liens were chosen by Congress as a means to pay administrative expenses. . . with a tax lien on it, § 724(b) provides for taxing authorities to bear the cost to some extent.”).

Material prepared by Sean A. O’Keefe, Esq.

In re Quezada, 368 B.R. 44, 49–50 (Bankr. S.D. Fla. 2007). The issue presented in Quezada was whether a Chapter 7 trustee was empowered to “administer” and sell the debtor’s otherwise exempt home to pay an outstanding domestic support obligation (“DSO”). The trustee contended that 11 U.S.C. § 522(c)(1)), which states that exempt assets are subject to DSO claims (entitled to a first priority under 11 U.S.C. § 507(a)(1), authorized the sale of the exempt property. The trustee contended that the operation of 11 U.S.C. § 724(b) also provided analogous support for administration and sale of the home. The court rejected this argument holding that these provisions did not overcome the statutory roadblock of § 704(a)(1), which only authorizes a trustee to sell “property of the estate”.

In re Covington, 368 B.R. 38, 41 (Bankr. E.D. Cal. 2006). In Covington, a Chapter 7 debtor who owed a domestic support obligation (“DSO”) attempted to exempt \$1,000 in a bank account and his automobile. The Chapter 7 trustee objected contending that the exemptions should be disallowed citing 11 U.S.C. § 522(c)(1), which states that exempt property is subject to DSO claims. The court rejected the trustee’s objection, holding that although Section 522(c)(1) provided a claimant holding such a claim recourse against exempt property, it did not provide for the disallowance of the exemption. In support of this ruling, the Covington court noted that although tax claims have had recourse to exempt assets since at least 1979, the trustee could cite no authority for the proposition that the exempt property could be sold by the trustee to pay tax claims.

In re KVN Corp., Inc., 514 B.R. 1, 9 (B.A.P. 9th Cir. 2014). In KVN, a trustee sought to sell an over-encumbered property pursuant to a stipulation with the secured creditor. This stipulation provided for a carveout that would allow the estate and the creditor to share the proceeds of the sale. In the motion seeking approval of this relief, the trustee contended that the sale was expected to generate \$5,000 in proceeds for the estate. The bankruptcy court denied this motion, citing In re Covington, 368 B.R. 38, 41 (Bankr. E.D. Cal. 2006) and other cases that stand for the proposition that over-encumbered property generally should be abandoned, not administered. The BAP reversed and remanded this ruling. Although the BAP agreed that over-encumbered property should generally be abandoned, it remanded the case back to the bankruptcy court. The sole issue on remand was whether the \$5,000 recovery to the estate was sufficient grounds to justify variance from the general rule.

In re Christensen, 561 B.R. 195 (Bankr. D. Utah 2016). In Christensen, the court’s ruled on two companion cases with similar facts. In both cases, the Chapter 7 trustee attempted to sell two homes that were over-encumbered. Each home was subject to a first mortgage and one or more junior tax liens that exceeded the properties’ fair market value as of the petition date (later it came to light that there was a nominal amount of equity above the liens). Notwithstanding the lack of value, the Chapter 7 trustee attempted to sell the properties pursuant to a stipulation with the IRS that purported to convey upon the Trustee a “carveout” from the IRS’s secured position upon sale.

Although each of the debtor’s in Christensen claimed a homestead, which constitutes an interest in property under Utah law, the trustee objected to these exemptions based upon the contention that no exemption exists absent equity. In reliance upon these objections, the trustee attempted to sell the homes free and clear of the exemptions pursuant to 11 U.S.C. § 363(f). The sales ultimately did not proceed because debtors converted their cases to Chapter 13.

The issue in contest in the Christensen opinion was whether the trustee and his law firm were entitled to be compensated for their attempt to sell the homes. The court concluded they were not. In so ruling, the Christensen court noted the general rule that over-encumbered assets should be abandoned, and it rejected the trustee's contention that he could achieve an end run around this rule by entering into a stipulation with the IRS that provided for a carveout.

The key point made by the Christensen court that is relevant to today's presentation is the following:

There is no provision in § 724 that enables the sale of "property in which the estate has an interest"—it only dictates how the property or the proceeds of such property are to be distributed. If the Trustee is not permitted to sell the Properties under § 363, there can be no proceeds and § 724 has no application. Even if the sale were permitted, nothing in § 724 permits the distribution priority the Trustee seeks.

561 B.R. 195, 213. In essence, the court ruled that if the predicates for the sale of a property under 11 U.S.C. § 363(f) are not extant, then you should never reach the Section 724(b) issue. In Christensen, the court held that the trustee's attempt to sell the homes under the "bona fide" dispute prong in Section 363(f)(4) was not available, since no bona fide dispute existed as to the debtors' entitlement to the claimed homestead exemptions. Relief under section 363(f)(3) or (f)(5) was unavailable since the trustee did not propose to pay the exemptions in full. Accordingly, section 724(b) never came into the legal equation.

As to whether Section 724(b) can be used to prime exemption, the Christensen court stated:

Although § 724 does provide for subordination of tax liens to pay administrative expenses, this Court concludes that § 724 does not take precedence over the Debtors' exemptions and § 724 does not conflict with the Code's fresh start policy because properly exempted property is not subject to the provisions of § 724. Noticeably absent in § 724 is any provision regarding distribution or treatment of exempt property. By its own terms, § 724 is only applicable to property in which the estate has an interest and that is subject to a tax lien. Because a debtor may exempt the legal interest in fully-encumbered property,<sup>84</sup> if the secured interests and the value of the debtor's exemption exceed the value of the property, the estate has no equitable or legal interest in such properly exempted property.

Section 724(b) has no application to property that is fully encumbered and properly exempted.

561 B.R. 195, 213. In essence, the court ruled that if no equity exists after the payment of secured claims and valid exemptions, the estate has no interest in the property and therefore Section 724 does not apply.



Only the Westlaw citation is currently available.

United States Bankruptcy Court,  
C.D. California.  
In re Dwight M. BOLDEN, Debtor.  
No. LA 04-29732 TD.

June 21, 2005.

United States Trustee, Los Angeles.

Timothy J. Silverman, Esq., Solomon, Grindle,  
Silverman & Spinella, San Diego, for State Street  
Bank, etc.

Kathryn Meyer/IRS Counsel, Los Angeles.

Dwight M. Bolden, Los Angeles, for Debtor.

Timothy J. Yoo, Los Angeles, for Chapter 7 Trustee.

Carmela Z. Tan, Esq., Robinson, Diamant &  
Wolkowitz, Los Angeles, for Chapter 7 Trustee.

McCalla, Raymer, et al., Bankruptcy Department,  
Roswell, GA, for Cenlar.

Warren L. Brown, Esq., Law Offices of Warren L.  
Brown, Glendale, for Debtor.

Ron H. Bombiger, Diversified Real Estate  
Brokerage, Los Angeles, for Broker.

Becket & Lee LLP, Newark, NJ, for Household  
Bank/eCast & American Express Travel.

MEMORANDUM OF DECISION RE TRUSTEE'S  
MOTION FOR AVOIDANCE AND TURNOVER  
OF TAX  
PENALTY LIENS AND DEBTOR'S MOTION FOR  
ABANDONMENT

DONOVAN, Bankruptcy J.

INTRODUCTION

\*1 On April 6, 2005, I announced my tentative decisions in two matters in Dwight M. Bolden's (Mr. Bolden) chapter 7 case. The first matter was the chapter 7 trustee's (trustee) motion for turnover of real property, Mr. Bolden's home. The second matter was Mr. Bolden's motion to compel the chapter 7

trustee to abandon real property, Mr. Bolden's home. After hearing oral argument, the hearings were continued to May 18, 2005, and on May 18, 2005, the hearings were continued again to June 1, 2005. At the June 1 hearings, I withdrew my April 6 tentative decisions and announced my final rulings. This memorandum will supplement my findings of fact and conclusions of law announced orally on June 1.

FACTS

Mr. Bolden filed a voluntary chapter 7 bankruptcy petition on September 14, 2004. At the time of filing, Mr. Bolden listed in his schedules \$587,875 in assets (\$570,000 in real property and \$17,875 in personal property), and \$585,895.09 in liabilities (\$570,000 in secured claims and \$15,895.09 in unsecured, non-priority claims). In schedule I, Mr. Bolden states that he is self-employed by the Law Offices of Bolden & Martin (Bolden & Martin), where Mr. Bolden has been employed for 15 years. Mr. Bolden's current monthly income is \$4,000. Mr. Bolden's statement of financial affairs states that as of September 29, 2004, his income for the year to date was \$43,258.50. Mr. Bolden further states that his yearly income in 2002 was \$57,678, and that he received no income in 2003. In schedule J, Mr. Bolden indicates that his current monthly expenditures are \$4,425.

Mr. Bolden's main asset is his residence, located at 5641 Sherbourne Drive in Los Angeles (the property). The property contains a 4 bedroom, 4 bathroom, 3,034 square foot house on a 9,250 square foot lot. The house was built in 1959. The house has an attached garage, central heating and air, a fireplace, and a private pool. The trustee listed the house for sale on January 17, 2005, for \$924,500.

Mr. Bolden valued the property at \$570,000 on schedule A. Schedule D indicates that there are three secured claims against the property: (1) a 1989 first deed of trust held by Cenlar Mortgage (Cenlar) in the amount of \$285,000, (2) an Internal Revenue Service (IRS) tax lien in the amount of \$285,000; and (3) a California Franchise Tax Board tax lien listed in an "unknown" amount.

The evidence shows that the IRS has eight secured tax liens against the property totaling \$1,324,632.52, comprised of \$450,672.75 in unpaid taxes, \$249,022.93 in penalties, and \$624,936.84 in interest. Each secured tax lien was recorded on a different

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(Cite as: 2005 WL 1444225 (Bankr.C.D.Cal.))

date, with respect to different taxes owed, and with its own priority. All of the secured tax claims are for unpaid income taxes. The secured tax liens relate to the following tax years: 1989; 1990; 1993-1995; and 1999-2001. The secured tax liens were assessed on the following dates: December 12, 1994; September 14, 1992; March 13, 1995; May 27, 1996; December 15, 1997; April 28, 2003; May 5, 2003; and April 14, 2003, respectively. The IRS filed one proof of claim in this case to cover its eight separate tax liens.

\*2 The property also is subject to unsecured priority tax claims held by the IRS in the total sum of \$537,369.60. Mr. Bolden's Schedule E acknowledges delinquent taxes for 2002 and 2003 owed to both the IRS and the Franchise Tax Board in "unknown" amounts. The evidence provided by the IRS indicates that these taxes were assessed in 1999-2003 and relate to the 1998-2003 tax periods, for income, FICA, and FUTA taxes.

The IRS also asserts unsecured general claims against Mr. Bolden totaling \$940,773.45, for income, FICA, and FUTA taxes for 1994 and 1999-2003.

Additionally, as of December 27, 2004, Bolden & Martin owed the California Employment Development Department (EDD) \$213,296.63 in unpaid taxes. The EDD filed a notice of state tax lien against Bolden & Martin as a result of its failure to pay its state tax liability.

The penalty portions of the IRS secured tax liens total \$339,272.

On Schedule C, Mr. Bolden claimed a \$50,000 homestead exemption pursuant to California Code of Civil Procedure § 704.730(a)(1). The trustee has not objected to this exemption. Mr. Bolden now claims that he is entitled to a \$75,000 homestead exemption, but he has not yet amended his schedules to reflect this change.

Mr. Bolden has refused to cooperate with the trustee's efforts to sell the property. Four property visits were scheduled for potential buyers. On February 4, 2005, the trustee's broker, Ron Bombiger, advised Mr. Bolden's attorney by fax of a property visit scheduled for February 5, 2005, at 11:00 a.m. On the same day, the trustee's broker advised Mr. Bolden's attorney by fax of additional property visits scheduled for (1) February 8 at 5:00 p.m.; (2) February 10 at 5:00 p.m.; and (3) February 12 at 11:00 a.m. Mr. Bolden's attorney responded to the

first notice by stating that he was unable to contact Mr. Bolden and that the broker's 24-hour notice was "stupid and rude." In response to the second notice, Mr. Bolden's attorney left a telephone message for the trustee's attorney stating that discussions with Mr. Bolden were underway regarding making the property available for prospective buyers' visits. Mr. Bolden did not make the property available for buyers' visits on the scheduled dates. A "For Sale" sign was placed on the property by the trustee's broker on February 7, 2005. Mr. Bolden apparently removed the "For Sale" sign from the property. Due to Mr. Bolden's lack of cooperation, the trustee's real estate broker has not had reasonable access to the property to facilitate the trustee's efforts to sell the property.

Mr. Bombiger's telephone log shows that between January 25, 2005, and February 16, 2005, 41 people called to inquire about the property. These people required an interior viewing of the property before deciding whether to submit a purchase offer to the trustee. On February 17, 2005, the trustee's real estate broker received a written offer to purchase the property for \$975,000. The offer was made subject to inspection of the property.

\*3 On February 18, 2005, the trustee filed a motion for turnover of the property. On March 14, 2005, Mr. Bolden filed a motion to compel the trustee to abandon the property. On April 6, 2005, the IRS filed a memorandum in support of the trustee's motion for turnover of the property. On May 13, 2005, Cenlar filed a joinder to the trustee's motion for turnover of the property and in opposition to Mr. Bolden's motion to compel abandonment.

#### DISCUSSION

##### A. Mr. Bolden's Motion for Abandonment

Mr. Bolden opposes the trustee's turnover motion, and pursuant to 11 U.S.C. § 554(b) and Federal Rule of Bankruptcy Procedure 6007(b), Mr. Bolden seeks an order compelling the trustee to abandon the property. [FN1] Section 554(b) requires the court to find that the property to be abandoned is either burdensome or of inconsequential value and benefit to the estate.

[FN1] Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. § 101-1330, and all rule references are to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036. Section 554(b) states:

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(Cite as: 2005 WL 1444225 (Bankr.C.D.Cal.))

On request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.

Rulc 6007(b) states:

A party in interest may file and serve a motion requiring the trustee or debtor in possession to abandon property of the estate.

Mr. Bolden's basis for requesting an order compelling abandonment is his claim that the total

Fair Market Value		\$ 925,000.00
Cost of Sale (6%)		(55,500.00)
Payoff First Trust Deed		(330,000.00)
IRS Tax Lien	(1,324,632.52)	
State FTB Tax Lien	(532,588.79)	
State EDD Tax Lien	(213,296.63)	
Total Tax Liens		(2,400,517.94 )
Net [Deficiency] From Sale [Before Homestead Exemption]		(\$ 2,126,017.00)
Homestead Exemption		(75,000.00 [FN2])
FN2. At this time, Mr. Bolden has claimed a \$50,000 homestead exemption, not a \$75,000 exemption. Mr. Bolden states that he will be claiming a \$75,000 homestead exemption and bases his analysis on the anticipated homestead exemption.		
Net [Deficiency] To Estate		(\$ 2,201,017.94 )

Based on this analysis, Mr. Bolden concludes that a sale of the property for \$925,000 will not satisfy the liens on the property but that other costs and fees would be incurred by the trustee and other professionals in connection with the sale of the property. Thus, Mr. Bolden asserts that the property would provide inconsequential value and benefit to the estate and should be abandoned by the trustee.

Mr. Bolden suggests the following as his expected order of distribution of sale proceeds, as prescribed by § 724(b) [FN3], should the property be turned over to the trustee and sold: (1) Cenlar's deed of trust; (2) Mr. Bolden's homestead exemption; (3) administrative claims; and (4) tax claims secured by liens. According to Mr. Bolden, the distribution scheme he envisions would satisfy only a small portion of the secured debt and leave nothing for unsecured creditors. Based on his analysis, Mr. Bolden concludes that the property is of little, no, or even negative value to the estate, and the trustee should be ordered to abandon it.

FN3. Section 724(b) states:

Property in which the estate has an interest and

tax liens against his home far exceed its value. Mr. Bolden contends that the property is of inconsequential value and benefit to the bankruptcy estate. Mr. Bolden analyzes the estate's interest in the property as follows:

FN2. At this time, Mr. Bolden has claimed a \$50,000 homestead exemption, not a \$75,000 exemption. Mr. Bolden states that he will be claiming a \$75,000 homestead exemption and bases his analysis on the anticipated homestead exemption.

that is subject to a lien that is not avoidable under this title and that secures an allowed claim for a tax, or proceeds of such property, shall be distributed--

(1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is senior to such tax lien;

(2) second, to any holder of a claim of a kind specified in section 507(a)(1), 507(a)(2), 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title, to the extent of the amount of such allowed tax claim that is secured by such tax lien;

(3) third, to the holder of such tax lien, to any extent that such holder's allowed tax claim that is secured by such tax lien exceeds any amount distributed under paragraph (2) of this subsection;

(4) fourth, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is junior to such tax lien;

(5) fifth, to the holder of such tax lien, to the

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(Cite as: 2005 WL 1444225 (Bankr.C.D.Cal.))

extent that such holder's allowed claim secured by such tax lien is not paid under paragraph (3) of this subsection; and  
(6) sixth, to the estate.

#### B. Trustee's Motion for Turnover

The trustee contends that Mr. Bolden makes two errors in his analysis. According to the trustee, Mr. Bolden first incorrectly lumps the eight IRS tax liens together as if they were a single secured claim against the property, and secondly, Mr. Bolden assumes incorrectly that his homestead exemption claim will be paid prior to avoided liens.

\*4 The trustee notes that there are eight tax liens, each recorded on a different date, each respecting different taxes owed, and each with its own priority in relation to other liens. The evidence here confirms that the tax liens constitute separate liens, not a single blanket lien and that there are eight separate and distinct IRS secured tax liens, each with its own priority, for eight separate and distinct tax years.

The trustee and the IRS persuasively argue that the avoided tax liens will come ahead of Mr. Bolden's homestead exemption for purposes of distribution. It is true, as Mr. Bolden argues, that the trustee cannot contest the validity of a claimed exemption after the 30-day period for objecting has expired and no extension has been obtained, even if a debtor has no colorable basis for the exemption, citing Taylor v. Freeland & Kronz, 503 U.S. 638, 112 S.Ct. 1644 (1992). Mr. Bolden claimed a \$50,000 homestead exemption on his Schedule C. The trustee did not object to the homestead exemption claim within the 30-day period allowed following the conclusion of the creditors meeting. Pursuant to Rule 4003(b) and the holding in Taylor v. Freeland & Kronz, an objection at this time would be time-barred, and the \$50,000 exemption claimed by Mr. Bolden at the outset would be allowed whether or not Mr. Bolden had a colorable statutory basis for claiming it. On the other hand, the trustee can contest the priority of the exemption with respect to competing liens. The basic rule of "first in time, first in right" is used to determine the priority of competing liens. United States v. City of New Britain, 347 U.S. 81 (1954).

Pursuant to § 522(c)(2), exempt property, such as that represented by Mr. Bolden's homestead exemption claim, remains liable for debts secured by a lien that is not avoided or for which a notice of such things as a federal tax lien has been filed. [FN4] The homestead exemption does not have precedence over the tax liens. Generally, a debtor is not entitled to claim a homestead exemption on

property that is subject to an IRS levy. Treas. Reg. on Proc. and Admin. § 301.6334-1(c); United States v. Estes, 450 F.2d 62, 65 (5th Cir.1971); Davenport v. United States, 136 B.R. 125, 127-28 (Bankr.W.D.Ky.1991) (a state-created homestead exemption is ineffective against a federal tax lien, but the proceeds of a sale of property are subject to a valid tax lien under § 522).

[FN4] Section 522(c)(2) states in pertinent part: Unless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose ... before the commencement of the case, except -

\* \* \*

(2) a debt secured by a lien that is -  
(A) (i) not avoided under subsection (f) or (g) of this section ...; and (ii) not void under section 506(d) of this title ...; or  
(B) a tax lien, notice of which is properly filed  
....

It has been recognized that the IRS has its own exemption scheme and that a "[state] homestead exemption does not erect a barrier around a taxpayer's home sturdy enough to keep out the Commissioner of Internal Revenue." United States v. Estes, 450 F.2d at 65 (no provision of a state's law may exempt property or rights in property from levy for the collection of federal taxes owed). The Supreme Court has concluded that the Supremacy Clause allows the federal government to "sweep aside state-created exemptions." United States v. Rodgers, 461 U.S. 677, 701 (1983).

\*5 The holder of a properly filed tax lien need not file an objection to a homestead exemption in order to challenge the homestead exemption. Braddock v. United States (In re Braddock), 149 B.R. 636, 639 (Bankr.D.Mont.1992). Requiring holders of tax liens to file objections to the homestead exemption would render § 522(c)(2) superfluous. *Id.* (tax liens are entitled to priority over homestead exemptions even where the IRS did not object to the homestead exemption). In other words, § 522(c)(2) neutralizes Mr. Bolden's claim that he is entitled to collect on his homestead exemption claim here because no timely objection to his \$50,000 claim was filed by the trustee. [FN5]

[FN5] Demarah v. United States (In re Demarah), 62 F.3d 1248, 1252 (9th Cir.1995), was cited by the trustee for the proposition that the Ninth Circuit held that (1) Congress has denied debtors the right to remove tax liens from their otherwise exempt property, and (2) portions of tax liens

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that secure noncompensatory tax penalties remain fixed on the property despite the debtor's attack. However, *DeMarah* is not directly applicable because it is a § 505 case in which the debtor sought to avoid and set aside tax penalties once the IRS began collection activity against the debtor's property. Here, § 724(a), not § 505, is involved. In this case, the trustee, not the debtor, is seeking, with the cooperation of the IRS, to avoid the penalty portion of the IRS tax liens in order to benefit unsecured creditors of the estate.

The trustee here contends that the property should not be abandoned because the liens that he seeks to avoid will confer a benefit on the estate and should be turned over to the trustee pursuant to § 542(a). [FN6]

FN6. Section 542(a) states in pertinent part:

[A]n entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.

The trustee notes that § 724(a) states: "The trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title." While § 726 deals generally with the distribution of property of the estate, § 726(a)(4) provides that the fourth priority in distribution of property of the estate is "in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim." Taken together, §§ 724(a) and 726(a)(4) establish a statutory basis to allow the trustee to avoid tax penalty liens of the IRS and Franchise Tax Board. Here, the tax penalty liens (with the exception of the IRS' trust fund recovery penalty) were assessed against Mr. Bolden before the order for relief, as fines or penalties, and not as compensation for actual pecuniary loss. The tax penalties were punitive in nature and

assessed to punish a failure to pay taxes.

The Supreme Court has explained that the bankruptcy statute "manifests a congressional purpose to bar all claims of any kind against a bankrupt except those based on a 'pecuniary' loss." *Simonson v. Granquist*, 369 U.S. 38, 82 S.Ct. 537, 538-39 (1962). The Court reasoned: "Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors." *Id.* at 539. This congressional intent to protect innocent creditors from delinquent taxpayers has been preserved in present § 724(a).

The trustee contends further that §§ 551 and 349(b) accord him the statutory right to preserve any liens avoided under § 724(a) for the benefit of the estate. Section 551 states in pertinent part: "Any transfer avoided under section ... 724(a) of this title ... is preserved for the benefit of the estate but only with respect to property of the estate." Section 349(b) states in pertinent part: "Unless the court, for cause, orders otherwise, a dismissal of a case other than under section 742 of this title--(1) reinstates--\* \* \* (B) any transfer avoided under section ... 724(a) of this title ...." Further, *Collier on Bankruptcy* states that § 551 applies to § 724(a) dealing with fines, penalties, and forfeitures. 5-551 *Collier on Bankruptcy*--15th Edition Revised ¶ 551.01. Thus, I conclude, that after avoiding the IRS tax penalty liens under § 724(a), the trustee has the statutory right under §§ 551 and 349(b) to preserve the liens avoided for the benefit of the estate.

\*6 Ultimately here, turnover of the property will confer a benefit on the estate because the trustee will avoid what he estimates is \$339,272 in tax penalties and interest on tax penalties for the benefit of the estate, as follows:

$$\text{FN7. } \$38,582 / (\$38,582 + \$70,565) \times \$170,656$$

$$\text{FN8. } \$45,532 / (\$45,532 + \$54,770) \times \$159,779$$

$$\text{FN9. } \$29,901 / (\$29,901 + \$61,676) \times \$93,824$$

$$\text{FN10. } \$32,902 / (\$32,902 + \$62,871) \times \$84,015$$

[Note: The following TABLE/FORM is too wide to be displayed on one screen. You must print it for a meaningful review of its contents. The table has been

divided into multiple pieces with each piece containing information to help you assemble a printout of the table. The information for each piece includes: (1)

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a three line message preceding the tabular data showing by line # and character # the position of the upper left-hand corner of the piece and the position of the piece within the entire table; and (2) a numeric scale following the tabular data displaying the character positions.]

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\*\*\*\*\*  
\*\*\*\*\* This is piece 1. -- It begins at character 1 of table line 1. \*\*\*\*\*  
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IRS Lien Recordation Date	Total Amount Claimed as a Lien on Petition Date	Principal Amount of Taxes	Amount of Penalties to Petition Date	Amount of Interest to Petition Date/ Amount of Interest Attributed to Penalties
2/12/93	\$279,803	\$70,565 (1 990)	\$38,582	\$170,656/\$60,325 [FN7]
FN7. \$38, 582 / (\$38, 582 + \$70,565) x \$170,656				
2/8/95	\$260,081	\$54,770 (19 89)	\$45,532	\$159,779/\$72,532 [FN8]
FN8. \$45, 532 / (\$45,532 + \$54,770) x \$159,779				
7/11/95	\$185,401	\$61,676 (1 995)	\$29,901	\$93,824/\$30,635 [FN9]
FN9. \$29, 901 / (\$29,901 + \$61,676) x \$93,824				
7/12/96	\$179,788	\$62,871 (1 994)	\$32,902	\$84,015/\$28,863 [FN10]
FN10. \$32, 902 / (\$32,902 + \$62,871) x \$84,015				
1....+...10.....+...20.....+...30.....+...40.....+...50.....+...60.....+...70...				

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\*\*\*\*\*  
\*\*\*\*\* This is piece 2. -- It begins at character 74 of table line 1. \*\*\*\*\*  
\*\*\*\*\*

Amount Avoided and Preserved for Estate (Penalties + Interest on Penalties)	Amount Paid to IRS on Lien	Balance Available for Subsequent Liens
\$98,907	\$180,896	\$386,104
\$118,064	\$142,017	\$244,087
\$60,536	\$124,865	\$119,222
\$61,765	\$118,023	\$1,199

74...80...+...90...+...0...+...1



The remaining four IRS tax liens listed on the IRS proof of claim are not included in the above chart since the proceeds available from the sale of the property would be exhausted by the first four liens recorded by the IRS. By avoiding the penalty portions of the tax liens and preserving them for the benefit of the creditors, the estate is enriched while the IRS still obtains the principal portion of its liens, with interest, in the order and priority of each respective lien. At the same time, Mr. Bolden cannot use the IRS' tax liens as a shield against the trustee's administration of the property for the benefit of creditors. This is because, with respect to each lien avoided, the trustee steps into the shoes of the lienholder, preserving for the estate the respective priority of each lien. See *In re Cavanaugh*, 153 B.R. 224 (Bankr.N.D.Ill.1993). The trustee "who avoids an interest succeeds to the priority that interest enjoyed over competing interests." *Retail Clerks Welfare Trust v. McCarty (In re Van de Kamp's Dutch Bakeries)*, 908 F.2d 517, 519 (9th Cir.1990). Congress' motivation for instituting this provision was to "prevent junior lienholders from improving their position at the expense of the estate when a senior lien is avoided." *Id.*; See also *Staats v. Barry (In re Barry)*, 31 B.R. 683 (Bankr.S.D. Ohio 1983); 5-551 *Collier on Bankruptcy*--15th Edition Revised ¶ 551.01.

The avoided tax penalties will be distributed according to the distribution scheme set forth in § 726.

1. What happens to the proceeds of a lien avoided under § 726(a)?

Section 726 provides the general distribution scheme for property of the estate. Section 726(a) specifies in part that "property of the estate shall be distributed--(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed before the date on which the trustee commences distribution under this section."

\*7 Section 507 sets forth priorities for distribution of expenses and claims. [EN1] The potentially relevant priorities under § 507(a) are as follows: (1) administrative expenses; and (8) allowed unsecured claims of governmental units. According to the priorities set forth under § 507, the administrative costs would be paid first. Section 507(a)(3) may be irrelevant, as it deals with wage claims, and there is no evidence that Mr. Bolden has employees or wage claims of employees to pay. The only other applicable priority is § 507(a)(8).

Thus, it seems, the unsecured portions of the tax claims would be paid second, after the administrative expense claims.

[EN1] Section 507(a) states in pertinent part:

The following expenses and claims have priority in the following order:

(1) First, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28;

\*\*\*

(3) Third, allowed unsecured claims ... earned within 90 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first, for-  
(A) wages, salaries, or commissions ...; or  
(B) sales commissions earned by an individual or by a corporation with only 1 employee ...;

\*\*\*

(8) Eighth, allowed unsecured claims of governmental units; only to the extent that such claims are for -

(A) a tax on or measured by income or gross receipts--[as limited by subsection (i)-(iii)];

\*\*\*

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity; [or]

(D) an employment tax on a wage, salary, or commission ... earned from the debtor before the date of the filing of the petition ...

2. If there is a benefit to the estate, turnover to the trustee is appropriate and the Debtor's motion to compel abandonment should be denied.

Based on the distribution scheme of § 726(a)(1) and the trustee's statutory right under § 551 to preserve liens avoided under § 724(a) for the benefit of the estate, a sale of the property will generate benefits to the estate in the form of significant anticipated payments to unsecured priority creditors.

The fair market value of the property appears to be about \$975,000 based on the purchase offer received by the trustee on February 17, 2005. I assume a cost of sale of about \$78,000 (8% of \$975,000). From the proceeds, Cenlar's deed of trust in the amount of about \$330,000

would be paid. The net that would be realized from a sale of the property, before tax liens, is about \$567,000. The sale will be conducted free and clear of the liens of the taxing agencies, with such liens to attach to the sale proceeds. The liens would be paid from the sale proceeds, to the extent available. Pursuant to § 724(a) and 551, the trustee would receive from the sale proceeds about \$339,272 in avoided tax penalties and avoided interest on tax penalties. This would allow the estate to pay administrative claims and a dividend to unsecured priority claimants. First, under § 507(a)(1), administrative claims will be paid. Second, under § 507(a)(8) unsecured claims of governmental units will be paid to the extent that such claims are for selected taxable years and for a tax on or measured by income or gross receipts or required to be collected or withheld and for which the debtor is liable. Unsecured, as well as secured creditors, would receive payment from the proceeds of a sale of the property. Thus, there is a benefit to the estate in allowing turnover of the property, avoidance of the penalty portions of the tax liens for the benefit of the estate, and sale of the property.

Mr. Bolden's request to compel the trustee to abandon the property should be denied. The principal of abandonment was developed by the courts to protect bankruptcy estates from the costs and burdens of administering property when such administration could not conceivably benefit unsecured creditors of the estate. Justice Rehnquist commented in his dissent from the majority opinion denying abandonment in *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494, 106 S.Ct. 755, 763 (1986) as follows: "[C]ourts ... developed a rule permitting the trustee to abandon property that was worthless or not expected to sell for a price sufficiently in excess of encumbrances to offset the costs of administration...." See *Carey v. Pauline (In re Pauline)*, 119 B.R. 727, 728 (9th Cir. BAP1990) (citing *In re Paolella*, 79 B.R. 607, 609 (Bankr.E.D.Penn.1987)).

\*8 As stated by the Court of Appeals for the Sixth Circuit, "An order compelling abandonment is the exception, not the rule. Abandonment should only be compelled in order to help the creditors by assuring some benefit in the administration of each asset." *Morgan v. K.C. Machine & Tool Co. (In re K.C. Machine & Tool Co.)*, 816 F.2d 238, 246 (6th Cir.1987). Where the benefits of administration exceed the costs of administration, abandonment should not be compelled. *Id.* In *K.C. Machine & Tool Co.*, the court stated, "Absent an attempt by the trustee to chum property worthless to the estate just to increase fees, abandonment should very rarely be ordered." *Id.*

In *Pauline*, the Ninth Circuit Bankruptcy Appellate Panel

upheld the bankruptcy court's decision requiring the trustee to find a buyer for the debtor's home within 60 days at a price sufficient to satisfy all liens on the home plus the allowed amount of the debtor's homestead exemption, in the absence of which the debtor's home would be deemed abandoned. *In re Pauline*, 119 B.R. at 727. However, in *Pauline*, the Panel affirmed the bankruptcy court decision in part, because (1) the IRS did not ask the debtor to sell the property for the IRS' benefit, and (2) the trustee apparently had "engaged in ... conduct designed to enhance the size of his bank account rather than the size of the funds available for the Debtor's unsecured creditors ...." *Id.* at 728. Unlike in *Pauline*, (1) the IRS here supports the trustee's turnover efforts and seeks a sale of the property by the trustee, and (2) a sale will benefit unsecured priority creditors, including the IRS, not just increase the fees paid to the trustee and his professionals.

By contrast to the situation discussed by the Panel in *Pauline*, here, once the trustee avoids \$339,272 in penalty portions of the tax liens and sells the property, there will be a material benefit to the estate. Abandonment is not proper here because the property is not burdensome or of inconsequential benefit and value to the estate, as required by § 554(b). Based on the inquiries and offers received by the trustee's broker, the property should sell quickly once the trustee has access to the property. Real estate commissions, legal fees, and other costs of administration that may total about \$90,000 will be offset by the excess value to the estate created by the sale. While the trustee and his attorneys and broker will receive fees as a result of a sale of the property, the fact that unsecured creditors will benefit significantly from a sale shows that this is not an attempt by the trustee merely to increase his fees. The efforts of the trustee and his professionals are necessary to value, market, and sell the property. The property should be turned over to the trustee so that the estate can realize the benefits of a sale. An order for turnover is necessary under the circumstances. Mr. Bolden has been uncooperative. The trustee needs a turnover order to market and sell the property. Turnover of the property will facilitate the trustee's sale of the property and will enable unsecured creditors to be paid.

#### CONCLUSION

\*9 The circumstances particular to this case, together with the evidence in the record, lead me to the conclusion that a turnover order will facilitate an expeditious sale of the property and will provide unsecured creditors, not just the trustee and his professionals, with significant benefits. The trustee's request for turnover of the property pursuant to § 542(a) should be granted, and Mr. Bolden's request for abandonment should be denied.

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The trustee's counsel is directed to prepare and lodge a proposed separate order consistent with this memorandum.

IT IS SO ORDERED.

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## **THE IRS IS YOUR FRIEND: HOW TRUSTEES CAN USE TAX LIENS TO WEAVE STRAW INTO GOLD**

**By Peter A. Davidson<sup>1</sup>**

In today's post-BAPCPA<sup>2</sup> environment trustees are more frequently scouring debtors' petitions in an effort to locate assets to administer. With increased exemptions,<sup>3</sup> and falling real estate values, there is often little to administer and most cases are "no asseted."<sup>4</sup> There are some cases, however, that trustees may be no asseting when, in fact, there are assets to administer that are not at first apparent. This article examines those cases where, because of the existence of federal tax liens, estates that appear to have no value in fact do have value because the trustee can use the tax liens to trump the debtors' exemptions and create value for the estate.

Consider the following hypothetical; Rumpelstiltskin<sup>5</sup> owns a home with \$50,000 of equity. He also has an individual retirement account ("IRA") with \$95,000, receives quarterly payments from the settlement of an accident caused

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<sup>1</sup> Peter A. Davidson is the Managing Partner of Moldo Davidson Fraioli Seror & Sestanovich LLP in Los Angeles, California. He is a past-president of the Los Angeles Bankruptcy Forum and serves as an Editor of the California Bankruptcy Journal, and as a board member and officer of the California Bankruptcy Journal Corporation. He writes a column "Ask the Receiver" for *Receivership News*. Peter represents bankruptcy trustees, receivers, creditors and debtors.

<sup>2</sup> BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 ("BAPCPA"). S.256, 109th Cong., 1st Sess. (April 20, 2005).

<sup>3</sup> California's state law exemptions, applicable to bankruptcy cases, were increased on April 1, 2004 and are to be adjusted at each three-year interval ending April 1, thereafter. They will, therefore, adjust on April 1, 2007 based on the change in the annual California Consumer Price Index for all urban consumer for the three year period ending December 31, 2006. CAL. CODE CIVIL P. § 703.150. The triennial adjustment period was enacted in 2003 to reflect the similar adjustments provided for in 11 U.S.C. § 104. Law Revision Commission Comments to CAL. CODE CIVIL P. § 703.15.

<sup>4</sup> "If all the debtor's assets are exempt or subject to valid liens, the trustee will normally file a 'no asset' report with the court and there will be no distribution to unsecured creditors. Most Chapter 7 cases involving individual debtors are no asset cases." [www.uscourts.gov/bankruptcy\\_courts/bankruptcy\\_basis/chapter\\_7.html](http://www.uscourts.gov/bankruptcy_courts/bankruptcy_basis/chapter_7.html).

<sup>5</sup> "Rumpelstiltskin is a dwarf character in a fairy tale of the same name that originated in Germany (where he is known as Rumpelstilzchen). The tale was collected by the Grimm Brothers who first published it in the 1812 edition of *Children's and Household Tales*." <http://en.wikipedia.org/wiki/Rumpelstiltskin>. In the story, Rumpelstiltskin spins straw into gold in exchange for a promise that the future Queen's first-born child would be his. *Id.*

by a defective loom, under which \$15,000 is still owed, and has a whole life policy with a cash surrender value of \$8,000. He owes the Internal Revenue Service ("IRS") \$300,000 and the IRS has recorded a tax lien in the county of his residence indicating Rumpelstiltskin owes \$250,000 of tax, \$30,000 of penalties and \$20,000 of interest.

Rumpelstiltskin files a Chapter 7 bankruptcy petition. His schedules assert the following exemptions: all the equity in his home,<sup>6</sup> his IRA,<sup>7</sup> his personal injury payment,<sup>8</sup> and the cash surrender value of his life insurance policy.<sup>9</sup>

Many trustees reviewing Rumpelstiltskin's schedules would no asset his case because it appears that all the debtor's assets of value are fully exempt. No asseting Rumpelstiltskin's case, however, would be a mistake. As will be explained more fully below, all of Rumpelstiltskin's exemptions are subordinated to the federal tax lien, which in turn is subordinated to the estate's administrative expenses, including the trustee's and his counsel's fees. Rumpelstiltskin's case, therefore, is worth administering.

A federal tax lien attaches to "all property and rights to property, whether real or personal, belonging" to a taxpayer.<sup>10</sup> The lien arises when an assessment is made and attaches to the taxpayer's property at the moment of assessment.<sup>11</sup> Once filed or recorded, it includes after acquired property.<sup>12</sup> The assessment

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<sup>6</sup> CAL. CODE OF CIVIL P. § 704.710 *et seq.*

<sup>7</sup> CAL. CODE OF CIVIL P. § 704.115

<sup>8</sup> CAL. CODE OF CIVIL P. § 704.140(d).

<sup>9</sup> CAL. CODE OF CIVIL P. § 704.100(b).

<sup>10</sup> 26 U.S.C. § 6321. ("If any person liable to pay any tax neglects or refuses to pay same after demand, the amount (including any interest, additional amount, addition to tax or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."). The Supreme Court has noted this language "is broad and reveals on its face that Congress meant to reach every interest in property that a taxpayer may have." *United States v. National Bank of Commerce*, 472 U.S. 713, 719-20, 105 S. Ct. 2919, 2924 (1985).

<sup>11</sup> "The assessment, essentially a bookkeeping notation, is made when the Secretary or his delegate establishes an account against the taxpayer on the tax rolls." *Laing v. U.S.*, 423 U.S. 161, 171, n.13, 96 S. Ct. 473, 479 (1976); 26 U.S.C. § 6203 ("The assessment shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary.").

<sup>12</sup> *United States v. McDermott*, 507 U.S. 447, 448, 113 S. Ct. 1526, 1527 (1993); *Crow v. Long* (*In re Crow*), 107 B.R. 184, 186 (E.D. Mo. 1989) ("The lien covers not only property in the

creates what is often known as the "secret lien" because the assessment – and hence the lien – is not public or of record.<sup>13</sup> The lien remains in effect until the taxpayer's liability is satisfied or becomes unenforceable by reason of lapse of time.<sup>14</sup> Unless the lien is filed or recorded, it is not effective against a judgment lien creditor, mechanic's lien holder, holder of a security interest or a good faith purchaser.<sup>15</sup> As a consequence, by operation of Bankruptcy Code § 544, an unfiled or unrecorded tax lien is not effective against a bankruptcy trustee.<sup>16</sup>

Once the lien is properly filed or recorded, however, the lien is effective against subsequent judgment lien creditors, good faith purchasers, secured creditors, mechanic lien holders and, except as discussed below, the debtor's bankruptcy trustee. Indeed, an IRS lien remains enforceable against encumbered assets even if tax debtor obtains a bankruptcy discharge, in which case the debtor would not have any further personal liability.

Section 522 allows a debtor to exempt certain property. The exemptions provided by the Code, or by state law where a state has opted out of the federal exemptions,<sup>17</sup> do not have precedent over tax liens. Section 522 (c)(2)(B) and case law specifically provides that exemptions are not effective against a debt secured by a tax lien, notice of which has been properly filed.<sup>18</sup> Numerous cases

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possession of the taxpayer at the time of the assessment but also any after-acquired property that comes into the taxpayer's possession, throughout the duration of the lien").

<sup>13</sup> *In re Suarez*, 182 B.R. 916, 919, n.2 (Bankr. S.D. Fla. 1995) ("This general tax lien of I.R.C. § 6321 is referred to as a 'secret lien' because it arises as a matter of law against the taxpayer without the necessity of the filing of a notice of Federal Tax lien.").

<sup>14</sup> 26 U.S.C. § 6322. ("Unless another date is specifically fixed by law, the lien imposed by section 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time.").

<sup>15</sup> 26 U.S.C. § 6323(a). ("The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.").

<sup>16</sup> 11 U.S.C. § 544. The IRS has apparently conceded this point. See, IRS Chief Counsel Advisor (Issue: August 25, 2006) IRS CCA 200634012, 2006 W L 2460482 ("Thus, the trustee's status under section 544 would entitle the trustee to prevail against unfilled federal tax liens outside of bankruptcy and, therefore, the trustee may avoid a statutory tax lien, notice of which had not been filed before the petition date.").

<sup>17</sup> 11 U.S.C. § 522(b)(2) allows states to opt-out of the exemptions provided in § 522 and provides, if that occurs, a debtor can only use the exemptions provided under state law. California has done so. CAL. CIV. PROC. CODE § 703.130.

<sup>18</sup> *In re Carlson*, 180 B.R. 593 (Bankr. E.D. Cal. 1995); *Crow v. Long (In re Crow)* 107 B.R. 184, 188 (E.D. Mo. 1989). While most of the cases and the examples here deal with and discuss

have concluded that "no provision of a state law may exempt property or rights to property from levies for the collection of federal taxes owed."<sup>19</sup> Indeed, the case law confirms that the Supremacy Clause of the U.S. Constitution permits the federal government to effectively sweep aside state created exemptions.<sup>20</sup>

What does all this mean for Rumpelstiltskin and his bankruptcy trustee? Two recent cases, *In re Laredo*<sup>21</sup> and *In re Bolden*<sup>22</sup> explain that while Rumpelstiltskin's exemptions are not effective against the IRS they can be woven by his Chapter 7 trustee into "gold" for the estate and creditors.

In *Laredo* the Chapter 7 Trustee filed a complaint to determine the priority of liens and claims to the proceeds from the sale of the debtors' home. The trustee requested a finding that the debtors' homestead exemption was subordinate to both a tax lien filed by the IRS and the administrative and closing expenses incurred in liquidating the home. The debtors' home had two consensual mortgage liens totaling \$249,971, and an IRS tax lien for \$114,843. In addition, the IRS had an unsecured priority claim for another \$167,426. The debtors' claimed a \$15,000 homestead exemption under Illinois law. The court authorized the trustee to sell the property for \$380,000, with the liens and interests attaching the proceeds from the sale.

The trustee contended that the debtors' homestead exemption should be limited to those funds remaining after *not only* the payment of the consensual liens but also the estate's administrative expenses and costs and the IRS tax lien. The Trustee further contended and that the debtors' homestead exemption could not be paid until the IRS tax lien was satisfied in full.<sup>23</sup> The Court agreed.

The court began its analysis by noting that § 522(c), as a general rule, recognizes the vitality of both federal and state exemptions. If an asset is subject to a valid exemption, then the property is not liable for creditors' claims that arose before the commencement of the bankruptcy case. However, § 522(c)(2)(B)

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federal tax liens, the statutes and the results discussed here are not so limited. Both 11 U.S.C. § 522 (c)(2)(B) and 11 U.S.C. § 724(b), discussed *infra*, speak of "tax liens," not federal tax liens. See *In re Jewell*, 84 B.R. 619 (Bankr. D. Minn. 1988) [State tax lien enforceable against debtors' homestead pursuant to 11 U.S.C. § 522(c)(2)(B)]. See *also infra*, note 26.

<sup>19</sup> *United States v. Estes*, 450 F. 2d 62, 65 (5th Cir. 1971).

<sup>20</sup> *United States v. Rodgers*, 461 U.S. 677, 701, 103 S. Ct. 2132, 76 L.Ed. 2d 236 (1983).

<sup>21</sup> *Grochocinski v. Laredo (In re Laredo)*, 334 B.R. 401 (Bankr. N.D. Ill. 2005).

<sup>22</sup> *In re Bolden*, 327 B.R. 657 (Bankr. C.D. Cal. 2005).

<sup>23</sup> 334 B.R. at 405.

provides an exception to this general rule. Where an asset is encumbered by a tax lien, notice of which has been properly filed, the tax lien is superior to the exemption.<sup>24</sup> A state created homestead exemption, therefore, is ineffective against a filed tax lien.<sup>25</sup>

The court then examined how the proceeds from the sale were to be distributed. Section 724(b), which is only applicable in Chapter 7 cases, governs the distribution of property of the estate against which a tax lien has been asserted.<sup>26</sup> It expressly provides that the tax lien is subordinated, up to the amount of the lien, to the rights of holders of claims entitled to priority under § 507(a)(1)-(7).<sup>27</sup> The court noted, citing a number of cases, that "Congress made a policy decision to favor claims of wage earners, the costs of the administration of the estate, and other priority claims over tax liens."<sup>28</sup> In effect § 724(b) allows certain administrative claims to "step into the shoes of the tax collector."<sup>29</sup>

Based on the distribution mechanism set forth in § 724(b), the court held that the first step would be to distribute the proceeds to pay the consensual lienholders which were senior to the filed tax lien. The next steps would be (i) to distribute the funds needed to pay all the priority claims under § 507 (a)(1)-(7) and then (ii) to pay the tax lien, to the extent the lien exceeds the amount

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<sup>24</sup> *Id.* at 410.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 411.

<sup>27</sup> The tax lien is also subordinate to unavoidable liens senior to the tax lien. 11 U.S.C. § 724(b)(1). "The most common type of lien falling within the scope of section 724(b) is a lien for real property taxes, and prepetition real property taxes have often been subordinated under section 724(b) [citing cases]." 6 L. KING, COLLIER ON BANKRUPTCY, ¶ 724.03 [3] at 724-10 (15th ed. rev'd. 2006). BAPCPA added new subsections (e) and (f) to § 724 and amended § 724(b). Amended § 724(b) provides that real property taxes are excluded from the effect of § 724(b) unless the provisions of new § 724(f) come into effect, which allows for the subordination of real property taxes to pay claims for wages, salaries and commissions entitled to priority under § 507(a)(4) and for contributions to employee benefit plans entitled to priority under § 507(a)(5). New subsection (e) provides: "Before subordinating a tax lien on real or personal property of the estate, the trustee shall – (1) exhaust the unencumbered assets of the estate; and (2) in a manner consistent with section 506(c), recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving or disposing of such property."

<sup>28</sup> 334 B.R. at 412. ("Section 724(b) permits a Chapter 7 trustee to liquidate property subject to a tax lien and to distribute the proceeds to priority claimants before making any distribution to taxing authorities.")

<sup>29</sup> *Id.* Because the administrative expenses are being paid out of the tax lien, § 522(k) which provides property the debtor exempts is not liable for the payment of any administrative expense (with certain exceptions) has no applicability.



distributed to the claimants holding priority claims and finally (iii) to disburse funds to the debtors on account of their exemption.<sup>30</sup> Because in *Laredo* there were not sufficient funds to pay the IRS lien in full, there were no proceeds left to satisfy the debtors' homestead exemption and the debtors would receive no payment on account of their exemption.<sup>31</sup>

The debtors had argued that there should never have been a sale in the first place because the projected proceeds of the sale were insufficient to pay all liens in full, including the tax liens. The trustee, therefore, should have abandoned the property because, they contended, the property was of inconsequential value and benefit to the estate. The court rejected this argument noting that lack of equity in property alone does not necessarily mean the property is of inconsequential value and benefit to the estate. This is especially true where a creditor's lien is or can be subordinated to the trustee's interest in the property and in *Laredo* the IRS' lien could be subordinated to priority claims pursuant to § 724(b).<sup>32</sup>

The factual situation in *In re Bolden* is very similar to that in *In re Laredo*, although there is a twist which resulted in the trustee being able to weave more straw into gold for creditors. Mr. Bolden was a lawyer whose main asset was his home. The trustee listed Bolden's home for sale for \$924,500. The IRS had filed eight tax liens against the property totaling \$1,324,632 comprised of \$450,672 of unpaid tax, \$249,022 of penalties and \$624,936 of interest. The property was also subject to an unsecured priority tax claim of \$537,396 and a unsecured non-priority tax claim of \$940,773. The California Employment Development Department also had a state tax lien of \$213,296. Bolden claimed a \$50,000 homestead exemption.<sup>33</sup>

Bolden refused to cooperate with the trustee's attempts to sell his home but, despite that fact, the trustee received a written offer to purchase the home for \$975,000, subject to an inspection of the property. The trustee filed a motion for turnover and Bolden sought an order compelling the trustee to abandon the property, contending that it was either burdensome or of inconsequential and benefit to the estate. Although Bolden claimed, correctly, that the total tax liens against his home exceed its value, the court concluded, as did the court in *Laredo*, that pursuant to § 523(c)(2) a homestead exemption does not have precedence over tax liens. It noted: "The homestead exemption does not have precedence

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<sup>30</sup> *Id.* at 412-13.

<sup>31</sup> *Id.* at 413-14.

<sup>32</sup> *Id.* at 415.

<sup>33</sup> 327 B.R. at 659-60.

over the tax liens. Generally, a debtor is not entitled to claim a homestead exemption on property that is subject to an IRS levy...It has been recognized that the IRS has its own exemption scheme and that a [state] homestead exemption does not erect a barrier around the taxpayer's home sturdy enough to keep out the Commissioner of the Internal Revenue".<sup>34</sup>

The court also held that it did not matter that neither the trustee nor the IRS filed objections to the debtor's homestead exemption claim, because there was no need to object to the homestead claim. Section 522(c)(2)(B) specifically gives tax liens priority over homestead exemptions and requiring an objection in light of § 522 (c)(2) would be "superfluous."<sup>35</sup>

Bolden's request that the trustee abandon the property was denied not only because abandonment is not appropriate where a creditor's lien can be subordinated to a trustee's interest in property, but also because here the trustee intended to avoid a portion of the IRS' liens and preserve that portion of its liens for the benefit of unsecured creditors.<sup>36</sup> Section 724(a) provides: "The trustee may avoid a lien that secures a claim of a kind specified in § 726(a)(4) of this title." Section 726(a)(4) includes payments "of any allowed claim, whether secured or unsecured, for any fine, penalty or forfeiture . . . or damages are not compensation for actual pecuniary loss suffered by the holder of such claim." Based on these sections the court concluded that § 724(a) allows the trustee to avoid that portion of a tax lien that secures a penalty and to preserve the avoid portion of the lien for the benefit of the estate under § 551.<sup>37</sup> Therefore, the court concluded turnover of the property would confer a substantial benefit to the estate because the trustee could avoid the tax penalties, and the interest on the tax penalties, for the benefit of the estate, which funds would be distributed according to the distribution scheme set forth in § 726.<sup>38</sup> As a result, despite the fact that the debtor would not receive any portion of the proceeds from the sale of his home to satisfy his homestead exemption, and the property had no equity in it, the sale of the property by the trustee was a benefit to the estate and created "gold" for creditors because of the existence of the IRS' tax liens.

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<sup>34</sup> *Id.* at 662-63.

<sup>35</sup> *Id.* at 663.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 664.

<sup>38</sup> *Id.* at 666.

While the decisions in *Laredo* and *Bolden* concerned homestead exemptions, their rationale are applicable to any exemption claimed by a debtor because § 522(c)(2) subordinates *all* of a debtor's exemptions to a tax lien where notice of the lien has been properly filed. Therefore, Rumpelstiltskin's exemption in his IRA,<sup>39</sup> his personal injury settlement, the cash surrender value of his life insurance policy, as well as his homestead exemption would be subordinated to the IRS' tax lien, which in turn would be subordinated to the estate's costs of administration. Further, as in *Bolden* the trustee could avoid and preserve for the estate the penalty portion of the lien.

Tax liens are not the only straw the Internal Revenue Code provides trustees for weaving into gold. If the IRS is a creditor, trustees can use the extended, ten year, statute of limitations period afforded by 26 U.S.C. § 6502(a)(1) to avoid fraudulent transfers instead of the more restrictive two year statute under 11 U.S.C. § 548<sup>40</sup> or the four year limitation under the Uniform Fraudulent Transfer Act.<sup>41</sup> The Trustee's right to assert claims of an actual unsecured creditor under applicable law to avoid transfers, includes claims the IRS may have as a creditor.<sup>42</sup>

Where taxes are owed, and a debtor has property of value, even if it is claimed exempt, trustees need to determine whether a tax lien has been filed, when and where, and, if not filed, when the assessment occurred. With this information the trustee may be able to weave an otherwise no asset case into gold for the estate and creditors.

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<sup>39</sup> *Quillard v. United States (In re Quillard)*, 150 B.R. 291 (D.R.I. 1993).

<sup>40</sup> BAPCPA amended the section, extending the one year look back period to two years.

<sup>41</sup> CAL. CIVIL CODE § 3439 *et. seq.*

<sup>42</sup> *Shearer v. Tepsic (In re Emergency Monitoring Technologies, Inc.)*, 347 B.R. 17 (Bankr. W.D. Pa. 2006) (Trustee can use ten year statute of limitations afforded IRS). *See also*, Peter Davidson, "Getting in Through the Back Door; Using the Federal Debt Collection Procedures Act to Pursue Otherwise Time Barred Fraudulent Transfer and Preference Claims," 20 *Journal of the National Association of Bankruptcy Trustees* 46 (2004).

### Bankruptcy Trustees\*\*\*

I love a debtor who indicates that property of the estate is subject to a tax lien. I am not concerned if the lien exists under federal law, or state law, in my case — West Virginia law. Either way, I look to administer the property and to sell it. I do understand that's not the national practice, so this article will explain, not only what I do, but why.

#### Finding the Tax Lien

Schedule D of a bankruptcy petition, if properly completed, is supposed to contain a list of all secured creditors. I think that a debtor's attorney should list a recorded tax lien on Schedule D. Properly completed forms should show the date the lien was recorded and the county in which the lien was recorded. Good debtor's counsel will list the book and page number.<sup>1</sup>

Sometimes, debtor's attorneys will misidentify where the information should be disclosed. Sometimes a lien is errantly listed as a priority debt on Schedule E. I tend to ask about tax debts disclosed on Schedule E. I am looking for liens and I am trying to understand if tax returns where the tax was left unpaid were timely filed. That can affect whether a priority exists or not. Sometimes, I learn in this process that there is a lien.

I am aware that some debtor's attorneys don't appreciate these issues. Sometimes taxing authorities will be listed as creditors on Schedule F. Sadly, sometimes tax creditors are not listed at all and a trustee may find liens when doing a review of records at the courthouse. I

am one of three trustees in our district which is in a rural state. Depending on whether I am serving in my usual spot, or covering a conflict for another trustee, there are there are thirty-two different counties where liens could be filed in the Northern District of West Virginia. 28 U.S.C. § 129. From time to time, I have been appointed in the Southern District of West Virginia which has twenty-three more counties. I am painfully aware that checking every jurisdiction can be a challenge.

#### Property of the Estate, Liens and Exemptions

It is a basic principle of bankruptcy law that all property in which the debtor has any legal or equitable interest when a bankruptcy case commences is property of the estate. 11 U.S.C. § 541(a)(1). Property of the estate under the Code includes property that is exempted until the exemption becomes effective. *Tignor v. Parkinson*, 729 F.2d 977, 980 (4th Cir. 1984).

While 11 U.S.C. § 522 authorizes debtors to exempt property from the estate under state or federal law, those exemptions only work to permit a debtor to make effective use of an exemption to retain only an interest in the equity in property.<sup>2</sup> In the hypothetical West Virginia example, a debtor with real property worth \$100,000 and secured debt of \$90,000 has only \$10,000 worth of equity. While the applicable state exemption in real estate is

\$25,800, only \$10,000 can be effectively used. That is because secured debt must be satisfied before the exemption can be effectively used. In an estate with just such an asset, a trustee will ordinarily confirm the validity of the lien and close the estate as a no asset case, effectively abandoning all such property. Where some other asset warrants keeping the estate alive, abandonment of such an asset may occur separately.

Some debtors will claim an exemption in secured property even where there is no equity. If the secured debt arises from a lien that was voluntarily created, a deed of trust, or mortgage, a lien on a title, etc., trustees do not object. There is little point. The asset will likely be abandoned under 11 U.S.C. § 554 because there is no benefit to the estate.

Where the lien is not the result of a voluntary transaction, but is instead the result of an involuntary event, a trustee, or a debtor, may act differently. A judgment lien might be subject to avoidance as a preference under 11 U.S.C. § 547, a fraudulent conveyance under 11 U.S.C. § 548 or otherwise under 11 U.S.C. § 544. If

avoided, a debtor might still be able to exempt some or all of what can be recovered under 11 U.S.C. § 522(g). If a trustee chooses not to act to avoid a lien, the debtor can do so.

A tax lien recorded on the eve of bankruptcy might be subject to avoidance under some or all of these principles. If avoided, the debtor could claim an exemption in the resulting equity and any non-exempt value of the asset could be administered for the benefit of the estate. But most tax liens are not going to be avoidable on such grounds. What role does

the exemption play when there are unavoidable tax liens?

Before turning to this question, it should be recalled that a federal tax lien attaches to all real property in the county where the lien is recorded and to all personal property of the debtor anywhere in the world once the lien is recorded in the county in which the debtor lives. See 26 U.S.C. § 6321 and *U.S. By and Through I.R.S. v. McDermott*, 507 U.S. 447 (1993). State laws are often similar. The West Virginia statute that we confront applies to all real property in the county in which the lien is recorded and all personal property in the state. W.Va. Code § 11-10-12.

Thus, if the value of the tax lien exceeds the value of the



1. The exemptions from a tax levy are not generally considered a viable exemption for a debtor to assert in bankruptcy court. So while the federal government can't sell a taxpayer's residence to collect a tax debt under 26 U.S.C. § 6334, that limitation does not create equity to be exempted by a debtor from a bankruptcy estate.
2. When bankruptcy practitioners discuss the fiduciary duty of trustees, it is typically said that a duty is owed to "unsecured creditors." This is good shorthand, but the better statement is that a trustee owes a fiduciary duty to every party to a case.
3. A tax lien creditor can't protect its own interests. This is the fundamental limitation in the Trustee Handbook that must be appreciated.

#### About the Author



Martin P. Sheehan has served on the NABT Board of Directors since 2003. He has been Secretary, Treasurer and currently Vice President for two years. He has been an active member of the Amicus Committee of NABT. He is the putative class representative on behalf of all trustees in a case against the United States to obtain fees for trustees in IFP cases.

Martin has been an attorney since 1980 and a trustee since 1994. In the past he has been a law clerk to a Federal District Court Judge and an Assistant United States Attorney. He holds a certification in Bankruptcy Law (Consumer Law) from the ABC, and is a bankruptcy Professor at West Virginia School of Law.

debtor's equity in all property, real and personal, then the claim of exemption is again an ephemeral claim. The claim of exemption does not allow a debtor to retain any equity. If the tax lien is smaller than totality of the equity, then the exemption can be effectively used to exempt the value not necessary, after marshaling all the property subject to the liens, to satisfy the liens.

There is a reasonable view that no objection to an exemption in property subject to a tax lien is necessary. As noted above, as a matter of law, the secured debt trumps the exemption. Nonetheless, I prefer, when I am aware of the lien, to file an objection to such exemptions. My objection is that there is no equity in property to which the exemption causes to be exempt.<sup>4</sup> This has the salutary effect of advising the debtor's attorney that there is no equity and that the trustee has a claim on every item of personalty.

Debtors will sometimes contend that rule does not apply to small items of property or to necessary property. My technical side is certainly able to argue in response that the lien applies to all personal property that the debtor owns, including used household furniture, medical appliances and miscellaneous junk owned by a debtor. Still my practical side wants to abandon that kind of property promptly. It is an old adage in the law that "pigs get fat, and hogs get slaughtered." I've been technically right and practically wrong. A word of advice, "Don't go there." Even if the law permits you to sell a debtor's iron lung machine, I usually reason that "used iron lung machines" are unsaleable.

On rare occasions, someone will claim an exemption in property subject to a tax lien, based on statutes that limit the power of a taxing authority to actually take and sell a specific item of property. See, e.g., 26 U.S.C. § 6334.<sup>5</sup> The exemptions from a tax levy are not generally considered a viable exemption for a debtor to assert in bankruptcy court. See *In re Voelker*, 42 F.3d 1050 (7th Cir. 1994); *U.S. v. Barbier*, 896 F.2d 377 (9th Cir. 1990); *Sills v. U.S.* (*In re Sills*), 82 F.3d 111 (5th Cir. 1996); *In re O'Gorman-Sykes*, 245 B.R. 815 (E.D. Va. 1999) and *In re Goodykoontz*, 284 B.R. 235 (Bankr. N.D. W.Va. 2001). So while the federal government can't sell a taxpayer's residence to collect a tax debt under 26 U.S.C. § 6334, that limitation does not create equity to be exempted by a debtor from a bankruptcy estate.

#### Property of the Estate Subject to a Tax Lien

So, there is property of the estate that is not exempt because it is subject to a tax lien. What does that mean to a trustee? The provisions of 11 U.S.C. § 724(b) provide that property subject to a tax lien shall be distributed in the following order: first, to secured creditors having a superior lien position to the tax lien; second, to holders of priority claims superior to the priority assigned in the Bankruptcy Code to priority tax claims; third, to the secured tax lien claimant to the extent of the original lien less any amounts paid to holders of priority claims; fourth, to junior secured lien claims; fifth, to the holder of the secured tax lien claim subjected to the statutory carve out for priority creditors; and sixth, to the estate. Functionally, the statute creates a "carve out" of the claim of a tax lien claimant for any creditor who holds a priority claim under 11 U.S.C. § 507(a)(1) through § 507(a)(7). The easy, and more common, examples are where a debtor owes a domestic support obligation, or wages, and has property subject to a tax lien. Then, § 724(b)(2) subordinates

the tax lien to permit the payment of priority domestic support obligations and wage claims. This reflects a congressional choice that domestic support and wages are more important than taxes, even taxes secured by a tax lien.

Examination of the types of claims that Congress has determined to be superior to a tax lien reveals that "administrative expenses" payable under 11 U.S.C. § 507(a)(2) are superior to tax lien claims, too. That is the provision that ultimately authorizes payment to a trustee of his administrative expenses.<sup>6</sup> I have long postulated that these provisions reflect a congressional preference for trustees to liquidate and pay themselves as part of the payment of tax liens owed by debtors. You don't have to look at a committee report, a treatise or the Handbook for Chapter 7 Trustees published by the Department of Justice. You simply have to look at the statute as written. That's what it says.

You can also rely on *Morgan v. K.C. Machine and Tool Company* (*In re K.C. Machine and Tool Company*, 816 F.2d 238 (6th Cir. 1987) and *Sheehan v. Posin*, 2012 WL 1413020 (N.D. W.Va. April 23, 2012).

So why do I love cases where debtors have tax liens? Because after accounting for secured debt that is superior to a tax lien, there are no exemptions to pay. The proceeds of sale go to pay the tax lien of a creditor who can't otherwise act to protect its own interest because of other statutory limitations. The proceeds are available by statute to pay the administrative expenses, including a trustee's commission, associated with doing so.

#### Other Objections

The sale of property subject to tax liens by trustees was routine in Region 4 while Clarkson McDow was the United States Trustee. He read the statutory scheme as I have explained it here. While he is now retired, Acting United States Trustee Judy Robbins has expressed no intention to change this practice in Region 4.

But what about the Trustee's Manual? Doesn't it prohibit the sale of property to benefit a single creditor? The Trustee's manual provides:

A trustee may only sell assets only if the sale will result in a meaningful distribution to creditors.

...

Generally, a trustee should not sell property subject to a security interest unless the sale generates funds for the benefit of unsecured creditors. A secured creditor can protect its own interests in the collateral subject to the security interest.

*Handbook for Chapter 7 Trustees*, at Chapter 4, C. 9.a and d at pages 4-14 and 4-16.

When bankruptcy practitioners discuss the fiduciary duty of trustees, it is typically said that a duty is owed to "unsecured creditors." This is good shorthand, but the better statement is that a trustee owes a fiduciary duty to every party to a case. Sometimes, distributions are only sufficient to pay a portion of the priority debt. In many cases, a miracle would not create funds to pay unsecured creditors. Still, paying the holder of a domestic support claim, the holder of wage claims, the holder of employee benefit claims and the payment of tax claims is worthwhile. It is a meaningful distribution to some creditors. Thus, the end

of the first sentence quoted above, recognizes that a trustee has a fiduciary obligation to make meaningful distributions even where unsecured creditors might receive nothing.

Sometimes, most often when an estate has litigation claims, a trustee has to concern himself with protecting a debtor's ability to share in a potential surplus. There can be complexities to that duty, paying creditors and protecting a surplus can be tricky without risking the ability to pay creditors to get something for the debtor. *See In re Brown*, 354 B.R. 100 (N.D. W.Va. 2006) (lawsuit re-transferred to debtors for an amount sufficient to pay creditors over objection of creditor who was also law suit defendant to preserve potential for surplus recovery by debtors.)

A tax lien creditor can't protect its own interests. This is the fundamental limitation in the

Trustee Handbook that must be appreciated. The Internal Revenue Code (and state laws as well) prohibits levying on various types of assets to satisfy a tax lien. But as noted, IRS has successfully resisted application of these exemptions from levy as applicable in the bankruptcy context. The reason for not selling property to pay a secured creditor does not apply to a secured creditor, such as a taxing authority, unable to protect itself. *See* footnote 4 above for the potential for a taxing authority to be manipulated by a tax debtor.

Finally, even if the Manual did outlaw practices contemplated by a statute, a regulation -the best view of the Manual - can't supersede a statute. The plain congressional policy is to liquidate the property and pay the tax lien.

So what does a trustee do with property subject to a secured tax lien? First, he smiles, because he knows he is going to LIQUIDATE AND PAY. ♣

#### FOOTNOTES:

- <sup>1</sup> This isn't really asking the impossible. It is common for debtor's attorneys to perform some record review before filing a case in our jurisdiction just to look for those judgment liens that need to be avoided. Finding a tax lien and writing the information about it on a bankruptcy schedule is not an onerous additional duty.
- <sup>2</sup> We are aware the debtors will sometimes assert an exemption greater than the equity available. Without commenting on the reasons for doing so, the claim of equity in non-existent value seems to be an ephemeral exercise.
- <sup>3</sup> W.Va. Code § 38-10-4(a) and (e).
- <sup>4</sup> William Brewer, the former President of the National Association of Consumer Bankruptcy Attorneys, has taken a radically different view in a brief he has filed with the United States Court of Appeals for the Fourth Circuit in *Reeves v. Callaway* (*In re Reeves*), No. 12-2127 (pending). He has argued that an exemption can be taken in any property, even fully encumbered property. (I do not disagree with the theory. As I said, I object to make sure that debtor's counsel understands the real priority in the property.)

Having taken this view, Mr. Brewer contends that the plain meaning of a variety of provisions of the Bankruptcy Code, that any property exempted in any way is not property that can be sold by a trustee. (Here I part company with him. I

believe that the word property means only that the value of the slice of equity in property is protected and where there is no equity, there is no such limitation on sale.)

The end result of Mr. Brewer's argument is that a debtor with large tax liens can file for relief under chapter 7, prevent sale of a residence subject partially or wholly to a tax lien and then prevent liquidation of the property to pay taxes under 26 U.S.C. § 6334 without making any payments on the taxes.

Any misstatement of Mr. Brewer's complete argument is solely the result of my effort to condense a brief into a footnote. His argument is quite interesting. I mean to applaud his boldness, even though I do disagree with his analysis of the Bankruptcy Code. The Fourth Circuit decision remains pending.

State laws can be similar. *See e.g.*, W.Va. Code § 11-10-13A.

- <sup>6</sup> Trustee compensation is governed by the formula in 11 U.S.C. § 326. It is allowed, after notice and court approval, under 11 U.S.C. § 330, which authorizes an administrative claim under 11 U.S.C. § 503. Such claims are made priority claims under 11 U.S.C. § 507(a)(2).

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**TITLE 11 - BANKRUPTCY****CHAPTER 7 - LIQUIDATION****SUBCHAPTER II - COLLECTION, LIQUIDATION, AND DISTRIBUTION OF THE ESTATE****§ 724. Treatment of certain liens**

- (a) The trustee may avoid a lien that secures a claim of a kind specified in section 726 (a)(4) of this title.
- (b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title (other than to the extent that there is a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the estate) and that secures an allowed claim for a tax, or proceeds of such property, shall be distributed—
- (1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is senior to such tax lien;
  - (2) second, to any holder of a claim of a kind specified in section 507 (a)(1)(C) or 507 (a)(2) (except that such expenses under each such section, other than claims for wages, salaries, or commissions that arise after the date of the filing of the petition, shall be limited to expenses incurred under this chapter and shall not include expenses incurred under chapter 11 of this title), 507(a)(1)(A), 507(a)(1)(B), 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title, to the extent of the amount of such allowed tax claim that is secured by such tax lien;
  - (3) third, to the holder of such tax lien, to any extent that such holder's allowed tax claim that is secured by such tax lien exceeds any amount distributed under paragraph (2) of this subsection;
  - (4) fourth, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is junior to such tax lien;
  - (5) fifth, to the holder of such tax lien, to the extent that such holder's allowed claim secured by such tax lien is not paid under paragraph (3) of this subsection; and
  - (6) sixth, to the estate.
- (c) If more than one holder of a claim is entitled to distribution under a particular paragraph of subsection (b) of this section, distribution to such holders under such paragraph shall be in the same order as distribution to such holders would have been other than under this section.
- (d) A statutory lien the priority of which is determined in the same manner as the priority of a tax lien under section 6323 of the Internal Revenue Code of 1986 shall be treated under subsection (b) of this section the same as if such lien were a tax lien.
- (e) Before subordinating a tax lien on real or personal property of the estate, the trustee shall—
- (1) exhaust the unencumbered assets of the estate; and
  - (2) in a manner consistent with section 506 (c), recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving or disposing of such property.
- (f) Notwithstanding the exclusion of ad valorem tax liens under this section and subject to the requirements of subsection (e), the following may be paid from property of the estate which secures a tax lien, or the proceeds of such property:
- (1) Claims for wages, salaries, and commissions that are entitled to priority under section 507 (a)(4).
  - (2) Claims for contributions to an employee benefit plan entitled to priority under section 507 (a)(5).

(Pub. L. 95-598, Nov. 6, 1978, 92 Stat. 2607; Pub. L. 98-353, title III, § 477, July 10, 1984, 98 Stat. 381; Pub. L. 99-554, title II, § 283(r), Oct. 27, 1986, 100 Stat. 3118; Pub. L. 103-394, title III, § 304(h)(4), title V, § 501(d)(23), Oct. 22, 1994, 108 Stat. 4134, 4146; Pub. L. 109-8, title VII, § 701(a), Apr. 20, 2005, 119 Stat. 124; Pub. L. 111-327, § 2(a)(27), Dec. 22, 2010, 124 Stat. 3560.)

**TITLE 11 - BANKRUPTCY  
CHAPTER 5 - CREDITORS, THE DEBTOR, AND THE ESTATE  
SUBCHAPTER III - THE ESTATE**

**§ 551. Automatic preservation of avoided transfer**

Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724 (a) of this title, or any lien void under section 506 (d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

(Pub. L. 95-598, Nov. 6, 1978, 92 Stat. 2602.)

**Historical and Revision Notes**

**legislative statements**

Section 551 is adopted from the House bill and the alternative in the Senate amendment is rejected. The section is clarified to indicate that a transfer avoided or a lien that is void is preserved for the benefit of the estate, but only with respect to property of the estate. This prevents the trustee from asserting an avoided tax lien against after acquired property of the debtor.

**senate report no. 95-989**

This section is a change from present law. It specifies that any avoided transfer is automatically preserved for the benefit of the estate. Under current law, the court must determine whether or not the transfer should be preserved. The operation of the section is automatic, unlike current law, even though preservation may not benefit the estate in every instance. A preserved lien may be abandoned by the trustee under proposed 11 U.S.C. 554 if the preservation does not benefit the estate. The section as a whole prevents junior lienors from improving their position at the expense of the estate when a senior lien is avoided.



**§ 726. Distribution of property of the estate**

Currentness

(a) Except as provided in section 510 of this title, property of the estate shall be distributed--

(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed on or before the earlier of--

(A) the date that is 10 days after the mailing to creditors of the summary of the trustee's final report; or

(B) the date on which the trustee commences final distribution under this section;

(2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is--

(A) timely filed under section 501(a) of this title;

(B) timely filed under section 501(b) or 501(c) of this title; or

(C) tardily filed under section 501(a) of this title, if--

(i) the creditor that holds such claim did not have notice or actual knowledge of the case in time for timely filing of a proof of such claim under section 501(a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

(b) Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6), (7), (8), (9), or (10) of section 507(a) of this title, or in paragraph (2), (3), (4), or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, except that in a case that has been converted to this chapter under section 1112, 1208, or 1307 of this title, a claim allowed under section 503(b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

(c) Notwithstanding subsections (a) and (b) of this section, if there is property of the kind specified in section 541(a)(2) of this title, or proceeds of such property, in the estate, such property or proceeds shall be segregated from other property of the estate, and such property or proceeds and other property of the estate shall be distributed as follows:

(1) Claims allowed under section 503 of this title shall be paid either from property of the kind specified in section 541(a)(2) of this title, or from other property of the estate, as the interest of justice requires.

(2) Allowed claims, other than claims allowed under section 503 of this title, shall be paid in the order specified in subsection (a) of this section, and, with respect to claims of a kind specified in a particular paragraph of section 507 of this title or subsection (a) of this section, in the following order and manner:

**(A)** First, community claims against the debtor or the debtor's spouse shall be paid from property of the kind specified in section 541(a)(2) of this title, except to the extent that such property is solely liable for debts of the debtor.

**(B)** Second, to the extent that community claims against the debtor are not paid under subparagraph (A) of this paragraph, such community claims shall be paid from property of the kind specified in section 541(a)(2) of this title that is solely liable for debts of the debtor.

**(C)** Third, to the extent that all claims against the debtor including community claims against the debtor are not paid under subparagraph (A) or (B) of this paragraph such claims shall be paid from property of the estate other than property of the kind specified in section 541(a)(2) of this title.

**(D)** Fourth, to the extent that community claims against the debtor or the debtor's spouse are not paid under subparagraph (A), (B), or (C) of this paragraph, such claims shall be paid from all remaining property of the estate.

Effective: April 1, 2016

11 U.S.C.A. § 522

## **§ 522. Exemptions**

### Currentness

**(a)** In this section--

**(1)** “dependent” includes spouse, whether or not actually dependent; and

**(2)** “value” means fair market value as of the date of the filing of the petition or, with respect to property that becomes property of the estate after such date, as of the date such property becomes property of the estate.

**(b)(1)** Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection. In joint cases filed under section 302 of this title and individual cases filed under section 301 or 303 of this title by or against debtors who are husband and wife, and whose estates are ordered to be jointly administered under Rule 1015(b) of the Federal Rules of Bankruptcy Procedure, one debtor may not elect to exempt property listed in paragraph (2) and the other debtor elect to exempt property listed in paragraph (3) of this subsection. If the parties cannot agree on the alternative to be elected, they shall be deemed to elect paragraph (2), where such election is permitted under the law of the jurisdiction where the case is filed.

**(2)** Property listed in this paragraph is property that is specified under subsection (d), unless the State law that is applicable to the debtor under paragraph (3)(A) specifically does not so authorize.

**(3)** Property listed in this paragraph is--

**(A)** subject to subsections (o) and (p), any property that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of the filing of the petition to the place in which the debtor's domicile has been located for the 730 days immediately preceding the date of the filing of the petition or if the debtor's domicile has not been located in a single State for such 730-day period, the place in which the debtor's domicile was located for 180 days immediately preceding the 730-day period or for a longer portion of such 180-day period than in any other place;

**(B)** any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety or joint tenant to the extent that such interest as a tenant by the entirety or joint tenant is exempt from process under applicable nonbankruptcy law; and

**(C)** retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.

If the effect of the domiciliary requirement under subparagraph (A) is to render the debtor ineligible for any exemption, the debtor may elect to exempt property that is specified under subsection (d).

**(4)** For purposes of paragraph (3)(C) and subsection (d)(12), the following shall apply:

**(A)** If the retirement funds are in a retirement fund that has received a favorable determination under section 7805 of the Internal Revenue Code of 1986, and that determination is in effect as of the date of the filing of the petition in a case under this title, those funds shall be presumed to be exempt from the estate.

**(B)** If the retirement funds are in a retirement fund that has not received a favorable determination under such section 7805, those funds are exempt from the estate if the debtor demonstrates that--

**(i)** no prior determination to the contrary has been made by a court or the Internal Revenue Service; and

**(ii)(I)** the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986; or

**(II)** the retirement fund fails to be in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986 and the debtor is not materially responsible for that failure.

**(C)** A direct transfer of retirement funds from 1 fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986, under section 401(a)(31) of the Internal Revenue Code of 1986, or otherwise, shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.

**(D)(i)** Any distribution that qualifies as an eligible rollover distribution within the meaning of section 402(c) of the Internal Revenue Code of 1986 or that is described in clause (ii) shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such distribution.

**(ii)** A distribution described in this clause is an amount that--

**(I)** has been distributed from a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986; and

**(II)** to the extent allowed by law, is deposited in such a fund or account not later than 60 days after the distribution of such amount.

**(c)** Unless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except--

**(1)** a debt of a kind specified in paragraph (1) or (5) of section 523(a) (in which case, notwithstanding any provision of applicable nonbankruptcy law to the contrary, such property shall be liable for a debt of a kind specified in such paragraph);

**(2)** a debt secured by a lien that is--

**(A)(i)** not avoided under subsection (f) or (g) of this section or under section 544, 545, 547, 548, 549, or 724(a) of this title; and

**(ii)** not void under section 506(d) of this title; or

**(B)** a tax lien, notice of which is properly filed;

**(3)** a debt of a kind specified in section 523(a)(4) or 523(a)(6) of this title owed by an institution-affiliated party of an insured depository institution to a Federal depository institutions regulatory agency acting in its capacity as conservator, receiver, or liquidating agent for such institution; or

**(4)** a debt in connection with fraud in the obtaining or providing of any scholarship, grant, loan, tuition, discount, award, or other financial assistance for purposes of financing an education at an institution of higher education (as that term is defined in section 101 of the Higher Education Act of 1965 (20 U.S.C. 1001)).

**(d)** The following property may be exempted under subsection (b)(2) of this section:

**(1)** The debtor's aggregate interest, not to exceed \$23,675<sup>1</sup> in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence, in a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence, or in a burial plot for the debtor or a dependent of the debtor.

- (2) The debtor's interest, not to exceed \$3,775<sup>1</sup> in value, in one motor vehicle.
- (3) The debtor's interest, not to exceed \$600<sup>1</sup> in value in any particular item or \$12,625<sup>1</sup> in aggregate value, in household furnishings, household goods, wearing apparel, appliances, books, animals, crops, or musical instruments, that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor.
- (4) The debtor's aggregate interest, not to exceed \$1,600<sup>1</sup> in value, in jewelry held primarily for the personal, family, or household use of the debtor or a dependent of the debtor.
- (5) The debtor's aggregate interest in any property, not to exceed in value \$1,250<sup>1</sup> plus up to \$11,850<sup>1</sup> of any unused amount of the exemption provided under paragraph (1) of this subsection.
- (6) The debtor's aggregate interest, not to exceed \$2,375<sup>1</sup> in value, in any implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor.
- (7) Any unmaturred life insurance contract owned by the debtor, other than a credit life insurance contract.
- (8) The debtor's aggregate interest, not to exceed in value \$12,625<sup>1</sup> less any amount of property of the estate transferred in the manner specified in section 542(d) of this title, in any accrued dividend or interest under, or loan value of, any unmaturred life insurance contract owned by the debtor under which the insured is the debtor or an individual of whom the debtor is a dependent.
- (9) Professionally prescribed health aids for the debtor or a dependent of the debtor.
- (10) The debtor's right to receive--
- (A) a social security benefit, unemployment compensation, or a local public assistance benefit;
  - (B) a veterans' benefit;
  - (C) a disability, illness, or unemployment benefit;
  - (D) alimony, support, or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;
  - (E) a payment under a stock bonus, pension, profitsharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor, unless--
    - (i) such plan or contract was established by or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose;
    - (ii) such payment is on account of age or length of service; and
    - (iii) such plan or contract does not qualify under section 401(a), 403(a), 403(b), or 408 of the Internal Revenue Code of 1986.
- (11) The debtor's right to receive, or property that is traceable to--
- (A) an award under a crime victim's reparation law;
  - (B) a payment on account of the wrongful death of an individual of whom the debtor was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;
  - (C) a payment under a life insurance contract that insured the life of an individual of whom the debtor was a dependent on the date of such individual's death, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;
  - (D) a payment, not to exceed \$23,675,<sup>1</sup> on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the debtor or an individual of whom the debtor is a dependent; or

**(E)** a payment in compensation of loss of future earnings of the debtor or an individual of whom the debtor is or was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor.

**(12)** Retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.

**(e)** A waiver of an exemption executed in favor of a creditor that holds an unsecured claim against the debtor is unenforceable in a case under this title with respect to such claim against property that the debtor may exempt under subsection (b) of this section. A waiver by the debtor of a power under subsection (f) or (h) of this section to avoid a transfer, under subsection (g) or (i) of this section to exempt property, or under subsection (i) of this section to recover property or to preserve a transfer, is unenforceable in a case under this title.

**(f)(1)** Notwithstanding any waiver of exemptions but subject to paragraph (3), the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is--

**(A)** a judicial lien, other than a judicial lien that secures a debt of a kind that is specified in section 523(a)(5); or

**(B)** a nonpossessory, nonpurchase-money security interest in any--

**(i)** household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;

**(ii)** implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or

**(iii)** professionally prescribed health aids for the debtor or a dependent of the debtor.

**(2)(A)** For the purposes of this subsection, a lien shall be considered to impair an exemption to the extent that the sum of--

**(i)** the lien;

**(ii)** all other liens on the property; and

**(iii)** the amount of the exemption that the debtor could claim if there were no liens on the property;

exceeds the value that the debtor's interest in the property would have in the absence of any liens.

**(B)** In the case of a property subject to more than 1 lien, a lien that has been avoided shall not be considered in making the calculation under subparagraph (A) with respect to other liens.

**(C)** This paragraph shall not apply with respect to a judgment arising out of a mortgage foreclosure.

**(3)** In a case in which State law that is applicable to the debtor--

**(A)** permits a person to voluntarily waive a right to claim exemptions under subsection (d) or prohibits a debtor from claiming exemptions under subsection (d); and

**(B)** either permits the debtor to claim exemptions under State law without limitation in amount, except to the extent that the debtor has permitted the fixing of a consensual lien on any property or prohibits avoidance of a consensual lien on property otherwise eligible to be claimed as exempt property;

the debtor may not avoid the fixing of a lien on an interest of the debtor or a dependent of the debtor in property if the lien is a nonpossessory, nonpurchase-money security interest in implements, professional books, or tools of the trade of the debtor or a dependent of the debtor or farm animals or crops of the debtor or a dependent of the debtor to the extent the value of such implements, professional books, tools of the trade, animals, and crops exceeds \$6,425<sup>1</sup>.

**(4)(A)** Subject to subparagraph (B), for purposes of paragraph (1)(B), the term “household goods” means--

**(i)** clothing;

**(ii)** furniture;

**(iii)** appliances;

**(iv)** 1 radio;

**(v)** 1 television;

**(vi)** 1 VCR;

**(vii)** linens;

**(viii)** china;

**(ix)** crockery;

**(x)** kitchenware;

**(xi)** educational materials and educational equipment primarily for the use of minor dependent children of the debtor;

**(xii)** medical equipment and supplies;

**(xiii)** furniture exclusively for the use of minor children, or elderly or disabled dependents of the debtor;

**(xiv)** personal effects (including the toys and hobby equipment of minor dependent children and wedding rings) of the debtor and the dependents of the debtor; and

**(xv)** 1 personal computer and related equipment.

**(B)** The term “household goods” does not include--

**(i)** works of art (unless by or of the debtor, or any relative of the debtor);

**(ii)** electronic entertainment equipment with a fair market value of more than \$675<sup>1</sup> in the aggregate (except 1 television, 1 radio, and 1 VCR);

**(iii)** items acquired as antiques with a fair market value of more than \$675<sup>1</sup> in the aggregate;

**(iv)** jewelry with a fair market value of more than \$675<sup>1</sup> in the aggregate (except wedding rings); and

**(v)** a computer (except as otherwise provided for in this section), motor vehicle (including a tractor or lawn tractor), boat, or a motorized recreational device, conveyance, vehicle, watercraft, or aircraft.

**(g)** Notwithstanding sections 550 and 551 of this title, the debtor may exempt under subsection (b) of this section property that the trustee recovers under section 510(c)(2), 542, 543, 550, 551, or 553 of this title, to the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if--

**(1)(A)** such transfer was not a voluntary transfer of such property by the debtor; and

**(B)** the debtor did not conceal such property; or

**(2)** the debtor could have avoided such transfer under subsection (f)(1)(B) of this section.

**(h)** The debtor may avoid a transfer of property of the debtor or recover a setoff to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee had avoided such transfer, if--

- (1) such transfer is avoidable by the trustee under section 544, 545, 547, 548, 549, or 724(a) of this title or recoverable by the trustee under section 553 of this title; and
- (2) the trustee does not attempt to avoid such transfer.
- (i)(1) If the debtor avoids a transfer or recovers a setoff under subsection (f) or (h) of this section, the debtor may recover in the manner prescribed by, and subject to the limitations of, section 550 of this title, the same as if the trustee had avoided such transfer, and may exempt any property so recovered under subsection (b) of this section.
- (2) Notwithstanding section 551 of this title, a transfer avoided under section 544, 545, 547, 548, 549, or 724(a) of this title, under subsection (f) or (h) of this section, or property recovered under section 553 of this title, may be preserved for the benefit of the debtor to the extent that the debtor may exempt such property under subsection (g) of this section or paragraph (1) of this subsection.
- (j) Notwithstanding subsections (g) and (i) of this section, the debtor may exempt a particular kind of property under subsections (g) and (i) of this section only to the extent that the debtor has exempted less property in value of such kind than that to which the debtor is entitled under subsection (b) of this section.
- (k) Property that the debtor exempts under this section is not liable for payment of any administrative expense except--
- (1) the aliquot share of the costs and expenses of avoiding a transfer of property that the debtor exempts under subsection (g) of this section, or of recovery of such property, that is attributable to the value of the portion of such property exempted in relation to the value of the property recovered; and
- (2) any costs and expenses of avoiding a transfer under subsection (f) or (h) of this section, or of recovery of property under subsection (i)(1) of this section, that the debtor has not paid.
- (l) The debtor shall file a list of property that the debtor claims as exempt under subsection (b) of this section. If the debtor does not file such a list, a dependent of the debtor may file such a list, or may claim property as exempt from property of the estate on behalf of the debtor. Unless a party in interest objects, the property claimed as exempt on such list is exempt.
- (m) Subject to the limitation in subsection (b), this section shall apply separately with respect to each debtor in a joint case.
- (n) For assets in individual retirement accounts described in section 408 or 408A of the Internal Revenue Code of 1986, other than a simplified employee pension under section 408(k) of such Code or a simple retirement account under section 408(p) of such Code, the aggregate value of such assets exempted under this section, without regard to amounts attributable to rollover contributions under section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8) of the Internal Revenue Code of 1986, and earnings thereon, shall not exceed \$1,283,025<sup>1</sup> in a case filed by a debtor who is an individual, except that such amount may be increased if the interests of justice so require.
- (o) For purposes of subsection (b)(3)(A), and notwithstanding subsection (a), the value of an interest in--
- (1) real or personal property that the debtor or a dependent of the debtor uses as a residence;
- (2) a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;
- (3) a burial plot for the debtor or a dependent of the debtor; or
- (4) real or personal property that the debtor or a dependent of the debtor claims as a homestead;



shall be reduced to the extent that such value is attributable to any portion of any property that the debtor disposed of in the 10-year period ending on the date of the filing of the petition with the intent to hinder, delay, or defraud a creditor and that the debtor could not exempt, or that portion that the debtor could not exempt, under subsection (b), if on such date the debtor had held the property so disposed of.

**(p)(1)** Except as provided in paragraph (2) of this subsection and sections 544 and 548, as a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition that exceeds in the aggregate \$160,375<sup>1</sup> in value in--

**(A)** real or personal property that the debtor or a dependent of the debtor uses as a residence;

**(B)** a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;

**(C)** a burial plot for the debtor or a dependent of the debtor; or

**(D)** real or personal property that the debtor or dependent of the debtor claims as a homestead.

**(2)(A)** The limitation under paragraph (1) shall not apply to an exemption claimed under subsection (b)(3)(A) by a family farmer for the principal residence of such farmer.

**(B)** For purposes of paragraph (1), any amount of such interest does not include any interest transferred from a debtor's previous principal residence (which was acquired prior to the beginning of such 1215-day period) into the debtor's current principal residence, if the debtor's previous and current residences are located in the same State.

**(q)(1)** As a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of an interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) which exceeds in the aggregate \$160,375<sup>1</sup> if--

**(A)** the court determines, after notice and a hearing, that the debtor has been convicted of a felony (as defined in section 3156 of title 18), which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of this title; or

**(B)** the debtor owes a debt arising from--

**(i)** any violation of the Federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws;

**(ii)** fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 or under section 6 of the Securities Act of 1933;

**(iii)** any civil remedy under section 1964 of title 18; or

**(iv)** any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years.

**(2)** Paragraph (1) shall not apply to the extent the amount of an interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) is reasonably necessary for the support of the debtor and any dependent of the debtor.

Effective: April 1, 2016

11 U.S.C.A. § 507

**§ 507. Priorities**

Currentness

(a) The following expenses and claims have priority in the following order:

(1) First:

(A) Allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition in a case under this title, are owed to or recoverable by a spouse, former spouse, or child of the debtor, or such child's parent, legal guardian, or responsible relative, without regard to whether the claim is filed by such person or is filed by a governmental unit on behalf of such person, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the petition shall be applied and distributed in accordance with applicable nonbankruptcy law.

(B) Subject to claims under subparagraph (A), allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition, are assigned by a spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative to a governmental unit (unless such obligation is assigned voluntarily by the spouse, former spouse, child, parent, legal guardian, or responsible relative of the child for the purpose of collecting the debt) or are owed directly to or recoverable by a governmental unit under applicable nonbankruptcy law, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the petition be applied and distributed in accordance with applicable nonbankruptcy law.

(C) If a trustee is appointed or elected under section 701, 702, 703, 1104, 1202, or 1302, the administrative expenses of the trustee allowed under paragraphs (1)(A), (2), and (6) of section 503(b) shall be paid before payment of claims under subparagraphs (A) and (B), to the extent that the trustee administers assets that are otherwise available for the payment of such claims.

(2) Second, administrative expenses allowed under section 503(b) of this title, unsecured claims of any Federal reserve bank related to loans made through programs or facilities authorized under section 13(3) of the Federal Reserve Act (12 U.S.C. 343), and any fees and charges assessed against the estate under chapter 123 of title 28.

(3) Third, unsecured claims allowed under section 502(f) of this title.

(4) Fourth, allowed unsecured claims, but only to the extent of \$12,850<sup>1</sup> for each individual or corporation, as the case may be, earned within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first, for--

(A) wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual; or

(B) sales commissions earned by an individual or by a corporation with only 1 employee, acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the debtor's business if, and only if, during the 12 months preceding that date, at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the debtor.

(5) Fifth, allowed unsecured claims for contributions to an employee benefit plan--

(A) arising from services rendered within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first; but only

(B) for each such plan, to the extent of--

(i) the number of employees covered by each such plan multiplied by \$12,850<sup>1</sup>; less

(ii) the aggregate amount paid to such employees under paragraph (4) of this subsection, plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.

(6) Sixth, allowed unsecured claims of persons--

(A) engaged in the production or raising of grain, as defined in section 557(b) of this title, against a debtor who owns or operates a grain storage facility, as defined in section 557(b) of this title, for grain or the proceeds of grain, or

(B) engaged as a United States fisherman against a debtor who has acquired fish or fish produce from a fisherman through a sale or conversion, and who is engaged in operating a fish produce storage or processing facility--

but only to the extent of \$6,325<sup>1</sup> for each such individual.

(7) Seventh, allowed unsecured claims of individuals, to the extent of \$2,850<sup>1</sup> for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for--

(A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition--

(i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;

(ii) assessed within 240 days before the date of the filing of the petition, exclusive of--

(I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and

(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days; or

(iii) other than a tax of a kind specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case;

(B) a property tax incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition;

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

(D) an employment tax on a wage, salary, or commission of a kind specified in paragraph (4) of this subsection earned from the debtor before the date of the filing of the petition, whether or not actually paid before such date, for which a return is last due, under applicable law or under any extension, after three years before the date of the filing of the petition;

(E) an excise tax on--

(i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or

(ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition;

(F) a customs duty arising out of the importation of merchandise--

(i) entered for consumption within one year before the date of the filing of the petition;

- (ii)** covered by an entry liquidated or reliquidated within one year before the date of the filing of the petition; or
- (iii)** entered for consumption within four years before the date of the filing of the petition but unliquidated on such date, if the Secretary of the Treasury certifies that failure to liquidate such entry was due to an investigation pending on such date into assessment of antidumping or countervailing duties or fraud, or if information needed for the proper appraisal or classification of such merchandise was not available to the appropriate customs officer before such date; or
- (G)** a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss.

An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.

**(9)** Ninth, allowed unsecured claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution.

**(10)** Tenth, allowed claims for death or personal injury resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance.

**(b)** If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(2) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.

**(c)** For the purpose of subsection (a) of this section, a claim of a governmental unit arising from an erroneous refund or credit of a tax has the same priority as a claim for the tax to which such refund or credit relates.

**(d)** An entity that is subrogated to the rights of a holder of a claim of a kind specified in subsection (a)(1), (a)(4), (a)(5), (a)(6), (a)(7), (a)(8), or (a)(9) of this section is not subrogated to the right of the holder of such claim to priority under such subsection.

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**§ 6321. Lien for taxes**

Currentness

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

**§ 6323. Validity and priority against certain persons**

Currentness

**(a) Purchasers, holders of security interests, mechanic's lienors, and judgment lien**

**creditors.**--The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.

**(b) Protection for certain interests even though notice filed.**--Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid--

**(1) Securities.**--With respect to a security (as defined in subsection (h)(4))--

**(A)** as against a purchaser of such security who at the time of purchase did not have actual notice or knowledge of the existence of such lien; and

**(B)** as against a holder of a security interest in such security who, at the time such interest came into existence, did not have actual notice or knowledge of the existence of such lien.

**(2) Motor vehicles.**--With respect to a motor vehicle (as defined in subsection (h)(3)), as against a purchaser of such motor vehicle, if--

**(A)** at the time of the purchase such purchaser did not have actual notice or knowledge of the existence of such lien, and

**(B)** before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

**(3) Personal property purchased at retail.**--With respect to tangible personal property purchased at retail, as against a purchaser in the ordinary course of the seller's trade or business, unless at the time of such purchase such purchaser intends such purchase to (or knows such purchase will) hinder, evade, or defeat the collection of any tax under this title.

**(4) Personal property purchased in casual sale.**--With respect to household goods, personal effects, or other tangible personal property described in section 6334(a) purchased (not for resale) in a casual sale for less than \$1,000, as against the purchaser, but only if such purchaser does not have actual notice or knowledge **(A)** of the existence of such lien, or **(B)** that this sale is one of a series of sales.

**(5) Personal property subject to possessory lien.**--With respect to tangible personal property subject to a lien under local law securing the reasonable price of the repair or improvement of such property, as against a holder of such a lien, if such holder is, and has been, continuously in possession of such property from the time such lien arose.

**(6) Real property tax and special assessment liens.**--With respect to real property, as against a holder of a lien upon such property, if such lien is entitled under local law to priority over security interests in such property which are prior in time, and such lien secures payment of--

**(A)** a tax of general application levied by any taxing authority based upon the value of such property;

**(B)** a special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the cost of any public improvement; or

**(C)** charges for utilities or public services furnished to such property by the United States, a State or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

**(7) Residential property subject to a mechanic's lien for certain repairs and**

**improvements.**--With respect to real property subject to a lien for repair or improvement of a personal residence (containing not more than four dwelling units) occupied by the owner of such

residence, as against a mechanic's lienor, but only if the contract price on the contract with the owner is not more than \$5,000.

**(8) Attorneys' liens.**--With respect to a judgment or other amount in settlement of a claim or of a cause of action, as against an attorney who, under local law, holds a lien upon or a contract enforceable against such judgment or amount, to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement, except that this paragraph shall not apply to any judgment or amount in settlement of a claim or of a cause of action against the United States to the extent that the United States offsets such judgment or amount against any liability of the taxpayer to the United States.

**(9) Certain insurance contracts.**--With respect to a life insurance, endowment, or annuity contract, as against the organization which is the insurer under such contract, at any time--

**(A)** before such organization had actual notice or knowledge of the existence of such lien;

**(B)** after such organization had such notice or knowledge, with respect to advances required to be made automatically to maintain such contract in force under an agreement entered into before such organization had such notice or knowledge; or

**(C)** after satisfaction of a levy pursuant to section 6332(b), unless and until the Secretary delivers to such organization a notice, executed after the date of such satisfaction, of the existence of such lien.

**(10) Deposit-secured loans.**--With respect to a savings deposit, share, or other account, with an institution described in section 581 or 591, to the extent of any loan made by such institution without actual notice or knowledge of the existence of such lien, as against such institution, if such loan is secured by such account.

**(c) Protection for certain commercial transactions financing agreements, etc.**--

**(1) In general.**--To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which--

**(A)** is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting--

**(i)** a commercial transactions financing agreement,

**(ii)** a real property construction or improvement financing agreement, or

**(iii)** an obligatory disbursement agreement, and

**(B)** is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

**(2) Commercial transactions financing agreement.**--For purposes of this subsection--

**(A) Definition.**--The term "commercial transactions financing agreement" means an agreement (entered into by a person in the course of his trade or business)--

**(i)** to make loans to the taxpayer to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business, or

**(ii)** to purchase commercial financing security (other than inventory) acquired by the taxpayer in the ordinary course of his trade or business;

but such an agreement shall be treated as coming within the term only to the extent that such loan or purchase is made before the 46th day after the date of tax lien filing or (if earlier) before the lender or purchaser had actual notice or knowledge of such tax lien filing.

**(B) Limitation on qualified property.**--The term “qualified property”, when used with respect to a commercial transactions financing agreement, includes only commercial financing security acquired by the taxpayer before the 46th day after the date of tax lien filing.

**(C) Commercial financing security defined.**--The term “commercial financing security” means (i) paper of a kind ordinarily arising in commercial transactions, (ii) accounts receivable, (iii) mortgages on real property, and (iv) inventory.

**(D) Purchaser treated as acquiring security interest.**--A person who satisfies subparagraph (A) by reason of clause (ii) thereof shall be treated as having acquired a security interest in commercial financing security.

**(3) Real property construction or improvement financing agreement.**--For purposes of this subsection--

**(A) Definition.**--The term “real property construction or improvement financing agreement” means an agreement to make cash disbursements to finance--

**(i)** the construction or improvement of real property,

**(ii)** a contract to construct or improve real property, or

**(iii)** the raising or harvesting of a farm crop or the raising of livestock or other animals.

For purposes of clause (iii), the furnishing of goods and services shall be treated as the disbursement of cash.

**(B) Limitation on qualified property.**--The term “qualified property”, when used with respect to a real property construction or improvement financing agreement, includes only--

**(i)** in the case of subparagraph (A)(i), the real property with respect to which the construction or improvement has been or is to be made,

**(ii)** in the case of subparagraph (A)(ii), the proceeds of the contract described therein, and

**(iii)** in the case of subparagraph (A)(iii), property subject to the lien imposed by section 6321 at the time of tax lien filing and the crop or the livestock or other animals referred to in subparagraph (A)(iii).

**(4) Obligatory disbursement agreement.**--For purposes of this subsection--

**(A) Definition.**--The term “obligatory disbursement agreement” means an agreement (entered into by a person in the course of his trade or business) to make disbursements, but such an agreement shall be treated as coming within the term only to the extent of disbursements which are required to be made by reason of the intervention of the rights of a person other than the taxpayer.

**(B) Limitation on qualified property.**--The term “qualified property”, when used with respect to an obligatory disbursement agreement, means property subject to the lien imposed by section 6321 at the time of tax lien filing and (to the extent that the acquisition is directly traceable to the disbursements referred to in subparagraph (A)) property acquired by the taxpayer after tax lien filing.

**(C) Special rules for surety agreements.**--Where the obligatory disbursement agreement is an agreement ensuring the performance of a contract between the taxpayer and another person--

**(i)** the term “qualified property” shall be treated as also including the proceeds of the contract the performance of which was ensured, and

**(ii)** if the contract the performance of which was ensured was a contract to construct or improve real property, to produce goods, or to furnish services, the term “qualified property” shall be treated as also including any tangible personal property used by the taxpayer in the performance of such ensured contract.



**(d) 45-day period for making disbursements.**--Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing by reason of disbursements made before the 46th day after the date of tax lien filing, or (if earlier) before the person making such disbursements had actual notice or knowledge of tax lien filing, but only if such security interest--

(1) is in property (A) subject, at the time of tax lien filing, to the lien imposed by section 6321, and (B) covered by the terms of a written agreement entered into before tax lien filing, and  
(2) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

**(e) Priority of interest and expenses.**--If the lien imposed by section 6321 is not valid as against a lien or security interest, the priority of such lien or security interest shall extend to--

(1) any interest or carrying charges upon the obligation secured,  
(2) the reasonable charges and expenses of an indenture trustee or agent holding the security interest for the benefit of the holder of the security interest,  
(3) the reasonable expenses, including reasonable compensation for attorneys, actually incurred in collecting or enforcing the obligation secured,  
(4) the reasonable costs of insuring, preserving, or repairing the property to which the lien or security interest relates,  
(5) the reasonable costs of insuring payment of the obligation secured, and  
(6) amounts paid to satisfy any lien on the property to which the lien or security interest relates, but only if the lien so satisfied is entitled to priority over the lien imposed by section 6321,

to the extent that, under local law, any such item has the same priority as the lien or security interest to which it relates.

**(f) Place for filing notice; form.**--

**(1) Place for filing.**--The notice referred to in subsection (a) shall be filed--

**(A) Under State laws.**--

**(i) Real property.**--In the case of real property, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; and

**(ii) Personal property.**--In the case of personal property, whether tangible or intangible, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated, except that State law merely conforming to or reenacting Federal law establishing a national filing system does not constitute a second office for filing as designated by the laws of such State; or

**(B) With clerk of district court.**--In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State has not by law designated one office which meets the requirements of subparagraph (A); or

**(C) With Recorder of Deeds of the District of Columbia.**--In the office of the Recorder of Deeds of the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

**(2) Situs of property subject to lien.**--For purposes of paragraphs (1) and (4), property shall be deemed to be situated--

**(A) Real property.**--In the case of real property, at its physical location; or

**(B) Personal property.**--In the case of personal property, whether tangible or intangible, at the residence of the taxpayer at the time the notice of lien is filed.

For purposes of paragraph (2)(B), the residence of a corporation or partnership shall be deemed to be the place at which the principal executive office of the business is located, and the residence of a taxpayer whose residence is without the United States shall be deemed to be in the District of Columbia.

**(3) Form.**--The form and content of the notice referred to in subsection (a) shall be prescribed by the Secretary. Such notice shall be valid notwithstanding any other provision of law regarding the form or content of a notice of lien.

**(4) Indexing required with respect to certain real property.**--In the case of real property, if--  
**(A)** under the laws of the State in which the real property is located, a deed is not valid as against a purchaser of the property who (at the time of purchase) does not have actual notice or knowledge of the existence of such deed unless the fact of filing of such deed has been entered and recorded in a public index at the place of filing in such a manner that a reasonable inspection of the index will reveal the existence of the deed, and  
**(B)** there is maintained (at the applicable office under paragraph (1)) an adequate system for the public indexing of Federal tax liens,

then the notice of lien referred to in subsection (a) shall not be treated as meeting the filing requirements under paragraph (1) unless the fact of filing is entered and recorded in the index referred to in subparagraph (B) in such a manner that a reasonable inspection of the index will reveal the existence of the lien.

**(5) National filing systems.**--The filing of a notice of lien shall be governed solely by this title and shall not be subject to any other Federal law establishing a place or places for the filing of liens or encumbrances under a national filing system.

**(g) Refiling of notice.**--For purposes of this section--

**(1) General rule.**--Unless notice of lien is refiled in the manner prescribed in paragraph (2) during the required refiling period, such notice of lien shall be treated as filed on the date on which it is filed (in accordance with subsection (f)) after the expiration of such refiling period.

**(2) Place for filing.**--A notice of lien refiled during the required refiling period shall be effective only--

**(A)** if--

**(i)** such notice of lien is refiled in the office in which the prior notice of lien was filed, and

**(ii)** in the case of real property, the fact of refiling is entered and recorded in an index to the extent required by subsection (f)(4); and

**(B)** in any case in which, 90 days or more prior to the date of a refiling of notice of lien under subparagraph (A), the Secretary received written information (in the manner prescribed in regulations issued by the Secretary) concerning a change in the taxpayer's residence, if a notice of such lien is also filed in accordance with subsection (f) in the State in which such residence is located.

**(3) Required refiling period.**--In the case of any notice of lien, the term "required refiling period" means--

**(A)** the one-year period ending 30 days after the expiration of 10 years after the date of the assessment of the tax, and

**(B)** the one-year period ending with the expiration of 10 years after the close of the preceding required refiling period for such notice of lien.

**(4) Transitional rule.**--Notwithstanding paragraph (3), if the assessment of the tax was made before January 1, 1962, the first required refiling period shall be the calendar year 1967.

**(h) Definitions.**--For purposes of this section and section 6324--

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

**(2) Mechanic's lienor.**--The term "mechanic's lienor" means any person who under local law has a lien on real property (or on the proceeds of a contract relating to real property) for services, labor, or materials furnished in connection with the construction or improvement of such property. For purposes of the preceding sentence, a person has a lien on the earliest date such lien becomes valid under local law against subsequent purchasers without actual notice, but not before he begins to furnish the services, labor, or materials.

**(3) Motor vehicle.**--The term "motor vehicle" means a self-propelled vehicle which is registered for highway use under the laws of any State or foreign country.

**(4) Security.**--The term "security" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form, share of stock, voting trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

**(5) Tax lien filing.**--The term "tax lien filing" means the filing of notice (referred to in subsection (a)) of the lien imposed by section 6321.

**(6) Purchaser.**--The term "purchaser" means a person who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice. In applying the preceding sentence for purposes of subsection (a) of this section, and for purposes of section 6324--

**(A)** a lease of property,

**(B)** a written executory contract to purchase or lease property,

**(C)** an option to purchase or lease property or any interest therein, or

**(D)** an option to renew or extend a lease of property,

which is not a lien or security interest shall be treated as an interest in property.

**(i) Special rules.**--

**(1) Actual notice or knowledge.**--For purposes of this subchapter, an organization shall be deemed for purposes of a particular transaction to have actual notice or knowledge of any fact from the time such fact is brought to the attention of the individual conducting such transaction, and in any event from the time such fact would have been brought to such individual's attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routine. 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 transaction would be materially affected by the information.

**(2) Subrogation.**--Where, under local law, one person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such rights for purposes of any lien imposed by section 6321 or 6324.

**(3) Forfeitures.**--For purposes of this subchapter, a forfeiture under local law of property seized by a law enforcement agency of a State, county, or other local governmental subdivision shall relate back to the time of seizure, except that this paragraph shall not apply to the extent that under local law the holder of an intervening claim or interest would have priority over the interest of the State, county, or other local governmental subdivision in the property.

**(4) Cost-of-living adjustment.**--In the case of notices of liens imposed by section 6321 which are filed in any calendar year after 1998, each of the dollar amounts under paragraph (4) or (7) of subsection (b) shall be increased by an amount equal to.--

**(A)** such dollar amount, multiplied by

**(B)** the cost-of-living adjustment determined under section 1(f)(3) for the calendar year, determined by substituting "calendar year 1996" for "calendar year 1992" in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of \$10, such amount shall be rounded to the nearest multiple of \$10.

**(j) Withdrawal of notice in certain circumstances.**--

**(1) In general.**--The Secretary may withdraw a notice of a lien filed under this section and this chapter shall be applied as if the withdrawn notice had not been filed, if the Secretary determines that--

**(A)** the filing of such notice was premature or otherwise not in accordance with administrative procedures of the Secretary,

**(B)** the taxpayer has entered into an agreement under section 6159 to satisfy the tax liability for which the lien was imposed by means of installment payments, unless such agreement provides otherwise,

**(C)** the withdrawal of such notice will facilitate the collection of the tax liability, or

**(D)** with the consent of the taxpayer or the National Taxpayer Advocate, the withdrawal of such notice would be in the best interests of the taxpayer (as determined by the National Taxpayer Advocate) and the United States.

Any such withdrawal shall be made by filing notice at the same office as the withdrawn notice. A copy of such notice of withdrawal shall be provided to the taxpayer.

**(2) Notice to credit agencies, etc.**--Upon written request by the taxpayer with respect to whom a notice of a lien was withdrawn under paragraph (1), the Secretary shall promptly make reasonable efforts to notify credit reporting agencies, and any financial institution or creditor whose name and address is specified in such request, of the withdrawal of such notice. Any such request shall be in such form as the Secretary may prescribe.