

Lien on Me

BY DEBORAH J. CARUSO¹

Arising Claims and Secret Liens

Dealing with the Maze of Personal Property Taxes in Bankruptcy

Perhaps because they often involve relatively small amounts, personal property tax claims tend to get ignored by everyone: counsel for debtors, trustees, and sometimes even by the taxing authorities themselves. Nonetheless, the claims can be significant and the legal issues are often surprisingly complex, particularly in cases where the debtor has many offices scattered throughout the nation.

This was the situation encountered by the chapter 7 trustee in the recent bankruptcy case of *ITT Educational Services Inc.* and its affiliated companies — one of the largest chapter 7 cases in recent history — which involved 137 brick-and-mortar campus locations in 39 states, and roughly 200,000 creditors.² Not surprisingly for an educational institution, personal property such as computers, telephone systems, and classroom and office furniture comprised a substantial part of the estate assets. The bankruptcy estate hired an international liquidation company to assist in the process of evaluating, securing and selling personal property. To minimize administrative costs to the bankruptcy estate, the property was collected from the various campus locations, consolidated at a few centralized facilities and subsequently sold at three large, multi-state public auctions.

Meanwhile, numerous local governmental taxing authorities began filing claims related to *ad valorem* taxes imposed on the debtor's personal property, based on where the property was located at various points in time, such as the end of the calendar year, the date property reports were filed by the debtors or the date taxes were billed. Since personal property taxation laws, processes and terminologies vary significantly among taxing jurisdictions, reviewing such claims is not a simple task.

The proper *amount* of a claim is usually not the issue to be addressed by counsel for the debtor or trustee, since any objection based on the claim amount is usually subject to the local taxing jurisdiction's relatively short statute of limitations and appeals rules.³ Instead, property tax claims are

generally challenged, if at all, on whether they are allowed as a secured claim, an administrative expense, an unsecured priority claim or a general unsecured claim.

In chapter 7 cases, where all estate property is to be liquidated, it is especially important to make a threshold determination of whether a property tax claim is secured or unsecured, since any lien must be paid from sales proceeds before they are inadvertently distributed to other creditors. If the property is sold by the bankruptcy estate free and clear of liens under 11 U.S.C. § 363(f), with the liens transferring to the proceeds of the sale, the trustee then holds the proceeds subject to the liens. Although Bankruptcy Rule 3002(a) provides that with certain limited exceptions a secured creditor must file a proof of claim for the creditors' claim to be allowed, the creditor nonetheless retains its lien even if no proof of claim has been filed.⁴ In that situation, a chapter 7 trustee must determine whether the property that was sold was subject to a personal property tax lien at the time of the sale, sometimes without the aid of a proof of claim from the taxing jurisdiction asserting the basis for its lien.

The nature and extent of any lien for personal property taxes is of greatest importance with respect to *pre-petition* taxes, since 11 U.S.C. § 503(b)(1)(B)(i) provides that property taxes incurred post-petition, whether secured or unsecured, are allowed as administrative expenses, whereas property taxes incurred pre-petition by the debtor are entitled to be paid ahead of eighth priority unsecured claims under § 507(a)(8)(B)⁵ and general unsecured claims. Furthermore, interest and penalties for a late payment of the tax, which are allowed as administrative expenses along with the tax in the case of post-petition taxes,⁶ are also treated differently for pre-petition taxes.⁷

If the taxing authority does not file a secured proof of claim, the chapter 7 trustee must determine whether the personal property tax was incurred pre- or post-petition. If it occurred pre-petition, whether it is secured by a lien under state law, whether the



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2 *ITT Educ. Servs. Inc., et al.*, Case No. 16-07207-JMC-7A. The case is pending in the U.S. Bankruptcy Court for the Southern District of Indiana.

3 See *In re Meggitt*, 2018 Bankr. LEXIS 993, at *9 (Bankr. N.D. Ohio March 30, 2018) (stating that under 11 U.S.C. § 505(a)(2)(C), bankruptcy court may not determine "the amount or legality of any amount arising in connection with an *ad valorem* tax on real or personal property of the estate, if the applicable period for contesting or redetermining that amount under applicable nonbankruptcy law has expired").

4 See 11 U.S.C. § 506(d); *Dewsnup v. Timm*, 502 U.S. 410 (1992).

5 See *In re Donahue*, 520 B.R. 782, 785 (Bankr. W.D. Mo. 2014) (summarizing that to qualify for priority under 11 U.S.C. § 507(a)(8)(B), tax must (1) be a "property tax," (2) have been incurred prior to commencement of case and (3) have been last payable without penalty after one year prior to commencement of case).

6 11 U.S.C. § 503(b)(1)(C) (penalties); *United States v. Ledlin (In re Mark Anthony Constr. Inc.)*, 886 F.2d 1101, 1106 (9th Cir. 1989) (interest).

7 See 11 U.S.C. § 502(b)(2) (post-petition interest disallowed); 11 U.S.C. § 506(b) (post-petition interest, fees and charges allowed for secured claims); 11 U.S.C. § 726(a)(4) (pre-petition penalties subordinated to general unsecured claims).

lien is avoidable and whether the lien can be subordinated to certain priority unsecured claims under 11 U.S.C. § 724 must be determined.

When Was the Tax Incurred?

The process for levying personal property taxes generally requires the owner of the property to file a return with the local tax authority each year reporting the value of all non-exempt personal property located in the taxing jurisdiction and owned by the taxpayer on a certain date (the “ownership” date). The taxing authority then sets the tax rate, determines the annual amount due and sends a bill to the taxpayer, often payable in two installments. The entire process from the ownership date to the due date of the tax bill can span more than one calendar year. When this process straddles the petition date, a determination must be made under state law whether the tax was “incurred” pre- or post-petition.⁸

Courts have held that property taxes are treated as incurred when the debtor’s liability for the tax becomes fixed under state law, even if the amount of the tax is not determined until a later date. Generally, the ownership date will be the date when the tax is incurred, even though the assessment (the valuation of the property), determination of the tax rate, billing and due date occur later.⁹ However, in some cases, the tax could be treated as being incurred later in the process, such as the due date or the date that a lien attaches.¹⁰

When Did the Lien Attach?

Although not as pervasive as *ad valorem* real property tax liens, some states impose an automatic lien for personal property taxes on the property taxed. State law varies as to the date when the lien attaches.¹¹ In some states, the lien does not attach to personal property until the tax becomes delinquent and the taxing authority takes steps to file a notice of unpaid taxes,¹² or takes control of the property by levy or distraint.¹³

Under § 362(b)(18) of the Bankruptcy Code, an exception to the automatic stay permits post-petition creation or perfection of a statutory lien¹⁴ for *ad valorem* property taxes if the tax comes due after the petition date. While this exception is most relevant for post-petition taxes, it can also apply to personal property taxes incurred pre-petition if the due date is post-petition.

Another exception to the automatic stay, § 362(b)(9)(D), permits post-petition assessment of taxes, but any resulting lien does not attach to property of the estate unless the tax

is a debt of the debtor that will not be discharged and the property or its proceeds are transferred out of the estate or revested in the debtor. Thus, in a chapter 7 corporate bankruptcy (where the debtor will not receive a discharge), the lien could attach to the estate property.

What Property Is Subject to the Lien?

Given the vagaries of the local laws regarding when taxes are “fixed” and the creation of liens, the legal issues quickly become quite complex, especially if personal property located in one jurisdiction before bankruptcy is moved during the bankruptcy to another location as part of the liquidation process. The same property could potentially be subject to multiple tax claims and asserted liens, depending on the language of the statutes for each jurisdiction.

A related issue involving property in multiple jurisdictions arose in *In re Conquest Airlines Corp.*,¹⁵ where a taxing authority asserted a claim of more than \$500,000 assessed against airplanes owned by the debtor. The question facing a chapter 7 trustee was whether a lien against “property” held by the debtor that arose on account of airplanes located in one county could be enforced with respect to other airplanes owned by the debtor in another county.

After some deliberation, which included consideration of the legislative history of the relevant statute, the court concluded that the language of the statute creating the lien did not intend “to do away with the longstanding statutory requirement ... that tax liens attach to property related to the tax that created the lien.”¹⁶ The court relied in part on policy considerations, noting that permitting the lien to extend to all property, regardless of whether it was ever subject to the taxing authority’s jurisdiction, “would dramatically increase direct competition among unassociated taxing authorities,” with unpredictable and potentially inequitable consequences.¹⁷

Is the Lien Avoidable?

Since statutory tax liens fall within the avoidance rules of 11 U.S.C. § 545, a trustee could avoid a statutory lien that first becomes effective upon the commencement of the bankruptcy estate. In *In re Knights Athletic Goods Inc.*,¹⁸ the court applied this provision to uphold avoidance of a lien that attached if the owner voluntarily “surrenders or transfers ... property to another after the date such property is assessed and before the tax thereon is paid.”¹⁹ Since the lien arose when the debtor’s property was voluntarily transferred to the trustee upon the filing of the bankruptcy petition, it was voidable under § 545(1)(A).

More commonly, the trustee can avoid a statutory tax lien under § 545(2) if it is not perfected at the time of the commencement of the case as being against a bona fide purchaser. This provision requires an analysis of state and local laws on the rights of a bona fide purchaser *vis-à-vis* the property tax lien.²⁰

⁸ See *West Virginia State Dep’t of Tax & Revenue v. IRS (In re Columbia Gas Transmission Corp.)*, 37 F.3d 982, 984 (3d Cir. 1994) (citing *Butner v. United States*, 440 U.S. 48, 55 (1979)).

⁹ See, e.g., *Midland Cent. Appraisal Dist. v. Midland Indus. Serv. Corp. (In re Midland Indus. Serv. Corp.)*, 35 F.3d 164 (5th Cir. 1994) (applying Texas law); *In re Members Warehouse Inc.*, 991 F.2d 116, 118-19 (4th Cir. 1993) (applying North Carolina law).

¹⁰ See, e.g., *In re Garfinckels Inc.*, 203 B.R. 814, 821-22 (Bankr. D.D.C. 1996) (because owner of personal property on Jan. 1 could avoid personal liability under Maryland law if certain events occurred before tax became due and lien attached on July 1, tax was incurred on July 1 because “courts essentially seek out the date on which the tax is inescapably imposed on the debtor or the estate and declare that to be the date the tax is incurred”).

¹¹ See, e.g., S.C. Code § 12-49-20 (lien attaches Dec. 31 for personal property taxes to be paid during ensuing year); Tex. Tax Code §§ 32.01 and 32.07 (lien attaches Jan. 1 and person owning property on that date is generally also personally liable for taxes); Tenn. Code § 67-5-2101 (same); Ore. Rev. Stat. § 311.405(3) (lien attaches July 1 for taxes imposed on personal property owned on preceding Jan. 1); Rev. Code Wash. § 84.60.020 (lien attaches on date that personal property is listed with and valued by county assessor); Md. Tax-Property Code § 14-805(b) (lien attaches on due date).

¹² See, e.g., 68 Okla. Stat. § 3102, 3103; see also 68 Okla. Stat. § 2929 (lien attaches when property is sold before tax is paid).

¹³ See, e.g., N.C. Gen. Stat. § 105-355(b) (levy).

¹⁴ A “statutory lien” is a “lien arising solely by force of a statute on specified circumstances or conditions.” 11 U.S.C. § 101(53).

¹⁵ 2012 Bankr. LEXIS 2749 *; 2012 WL 2236717 (Bankr. W.D. Tex. 2012).

¹⁶ *Id.* at *14.

¹⁷ *Id.* at *23.

¹⁸ 128 B.R. 679 (D. Kan. 1991).

¹⁹ Kan. Stat. § 79-2020.

²⁰ See *United States v. Hunter (In re Walter)*, 45 F.3d 1023, 1029 (6th Cir. 1995) (state law governs whether statutory lien created by state law can be avoided by bona fide purchaser).

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Most states give property tax liens automatic priority over other liens, but in some cases, notice of the lien must be filed or other steps must be taken in order to perfect the lien as to bona fide purchasers,²¹ or the issue may not be directly addressed in the statute.²² A lien that was unperfected on the petition date, but perfected thereafter as permitted by § 362(b)(18), might be considered perfected on the petition date if state law permits the perfection to relate back to a time prior to the petition date.²³

Moreover, § 547(c)(6) provides that the trustee may not avoid as a preference under § 547 “the fixing of a statutory lien that is not avoidable under section 545.” The term “fixing” has been interpreted as meaning “perfection,”²⁴ so a delay in perfecting the lien does not make it avoidable as a preference.

Some courts have held that § 545 is the exclusive avoidance provision for statutory liens and that the trustee cannot rely on his/her strong-arm powers under § 544.²⁵ In any event, state laws giving personal property tax liens priority over all other liens should preclude avoidance under § 544, where the trustee has only the status of a lien creditor rather than a bona fide purchaser with respect to personal property. Under § 724(a), however, the chapter 7 trustee can avoid the

lien to the extent that it secures a claim for pre-petition penalties that are not compensation for actual pecuniary losses.

Can the Lien Be Subordinated?

Even if the personal property tax lien is unavoidable, it can be subordinated by the trustee under § 724(f) in order to pay unsecured claims entitled to priority under §§ 507(a)(4) (wages) and 507(a)(5) (employee benefit plan contributions) if unencumbered assets of the estate are insufficient to pay those priority claims. In effect, these unsecured priority claimants are allowed to step into the shoes of the tax claimant and receive proceeds from the sale of the property securing the lien, up to the amount of the secured tax claim, after recovery by the trustee of necessary costs and expenses of preserving and disposing of the property.²⁶ **abi**

²² See, e.g., *In re Ciena Capital LLC*, 2010 Bankr. LEXIS 2573, 2010 WL 3156538, *15-16 (Bankr. S.D.N.Y. 2010) (concluding that Michigan personal property tax lien would be enforceable against bona fide purchaser under Michigan law where statute gave lien “precedence over all other claims, encumbrances, and liens” unless property was sold in regular course of retail trade).

²³ 11 U.S.C. § 546(b)(1)(A); see *In re Western States Distribs. Inc.*, 179 B.R. 666, 668 (Bankr. D. Colo. 1995) (post-petition perfection of inchoate lien related back to pre-petition assessment date).

²⁴ See *Baker Hughes Oilfield Operations Inc. v. Cage (In re Ramba Inc.)*, 416 F.3d 394, 400 (5th Cir. 2005) (“[A] lien is said to be ‘fixed’ when a creditor has perfected his security interest and ‘fastens liability’ against the debtor’s property.”).

²⁵ See, e.g., *In re Sullivan*, 254 B.R. 661, 667 (Bankr. D.N.J. 2000) (state income tax lien). But see *In re LMS Holding Co.*, 50 F.3d 1526, 1527, n.2 (10th Cir. 1995) (“While we believe that the more specific provision for avoidance of statutory liens under § 545 is applicable here, either section provides the same avoidance power.”).

²⁶ 11 U.S.C. § 724(e) and (f).

²¹ See, e.g., *Los Angeles Cnty. Treasurer & Tax Collector v. Mainline Equip. Inc. (In re Mainline Equip. Inc.)*, 539 B.R. 165, 170-72 (under California statutes, notice of personal property tax lien must be filed with secretary of state rather than county recorder to defeat bona fide purchaser).

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