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subject: Enforcing Liens On Exempt And Excluded Property

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ISSUES

1. Does a Notice of Federal Tax Lien need to have been filed before the bankruptcy case is commenced in order for the IRS to legally pursue collection of discharged liabilities against the debtors' prepetition assets, such as ERISA-qualified pensions, which never become property of the bankruptcy estate? Is the Service required to file a prepetition Notice of Federal Tax Lien in order to enforce its lien for discharged taxes against exempt property?

2. Assuming a prepetition Notice of Federal Tax Lien does not need to have been filed to legally pursue collection of discharged liabilities against property excluded from the estate, is the amount that can be collected limited to the value of the asset as of the bankruptcy petition date?

CONCLUSIONS

1. No, a Notice of Federal Tax Lien need not have been filed prepetition in order for the IRS to legally pursue collection of discharged liabilities against assets excluded from the bankruptcy estate. The excluded property never becomes subject to a trustee's or a debtor's power to avoid the statutory tax liens on it and the liens are not rendered void by the Bankruptcy Code. Therefore, excluded property remains subject to a statutory or "secret" tax lien, as well as, a tax lien for which a Notice of Federal Tax Lien has been filed, and may be pursued for collection after discharge. But, property that was in the bankruptcy estate and was later claimed as exempt from the bankruptcy estate may not be pursued unless a Notice of Federal Tax Lien was filed prepetition because the statutory tax liens are avoided on exempt property unless notice of the tax lien is filed.

2. No, the amount that can be collected on a statutory tax lien, regardless of whether a Notice of Federal Tax Lien has been filed, is not limited to the value of the asset as of the petition date. Once a lien attaches to property existing as of the petition date it attaches to any appreciation of that asset until the lien is enforced against that property.

LAW AND ANALYSIS

I. BACKGROUND.

A. Tax liens in general.

A federal tax lien attaches to "all property and rights to property, whether real or personal, belonging" to the taxpayer. 26 U.S.C. §6321. The lien imposed by §6321 arises when an assessment is made and continues until either the taxpayer's liability is satisfied or the statute of limitations on collection expires. 26 U.S.C. §6322. The lien attaches to the taxpayer's property and rights to property as of the moment of assessment and, once filed, attaches to any after acquired property. Glass City Bank v. United States, 326 U.S. 265, 66 S. Ct. 108, 90 L.Ed. 56 (1945).

The statutory lien created by Section 6321 is often referred to as a "secret" lien since it arises as a matter of law against the taxpayer without the necessity of filing public notice. In re Suarez, 182 B.R. 916, 919 (Bankr. S.D. Fla. 1995) (citing Stevan v. Union Trust Co., 316 F.2d 687 (D.C.Cir. 1963). However, the statutory or "secret" lien is not effective against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until a notice of federal tax lien has been filed. 26 U.S.C. §6323. If a Notice of Federal Tax Lien is not filed then one of the four types of creditors listed in §6323 will prime the IRS who holds only a statutory or "secret" lien.

B. Bankruptcy in general.

The ultimate goal of a debtor in bankruptcy is to obtain a fresh start and have many of his debts discharged. When a discharge order is entered a debtor is discharged from personal liability for the discharged debts. 11 U.S.C. §524(a)(2). While section 524 (a)(2) absolutely prohibits the collection of discharged liabilities from the debtor personally, this provision does not prohibit the postdischarge enforcement of valid liens on property of the debtor that existed when the bankruptcy petition was filed. In re Isom, 901 F.2d 744 (9th Cir. 1990). "Thus a bankruptcy discharge extinguishes only one mode of enforcing a claim – an *in personam* action – while leaving intact another – an *in rem* action." Johnson v. Home State Bank, 501 U.S. 78, 111 S. Ct. 2150 (1991).

When a person files any type of bankruptcy petition a bankruptcy estate is created by law. Such estate is comprised on "all legal and equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. §541(a). Essentially all of the debtor's property acquired prepetition goes into the bankruptcy estate, subject to certain exclusions set forth in section 541(b) and (c). In addition to these exclusions, a debtor is allowed to claim certain property as exempt from the bankruptcy estate. Property such as a homestead, a car, property used in a trade or business, and some retirement assets are allowed as exempt property to ensure a debtor has something with which to begin his "fresh start". 11 U.S.C. §522. Generally, exempt property is not liable for any prepetition debts during or after the bankruptcy case except debts secured by unavoided liens and tax liens with respect to which a Notice of Federal Tax Lien has been filed. 11 U.S.C. §522(c). In essence, a debtor may avoid a statutory tax lien on his exempt property by exempting the property from the estate, but he may not avoid a tax lien where a Notice of Federal Tax Lien has been filed. Whereas excluded property never becomes property of the estate, exempt property initially becomes estate property under section 541(a) and later, during the case, is returned to the debtor.

Property excluded from a bankruptcy estate is set forth in Bankruptcy Code sections 541(b) and (c). It includes certain ERISA-qualified pension plans. 11 U.S.C. 541(c)(2); Patterson v. Shumate, 504 U.S. 753, 112 S.Ct. 2242 (1992).[1] The Supreme Court stated that by excluding ERISA-qualified pension plans from estate property "it gives full and appropriate effect to ERISA's goal of protecting pension benefits" from the claims of creditors in bankruptcy. Patterson v. Shumate, 504 U.S. at 764. In essence, excluded property does not touch the bankruptcy estate and become subject to the claims filed by the creditors in the bankruptcy action.

II. How bankruptcy affects tax liens on excluded property.

[1] Courts have developed different tests for determining whether a plan is an "ERISA-qualified pension plan" under Patterson v. Shumate such that it would qualify as property excluded from the bankruptcy estate. For instance, the court in Skiba v. Gould, 337 B.R. 71 (W.D. Pa. 2005) held that in order to be excluded from a bankruptcy estate a pension plan must contain a trust although no such language exists in Patterson.

The general rule is that liens survive bankruptcy unless invalidated by some bankruptcy law provision. Bische v. United States, 159 B.R. 546 (BAP 9th Cir. 1993). While several Bankruptcy Code provisions authorize the avoidance of lien interests including tax liens on property of the estate, none of these provisions authorize the avoidance of such liens on excluded property. One Bankruptcy Code section that affects liens is section 506. It provides in part that "to the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void,"… 11 U.S.C. §506(d). This section would not apply to liens on excluded property because whether the IRS has filed a notice of federal tax lien before the petition date or merely has a statutory lien under 26 U.S.C. §6321, the attachment of the tax lien to excluded property belonging to the debtor does not entitle the IRS to file a secured claim in the bankruptcy case. [2] Bankruptcy Code Section 506(a) provides in part that an allowed claim of a creditor secured by a lien on property in which the estate has an interest is a secured claim. Therefore, a lien interest on excluded property does not secure a claim against the debtor and consequently such lien interest is not subject to being avoided under section 506(d).

Confirmation of a chapter 13 plan would also not void or strip a lien from attaching to excluded property. Section 1327 of the Bankruptcy Code provides that property of the estate that vests in the debtor is free and clear of any claim or interest of a creditor provided for in the plan. 11 U.S.C. §1327(b) and (c). The statute is clearly limited to lien interests on property of the estate. Similarly in a Chapter 11 plan, confirmation does not strip a lien from attaching to excluded property. Section 1141 provides that after confirmation of a plan, property dealt with by the bankruptcy plan is free and clear of all claims and interests of creditors. 11 U.S.C. §1141(c). Thus, only lien interests on property dwelt with by the plan are eliminated after confirmation and thus would not include lien interests on property excluded from the estate that is not dwelt with by the plan.

The Bankruptcy Code also provides special powers to avoid, or render ineffective, certain unperfected liens so that estate property is available for distribution to unsecured creditors. It is our view that such powers do not apply to excluded property. The Bankruptcy Code provides that a trustee obtains the rights of a hypothetical judicial lien creditor or a lien creditor who obtains an execution against the debtor as of the date of the commencement of the case and this status allows him the power to avoid any transfer of property of the debtor or any obligation incurred by the debtor that would be voidable by such creditor under nonbankruptcy law. 11 U.S.C. §§544(a) (1) and (2). Under subsection (a)(1), the status of a judicial lien creditor would seem to satisfy the requirements of a judgment lien creditor under I.R.C.6323(a) and as further defined in Treas. Reg. §301. 6323(g), and under subsection (a)(2), the status of a lien creditor who has executed against the debtor would satisfy the requirements of a holder of a security interest as defined in Treas. Reg. §301.6323(h)-1(a). Thus, the trustee's status under

[2] In United States v. Snyder, 343 F.3d 1171, 1173 (9th Cir. 2003), acq. 2004-41 I.R.B. 593, the Ninth Circuit held that the Service did not hold a secured claim with respect to a debtor's interest in an ERISA-qualified pension plan because such interest was excluded from the bankruptcy estate under section 541(c)(2).

section 544 would entitle the trustee to prevail against unfiled 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. [3] The same type of power is given to a trustee under 11 U.S.C. §545. It also provides that a trustee may avoid the fixing of a statutory lien on "property of the debtor" under certain circumstances. It should be noted, however, that amendments to section 545 made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, clarify that the trustee's status as a bona fide purchaser under section 545 is not the same as a purchaser under Internal Revenue Code section 6323(a) and therefore, the trustee could not avoid the fixing of an unfilled federal tax lien.

While the trustee has the power to avoid unfiled federal tax liens under sections 544, we believe this power only extends to avoiding such liens on property of the estate and not on property excluded from the estate. The trustee's avoidance powers under section 544 are broadly defined and this section provides that the "trustee …may avoid any transfer of property of the debtor or any obligation incurred by the debtor…" Sections 544(a) does not limit the trustee's avoidance power to property of the estate but uses the phrases "property of the debtor" and "any obligation incurred by the debtor". But, by definition, a trustee is a representative of the bankruptcy estate. 11 U.S.C. §323. As such, his avoidance powers will only be enforced to benefit the bankruptcy estate. Moore v. Bay, 284 U.S. 4 (1931). A trustee's "avoidance powers provide recovery of property or avoidance of property interests previously transferred to the extent that these transfers would disturb what would otherwise be coequal treatment of similarly situated creditors. Courts and legislative history have referred to this as the "prime bankruptcy policy of equality of distribution among creditors"." Norton Bankruptcy Law and Practice 2d, Chapter 54. p. 54-2 to 54-3. It is our position that the trustee's lien avoidance powers are limited to the extent that the lien avoidance benefits the bankruptcy estate and brings property of the debtor into the bankruptcy estate for distribution to creditors. Since the Supreme Court has held that excluded property is not property of a bankruptcy estate subject to claims of creditors, the excluded property should not be subject to a bankruptcy trustee's avoidance powers.

Excluded property, such as an ERISA-qualified pension plan described in the Patterson v. Shumate case, is different from exempt property because it never becomes property of the bankruptcy estate. Since excluded property never becomes property of the estate it never becomes subject to the trustee's power to avoid statutory tax liens or the debtor's power to avoid statutory liens by exempting the property from the bankruptcy estate. There is no Bankruptcy Code section that would void or avoid a tax lien on excluded property. A statutory or "secret" tax lien which attaches to a taxpayer's excluded property before a bankruptcy petition is filed remains unaffected by the bankruptcy action. In other words, liens for discharged taxes on property excluded from a debtor's bankruptcy estate, continue to encumber a debtor's prepetition property in

[3] Courts have held that avoidance power under 11 U.S.C. §544 applies to Chapter 7 and Chapter 11 cases. There is a conflict among the courts as to whether the debtor may exercise these powers in a Chapter 13 case.

the same manner after as before a bankruptcy petition is filed. Accordingly, a tax lien which attaches to the excluded property before the taxpayer files a petition in bankruptcy is unaffected by the bankruptcy action and the IRS may proceed to enforce either its statutory tax lien, or its tax lien secured by a filing of a Notice of Federal Tax Lien, against that property. [4] See Rich v. United States, 197 B.R. 692 (1996), (wherein the parties agreed that if property is excluded from a bankruptcy estate it is subject to a statutory tax lien where Notice of Federal Tax Lien has not been filed.)

III. Tax liens for dischargeable taxes only attach to a debtor's prepetition property but any appreciation on that property inures to the benefit of the IRS.

The discharge injunction under section 524 limits the property or rights to property to which a tax lien for discharged liabilities attaches. Generally, a tax lien attaches to all property rights of a taxpayer as of the moment of assessment and attaches to any after acquired property. Glass City Bank v. United States, 326 U.S. 265, 66 S.Ct. 108, 90 L.Ed. 56 (1945). But, a prepetition tax lien for discharged taxes does not apply to property acquired after a bankruptcy petition is filed. In re Paeplow, 972 F.2d 730 (7th Cir. 1992); In re Marshall, 204 B.R. 838 (Bankr. S.D. Ga., 1997);In re Conner, 27 F.3d 365, 366 (9th Cir. 1994). Until the after-acquired property comes into existence, the federal tax lien is not "choate" or perfected as to that property. United States v. New Britain, 347 U.S. 81, 84, 74 S.Ct. 367, 369, 98 L.Ed. 520 (1954). But, by the time the postpetition property is acquired by a debtor, his personal liability for the underlying tax has been discharged and cannot be the basis for a lien. In essence, a lien can never be perfected against the after-acquired property because the personal liability for the tax and the existence of the property cannot occur simultaneously. "The affixing of a creditor's lien against a debtor's property is based upon the existence of a debt as the personal liability of the debtor." In re Marshall, 204 B.R. at 840. The discharge injunction enjoins any act to collect a discharged debt as a personal liability of the debtor. 11 U.S.C. §524 (a)(2). Any attempt to enforce an unperfected tax lien based on a discharged liability is prohibited by the discharge injunction. Thus, the filing of a petition in bankruptcy limits the reach of a prepetition tax lien for discharged taxes to a debtor's property or rights to property which are in existence as of the petition date. Any property or rights to property acquired by the debtor after bankruptcy are not encumbered with a prepetition lien for discharged taxes, whether it is a "secret" tax lien, or a tax lien where notice has been property filed. After bankruptcy, the IRS holds and can only enforce a prepetition tax lien for discharged taxes on property to the extent the taxpayer had an interest in that property as of the bankruptcy petition date.

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[4] The IRS is in a unique situation with regard to ERISA-qualified pension plans excluded from a bankruptcy estate. While another creditor may be in the same lien situation as the government and hold a lien interest against an excluded ERISA-qualified pension plans, only the federal government would be able to enforce its liens. This is because the ERISA plans contain an anti-alienation provision which bars creditors from enforcing their liens against the plans but the anti-alienation provisions of ERISA-qualified plans are not enforceable against the federal government.

Although a lien only attaches to property or rights to property of the debtor as of the petition date, the lien is not limited to the value of the property as of the petition date. Once a tax lien, regardless of whether notice has been filed, attaches to property existing at the petition date it attaches to any appreciation of that asset until the lien is enforced against that property. The Supreme Court has held that a creditor's lien stays with the property until the foreclosure, and therefore, any increase in valuation during the pendency of the bankruptcy rightly accrues to the benefit of the creditor. Dewsnup v. Timm, 502 U.S. 410, 112 S. Ct. 773 (1992); See also, United States v. Comer, 222 B.R. 555 (ED Mich. 1998).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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