

DECISION

**THE COMPTROLLER GENERAL
OF THE UNITED STATES**
WASHINGTON, D.C. 20548

FILE: B-201164

DATE: June 8, 1981

MATTER OF: Priority between a Federal Tax Lien and
an Assignment under a Government Contract

- DIGEST:**
1. Assignment of claim to proceeds under Federal Government contract must be recognized by contracting agency and all other Federal Government components including Internal Revenue Service, if assignee complied with filing and other requirements of Assignment of Claims Act, 31 U.S.C. § 203, even though assignee failed to perfect assignment under Uniform Commercial Code and similar State provisions.
 2. Where IRS (or other Federal entity) has claim against contractor-assignor which arose before assignment was completed under Assignment of Claims Act, amount of Federal claim may be set-off against amounts otherwise due to assignee, assuming absence of no set-off clause in the contract. Assignee stands in shoes of assignor. Government's right to set off tax debts of assignor that were in existence, even if not yet mature, prior to date on which assignment became effective are not extinguished by assignment, although actual set-off cannot be made until tax debt matures.
 3. If Government contract contains a "no set-off" clause, Government cannot set-off tax debt of assignor under any circumstances.

The former Administrator of General Services requested a decision on whether a Federal tax lien or an assignment of a Government contract pursuant to the Assignment of Claims Act (31 U.S.C. § 203 (1976)) has greater priority.

The Administrator's request arose as a result of a disagreement between the Administration (GSA) and the Internal Revenue Service (IRS) over the relative priority of a Federal tax lien against a Government contractor and the claim of the bank to which the contractor had assigned his rights under the contract. Specifically, on December 8, 1977, the contractor, PAL Industries Inc., assigned all of the proceeds due under a contract with GSA to the First Pennsylvania Bank. The bank notified GSA of the assignment on February 3, 1978, and otherwise complied with the requirements of 31 U.S.C. § 203, the Assignment of Claims Act of 1940, as amended. However, the bank did

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not file a financing statement with the appropriate State office in Pennsylvania. Pennsylvania law, modeled on the Uniform Commercial Code, requires that such a statement must be filed in order to protect an assignee's interest in accounts or contract rights. Pa. Stat. Ann. Tit. 12A, § 9-302(1) (Purdon 1970).

On January 10 and February 14, 1979 (after tax assessments were made against the contractor), IRS filed notices of tax lien for taxes owed by the contractor for three tax periods ending in 1978 and one tax period ending in December 1976. Although IRS sent GSA a notification of levy on the unpaid contract proceeds in February 1979, GSA paid the balance of the monies due on the contract to the assignee on October 2, 1979. GSA based its decision that the assignment took precedence over the levy on the fact that the assignment had been completed prior to the date of the first tax assessment.

It is the view of IRS that its tax lien had priority over the assignment and that GSA acted improperly in making any further payments to the assignee after being notified of the tax lien against the contractor-assignor. Although IRS is no longer asserting a claim against GSA in this specific situation, it anticipates that this issue will arise again. Both GSA and IRS are interested in having this issue resolved. Accordingly, in addition to addressing the specific facts of this case, our decision will also consider the priority of liens question under several different factual situations.

The IRS position may be summarized as follows. An assignment which is not perfected under local law at the time the IRS files a notice of Federal tax lien does not have priority over the Federal tax lien. The assignment falls within the definition of a security interest under Internal Revenue Code (I.R.C.) § 6323(h)(1), as an "interest in property acquired by contract for the purpose of securing payment or performance of an obligation * * *." Lien priority between a security interest and a Federal tax lien is determined by comparing the time the security interest arose with the date that the notice of Federal tax lien was filed. I.R.C. § 6323(a). A security interest is deemed to be in existence and is valid against the Federal tax lien only if the security interest is protected under local law against subsequent judgment lien creditors. I.R.C. § 6323(h)(1)(A). As previously noted, under Pennsylvania law, modeled on the Uniform Commercial Code, a financing statement must be filed in order to protect an assignee's interest in accounts or contract rights. The First Pennsylvania Bank did not file a financing statement and thus its security interest was not perfected. An unperfected security interest is subordinate to the rights of a person who becomes a lien creditor without knowledge of a security interest and before it is perfected. Pa. Stat. Ann. Tit. 12A § 9-301 (Purdon 1970). Failure to file a financing

statement thus results in a security interest being subordinated to a Federal tax lien. Sams v. Redevelopment Authority, 435 Pa. 524, 261 A. 2d 566 (1970).

The IRS states that the only question remaining which could affect its analysis of the relative priority between a Federal tax lien and an assignment under Government contract is whether the provisions of 31 U.S.C. § 203 (1976) 1/ remove assignments of claims under Federal contracts from the application of the Uniform Commercial Code (UCC).

Implicit in the IRS position is the assumption that the contract in question did not contain what is generally referred to as a "no set-off clause". In this connection, 31 U.S.C. § 203 reads in pertinent part as follows:

"Any contract of the Department of Defense, the General Services Administration, the Atomic Energy Commission, or any other department or agency of the United States designated by the President, * * * may, in time of war or national emergency proclaimed by the President (including the national emergency proclaimed December 16, 1950) * * * provide or be amended without consideration to provide that payments to be made to the assignee of any monies due or to become due under such contract shall not be subject to reduction or set-off, and if such provision or one to the same general effect has been at any time heretofore or is hereafter included or inserted in any such contract, payments to be made thereafter to an assignee of any monies due or to become due under such contract, whether during or after such war or emergency, shall not be subject to reduction or set-off for any liability of any nature of the assignor to the United States or any department or agency thereof which arises independently of such contract, or hereafter for any liability of the assignor on account of * * * (4)

1/ The question as posed by the IRS refers to the Anti-Assignment Act, at 31 U.S.C. § 203, and the Assignment of Claims Act at 41 U.S.C. § 15. We assume that in referring to the Anti-Assignment Act, the IRS means the first paragraph of 31 U.S.C. § 203, which prohibits assignments. The remainder of 31 U.S.C. § 203 is the Assignment of Claims Act of 1940, as amended. The latter Act is also classified to 41 U.S.C. § 15.

taxes, social security contributions, or the withholding or nonwithholding of taxes or social security contributions, whether arising from or independently of such contract."

Having obtained a copy of the PAL Industries contract with GSA, we have determined that such a no set-off clause was included in the contract with the proviso (mirroring the statutory language) that the clause only applies if the contract is entered into in time of war or national emergency as defined in 31 U.S.C. § 203. Although the National Emergencies Act (Public Law No. 94-412, approved September 14, 1976, 90 Stat. 1255, 50 U.S.C. § 1601 et seq.) terminated (two years thereafter) the national emergency then in effect, section 502 of the Act (50 U.S.C. § 1651) specifically provided that it did not apply to any of the powers and authorities conferred under 31 U.S.C. § 203 and 41 U.S.C. § 15. Accordingly, it is clear that the no set-off clause was a binding provision in the contract between PAL Industries and GSA.

It is well settled that the presence of a no set-off clause in a contract prohibits IRS or any other Government agency from making any claim to the monies due the assignee under the contract. For example, in 37 Comp. Gen. 318 (1957) we said that the no set-off provision of the Assignment of Claims Act, when part of a contract, "expressly nullifies the effect of section 6321 of the Internal Revenue Code of 1954 * * *."

Apparently IRS was unaware of the presence of the no set-off clause when it contested GSA's refusal to recognize the validity of the IRS tax lien, and is willing to concede that set-off is not permissible when such a clause is included in a contract. Therefore, although GSA's decision in this case to pay the balance of the contract proceeds to the assignee was correct, we must still consider the legal merits of the IRS position whenever a no set-off clause is not included in a contract.

As indicated above, the essence of the IRS position (assuming the absence of a no set-off clause) is that, since the assignment of the claim on a Government contract under 31 U.S.C. § 203 gives the assignee no more than a "security interest" in the assignor's rights under the contract, the assignment, until recorded and perfected under State law, will be subordinate to the claim of any other party that becomes a lien creditor, including the IRS, once it files a notice of Federal tax lien. For the reasons set forth hereafter, we disagree with the IRS position.

First, we think that the provisions of the UCC with respect to the perfecting of an assignment are preempted by the provisions of the

Assignment of Claims Act as far as recognition by the Federal Government is concerned. The Assignment of Claims Act sets forth the filing and notice requirements that must be complied with by the assignee in order to complete a valid assignment. Once the assignee has satisfied these requirements and has notified the Federal contracting agency of the assignment, his rights, at least insofar as any other claims by the Federal Government are concerned, become fixed. Implicit in this statement is the recognition that the Federal Government is a unit. If the contracting agency is bound to acknowledge the assignment, a sister agency may not disavow it. (It is not our intention to express any position on whether the assignment of a claim under a Government contract should be viewed as perfected without filing in accordance with State law when the dispute only involves competing private claims. That is a matter for litigation between the assignee and the non-Governmental creditor, and in any case, is not at issue here.)

We turn now to the characterization of the assignee's interest in payments due on a Federal agency's contract with the assignor as a "security interest," as opposed to a more extensive property interest. In the numerous cases of this type that this Office has considered, involving conflicting claims by the assignee and a Government agency (generally the IRS), we have always treated the assignment of a claim on a Government contract as an outright and absolute sale of all of the assignor's rights and property interest under the contract, and not as a more limited transfer of a security interest. For example, in 37 Comp. Gen. at 320, supra, we said:

" * * * [where the contract does not contain a no set-off clause] the assignee stands in the shoes of the assignor and the Government may set off against the assignee any claims of the Government against the assignor which had matured prior to the assignment. Southside Bank and Trust Company v. United States, 221 F 2d. 813. However, under the common law applicable to assignments, debts of the assignor which mature after an assignment is made may not be set off against payments otherwise due the assignee. 30 Comp. Gen. 458, 459, and cases cited there.

"These principles are applicable to a Federal tax indebtedness owed by a Government contractor, apart from any lien which may exist. Where the contract does not contain a no set-off provision it may well be that the lien created by section 6321 of the 1954 Internal Revenue Code would prevent the effective assignment of monies thereafter becoming due the taxpayer under a Government contract. If the

assignment of the contract proceeds was made before the tax became due, there would be no property or right to property owned by the taxpayer to which the lien could attach, at least to the extent of the assignee's entitlement to such proceeds."

In a similar vein, see 56 Comp. Gen. 499 (1977); 30 Comp. Gen. 98 (1950); 29 Comp. Gen. 340 (1949); 20 Comp. Gen. 458 (1941); and other cases cited in those decisions. In other words, an assignor does not retain any property interest in the assigned contract which would be subject to attachment by any lien creditor, including the Federal Government. See Monroe Banking and Trust Co., v. Allen, 286 F. Supp. 201 (N.D. Miss. 1968); United States v. Lester, 235 F. Supp. 115 (S.D. N.Y. 1964); United States v. Trigg, 465 F. 2d 1264 (8th Cir. 1972); Lyon v. Ty-wood Corp., 212 Pa. Super. 69, 239 A. 2d 819 (1968).

In all of our decisions in this area it has been our consistent position, whenever a conflict arises between the assignee and the Government, that the assignment of a claim under 31 U.S.C. § 203 becomes effective on the date the contracting agency receives notification of the assignment. See 56 Comp. Gen. 499, *supra*; 37 Comp. Gen. 808 (1958); 20 Comp. Gen. 458, *supra*; B-152008, September 10, 1963). Considering the long-standing position of our Office, we do not believe that a convincing legal case can be made for overruling our prior decisions and imposing a new requirement that assignees must file notice of the assignment within their States, as well as with the contracting agency, in order to be assured of priority over a subsequent Government claim.

Moreover, even if we accept the IRS contention that an assignment of a claim on a Government contract should be treated as the transfer of a security interest, a strong argument could still be made that as far as the Government is concerned, the assignment becomes effective as soon as the contracting agency is notified. Under the UCC provisions adopted by Pennsylvania, "an unperfected security interest is subordinate to the rights of * * * a person who becomes a lien creditor without knowledge of the security interest and before it is perfected* * *." (Emphasis added.) Pa. Stat. Ann. Tit. 12a, § 9-301(1) (Purdon 1970). Once the assignee notifies the contracting agency of the assignment, as is required by 31 U.S.C. § 203 in order for the assignment to become effective, the Federal Government (again, viewed as a unit) has actual notice of the security interest. Therefore, a tax lien filed thereafter would not be entitled to priority. See United States v. Hunt, 513 F. 2d 129 (10th Cir. 1975); and United States v. Ed Lusk Construction Co. Inc., 504 F.2d 129 (10th Cir. 1974).

There is one final issue to resolve. While we have held that the assignment of a Federal contract becomes effective when the contracting agency receives notification of it and the assignee otherwise complies with the Assignment of Claims Act, it is not clear from our prior decisions precisely when the IRS tax lien "arises." This is important because under our theory of the assignment constituting a transfer of all the rights of the assignor at the time of the assignment, it is clear that he cannot transfer a greater right against the Government than he possessed at that time. If he owed taxes to IRS before he transferred his right to Government proceeds, the debt--and the Government's right to set it off--is not extinguished.

Our prior cases have been somewhat inconsistent on this question. For example, in 37 Comp. Gen. 318 supra, we said that the Government could set off those debts of the assignor which had "matured" prior to the date the assignment became effective. Also see 20 Comp. Gen. 458 supra, B-170454, August 12, 1970, and most recently 56 Comp. Gen. 499, supra. In determining the date on which the tax claim matured, this line of cases generally looks to the date of assessment pursuant to sections 6321 and 6322 of the Internal Revenue Code. In other words, in these cases the Government could set off a tax claim against the contract proceeds due the assignee, if the tax assessment against the contractor had been made prior to the contracting agency's receipt of notification of the assignment.

Another line of cases takes the position that as long as the tax claim was in existence prior to notification of the assignment to the contracting agency, even if it was not yet "matured" (i.e., was payable by the contractor), the Government's right of set-off was preserved, although the actual set-off could not be made until the tax debt had matured. For example, in 37 Comp. Gen. 808, at 809, we said the following:

"It is conceded that a judicial line of authority exists to support the contention that only those claims arising independently of the contract which had matured, i.e., were actionable prior to receipt of notice of assignment by the debtor, can be set off against the assignee. That line of authority was followed and cited in the dicta contained in our decisions at 20 Comp. Gen. 458; 37 Comp. Gen. 318.* * *

"While there is unquestionable authority with regard to * * * [the] position as to the necessity that the claim be matured prior to receipt of notice of assignment, there is valid and learned authority to the opposite effect. * * * Under [this] authority * * * the taxes, penalty and interest for the third quarter of 1953 were properly set off since the claim

existed prior to notice of assignment and had matured at the time set-off was actually made."

Also, see B-157394, October 5, 1965; B-150865, March 20, 1963; and B-152008, September 10, 1963.

Thus, in all of these cases, we held that if the assignor's obligation to pay the taxes in question had already come into existence before the assignment was made and the agency notified, the tax claim would have priority over the assignment even though the taxes were not yet due when the assignment became effective. The relative merits of these two theories were thoroughly discussed in B-152008, September 10, 1963. In that decision we said the following:

"The rights of the Government in the instant situation may be viewed in two ways. Firstly, the Internal Revenue Service might attempt to assert a lien for unpaid taxes upon the accrued rentals under the Internal Revenue Code, 26 U.S.C. 6321, 6322. Secondly, the United States Government may exercise the common law right of any debtor to set off amounts due from it to a claimant toward the extinguishment of that claimant's indebtedness to the Government.

"If this matter were to be disposed of solely with reference to the first theory of the Government's position, the Bank might well prevail, since as between two conflicting liens upon the same property the first in time is first in right, and the assignment was perfected on January 16, 1963, whereas the tax lien does not arise until the time at which the assessment is made by 26 U.S.C. 6322 and the earliest assessment in this case was not effected until February 12, 1963.

"But the rights of the Government here may be determined under the second theory, that is, by the rules regarding the Government's right of set-off at common law.

* * * * *

"Debts owed by the assignor to the Government which arise after perfection of the assignment may not be set off against payments due the assignee. 20 Comp. Gen. 458, 459. Debts owed the United States by the assignor which existed, whether matured or not, before notice of the assignment was

given the obligor, may, at the time they mature, be set off against mature obligations owed by the Government to the assignor. 37 Comp. Gen. 808. An employer's obligation to pay the Government amounts withheld from his employee's salaries for tax or social security purposes comes into existence, irrespective of its inchoate character, at the time the employee has completed earning the salary to which the obligation applies, i.e., in general, on pay day, even though the actual payment to the Government need not be made until later. During the interim between the withholding and the satisfaction of the liability to the Government, an employer holds the amounts involved as a constructive trustee for the Government. Thus a notice of assignment received by the Government does not render the assignee immune from set-off of newly arising tax or social security withholding liabilities of the assignor until the beginning of the pay period next following the pay period of the particular employer during which notice of assignment is received.

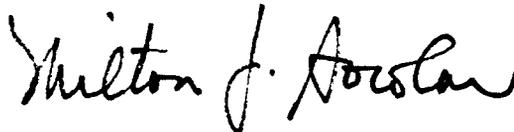
"In this case both the withholding tax obligation for the fourth quarter of 1962 and the Federal Unemployment Tax obligation for the year 1962 were claims existing, even though not yet mature, at the time the Notice of Assignment was received by the Post Office Department. That part of the withholding tax liability for the first quarter of 1963 which came into being by virtue of the beginning of pay periods prior to January 16, 1968, is likewise available to the Government for purposes of set-off."

It is our view that the approach we followed in B-152008 is preferable. Accordingly, whenever this situation arises in the future (assuming the absence of a no set-off clause), the Government's common law right to set-off a tax debt of the assignor that was in existence, even if not yet due (mature), prior to the date on which the contracting agency was notified of the assignment will not be extinguished by the assignment, although the actual set-off cannot be accomplished until the tax debt matures.

Although we recognize that the priority issue is moot with respect to the PAL Industries case, we will illustrate the above holding by reference to the facts in that case. (For purposes of the illustration, we will assume, contrary to fact, that the contract did not have a no set-off clause).

The assignment to First Pennsylvania Bank became effective on December 2, 1977, when GSA received notification of it. Although the dates on which the tax assessments against the contractor were made, as well as the date on which the Federal tax lien was filed (and on which GSA received the notice of tax levy) occurred after the date of the assignment, it appears that a portion of the taxes involved was payable for the tax period ending December 1976. Accordingly, since the tax debt for the period ending December 1976 came into existence prior to the date on which GSA received notification of the assignment, application of the priority rules set forth above would have required GSA to set-off that amount against the contract proceeds otherwise payable to the assignee.

To the extent that anything we have said in any of our prior decisions is inconsistent with our conclusions herein, those decisions are modified accordingly.

A handwritten signature in cursive script that reads "Milton J. Aorstan".

Acting Comptroller General
of the United States