

Federal Tax Liens Summary for Ameriquest® Professional Staff

Whitestone Office

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Background of the Speaker



■ Professional status

- Certified Public Accountant [Texas]

■ Education

- MBA Columbia University
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- BA University of Hawaii

■ Military Service

- US Navy (Vietnam Era)
- US Naval Reserve
- US Coast Guard Auxiliary Volunteer



Contents

- Federal Tax Liens - how do they arise, and to what property they attach?
- How to avoid and minimize the effect of tax liens?
- Priority of tax liens - do other liens prevail over the Federal Tax Lien?



SECTION 6321 LIEN FOR TAXES

- If any person liable to pay any tax
 - neglects or
 - refuses to pay the same
 - after demand,
- the amount
 - including any interest,
 - additional amount,
 - addition to tax, or
 - assessable penalty,
 - together with any costs that may accrue in addition thereto
- shall be a **lien** in favor of the **United States**
 - upon all property and rights to property,
 - whether real or
 - personal,
 - ▶ belonging to such person.



Basic Rules

- A Federal Tax Lien (FTL) is created by statute and attaches to a taxpayer's property and rights to property for the amount of the liability. This is the "statutory" or "silent" FTL.
- The following must happen:
 - An assessment must have been made.
 - A demand for payment must have been made.
 - The taxpayer must have neglected or refused to pay within 10 days of notification.
- The FTL will continue until the liability is satisfied or becomes unenforceable by lapse of time or a bond is accepted in the amount of the liability.



What is a lien?

- The law generally defines a lien as a charge or encumbrance that one person has on the property of another as security for a debt or obligation.
 - A special "sticker" similar to what a moving company puts on the furniture, boxes, and other contents of a house when it takes the owner's property from one place to another.
 - The lien (or "sticker") does not change the ownership or other qualities of the property to which it is affixed; it merely identifies the property as having some kind of claim against it.
- Liens may be divided into three general categories:
 - common-law liens,
 - consensual liens, and
 - statutory liens.
- This presentation deals with the statutory liens provided for by the Internal Revenue Code of 1986.
 - The principal lien considered in this section is the "general" tax lien, sometimes referred to as the assessment lien.
 - The general tax lien is provided for by IRC 6321 and is a very broad lien; it generally encompasses the Service's right to use any property of the taxpayer as security for a tax debt.



Property to which the tax lien attaches

- The federal tax lien attaches to all property and rights to property of the taxpayer. This is a very broad concept and includes not only items which are typically thought of as property, e.g., tangible items and "things," but also intangible items and "rights" which a taxpayer may have, but are not necessarily marketable.
- The courts have interpreted this very broad "all property and rights to property" language to include all real, personal and intangible property of greatly varying natures, as well as future interests, and property acquired by the taxpayer after the lien has come into existence. The only exception is that the lien does not attach to any interest of an Indian in restricted land held by the United States. Treas. Reg. 301.6321-1.



How and when the tax lien arises

- The federal tax lien arises when any "person" liable to pay any federal tax fails to pay the tax after a demand by the Government for payment. IRC 6321.
- For federal tax law purposes, a "person" is defined to include
 - individuals,
 - trusts,
 - estates,
 - partnerships,
 - associations,
 - companies or
 - corporations.
- The lien is effective from the date the Government assesses the tax, even though the notice and demand for payment ordinarily gives the taxpayer an additional 10 days after assessment to pay the tax.
 - Thus, if the taxpayer neglects or refuses to pay the assessed tax, then the lien is deemed to relate back to the assessment date. I.R.C. 6322.
 - The general tax lien created by the assessment is perfected and choate as of the date of the assessment.



Duration of the Federal Tax Lien

- The federal tax lien continues until the liability for the amount assessed
 - is satisfied or
 - becomes unenforceable by reason of lapse of time. IRC 6322.
- Federal law provides a **ten-year statute of limitations** on the Service's efforts to collect such assessed amounts. IRC 6502.
 - However, there are some circumstances which sometimes arise to extend the period between assessment and the time when the lien would otherwise become unenforceable by reason of lapse of time.



Extension of Statute of Limitations on the Lien

- Extensions of the statute of limitations on the federal tax lien may arise by agreement between the taxpayer and the Service as well as by operation of law.
- Certain events involving the courts will **suspend** the statute of limitations.
 - If a taxpayer files a **petition in bankruptcy** after the assessment of a tax liability,
 - then the statute of limitations on collection is suspended for the period during which the Service is prohibited from collecting the tax liability and for six months thereafter. IRC 6503(h).
 - If the Service makes a **jeopardy assessment** of income taxes and the taxpayer petitioned the United States Tax Court for redetermination of his tax liability,
 - the statute of limitations on collection is suspended during the pendency of the Tax Court proceeding.
 - The running of the statute of limitations on collection is also suspended during the period when all or substantially all the assets of the taxpayer are in the custody or control of any court, state or federal, as in a **receivership** or **decendent's estate proceeding**.
 - IRC 6331(k)(1) and (3) suspend the statute of limitations in certain situations for an **offer-in-compromise** or an **installment agreement**.



Filing the Lien

- The federal tax lien arises (and is perfected) when the Service meets the requirements of IRC 6321, i.e., an assessment and a notice and demand for payment.
 - However, the law provides that in order for the federal tax lien to have priority against certain competing lien interests, the Service **must file** a Notice of the Federal Tax Lien (NFTL) pursuant to IRC 6323.
- The filing of a NFTL is not a step required to give rise to or to perfect the lien
 - The act of filing **protects the Government's right of priority** as against certain third parties, typically a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor. IRC 6323(a).
 - Generally speaking, unless the Service properly files a notice of its federal tax lien, its assessment lien is **not valid** against such creditors. The full extent of the priorities between the Service and other lien claimants is discussed in later sections.
- Most states require the NFTL be filed where other encumbrances on property are filed,
 - e.g., in the real and/or personal property records in the office of the county recorder or the clerk of the county where the real property is located or where the taxpayer resides.



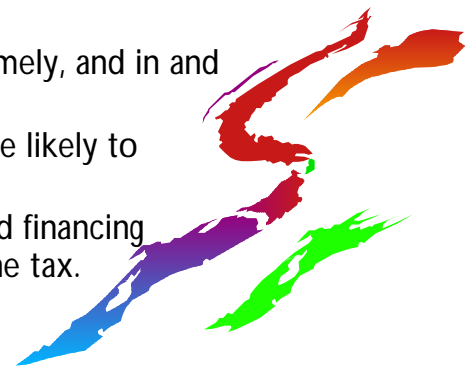
Criteria for not filing the NFTL

- In general, if the taxpayer meets one of the criteria below, a NFTL should not be filed.
 - However, a NFTL may be filed when, in the judgment of the revenue officer, it is in the best interest of the government to record the lien.
 - The aggregate unpaid balance of assessment is less than \$5,000.
 - A NFTL is already filed, but a subsequent assessment has been made for less than \$5,000.
 - The taxpayer is a defunct corporation whose assets have been previously liquidated.
 - The taxpayer is deceased and there are no known assets in an estate.
 - The taxpayer resides abroad and has no known assets in the United States.
- Liens should not be filed in the following circumstances.
 - The taxpayer is a corporate entity that has gone through a liquidating bankruptcy or receivership regardless of dollar amount.
 - Against a non-paying officer when an adjustment to the Trust Fund Recovery Penalty is pending because the assessment has been paid by more than one officer.
 - There is an indication that the liability has been satisfied or that credits are available to satisfy the liability.
 - The taxpayer is in bankruptcy and the NFTL relates to liabilities incurred before the taxpayer filed for bankruptcy.



Criteria for not filing the NFTL cont'd

- Because there is no rule to fit all situations, a decision may be made to delay filing or refrain from filing a NFTL when, in the revenue officer's judgment,
 - filing will hamper collection,
 - filing is not proper because there is genuine doubt as to the validity of the liability, or
 - when information forthcoming could lead to a determination of either of the above.
- For example, a taxpayer may be able to secure short-term financing in order to pay the liability
 - but only if the lender can be assured priority over the Service.
- The NFTL may
 - threaten sources of funding,
 - lead to breached financing statements,
 - prohibit a non-profit from accessing a grant, or
 - reduce a non-profit's ability to get donations.
- Revenue officers should balance these concerns against the likelihood the tax can be collected in full without filing a NFTL.
- Taxpayers commonly request relief from filing the NFTL because they fear the lien may lower their credit rating.
 - A lowered credit rating is a natural consequence of failure to pay financial obligations timely, and in and of itself is not sufficient reason to withhold filing the NFTL.
 - The revenue officer must consider whether the resultant lowered credit rating would be likely to hamper the taxpayer's ability to pay the tax liability.
 - For example, in some cases filing a NFTL may cause the taxpayer to default secured financing agreements with other creditors and result in the loss of revenue needed to pay the tax.



Effect of errors in NFTL

- Errors appearing on the face of the Service's filed NFTL often create problems not only in evaluating the validity of the NFTL, but also in determining relative priorities between the Service's claim and other competing lien claimants.
- The guiding legal principle in these cases is whether the name on the NFTL is sufficient to put a third party on notice of a lien outstanding against the taxpayer.
- Since this is essentially a fact question, however, it is especially important to pay attention to the "details."
 - Thus, for example, if a person is known or suspected to use any aliases or owns property held for him/her by a nominee, agent or trustee, it is desirable to prepare individual NFTL for filing in all the necessary names.



Withdrawal of Notice of Federal Tax Lien

- There is an important distinction between "releasing" a federal tax lien and "withdrawing" a filed notice of that lien.
 - The release of a federal tax lien extinguishes not only the lien itself, but also **automatically extinguishes the underlying liability**. IRC 6325(a).
- Sometimes, however, circumstances arise where it is in the **best interest of the government** to withdraw the NFTL without extinguishing the underlying liability
 - The Service has authority to "withdraw" a notice of federal tax lien, in certain circumstances. IRC 6323(j).
 - The withdrawal of the NFTL **only withdraws public notice of the lien**; it does not extinguish the underlying liability, nor does it release the underlying federal tax lien.
- The Service may withdraw a notice of federal tax lien if the Area Director determines that one of the following four conditions is met:
 - The Service's filing of the NFTL was premature or otherwise not in accordance with administrative procedures.
 - The taxpayer has entered into an installment agreement unless the agreement provides otherwise.
 - The withdrawal of the NFTL will facilitate collection of the tax liability underlying the NFTL.
 - The withdrawal of the NFTL would be in the best interest of the taxpayer, as determined by the National Taxpayer Advocate, and in the best interest of the United States, as determined by the director.

Yippee! I'm
going to Tax
Court!!!

Collection Due Process

- The Service must generally notify the taxpayer within 5 business days of filing the NFTL.
 - The notice of lien must be given in person, left at the taxpayer's home or place of business, or sent by certified or registered mail to the person's last known address.
 - The notice must also inform the taxpayer of the amount of the unpaid tax, the taxpayer's right to request a hearing, the available administrative appeals procedures, and applicable procedures for releasing the lien. IRC 6320(a).
- The taxpayer must request a hearing by the date stated on the notification.
 - If the taxpayer timely responds, the taxpayer is entitled to a hearing with the Office of Appeals conducted by an officer or employee with no previous involvement regarding the underlying tax liability. IRC 6320(b).
 - This hearing is essentially a "de novo" review of the appropriateness of the lien filing. This may include the Appeals Officer's review of the basis of the assessment (e.g., consideration of an innocent spouse defense), or whether alternative means of collection (e.g., an offer in compromise, installment agreement, selection of assets to be used to satisfy the liability, etc.) are more appropriate.
- However, the scope of the Appeals Officer's review of the merits of the underlying tax liability is limited
 - The Appeals Officer may consider the merits of the assessment itself only if the taxpayer did not previously receive a valid statutory notice of deficiency regarding the tax liability or the taxpayer did not otherwise have an opportunity to dispute the underlying liability. IRC 6320(c).
 - If the taxpayer disagrees with the Appeals Officer's determination, then he or she has 30 days to appeal the decision to the appropriate judicial forum.



State law and property

- State law is very significant when considering the property and rights to property to which the federal tax lien attaches. The fundamental question is whether a taxpayer has a property interest or right to property to the property in question. The answer is that the Government looks to state law to determine a taxpayer's rights in a particular piece of property, but federal law determines whether such interests qualify as property or rights to property
- For example, many states have laws which exempt certain types of property from the claims of creditors, including state and local taxing authorities. However, whether property is subject to exempt status under state law is not relevant in determining whether property or rights to property are subject to the federal tax lien



Priority of tax liens - do other liens prevail over the Federal Tax Lien?

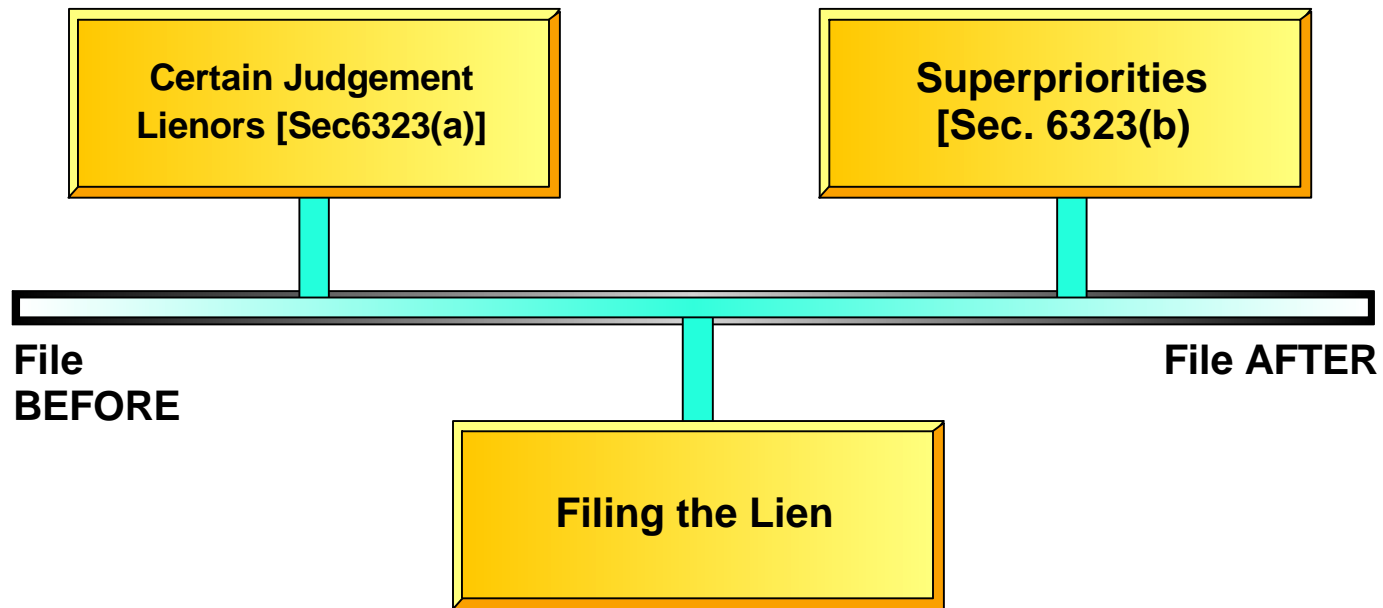


Lien Priorities

- The Federal Tax Lien (FTL) is not valid against [Sec 6323(a)]
 - purchasers,
 - holders of security interests,
 - mechanics lienors, and
 - judgment lien creditors
 - until a Notice of Federal Tax Lien (NFTL) has been filed.
 - The filing of the NFTL notifies creditors that the FTL exists.
 - ▶ The FTL becomes valid against those creditors discussed above at the time the NFTL is filed. Refer to IRC 6321.
- Exceptions exist for ten "superpriorities." [Sec. 6323(b)]
 - Securities
 - Motor Vehicles
 - Retail purchases
 - Casual sales
 - Possessory liens
 - Real property tax and special assessment liens
 - Small repairs and improvements of residential real property.
 - Attorney liens
 - Certain insurance contracts
 - Deposit secured loans



Priorities - before and after the filing



45-Day Disbursement Period

- The law provides priority generally
 - with respect to security interests in property held *before the notice of lien filing*
 - which arose [the security interests] as a result of disbursements made prior to the 46th day after the filing of a tax lien, unless actual notice or knowledge of the filing is obtained sooner.
 - However, for the priority to exist in such cases, certain conditions must be met
- This provides lenders a limited window of protection (against a subsequent federal tax lien)
 - with respect to certain on-going financing arrangements the lender may have with a borrower/taxpayer.
 - typically arise in context of revolving credit arrangements between a taxpayer and a lender



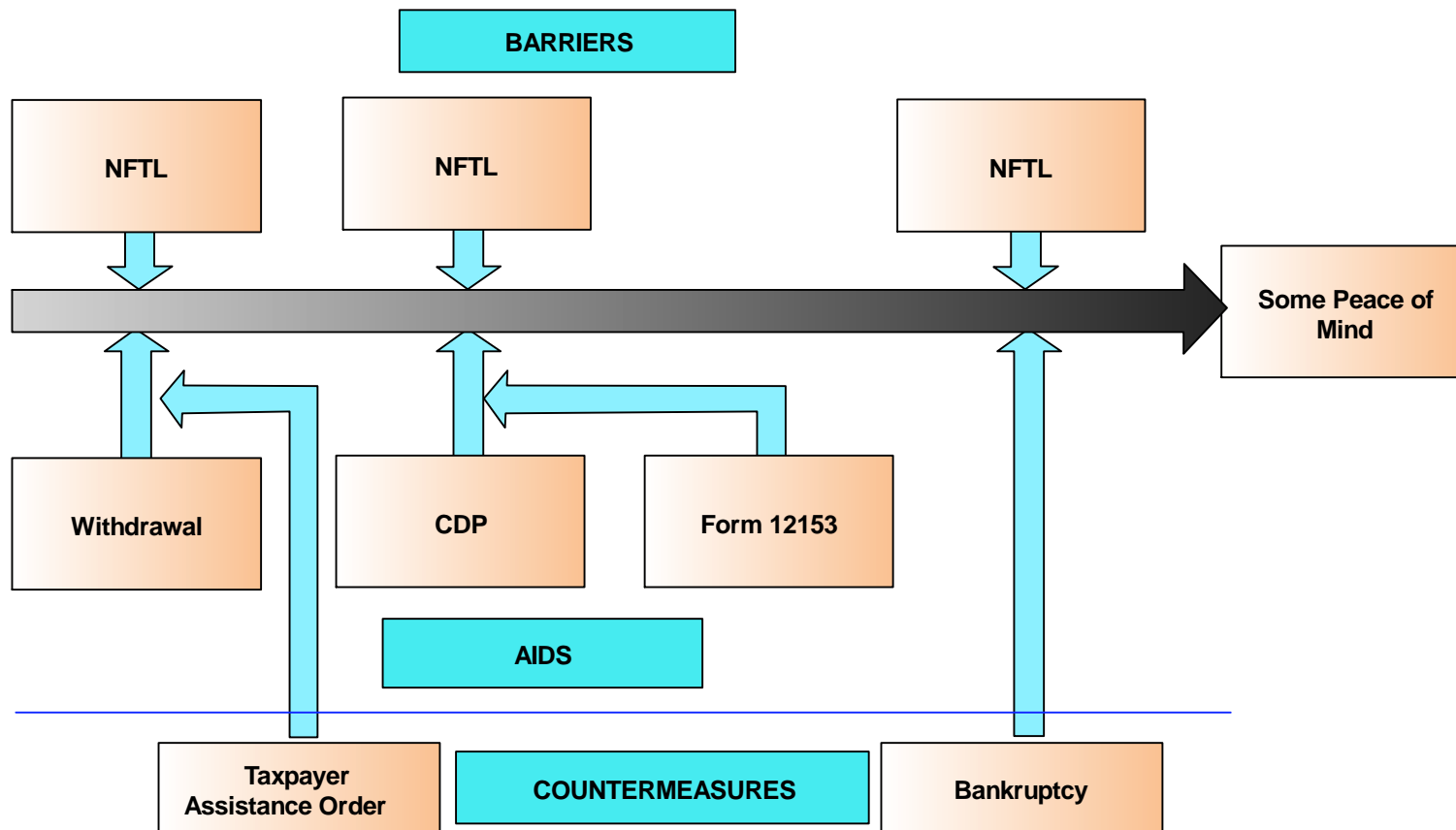
Home Equity Line of Credit

[IRM 5.12.2.4]

- It is advisable to investigate the facts of the case to determine
 - how the funds were used in order to determine the priority of the FTL.
- If the funds are drawn after the NFTL is filed,
 - determine if the mortgage/lender has a security interest in the real property.
 - Verify the amount of money or money's worth that changed hands.
 - Determine if:
 - The entire amount was turned over to the taxpayer;
 - The taxpayer is allowed to draw against the funds as he wants;
 - A specific amount was approved;
 - The taxpayer paid down the amount owed



Ways to minimize effect of NFTL



Relief from the Federal Tax Lien

- Three major and three minor types of relief from the federal tax lien.
 - Discharge of Property From the Effect of the Tax Lien
 - Nonjudicial Foreclosure by Senior Competing Lienor
 - Release of Lien



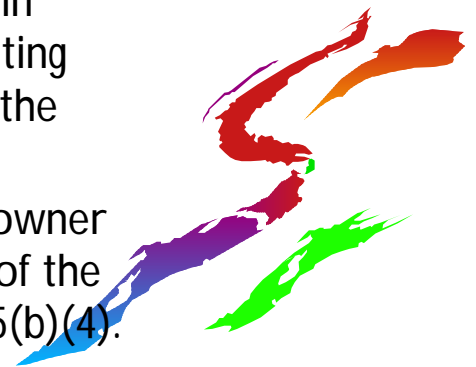
Relief from the Federal Tax Lien

- There are substantial legal differences between the "release" of the tax lien under IRC 6325(a) and the "discharge of property" from the tax lien under IRC 6325(b).
- This section is concerned only with the discharge of property under IRC 6325(b).
 - Thus, the following statements must be confined to this context and not confused with statements made in regard to the release of the federal tax lien pursuant to IRC 6325(a).
- The discharge of a particular piece of property under IRC 6325(b) has no effect whatever on the life span or vitality of the lien outstanding against the taxpayer, except in respect to the particular property discharged.
 - In other words, even if the tax lien is discharged as to particular property under IRC 6325(b), the federal tax lien imposed by IRC 6321 still remains on all other property subject to its scope. The only method to release the federal tax lien itself is prescribed by IRC 6325(a).



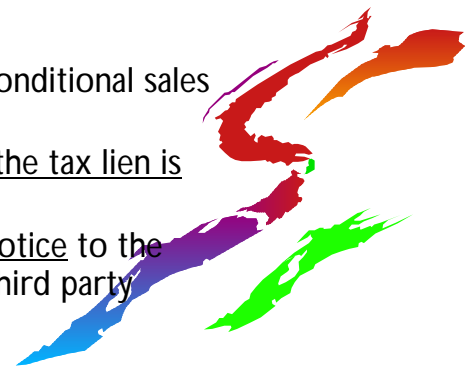
Discharge of Property From the Effect of the Tax Lien

- The Internal Revenue Code provides that the Service may issue a certificate of discharge of property from the federal tax lien if one of the following conditions is met:
 - 1. If the fair market value of the taxpayer's property remaining subject to the lien after the discharge is double the sum of the tax liability, plus all other encumbrances on that property entitled to priority over the Government's lien. IRC 6325(b)(1).
 - 2. If the Service receives a deposit of an amount equal to the value of the Government's interest in the property. IRC 6325(b)(2)(A).
 - 3. If the Service's interest in the property has no value. IRC 6525(b)(2)(B).
 - 4. If the subject property is sold, and the federal tax lien encumbers the sales proceeds in the same manner and with the same priority relative to other competing liens and claims. IRC 6325(b)(3). This provision often assists in facilitating the sale of property whenever a dispute exists among competing lienors, including the Government concerning their respective rights in the property.
 - 5. If (1) the owner requests a certificate of discharge and (2) the owner deposits with the Government an amount of money equal to the value of the Government's interest furnishes a bond for the same amount. IRC 6325(b)(4).



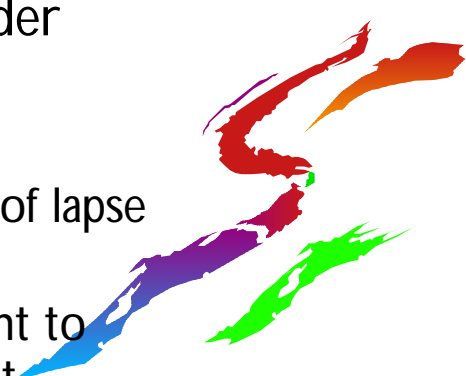
Nonjudicial Foreclosure by Senior Competing Lienor

- Generally speaking, when a senior lienholder sells a taxpayer's property in the course of enforcing a security interest,
 - this "foreclosure sale" may extinguish a federal tax lien.
 - Such foreclosure sales can be either a
 - judicial sale (i.e., pursuant to a judicial proceeding), or
 - a nonjudicial sale.
 - Most controversies involving the priority of the federal tax lien involve nonjudicial sales, which are sales made pursuant to one of the following:
 - An instrument creating a lien on the property sold.
 - A confession of judgment on the obligation secured by an instrument creating a lien on the property sold.
 - A statutory lien on the property sold.
- Nonjudicial sales include
 - the divestment of a taxpayer's interest in property by
 - operation of law,
 - public or private sale,
 - forfeiture, or
 - termination under provisions contained on a contract for deed, land sale contract, or conditional sales contract. IRC 7425(b).
 - If timely notice of the foreclosure or nonjudicial sale is given to the Government, then the tax lien is discharged in the manner provided by local law.
 - Where foreclosures or sales covered by this provision are made without proper notice to the Government, then the tax lien continues against the property into the hands of a third party



Release of Lien

- As noted earlier, there is a fundamental legal distinction between the "release" of a federal tax lien provided for by IRC 6325(a) and the "discharge" of property from the tax lien provided for by IRC 6325(b).
 - The principal difference is that the release of a lien extinguishes the federal tax lien itself. In other words, a release goes to the very existence of the federal tax lien; a **discharge** applies merely to a particular piece of property covered by the lien..
- Before the Service can issue a Certificate of Release (as distinct from a Certificate of Discharge), the taxpayer must meet certain specified conditions. IRC 6325(a); Treas. Reg. 301.6325-1. A Certificate of Release of the federal tax lien is authorized under each of the following three conditions:
 - The amount assessed (plus interest) is paid.
 - The amount assessed becomes legally unenforceable by reason of lapse of time.
 - A bond is furnished satisfactory in terms and sufficient in amount to secure the payment of the outstanding assessments plus interest.



Effect of Offer in Compromise

- When the Service accepts an offer in compromise, including a collateral agreement, the lien against the taxpayer is released, provided that all of the following conditions are met:
 - 1. It is a cash offer, or all installments under the terms of the offer, including any accrued interest, have been paid.
 - 2. Any assets required to be assigned or turned over to the Government under the terms of the offer have been so assigned or turned over by the offer, with the exception that the collateral agreement is still in force and payments of future income may become due.
 - In the event the taxpayer fails to pay any amount due under the collateral agreement or violates the future compliance provisions of the compromise, the Service may declare the offer in default under the provisions specified within the offer and the collateral agreement and the balance of the unpaid liability reinstated.



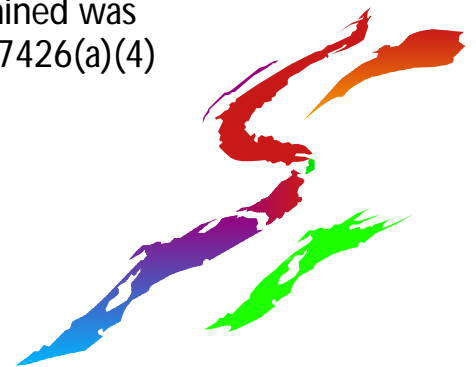
Certificate of Nonattachment

- The Service may issue a Certificate of Nonattachment of the federal tax lien if it determines that a person (other than the taxpayer) may be injured by the appearance of the Service's NFTL. IRC 6325(e).
 - This situation typically arises when the name of the taxpayer is similar (or identical) to that of another person. This certificate can be filed in the same office where the Service filed the NFTL, and is conclusive that the lien of the Government does not attach to the property referred to in the certificate. The Service may also revoke the certificate in the same manner as a Certificate of Release of Lien. IRC 6325(f)(2).
- The certificate of nonattachment is not related in any manner to the discharge of property or the release of a federal tax lien.
 - The certificate of nonattachment is used only when, as a matter of fact and law, the federal tax lien never attached to the property involved.
 - The owner of certain property may be subjected to unnecessary hardship because of a lien against a taxpayer with a similar name, thus, perhaps, constituting a cloud on the former's title to his/her property.



Substitution of Value

- The fact that federal tax liens directly affect only the taxpayer's **property** (rather than the taxpayer) sometimes creates problems when the Service's lien attaches to property in the hands of a nontaxpayer third party.
- The third party owner of this property (previously owned by the taxpayer) against which the Service has a NFTL may obtain a certificate of discharge with respect to the lien on that property.
- The Service shall issue such a certificate of discharge if the third party owner (but, not the taxpayer) either deposits the amount of the Service's lien interest in the property (as determined by the Service) or posts an acceptable bond for that amount. IRC 6325(b)(4).
 - The third party then has 120 days to file a court action to determine the value of the Service's lien interest in the property.
- If the Service determines that the taxpayer's liability can be satisfied by other sources, or the value of the property is less than the deposit or bond, then the Service will refund the deposit (with interest) and/or release the bond.
- If the third party does not institute proper court proceedings within the 120 day after the Service issues the Certificate of Discharge, then the Service has 60 days within which to apply the amount deposited (or collect on the posted bond) to the amount the Service determined was secured by the lien, and refund (with interest) any remainder to the third party. IRC 7426(a)(4) and (b)(5).



Subordination of the Tax Lien

- Subordination is the act or process by which one person's rights or claims are ranked below those of others.
- The Service may issue certificates to which the tax lien is subordinated. IRC 6325(d).
 - Certificates subordinating a tax lien to another, subordinating a tax lien to another interest if paid an amount equal to the amount with respect interest may also be issued where the Service believes that the subordination of the tax lien to another interest will ultimately result in an increase in the amount realized by the United States from the property subject to the lien and will aid in the collection of the tax liability.
- Both of these rules are designed to facilitate collection of delinquent tax liabilities by providing more flexible procedures.
 - In the first case, since the tax lien is being subordinated only to the extent the United States receives, on a dollar-for-dollar basis, an equivalent amount, the Government's interest cannot in any event be injured and a new procedure for collecting taxes is made available.
 - Permitting a federal tax lien to be subordinated to another interest where the Service believes this will ultimately aid in the collection of the tax is designed to give the Service flexibility so that, for example, funds may be borrowed to increase the value of the property subject to the tax lien.
 - This may occur, for example, in the case of a crop which needs harvesting and without which the tax lien has little or no value.
 - This authority is intended to be used under conditions similar to which an ordinarily prudent business person would consider in deciding whether to subordinate his/her rights in a debtor's property in order to secure additional long run benefits.

