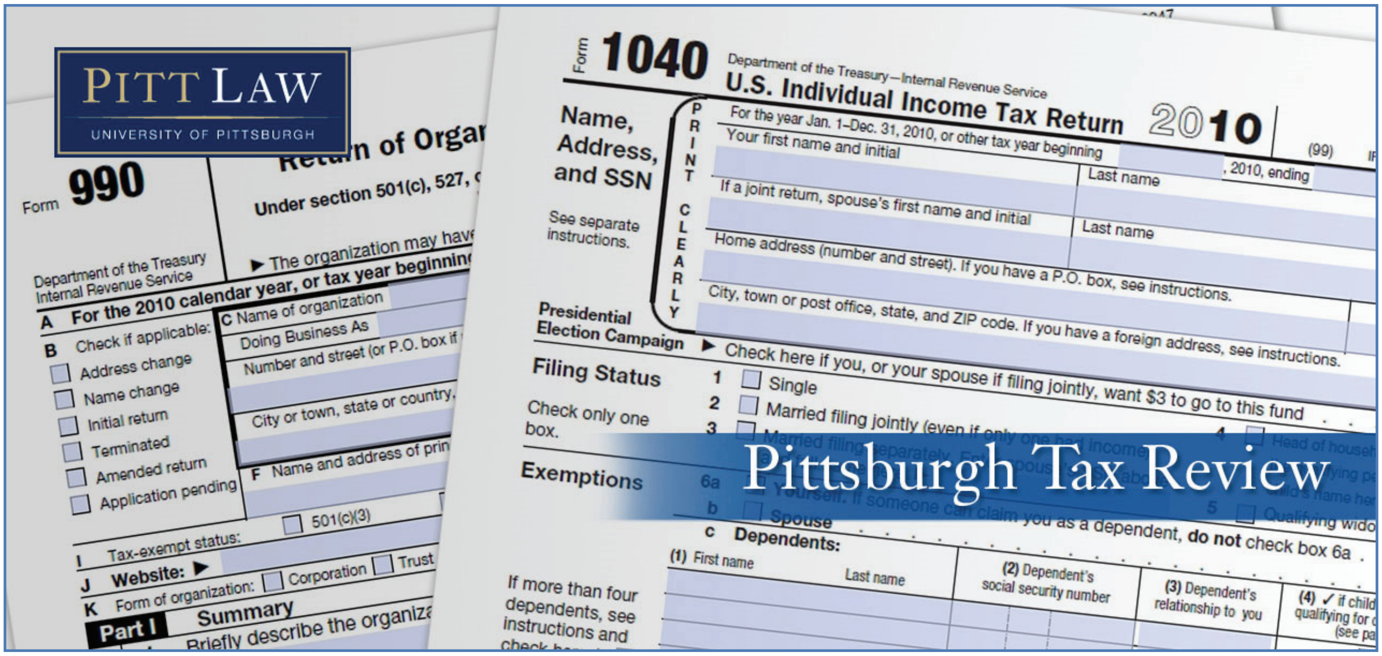

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THE UNEASY CASE AGAINST TAX LIEN SUBORDINATION

Shu-Yi Oei

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Shu-Yi Oei[*]

Abstract

I.R.C. § 6323, which governs how the federal tax lien ranks against the interests of the taxpayer's other creditors, subordinates the tax lien to the claims of other creditors in various ways. Tax lien subordination is commonly justified on the grounds that it enhances taxpayer asset value, facilitates commercial transactions, and reduces monitoring costs for private creditors. This short essay argues, however, that these benefits may be illusory. Tax lien subordination may, in fact, create costs and distortions and may lead to unfair distributive results. This essay suggests that the tax lien priority scheme might be made less costly by reducing its multiple levels of subordination. This could be accomplished in two ways: First, by reducing the magnitude or number of the superpriorities and other prioritized interests; and second, by eliminating the priority of the four horsemen over the un-noticed federal tax lien, or, alternatively, by moving away from a system of pure public notice and toward a semi-private inquiry-based system.

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[*] Hoffman F. Fuller Associate Professor of Tax Law, Tulane Law School. The author would like to thank the participants of the 2013 Pittsburgh Tax Workshop, the 2013 University of Washington Tax Symposium, and the Tulane Law School Junior Faculty Brownbag Series for their feedback on this essay. My particular thanks to Tessa Davis, Mirit Eyal-Cohen, Adam Feibelman, Catherine Hardee, Marjorie Kornhauser, Saru Matambanadzo, Diane Ring, Amy Stein, and Kristen van de Biezenbos for helpful comments on drafts.

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INTRODUCTION

The federal tax lien constitutes the government's legal claim on a taxpayer's property where the taxpayer has failed to pay a tax owed. The tax lien is a powerful tax collection device that is available to the IRS to help facilitate revenue collection. However, its use has come into question in recent years. Critics, including the National Taxpayer Advocate ("NTA" or "Taxpayer Advocate"), have pointed out that while the tax lien can improve tax collection and compliance, IRS decisions on when to file a public Notice of Federal Tax Lien ("NFTL") can have adverse impacts on both the taxpayer's financial situation and the IRS's ability to collect.[1]

Such criticisms raise questions about the appropriate scope of how the IRS should deploy its tax lien power. However, quite apart from questions about deployment, there is a more fundamental problem: The *design* of the tax lien priority scheme has several troubling features. The design of the tax lien law is important because the tax lien's design features cannot help but impact the way the IRS chooses to exercise its lien power. In sum, deployment issues are dependent upon and cannot be isolated from design considerations.

This short symposium essay presents a preliminary critique of our system of prioritizing the federal tax lien against the interests of other creditors.[2] It focuses, in particular, on places where the law provides that the IRS's lien lines up behind—*i.e.*, is subordinated to—the interests of other creditors with respect to order of repayment. Tax lien subordination has a couple of different aspects. First, until a public NFTL is filed, the tax lien will not be valid against the interests of purchasers, security interest

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[1] *See* 1 NAT'L TAXPAYER ADVOCATE, FY 2011 ANNUAL REPORT TO CONGRESS 109 (2011) [hereinafter 2011 NTA ANNUAL REPORT] (showing that "lien filings under the criteria for the study period have a negative effect on the compliance behavior and financial viability of affected taxpayers"); 1 NAT'L TAXPAYER ADVOCATE, FY 2012 ANNUAL REPORT TO CONGRESS 403–25 (2012) [hereinafter 2012 NTA ANNUAL REPORT] (noting that despite the IRS's "fresh start" program, the continued use of automatic tax lien filing raises questions about the effectiveness of tax lien filings); *see also infra* notes 79–85 and accompanying text. *See also* Danshera Cords, *Lien on Me: Virtual Debtors Prisons, the Practical Effects of Tax Liens, and Proposals for Reform*, 49 U. LOUISVILLE L. REV. 341 (2011) (recommending changes in the manner in which the IRS files Notices of Federal Tax Lien, the procedures for withdrawal of NFTLs, and how tax liens are reported in taxpayer credit reports).

[2] *See* I.R.C. § 6323.

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holders, judgment lien creditors, and mechanic's lienors (the so-called "four horsemen").[3] Second, even after a public NFTL is filed, certain creditors (the "superpriorities") and some other types of creditor interests are allowed priority over the publicly noticed federal tax lien.[4] In addition, the IRS can also consent to subordination of the federal tax lien in certain situations, including where it believes that the amount realizable by the government from the liened property and the ultimate collection of the tax will be increased by virtue of such subordination.[5] Thus, subordination in one form or another occurs throughout the life of the federal tax lien.[6]

This essay critiques the design of the tax lien priority scheme, focusing, in particular, on these subordinative aspects. It argues that despite the sound policy reasons underlying their design, these statutory features—subordination of the unfiled tax lien to the four horsemen and subordination of the filed tax lien to various interests—may in fact work together to create a system that is unnecessarily costly and that distorts the behaviors of taxpayers, those who transact with the taxpayer, and the IRS. First, the statutory scheme creates strong incentives for the IRS to file NFTLs, and this has negative effects on taxpayers. Second, at the same time that the statute strongly incentivizes NFTL filings, it then reduces the power of the tax lien as a revenue generation tool by subordinating the IRS's interest to a number of private creditor interests. This has the potential to create a significant mismatch between the immense negative impact of the public NFTL filing and the actual revenue-generating power of the tax lien. Finally, both these aspects of tax lien subordination may not generate as much value to the taxpayer, the IRS, or private creditors as one might expect, and they may give rise to unfair distributive results.

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[3] I.R.C. § 6323(a), (f).

[4] I.R.C. § 6323(b), (c).

[5] I.R.C. § 6325(d).

[6] Subordination also occurs in federal liquidation bankruptcy proceedings. 11 U.S.C. § 724(b) (2012). While not discussed in this essay, the subordination of the tax lien to the interests of various priority creditors in the bankruptcy context raises similar issues of efficiency and fairness. *See, e.g.*, Frances R. Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach*, 50 TAX LAW. 103, 164–66 (1996) (discussing 11 U.S.C. § 724(b) distributive scheme); Jack F. Williams, *A Comment on the Tax Provisions of the National Bankruptcy Review Commission Report: The Good, the Bad, and the Ugly*, 5 AM. BANKR. INST. L. REV. 445, 458 (1997) (discussing some of the policies behind subordination of the tax lien under 11 U.S.C. § 724(b)).

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The broader question that must be weighed in evaluating the statute's design is whether the costs and distortionary effects of the tax lien priority scheme outweigh its projected benefits, and whether the distribution of costs and benefits is acceptable. Such costs and benefits include the costs and benefits to the IRS, the taxpayer, the taxpayer's creditors, and persons who may enter into transactions with the taxpayer in the aftermath of a tax delinquency. This essay suggests that given the tax lien statute's design, it is quite possible, perhaps even likely, that the costs of subordination may outweigh the benefits, or that costs and benefits are being distributed in an unacceptable way.

The question, then, is how the tax lien priority scheme might be reformed. Reform is a complicated endeavor because the giving of public notice is an important and longstanding feature of secured credit, and yet, many (though not all) of the costs of the tax lien priority system stem from the strong incentive for the IRS to file an NFTL in order to take priority over the four horsemen.[7] Reform is also complicated because of the backdrop of pre-1966 judicial decisions governing the relationship between the federal tax lien and the interests of other creditors.[8] Nevertheless, this essay makes two suggestions that may help ameliorate the costs and distortions in the current system: First, assuming that public notice of the existence of the tax lien is something that we have to live with, it is somewhat illogical to then handcuff the power of the NFTL by subordinating the publicly noticed tax lien to the interests of the superpriorities and other creditors. Circumscribing the subordination of the tax lien to the superpriorities and other commercial interests (with a possible exception for unsophisticated creditors who cannot reasonably be expected to perform due diligence) is likely to help reduce the imbalance of costs and benefits as compared with the current tax lien priority scheme. This essay also makes a second, slightly more radical, suggestion for reform: Eliminating the priority accorded to the four horsemen over the unfiled federal tax lien may help reduce the incentive for the IRS to file NFTLs in order to prime the four horsemen. However, assuming that

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[7] *See infra* Part II.B.1.

[8] *See, e.g.*, United States v. White Bear Brewing Co., 350 U.S. 1010 (1956); United States v. Security Trust & Savings Bank, 340 U.S. 47 (1950); *see also infra* Part II.A.2 (discussing the choate lien doctrine).

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complete elimination of the priority of the four horsemen is not feasible, we could still reduce the stigmatizing effects of the NFTL by moving away from a system of public notice and toward a more *inquiry-based* system in which creditors would need to inquire with the IRS about the existence of a tax lien. This second suggestion calls into question a longstanding feature of secured lending—the giving of public notice—and it may hence be unfeasible. However, such a change would clearly help reduce the stigma associated with a public NFTL filing.

This essay proceeds as follows: Part I introduces the basic workings of the federal tax lien and discusses the various ways that current law subordinates the tax lien to the interests of other creditors. Part II outlines the policies that underlie and justify tax lien subordination and makes the case against tax lien subordination. Part II argues that even though the policy rationales underlying subordination of the tax lien may make some sense, tax lien subordination introduces costly distortions into taxpayer and creditor decisions prior to an NFTL filing, IRS tax collection decisions, and decisions of later-arriving parties. Moreover, tax lien subordination may not necessarily enhance the value of taxpayer assets in a way that benefits either the IRS or the taxpayer. Finally, Part III proposes that the tax lien filing and subordination system might be reformed by (1) circumscribing the superpriorities and other interests given priority over the publicly noticed federal tax lien, and (2) rethinking the need for public filing in order to perfect the tax lien against the interests of the four horsemen.

Underlying this essay's argument is a critique of the longstanding primacy accorded to the four horsemen over an un-noticed tax lien,[9] as well as an interrogation of the existence and expansion in 1966 of the superpriorities and other types of interests granted priority over the tax

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[9] While the Federal Tax Lien Act of 1966, Pub. L. No. 89-719, 80 Stat. 1125 (Nov. 2, 1966), updated the lien priority statute to take into account revisions to the Uniform Commercial Code in the 1950s, the priority accorded to mortgagees, pledgees, purchasers, and judgment creditors predates the 1966 legislation. *See* I.R.C. § 6323(a), prior to amendment by Pub. L. No. 89-719, 80 Stat. 1125 (Nov. 2, 1966). *See also* Priority of Federal Tax Liens and Levies, Hearings before the Committee on Ways and Means, House of Representatives, 89th Cong. 2d Sess., on H.R. 11256 and H.R. 11290, at 36–38 [hereinafter PRIORITY OF FEDERAL TAX LIENS AND LEVIES] (Statement by Hon. Stanley S. Surrey, Assistant Secretary of the Treasury, explaining the necessity of the 1966 legislation).

lien.[10] These features of the tax lien priority statute may seem so entrenched in our tax law as to be immovable. However, in light of the known costs of an NFTL filing, and in light of insights generated by post-1966 scholarship discussing the merits of secured lending and the way secured creditors should be ranked against other creditor interests,[11] it is appropriate to at least reconsider how the tax lien prioritization scheme might be redesigned.

The argument advanced here is a preliminary critique: this essay has not attempted to quantify or empirically determine the costs and benefits of the current tax lien priority scheme. Rather, it has merely described and assessed the types of distortions and costs that ought to be considered. Further empirical study may well demonstrate that the benefits of tax lien subordination do, in fact, outweigh its costs. However, given what we currently know about the costs of tax lien subordination, it is at least plausible that an alternative scheme of ranking liens and other interests may lead to a better outcome for everyone concerned.

I. The Federal Tax Lien and Its Subordination

This Part describes the basic framework of the federal tax lien law and discusses the places in which the tax lien priority statute, I.R.C. § 6323, subordinates the federal tax lien to other interests.

A. The Federal Tax Lien and the Notice of Federal Tax Lien

The federal tax lien arises by operation of law upon assessment and the debtor's failure or refusal to pay the tax upon demand.[12] The lien is created in the amount of the tax, including interest, additions to tax, and assessable penalties and costs.[13] It continues until the tax debt is satisfied or becomes

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[10] *Id.* For commentary on the 1966 legislation, see Peter F. Coogan, *The Effect of the Federal Tax Lien Act of 1966 upon Security Interests Created under the Uniform Commercial Code*, 81 HARV. L. REV. 1369 (1968); Dean L. Overman, *Federal Tax Liens: A Guide to the Priority System of Section 6323 of the Internal Revenue Code*, 16 B.C. L. REV. 729 (1975); William T. Plumb, *Federal Liens and Priorities, Agenda for the Next Decade*, 77 YALE L.J. 228 (1967).

[11] *See infra* notes 111–15 and accompanying text.

[12] I.R.C. § 6321.

[13] *Id.*

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unenforceable due to lapse of time.[14] The lien attaches to all of the taxpayer's property and property rights, including property and property rights acquired by the taxpayer after the lien arises.[15] The tax lien is perfected against certain parties upon assessment, the receipt of the Notice and Demand for Payment, and the taxpayer's failure to pay.[16] However, in order for the tax lien to have priority over purchasers, security interest holders, mechanic's lienors, or judgment lien creditors (the four horsemen), an NFTL must be filed.[17]

Unlike certain other types of interests such as mortgages, the tax lien only arises upon nonpayment of a tax liability.[18] This means that there is significant stigma associated with the existence of the tax lien and the subsequent public filing of the NFTL that may not be present in the creation and perfection of certain other types of creditor interests.[19]

B. The Multiple Facets of Tax Lien Subordination

There are three main places in the tax lien priority statute in which the federal tax lien is subordinated to other interests: First, the tax lien is

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[14] I.R.C. § 6322.

[15] I.R.C. § 6321; Treas. Reg. § 301.6321-1.

[16] *Id. See also* Steven R. Mather & Paul H. Weisman, *Federal Tax Collection Procedure—Liens, Levies, Suits and Third Party Liability*, TAX MGMT. PORTFOLIOS NO. 637 (BNA), at A-20(1) (2009) (noting that the lien "is automatically perfected following assessment, notice and demand, and nonpayment" but that the lien "is not perfected against purchasers, holders of security interests, mechanic's lienors or judgment lien creditors until the [NFTL] is filed").

[17] I.R.C. § 6323(a), (f); *see also* Mather & Weisman, *supra* note 16, at A-20(1).

[18] I.R.C. § 6321. For example, a mortgagee may take a security interest in the mortgaged property prior to the borrower defaulting on the debt. The fact that the IRS cannot take a security interest in advance of a taxpayer's default has been noted in the bankruptcy debate about whether tax debts should take priority over other debts. *See* 4 ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY ¶ 507.02[4][b] (16th ed. 2011); Barbara K. Day, *Governmental Tax Priorities in Bankruptcy Proceedings: An International Comparison*, 15 J. BANKR. L. & PRAC. 5, art. 2 (2006) (noting that the IRS is "unable to . . . obtain security for debt before extending credit"); Hill, *supra* note 6, at 150 ("The Service may not take any action before a taxpayer has refused to pay, and then may act only subject to significant limitations.").

[19] That such stigma exists is supported by the numerous adverse effects on a taxpayer's financial viability (in terms of job applications, loan applications, ability to rent property, or ability to refinance) that follow an NFTL filing. *See infra* notes 79–85 and accompanying text; *see also supra* note 1.

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subordinated to the interests of the four horsemen where an NFTL has not yet been filed.[20] Second, even after the NFTL has been filed, the tax lien is subordinated to certain creditors with superpriority.[21] Third, the tax lien is subordinated to certain other interests, including (1) certain security interests that arise after NFTL filing but that are subject to a written agreement entered into prior to the NFTL filing; and (2) certain interest and expenses relating to liens or security interests having priority over the federal tax lien.[22]

These three dimensions of subordination are obviously not the same. The first concerns subordination of the tax lien absent public filing. The second and third concern subordination of the tax lien that occurs even after an NFTL has been filed. Thus, the three dimensions of subordination relate differently to the giving of public notice. Subordination is nonetheless useful as a loose umbrella concept that encompasses places in the tax law providing that the IRS's lien ranks behind the interests of another creditor in repayment order. This essay argues that the various layers of subordination in the tax lien priority scheme, working together, interact to create unnecessary costs and distortions.

1. Subordination of Choate but Un-Noticed Federal Tax Lien to the Four Horsemen

I.R.C. § 6323(a) provides that even though the federal tax lien is perfected and valid against certain interests upon failure to pay the assessed tax liability upon notice and demand, certain other creditors whose interests arise after the federal tax lien has arisen but before a Notice of Federal Tax Lien has been filed will be protected against the effects of the tax lien.[23] These creditors, known as the four horsemen, are purchasers,[24] holders of a

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[20] I.R.C. § 6323(a).

[21] I.R.C. § 6323(b).

[22] I.R.C. § 6323(c).

[23] I.R.C. § 6323(a), (f); *see also* I.R.C. § 6321. In addition, if the NFTL has not been properly filed prior to bankruptcy, the bankruptcy trustee/debtor-in-possession may avoid the tax lien using its strong-arm powers. 11 U.S.C. § 544.

[24] A purchaser is defined as a person who, for full and adequate consideration, acquires an interest (other than a lien or security interest) in property that is valid under local law against subsequent purchasers without actual notice. I.R.C. § 6323(h)(6). An interest in property for this purpose includes leases of property, written executory contracts to purchase or lease property, an option to purchase or

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security interest,[25] mechanic's lienors,[26] and judgment lien creditors.[27] In other words, filing an NFTL is necessary in order for the tax lien to have priority over these creditors.[28] In determining when a competing lien arises, the choateness doctrine has traditionally applied: the competing lien can only prime (*i.e.*, take priority over) the federal tax lien if the competing lien specifically identifies the identity of the lienor, the amount of the lien, and the property subject to the lien.[29] The competing lien must also be perfected.[30]

What is an NFTL? An NFTL essentially constitutes public notice to other creditors of the government's legal claim on the taxpayer's property.[31] The filing of an NFTL puts other creditors and the public on notice that the government has a claim on the taxpayer's property as a result of an unpaid

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lease property or any interest in property, or an option to renew or extend a lease of property (provided such leases, contracts, and options are not a lien or security interest). *Id.*

[25] A security interest is any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. I.R.C. § 6323(h)(1).

[26] A mechanic's lienor is "any person who under local law has a lien on real property (or on the proceeds of a contract relating to real property) for services, labor, or materials furnished in connection with the construction or improvement of such property." I.R.C. § 6323(h)(2). The mechanic's lien arises at the "earliest date such lien becomes valid under local law against subsequent purchasers without actual notice, but not before he begins to furnish the services, labor, or materials." *Id.*

[27] A judgment lien creditor is one "who has obtained a valid judgment, in a court of record and of competent jurisdiction, for the recovery of specifically designated property or for a certain sum of money." Treas. Reg. § 301.6323(h)-1(g) (2011). A judgment lien will not be considered perfected until the identity of the lienor, the property subject to the lien, and the amount of the lien have been established. *See id.*

[28] I.R.C. § 6323(a); *see also* Mather & Weisman, *supra* note 16, at A-21.

[29] *See* United States v. The Equitable Life Assurance Soc'y, 384 U.S. 323 (1966) (federal tax lien had priority over attorney fee lien, where attorney fees were not choate at the time when the tax lien attached); United States v. City of New Britain, 347 U.S. 81, 86 (1954) ("the priority of each statutory lien contested here must depend on the time it attached to the property in question and became choate"). *See also* MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE ¶ 16.01[2] (discussing choate lien doctrine); *id.* at ¶ 16.02[2][a] (2013) (discussing interaction of choate lien doctrine with I.R.C. § 6323).

[30] *See* United States v. McDermott, 507 U.S. 447 (1993) (discussing timing of perfection of federal tax lien and competing state judgment lien).

[31] I.R.C. § 6323(a), (f).

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tax debt.[32] The tax lien statute specifies the place at which the NFTL should be filed and the form that filing should take.[33] The method of filing will vary based on the type and location of the property.[34] However, the decision whether to actually file the NFTL is at the discretion of the IRS, and the Internal Revenue Manual specifies the conditions under which the IRS will actually file an NFTL.[35] For example, under the IRS's "fresh start" initiative, NFTLs will not be filed unless the amount owed by the taxpayer exceeds a certain dollar amount.[36] The IRS is required by statute to provide notice to the taxpayer of an NFTL filing.[37] The notice must inform the taxpayer of certain matters, including the taxpayer's right to request a "collection due process" (CDP) hearing with the IRS Office of Appeals, the available administrative appeal remedies and procedures, and the procedures for obtaining release of the tax lien.[38]

Even though the NFTL filing is discretionary, the significant nature of the four horsemen creates strong incentives for the IRS to file NFTLs to protect its interests. As discussed in Part II, this may be problematic because the existence of an NFTL can create multiple adverse

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[32] 1 NAT'L TAXPAYER ADVOCATE, FY 2009 ANNUAL REPORT TO CONGRESS 19 (2009) [hereinafter 2009 NTA ANNUAL REPORT] (noting that the tax lien is "sometimes called the 'secret' lien" and that the NFTL is filed "[t]o put third parties on notice and establish the priority of the government's interest in a taxpayer's property against [the four horsemen]").

[33] I.R.C. § 6323(f).

[34] *Id.*

[35] For a summary of the IRS's lien filing practices, see Cords, *supra* note 1, at 347–52 (describing the IRS's lien filing, release, and withdrawal policies). *See also* INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 5.12.2 (2013) [hereinafter INTERNAL REVENUE MANUAL] (Notice of Lien Determinations; laying out criteria for when IRS will file an NFTL).

[36] *See IRS Fresh Start Program Helps Taxpayers Who Owe the IRS*, IRS (Apr. 17, 2013), http://www.irs.gov/uac/Newsroom/IRS-Fresh-Start-Program-Helps-Taxpayers-Who-Owe-the-IRS; *see also* 2012 NTA ANNUAL REPORT, *supra* note 1, at 403 (describing the IRS's fresh start initiative); *Struggling with Paying Your Taxes? Let IRS Help You Get a Fresh Start*, IRS (Apr. 10, 2014), http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Struggling-with-Paying-Your-Taxes-Let-IRS-Help-You-Get-a-Fresh-Start.

[37] I.R.C. § 6320.

[38] I.R.C. § 6320(a)(3). For discussions of the CDP procedures, see generally Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 HOUS. L. REV. 1145 (2004); Bryan T. Camp, *The Failure of Adversarial Process in the Administrative State*, 84 IND. L.J. 57 (2009).

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consequences for a delinquent taxpayer over and above the tax delinquency itself.[39]

2. Subordination to the Superpriorities

A second aspect of tax lien prioritization consists of subordination of the properly noticed federal tax lien to the so-called "superpriorities" even after an NFTL has been properly filed. At the same time that the tax lien statute effectively forces the IRS to file an NFTL in order to rank ahead of the four horsemen, I.R.C. § 6323(b) provides that even after an NFTL is filed, the federal tax lien will not take priority over certain classes of "superpriorities."[40] While the pre-1966 law did contain a number of such superpriorities, the Federal Tax Lien Act of 1966 expanded the superpriorities to encompass a number of new interests.[41]

Very generally, the superpriorities are:

- Purchasers of or security interest holders in securities, if such purchaser or security interest holder does not have actual notice or knowledge of the federal tax lien's existence;
- Purchasers of motor vehicles who did not have actual notice or knowledge of the existence of the tax lien at the time of purchase and who acquired possession of the vehicle (and did not relinquish possession) before obtaining such notice or knowledge;
- Purchasers of tangible personal property at retail in the ordinary course of the taxpayer's trade or business, unless such purchase was intended to (or the purchaser knew the purchase would) hinder, evade, or defeat the collection of tax;
- Purchasers of household goods, personal effects, or certain other types of tangible personal property in casual sales for less than

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[39] *See infra* Part II.B.1.

[40] I.R.C. § 6323(b).

[41] *See* Federal Tax Lien Act of 1966, Pub. L. No. 89-719, 80 Stat. 1125 (Nov. 2, 1966); *see also* S. REP. NO. 89-1708 (1966), *reprinted in* 1966 U.S.C.C.A.N. 3722; H.R. REP. NO. 89-1884 (1966), *reprinted in* 1966-2 C.B. 815. The primacy of mortgagees, pledgees, purchasers and judgment creditors over a publicly noticed federal tax lien predated the 1966 Act. *See also supra* note 9 and accompanying text.

$1,000, if the purchaser does not have actual notice or knowledge (1) of the existence of the tax lien or (2) that the sale is one of a series of sales;

- Holders of liens under local law for the reasonable price of repair or improvement of tangible personal property subject to the lien, if the lienholder is and has been continuously in possession of such property from the time the lien arose;
- Holders of certain real property tax liens, if such lien is entitled under local law to priority over security interests in the real property that are prior in time to the tax lien;
- Holders of mechanic's liens on certain types of owner-occupied residential real property, if the contract price is not more than $5,000;
- Holders of certain attorney's liens, if the lien is enforceable against a judgment or claim settlement amount, to the extent of the attorney's reasonable compensation;[42]
- Organizations that are insurers under life insurance, endowment, or annuity contracts, in situations where such insurer has not had actual notice or knowledge of the existence of the lien and in certain other circumstances; and
- Loans made by certain banks and savings institutions that are secured against savings deposit, share or other accounts with such institutions, to the extent the loans were made without actual notice or knowledge of the existence of the tax lien.[43]

The existence of these superpriorities in the tax lien priority statute contrasts with a system that simply prioritizes the tax lien against other interests based on when the interest arises and when public notice of the

[42] This does not include judgments or settlement amounts against the United States if the United States offsets such judgment or settlement amount against any liability of the taxpayer to the United States. I.R.C. § 6323(b)(8).

[43] I.R.C. § 6323(b)(1)–(10).

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interest has been filed.[44] As Part II.B will explain further, the existence of the superpriorities means that after the IRS has filed an NFTL in order to take priority over the four horsemen, the power of the tax lien as a tax collection device is then reduced by virtue of subordination to multiple other creditor interests that overlap with the four horsemen.[45] This creates a potential mismatch between the potential negative effects of public NFTL filing and the actual benefits in terms of tax collection.

3. Subordination to Certain Commercial Transactions and Other Interests

In addition to the superpriorities, the federal tax lien also will not take priority over security interests in certain commercial transactions coming into existence after the NFTL is filed by virtue of a written agreement entered into before the NFTL filing, if such security interests are protected under local law against a judgment lien arising (as of the time of tax lien filing) out of an unsecured obligation.[46] The types of commercial transactions covered are real property construction or improvement financing agreements, obligatory disbursement agreements, and commercial transactions financing agreements.[47]

The federal tax lien is also subordinated to certain security interests coming into existence after an NFTL filing by virtue of certain disbursements made before 46 days after the NFTL filing (or, if earlier, before the person making the disbursements had actual notice or knowledge of the tax lien filing), if the security interest is in property subject to the tax lien at the time of tax lien filing and is covered by the terms of a written agreement entered into before the tax lien filing.[48] Finally, if a lien or security interest has priority over the federal tax lien, that priority is extended to interest and carrying charges on that lien or security interest,

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[44] *See* Overman, *supra* note 10, at 742 ("Under the basic federal priority standard, "first in time is first in right[]"[;] if none of the special rules . . . apply, a federal tax lien takes priority over a state-created lien unless the state lien is specific and perfected before the federal tax lien arises.").

[45] *See infra* Part II.B.2.

[46] I.R.C. § 6323(c)(1).

[47] *Id.*

[48] I.R.C. § 6323(d).

attorney compensation for collecting or enforcing that lien or security interest, costs of insuring payment of the secured obligation, and certain other costs and amounts associated with protecting that lien or security interest.[49]

Like the I.R.C. § 6323(b) superpriorities, the priorities for these commercial transactions and other interests represent another deviation from a system of lien prioritization in which the interests of creditors are ranked based on when they arise. Like the superpriorities, they may create value for the taxpayer and IRS but also ultimately reduce the collection power of the properly noticed federal tax lien.

4. Voluntary Subordination to Other Creditors

Finally, the IRS may also subordinate the federal tax lien to the interests of other creditors in certain circumstances, notwithstanding the fact that an NFTL has been filed.[50] The IRS does so by issuing a certificate of tax lien subordination.[51] In order to obtain subordination of the federal tax lien, the taxpayer must submit an application setting forth the reasons subordination should be granted, descriptions and appraisals of the property subject to the tax lien, and other documentation.[52]

Most pertinently, the IRS may issue a lien subordination certificate if the IRS believes that the amount realizable from the property listed on the certificate (or from any other liened property) will ultimately be increased by reason of the issuance of a certificate of tax lien subordination and that ultimate collection of the tax owed will be facilitated by such subordination.[53] For example, in the case of a taxpayer making monthly

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[49] I.R.C. § 6323(e).

[50] I.R.C. § 6325(d).

[51] *See Instructions on how to apply for a Certificate of Subordination of Federal Tax Lien*, IRS, http://www.irs.gov/pub/irs-pdf/p784.pdf [hereinafter *Instructions for Certificate of Subordination*]; *see also Application for Certificate of Subordination of Federal Tax Lien*, IRS (June 2010), http://www.irs.gov/pub/irs-pdf/f14134.pdf.

[52] *Id.*

[53] I.R.C. § 6325(d)(2). The IRS may also issue a lien subordination certificate (1) if the taxpayer pays an amount equal to the amount subordinated, or, (2) in the case of the lien for recapture of real estate tax attributable to special use valuation of certain farm or other qualified real property, if the IRS thinks that its interests will be adequately secured after such subordination. I.R.C. § 6325(d)(1), (3).

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payments on an outstanding tax owed, the IRS may voluntarily subordinate the tax lien to encourage a wholesaler to supply the taxpayer with more inventory, if it can be shown that the additional inventory would allow taxpayer to increase her monthly repayment to the IRS.[54]

II. CRITIQUING THE TAX LIEN PRIORITY SCHEME

The way in which the tax lien priority statute is designed gives rise to important efficiency and distributive consequences. The order in which the creditors line up determines how much each creditor gets paid and how much revenue the IRS forgoes. It also determines how much delinquent tax remains outstanding and hence affects the taxpayer's ability to borrow, enter into transactions, or otherwise operate going forward. From a behavioral standpoint, it impacts creditor, taxpayer, and IRS actions leading up to and in the aftermath of a tax delinquency.

There are good policy reasons for the existence of the multiple layers of tax lien subordination that exist in current law. In particular, it is clear that uncertainties for commercial lending (particularly in light of the Supreme Court's articulation of the choate lien doctrine), as well as the widespread adoption of the Uniform Commercial Code, were significant factors leading to the expansion of the rights of the four horsemen and the proliferation of the superpriorities and other prioritized interests in the Federal Tax Lien Act of 1966.[55] Moreover, from both a social insurance and a value-creation standpoint, there are reasons why the IRS, even after having properly filed a public tax lien notice, might want to cede some of this revenue to other creditors: The imposition of an income tax burden can exacerbate the financial distress experienced by certain taxpayers, and the existence of an unpaid tax liability can impede the consummation of business transactions between otherwise willing parties.[56] Thus, in certain

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[54] *Instructions for Certificate of Subordination*, *supra* note 51, at Section 7.

[55] *See supra* note 10; *see also* PRIORITY OF FEDERAL TAX LIENS AND LEVIES, *supra* note 9, at 36–41 (statement of Stanley S. Surrey discussing policies behind 1966 changes).

[56] Scholars and commentators have noted the role that tax collection policy can play in the creation and amelioration of economic distress. *See, e.g.*, James Andreoni, *The Desirability of a Permanent Tax Amnesty*, 45 J. PUB. ECON. 143, 144–45 (1991) (suggesting that tax amnesty can function "as a partial social insurance"); Shu-Yi Oei, *Who Wins When Uncle Sam Loses? Social*

contexts, it may seem justified for the tax creditor to cede its positional priority to other creditors in order to create value for the taxpayer, encourage private economic transactions, or ameliorate financial distress. On the other hand, such a system may also generate costs.

This Part discusses the policy rationales underlying the structure of the tax lien priority statute and then argues that the way the statute subordinates the IRS's claim to the interests of other creditors creates costly distortions.

A. Policy Rationales for Subordination of the Tax Lien to Other Interests

The main policy reasons for subordinating the tax lien to the interests of the four horsemen until an NFTL has been filed revolve around respecting the need for public notice and respecting the interests of secured creditors and other private creditor interests. Subordination to the superpriorities and other commercial interests is also driven by respect for certain private creditor interests, as well as an interest in enhancing value for the taxpayer and the IRS by encouraging commercial transactions and protecting certain types of creditors for whom monitoring may not be feasible.

1. Protecting the Integrity of Public Notice and Perfection

A clear unspoken policy rationale underlying the subordination of the unfiled federal tax lien to the interests of the four horsemen is the interest in maintaining a system of creditor notification in which public filing and notice is required in order for perfection.[57] The Article 9 system of secured credit is predicated upon a notice filing system in which properly filed public notice is required in order for a financing statement to be effective against the interests of other creditors.[58] By requiring public filing in order for the tax lien to prime the interests of the four horsemen, the tax lien statute evinces respect for such public notification.

Insurance and the Forgiveness of Tax Debts, 46 U.C. DAVIS L. REV. 421 (2012) (analyzing various tax forgiveness programs through a social insurance frame); *see generally supra* note 1.

[57] S. REP. NO. 89-1708, *supra* note 41, at 3723 (noting that the 1966 Act "substantially improves the status of private secured creditors"); H.R. REP. NO. 89-1884, *supra* note 41, at 2 (noting the same).

[58] *See* U.C.C. § 9-322 (describing "first in time to file or perfect" rule); U.C.C. § 9-504 (describing sufficient indication of collateral in the U.C.C. financing statement); U.C.C. § 9-521 (providing for a uniform form of written financing statement).

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2. Respecting Private Creditor Interests

More broadly, subordination also reflects a clear policy interest in protecting the rights of certain private creditors.[59] This is clear with respect to subordination to the four horsemen. It is also clear from the superpriority status awarded to creditors such as purchasers of securities, attorney's lienors, and banks that transact with the taxpayer in certain circumstances.[60] In fact, a key policy reason behind the superpriorities was to protect the interests of secured creditors in light of Supreme Court jurisprudence requiring that a competing lien or interest had to be "choate" and "specific" in order to prime the federal tax lien.[61] Choateness generally required that the identity of the lienor, the property subject to the lien, and the amount of the lien be established and fixed, and this was often difficult to satisfy with respect to certain types of collateral, such as inventory.[62] Several of the superpriorities and other prioritized interests represent subordination of the tax lien to private creditor interests that would have been held inchoate under the Supreme Court's interpretation of the doctrine.[63]

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[59] *See supra* note 57.

[60] I.R.C. § 6323(b)(1), (8), (10); *see also* Overman, *supra* note 10, at 739 (noting that the "dominant effect" of the 1966 Act was "to improve the position of secured creditors by (1) extending protection against unfiled tax liens to mechanic's lienors; (2) providing a clear definition of certain classes of secured creditors already protected regardless of the choateness at the time notice of the tax lien was filed; (3) broadly increasing the classes of creditors holding property interests for whom superpriority was to be given even against a noticed tax lien; (4) giving priority status to certain interests created after filing of a tax lien if they arose under specified types of financing agreements entered into before filing of the tax lien; and (5) providing a time period up to 45 days for further protection of some interests after filing of notice of the tax lien" (footnotes omitted)).

[61] *See* Coogan, *supra* note 10, at 1377–80 (discussing choate lien doctrine); Overman, *supra* note 10, at 731–37 (same); Comment, *Federal Tax Liens and Assignees of Accounts Receivable: Priority Without Reason*, 29 U. CHI. L. REV. 548 (1962); *see also White Bear Brewing*, 350 U.S. 1010; United States v. R.F. Ball Construction Co., 355 U.S. 587 (1958).

[62] *See supra* note 61. *See also* SALTZMAN & BOOK, *supra* note 29, at ¶ 16.01[2] ("After Security Trust, . . . , the Supreme Court has generally used the choate lien doctrine to find 'inchoate' almost every variety [of lien] with the result that these liens were subordinate[d] to the government's later-arising tax lien.").

[63] Coogan, *supra* note 10, at 1381 (noting that "subsections (b) through (e) [of I.R.C. § 6323] now give priority over a tax lien to certain interests which would have been held inchoate and incomplete under the old case law"); *see also, generally*, Frank R. Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905 (1954).

The legislative history of the Federal Tax Lien Act of 1966 supports the idea that the protection of secured and private creditor interests and conformity with the Uniform Commercial Code (which by and large advances the primacy of secured credit) are important policy concerns underlying tax lien subordination.[64] Both the Senate and House Reports indicate that the 1966 Act "substantially improves the status of private secured creditors" by expanding and clarifying the categories of creditors having priority over an unfiled tax lien and by expanding the types of creditors being granted superpriorities.[65] In addition, the Ways and Means Committee hearings on the proposed legislation support the notion that protecting the interests of business transactions was a key factor in the 1966 legislation.[66] Thus, both with respect to subordination to the four horsemen and subordination to the superpriorities, the protection of private (and, particularly, private secured) creditors is an important goal.

While the preferential position accorded to secured credit has been a subject of some debate among academics,[67] protection of secured creditors has long been an important feature of the bankruptcy distributive scheme and under Article 9 of the Uniform Commercial Code.[68] In this regard, the federal tax lien law has merely followed suit. On the other hand, the primacy of secured credit has not gone completely unchallenged: As

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[64] *See supra* note 57. The 1966 Act also modernized the treatment of tax liens to conform to the Uniform Commercial Code provisions. S. REP. NO. 89-1708, *supra* note 41, at 3722 (noting that "[t]his bill is in part an attempt to conform the lien provisions of the internal revenue laws to the concepts developed in [the U.C.C.]"); H.R. REP. NO. 89-1884, *supra* note 41, at 1–2 (noting the same).

[65] S. REP. NO. 89-1708, *supra* note 41, at 3723; H.R. REP. NO. 89-1884, *supra* note 41, at 2.

[66] *See* PRIORITY OF FEDERAL TAX LIENS AND LEVIES, *supra* note 9, at 36–41 (testimony of Stanley S. Surrey noting that "all interested parties . . . are in favor of the proposed act and agreed that it represents a careful and proper balancing of the interests of the Government and the needs of the business community"; also noting that revising the federal tax lien law in order to accommodate changes to the Uniform Commercial Code is necessary because "these rules play an important part in day-by-day commercial activity").

[67] *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) [hereinafter Bebchuk & Fried, *Uneasy Case*]; Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279 (1997) [hereinafter Bebchuk & Fried, *Uneasy Case II*]; Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373 (1997); Douglas G. Baird, *The Importance of Priority*, 82 CORNELL L. REV. 1420 (1997).

[68] *See generally* U.C.C. §§ 9-101–709 (2010).

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discussed below, in both the bankruptcy and Article 9 contexts, secured credit's privileged position has been subject to extensive critique.[69]

3. Enhancing Value for Taxpayer and IRS

One of the main reasons for subordinating the tax lien to the superpriorities and other commercial interests is to enhance the value of the property subject to the tax lien by encouraging certain creditors to perform services or otherwise continue to engage in commercial transactions with a distressed or delinquent taxpayer. The theory is that the reduction of monitoring burdens and the risk of loss may encourage private parties to transact with the taxpayer without fear of their interests being displaced by a tax lien, and may enhance taxpayer asset value and IRS collection amounts.

This rationale is articulated both in the legislative history and by secondary commentators.[70] For example, in the case of real property construction and improvement financing agreements, the legislative history indicates that it is appropriate to subordinate the tax lien because "the construction is expected to enhance the value of the property underlying the tax lien."[71] This logic also applies in the decision to subordinate the tax lien to attorneys' lienors, certain mechanics' lienors, purchase money security interests, certain possessory liens on personal property for repair or improvement of the property, and, arguably, certain loans made by banks and deposit institutions secured by bank deposits.[72] As discussed, many of these interests would otherwise have been found to be inchoate (and hence subordinate to the tax lien) under prior judicial doctrine, and the argument for their superpriority status was that the choate lien jurisprudence acted as

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69 *See, e.g.*, Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1891 (1994) (noting that "[s]ecurity tends to misallocate resources by imposing on unsecured creditors a bargain to which many, if not most, of them have given no meaningful consent . . . ."); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 812–14 (1987) (arguing against a collectivist view of bankruptcy that privileges secured creditors); *see also infra* Part II.B.4.

70 H.R. REP. NO. 89-1884, *supra* note 41, at pt. 1 (1966); *see also* Mather & Weisman, *supra* note 16, at A-36 (noting that some superpriority interests exist "because the protected party is contributing to an increase in the taxpayer's assets or net worth").

71 S. REP. NO. 89-1708, *supra* note 41, at 3723; H.R. REP. NO. 89-1884, *supra* note 41, at 2–3.

72 *See* Mather & Weisman, *supra* note 16, at A-36–A-39.

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a freeze on commercial transactions by making secured lenders vulnerable.[73] Because of the interest in facilitating commerce and enhancing value, the lienholder in these contexts sometimes enjoys superpriority status even if she has actual knowledge of the existence of the federal tax lien.[74]

Value enhancement may benefit the taxpayer because it increases the value of the taxpayer's assets, making it more likely that the taxpayer can repay its tax and other debts. It may also benefit the IRS because enhanced asset values can increase the chances of the taxpayer being able to pay the tax owed. Thus, subordinating the tax lien to the superpriorities can appear to be a win–win proposition for the IRS and the taxpayer: The taxpayer becomes less likely to experience financial distress and is better able to enhance the value of his assets, and the IRS becomes more likely to be able to collect on the unpaid tax liability (or able to collect a larger amount of the liability).

4. Protection of Interests of Certain Parties Transacting with the Taxpayer without Knowledge of Lien Filing

Another related rationale for subordinating the tax lien to certain superpriorities is to protect the interests of creditors who might have transacted with the taxpayer without knowing about (or without being reasonably expected to know about) the existence of the tax lien.[75] For example, it is arguably unreasonable to expect purchasers of property in casual sales or ordinary course purchasers of automobiles to conduct a tax lien search before engaging in those transactions.[76] This might also be true for some mechanics' lienors. In such situations, the tax lien is subordinated in order to protect the casual or unwary purchaser from losing the benefit of the bargain into which they entered.

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[73] *See supra* notes 61–63 and accompanying text.

[74] *See, e.g.*, I.R.C. §§ 6323(b)(7), 6323(b)(8); *see also* Treas. Reg. 301.6323(b)-1(g)(1), -1(h)(1) (2011).

[75] *See* Mather & Weisman, *supra* note 16, at A-36 (noting that some superpriority categories "protect[] interests where it is unreasonable or impracticable to expect the protected interest to conduct a tax lien search prior to engaging in a transaction with the taxpayer").

[76] *Id.*; *see also* I.R.C. §§ 6323(b)(2), (3).

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B. Critiquing the Subordination of the Federal Tax Lien

Despite the apparently sound policy reasons for how the tax lien statute is designed, its structure has several problematic aspects. Subordination of the federal tax lien to other interests privileges certain private creditors over the IRS, in the hope that this will generate value for the IRS, the taxpayer, and those creditors. However, subordination can also come at a cost to the IRS, the taxpayer, and later-arriving parties who might otherwise have transacted with the taxpayer after a tax delinquency. Thus, the question that must be answered is whether the benefits generated by the structure of the tax lien priority statute exceed the cost to the IRS, the taxpayer, and the later-arriving parties of subordinating the IRS's interests.

In weighing costs and benefits, the *distribution* of costs and benefits across the taxpayer, the IRS, and the taxpayer's other creditors (both current and later arriving) is also important. Ideally, the goal of the tax lien priority scheme and of tax collection more broadly should be to generate revenue for the IRS, but also to help bring taxpayers back into compliance and to mitigate the damage to the taxpayer's rehabilitation prospects going forward. Prioritizing the interests of certain private creditors over the IRS may or may not facilitate both these goals. However, what is clear is that revenue collection and taxpayer rehabilitation should not be completely subsumed to the interests of private creditors.[77]

For the following reasons, it is possible that the costs of tax lien subordination may exceed its benefits and that the distributive allocation of costs and benefits between the IRS, the taxpayer, and other creditors may not be acceptable. First, requiring public notice of the tax lien in order for the IRS to take priority over the four horsemen distorts the IRS's decisions regarding when and whether to file an NFTL. Excessive NFTL filings can harm the taxpayer and discourage later-arriving parties from transacting with the taxpayer in a way that may be costly to the taxpayer and IRS.

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[77] *Cf.* Hill, *supra* note 6, at 106–07 (describing how the bankruptcy tax rules lead to a "value shift from taxpayers to secured and priority creditors of the debtor"); Shu-Yi Oei, *Getting More By Asking Less: Justifying and Reforming Tax Law's Offer-in-Compromise Procedure*, 160 U. PA. L. REV. 1071, 1098 (2012) (discussing the possibility of private creditor capture of the benefits of IRS forbearance in tax collection); Oei, *supra* note 56, at 445–61 (describing the goals and possible outcomes associated with the IRS exercising forbearance in tax collection).

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Second, once a public NFTL has been filed, it makes little sense to then subordinate the tax lien to superpriorities and other interests, because this causes a mismatch between the negative effects of the public NFTL and its actual collection power. Third, subordination may not actually create added value but may simply transfer it to private creditors. Furthermore, even if subordination does create some value, it may create it in a way that yields unacceptable distributive consequences.

1. The Value-Reducing Consequences of Subordination to the "Four Horsemen"

The subordination of the un-noticed federal tax lien to the four horsemen creates a strong incentive for the IRS to file an NFTL in order to gain priority over those creditors, even where an NFTL filing may actually reduce tax collections and harm the taxpayer going forward.[78] While the counterproductive effects of the IRS's NFTL filing policy have been strongly critiqued by the NTA, it is also important to highlight the existence of a significant built-in incentive for the IRS to file NFTLs in order to gain priority over the four horsemen. The point is that the IRS's much-critiqued *execution* of its NFTL filing policy is at least in part attributable to the *design* of the tax lien subordination system.

a. The Negative Effects of an NFTL (and the IRS's Persistence in Filing NFTLs)

The negative effects of an NFTL filing on a taxpayer are immense. A 2010 IRS focus group report ranked NFTL filings as the "number one factor that affects a taxpayer's economic circumstances and credit report," ahead of both foreclosure and bankruptcy.[79] For example, participants in the IRS focus group indicated that the NFTL filing would affect taxpayer credit reports, job and loan applications, insurance rates, ability to refinance, ability to sell property, ability to rent or lease property, and interest rates.[80]

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[78] *See infra* notes 86–87 and accompanying text.

[79] 2011 NTA ANNUAL REPORT, *supra* note 1, at 109 (citing *Final Report: Federal Tax Liens, the General Public and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, Small Business/Self Employed Division (SB/SE) Research, Denver, Project DEN0141 (Dec. 2010)).

[80] 2011 NTA ANNUAL REPORT, *supra* note 1, at 112.

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Other focus group participants also suggested that NFTL filings could be especially harmful in the case of small businesses because the NFTL can cause small businesses to be unable to obtain financing to keep running the business.[81] The Taxpayer Advocate has also noted the harmful effects of an NFTL filing on taxpayers, citing some of the same adverse effects mentioned by focus group participants.[82] The Taxpayer Advocate has noted that an NFTL filing reduces the taxpayer's credit score by an average of 100 points, and that the existence of the NFTL stays on a taxpayer's credit report for seven years, even after the liability has been paid and the lien released.[83]

In addition to harmful effects on the taxpayer, the tax lien filing has adverse consequences for the IRS as well. A 2011 Taxpayer Advocate Service research study found that IRS tax lien filing for the study period was negatively associated with taxpayer compliance behavior with respect to the liabilities at issue, taxpayer filing compliance, and taxpayer income earned after the NFTL filing.[84] Similarly, in a subsequent research study in 2012, the Taxpayer Advocate Service noted that NFTL filing was associated with the IRS collecting significantly less revenue from taxpayers against whom a lien was filed and also with a greater increase in the total tax liabilities of taxpayers against whom a lien had been filed.[85]

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[81] *Id.*

[82] 2009 NTA ANNUAL REPORT, *supra* note 32, at 17 (noting that "[t]he filing of a tax lien can significantly harm the taxpayer's credit and thus negatively affect his or her ability to obtain financing, find or retain a job, secure affordable housing or insurance, and ultimately pay the outstanding tax debt").

[83] 2009 NTA ANNUAL REPORT, *supra* note 32, at 20. If the tax is not paid, the lien may remain on the taxpayer's credit history for longer. *Id.* at 20 n.19.

[84] Terry Ashley et al., *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, 2 TAS Ann. Rep. Cong., 91, 94 (2011), http://www.irs.gov/pub/irs-utl/irs_tas_arc_2011_vol_2.pdf. The study found that NFTL filing had a positive impact on taxpayer payment compliance on subsequent liabilities, but noted that "[i]t is unknown if the lien filing actually improves subsequent payment compliance or if the lien filing is merely reducing the likelihood that a taxpayer will report subsequent liabilities, since the lien filing also shows a negative effect on subsequent filing compliance." *Id.* at 106.

[85] Terry Ashley et al., *Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior*, Taxpayer Advocate Serv., http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Research-Studies-Investigating-the-Impact-of-Liens-on-Taxpayer-Liabilities-and-Payment-Behavior.pdf.

Yet, despite this, the IRS persists in filing NFTLs. While the IRS has been willing to forgo NFTL filings when the amount owed is below a certain threshold amount, for bigger sums, there are strong incentives to file an NFTL in order to get ahead of the four horsemen, regardless of the *ex post* fall out.[86] Because these interests are quite significant, it would be hard to persuade the IRS not to file an NFTL, even if these interests do not exist yet, and even in the face of the NFTL's adverse effects on tax collection and taxpayer rehabilitation. For this same reason, approaches that advocate that the IRS determine whether an NFTL will actually increase the likelihood of collection prior to filing the NFTL are difficult for the IRS to administer and are unlikely to work, because there the IRS must protect its interests against later-arising security interests that may not exist yet.[87]

b. Explaining and Assessing the NFTL's Harmful Impacts

Structurally, the reason for the adverse impacts resulting from an NFTL filing is the reactions of third parties to the existence of the federal tax lien.[88] These third-party reactions are for the most part unavoidable, because the NFTL filing is public and it is difficult to direct or control the reactions of others to the lien's existence.[89]

A significant reason for the reactions of third parties is that there is a good deal of stigma associated with the existence of an NFTL filing. This is, in part, because an NFTL filing occurs in response to a delinquency that has already occurred. In other words, once an NFTL is filed, everybody knows that the taxpayer has failed to pay her taxes, which may carry the suggestion of severe financial difficulties, and this may discourage employers, landlords, or potential lenders from transacting with the

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[86] *See* 2009 NTA ANNUAL REPORT, *supra* note 32, at 19 (noting that "[t]he purpose of the NFTL is to protect the IRS's priority over other creditors").

[87] *See, e.g.*, Cords, *supra* note 1 (advocating the performance of such an analysis by the IRS prior to filing an NFTL).

[88] *See supra* notes 1 and 79–83 and accompanying text.

[89] It is true, however, that some incremental measures can be taken that make the NFTL less public or that mitigate the stigmatizing impacts of the NFTL filing. *See, e.g.*, Cords, *supra* note 1, at 366–69 (suggesting that swifter removal of the NFTL from the taxpayer's credit reports and better practices for the withdrawal of the NFTL after the tax has been paid would lessen the negative effects of the NFTL filing).

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delinquent taxpayer. In addition, the adverse reactions of third parties may also partially have to do with the more general stigma associated with the expressive connotations of failing to pay one's taxes, which may be less present with respect to other types of unpaid debts.[90]

Something else that may be happening is that those deciding whether to transact with the taxpayer may lack full information about how much value subordination generates. Thus, any value generated by subordinating the tax lien to the interests of private creditors may not necessarily be observable to later-arriving parties, who may react negatively to the NFTL's very existence but at the same time may not take the positive *ex ante* effects of subordination fully into account.[91] In other words, the presence of an NFTL may be more salient to later-arriving parties than the value created by various aspects of tax lien subordination.[92]

In sum, the existence of an NFTL creates more costs to taxpayers (and, indirectly, the IRS) going forward than if, say, an ordinary creditor were to perfect a security interest against a debtor. An NFTL filing not only harms the taxpayer but also generates adverse collections consequences for the IRS. Expressed in terms of costs and benefits, it might be said that in having the ability to transact with one of the four horsemen prior to a tax delinquency, the taxpayer is in fact required to take on additional costs on the back end, because she must be prepared for the likelihood and fallout of an NFTL filing should she become delinquent. These are non-obvious and deferred costs to the taxpayer and IRS that are in addition to the visible upfront costs of borrowing. Finally, it should be observed that, in addition to governing the distribution of costs and benefits as between the debtor, the government and the debtor's current creditors, the filing of the NFTL

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[90] *See generally* Darren Azman, *Don't Tell Mom I Didn't Pay My Taxes!: The Efficacy of State Shaming Campaigns on Taxpayer Compliance and Ideas for the Future*, 63 TAX LAW. 1251 (2010); Joshua Blank, *What's Wrong with Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539 (2009); Marjorie E. Kornhauser, *Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?*, 18 CAN. J. LAW & JUR. 95 (2005).

[91] *See* 2012 NTA ANNUAL REPORT, *supra* note 1, at 406–07; 2011 NTA ANNUAL REPORT, *supra* note 1, at 112 (both noting the harmful effects of an NFTL filing on various aspects of a taxpayer's life).

[92] This may be because an NFTL is more visible to such later-arriving parties than the value generated *ex ante* by tax lien subordination. *See generally* Deborah Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 YALE J. ON REG. 253, 262 (2011) (defining salience as "a bias in favor of prominent or visible information that affects people's economic behavior and responses").

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also creates costs with respect to later-arriving parties who may decide not to transact with the debtor due to the NFTL's existence.

2. Counterproductive Subordination to the Superpriorities, After Public Notice

To make matters worse, after strongly incentivizing NFTL filings in order to take priority over the four horsemen, the tax lien statute then undermines the publicly noticed tax lien's power by subordinating the tax lien to the superpriorities and other creditor interests.[93] This statutory structure can lead to a significant mismatch between the adverse impacts of an NFTL filing and the efficacy of the tax lien in actually raising revenue.

As discussed above, key policy rationales underlying the superpriorities are: to generate more value for the taxpayer and IRS by protecting private creditor interests and to protect those purchasers and creditors who cannot be expected to monitor for the existence of an NFTL. These policies may be somewhat justifiable.[94] However, subordination to the superpriorities and other commercial interests also weakens the collection power of the publicly noticed tax lien. It is possible that subordination generates enough added value for the taxpayer and IRS that the lien's overall collection power is not ultimately weakened. However, as Part II.B.3 discusses, it is at least open to question whether this is in fact what actually happens.[95] Furthermore, even if subordination (both to the four horsemen and to the superpriorities and other commercial interests) creates value, the distributive allocation of this value may be problematic because private creditors, rather than the IRS or taxpayer, may be the primary beneficiaries.

3. Critiquing the "Value Generation" Claim

Finally, it is possible that subordination of the tax lien to the superpriorities and other commercial interests may not, in fact, enhance the value of the taxpayer's assets. As discussed above, one of the theories underlying subordination is that if subordination enhances the value of the

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[93] I.R.C. § 6323(b)–(c).

[94] *See supra* Part II.A.

[95] *See infra* Part II.B.3.

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taxpayer's property, this will generate more collectible value where the tax lien attaches to that property.[96] It may also perhaps prevent the marginal taxpayer from falling into delinquency.[97] For example, the decision to subordinate the interests of the tax creditor to possessory liens for repairs or improvements of property, or to certain mechanics' liens, is based on this idea.[98] Similarly, the decision to subordinate the tax lien to certain parties for whom monitoring would be unfeasible is based in part on the idea that this may incentivize such parties to transact with the taxpayer more freely, without worrying about their transactions being overridden by a tax lien they did not know about.[99]

In agreeing to have its interest subordinated, the government is giving up collectible value to those other creditors, in the hopes that the asset value created by these transactions will lead to increased collections and fewer delinquencies. In sum, the hope is that the benefits generated outweigh the costs. In this calculus, the benefit generated by subordination should include the value created for creditors who have transacted with the taxpayer, as well as the benefits to the taxpayer and IRS (including any enhancement of taxpayer asset value or viability that results from tax lien subordination). On the flip side, the costs of subordination must include the economic and social costs to the taxpayer of having a persistent tax delinquency that has not been cured by the exercise of the IRS's tax lien power. It must also include the costs to the taxpayer associated with those transactions that might have occurred after a tax delinquency that do not in fact occur as a result of tax lien subordination and the failure to cure the delinquency. The costs of subordination must also include the costs to the IRS of possibly collecting a smaller amount due to subordination of the tax owed to other creditor claims. In addition, the *distribution* of costs and

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[96] *See supra* Part II.A.3.

[97] *Id.*; *cf.* Andreoni, *supra* note 56 (characterizing tax amnesty as playing a social insurance role); James Andreoni, *IRS as Loan Shark: Tax Compliance with Borrowing Constraints*, 49 J. PUB. ECON. 35, 44–45 (1992) ("amnesty turns tax cheating into a loan"); Oei, *supra* note 77, at 1095–97 (discussing rehabilitative value of the IRS's Offer in Compromise procedure); Shu-Yi Oei, *Taxing Bankrupts*, 55 B.C. L. REV. 375, 394 (2014) (discussing how IRS forbearance "may help keep marginal bankruptcy filers afloat").

[98] I.R.C. § 6323(a); *id.* §§ 6323(b)(5), (7).

[99] *See supra* Part II.A.4; *see also* I.R.C. §§ 6323(b)(2), (3).

benefits between taxpayers, the IRS, and current and later-arriving private creditors must be acceptable.

a. Does Usable Value Actually Get Created?

Without an in-depth empirical examination, it is impossible to know whether the benefits of subordination to the superpriorities and other creditors outweigh the costs. For example, there is no guarantee that the cost to the taxpayer of work done on a home by a mechanic's lienor holding superpriority will be outweighed by an increase in the home's value.[100] If it is not, then value would have been transferred to the contractor without actually increasing overall value from the transaction.

Furthermore, even supposing that asset value is enhanced, there is no guarantee that the taxpayer will be able to tap into that increased asset value in order to pay the IRS and bring herself back into tax compliance. Even if tax lien subordination does improve the taxpayer's overall financial picture, subordination may nonetheless result in an increased debt load for taxpayers and may not lead to increased collections for the IRS due to liquidity constraints and the difficulties associated with reducing illiquid assets to cash in the short term. For example, balance sheet improvements may not result in better actual tax compliance outcomes in a situation where, even if property value increases as a result of work and improvements, the taxpayer cannot tap into that value increase without selling the asset. In this sense, it is possible that tax lien subordination may actually result in increased taxpayer defaults. In short, despite the policy intentions of the statute, it is uncertain that value will actually be created for the taxpayer, and, if so, how much.

b. The Distributive Allocation of Costs and Benefits—Is It Acceptable?

As noted, apart from simply adding up costs and benefits, the distribution of the costs and benefits is also significant. One of the problems with tax lien subordination is that even if value is generated, it may well be

[100] *See* I.R.C. § 6323(b)(7).

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third-party creditors who are the main beneficiaries, rather than the IRS or taxpayer.

i. Does the IRS Benefit?

Even if the benefits of lien subordination were to outweigh its costs, there is a real question concerning how much the value created will actually benefit the IRS. This is in part because subordination of the tax lien forces the IRS to cede its place in line to the various priorities and superpriorities even if the IRS has properly filed an NFTL, which means other creditors get repaid first, soaking up enhanced asset value. In fact, one of the criticisms of the IRS's policy of automatic NFTL filing is that in many cases, there has been no inquiry about whether the lien filing will actually generate significant (or any) revenue for the IRS.[101] And, clearly, one of the factors affecting whether the IRS captures revenue is whether and how many other creditors are being paid ahead of the IRS.

The benefits to the IRS are especially in question because some superpriorities exist for social policy reasons or because of the interest in reducing monitoring costs for unsophisticated persons.[102] For example, the superpriority given to casual purchasers of household goods and certain personal property is largely driven by protection of these persons.[103] These types of subordination may or may not create value, but in any case the value they create may well be captured by third-party creditors and others who transact with the taxpayer, rather than by the IRS. Loss in value to the IRS is thus especially likely to be an issue where there are multiple creditors to whom the IRS's lien is subordinated, and where some of those creditors are not necessarily of the type who are likely to enhance the value of the taxpayer's assets.

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[101] *See supra* note 1; *see also* 2009 NTA ANNUAL REPORT, *supra* note 32, at ix (noting that the IRS's lien filing approach "harms taxpayers, does not produce significant revenue, and undermines broader IRS compliance goals").

[102] *See supra* Part II.A.4.

[103] I.R.C. § 6323(b)(4).

ii. Is the Taxpayer Unfairly Burdened?

In addition, the taxpayer—and not just the government—bears some of the cost of any value transferred to private creditors and other transacting parties by virtue of tax lien subordination, particularly if insufficient value enhancement occurs. These costs may be borne by the taxpayer in the form of the delinquent taxes that remain uncollectible due to subordination of the government's tax lien and the secondary impacts on taxpayers of having those outstanding tax liabilities.[104] Such tax delinquencies will usually remain outstanding after creditors' rights to the liened property have been exhausted, and this would hurt the taxpayer's ability to stay in compliance or rehabilitate itself into compliance.[105] The costs to the taxpayer may also be borne in the form of transactions with later-arriving parties that may otherwise have occurred but that did not occur (for example, due to a taxpayer's failure to cure a tax delinquency or due to excessive amounts of leverage). As discussed above, these costs are in addition to the costs to the taxpayer associated with the negative effects of an NFTL filing.[106]

Of course, the taxpayer may also enjoy some of the value created by tax lien subordination, but as this essay has argued, it is not certain that there will be a net benefit. Moreover, even if the benefits of subordination outweigh its costs, it is not clear who captures the benefits. Particularly in cases where the tax lien is subordinated to multiple other creditor interests, some of which may not enhance taxpayer asset value, it may be someone other than the taxpayer or IRS who benefits from any value created. To the extent that third-party creditors or purchasers capture the benefits, the taxpayer may bear the costs of such value transfer.

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[104] This assumes that the outstanding taxes are not ultimately forgiven as part of an Offer in Compromise, a partial payment Installment Agreement, or a Currently Not Collectible designation. *See* I.R.C. § 7122; Treas. Reg. § 301.7122-1 (Offer in Compromise procedure); I.R.C. § 6159 (Installment Agreement); INTERNAL REVENUE MANUAL § 1.2.14.1.14 (Nov. 19, 1980) (IRS Policy Statement 5-71, noting that "[i]f, after taking all steps in the collection process, it is determined that an account receivable is currently not collectible, it should be so reported in order to remove it from active inventory."). This also assumes that subordination does not enhance taxpayer asset value to the point where the taxpayer is able to pay off a great amount of its delinquent tax (*i.e.*, where the IRS is able to increase its amount of tax collected).

[105] *See supra* note 104 and accompanying text. *See also infra* Part II.B.4.

[106] *See supra* Part II.B.1.

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c. The Bankruptcy Endgame

Furthermore, the bankruptcy endgame must be considered: If a distressed taxpayer were to fall into bankruptcy, the outstanding tax liability may not be dischargeable in bankruptcy.[107] If subordination has not turned out to be value enhancing, pre-bankruptcy subordination of the tax lien to other creditors may increase the amount of such nondischargeable taxes that the taxpayer owes at the time of a bankruptcy filing. For those taxpayers who do end up in bankruptcy, the ultimate horrible would be that (1) tax lien subordination does not generate the anticipated value, (2) the resultant outstanding (and nondischargeable) tax debt is greater than it would have been absent tax lien subordination, and (3) when the taxpayer files for bankruptcy protection, she is stuck with that larger, nondischargeable tax debt (the increased magnitude of which is due to non-bankruptcy subordination to a private creditor debt that would have been dischargeable in the bankruptcy).

The possibility of this outcome suggests that at least some subset of individual taxpayers would probably rather pay their first dollar to the IRS (to reduce the amount of nondischargeable debts were the taxpayer to file for bankruptcy), rather than to some private creditor with superpriority (whose debt would have been dischargeable in the bankruptcy).

d. An Example

An example may help clarify the potential problems with the current statutory scheme: The statute provides that the properly filed federal tax lien is subordinated to a mechanics' lien on certain owner-occupied property to the extent of $5,000.[108] Assume that the taxpayer has contracted with a contractor to work on her home and the final contract price comes to $10,000. The taxpayer does not pay up, and a mechanics' lien is recorded on the property. The taxpayer also has a delinquent tax owed and the IRS has filed an NFTL in order to protect itself against the mechanics' lienor and other creditors.

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[107] 11 U.S.C. § 523(a).

[108] I.R.C. § 6323(b)(7).

The policy justification is that giving the mechanics' lien superpriority to the extent of $5,000 may incentivize the contractor to perform services for taxpayers of whom they may otherwise be leery. This may add value to the taxpayer's home. However, as many who have undertaken home renovation projects or tested real estate markets know, there is no guarantee that the mechanic's services will actually enhance or preserve the value of the property to an extent greater than the cost of the services.

In addition, putting the contractor ahead of the IRS may increase the outstanding tax liabilities owed by the taxpayer even if taxpayer's home value has been enhanced, due to the difficulty of liquidating the asset into payable cash.[109] Any such unpaid tax liabilities may lessen the financial viability of the taxpayer on a going-forward basis. Moreover, it is possible that later-arriving parties, such as potential employers, landlords, and lenders, may decide not to transact with the taxpayer due to the continuing tax delinquency or the existence of the publicly filed NFTL.[110] Finally, if the taxpayer were to file for bankruptcy protection, the amount of nondischargeable tax debt outstanding may be larger than it would have been absent tax lien subordination.

Thus, even though the hope is that giving such mechanics' liens a superpriority will yield benefits for the IRS and taxpayer, this example illustrates that this outcome is not guaranteed. The only person who may benefit is the mechanic, and the taxpayer and IRS may be harmed in the process.

4. The Relationship of the Tax Lien Priority Statute and Article 9

A final nagging issue bears addressing: This essay's critique of tax lien subordination cuts at a set of statutory features that elevate the position of secured creditors and commercial interests over the federal tax lien.[111] The main worry, of course, is that this may undermine secured lending by making it harder or more expensive for commercial transactions to occur.

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109 *See supra* Part II.B.3.a (discussing liquidity-based limitations on ability to repay a delinquent tax).

110 *See supra* Part II.B.1.

111 *See* Overman, *supra* note 10, at 731 (noting that prior to the 1966 Act, "the federal tax lien . . . held the upper hand in its battle with competing liens"); *see also id.* at 739 (noting that the 1966 Act improved the position of secured creditors).

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Another concern is that the critique cannot be taken seriously, because Article 9 and the institution of secured lending is so entrenched.

A full analysis of the institution of secured credit is beyond the scope of this essay and is a topic for another day. However, a few brief comments can be made. Since the enactment of the 1966 Federal Tax Lien Act, there has developed a significant body of scholarship debating the merits of secured lending. It is true that various influential contractarian and efficiency-based arguments have been advanced in favor of secured credit.[112] On the other hand, secured lending has also been subject to extensive critique. For example, Professors Bebchuk and Fried have critiqued secured credit on efficiency grounds.[113] Other scholars have advanced criticisms based on fairness, distributive justice, and other grounds.[114] The debates for and against the priority of secured creditors pertain not only to ordinary course commercial transactions but also to the appropriate design of the ranking of creditors in bankruptcy.[115]

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[112] *See, e.g.*, Douglas Baird, *The Importance of Priority*, 82 CORNELL L. REV. 1420 (1997); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1395 (1986) (arguing that "efficiency theories best explain the incentive to finance with secured debt and that most fears of distributional consequences are ill-founded"); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1148 (1979) ("Since creditors remain free to select their own debtors and to set the terms on which they will lend, there is no compelling argument based upon considerations of fairness for adopting one legal rule (debtors can rank creditor claims in whatever way they see fit) rather than another (all creditors must share equally in the event of bankruptcy).").

[113] Bebchuk & Fried, *Uneasy Case*, *supra* note 67 (critiquing the efficiency case for full priority of secured debt and suggesting that a partial priority rule may be superior); Bebchuk & Fried, *Uneasy Case II*, *supra* note 67 (developing further the analysis in *Uneasy Case*).

[114] *See, e.g.*, Kenneth N. Klee, *Barbarians at the Trough: Riposte In Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1468 (1997); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 931 (1985) (critiquing the efficiency case for secured credit as "unfounded on any discussion of the factual world of commerce"); LoPucki, *supra* note 69; Warren, *supra* note 69.

[115] Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 816 (1987); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 155–56 (1989); Warren, *supra* note 69.

The key point, for purposes of this essay, is that since the enactment of the 1966 Federal Tax Lien Act and its clear policy concern with advancing commercial interests, our understanding of the institution of secured credit with all of its benefits and costs—particularly in relation to the interests of involuntary creditors, such as tort creditors and the government—has advanced a good deal. In short, this essay's critique of how the tax lien statute ranks the government's interest against the interests of other creditors does not exist in a vacuum. Rather, it takes place against the backdrop of a larger commercial law and bankruptcy debate over the very same issue.

III. Envisioning a Different Tax Lien Priority Scheme

How might the tax lien priority scheme be reconceived to eliminate distortions, reduce costs, and introduce more certainty? Broadly speaking, the obvious strategy is to eliminate the features of the tax lien statute that create the existing distortions. This Part suggests two possible changes, the second more radical than the first. First, reducing the extent of subordination of the tax lien to the superpriorities and other commercial interests is likely to reduce the distortionary effects and costs of the tax lien. Second, eliminating the priority accorded to the four horsemen over the unfiled federal tax lien may help reduce the IRS's incentive to file NFTLs in order to take priority over the four horsemen. However, assuming that complete elimination of the need for public filing is not feasible, an incremental move away from a system of public notice and toward a more inquiry-based system might help reduce the stigmatizing effects of the NFTL filing.

A. Reducing the Superpriorities and Other Prioritized Interests

The first suggestion is to reduce the magnitude or at least the number of the superpriorities and commercial transactions over the properly filed federal tax lien. This would ameliorate the current mismatch between the stigmatizing effect of the NFTL and its power to collect. It would also increase certainty and reduce distortion. Reducing the magnitude of the superpriorities would simply require parties to make commercial and transactional decisions while taking appropriate account of outstanding tax liabilities.

The obvious objection to this proposal is that the superpriorities add value and encourage commercial transactions by protecting the interests of

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certain secured and private creditors. A reduction or removal of the superpriorities would constitute a return to something like a pre-1966 state of affairs in which the Supreme Court's choate lien jurisprudence created problems for secured lenders and other creditors and lienholders.[116] However, if choate lien jurisprudence was the problem, the solution ought to be judicial recalibration of that jurisprudence to offer slightly more protection for private creditor interests. The point is that provision of numerous statutory superpriorities—some of which are quite broad—for otherwise-inchoate private creditor interests may go too far in the other direction.[117] These types of interests could instead be offered a more limited protection through modification of the judicial choate lien doctrine.

Another possible objection to my proposal is that some of the superpriorities and certain of the four horsemen exist on social policy and consumer protection grounds. For example, it would arguably be unfeasible for motor vehicle purchasers to engage in extensive due diligence regarding the debtor's tax compliance status before entering into transactions with the debtor. A possible response is that in some instances it would be easier than one might think for transacting parties to obtain information about the debtor's tax picture. For example, in the case of motor vehicle purchasers, eliminating the superpriorities and other instances of tax lien subordination could cause it to be commonplace for car dealers to include information about their tax compliance status (or at least a representation that taxes have been paid) in the vehicle purchase paperwork. It is also possible that a system of insurance or indemnification might develop to account for the increased risk of being primed by the tax lien.[118]

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[116] *See supra* notes 61–63 and accompanying text.

[117] For example, the I.R.C. 6323(c) protection for certain pre-agreed commercial transactions is quite open ended. Some other superpriorities are protected regardless of the creditor's actual knowledge of the tax lien. *See supra* note 74 and accompanying text.

[118] For example, insurance for secured creditors been proposed by Professor Lynn LoPucki. LoPucki, *supra* note 69, at 1912–13 (proposing a rule allowing involuntary creditors priority over secured creditors combined with insurance to "insure the secured creditor against losses from subordination of the security interest to tort claims"). *But see* Susan Block-Lieb, *The Unsecured Creditor's Bargain: A Reply*, 80 VA. L. REV. 1989, 2007–09 (critiquing LoPucki's insurance proposal). *See also* Kristen van de Biezenbos, *A Sea Change in Secured Lending*, 48 U. MICH. J.L. REFORM ___ (forthcoming 2014) (on file with author) (drawing upon insights from maritime law to propose awarding priority to involuntary creditors while protecting secured creditors through insurance).

On the other hand, there are certainly some instances in which it would be difficult for transacting parties to perform extensive tax compliance diligence or to insure *ex ante*. Purchasers at casual sales come to mind. The proposed reforms might result in an unacceptable shifting of risk to these persons. Despite potential cost reductions, considerations of social policy and consumer protection might counsel against total elimination of the protections accorded to those creditors for whom monitoring is unfeasible. In these instances, something less than total elimination of the superpriorities and other interests is likely more realistic, while representing partial improvement.

B. Rethinking the Four Horsemen (and Rethinking Public Notice)

A more radical suggestion would be to circumscribe the priority of the four horsemen—security interest holders, purchasers, mechanics' lienors, and judgment lien creditors—over the un-noticed federal tax lien. As discussed, the presence of a public NFTL can have serious negative consequences for a taxpayer, but the need to protect its interests over the four horsemen creates strong incentives for the IRS to file NFTLs. Removing the ability of the four horsemen to prime an unfiled tax lien would lessen the need for the IRS to file NFTLs, and could help avoid some of the distortions associated with taxpayer, creditor, and other third-party reactions to an NFTL filing. In effect, this change unifies the creation and noticing of the federal tax lien. Another way of looking at it is that it puts the unfiled (and thus, effectively, secret) federal tax lien *pari passu* with secured creditors, purchasers, judgment lien creditors, and mechanics' lienors.

Removing the need for an NFTL filing in order to prime the four horsemen attacks a fundamental feature of secured credit, the giving of public notice.[119] This reform may seem overly radical and unfeasible. Critics could object that secured creditors, mortgagees, purchasers, judgment lien creditors, and mechanics' lienors would not have a way of accurately determining the existence of a tax obligation that would defeat their interests. However, eliminating the need for NFTL filings would simply require those persons to think about the tax picture of the debtor

[119] *See supra* Part II.A.1.

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more closely before acting, or to price the risks of an outstanding tax liability accordingly. This could be done by demanding to see recent tax returns or other evidence of compliance with tax obligations before lending or transacting. For example, at least the more sophisticated of these creditors should be incentivized to perform diligence about the debtor's tax situation before transacting, or to otherwise protect their interests by seeking indemnification, purchasing insurance, or otherwise. While these increased monitoring costs may be an additional constraint on lending transactions, they may, on the whole, be justified. In particular, removing or reducing the primacy of the four horsemen may actually make it less expensive for the taxpayer to transact with the types of creditors, once *ex post* costs are taken into account. Moreover, these incremental costs could be mitigated with some movement toward greater tax transparency and taxpayer information availability (though not so much as to simply recreate the stigma associated with an NFTL filing).[120]

Assuming that completely eliminating the primacy of the four horsemen is unfeasible, there are nonetheless some intermediate steps that could be taken to alleviate the stigmatizing effects of the completely public NFTL. For example, Professor Danshera Cords has proposed reforms to the Fair Credit Reporting Act to require credit reporting agencies to remove unpaid tax liens from a taxpayer's credit report within seven years after the tax debt becomes unenforceable, and to require the IRS to withdraw the lien upon payment of the tax or upon the taxpayer's request.[121] This is a step in the right direction; however, it does not by itself alleviate the stigma associated with having a publicly noticed tax lien for those seven years. Another possible middle-ground approach might be to preserve the primacy of the four horsemen over the unfiled tax lien but, rather than preserving the current system of totally public notification, move instead towards an

[120] Calls for increased transparency with respect to taxpayer returns are not new. *See, e.g.*, Stephen W. Mazza, *Taxpayer Privacy and Tax Compliance*, 51 U. KAN. L. REV. 1065, 1069 (2003) (arguing that government should be allowed to "selectively disclose taxpayer information to the public"); Joseph Thorndike, *Show Us the Money*, 123 TAX NOTES 148 (2009) (arguing that tax returns should be made public). *But see* Joshua D. Blank, *In Defense of Individual Tax Privacy*, 61 EMORY L.J. 265, 269 (2011) ("tax privacy enables the government to influence individuals' perceptions of its tax-enforcement capabilities by publicizing specific examples of its tax-enforcement strengths without exposing specific examples of its tax-enforcement weaknesses").

[121] Cords, *supra* note 1, at 366–69.

inquiry-based system. In other words, perhaps the IRS should be made to "file" a perfecting notice of tax lien in a semi-public way, such as in an IRS database. Secured lenders and purchasers may then be required to *inquire* about the existence of this semi-public filing and perhaps pay a small fee to obtain the information. The IRS would then be obliged to provide information about the tax lien upon such inquiry.

Moving toward an inquiry-based system has the benefit of making it slightly harder for the general public and for casually searching parties to obtain information about the federal tax lien. Such a move could arguably also be done in a way that alleviates the negative impacts of the NFTL on the taxpayer's credit score. Adopting a semi-private, inquiry-based system is probably also more realistic than complete elimination of public filing of the tax lien. In sum, such a move has the potential to generate lower costs to the taxpayer and IRS compared to a completely public NFTL filing.

CONCLUSION

This essay has advanced the thesis that although subordination of the tax lien to other creditor interests may appear to enhance the value of the taxpayer's assets and to facilitate commerce, these benefits may in fact be illusory, or at least overstated. The current longstanding system of multiple layers of subordination of the tax lien to various creditor interests generates distortions in the behaviors of the taxpayer, the IRS, and other later-arriving parties that may detract from any value enhancement that might occur. In light of the costs and distortions inherent in the current tax lien priority system, this essay has suggested that reverting to a simpler system of prioritizing creditor interests and liens that (1) reduces the superpriorities and/or (2) eliminates the primacy of the four horsemen over the unfiled tax lien or at least backs away from a system of completely public NFTL filing, should at least be considered.

The argument advanced here is necessarily uneasy, because the costs and distortions of the current system and how they weigh against the likely costs and benefits of my suggested reforms need to be more closely studied. This essay has not undertaken that study. My hope in this essay is to invite a conversation—particularly in light of advances in bankruptcy and Article 9 scholarship on the merits of secured credit and on the question of how creditors should be ranked—about whether fundamental reform of our longstanding tax lien priority scheme might be desirable.

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