

IRS Trust Fund “Lien” (26 U.S.C. § 7501) – Validity and Priority Issues

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“A § 7501 trust is, therefore, like a dark cloud hanging over a debtor’s assets, waiting to attached to some identifiable asset. The issue becomes what is necessary to allow a § 7501 trust to descend upon certain assets of a debtor and claim such assets for its *res*.”

– Judge Derby, *In re Sunrise Paving*, 204 B.R. 691 (Bankr. D. Md. 1996)

I. The IRS Trust Fund (26 U.S.C. § 7501)

a. Statute

i. 26 U.S.C. §§ 3102 and 3402– social security and income taxes to be withheld from employee’s pay

ii. 26 U.S.C. § 7501(a):

“Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a **special fund in trust for the United States**. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.”

b. Bankruptcy Application

i. Preferences – assertion of trust as preference defense for the IRS

ii. Dischargeability in individual cases –

1. automatic non-dischargeability for trust fund tax liabilities [§ 523(a)(1)(A), per § 507(a)(8)(C)];

2. (?) non-dischargeability actions for debtor’s intentional payment of trust fund taxes with secured creditor’s collateral [§ 523(a)(6) willful and malicious injury; see *In re Zwosta*, 395 B.R. 378 (6th Cir. BAP 2008)] -- and/or to the detriment of other creditors [§ 727].

iii. Secured Lienholders / Property of the Estate issues

1. 11 U.S.C. § 541(b)(1):

“Property of the estate does not include – any power that the debtor may exercise solely for the benefit of an entity other than the debtor.”

2. 11 U.S.C. § 541(d):

“Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest... becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.”

3. Legislative history behind Section 541 – “Congress intended to replace the strict tracing rule of the Bankruptcy Act with a more lenient rule in terms of tax fund trusts.” *In re Sunrise Paving*, at 695 (citing *Begier*, infra at 65). Section 541 was intended to do away with strict tracing rule set forth in *U.S. v. Randall*, 401 U.S. 513 (1971), and, rather, allow “reasonable assumptions” to govern the tracing of funds.

II. The reach of the IRS Trust Fund “Lien”?

a. *Begier v. IRS*, 496 U.S. 53 (1990) – a preference claim case

i. Prepetition payments of trust fund taxes to IRS are not avoidable as preferential transfers. Tax payments were transfers of property held in trust (**not property of the debtor**) because (i) trust pursuant to IRC § 7501 was created at time of transaction (ie, payment of wages) and (ii) sufficient nexus existed due to debtor’s payment of funds to the IRS.

ii. Supreme Court found that strict adherence to the common law tracing rules typically used to determine what is trust property do not need to be applied to the IRS Trust

1. Common law trust – settlor sets aside particular property as the trust *res* (ie, if no property, no trust exists)

2. IRS Trust – “an abstract ‘amount’ – a dollar figure not tied to any particular assets – rather than in the actual dollars withheld” *Begier*. (in other words, a trust created before the *res* exist, or a “floating trust”)

iii. Supreme Court only required a “nexus” (not a direct tracing) to establish that the property is subject to the IRS Trust.

iv. So, the § 7501 IRS trust is far reaching?

b. Issue the IRS has presented in a recent case in regards to cash collateral and lien priorities:

After remaining silent through several interim cash collateral orders, which were contested by two secured lenders, the IRS filed a

“Motion for the Court to Order the Debtor to Account for, Segregate, and Turnover Monies Held in Trust for the United States and to Suspend the Court’s Cash Collateral Order”

[*In re Essex Construction, LLC*, Case No. 16-24661-TJC, Dk. 128; IRS should have filed an adversary proceeding? – FRBP 7001]

- i. Relying on *Begier*, the IRS asserted a trust of \$1.3M for monies withheld from employee’s wages but not paid to the IRS over the course of 3 years prior to the petition date, and, thereby, argued that the trust primes secured lenders as to the debtor’s cash collateral (or better stated, that the debtor’s cash is not property of the estate due to the trust)
- ii. IRS relies on the *Begier* decision to say that (i) the trust fund lien arose at the time wages were paid and (ii) the trust remains despite comingling (and ignoring tracing principles). Thus:
 - ➔ Debtor has no equitable interest in such funds
 - ➔ Funds are not property of the estate
 - ➔ Funds are not subject to secured liens, not subject to cash collateral orders, etc.

III. Validity (Limitations) of the IRS Trust Fund “Lien”

a. Identification – What Makes up the Trust?

- i. The *Begier* case established that the IRS Trust *res* need not be directly traceable, but also acknowledged that (1) the IRS must show some connection (a “nexus”) between the §7501 trust and the assets sought to be applied to IRS obligations; and (2) the act of voluntarily paying its trust-fund obligation can establish the required nexus. *Begier*, 496 U.S. 65, 67.

ii. Satisfying *Begier's* “nexus” standard – Bankruptcy Courts have made it difficult for the IRS

1. *In re Sunrise Paving*, 204 B.R. 691 (Bankr. D. Md. 1996) – Judge Derby denied an IRS motion to compel payment of funds from Ch. 7 estate on basis of a § 7501 trust. But, Court’s decision was based on lack of evidence establishing trust *res*, and Judge Derby noted that there remains open issue as to priority between IRS Trust Fund “Lien” and the liens of secured creditors.
2. *In re Wellington Foods, Inc.*, 165 B.R. 719 (Bankr. S.D. Ga. 1994) – without a voluntary payment or segregation, there is no conclusive presumption of a nexus between creation of the trust and any particular asset of the debtor.
3. *In re Ruggeri Elec. Contracting*, 214 B.R. 481 (Bankr. E.D. Mi. 1997) – *Beiger* only controls when there has been a voluntary pre-petition payment of trust fund taxes
4. *In re TCB Carpet Services, Inc.*, 2000 U.S. Dist. Lexis 15334 (N.D. Ill. Oct. 10, 2000) – the “nexus” requirement under *Beiger* requires more than simply pointing out that the funds in the debtor’s bank account ultimately came about because the debtor paid its employees.

iii. Tracing (clearly satisfying the “nexus”) –

1. *In re Dameron*, 155 F. 3d 718, (4th Cir. 1998) – party claiming entitlement to a trust must identify the fund or property subject to the trust); *City of Farrell v. Sharon Steel Corp.*, 41 F.3d 92, (3rd Cir. 1994) (claimant must demonstrate entitlement to trust property).

iv. Lowest Intermediate Balancing Test.

If the amount on deposit in the commingled fund has at all times equaled or exceeded the amount of the trust, the trust’s funds will be returned in their full amount. Conversely, if the commingled fund has been depleted entirely, the trust is considered lost. Finally, if the commingled fund has been reduced below the level of the trust fund but not depleted, the claimant is entitled to the lowest intermediate balance in the account. In no case is the trust permitted to be replenished by deposits made subsequent to the lowest intermediate balance.

Dameron, 155 F. 3d at 724 (internal quotations and citations deleted); *In re Massenburg*, 554 B.R. 769, 774 (Bankr. D. Md. 2016) (same); *In re Quality Telecomm. Servs., Inc.*, 2006 Bankr. LEXIS 4512 *6-7 (Bankr. D. Md Feb. 28, 2006).

b. Depletion?

- i. Once a § 7501 trust fund is depleted, it cannot be replenished. *In re Al Copeland Enter., Inc.*, 133 B.R. 837,839-840 (Bankr. W.D. Tex. 1991) (“[s]tated another way, once the trust fund is depleted, it cannot be replenished”). A trust fund is lost if it is depleted. *Id.*; see also *In re Dameron*, 155 F.3d 718, 724 (4th Cir. 1998). “In no case is the trust permitted to be replenished by deposits made subsequent to the lowest intermediate balance.” See *Dameron*, 155 F.3d at 724. In an account where trust funds are commingled with other funds and trust funds are depleted, the lowest level of trust fund depletion is called the lowest intermediate balance. *Id.* A § 7501 trust cannot rise above the lowest intermediate balance.
- ii. Section 7501 does not impress a trust on after-acquired funds? *Slodov v. United States*, 436 U.S. 238, 256-57 (1978) – NOTE: pre-*Begier* and pre-Bankruptcy Code (§ 541)

c. Limiting *Begier* to its context (preference claim)?

- i. *In re Catholic Diocese of Wilmington, Inc.*, 432 B.R. 135 (Bankr. D. Del. 2010)

In establishing the “nexus” test in *Begier*, the Supreme Court deviated from the long-standing LIBT [Lowest Intermediate Balance Test] due to the unique facts and circumstances raised by the specific type of trust at issue in the case. As such, the holding in *Begier* should be narrowly construed and the nexus test should only apply in cases where a court is faced with facts similar to those in *Begier*. The trust at issue in this case, however, bears no similarity to that at issue in *Begier*.

- ii. *MJK Clearing*, 371 F.3d 397 (8th Cir. 2004)

IV. Priority of Trust Fund Lien

a. v. Pre-Existing Secured Lender

- i. Limited case law addressing the conflict and priority between a secured creditor and the IRS when the IRS seeks to claim that assets pledged to the secured creditor are trust fund taxes. *Sunrise Paving*, 204 B.R. at 696.
- ii. The best analysis of this conflict has arisen in the context of a dischargeability action brought by a secured creditor asserting that a debtor caused a willful and malicious injury by transferring the secured creditor’s collateral to the IRS. *In re Zwosta*, 395 B.R. 378 (6th Cir. BAP 2008).

- iii. In *Zwosta*, after their company ceased operations, the debtors continued to collect their company's receivables, and paid approximately \$36,000 of the collected receivables to the IRS to reduce their trust fund liability. *Id.* at 381-382. However, a secured creditor held a blanket lien on all the company's assets including the receivables. The case involved the same argument by the IRS with respect to the creation of a §7501 trust. *Id.* at 384. The court acknowledged that *Begier* advised that a trust could be created by a voluntary payment to the IRS, but the imposition of that trust is subject to the pre-existing interest of a secured creditor in those funds. *Id.* at 386. Therefore, a secured creditor's perfected interest is superior to the IRS even if the debtor makes a voluntary payment to the IRS. *Id.*; see also, *Slodov v. U.S.*, 436 U.S. 238, 256 (1978) (imposing a trust on all after-acquired corporate funds without regard to the interests of other creditors would conflict with the priority rules applicable to the collection of back taxes).
- iv. "A perfected security interest is superior to a later arising tax lien." (note: tax lien different than § 7501 trust claim) See *Bank of Haw.*, 2002 U.S. Dist. Lexis 12059, *18. After a § 7501 constructive trust is dissipated, even if a debtor later acquires sufficient funds to pay the taxes, the after-acquired funds are subject to a secured creditor's lien. *Zwosta*, 395 B.R. at 384-86. "[Section] 7501 does not impress a trust on after-acquired funds." *Id.* at 385 (quoting *Slodov*, 436 U.S. at 259).
- v. *Zwosta* relies on the Supreme Court's decision in *Slodov* rather than *Begier*, on the basis that *Begier* did not involve the interest of a secured creditor.
- vi. *Slodov* is an individual debtor case, it pre-dates *Begier* and the enactment of the Bankruptcy Code and Section 541, and still leaves a factual issue as to what property would be subject to the IRS § 7501 Trust.
- vii. *Slodov* was the case of individual who took over operations of entity with pre-existing tax withholding liabilities, and the IRS argued that *Slodov* would be responsible for those pre-existing liabilities because he didn't pay the liabilities with future revenues. The Court had to deny the existence of the IRS § 7501 Trust to find that the *Slodov* was not personally responsible for the liabilities incurred prior to his involvement with the business. Result-oriented?

b. Bankruptcy planning implications?

- i. Advising a corporate debtor to pay tax obligations rather than secured debt creating a potential personal dischargeability issue for individual owner-directors?

V. Other trust v. lien issues

a. Construction Trust Statutes

The Maryland Construction Trust Statute provides that any monies paid under a contract by an owner to a contractor, or by the owner or contractor to a subcontractor for work done or materials furnished, or both, for or about a building by any subcontractor, shall be held in trust by the contractor or subcontractor as trustee, for those subcontractors who did work or furnished materials or both, for or about the building, for purposes of paying those subcontractors. Md. Code Ann., Real Prop. § 9-201(b)(1)

- i. Assume we have a debtor that is an intermediate contractor that is holding money from a general contractor and that money is earmarked for payment of materials from a subcontractor. And, also the debtor has a secured lender with a blanket lien.
- ii. As to the money that the debtor-intermediate contractor is holding, who wins between the secured lender with a lien on the debtor's cash and a subcontractor with construction trust claim as to the funds?
- iii. Is the cash subject to the construction trust and, therefore, not property of the debtor (the bank's collateral)? Or, is the subcontractor's trust claim junior to the secured lienholder since the subcontractor is presumed to be on notice of the perfected lien when dealing with the debtor?