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## Avoiding Tax Liens on Personal Property in Bankruptcy: A Look at the Interplay Between the Bona Fide Purchaser Provisions of the Tax and Bankruptcy Codes

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**AVOIDING TAX LIENS ON PERSONAL PROPERTY  
IN BANKRUPTCY: A LOOK AT THE INTERPLAY  
BETWEEN THE BONA FIDE PURCHASER PROVISIONS  
OF THE TAX AND BANKRUPTCY CODES**

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## I. INTRODUCTION

The resolution of tax disputes in bankruptcy is a dynamic area of the law where developments often occur on a weekly basis. This Article will examine a strategy for a debtor or trustee to attack tax liens on personal property in bankruptcy. The issue revolves around a bankruptcy trustee's power to invalidate tax liens in certain situations, and the bankruptcy debtor's powers, derived from those of the trustee, to accomplish the same thing albeit for entirely different motivations.<sup>1</sup> The question is: When can a trustee or debtor avoid an otherwise valid tax lien on money, securities, accounts receivable, automobiles, and other types of personal property by applying the bona fide purchaser provisions of the Tax Code<sup>2</sup> in connection with the lien avoidance provisions of the Bankruptcy Code.<sup>3</sup> The focus of this article is on the tantalizing language of section 6323(b) of the Internal Revenue Code, which says unequivocally that a properly filed or recorded tax lien is not valid against a bona fide purchaser in regard to certain common categories of personal property. Since the Bankruptcy Code deems the trustee to be a bona fide purchaser,<sup>4</sup> the trustee may invalidate tax liens on personal property.

Adjudicating tax claims through bankruptcy creates a conflict between the government's interest in raising revenues and the bankruptcy policy of rehabilitating debtors and giving them a "fresh start."<sup>5</sup> Taxpayers have tremendous forum-shopping potential to fight a tax assessment because of the overlapping jurisdiction of the Tax Court, district courts, Claims Court and

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1. Ostensibly, the bankruptcy trustee's objective will be to liquidate the estate and use the proceeds to pay dividends to the creditors. In contrast, the debtor typically will have no motivation to maximize the return for creditors but would instead want to utilize Internal Revenue Code ("I.R.C.") § 6323(b) (1988) to avoid liens on exempt assets. See 11 U.S.C. § 522 (1988). For the debtor in Chapter 11, the motivation to avoid liens will be to free assets that may be essential for a reorganization. See *infra* Section III.

2. See I.R.C. § 6323(b) (1988).

3. See 11 U.S.C. § 545(2) (1988).

4. Section 544 of the Bankruptcy code grants the trustee the status of bona fide purchaser as to real property. Similarly § 545 grants the trustee this status as to statutory liens, including personal property. *In re Loretto Moreny, Ltd.*, 898 F.2d 715 (9th Cir. 1990).

5. The Supreme Court has characterized the evolution of bankruptcy law as promoting two goals: "Equality" among creditors but also as favoring a "discharge" of the debtor. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 587 (1935).

bankruptcy court with regard to tax claims.<sup>6</sup> The district and Claims Courts are the least popular venues because they require a taxpayer to pay the entire disputed tax claim before commencing an action for a refund.<sup>7</sup> Compared to the Tax Court, the district and Claims Courts offer a different body of case law that may be more favorable to the taxpayer.<sup>8</sup>

The bankruptcy court's broad jurisdiction offers procedural and substantive advantages that do not exist in the other forums.<sup>9</sup> First, compared to the Tax Court, where assessments are presumptively correct, bankruptcy court relegates the government to the status of one of many creditors who can proceed by filing a proof of claim.<sup>10</sup> Second, the filing of a bankruptcy petition invokes an automatic stay, which prevents the government or any other creditor from filing liens, levying on property, and garnishing wages. The automatic stay also often stops the accrual of interest and penalties that compound tax liabilities.<sup>11</sup> Finally, even where a taxpayer has missed the 90-day statute of limitations for filing a petition in Tax Court, the door to challenge a tax assessment in bankruptcy court is not closed by the running of a limitations period.<sup>12</sup> Bankruptcy court also offers the convenience of being able to litigate both state and federal tax claims, without the burden of having to pay the disputed amount in advance.

Despite the advantages inherent in a debtor's selection of a bankruptcy forum, taxing authorities have enjoyed a history of special treatment in

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6. A benefit conferred by the Bankruptcy Code is that it provides an additional forum to litigate important tax issues. The bankruptcy court has concurrent jurisdiction with the Tax Court covering all tax liabilities, including those that were pending before the Tax Court at the commencement of a bankruptcy proceeding. For all tax issues, a bankruptcy court's decision will bind the government. *See, e.g.*, 11 U.S.C. § 505(a) (1988).

7. The district court is available only to taxpayers who seek refunds of taxes, requiring the taxpayer to first pay the disputed tax and then file a refund. *See* I.R.C. § 7422(a) (1988); 28 U.S.C. § 1346(a)(1) (1988). Because many taxpayers are unable to pay the entire disputed amount plus interest and penalties, district court is often not a viable alternative. Furthermore, the statute of limitations for bringing a refund suit raises an important issue in drafting a refund claim. A refund suit must be filed within two years from the date the Internal Revenue Service mails a "Notice of Disallowance" of a claim for refund. *See* 26 U.S.C. § 6352(a)(3) (1988).

8. The taxpayer loses more often in the Tax Court than in other forums. In 1988, taxpayer victories in the Tax Court occurred in only 4.7 percent of the cases filed while, for the same period, taxpayers won 11.3 percent of the cases in district courts and claims courts. *See* 1988 IRS ANN. REP. at 38.

9. The principal provisions of the Bankruptcy Code that permit a bankruptcy court to resolve tax disputes are 11 U.S.C. §§ 105, 505 (1988). Section 105 vests a bankruptcy court with broad powers and provides that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105 (1988). Section 505 permits a bankruptcy court to consider the merits of any addition to tax, whether or not it has been assessed, paid, or contested before and adjudicated by a judicial or administrative body. *See* ROBERT S. SCHRIEBMAN, *IRS TAX COLLECTION PROCEDURES, A MANUAL FOR PRACTITIONERS* ¶ 1577 (2d ed. 1988).

10. 11 U.S.C. §§ 501 and 502 (1988).

11. *See also* Paul D. Bancroft, *Postpetition Interest On Tax Liens In Bankruptcy Proceedings*, 62 AM. BANKR. L.J. 327 (1988).

12. 11 U.S.C. § 505(a) (1988).

bankruptcy court that has continued to the present day.<sup>13</sup> The genesis of federal law affording special protection to the government in insolvency proceedings can be traced to the Tax Act of 1792.<sup>14</sup> Today, the Bankruptcy Code protects tax claims over general unsecured claims through a combination of priority<sup>15</sup> and non-dischargeability<sup>16</sup> rules that makes a debtor's prospect of gaining relief from tax liabilities incurred within three years of filing bankruptcy unlikely. While the three-year rule poses a hardship for many debtors, the rule is more generous than the pre-1966 bankruptcy law where no taxes were dischargeable. Congress amended the Bankruptcy Act in 1966 to allow a debtor to discharge certain tax liabilities as a means of providing relief for the "financially unfortunate."<sup>17</sup>

With regard to dischargeable taxes, tax liens can push the balance further away from providing a fresh start. Specifically, where a tax claim is a non-priority claim, a tax lien converts a dischargeable tax into a non-dischargeable claim.<sup>18</sup> In such cases, although the debtor is relieved of the duty to pay the tax under bankruptcy law, his property may still be seized to satisfy the claim.<sup>19</sup> As the Ninth Circuit explained, the debtor is only relieved of *in personam* liability and the tax lien will survive as an *in rem* liability<sup>20</sup> on property the debtor possessed at the time of the bankruptcy.<sup>21</sup>

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13. One of Congress' first initiatives was to give the United States absolute, or near-absolute, priority over private creditors. See Act of March 3, 1797, ch. 20 § 5, 1 Stat. 512, 515.

14. The Act provides that:

cases in which a debtor, not having sufficient property to pay all his or her debts, shall have made a voluntary assignment thereof, for the benefit of his or her creditor, or in which the estate and effects of an absconding, concealed, or absent debtor shall have been attached by process of law, as to cases in which an act of legal bankruptcy shall have been committed.

Act of May 2, 1792, ch. 27, § 18, 1 Stat. 259, 263.

15. See 11 U.S.C. § 507 (1988). The Bankruptcy Code classifies income tax claims incurred within three years of a bankruptcy filing and payroll taxes/withholding taxes as priority claims that are non-dischargeable. Consequently, they must be paid in full plus interest within six years of their assessment. *Id.*

16. See 11 U.S.C. §§ 523, 727, 1141 (1988).

17. *Id.* See also 11 U.S.C. § 506 (1988); Priscilla Carter, *Nondischargeable Taxes May Argue Against a Bankruptcy*, 20 TAX'N FOR LAW 215 (1992).

18. Taxes that are dischargeable are capable of being erased such that the debtor will never have to pay them. The longevity of tax liens is substantially longer than three years, as the Tax Code provides that a tax lien will have an expiration date which occurs ten years plus 30 days after initial filing. I.R.C. § 6323(g) (1988).

19. See, e.g., *In re Isom*, 901 F.2d 744 (9th Cir. 1990). Furthermore, the government, as a secured creditor, may be entitled to post-petition interest on a tax claim, further diminishing the resources available to a debtor's estate.

20. *Id.*

21. *Id.* See also *United States v. Turner*, 625 F.2d 328 (9th Cir. 1980).

An entity which is subject to a tax lien carries a tremendous burden that may make it impossible to finance receivables or operate a business.<sup>22</sup> A lien enables the government to seize personal and business property, including cars, accounts receivable, household furnishings, and funds deposited in a bank account.<sup>23</sup> A combination of a state and federal wage garnishment can take more than fifty percent of an individual's paycheck.<sup>24</sup> In short, the potent effect of tax liens creates a vicious circle which severely hampers a taxpayer's ability to repay the tax.

Part II of this Article will provide a historical overview of tax liens and the origins of Internal Revenue Code section 6323(b). This introductory section is supplemented by a brief examination of the lien avoidance powers of the bankruptcy trustee, which enable a trustee to invalidate all liens that would be invalid against a bona fide purchaser.<sup>25</sup> Part III will examine the case law supporting the power to avoid tax liens on personal property in Chapter 7 (liquidation), Chapter 11 (reorganization), and Chapter 13 (wage earner bankruptcies). While this power is well-established, courts have not permitted the power to be used in Chapter 13 cases. The power to invalidate state tax liens is also included in the discussion of Chapter 7 bankruptcy.<sup>26</sup> After examining the statutory arguments and policies, this Article contends that no justification exists for distinguishing between Chapter 13 and other types of bankruptcies. This Article will conclude that the interest in giving a debtor a fresh start mandates that bankruptcy courts continue to allow a debtor to avoid tax liens on personal property so as to further a debtor's prospects for reorganization.

## II. BACKGROUND ON JURISDICTIONAL ISSUES AND TAX LIEN AVOIDANCE

### A. The "Automatic" Tax Lien And Its Unique Attributes

Tax liens become effective against a taxpayer without the government filing a notice of lien and have, therefore, been called "automatic" liens.<sup>27</sup> These liens, which have existed for more than a century, afford the

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22. While a debtor can exempt household belongings, tools of the trade, homestead, and other necessities from most judgment and statutory liens, the Bankruptcy Code makes these assets vulnerable to tax liens. See 11 U.S.C. § 522(c)(2)(B) (1988).

23. Any property can be seized, including accounts receivable in the hands of a third party. See *infra* notes 88-99 and accompanying text.

24. See Consumer Credit Protection Act, 15 U.S.C. § 1672(b)(3); IRC Treasury Regulations § 301.6334-3.

25. See *infra* notes 50-68 and accompanying text.

26. Depending on the jurisdiction, a similar bona fide purchaser provision may be applicable.

27. Current law provides that if a person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States upon all property belonging to that person. See I.R.C. § 6321 (1988); *United States v. New Britain*, 347 U.S. 81 (1954).

government special protection.<sup>28</sup> One court has commented that from almost the inception of the Constitution, Congress has expressed "solicitude for the protection of federal revenue."<sup>29</sup> Automatic liens became an integral part of the tax enforcement scheme in the late nineteenth century. Before 1866, the tax law merely gave the federal government priority, but did not provide for a lien until the government brought suit against a debtor.<sup>30</sup> The Act of July 13, 1866 introduced the notion of a lien that would arise "upon all property and rights to property belonging to such person."<sup>31</sup> This lien arises immediately at the time a government entity assesses a tax liability, even if the government does not file a notice of the lien.<sup>32</sup>

Taken by itself, the broad language of the modern Tax Code providing for an automatic lien dispenses with the requirement that a tax lien be recorded in order to be valid against third party purchasers.<sup>33</sup> While an assessment lien may attach without filing, another section of the Tax Code explicitly requires that the Secretary file a notice of lien to perfect the lien.<sup>34</sup> The apparent discrepancy between these two Tax Code sections has created uncertainty in judicial decisions. In fact, the Internal Revenue Service has cited the language giving the government an automatic lien in instances where revenue agents have failed to file a proper notice of federal tax lien as is required to perfect all liens with regard to third party purchasers.<sup>35</sup>

The United States Supreme Court has taken a limited interpretation of the language giving the government an automatic lien and has held that the government must still file a notice of federal tax lien.<sup>36</sup> A recent decision involved a federal assessment against a husband and wife who transferred property to a third party. Specifically, the Court clarified that while the assessment creates a lien against the taxpayers, the automatic lien is impotent with regard to third parties and held that the government enjoys no better position than any other creditor who failed to file a lien. The Court stated:

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28. *United States v. First Nat'l Bank*, 458 F.2d 560, 563 (6th Cir. 1972).

29. *Id.* at 565.

30. *See Prince v. Bartlett*, 12 U.S. (8 Cranch) 431 (1814).

31. *First Nat'l Bank*, 458 F.2d at 565 (quoting Act of July 13, 1866, ch. 184, § 9, 14 Stat. 98, 107 codified, R.S. § 3186) (now codified as 31 U.S.C. § 191).

32. *See* I.R.C. § 6322 (1988).

33. The Tax Code suggests that the mere act of assessment is sufficient to create a valid tax lien and that a tax lien continues until the tax liability is satisfied or becomes unenforceable. *See* I.R.C. §§ 6321-6322 (1988).

34. I.R.C. § 6323(a) provides: "The lien imposed by section 6321 shall not be valid as against any purchaser . . . until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary." I.R.C. § 6323(a) (1988).

35. I.R.C. § 6323(f) (1988).

36. *United States v. McDermott*, 113 S. Ct. 1526, 1527 (1993); *see also In re Miller*, 98 B.R. 110, 112 (Bankr. N.D. Ga. 1989) (stating that a federal tax lien remains unsecured until it is properly filed). The proper place for filing a tax lien is the office which the taxpayer's state of residence has designated for that property. *See* I.R.C. § 6323(f)(1) (1988).

Upon that assessment, the law created a lien in favor of the United States on all real and personal property belonging to the McDermotts, including after-acquired property. Pursuant to 26 U.S.C. Section 6323(a), however, that lien could "not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof . . . has been filed."<sup>37</sup>

In *TKB International v. United States*, the United States Court of Appeals reiterated the rule in *McDermott*.<sup>38</sup> The issue before the court was whether the Internal Revenue Service had to comply with the general requirement that perfection of a lien requires filing. The court stated:

A crucial question, then, is whether there is any statutory requirement that general tax liens be filed. Here, that crucial question is easily answered. The validity and priority of a Section 6321 lien as against certain third parties with subsequently arising interests in the property . . . to which the lien has attached are governed by 26 U.S.C. Section 6323 . . . .  
As against subsequent purchasers, then, "we must deem the United States lien to have commenced no sooner than the filing of notice."<sup>39</sup>

The Ninth Circuit in *TKB* took an even more narrow view of the broad automatic lien provisions than the Supreme Court did in *McDermott*. The *TKB* court applied a statutory interpretation that adhered to the letter of the statute. The case involved a tax lien against real property that was filed outside the property's direct chain of title.<sup>40</sup> The real property was held by a corporation, Creative Ways, that transferred the property to Videorated, a second corporation owned by the same two shareholders which owned Creative Ways. While no consideration was given for the transfer, the recorded deed indicated that Videorated paid a transfer tax. Prior to the transfer, Creative Ways incurred significant payroll tax liabilities and the government filed notices of federal tax liens in the proper county on several later dates.<sup>41</sup> Through foreclosure, Videorated then lost the property to TKB, an entity that owed no taxes to the United States.

The government later sought to satisfy Creative Ways' tax liabilities by seizing the property from TKB. TKB responded by bringing a suit alleging that the Internal Revenue Service had wrongfully levied against the property and seeking to enjoin the Internal Revenue Service from selling the property. In resolving the issue of whether a reasonable inspection of the title by TKB would disclose the interest of the Internal Revenue Service, the court looked strictly at compliance with the state law recording requirements and not at whether the transferee had actual knowledge of the tax assessment. The

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37. *United States v. McDermott*, 113 S. Ct. 1526, 1527 (1993) (citations omitted) (quoting 26 U.S.C. § 6323(a)).

38. *TKB Int'l, Inc. v. United States*, 995 F.2d 1460, 1464 (9th Cir. 1993).

39. *Id.* (quoting *McDermott*, 113 S. Ct. at 1528).

40. *Id.* at 1461 (citations omitted).

41. *Id.* at 1462.

Ninth Circuit agreed with the district court that “one could reasonably conclude that a tax lien did not attach to the property.”<sup>42</sup> Because the government did not file its lien until after the transfer from Creative Ways to Videorated, the court concluded that the government failed to comply with its procedures to record a valid tax lien.<sup>43</sup> In addition, the court rejected the government’s argument that a sale of property in foreclosure is subject to a tax lien, as the language of the Tax Code might suggest.<sup>44</sup> The court reasoned that the purpose of this provision is to protect “properly filed” tax liens and therefore had no effect on the instant case where the lien was found to be invalid.<sup>45</sup>

The requirement that the government file a notice of tax lien in the appropriate county is so strong that the *TKB* court invalidated the lien even where a third party acquired the property with knowledge of the tax lien.<sup>46</sup> *McDermott* and *TKB* indicate that the automatic lien has no bearing on third party transferees and demonstrate that the letter of the statute should guide the courts in interpreting the validity of liens.

### *B. Priority of Tax Liens and I.R.C. Section 6323(b)*

Historically, I.R.C. section 6323(b) has not played a prominent role in bankruptcy proceedings. To most bankruptcy practitioners, the section is no more significant than the other enforcement sections buried at the end of the Tax Code. By itself, the section establishes a limited circumstance where a tax lien will be invalid against a good faith purchaser of personal property. When read together with the ability of a bankruptcy trustee to avoid liens invalid against bona fide purchases, section 6323(b) becomes intriguing because of its broad applicability to the numerous bankruptcy filings where a taxing agency is a creditor and has filed a lien.<sup>47</sup>

The legislative history of section 6323(b) is often cited by bankruptcy court decisions in applying the section as part of the trustee’s arsenal to attack liens. Prior to 1939, the tax law provided for a lien that was so

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42. *Id.* at 1465.

43. *Id.* See generally I.R.C. § 6323(f)(4) (1988).

44. I.R.C. §§ 7425(b) and (c)(1) provide, in pertinent part, that a nonjudicial sale of the property will not disturb an IRS lien unless the IRS is given notice of the sale. I.R.C. § 7425 (1988). See also *Whiteside v. United States*, 833 F.2d 820, 822 (9th Cir. 1987).

45. *TKB*, 995 F.2d at 1466.

46. *Id.*

47. Outside of bankruptcy, a federal tax lien can only be defeated in one of three ways: (1) competing lienors may establish that the property on which the government seeks to levy is not the taxpayer’s property; (2) creditors may claim a prior specific and perfected lien is entitled to precedence under the common-law rule that “the first in time is the first in right;” or (3) as long as a federal lien is unfiled, creditors may seek to bring themselves within the classes of a judgment creditor or bona fide purchaser, which are specifically protected by statute. Through a trustee’s avoidance powers, § 6323(b) enhances the limited ability to dispute tax liens. See Annotation, *Priority In Relation To Competing Liens and Other Interests Of Federal Tax Liens, As Affected By § 6323 Of The Internal Revenue Code of 1954*, 7 L. Ed. 2d 904 (1992).

powerful that it defeated even a bona fide purchaser of personal property.<sup>48</sup> As a result, someone who purchased an asset from a party who was subject to a tax lien would take the asset subject to the lien even if the purchaser had no notice of the lien.<sup>49</sup> While the law has evolved to expect purchasers of real property to do a title search, a similar expectation is unreasonable for purchasers of personal property, stock, financial instruments, or automobiles. A purchaser of a stock on an exchange does not anticipate purchasing a tax liability with the personal property. Accordingly, Congress recognized the detrimental effect of the omnipotent tax lien and carved out exceptions for securities and other types of tangible and intangible personal property:

The heavy burden on ordinary commercial transactions because of the impossibility of checking the recorder's office of the residence of every prior holder of a security to determine whether a tax lien had been filed against the holder motivated Congress to amend the Code in 1939 to create a superpriority which would be afforded to securities.<sup>50</sup>

The structure of I.R.C. section 6323(b) is no more complicated than a simple laundry list of items to which the section grants a "superpriority" status for bona fide purchasers. The section contains ten separate categories of personal property<sup>51</sup> including subsection (b)(1), which protects purchasers of securities. The securities category has the greatest practical significance in light of the Tax Code's broad definition of "security." The definition includes all forms of money, account receivables, retirement plans and other negotiable instruments, greatly enhancing a bona fide purchaser's protection with regard to tax liens.<sup>52</sup>

Section 6323(b) evolved for purposes that have no direct relationship to bankruptcy law. However, in enacting the Bankruptcy Code, Congress considered the interaction of section 6323(b) with the trustee's lien avoidance powers and Congress concluded that the trustee should be able to utilize section 6323(b) to dislodge essential personal and business assets from the grasp of tax liens.<sup>53</sup>

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48. The 1939 and 1954 statutes are substantially identical except that § 6323 of the 1954 Code contains, in subdivision (b), a provision as to the form of notice of the tax lien which has no counterpart in § 3672 of the 1939 Code. *See* *United States v. Snyder*, 149 U.S. 210 (1893).

49. *Id.* (holding secret tax liens to be good as against a purchaser for value without notice).

50. *See* H.R. REP. NO. 1884, 97th Cong., 1st Sess. 5 (1979).

51. I.R.C. § 6323(b)(1)-(10) list certain categories of personal property including:

- (1) Securities (money, shares of stock, negotiable instruments, etc.);
- (2) Motor vehicles;
- (3) Personal property purchased at retail;
- (4) Personal property purchased in casual sale if less than \$250;
- (5) Personal property subject to possessory lien;
- (9) Certain insurance contracts;
- (10) Passbook loans secured by an account.

52. I.R.C. § 6323(h)(4) (1988).

53. *See infra* notes 89-92 and accompanying text.

*C. Avoidance Powers and the Importance of a  
Trustee's Status as a Bona Fide Purchaser*

The trustee's avoidance powers permit a trustee to void a variety of voluntary and involuntary transfers of property made by the debtor prior to filing for bankruptcy.<sup>54</sup> Descending from the former Bankruptcy Act, section 545 of the Bankruptcy Code permits the trustee to avoid the fixing of certain statutory liens.<sup>55</sup> Avoiding a transfer enables the trustee or debtor-in-possession to recover the transferred property or its value.<sup>56</sup> In essence, certain pre-bankruptcy transfers can be invalidated under section 545 for such reasons as imperfection of interests, fraud, or failure to assert an interest in a timely fashion. These avoidance powers enable the trustee to increase the assets of the debtor's estate for the benefit of all creditors.<sup>57</sup>

The policy of fairness to all creditors and freeing of assets to permit a viable reorganization are greatly compromised by a tax lien. The problem arises because of the unlimited reach of a lien which arises automatically and attaches to all of a debtor's assets immediately upon the assessment of the tax.<sup>58</sup> The effect is to interfere substantially with the fundamental powers of a debtor including the ability to sell assets,<sup>59</sup> assign leases,<sup>60</sup> and to factor receivables. Specifically, the tax lien automatically subordinates all unsecured creditors behind the tax lien, and becomes secured up to the value of the debtor's unencumbered property. Affording so much protection to the government at the cost of other creditors creates an incentive for the government to push for a liquidation rather than to work towards a reorganization.

Section 545<sup>61</sup> provides the mechanism to avoid statutory liens, including tax liens.<sup>62</sup> A statutory lien arises by statute and comes into existence

54. The Bankruptcy Code's "strong-arm" clause provides that the trustee shall have the power to avoid any transfer of the debtor's property that is voidable by a judicial lien creditor, a creditor holding an unsatisfied judgment against the debtor, or a bona fide purchaser of real property from the debtor. See 11 U.S.C. §§ 544-546, 548-551 (1988). See also Tammy G. Cohen, *Recent Development In Bankruptcy Law: Trustee's Rights and Powers of Avoidance*, 1 BANK. DEV. J. 342 (1984).

55. Congress derived 11 U.S.C. § 545 largely from former § 67b and c of the Bankruptcy Act. See S. Rep. No. 989, 95th Cong., 2d Sess. 85 (1978); H.R. Rep. No. 595, 95th Cong., 1st Sess. 371 (1977).

56. 11 U.S.C. § 550 (1988).

57. While long-standing bankruptcy policy supports the enforcement of valid liens, Congress recognized that special interest groups had secured favorable legislation granting generous liens. In particular, rent liens often consumed a substantial portion of a bankruptcy estate and threatened the policy of equitable distribution among creditors. See H. Rep. No. 1409, 75th Cong., 1st Sess. 16 (1937).

58. See *supra* notes 25-42 and accompanying text.

59. 11 U.S.C. § 363 (b)(1) (1988).

60. 11 U.S.C. § 365 (1988).

61. 11 U.S.C. § 545 (1988).

62. A tax lien is a statutory lien because it arises "solely by force of a statute on specified circumstances or conditions" and is not based upon an agreement to give a lien or upon judicial action. 11 U.S.C. § 101 (1988).

without the consent of the debtor.<sup>63</sup> Unlike liens which arise under the Uniform Commercial Code or a mortgage, a statutory lien is not formed by agreement. Common examples of statutory liens include mechanic's, materialmen's, warehousemen's, and tax liens.<sup>64</sup> Following closely the structure of the former Bankruptcy Act, section 545 attacks four classes of statutory liens which may be avoided by the trustee in bankruptcy.<sup>65</sup> The second class establishes a bona fide purchaser test which has been described as the heart of a trustee's avoidance powers and is of principal importance in attacking tax liens.<sup>66</sup> This section vests the trustee with the power to avoid the fixing of any statutory lien on the property of the debtor that is "not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists."<sup>67</sup>

Thus, a trustee in bankruptcy does not merely step into a debtor's shoes, but takes significantly greater rights than the debtor had at the time of the filing. Case law interpreting the Act of 1898 is generally in accord and has recognized that a trustee takes the rights that a debtor could assert at the time of filing.<sup>68</sup> In addition, early case law permitted the trustee to act for the benefit of the estate, providing a judicial basis for codifying the strong-arm clause of the current Bankruptcy Code.<sup>69</sup>

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63. 11 U.S.C. § 101 is derived from the 1966 Amendment to the Bankruptcy Act and provides: "'statutory lien' means lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interests or judicial lien." *Id.*

64. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 314 (1977).

65. "The substance of this provision has been carried forward into §§ 545(2) and 546(b) (Supp. III 1979)." *In re Cummins*, 656 F.2d 1262, 1263 (9th Cir. 1981).

11 U.S.C. § 545 provides:

The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien—

(1) first becomes effective against the debtor—

- (a) when a case under this title concerning the debtor is commenced;
- (b) when an insolvency proceeding other than under this title concerning the debtor is commenced;
- (c) when a custodian is appointed or authorized to take or takes possession;
- (d) when the debtor becomes insolvent; . . .

(2) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists;

(3) is for rent; or

(4) is a lien of distress for rent.

11 U.S.C. § 545 (1988).

66. See S. Rep. No. 989, 95th Cong., 2d Sess. 85 (1978); H.R. Rep. No. 595, 95th Cong., 1st Sess. 371 (1977).

67. 11 U.S.C. § 545(2) (1988).

68. See *York Mfg. Co. v. Cassell*, 201 U.S. 344, 352 (1906).

69. *Commercial Credit Co. v. Davidson*, 112 F.2d 54, 56 (5th Cir. 1940).

For a debtor or trustee, the enforceability of a lien depends on its state of perfection as of the date the debtor files a petition for bankruptcy relief.<sup>70</sup> Status of perfection is not defined by the Bankruptcy Code and requires that one consider applicable state or federal law. In some circumstances, it may be possible to perfect a security interest after the debtor files for bankruptcy relief if applicable law permits perfection to relate back to a time prior to the filing.<sup>71</sup>

Under section 6323(b), the issue of whether a tax lien on personal property is properly perfected does not arise because the section provides that the lien is unenforceable against a bona fide purchaser. Thus, the interaction between sections 6323(b) and 545 provides the statutory basis for invalidating properly filed tax liens on personal property. Avoiding tax liens on personal property may appear unrelated to the Tax Code's policy of protecting bona fide purchasers in ordinary commercial transactions.<sup>72</sup> However, the result frees the debtor from the effect of the automatic lien, making it possible to reorganize. In enacting the current Bankruptcy Code, Congress debated the interaction between sections 6323(b) and 545 and chose not to limit a trustee's ability to avoid tax liens on personal property.<sup>73</sup> The alternative would be to paralyze the debtor and make liquidation inevitable in many cases where an estate is subject to a tax lien.

### III. THE INTERPLAY BETWEEN THE BONA FIDE PURCHASER PROVISIONS OF THE TAX AND BANKRUPTCY CODES

Bona fide purchaser protections are an important aspect of both the Bankruptcy and Tax Codes and have existed for most of this century. Together, the overlap creates an opportunity for a debtor or trustee in bankruptcy to avoid tax liens on a wide range of property, from retirement accounts to securities. The interplay exists because of the long-standing principle that favors bona fide purchasers who purchase personal property from an individual who is subject to a tax lien.<sup>74</sup> Generally, a bona fide purchaser is someone who gives adequate consideration and takes property without notice of a prior entity's claim on the property.<sup>75</sup> The interest in protecting the free flow of goods in the marketplace has long mandated that

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70. S. Rep. No. 989, 95th Cong., 2d Sess. 85 (1978); H.R. Rep. No. 595, 95th Cong., 1st Sess. 371 (1977) ("Liens that are not perfected or enforceable on the date of the petition against a bona fide purchaser are voidable.").

Bankruptcy cases are commenced through the filing of a petition. See 11 U.S.C. §§ 301, 302(a), 303(b), 304(a) (1988).

71. See 11 U.S.C. § 546(b) (1988).

72. See *supra* notes 46-47.

73. See *infra* notes 88-94.

74. See Michael J. Kaplan, *Invalidating Against Trustee in Bankruptcy, Statutory Liens Not Perfected or Enforceable at Date of Bankruptcy Against One Acquiring Rights of Bona Fide Purchaser From Debtor*, 21 A.L.R. FED. 635 (1974).

75. See I.R.C. § 6323(g) (1988).

such purchasers be permitted to retain the property, notwithstanding the claims of a lienholder who has a secret lien in the transferred goods.

While the Tax Code protects bona fide purchasers with regard to certain property, the Bankruptcy Code transforms a debtor or trustee in bankruptcy into a hypothetical bona fide purchaser on the date of the commencement of the case.<sup>76</sup> Even where the government has properly recorded a tax lien, the Tax Code provides that the lien is invalid against a bona fide purchaser for certain categories of personal property.<sup>77</sup>

In a nutshell, the following syllogism illustrates the trustee's or debtor's power to avoid a tax lien: Section 6323(b) of the Internal Revenue Code explicitly provides that a tax lien, even if properly filed, is invalid against a bona fide purchaser as to certain categories of personal property.<sup>78</sup> These categories include property that the typical bankruptcy debtor is most likely to possess; i.e. cars, items purchased at retail, securities, and similar items. Since the trustee in bankruptcy steps into the shoes of a bona fide purchaser and acquires all of the legal characteristics of one, it follows that the tax lien is unenforceable at the moment of the filing of the bankruptcy and subject to avoidance by the trustee.<sup>79</sup> Legislative history reinforces an interpretation in favor of the trustee or debtor having the power to avoid such liens.<sup>80</sup>

The United States has disputed whether a bankruptcy trustee has standing as a bona fide purchaser under the Tax Code. As will be discussed below, the majority of courts have held that a Chapter 11 debtor or trustee may avoid properly-filed tax liens on the property listed in the Tax Code's bona fide purchaser provisions found in I.R.C. section 6323(b). In reorganization cases under Chapter 11, the distinction between trustee and debtor-in-possession is less significant because the Bankruptcy Code gives the debtor-in-possession all of the powers of a trustee.<sup>81</sup> The common objective of

76. The Bankruptcy Code provides that the trustee may avoid a lien on property to the extent that such lien is not valid as against a bona fide purchaser on the commencement of the case. This provision gives the debtor or trustee the power to avoid improperly perfected liens or other transfers of property that have not been properly perfected. See 11 U.S.C. § 545(2) (1988).

77. See I.R.C. § 6323(b) (1988).

78. I.R.C. § 6323(b) (1988).

79. See 11 U.S.C. § 545(2) (1988) (providing that the trustee may avoid statutory liens such as tax liens which are "not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists.").

80. See *infra* notes 91-94 and accompanying text.

81. 11 U.S.C. § 1107(a) (1988). The Bankruptcy Code was enacted as the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, (92 Stat.) 2549 (codified as amended at 11 U.S.C. (1988)) on November 6, 1978, and most provisions became effective on October 1, 1979.

The Supreme Court held the Bankruptcy Reform Act to be unconstitutional, *Northern Pipeline Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 87 (1982). In response, many district courts adopted emergency rules under which bankruptcy matters were referred by the district courts to bankruptcy judges for determination, subject to review by the district court. See, e.g., Bankruptcy Rules for S.D.N.Y. (McKinney's New York Rules of Court 1983).

The Code and related provisions were amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. 98-353, 98 Stat. 333 (1984). That Act amends 28 U.S.C. § 1334 to provide that the district courts have original and exclusive jurisdiction under

freeing assets from liens, often a necessary ingredient for a successful reorganization, is shared by debtor-in-possession and trustee alike.<sup>82</sup>

*A. Chapter 11 Debtors May Avoid Tax  
Liens on Personal Property*

Corporations and individuals in economic straits often seek refuge in Chapter 11, which allows firms to remain intact as going concerns while undergoing a dramatic restructuring of debt obligations. The single most important attribute of a Chapter 11 is that it permits prior management and officers to remain in control of the assets and affairs of the business.<sup>83</sup> Under the provisions of Chapter 11, the debtor, also known as the debtor-in-possession, has all of the powers of a trustee to sell, lease, borrow, or use property.<sup>84</sup> In addition, the debtor can exercise avoidance powers to recover preferences and attack the validity of liens.<sup>85</sup>

Giving the debtor the power to avoid liens as an "ideal lien creditor" favors the policy of assuring that all creditors that might be equals in a hypothetical race outside of bankruptcy will be treated as equals once a debtor files a petition.<sup>86</sup> While tax claims enjoy many special protections in bankruptcy, tax liens on personal property of the type listed in I.R.C. section 6323(b) may be invalidated.<sup>87</sup>

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title 11 of the Bankruptcy Code. A new Chapter 6 of title 28 of the United State Code was also created, providing for the appointment of bankruptcy judges, who are given authority to hear and determine certain proceedings under Chapter 11 upon reference by the district court, and subject to review by the district court. 28 U.S.C. §§ 157, 158 (1988). By vesting jurisdiction in the district courts and limiting the role of bankruptcy judge, the constitutional objection was obviated.

82. *See infra* notes 95-105 (discussing cases where a lien on accounts receivable in the hands of a third party was avoided).

83. In Chapter 11 cases, a party can bring a motion to appoint a trustee if there is cause or if it is in the interest of creditors or any equity holders, but this power is rarely exercised because of the great expense of appointing a trustee. *See* 11 U.S.C. § 1104 (1988).

84. *See* 11 U.S.C. §§ 363-364 (1988).

85. The Bankruptcy Code gives the debtor-in-possession nearly all of the rights, powers, and duties of a bankruptcy trustee. *See* 11 U.S.C. § 1107(a) (1988).

Included in the powers given to a trustee in a Chapter 11 proceeding is the right to avoid the fixing of a statutory lien on the debtor's property if such a lien is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists.

11 U.S.C. § 545(2) (1988).

86. DOUGLAS G. BAIRD & THOMAS H. JACKSON, *CASES, PROBLEMS, AND MATERIAL ON BANKRUPTCY* 310-11 (1990).

87. The protections include 11 U.S.C. § 522(c)(2)(B) (1988) (preventing a debtor from avoiding a tax lien on exempt property) and 11 U.S.C. § 547(c)(6) (1988) (preventing a debtor from avoiding the perfection of a tax lien as a preference).

In *United States v. Sierer*,<sup>88</sup> a United States district court applied this reasoning to permit a debtor-in-possession to avoid a federal tax lien—holding the lien to be invalid as to the debtor's personal property. The case involved a Chapter 11 debtor who disputed the validity of an Internal Revenue Service lien with regard to a range of personal property, including money market accounts, stocks, individual retirement accounts, promissory notes, cash, and automobiles. The United States had not perfected the lien prior to the petition date.<sup>89</sup>

The debtors filed an adversary proceeding, claiming the right to avoid the tax lien on their property to the extent that a hypothetical bona fide purchaser could acquire such property free of any tax liens pursuant to I.R.C. section 6323(b). The Internal Revenue Service objected both on statutory and policy grounds, asserting that a debtor-in-possession lacks all of the attributes of a bona fide purchaser.<sup>90</sup> The court rejected both the statutory and policy arguments asserted by the government, stating that "a debtor-in-possession, by law, is given the same powers as a trustee, who by law, is given the powers of a hypothetical bona fide purchaser."<sup>91</sup>

The court's reasoning placed no weight on the Internal Revenue Service's reliance upon Chapter 13 cases, where courts have generally not allowed a debtor to avoid tax liens.<sup>92</sup> In addition, the court disagreed with the government's contention that the legislative history regarding tax liens and personal property in I.R.C. section 6323(b) is ambiguous. Instead, the court relied upon the clear meaning of the statute and prior judicial decisions in Chapter 11 and 7 allowing the trustee to avoid such tax liens.

The court's analysis demonstrates how Bankruptcy Code section 545(2) should be read in conjunction with I.R.C. section 6323 in that constructive notice of a lien does not, by itself, render the federal tax lien valid as against a hypothetical bona fide purchaser. As a result, the trustee or debtor-in-possession as a hypothetical bona fide purchaser could acquire the property enumerated in the Tax Code free and clear of a lien notwithstanding the fact that the public could be charged with notice of the lien through the recording system. The practical effect of the court's holding was to permit the debtor to avoid tax liens with regard to stocks, money deposited in bank and retirement accounts, and an automobile in the debtor's possession at the time of filing.

The notion of a hypothetical bona fide purchaser is difficult to grasp. The meaning of a bona fide purchaser outside of bankruptcy is someone who

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88. 139 B.R. 752, 755 (Bankr. N.D. Fla. 1991).

89. *Id.*

90. *Sierer v. United States*, 121 B.R. 884, 884-85 (Bankr. N.D. Fla. 1991).

91. *Sierer*, 139 B.R. at 755.

92. *Id.* See also *infra* notes 189-92 and accompanying text. However, the court cited with apparent approval a Chapter 13 case granting a debtor standing to exercise avoidance powers. See *In re Ware*, 99 B.R. 103, 105 (Bankr. M.D. Fla. 1989) (allowing a Chapter 13 debtor standing under the holding in *Coan v. United States*, 72 B.R. 483 (Bankr. M.D. Fla. 1987)).

takes property for consideration without knowledge of a prior interest in property. The debtor or bankruptcy trustee, who reads a debtor's bankruptcy petition, would immediately become aware of a pre-existing tax claim prior to taking possession of the debtor's property, providing the debtor has accurately scheduled all of his creditors. However, the status of a hypothetical creditor makes actual or constructive knowledge of a tax lien irrelevant because the Bankruptcy Code imputes the attributes of a bona fide purchaser to a debtor or trustee on the date of filing.<sup>93</sup>

Until recently, few cases have analyzed this interplay between the Tax and Bankruptcy Codes, even though the legislative history of the Bankruptcy Code clearly contemplates the result. In concluding that the debtor could avoid the tax lien, the court made several observations regarding the legislative history. First, the Senate version of the bill sought to include a provision which would have limited a debtor's power to avoid liens on property enumerated in I.R.C. section 6323. Second, the bill states that a trustee in a bankruptcy case has the same power which a bona fide purchaser has to take over certain kinds of personal property, despite the existence of a purported tax lien covering that property. Finally, Congress' decision to omit a Senate amendment that would have restricted the trustee's power to avoid liens indicates "with some clarity that section 545(2) was meant to afford section 6323(b) exemptions to the debtor-in-possession."<sup>94</sup>

In response, the federal government argued that the policy of preserving the free flow of goods in commerce is not furthered by permitting the trustee in bankruptcy to avoid tax liens on personal property.<sup>95</sup> Since a trustee in bankruptcy merely steps into the shoes of the debtor at the time of filing and in no way purchases the debtor's assets, this argument would appear to have merit. However, in enacting the Bankruptcy Code, Congress specifically rejected the argument that the trustee as a purchaser is a mere legal fiction that should not be extended to property listed in I.R.C. section 6323(b).<sup>96</sup> The Senate Proposal, which the Joint Committee deleted from the final bill, would have limited bankruptcy section 545's effect on tax liens, stated:

For purposes of subsection (a), if a statutory lien for taxes has been perfected in the manner prescribed by law for perfection against bona fide purchasers in general, such lien shall be considered perfected against the trustee with respect to all the debtor's property within the jurisdiction to which such perfection applies, notwithstanding that under applicable law

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93. 11 U.S.C. § 545(2) (1988). Independent of the Bankruptcy Code, the IRS's interpretation of the "purchaser" provisions of the Tax Code would appear to have merit. The Tax Code protects purchasers who "for adequate and full consideration in money or money's worth, acquire an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice." I.R.C. § 6323(h)(6) (1988).

94. *Sierer*, 139 B.R. at 754.

95. *Sierer*, 121 B.R. 884, 885.

96. 124 Cong. Rec. H11,114 (daily ed. Sept. 28, 1978); S17,431 (daily ed. Oct. 6, 1978).

such perfection may be ineffective against particular property or against particular purchasers or classes of purchasers.<sup>97</sup>

In explaining the effect of this proposed change, the Senate Report states: "Subsection (b) [of Section 545 as proposed by the Senate] limits the trustee's power to avoid tax liens under federal, state, or local law. For example, under Section 6323 of the Internal Revenue Code."<sup>98</sup> The Report goes on to explain in great detail the current state of the law under the Bankruptcy Act as granting the trustee the status of a bona fide purchaser that can avoid tax liens on "stocks, securities, motor vehicles, inventory, and certain household goods."<sup>99</sup>

After analyzing the legislative history and the proposed Senate amendment, the court concluded that "it is of no avail to attack the status of a debtor-in-possession as a bona fide purchaser."<sup>100</sup> In casting its holding in this strong language, the court was influenced by the fact that Collier, the leading authority on bankruptcy, states without exception that a trustee in bankruptcy can avoid federal tax liens and has all of the characteristics of a bona fide purchaser.<sup>101</sup>

The question of whether a debtor can avoid tax liens on personal property that is in the possession of a third party at the time of the filing of a petition raises issues that were the subject of a recent bankruptcy decision. A Bankruptcy Court in the Eastern District of New York recently applied the *United States v. Whiting Pools*<sup>102</sup> doctrine to a dispute between a Chapter 11 debtor and the United States regarding ownership of the debtor's

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97. S. 2266, 95th Cong., 2d Sess. § 545(b) (1978).

98. *Id.*

99. Alluding to the trustee's power to avoid a statutory lien which is unenforceable at the commencement of the case against a bona fide purchaser found at § 545(2), Notes of the Committee on the Judiciary, Senate Report No. 95-989 state, in pertinent part:

Section 545 of the House amendment modifies similar provisions contained in the House bill and Senate amendment to make clear that a statutory lien may be avoided under section 545 only to the extent the lien violates the perfection standards of 545. Thus a federal tax lien is invalid under section 6323(b) and (c) of the Internal Revenue Code of 1954. As a result of this modification, section 545(b) of the Senate amendment is deleted as unnecessary. The House amendment retains the provision of section 545(2) of the House bill giving the trustee in a bankruptcy case the same power which a bona fide purchaser has to take over certain kinds of personal property despite the existence of a tax lien covering that property. The amendment thus retains present law, and deletes section 545(b) of the Senate amendment which would have no longer allowed the trustee to step into the shoes of a bona fide purchaser for this purpose.

S. REP. NO. 989, 95th Cong., 2d Sess. 85 (1978).

100. *Sierer*, 139 B.R. at 755.

101. *Sierer*, 121 B.R. at 887 (quoting LAWRENCE KING, 4 COLLIER ON BANKRUPTCY ¶ 545.04, at 545-24 (15th ed. 1990)).

102. 462 U.S. 198 (1983).

accounts receivable held by a third party that was targeted by a tax lien.<sup>103</sup> *Whiting Pools* has become a landmark Supreme Court decision on the scope of the automatic stay. In *Whiting Pools*, the Internal Revenue Service seized Whiting's personal property pursuant to the Tax Code's levy and distraint provisions. The day after the Internal Revenue Service's seizure of the property, Whiting filed a Chapter 11 petition and continued to operate his business as a debtor-in-possession. Intending to sell the property in a tax sale, the Internal Revenue Service sought bankruptcy court approval for a declaration that the automatic stay provision of the Code was inapplicable to property seized by the Internal Revenue Service prior to the petition. The debtor counter-claimed, asserting that the property constitutes a part of the bankruptcy estate and should be returned to the debtor. In holding that possession of property does not give the Internal Revenue Service ownership, the Court maintained that "ownership of the property is transferred only when the property is sold to a bona fide purchaser at a tax sale."<sup>104</sup> The filing of a bankruptcy petition gives rise to a bankruptcy estate which extends to every interest in property that a debtor owns.<sup>105</sup> The statutory language and legislative history indicate an intent for the estate to extend "to all legal and equitable interests" of the debtor.<sup>106</sup> The bankruptcy estate even applies to property that may have been seized by a creditor prior to filing and that is no longer in the hands of a debtor.

The Court reasoned that the broad definition of a bankruptcy estate which includes all "legal and equitable" interests of the debtor includes rights associated with the seized property. The Supreme Court identified three interests retained by the debtor in the property seized by the Internal Revenue Service: (1) the right to a notice of sale;<sup>107</sup> (2) the right to redeem the property prior to a sale by paying its tax obligations;<sup>108</sup> and (3) the right to any surplus realized on the sale of the property.<sup>109</sup> Even though the proceeds of any sale would be unlikely to exceed the tax liabilities, the court found the above interests to be sufficient to consider the property part of the debtor's estate and ordered the Internal Revenue Service to turn over the seized property taken in enforcing a valid tax lien.<sup>110</sup>

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103. *United States v. Federation of Puerto Rican Orgs. (In re Federation of Puerto Rican Orgs.)*, 155 B.R. 44 (Bankr. E.D.N.Y. 1993).

104. *Whiting Pools*, 462 U.S. at 211.

105. *See* 11 U.S.C. § 541 (1988).

106. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 367 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 82 (1978) ("The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property, causes of action. . . and all other forms of property. . .").

107. *See* I.R.C. § 6335(b) (1988).

108. *See* I.R.C. § 6337(a) (1988).

109. *See* I.R.C. § 6342 (1988).

110. *Whiting Pools*, 462 U.S. at 211-12.

Applying the *Whiting Pools* doctrine, a district court considered the estate's interest in property in the hands of a third party.<sup>111</sup> Specifically, a state agency owed the debtor approximately \$1,715,000 for pre-petition services provided under Medicaid.<sup>112</sup> Prior to the debtor's filing, the Internal Revenue Service mailed a notice of levy to the state agency, showing pre-petition tax liabilities assessed against the debtor in the amount of \$3,400,000 for unpaid employment taxes. However, the Internal Revenue Service did not file a notice of lien with the New York Secretary of State until after the debtor filed for Chapter 11. The Internal Revenue Service objected to payments made by the state agency to the debtor-in-possession, asserting that the Service had a secured claim in the proceeds held by the agency. The court ultimately held that the claim was unsecured and not valid against a hypothetical bona fide purchaser.<sup>113</sup>

The court reasoned that the debtor's estate had an interest in property held by the third party even though it was subject to an Internal Revenue Service lien and levy.<sup>114</sup> The receivables from the state office were found to be analogous to the property in *Whiting Pools* and "are the undisputed property of the reorganization estate."<sup>115</sup> Unlike money which is governed by a specific Tax Code provision, the Internal Revenue Service does not acquire ownership of receivables merely by serving a notice of levy on the organization owing on the receivables.<sup>116</sup>

Finding the receivables in the possession of a state agency to be property of the bankruptcy estate, the court then considered whether the Internal Revenue Service had a secured interest in the receivables. The court noted that the general principle against recognizing secret liens applies to the Internal Revenue Service, and turned to state law to determine if filing a notice of levy would be sufficient to perfect its interest in the receivable.<sup>117</sup> The court concluded that because state law required actual possession to perfect such an interest without filing, the Internal Revenue Service had only an unsecured claim.<sup>118</sup>

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111. *In re Federation of Puerto Rican Orgs.*, 155 B.R. 44, 45 (Bankr. E.D.N.Y. 1993).

112. *Id.*

113. *Id.*

114. *Id.* at 47. I.R.C. § 6331 (1988) (if a person liable to pay taxes refuses to pay within ten days after notice and demand, the IRS may collect the tax by levy upon all property and rights to property belonging to the person). The section also provides that the IRS may then seize and sell the property to satisfy the tax liabilities. *Id.*

115. *Federation of Puerto Rican Orgs.*, 155 B.R. at 47.

116. *Id.*

117. *Id.* at 48 (citing *United States v. Speers*, 382 U.S. 266, 275 (1965) (an unfiled federal tax lien is not valid against trustee in bankruptcy; Congress has made no exception for the IRS to a "general policy against secret liens"); *In re Hudgins*, 967 F.2d 973 (4th Cir. 1992) (a Chapter 11 debtor could avoid improperly filed federal tax liens (under 11 U.S.C. § 545(2) (1988)) if the purchaser would have no constructive notice). The Ninth Circuit has held that state law determines whether an IRS lien is enforceable against a third party. *See In re Loretto Winery Ltd.*, 898 F.2d 715, 718 (9th Cir. 1990).

118. *Id.* at 48-49.

Second, the court focused on whether the debtor could utilize section 6323(b) to avoid the tax lien on the accounts receivable. In reasoning that a debtor can avoid the lien, the court stated that section 6323(b) supports the argument that a debtor can invalidate the lien regardless of its enforceability under state law. The court stated that because a trustee continues to have the power to avoid federal tax liens which are invalid under section 6323(b), it must also have the power to avoid unfiled tax liens.<sup>119</sup> With regard to personal property in the hands of a third party, the holding indicates the court's view that a tax lien would be invalid and subject to avoidance by a debtor under section 545(2).

### *B. A Chapter 7 Trustee Has the Identical Right to Avoid Tax Liens as a Chapter 11 Debtor*

Chapter 7 bankruptcies involve a liquidation of assets orchestrated by a court-appointed trustee. Chapter 7 enables an honest debtor to gain a fresh start by obtaining forgiveness of most debts with little or no cost incurred.<sup>120</sup> Shortly after the filing of a Chapter 7 petition, an interim trustee will be appointed to whom the debtor surrenders all non-exempt property of the estate.<sup>121</sup> Through sale, the trustee attempts to maximize the cash that can be received from the estate's property. To assist in maximizing the size of a Chapter 7 estate, the Bankruptcy Code gives the trustee extraordinary powers to set aside liens, recover property, avoid certain types of transfers, and assume or reject executory contracts and unexpired leases.<sup>122</sup>

The government has attempted to distinguish between the Chapter 7 trustee and the Chapter 11 debtor-in-possession, asserting that the former does not have statutory avoidance powers and should therefore not be able to escape tax liens on statutory property.<sup>123</sup> Courts, including the sixth and the Seventh Circuits,<sup>124</sup> have categorically rejected this argument as con-

119. *Id.* at 49 (quoting LAWRENCE KING, 4 COLLIER ON BANKRUPTCY ¶ 545.04[3] (15th ed. 1993)).

120. *See* *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (emphasizing the purpose of a liquidation as relieving the "honest debtor from the weight of oppressive indebtedness. . .").

121. 11 U.S.C. § 701(a) (1988).

122. *See* *Commodity Futures Trading Comm'n v. Weintraub*, 41 U.S. 343, 344 (1985) (holding that the right to assert the attorney-client privilege passes to the trustee in bankruptcy).

123. The *Miller* court recognized the power of a Chapter 7 debtor to utilize the avoidance powers under 11 U.S.C. § 545(2) to avoid a tax lien on any property which is not properly perfected at the time of the commencement of the case. *In re* Jack and Sandra Miller, 98 B.R. 110, 112 (Bankr. N.D. Ga. 1989). *See also* *In re* Duane Trucking Co., 32 B.R. 182 (Bankr. N.D. Iowa 1983).

124. *See* *United States v. Daniel (In re R & T Roofing Structures)*, 79 B.R. 22 (Bankr. D. Nev. 1987) (allowing Chapter 7 debtor to utilize avoidance powers, under 11 U.S.C. § 547, to avoid an IRS seizure of funds in a bank account to satisfy a lien arising from trust fund taxes). The district court in *Daniel* distinguished two bankruptcy court decisions which denied a debtor the right to avoid seizures on trust fund taxes where the debtor's estate had actually separated the funds and earmarked them for payment to the Internal Revenue Services. *Id.* at 24 (quoting *In re* Rodriguez, 50 B.R. 576 (Bankr. E.D.N.Y. 1985); *In re* Razorback Ready-Mix Concrete

trary to the legislative intent for a trustee to have all of the characteristics of a bona fide purchaser.<sup>125</sup>

In Chapter 7 bankruptcy cases, courts have held that a properly filed federal tax lien is not valid against property defined in section 6323(b). A Chapter 7 trustee has the full statutory power of a bona fide purchaser, under both the Tax and Bankruptcy Codes, that may be exercised against tax liens and preferential transfers.<sup>126</sup> After determining that a Chapter 7 trustee had the power to avoid federal tax liens on securities, in *In re Christison*, the Seventh Circuit considered whether a debtor's right to receive payments from a lease transaction constitutes a security that would be exempt from a federal tax lien. The term "security," as defined in section 6323(b) and used by the *Christison* court, extends well beyond the traditional categories of investment contracts to include all forms of money. "Securities" are one of the potentially broadest categories of property listed in section 6323(b), which creates a great potential to invalidate federal tax liens with regard to a variety of financial instruments, money, and contractual rights.<sup>127</sup>

While concluding that the trustee possessed the right to avoid tax liens on securities, the court ultimately ruled in favor of the government, finding the tax lien to be valid because the lease payments did not constitute a security and were outside of the protection of section 6323(b).<sup>128</sup> The Seventh Circuit decision in *Christison* illustrates a definition of security that would exclude certain types of non-negotiable financial instruments from the Tax Code's otherwise broad definition. In *Christison*, the government filed a notice of federal tax lien for unpaid taxes for the three years prior to the bankruptcy filing and levied upon funds held by the debtor's landlord.<sup>129</sup> These funds were paid to the landlord pursuant to a contract that provided that the debtor would pay a portion of its profits from retail sales to the landlord.<sup>130</sup> The court declined to hold that the amounts owed by the debtor under the lease arrangement constituted "money," a term contained

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Co., 45 B.R. 917 (Bankr. E.D. Ark. 1984)).

125. *United States v. In re John Darnell*, 834 F.2d 1263, 1265 n.5 (6th Cir. 1987).

126. *In re Christison*, 960 F.2d 613, 614 n.3 (7th Cir. 1992).

127. The following definition of "security" in the Tax Code has invited a broad interpretation by the courts:

[A]ny 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.

I.R.C. § 6323(h)(4) (1988).

128. *Christison*, 960 F.2d at 616.

129. *Id.* at 613.

130. *Id.* at 614.

within the Tax Code's definition of a security.<sup>131</sup> Relying on prior decisions and legislative history, the court concluded that money must be in a form which is negotiable in order for it to be within the ambit of the Tax Code's definition.<sup>132</sup> The court's rationale was that an attempt to enforce a lien on an accounts receivable or a contract right would not impair the negotiability of securities in a manner that would seriously interfere with business transactions.<sup>133</sup> Thus, the court's definition limits "securities" to items which are fungible and likely to be traded in regular commercial transactions.

A later bankruptcy court decision in *Larson v. Orix*<sup>134</sup> reiterated the principle that a Chapter 7 trustee could exercise avoidance powers based on section 6323(b) and void a properly-filed tax lien. Unlike the Seventh Circuit in *Christison*, the *Orix* court found the property to constitute a "security" permitting the trustee to avoid the lien.<sup>135</sup> The case involved a Chapter 11 bankruptcy case that was converted to a case under Chapter 7. The property of the estate consisted of corporate stock, rents from an apartment complex, and a restitution order requiring a return of funds to the debtor, all of which arguably fall within the categories of assets described in section 6323(b).

At the time of the dispute with the Internal Revenue Service, the trustee had already liquidated the assets of the corporation and held approximately \$16,000 in proceeds.<sup>136</sup> While the court stated that the proceeds in the hands of the trustee are subject to the tax lien, the court nonetheless ruled that "the tax liens do not attach to Midwest Aviation stock owned by the Debtor. . . ."<sup>137</sup> The court based its decision on the fact that stock interests fall within the definition of a security for purposes of I.R.C. section 6323(b), making a tax lien avoidable with respect to the stock.<sup>138</sup> In addition, the court noted that absent a piercing of the corporate veil, a debtor who sells stock in the corporation is not selling the property or assets of the debtor. Presumably, the court discussed this issue to rebut an Internal Revenue Service claim that a portion of the corporate assets of the debtor might include real property or other items of non-personal property that fall outside of section 6323(b).

With regard to rents held by the estate, the court reached a similar conclusion; holding the tax lien to be avoidable.<sup>139</sup> Because the Bankruptcy

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131. *Id.* at 615.

132. *Id.* See also I.R.C. § 6323(h)(6) (1988).

133. *Christison*, 960 F.2d at 616 (quoting H.R. REP. NO. 855, 76th Cong., 1st Sess. 26 (1939)).

134. *Larson v. Orix*, 1993 Bankr. Lexis 1518, at \*24 (Bankr. D.N.D., July 1, 1993).

135. *Id.*

136. *Id.* at \*11.

137. *Id.* at \*24.

138. See I.R.C. § 6323(b)(1) (1988).

139. *Larson*, at \*24.

Code specifically provides that statutory liens on rents are avoidable, the court did not rely upon section 6323(b). Specifically, the Code provides that "the trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien . . . is for rent."<sup>140</sup> The United States attempted to label its lien as an interest in "proceeds from the leasing" of the apartment complex as an effort to fall outside of section 545(3). The court's disposition of this argument emphasized that tax liens are statutory and that the Code expressly authorizes a trustee or debtor to avoid statutory liens on rent obligations.<sup>141</sup> In discussing the avoidance powers of a Chapter 7 trustee, the court cited a number of decisions involving Chapter 11 debtors suggesting that no distinction should be made between trustees in liquidations and a debtor-in-possession in a Chapter 11.<sup>142</sup> In summary, the court found that both Chapter 7 and Chapter 11 trustees have equal standing as bona fide purchasers to avoid tax liens.

### 1. Cases Converted from Chapter 11 to Chapter 7 Should Not Affect the Right to Avoid Tax Liens

Conversion is the procedural process for changing a case filed under one Chapter of the Bankruptcy Code to a different Chapter.<sup>143</sup> The device is often used as a creditor's remedy, whereby a creditor or party-in-interest may ask a bankruptcy court to convert a reorganization case to a liquidation. The broad grounds for conversion include the following: Failure of a debtor to propose a reorganization plan, substantial delay, or where the continuation of a case is unlikely to further the best interests of creditors.<sup>144</sup>

In *United States v. Hunter*,<sup>145</sup> the district court for the Northern District of Ohio took a view with regard to Chapter 11 cases that are converted to cases under Chapter 7 that departs from the analysis applied in other published decisions. In *Hunter*, the Internal Revenue Service challenged whether a Chapter 7 trustee meets the requirements of a bona fide purchaser when the Internal Revenue Service filed a notice of federal tax lien prior to the case's conversion to Chapter 7.<sup>146</sup> There, the court held that the filing of a proof of claim by the Internal Revenue Service during a Chapter 7 had the effect of perfecting the government's interest in an automobile, thereby denying the Chapter 7 trustee status as a bona fide purchaser.<sup>147</sup> The holding, which denied the trustee the power to avoid the

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140. 11 U.S.C. § 545(3) (1988).

141. *Larson*, at \*23.

142. *Id.* at 17; *In re Henderson*, 133 B.R. 813 (Bankr. W.D. Tex. 1991); *In re Sierer*, 121 B.R. 884 (Bankr. N.D. Fla. 1990).

143. *See* 11 U.S.C. § 1112 (1988).

144. *See* 11 U.S.C. § 1112(b) (1988); H. Rep. No. 595, 95th Cong., 2d Sess. 117 (1978).

145. 158 B.R. 984 (N.D. Ohio 1993).

146. *Id.* at 985.

147. *Id.* at 987.

tax lien, is problematic in that the Bankruptcy Code imputes all of the attributes of a bona fide purchaser to the trustee or debtor in bankruptcy. Therefore, it should be irrelevant what knowledge a debtor or trustee actually possesses at the inception of a case. This minority decision applied a constructive knowledge theory that is inconsistent with the holdings of other appellate and bankruptcy court decisions.

The conversion of a case from one chapter of the Bankruptcy Code to another chapter should not affect the court's analysis of the lien avoidance issues. Conversions commonly occur when a debtor-in-possession fails to exercise avoidance powers for the benefit of creditors to recover preferential transfers or to set aside invalid liens.<sup>148</sup> Therefore, upon conversion of a case to Chapter 7, the trustee must have the equivalent avoidance powers that a trustee or debtor-in-possession could exercise in a Chapter 11 case.

Distinguishing between a Chapter 11 trustee's avoidance powers and those possessed by a Chapter 7 trustee contradicts basic bankruptcy principles. In enacting Chapter 11, Congress sought to give financially distressed entities an opportunity to reorganize and to avoid an unnecessary liquidation and the resulting loss of jobs. Limiting the powers of a Chapter 7 trustee in a case that was originally filed as a Chapter 11 bankruptcy places an unfair cost on the right to file under Chapter 11. Because the Bankruptcy Code gives debtors the right to file Chapter 11 and the benefit of the doubt with regard to an exclusive period to file a reorganization plan, Congress could not have intended courts to discriminate against cases converted to Chapter 7.<sup>149</sup> Since a debtor always has the option of choosing between a Chapter 11 and a Chapter 7 filing, the potential loss of avoidance powers should not be a factor motivating debtors to opt for a Chapter 7 liquidation in lieu of a reorganization under Chapter 11.

A final issue raised by the *Hunter* decision concerns whether property stolen from the debtor and later returned to the estate pursuant to a restitution should be subject to avoidance under section 6323(b). In *Hunter*, the bankruptcy estate contained \$17,500 which a thief had previously returned to the estate, but it was unclear what property was originally stolen from the debtor. The court held that while the Chapter 7 trustee steps into the shoes of a hypothetical bona fide purchaser, even where no purchaser exists, the trustee cannot avoid a lien with regard to stolen property.<sup>150</sup> The court reasoned that no purchaser actually existed and "it would be ridiculous to call an individual who converts property as a 'purchaser' of the same."<sup>151</sup>

While Congress intended the bona fide purchaser provisions of the Tax Code "to encourage free movement of these assets in general commerce, and

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148. See *Leird Church Furniture Mfg. Co. v. Union Nat'l Bank (In re Leird Church)*, 61 B.R. 444 (Bankr. E.D. Ark. 1986) (stating that the trustee, as opposed to the debtor, is vested with the right to bring adversary proceedings).

149. See 11 U.S.C. § 1121(b) (1988).

150. *Hunter*, 158 B.R. 984.

151. *Id.*

to protect bona fide purchasers,<sup>152</sup> this reasoning should not have been the basis for the court's result. The free flow of goods rationale reflects the legislative purpose behind the Tax Code not the Bankruptcy Code. The trustee in bankruptcy is vested with avoidance powers to recover property for the benefit of the estate so that a creditor who has acted for its own interest, but has failed to comply with the requirements to perfect a security interest, will not benefit at the cost of other creditors. The fact that a theft or a conversion is not a commercial transaction is irrelevant because the Code imputes all of the attributes of a bona fide purchaser to the trustee on the date of the petition. It is irrelevant how the estate actually acquires the property or whether a transaction actually occurred, so long as the property is part of the bankruptcy estate at the time of the petition.<sup>153</sup>

In cases of stolen property, a more appropriate line of reasoning would be to look at the origin of the property stolen. If the property stolen from the estate is personal property subject to avoidance under I.R.C. section 6323(b), then the trustee should be able to avoid a tax lien on the money that is returned pursuant to the restitution order. Since the policy behind the tort of conversion is to put the plaintiff in the position that it would be in had the tort never occurred, the applicability of the lien avoidance should be determined by the nature of the property converted rather than an analysis of the transaction.

## 2. The Avoidance of Liens by a Chapter 7 Debtor; the Uncertain State of the Law

In scrutinizing the law on tax lien avoidance on personal property, the motivations of the trustee and the debtor are likely to be different. The trustee in a Chapter 7 bankruptcy case may want to avoid a tax lien on personal property in order to preserve the property of the bankruptcy estate for the benefit of the creditors.<sup>154</sup> Accordingly, a trustee's interest in avoiding tax liens will be directed at non-exempt assets, which a debtor would have to surrender to the trustee.<sup>155</sup> The debtor, in contrast, ordinarily has no desire to maximize assets for the benefit of creditors.<sup>156</sup> While

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152. 11 U.S.C. § 541 (1988).

153. *See* 11 U.S.C. § 541 (1988) (defining property of the estate as all legal and equitable interests of the debtor in property).

154. *See supra* notes 112-115. Ostensibly, the trustee's objective will be to liquidate the estate and use the proceeds to pay dividends to the creditors.

155. Exempt property is property that which the debtor is not required to surrender to the bankruptcy court. *See* 11 U.S.C. § 522(d)(1)-(d)-(d)(11).

156. Another situation exists where a debtor may be motivated to avoid a tax lien on personal property. For example, in the case of priority taxes, a Chapter 7 is useless. A priority tax may be paid off in small monthly payments in a Chapter 13. The main benefit is that, by virtue of the automatic stay, it keeps the taxing entity from seizing assets. If the tax claim that is to be paid through the Chapter 13 plan is unsecured (i.e., there is no tax lien attaching to it), then the taxing entity is not entitled to continue accruing interest on the claim. On the other hand, if the claim is secured, it must include interest. Thus, the debtor may look forward to

a tax lien attaches to exempt personal property, the debtor will wish to enjoy the full benefit of the use and ownership of the property without having to worry about seizure by the taxing entity to satisfy a tax lien.<sup>157</sup> A Chapter 7 trustee has no incentive to avoid transfers of property that a debtor could exempt because such actions would not increase the overall size of the estate. As a result, Bankruptcy Code section 522(h) and the legislative history give the debtor the right to exercise avoidance powers where the trustee fails to act. The legislative history states: "If the trustee does not pursue an avoiding power to recover a transfer of property that would be exempt, the debtor may pursue it and exempt the property, if the transfer was involuntary and the debtor did not conceal the property."<sup>158</sup> Subsection (h)(1) explicitly states that a debtor will have avoidance powers under Bankruptcy Code section 545, giving a debtor the trustee's status to avoid liens as a bona fide purchaser.<sup>159</sup>

While few published decisions have specifically addressed a Chapter 7 debtor's, as opposed to the trustee's, standing to avoid liens on personal property pursuant to I.R.C. section 6323(b),<sup>160</sup> the Bankruptcy Code clearly indicates that Chapter 7 debtors possess this power.<sup>161</sup> Numerous cases have strongly indicated, at least in dicta, that the debtor shares the trustee's ability to avoid tax liens.<sup>162</sup>

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paying substantially less money over the life of the plan if he can eliminate any tax liens which may have been recorded against the property and thus render the claims unsecured. Thus, a debtor will be better off paying a tax claim through Chapter 13 (adjustment of debt for an individual. 11 U.S.C. § 1301-1330) than through a Chapter 7 liquidation.

157. 11 U.S.C. § 522. Generally, a debtor will have the option to select a menu of state or federal exemptions which, to a different extent, permit a debtor to exempt items including: household belongings, tools of the trade, homestead, and other necessities from most judgment and statutory liens.

158. H.R. REP. NO. 595, 95th Cong., 1st Sess. 360 (1977).

159. 11 U.S.C. § 522(h)(1) (1988).

160. *In re Branch*, No. 92-00227-5-ATS 1993 WL 540476 (Bankr. E.D.N.C. Sept. 28, 1993) (granting a Chapter 7 debtor's objection to tax lien as to certain assets by operation of I.R.C. § 6323(b) (1988)); *In re Hanson*, 132 B.R. 406 (Bankr. E.D. Ga. 1991) (denying the Chapter 7 debtor's attempt to hold the IRS in contempt for violation of the automatic stay for asserting a lien on assets, on the ground that the assets were not included in the categories prescribed by I.R.C. § 6323(b) (1988)). Neither case cited challenged the debtor's standing to attack the validity of the lien.

161. 11 U.S.C. § 522(h)(1) (1988). In the event the trustee fails to initiate a lien avoidance action pursuant to 11 U.S.C. § 545(2) (1988), because there are no nonexempt assets which would benefit the estate, the debtor personally may initiate such an action by operation of § 522(h), which provides that the debtor may avoid a lien as to exempt property if the trustee could have avoided it under § 545, but fails to do so.

162. *In re Goebel*, 153 B.R. 593 (Bankr. M.D. Fla. 1993) (while denying a Chapter 7 debtor standing to avoid a tax lien on § 6323(b) assets because they were not exempt, the court stated in dicta: "In certain situations the Bankruptcy Code grants a Chapter 7 debtor avoidance powers otherwise limited to the trustee. For example, 11 U.S.C. § 522(h) confers standing upon a debtor to invoke the trustee's section 545 powers to the extent that the debtors could exempt the property involved."); *In re Henderson*, 133 B.R. 813 (Bankr. W.D. Tex. 1991) (while denying a Chapter 13 debtor standing to avoid a tax lien on securities and other § 6323(b) assets, the court stated that "some limited powers to avoid transfers are granted in Chapter 5 [specifically § 522(h)] to the debtor if the property could have been claimed as exempt. . . .").

The threshold question is whether courts ever recognize the debtor's standing to avoid or extinguish a properly-filed tax lien.<sup>163</sup> Clearly, the trustee has the power to avoid an improperly-filed tax lien.<sup>164</sup> More importantly, courts have permitted the trustee, and in some instances, the debtor to avoid properly filed tax liens which were found to be invalid for one reason or another, without letting the prohibition of Bankruptcy Code section 522(c)(2)(B) interfere with a debtor's standing to avoid a tax lien.<sup>165</sup> Other courts have refused to avoid a tax lien for reasons going to the merits of the lien, rather than to the debtor's standing to raise the issue.<sup>166</sup>

In most of the cases recognizing the trustee's or debtor's power to avoid invalid tax liens, the authority cited is the lien avoidance power under Bankruptcy Code section 545(2). However, other cases have relied upon Bankruptcy Code section 506 to give a debtor standing.<sup>167</sup> It would seem logical that a tax lien which is invalid for any reason may be avoided, and, therefore, a tax lien which by the very language of I.R.C. section 6323(b) is invalid as to certain personal property should be avoidable, at least as to exempt property.

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163. Arguments have been raised against recognizing the trustee's or debtor's lien avoidance powers. In the case of Chapter 13, the argument often rests, as well, on 11 U.S.C. § 1303 (1988) which arguably limits the right of the debtor by not explicitly granting such debtor lien-avoidance powers.

164. See *In re Southern Transfer & Storage Co.*, 157 B.R. 691 (Bankr. M.D. Fla. 1993) (permitting the avoidance of a tax lien that was not recorded on motor vehicle records as required by state law); *In re De La Vergne, II*, 156 B.R. 773 (Bankr. E.D. La. 1993) (avoiding a tax lien because the taxpayer's name was spelled incorrectly); *In re Barnett*, 62 B.R. 638 (Bankr. D. Md. 1986) (finding an otherwise properly filed lien to be invalid because it was recorded in the wrong county).

165. *In re Schwartz*, 954 F.2d 569 (9th Cir. 1992) (a debtor in a Chapter 13 can avoid a properly-filed tax lien where the lien arose from an assessment which occurred during the automatic stay and was therefore void); *In re Voelker*, 164 B.R. 308 (Bankr. W.D. Wis. 1993) (a Chapter 13 debtor could object to, and therefore avoid, a properly filed tax lien on the grounds that it was invalid against property exempt from tax levy pursuant to I.R.C. § 6334 (1988)); *In re King*, 102 B.R. 184 (Bankr. D. Neb. 1989), *rev'd*, 137 B.R. 43 (Bankr. D. Neb. 1991) (same ruling); *In re CS Assoc.*, 161 B.R. 144 (Bankr. E.D. Pa. 1993) (holding a properly filed tax lien invalid as to assets acquired post-petition); *In re Hudgins*, 967 F.2d 973 (4th Cir. 1992) (a properly filed lien naming a corporation was held invalid as to assets of the corporation owner's individual Chapter 11 estate).

166. See, e.g., *In re Burns*, 974 F.2d 1064 (9th Cir. 1992) (a tax lien was valid on the merits but, by not raising the standing issue under 11 U.S.C. § 522(c)(2)(B) (1988), appearing implicitly to recognize a debtor's right to assert the argument). Contrary, however are some cases which have interpreted § 522(c)(2)(B) to prohibit the debtor's or trustee's powers to avoid tax liens on any basis. See, e.g., *In re Quillard*, 150 B.R. 291 (Bankr. D. R.I. 1993) (denying a Chapter 7 debtor the power to avoid a tax lien on exempt individual retirement account); *In re Mattis*, 93 B.R. 68 (Bankr. E.D. Pa. 1988) (denying a Chapter 13 debtor standing to avoid lien on personal property claimed non-lienable under I.R.C. § 6323(b) (1988)); *In re Henderson*, 133 B.R. 813 (Bankr. W.D. Tex. 1991) (denying a Chapter 13 debtor standing to avoid lien on non-exempt property because of 11 U.S.C. § 522(c)(2)(B) (1988) and also because of the court's view that 11 U.S.C. § 1303 (1988) limits a debtor's avoidance powers).

167. For example, see the following pre-*Dewsnup* cases: *In re Frengel*, 115 B.R. 569 (Bankr. N.D. Ohio 1989) (permitting the debtor in Chapter 7 to avoid the unsecured portion of a tax lien); *In re Dembo*, 126 B.R. 195 (Bankr. E.D. Pa. 1991) (same result, by operation of 11 U.S.C. § 506 (1988)). In 1992, the Court held that a debtor could not strip a lien on real property under 11 U.S.C. § 506 (1988). *Dewsnup v. Timm*, 502 U.S. 410 (1992).

A bankruptcy court decision from the Northern District of Georgia relied upon a Chapter 7 debtor's avoidance powers under section 545(2) to defeat an improperly-perfected tax lien.<sup>168</sup> The court's summary of the law clearly articulates that a Chapter 7 debtor may protect exempt property from an invalid federal tax lien. The case illustrates one of many circumstances where a creditor might attempt to enforce an invalid lien.<sup>169</sup> Invalid liens present a circumstance where a debtor need not exercise avoidance powers in order to protect an exempt asset from the actions of creditors.<sup>170</sup> In the above bankruptcy court decision, the automatic stay provided a rationale for the court's refusal to allow the Internal Revenue Service to levy on property pursuant to an invalid lien: "A filed petition . . . operates as a stay, applicable to all entities of . . . any act to create, perfect or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title."<sup>171</sup>

In all Chapter 7 cases, the automatic stay remains in effect until the case is closed, dismissed, or a discharge is granted.<sup>172</sup> The only exception is where a creditor moves the court for relief from the automatic stay.<sup>173</sup> The court cited the legislative interests in providing debtors with a fresh start and in insuring equality in distribution as justification for the imposition of the automatic stay. Furthermore, the court noted that the automatic stay is applicable to all claims, "even non-dischargeable and priority claims."<sup>174</sup> Accordingly, the court held that in the absence of a valid lien, the Internal Revenue Service would not be granted relief from the automatic stay and had no basis for objecting to the disbursement of exempt funds subject to an invalid lien.<sup>175</sup>

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168. *In re Miller*, 98 B.R. 110, 112 (Bankr. N.D. Ga. 1989). *See also In re Dunne Trucking Co.*, 32 B.R. 182 (Bankr. N.D. Iowa 1983).

169. A tax lien may be invalid as to a debtor's property in any one of the following circumstances:

- (1) Not recorded.
- (2) Recorded, but in the wrong county.
- (3) Recorded, but is being asserted against the wrong property or property that is not property of the estate. For example, a tax lien against a partner is asserted against partnership property.
- (4) The lien is for a different tax period. For example, the lien is for a year which was discharged in a previous bankruptcy, but the IRS is now attempting to assert it for a non-discharged tax year.
- (5) The IRS is attempting to use a lien for taxes which were discharged in a previous bankruptcy against after-acquired assets.
- (6) The lien has expired.
- (7) The IRS recorded the lien after the bankruptcy filing in violation of the automatic stay.
- (8) The lien is based upon an assessment which, itself, is invalid or void.
- (9) Technical defects such as not signed.

170. *Miller*, 98 B.R. at 113.

171. 11 U.S.C. § 362(a)(5) (1988).

172. 11 U.S.C. § 362(c)(2) (1988).

173. *See* 11 U.S.C. § 362(d) (1988).

174. *Miller*, 98 B.R. at 113.

175. *Id.*

Courts denying a Chapter 7 debtor's right to avoid tax liens have emphasized Bankruptcy Code section 522(c)(2)(B).<sup>176</sup> The sub-section limits a debtor's ability to avoid a "debt secured by a lien that is—a tax lien, notice of which is properly filed."<sup>177</sup> The effect is to make a debtor's exemptions ineffective against the execution and the creation of statutory liens of the United States for taxes.<sup>178</sup>

The authors disagree with the application of section 522(c)(2)(B) to bar the avoidance of tax liens under section 6323(b). By its own language, section 522(c)(2)(B) applies only to a tax lien which was "properly filed." While the Code does not define "properly filed," Congress, in enacting section 522(c)(2)(B), sought to apply the holding of a landmark Supreme Court decision providing that "[t]he bankruptcy discharge will not prevent enforcement of *valid* liens."<sup>179</sup> The corollary to that rationale is that invalid liens may be avoided. For example, the lien may have been filed during the pendency of the automatic stay in a previous bankruptcy of the same debtor, thus rendering it, in most jurisdictions, void *ab initio*.<sup>180</sup> As it would be absurd to allow the government to enforce such liens, the Code should be interpreted as barring a debtor from avoiding only *valid* liens on exempt property.

In denying a debtor standing to avoid tax liens, the case law applying section 522(c)(2)(B) often will acknowledge that the prohibition against avoiding "properly filed" tax liens found in Bankruptcy section 522(c)(2)(B) assumes that the lien is valid and does not prohibit the avoidance of invalid liens. A decision from the Ninth Circuit Bankruptcy Appellate Panel is frequently cited as standing for the proposition that tax liens always survive bankruptcy.<sup>181</sup> However, the opinion actually makes it clear that the rule applies only to valid liens by stating that "the bankruptcy discharge does not prevent the enforcement of valid liens. The rule of *Long v. Bullard* is accepted with respect to the enforcement of valid liens on nonexempt property as well as on exempt property."<sup>182</sup> Clearly, the trustee would

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176. 11 U.S.C. § 522(c)(2)(B) (1988). See also *In re Deming*, 1994 Bankr. LEXIS 1129, at \*23 (Bankr. E.D. Pa. 1994).

177. 11 U.S.C. § 522(c)(2)(B).

178. *In re Deming*, at \*27 (citing *Leuschner v. First W. Bankr. & Trust Co.*, 261 F.2d 705 (9th Cir. 1958)); *Knox v. Great W. Life Assur. Co.*, 212 F.2d 784 (6th Cir. 1954).

179. H.R. Rep. No. 595, 95th Cong., 1st Sess. 361 (1977) (citing *Long v. Bullard*, 117 U.S. 617 (1886)).

180. See *supra* note 134.

181. *In re Isom*, 95 B.R. 148 (Bankr. 9th Cir. 1988). In *Isom*, the court found that the lien was unenforceable as to the debtors personally, but enforceable, and hence valid, as against the assets. Therefore the lien could not be avoided as to those assets.

182. *Id.* at 150. See also *Burford v. United States (In re Burford)*, No. 91-00030-E, 1991 WL 353294, at \*2 (N.D. W. Va. 1991), *aff'd* 977 F.2d 571 (4th Cir. 1991) (denying the trustee's attempt to avoid a tax lien, but citing the rule in *Long v. Bullard*, stating "[the rule] is accepted with respect to the enforcement of valid liens. . .").

have no problem avoiding an improperly filed tax lien.<sup>183</sup> More importantly, courts have permitted the trustee to avoid properly filed tax liens which were found to be invalid without letting the prohibition of section 522(c)(2)(B) interfere with this right.<sup>184</sup>

For example, the bankruptcy court for the Northern District of Georgia has held that an attempt by the Internal Revenue Service to enforce an invalid lien against a debtor's exempt property violates the automatic stay.<sup>185</sup> I.R.C. section 6323(b), which invalidates tax liens on personal property, provides a similar basis for concluding that a tax lien on personal property is invalid and falls outside of the scope of section 522(c)(2)(B). As Congress intended Bankruptcy Code section 522(c)(2)(B) to apply only to "valid" liens,<sup>186</sup> this section should pose no obstacle to a debtor's power to avoid invalid liens on personal property pursuant to I.R.C. section 6323(b).

One bankruptcy court has concluded that a Chapter 7 debtor lacks standing to avoid tax liens. In *In re Robinson*,<sup>187</sup> a bankruptcy court for the District of Vermont denied a Chapter 7 debtor standing to avoid a tax lien pursuant to I.R.C. section 6323(b). The court cited Bankruptcy Code section 522(c)(2)(B) as limiting a debtor's power to avoid liens. In reaching this result, the court ignored the seemingly obvious limitation that makes 522(c)(2)(B) applicable only to "properly filed" tax liens. A lien which is not enforceable against a bona fide purchaser pursuant to section 6323(b) should not be treated as a "properly filed" lien.

Because of the inconsistency in the case law with regard to a Chapter 7 debtor's standing to avoid tax liens, a Chapter 7 debtor should attempt to avoid the standing issue by requesting that the trustee join or intervene in a debtor's motion to avoid a tax lien. This strategy proved successful in *United States v. Branch*,<sup>188</sup> where the bankruptcy court for the Eastern District of North Carolina permitted a Chapter 13 debtor to avoid a tax lien by exercising his power under I.R.C. section 6323(b). Citing the presence of the trustee as a defendant, the court denied the government's motion to dismiss on the ground that the debtor lacked standing.<sup>189</sup> While the *Branch*

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183. See, e.g., *In re Southern Transfer & Storage Co.*, 157 B.R. 691 (Bankr. N.D. La. 1993) (permitting avoidance of tax lien because it was not recorded on motor vehicle records as required by state law); *In re De La Vergne, II*, 156 B.R. 773 (Bankr. E.D. La.) (avoiding a tax lien because the taxpayer's name was spelled incorrectly).

184. See, e.g., *United States v. LMS Holding Co.*, 161 B.R. 1020 (Bankr. N.D. Okla. 1993) (invalidating a properly filed tax lien because not re-recorded after transfer of assets); *In re Barnett*, 62 B.R. 638 (Bankr. D. Md. 1986) (invalidating a properly filed lien invalid because recorded in wrong county); *In re CS Assoc.*, 161 B.R. 144 (Bankr. E.D. Pa. 1993) (invalidating a properly filed tax lien as to assets acquired post-petition); *In re Hudgins*, 967 F.2d 973 (4th Cir. 1992) (invalidating a properly filed lien naming corporation held invalid as to assets of corporation owner's individual Chapter 11 estate).

185. See *In re Miller*, 98 B.R. 110, 112 (Bankr. N.D. Ga. 1989).

186. See *supra* note 179 and accompanying text.

187. *In re Robinson*, 166 B.R. 812, 814 (Bankr. D. Vt. 1994).

188. 170 B.R. 577 (Bankr. E.D.N.C. 1994).

189. *Id.*

decision involved a Chapter 13 debtor, this strategy is open to Chapter 7 debtors.<sup>190</sup>

### 3. The Avoidance of State Tax Liens on Personal Property

State tax enforcement often functions in a parallel fashion to federal enforcement and provides a further illustration of how bankruptcy courts have interpreted the avoidance powers as to tax liens on personal property. In fact, many state tax codes contain language similar to that of I.R.C. section 6323(b), which render liens invalid as to a bona fide purchaser.<sup>191</sup>

Without provisions protecting bona fide purchasers, state tax liens would disrupt ordinary commercial transactions involving tangible and intangible personal property. The justification for distinguishing between real and personal property follows from the notion that a prudent purchaser of real property would check the county records through a title search and discover any tax liens.<sup>192</sup> In contrast, a purchaser of a security or chattel paper would not ordinarily be expected to conduct a comparable title search and should not be the victim of a state tax code that creates a lien on all personal and real property owned by a taxpayer at the time of assessment.<sup>193</sup> Accordingly, provisions for the non-enforceability of tax liens against bona fide purchasers of personal property often mirror the provisions in the federal tax code.

In states having tax code provisions similar to section 6323(b), bankruptcy courts have invoked the trustee's status as a bona fide purchaser to invalidate liens on personal property.<sup>194</sup> This was the holding of a Ninth Circuit decision where the state had assessed and levied property taxes on equipment held by the debtor.<sup>195</sup> The taxing authority had properly perfected the lien by filing a certificate of delinquency in the proper county.<sup>196</sup> With regard to personal property, the court noted that the state's

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190. See *In re Walter*, 139 B.R. 695 (Bankr. N.D. Ohio 1992); *sub. nom. United States v. Hunter* 1993 U.S. Dist. Lexis 8249 (Bankr. N.D. Ohio 1993) (holding that a Chapter 7 debtor may exercise tax lien avoidance powers utilizing I.R.C. § 6323(b)).

191. See *infra* notes 194-210.

192. For example, in California, judgment liens are acquired by filing an abstract of judgment with any county recorder. This filing will result in the attachment and perfection of a lien against all real property owned by the debtor in that county. CAL. CIV. PROC. CODE § 674 (West 1993).

193. See *supra* note 45-46 and accompanying text.

194. *In re Cummins*, 656 F.2d 1262 (9th Cir. 1981); *In re Tropicana Graphics, Inc.*, 24 B.R. 381 (Bankr. C.D. Cal. 1982) (quoting CAL. CIV. PROC. CODE § 674 (West 1980)). ("Unlike real property, a judgment lien has no analogue that reaches personal property."). See also *In re Boerne Hills Leasing Corp.*, 15 F.3d 57 (5th Cir. 1994). In a conversion from Chapter 11, the court acknowledged that, under the state's bona fide purchasers provisions, the trustee or the debtor could avoid the tax lien as to personal property, but that a third party creditor had to first obtain authorization from the trustee before it could acquire standing to avoid such liens. *Id.*

195. *Cummins*, 656 F.2d at 1264.

196. *Id.* (quoting CAL. REV. & TAX CODE § 2191.3 (West 1980)).

general statutory scheme creates an exception for personal property which is "ordinarily" not subject to levy and sale to satisfy a judgment. The state Tax Code further provided that "judgment liens do not attach to personal property."<sup>197</sup>

With this statutory framework, the court concluded that a tax lien is "ineffective against a bona fide purchaser, and therefore against the trustee in bankruptcy."<sup>198</sup> The court relied upon the general powers of a trustee in bankruptcy to avoid statutory liens that would be ineffective against a bona fide purchaser. In commenting on the changes between the old Bankruptcy Act and the current Bankruptcy Code, the court observed that the result would be the same under current law stating that "substance of this provision is carried forward into Sections 554(2) and 546(b) of the new Bankruptcy Code."<sup>199</sup>

Upon invalidation of the tax lien, the court commented on an additional issue that limits a taxing authority's right to participate as an unsecured creditor. The principle that it would be unfair to require an estate's creditors to pay property taxes at the expense of other creditors in excess of the benefit the estate has received from the property compelled the court to limit the claim.<sup>200</sup> The current Bankruptcy Code<sup>201</sup> contains provisions limiting the claim for a tax assessed against property of the estate to the value of the estate's interest in the property. Therefore, the court "refused payment of the claim on any basis," disallowing it both as a priority and as a general unsecured claim.<sup>202</sup>

State taxing authorities have unsuccessfully asserted that either giving notice to the trustee or actual seizure of personal property should perfect a tax lien, making it enforceable against a bankruptcy trustee or debtor.<sup>203</sup> These arguments have failed because statutes are the exclusive basis for tax liens which must provide a provision that defeats the rights of a bona fide purchaser in order to prevail against a bankruptcy trustee.<sup>204</sup>

For example, a landmark ninth circuit decision involved an attempt by the California Franchise Tax Board to perfect a tax lien on personal property.<sup>205</sup> The court held that the Tax Board could not perfect its interest

197. *Id.* at 1265 n.3.

198. *Id.* at 1265.

199. *Id.* at 1263.

200. *Id.* at 1267.

201. 11 U.S.C. § 502(b)(4) (1988).

202. *Id.* (quoting *In re Nussbaum*, 257 F. Supp. 498 (S.D. Tex. 1966)); LAWRENCE KING, 3A COLLIER ON BANKRUPTCY ¶ 64.406 at 2201 (14th ed. 1975).

203. See *Tropicana Graphics, Inc. v. California Employment Dev. Dept. (In re Tropicana Graphics, Inc.)*, 24 B.R. 381 (Bankr. C.D. Cal. 1982); *Franchise Tax Bd. v. Danning (In re Perry)*, 487 F.2d 84 (9th Cir. 1973) *cert denied*, 415 U.S. 978 (1974); *In re J.R. Nieves & Co.*, 446 F.2d 188 (1st Cir. 1971). See also *In re Phillips Const. Co.*, 579 F.2d 431 (7th Cir. 1978).

204. See, e.g., *In re Allgeier & Dyer, Inc.*, 18 B.R. 82, 86-87 (Bankr. W.D. Ky. 1982); *Smith v. Addiego*, 129 P.2d 953 (Cal. Dist. Ct. App. 1942).

205. *Perry*, 656 F.2d at 88.

by merely giving notice to the trustee.<sup>206</sup> A later decision involved the seizure of funds from a debtor's bank account by a state taxing authority pursuant to a notice of levy.<sup>207</sup> The state filed its notice of levy prior to the date of the debtor's bankruptcy filing under Chapter 11. While the California Unemployment Insurance Code provides for a lien to arise on all tangible and intangible personal property, the Code contains exceptions for bona fide purchasers.<sup>208</sup> Reading the state exception for bona fide purchasers together with the lien avoidance powers of a trustee, the court found the lien to be invalid as to personal property against a bona fide purchaser and ordered the state to return the funds.<sup>209</sup>

State tax enforcement schemes often mirror their federal counterparts and have utilized the notion of a bona fide purchaser to limit the scope of tax liens. However, avoiding a federal tax lien does not guarantee that the state lien will vanish. A state tax code can introduce a new definition of a bona fide purchaser that may not be consistent with the statutory bona fide purchasers in the Bankruptcy Code.

### *C. The Avoidance of Tax Liens in Chapter 13*

Congress intended Chapter 13 to provide a more efficient alternative for debtors to reorganize their finances than Chapter 11. Chapter 13 involves a court-imposed plan whereby tax and other claims may be paid over time in deferred cash payments. For debtors who qualify, Chapter 13 provides greater flexibility and dischargeability for a debtor than exists under Chapter 7.<sup>210</sup> Common reasons for filing Chapter 13 include stopping a home foreclosure and paying a mortgage arrearage in an extended plan, providing debt relief where the debtor has nonexempt assets (i.e., a small business with assets that would be liquidated under Chapter 7), and reducing fraud claims which may not be dischargeable in Chapter 7.<sup>211</sup>

Unlike Chapter 7 and 11, Chapter 13 contains fewer exceptions to discharge and only requires that a debtor's plan provides for full payment of priority taxes under section 507(a)(7).<sup>212</sup> The practical effect is that a Chapter 13 debtor may discharge non-priority taxes for a year in which no return was filed despite section 523, which would otherwise render these taxes non-dischargeable.

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206. *Id.* at 89.

207. *Tropicana*, 24 B.R. at 382.

208. *Id.* at 383.

209. *Id.*

210. Debtors are eligible to file Chapter 13 only if, as of the date of filing the petition their liquidated, non-contingent secured debts are under \$750,000 and liquidated, non-contingent unsecured debts are under \$250,000. 11 U.S.C. § 109(e) (Supp. 1994).

211. 11 U.S.C. § 523 (1988).

212. *See* 11 U.S.C. § 1322(a)(2) (1988).

While priority taxes cannot be discharged in bankruptcy, a debtor's reorganization plan in Chapter 13 or 11 can provide for the payment of these taxes over an extended period of time. In Chapter 13, a permissible repayment period will be between thirty-six and sixty months. Chapter 13 plans offer a unique advantage over Chapter 11 plans in that the government will not be entitled to post-petition interest for priority tax claims.<sup>213</sup> Another significant advantage of Chapter 13 is a greater ability to discharge tax penalties even if the underlying tax liability has priority status. This benefit exists because penalties are never priority claims in bankruptcy, and the exception to discharge of penalties in section 523 does not apply in Chapter 13.

#### 1. Avoidance of Tax Liens Pursuant to Section 6323(b) Raises Similar Obstacles that Impede the Chapter 7 Debtor

The view that a Chapter 13 debtor may exercise statutory avoidance powers has achieved only minority status in published bankruptcy opinions. Restricting the avoidance powers of Chapter 13 debtors compared to Chapter 11 debtors seems peculiar, as Congress intended to make Chapter 13 the preferred choice for smaller debtors.<sup>214</sup> As both individuals and corporations are eligible to file under Chapter 11,<sup>215</sup> an individual debtor should not be pushed into a more expensive Chapter 11 bankruptcy simply to achieve a more advantageous position with respect to tax liens.<sup>216</sup> Furthermore, legislative history, case law, and statutory arguments support the general right of Chapter 13 debtors to exercise avoidance powers with respect to tax liens.

Though reversed on appeal, a 1987 bankruptcy decision permitted a Chapter 13 debtor to avoid a properly filed tax lien pursuant to bankruptcy section 545(2) and I.R.C. section 6323(b).<sup>217</sup> The key issue was whether a Chapter 13 debtor is the equivalent of a Chapter 11 or 7 debtor or trustee who has standing to exercise statutory avoidance powers.

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213. See 11 U.S.C. § 1322(a)(2) (1988); *In re Wakehill Farms*, 123 B.R. 774 (Bankr. W.D. Ohio 1990); *In re Hageman*, 108 B.R. 1016 (Bankr. N.D. Iowa 1989); *In re Boston & Maine Corp.*, 719 F.2d 493 (1st Cir. 1983). Courts have stated that the government will not be entitled to "present value" payments. See, e.g., *In re Young*, 61 B.R. 150 (Bankr. S.D. Ind. 1986).

214. See, e.g., *In re Lybrook*, 951 F.2d 136 (7th Cir. 1991) (quoting H.R. Rep. No. 595, 95th Cong., 2d Sess. 116-19 (1978)) (stating that the legislative history does reveal that, in liberalizing the old Chapter XIII, the framers of the new Chapter 13 wanted to encourage repayment plans as an alternative to straight bankruptcy).

215. *Toibb v. Radloff*, 507 U.S. 157 (1991).

216. The inordinate expense of pursuing a Chapter 11 begins with the \$800 filing fee and escalates to cover the costs of preparing debtor's monthly operating reports and quarterly trustee fees.

217. *Coan v. United States (In re Coan)*, 72 B.R. 483, 484 (Bankr. M.D. Fla. 1987), *vacated sub nom. In re Coan*, 134 B.R. 670 (Bankr. M.D. Fla. 1991).

In finding that a Chapter 13 debtor may avoid tax liens, the court looked first at the structure of the Bankruptcy Code.<sup>218</sup> The Code contains a definitions section (Chapter 1) and two sections (Chapters 3 and 5) that contain provisions of general applicability for all petitions filed under Chapters 7, 11, or 13.<sup>219</sup> Chapter 5 contains section 545, which is the provision allowing a debtor or trustee to avoid statutory liens. As a provision of general applicability, the court concluded that a Chapter 13 debtor should be able to utilize this section to attack tax liens.

In addition, the court observed that a number of courts have concluded that a Chapter 13 debtor has statutory avoidance powers.<sup>220</sup> While the cases did not involve tax liens, the *Coan* court could find no statement in the legislative history that justified making a distinction between Chapter 13 debtors and those under other Chapters of the Bankruptcy Code.<sup>221</sup>

## 2. Chapter 13 Case Law Limits a Debtor's Power to Avoid Tax Liens

The majority of Chapter 13 cases have concluded that a Chapter 13 debtor should not be allowed to avoid tax liens on property given special priority under Tax Code section 6323(b).<sup>222</sup> The typical scenario involves a Chapter 13 debtor or trustee bringing an adversary proceeding to determine the validity, priority, and extent of a United States tax lien. In this proceeding, the debtor asserts that the tax liens on personal property are invalid and asks the court to enter an order avoiding the lien. The Chapter 13 courts have agreed that Congress intended to give debtors the power to avoid tax liens, but have refused to grant Chapter 13 debtors "standing" to avoid the liens pursuant to Bankruptcy Code section 545(2).<sup>223</sup>

Without providing policy reasons for discriminating against Chapter 13 debtors, these cases have focused on two principal statutory arguments. First, the courts take a restrictive reading of Bankruptcy Code section

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218. *Id.* at 485.

219. See 11 U.S.C. § 103 (1988) (providing that the provisions of Chapter 5 of the Bankruptcy Code are provisions of general applicability and apply to any case filed under Chapter 7, Chapter 11, Chapter 12 or Chapter 13).

220. *Coan*, 72 B.R. at 485 (quoting *In re Hall*, 26 B.R. 10 (Bankr. M.D. Fla. 1982); *In re Chapman*, 51 B.R. 663 (Bankr. D.C. 1985); *In re Boyette*, 33 B.R. 10 (Bankr. N.D. Tex. 1983). See also *Einoder v. Mount Greenwood Bank (In re Einoder)*, 55 B.R. 319 (Bankr. N.D. Ill. 1985); *Ware v. Mi (In re Ware)*, 99 B.R. 103 (Bankr. M.D. Fla. 1989).

221. *Coan*, 72 B.R. at 486. ("Thus a Federal tax lien is invalid under § 545(2) with respect to property specified in Sections 6323(b) and (c) of the Internal Revenue Code of 1954.") (citing 124 Cong. Rec. 32,400 (1979) (statement of Rep. Edwards)).

222. See, e.g., *In re Williams*, 109 B.R. 179 (Bankr. W.D.N.C. 1989); *In re Mattis*, 93 B.R. 68 (Bankr. E.D. Pa. 1988); *In re Ridgley*, 81 B.R. 65 (Bankr. D. Or. 1987); *In re Driscoll*, 57 B.R. 322 (Bankr. W.D. Wis. 1986).

223. *In re Groanvelt*, No. 88-01911-13, 1989 Bankr. LEXIS 1668, at \*3 (Bankr. Idaho Aug. 10, 1989).

1303.<sup>224</sup> This section pertains only to cases under Chapter 13 and provides that the debtor shall have certain powers pertaining to the management and sale of property of the estate “exclusive of the trustee.”<sup>225</sup> In holding that a Chapter 13 debtor lacks standing to avoid tax liens, one bankruptcy court stated that “[s]ection 1303 specifically limits the debtor’s authority to subsections (b), (d), (e), (f) and (1) of 11 U.S.C. Section 363.”<sup>226</sup> In support of this assertion, the court argued that when compared to section 1107, which gives a Chapter 11 debtor “all” of the powers of a trustee, section 1303 only gives the debtor specific powers, which do not include the power to avoid statutory liens.

Reading section 1303 as limiting a Chapter 13 debtor’s powers ignores the word “exclusive,” which appears on the face of the statute.<sup>227</sup> A comparison of sections 1303 and 1107 further indicates a patent flaw in the court’s interpretation of section 1303. The following excerpt from the legislative history to section 1303 contradicts the court’s interpretation and indicates that the word “exclusive” is essential to the meaning of the provision: “The section does not imply that the debtor does not also possess other powers concurrently with the trustee. For example, although section 1107 is not specified in section 1303, certainly it is intended that the debtor has the power to sue and be sued.”<sup>228</sup> From this language, it is clear that the purpose of this section is not to define the universe of powers that a Chapter 13 debtor may exercise. The section refers only to those powers that a debtor will have “exclusive of the trustee.”<sup>229</sup> Because the Chapter 11 provision does not use the word “exclusive” and is intended to define the complete powers that a Chapter 11 debtor may exercise, the court’s comparison of the Chapter 11 and 13 provisions compares apples to oranges, completely ignoring the legislative history of the statute. Collier’s comment to the Bankruptcy Code similarly reiterates that point: “The grant of this power is not intended to indicate that the debtor does not also have other powers concurrently with the trustee.”<sup>230</sup>

Furthermore, an entire body of case law has emerged which permits a Chapter 13 debtor to utilize the full gamut of avoidance powers to attack

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224. *Id.*

225. 11 U.S.C. § 1303 (1988) (“Subject to any limitations on a trustee under this chapter, the debtor shall have, exclusive of the trustee, the rights and powers of a trustee under sections 363(b), 363(d), 363(e), 363(f), and 363(l), of this title.”).

226. *Groanvelt*, No. 88-01911-13 1989 Bankr. LEXIS 1668, at \*4-5.

227. 11 U.S.C. § 1303.

228. 124 Cong. Rec. 32409 (1978); S. 17,423 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini).

229. 11 U.S.C. § 1303.

230. COLLIER’S BANKRUPTCY CODE, Comment to § 1034 (Pamphlet ed. 1994).

preferences, avoid liens, and to bring fraudulent conveyance actions.<sup>231</sup> Section 1303's omission of avoidance powers did not compel these courts to hold that a Chapter 13 debtor lacked standing. The fact that a debtor is attacking a tax lien and not another type of statutory lien should have no bearing on the standing question.

In addition to section 1303, courts have cited section 522(c)(2)(B)<sup>232</sup> as an additional argument to deny a Chapter 13 debtor standing to attack tax liens.<sup>233</sup> This section provides that properly filed tax liens continue against exempt property and will be unaffected by a bankruptcy.<sup>234</sup> For example, a debtor who is entitled to keep a home under a state homestead exemption would ordinarily be able to avoid judgment liens that impair this exemption. Section 522(c)(2)(B) creates a special exception that bars a debtor from avoiding a "properly filed" tax lien on exempt property.

Chapter 13 cases have interpreted section 522(c)(2)(B) as a grounds for denying a debtor the right to avoid tax liens on personal property enumerated in I.R.C. section 6323(b).<sup>235</sup> One court stated that "11 U.S.C. section 522(c)(2)(B) bestows added protection upon perfected tax liens and provides that exempt property remains liable for a tax lien. . . ."<sup>236</sup> One flaw in the court's reasoning is that section 522(c)(2)(B) applies only to a valid tax lien which is "properly filed." In quoting the Congressional Record, the court contradicts itself by acknowledging the invalidity of a federal tax lien: "[A] federal tax lien is invalid under section 545(2) with respect to property specified in section 6323(b) and (c) of the Internal Revenue Code of 1954."<sup>237</sup>

Fortunately, the same strategy that enables a Chapter 7 debtor to avoid the standing issue applies with equal force in Chapter 13. The bankruptcy

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231. *See, e.g., In re Boyette*, 33 B.R. 10 (Bankr. N.D. Tex. 1983) (section 1303 does not restrict the debtor from possessing other powers concurrently with the trustee, so that a Chapter 13 debtor also has standing to utilize the trustee's avoiding powers under § 544). *See also In re Hall*, 26 B.R. 10 (Bankr. M.D. Fla. 1982); *In re Chapman*, 51 B.R. 663 (Bankr. D.C. 1985); *Einoder v. Mount Greenwood Bank (In re Einoder)*, 55 B.R. 319 (Bankr. N.D. Ill. 1985); *In re Ware*, 99 B.R. 103 (Bankr. M.D. Fla. 1989).

232. *See supra* note 149 and accompanying text discussing 11 U.S.C. § 522(c)(2)(B) (1988).

233. *See In re Ridgley*, 81 B.R. 65 (Bankr. D. Or. 1987).

234. 11 U.S.C. § 522(c)(2)(B) states in pertinent part:

(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— . . .

(2) a debt secured by a lien that is— . . .

(B) a tax lien notice of which is properly filed.

11 U.S.C. § 522(c)(2)(B).

235. *See, e.g., Koppersmith v. United States (In re Koppersmith)*, 156 B.R. 537, 538 (Bankr. S.D. Tex. 1993); *Verma v. First United Federal (In re Verma)*, 91 B.R. 17 (Bankr. W.D. Pa. 1987); *Gerulis v. United States (In re Gerulis)*, 56 B.R. 283 (Bankr. D. Minn 1985) (holding that § 522(c)(2)(B) prevents the avoidance of a lien for tax penalties).

236. *In re Groanvelt*, No. 88-01911-13, 1989 Bankr. LEXIS 1668, at \*5 (Bankr. Idaho Aug. 10, 1989).

237. *Id.*

court for the District of North Carolina has permitted a trustee to intervene in a debtor's motion to avoid a tax lien pursuant to section 6323(b).<sup>238</sup>

The limitation on a Chapter 13 debtor's right to avoid tax liens is comparable to the result in Chapter 7. Courts have interpreted the statutory protection accorded to tax liens as barring a debtor's right to avoid tax liens. Reading section 522(c)(2)(B), which prevents a debtor from avoiding tax liens on exempt assets, as barring lien avoidance with respect to all assets provides too much protection to the government—often at the cost of hindering a debtor's reorganization prospects.

#### IV. PROPOSAL

The debtor has an interest in erasing tax liens for dischargeable taxes, and in some cases non-dischargeable taxes, on her property. The Tax and Bankruptcy Codes create a seemingly impregnable shield around most tax liens. Clearly, a tax lien on real property cannot ordinarily be avoided. Likewise, a tax lien on personal property may not be avoided as a preference.<sup>239</sup>

I.R.C. section 6323(b) apparently provides a light in the gloom for debtors, albeit a flickering one for debtors under Chapter 13. This code section provides a basis upon which to avoid otherwise properly filed liens on most ordinary personal assets, including cash, securities, vehicles and accounts receivable. The authors of this Article believe that such avoidance power is consistent with congressional intent and the public policy favoring a fresh start. This fresh start includes the right to retain certain basic exempt property so that debtors need not start over totally destitute of all personal property.

In furtherance of the spirit of the fresh start, the Bankruptcy Code provides a way to discharge stale personal income taxes in many cases. Why, then, discharge the taxes only to leave the debtor's most basic personal property subject to tax liens? Such a result seems inconsistent with public policy and unnecessarily harsh.

Among reported cases, the clear majority rule is that either the trustee or the debtor has the power to avoid a manifestly invalid tax lien.<sup>240</sup> The taxing entity should not be permitted to assert liens which have no power in law by asserting a strained argument that the debtor has no standing to object. An expired lien, a lien against a different taxpayer, a lien on property which is not owned by the debtor, a lien filed during the automatic stay, a lien recorded in the wrong county, and a lien for discharged taxes now being asserted on future-acquired assets exemplify typical categories of

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238. See *supra* notes 171-73 and accompanying text.

239. 11 U.S.C. § 547(c)(6) (1988); *In re Carolina Resort Motels, Inc.*, 51 B.R. 447 (Bankr. D. S.C. 1985).

240. See *supra* note 43.

illegal and empty liens. These liens should not be enforceable against a debtor on the ground that the debtor has no power to avoid them. Fortunately, most courts have in fact permitted such liens to be avoided.

Why, then, should the courts struggle with regard to liens on property described in section 6323(b), when such liens, by the language of their own authorizing statute, are invalid against the trustee? Merely because such avoidance powers operate to benefit the debtor, and not the creditors, seems hardly an argument as bankruptcy was intended to be a remedy for the debtor as well as the creditor.

In Chapter 11, the Bankruptcy Code clearly gives the debtor the power to avoid tax liens on section 6323(b) property. As to the debtor's lien avoidance powers in Chapter 7, case law does not explicitly favor the debtor, but is nevertheless strongly implicit in the debtor's favor. With regard to Chapter 13, the emerging rule disfavors the debtor. However, analysis of the Chapter 13 case law indicates inconsistencies in the arguments articulated in favor of discriminating against Chapter 13 debtors with regard to this important right.<sup>241</sup> Furthermore, such decisions are contrary to the clear public policy favoring Chapter 13, which provides some remuneration to creditors, over Chapter 7. The interest in giving a debtor a fresh start and providing an incentive to repay creditors through a Chapter 13 mandates that bankruptcy courts resist the recently emerging rule and allow a debtor to avoid tax liens on personal property so as to further a debtor's prospects for reorganization.

## V. CONCLUSION

The existence of a tax lien on a debtor's accounts receivable, liquid securities, and other personal property puts unnecessary iron shackles on a debtor. The bankruptcy laws foster cooperation amongst creditors and try to discourage individual creditors from taking action that will compromise the interest of all other parties. The avoidance of a tax lien, which attaches to all of a debtor's property, accords too much protection to the government; particularly in light of the special provisions in the bankruptcy laws that give special treatment to tax claims.

The avoidance a tax lien pursuant to section 6323(b) leaves the government's interest in a debtor's real property intact. As modern business relies increasingly on electronic wire and credit transfers, the ability of a debtor to protect vital business receivables from tax enforcement in periods of financial crisis will become increasingly significant.

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241. See *supra* notes 195-215 and accompanying text.

