INTERNAL REVENUE SERVICE

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MEMORANDUM FOR DISTRICT COUNSEL, NORTH

FROM: Michael R. Arner
Senior Technician Reviewer (General Litigation)

SUBJECT:

This is in response to your memorandum in which you requested that we review your January 27, 1998, memorandum to Special Procedures, North District, as well as your undated memorandum which takes a contrary position.

LEGEND:

Taxpayer x
Years
Assessment
Amount $

ISSUE(S):

Whether the taxpayer's assignee is entitled to priority over the federal tax lien pursuant to I.R.C. § 6323(a) as either the holder of a security interest or a purchaser.

CONCLUSION:

We have given thorough consideration to both advisory opinions and believe that both present adequate legal arguments to support contrary positions. Nevertheless, it is our view that the position taken in the January 27, 1998, memorandum is the preferable one, namely, that under law, et al., does not have a perfected security interest in the taxpayer's accounts receivable and, therefore, the Service's tax lien is entitled to priority pursuant to I.R.C. §§ 6323(a) and (h).

FACTS:

X, the taxpayer, was assessed tax liabilities of approximately $16,000 on May 23, 1997. Notices of Federal Tax Lien were not filed until November 1997.

The taxpayer provided welding repairs and industrial clean-up work. Prior to the assessments, it had apparently entered into a factoring agreement with certain and individuals, namely, . The agreement provided that all invoices assigned by the taxpayer would note the fact of the assignment on the face of the invoice, and would provide that the payment of the invoice be made to Post Office Box which differed from the taxpayer's normal box number. This box was opened in March 1997 by Mrs. i in the taxpayer's name. Checks received at Box would be deposited in a corporate bank account in the taxpayer's name and would then cash the previously endorsed check signed by the taxpayer. The taxpayer agreed not to write any checks on the account without permission.

The taxpayer would perform work for third-party clients including , Inc., would get payment from et al., equal to 70 percent of the service invoice price, would send an invoice to the client, would receive the client's payment at the designated box, and would deposit the payment it received from the client into the taxpayer's account. would then cash the previously endorsed check for 100 percent of the invoice amount received. The copies of the taxpayer's invoices to l that were received from representative all have a typed notation that the receivable had been assigned to . It is not known whether the taxpayer had access to Box , the bank account checks, the designated bank account, or whether these were all controlled by Mrs. i for et al.

Although there was a written agreement of the above arrangement and the taxpayer had executed a Uniform Commercial Code (hereinafter UCC) financing statment in favor of , it was never recorded.

Between the assessment date and the dates of recordation of the Notices of Federal Tax Lien, the taxpayer performed services, received advances, billed the clients, received payments and issued checks totalling almost $60,000 to .

The corporate owner and director of the taxpayer corporation, Mr. , died on September 18, 1997. Checks from alone of over $22,000 payable to the taxpayer were received by Mrs. after Mr. s death and were deposited and paid over to

LAW AND ANALYSIS:

In both of the memoranda we reviewed, it is stated that under the express terms of the contract agreement between the taxpayer and et al., that law is to be determinative. However, you concluded that since all the property and rights to property arose in , the law of should apply. We agree that the outcome here would be no different whether or law applies since they do not appear to differ significantly with respect to security agreements and UCC filings.

We believe your January 27, 1998, memorandum correctly states the rationale for the theory upon which the Service should prevail here. The facts reflect that what the parties had contemplated when they entered into their contract, was a security agreement for accounts receivable financing.

In order to determine lien priority questions, it is necessary to look to state law. State law determines property rights. Federal tax lien priorities are established by federal law. Aquilino v. United States, 363 U.S. 509 (1960); United States v. Acri, 348 U.S. 211 (1955). The basic rule in determining the priority of liens is often referred to as "the first in time, first in right." United States v. City of New Britain, 347 U.S. 81 (1954). I.R.C. § 6323(a) lists certain categories of persons whose interests arise after the general tax lien exists but before the Notice of Federal Tax Lien is filed and provides that the interests of those persons have priority over the unfiled tax lien. The persons that fall within the purview of section 6323 are purchasers, holders of security interests, judgment lien creditors and mechanic lienors. The focus of the instant case concerns security interest holders and purchasers.

In . Stat. Ann. §§ 679.301(1)(B) & 679.302(1) are relevant to the outcome of security interest cases. Section 679.302(1) basically requires that in order to perfect a transaction subject to UCC Article 9, it is necessary to file a financing statement. Section 679.301(1)(B) provides that a failure to file a financing statement entitles a lien creditor to enjoy priority over an unperfected security interest. As a general rule, under the UCC, a security interest in accounts, contract rights, other intangibles, is not perfected unless it is recorded. As stated above, in cases involving the priority of the federal tax lien, it is necessary to look to state law to determine whether the competing security interest lienor meets the requirements of I.R.C. § 6323(a), i.e., whether there was perfection under state law.

One of the tests that a competing lienor who claims priority over the federal tax lien as a security interest holder must meet under I.R.C. § 6323(h)(1) which defines a "holder of a security interest," is that he must be protected under local law against a subsequent judgment lien arising out of an unsecured obligation. Your draft memorandum takes the view that , under the theory that he is a holder of a security interest, would meet the test under section 6323(h)(1) since, having already obtained the proceeds from the receivables, he would be protected against a subsequent judgment lien creditor, notwithstanding that there was a failure to record. In essence, the memorandum concludes that the receivables were reduced to cash and were paid to . Since the receivables no longer exist, a judgment lien creditor could never levy upon them. Thus, the position taken by the draft memorandum is that even though under the UCC there was no recording and, therefore, an invalid security interest existed under state law, under federal law, nevertheless, qualifies as a holder of a security interest. The crucial date for determining whether the holder of a

security interest should prevail over the federal tax lien is the date of filing of the Notice of Federal Tax Lien, i.e., whether the security interest was perfected under local law as of that date. We do not agree that could meet the statutory test to be considered the holder of a security interest on the date the Notice of Federal Tax Lien was filed.

However, an argument that , et al. might raise is that under certain UCC provisions, it is not necessary to file in order to perfect the security interest. For example, a security interest can, at times, be perfected when the secured party takes possession of the collateral. Stat. Ann. §§ 679.302(1)(a) and 679.304(1). Except for automatic perfection, possession is the only method of perfecting a security interest in a negotiable instrument or in a "security" against a holder in due course, etc. . Stat. Ann. §§ 679.308 and 679.309. These types of collateral are called instruments. In order to perfect a security interest in a cashier's check, the creditor must have physical possession of the check. Automatic perfection, pursuant to . Stat. Ann. § 679.302(1)(b) occurs where a security interest is created in instruments or negotiable documents to the extent the security interest arises for new value (not past consideration) given by the creditor to the debtor under a written security agreement. In this type of situation, the creditor is given automatic protection without the need to have filed a financing statement or taking possession. To be protected after 21 days, the secured party must take or regain possession of the instrument. . Stat. Ann. § 679.304(4)-(6). See also, Treas. Reg. § 301.6323(h)-1(a)(2)(B)(ii). We agree with the statement in your January 27, 1998, memorandum to the effect that did not become protected by "possession" since the collateral at issue was not negotiable instruments or other "instruments" but accounts receivable. . Stat. Ann. § 679.305 excludes accounts from collateral that may be perfected by possession. In fact, for some types of intangibles, i.e., accounts and general intangibles, filing is the only available method of perfection. Stat. Ann. § 679.304, Comments to the 1972 revision p.256 (West 1990).

Note that Stat. Ann. § 679.306 concerns "proceeds" and the secured party's rights on disposition of that collateral. Money, checks, deposit accounts and the like are cash proceeds. Subsection (3) of that statute states:

> The security interest in proceeds is a continuously perfected interest if the interest in the original collateral was perfected, but it ceases to be a perfected security interest and becomes unperfected 10 days after receipt of the proceeds by the debtor unless:

> (a) A filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected by filing in the office or offices where the financing statement has been filed and, if the proceeds are acquired with cash proceeds, the description of collateral in the financing statement indicates the types of property constituting the proceeds.
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> (b) A filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or
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> (c) The security interest in the proceeds is perfected before the expiration of the 10-day period.

In the instant case, even if attempted to argue that when the accounts receivable were paid by check to the taxpayer and that 's receipt of the proceeds therefrom constituted "perfection" of his security interest, he should not prevail since the above statute requires that the financing statement covering the original collateral, the accounts receivable, must have been perfected. As stated earlier, this never occurred.

In addition to the foregoing argument, we are also of the view that it is not possible to disregard the fact that this entire transaction was supposedly structured as one for security. In Southern Rock Inc. v. B.V. Auto Supplies, 711 F.72d 638 (5th Cir. 1983), the court discusses UCC § 9.102 (Texas) and notes that the test for creation of a security interest is whether the transaction was intended to have effect as security. Thus, if this whole transaction cannot really be considered as one for security, the test under 6323(h)(1) should not be relevant, i.e., a security interest never existed in the first place. In addition, under the assumption that the transaction between the taxpayer and did actually constitute a security interest, there exists authority for the proposition that a lender must take steps to record his security interest in order to prevail over the federal tax lien if state law requires such recording as does . Stat. Ann. § 679.301(1)(B)). See Plumb, Federal Tax Liens, 114 (3rd ed.) (1972).

An alternative argument to be considered is whether qualifies as a "purchaser" under I.R.C. § 6323(a). We agree with the conclusion in the January 27, 1998, memorandum that does not qualify as a purchaser. Under section 6323(h)(6), a purchaser means "a person who, for adequate and full consideration in money or money's worth acquires an interest . . . . in property which is valid under local law against subsequent purchasers without actual notice." The theory under which could be considered a purchaser would be that he took the taxpayer's assignment as an outright or absolute one and not as one for security as described above. In other words, he purchased the accounts receivable and received payment prior to November 1997 when the Notice of Federal Tax Lien was filed.

may not be able to meet the definition of "purchaser" under section 6323(h)(6) in that he may not have paid "adequate and full consideration in money or money's worth" for the taxpayer's assignments. The facts reflect that between the date of the tax assessment and the date the Notice of Federal Tax Lien was filed in November 1997 the taxpayer issued some $60,000 in checks to . Following the death of , the corporate owner and director, an additional $22,000 was paid over to . The facts do not reflect whether this $22,000 was paid prior to the filing of the Notice of Federal Tax Lien. Assuming that such amount was paid prior to the filing of the tax lien, if we were to consider the entire transaction to have constituted an outright or absolute assignment, it may be that the total of $82,000 would not have been sufficient consideration to support the sale of accounts receivable, i.e., depending on what the total amount of assigned receivables was. However, although neither the January 27, 1998, nor the draft memorandum reflect this figure, in all probability, could no doubt, establish that adequate consideration was paid. See Jones & Jeffry Construction Co. v. United States, 77-2 U.S.T.C. ¶ 9695 (E.D. Tex. 1977) where plaintiff could not establish that it paid full and adequate consideration and, thus, was not considered to be a purchaser.

Assuming that we consider a purchaser under law, Southern Rock, and Sun Bank N.A. v. Parkland Design, 466 So.2d 1089 (1985), (not a tax case) which are cited in the January 27, 1998, memorandum would be on point since this is the argument that was attempted in the these cases where there was a failure to record. According to each of those courts, Article 9 of the UCC "encompasses not only financing types of assignments of accounts but also absolute sales or transfers of accounts". Stat. Ann. 679.102(1)(b). While it is true that in those cases, the "secured party" didn't get paid in cash from the liquidation of the receivables as in our case, nevertheless, the UCC, unless one happens to meet one of the filing exemptions under . Stat. Ann. § 679.102(1)(a)(b),1/ requires recording for an outright or absolute assignment as well as for an assignment for security. The assignment here does not meet the criteria for an exception and, thus, in the instant case, we have an unperfected assignment under state law. Accordingly, we don't believe that could meet

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1/ . Stat. Ann. § 679.102(1)(a)(b)provides that this chapter applies to "any sale of accounts" except as excluded in section 679.104(6). That section provides that this chapter does not apply to the sale of accounts or chattel paper as part of a sale of the business out of which they arose, or an assignment of account or chattel paper which is for the purpose of collection only, or a transfer of a right to payment under a contract to an assignee who is also to do the performance under the contract or a transfer of a single account to an assignee in whole or partial satisfaction of a preexisting indebtedness.

the requirements necessary to be considered a purchaser under sections 6323(a) and (h)(6) in that by not recording, he would not be protected against a subsequent purchaser without actual notice. In any event, in order to be entitled to the preference given purchasers under section 6323(a), one cannot be a person who acquired a lien or security interest in the property. Section 6323(h)(6). See Heller Financial, Inc. v. United States, 89-1 U.S.T.C. ¶ 9368 (N. D. Tex. 1989).

In summary, based upon the foregoing discussion, we are of the opinion that, as concluded in your January 27, 1998, memorandum, the Service is entitled to priority over the lien claim of , et al, whether we consider him not to be a holder of a security interest or a purchaser as described in sections 6323(a) and (h).

We trust that the above will be helpful. If you have any questions, please do not hesitate to contact us at 202-622-3610.