SURETY TODAY PRESENTATION

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The Surety v. The Internal Revenue Service

(GEORGE)

Introduction

This Surety Today presentation concerns the surety's rights and obligations with respect to the Internal Revenue Service, or the IRS. There are really two major topics to discuss.

The first topic concerns the possible claims that the IRS may have against the surety for the payment of the principal's withholding tax obligations to the IRS. These surety obligations may arise under two circumstances:

A. First, the IRS may have claims against the performance and/or payment bonds that the principal and the surety executed for the obligees, whether the obligees are the federal government under the Miller Act, state and local governments under the various Little Miller Acts, private owner/obligees, and/or general contractors for subcontractor principals.

B. Second, the surety may require some form of funds control at some time arising from the execution of the bonds to receive and control the principal's use of the bonded contract funds, or the surety may take actions under the performance bond, such as financing the principal. Either situation may saddle the surety with obligations to the IRS to pay the principal's withholding taxes.

The second topic concerns those instances when the surety and the IRS make competing claims and assert their priorities to the bonded contract funds on one or more bonded projects. To the extent that the IRS may prevail, the surety "suffers a loss" when its ability to obtain the bonded contract funds to reduce its loss fails and those bonded contract funds end up, instead, in the hands of the IRS.

I.

(MIKE)

A. Claims that the IRS may have against the Surety for payment of taxes

1. IRS Claims for Payroll Taxes Under the Miller Act

After July 15, 1967, a surety is liable under the Miller Act for taxes imposed on wages related to the bonded project. It doesn't matter if the surety was financing the principal, exercising control over the principal's operations or whether the surety was controlling the funds (George will discuss these issues later). Congress decided that under the Miller Act a surety should be liable under the Performance Bond for these particular wage related taxes. The Miller Act now provides:

> **(1) *In General.* -** Every performance bond required under this section [Miller Act] specifically shall provide coverage for taxes the Government imposes which are collected, deducted, or withheld from wages the contractor pays in carrying out the contract with respect to which the bond is furnished. (clarification added).

40 U.S.C. §3131(c).

The good news is that the liability for taxes under the Miller Act is limited to those relating to wages for labor on the bonded project, as opposed to the other multitude of taxes that are out there. While Congress placed the liability for such taxes squarely in the surety's lap, they also placed a notice requirement and a limitations period upon the IRS in order to seek recovery.

The Miller Act provides that the Government shall give the surety written notice with respect to unpaid taxes within 90 days after the date when the contractor files a return or if no return is filed, within 180 days from the date when a return was required to be filed. The Miller Act further provides that the Government may not bring a civil action on the bond for the taxes unless the notice is timely given and such civil action is filed within 1 year of the date that the notice is given.

It has been held that as long as the notice was timely, the government need only "substantially comply" with the notice requirements. The Fourth Circuit stated that the purpose of the notice requirement is to alert a surety of the principal's default on payment of its withholding taxes and that payment of the debt is expected from the surety. The Miller Act does not require the government to detail with specificity the contracts, bonds, and amount of delinquent taxes. The fact that a timely notice may contain certain factual errors and imperfections does not relieve a surety from its legal obligation to perform. *United States v. Am. Mfrs. Mut. Cas. Co.*, 901 F.2d 370, 374 (4th Cir. 1990). Of course, the express liability under the Miller Act for wage taxes is limited to the Miller Act surety, the Act does not apply to the lower tier bonds or non-Miller Act projects.

2. IRS Claims Against Non-Miller Act Payment and Performance Bonds

Historically, the IRS has attempted to assert claims against payment bonds and performance bonds for wage withholding taxes on non-Miller Act projects including state and local projects. In *United States Fidelity & Guaranty Co. v. U.S.*, the IRS asserted that under the payment bond the surety assumed responsibility for the principal's obligation to pay for labor and material, which the IRS contended included the obligation to pay payroll taxes. The 10th Circuit held that the obligation of the principal to pay payroll taxes arose from statute and the subcontract provision requiring payment of taxes was merely declaratory of the existing liability under the federal tax laws. Thus, the Court concluded that the failure to pay taxes was not a breach of contract. Equally important, the Court also held that the duty to pay payroll taxes was not within the principal's obligation to pay for labor and was therefore not covered by the payment bond.

The Fourth Circuit observed that from the statutes and regulations it seems clear that when an employer withholds the tax from an employee's wage and pays the balance to the employee, the employee (the laborer) has been paid in full. The full wage has been received. The employer has discharged its contractual obligation to pay the full wage. Thereafter, only the liability to pay the tax remains. That is a tax liability for which the employer alone is liable to the Government. *United States v. Crosland Const. Co.*, 217 F.2d 275 (4th Cir. 1954). There have been no recent cases in which the IRS has sought to recover payroll taxes under a payment bond.

While the IRS may have given up on the payment bond avenue of attack, it has not gone away, rather the IRS simply shifted the attack to the performance bond. The primary theory employed by the IRS is to assert that based on the language of the bonded contract requiring payment of taxes, the IRS is a third-party beneficiary under the performance bond. In *U.S. v. Phoenix Indemnity Co.*, 231 F.2d 1956 (4th Cir. 1956), the principal entered into a contract with the Housing Authority of the City of Fayetteville, North Carolina for the construction of low cost housing. The bonded contract provided that the principal was required to provide and pay for all materials, labor and taxes. The principal defaulted and the co-sureties agreed to complete the work. Subsequently, the IRS determined that the principal had failed to pay certain taxes, including the payroll withholding taxes.

The trial court ruled that the sureties had no liability under the bonds for the taxes. However, the Fourth Circuit in *Phoenix* reversed and ruled that because of the contract language, the principal, as part of its performance of the contract was required to withhold and pay payroll taxes and because the contract was incorporated into the bond it was the surety's obligation under the performance bond to satisfy the principal's obligation to pay the taxes. With no real analysis, the Court held that "the performance bond was made for the government's protection and it is entitled to sue thereon as a third party beneficiary."

The Fifth Circuit in *U.S. v. Maryland Casualty Co.*, 323 F.2d 473, 474 (5th Cir. 1963) rejected the Fourth Circuit ruling in *Phoenix*. In *Maryland Casualty,* the IRS sued the surety for recovery of payroll withholding taxes under the performance bond issued by the surety for a subcontractor. It was stipulated that the principal did not pay the taxes. The trial court dismissed the IRS' suit. The IRS appealed and the Fifth Circuit affirmed the dismissal. The bonded subcontract provided that the principal was to "keep records and make payments on all Federal and/or State Payroll Taxes and/or deductions." However, the Court, citing to a Supreme Court case, held that tax liability is based squarely on statutes and any contractual language regarding payment of taxes was merely declaratory of an existing statutory obligation. Thus, the failure to pay taxes is not a breach of contract, but rather a breach of statutory obligation, therefore, there is no liability under the performance bond. The IRS asserted that it was a third-party beneficiary of the bond, but the *Maryland Casualty* court noted that the IRS had the burden of establishing that it was the intended beneficiary of the bond and it had failed to meet that burden. The Court noted that there was nothing on the face of the bond to indicate an intention to make the IRS an intended beneficiary.

Courts in other jurisdictions have gone in both directions on the issue of the surety's exposure under a performance bond to payroll withholding taxes. The most recent case, *Island Ins. Co. v. Hawaiian Foliage & Landscape, Inc.*, 288 F.3d 1161 (9th Cir. 2002) found the surety liable for such taxes under its performance bond. In that case, the surety bonded a landscaping subcontractor on a golf course project for the city and county of Honolulu. The principal defaulted and failed to pay various state and federal taxes. The surety filed a declaratory judgment action seeking a declaration that it was not liable for the taxes. The trial court granted summary judgment in favor of the surety. The Ninth Circuit reversed. The subcontract clearly required the subcontractor to pay all applicable taxes, including payroll withholding taxes. The bond clearly covered performance of the subcontract. Thus, the Court concluded that reading the subcontract and the bond together the IRS was a third-party beneficiary of the bond. There is a dissenting opinion in the case that basically gets the issue right and would find no liability under the bond.

The takeaway here is that a surety may have exposure under its performance bond to the IRS for withholding taxes if the language of the bonded contract and the bond together evidence an intent by the parties to benefit the IRS and you are in one of the jurisdictions that accepts that reasoning or you have a Miller Act performance bond.

(GEORGE)

B. Claims that the IRS may have against the Surety for Obtaining Joint Control Over the Bonded Contract Funds, Including Financing the Principal.

When the surety initiates some form of funds control, whether joint control with the principal or some other surety controls over the principal's use of the bonded contract funds, including under a financing agreement in the event of a principal's performance default under the bonded contracts, the surety may be directly liable for the principal's withholding taxes as a result of the surety's payment of the wages of the principal's laborers on the bonded contracts. In either case of funds control, with or without surety financing, the surety may take control over the principal's receipt and determine the principal's use of the bonded contract funds in order to reduce the surety's potential or ultimate loss. The Internal Revenue Code creates potential tax liability for the surety under three sections and theories.[1]

1. Section 3401 [26 U.S.C. § 3401]

First, under Section 3401, the surety may be liable for withholding taxes as the "employer" when it exercises exclusive control over the principal's employees and, more importantly, when the surety exercises control over the payment of the wages to those employees. Two bad things may happen if the surety is found to be an "employer": (a) first, the

[1] *See* George J. Bachrach, Michael A. Stover & Shane C. Mecham, *Ch. 4, Financing the Principal, in* BOND DEFAULT MANUAL 338-41 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox eds., Am. Bar Ass'n, 4th ed. 2015); James D. Ferrucci, *The Surety, the IRS and Payroll Taxes* (unpublished paper submitted at the Twenty-Seventh Annual Surety Claims Institute annual meeting on June 20, 2002).

surety may be liable for <u>both</u> the employees' share of the amounts of withholding taxes that were required to be deducted and paid to the IRS <u>AND</u> the employers' share of those taxes; and (b) second, as an "employer," the surety may be liable for penalties for the "employer's" failure to file quarterly tax returns and failure to deposit the withholding taxes with the IRS.

2. Section 6672 [26 U.S.C. § 6672]

Second, under Section 6672, the surety's control over the bonded contract funds may make the surety a "responsible person" for the payment of a penalty equal to the amount of the taxes that were to be withheld by the principal, and the surety's "willful" failure to pay the withheld taxes as a "responsible person" may subject the surety to liability beyond the amounts withheld for the principal's laborers on the bonded contracts.[2]

There are two conditions. First, the "responsible person" must have been "required to collect, truthfully account for, and pay over any" payroll taxes – namely the person, individually or jointly, who has "the final word as to what bills should or should not be paid, and when."

Second, the "responsible person" must have willfully failed to perform those required functions of collecting, accounting for, and paying over the withholding taxes to the IRS. "Willful" is not a wrongful act. "Willful" means "in general, a voluntary, conscious, and intentional act." A surety's decision NOT to pay withholding taxes to the IRS from the controlled funds and to pay, instead, other creditors to reduce the surety's loss, is taking a "willful" action as a matter of law.

The reality is that the surety exercising funds control over the bonded contract funds to reduce its bond losses, whether it is financing the principal or not, is a "responsible person." Furthermore, under the loose definition of "willful," the surety preferring to pay other creditors and not pay the withholding taxes to the IRS will face tax liability to the IRS for those withholding taxes.

3. Section 3505 [26 U.S.C. § 3505]

Third, under Section 3505, which specifically mentions the "lending" surety, the financing surety may be liable for withholding taxes if it is a "net payroll lender." The surety is liable to the IRS for 100% of the withholding taxes, plus interest, when the surety directly pays the wages of its principal's laborers (whether as funding from a controlled account or the payment of a payment bond claim) [Section 3505(a)]. However, when the surety indirectly funds, advances or provides financing for the payments of those wages to the principal "with actual notice or knowledge" that the principal will not withhold and pay over the necessary payroll taxes, the surety is liable to the IRS for taxes and interest totaling up to 25% of the advances made for payroll [Section 3505(b)]. Section 3505 liability may be unavoidable by the

[2] *See* Anderson v. United States, 561 F.2d 162, 166 (8th Cir. 1977). *See also* Fidelity & Cas. Co. of N.Y. v. United States, 490 F.2d 960, 964 (Ct. Cl. 1974) (holding that if the surety is deemed to be a "responsible person" under § 6672 and is deemed to have "willfully" failed to pay the withheld taxes, it may be subject to liability for unpaid taxes and penalties that actually exceed the amount required to be withheld for the principal's laborers).

financing surety. Section 3505(b) liability may be cheaper for the surety than Section 3505(a) liability depending upon the amount of the surety financing for the principal's wages.

In order to protect the surety from the tax liabilities of Section 3505 and litigation with the IRS, the normal financing agreement between the surety and the principal contains specific provisions for the payment by the surety and the principal of all withholding and payroll taxes.[3] Furthermore, at the time the tax payments are paid by the surety and the principal, the surety must file quarterly Form 4219 with the Internal Revenue Service.[4]

In summary, the takeaway from this part of the presentation is that when the surety takes some kind of control over the principal's receipt and use of the bonded contract funds, whether the surety is financing the principal or not, the surety must withhold and pay the payroll taxes to the IRS and report those amounts as required by the IRS.

II.

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A. The Competing Surety and IRS Claims to the Bonded Contract Funds

Inevitably the day will come when the surety, having paid payment bond claims or paid to complete the work or both, seeks payment of the remaining contract funds and the IRS, seeking recovery of unpaid taxes, makes a claim against those same remaining contract funds. Who wins, who has priority, whose rights are better? That is the focus of this section.

We all know that the surety has its subrogation rights which allow it to stand in the shoes of the principal, the subcontractors, suppliers and laborers of the principal and/or the obligee, as well as others, such that the surety can assert the rights that those parties had. The surety's

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3 For example, the financing agreement may contain language similar to the following:

> g. Unless otherwise agreed, on a weekly basis the Principal shall provide to the Surety's representative for approval the Principal's payroll for the performance of the work on the Bonded Contracts (the "Payroll"), broken down by Bonded Contract, including the net pay for each employee, taxes to be withheld, and all other fringe benefits and deductions.
>
> h. Payment of all withholding and payroll taxes and other amounts deducted From employee wages on the Bonded Contracts from the date of this Agreement forward shall be made on a priority basis directly from the Special Account to the appropriate payee(s) for all withholding and payroll taxes and other normal payroll burden expenses. It shall be the Principal's responsibility, within the time limits of all appropriate statutes and regulations, to prepare and present to the Surety's representative the necessary information and documentation to pay all such taxes and other deductions from the Payroll, including an envelope addressed to the appropriate payee(s) or with an appropriate deposit slip to the correct account to receive the appropriate check(s). Upon receipt of the above documentation, and to the extent there are sufficient Bonded Contract Funds or other funds or monies in the Special Account, the Surety shall promptly approve the direct payment of such Payroll taxes and deductions.

4 *See* Form 4219, Statement of Liability of Lender, Surety, or Other Person for Withholding Taxes under Section 3505 of the Internal Revenue Code.

subrogation rights arise as of the date that the principal is declared in default or is in default in fact and relate back to the date of issuance of the bonds for the project.

The Internal Revenue Code (or "Tax Code") grants numerous rights to the IRS for the collection of delinquent taxes. Chief among those rights are the tax lien and the tax levy. The Internal Revenue Code at 26 U.S.C. § 6321 gives the IRS the ability to place a lien upon all property or property rights of a delinquent taxpayer up to the amount of the delinquency. The tax lien applies to all real and personal property of the taxpayer. While a tax lien is deemed to arise at the time that an assessment is made, for a lien to be valid against other lien holders, it must be recorded with the proper authority in each state where the property is located. Section 6323(f) of the Tax Code details the procedures that the IRS must follow in providing its notice of lien. If the tax lien is properly recorded, it will attach to existing property and property that is acquired by the taxpayer after the date of recording. The IRS right of levy allows it to assert actual or constructive possession over the taxpayer's property. 26 U.S.C. § 6332. A notice of levy is a demand to a party that the party turn over to the IRS all property held by that party in which the delinquent taxpayer has rights. The Tax Code provides for personal liability and penalties for any person that fails to turn over property levied by the IRS.

1. The Taxpayer Must Have Property Rights for an IRS Tax Lien or Levy to Attach

As I mentioned, the IRS lien or levy can only attach to property rights of the taxpayer. Thus, the first issue to review in a priority dispute with the IRS is whether the delinquent taxpayer had valid property rights in the property on which the lien or levy has attached. To determine if the taxpayer has property rights in the bonded contract funds, one must look to the status of the work, the terms and conditions of the bonded contract, whether the principal was declared in default or was in default in fact, the applicable state law and other facts and circumstances surrounding the project. Typically, construction contracts will provide that a principal's failure to meet the schedule, failure to timely pay subcontractors and suppliers, performance of defective work, etc., constitutes a material default and the obligee is then entitled to withhold the bonded contract funds to remedy the default. Many courts have held that a principal's default of its bonded contract obligations divests the principal of its property interest in the bonded contract funds. Upon the principal's default, the obligee's right to the bonded contract funds supersedes any rights of the principal to payment for work completed, until such time as the principal's scope of work has been completed and all subcontractors and suppliers have been paid. If the principal's property rights in the bonded contract funds are gone, there is no property interest upon which an IRS tax lien or levy can attach and any attempt to lien or levy would have no effect.

The concept is simple enough, but applying the concept in practice can be difficult because of the variation of contract terms, state law and other variables. The Fifth Circuit in *Capitol Indemnity Corp. v. United States*, 452 F.3d 428 (5th Cir. 2006) dealt with a typical circumstance where the bonded contract required the principal to timely pay its subcontractors and suppliers and entitled the obligee to withhold payment to the principal if it was in breach of its payment obligations. The IRS filed a tax lien, sometime later the obligee although approving the principal's application for payment did not release the bonded contract funds because it had determined that the principal was not timely paying its subcontractors and suppliers. The IRS issued a Notice of Levy to the obligee demanding that any of the principal's property held by the obligee be turned over to the IRS. The obligee terminated the principal, the surety completed the bonded project and paid the principal's subcontractors and suppliers. The surety then filed a wrongful levy action. The Fifth Circuit found that the IRS had failed to establish that the principal was entitled under the bonded contract to further bonded contract funds because of its failure to pay its subcontractors and suppliers and the applicable bonded contract language. The court concluded that there was no nexus between the taxpayer and the property levied upon and therefore, the IRS had no interest in the bonded contract funds.

A different result was reached in the Seventh Circuit, in the case of *Capitol Indem. Corp. v. U.S.*, 41 F.3d 320 (7th Cir. 1994), *cert. denied*, 515 U.S. 1144 (1995). In that case, the principal fell behind on the work and its subcontractors and suppliers were not being timely paid. However, the obligee and its architect had committed to having the principal finish the bonded project and frequently modified the scope and terms of the contract to keep the bonded contract funds flowing to the principal. The IRS recorded liens on the principal's property in regard to delinquent tax obligations unrelated to the bonded project. Thereafter, the IRS served the obligee with a levy, demanding immediate possession of all of the principal's property. The obligee decided to make no further payments to the principal following receipt of the levy, however, the architect approved the principal's application for payment after the levy was served. The surety filed a wrongful levy action asserting that the principal was in default in fact prior to the recording of the IRS lien and that the principal had no property interest in the bonded contract funds. The court ruled that the obligee had waived its right to retain the bonded contract funds by accepting the principal's performance and permitting the principal's default under the bonded contract. The court also ruled that under the bonded contract terms the architect's approval of the application for payment created a property right to the bonded contract funds in favor of the principal. Accordingly, the court held that because the principal had a property interest in the bonded contract funds the IRS was entitled to the funds.

In a Sixth Circuit decision in *In re Construction Alternatives,* 2 F.3d 670 (6th Cir. 1993), the IRS filed tax liens against the principal for delinquent tax obligations related to other projects and the principal later filed bankruptcy. At the time of the bankruptcy, the work on the bonded project was complete, but the principal had failed to pay some of its subcontractors and suppliers. The surety paid those claims under its payment bond. The bankruptcy court ruled that the IRS had priority over the surety to the bonded contract funds and the surety appealed. The Sixth Circuit held that the bonded contract did not provide for retainage and did not allow the obligee to withhold the bonded contract funds from the principal because of its failure to pay its subcontractors and suppliers. Because the principal had completed all of the work required under the bonded contract, the court held that the principal retained a property interest in the bonded contract funds which was subject to the IRS lien.

As these cases demonstrate, the analysis of whether the delinquent taxpayer has a property interest in the bonded contract funds can be complicated and depends on consideration of a variety of factors.

2. The Resolution of Priority Disputes Between the Surety and the IRS

Prior to 1966, the priorities of other types of liens versus federal tax liens was determined solely under the "first in time is the first in right rule" interpreted together with the "choate doctrine." Under the "choate doctrine," a state created lien is deemed "choate" only when "there is nothing more to be done . . . when the identity of the lienor, the property subject to the lien, and the amount of the lien are established." Typically, a surety's subrogation rights to the bonded contract funds would not become "choate" with respect to a specific loss until the claim was paid. The choate doctrine also precluded the surety from arguing that its subrogation rights related back to the date of the issuance of the bonds in priority disputes with the IRS.

In 1966, Congress changed the priority analysis when it enacted 26 U.S.C. § 6323(c) of the Internal Revenue Code, which addresses the priority of certain liens and interests relative to a tax lien. Section 6323(c) states in relevant part that a tax lien shall not be valid with respect to a "security interest" that arose after the tax lien if that security interest:

> (A) is in qualified property covered by the terms of a written agreement entered into before the tax lien filing and constituting…
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> (iii) an obligatory disbursement agreement, and
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> (B) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

So, we need to unpack this statute a little bit and define some of the key terms. First, the term "obligatory disbursement agreement" is defined as an agreement to make disbursements that are required to be made by reason of the rights of a person other than the taxpayer. This definition includes agreements such as the performance and payment bonds. The statute specifically addresses sureties and provides:

> (C) Special Rules for surety agreements. Where the obligatory disbursement agreement is an agreement ensuring the performance of a contract between the taxpayer and another person—
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> (i) the term "qualified property" shall be treated as also including the proceeds of the contract the performance of which was ensured, and
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> (ii) If the contract the performance of which was ensured was a contract to construct or improve real property, to produce goods, or to furnish services, the term "qualified property" shall be treated as also including any tangible personal property used by the taxpayer in the performance of such ensured contract.

The term "security interest" is defined in §6323(c) as:

> . . . [A]ny interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.

Based on the text and legislative history of § 6323(c), it is evident that Congress intended to allow for circumstances under which a surety's subrogation rights to the bonded contract funds could relate back to the date of issuance of its bonds and have priority over tax liens filed post-bond but pre-surety losses, with the priority issue determined based on whether the surety's subrogation rights to the bonded contract funds would take priority under the applicable state law over a hypothetical judgment lien that would be deemed filed as of the filing of the tax lien.

There are conflicting cases on the issue of whether the surety's subrogation rights are a "security interest" "acquired by contract" as required by the Tax Code. Some courts have held that subrogation rights arise not by contract, but by operation of law and are rights in equity and thus are not a security interest under the Tax Code. Other courts note that the subrogation rights arise through performance under the bonds and indemnity agreement and the surety is enforcing the rights of the parties in whose shoes its stands and those rights were acquired by contract and thus satisfy the security interest requirement of the Tax Code. Of course, the issue is obviated if the surety files its Indemnity Agreement as a financing statement with a UCC-1. There are also many state law issues that can dictate the outcome of a priority dispute to the bonded contract funds between the surety and the IRS under §6323(c) including the following:

(i). ***Whether the Relation Back Doctrine is Recognized under State Law***

At least one jurisdiction has held that under state law the relation back doctrine did not apply. In jurisdictions that may not apply the relation back doctrine, the IRS may prevail over the surety as to the bonded contract funds when a tax lien predated the bonds or the tax lien predated the principal's default.

(ii). ***Whether the Relation Back Doctrine is Limited to Retainage or Progress Payments***

In some states the relation back doctrine applies solely to the bonded contract funds in the form of retainage and not to other bonded contract funds such as progress payments. Other states apply the relation back doctrine equally to progress payments and retainage. In jurisdictions that limit the "relation back" doctrine to retainage only, the IRS may prevail over the surety as to the bonded contract funds when a tax lien predates the bonds or the tax lien predates the surety's loss. When the relation back doctrine applies to all of the bonded contract funds and the tax lien is recorded after the date of the bonds, the surety should have priority under §6323(c) as to all of the bonded contract funds held by the obligee as of the date of the principal's default or default in fact.

(iii). ***The Status of Claimant's Rights to the Bonded Contract Funds if the Claimants did not Perfect their Rights under Mechanics Lien or Other Applicable Statutes***

Some courts have ruled that a surety claiming subrogation rights through a subcontractor or supplier to the principal, may not assert such rights to the bonded contract funds ahead of the IRS if the subcontractor or supplier has not perfected its lien rights or has no lien rights against the bonded contract funds. Other courts hold that such perfection is not required in order for the surety to have priority over the IRS.

The takeaway here is: that priority disputes between the surety and the IRS will be governed by §6323(c) under which priority will be determined by whether the surety's subrogation rights to the bonded contract funds would have had priority over a hypothetical judgment lien filed on the date of the filing of the IRS tax lien.

(GEORGE)

B. The effect of an IRS tax levy against the bonded contract funds.

1. The tax levy and its effect on the priority rights of the surety and the IRS.

As Mike just discussed, the timing of the recording of an IRS tax lien determines the relative priorities of the IRS and other secured creditors to the bonded contract funds. In contrast, an IRS tax levy brings the property into IRS custody, but does not determine the IRS's priority rights to the bonded contract funds. The IRS may not defeat the surety's rights to the bonded contract funds by merely filing a "tax levy" on the obligee holding the bonded contract funds without recording, at some point, a "tax lien" that provides the IRS with the starting date for its claimed priority rights in the bonded contract funds.

2. The procedures that a surety must follow in order to assert its subrogation rights and priority rights to the bonded contract funds subject to an IRS lien.

However, once the IRS files a "tax levy" against the obligee that is holding the bonded contract funds, the surety must take steps to protect its priority rights to the bonded contract funds, whether as a secured creditor or pursuant to its subrogation rights. The Internal Revenue Code [26 U.S.C. § 7426(a)(1)] provides that if the IRS serves a tax levy on a third party's property in order to collect taxes owed by another, the third party may bring a wrongful levy action against the United States[5] to establish its rights to the levied property. A third party wrongful levy action must be initiated within nine months from the date of the service of the notice of tax levy on the party holding the alleged property of the taxpayer.[6]

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[5] The United States may serve a notice of levy in order to collect any outstanding taxes pursuant to 26 U.S.C. § 6331(a). While the United States is normally immune from a suit, it has consented to jurisdiction in the district court in the event that a person claims an interest in the property which has been levied upon and that the levy is a wrongful levy under 28 U.S.C. § 7426(a)(1) as follows:

> Wrongful Levy.-- If a levy has been made on property or property has been sold pursuant to a levy, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in or lien on such property and that such property was wrongfully levied upon may bring a civil action against the United States in a district court of the United States. Such action may be brought without regard to whether such property has been surrendered to or sold by the Secretary.

See United Sand & Gravel Contractors, Inc. v United States, 624 F.2d 733, 736 (5th Cir. 1980). *See also* Matthew M. Horowitz, *Ch. 12, The Surety v. Other Taxing Authorities and Governmental Lienors, in* THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 485-91 (George J. Bachrach, James D. Ferrucci & Dennis J. Bartlett eds., Am. Bar Ass'n 2013) and Adam Cizek & Michael Safris, *IRS Notice of Levy on Bonded Contract Funds: What Does the Surety Do Next?* (unpublished paper submitted at the Eighteenth Annual Northeast Surety and Fidelity Claims Conference on September 27, 2007).

[6] 26 U.S.C. § 6532(c)(1).

Mike addressed the impact on the surety's subrogation rights to the bonded contract funds when the IRS serves a tax levy on the obligee holding the bonded contract funds in our March 13, 2017 Surety Today presentation. Regardless of what priority rights the surety may assert in the bonded contract funds and how those rights were created – a security interest or subrogation rights – that would otherwise defeat the IRS's priority rights under its tax lien, if the surety does not file a wrongful levy action within nine months from the date of service of the notice of tax levy, then the surety may lose its priority rights. The United States Supreme Court has ruled that a wrongful levy action is the exclusive remedy for a third party, such as a surety, to assert its rights to property levied on by the IRS to satisfy the delinquent tax obligations of another party, such as the principal.

While the tax levy is normally served on the obligee holding the bonded contract funds, it could also be served on a third-party Funds Control company being used by the surety for the principal or even the surety itself, which has been paid the bonded contract funds and is holding them in reserve for future payments to reduce the surety's bond losses. The procedural steps that the surety must take to file a wrongful levy action are set forth in *School Board v. J.V. Construction Corp*, 2004 WL 1304058 (S.D. Fla. Apr. 23, 2004), which Mike discussed in more detail on March 13, 2017.

<u>In summary</u>, the service of a tax levy does not affect the relative priorities of the IRS as against the surety to the bonded contract funds. But, if the IRS serves a tax levy, the surety must take action to assert its priority to the bonded contract funds within nine months of service of the tax levy through a wrongful levy action or lose its priority status in the bonded contract funds as against the IRS.