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[SEMINARS](#)

[WEB LINKS](#)

[CONTACT](#)

SEARCH

OK

DIVISIONS

Corporate & Real Estate

Labor & Employment

Litigation

FAST BREAKING DEVELOPMENTS

[\[back to main\]](#) [\[previous\]](#) [\[next\]](#)

5. Federal Tax Liens.

(a) Secret Lien. The most common federal tax liens are those securing federal income taxes, withholding taxes and social security taxes. Under §6321 of the Internal Revenue code ("IRC"), the lien arises at the time the assessment is made. However, since the assessment process is not a public record, the lien is secret until a notice of federal tax lien ("NFTL") is recorded with the Bureau of Conveyances. NFTLs do not need to be filed with the Land Court. Between the time the assessment is made and the time the NFTL is recorded, the lien is still valid against the taxpayer and all other persons, except for those specifically protected by statute.

(b) Protection of Certain Persons from the Effect of the Secret Lien. There are basically four classes of creditors, or third parties, that one needs to be aware of when dealing with federal tax liens.

(i) Perfection by Filing Before Tax Lien is Filed. Under IRC §6323(a), a federal tax lien is not valid as against the following persons who obtain their interest in the property before the NFTL (meeting the requirement of IRC §6323(f)) has been recorded with the Bureau:

- (1) A purchaser;
- (2) a holder of a security interest;
- (3) a mechanic's lienor; or
- (4) a judgment lien creditor.

Each of the above terms, except for judgment lien creditor, is defined at IRC §6323(h). Generally speaking, purchasers, holders of security interests and mechanic's lienors are those who have properly recorded (or filed) their interests under Hawaii law, so as to give them protection and priority over third persons. However, in the case of mechanic's liens, the mechanic's lien claimant must have actually provided materials or labor as of the date the notice of federal tax lien is recorded in order to have priority over the tax lien. --Thus, if the mechanic's lien claimant does not provide labor or materials until after the NFTL is recorded, but construction of the "improvement" commenced before the NFTL was recorded, the mechanic's lien claimant cannot take advantage of the usual "relation back" doctrine under Hawaii law to obtain priority over the federal tax lien. (See the discussion of mechanic's liens in part 6 of this paper below.)

Judgment lien creditors are those who have obtained a judgment in a court of competent jurisdiction, for the recovery of specifically designated property or for a certain sum of money. In addition, the judgment lien must be recorded under HRS §636-3 to affect regular system property, or filed under HRS §501-102 for Land Court property. GGG (HI), Inc. v. New York Diamond, Inc., 944 P.2d 1341 (Haw. App. 1997).

Trustees in bankruptcy have been given similar protection under U.S. v. Speers, 382 U.S. 266, 15 L.Ed. 2d 314 (1965).

(ii) Semi-Super Priorities. There are four types of security interests which can have priority over federal tax liens even though they may arise after the NFTL is recorded: (i) real

property construction or improvement financing agreements; (ii) obligatory disbursement agreements; (iii) commercial transaction financing agreements; and (iv) security interest created by disbursements made within 45 days after the filing of the NFTL in property existing at the time the NFTL is recorded. Since these security interests are subject to numerous rules and restrictions, they are sometime called "semi-super" priorities, as opposed to the super priorities referred to below. IRC §6323(c) sets out the requirements for these interests. However, in general, all four interests require that (1) an agreement giving rise to the lien must have been entered into before the NFTL was recorded, and (2) the lien must have priority under Hawaii law against a judgment lien arising out of an unsecured obligation as of the time the NFTL is recorded.

(iii) Super Priority Exceptions. IRC §6323(b) gives priority to ten types of interests, even though they may arise after the NFTL has been recorded. These include matters such as: purchasers and holders of security interests in securities, who did not have actual knowledge of the federal lien at the time they acquired their interest; purchasers who acquire motor vehicles, who did not have actual knowledge of the federal lien at the time they acquired their interest; retail purchases of personal property; real property tax liens; and mechanic's liens of not more \$5,000 on residential property. The IRS also recognizes purchase money security interests as having super priority over federal tax liens. See Rev. Rul. 68-57, 1968-1 C.B. 553. In cases where the claimant cannot qualify under the super priority rules because he had actual knowledge of the tax lien, he may be able to qualify under one of the semi-super priority exceptions (which generally do not have an actual knowledge requirement).

(iv) Other Liens and Interests. In the event a lien or interest is not covered under any of the categories described above in subparagraphs (i) through (iii), then it must be "choate" before the NFTL is recorded in order to have priority. An interest is considered to be choate when the following matters are known: (1) the identity of the claimant; (2) the property that is subject to the lien; and (3) the amount of the lien. U.S. v. McDermott, 113 S. Ct. 1526 (1993). The most common claim that falls in this category is a general state tax lien. Under federal law, state tax liens are not entitled to the priority of a judgment creditor unless a judgment has been obtained. Treas. Regs. §301.6323(h)-1(g); U. S. v. Gilbert Associates, Inc., 345 U.S. 361 (1953); In Re Priest, 712 F. 2d 1326 (9th Cir. 1983).

(c) Enforcement of Lien. A federal tax lien may be enforced either by an administrative levy or by court proceeding instituted within 10 years after the date of the assessment, or within any period of time agreed upon by the IRS and the taxpayer, so long as the agreement was entered into within the 10 year period. IRC §6502. The 10 year period may be tolled under various circumstances. In addition, a tax lien may be extended if it is refiled within the one year time period ending 30 days after the expiration of 10 years from the date of the assessment of the tax. IRC§6323(g). If the lien is properly refiled during such refiling period, it will have priority as of the date of its original filing.

After the expiration of a 180 day redemption period following sale of the property pursuant to an administrative levy, the government will issue a deed conveying all right, title and interest of the taxpayer as of the date the federal tax lien attached to the property. IRC §6338(b). All liens and encumbrances that are subordinate to the federal tax lien are discharged by the sale. IRC §6339(c). Note that in order to redeem property, the owner of the property (or other person entitled to a redemption right), must pay the price paid by

the purchaser at the sale plus interest at the rate of 20% per annum.

(d) Effect of Mortgage Foreclosure. The holder of a superior mortgage may discharge an inferior tax lien against the property being foreclosed by naming the United States as a party in the suit. If the United States' lien against the property was discharged from the property by the foreclosure of a superior mortgage lien, the United States has 120 days after confirmation of the foreclosure sale within which to redeem the property, if the tax lien arose under the Internal Revenue Laws. If the federal tax lien arose under other laws, then the period of redemption is one year. 28 U.S.C. §2410(c). A federal tax lien that is recorded after the foreclosing mortgagee's lis pendens is recorded will also be discharged from the property, even if the United States is not named in the lawsuit.

(e) Partnerships. Under federal income tax law, a partnership is liable for payment of withholding taxes, social security taxes, and certain excise taxes. Under Hawaii law, each general partner is liable for all taxes and debts of the partnership. Accordingly, federal tax liens filed against a partnership for withholding taxes, social security taxes, and certain excise taxes constitute liens against both the partnership property and each general partner's property. See Adler v. Nicholas, 166 F.2d 674 (1948); In Re Crockett, 150 F. Supp. 352 (1957).

However, income tax is not imposed on the partnership, but rather each partner is taxed on his distributive share of the partnership income. Therefore, a lien filed against a partner with respect to that partner's income tax deficiencies will encumber all property owned by that partner but will not encumber property owned by the partnership. U.S. v. Worley, 213 F. 2d 509 (6th Cir. 1954), cert. den., 348 U.S. 917 (1955).

[\[back to top\]](#)

[\[back to main\]](#) [\[previous\]](#) [\[next\]](#)