

INTERNAL REVENUE SERVICE
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MEMORANDUM FOR KENTUCKY-TENNESSEE DISTRICT COUNSEL

FROM: Alan C. Levine
Chief, Branch1 (General Litigation)

SUBJECT: GL-605772-97

We are responding to your October 21, 1998, inquiry. This document is not to be cited as precedent.

LEGEND

District A
Contractor A

Surety Firm A
Date A
Date B
Date C
Amount A
Amount B
Amount C

FACTS

District A [REDACTED] entered into a contract with Contractor A [REDACTED].

The surety firm, Surety Firm A [REDACTED], held Contractor A's [REDACTED] performance and payment bonds. Contractor A [REDACTED] defaulted on the contract. You explained in your Date A [REDACTED], letter to District A [REDACTED] that there is no conclusive proof of the day of default except that it occurred on or before Date B [REDACTED], the day that Surety Firm A [REDACTED] received notice from District A [REDACTED] that Contractor A [REDACTED] defaulted.

A notice of federal tax levy was served on District A [REDACTED] for property belonging to the taxpayer Contractor A [REDACTED]. As of the date of writing, District A [REDACTED] has failed to honor the tax levy. The amount in question is Amount A [REDACTED], which is the Amount B [REDACTED] owed to Contractor A [REDACTED] at the time of its default reduced by an outstanding mechanics lien of Amount C [REDACTED]. You request our reviews on whether you should recommend that the United States bring an enforcement suit under I.R.C. § 6332(d)(1) and assert the 50% penalty under I.R.C. § 6332(d)(2) against District A [REDACTED].

LAW AND ANALYSIS

1. Enforcement suit under § 6332(d)(1)

I.R.C. § 6332(a) provides that "any person in possession of property or rights to property subject to levy upon which a levy has been made shall, upon demand of the Secretary, surrender such property or rights to the Secretary, except such part of the property or rights as is, at the time of such demand, subject to an attachment or execution under any judicial process." Courts recognize two defenses for the failure to honor a levy: (1) the party did not possess any property or rights to property of the taxpayer, or (2) the property was subject to a prior attachment or execution. See, e.g., United States v. General Motors Corp., 929 F.2d 249 (6th Cir. 1991). District A [REDACTED] has raised the former defense in the present case. [REDACTED]

[REDACTED] is considered not to be in possession of Contractor A's [REDACTED] property, at the time the notice of levy was served, because the property belonged to Surety Firm A [REDACTED] or District A [REDACTED], then District A [REDACTED] would have a proper defense for not honoring the levy. We are not aware of any legal theories that would enable District A [REDACTED] to prove that it was not in possession of Contractor A's [REDACTED] property at the time of the levy.

Priority of a federal tax lien is determined by the common law rule of "first in time, first in right." United States v. New Britain, 347 U.S. 81, 85 (1954). However, federal law recognizes state law subrogation rights. Where there is a claim of subrogation to the lien priority of a secured creditor, federal lien law provides that

the issue of subrogation is controlled by local law.^{1/} See I.R.C. § 6323(i)(2). Surety Firm A [REDACTED] would have priority over the government as to the proceed payments if it was subrogated to the rights of District A [REDACTED], laborers or materialmen if any of the third parties perfected its lien against the property before the Service filed the notices of federal tax lien on Date C [REDACTED] and Date B [REDACTED]. In the letters you provided, District A [REDACTED] has not alleged that there were any liens that were perfected before Date C [REDACTED], that Surety Firm A [REDACTED] could claim subrogation rights to.

In addition, we agree with you that there is nothing in the District A/Contractor A [REDACTED] / [REDACTED] contract or Kentucky law that would provide for all the unpaid earnings of Contractor A [REDACTED] to become the property of surety firm A, [REDACTED], or the property of District A [REDACTED]. We agree with your reading of National Surety Corp. v. State National Bank of Frankfort, 454 S.W.2d 354 (Ky. 1970), that a surety is entitled to be subrogated to the rights a contractor has in contractually retained percentages of contract proceeds when a subcontractor defaults. Provided for in the District A/Contractor A [REDACTED] contract are conditions which would provide for District A [REDACTED] to retain money earned but owed to Contractor A [REDACTED]; however, the circumstances in this fact pattern do not fit into any of the conditions provided for in the contract. [REDACTED] [REDACTED] would be subrogated to the rights of District A [REDACTED] in the circumstances provided for in the contract, these circumstances did not occur.

Ky. Rev. Stat. 376.070 imposes an obligation on the contractor to apply payments from the owner to claims of those who have furnished labor or materials on the project; however, Ky. Rev. Stat. 376.070 does not establish a trust for the benefit of the materialmen. See Commonwealth of Kentucky for the Benefit of United Pacific Ins. Co. v. Laurel County, 805 F.2d 628 (6th Cir. 1986), cert. denied, 484 U.S. 817 (1987). [REDACTED] [REDACTED] r from having an interest in the earned but unpaid payments at issue in this case.

2. Fifty-percent penalty under I.R.C. § 6332(d)(2)

Section 6332(d)(2) provides for a 50% penalty for anyone who fails to surrender any property subject to a levy unless the person failing to honor the levy can show reasonable cause for his or her failure. There is reasonable cause in refusing to comply with a levy if there is a “bona fide” dispute over the Service’s legal right to levy upon the property in concern. United States v. Sterling National Bank & Trust

^{1/}The scenario that you provided involved a transaction that occurred in Kentucky and Kentuckian taxpayers. Therefore, it is governed by Kentucky law. If Surety Firm A [REDACTED] is subrogated to the rights of a party with a senior lien to the government then Surety Firm A [REDACTED] will have priority over the government for the amount of the senior lien.

Co. of New York, 494 F.2d 919, 923 (2nd Cir. 1974); United States v. Citizens and Southern National Bank, 538 F.2d 1101, 1107 (5th Cir. 1976), cert. denied, 430 U.S. 945 (1977). However, reasonable cause does not “include a clearly erroneous view of the law, stubbornly adhered to after investigation should have disclosed the error.” State Bank of Fraser v. United States, 861 F.2d 954, 962, reh’g denied, 1988 U.S. App. Lexis 18065 (6th Cir. 1988) (quoting the dissent in Sterling National Bank, 494 F.2d at 924.)

[REDACTED]. It appears that District A [REDACTED] has made good-faith efforts to resolve the issue of the levy with your office. Also, while we interpret the case law mentioned above as not containing any law that would preclude the levy from attaching to the proceed payments we do not believe that it is “clearly erroneous” to interpret it otherwise. A clear answer to the issue of whether or not earned but unpaid proceed payments are the property of the surety firm when the contractor defaults is not provided for in the case law or otherwise. Therefore, while we agree with your position in bringing an enforcement suit under section 6332(d)(1), we think you should reconsider whether to recommend asserting the 50% penalty under section 6332(d)(2). If you decide to recommend this penalty, when your letter to Department of Justice comes through this office we will again review the appropriateness of the penalty and perhaps we will find that a proper foundation has been established for the penalty.

CONCLUSION

[REDACTED] contract that precludes Contractor A’s [REDACTED] earned but unpaid progress payments from being the property of Contractor A [REDACTED] at the time of the levy. However, we advise you to reconsider whether asserting the 50% penalty under section 6332(d)(2) would be appropriate in this case.

If you have any further questions please call (202)622-3610.