

Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: **20102601F**

Release Date: 7/2/2010

CC:SB:7:SJ:2:JWStrate

GL 110827-10

UIL 50.36.00-00

date: April 22, 2010

to: Larry Kakos
Revenue Officer
Collection Division HQ 5117
San Jose, California

From: John W. Strate
Senior Attorney
(Small Business/Self-Employed)

subject: , Wrongful Levy

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges such as attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

Whether . had a property interest in funds being withheld by the City of pursuant to a "Stop Notice."

CONCLUSION

Based on the discussion below, we conclude that . had no property interest in the funds withheld pursuant to the "Stop Notice" and that the funds be returned to the City of .

FACTS

and taxes in the amount of \$ or “the taxpayer”) has unpaid as follows:

<u>Type of Tax</u>	<u>Tax Period</u>	<u>Amount Due</u>
--------------------	-------------------	-------------------

contracted to provide improvements to property owned by the City of , California. On entered oral contracts with . doing business as in which agreed to provide materials and services to . incurred liabilities to in the amount of \$ and \$. failed to pay these amounts and owes a total of \$.

On , served the City of with a Preliminary 20-Day Notice pursuant to California Civil Code section 3098.

On , the Service filed a Notice of Federal Tax Lien (“NFTL”) with respect to the tax periods ending and

completed the project during .

On , served the City of with two Stop Notices pursuant to California law requiring the City of to withhold payment to

On , sued in the County Superior Court, case number for breach of contract and to enforce the two “Stop Notices.”

In , the Service issued a Notice of Levy to the City of which was holding funds owed to .

On , the City of sent the Service a check in the amount of

\$, which was the amount that the City of owed .

On , sent the Service an administrative wrongful levy claim pursuant to I.R.C. § 6343(b).

DISCUSSION

In cases where a taxpayer, after notice and demand, neglects or refuses to pay tax, the Service may file a Notice of Federal Tax Lien (“NFTL”). I.R.C. § 6321. The NFTL reaches all property and rights to property, both real and personal, belonging to the taxpayer. Id.

A levy is an administrative means of collecting taxes by seizure of the taxpayer’s property or rights to property to satisfy delinquent taxes. See I.R.C. § 6331. It is a summary, extra-judicial remedy of self-help for the purpose of compelling payment of the tax debt. See United States v. National Bank of Commerce, 472 U.S. 713, 720-21 (1985) (a levy is a provisional remedy that protects the Government against diversion or loss while such claims are being resolved). See also Air Operations International Corp. v. United States, 2002-1 U.S.T.C. ¶ 50,423 (S.D. Fla. 2002) (after a levy a third party cannot perfect a security interest in levied-upon funds). In addition to reaching the taxpayer’s property, the levy also reaches any property transferred to a third party that is subject to a federal tax lien. Hans v. United States, 944 F.2d 526 (9th Cir. 1991); United States v. Donahue Industries, Inc., 905 F.2d 1325 (9th Cir. 1990).

The Supreme Court recognized in United States v. National Bank of Commerce, 472 U.S. 713, 721-22 (1985) that there are only two valid defenses to a third party’s refusal to surrender property upon demand: (1) the party is not in possession of nor obligated with respect to property or rights to property of the taxpayer; or (2) at the time of service of the Notice of Levy, the property or rights to property were subject to attachment or execution under judicial process. I.R.C. § 6332(a). This case turns on whether had a property interest in funds withheld pursuant to a “Stop Notice.”

Whether the taxpayer has a property interest in property is determined by state law. Drye v. United States, 528 U.S. 49, 58 (1999). If under state law, a prime contractor-taxpayer has no property interest in funds due from the owner except in any surplus that might remain after payment of the subcontractor, there can be no levy on payments owed the subcontractor. See United States v. Durham Lumber Co., 363 U.S. 522 (1960). Since both and are located in California, we look to California law to determine if had a property interest in the funds withheld by the City of .

In California, a subcontractor providing materials to a general contractor is

entitled to a “Stop Notice” upon failure of the general contractor to pay for materials used on the contract. Connolly Development, Inc. v. Superior Court of Merced County, 17 Cal. 3d 803, 132 Cal. Rptr. 477 (Cal. Sup. Ct. 1976), appeal dismissed, 429 U.S. 1056 (1976). The “Stop Notice” involves a notice served on the owner or lender, which in turn gives notice to an owner to withhold payments to a general contractor, or gives notice to a lender to withhold payment from the owner to a general contractor. In effect, this allows a materialman or subcontractor to cause money to be earmarked for his benefit. While a “Stop Notice” does not constitute a mechanic’s lien, it is a garnishment of the funds of the owner. Id. at 813.

Any person entitled to a mechanic’s lien under Cal. Civ. Code §§ 3110, 3111 and 3112, other than a general contractor, is entitled to give a “Stop Notice.” Cal. Civ. Code § 3181. As a prerequisite to the serving of a “Stop Notice,” the claimant must have served a preliminary 20-day notice. Cal. Civ. Code §§ 3183(a). In this case, filed a preliminary 20-day notice on .

Upon receipt of a “Stop Notice,” the owner has the duty to withhold from the contractor sufficient money to answer the claim, unless a payment bond is recorded. Cal. Civ. Code § 3186 (“It shall be the duty of the public entity, upon receipt of a stop notice . . . to withhold from the original contractor . . . money or bonds . . . due or to become due to that contractor in an amount sufficient to answer the claim stated in the stop notice and to provide for the public entity’s reasonable cost of any litigation thereunder.”) California law prohibits the original contractor from making an assignment of money due under the contract once a stop notice has been filed. Id. § 3193. Further, any garnishment of, or statutory lien placed on such money will be “subordinate to the rights of all stop notice claimants.” Id. Thus, when filed the two “Stop Notices” on , the City of became obligated to withhold amounts owed to under the contract. The filing of the “Stop Notices” constituted a lien on the funds being held by the City of .

The only legal precedent we have found directly discussing the effect of a “Stop Notice” on the Service’s levy is a Third Circuit case considering the lien laws of New Jersey. The Court held that a taxpayer had no property interest in funds retained by a contractor pursuant to a “Stop Notice.” Shore Block Corp. v. Lakeview Apartments, 377 F.2d 835 (3rd Cir. 1967). There, a subcontractor failed to pay a materialman. Id. at 837-38. The materialman filed a “Stop Notice” on January 29, 1965 with the contractor to withhold payments to the subcontractor. Id. Subsequently, the Service filed a lien for unpaid taxes of the subcontractor. Id. The Service then filed a levy on the funds withheld pursuant to the “Stop Notice.” Id. The court reasoned that the issue did not concern lien priorities. Id. at 841. Rather, the issue was whether the subcontractor had a property interest in the funds withheld pursuant to the “Stop Notice.” Id. The court stated that “[s]ince the subcontractor never had the right to obtain the garnished funds, neither could the United States assert a tax lien against them. Id.

Turning to California law, in United States Fidelity & Guaranty Company v. Oak Grove Union School District of Sonoma County, 205 Cal. App.2d 226, 230-31 (1962), the court stated

(1) In a public works contract there can be no lien against the property; hence the use of stop notices to provide protection to subcontractors against defaulting contractors. (2) In a sense the stop notice constitutes a lien on the property (earnings) of the contractor held by the owner. When the notice is filed [sic] the claimant immediately has a right against those earnings held by the public agency. In effect, the filing imposes a trust obligation on the public agency.

When _____ filed the two “Stop Notices” with the City of _____, _____ immediately had a right to the funds earned by _____. The City of _____ was effectively holding those funds in trust for _____.

Cal. Civ. Code § 3264 provides in relevant part that: “[t]he rights of all persons furnishing labor, services, equipment, or materials for any work of improvement, with respect to any fund for payment of construction costs, are governed exclusively by [Cal Civ Code sections 3156 through 3214] . . . and no person may assert any legal or equitable right with respect to such fund,” See Falcon Construction Co. v. United States, 1988 WL 383111 (E.D. Cal. 1988) (holding that the Service could levy withheld funds, in part because no stop notice had been filed); see also Pankow Construction Co. v. Advance Mortgage Corp. et al, 618 F.2d 611 (9th Cir. 1980) (holding that “claims on construction loan funds by persons furnishing services or material are confined” to mechanics liens and stop notices). Further, at least one appellate court in California has interpreted sections 3186 and 3193 as imposing an “absolute statutory duty” on owners “to pay the valid amounts of [stop notice] claims to the stop notice claimants and no one else.” Stanislaus Pump v. City of Modesto, 200 Cal. App.3d 1442, 1447, 246 Cal. Rptr. 601, 604 (5th Dist. 1988). However, this case evaluated the ability of the contractor to make an assignment, and not a competing claim of the United States.

There are no reported cases in the Ninth Circuit on the effect of a “Stop Notice” when it is competing with a federal tax lien or levy. Some cases indicate that the Circuit would recognize the stop notice as depriving a contractor of property interest in withheld contract proceeds. See, e.g., United States v. J.D. Grainger Co., Inc., 945 F.2d 259, 262 (9th Cir. 1991) (“A number of courts have held that a taxpayer-contractor has no property interest . . . in funds held by a surety or withheld by the contracting party for payment of subcontractors or other creditors of the taxpayer.”). On the other hand, some cases indicate some hostility toward this theory. See, e.g., American Fidelity Fire Ins. Co. v. United States, 385 F.Supp. 1075, 1078 (N.D. Cal. 1974) (finding no support for the premise that once a stop notice is issued, “payments due the contractor become not property of the contractor, but a trust fund for the payment of laborers and materialmen”).

Because the "Stop Notice" is not a mechanic's lien, but rather an equitable remedy under state law, the Service's position is that the federal tax lien would ordinarily prime the "Stop Notice." However, the Service's litigating position is that the Service will not assert priority of a filed federal tax lien vis a vis an unperfected mechanic's lien such as a "Stop Notice" to the extent there are unpaid laborers or materialmen, then the "Stop Notice" is recognized a superior to the federal tax lien. See California Local Law Guide, <http://ccintranet.prod.irsounsel.treas.gov/OrgStrat/Offices/sbse/Pages/CaliforniaLocalLaw.aspx>. This position is based on the understanding that a contractor who has not paid his subcontractors could be deemed to have no property interest in the contract proceeds. See IRM 5.17.2.7.1.12(3). California case law has not explicitly answered the questions whether a stop notice deprives a contractor of a property interest. However, it seems likely they would do so given the chance, based on the statutory duty to withhold funds.

Therefore, we recommend that you return the \$ _____ to the City of _____ for a continued withholding of the funds subject to the Stop Notices filed by _____.

If you have any questions, please call John Strate at (408) 817-4684.

PETER R. HOCHMAN
Associate Area Counsel
(Small Business/Self-Employed)

By: _____
JOHN W. STRATE
General Attorney
(Small Business/Self-Employed)