Lesson 6

FUTURE ADVANCES AND AFTER-ACQUIRED PROPERTY
(March 2012)

CONTENTS

I. OBJECTIVES

At the end of this lesson you will be able to:

- Explain the 45-day rule for making disbursements.
- Identify commercial transactions financing agreements, real property construction or improvement financing agreements, and obligatory disbursement agreements.
- Explain the special priority given such agreements vis-à-vis the federal tax lien.

II. BACKGROUND

A. Brief history of tax lien priority

Brief history of tax lien priority (See Rice Investment Co. v. United States, 625 F.2d 565 (5th Cir. 1980) for additional discussion of following history.)

1. Every federal tax liability that is not paid on demand becomes a secret lien, effective from the date of assessment, upon all property and rights to property belonging to the taxpayer.

2. When Congress first created the federal tax lien, the secret lien prevailed over

all creditors, even a subsequent *bona fide* purchaser. Between 1913 and 1964, Congress showed an increased awareness of the importance of the security of titles and of the need of certain creditors to be able to rely upon a taxpayer's apparent unencumbered ownership of property:

a) 1913--purchasers, mortgagees, and judgment creditors protected against federal tax liens of which notice had not been filed.

b) 1939--pledgees added to protected class.

c) 1966--mechanic's lienors added to protected class.

3. Congress also awarded certain classes of creditors superpriority, i.e., priority over even a filed lien, subject to limitations:

a) 1939--purchasers and lenders secured in "securities."

b) 1964--purchasers of motor vehicles.

c) 1966--tangible personal property purchased at retail and in casual sales; tangible personal property subject to local law possessory liens; real property tax and special assessment liens; residential property subject to mechanic's liens; attorney's liens; certain insurance contracts and certain deposit-secured loans.

4. The secret federal tax lien retained its priority from the date of assessment against the taxpayer and all other classes of creditors.

5. The Supreme Court in United States v. City of New Britain, 347 U.S. 81, 85 (1954) established the principle of "the first in time is the first in right," and held that in order to be the first in time, the non-federal lien must be choate. A lien is choate when the following are established:

a) the identity of the lienor;

b) the property subject to the lien; and

c) the amount of the lien.

Except for certain possessory liens and certain state and local tax liens, no common law, equitable, or statutory lien could meet the judicial standard of choateness until the lienor's claim had been reduced to judgment.

6. Even under the “the first in time is the first in right” standard, mortgages and other contractual security interests were vulnerable to subsequently filed Notices

of Federal Tax Lien to the extent that the security embraced after-acquired property or involved disbursements (whether optional or obligatory) yet to be made.

7. This situation created serious difficulties in the business community. Section 6323(c) and (d) were enacted to alleviate, at least in part, the conflicts presented in certain types of business arrangements.

B. Definition of "Security Interest"

The term "security interest" is defined by I.R.C. § 6323(h)(1), which imposes four requirements on the creation of a security interest:

1. The security interest must be acquired by contract to secure payment, performance of an obligation, or indemnity against loss;

2. The holder must part with money or money's worth;

3. The collateral to which the security interest is to attach must already be in existence. Under Treas. Reg. § 301.6323(h)-l(a), a contract right is in existence when the contract is made; and

4. The security interest must be protected under local law against a subsequent judgment lien arising from an unsecured obligation at the time of tax lien filing.

III. FUTURE ADVANCES AND AFTER-ACQUIRED PROPERTY

A. Limited Superpriority for Security Interests and Future Advances

1. I.R.C. § 6323(c) Generally

I.R.C. § 6323(c) provides a limited superpriority with respect to property covered by the terms of three written agreements: commercial transactions financing agreements, real property construction or improvement financing agreements, and obligatory disbursement agreements.

To understand section 6323(c) one must examine both the statute and the accompanying regulations. While section 6323(c) is a complicated statute, there is an underlying theory that assists in understanding this section. Specifically, in very limited situations, Congress has provided a priority for certain security interests that come into existence after the filing of a tax lien. Generally, such security interests arise in two situations. The first is where a commercial creditor perfects his security interest prior to the filing of a NFTL, in which case the commercial security interest primes the NFTL as to limited assets that the taxpayer acquires within 45 days after the filing of the NFTL. Donald v. Madison

Industries, 483 F.2d 837, 843 (10th Cir. 1973). The second situation is where the commercial creditor perfects his security interest prior to the filing of a NFTL and then makes post-NFTL loans/disbursements to a taxpayer who acquires certain property within the 45 days of the filing of the NFTL. (In very limited situations, section 6323(c) also grants a priority to certain purchasers of commercial financing security, e.g., accounts receivable.)
In order for the protections of I.R.C. § 6323(c) to apply, for the three types of agreements addressed in (c)(2), (c)(3), and (c)(4), several requirements must be met:

a) The security interest must in **qualified property**;

b) There must be a **written agreement,** i.e.**,** a commercial transactions financing agreement, a real property construction or improvement financing agreement, or an obligatory disbursement agreement, entered into before the filing of the tax lien; and

c) The security interest must be **protected under local law** against a judgment lien arising out of an unsecured obligation as of the time of the tax lien filing.

2. I.R.C. § 6323(c)(2) – Commercial Transactions Financing Agreements

A commercial transactions financing agreement is an agreement entered into by a person in the course of trade or business either (1) to make loans to the taxpayer to be secured by commercial financing security (defined in I.R.C. § 6323(c)(2)(C) as paper of a kind ordinarily arising in commercial transactions, accounts receivable, mortgages on real property, and inventory, and discussed further below) or (2) to purchase commercial financing security, other than inventory, acquired by the taxpayer in the ordinary course of the taxpayer's trade or business. Note that both the lender and the taxpayer-debtor must have entered into the loan/sale within the ordinary course of business. Moreover, such an agreement qualifies as a commercial transactions financing agreement only to the extent that such loan or purchase is made before the 46th day after the date the Service files a NFTL, or earlier if the lender or purchaser had actual notice or knowledge of the notice of lien filing.

Commercial financing security includes mortgages, accounts receivable, inventory, paper-giving contract rights, documents of title to personal property, negotiable instruments or securities. In other words, it has to be paper of a kind ordinarily arising in commercial transactions. It does not include general intangibles such as patents or copyrights. In the case of loans, inventory includes raw material and goods in process, as well as property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business.

a) Effect of Actual Knowledge on a Commercial Transaction Financing Agreement

Treas. Reg. § 301.6323(c)-1(d) addresses the effect of acquiring actual knowledge of the filing of the NFTL within the 45 days. "Commercial financing security acquired before such [46th] day may be qualified property even though it is acquired by the taxpayer after the lender received actual notice or knowledge of the filing of the tax lien. For example, although actual notice or knowledge of the filing of the notice of the tax lien has the effect of ending the period within which protected disbursements may be made to the taxpayer, property which is acquired by the taxpayer after the lender receives actual notice or knowledge of such filing and before such 46th day, which otherwise qualifies as commercial financing security, becomes commercial financing security to which the priority of the lender extends for loans made before he received the actual notice or knowledge."

Example: Assume Bank and Widget Co. sign a security agreement on January 1 designating inventory as collateral, and Bank files its financing statement on January 1. On January 9, the Service files a NFTL. On January 15, without any knowledge of the NFTL, and pursuant to the security agreement, Bank loans $10,000. On January 20, Bank learns of NFTL. On January 22, Bank loans $5,000. On January 30, Widget Co. gets new shipment of inventory. The $5,000 loan on January 22 will not qualify for section 6323(c) status, because the Bank knew on January 20 that a NFTL had been filed. The $10,000 loan of the 15th, however, will qualify for section 6323(c) status because the Bank had no knowledge of the NFTL. The section 6323(c) priority will apply not only to the inventory existing on January 15, but also to any inventory acquired within the 45 day period following the filing of the NFTL, which includes the new inventory acquired on January 30.

b) Applicable Definitions

(1) Accounts receivable

"An account receivable is any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper." Treas. Reg. § 301.6323(c)-1(c)(2)(ii). With regard to "qualified property," an account receivable "is acquired by a taxpayer at the time, and to the extent, a right to payment is earned by performance." Treas. Reg. § 301.6323(c)-1(d).

(2) Contract Rights

"A contract right is any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper." Treas. Reg. § 301.6323(c)-1(c)(2)(i). With regard to "qualified property," a contract right "is acquired by the taxpayer when the contract is made." Treas. Reg. § 301.6323(c)-1(d).

(3) Proceeds

"The term 'proceeds' includes whatever is received when collateral is sold, exchanged, or collected. For purposes of this paragraph, the term 'identifiable proceeds' does not include money, checks, and the like which have been commingled with other cash proceeds. Property acquired by the taxpayer after the 45th day following tax lien filing, by the expenditure of proceeds, is not qualified property." Treas. Reg. § 301.6323(c)-1(d).

In Plymouth Savings Bank v. United States, 187 F.3d 203 (1st Cir. 1999), the Bank perfected its security interest in the taxpayer's personal property, including proceeds of services, before the Service filed its NFTL. Within the 45-day period, taxpayer entered into a personal services contract, but did not perform any services within the 45-day period. Thus, at the end of the 45-day period, the taxpayer had only a contract right, not an account receivable. Subsequently, taxpayer performed the required services, thus creating an account receivable. In the following interpleader, the Bank argued that it was entitled to the funds under section 6323(c) because it had perfected a security interest in taxpayer's contract rights (commercial financing security) long before the Service filed the NFTL, and the funds were "proceeds" of the contract right. See Treas. Reg. § 301.6323(c)-1(d). The government argued that the funds were proceeds of an account receivable created more than 45 days after the filing of the NFTL; consequently, the federal tax lien primed the Bank's security interest. The First Circuit held for the Bank, reasoning that taxpayer's "rendering of the contracted-for services effectively 'exchanged' her contract right, converting it into an account receivable." The First Circuit observed that other courts had similarly rejected the government's interpretation of contracts and accounts receivable. See, e.g., Bremen Bank & Trust Co. v. United States, 131 F.3d 1259 (8th Cir. 1997); State Bank of Fraser v. United States, 861 F.2d 954 (6th Cir. 1988).

(4) Commingling of cash proceeds

As mentioned above, the definition of "proceeds" includes the statement that "[f]or purposes of this paragraph, the term 'identifiable proceeds' does not include money, checks and the like which have been *commingled with other cash proceeds*." Treas. Reg. § 301.6323(c)-1(d) (emphasis added). In other words, even if state law provided for the tracing of commingled funds, the regulation rejects tracing. Instead, the regulation establishes a bright line test: if the proceeds consisting of money, checks, and the like are commingled with other cash proceeds, the creditor loses its section 6323(c) priority. While this result may appear harsh, it is analogous to a similar rule that existed under old U.C.C. § 9-306(4)(b) that limited a security interest to cash proceeds that had not been commingled.

3. I.R.C. § 6323(c)(3) – Real Property Construction or Improvement Financing Agreements

This is the second category arising under section 6323(c) for which there is little litigation. There is no 45-day rule for making disbursements in this category. Notice or knowledge of the pre-existing notice of federal tax lien is immaterial.

a) Under section 6323(c)(3), the term "real property construction or improvement financing agreement" is defined as an agreement to make cash disbursements to finance the following:

(1) An owner's construction or improvement of real property (including the demolition thereof). In this situation, the creditor's lien, usually a bank lien, would prime the federal tax lien for a disbursement made after the filing of the NFTL as to owner's real property only.

(2) A contractor who obtains financing, usually a bank lien, to construct or improve real property. Note that the contractor is not the owner of the real property. The bank's lien will prime the NFTL as to the proceeds due under the construction contract only, i.e., the security interest is in the contract proceeds, not the real estate.

(3) The raising or harvesting of a farm crop or the raising of livestock or other animals. Note: Disbursements of goods and services to finance raising/harvesting of crops and livestock are treated as disbursements of cash.

b) When used with respect to a real property construction or improvement financing agreement, the term "qualified property" consists of the following:

(1) Real property itself if lender makes advances to the owner;

(2) Proceeds of the contract if lender makes advances to a contractor; or

(3) In the case of an agreement to finance the raising or harvesting of a farm crop, any property belonging to taxpayer at the time of tax lien filing, i.e., it is not limited to the crops and/or livestock or other animals.

c) Using the above definitions, under section 6323(c)(3), a holder of a security interest arising out of a real property construction or improvement financing agreement is entitled to priority against a filed notice of federal tax lien under the following conditions:

(1) A written agreement was entered into before the filing of the notice of tax lien.

(2) The interest is given priority under state law against a judgment lien creditor as of the time of the filing of the notice of tax lien.

4. I.R.C. § 6323(c)(4) – Obligatory Disbursement Agreements

Again, there is no 45-day rule for making disbursements in this category. Notice or knowledge of the pre-existing notice of federal tax lien is immaterial.

To understand this category, remember that under section 6323(c)(4) there are general obligatory disbursement agreements and the special provisions applicable to obligatory disbursement agreements that are surety arrangements. (Under a surety agreement the surety agrees to perform a contract if the taxpayer fails to perform.)

a) General obligatory disbursement agreements:

Section 301.6323(c)-3(b) defines an "obligatory disbursement agreement" as a written agreement under which a lender, in the course of his trade or business is obligated to make disbursements because someone other than the taxpayer has relied on that obligation, e.g., an irrevocable letter of credit. In other words, the lender is typically paying a third party for property/services provided to the taxpayer. An obligatory disbursement agreement requires that on the filing date of the tax lien, the lender's security interest must be protected against a hypothetical judgment lien creditor. When used with respect to obligatory disbursement agreements, the term "qualified property" means the following:

(1) Property in existence at the time of filing of the tax lien;

(2) Property acquired by the taxpayer after the notice of tax lien is

filed that is directly traceable to disbursements required to be made under the agreement.

b) Special rule for surety agreements:

In surety agreements, in addition to property in existence at the time of filing of the tax lien and after-acquired property traceable to disbursements required under the agreement, “qualified property” means:

(1) Proceeds of a contract, the performance of which was ensured; and,

(2) If the contract provides for the construction or improvement of real property, or the production of goods or the furnishing of services, then it will include any tangible personal property used by a taxpayer in the performance of the insured contract.

B. The 45-Day Rule for Disbursements: I.R.C. § 6323(d)

Under section 6323(d), even though a NFTL has been filed, the NFTL is not valid with respect to a security interest that came into existence after the tax lien filing by virtue of disbursements made after the tax lien filing. This subsection shares a number of common requirements with section 6323(c)(2) commercial transaction financing agreements:

1. Prior to the filing of the tax lien, there must be a written agreement that creates the security interest.

2. As of the filing date of the tax lien, the security interest must prime a hypothetical judgment lien creditor.

3. The lender must not have actual knowledge of the filed lien when it makes the loan.

4. The disbursement must be made within 45 days of the filing of the lien. If, within the 45 day period, the lender acquires knowledge of the filed lien before making the disbursement, then the 45 days is shortened to the day on which the knowledge is acquired.

However, section 6323(d) and section 6323(c)(2) differ with regard to the types of property covered and the time at which the property was acquired: Section 6323(d) applies to all the taxpayer’s property as of the date of the filing of the tax lien, but not after-acquired property. On the other hand, section 6323(c)(2) applies only to defined “qualified property,” but may cover some after-acquired property. Put another way, section 6323(d) is both broader and narrower than section 6323(c)(2).

A final note: An effect of the complicated provisions of subsections 6323(c) and

6323(d) may be to cause financiers to avoid these technicalities by casting more transactions in the form of a purchase money security interest, thus avoiding the effect of knowledge of the filing, the 45-day rule, and questions as to the characterization of the new collateral.