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Creditor's Rights—United States Tax Lien—Competition with Other Interests

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CREDITORS' RIGHTS

United States Tax Lien — Competition with Other Interests

A. *Aquilino v. United States*[1] involved the question of relative priority between a federal tax lien and two mechanics liens. The taxpayer, a general contractor, owed withholding and social security taxes for which, under the 1939 Internal Revenue Code, the tax lien arose. It was duly filed against personal property of the taxpayer by the government. Subsequently, two materialmen filed mechanics liens against real property which had been improved by the taxpayer, and one of them obtained a judgment against the taxpayer for the amount of his claim. The owner of the real property, who was the original defendant in this action by the mechanics lienors brought to foreclose the liens, deposited the amount still owing to the taxpayer by her into court and moved successfully to have the United States, which had levied on this debt under its general lien, substituted as defendant. Held: The tax lien gave the United States prior right to the fund.[2]

The New York Lien Law provides two remedies to unpaid materialmen. Under a mechanics lien they are entitled to a preference over a contractor to funds for contracting work done.[3] The other remedy is a claim as beneficiary of a statutory trust to funds received by the contractor.[4] In contesting the federal levy on the indebtedness and its satisfaction out of the deposited fund, the plaintiffs argued that they had, by virtue of the New York statutory trust provisions, such a beneficial interest in the debt to the taxpayer that there was no property interest of his upon which the government could levy, and further that the fund deposited was a substitution for real property on which they had a prior claim and against which the United States had not filed.[5]

However, the relative priority of a federal lien is a federal question,[6] and the Court of Appeals felt bound by the Internal Revenue Code and the decisions construing it. Under the Code, the tax lien arose the moment an assessment list was received by the local Collector notifying him of a tax deficiency, becoming automatically and immediately valid against "all property and rights to property, whether real or personal" belonging to the delinquent taxpayer, with the

1. 3 N.Y.2d 511, 169 N.Y.S.2d 9 (1957).
2. Aquilino v. United States, 3 N.Y.2d 511, 169 N.Y.S.2d 9 (1957).
3. N. Y. LIEN LAW §§3, 56.
4. N. Y. LIEN LAW §§13(7), 36-a, 240.
5. Brief of Respondents Aquilino and Spero, pp. 10, 16-17, Aquilino v. United States, *supra* note 2.
6. United States v. Waddill, Holland & Flinn, Inc., 323 U.S. 353, 356-7 (1945).

exception that it was not good against mortgagees, pledgees, purchasers, or judgment creditors until filed in accord with state law.[7]

The statute does not prescribe any order of priority, but the Supreme Court, adopting the rationale of an analogous federal priority statute, held in 1950 that the tax lien will precede any antecedent lien under state law which is in some sense inchoate or unperfected.[8] This has been interpreted to require that a competing lien must attach to specified property, must be definite in amount, and must be accompanied by some change in title or possession.[9]

In virtually all subsequent cases,[10] the Court has been able to find the contesting lien sufficiently inchoate to preserve the superiority of the tax lien. Thus, mechanics liens or attachments filed before, but not perfected until after, the federal tax lien arose, have been held inferior, notwithstanding the fact that application of state decisions and property law standards would lead to a different result. The courts have refused to allow a state rule to nullify the intention of Congress that the taxing power be protected.[11]

Applying these principles to the instant case, it seems clear that the mechanics lienors here cannot be said to have perfected a choate lien prior to the time the federal lien arose. The rights of the mechanics are contingent on the outcome of an action for the enforcement of that lien,[12] in which action the establishment of the debt on which the lien is founded is one of the issues to be decided.[13] And any interests in the statutory trust created for the benefit of the materialmen are dependent on timely enforcement under the Lien Law.[14] Thus, at the time the federal lien attached to the debt owed by the property owner, there was no perfected lien — in the federal sense — outstanding. And the plaintiff who obtained a judgment did not do so before the tax lien was filed, and thus did not come within the protection of §3672 of the 1939 Code as a judgment creditor.

This case overruled a prior Court of Appeals memorandum opinion to the extent that the latter seemed to imply that the mechanics lienor would be pro-

7. Int. Rev. Code of 1939, ch. 36, §§3670-3672, 53 Stat. 47 (now INT. REV. CODE OF 1954, §§6321-6323). The procedure for filing the tax lien in New York is governed by LIEN LAW §240.

8. United States v. Security Trust, 340 U.S. 47, 51 (1950).

9. United States v. Kings County Iron Works, 224 F.2d 232, 236 (2d Cir. 1955).

10. See United States v. Acri, 348 U.S. 211 (1955); United States v. Liverpool, 348 U.S. 215 (1955); United States v. Scovil, 348 U.S. 218 (1955). *But see* United States v. City of New Britain, 347 U.S. 81 (1954).

11. United States v. Waddill, Holland & Flinn, Inc., 323 U.S. 353, 357 (1945).

12. N. Y. LIEN LAW §41.

13. Johnson Service Co. v. Hildebrand, 149 App.Div. 680, 134 N.Y.Supp. 187 (1912), *aff'd* 210 N.Y. 574, 104 N.E. 1132 (1914).

14. N. Y. LIEN LAW §75.

tected by virtue of the New York statutory trust concept.[15] The present position seems to be required by the federal decisions, which have read a very broad priority in favor of the United States into the tax statute. Criticizing this development, Justice Douglas observed, in a dissent from a 1956 Supreme Court holding, that the line of decisions seems to hold that a lien, asserted under state law, cannot compete with the tax lien unless it is reduced to a judgment before the inception of the tax lien.[16] It is perhaps significant that this view was endorsed by government counsel, arguing *for* a broad federal lien priority, before the Court of Appeals in the instant case.[17] In light of this decision, it would seem clear that the mere assertion of a mechanics lien or reliance on the statutory trust will afford no protection from a subsequently vesting federal tax lien.

B. However, the cases demonstrate that the claim of the federal government is still subject to attack where in fact the taxpayer did not have a property interest against which the lien could lodge. In *AEtna Casualty and Surety Company v. United States,*[18] decided by the Court of Appeals later in this term, the surety company, seeking to recover funds by the New York City Housing Authority by virtue of its completion of construction defaulted upon by its principal, a contracting firm, contested the claim of the government to the funds on account of its lien for unpaid taxes due from the contracting firm.

In the original contract between the contractor and the Authority, provision was made for partial payments as the work progressed, provided the contractor first prove that it was performing satisfactorily. Under the contract, the Authority was empowered to withhold or reduce such payments and apply them directly to the payment of sub-contractors, materialmen, etc. In effect, the contractor's right to any payment was subjected to a condition precedent that it fully and faithfully perform its contract obligations which, as events proved, it was not able to do. In the application for the performance bond, required by the Authority, the contractor had made AEtna assignee and subrogee. As a result of the contractor's default, the surety incurred losses far in excess of payments remaining in the possession of the Authority at the completion of the work. The tax liens in question arose subsequent to the execution of the bonds but before the contractor's default.

On these facts, the Court held that at no time did the contractor acquire an interest in the funds upon which the federal lien could attach.[19] In so doing, it rejected the United States claim that the determination of this issue must

15. Cranford Co. v. Leopold & Co., 298 N.Y. 676, 82 N.E.2d 580 (1948).
16. United States v. White Bear Brewing Co., 350 U.S. 1010, 1011 (1956).
17. Brief of Appellant, p. 17, Aquilino v. United States, *supra* note 2.
18. 4 N.Y.2d 639, 176 N.Y.S.2d 961 (1958).
19. AEtna Casualty and Surety Company v. United States, 4 N.Y.2d 639, 176 N.Y.S.2d 961 (1958).

rest upon federal law and found instead that the problem whether property belongs to a taxpayer or not is a state law problem. Only after the interest of the delinquent taxpayer in the property has been established does the federal lien attach and the problem of priority of liens, as to which law is dominant, arise.[20]

By New York law, a surety which performs under its bond is an equitable lienor as of the date of the execution of the bond and is subrogated to the rights of the party protected by the bond, even though this equitable lien is not enforcible until the surety suffers a loss.[21] Just as the Authority could withhold and apply the funds, on default of the contractor, so could AEtna, subrogated to the Authority's rights as it was, with the result that the contractor never had any right or claim to the funds.

The distinction between the application of state law to determine property rights (who owns the property?) and the application of federal law to determine the relative priority of liens (when is a lien perfected within federal concepts?) is a question of some subtlety. In the *Aquilino* case, the statutory trust concept in New York which purports to create a type of proprietary interest in materialmen was not allowed to defeat the claims of the federal government because it had yet to be enforced. In *AEtna,* however, a proprietary interest superior to any claim of the United States is recognized even though the right to enforce that proprietary interest did not arise until after the tax liens came into effect. The distinction seems to be that in the former case the taxpayer had a vested interest in receiving the funds due, subject to his obligation to pay materialmen, whereas in *AEtna,* no right to receive the disputed funds had ever arisen in the taxpayer.

Validity of Mortgage Where Accompanying Notes Invalid

When Amherst Factors, a domestic corporation not organized under the Banking Law, brought an action to foreclose a mortgage executed by deceased to secure a loan to a third party by Amherst, deceased's administratrix sought to have the mortgage declared void. She argued that a discounting of notes given by the recipient to Amherst, in violation of Section 131 of the Banking Law[22] made both the notes and the mortgage, securing payment of those notes, void,

20. Fidelity and Deposit Co. of Maryland v. New York City Housing Authority, 241 F.2d 142 (2d Cir. 1957); Morgan v. Commissioner, 309 U.S. 78, 80 (1939).

21. U. S. Fidelity and Guaranty Co. v. Triborough Bridge Authority, 297 N.Y. 31, 74 N.E.2d 226 (1947); Scarsdale National Bank and Trust Co. v. U. S. Fidelity and Guaranty Co., 264 N.Y. 159, 190 N.E. 330 (1934).

22. The section provides that only corporations organized under the Banking Law have power to discount notes, and that ". . . all notes and other securities for the payment of any money . . . made or given to secure the payment of any money loaned or discounted by any corporation or its officers, contrary to the provisions of this section shall be void."