

Priority of Federal Tax Liens: Don't Wait To Perfect.

Mortgages and security interests are a routine part of the business of banking. Sometimes, however, the routine element of recording the relevant interest doesn't get the requisite attention, a situation that can create problems once the IRS files a federal tax lien.

A recent case from the Fourth Circuit highlights the potential pitfalls for lenders who delay in perfecting their rights in collateral. *In re Restivo Auto Body, Inc.*, 2014 U.S. App. LEXIS 20927 (4th Cir. Oct. 31, 2014). The debtor, Restivo Auto Body, had borrowed a million dollars from Susquehanna Bank, a loan which was to be secured by a deed of trust on two parcels of real estate. The loan documents, including the deed of trust, were executed on January 4, 2005. *Id.*, slip op. at *2.

Six days later, the IRS filed a notice of federal tax lien against Restivo, which had failed to pay its employment taxes. The bank didn't formally record its deed of trust until February 11th. *Id.* When Restivo filed for bankruptcy, a dispute broke out over the relative priority of the bank and the IRS. Under Maryland law, when a deed of trust is recorded, its perfection relates back to the date it is executed. As a consequence, both the district court and the bankruptcy court concluded that the bank had priority over the IRS.

On appeal, the Fourth Circuit rejected the bank's argument that its lien had priority over the IRS because it was perfected as of the date of execution. The outcome turned on the language of Section 6323 of the Code, coupled with close attention to verb tenses.

Generally, the Code gives a federal tax lien priority, subject to various exceptions. Among the exceptions is a security interest, as the tax lien does not tax priority over a security interest unless a formal notice of the tax lien has been filed. I.R.C. § 6323(a).

In *Restivo*, the priority dispute turned on the statutory definition of "security interest" in the Code. Section 6323(h)(1) provides that a "security interest" exists at any point in time if two requirements are met:

- "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
- "the holder has parted with money or money's worth."

In the Fourth Circuit's view, the key to understanding the language of Section 6323(h)(1) was the use of the present perfect verb tense in the Code's requirement that the "*interest has become protected.*" 2014 U.S. App. LEXIS 20927, slip op. at *10-*11. Because Congress selected this particular verb tense, the Court ruled that Section 6323(h)(1) "must be read to mean that at the time that the IRS filed its lien, a security interest must have been in existence and must have become protected under local law in order to obtain priority." *Id.*, slip op. at *12. And since the bank had not yet perfected its interest as of that date, the IRS had priority under the statute. *Id.*, slip op. at *13.

Despite its misstep, the bank ultimately prevailed. The district court had also held that the bank had a valid security interest based on Maryland's doctrine of equitable conversion. Under Maryland law, lenders are treated as if they were purchasers for purposes of protection from judgment creditors, and in Maryland, a bona fide purchaser is protected from liens of

subsequent judgment creditors. The court of appeals agreed with this analysis, and the bank retained its priority. *Id.*, slip op. at *20-*23.

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